Let the Outsiders In:

Reforming Japanese Corporate Boards

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Japanese companies are rushing to fill board seats with outside directors, following the enactment of new corporate governance reforms by Prime Minister Shinzo Abe's administration in June. As part of the LDP's ambitious economic stimulus plan, popularly known as "Abenomics," a Corporate Governance Code has been promulgated for the first time in history. The Code urges all publicly traded companies to appoint at least two independent outside directors to their boards. Though not a legal requirement—as is the case with most governance codes—companies that fail to adhere to this principle of the Code must explain their reasons to their shareholders. Abe's boardroom shakeup is designed to make Japanese companies more transparent and responsive to shareholders, to boost investor confidence, and to attract foreign capital.

But appointing more outsiders to boards is not a panacea that will immediately change the business culture of Japanese companies,with their famously compliant boards. Instead, companies must hire experienced, globally-minded senior executives to their boards

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Historically, Japanese companies have been governed by insider boards composed primarily of senior members of the management team. There is little to no independent oversight. But nearly 20 years of economic stagnation—China surpassed Japan as the world's second largest economy in 2010—and the recent series of high-profile scandals at companies such as Toshiba and Olympus have drawn attention to the country's lax corporate governance laws. According to Sustainalytics, Japanese companies have the lowest average governance ranking of developed markets, in line with their lack of corporate oversight and gender diversity. In 2004, for example, more than 70 percent of companies listed in the first section of the Tokyo Stock Exchange (TSE) had no outside directors. Though that figure has dropped precipitously in the past decade—only a quarter of these TSE companies still had no outside directors by 2014—the culture and function of Japanese boards has yet to catch up.

External directors are essential to holding management in check and ensuring that shareholder interests are prioritized. Accordingly, most developed—and even emerging—economies have regulations ensuring a certain percentage of board members are outsiders.

Prime Minister Abe's 2-by-2020 campaign, then, is a step in the right direction. And Japan is quickly advancing in the numbers game. Currently, 94 percent of publicly traded companies on the first section of the TSE have at least one outside director. The percentage of companies with two or more independent outside directors—the proportion suggested by Japan's new corporate governance code—has jumped to 48.4 percent from only 21.5 in 2014.

But simply bringing in outside directors is not enough; the choice of board members is crucial. Many Japanese companies appoint so-called outsiders that are neither independent nor truly outside the fold. According to a 2013 survey by ProNed, 62 percent of external director positions in Japan were filled by the chairman and/or CEO through personal connections. That often means relatives, friends, company attorneys, celebrities, or executives from connected companies or banks. These members add little in terms of management oversight and are often more loyal to their executive connections than to shareholders—a problem the corporate governance code was designed to remedy, not exacerbate.

Shinzo Maeda, former president and CEO of Shiseido Co. LTD, the largest Japanese cosmetic company, and a recently appointed external board member at Toshiba, explains: "Japanese companies historically have evolved from family companies that were private for many generations with family member CEOs. When they go public, they like to maintain the same make up of family members in

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key executive positions, including board members, which are usually comprised of family members and friends. This has led to problems as witnessed with several recent cases like Olympus, Toshiba, and Asahi Kasei, to name a few. We now have a corporate governance code which we all need to follow. I am completely supportive of these new guidelines that must be enforced."

The role of boards in Japanese companies also needs to be strengthened for the addition of real outsiders to make an impact. Corporate boards in Japan often have little say in executive succession and have no real decision-making power, as the major strategic decisions are usually determined ahead of meetings and simply rubber-stamped by the board. This inadequate supervision of management also leads to chronic underperformance, as lifelong corporate employees are often risk adverse, to the peril of shareholders and potential profits. Consequently, Japanese companies provide consistently lower returns on equity than do their American and EU counterparts. Increasing the number of outside directors is one important step toward fixing that problem.

Nicholas Benes of The Board Director Training Institute of Japan (BDTI), the initial proposer of Japan's Corporate Governance Code, says, "The differences in return on equity (ROE) are startling. A famous government report in Japan pointed out that Japanese publicly traded companies' ROE only averages 5.3 percent, compared with 22.6 percent in the U.S. and 15 percent in Europe."

As part of his Abenomics reforms, Prime Minister Abe has also urged companies to hire more female executives and board members. He has called this vital for sustained economic growth, particularly because of Japan's aging population and its below-average female labor participation rate. A McKinsey report found that women account for only 1% of executive-level management positions in Japan and hold a mere 2% of board seats. Women are thus a crucial, untapped well from which to source the next generation of independent outside directors. "While the number of female executives in large, listed companies is small, female executives are prevalent in small and midsized companies. If companies were more open-minded and not just looking for 'familiar names from major companies,' an experienced recruiter would be able to scout these women as director candidates," says Benes.

Another issue is the small number of foreigners serving on Japanese corporate boards. Benes points out that "a Harvard Business School study showed that if a company's foreign revenues are, say 60 percent of the total, about half that number—that is, 30 percent—of its senior executives and board directors should be of foreign nationality, or statistically it will lose competitiveness over time. But foreign directors continue to hold less than one percent of board seats in Japan. This doesn't make sense, at a time when Japanese companies are trying hard to 'globalize'." Though that one percent

figure has remained stagnant for the past 15 years, the new Code will likely ignite change. As more companies search for outsiders to fill their boards, some will invariably look beyond their shores to fill a seat or two.

"Success of a Japanese board is created by understanding the cultural context and pushing for the right agenda," advises Seiko board member Carsten Fischer, one of the few foreigners on a Japanese board. "In some cases there seem to be fewer transparent and forward-looking discussions in the board compared to other regions, partly because the executive branch is not always comfortable giving up control. Asking the right questions in the right way goes a long way I found."

Ultimately, what matters most is not how many outside directors a company has, or whether they are female or foreign, but whether those outside directors are truly independent and resolute about holding management accountable and prioritizing shareholder interests. Currently, only one percent of board vacancies in Japan is filled by an executive search firm. But that will likely change with this surge in demand for new board and executive hires. By helping find and vet the next generation of globally-minded, experienced directors, executive search firms can play a vital role in modernizing and reinvigorating Japan's stagnant economy.

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