Japan Policy – Director Classification - Independence Criteria

Background and Overview

Under common Japanese market practice, shares held by companies for purposes other than pure investment, including cross holding shares, are usually aimed at strengthening business relationships. Such practices reduce market discipline over corporate executives as management-friendly shareholders will generally always support company-backed proposals and oppose shareholders' proposals. Therefore, directors and statutory auditors representing cross-shareholding partner companies cannot be regarded as independent.

Japan's Corporate Governance Code, updated in June 2018, calls on companies to revisit their rationale for owning such cross holding shares with an eye toward their cost of capital and risk-return profiles. Cash tied up in such cross shareholdings cannot be allocated either for investments in the core business or for return to shareholders, causing capital efficiency to deteriorate. It has long been noted that Japanese companies' low capital efficiency largely accounts for long-term underperformance of shareholder returns.

Key Changes Under Consideration

ISS proposes to implement a new independence criterion for Japanese directors and statutory auditors, after a one-year transition period meaning that the new criterion will be effective from February 2020. Under the proposal, ISS would regard both directors and statutory auditors who work (or worked) at companies whose shares are held by the company in question as "cross-shareholding shares[1]", as affiliated outsiders.

Intent and Impact

The proposed policy would be implemented in February 2020. This one-year transition period is intended to give companies time, if they wish, to revisit their rationales for holding such shares. Based on the total number of outside directors at the 100 companies which are most widely held by ISS clients (as of June 2018), 7.6 percent of the outside directors who are currently categorized as independent, would be regarded as affiliated outsiders following the implementation of the new independence criterion.

In order to collect the relevant data, ISS currently plans to use information in companies' Yuho annual securities filings, which are usually disclosed after the annual meeting. Therefore, ISS will use information disclosed after the prior year's AGM. For instance, ISS will use information in Yuho filings released in June 2019 to analyze whether outsiders represent cross-shareholding companies at June 2020 AGMs.

Request for Comment

While we will appreciate any comments on this topic, ISS specifically seeks feedback on the following:

[1] Traditionally, Japanese companies have often held shares of other companies for reasons other than pure investment purposes, for instance, in order to strengthen business relationships. Cross-shareholdings here refer not only to mutual shareholdings but also unilateral holdings.

- Does your organization consider it appropriate to regard directors and statutory auditors associated with companies whose shares are held for reasons other than pure investment purposes (for instance, in order to strengthen business relationships) as affiliated outsiders?
- Under current Japanese disclosure rules, all cross-shareholding shares whose book value on the balance sheet exceeds one percent of capital must be disclosed. If a company holds such shares in fewer than 30 other companies, then 30 companies, including companies whose shares held do not exceed the one-percent threshold, need to be disclosed in the order of book value on the balance sheet. Do you consider it appropriate to use this definition of cross-shareholding under the current disclosure rules in implementing the proposed policy? If not, what definition do you consider appropriate?
- Do you consider it appropriate to give a grace period (or moratorium) of one year before the implementation of the new independence criteria, in order to give companies time, if they wish, to revisit the rationale of cross-shareholding practices? If not considered appropriate, when should the new policy be implemented?