Provisional Translation

Opinion Statement for the Twenty First Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code

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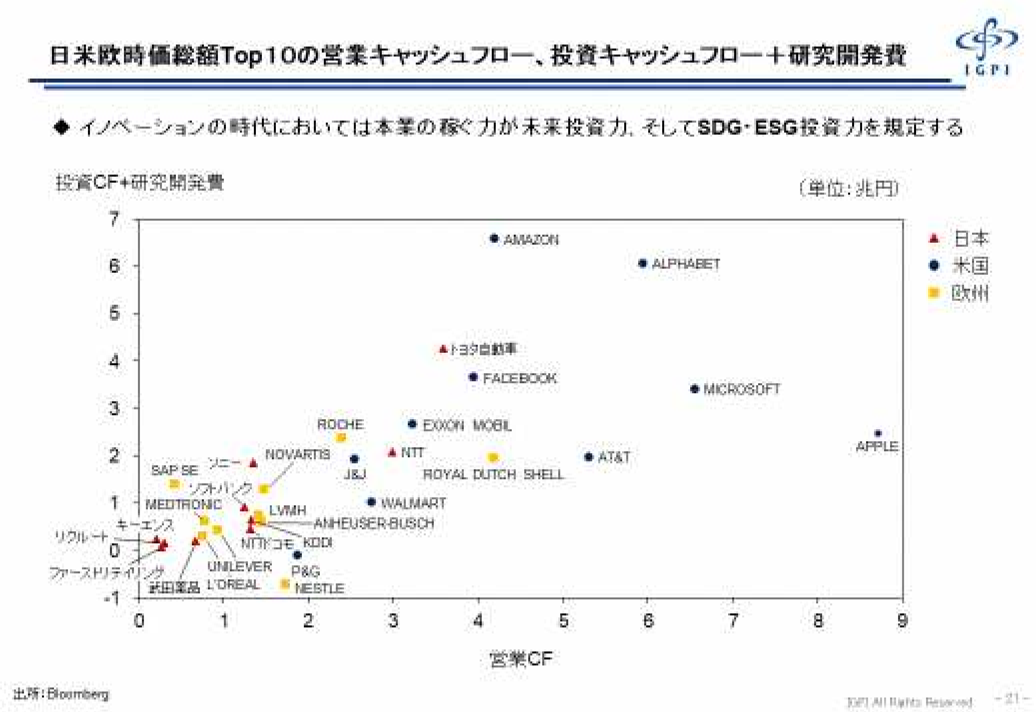
Kazuhiko Toyama

Japanese companies need strong management if they are to prevail in an era of disruptive innovation with digital transformation (DX) accelerating due to the pandemic, and thereby contribute to economic growth and the formation of national wealth. To do this, companies must appoint outstanding management teams, bringing legitimacy and supporting the appropriate functioning of the board. If this is not the case, it is vital that companies have the framework in place to replace the board if required.

As the graph below suggests, the real reason why Japanese companies underperform their Western counterparts in terms of ability to invest for the future is the insufficient earnings power of their core businesses.



The lack of operating cash flow, which is essentially equity that is created by the company (risk capital that does not need to be repaid), means Japanese companies are reluctant to invest in high-risk innovation. This reduces companies’ ability to search out and leverage the benefits of disruptive innovation, undermines the transformative power of their business model and consequently leads to a decline in growth potential and earnings power. Over the past 30 years, this has created a vicious cycle in which Japanese companies' earnings power and ability to invest for the future are reduced. The same is true for SDG/ESG investment which is a topical issue. Thus the large gap in the earnings power of core businesses directly leads to the difference in ability to invest in SDGs and ESG.

The starting point for breaking out of this vicious cycle is the establishment of strong management leadership. In terms of governance, moreover, a strong board should appoint a strong management team and endorse strong leadership. If this fails, there should be a mechanism in place, both in name and reality, to replace the board as appropriate. From this point of view, the following points should be included in the Corporate Governance Code.

① Membership of the nomination committee

The nomination committee should include independent directors with a range of management experience. In addition, in case of companies in the "prime market", the nomination committee should also comprise a majority of independent directors.

② Diversity and composition of independent directors

As a whole, the board should incorporate different aspects of diversity, such as professional background (particularly experience in management or professional executive roles, such as CFO, in different companies), nationality and age, as well as gender. Furthermore, companies in the "prime market" should in principle have a majority of independent directors.

③ Ensuring executive diversity

In order to appoint outstanding management teams, it is necessary to have outstanding management candidates. In an era of discontinuous change due to disruptive innovation, the diversity of the pool of candidates is also important. This diversity should also apply to choosing whether to hire new graduates or mid-career employees (including rehiring former employees), as well as to gender, nationality and career path. I believe an effective way of promoting the diversity of such candidate pools over the long term is to set optional numerical targets for women, foreigners and mid-career hires to management level appointments.

④ Responsibilities and diversity of inside directors

Inside directors fulfill a role as directors of the company as a whole when they attend board meetings. In many cases inside directors are not fully aware of this; they will often just attend board meetings as a representative of the department they are in charge of. The role of inside directors is important as a way of addressing the asymmetry of information that occurs with independent directors. The Companies Act expects that inside directors should be prepared to criticize internal matters, as necessary, from the viewpoint of the entire company. This should be noted in the Corporate Governance Code.

In addition, the diversity of inside directors, especially mid-career hires who have worked at or have management experience from other companies, is vital insofar as they can criticize internal matters without being so bound by “unwritten rules”. The Corporate Governance Code should clarify the encouragement of diversity amongst inside directors to the same extent as the emphasis on executive level diversity in ③ above. This is a strong incentive (for both individuals and the company) to promote diversity at the executive level.

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