Corporate Governance in Japan

Don't be afraid to turn the Black Ships away this time 20th Aug 2015

Mike Newman

Executive Summary

No corporate governance code is perfect

Prime Minister Abe has thrust the Corporate Governance Code (the 'Code') on companies in Japan with the aim of bringing the country in line with best practice abroad. Its introduction has been widely welcomed by the investment community, even if in their view it is somewhat late and perhaps not enough. To be clear, Japan is right to focus on a code that fits its needs.

Exhibit A

First, **NO** corporate governance code is perfect. Take *'The Public Company Accounting Reform and Investor Protection Act'*, better known as the *Sarbanes Oxley Act (SOX*) as Exhibit A. Introduced in 2002 after a plethora of scandals (most famously - WorldCom, Enron and Tyco) it pushed the requirement for 'fiduciary duty to shareholders, corporate compliance and ethical behaviour' through greater independence in the boardroom.

SOX failed

Unfortunately SOX has failed as have many codes in other jurisdictions. While the composition of boards may have changed with the introduction of independent directors, investor losses have hit new records – Global Financial Crisis (GFC), HP, Tesco, Petrobras, Penn West, HealthSouth, Parmalat, GSK and the list goes on. So before critics beat Japan over the head for any shortcomings of its new 'Code' they should look in their own backyard first. Japan's new 'Code' is not focused on monitoring like SOX. It is a major difference.

Trust – the critical intangible

Good corporate governance is about building a culture of trust (both inside and outside the boardroom). Japan should be aiming squarely at building structure around that trust. However gatekeepers must show consistency and prosecute criminal corporate behaviour regardless of market capitalisation. There is no quid pro quo here. Any loss of trust undermines confidence. After the relatively soft treatment of Olympus, the market will be watching closely to see if the regulator will flex its new powers with regards to the Toshiba accounting scandal. If Japan wishes to highlight to the world it has changed it must set an example. Furthermore, Auditors and Rating agencies should not escape punishment either for being asleep at the wheel.

Over regulation not the answer

However, over-regulation is **NOT** the answer. If reporting requirements are too onerous it will drive (foreign and/or domestic) issuers away, which in turn damages liquidity and exacerbates the cost of market access.

Japanese corporates should embrace the 'Code'

The message for Japanese companies is simple. Forget SOX as a prerequisite. A well-managed company should never feel threatened by the number of independent directors challenging consensus in the boardroom. Good governance is being open to constructive criticism. If a company has lacked strategic direction for years, a fresh perspective from independent minds is invaluable.

Companies must focus on qualitative aspects when hiring independent directors over quantitative parameters. Soft options to meet minimum regulatory requirements to protect the status quo is a recipe for failure. Independent directors should not be viewed as an 'unavoidable cost' but as a 'wise investment' for firms. Which company would rationally choose inferior staff for its operations? Would an airline actively seek unqualified pilots to fly its passengers? That is not the way of sustaining good reputation in the long run.

No need to fear activists

Stewardship code

Japanese companies must accept they are listed entities and cannot dictate who owns them. With the stewardship code aligning investor interests, corporates must better understand their own shareholders. Shareholder lists are always changing and trusts can obscure the underlying owners. As companies become larger the shareholder ratio shifts from individuals to professional institutions.

Firms must invest more in investor relations (IR) to handle higher demands for information and enable its IR to work as integral outlets of good corporate governance. Management must embrace IR's role and not treat it as a cost centre. Good IR teams keep management informed of shifts in ownership, hot topics and can be invaluable in managing crises.

Stock incentives encouraged

Stock incentives as a part of total compensation remain tiny for the majority of Japanese corporate management. Management compensation better aligned to shareholder returns would be welcomed. Evidence shows that higher internal ownership leads to better performance.

TSE needs to maintain orderly markets

The message for Japan's stock exchange is simpler. As the market watchdog, its role is to maintain an orderly market and promote adequate risk pricing without excess volatility. It should ensure that all companies first release information via the exchange and not media outlets. Distribution to subscription-based services, a growing part of the media, means that 'information' becomes privileged and not fairly distributed.

The new JPX-Nikkei 400 Index championing best practice corporate governance is a positive step. It would have been more powerful to immediately remove Toshiba from the Index once the accounting scandal became public. Toshiba will be removed on August 31st through a regular index reshuffle. The exchange could have enhanced its reputation which would reinforce market confidence and drive liquidity. This would ultimately fortify TSE revenue.

No need for over-regulation…

…but need adequate funding

Japanese regulators have the most important role to play. The justice system must not compromise even if it has to set precedent by seeking the maximum penalties for criminal behaviour including lengthy jail sentences. This does not call for over-regulation which has shown itself to be ineffective in preventing illegal/unethical behaviour. If the cost of compliance becomes too onerous it ends up impacting those playing fairly.

Regulators need adequate funding to invest in technology to catch anomalies in growing market segments (e.g. high frequency trading) and hire competitively in the marketplace for best-in-class investigators. Japan's FSA is underfunded on a global basis.

Best turn the Black Ships of Best Practice around

"I always pass on good advice. It is the only thing to do with it. It is never of any use to oneself" – Oscar Wilde

SOX has not protected investors

SOX, despite claims, has been ineffective in protecting investors since its introduction in 2002. SOX did not prevent the Global Financial Crisis (GFC) or many other corporate crimes. The same can be said of similar regulations in other jurisdictions around the world.

Malfeasance hasn't stopped post Lehman either

Fail

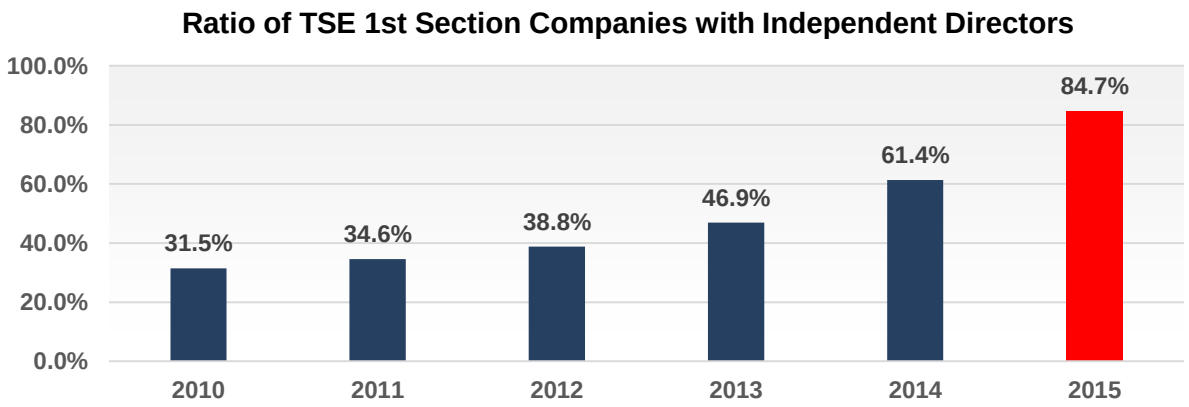
Despite the harsh lessons that should have been learnt post Lehman Shock, ever greater levels of regulation have failed to cease questionable corporate behaviour - Tesco, HP, Petrobras, Penn West, GSK, HealthSouth, Stanford Financial, BP, Parmalat and a litany of banks have all been thrust into the spotlight for all the wrong reasons. Investor losses have dwarfed pre-SOX levels. The best practice framework designed to prevent market malfeasance has only led to higher transaction costs and increased volatility, two unwelcome outcomes.

Harmonisation difficult

Harmonising corporate governance standards across the globe is not without its challenges. US Treasury Secretary Jack Lew is pushing for this. We need to be cognisant of the differences in individual country culture when locking in roadmaps. SOX was set up as a monitoring tool. Japan's 'Code' has been set up to improve shareholder returns and improve the mid-long term health of Japanese companies. It is a major point of difference.

China

China's own corporate governance framework will be done in context with its own priorities. China is pragmatic and will develop a code which seeks market efficiency to activate its massive savings pool without over burdening compliance. The Chinese are not wanting to tread the depths of poor governance but they won't accept failed policies no matter how well intentioned. To that end Japan should set its own agenda, independent of other countries.



Source: TSE

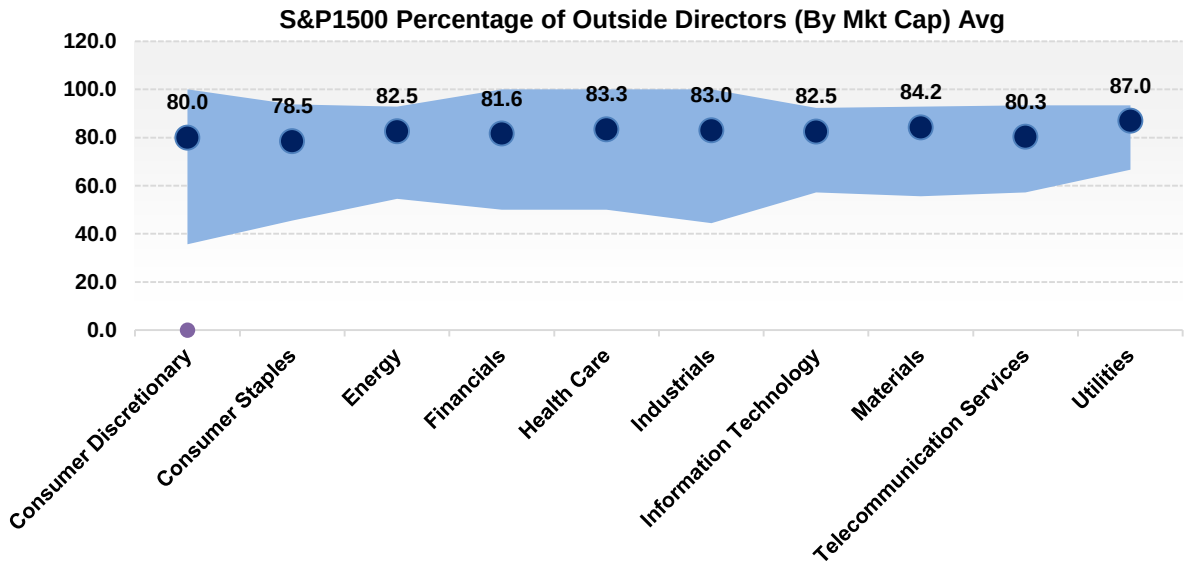
Mindset issues

Encouraging corporates in Japan to introduce a minimum of two independent directors under a new 'Code' is definitely a step in the right direction. Still improving board behaviour is a mindset issue, not a regulatory one. A successful company should be willing to encourage open debate. More so for a company that has been struggling for years with its strategic direction. Both would benefit from fresh perspectives offered by independent minds. Corporate governance should be embraced.

Putting SOX in perspective

Independent directorship on S&P 82%...

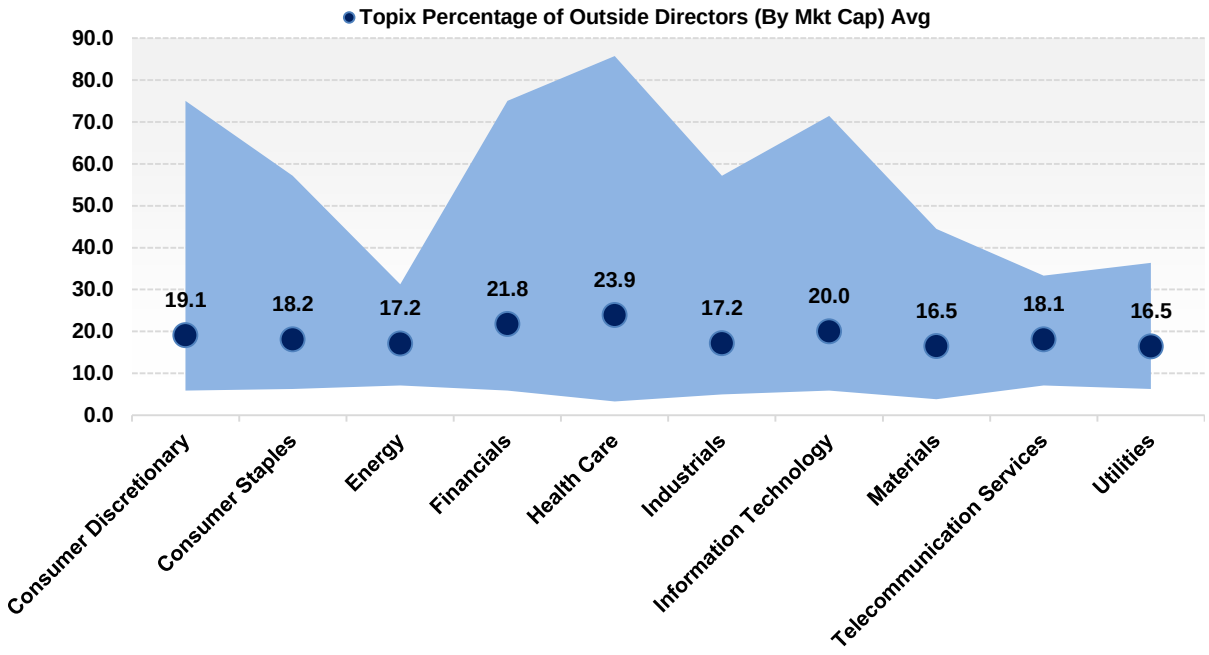
The Sarbanes Oxley Act mandated in 2002 that all members of a listed firm's audit committee must be independent. The NYSE and NASDAQ followed up shortly after adding a majority of independent directors as a listing requirement. The chart below highlights the level of independent directors for the S&P1500 by GICS sector. The blue bands represent the upper and lower levels for each sector. Most recently independent directors comprise on average 82% of board composition.



Source: Custom Products Research, company filings

…Japan at 19%

For TOPIX listed companies, independent directors make up 19% of board composition. TOPIX 500 is 18%. The top 10% by market cap on TOPIX is 25%.

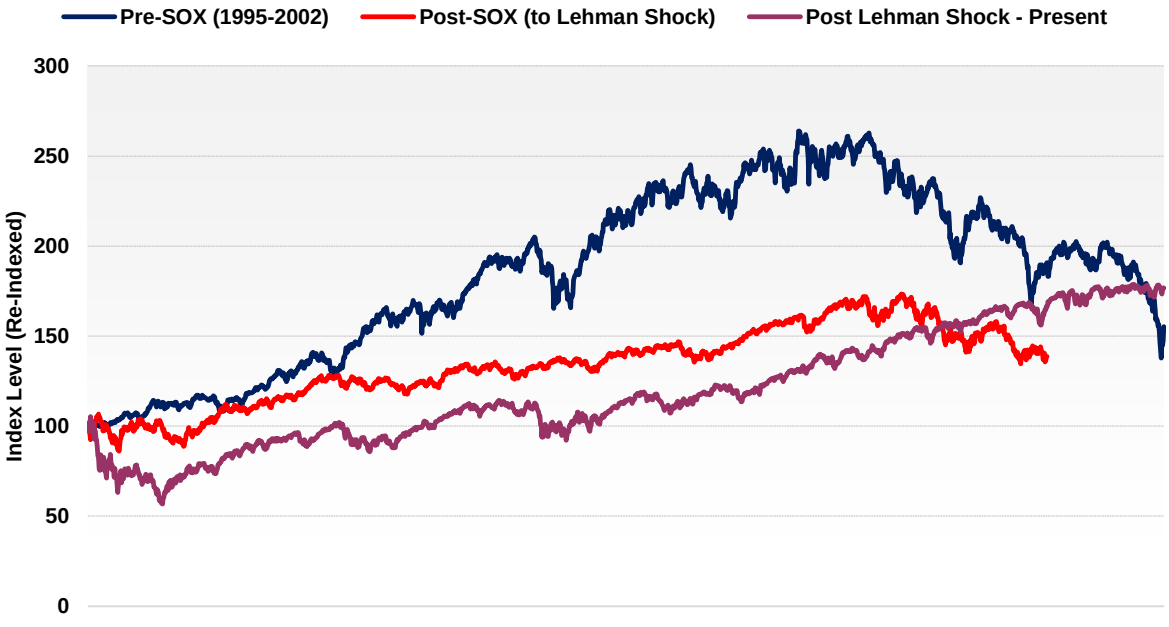


Source: Custom Products Research, company filings

Has regulation made a difference to performance?

Ambiguous

The following chart is ambiguous to say the least in linking corporate governance to better performance. In the period pre-SOX (1995-2002) the euphoria created by the 'internet bubble' drove total returns to those 'irrational exuberant' levels.



Source: Custom Products Research

GFC

In the period immediately after SOX market performance was more muted but the demise of Lehman Brothers in September 2008 and the ensuing GFC brought markets to a halt again.

Following on from Lehman Shock, the S&P500 has reached new highs in 2015. The following study sheds some light on the importance of board member share ownership and price performance.

In short, regulation has not made a difference to market performance but good governance seems to.

Does governance cause performance or the other way around?

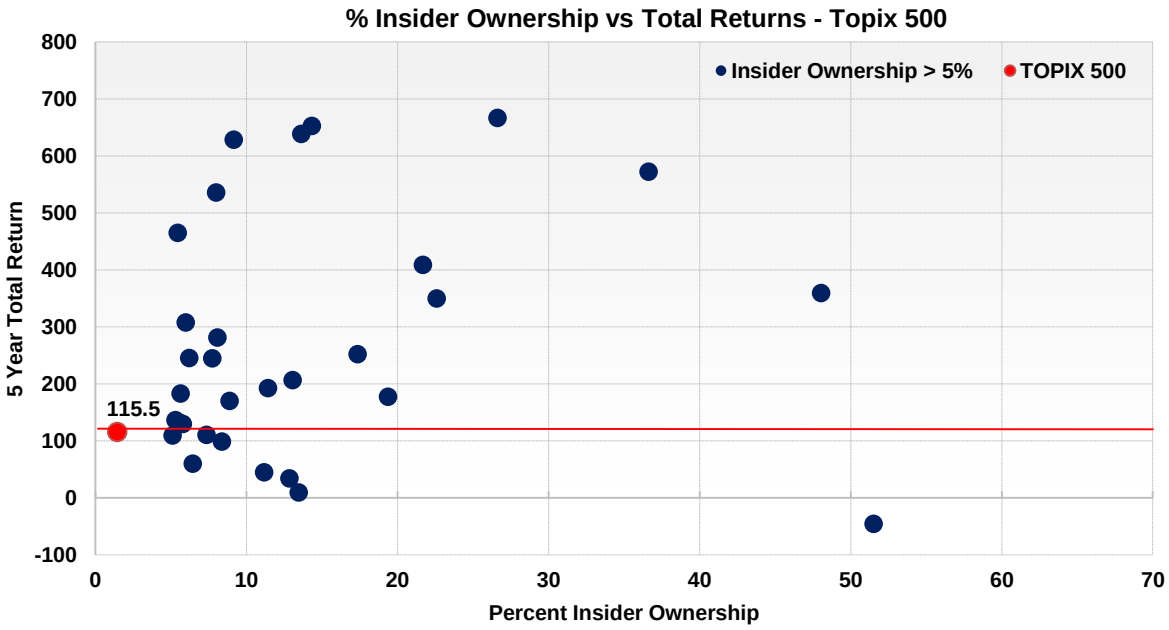
Review of SOX

Will better governance necessarily improve performance? A 2009 study from *Bhagat & Bolton* titled, *'Corporate Governance and Firm Performance: Recent Evidence'* wrote its findings with respect to the SOX introduction in 2002 and whether regulation had an impact on behaviour,

Stock ownership by insiders important

"The stock ownership of directors is consistently positively and significantly related to performance through each of the sub periods."

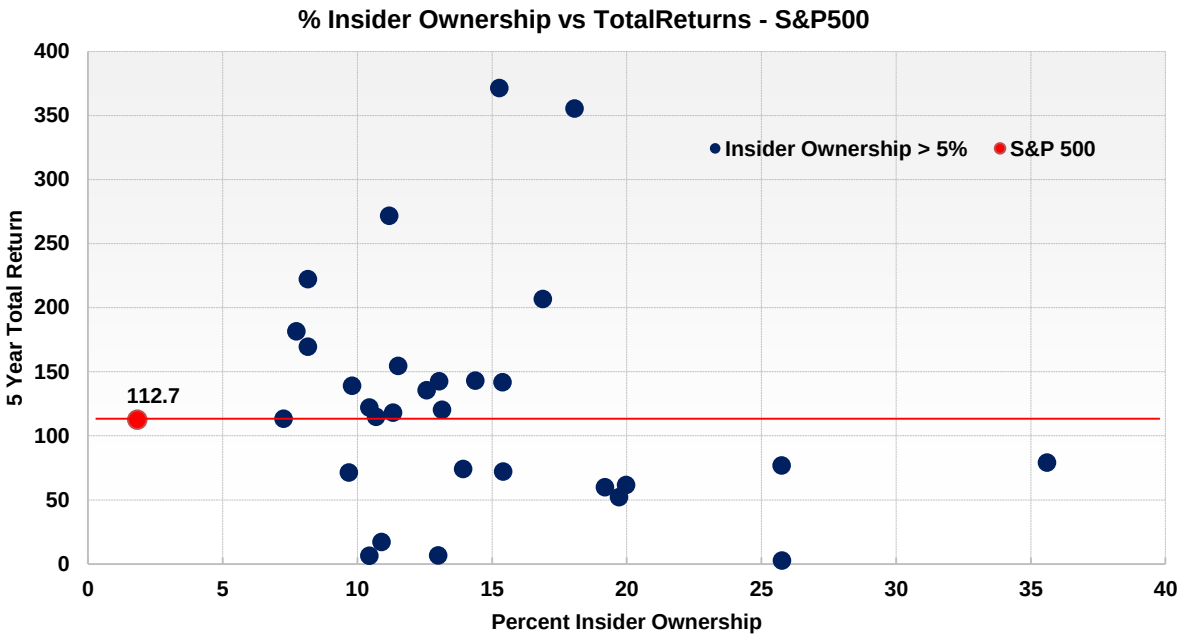
They also make the observation that; *"We find that board independence and direct stock ownership appear to be effective governance mechanisms."*



Source: Custom Products Research, Company filings

Qualifying Bhagat & Bolton

When qualifying Bhagat & Bolton's claim of direct stock ownership (using 5% or more of outstanding stock) in the Japanese equity context we see that those stocks outperformed the benchmark index. US stocks also experienced a similar trend. Not surprisingly having one's personal wealth invested in one's company should create a sense of wanting to create value.



Source: Custom Products Research, Company filings

Japan's approach to corporate governance – a good start.

The initial resistance to independent directors in Japan

While there was initially strong resistance to mandatory independent directors by the industrial lobby to the Democratic Party of Japan's (DPJ), it eventually found support with the Liberal Democratic Party (LDP) and the Keidanren to follow a 'comply or explain' edict on corporate governance. The new amendments on external directors were to prevent companies from stacking the board with previously considered 'outside' (e.g. relatives) but not 'independent' directors. If companies chose not to appoint 'independent' directors they need to explain that rationale to shareholders.

Comply or explain

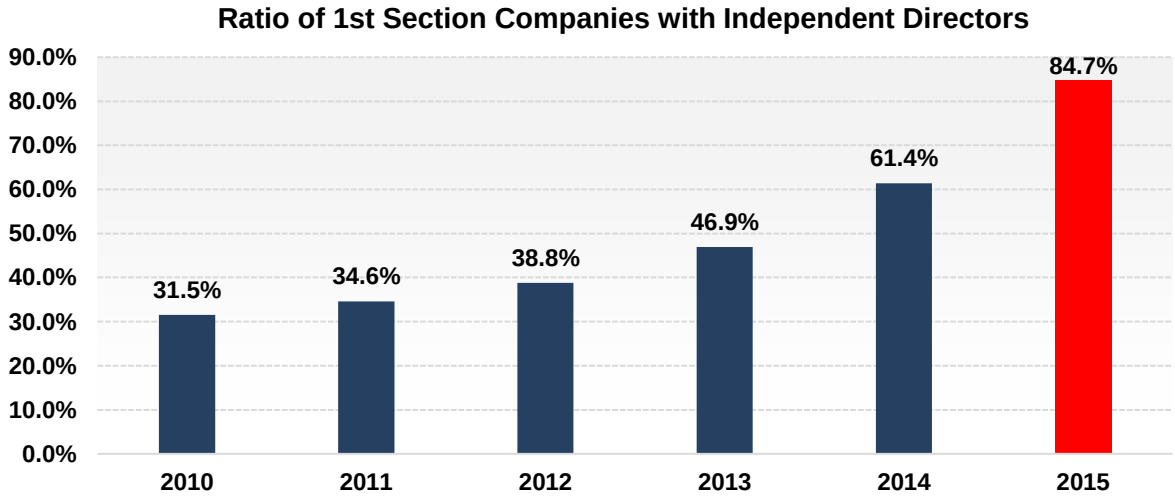
Since June 2014 the LDP has pushed through legislation which essentially 'strongly encourages' companies to 'comply' rather than face the embarrassment of 'explaining' why it doesn't need independent directors at AGMs, in proxy statements and in exchange filings.

The new Japanese Corporate Governance Code makes it very clear that the boards should:

Frank, active board meetings

"…Endeavour to select independent director candidates who are expected to contribute to frank, active and constructive discussions at board meetings…independent directors should…aim to contribute to the sustainable growth of companies and increase corporate value over the mid to long term. Companies should appoint at least two independent directors that sufficiently have such qualities…"

The Tokyo Stock Exchange (TSE) has highlighted the sharp uptick in corporate compliance in board diversification and independence.



Source: TSE

Rational hiring policy

While this is an admirable achievement we still think there remain potential question marks on the value added quotient of some these independent directors. Soft options to meet minimum regulatory requirements to protect the status quo is a recipe for failure. Independent directors should not to be viewed as an 'unavoidable cost' but as a 'wise investment' for firms. Which company would rationally choose inferior staff?

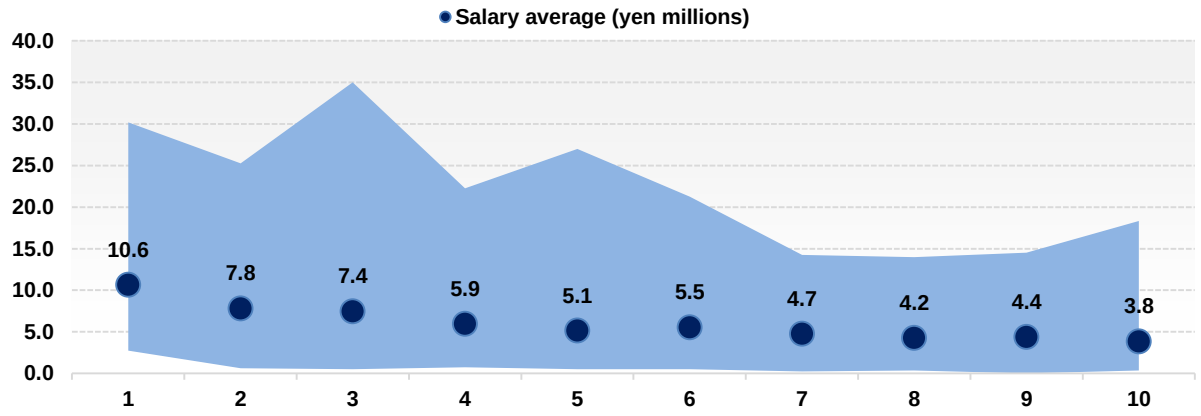
Not the quantity…

…but the quality

Companies must focus on qualitative aspects when hiring independent directors over quantitative parameters. A well-managed company should never feel threatened by the number of independent directors challenging consensus in the boardroom. Good governance is being open to constructive criticism. If a company has been struggling for years with its (lack of) strategic direction fresh perspectives from independent minds are invaluable.

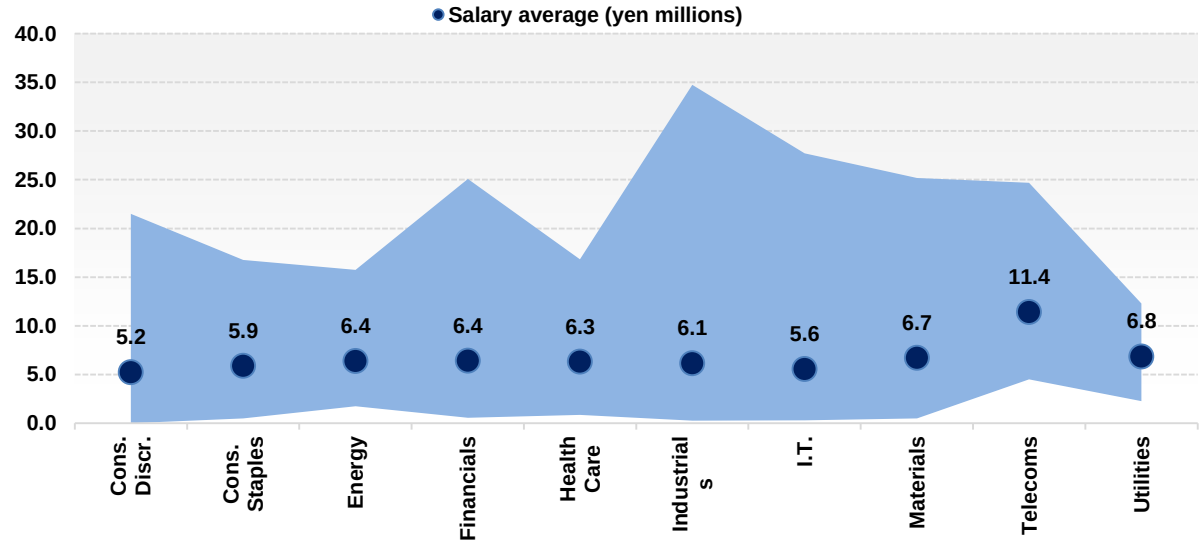
Average salaries

Average salaries paid for independent directors in Japan varies, typically by market cap from around ¥3.8mn to ¥10.6mn. The chart below shows the bands for salaries within market capitalisation split by deciles ("1" being the largest cap to "10" being the smallest)



Source: Custom Products Research

The following chart looks at independent directors salaries by sector.



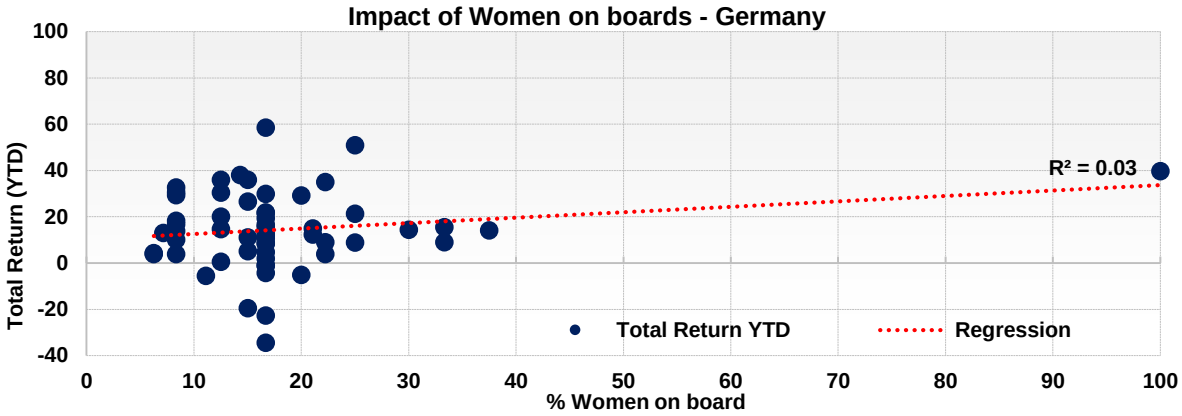
Source: Custom Products Research

No minimum

The Code also makes it clear that companies should not just meet minimum standards but should aim for independent directors to comprise one third of the board.

Women on boards

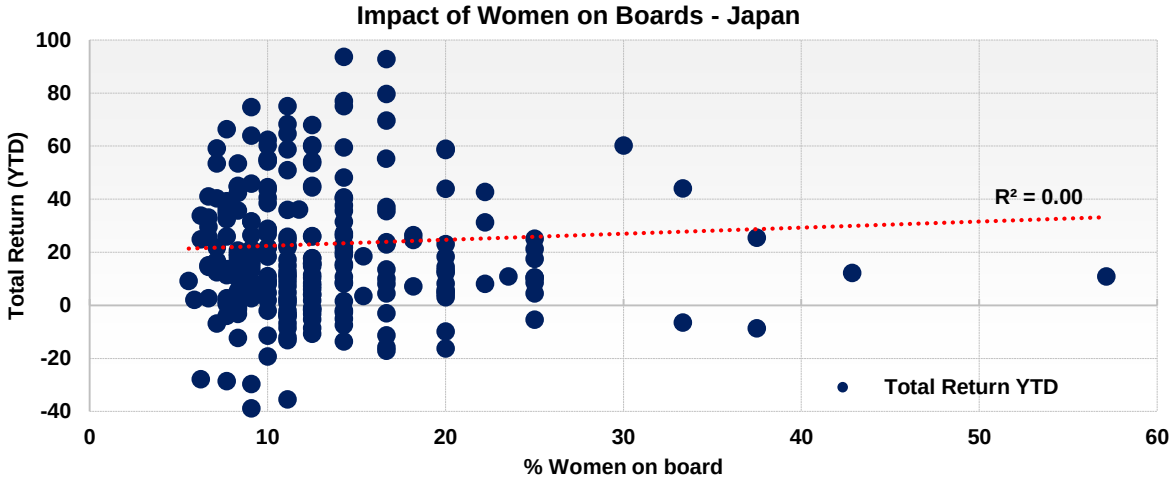
It also makes clear that companies should further diversify and put more women on boards. Note Germany's parliament passed legislation requiring the country's largest 100 companies to appoint 30% of board seats to women from 2016 and 50% from 2018. Currently women hold 3% of seats at major Japanese firms.



Source: Custom Products Research, company filings

Half the board of Bridgestone are women

Looking at returns to date, there is little correlation between the number of women serving on boards and better performance in Germany or Japan. From a pure best practice in corporate governance perspective, meritocracy and qualification should take precedence over gender. That is not to say there are not many qualified women in Japan. Over half of Bridgestone's board is comprised of women.



Source: Custom Products Research, company filings

Foreign Directors on Japanese boards

Firms seeking diversity should also consider foreigners with appropriate qualifications for their boards. Japanese companies searching for growth abroad via M&A may well benefit from broader cultural input. JR Central recently appointed a foreigner, Torkel Patterson, to its board. JR Central President Tsuge said,

"In terms of introducing the high-speed railway system overseas, we are pinning our hopes on Patterson, not only for his advice, but also for his broad network in foreign countries."

The Code also pushes forward other topics such as succession planning, explanations for cross shareholdings and naturally shareholder returns through better capital efficiency.

Stewardship Code – a voluntary but clever ploy

Stewardship Code

In May 2014 the FSA has put forward the Principles for Responsible Investors otherwise known as the 'Stewardship Code' which:

Principles based

"Refers to the responsibilities of institutional investors to enhance the medium- to long-term investment return for their clients and beneficiaries by improving and fostering the investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment. This Code defines principles considered to be helpful for institutional investors who behave as responsible institutional investors in fulfilling their stewardship responsibilities with due regard both to their clients and beneficiaries and to investee companies."

184 signed

The FSA have had 184 institutions sign voluntarily. It is not a law so there are no legally binding regulations.

Ultimately the code does not invite institutional investors to interfere with company management but does encourage dialogue:

Encourage dialogue

"At a company, the board of directors has the responsibility to enhance the corporate value by exerting adequate governance and proper oversight on the management, taking decisions on key policy and business matters. The function of the board and that of institutional investors as defined in the Code are complementary and both form essential elements of high-quality corporate governance, which are indispensable in ensuring the sustainable growth of the company and the medium- to long-term investment return for the clients and beneficiaries. With due regard to the roles of both the board and institutional investors, the Code promotes constructive engagement, or purposeful dialogue, between institutional investors and investee companies."

Admittedly it will take time to get investors and companies on the same page given long standing cross shareholdings and silent institutional shareholders. Getting to know the real state of the shareholder registry will be important for corporations in the new world of greater corporate governance. Investor relations is an important function in understanding shareholders.

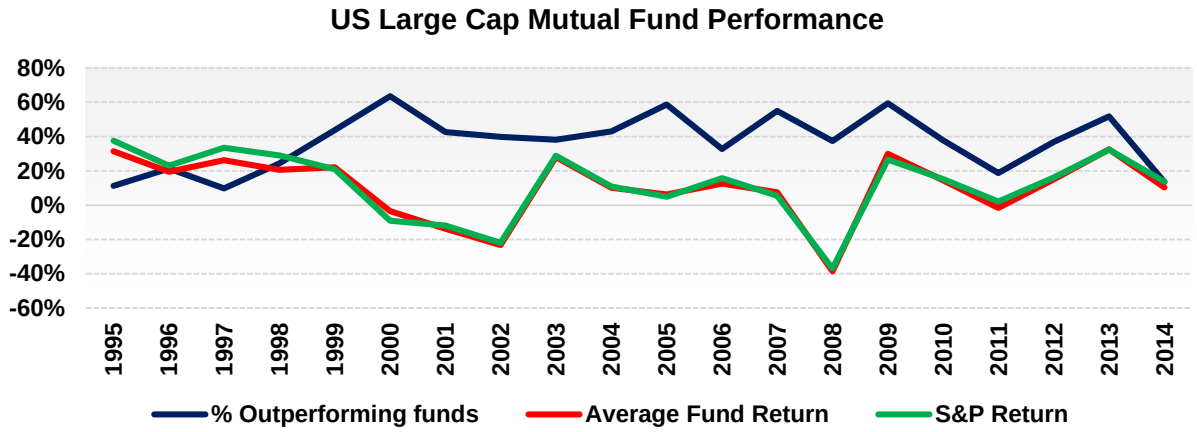
The changing landscape of the buy and sell side

Increased compliance and tighter regulations on sell-side…

Increased levels of compliance, tighter controls on what can be written by analysts and compacting commission rates due to the growing proportion of electronic trading is making life difficult for the sell-side broking community. The European Securities & Markets Authority (ESMA) has proposed a toned down version of the MiFID II regulatory framework to ban the use of commissions to pay for broker research. There will be stringent rules around pricing and payment to increase transparency and brokers will need to separate research and execution fees. This will lead to an emergence of third party independent research houses that can directly bill for research.

…and buy-side

The buy-side investment houses have not helped either. Morningstar's study of large-cap US mutual funds revealed that in the last 20 years, only a quarter have beat the S&P500 Index. The tight bunched nature of returns to the market have pushed investors from higher fee (1~2%) active funds toward relatively low fee (~0.3%) Exchange Traded Funds (ETF). Similar performance but at lower cost. This is becoming a global phenomenon.



Source: Morningstar, The Economist

ETF growth

ETFs, which are essentially pooled portfolios of assets, have exploded over the last decade from $416 billion to $2.5 trillion globally. In the US so far this year, more funds have gone into ETFs than actively managed mutual funds. ETFs are a convenient way for investors to buy exposure to thematics – whether it be emerging markets, commodities, internet retail, high yield bonds, S&P, TOPIX and so on. That means even smaller investors can get exposure to a broader range of stocks that would be out of reach if bought through regular equities.

Corporate access

Many Japanese corporates have outsourced their overseas non-deal roadshows (NDR) to sell-side brokers in order to have access to investors in those regions. Regulators like the UK FCA have banned the payment of commission for this service. This will obviously impact broker's corporate access profitability.

Get to know your shareholders

The simple message from this is that Japanese corporates will need to beef up their IR teams to interact with overseas investors. The benefit is that IR teams can prioritise meetings according to their needs and not the broker's. Of course this only works if IR teams and management understand their shareholders. This is covered in the following section.

Investor Relations – The First & Last Line of Defence

Best ally lies within

Japanese corporates have the best ally within their own organisations - investor relations (IR). Perhaps what is not widely understood is that effective IR has more to do with a high level of engagement with the board and not as a mere outlet for investors to get company information. As a former sell-side analyst it is obvious which boards are close to their IR team. The closer the team is to management results in a higher level of engagement with investors.

Effective IR is paramount

An effective IR team acts as the first and last line of defence for the leaders of its company. For example, when companies conduct earnings presentations, an IR team that has good connectivity with shareholders (current, potential, previous or borrowing), sell-side brokers and the media can ensure their CEO or CFO is prepared to answer any (especially contentious or difficult) questions. This is of particular value when companies need to explain the drivers of their businesses. A good IR team must have the trust and access to management including the ability to speak frankly about investor concerns.

Handling crisis

When companies are required to handle crisis (e.g. scandal, product recall, dealing with natural disaster etc.) good IR teams come into their own. Companies that invest in services that provide access to share owners on a granular level have a distinct advantage. It enables firms to understand the voting mentality of their owners. Is it activists pushing for change or is it actually passive shareholders embedded inside a trust? Being able to see what type of investor typically holds the company's shares enables IR to engage them more effectively. For example, without this information a company might not visit investors in Europe who had recently acquired a healthy percentage of the company's shares.

Getting granularity

In depth ranking analysis

Japanese companies should not be afraid of activist funds. If IR and management understand shareholder expectations and are driving a culture of maximising returns under the new Code an activist fund may well see the company is purely a good investment. Several financial data firms provide in-depth analysis on performance, returns, valuation and what drives the company's stock price. They rank companies against their peers on a sector, market and global basis. This provides context and perspective for boards to understand how investors view them. Which then begs the question how well do corporates know their shareholders?

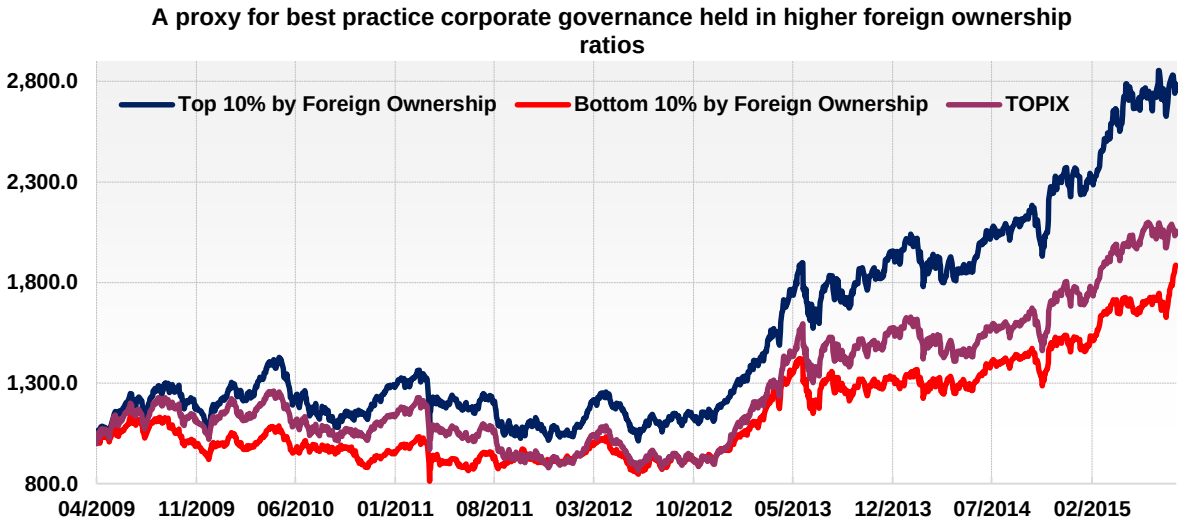
How well do you know your shareholders (KYS)?

Staying on top of changes in mix of shareholder ownership

How well do companies really know their shareholders? Companies that migrate from TSE 2nd Section or JASDAQ to TSE 1st Section can see significant changes in the shareholder mix as the two charts on the following page highlight clearly. Individual shareholders tend to dominate the shareholder registries of smaller market capitalisation firms (as shown in the TSE2/JASDAQ chart).

It can be complex

As companies become larger institutional investor start to take note (as shown by higher institutional/foreign ownership). These might be index, pension, active, passive, hedge, or GARP funds. These same institutional shareholders can be hidden within trustee accounts. Larger scale institutional managers can have funds spread across multiple portfolios with different investment horizons or even jurisdictions. It can be complex.



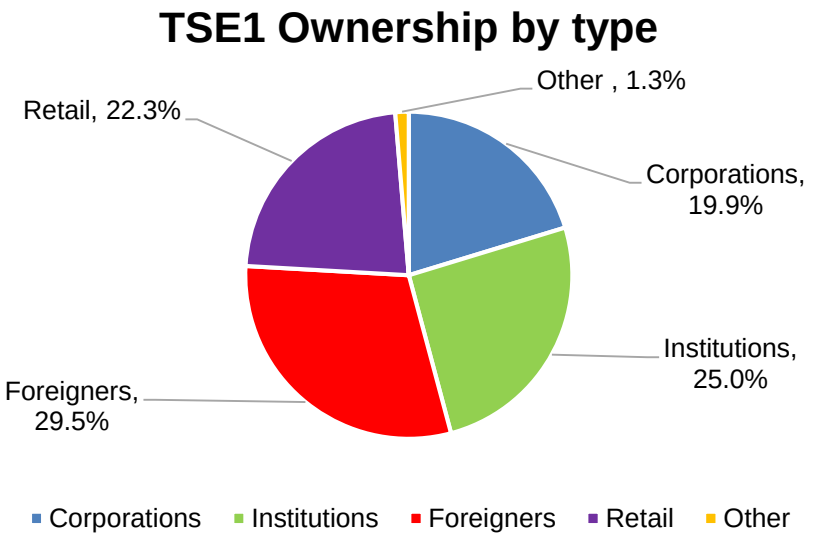
Source: Custom Products Research

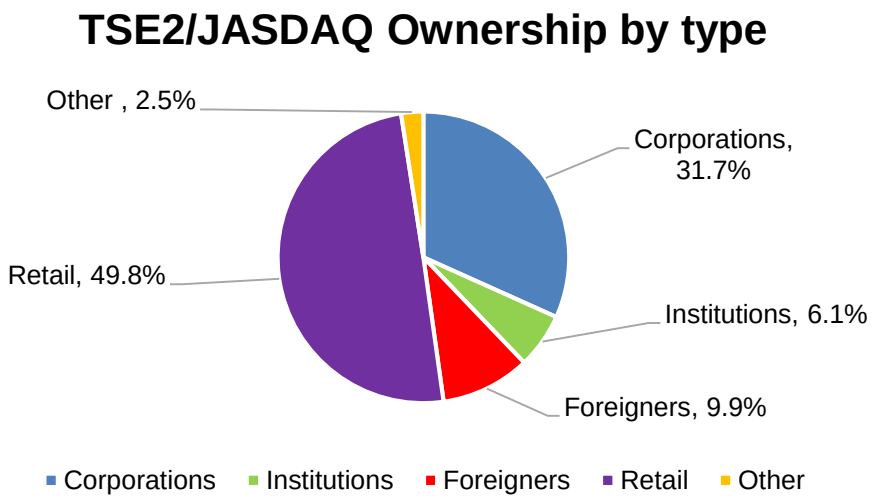
No right to choose who owns shares

Companies that choose to list must accept the fact they cannot chose who owns their shares. However, there is nothing stopping corporates from promoting to specific investor groups provided they remain open to any requests.

No complaints

There have been numerous occasions where Japanese companies have complained about certain investors, usually hedge funds or activists. Some companies have even asked brokers selling cross shareholdings to reveal the buyer for the purpose of guaranteeing the new owner would support the board's decisions. Not only is this terrible corporate governance (voters will generally support sensible management decisions) but it is also against the law.





Source: Custom Products Research, TSE

Poison pills have also been used in certain cases to dilute the relative impact of these institutions often to the detriment to existing shareholders.

Poison Pills – Japanese courts have ruled against in past

378 companies in Japan with poison pills

There are presently 378 Japanese listed companies with poison pills in place. Hostile takeovers in Japan are a rare event. Put simply poison pills are exercised when a company wants to fend off a hostile takeover bid by diluting the potential acquirers ownership through the issuance of new shares to existing owners.

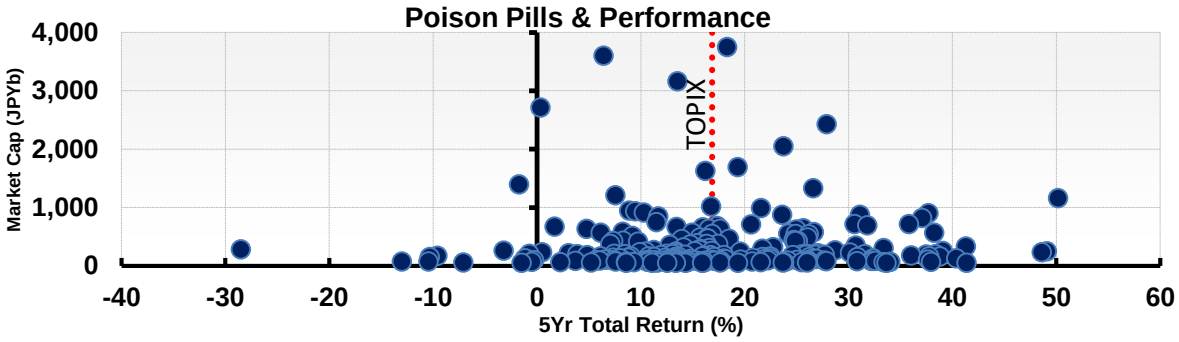
Poison pill issuers underperform relative

In some respects poison pills somewhat fly in the face of the corporate governance code in that issuing them does not underpin best practice for boards. Looking at the performance of companies that have poison pills in force, over 60% of them have underperformed the market in Japan over the last five years.

Poison pills became somewhat fashionable following the hostile takeover bid launched by Livedoor on Nippon Broadcasting. In 2005 Nippon Broadcasting tried to issue warrants but was stopped by the courts on the basis it was 'in principle illegal'.

Some ruled illegal

In the same year FA equipment maker Nireco Corp had its proposal to issue two equity warrants for every one of its shares ruled illegal. Nireco's plan was to allow shareholders to receive one new share for each warrant for only ¥1. The rights were valid for three years and even if holders sold their shares they maintained their rights thus creating the potential for excess dilution.



Source: Custom Products Group

Bull-dog Sauce

However Bull-dog Sauce was viewed as a negative mark on corporate governance by the foreign investment community. The company issued warrants to dilute US hedge fund Steel Partners' position from around 10% to c.3% to prevent a takeover. Free equity warrants were issued to all shareholders (3 new equity warrants for 1 share held) but Steel Partners was excluded from exchanging its shares. Bulldog was ordered to buyback these warrants to the tune of ¥2.3bn plus legal/advisory fees (¥700mn), wiping 15% of the assets at the time. 80% of shareholders voted in favour of the deal. The Tokyo High Court ruled that Steel Partners was an *"abusive acquirer".*

Bad for Japan

Warren Lichtenstein, manager of Steel Partners responded that the decision *"would weaken international faith in the integrity of the Japanese capital markets, and would not only deter investment in Japanese companies but also undermine Japan's efforts to become a global centre."*

TSE – The importance of Market Surveillance

Market surveillance paramount

Market surveillance is a vital function for efficient markets and liquidity. The Australian Securities & Investments Commission (ASIC) puts it well –

Fair and efficient

"Our core priority for markets is the promotion of investor confidence through fair and efficient markets. This requires market infrastructure that is robust, where the trading, clearing and settlement of transactions is orderly and efficient, and where market misconduct is minimised… We are committed to preventing inappropriate conduct and improving poor compliance practices before they affect the integrity of markets."

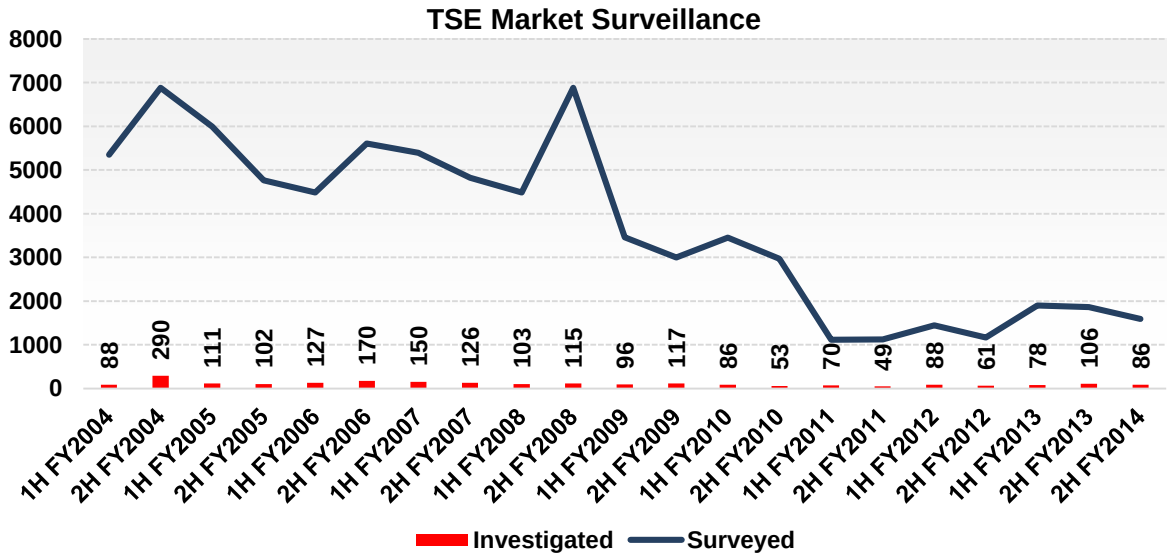
ASX

The Australian Securities Exchange (ASX) and the Australian Securities & Investments Commission (ASIC) in FY2014 conducted the following market surveillance.

- 22 significant enforcement outcomes
- 15 infringement notices issued by the Markets Disciplinary Panel (MDP)
- 154 matters referred for further investigation
- 36,346 trading alerts (i.e. indicators of unusual trading activity – volume/price spikes)
- 224 market enquiries (where internet, media, broker reports or chat sites can't support price moves)
- 51 risk-based assessment visits
- 55 participant compliance reviews, and
- 17 industry presentations.

TSE

The TSE in its quarterly compliance compendium (in Japanese only) reported the following market surveillance. From a peak of 7,000 alerts in 2H FY2008, alerts fell to around 1,600 in 2H FY2014. Investigations from then have remained relatively static.



Source: TSE

Despite the random nature of alerts and risk assessments the exchange (i.e. supervisor) must be the first stage of spotting trading irregularities and accelerating action to regulators if required.

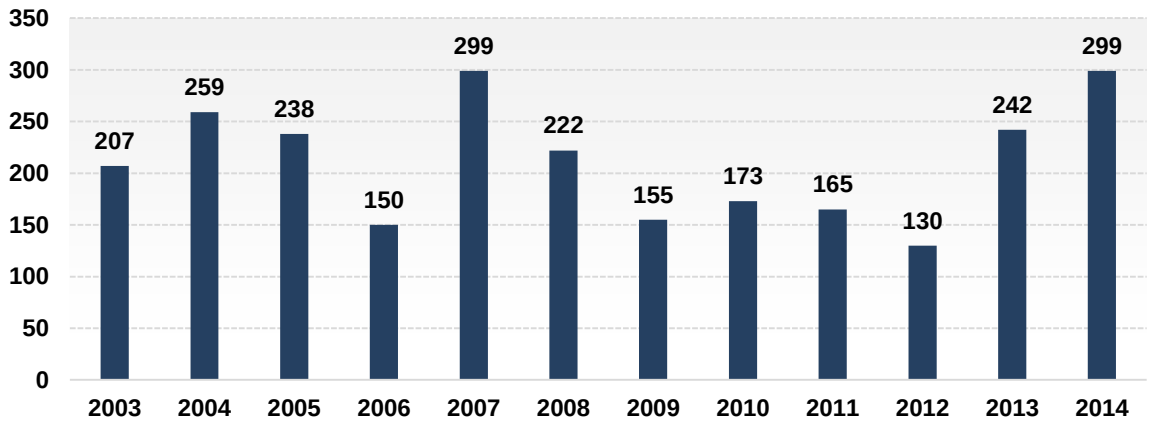
Need to be paranoid

Indeed Nasdaq OMX CEO Robert Griefeld said recently that exchange operators need to *"assume the worst…we have to build our defences and infrastructure around that perspective. We need to be paranoid."*

FY2014 TSE Investigations by type

Category	Surveyed	Examined
Increased Capital	153	50
Reduction in Capital	3	1
Treasury Stock acquisition	107	4
Stock Split	119	8
Dividend Changes	383	12
Merger	5	0
Business alliance/dissolution	101	11
Damage during the course of business operations	89	4
Change in major shareholders	19	0
Information on financial results	718	26
Other Important facts	280	38
Sub Total	1977	154
Stock price fluctuations	1008	29
Short Selling	0	0
Sub Total	1008	29
Derivative related	775	1
Other	1	0
Total	3761	184

Number of Inappropriate disclosures on TSE



Source: TSE

Whistle-blowing – a 10 fold rise in the US & UK. What about Japan?

Whistle Blowing

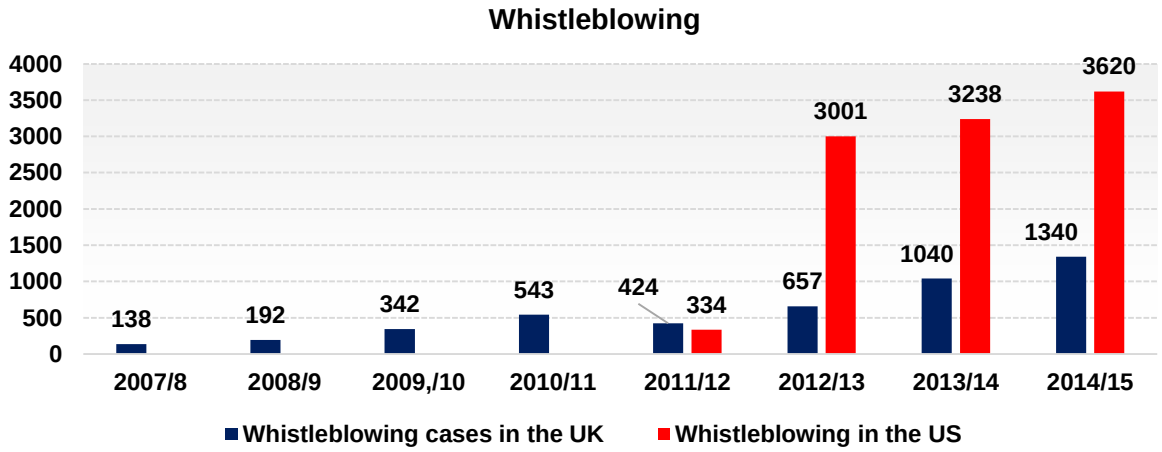
The new Japanese Corporate Governance Code makes efforts to push frameworks for whistle-blowing. The framework is recommended to be independent of management and monitored by outside directors or auditors to ensure appropriate responses to any raised activity and prevent disadvantageous treatment of the whistle-blower.

UK`s rules

The UK Financial Conduct Agency (FCA) and the Bank of England's Prudential Regulation Authority (PRA) introduced measures to better protect employees raising inappropriate corporate behaviour or unethical business practice. Employees can take grievances to either the FCA or PRA and have the further assurance that 'protected disclosure' is a completely binding part of their employment contract.

10 fold increase in UK

The FCA was able to process 1,340 whistleblowing cases in 2014/2015 up from 138 in 2007/2008. Studies in the UK conducted by the FCA showed monetary rewards did little to improve overall market integrity.



Source: FCA, SEC

Missing the Madoff Ponzi scheme

In May 2011 the Securities and Exchange Commission (SEC) introduced a new whistle-blower program under Section 92 of the Dodd-Frank Act. This was partly in response to its much publicised failure to investigate the US$50bn Bernard L. Madoff Ponzi scheme despite being made aware of it multiple times by a whistle-blower, Mr Harry Markopolos, since 2000. Markopolos wrote in his November 7, 2005 submission to the SEC,

Markopolos letter in 2005

"Scenario # 2 ***(Highly likely)*** *Madoff Securities is the world's largest Ponzi Scheme. In this case there is no SEC reward payment due the whistle-blower so basically I'm turning this case in because it's the right thing to do. Far better that the SEC is proactive in shutting down a Ponzi Scheme of this size rather than reactive."*

10 fold increase in US whistleblowing

The SEC now encourages whistle-blowing by offering sizable monetary awards (10 to 30% of the monetary sanctions collected). Successful enforcement actions as a result of whistle-blowing has led to awards as high as US$30,000,000. As a result the SEC has seen a 10 fold increase in claims over the last few years.

Japan's whistle blowing affected by culture

Whistleblowing in Japan has generally been regarded by firms as disloyal behaviour. In a case unrelated to the former Olympus CEO Michael Woodford, another employee within the Olympus filed a law suit complaining of unfair treatment by the firm. Hewas demoted for calling divisional management's aggressive hiring practices from a supplier into question. The Supreme Court ended up ruling in favour of the employee, which could well be a precursor for wider spread amendments to regulations that encourage whistle blowing.

Subject of whistle-blower Disclosures

Subject	Count
Fitness & Propriety	247
Culture of Organisation	201
Consumer Detriment	167
Systems & Controls	134
Crime	119
Consumer credit concerns	86
Market Activity	76
Pressure on sales staff	73
Treating customers fairly	68
Non-regulated products	65
Pension	39
FX-related	20
Competition	3
Other	42
Total	**1340**

Source: UK FCA

Whistle-blower cases by Sector

Sector	Count
Financial Advisors	271
Consumer Credit	208
Retail Banking	156
Retail Insurance	155
Unauthorised Business	126
Markets	113
Investment Banking	93
Asset Management	35
Commercial Insurance	24
Mutuals & Credit Unions	18
SIPP	10
Mortgage Intermediary	7
Building Societies	6
Payment Societies	3
Friendly Societies	2
E Money	1
Other	112
Total	**1340**

Criminal vs Unethical

Japan enacted the Whistle-blower Protection Act in June 2004 (effective since April 1, 2006) to lift compliance by corporates. It has not encouraged individuals to speak out as it tends to focus on companies committing 'criminal' acts rather than 'unethical' acts as was the case above. The idea was that a disgruntled employee may just be seeking to 'disrupt corporate order' or 'injure the reputation of the company'. Although in theory employees have rights under the act, in practice it has been mostly ineffective as most employees are not prepared to take the risk.

The importance of the regulator & proper funding

Vital role but imperative to have quality investigators

Regulators have a vital role to play in preventing fraud. Market integrity depends on it. However without adequate funding regulators face pressures on many fronts. The SEC was publicly admonished by Congress for its failure to catch Bernard L. Madoff Investment Securities (BMIS) LLC despite being presented with evidence multiple times from a whistle-blower for over 9 years. It issued the following statement:

SEC admits Madoff failure

"The Office of the Inspector General (OIG) investigation did find, however, that the SEC received more than ample information in the form of detailed and substantive complaints over the years to warrant a thorough and comprehensive examination and/or investigation of Bernard Madoff and BMIS for operating a Ponzi scheme, and that despite three examinations and two investigations being conducted, a thorough and competent investigation or examination was never performed."

The need to hire the best

If law makers are serious about stopping fraud, the highest priority is to staff the regulator with top calibre investigators who understand ever more complex markets over just interpretation of law. However if remuneration is not commensurate with what could be received in the private sector, regulators may face difficulties in hiring the talent required to collar crime.

SEC's funding problems

Part of the problem is that the SEC receives its funding from Congress. The SEC should be able to keep user fees (self-financing) to allow it multiyear budgeting and flexibility in hiring more market-savvy investigators. Industry associations are behind paying higher user fees. Rick A. Fleming of the SEC's Investor Advocate said in August 2014,

Industry happier to pay higher fees to help SEC prosecute

"To some, the idea of a "user fee" sounds a lot like a tax. But several industry associations that represent investment advisers have actually endorsed the concept of user fees. They recognize that a rogue adviser not only harms investors, but also leaves a stain on the advisory industry, so they support an increased regulatory presence and are willing to pay for it. Let me repeat that – they are willing to pay more money to the SEC so that it can conduct more examinations of advisers."

Funding cuts

Instead of keeping user fees the SEC must turn them over to the US Treasury and apply to Congress for funding. Since 2011 the SEC has been investing in technology systems to catch more fraud since Madoff's Ponzi scheme, but in 2014 Congress slashed funding for this in half.

Alternatives

There are suggestions that third-party audits might be a solution to alleviate pressure on the SEC's limited resources. However Fleming hesitantly responded,

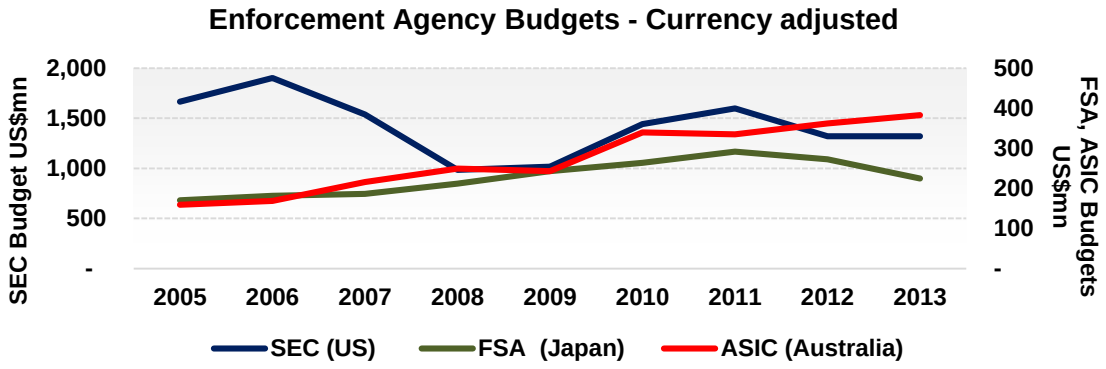
The dangers of 3rd party audits

"I believe third-party audits are the less desirable option than user fees, and I worry that it will be impossible to reverse course if the Commission starts down that road. But if the Commission isn't given the resources to do the job adequately, and given them soon, it may be left with few options. I am concerned that we may end up with a solution that ultimately is more expensive for the industry and less effective for investors. Accordingly, I have urged and will continue to urge Congress to act quickly to provide additional resources to the SEC so that it can examine investment advisers more frequently."

Comparing Regulators

SEC vs FSA vs ASIC

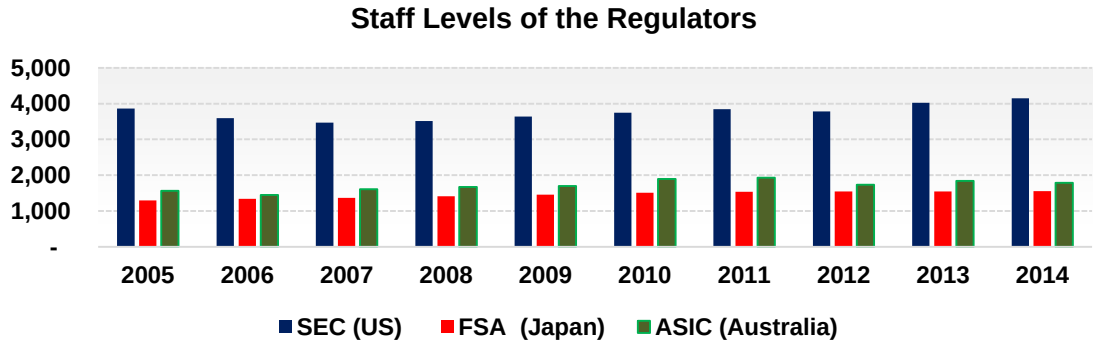
The SEC makes a compelling case for the importance of adequate funding. The SEC has twice the funding than the Australia's ASIC and Japan's FSA. On a currency adjusted basis, the Australian government funds ASIC more than the Japanese lawmakers fund the FSA which is an interesting statistic given 3,487 stocks listed on the TSE versus c. 2,200 on the ASX.

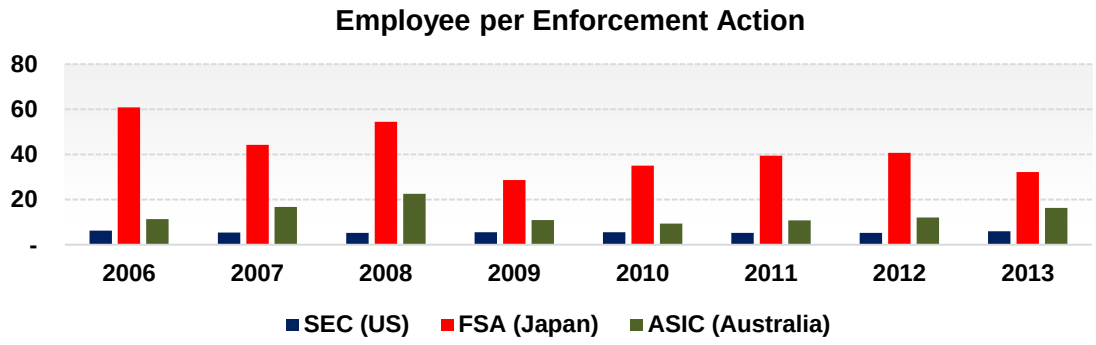


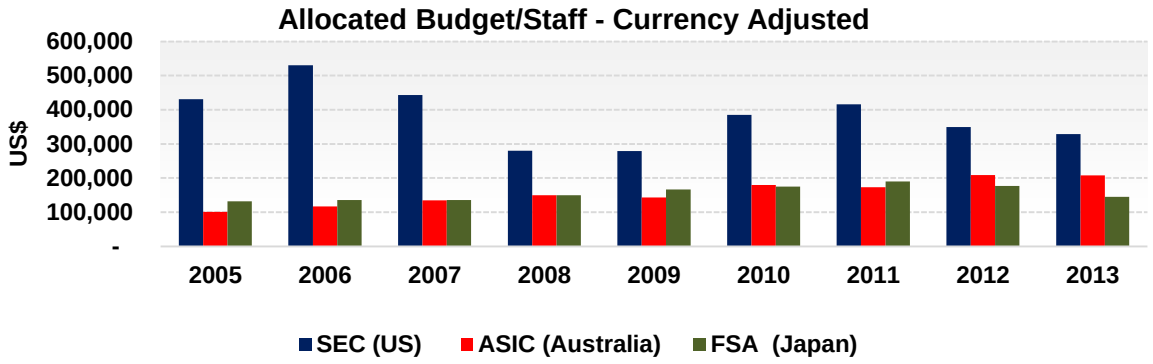
Source: SEC, ASIC, MoF, FSA

Staff levels

The SEC employed over 4,000 staff in 2014 versus almost 1,800 by ASIC and around 1,550 by Japan's FSA. Although not all staff are involved with investigation, the employee per enforcement actions reveals some degree of relative efficiency or deployment on investigation.







Source: SEC, ASIC, FSA

These charts suggests Japan's law makers should be increasing funding for the FSA to ensure market stability and continued confidence. So much is riding on the FSA to protect the integrity of the new 'code'.

Japan's regulators should take a zero tolerance view

Criminal prosecutions

Former Olympus CEO Michael Woodford said,

"Criminal prosecutions are important if you are going to change the way people act. People don't do bad things if they know they are going to get caught and are forced to face the consequences."

Relatively lenient sentences to date

Examples of corporate malfeasance abroad have seen multi decade jail terms for executives and multi-million (sometimes billion) dollar fines for both corporate and individuals. Japan's regulators and judiciary have meted out relatively lenient sentences to date despite cases of gross misconduct such as Olympus Corp. Toshiba could provide just the level of high profile corporate to publicly admonish that would get the market and corporate Japan listening.

Perception

Perceptions will be significantly improved should there be landmark cases of Japan's regulators and judiciary stomping out unethical behaviour – from investor, broker, auditor, rating agencies to corporate. Japanese authorities must not underestimate the pent up frustration in this area.

Foreign perception on Japan's approach to crime & poor corporate governance

CEOs must be held accountable

Japanese authorities must make CEOs accountable if it is to be taken seriously by the global investment community. Many global institutional investors will freely admit that soft sentences in Japan act as a brake to increased investment. The feeling is that leniency does not create an environment to discourage repeat offenses.

Resignations?

Resignations to take responsibility for criminal behaviour are simply not enough. Pay cuts for existing managers admitting poor governance has negligible perceived impact. Serious breaches of the law must be met with the appropriate charges even for individuals.

Stiff sentencing in US…

…it hasn't stopped crime dead

WorldCom CEO Bernie Ebbers was sentenced to 25 years based on nine counts of conspiracy, securities fraud and false regulatory filings to the tune of $11bn. Enron's former CEO Jeffrey Skilling was convicted on 35 counts of fraud, insider trading and other crimes related to Enron and sentenced to 24 years prison and fined $45 million. Madoff got 150 years, Stanford got 110 years jail time. This has not necessarily stopped corporate crime but it should throw a flag in the minds of those considering it. If the consequences are too soft then clearly the risks diminish for the perpetrator.

Consistency regardless of market cap

Olympus executives ended up with suspended sentences although an adviser to the company received a four year jail sentence on July 1, 2015. Livedoor's former CEO Takafumi Horie served 2½ years in prison for market manipulation and falsifying accounts. Members of Toshiba's management team admitted to earnings manipulation and the SESC plans to recommend a fine. Bonds that were raised by Toshiba over the five years to 2013 will figure in the decision. The question is whether such capital raisings which hid the truth about underlying 'risk' will be considered by the courts as 'market manipulation'? Whether the regulator or courts draw a distinction between 'explicit' and 'implicit' manipulation, 'intent' to mislead investors is not in question.

Automatic suspension

Delist?

The TSE should have immediately removed (or at the very least suspended) Toshiba from the JPX-Nikkei 400 index, which is designed to showcase best practice corporate governance, (good disclosure, high ROE, three years of successive profit growth and IFRS adoption). Other questions revolve around trading activity in Toshiba shares before the scandal came to light. Toshiba will be removed from the JPX-Nikkei 400 on August 31st, 2015. The TSE should consider delisting Toshiba although this would raise its own set of complications. This however is double standards. There cannot be a separate rule for large companies. Toshiba should be delisted as another sign of enforcing zero tolerance.

Takata's ongoing poor governance

Takata Corp had covered up defects in its airbags, which led to deaths but the existing CEO still presides. This on any level is poor corporate governance regardless of whether the family holds a majority of the stock. An investor cannot find comfort in true reform if the existing management remains at the helm. No-one can seriously believe that they have learnt their lesson. Class action suits still hang over the company but is it going to be left to the US Securities and Exchange Commission (SEC) to prosecute Takata management given its ADR status? The SEC chose not to prosecute Olympus but the UK Serious Fraud Office (SFO) did investigate given the company's UK subsidiary Gyrus Group.

Conclusion

Japan should congratulate its 'Code'

Japan should congratulate itself for the moves it has made to foster the Corporate Governance Code in the manner that it has. Like any new structure there will be growing pains. That this 'Code' is geared to unlocking shareholder value and unlocking sustainable long term growth as opposed to SOX's 'monitoring' bias says a lot about the way Japanese corporates should reflect upon it. Companies should not b intimidated. Good governance is desirable. Commit to hiring value added independent directors in the same way you look to employ operational staff.

Japan underestimates the potential of its moves

The long term positive impacts to liquidity for the exchange and its participants not to mention the corollary effects to the economy should not be underestimated. If Japan gets this right and companies embrace the new spirit of 'independence' then they could end up surprising even themselves. For decades this author has witnessed the pent up frustration of foreign investors in this area. Many have freely admitted that their customers would willingly invest more in Japan were it better in the corporate governance space. While investors always allocate capital on a caveat emptor basis when approaching risk, it is doubly important that the regulators and judiciary move swiftly and harshly on any unethical behaviour. Toshiba is a perfect example for the authorities to flex their new powers.

Mustn't forget the focus on the judicial system to protect fair and orderly market behaviour

Adequate funding of the regulator cannot be emphasized enough. Having new powers does not mean anything unless the resources can execute upon them. Too many examples of this over history. Complacency is not an option. Proactive not reactive.

Perhaps Justice Cooke of the UK Southwark Crown Court, who sentenced Tom Hayes to 14 years jail for the Libor scandal in July 2015, put it best with the importance of zero tolerance on corporate crime:

"You [Tom Hayes] played a leading role in the manipulation of Libor. You exerted pressure on others, essentially trained those junior to you in the activity, made corrupt payments to brokers for their assistance… The conduct involved here is to be marked out as dishonest and wrong, and a message sent to the world of banking accordingly. The reputation of Libor is important to the City, as a financial sector, and the banking institutions of this City. Probity and honesty is essential, as is trust… the Libor activity, in which you played a leading role, put all that in jeopardy."

So the final message to Japan is simple. Turn the Black Ships of best practice back. Learn from the mistakes of the global market and create your own wake.

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