Corporate Governance for Japan Inc: Bracing for Change, Hoping for Impact

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The outlook for Japanese corporate governance is improving albeit incrementally. Intertwined with Abenomics' Third Arrow reforms, the draft Corporate Governance Code is about to conclude its public review with the possibility of implementation by mid-year.

To be sure, progress has been slow. Still, the draft Code is Japan's first comprehensive effort to lay down defensible preferences for board composition, including independent directors, and replace this country's historical firm-to-firm cross-shareholding practices with an emphasis on shareholder interests.

There are those who regard the moves as revolutionary. The Abe government is hoping to encourage corporate Japan to restructure based on generally accepted corporate governance practices (notably OECD corporate governance guidelines) and at another level, to establish Tokyo as premier financial center in Asia. The objective is to attract foreign investment and global business.

Investors and business leaders say that at a more granular level, the Code shifts a company's emphasis to more efficient allocation of capital, improving the rate of return on equity and ultimately, increasing shareholder value. This means each of the 2,350 listed companies on the Tokyo Stock Exchange will have to consider in a disciplined and accountable way whether to comply with the Code's principles and if not, be prepared to explain why not.

It's an "excellent effort," says Nicholas Benes, head of the Board Director Training Institute of Japan (BDTI) and who proposed the code as well as served as advisor to the government. Still, one of many outstanding questions is whether progress could get unwound by interests that have long-since held sway. (Consider circumstances in Washington DC and the recent successes of the multi-million dollar lobbying effort there at watering down financial reform initiatives.)

This is tough business. In Japan, the draft Code benefits from the fact the initiative does not stand alone. Drafted by a joint secretariat of the Japan's Financial

Services Administration and the Tokyo Stock Exchange, the initiative complements a year-old Stewardship Code, which addresses institutional investor fiduciary practices.

There's also the JPX Nikkei 400 Index of companies that links return on equity and efficient capital allocation with the promotion of good governance. While there may be little new at first glance, the real milestone is the fact that the Index requires that its companies have a minimum of two independent directors.

On the one hand, the index is a sort of *good corporate citizen* indicator. On the other, the requirement of a minimum mandates implementation of one of the draft Code's central principles.

So far so good. The Government Pension Investment Fund (GPIF) with US$1.2 trillion in assets, has publicly endorsed the index's adoption. This is significant on two fronts. The giant Japanese pension fund has under review reducing its historically large commitment to Japanese government bonds and increasing its allocation to equities, including in all likelihood those in the JPX Nikkei 400 Index. And if Japan's giant pension fund takes these steps, then it's highly likely other institutional investors will follow suit.

While there's reason to be optimistic about the initiatives' implementation, there's also skepticism, including among those critical of the wide swath cut by the Abenomics' Third Arrow. Some say the Third Arrow may be little more than *100 darts* in search of a target, let alone a Bull's eye.

The *secret sauce* in getting the measures underway and enforced will be proponents' ability to keep the focus tightly trained on the benefits of good governance to the corporate bottom line and ultimately shareholder value. Education about the measures' rationale will be mandatory.

As things stand now, the measures mostly stop short of mandating compliance. They encourage, and that's helpful when a sea change in how business is done is contemplated. They underscore flexibility which can translate into the opportunity to ease into step with peers on corporate governance matters.

In principle, the standards are reference points for independent directors on listed company boards. It's a minimum of two for a listed company, but jumps to one-third if the company is global. There are no restrictions on nationalities and certainly not gender. And if a company chooses not to play, that company must explain why *(the comply-or-explain rule*). While disclosure is required, compliance is not – which is similar to other corporate governance codes globally.

Critical will be how companies address their cross-shareholding practices. The draft Code stipulates that outside directors cannot be company executive directors

or employees of the company, any of its subsidiaries and parent or any of the parent's subsidiaries. That's inclusive!

A 2013 report titled *Pros and Cons of Mandating the Appointment of Outside Directors: Based on new empirical testing*, asserts that a mere 9% of Japan's listed companies have independent directors. This compares with 70% in the United States and 30% in South Korea. Furthermore, the US rule is one-half or better of board directors must be independent; one-fourth in South Korea; an *appropriate* number in Germany; and one-half the board in France.

Companies without a demonstrated commitment to the value of outside directorships and extending appropriate fiduciary oversight to boards *risk* accountability to investors and shareholders. At the end of the day, it's the shareholders who own the company –and shareholders who share management's commitment to growing value.

Growing value requires sound decision-making and resource allocation. If both management and boards are allowed to do their jobs, there's ever more opportunity to realize success.

Astonishingly, Japanese companies now earn $9.50 a year for every $100 of shareholder equity, according to a Nomura Securities report. This compares with $17.70 at US companies and $11.80 at Asian companies outside Japan.

Yes, new standards can open the door for shareholder activism, and this can breed a whole set of challenges. But this risk is not a reason to forgo good governance when the outcomes can include better decision-making in favor of greater efficiencies in the short term, and stronger, value-enhancing strategies in the longer term.