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Japan's Corporate Governance Code: A UK Perspective

The importance of good corporate governance has been highlighted by corporate scandals across various industries in most major economies. This has led to significant effort being devoted to the development of global standards and guidance around corporate governance. In this context, the Japanese Financial Services Agency ("FSA") released the final version of its Corporate Governance Code ("Japanese Code") on 5 March 2015, which was implemented by the Tokyo Stock Exchange ("TSE") and entered into force on 1 June 2015.

In the UK, the Corporate Governance Code ("UK Code") is set by the Financial Reporting Council ("FRC") which is responsible for promoting high quality corporate governance and reporting to foster investment. Whilst the principles of good corporate governance may appear self-evident, the UK experience shows that their actual implementation is often challenging. FTI Consulting has made a comparison of the UK and Japanese Codes and outlined a number of areas where the UK experience might provide valuable lessons.

At the international level, the Organisation for Economic Cooperation and Development (OECD), an international body with the objective to promote policies that will improve the economic and social well-being of people around the world, has developed Principles for Corporate Governance.

The Japanese Code reflects OECD Principles and elements of the UK Code. Most notably, the Japanese Code adopted the 'comply or explain' principle established by the UK Code which requires firms to either adhere to its principles or explain why it would be disproportionate to do so given a firm's particular circumstances.

There are a number of key themes that are similar in the Japanese and UK Codes.

Responsibilities of the Board

It is critically important that Boards are composed of a group of people that collectively have the experience, knowledge and authority to fulfil its obligations. The Board is responsible for setting the firm's strategy and corresponding risk appetite. The Board must also carry out competent oversight over the executives, ensuring they are executing the business strategy within the risk appetite.

Independence of the Board

Firms are required to appoint at least two Independent Non-executive Directors ("INEDs") with the aim of providing an independent perspective and challenge to the Board and executives. INEDs have specific roles that place them at crucial decision-making positions. They are expected to bring knowledge of the external market to the processes of formulating strategy and mitigating risks.

Internal Risk and Control Framework

Boards must ensure that the firm's systems and controls are set up in a way to provide effective and proactive risk management. This includes the establishment of appropriate systems and controls and management information that demonstrates the monitoring of the same. This must be overseen and reviewed by the Board on a regular basis which needs to be evidenced in disclosures about risk management systems.

Engagement with Stakeholders

Honest and fair dialogue with a firm's stakeholders, in particular its shareholders, is seen as vital to good governance and to ensure accountability of the Board and executive management. This should consider the needs and rights of minority shareholders and ensure their views are taken into account when setting company strategy.

Lessons from the UK Experience

Implementing corporate governance in a practical and invulnerable way is often much more challenging than outlining the guiding principles. Below, we take a look at the areas where the UK experience may provide valuable lessons.

Board Composition and Challenge

For a Board to be effective at overseeing the firm and challenging management, there are three key areas that firms must get right. Firstly, a Board must consist of directors who have the right mix of technical understanding, strategic vision and financial and regulatory knowledge. Firms should invest considerable time in getting this mix right, identifying candidates with specific expertise in one or two of these areas rather than cursory knowledge of all. Secondly, a Board is strongest when it is led by a strong, independent chair who encourages discussion and challenge. Whilst separation of the roles of chair and CEO is not a requirement in the Japanese Code, it has been shown that firms with such arrangements outperform those which combine both roles.

Thirdly, a Board is only as effective as the Management Information (MI) it receives and reviews. The Board should play an active role in defining and requesting such MI rather than relying solely on executives to provide them with the information they deem necessary.

Making Good Use of INEDs

INEDs are often perceived as the guarantor of proper challenge and the rights of minority shareholders and other stakeholders. This is only true where they have been empowered by firms to play this role. The group of INEDs, just as the Board as a whole, should possess the right mix of knowledge and understanding of the firm's key business and risk areas. In the UK, the case of the Co-operative Group is an illustration of how independent directors may be ineffective at holding the executive to account.[1]

Further, to understand and oversee the business, INEDs must be placed at key decision-making positions. This means they should lead key Board committees. In the UK with its unitary Board structure, this typically means that INEDs chair the Nomination, Audit and Remuneration Committees. Whilst the structure in Japanese firms may be different, as required by regulation, the UK experience shows that effective challenge from INEDs can only occur where they occupy such key positions.

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Board Education

A big part of a Board's ability to challenge the executive is the level of the Board members' understanding the business and its operating environment. To be able to do so, Board members need to be kept abreast with developments in technology, business strategy and regulation. Firms need to invest in ongoing education programmes and Board members should actively request education for themselves within the firm and also beyond.

Risk Management Frameworks

The multitude of corporate scandals from Olympus in Japan to Volkswagen in the U.S. and Europe has highlighted the importance of having proper internal controls in place that can identify risks early and mitigate them effectively. Whilst risks might differ, the process of risk identification and management/mitigation is similar across industries.

Typically, firms are organised into lines of defence (most industries operate two lines, others three lines). Each line carries responsibility for identifying risks, mitigating or managing them and actively monitoring them. The frontline business is typically referred to as the first line. Whilst it is mainly occupied with generating revenue for the firm, it must also understand, evaluate and manage the risks it brings into the firm. This is vital and probably the area where most firms fail as short-term revenue generation is prioritised over the consideration of medium to long-term risks.

The second line is manifested in the Risk or Compliance functions which must be independent of the business. The second line should have separate reporting lines from the business and be represented at key committees within the firm. This will ensure that Risk and Compliance staff are empowered to raise concerns and challenge the first line.

Culture

Corporate culture describes the shared values and attitudes held by the employees of a firm. Recent failings, in particular in the financial services industry, have highlighted the importance of culture for how well a firm will deal with issues such as conflicts of interest. Policies and procedures can set out rules for appropriate behaviour. However, such rules might not cover

1 http://www.co-operative.coop/Corporate/PDFs/Myners/Report_of_the_Independent_Governance_Review.pdf

A positive culture encourages employees to speak up and challenge behaviour where they believe it might harm the firm or its clients. To achieve this, firms should make honesty and integrity an essential part of hiring decisions.

all circumstances and even where they do, a corporate culture that prioritises revenue generation over the interests of customers or shareholders will lead employees to seek ways to circumvent the existing framework.

The UK experience has shown that corporate culture is hard to change but has also identified a number of key enablers. Firm Boards and senior management are required to clearly set out what is acceptable and desired behaviour — and what is not. They are also expected to demonstrate these in performing their roles. This is referred to as getting the 'tone from the top' right.

This needs to be supported by an incentive structure that rewards desired behaviour. For example, bonus schemes should seek to take into account the fair treatment of customers and compliance with internal policies.

A positive culture encourages employees to speak up and challenge behaviour where they believe it might harm the firm or its clients. To achieve this, firms should make honesty and integrity an essential part of hiring decisions. Managers should adopt an open-door policy where they are accessible to all staff. Firms should support this with a formal whistle-blowing policy that allows employees to raise concerns confidentially and outside their line management.

Conclusion

Standards for corporate governance are important for establishing a level-playing field among firms and guiding boards and senior managers on what good looks like. However, such standards rarely provide practical advice on how to deal with the specific circumstances of the firm and the operating environment it finds itself in.

That is where the lessons from other countries and industries can be helpful. FTI Consulting has extensive experience in working with firms across a number of industries, helping them with setting up the right structures, recruiting the right people and keeping abreast with the developments relevant to the industry and the individual firm.

We would be delighted to discuss the challenges of your individual firm with you and explore how we could help you.

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Jeanette Lichner
Senior Managing Director
+44 20 3727 1316
jeannette.lichner@fticonsulting.com

Ben Fouracre
Japan Representative & Senior Director
+81 3 5369 3933
ben.fouracre@fticonsulting.com

Florian Nitschke
Senior Consultant
+44 20 3727 1572
florian.nitschke@fticonsulting.com

Sayaka Kobayashi
Senior Consultant
+81 3 5369 3934
sayaka.kobayashi@fticonsulting.com

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