

Japan at the Tipping Point

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

- A logjam..., then:
- One person, then several, than many
- The power of logic + political leadership
- “Best practice” and “accountability”
- “Multiple”, + “committee” + entirely new concepts (lead INED, board evaluation, etc.)
- A PDCA cycle to improve governance → aspirational

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

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

Shareholders

Corporation

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

Board delegates to management = mainly, to itself



Board of Directors

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

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

No legal basis or best practices for committees of the board

Management
Representative Director C
Managing Director D
Other inside directors

Board of Statutory Auditors (Kansayaku)

Board members supposedly monitor, evaluate, oversee (who? → often themselves, long-time colleagues)

For “large” companies, at least 3 persons, and > half are “outside”. Do not vote, but can speak (on the record =in minutes). Perform “legal/business” and “accounting” audits

Apparent authority

Possible apparent authority issues

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

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
- Politics of “promotion” to the board (being valued as *loyal manager*) resulted in 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?”
- Instead of “maximizing”, “salary-men” often avoid risk, keep head low
- Directors often lack key skill sets (e.g. finance) needed for **directing**
- Many outside directors are friendly “cocker spaniels, not dobermans”
- **Little rigorous, consistent concept of “best practice” or the role of the board**
- **The board is a “meeting of division heads that fulfills minimum corporate law formalities”, not a “monitoring”, direction-setting board**
- **Boards often put off the difficult decisions that are most needed: divestments, restructuring, strategic redirection, capital allocation**
- **“Director professionalism” and common skill sets are badly needed**

The Concept of “Best Practices” Has Arrived in Japan

**The Corporate Governance Code
(Japan’s First)**

Genesis of Japan's Corporate Governance Code

- American Chamber of Commerce in Japan's 2010 "Growth Strategy Task Force" White Paper proposed a comprehensive growth strategy based on economic analysis (Chair: Nicholas 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: LDP set up the Japan Economic Revival Headquarters, which used same economist used by ACCJ for its analysis: Prof. Kyoji Fukao
- In 2013, Benes proposed to the LDP the creation of a comply-or-explain corporate governance code, the drafting process to be led by the FSA and the Tokyo Stock Exchange
- Early 2014: Benes guided key dietmen and the FSA on the process, and the contents of the code. The code became the primary "pillar" of Japan's 2014 growth strategy. An advisory panel is formed
- April 2014: Japan's Stewardship Code is finalized and published
- **The Corporate Governance Code was finalized in early March, and technical details for disclosure are now being decided by the TSE**

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 will exist
- General acknowledgement of the weaknesses 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



Provisions in the Draft Code

- “Multiple” non-executive 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
- 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** 

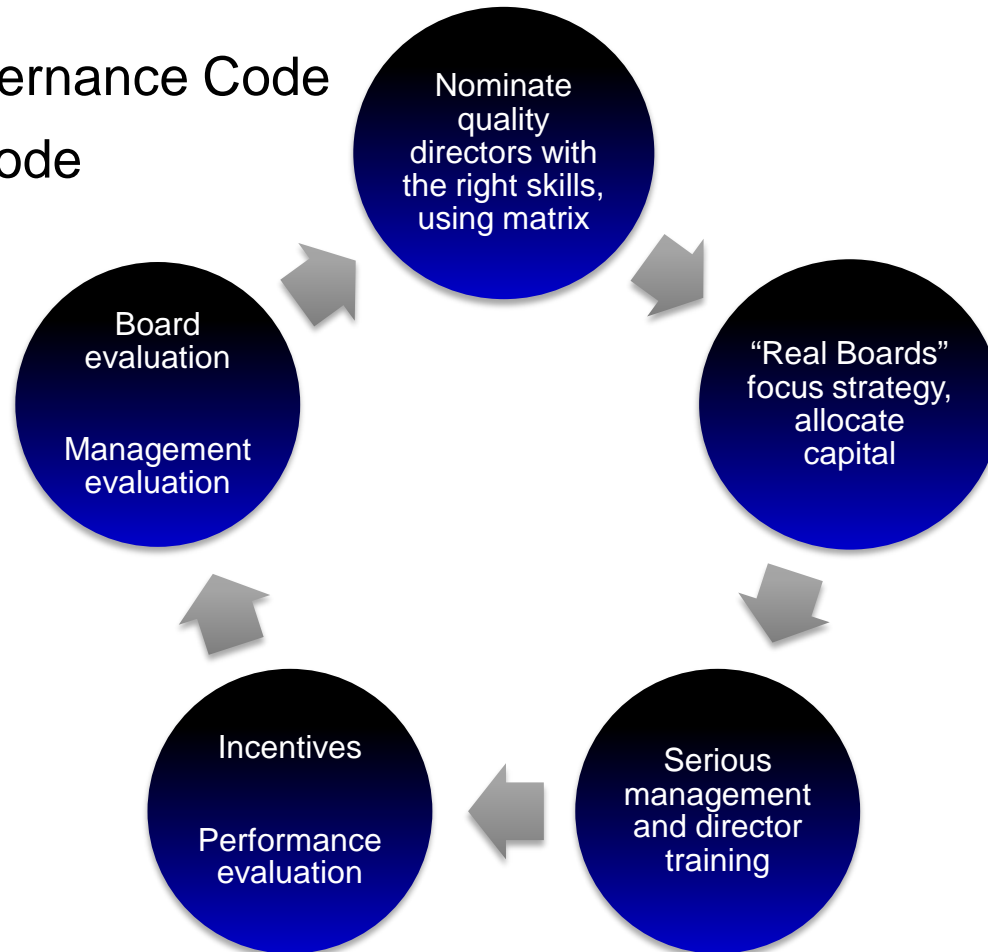
Still Needed - (Superior Companies will likely adopt over time)

- Comply/explain rule for enough INEDs to form independent committee
- “Nominations etc.” committee composed only of INEDs
- Committee advises on all matters involving managerial self-interest
- Practice standards for committee procedures: 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, pre-board appointment
- Disclosure of all amounts paid to retired board members (as “advisors”)
- Disclosure of detailed “corporate governance guidelines”, codes of conduct, by the company on its web site

✓ **A virtuous cycle** 

The Virtuous Cycle: Japan (Finally) Brings PDCA to Governance

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



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

- A more active M&A market (now, 1/4th of US as % of GDP). More combinations, alliances with both domestic and foreign firms
- Accelerating differentiation between management teams. Greater executive mobility, diversity. Managerial / director substance will matter more (or as much as) age
- New types of performance-linked compensation, + shareholder approval
- Japan will now enter a period of continuously refining best practices for stewardship, engagement, and governance
- Potential obstacle: superficial “compliance” and box-ticking with no deep thinking
- → How can investors *efficiently* engage so as to have companies nominate qualified, dedicated boards, and to assess the true substance (likely 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, especially before the AGM
- As an investor, the most important thing is to **make sure there is a high-quality board in place**
- How can investors tell whether the 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 governance and directorship training, both before and after nomination to the board? Does it use external specialists for the training? Is it extensive? Is the CEO committed to the policy? Does he lead, participate?” In short, is the company trying to improve its board?

A lot of new learning is needed, by both investors and companies. Sincerity, humility, and open minds about this are the most important aspects

About BDTI

About the Institute

An Interview with
BDTI's Leaders

Disclosures

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Training

Consulting

Interactive Forum

Participation

About the Institute

Smart investors are helping + sending a message



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

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- » Nicholas E. Benes
- » **Above: Sustaining Donors**
- » Give2Asia
- » The Canadian Chamber of Commerce in Japan (CCCJ)

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

Donations

Support low-cost training, send constructive message

Support

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

BDTI

Corporate Members

Share and learn systematic governance, board training policies

BDTI's Diverse Perspectives and Network

BDTI

Expert
Perspective

- Broad knowledge of CG, domestic + abroad
- Legal experts
- Financial specialists

- Why CG is so essential
- Duties/role of directors
- Role, value of INEDs
- Value creation based on sound CG and modern financial methods

Investor
Perspective

Manager
Perspective

- Investment experience
- Networked among global institutional investors

- “Core” director skills
- Building a “real” board
- Handling difficult decisions

- Practical knowhow gained on boards + from actual management

- Communicating strategy and vision for growth, value creation
- Global organization
- The language of investors



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