Japan Policy – Director Elections – Outside Directors

Background and Overview

Corporate governance in Japan has historically been criticized for lack of outside director oversight, but the presence of outside directors on Japanese boards has increased in recent years. Especially notable is the pace at which companies are adding outside directors. In 2014, only 32.6 percent of companies had multiple outside directors, but as of June 2017, 84.7 percent of companies now have multiple outsiders on the board, according to ISS data.

The trend is especially prominent for companies employing one of the two governance structures featuring committees: the U.S.-type three-committee structure and the board with audit committee structure. As of June 2017, on average, 5.1 out of 9.6 board members are outsiders at companies with a U.S.-type three-committee structure, and 3.0 out of 9.7 members are outsiders at companies with a board with audit committee structure (whereas companies with a statutory auditor system have on average 2 outsiders out of 8.4 board members).

Companies adopting such types of committee structure have increased significantly since 2015 with the introduction of the board with audit committee structure created by the 2014 amendments to Japan's Corporate Law. Until 2014, less than 2 percent of Japanese companies had adopted a committee structure (i.e., a U.S.-type three-committee structure). As of August 2017, 25 percent of companies have adopted one of the two types of committee structure, but the sharp increase can be explained almost exclusively by the surge in the number of companies switching to a board with audit committee structure.

Key Changes Under Consideration

ISS proposes to implement a new policy, after a one-year transition period effective from February 2019, applicable to companies with three committees or with an audit committee. Under the proposed policy, if at least one-third of the board members, after the shareholder meeting, will not be outside directors, ISS will recommend a vote against top executive(s)[1].

Intent and Impact

In 2013, ISS adopted a policy to recommend against top executives of companies whose boards do not include at least one outsider. In 2016, the policy was strengthened to require at least two outside directors. During that time, the board profile of Japanese companies has significantly improved, and the new policy aims to help accelerate the trend to a level comparable to global peers.

This proposed policy will be applied only to companies with three committees or with an audit committee, because these governance structures, by design, are intended to separate management and supervision. If companies opt for such a governance structure, that choice can be interpreted as the company's intention to separate management from supervision, so it is reasonable to require a greater outsider presence than at companies that maintain the traditional statutory auditor-based governance structure. The Corporate Governance Code of Japan recommends that all companies appoint at least

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[1] In most cases, the top executive will be the "shacho" (president). However, there are companies where the ultimate decision-making authority rests with the "kaicho" (executive chairman) or "daihyo torishimariyaku" (representative director).

two independent directors, and at the same time, the Code refers to one-third independence, depending on each company's circumstances, including governance structure.

This proposed policy does not factor in outside directors' independence. While independence is conceptually important, too much emphasis on independence at this stage of Japan's corporate governance development might prompt companies to recruit individuals with little business background, such as attorneys, accountants, or academics. Although one or two outside directors with such qualifications may be acceptable, a board where individuals with such qualifications occupy all of the outside director posts is not ideal.

The proposed policy will not be implemented until 2019. This one-year transition period is intended to give companies sufficient time to recruit qualified outside director candidates. This approach is consistent with the implementation of ISS' director election policy in 2013 requiring companies to have at least one outsider, and in 2016 requiring at least two outsiders, both implemented with a one-year transition period.

Based on ISS data as of August 2017, the proposed policy may result in adverse recommendations on top executives at 52.6 percent of companies with an audit committee system and 2.8 percent of companies with a three-committee system. However, given the increasing trend of Japanese companies raising outsider representation as a whole, by the time of the full policy implementation in 2019, the number of adverse ISS recommendations, particularly at companies with an audit committee system, is expected to be lower than the number based on the current data.

Request for Comment

While we appreciate any comments on this topic, ISS is specifically seeking feedback on the following:

- Do you consider the proposed threshold of one-third of the board comprising outside directors appropriate as applicable to companies with three committees or with an audit committee? If not, what percentage of outsiders would your organization consider acceptable when voting on the election of directors at companies with an audit committee and companies with three committees?
- Should the proposed policy be applied as well to companies with a statutory auditor system? (Note: if the policy is to be applied to companies with that governance system, adverse recommendations will be made at 73.2 percent of such companies based on ISS data as of August 2017.)
- Do you think that a one-year transition period, i.e. with implementation of the proposed policy from February 2019, is sufficient? If not, please explain why it is not sufficient.
- The proposed policy does not require independent directors, but requires outside directors, because of concerns that too much emphasis on independence would prompt companies to recruit individuals with little business background. Notwithstanding such concerns, should the proposed policy still require independent directors?