ICGN
International Corporate Governance Network

Ensuring board quality with independence and diversity
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As the world's third largest capital market, Japan is a geographic priority for global investors. With over 30% of equity held by foreign investors, we share a common imperative with Board Directors of Japanese companies to preserve and enhance long term value contributing to sustainable economies world-wide.

ICGN Members are based in 49 countries representing assets under management in excess of US $34 trillion. We have engaged in with policy makers to support corporate governance reforms in Japan for over two decades. More recently we have welcomed reforms under the auspices of Japan's Revitalisation Strategy such as the Corporate Governance Code (2017) and Stewardship Code (2016). These important principles are instrumental incentives for sustainable growth by helping to build relationships between companies and investors as described by Professor Ito in his seminal 2014 Report.

It is now time to put these 'principles' into 'practice'. A priority is to ensure that Boards in Japan are truly effective in their role to promote the long term success of the companies they serve. In doing so, boards must have unbiased leadership, be appropriately diverse and ensure independent directors are willing and able to constructively challenge management.

ICGN welcomes the increase of companies in Japan with two or more independent directors from 21.5% in 2014 to 91.3% in 2018. We are particularly pleased to note that the companies with more than one third of directors have increased from 6% to 34% during the same period. However, we respectfully suggest that this momentum is expedited to ensure that all publicly listed corporate boards in Japan benefit from a significant element that is fully independent – at least one-third independent directors or a minimum of three to ensure fully independent board committees.

Independent directors play a crucial role in constructively challenging management, free from external influence. They can help offset the domination of decision-making by any single individual such as the Chairman and or the CEO and generate healthy debate around a company's vision, mission and strategy. Independent Directors must also have the requisite business skill and knowledge of the sector(s) of operations to help generate this healthy debate. The value of independent directors will only be fully realised when the board is appropriately diverse to allow for a mix of business and industry knowledge and perspectives.

The emerging situation with Nissan is an example of why it is so important that the momentum for reform is progressed as expeditiously as possible. While we could not have anticipated the misconduct of the Chairman and former CEO of Nissan, this example does highlight the very important need for robust independence on corporate boards in Japan and the importance of effective board committees, led by independent directors, such that decisions by executives are subject to robust challenge and debate, and the accuracy of public disclosures is fully tested.

Board quality is dependent on board diversity. Diverse Boards and management teams are less prone to 'group think' and more likely to embrace new approaches to meet future company threats and opportunities. This allows for better business decision-making which ultimately leads to better financial returns and long term value creation.

A Board's approach to diversity should be described in a publicly disclosed 'Diversity Policy' including measurable targets and a time period over which such targets will be achieved. If a company has chosen not have such a policy, it should explain why it reached the conclusion that such a policy was not appropriate for it, and identify any risks or benefits associated with the decision not to have such a policy.

It is helpful for Boards to disclose a skills matrix aligned with the company's long term strategic needs to aid board succession planning. This should be complemented with information on gender and ethnicity, supported by individual biographical information. In 2017, 16% of US S&P500 companies disclosed a board matrix showing how individual director skills connect to the company's strategy and risk profile according to data from EY.

Boards should set targets over a 3-5 year time horizon and report on progress in meeting the targets by identifying the specific proportions of women in the company both at a board and senior management level. Disclosure around any obstacles that companies face in achieving targets is useful. This sheds light on any industry-specific impediments to achieving diverse corporate leadership which may need to be dealt with by policy makers.

Lengthy director tenure can be problematic in some markets and a major barrier to board quality. Board service should be contingent on individual director performance and annual re-election premised on satisfactory evaluations of his or her contribution to the board. This process would allow for long-standing directors to step down, thus unlocking vacancies to enable appropriate board diversity to improve board quality.

An effective review of board evaluation and regular refreshment should be led by the Nomination Committee. A board evaluation conducted by an external consultant once every three years can help inform candidates of strategic relevance to the company. The role of Nomination Committees includes the development of diversity criteria, engagement of search firms and the consideration of candidates on the basis of their experience and skills (i.e. not to tick a quota box). A report from the nomination committee explaining how they considered the representation of women in director selection and board evaluation is useful. The report should include the skills matrix and the committee itself should include female directors to lead by example!