Commemorating the Tenth Anniversary of Japan Corporate Governance Network

Corporate Governance in Japan and International Trends:
What can be learned from the UK

Date and Time: March 25, 2013 14:30-17:10
Venue: The Nippon Foundation Conference Room

Presentation by Meryam Omi, Environmental, Social and Governance Manager, Legal & General Investment Management

Ms. Omi began her presentation by admitting she had been surprised when she had joined her team four years earlier to be told that Japan was considered a "special case," but what she has learned since then confirms that Japan still has some way to go in the area of corporate governance.

Legal & General places a high emphasis on corporate governance within the companies that it monitors and has seen a shift in the last 13 years from companies saying they are carrying out corporate governance to firms doing it well. Ms. Omi emphasized that her department reports directly to the CEO and is therefore independent of any influence on its findings, and looks at the long-term picture rather than for short-term gains.

Given the vast number of markets and sectors, Ms. Omi's L&G team focus their attention on the four areas of executive pay, the diversity of the board, listing rules and auditors.

She pointed out that most companies are now aware that if they do corporate governance well, then it benefits them and that her aim is to help share expertise and information to bring companies that are lagging behind up to the higher standards being demonstrated by other firms.

And she is a firm believer that corporate governance leads to stronger management in the future - but that it can take time to reach that point.

Turning to the situation in Japan, however, she said there are some areas of concern.

Showing a graph of the composition of boards in Japan, Hong Kong, Singapore and South Korea, the situation in Japan was starkly different from the other markets in that the vast majority of board members were insiders and just a fraction either affiliated or independent.

Other markets in the region have stronger rules on corporate governance and stock exchanges that are more engaged with foreign investors, she said.

But there has been progress in Japan, she said, with more than half the listed companies having at least one outside director, although that is partly because the TSE stipulates it, she added. There is also a growing sense within firms that only having a single outside director does not add much and they are looking to appoint more to "shift the conversation," she said.

One drawback that is an issue in Japan is that companies often state that they wish to appoint an outside director who has experience of the same sector because they already have a firm understanding of the business, but Ms. Omi says this is a mistake. The value of an outside director, she said, is in having someone who is completely different and does not think like everyone else on the board. They have different solutions and strategic thinking that can be immensely important.

Turning to the issue of female representation in boardrooms here, Ms. Omi said it is "a real shame that 50 percent of the population is under-represented on Japanese boards."

Another graph showed that while women account for 11.1 percent of boards in developed countries and 7.2 percent in emerging markets, the figure in Japan is a paltry 1.1 percent.

The issue of the aging population in Japan must also be considered, she added, and there is a need to have the voices of the nation's younger generations represented on boards.

Arguably more important is the question of foreign nationals in Japanese boardrooms, particularly given that with a shrinking market at home, companies here are going to have to increasingly look overseas for markets and profits. Ms. Omi pointed out that many firms have fared poorly when they set up in an overseas market because they lacked the understanding and experience of that market, something that could be remedied by having greater foreign representation on their boards.

It is fair to say, she added, that if a Japanese company wants to succeed in a foreign market it would help immeasurably if it could show it had brought in outsiders to its board - while such changes to also not go unnoticed by investors.

The question is where Japan goes from here, Ms. Omi suggested.

The market appears to be at a standstill in Japan at present and unsure of where to go next, she suggested. A decision needs to be taken on the route Japan should take, and quickly.

Ms. Omi said it is her belief that Japanese companies should have at least one-third of their boards made up of independent directors within the next three to five years and that companies take the "comply and explain approach." The need to make this change is most critical in medium-size and large firms, she said, particularly those with business overseas. The next step is to increase the proportion of outside directors to 50 percent.

There needs to be a reconsideration of the actions of boards here, how often they meet, how long they meet for and the formats of their meetings, she said, while outside directors need to be provided with "meaningful" support and training if they are newcomers to the sector.

Finally, she said, Japanese companies must determine why an outside director would want to come and work for them and what would motivate them to be an asset to the organization. That is when a company starts to attract the right sort of candidates, she said.

Presentation by Mr. Simon Learmount, Lecturer in Corporate Governance, The Judge Business School University of Cambridge.

Mr. Learmount has had an interest in corporate governance for 20 years and said he has witnessed a huge amount of change in the UK in that time, but far less in Japan.

A key element of his presentation would revolve around responsibility, he said at the outset, and the shift that is evident from the rights of shareholders and directors to a situation in which people are enacting their responsibilities. This has been positive for the UK and he expressed the hope that a similar impact might be seen in Japan in the future.

Citing the 2006 UK Companies Act, Mr. Learmount said, "A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole."

It is clear, he said, that the act states directors are not beholden to the shareholder but has a primary duty to the company.

In addition to that, the 2010 UK Corporate Governance Code states that "The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company."

Mr. Learmount said this indicates there has been a shift in the UK to a more nuanced and inclusive debate that is encapsulated in this definition, which permits a UK director to look at all aspects of managing a company and focuses on the long-term.

Corporate governance in the UK is based in four key areas, he said. The first is that the process is inclusive and ongoing, which is in stark contrast to some other jurisdictions. Secondly, corporate governance is in place to ensure accountability but none of the stakeholders can lose sight of the fact that companies exist to make money. A third element is that shareholders are increasingly required to act with responsibility. Finally, Mr. Learmount said, there is the emergence of a fiduciary version of capitalism in the UK.

He provided a brief overview of the historic development of reforms in this area in the UK, starting with the scandals of the early 1990s, such as Polly Peck and Coloroll, which demonstrated just how easy it was to fabricate corporate accounts.

The Cadbury Committee, which issued its report in 1991, cleverly pointed out that it was not enough to simply examine the rules and regulations. What was needed was a thorough examination of the processes that had allowed the scandals to happen. One of the most important conclusions was that there was a need to balance power within the board. That can be achieved by splitting the roles of the chief executive and the chairman.

There is also a need to have dialogue between the inside board members and the external directors.

Other reports that he touched on included that by Greenbury in 1995, focused on remuneration, Hampel three years later, Turnbull in 1999, with its examination of risk, Myners in 2001 and Higgs in 2003.

A diagram demonstrated the "very significant change" in the ownership of shares in the UK, with the traditional model of individuals holding shares being replaced by institutional investors.

This raises questions over whether shareholders act as owners or profiteers and Mr. Learmount cited the example of Laxey Partners, which targeted British Land in 2002 and eventually received a 15 percent return on the investment. Mr. Learmount argued that if one examines their real rights, investors do not exercise their rights in a meaningful way.

Another issue that has been noted, he pointed out, is the growth of aggressively activist hedge funds, which tend to target undervalued companies that are profitable and enjoy high cash flow but have value that can be extracted. The potential investors will present logical arguments aimed at delivering more value and seek influence rather than control.

Studies on the impact of short-term involvement in a company produce positive effects, although longer-term studies do not necessarily bear that out, he said.

From the late 1900s until 2008, there was a great deal of debate about whether activist investors were positive or negative, but since 2008 there has been a clear shift away from corporate governance being a case of confrontation between shareholders and directors and towards a dialogue about the responsibilities of both sides in the equation.

An additional player in the UK is the government, which became far more involved since the 2008 financial crises, part of the blame for which was laid at the doors of the government and regulators for failing to adequately monitor what was going on.

That has led to the evolution of the idea of shareholder responsibility and, in 2010, the drawing up of the UK Stewardship Code. Mr. Learmount suggested the code is something that could benefit Japan.

Debate continues on improving company reporting, increasing the diversity of boards, primarily by introducing more women, linking directors' pay to performance and making employee ownership more accessible.

M. Learmount reiterated that his analysis indicates that the UK is moving towards a different form of capitalism, fiduciary capitalism, and is less about different partners wanting to exercise the rights and more towards people understanding the role the different organisations and actors have in the financial system.

The government and regulators are playing a larger role in the system in the UK today, with the system consequently more flexible and joined up in the form of a "virtuous circle," he said.

What is required in Japan, Mr. Learmount suggested, is more Japanese companies and directors taking part in the debate and being more engaged in changes.

Christina L. Ahmadjian, Professor at the Graduate School of Commerce and Management, Hitotsubashi University.

In brief comments before the question and answer session, Professor Ahmadjian said there had been debate in the past about Japan joining the "global standard" on corporate governance, but that it had avoided becoming like the US. She added that while some executives have promoted corporate governance, shareholders - including foreign shareholders - have been remarkably quiet.

It is interesting in the debate over the relative importance of employees and shareholders, neither side has really won over the last 20 years and is measurably better off.

And while having some outside directors is clearly an improvement, she said, they are still too few in number and are merely considered as advisors with very little input in the decision-making process.

The critical issue for corporate governance in Japan is the question of growth for shareholders, Professor Ahmadjian said, and there is a need to think far more about growth in this market.

Mr. Takaya Seki, Managing Director of Corporate Practice Partners, Inc., served as moderator of the subsequent exchange of questions and answers.

Question: In the UK, how many meetings does a board have, how long do they last and what is the format?

Answer: Mr. Learmount: That's an interesting question, but perhaps the wrong question. What I think companies focus on is making sure they take an appropriate amount of time and the appropriate frequency of board meetings. A colleague at Barclays Bank told me that the board there meets about six times a year, but those meetings are thoroughly prepared for and taken very seriously. At other times, such as during the financial crisis, there were board meetings almost constantly. Do what is appropriate.

Question: For a typical FTSE100 company in the UK, how many outside directors are there?

Answer: Mr. Learmount: What a lot of companies strive for is balance, not a mandated number. The Cadbury Committee looked for a balance of power in the board. In some circumstances, maybe it is more appropriate to have more insiders because a company needs to be able to move fast and inside knowledge is important. In the UK, the appropriate composition of the board is one that makes sure it does the job well, with prudence and for wealth generation. Numbers are less important, but have to be fit for purpose.

Answer: Ms. Ahmadjian: If you ask a lot of Japanese companies about balance, they will say that the all-insiders model is OK for them. I agree this approach is very sensible in the UK, but it is dangerous in Japan. A majority of the board sets policy, but I can't think of any company in Japan where outside directors set strategy or policy. That is a fundamental contrast.

Question: When it come to decision-making in corporate governance in the UK, who is in charge?

Answer: Ms. Ahmadjian: I still can't figure out who makes the decisions at Japanese companies, on corporate governance or other issues. Decisions are not made in many Japanese companies. If you look at the economy as a whole and compare it to other Asian markets, the strong hand of government and corporate government organisations is visible. Not here in Japan. I think what is remarkable is that foreign investors have not had the influence that they expected to have. Ten years ago, I thought that foreign investors were really going to change Japan.

Answer: Mr. Learmount: I think I'm beginning to detect in the UK an increase in the interest among the general public in corporate governance. For the longest time, the debate was in the financial media and among professionals, but since the financial crisis, the scope of that debate has grown. People are worried about how their pensions are being invested and executive pay, in particular. In Japan, the average pay of a senior executive is Y21.4 million, but for a FTSE100 company in the UK, it is Pounds4.8 million. A lot of people in the UK worry about the chasm that has opened up between directors and bankers and ordinary people and that is forcing its way into the public consciousness.

Question: How can Japan get into the virtuous circle that you mentioned?

Answer: Mr. Learmount: The context is important. The UK provides a good model of how corporate governance worked for the UK; it is appropriate for the systems that we have in place, our employment, the way our markets work and so on. I think that simply looking at UK structures and processes and then trying to apply them to Japan would be a mistake. It is the principles of the reform that are more important; The inclusiveness of the debate, the ways the recommendations are implemented, the importance of enterprise and strategy. This all needs to be debated. If we spend too much time just looking at the UK and our examples, it will end in failure, but trying to understand the processes is very important.

Answer: Ms. Ahmadjian: Companies need to make money and we do not see enough of that going on in Japan. We have to discuss what is needed to let companies grow and make money again. We can get bogged down in the questions, but Japanese companies have to compete globally and make money.

Answer: Ms. Omi: One thing I do not want to see is any more study groups. We need to stop studying and actually get on and do it. Sometimes it will go well and other times it will go wrong, but we learn from those actions.

Answer: Mr. Learmount: I would like to add that corporate governance is no longer just about attracting capital but also looking into strategy. If you have good corporate governance, know the markets and your consumers, there is a need for a broader geopolitical and business overview. In three to five years, I expect to see a wave of acquisitions by Chinese companies.

Question: How can Japanese companies make both long and short-term relationships with investors?

Answer: Ahmadjian: I believe Japanese companies should be looking for long-term investors. I see so often the excuse in Japanese companies that they are looking long-term - and sometimes that can feel like 100 years.

Question: With foreign investors owning Japanese shares, how important is the English language?

Answer: Omi: The trend is good but when I meet with Chinese and Singaporean companies, they all speak perfect English in meetings. In Japan, I see difficulties in English or officials need translators. That creates a barrier and there can be 'lost in translation' moments. I think information in English here is improving in terms of disclosure, but some of the best material is still only available in Japanese. This is a country that needs to look at its employees' language skills.

Question: Mr. Learmount, you were in Hong Kong and Chine before arriving here; what are your impressions in comparing the countries?

Answer: Mr. Learmount: I detect in many of the relationships that I have had with Japanese companies a kind of defensiveness. I think one thing that is very important to understand is that long-term investors have an interest in making sure that the companies they invest in are successful, so that should be welcomed with open arms. In China, I met the chief executive of the largest real estate company in the country and he was desperate to learn as much as he could from our connections with investors, students and others. All senior executives in China have been educated overseas, speak perfect English and understand the U.S. and European ways of doing business. That is in stark contrast to my experiences in Japan.

Question: How about the ratio and role of women?

Answer: Ms. Omi: In the UK, there is an initiative called the 30 Percent Club, started by a female CEO, although it's not a quota system. You have to grow talent from within a company. The point is that we need to have a goal. We need women to feel that they are heading somewhere. These are educated women, they're smart - so why would they come to your company and your board meetings? The bigger question is about the value of women being a part of the conversation. Women bring a different perspective. They ask questions that men might not dare to.

Answer: Mr. Learmount: The argument should be because women are totally under-represented on boards. It is ethically wrong to only have men leading an organisation in a society. In the UK, 18 months ago, the government started collecting well-being data. Previously they had used GDP per capita data, but there was a realisation that that was not enough. Economic success is only a means to an end. We should be striving for justice and to be a fair and happy society. To achieve that, we also have to have representation of young people on boards and I think we will see that in the next 10 years.

Question from the floor: What about the question of linking executive pay to performance?

Answer: Mr. Learmount: Executive pay and performance are an area where the UK needs to wake up. Perhaps we have painted a picture that is too rosy of the UK today. The average annual pay for a FTSE100 executive is Pounds4.8 million; that is a lot of money, particularly when the average pay for workers has fallen back below 2008 levels. I am not sure that the government has got this right yet and I am not sure about the solutions.

Question from the floor: As major Chinese corporations are state-owned, are global investors comfortable investing in Chinese companies?

Answer: Mr. Learmount: What is happening in China is a very different sort of corporate governance, one that is evolving taking into account the Communist Party and sometimes even the Peoples' Liberation Army. I think that over time a lot of work will be done to understand corporate governance there, but all the interactions I had in China suggest that their companies play an important role in the global economy. I feel there is a lot more activity in China, with foreign investors and universities and large opportunities.

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