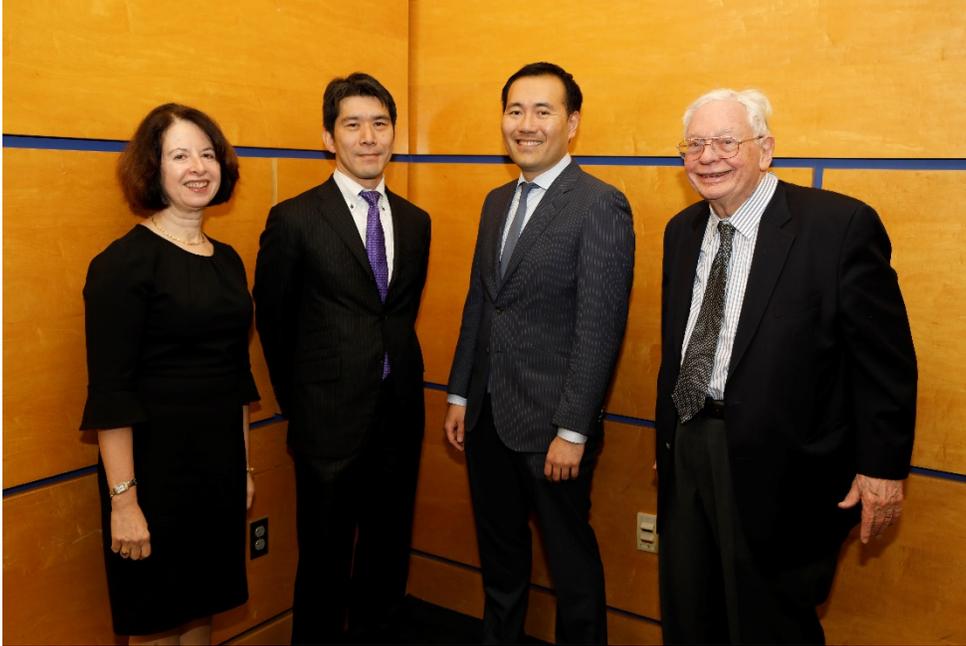


Changing the Game in Japan's Equity Markets: An Update on Corporate Governance Reforms

Tuesday, April 3, 2018



Featured Speakers:

Akitsugu Era – Director and Head of Investment Stewardship Team, BlackRock Japan

Ryota Kimura – Chief Representative & General Manager, New York Representative Office, Japan

Exchange Group, Inc.

The Center for Japanese Economy and Business (CJEB) and The Mitsui U.S.A Foundation co-organized a symposium on corporate governance in Japan that took place on April 3, 2018 at Columbia Business School. The symposium, titled “Changing the Game in Japan’s Equity Markets: An Update on Corporate Governance Reforms,” Mr. Akitsugu Era, Director and Head of Investment Stewardship Team at BlackRock Japan, and Mr. Ryota Kimura, Chief Representative and General Manager and New York

Representative at the Japan Exchange Group, presented individually on the topic and then participated in a panel discussion led by Professor Alicia Ogawa, Director of the Project on Japanese Corporate Governance and Stewardship at CJEB. Professor Hugh Patrick, director of CJEB, began the proceedings by delivering welcoming remarks.



Alicia Ogawa

The two panelists brought a wealth of information to the symposium. With his experience at the Japan Exchange Group, which operates both the Tokyo and Osaka Securities Exchanges, Mr. Kimura connected corporate governance reforms in Japan with Prime Minister Abe's goal of revitalizing the Japanese private sector. Mr. Era gave a detailed account of how BlackRock engages companies in Japan to push for greater transparency and enhanced corporate governance. Professor Ogawa directed the conversation with a brief introduction

outlining the context. She contrasted the way corporate governance reforms in the U.S. and Europe were being implemented to counter excessive risk-taking and short-term visions with how Japan, under Prime Minister Abe, is using reforms to nudge Japanese managers to take greater risks in their business decisions. She summarized these differences as an exercise to highlight best practices and learn from the mistakes that both extremes make in their governance. In Japan, the corporate governance code is voluntary under Japanese laws, but as the world becomes more competitive and stock exchanges compete for IPOs, the speakers hinted that Japan has to evolve. The challenge, not just for Japan, is in how to maintain high standards of corporate governance without compromising corporate freedom. Another challenge lies in the fact that corporate governance reforms require a more active engagement which is the complete opposite of the rise in big passive investment funds. So while companies like Vanguard and Fidelity have made it easy for the middle class to invest, ETFs are allocated according to a formula, not a face-to-face relationship and deep understanding of portfolio companies. Given this trend, Professor Ogawa concluded her remarks that there is a concern that bad management won't have to worry about index funds that will buy their stocks regardless of how management performs.

Mr. Kimura began his presentation by reporting that 26% of the companies listed in Japan are fully compliant, with the rest failing to comply mainly due to one of two reasons: either 1) facing difficulties with English disclosures, or 2) issues related to the board. With only a quarter of the listed companies utilizing the Investor Communications Japan (ICJ) Broadridge Platform, a platform that provides information in English to international investors, three quarters of the companies by default do not have enough infrastructure to communicate with international investors. He noted that smaller companies and startups have the most difficulty with providing English disclosures. He said that the question that lingers is whether international investors really want small companies to spend their resources on communication rather than focusing on the entire core business. He also pointed out the



Ryota Kimura

issue of diversity within Japanese boards. Although the number of independent directors in Japanese boards is improving, less than 3% of board members in Japan are women. Gender inclusion is not the only diversity issue; indeed, background and nationality equally problematic. He further noted that CEO compensation is in cash and not equity which poses a problem given there is a dissociation between equity performance and compensation. There is also a controversial issue surrounding the lack of transparency as former CEOs stay with companies, earning hefty pay and compensation, with virtually no responsibilities or expectations. The Japan Exchange Group, he remarked, has introduced steps to aid companies in disclosing this information. According to Mr. Kimura, a newly revised corporate governance code will be implemented just before June focusing on several key areas, including cost of capital, transparency in the process of nominating a CEO, diversity of board members, cross shareholdings, and corporate pensions.

BlackRock Japan invests in 2,400 Japanese companies every year. According to Mr. Era, BlackRock engages with 350 companies in a year. In his presentation, Mr. Era said BlackRock has a long stewardship track record in Japan and has been working in Japan for 15 years. His work has entailed working closely with the Ministry of Economy, Trade, and Industry, with the FSA, and with the cabinet office involved in the implementation of Prime Minister Abe's Third Arrow of Abenomics, or the set of economic reform strategies introduced by Abe. Mr. Era stated that the number of companies BlackRock engages with has been increasing in the last three years and that that number has quadrupled since he joined BlackRock in 2011. BlackRock's engagement strategy is in shifting a company's focus to the long-term and engaging companies on how they are transforming their business portfolio, what their capital allocation is like, and what M&A strategy they incorporate. BlackRock also discusses how they manage risks and adapt technology, as well as corporate culture. What are the companies' core values and decision-making processes? How do the companies develop their talent pool? And how are the companies dealing with labor force scarcity given Japan's dwindling population? Mr. Era identified a third area of engagement as well, which is corporate governance, and specifically, board effectiveness and board monitoring and oversight.

Mr. Era compared the ROE in Japanese companies, stating that the percentage was far lower in Japan than in Europe or the U.S. This is why the Japanese government has taken initiatives to turn



Akitsugu Era

around business performance. It is in the government's interest for companies to perform better as the Japanese population is aging and there is more pressure on how to fund retirement as a society. Overall, Mr. Era said that there is a positive perception of investors. While investors 20 years ago weren't considered key stakeholders in Japanese companies, they are now taken into greater consideration. Even with these changes, he noted that Japanese corporations are fundamentally different from American and European corporations. The majority of them operate under a dual board structure, with one board involved in business execution and the other providing oversight. Another difference is that shareholders have stronger legal rights and corporations still have long-term employment, where directors, including CEOs, often are promoted internally. Only 7% of the companies in Japan have CEOs coming from outside.



In his view, success in corporate governance reforms is heavily dependent on preventing a box-ticking compliance driven approach. The rate of compliance is oddly high to him, though the current code has been structured largely on the practices in the U.S. and the U.K.

In beginning the panel discussion, Professor Ogawa first brought forth a question about corporate scandals, noting that such scandals

are not unique to Japan. Professor Ogawa cited the recent Toshiba and Wells Fargo scandals, showing that even in the U.S., none of laws worked, the media didn't work, external directors didn't know, and investors didn't raise questions on the internal issues brewing at Wells Fargo. She asked the panelists' opinions on the best ways to contain these scandals. Mr. Kimura responded that there is a need for a mechanism to quickly detect a defect in a company and that that mechanism could work to make companies realize that a corporate scandal leads to a huge deterioration of corporate value. Professor Ogawa noted that since few Japanese executives have their pay tied to share price performance, it is not clear that the people who should be made to suffer will be made to suffer if investors choose to devalue stock. She added that she had heard people say that the whistleblower law in Japan should be reformed as it does not protect people who blow the whistle. In the U.S., she said, it is not the power of investors and government but social media that brings companies down, a mechanism that does not seem to exist in Japan. Mr. Era added that scandals occur because companies lose their integrity. He feels companies should focus on transparency of information since companies that are more transparent both internally and externally often have a better culture. In his view, it is very difficult for outside non-executive directors to understand and identify issues unless they have the right information. Even with the right skill set and expertise, he added, as long as a director doesn't have sufficient internal information, it would be very difficult for such non-executive directors or even audit firms to identify internal issues, hence his insistence on transparency.

Professor Ogawa also touched on ways of instilling corporate culture when bonuses are not dependent on those values companies boast about. Mr. Era noted the difficulty in measuring value alignment and thus the need for engagement. While Professor Ogawa repeated that companies need active investors to spend a lot of time talking to industry association, suppliers, and people who used to work at the firm to better understand company culture, Mr. Era pointed out that deep active investors generally deal with only a handful of portfolio companies and that the idea, while good, is not scalable. Mr. Era referred to the extraordinary legal powers that Japanese shareholders have in the nomination of the board, calling special meetings, having proxy access and the range of issues which can be proposed to the company is much broader. But Professor Ogawa questioned the true strength of shareholders' rights, wondering about why they don't seem to be used more aggressively. Mr. Kimura disagreed, stating he doesn't think shareholder powers are very strong practically, and though, they could be strong legally, access to the company is extremely limited in reality.



An issue that perhaps seems to underline the Japanese business environment is that there are far fewer growth opportunities in Japan so change is inevitable. However, the goal is not to push companies to take just any risk or excessive risk but constructive risk that includes management assessing key risks and trying to understand how to incorporate those risks in the business strategy. The panelists seemed to be in agreement that the Japanese business environment is a more activist friendly environment because it encourages the turnaround of a company which is what Japanese companies need at this time.