

The Pathway to “Strategic Boards” with Independent Directors in Japan

Regulatory Exhortation, Investor Dialogue, and Self-Interest



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No Turning Back Now

- Recently, key regulators* such as the FSA, METI, and the TSE have, variously, acknowledged that:
 - Japan's stock markets face a credibility problem with regard to corporate governance, and greater protection of minority holders is necessary**
 - Traditional reliance on statutory auditors as the source of “independence”, often results in inadequate governance and investor protection**
 - The traditional assumption that statutory auditors are sufficiently “independent” merely by virtue of having no vote, no longer stands
 - Inevitable implication: a legal or exchange rule defining “independence” for the first time, is just a matter of time. (Don't look now, but the dam just crumbled.)
 - Regardless of shareholder opinions, all directors have the duty to make their own independent decision in the case of TOBs, and to ensure that an “independent” committee actually *is* independent

* Or what is virtually the same thing, advisory “study groups” that they have established and led.

** See the Appendix on the last page.



“It’s All Up to You Now, TSE”

- FSA* and METI* have concluded that:
 - THEREFORE, more “independence” on Japanese boards is necessary, as a general matter
 - THEREFORE, “most likely”, more independent directors on Japanese boards are needed
 - Boards with one or more independent directors, should probably be the “model” that companies should follow
 - At the very least, companies should be required to: (a) have at least one independent external director or statutory auditor, or (b) if they do not, explain/disclose as to why they do not; and (c) increase dialogue with their investors about their governance structures and the composition of the board
- TSE has been requested to change its listing rules to “put something like this in effect”

* Or what is virtually the same thing, advisory “study groups” they have established and led.



Can You Hear the New Word?

- The new word in town, is “**independence**”
 - Presently, this word is not defined anywhere in Japanese law, in the context of directors or statutory auditors.
 - “Outside” does not mean “independent”. The CEO’s brother, mistress, favorite lawyer, or best friend, can all be “outside directors” under the law!
- Superficially, some sort of beefed-up disclosure that looks like “comply or explain” is not too hard to implement....
 - The TSE already requires companies to submit reports (disclosed on its web site) about their corporate governance practices and structure
- But in order to adopt even this loose regime, will not the TSE have to define “independence”?
 - To not do so, would make Japan a laughingstock. “Comply or explain” about “independence”, without defining the latter ? Comply with what?
- Defining “independence” will be a seminal change



Japanese Managers are Much More “Exposed” Than They Realize

- “Access to the Proxy” has been a reality in Japan for decades. The minimum level, 1% or 300 voting units, is not a large investment
 - Under the new Company Law, a vote by 50% of a quorum can replace the entire board at any time. Some companies have a 34% quorum! $50\% \times 34\% = \text{only } 17\%$
- Depending on the company, there is now a significant possibility that director candidates proposed by companies may not be elected
 - Examples of factors accelerating this trend: (1) Glass, Lewis policy to vote against the top man on any board slate without two independent outside directors; (2) rules may be adopted to require disclosure of all cross-shareholdings, and disclosure of aggregate voting records of insurance companies and institutional investors
- Far beyond U.S.-style “say on pay”: per the Company Law, corporations specify an absolute ceiling on all director compensation in their Articles
 - *Further:* (1) most directors would receive very small “severance compensation” if terminated; (2) many companies have adopted 1-year director terms in the name of “good governance”, and are abandoning the “retirement allowance” system; so the protection provided by Article 339, is often both inconvenient and negligible
- “Joint shareholder proposals” are easy (and even easier now, per recent changes)
 - If individual Japanese investors ever combine to submit joint shareholder proposals, boards of neutral independent outsiders could become a reality overnight



What the Future Holds

- Smart companies will see the writing on the wall
 - These firms will seek to preemptively differentiate themselves as leaders in improving governance
- Independent external directors will appear in increasing numbers*
 - A widening gap between smart and capable companies, from slow and unconfident companies...in part, reflected by stock prices
- For the first time, the chance to create true “strategic boards”, that add great value to management *while* monitoring and benefiting shareholders and other stakeholders as well
 - But at present, very few executives can see how such a board might benefit them
 - And almost no one in Japan knows how to design and run such a board...i.e., a “real” board, that actually has constructive debates and sets strategy and policy
 - Henceforth there will be a need for training (3-4 days intensive courses) of both internal (executive) and independent insider appointees to boards, in order to create consensus and cultivate common practices, principles, and knowledge base...and to certify *all* director candidates to investors as being worthy of appointment



The Upside for the Market is Clear...

- Japan's Company Law makes it possible to jump ahead of the U.S. system of governance...
 - ...and create an even more rational one that better promotes the long-term interests of all shareholders and stakeholders
- A very small number of legal changes and/or new rules will help a lot
 - Still needed: TSE or Company Law amendment requiring a minimum level of independent outside directors. The DPJ's "Manifesto" suggests this, as part of a "Public Companies' Law" that it proposes (a concept rejected by the LDP-supported bureaucracy so far)
 - Amendment of the Company Law to permit any type of company to create legally valid committees, and to permit the board to legally delegate decisions to committees
- But even without legal or regulatory changes, in terms of market reality the train has just left the station. Smart companies will see this



...But the Transition Will Require Effort

- Even if there were laws/rules requiring independent outside directors, and permitting legally valid committees, there would still be an intense need for services to:
 - Identify quality external director candidates,
 - Train and certify *all* director nominees (including executive appointees)* in intensive joint training courses, and
 - Foster consensus between executives and “committed, independent” outsiders regarding practices
- The fostering of consensus and common practice will create “strategic boards” that realize the full potential of “independence”
 - This will be harder and will take more time than sitting back and watching nominal numbers of outside directors** increase...but will add far more value
- Needed: an independent foundation that combines best world-wide practices with Japanese legal reality and emerging experience, to “raise the bar” re training and foster this consensus

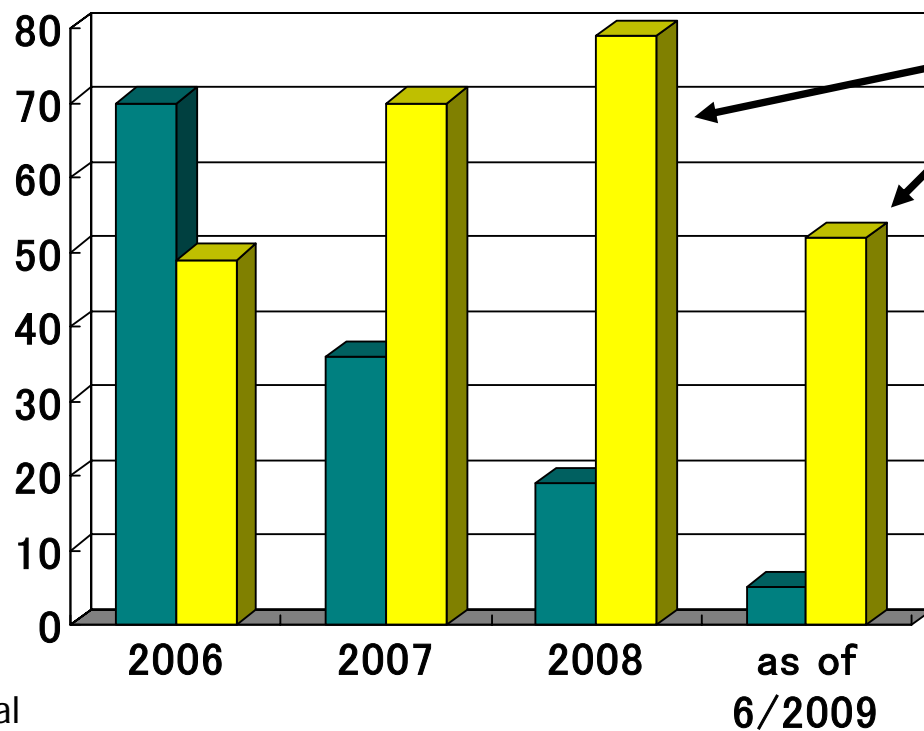
* Comparative reference: RiskMetrics Group lists 92 “Accredited Director Education Programs” in the U.S on its web site. To my knowledge, there are NO programs in Japan that compare to these.

* Remember, “outside” does not mean “independent”.

Appendix

The Market Needs Better Governance and Protection of Minority Holders to Revitalize It

TSE (all sections): Total # Companies, IPOs, De-listings



The result of consolidation, insolvencies, take-private deals, making subs 100%-owned, compliance issues, and securities fraud cases
But regardless of the reason, many of the investors in these companies had a bad experience...especially individual shareholders. And over the past few years, many foreign investors have left the market

Number of total companies listed on TSE exchanges:*

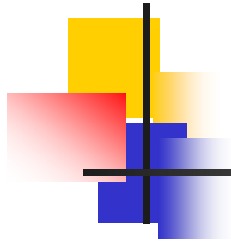
2416

2414

2389

2364

* Discrepancies in chart vs. these #s result become some "new listings" are just transfers from Hercules or JASDAQ.



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