

(Reference Translation)

## Expected Role of Independent Directors/Auditors

March 31, 2010

Tokyo Stock Exchange, Inc.

Advisory Group on Listing System Improvement

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In December 2009, Tokyo Stock Exchange, Inc. (hereafter “TSE”) partially revised the Securities Listing Regulations and related rules. As part of the corporate governance framework desired of all listed companies, listed companies are required to secure at least one independent director/auditor pursuant to Rule 436-2, Paragraph 1 of the Securities Listing Regulations.

From the viewpoint of facilitating understanding of and promoting the establishment of the independent director/auditor system, the Advisory Group on Listing System Improvement has compiled in the following pages a summary of the significance and role expected of independent directors/auditors.

The key point in the application of this system is in bearing in mind its main purpose of protecting general shareholders. If the system falls into formality, and is applied against its intended purpose (for example, a person notified to the TSE as an independent director/auditor acts against the expectations of general shareholders), not only will shareholders/investors lose trust in listed companies, but also the domestic securities market as a whole will lose both domestic and foreign credibility. Thus there is a concern that such a situation will become a factor in reducing the global competitiveness of the Japanese economy.

Therefore, it is appropriate for the TSE to persist in requesting a suitable response from individual listed companies in consideration of the idea behind the implementation of the independent director/auditor system. This is based on the premise that the TSE needs to strive to facilitate and disseminate a proper understanding of the idea behind the system, and the role expected of independent director(s)/auditor(s), amongst independent director(s)/auditor(s) of listed companies and all parties related to listed companies.

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## The Significance of Independent Directors/Auditors

The TSE “Principles of Corporate Governance for Listed Companies” advocate the appropriate operation of corporate governance for listed companies is a vitally fundamental requirement for enhancing corporate value on a continuous basis.

In general, companies have various stakeholders such as shareholders, management, employees, clients and creditors. What listed companies have both in common with, and are at the same time unique from other companies, is the existence of general shareholders.

Listed companies have a large number of shareholders who change with trading of the listed company’s stock in the secondary market. The shareholder ratio of each of these respective shareholders is extremely small, and as such, they do not have a significant influence on company management. Such shareholders are known as general (or minority) shareholders. Listed companies benefit from the existence of general shareholders in various ways, such as gaining access to smooth fund-raising opportunities. However, due to general shareholders’ lack of influence on company management and the high liquidity of the listed company’s stocks in the market, the company management may well tend to neglect such general shareholder interests.

For listed companies, general shareholders are an indispensable presence. Their interests may be rephrased as shareholders’ common interests and this usually coincides with the interests of the listed company. As such, in terms of achieving business objectives and aiming for sustained improvement in corporate value, it is extremely important for the company management to carry out business operations in consideration of general shareholder interests.

In addition, the proper protection of general shareholder interests is a condition

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required to fully harness the benefits of the fund-raising function in the securities market, and can also be said to form the basis for the listing system for stocks. It follows that an environment which properly protects general shareholder interests is also crucial for the development of not only listed companies but also the nation's economy.

Most of the stakeholders surrounding listed companies stand to gain from the company's enhanced corporate value. However, stakeholders do not always share a common interest. Therefore adjustments managing such varying interests are carried out through the course of daily management. Yet, in some cases, it may be inappropriate to entrust such adjustments of conflicts to daily routine management.

In particular, in a situation of highly conspicuous conflicts of interest between the management of a listed company and general shareholders, there is a possibility that a decision which undermines general shareholder interests will be made. In such a situation, there is a great need for a framework, which makes fair and justifiable decisions which take into account general shareholder interests, to be established within listed companies.

With regards to this point, for example, in relation to MBO (Management Buy-out), it is recommended in the "Guidelines on Increasing Corporate Value and Ensuring Regulatory Compliance in the Context of Management Buyouts (MBOs)." (published by the Ministry of Economy, Trade and Industry on September 4, 2007) that in an effort to exclude arbitrariness from the decision-making process, a person from an independent position should be consulted on the justification for and conditions of the MBO, and the resulting decision based on such consultations should be honored.

In addition, in relation to takeover defense measures, it is stated in the "Guidelines Regarding Takeover Defense for the Purposes of Protection and

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Enhancement of Corporate Value and Shareholders' Common Interests" (published by the Ministry of Economy, Trade and Industry, and the Ministry of Justice on May 27, 2005 ) that if a corporate structure is designed to honor the judgment of a highly independent outside director(s)/auditor(s), who strictly supervise activities aimed at protecting internal board members, it will have the effect of shareholders and investors trusting the impartiality of the decision made by the board.

Furthermore, in relation to placements of new shares to a third party, in the TSE listing rules, out of third party allotments, in the event of share dilution of 25% or more, or when a change in the controlling shareholder is expected, listed companies are required to either obtain from a person, who has a specific degree of independence from the company management, an opinion regarding the necessity and suitability of such allotment, or confirm the intent of shareholders regarding such allotment by means such as a resolution in the general shareholders meeting.

The point in common in these guidelines and rules is the idea that in the event that of a clear conflict of interest amongst the stakeholders of a listed company, incorporating the objective judgment of a person from an independent position in the decision making process is an effective and necessary approach for fair and justifiable decisions which take into account general shareholder interests.

This issue is not limited to situations where the conflict of interest between the company management and general shareholders becomes highly conspicuous as mentioned above. When we consider that decisions made in the course of daily management may ultimately undermine general shareholder interests, involving a person from an independent position in the decision making process under normal circumstances will, again, be effective and necessary for fair and justifiable decisions which take into account general shareholder interests.

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In such circumstances, the decision making process for significant matters at a listed company is conducted by convening directors and auditors to a board meeting. As such, it is important to secure director/auditor who participates in the board meeting as a person(s) from an independent position.

With regards to the corporate governance of listed companies, in the end, a framework most suitable and effective for the company should be established through continuous discussion and agreement between individual companies and their shareholders. At the same time, since listed companies' stocks are available for investment by a large unspecified number of investors in the securities market, in consideration of general shareholder interests, there should be a corporate governance framework that is expected in all listed companies. This framework also needs to be objective and easy to understand.

The significance of the independent director/auditor system is as described above.

## **Expected Role of Independent Directors/Auditors**

**Independent directors/auditors are expected to take action in light of protecting general shareholder interests, such as raising opinions, etc. so that general shareholder interests are considered in such situations as business execution decisions made by the board of directors, etc. of listed companies.**

General shareholder interests are basically taken care of through enhancing the corporate value of a listed company, and the role for such enhancement should be essentially borne by all directors and auditors of the listed company. The reason for requiring listed companies to appoint an independent director/auditor is that, due to general shareholders' lack of influence on company management and the high liquidity of the listed company's stocks in the market, the company management tends to neglect such general shareholder interests. Given that listed companies are required to secure at least one independent director/auditor and that an outside director or auditor is also eligible for the position, independent directors/auditors are expected to act to protect general shareholder interests. Such actions include encouraging board decisions which consider these interests through taking opportunities to express their opinions and raise issues, etc. from the viewpoint of general shareholder interests in the decision-making process, and sharing such opinions and issues with other directors/auditors on the board.

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(Points to take note)

- It is desirable for independent directors/auditors to fulfill the role mentioned above by, for example, making appropriate decisions in consideration of the following points.

- Is the business execution decision, etc. at a listed company reasonable from the perspective of achieving business objectives of the company and enhancing its corporate value?

In particular, is there sufficient consideration for general shareholder interests?

- Is there enough information necessary for the independent director/auditor to properly evaluate business execution decisions, etc. provided in advance?
- Is there any structure/arrangement designed to accurately and appropriately disclose, the objective, content of the business execution decision, etc. and its effect on corporate value?

- It is desirable that an independent director/auditor appropriately exercises the rights of outside directors or outside auditors prescribed in the Companies Act, to protect general shareholder interests.
- \* The protection of general shareholder interests does not exclude, in a situation which requires adjustments to manage conflicting interests of other stakeholders, the consideration of the interests of such other stakeholders.
- \* Measures that independent directors/auditors should take to protect general shareholder interests are not limited to preventing corporate misconduct and reining in activities that entail excessive risk. These measures may include,



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verbal statements encouraging proper action to realize the enhancement of corporate value, in situations where a decision related to business execution is to be made. (In cases where an independent director/auditor is a statutory auditor, such independent directors/auditors may possess different rights from those of a director in relation with rights under the Companies Act.)

- It is desirable for an independent director/auditor to always remain highly sensitive to the voice and expectations of general shareholders.
- \* This does not mean receiving feedback directly from each individual shareholder.
- It is desirable for an independent director/auditor to always make considerations to maintain smooth communications with other directors, auditors, business executives and employees at the listed company.
- \* In order for an independent director/auditor to properly fulfill the role with regard to protecting general shareholder interests as mentioned above, it is necessary for all other directors, auditors, business executives, and employees at the listed companies to understand the role expected of independent directors/auditors, and make efforts to facilitate the proper functioning of the independent director/auditor system (such as developing a system to disseminate information in a timely and appropriate manner to independent directors/auditors, collaborating with departments, and securing support staff members).