Japanese Corporate Governance at the Tipping Point

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Japan's Governance Code: A Driver for Change, and also an *Example* of Change

- A logjam re the Company Law…, then:
- One person, then several, then national strategy
- The power of analysis, logic + political leadership
- "Best practice" guidelines and "accountability"
- "Multiple", + "committee" + entirely new concepts (lead independent director, board evaluation, etc.)
- Together with the Stewardship Code, a PDCA cycle to improve governance. CG practice is now aspirational, not limited by law

Legal Lay of the Land: Current Structure 98% of Japanese Companies. So Far, Without a Corporate Governance Code and the Concept of Best Practices, Governance Started **and Stopped** Here

Shareholders

"Agency" issues = e.g. "can we trust what goes on in closed rooms? " (Need to avoid "**Tone-Deaf Boards in Sound-Proof Rooms**")

Corporation

(1)

(2)

Shareholders and "company" delegate, **entrust "governance" to a small number of supposedly qualified, trusted fiduciaries =** the directors and statutory auditors

Reporting, monitoring, "skeptical inquiry"(?)

Board delegates to management = mainly, to itself

Board of Directors

Directors **A, B, (outside; but not mandatory)** + , D, E, F…

Each statutory auditor has duty to attend meetings of the BOD; but note, **BOD meetings are valid without them**

Management

No legal basis or best practice guidelines for committees

Apparent authority

Representative Director C
Managing Director D
Other inside directors

Board of Statutory Auditors (Kansayaku)

Possible apparent authority issues

Shikko-yakuin (so-called "executives officers" **who, however have no fiduciary duties, legally**

Board directors are **legally expected to monitor, evaluate, oversee each other** (? usually, long-time colleagues)

Do not vote on the main board, but can speak (on the record ＝in minutes). **Their strong powers to access info not always shared with outside directors**

Post-War, Internal Boards Gradually Lost the Ability to Make Many of the Hard Decisions

- Hard to criticize the “senior” directors (or CEO) who “*promoted*” you for your loyalty. Low awareness of responsibilities and liability of directors
- In the absence of any other standard or pressure, “directors” often think, act like **managers in a hierarchy.** “Aren’t the two roles the same?”
- “Salary-men” get ahead by avoiding risk, keeping head low. Sluggish reinvestment
- Directors often lack key skill sets (e.g. finance) needed for **directing**
- Many outside directors are friendly “cocker spaniels, not dobermans”
- **No rigorous, consistent concept of “best practices” or the role of the board**

> - **The board is a “meeting of division heads that fulfills minimum corporate law formalities”, rather than a “monitoring”, direction-setting board**
> - **Boards often put off the difficult decisions that are most needed: divestments, restructuring, strategic redirection, capital [re]allocation**
> - **“Director professionalism” and common skill sets are badly needed**

The Concept of "Best Practices" Has Arrived in Japan

The Corporate Governance Code

Genesis of Japan's Corporate Governance Code: Improving Productivity and Asset Allocation

- American Chamber of Commerce in Japan's 2010 "Growth Strategy Task Force" White Paper proposed a comprehensive, detailed growth strategy based on economic analysis by Prof. Kyoji Fukao (Chair: Benes of BDTI)
- Strategy focused on the need to improve productivity, efficient asset reallocation, economic "metabolism", corporate governance functions, entrepreneurship, and labor mobility: the basis for the "third arrow"
- 2013: the LDP set up the Japan Economic Revival Headquarters, which used same economist used by ACCJ for its analysis, Prof. Fukao
- In 2013-2014, to break the logjam re the Company Law, Benes proposed to the LDP the creation of a comply-or-explain corporate governance code, drafting to be led by the FSA and the Tokyo Stock Exchange
- Early 2014: Benes guided dietmen, and later the FSA, on the process and the key contents for a CG code. The code became the primary "pillar" of Japan's 2014 growth strategy. An advisory panel is formed
- **March 2014: Japan's Governance Code is finalized and published**

No Going Back Now: a Corporate Governance Code Will Be a Conduit for Corporate Change

- Improving corporate governance is now national policy, in order to improve earnings and productivity. The Rubicon has been crossed
- For the first time, an authoritative formulation of best practice exists
- General acknowledgement of the weak aspects of Japanese boards
- Increasing ROE and ROIC is now acceptable to articulate as a goal
- Detailed “comply-or-explain” disclosure about governance practices at each company will enable investors to meaningfully engage with companies and be good stewards
- Policies for ROE, stewardship, capital allocation, reinvestment, appropriate risk-taking, alignment of interests have a tailwind now
- When change finally *does* happen in Japan, it can occur quickly

“Minimum Corporate Formalities” Boards → **“Talk the Talk”Boards** → **REAL Boards**

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Provisions in the Corporate Governance Code

- “Multiple” independent directors; encouragement re “one-third”
- Principle of separation of oversight from management functions
- Encouragement of board committee for nomination, compensation, etc.
- Principles re prudent risk-taking, capital allocation, sustainability
- Director training and evaluation, + board self-evaluation
- Succession planning, evaluation of executives (= change if needed)
- Encouragement of “executive sessions”, lead independent director
- Duty of *kansayaku* to obtain information [+ share it with directors]
- Encouragement of board diversity and appointment of female directors
- Disclosure of “reason”/logic for dir. nominations, cross-shareholdings
- Explanation of company policy with respect to Code provisions
- Disclosure of arrangements for engagement with/by shareholders

✓ **A virtuous cycle** ⟶

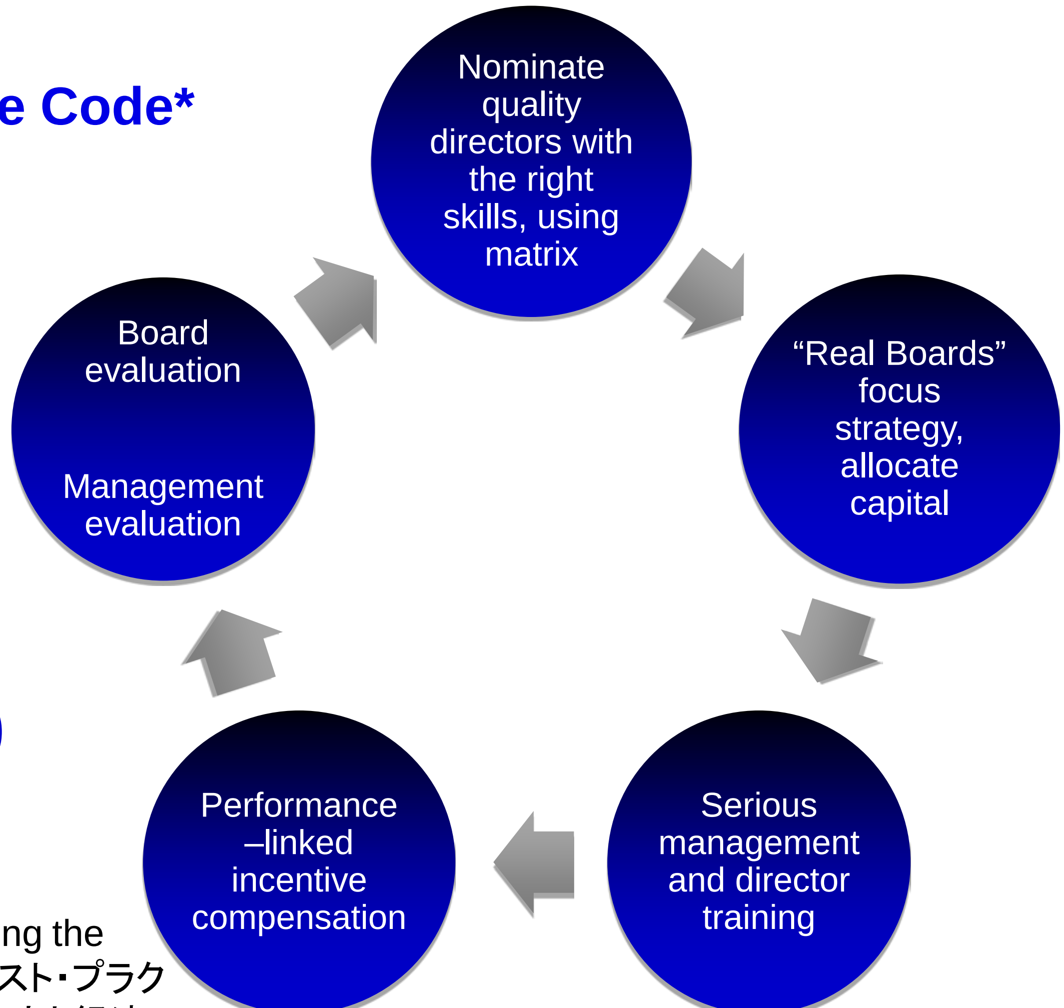
Still Needed – Subjects for the Next Revision
(Superior Companies are already adopting some)

- Comply/explain rule for enough INEDs to form independent committee
- Clear rule for“ Nominations etc.“ committee composed only of INEDs
  - Committee advises on all matters involving managerial self-interest
  - Practice standards for committees: e.g., minutes, attendance of a *kansayaku*
- Fiduciary contracts with “executive officers” who are not on the board
- Director training, board evaluations by specialist 3rd-party organizations. Governance/finance training at mid-senior levels
- Disclosure of all amounts paid to retired board members (as “advisors”). Director contracts with non-disparagement, non-interference provisions
- Disclosure of detailed “corporate governance guidelines”, codes of conduct, by the company on its web site
- Japan needs to set a fixed schedule for periodic review and revision (E.g. germany has a specialized commission which reviews every year)

The Virtuous Cycle: Japan Brings PDCA to Governance

- **Corporate Governance Code***
- **Stewardship Code***
- National policy
- Expectations

→「車の両輪」＊
(“Two wheels
on the same axle”)



＊ Article by Nicholas Benes proposing the CG Code 、「上場企業が目指すべきベスト･プラクティスの行動基準を」、Asahi Judiciary 法と経済のジャーナル 2014/01/27。

Implications of the the Corporate Governance Code *(Over time)*

- More dynamic capital [re]allocation and reinvestment, and a more active M&A market (now,1/4th of US as % of GDP). More combinations, alliances with both domestic and foreign firms
- Differentiation between management teams. Greater executive mobility, diversity. Managerial skill will matter more than age
- New types of performance-linked compensation,+ shareholder approval thereof as necessary
- Japan will now enter a period of continuously refining best practices for stewardship, engagement, compensation, and governance
- Potential obstacles: superficial "compliance" and box-ticking with no deep thinking, and the transactions costs of "engagement"
- How can investors *efficiently* "engage" (a) to encourage companies to nominate qualified, dedicated boards, and (b) to assess the true substance and effectiveness of a company's governance practices?

How Can Investors *Efficiently* "Engage" with Companies? How Should Companies Respond?

- Japanese managers are skilled at "form over substance". Moreover, investors can only "engage" with a limited number of companies
- As an investor, the most important thing is to **make sure there is a high-quality board in place.** But how can investors tell whether a board is a good one? - whether "the spirit is in the Buddha", or the firm is just going through the motions?
- **The best litmus tests:** "Does the company have a clear policy for executive and director training, both before and after nomination to the board? Does it use external specialists for the training? Does the CEO lead or participate?" In short, <u>is the company trying to improve its management team and its board</u>?

A lot of new learning is needed, by both investors and companies. Sincerity, humility, and open minds about this fact are essential. **Effective governance and management training are key.**

Smart investors are helping out + sending a message

Board of Directors

- Kenichi Osugi
- Nicholas E. Benes
- Koichiro Hayashi
- Nobuyuki Hiraizumi
- Masataka Ueda
- Sachiko Ichikawa

Advisors

- Christina Ahmadjian
- Harald Baum
- Thomas J. Dreves
- Robert Eberhart
- Peter Fuchs
- Kyoji Fukao
- Kotaro Inoue
- Ken Kiyohara
- Katsuyuki Kubo
- Curtis J. Milhaupt
- Yosuke Mitsusada
- Koichiro Naganuma
- Kazuo Noda
- Theodore A. Paradise
- Takuji Saito
- Takaya Seki
- Wataru Tanaka
- Ko-Yung Tung
- Masao Yanaga
- Yumiko Miwa
- Keiichi Karatsu

About the Institute

The only certified public-interest non-profit in Japan committed to building sound corporate organizations and the "directorship" skills needed by every board member, by providing training that the age of globalization demands.

The Board Director Training Institute of Japan (BDTI), a non-profit Japanese "public interest" organization certified by the government, was established in 2009 by experts and opinion leaders active in academic and business circles. BDTI's mission is to increase **trust** between corporations and the public, and facilitate the safe, sustainable and ethical development of the Japanese economy and Japanese companies, by improving corporate governance and accelerating the spread of effective management methods. We believe that training is the key to doing these things while also enhancing corporate value, for the reasons explained in this **memo** and also in this **Summary of BDTI, its Programs and Activities**.

Since BDTI's establishment, we have been fortunate enough to receive the support and participation of senior leaders (and leading firms) around the world, all of whom share our purpose and sense of mission.

In order to spread knowledge about corporate governance and related management methods widely, BDTI provides a low-cost **E-Learning Course** with modules covering both Company Law core knowledge and corporate governance theory and practice.

Together with first-class collaborating organizations and professionals, BDTI also offers (a) **intensive "director training" programs** that combine corporate governance know-how with global management methods; (b) **customized programs** for enhancing director skills, or governance and compliance awareness; and (c) **seminars on specific topics**, led by lecturers who are experts in each respective field.

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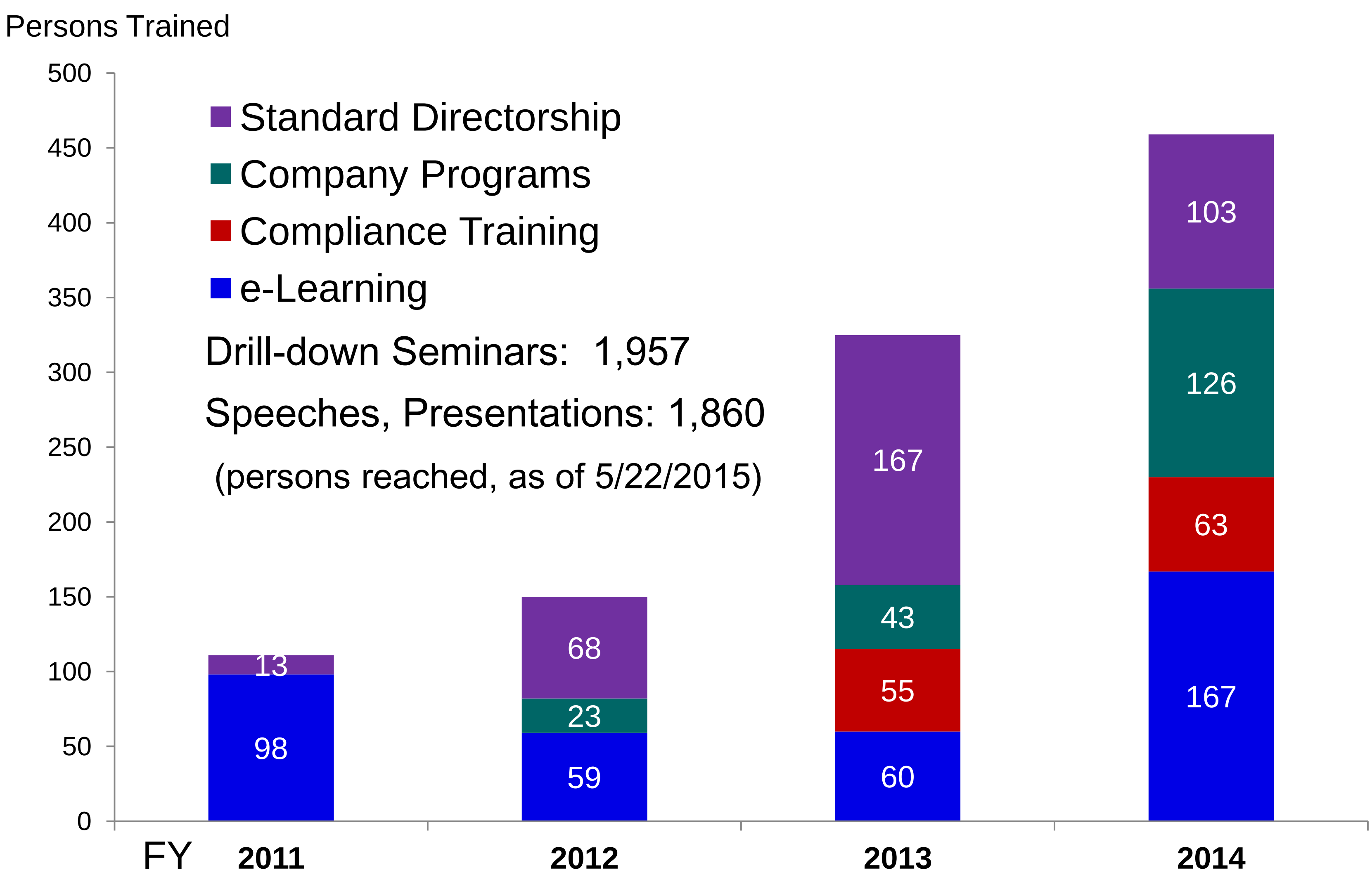
- Nicholas E. Benes
- ***Above: Sustaining Donors***

- Give2Asia
- The Canadian Chamber of Commerce in Japan (CCCJ)

BDTI's Training Activities: Progress So Far



Translation of the Japanese version.

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A Virtuous Circle to Support Engagement

- Strategic leadership of companies, by boards one can have confidence in

→**Board training**
→**Sharing best practices**

Investors

Constructive Engagement ⇒
Improve both firm and investment performance

- Value creation model
- CG Code adoption
- Substance, not just form

→***Effective* governance, capital allocation**

Companies

Support

Donations
↓
Support low-cost training, send constructive message

- "Public interest" non-profit
- Specialists⇒ quality training
- Objective⇒ effective boards, highly evaluated and trusted

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Corporate Members
↓
Share and learn systematic governance, board training policies

Help BDTI make Japan’s boards more effective and aligned with the interests of shareholders, society, and the global economy.

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