

Effective Implementation of Corporate Governance Principles in Japan

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1. Introduction

Thank you very much for your kind introduction. It is a great honor to have an opportunity to explain the Corporate Governance Reform, CG reform, in Japan to the distinguished participants in this room.

The Japanese government has particularly highlighted CG reform as a top agenda of its growth strategy. We formulated the Stewardship Code in 2014 and the CG Code last year, and these two codes are in line with the new G20/OECD Principles in terms of contents and objectives. Today, I would like to outline, first, how they are steadily improving and implemented and, second, how we are facilitating their further progress. I'm hope our experience will provide some useful insights for you.

2. Background to the Two codes

Let me begin with the background to Japan's two codes to show their consistency with the OECD Principles, which were revised last year and are regarded as the global standard of this field including for the World Bank and FSB.

Japan has formulated its CG Code along with new G20/OECD Principles of CG, by inviting a CG top expert from OECD to advise our formulating process, while we were actively involved in the discussion of OECD CG Committee as a Vice Chair.

Therefore, Japan's codes and OECD principles are mutually coordinated, and Japan's codes are completely consistent with the new Principles.

More specifically, the Japanese CG code incorporates all critical

elements of OECD Principles such as rights and equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and responsibility of the board.

The Stewardship Code corresponds with the new chapter of OECD's Principle, "Institutional investors, stock markets, and other intermediaries."

Having pointed out the consistency, on the other hand, Japanese codes include three additional unique principles.

First, "Dialogue with Shareholders". This aims at encouraging companies to engage in constructive dialogue with shareholders even beyond general shareholders meetings.

Second, "combined effects of the CG code and stewardship code." They are expected to work together to create a virtuous cycle of sustainable corporate growth and higher returns for investors.

Third, Japan's codes place strong emphasis on corporate growth and increased corporate value.

Next, I'll show the overview of the two codes.

Japan's Stewardship Code provides principles of actions for institutional investors, stipulating their responsibilities for ultimate providers of funds. Institutional investors are required to enhance the mid-to long-term investment return by improving the invested companies' corporate value through constructive engagement.

On the other hand, the CG Code provides principles of actions for companies, stipulating their responsibilities for shareholders and other stakeholders. In the Code, 'corporate governance' means a structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the perspectives of shareholders and also customers, employees and local communities.

Japan's Stewardship Code and CG Code work together like two wheels on a cart and realize a virtuous economic cycle through constructive dialogue between institutional investors and companies, and ultimately lead to the growth of the economy as a whole.

3. Improvement of governance framework in Japan

The initial results of introducing two codes are significant. I would like to touch upon four examples of how companies are improving their

governance framework.

First, around 50% of the TSE First Section listed companies now have more than two independent directors, jumping from merely 10% in the past. Furthermore, over 10% of the companies have formed a board structure in which their independent directors constitute more than one-third of all board members.

Second, Japan's three major banking groups have unveiled their plans to unwind cross-shareholdings by around 30% within 3 to 5 years. This unwinding is steadily progressing, and other sectors have also started to follow suit.

Third, almost all major institutional investors in Japan have already accepted the Stewardship Code. In total, 206 domestic and foreign investors have expressed compliance with it.

Investors which accepted the code have complied with around 90% of Code's principles. In the past, most Japanese institutional investors were generally regarded as 'silent shareholders', however they are now more actively engaged in constructive dialogue with companies.

Fourth, over 80% of all listed companies comply with over 90% of the principles contained in the CG Code, and when they do not meet any of the principles many of the companies have publicly explained why not.

4. Follow-up of Japan's two codes

While we witness significant progress in the acceptance of two Codes, this is not the goal itself; it is only a starting point. What is more important is that we should encourage more companies to develop a governance system in substance not just in form.

These two Codes must function like two wheels on a cart, to facilitate a sustainable increase in corporate value. In order to further improve CG, we established the follow-up council for the two Codes last August.

Meetings have been held on a monthly basis seven times to date. At this council, we continue our discussion on the issues including cross-shareholdings, board of directors and institutional investors.

The council published an opinion statement in February, based on intensive discussion about boards of directors and CEOs. Let me

introduce the main proposals.

Many Japanese companies are perceived as unable to effectively adapt to the challenging environment in the midst of globalization, technological innovation, rapid demographic change and environmental issues.

Here, the selection of the board of directors, especially the CEO, is critical for a company to achieve a sustainable increase in corporate value.

Regarding the function of the board of directors, they should fully exercise oversight functions and determine strategic directions.

Concerns are raised on transparency in the CEO selection process, especially when existing CEOs unduly exercise their influence on the process, allegedly like Toshiba. It is important to ensure objectivity, timeliness and transparency in the process.

Concerns are also expressed on the insufficiency of qualified CEO candidates. Japanese companies need to cultivate human resources from a long-term perspective through more involvement of the board of directors.

It is also argued that the dismissal of CEOs is not properly conducted. The framework to dismiss CEOs based on a proper performance test needs to be in place.

Furthermore, with respect to the board of directors, I'd add the following three matters pointed out by the council.

First, the independence and objectivity of the membership of boards are important. So, it is desirable not only to increase the number of independent directors but to appoint outside directors with diverse backgrounds to address various managerial challenges.

Second, in order to respond to rapid changes in the business environment, the board should focus on the strategic aspects of business decisions.

Third, the performance of the board should be regularly evaluated to identify challenges and problems of its effectiveness.

Most shareholders' meetings are held this month in Japan and I hope that all companies make use of this statement and I encourage all institutional investors to more actively engage in constructive dialogue with invested companies based on these proposals.

The follow-up council moves on to the agenda of effectiveness of

dialogue between institutional investors and invested companies. It intends to publish an opinion statement concerning enhanced engagement by institutional investors with companies. I would like to introduce ongoing discussions of the council on this matter.

Through the implementation of Japan's two codes and the publication of the opinion statement concerning boards of directors, fundamental frameworks of CG reform have been sufficiently developed. To proceed to the next step, it is imperative to enhance constructive dialogue between investors and companies, which leads to accelerating reforms effectively. Let me mention several opinions which are currently discussed at the council.

First, investors are required to provide companies with meaningful insights based on the in-depth understanding of companies including their management philosophy.

Second, concerns are expressed on asset manager's own governance, including conflicts of interest with the parent company.

Third, an effective way to dispel doubts about conflict of interest would be disclosures of voting results. This would be especially applied to the insurance industry, which has a low disclosure rate of specific policies for exercising voting rights, and voting results by agenda.

Fourth, as for the comparison of passive and active management, passive managers do not have a choice to sell the shares, so they need to increase the long-term corporate value through engagement with companies. On the other hand, because it is difficult for passive managers to expand the scope of dialogue to all of the invested companies, more efficient ways of engagement should be pursued.

Fifth, asset owners are expected to evaluate asset managers in consistency with the Stewardship Code from long-term perspectives.

Sixth, proxy advisors should make an effective judgement and avoid falling into formalism, and institutional investors should not mechanically depend on the advisors' recommendations but should exercise their voting at their own judgement, for instance, by monitoring the results of advisors' performance.

Last, I'd like to add Japan's recent initiatives concerning the technological innovation of the financial market from a CG perspective.

New G20/OECD Principles capture recent developments of stock

markets and exchanges.

The principles state that while the quality of and access to market information, including fair and efficient price discovery regarding investment, are important for shareholders in exercising their rights, most of the large stock exchanges now intend to embrace profit maximizing business in competition with other exchanges. It then becomes more difficult for exchanges to exercise self-regulatory functions to enhance the integrity, transparency and stability of the markets.

In this context, it is necessary to analyze how particular business models of stock exchanges affect the incentives and ability to carry out these functions.

In accordance with the Principles' point of view, Japan launched an official study group to discuss these issues including the impact of recent IT innovation such as the significant increase in algorithmic trading. Taking into account the current market development, we would like to consider necessary steps and measures to establish a financial market which contributes to effective CG.

5. Conclusion

To conclude, it is crucial for each company to accelerate CG reforms for sustainable growth without hesitation. We also hope that institutional investors play a greater role in facilitating these reforms through active investment and engagement with invested companies.

These initiatives to bolster CG will boost Japanese companies' earning capacities and facilitate higher returns for shareholders, thereby helping to improve the functions of financial and capital markets in which growth capital is effectively intermediated.

Today, I have briefly sketched how Japan introduced the corporate governance reforms, ensuring consistency with OECD Principles. Japan has been successful so far in benefiting from the rich knowledge and global legitimacy of the OECD while being flexible in implementation while adapting to the specific circumstances facing a country or a company. I would like to invite all jurisdictions to join this kind of initiative of using the Principles to improve corporate governance as effective measures toward sustainable growth.

Thank you very much for your attention.