Corporate Governance Code
and
Roles of Independent Outside Directors

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Institute of Corporate Governance, Japan

http://icgj.org

Organization: Independent and Based mainly on Individual membership

Mission Statement:

Corporate governance is the aggregate of the activities of corporate stakeholders seeking to maximize the value of the company. It provides a framework for resolving conflicting interests that allows for optimal balance, paving the way for achieving the best possible returns. Recognizing that corporate governance takes varied forms depending on the stage of development of the company, and the degree to which ownership and management are independent, it is the mission of the ICGJ to undertake actions aimed at helping Japanese companies improve corporate governance across the board, secure in the conviction that such improvements will eventually result in an economy that is more dynamic and more robustly competitive in the international arena..

Activities:

- Research and Propagation of Opinions
- Training and Education
- Consultancy for Director Nomination
- Consultancy for Risk Management & Internal Control

The Institute of Corporate Governance, Japan, was founded in September 2009 by a group of 5 brave souls, including myself, who sought to contribute to improvements in the effectiveness of corporate governance as practiced in Japanese corporations. The ICGJ maintains independence from all other organizations and is based on individual and corporate membership. Currently, we have 85 individual and 12 corporate members.

Our mission is to help enhance the value of Japanese companies by taking actions aimed at realizing better corporate governance. Such improvements, we believe, will result eventually in a more dynamic economy with robust international competitiveness. With this in mind, the Institute engages in four core activities.

The first of these entails research, dissemination of pertinent information, and propagation of opinions regarding corporate governance. For this purpose, we hold monthly seminars, inviting prominent speakers, publish articles and post a variety of blog entries on the ICGJ's web site. Secondly, we provide customized programs to educate and train executives and directors of Japanese companies.

The third activity is built around consultancy services offered to Japanese companies who are seeking candidates for independent outside directorships.

Finally, the Institute assists Japanese companies in setting up and implementing internal control and risk management systems.

Now, let me turn to the main subject. Today, I am not going to explain the details of the Corporate Governance Code. Instead, I would like to set out some of the salient corporate governance issues which have engaged the attention of various experts and business executives over the past two or three years, and to examine the basic governance principles from which the needed improvements are expected to follow.

I should make clear that for the most part I will be discussing the situation of Japanese corporations from a macro perspective. I won't be making veiled references to any specific company unless I mention it by name.

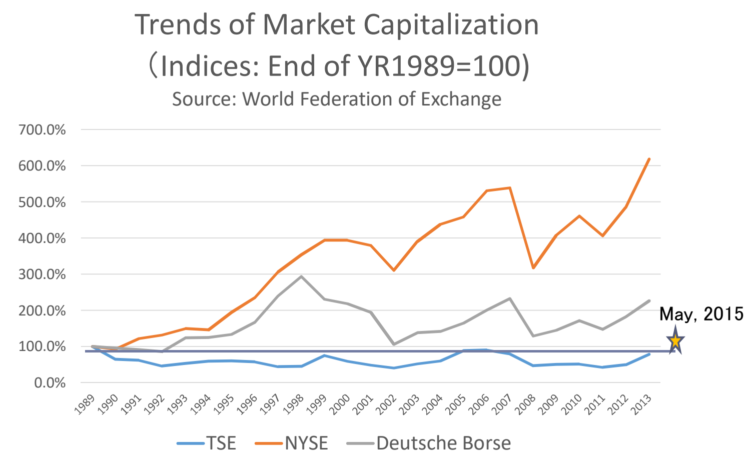
Events Concerning Corporate Governance in 2014 - 2015

Events	Dates	Organi-zations
JPX-Nikkei Index 400 launched and in operation	Jan, 2014	JPX-TSE
The Japanese version of Stewardship Code in effect	Feb, 2014	FSA
The Japan Revitalization Strategy (Revised in 2014)	Jun, 2014	Cabinet
The Amended Companies Act passed the Diet	Jun, 2014	MOJ
The Council of Experts Concerning the Corporate Governance Code commenced	Aug, 2014	FSA, TSE
The Ito Report published	Aug, 2014	METI
The Corporate Governance Code finalized	Mar,2015	FSA, TSE
The Amended Companies Act enforced	May,2015	MOJ
The Corporate Governance Code in effect	Jun, 2015	TSE

The year 2014 was an epoch-making year for the reform of corporate governance in Japan. The above table summarizes the key events for that year and the one following. Time restrictions won't allow me to go through the events in detail, but in particular I want to stress the importance of the Stewardship Code established in February 2014. By the same token, the Abe cabinet's Japan Revitalization Strategy (Revised in 2014) served as the trigger for the creation of Japan's Corporate Governance Code. The latter came into effect on June 1, 2015 as a key part of the listing rules of the TSE.

What has been going on behind these events? For the past two or three years, businessmen, public sector administrators, politicians and journalists have been concerned that something had gone wrong with Japanese companies. Was it perhaps because corporate governance had not been working very well to create value for these companies? Questions such as this one were the impetus for the steps taken as listed above. Let us take a closer look at where the problems lay.

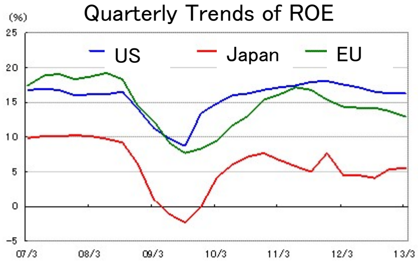
What Had Gone Wrong? - 1



This chart shows you trends of market capitalization of companies in three exchanges, the NYSE, the Deutsche Borse (German Exchange) and the TSE, for the period of 1989 to 2013. The source of the data is the World Federation of Exchange. I have set the base level for these indices at 100% as of the end of 1989. As can be readily seen, the market capitalization – in other words, corporate value – of Japanese companies has remained continuously sunk under that level through 2013. The recent bullish market has finally pushed the figure up over the level of 1989. Congratulations for it. However, there is still a long way to go to catch up to the front-runners, the capitalization of companies on the NYSE, which grew more than six times over the level of 1989. Even the value of listed German companies doubled during this period.

What Had Gone Wrong? - 2

Quarterly Trends of ROE

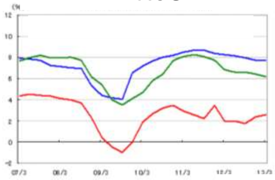


Source: Mitsui Sumitomo Asset Management Focus No.12, June 12, 2013

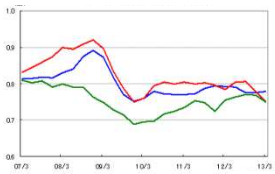
ROE of Japanese Companies is way low compared to US and EU

It is attributed to extremely low ROS

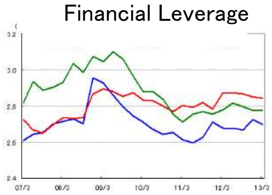
ROS



Total Assets Turnover



Financial Leverage

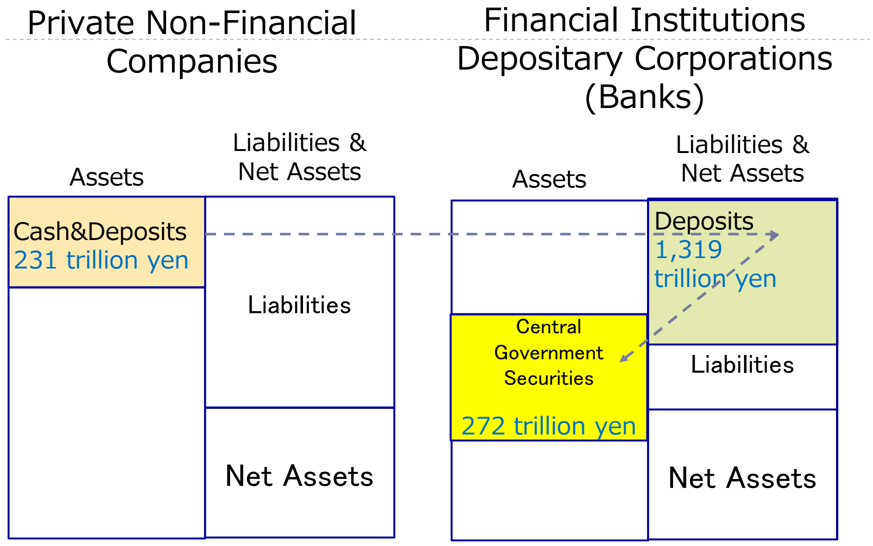


Note1: The data cover Mar 2007 to Mar 2013 Note2: US(S&p500), Japan(TSE 1section), EU(MSCI)

Here is another example.

The above charts, from a report issued by Mitsui Sumitomo Asset Management, compare the average ROE of companies in the United States, the EU and Japan for the period from March 2007 to March 2013. The companies referred to are listed in the S&P 500 in the United States, the MSCI in the EU and Section One of the TSE in Japan. The blue line refers to the United States, green to the EU and red to Japan. Taking a look at these charts, you will find that the ROE of Japanese companies had been continuously hobbling around 5%. Contrarily, those of the United States and the EU had been more than double that, actually maintaining a level around 15%. As you well know, ROE breaks down into three factors, namely ROS (return on sales), total assets turnover and financial leverage, which is the reciprocal of Equity Ratio. If you take a look at these factors one by one, you will quickly discover that the ROS—in other words, the profitability of sales—of Japanese companies is conspicuously low compared to the other two.

What Had Gone Wrong? - 3



(Source: Flow of Funds by BOJ, AS of End of December, 2014)

One more example:

The above statistics are from a Flow of Funds study by the Bank of Japan. They derive from the balance sheets of private non-financial companies and depositary corporations in the sector of financial institutions, namely banks, as of the end of 2014. Take a look at the balance sheet of private non-financial companies – you will find a colossal amount of dormant money sitting on the top left-hand side of the B/S, 231 trillion yen, or approximately $2 trillion. This enormous sum of money flows to the deposits account on the liabilities side of the banks' balance sheet. In turn, you will find that approximately 20% of the banks' deposits of 1,319 trillion yen, which is 272 trillion yen, is invested in central government securities, namely JGB's (Japanese Government Bonds). It is interesting to note that nearly the same amount of the cash and deposits of private non-financial companies are indirectly invested in JGBs through banks. Given the fact that yields of JGBs are extremely low—for instance, the yield for 10 year JGB's is now just below 50 bps—how is it that Japanese companies are able to retain profitability? In fact, investors who put their money into a company which has redundant cash is actually, if indirectly, investing the money into JGBs through the process.

FANUC Fanuc Corporation

ROE: 16.3%

Cash & Deposits: 54% of Total Assets

Yields on Cash & Deposits: 31bps

$$\frac{\text{Net Earnings} - \text{Interests Received} * \text{Tax Rate}}{\text{Net Assets} - \text{Cash \& Deposits}}$$

48.3%

All data are from the fiscal year ended on March 31st 2015

Here is a good example to illustrate this problem at the micro level. It concerns a company named Fanuc Corporation, a manufacturer of Factory Automation Equipment, Industrial Robots and Robot-Related Machinery, and an excellent company indeed.
Sales revenues in the fiscal year ended in March 2015 were 729 billion yen, with net earnings of 207 billion yen. Its ROS was 28.4% and its ROE was 16.3 %. However, if you take a closer look at the balance sheet of the company, you will find more than 50% of the total assets consisted in cash & deposits.

Suppose for a moment that we were to remove the effects of Fanuc's cash and deposits from the calculation of its ROE; what would be the result? It is probably safe to assume that most of the interest received in that year came from deposits. Taking into account the amount of interest reported on the income statement, it is reasonable to estimate the return on cash and deposits at a maximum of around 30 bps. As in the chart above, I then removed the effects of cash & deposits from the ROE calculation using this simple formula: Net earnings minus interest received after tax adjustment, divided by net assets minus cash & deposits. In Fanuc's case, this yields a figure of 48.3% -- the actual earning power of the company's equity capital. As cited above, this earning power is badly diluted by the 30 bps return on cash & deposits. This is what has been going on in Japan on a nationwide scale. We Japanese have been working as hard as ever but the money has been sleeping!

Who is responsible for this situation? Pretty much everyone is, in one way or another.

Where Does The Responsibility Lie?

Management

- Less attention to efficient use of Capital
- Inadequate understanding costs of equity capital
- Tendency to retain redundant and unnecessary cash
- Tendency to avoid necessary risk-taking

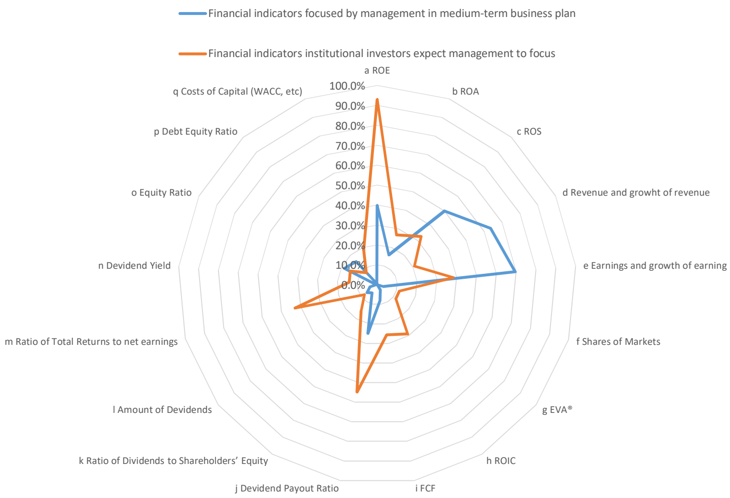
There is a good deal of responsibility to go around, but management itself comes in for the largest share. I believe the chief causes for the problem lie in the following areas:
To begin with, as I will show later, the managements of Japanese companies have tended not to focus strongly enough on the efficient use of capital. They have instead emphasized market share and the size and growth of sales revenues. Some offer excuses that they can barely maintain international competitiveness because they have exhausted efforts and resources competing for shares of the domestic market that produce margins too thin to support forays into the international arena.

Another issue is the lack of understanding of the actual costs of equity capital. Many tend to think that the costs consist solely in dividend payments, and that retained earnings carry no cost at all, serving rather as a kind of free insurance for liquidity crises or free funds for future investment. Managements therefore tend to retain redundant and unnecessary cash, creating the macro situation that Japanese companies find themselves in today.
Yet another problem is the tendency of Japanese companies to avoid necessary risk-taking on their own. As I will explain later, fear of downside consequences often prevents managers from aggressively pursuing strategic risks even when they are clearly called for. As a result, money is kept in the safe.

Further Evidence

A survey by the Life Insurance Association of Japan

The period of the survey: Oct 10 ~ Nov 10, 2014 589 companies and 86 institutional investors



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A 2014 survey by the Life Insurance Association of Japan provides further evidence of where the problems lie. The results are taken from questionnaires distributed among 589 companies and 86 institutional investors. Corporate management was asked, “What financial indicators will you emphasize in your medium-term business plan?” Institutional investors were asked, on the other hand, “What financial indicators do you expect management to focus on in their medium-term business plan?” A comparison of the results is quite revealing.

To illustrate this, I made a radar graph using the survey data; the gap between the expectations of the two sides shows up unmistakably. For example, more than 90% of the investors expected management to focus on ROE, but only 40% of corporate respondents mentioned ROE as a key component of their plan. Similarly, dividend payout was cited by some 55% of the investors, whereas only 25% of company managers made it a point of emphasis; and while 40% of the investors wanted management to pay attention to the ratio of total returns to net earnings, the concern was shared by virtually 0% on the management side.

In contrast to investor expectations, management, for its part, emphasized return on sales (50% versus 30%); amount of revenues and revenue growth (60% versus 20%); and earnings and earnings growth (80% versus 40%).

The survey confirms earlier observations about the inadequate attention paid to the efficient use of capital, and the insufficient understanding of the costs of equity capital. In fact, only 0.5% of the managements of responding companies said that they would focus on the costs of capital.

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Cultural Facets of Corporate Governance

- Management by an inner circle
- Hierarchy based on seniority prevails at board meetings
- Thin executive markets
- Longer-term tenure vs high remuneration
- Risk aversion as a residue of life-time employment system

Lead to

Reticent and Inactive Boards

Here, I will take a look at corporate governance from a somewhat different angle. Since corporate governance is an activity, or set of activities, undertaken by human beings, it seems obvious that it will be deeply affected by the culture of the country, or even of the company itself. Below are some examples of cultural facets influencing corporate governance in Japan.

First, the management of most Japanese companies is left in the hands of a closed inner circle. New recruits to the company (still mostly males in today's Japan) start their careers right after university. Then, after some 30 years of tedious endeavor, only a few of them will be appointed as directors by the CEO, who will have been appointed in exactly the same fashion by his predecessor. In most cases, there are no transparent procedures in the nomination process. Within the board or in the much wider management circle, they tend to speak using an enigmatic jargon which defies understanding by people outside the company. Sometimes, the common sense that prevails within the inner circle is quite different from that of the society at large.

In this culture, hierarchy based on seniority tends to prevail at board meetings so as to depress open and frank discussions among the directors. Another cultural facet is that there is almost no executive market for directors. What happens when a director finds him/herself in opposition to a business plan proposed by the CEO? If there is no executive market to function as a safety net in case the CEO decides to kick him/her out because of said opposition, the director in question will generally find it more prudent to keep his/her mouth shut.

Under the lifetime employment system, executives tend to stay on long as possible, even after some of them have been appointed as directors and even after they have stepped down from top executive positions. Some of them expect to stay with the company grabbing positions called "Komon" or "Sodanyaku" with perks such as an office, a secretary, a car with a chauffeur and, of course, quite decent remuneration. It is difficult to translate "Komon" and "Sodanyaku" into another language because there are no such weird practices seen outside of Japan. If mid-level managers fail to get good evaluations from their bosses, they have to give up the idea of flying to such a utopia. That's why they tend to prefer longer-term tenure to higher remuneration for which they have to take risks. Risk-aversion is the inevitable result. All these cultural practices lead to reticent and inactive boards.

An Ultimate Objective of The Corporate Governance Code

By establishing fundamental principles for effective corporate governance , breaking the current stagnant board practices that currently prevail, to achieve sustainable growth and increase corporate value over the mid- to long-term.

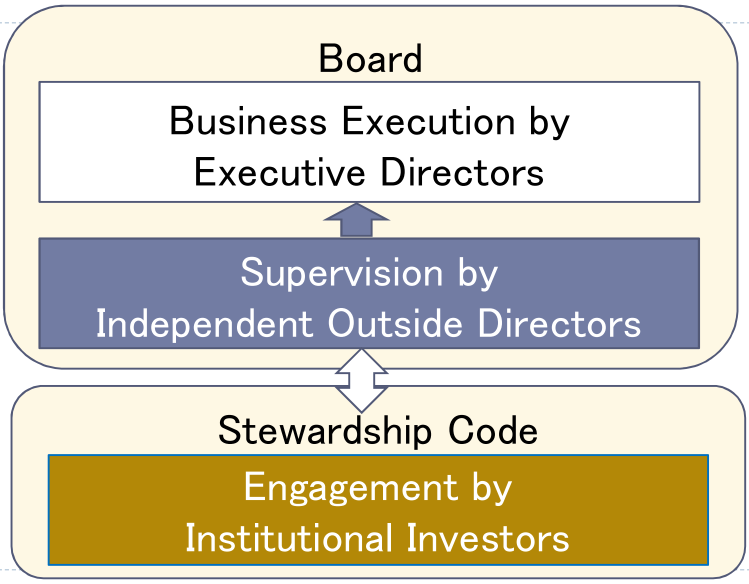
I am not pointing out flaws in the management of Japanese companies just to get their goat, but because I regard these problems as quite serious. Otherwise, the Council of Experts for the Corporate Governance Code would not have added Principle 4.12 concerning Active Board Deliberation:

The board should endeavor to foster a climate where free, open and constructive discussions and exchanges of views take place, including the raising of concerns by outside directors.

The Corporate Governance Code is essential for Japanese companies to break through this situation. One of Ultimate Objectives of the Code is as follows:

By establishing fundamental principles for effective corporate governance – and breaking the stagnant board practices that currently prevail (this part is my insertion) – to achieve sustainable growth and increase corporate value over the mid- to long-term.

Roles of Independent Outside Directors



Given the prevailing circumstances I have described here, it is almost impossible for directors who have run up the ladder of corporate hierarchy in Japanese companies to break through this situation. That is why the Corporate Governance Code calls for independent outside directors. However, it seems to me that there has been no common understanding about the roles of such directors.

A major reason is that no clear separation has been established between the execution of businesses and supervision over it. In Japanese companies, it is likely that independent outside directors, who are virtually all non-executive directors, are involved in the decision-making process for business execution. Presidents of Japanese companies sometimes say that they expect independent outside directors to give them advice on the conduct of business. I do not believe, however, that this is the critical role that independent outsider directors must play. At best, such advice is a by-product, which may or may not prove useful. On the contrary, the essential role of independent outside directors is to supervise the executive directors' execution of business.

Earlier in this presentation, I cited management as the party most responsible for the situation I have described. Here, however, I would like to add institutional investors as the second most responsible party. For the most part, they have been very reticent about engaging with the management of Japanese companies. Without going into the particulars, let me just say that it was this that necessitated the creation and implementation of the Japanese version of the Stewardship Code.

On the one hand, within the board of a company, it is critical that independent outside directors play a role to steer management to a right course that maximizes corporate value. On the other hand, outside of the company, institutional investors have to play the same role through engagement with the board of the company in which they have invested their funds. The framework governing dialogue with shareholders is prescribed in Principle 5 of the Corporate Governance Code which stipulates dialogue with shareholders. It seems to me that the Stewardship Code has already begun working. One good example is Fanuc Corporation, which I picked up as an example of a cash-rich company. It was reported by *Nikkei* that Fanuc has created a special section responsible for engendering dialogue with institutional investors and carried out such dialogues with 19 of them. As a result, the company shifted its financial policy to return redundant cash to shareholders by buying back stock and raising their dividend payout ratio. This report has boosted the stock price since then.

Chief Areas OF Concern For Independent Outside Directors?

Risk Management

- Internal Control System – Compliance
- Conflict of Interests
- Disclosure

Business Strategies

- Efficient Use of Capital
  - Redundant Cash
  - Cross-holding shares
- Costs of Capital
- Decision Making Processes

Next, what do independent outside directors need to watch out for? There are two main areas. One is obviously business strategy. The Corporate Governance Code carefully prescribes principles regarding this issue in its Principle 4 which stipulates responsibility of the board. I won't go into greater detail here, but just stress that independent outside directors have to concern themselves with the efficiency of the use of equity capital from the shareholders' point of view. In other words, they will be continually asking management, "How is our money being used?" In particular, the amount of cash has to be carefully monitored as I discussed earlier. Another important factor is the status of cross-holding shares. The Corporate Governance Code also prescribes principles for this issue. It is incumbent on management to explain to shareholders precisely why they hold such shares if they do.
Of course, efficiency of use of capital always has to be benchmarked to the costs of equity capital. Any new investment plans, including M&A, have to be checked from the point of view of marginal efficiency of capital. Decision-making processes also have to be watched based on sound principles of business judgment. Has management gone through every probable alternative scenario with prudent risk assessment? This is a question that must be asked.

The second general area is risk management. Without proper risk management, it is impossible for corporate management to aggressively pursue business that entails risks. One key aspect is to have in place a neatly designed and implemented internal control system, including compliance. The risk of failure in internal control exists in management itself. If management overrides the internal control system, it obviously doesn't work. The recent alleged accounting fraud by Toshiba is, I would say, one typical example of the consequences of overriding internal control. In this regard, independent outside directors serve as the last resort to prevent such internal control lapses.
Conflict of interest is another area to keep a diligent eye on. Management executives are the ultimate insiders in terms of both corporate information and the discretionary execution of business. So, there will always be the temptation for them to act in their own interests rather than that of the whole. Only independent outside directors can be a breakwater against this sort of conflict of interest. Proper and fair disclosure of corporate information is a matter of serious concern. Principle 3 of the Corporate Governance Code deliberately prescribes standards for insuring the transparency of corporate information.

The new measures for reform of corporate governance have just begun. Actually, this is the beginning of the beginning, but the data I used earlier in this presentation have already started to show signs of recovery. For instance, market capitalization has gone beyond the 1989 level after long stagnation and it is reported that an increasing number of companies are realizing an ROE of more than 10%.

What Remain To Be Done ?

Education for Directors

Creation of Executive Market for Directors

Assessment of Board Effectiveness

Ensuring that this trend continues to thrive requires us to consider what has to be done from now on. First of all, I would like to stress the importance of education for directors, regardless of whether or not they are independent outside directors. Corporate directors have to have a kind of discernment which is more than just the accumulation of knowledge, skill and proficiency but an amalgam of those things shaped and guided by wisdom and a strong sense of ethics. We need educational programs where corporate directors or candidates for corporate directorships can acquire such discernment along with knowledge and skills, while at the same time exchanging ideas and experiences to breed better corporate governance practices.

I know there are a few programs for corporate directors, such as those of Singapore Management University, IMD in Switzerland and Harvard Business School in the United States. It is my hope that the ICGJ can work with suitable institutions in Japan – JPX, for example – to create this kind of educational program here.

Secondly, I would like to return to the necessity for an effective executive market for corporate directors. This is an area where the private sector will have to take the lead, but it is a question of urgency given the burgeoning role of independent outside directors and, as already pointed out, the need for a safety net for those who dare to speak out at board meetings.

Lastly, I would like to emphasize the need for a rigorous self-assessment of board effectiveness. This may be the most difficult challenge for Japanese companies, but it is one worth undertaking if real improvements in corporate governance are to be achieved. Although the process has just begun, by tackling these challenges, I believe Japanese companies will regain their robust international competitiveness and achieve sustainable growth and higher corporate value over the long to medium term.

Thank you for your devoted listening.

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