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Japan's Corporate Governance Code

A Corporate Governance Code that will define the responsibilities of Boards of Directors and other conditions to be observed by listed companies is being formulated by the Tokyo Stock Exchange. If this Code increases the transparency of business management, it can be expected to contribute to increased corporate value, in addition to boosting confidence among domestic and overseas investors. What is the significance of the introduction of the Code for Japanese companies, and what points should companies take into consideration in relation to the Code?

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How will Japanese Companies Change with the Introduction of the Corporate Governance Code?

What is the purpose of the Corporate Governance Code, and will it be an effective means of increasing the corporate value of Japanese companies?
In this issue of *My Vision*, we ask executives of the Japan Exchange Group, of a listed company, and of an institutional investor, a professor of commerce and management, and the Head of Corporate Affairs for the OECD to discuss these issues.

Interviewer: Masaki Wakebe, NIRA Research Coordinator Editor: Kazuyoshi Harada
Period of interviews: December 2014

We must increase corporate value through dialogue

Kunio Ito

Professor, Graduate School of Commerce and Management,
Hitotsubashi University

The essence of corporate governance is the exercise of self-discipline by internal board members. External discipline, which supplements this self-discipline, is provided by outside directors. Outside directors have two functions: Monitoring, in order to control management excesses, and advising, in order to increase corporate value and boost the company's earning power. In contemporary Japan, rather than controlling management recklessness, the function that we need outside directors to fulfill is to encourage managements to take the necessary risks.

Data from the U.S. indicates that various aspects of corporate governance, including the size of board and the degree of involvement of outside directors, influence corporate value and profitability. It is therefore not enough to simply introduce outside directors. Unless the outside directors who are selected are able to offer advice from an external perspective that contributes to medium- and long-term growth scenarios, and managements are prepared to give attention to that advice and link it to actual growth, the system cannot function.

At the same time, managements must, while maintaining both a sense of tension and a sense of cooperativeness, engage in dialogue with investors towards increasing corporate value over the medium- and long-term. Last summer, I chaired the compilation of the Ito Review, entitled "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors." The Ito Review calls for meaningful dialogue between companies and investors based on the perspective that managements do not create corporate value in isolation, but should seek to create sustainable value through "collaborative creation" with investors. As a precondition of this dialogue, we would need to consider mechanisms for the disclosure and reporting of medium- and long-term company data to investors – not merely financial data, but also non-financial data, such as information concerning intangible assets. Such an initiative would also increase the number of medium- to long-term investors. ■

> Professor Ito emphasizes the concept that the key to the realization of sustainable growth is the creation of corporate value, and has an established reputation for conducting research and making proposals that directly address the problems and the realities facing Japanese companies.

Corporate governance accords with Japanese thinking

Atsushi Saito

Director & Representative Executive Officer, Group CEO,
Japan Exchange Group, Inc.

Even the most excellent manager cannot continue to function in their position forever. The essence of the Japan's Corporate Governance Code will be its incorporation of mechanisms to both rein in and spur on management as necessary in order to ensure that companies remain durable. The Code will not be a law, and therefore will not possess binding power, but companies will need to explain their reasons if they fail to observe it. If the explanation is not convincing, shareholders and investors will demand that improvements be made. This is based on the logic of the market.

Corporate Governance Codes and the idea of corporate governance have emerged from the concept of democracy. In Japan, management frequently fails to sufficiently consider the benefit of shareholders, who we may consider to be the sovereigns of listed companies, and in many cases the opinions of shareholders are not reflected in management decisions. If companies fail to increase their return on equity, their share price will not increase; negligence in this area is not limited to managers, but extends to the operators of pension funds and investment trusts. The entrusters of pension funds and investment trusts have also been negligent. Historically, in the U.S., lack of adequate returns from the operation of pension funds and inappropriate use of the funds became a problem, and in 1974 fiduciary responsibility in the operation of the funds was made a law. Fund operators were required to operate funds in good faith in the interests of their entrusters. One effect of this has been that the U.S., with an economic scale more than twice Japan's, achieves annual economic growth of 3-4%. Japan should learn from this history.

Naturally, merely observing the forms of a Code will not lead to increased rates of profit. However, based on my experience in the Industrial Revitalization Corporation of Japan, I believe that a Corporate Governance Code will certainly have an effect. The most important thing will be the attitude of top management. Management should listen to opinions from outside the company and give them careful consideration rather than making unilateral decisions. I think that this attitude fits well with the Japanese way of thinking. ■

Since his appointment as CEO of the Tokyo Stock Exchange in 2007, Mr. Saito has worked to improve corporate governance in Japan, and he has been a key figure in the development of the Code which is currently being formulated.

The CEO holds the key to success or failure

Takashi Kawamura

Chairman Emeritus, Hitachi, Ltd.

The CEO is the heart of corporate governance. If the CEO is not solidly focused on increasing corporate value, no matter how much effort other members of the company team put in, progress will not be made. The role of the Board of Directors is to wind up the spring if the CEO is doing too little, and to apply the brakes if the CEO is going too far. Taking Japan's university entrance exams as an example, the Board of Directors is like the home tutor, and the CEO is like the person taking the test. Ultimately, it is the latter who will enter the university, and unless they continue to make an effort, all will be in vain. However, over the long term, even good company directors can lose their energy or become corrupt. In such cases, the Board of Directors must go into action to correct the situation, even dismissing the CEO if necessary.

At Hitachi, we are working to take a global perspective by introducing board members from overseas. At Board meetings, they argue over proposals with our outside directors, who also include executives from overseas. If they are not convinced by a proposal, then we know that it will not work globally, and we throw it out. In other words, our Board is having a virtual experience of global competition.

In addition, we are a conglomerate, and we have numerous subsidiaries. By minimizing, as much as possible, items for decision by our Board of Directors and delegating authority to the CEOs of our subsidiaries, we have dramatically increased our management pace. At the same time, the CEOs of even unlisted subsidiaries are directly conducting IR activities. Institutional investors are also responding to this, and are actively offering a variety of opinions. The sense of responsibility among the CEOs of our subsidiaries has increased significantly. Whether we are talking about the headquarters or a subsidiary, if the CEO is able to make effective use of opinions from outside the company, you will have excellent governance and excellent management. ■

During his tenure as Chairman & President & CEO of Hitachi, Mr. Kawamura pushed ahead with improvements to corporate governance, including overseeing the company's transition to become a "company with committees" and introducing overseas outside directors. His efforts resulted in a V-shaped recovery for the company.

The purpose of the OECD Principles: the economic growth, the investment and the value creation

Mats Isaksson

Head of Corporate Affairs, OECD

Corporate governance is not an end in itself. The ultimate purpose of the rules, regulations and practices that we develop is to contribute to economic efficiency, sustainable growth and financial stability. In particular, we want to make sure that that household savings can be channeled to corporations in the real sector where they contribute to capital formation through productive corporate investments. For us, the objective of corporate governance policy is to create the best possible conditions for corporations to access capital; for capital markets to allocate capital to the best possible use, and; for markets and managers to manage the use of this capital for productivity and growth in individual companies. Since their adoption in 1999, the OECD Principles have provided a leading policy tool for reforms in both OECD and non OECD countries. The Principles is also one of the Financial Stability Board's key standards for sound financial systems. It is important to recall that the Principles are "outcome oriented", leaving room for individual countries to adapt their implementation to their own economic, legal and historical context. This focus on "outcome" rather than form is actually quite demanding, since it calls for the objective of the Principles to be met regardless of the economic, legal and historical context. I am confident that a new Code in Japan will promote the objectives and outcomes that are laid down in the OECD Principles and that it rests on their core values. The discussion at the FSA started with the economic reality, and identified what we want to achieve with the code.

We concluded that the quality of corporate governance rules, regulations and practices is an increasingly important factor for investment decisions. Not least, because of the increasingly international character of investment. International flows of capital enable companies to access financing from a much larger pool of investors. If countries are to reap the full benefits of the global capital market, and if they are to attract long-term "patient" capital, corporate governance arrangements must be credible, well understood across borders and adhere to internationally accepted principles. The OECD Principles contributes to this.. ■

Mr. Isaksson participated in the development of the OECD Principles of Corporate Governance and was in charge of the comprehensive revision of the Principles in 2004. He also acts as an adviser to The Council of Experts Concerning the Corporate Governance Code of Financial Services Agency.

Better Governance Requires Stronger Independent Directors and Healthy Voting Behavior from Shareholders

Takumi Shibata

Representative Director, President & CEO,
Nikko Asset Management, Co., Ltd.

Japan has introduced two pressure cookers for enhancing corporate value, one being the recently announced Corporate Governance Code and the other being the still new Stewardship Code.

The Corporate Governance Code will become effective only if boards become more effective in discharging their oversight responsibilities. Boards may choose to take a long-term approach like Chinese medicine in order to safeguard corporate performance or to take a quick surgical approach to dismiss corporate executives.

On limited occasions, institutional investors may find that they need to get in touch with corporate boards, away from routine investor relationship activities. Who is available for institutional investors to contact at companies on those rare occasions? They want to talk to non-executive independent directors at the very least but more likely they would like to talk with a non-executive chairman or lead independent director if those functions were to exist in the target companies.

It is becoming a standard practice at companies in the UK, and to a lesser extent in the US, for outgoing CEOs to leave their companies and become non-executive chairmen of other companies – signaling the age of the professional non-executive chairman. While people complain about the shortage of talent for non-executive roles in Japan, they will be pleased to see an abundant supply of ex-CEO's that will seek non-executive chairman positions once this practice is introduced and takes root in Japan.

What then should we do to make the other pressure cooker, the Stewardship Code, function better in Japan? All we need to do is to make it compulsory for institutional investors to establish independent committees to exercise shareholder voting rights. A shareholder voting committee, if it is independent, will have no choice but to adhere to the principles of the newly introduced Stewardship Code. This will create a major break away from the current practice of numerous institutional investors who automatically side with corporate executives in AGM's, even when corporate performance is in question.

There is merit in encouraging institutional investors to engage constructively with corporate executives. One of the founding principles of capitalism, however, is the separation of ownership and management. Therefore, most institutional investors, including ourselves, do not seek to interfere with corporate executives running companies on a day-to-day basis. Institutional investors should therefore make sure that boards properly represent shareholder interests, and they should use their right to engage with corporate executives sparingly to help management in order to enhance shareholder value. ■

Mr. Shibata has had an extensive career in global financial business and has been actively engaged in the development of capital markets. He is President & CEO of Nikko Asset Management Co., Ltd. and prior to that he was the Group COO of Nomura Holdings. He has an MBA from Harvard Business School.

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About this Issue

Japan's Corporate Governance Code

The average rate of return on equity for Japanese companies is lower than it is for companies in the U.S. and Europe, and this lack of performance represents a problem. This situation has led to repeated discussion of the necessity of improving corporate governance with a view towards increasing long-term corporate value.

Forming the background to these discussions are the principles delineated by the Exposure Draft of Japan's Corporate Governance Code, issued by the Financial Services Agency in December 2014, which it is considered will contribute to the realization of effective corporate governance. The proposal set out five basic principles – The guarantee of shareholder rights and equality, appropriate cooperation with stakeholders other than shareholders, guarantee of appropriate disclosure and transparency, responsibility of Boards of Directors, and dialogue with shareholders – and outlined a variety of other principles in line with these, including the necessity for appointing at least two outside directors to ensure that the responsibilities of Boards of Directors are fulfilled. In the event that it failed to observe the Code, a company would be required to offer an explanation. “Principles for Responsible Institutional Investors” (the Japan's Stewardship Code), which was also announced in 2014, had already demanded that investors engage in ongoing dialogue with companies towards increasing corporate value.

How will the Corporate Governance Code change Japanese companies? And will it lead to an increase in their corporate value?

In this issue of *My Vision*, we have sought both theoretical and practical perspectives on these questions. In addition to discussing their expectations for the Code, our interviewees have pointed towards further problems standing in the way of the realization of increased corporate value. It will be essential for companies and market participants to face these problems squarely and work towards their resolution in order to increase the earning power of Japan's companies.

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