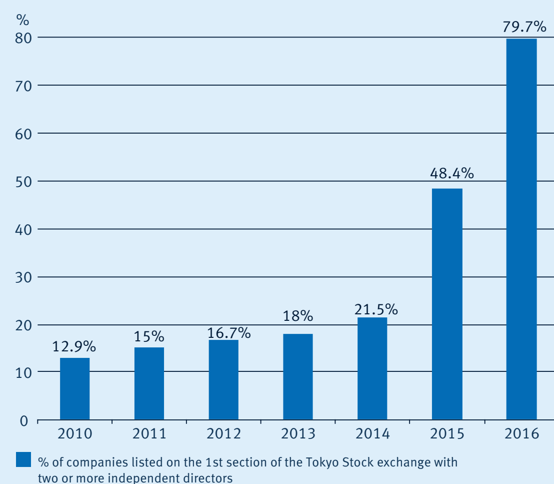
Governance

A slow revolution in Japanese governance

There has been significant change in the governance environment in Japan, driven by a desire to revitalise the economy and push companies to improve capital efficiency.

Alison Kennedy
Governance & Stewardship Director

Chart 1
Rise of the independents



Source: Tokyo Stock Exchange (as of July 2016)

Rewriting the rulebook

The governance architecture in Japan has undergone a major restructuring in recent years. There have been a number of important changes, including the introduction of a Corporate Governance Code for companies and a Stewardship Code for investors. Companies have to report on compliance with the Corporate Governance Code in their governance report and over 200 institutions have signed the Stewardship Code. There was also the launch of the JPX-Nikkei 400 Index, which uses governance data as one of the inclusion criteria, and the restructuring of the giant Government Pension Investment Fund, which now rates its external managers on their environmental, social and governance activities.

The response of corporate Japan to the new regulatory landscape has been emphatic. Board composition has changed markedly: almost 80% of the 1,400 companies listed on the Tokyo Stock Exchange (TSE) First Section now have two or more independent directors, compared with 21% just two years ago (see Chart 1). 350 of these 1,400 companies have moved to the new ‘company with audit committee’ governance framework. This was introduced as a halfway house between the traditional ‘company with statutory auditor’ system and the ‘company with three committees’ system widely used in Europe and America. Although not ideal, this new framework provides improved accountability and board independence.

However, the benefits of these various changes are not always easy to measure. For example, the contribution from newly appointed independent directors is difficult to judge; as many are academics or were formerly statutory auditors their commercial experience is limited. The lifetime employment culture presents Japan with a real problem in finding suitably qualified individuals ready and willing to become independent directors. In addition, the widespread practice of companies retaining the services of former CEOs as ‘advisors’ can stifle innovation and hinder change. Another major hurdle is the lack of real understanding among investors as to what governance engagement is and what it can realistically achieve. Investor engagement and disclosure is reminiscent of the UK ten years ago.

Governance revolution has further to run

In spite of these challenges, the pace of change remains high and further developments are planned. One specific example is the recent consultation by the TSE on the reporting requirements for listed companies. The objective of the proposals was to allow companies more freedom in choosing the format that they use for the ‘earnings digest’, which is used for reporting quarterly. These changes would potentially remove the requirement for companies to produce full financial statements before the AGM and so reduce the amount of information available when making voting decisions. To us, this seemed a retrograde step and so, along with Legal & General Investment Management and the UK’s railways pension scheme, Railpen, we co-ordinated over 40 global investors in support of a letter to ask the TSE to reconsider this change. We await the outcome of this consultation.

On a more positive note, the Stewardship Code is being reviewed and there are proposals that would require investors to disclose voting decisions at individual company meetings. Such disclosure is routine in many markets but not in Japan, where investors normally only disclose their votes in aggregate. Requiring full voting disclosure would be a significant and welcome development. Also, this year will see the government reviewing the amendments made to the Companies Act two years ago, including consideration of whether the appointment of an outside or independent director should be made compulsory. This was not in the previous amendments but could well find support now.

Still work to do

We are undoubtedly still in a period of transition. The risk is that Japanese companies now think they have done enough, so investors need to keep the pressure on to ensure further progress. There is still a great deal of education required, both of directors and investors. We need to see an improvement to the quality and diversity of independent directors and an end to the unhelpful practice of appointing former CEOs to advisory roles. Only then will we see a change in the role of the board from simply a rubber-stamping body to a genuine forum for discussion and challenge. Ultimately, this may take generational change but there is no doubt that momentum continues.

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