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Corporate Governance Reform (4)

—*Outside Directors*—

May make outside directors mandatory, increase their independence

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Summary

- Japan's Ministry of Economy, Trade and Industry (METI), Financial Services Agency (FSA), and the Tokyo Stock Exchange (TSE) have set up investigative committees to examine the corporate governance of listed companies.

- Although many listed companies are under no obligation to appoint outside directors, nearly half do so. Still, there is a view that such directors should be mandatory for all listed firms.

- There are also calls for standards regarding the independence of outside directors, since many institutional investors question whether they are genuinely separate from management.

- This report looks at current issues regarding outside directors, and outlines the investigative committees' deliberations.

What is an Outside Director?

Two issues have been raised regarding outside directors in Japanese companies:
(1) Making their appointment mandatory;
(2) Reinforcing their independence.

Outside directors are independent academics and other specialists with no vested interest in a given company, appointed to reinforce supervision of its board. Outside directors must never have been employed by the company in question. (For precise definition, see Corporate Law Article 2.15.)

Outside directors not mandatory

For companies adopting a "committee" system (three committees: nomination, compensation, audit), a majority of each committee must be outside directors (Corporate Law Article 400.3). In contrast, companies using the conventional "auditor" system (one audit committee) are not required to have outside directors.

No established standards regarding independence

Japan's Corporate Law contains no regulations on the independence of outside directors. However, shareholders expect outside board members (directors and auditors) to be independent of company presidents and other executives. Two sets of rules guarantee shareholders access to relevant information. The Corporate Law requires companies to release profiles of outside director candidates in shareholder meeting reference materials before appointment. Then, once the outside director

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has been appointed, their independence and business activities are disclosed in a business report. Meanwhile, the TSE requires listed firms to issue a report providing shareholders a clear explanation regarding that company's corporate governance status. This report must disclose the attributes of each outside director and their connections with the company.

Investors determine independence based on disclosed info

These documents are to disclose any information that might call into question whether an outside director has a vested interest in a company, or whether they are related to anyone connected with the company. Based on this information, institutional investors apply their own standards to gauge the outside board members' independence.

Issues Regarding Outside Directors

Should Appointment of Outside Directors be Compulsory?

Most listed companies use the auditor system, which does not require outside directors. While in practice nearly half of these firms do have outside directors, many appoint only one, which casts doubt on whether their supervisory function has any teeth. The investigative committees discussed whether it should be mandatory to appoint a fixed minimum number or percentage of outside directors.

Should Outside Directors be More Independent?

Although outside directors are elected at shareholder meetings, it is often the company presidents who choose the candidates. The fact that these executives are hand-picking their own supervisors has been raising questions. Thus, there is a view that regulation is necessary to reinforce the independence of outside directors.

Moves by Institutional Investors

Some institutional investors think outside directors should be a stronger force, and some go so far as to call for real independence.

Institutional investors judge independence by own standards

For instance, Japan's Pension Fund Association has a policy of voting against proposals to appoint directors if (1) there is not a fixed percentage of outside directors or (2) there is any doubt regarding the independence of outside directors. A number of investment companies and insurers adopt the same approach.

Further, some overseas investment funds have been known not only to vote against company-nominated candidates, but to put forward their own candidates. There have also been attempts to force companies to appoint outside directors by amending their articles of incorporation. However, this does not always result in the selection of a neutral outside director. This is a major difference between investment funds, some of which make active use of their shareholder rights, and pension funds/insurance companies.

Examples of Fund Shareholder Proposals Regarding Outside Directors — **Chart 1**

	Proposing Shareholder	Company	Proposal	Outcome
2008	The Children's Investment Master Fund	J-Power	Amendment to articles of incorporation (add at least 3 outside directors to board)	Rejected
	Effissimo Capital Management Pte.	Gakken	Removal of Gakken president Yoichiro Endo	Withdrawn
	FS Fund 1 (managed by FCA Consulting)	Kitazawa Sangyo	Appointment of directors	Rejected
2007	Safe Harbor Master Fund	SNT	Appointment of directors	Rejected
	HSBC Fund Services Sparx Asset Management Corporated (managed by Sparx Group affiliate)	Pentax	Appointment of directors and auditors	Withdrawn

Source: Shareholder meeting notifications and decisions; compiled by DIR.

Debate on Compulsory Appointment of Outside Directors

OECD recommends appointment of independent outside directors

Calls for compulsory appointment of outside directors, with the expectation they provide effective boardroom oversight, are nothing new. There is a strong view in Japan and overseas that outside directors are needed to improve corporate governance. In 2004, the Organisation for Economic Co-operation and Development (OECD) adopted a revised version of the *OECD Principles of Corporate Governance* that contained a new recommendation related to good practice, including the appointment of independent directors. This version states, "Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest." [1]

Calls in Japan to reinforce function of outside directors

In addition, the Japan Corporate Governance Forum published *New Corporate Governance Principles* in December 2006 [2], asserting that although outside directors are not legally required, every board should have at least two in order to ensure a reasonable supervisory function. It stresses the need for these directors to be completely independent.

Nippon Keidanren's opposing view

There are also strong arguments against mandating the introduction of outside directors, and against increasing their independence. A case in point is Nippon Keidanren's (Japan Business Foundation) frequent opposition (Chart 2). In June 2006, it published a report on what corporate governance should look like in Japan, reiterating its earlier claims and opposing changes to the rules regarding outside directors[3].

Nippon Keidanren's Claims — **Chart 2**

Compulsory appointment of outside directors	Greater independence
Need to consider differences in other countries' systems ➢ No proof external directors have any bearing on company performance ➢ In US, authority tends to center on management, supporting argument for independent board members, but situation different in Japan. Need to ascertain results from reinforcing auditor role and introducing committee system ➢ Role of auditors under Corporate Law strong enough ➢ Information on corporate governance well disclosed by companies	Need to select outside auditors/directors based on comprehensive aptitude ➢ Qualifications should cover character, insight, and ability, and not simply candidate's relationship with company. ➢ Unnecessary restrictions hinder appointment of promising candidates

Source: Nippon Keidanren; compiled by DIR.

Investigative Committees' Discussions

The METI Corporate Governance Research Team, FSA Study Group on the Internationalization of Japanese Financial and Capital Markets, and the TSE Informal Committee have deliberated over the compulsory appointment of outside directors and considered increasing their independence.

No common understanding regarding function of outside directors

It seems the key to these issues lies in the function an outside director is expected to have. Assuming it is to improve a company's earnings, it is difficult to actively promote their compulsory appointment when there is no proof of a correlation between their presence and profit/share price. On the other hand, it is easy to argue in favor of appointing an independent outside director if their role is to oversee management, even though it is hard to rate their effectiveness in this role, or compare their performance to the auditor system.

[1] http://www.oecd.org/dataoecd/32/18/31557724.pdf (page 66)
[2] http://jcgf.org/jp/publishment/pdf/CGPrinciple20061215.pdf (Japanese only)
[3] http://www.keidanren.or.jp/japanese/policy/2006/040.html (Japanese only)

Institutional investors do not necessarily think outside directors exist to improve earnings. The *White Paper on Corporate Governance in Japan* published by the Asian Corporate Governance Association in May 2008[4] draws upon the views of influential US and UK institutional investors, stating that Japanese companies give management almost total autonomy and, in their opinion, seldom provide real, independent supervision of management decisions. The paper claims this is obscuring management transparency. Further, it states that, "The presence of genuinely independent directors also provides an important safeguard against the potential for managerial self-interest and weak execution of company strategy." Rather than actively increase company earnings, institutional investors seem to expect outside directors to prevent companies from making decisions that would work against the interest of stakeholders.

Chart 3 lists the arguments discussed by the three committees.

Issues Under Discussion by Three Committees — **Chart 3**

METI Corporate Governance Research Team	FSA Study Group on the Internationalization of Japanese Financial and Capital Markets	TSE Informal Committee
Minutes from 2 December 2008 ▪ See more cons than pros to compulsory appointment of outside directors: (1) not a cure-all; (2) outside directors unfamiliar with companies' operations and may slow decision-making; (3) may be difficult to secure qualified talent. ▪ Supervisory/monitoring function not complete under current auditor system. Outside directors could help fill this gap. ▪ Outside auditors expected to have same supervisory function as outside directors, so great independence important.	**Minutes from 10 February 2009** ▪ Appointment of outside directors should be responsibility of companies after going public. Having auditors would not fully cover lack of outside directors, as auditors have no voting rights. ▪ While it may be sensible to appoint outside directors to placate foreign investors, intrinsic effectiveness unclear.	**Minutes from 18 March 2008** ▪ Appointing outside directors common practice globally. In Japan, though, companies with auditor system produce higher earnings than those with outside directors. Necessary to convey effectiveness of Japanese corporate governance style. **Minutes from 26 September 2008** ▪ In addition to shareholders, directors not directly involved in company operations could keep eye on managers from shareholder standpoint.

Source: Minutes of each committee; compiled by DIR.

A major obstacle to using outside directors is the traditional Japanese practice of appointing directors from inside the company. There also are doubts about whether outside directors can fulfil the role expected of them. Further, if it becomes mandatory for all listed companies to appoint more than one outside director, human resources competent for the position could soon be depleted. While these are key factors in opposing opinions, the dominant view is that making outside directors obligatory (the case overseas) is one viable course toward improved supervisory function.

Autonomy to go to shareholders

As explained earlier, the Corporate Law does not oblige companies to appoint outside directors unless they adopt the committee system. However, there is certainly no prohibition against doing so, and if shareholders wish they can select candidates from outside the company to challenge management. The rarity of such behavior is probably a reasoned choice on the part of most shareholders. Furthermore, management teams aiming to attract foreign investors are likely to consider changing to a corporate governance structure that is easier to explain to foreign investors. Thus, since clear roads to the reform of corporate governance already exist, it seems Japanese shareholders and managers are happy with the status quo regarding outside directors.

If outside directors are shown to be effective and shareholders start asking for them, we think companies will appoint them in numbers without being forced to do so. Rather than pushing new systems that are not proven to be effective, we think the decision should be entrusted to shareholders.

[4] http://www.acga-asia.org/public/files/Japan%20WP_%20May2008.pdf

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