An Interview with Nicholas E. Benes, Representative Director, the Board Director Training Institute of Japan (BDTI)

Corporate Governance Reform in Japan: Enhancing the Profile of Japan Inc.

Interviewer: Naoyuki Haraoka Writing: Chaobang Ai

History of Discussion on Corporate Governance

The corporate governance code in Japan issued at the end of last year is considered one of the vital reforms of the Japanese economy under the growth strategy of "Abenomics". Mr. Nicholas Benes, representative director of the Board Director Training Institute of Japan (BDTI), has been working on this topic for a long time.

JS: The Financial Services Agency (FSA) finally issued the draft corporate governance code in December last year. Could you please briefly explain your role in creating these rules?

Nicholas E. Benes, Representative Director, the Board Director Training Institute of Japan (BDTI)

Benes: For more than 12 years, I have been an ardent advocate for corporate governance reform in Japan. My background is as a trained lawyer, investment banker and M&A advisor, and I have sat as an outside director on many boards, particularly of troubled companies. In this capacity you come to see what is wrong with the system, and it becomes troubling at a personal level. It is painful to watch. Bad governance doesn't just damage shareholders — it is not good for customers, not good for the son of the founder who goes personally bankrupt, not good for a lot of people or for society in general. As an M&A advisor, you find that a deal that should get done does not get done, and as a result the company goes bankrupt later on. That sort of loss constantly occurs in Japan, when people cannot make the hard decisions due to dysfunctional governance.

I founded the BDTI because I saw that we while we have to improve legal structures and notions of "best practice", that is only half the equation. The other half of the problem is that many directors are not sitting there as board members, but rather as divisional heads. Instead of oversight, you have *tatewari* (vertical sectionalism) between insiders who lack the common skill sets that directorship requires. Whether they are inside or outside directors, many do not have enough knowledge about finance, or corporate strategy alternatives, or M&A, or corporate law, or governance theory and practice. If the other directors lack these common skills, then as an outside director on the board I can make my arguments, but I may not be able to convince them regarding many of the most difficult, important decisions that will save the company or influence its value in the future — because they are in their silos, and do not fully understand the topics I am talking about, or they just want to avoid confrontation.

For all these reasons, I proposed that Japan create a corporate governance code as part of the growth strategy. In the fall of 2013, I was advocating that adopting the principle of comply-or-explain in the new Company Law was much more important and powerful than anything else that could be done in this domain for years to come. It would legitimize that concept in the arena of corporate governance policy for the first time in Japan, and provide the base for immediately proposing a corporate governance code. I also stressed that the FSA should be in charge of the process of creating such a governance code, rather than the Ministry of Economy, Trade and Industry (METI), and that the logical place for the code to be reflected was in the listing criteria of the Tokyo Stock Exchange (TSE) and other exchanges, which the FSA is in charge of regulating.

So I was invited to make a presentation to the Liberal Democratic Party's (LDP) economic policy department, and my argument to them was several-fold. First, there was already a stewardship code, but for this to be effective there needed to be much more disclosure about corporate governance practices in each company, which in most countries is brought about through corporate governance code comply-or-explain disclosure. Secondly, the LDP needed "real meat" for its growth policy, and this code was the only thing it could propose soon and actually get done that year — 2014 — so as to impress investors that it was serious about making change in Japan, rather than having an empty quiver. Actually, governance improvement had been stressed in the American Chamber's "Growth Strategy Task Force" white paper that I led back in 2010, and many other themes in that report — for instance, the need to raise productivity — had percolated into the third arrow of Abenomics. So these were powerful arguments. Linking this code directly to the need for productivity increases as a key "pillar" of the growth strategy was what enabled the LDP to push forward with this reform.

A Positive Step

JS: What is your overall impression of this draft of the corporate governance code?

Benes: I think it is a good first effort, especially considering that it was done in a short time, in a country that has little history of debating the contents of a corporate governance code. My proposal, again, was pretty clear: the FSA should be in charge; a deadline, say within a year; enforcement via the TSE listing rules; compliance with OECD principles; and acceptance by foreign investors. I was very happy to see that the government put every single one of those criteria in the growth strategy.

The most important thing is that the code's very creation has instilled the concept that there is such a thing as "governance best practices" expected by society, investors and stakeholders, and that one of the board's roles is to strive to improve the quality of its members and practices so it will be more effective. Based on this concept, and the vastly enhanced disclosure about each company's governance methods that will arise from comply-or-explain, companies will further refine their practices as they explain and discuss with shareholders.

The FSA did a high-quality job of setting forth essential principles for things like the role of the board, disclosure about nomination and compensation policies, director training, and self-review by the board. All of these I had proposed to the FSA early on. These features establish a framework whereby companies will be motivated to improve their governance, in a sort of PDCA-style cycle. Because they must disclose their training policies and reasons for appointing each director, and subsequently must review the board's effectiveness and disclose their conclusions to investors, firms will be be motivated to refine their thinking and select more suitable board member candidates — both "internal" and "external" directors. No longer will companies be able to say, "Just trust us. We know what is best", without showing that they have a serious process and clear criteria in place for always trying to do *better*, mindful of the challenges the company will face, rather than just rewarding managers for loyalty to a certain CEO.

The most important thing the FSA and the advisory panel could have done better would have been to establish clearer standards — subject to comply-or-explain disclosure —encouraging the formation of committees composed only of independent directors. Such committees are needed to advise the board on nominations, compensation, and other matters where managerial self-interest tends to affect the result, such as management buy-out negotiations, investigations of misfeasance, and the use of takeover defenses. The draft code very nicely mentions the use of "executive sessions", which are meetings with only outside directors, and possibly including an outside statutory auditor. This is as I proposed, and sets the base for proposing an independent committee. But the part that actually mentions such independent committees to consider things like nominations and advise the board is far too vague on its purpose and requirements, and only says "a committee *mainly* composed of independent directors". This means the CEO could sit on such a committee and for all practical purposes control it, which is what

happens now. Further, this language is placed in the section on "Use of Optional Governance Approaches", which means that it will almost certainly not be subject to comply-or-explain disclosure. It is only suggesting the creative use of completely optional governance methods. In that case, investors may not be clearly told whether or not a company has formed such an independent committee, and what its procedures are. This is unfortunate, because those are two things that investors most want to confirm.

In addition, the number of "at least two independent directors" set 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. It would have been better to say "at least three".

JS: Who do you think will qualify as these multiple independent directors?

Benes: They will come from a variety of backgrounds, hopefully many with training and updated knowledge about relevant laws and governance practices provided by institutions such as the BDTI. After all, as one of its key comply-or-explain rules, the code encourages training of all board members and statutory auditors, and requires the disclosure of the company's policy about training board members. Very quickly, the role of independent director will expand from being one that is often taken by attorneys, Certified Public Accountants, ex-bureaucrats and professors, and more of these positions will be filled by executives who are still currently working, or those who have only recently retired. The idea that there are not many such persons in Japan is a myth. In fact, in Japan's "aging society" there are increasingly *many* recently retired persons who have much useful experience and would like a little extra income and activity. But based on my experience serving as an outside director, they need to be screened by some sort of orientation and training process, in order to be assured of high quality.

As a general rule, the best outside directors are those who are willing to admit they can always learn more, and that it is always good to *prepare* in order to make the best possible contribution to the company. There is no room for complacency on a board. I would much rather have next to me as a fellow board member a person with that level of dedication and sincerity, than someone who is "famous" but not very dedicated or willing to spend much time at his or her duties.

Enhancing Productivity — One Merit of the Corporate Governance Code

JS: Do you think this code will help to raise productivity and growth?

Benes: There are only three ways to grow an economy: you expand capital, expand labor, or expand productivity. Japan has a declining labor pool, which will be extremely hard to expand, and already has an abundance of capital. The problem is that much of this capital is not very productive. Productivity is therefore the key to Japan getting out of its fiscal predicament, and the reasons for low productivity are specifically tied to lack of labor mobility, lack of an M&A market, and lack of rigorous governance. One of the ways you can tell this is from Japan's consistently negative "exit effect", which is to say that in many sectors of this economy the more productive companies are leaving, going offshore, or just not doing business anymore, raising the percentage of low-productivity or even "zombie" companies who are being propped up and have no other alternative but to stay. This lowers average productivity in that sector. Firms should leave the market, but they do not. This is intrinsically closely tied to the inability of Japanese companies to get out of non-core business, or for banks to pull the plug on zombie companies; the creative destruction process is not happening. It is a governance issue.

So will the code increase productivity? I think it will. The timeframe *depends* on the company; some will "get it" faster than others. But this code will bring about a sea change in Japan on a number of fronts. The big one is that what was once a sacred cow — the rhetoric that we do not need much corporate governance here because Japanese management is just fine the way it is — will no longer be persuasive.

Instead, it is now national policy that improving corporate governance is a good thing, so no more trivial debate is needed about fundamental issues.

Secondly, Japan has established in the minds of the public, investors and companies alike, the concept that there is such a thing as "best practice" in governance that goes beyond the minimum requirements of the company law. Corporate governance for many years in Japan meant formalistic board meetings where we just rubber-stamp everything to satisfy the minimum requirements of corporate law, but now the concept of best practice, and of constantly improving it, has taken root.

Thirdly, as a result of the stewardship code and the corporate governance code together, we will have an environment that recognizes and talks about how sustainability depends on profitability. These are topics that are now being actively discussed and that people are taking more interest in.

Other Positive Effects of the Code

JS: Do you think Japan will be able to better attract foreign direct investment (FDI) thanks to this reform?

Benes: Indirectly, yes. It reflects the improved governance climate here, and the transparency of capital markets, which is always viewed as an advantage for FDI. People dislike the opaque non-transparency in places like China, conversely. Better governance also means more pressure from shareholders to focus on core businesses, and getting rid of non-core assets, some of which will be bought by foreign investors. At the same time, this has the potential to significantly improve profitability and productivity in Japan.

A major reason you have low FDI in Japan is that you have such a small M&A market. The domestic M&A market is about one-fourth or one-fifth the size of that in the United States or the United Kingdom, in proportion to GDP. That is because many non-core assets and business lines never get sold. So yes, better corporate governance will free up more investments for foreign direct investors, that is true.

JS: As corporate governance becomes more efficient and productivity rises, would we also expect wages to increase?

Benes: Well, that depends. My opinion is that the present position the government is taking to pressure companies to raise wages is not a long-term solution. Companies raise wages when they have enough profit to do so and want to keep their employees motivated. The real flow of cause and effect is that if we raise profitability, we will have more money this year, and then we can give you a bigger bonus or raise your base wage. This dynamic will take some time to work its way through the economy. So to expect wage increases soon is unrealistic. Having said that, it all depends on the industry. Some of the companies with domestic production in cars, for example, benefit massively from the weak yen, and so should be able to increase wages sometime soon, and should want to reap the advantages of retaining domestic production.

Stewardship Code & Corporate Governance Reform

JS: Will the Stewardship Code adopted by the FSA last February also be useful to achieve the goals of this corporate governance reform?

Benes: When I was proposing the corporate governance code to the LDP, I argued that a stewardship code, by itself, is only one wheel on a car. In order for it to be effective, you need much more disclosure about corporate governance practices in each company, or you are in a position of telling institutions to be stewards under conditions where they do not have enough information to be good stewards. Facilitating greater information flow is usually done through corporate governance code comply-or-explain disclosure. My point was that "without a corporate governance code, you will soon be criticized for having a stewardship code that is ineffective because investors do not have enough disclosure."

As an investor, I look at your strategy, your past financials, and so on, but in terms of engagement and stewardship, the most important thing I want to make sure of is that you have a the best board in place, which selects the best managers. And so assessing your governance practices is really the most important thing, because what it also ensures is that you are selecting the right people as directors on an ongoing basis. If you have to explain why you selected these particular people to be your directors under comply-or-explain principles, and if you explain in your disclosure very badly, you will have meetings and dialogue with investor signatories of the stewardship code who will ask some very tough questions. In other words, comply-or-explain sets up an environment where it is likely, under the stewardship code, that investors will be asking you a lot of follow-up questions about things like your policy for selecting directors, or how you measure their effectiveness as board members, or what concrete policies the board is putting in place to improve capital allocation and raise return on investment (ROI). I have great hope that this process will be effective in Japan. Japanese people tend not to like tough questions or conflicts and confrontation, so may find it in their interest to observe the spirit of the reforms early on, rather than just formalistically going through the motions.

Need to Raise High-Quality Board Directors Increasing

JS: Finally, this code also highlights the importance of board director training. How do you think this can be achieved effectively, and how might the BDTI contribute to it?

Benes: The trouble in Japan is that for so long there have been no rules about director training. Prior to the BDTI's certification by the government, there had never even been a statement by the government, ever, that governance training is good for society and good for companies. Almost every country in the world has some kind of rule or guidance about board training, saying it is beneficial and in general companies should do it. Japan does not. Thus there is no demand for governance training — and if you think about this, it is ridiculous, because companies are going to investors and providing, say, four lines of resume information from which they cannot know whether its director candidates know anything about company law, or corporate governance practices, or reading financial statements, or what a director's most important duties are. And yet those shareholders are asked by the company to vote for those candidates. The company says to investors: "Just believe us — they have never been directors before, but they will do a good job."

The most important thing we do at the BDTI is not just to impart knowledge. We teach that directing is a different job than managing, and that the role of a director is to say "what needs to be said, when somebody needs to say it." We provide the topics that constitute the minimum knowledge you need to know as a director, and go through them enough to help you understand the role and your strengths and weaknesses, so that you then can go out and study more in the future. That is the correct mindset to have: that as a director you are always learning, and if you think you no longer have anything to learn, then you will not be as effective as a director as you should be. What we can do is give people this mindset, that becoming a better director is something you constantly strive for, with a full understanding of how essential your role is for the company and for society.

We have many programs, including e-learning as well, and anybody can apply for our one-day intensive courses in English or Japanese. Over the last three years, about 440 people in total have received director training from us. We have done two-day courses in the past, and probably will again in the future as demand increases, or perhaps provide a second-level course. We also do customized training for particular companies if they hire us to do so, but much of the content is similar material.

We go over all key aspects of corporate law, securities law, corporate governance and the role of directors in decision-making, but also focus on very practical subjects — such as board practices, global management, and basic finance — that you should know as a director. We cover reading and understanding financial statements, because this is where many Japanese managers are weakest even though it relates directly to increasing return on equity (ROE) and productivity. And at the end of the day-long courses, we do various case studies that teach key lessons about effective governance practice.

The wonderful thing we have found about Japanese people in this area is that when you explain the topics logically, everybody gets this stuff. People get excited, because it all starts to make sense: why we have corporate governance rules, or why certain practices are useful, or what a director's most important roles are. The most frequent and important comment we get in feedback is: "Thank you, because I finally really understand what being a director is all about". They are basically saying, "I never really understood how a director was different from a manager and what I was expected to do. And I was a director! Now I understand." I admire this honesty. JS

Naoyuki Haraoka is editor-in-chief, Japan SPOTLIGHT, and executive managing director, Japan Economic Foundation.

Chaobang Ai is a writer, editor and blogger living in Tokyo.