THE NETWORK FOR SUSTAINABLE FINANCIAL MARKETS

Response to Japan’s Financial Services Agency (FSA) Request for Comments on the “Japan’s Corporate Governance Code”

31 January 2015

Introduction

The Network for Sustainable Financial Markets (SFM) is an international, non-partisan network of finance sector professionals, academics and others who have an active interest in long-term investing. We believe that the recurring crises recently experienced in our financial markets are not isolated incidents. Rather, this instability is evidence that the financial market system is in need of well thought-out reform so that it can better serve its core purpose of creating long-term sustainable value.

We appreciate the opportunity to respond to this request, since we recognise the need to search for more sustainable business systems connected globally. It is good that in Japan finance is less dominant, but this has a downside too. It is of critical importance to balance financial and social objectives. If social objectives and interests come to dominate too much, it will destroy economic value creation. If financial objectives come to dominate too much, long-term economic value creation will also be destroyed.

Earlier we have been active in various other consultation rounds, including the Ito Review and the Japan’s Stewardship Code. Some parts of this response have been used in other SFM consultations as well.

SFM Guiding Principles

I. The Economic and Social Purpose of Markets is to Create Long-Term, Sustainable Value, which Requires the Efficient Allocation of Capital towards that Goal

II. Sustainable Value Creation Requires that Hidden Risks and Rewards be Identified and Valued

III. Balance Between Short-Term and Long-Term Views is Needed

IV. Market Participants Must Take Responsibility for Their Actions

V. Governance at All Financial Institutions Should be Improved

VI. Better Alignment of Financial Interests is Needed to Reduce Agency Costs

VII. A Coordinated Global Approach is Needed to Better Protect the Financial Markets

SFM website: http://www.sustainablefinancialmarkets.net/
SFM Japan Working Group website:
http://www.sustainablefinancialmarkets.net/japan-working-group/

Corporate governance: maximisation of interest alignment among corporate stakeholders

Here we specifically refer to General Principles 1, 2 and 5, and Principles 1.2 and 2.3 of the Draft Code.

We appreciate the Code's definition of corporate governance in General Principle 1. The stability of the Japanese system offers a valuable and rich perspective for ESG (environmental, social and governance)-oriented long-term investments, but it needs accountability and therefore transparency and stakeholder engagement inclusive of shareholders. We also appreciate that these relationships are not aligned with the dominant neoclassical economic thinking that, assuming perfect information, perfect capital markets, and perfect competition, "the market is a separate area of society, apart from social and cultural concerns, in which individual self-interest could be expected to advance both personal and social interests"[1]. We would value more specific awareness and identification of the social and economic aspects of various governance systems that often arise in Japan, not in order to promote isolationism or worse, socialism, but to develop sustainable long-term investments.

Similarly, we also welcome General Principle 2, which requires continuous engagement with a wide variety of stakeholders, not only with shareholders. However we would propose that the Code specifically suggest as a "best practice" the maximisation of interest alignment among stakeholders[2] through identification and valuation of the negative and positive externalities of their activities, as is stressed in the SFM Guiding Principles. We also believe that Principle 2.3 is weak regarding the negative externalities, since companies should consider 'black swan' type (i.e., low-frequency, high impact) events, in addition to high-frequency, low impact negative events that normally occur in the course of daily management practices. ESG factors are closely related to extreme events such as the Fukushima nuclear disaster[3] and require companies to have forward-looking viewpoints that provide them with an opportunity for more comprehensive scenario analysis.

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1 Williams, Cynthia A., De Graaf, Frank Jan. The Intellectual Foundations of the Global Financial Crisis: Analysis and Proposals for Reform. *UNSW Law Journal*, 2009, 32(2): 390-415.
2 Suzuki, Tomo (2012) 'The Impact of IFRS on Wider Stakeholders of Socio-Economy in Japan'. On the request of the State Minister Shozaburo Jimi, Financial Services Agency, the Government of Japan. First submitted: 30th March, 2012 in Tokyo. 217 pages. Professor Tomo Suzuki, Saïd Business School, University of Oxford, OX1 1HP UK.
3 Preventable Surprises diagnosis framework is suitable for diagnosis and prevention of the extreme events. The framework identifies six drivers of mismanagement: regulatory capture, narrow conception of risk, organisational learning disabilities, leadership failures, weak concern for negative externalities, and shareholder value fundamentalism. (access 16 January 2015)
http://www.preventablesurprises.com/diagnosis-and-prevention/the-diagnosis/

Furthermore as General Principle 5 suggests, investor relations (IR) activities should target long-term investors[4] to ensure stable sources of finance despite the declining proportion of cross-shareholding in the market[5], since corporate short-termism just leads to an increasingly short-term-oriented investor base, higher equity betas, and thus increases the cost of capital[6]. Management discussion about ESG factors is useful to contact and keep long-term investors[7].

We would also suggest that more attention be paid to the facilitation of proxy voting. Proxy voting is extremely challenging for shareholders of Japanese companies, in part because the voting materials are often not disclosed until just prior to the annual meeting, and sometimes only in Japanese. Those factors, together with the fact that the large majority of Japanese companies' annual meetings are concentrated in a single month (June) can make thoughtful, well-informed proxy voting next to impossible. We believe that specific comply-or-explain disclosure should encourage: (a) timely (at least 4 weeks before the AGM) disclosure of annual meeting materials, in at least Japanese and English; and (b) extending the permissible period for AGMs following closing of the books, as essential additions to Principle 1.2

In subsequent revisions, stakeholder-aligned corporate governance would be particularly demonstrated in the three areas: board composition and practice, executive remuneration structure, and corporate pension management.

Board practice: a completely independent committee is essential for independent directors' most important roles

Here we specifically refer to Principles 2.4, 4.7, 4.8 and 4.10 of the Draft Code.

While not every country or exchange insists on standards of majority independence for boards and key committees, Japan is particularly noteworthy for its insider-heavy boards. At present, many Japanese boards have only one or two independent outside directors, and in some cases none. We recognise the value of insider acumen in strategic management, but we believe that this is best when tempered by the different perspectives brought by outsiders. In other words, diverse directors examine more options more carefully than homogeneous groups do[8].

Although Principles 4.7 and 4.8 make it clear that the roles, responsibilities, and effective use of independent directors is extremely important, the number of "at least two independent directors" set

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4 Wong Simon, Seven Ways CEOs and Investors Can Promote the Long Term (29 September 2011). *Harvard Business Review*, 2011. Available at SSRN: http://ssrn.com/abstract=1947636

5 Decline of cross-shareholding, SankeiBiz, 5 September 2013 (access 16 January 2015) http://www.sankeibiz.jp/macro/news/130905/eca1309050600002-n1.htm

6 Brochet Francois, Loumioti Maria, Serafeim George. Short-termism, Investor Clientele, and Firm Risk. Harvard Business School Working Paper 12-072. August 2012.

7 Global Trends in Investor Relations: A Survey Analysis of IR Practices Worldwide – Eighth Edition, BNY Mellon, December 2012, P13. http://www.irs.org.uk/files/2012_BNYM_Global_IR_Survey.pdf

8 Phillips Katherine, How Diversity Makes Us Smarter, 16 September 2014 (access 16 January 2015) http://www.scientificamerican.com/article/how-diversity-makes-us-smarter/

forth in Principle 4.8 is insufficient to form an independent committee to advise the board with respect to nominations, compensation, and other matters where the objectivity of independent directors is considered most essential by global investors because of managerial self-interest or other issues. Such an committee is suggested as a *possible* best practice by Supplemental Principle 4.10.1, but: (a) the language indicates that it need only be “mainly” composed of independent directors, rather than solely by them; (b) it only refers to nominations and compensation matters as the subject of deliberation and advice, and does not refer to other situations (e.g., MBOs (management buyouts) or investigations, etc.) where self-interest or de facto interested-party status is an issue; and (c) apart from these problems, it is clear that this language in Supplemental Principle 4.10.1 will not be subject to comply-or-explain disclosure because Principle 4.10 only relates to the use of completely “optional” governance approaches in the first place.

In this respect, therefore the draft code is not consistent with international best practice regarding the very most important issue affecting the “effectiveness” of independent directors. Supplemental Principle 4.8.1 refers to executive sessions, thereby setting the hypothetical base for a totally independent committee, but does not proceed to describe or require such an independent committee. In order to avoid apparent contradiction and to promote clear disclosure and international best practice, the Draft Code should place the language of Supplemental Principle 4.10.1 under Principle 4.8, thereby making the existence and mandate of such an independent committee subject to comply-or-explain disclosure. At the same time, the language should be tightened so that the committee is described as only being composed of independent directors, and is intended to advise upon any other matters which the board determines require full objectivity unaffected by the presence of management. As is suggested in the Background section of Principle 4.10, international investors in particular would like companies to clearly disclose whether or not they have such an independent committee, and if not, why not.

We would also suggest the amendment of Principle 2.4 that the nominating committee charters of all corporations be revised to mandate that each director search include independent, diverse candidates, and that the definition of diversity include gender. Japan has, arguably, the most talented, best-educated, least-utilized female workforce on the planet, and fostering more of that talent in strategic decision-making would be helpful, particularly given Japan’s challenging demographics. We also note with pleasure the proposal to discourage over-boarding, but suggest that some limit should be specified. It is common to see, at least in North America, suggestions from proxy voting agencies that shareholders withhold votes from directors who serve on more than two boards while being employed elsewhere on a full-time basis.

Modest but value creation-oriented executive remuneration structure

Here we specifically refer to Principle 4.2 of the Draft Code.

Japanese corporate cohesion successfully avoids pay disputes between employer and employees, and between corporate sector and society[9]. Principle 4.2 suggests that there should be a higher proportion of variable executive pay. However, such variable compensation should be linked to growth of economic profit and ROIC (Return On Invested Capital) over WACC (Weighted Average Cost of Capital)[10]. Stock options as a mid-/long-term incentive based on TSR (Total Shareholder Return) recommended in the Principle does not actually reflect the performance of senior management and board directors, since the market prices are linked to companies' short-term earnings guidance and investors psychology, rather than corporate intrinsic value that also reflects sustainability goal-setting and achievement[11]. Instead, the growth of economic profit and ROIC over WACC are more useful key performance indicators for the purposes of ensuring sustainable corporate growth.

Corporate pension funds' responsibility to invest aligned with employees' interests

Here we specifically refer to General Principle 2 of the Draft Code.

General Principle 2 should clearly specify that corporate pension funds must act on fiduciary duty[12] with sustainability thinking that is aligned to their employees' long-term interests, since their management tends not to be recognised as a part of corporate governance despite their responsibilities for their employees. The Corporate Governance Code should encourage corporate pension funds – which for practical purposes, are presently administered by the company's management itself – to sign the Japan's Stewardship Code[13], in order to introduce necessary fund governance structure.

To complement this, the FSA should also take regulatory approaches that will enhance the stewardship activities of all institutional investors, but in particular corporate pension funds. In order for institutional investors to have the capabilities necessary for their stewardship activities as Japan's Stewardship Code Principle 7 suggests, the FSA should require institutional investors to organise educational programmes to promote fiduciary professionalism and share market-specific best practice. The capacity building practices should cover topics including the risks of excessive investment herding behaviour for both the economy and fund participants/beneficiaries, the duty of impartiality and the need to balance short-term and long-term obligations, fee structures that better align the interests of service providers with those of fund participants/beneficiaries, the importance of systemic and extra-financial risks, and the benefits of collective engagement (such as is referred to in

9 Leading or Lagging? High Pay Centre, 2013, P17. http://highpaycentre.org/files/Leading_or_lagging_final.pdf
10 Burgman Roland, Clief Mark Van. Total Shareholder Value (TSR) and Management Performance: A Performance Metric Appropriately Used, or Mostly Abused, Rotman Institute of Pension Management, 5.2: 26-33
11 Wong Simon, People have evolved past homo econoicus (July 6, 2014). *Financial Times*, 2014. Available at SSRN: http://ssrn.com/abstract=2463708
12 The definition of fiduciary duty and related problems were deliberated in the SFM Response to the Japan's Stewardship Code: http://www.sustainablefinancialmarkets.net/wp-content/uploads/2014/02/Final-SFM-Response-to-Japan-FSA-Request-for-Comments-on-the-Japan-Stewardship-Code.pdf
13 Miyai Hiroshi, Governance of Corporate Pension Funds: Enhancement of Governance by Sign to the Japan Stewardship Code, *Corporate Pensions*, December 2014

Principle 5 of the UK Stewardship Code).

Concluding remarks: comply-or-explain disclosure is the key for effective implementation of the Code

We would respectfully stress that for the most part, the contents of Code will only have impact to the extent that comply-or-explain disclosure is required. All Principles, Supplemental Principles, or suggested practices mentioned in the Code should be subject to comply-or-explain disclosure.

Respectfully submitted,
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