Session 2: Corporate Governance of Globally-Active Enterprises - Challenges and Good Practices

Introduction

The participants shared challenges and examples of good practices related to corporate governance (CG) of globally active enterprises. They also discussed, from an overseas perspective, challenges of CG that Japanese companies ought to address, good practices they should adopt, and the role expected to be played by the SESC.

The outline of opinions expressed during the session was as follows.

Group governance and M&A at global companies

○ For the purpose of better group management, if internal structures and rules are standardized throughout the corporate group as much as possible, internal audits become easier to perform and it also becomes easier to view the group as a whole. In this sense, a positive spiral of group governance can be established. It is also important for senior management at head office and at the frontline departments to communicate closely with each other.

○ As a means of evaluating ourselves, our company is increasingly seeking to improve the ratings and to win awards given by external organizations. The goal of these challenges are not necessarily to win good ratings or awards, but rather identify and address points that cannot be answered through the challenges, or in other words, points that have not been addressed. Doing this can contribute to the development of the company.

○ Recent incidences of wrongdoing at overseas subsidiaries seem to indicate that parent companies' governance functions are ineffective, and that wrongdoing seems to happen in the shadows which parent companies did not govern well. Companies acquired through M&A and subsidiaries of regional headquarters are examples of entities operating in the shadows. Given this situation, although it is difficult for auditors to audit global companies with a very high level of quality, the key is to ensure that Japanese auditors can effectively govern local auditors. It is especially important to maintain a mindset of communicating with local auditors with appropriate frequency.

- In addition to bolstering corporate group governance, it is also necessary to enhance group governance of local auditors by Japanese auditors. Both approaches are vital for making financial information more reliable.

- Compared with the U.S., labor productivity in Japan is fairly low, which points to the inefficiency of Japan's management model. This gap has emerged over 30 years as U.S. legislation such as ERISA has made managers fearful and forced them to improve investment performance.

- There are also big gaps between the U.S. and Japan in terms of stock market capitalization and sales per share. These gaps have meant that a cycle of portfolio management that employs a management strategy of "getting rid of 'pets' with low market share and little growth potential in favor of pouring money into startups, growing these startups into cash cows, and using the money generated from them to make new investments in startups" has not emerged in Japan. I think the opinions of shareholders can be effective for changing this situation.

Enhancing international competitiveness, group governance, and the perception of Japanese companies among overseas investors

- There are huge differences between CG in the U.K. and in Japan. In Japan, differences in CG arise depending on factors such as corporate culture, the personality of the CEO, and shareholder composition. Regarding resource allocation and decision-making, in the U.K. (1) shareholder orientation is high (in Japan it is low), (2) more than half of board members are independent directors (in Japan only two or three are), (3) the chairman maintains independence (in Japan the chairman is often the former president), and (4) the CEO's successor is selected by a nominating committee (in Japan the current CEO designates a male successor). So there are differences between the U.K. and Japan.

- Although independent directors in Japan are becoming more diverse, there are only 320 foreign directors out of a total of 40,000. This is a relatively low figure compared with the U.K., France, Germany and the U.S. In these countries the CEO and other directors expect foreign outside directors to point out different things from the other directors during the decision-making process.

○ Overseas investors expect the boards of Japanese companies to not only include foreign directors, but also to be a reflection of global business. For example, they need to understand markets, domestic and overseas regulations, and local companies. They also place importance on a basic system of CG being in place, sound financial reporting, an internal culture of accountability, consistency and self-discipline in management. As an ideal for governance, it is important that management look at it not only from the perspective of compliance, but also as a tool for bringing change to the company on a continuous basis.

○ Regarding M&A governance, despite advances in the technical aspects of M&A, the success rate is still around 30% which is the same level it was 20 years ago. This is because boards are not engaging in adequate discussion before deciding to proceed with M&A deals.

Free discussion

・Japan's CG Code

○ During the past few years the regulatory framework for CG at Japanese companies has changed substantially. Although I think the hard aspects such as the regulations are not much different from those in the U.K. and are in good shape, there are problems with the soft aspects such as the side of achieving the required corporate culture and CG.

○ Sufficient time can be given to reforming CG policy. A concern is, with each company in the midst of transformation, whether the next revisions of CG Code should actually happen? CG is a problem that needs to be digested at the level of top management, so it needs time. Isn't there the concern of a misunderstanding arising whereby people incorrectly assume that by revising CG, the revised points are the only points that require attention?

・Japanese companies' "cross shareholdings"

○ Even though CG has been introduced, the situation regarding cross shareholdings of Japanese companies has not really changed. In the next CG a philosophical framework could be included.

○ There should be tough rules that force companies to explain to investors why they are holding these shares. Depending on the reason, there are also cases that are not problematic, such as cases where principal investors become shareholders jointly.

・Who should monitor governance at listed companies

○ With monitoring of companies by their main banks getting weaker, the stakeholders that surround companies comprise consumers, customers, employees, suppliers, local communities, and shareholders/investors. If the feedback obtained from communication with these stakeholders is humbly accepted by companies, it can be an effective way of monitoring CG.

○ Even among activist investors, investors have recently emerged who make ESG their theme or think about what sorts of things should constitute management objectives for companies. So equity holders also have a role to play as monitors of governance.

○ Ultimately, it is the directors who should make the decisions, but if there has been a problem, there should be communication between investors who are actively investing funds and members of the board of directors.

○ Even though investors are mentioned as playing a role in governance, in Asia it is extremely rare for investors to talk to corporate boards.

・Governance for enhancing corporate value after M&A

○ It is important for statutory auditors, the internal audit function, and external auditors to each carry out checks from their own standpoints.

○ It is important to strengthen internal audit departments.

○ It is important for there to be a vibrant and globally minded accounting profession in Japan. This means continuing to recruit and train high quality accountants with good communications ability. The status of the profession also needs to rise. At companies I have observed, the status of internal audit also needs to be raised. As firms expand internationally, both quantity and quality of internal audit teams need to be strengthened. There are still too few people with English speaking ability in this area.

○ The board of directors should control the M&A process. Independent directors should look at how specific M&A deals will add value to the company. Furthermore, independent directors do not just need to check that M&A add value. They have to understand how each acquisition or merger fits in with the company's overall strategy. In order to do this, it is even more important that companies have regular comprehensive discussions of big picture, long term strategy at the board.

・How many years will it take for the concept of shareholder accountability to take root in Japan?

○ There are no doubt differences among companies, but I think it takes about five years to go from recognizing the importance of accountability to actually propagating it within the company.

○ About ten years.

○ Accountability for CG is already taking shape.

○ It will take decades to get it up to the levels in the U.K. and U.S.

○ It will not be achieved in my lifetime to get it up to the levels in the U.K. and U.S. It is not necessarily meant to be a pessimistic statement. Japan needs to decide what kind of governance framework it wants to end up with. Not necessarily to aim for the US and/or UK model.

Expectations for the SESC

○ I would like the SESC to push companies to adopt a more proactive approach to disclosure that goes beyond legal requirements.

○ It is important to "identify root causes" and "expand the release of information." There can be a myriad of root causes, but if any of them relate to group governance, you should perform an in-depth analysis of them, and further broaden information channels to give market participants a deep level of understanding.

○ To focus on transparency and accountability. Both when the SESC has taken action as a regulator and when it has not, the SESC should provide an explanation. It should be able to tell markets why it did not take action even though it had suspicions.

Conclusion

The following was recognized through this session.

Out of the U.S., Europe, and Japan, it was the U.S. that recovered fastest from the 2008 financial crisis. It is said that the difference was that compared with other countries, capital markets in the U.S. were far larger than anywhere else, and that is why they were able to bounce back quickly.

From now on the hope is that in Japan, too, capital markets develop and become stronger, that the investment chain functions properly, and that national wealth is created for Japan. During that process, the job of the SESC is set to become even more important.