



JAPAN PROXY
SEASON 2020 -
IMPACTS OF THE
COVID-19 PANDEMIC
ADDITIONAL ISS POLICY GUIDANCE

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CONTEXT:

The Impacts of COVID-19 Pandemic on Shareholder Meetings in Japan

In Japan, companies are required to disclose their financial results and hold their general meetings within three months after the fiscal year end which for close to two-thirds (63 percent) of issuers (or roughly 2,400 firms) falls on March 31. Typically, by mid-May, financial results are announced, which is a prerequisite for companies to complete their audit and conduct other year-end procedures. This process leads to the release of proxy circulars in late May or early June for shareholder meetings, which are most often scheduled for late June.

Reporting audited financial statements at the general meeting is mandatory and a failure to do so could lead to a delisting. However due to the pandemic, there appears to be a significant delay in the audit process for many companies. Given these delays, the Ministry of Justice, the Financial Services Agency (FSA) and the Tokyo Stock Exchange came up with two options for companies that are unable to report audited financial statements: postpone their meetings or adjourn them.

Postpone or adjourn?

Under the **postponement option**, companies can delay both the disclosure of their financial results and their general meeting to a later date. Companies opting for this choice must establish a new record date for the postponed AGM. Shareholders will be able to review voting items and cast their votes at a meeting when the business report and audited financial statements are available. If a shareholder vote is required to approve a dividend payment, a new dividend record date will also need to be set. (Ordinarily, the fiscal year-end is the record date for dividends and for voting rights at the annual meeting.)

In contrast, under the **adjournment option**, there is no need to establish a new record date and a company can hold its general meeting as originally planned in June. All ballot items will be voted, but after the voting is closed the meeting will be adjourned until a later date. The adjourned meeting will be reconvened once the audited financial results become available. As votes were cast prior to the adjournment however, no ballot items can be voted at the resumed meeting. Shareholders will only be able to review the audited financial statements and business report for the resumed meeting.

As of this writing in early May, we are aware of approximately 40 companies that are considering postponing their meetings to a later date and roughly 85 companies that are considering the adjournment option. Only nine companies so far have officially announced postponements. The vast majority of companies have not yet indicated their plans.

ISS policy changes for 2020 in Response to COVID-19 Pandemic

ISS recently announced its global approach in response to the pandemic; [ISS policy guidance: Impact of the COVID-19 Pandemic](#). ISS policy for Japan will be applied with reference to this guidance.

Additionally, with respect to a number of market-specific issues for Japan, we will be adopting the following approaches.

ROE (Return on Equity) Policy

ISS Japan policy will generally recommend votes to oppose the re-election of the top executives at companies that have underperformed in terms of capital efficiency (i.e., when the company has posted average return on equity [ROE] of less than five percent over the last five fiscal years), unless an improvement (defined as ROE of five percent or greater for the most recent fiscal year) is observed.

However, because of the significant impact of the COVID-19 pandemic on companies' performance in 2020, ROE is not considered to be an appropriate indicator to measure capital efficiency of companies this year. Accordingly, ISS will be suspending the application of the ROE policy to Japanese director elections for the time being.

Approach to Companies choosing the Adjourned Meeting Option

As noted above, due to a delay in audit completion because of operational difficulties imposed by the COVID19 pandemic, some companies may opt for the adjourned meeting approach. In that case, their shareholder meeting (first meeting) will be held on the day as originally planned, but audited financial statements and business report will not be available for shareholders to consider before making their voting decisions. Once votes are cast, the meeting will be adjourned to a later date. The adjourned meeting (second meeting) will be resumed once the audited financial statements become available. However, shareholders will not be able to change their original votes or to vote at the second meeting. Normally, general meetings are only held after the disclosure of audited financial statements and business report so that shareholders can make informed decisions, and therefore the adjourned meeting option is not ideal.

For Japanese companies who chose the adjourned meeting option for 2020, the following additional changes will be applied to ISS voting policy application:

- **Income allocation/Dividends**

For companies whose articles require shareholder approval to pay final dividends, in normal times, dividends are proposed and voted on only after audited financial statements are available. This year, for companies choosing the adjournment option there are concerns that dividends determined before the audited financial statements are available may turn out to be excessive. Such dividends may negatively impact a company's financial health and its ability to use cash for other corporate purposes when the impact of the COVID-19 pandemic on corporate operations is still unknown. Even if this may not be common (particularly given Japanese companies' propensity to reserve cash), in light of the high level of uncertainty posed by the pandemic, prudent shareholders may find it inappropriate to approve final

dividend payments before audited financial statements are available. Accordingly, an ABSTAIN vote will be recommended on income allocation proposals this year at meetings that will be adjourned where no audited financial statements are available.

- **Election of directors and statutory auditors**

At meetings that will be adjourned, shareholders will be asked to vote on director and statutory auditor elections without knowledge of the audited financial statements and business report. It will be difficult or impossible for shareholders to make informed voting judgments without being able to review the company's financial and operating performance, outside directors and statutory auditors' board attendance records, and other information to determine the independence of outside director and statutory auditor candidates.

When such information is not available this year, ISS will use past disclosures as an alternative source of information on director and statutory auditor elections and their independence classifications.

Concerning board meeting attendance, we and shareholders will be able to evaluate attendance records only when that information is disclosed in the proxy circular. Note that the attendance of inside directors and inside statutory auditors is not disclosed in Japan, so attendance guidelines are applied only to outside directors and outside statutory auditors.

Even before the COVID-19 pandemic, some companies with proactive disclosure practices have already disclosed attendance records in the proxy circular for shareholders' convenience. Attendance records are not complex and therefore should be easily ready for disclosure by companies and requesting the information in the proxy circular is not considered to place an additional significant burden on companies. Accordingly, companies opting for the adjourned meeting option are encouraged to disclose such information in their proxy circular. If the information is not disclosed in the proxy circular, a negative vote will be recommended under ISS Japan policy for poor information disclosure.

- **Appointment of external auditors**

In Japan, a shareholder vote on the appointment of the external auditor is required only when a change in auditor is proposed. Under normal circumstances, shareholders may want to review the outgoing auditor's report before voting on a proposal seeking to appoint a new external auditor, as any qualifications or uncertainties noted may be important in understanding possible reasons for the proposed change. If the audit is not complete, and the outgoing auditor's report is not available for review, shareholders may not be able to evaluate the appropriateness of the proposed change. In such circumstances this year, an ABSTAIN vote will be recommended on the appointment of external auditors.

- **Compensation proposals**

Like income allocation and dividends, certain types of compensation-related proposals, namely stock options, deep-discounted stock options, restricted stock awards, performance-based shares, and annual bonuses are normally evaluated within the context of the company's financial performance and standing. Therefore, when the audit is not complete and financial statements and business report are

unavailable, shareholders cannot fully evaluate such proposals. Accordingly, an ABSTAIN vote will be recommended on those types of compensation proposals at adjourned meetings this year.

For proposals seeking to increase director compensation ceilings, under current ISS Japan policy, when it is not clearly stated in the proposal that the increase is intended to increase the proportion of performance-based compensation, we will normally review financial performance of the company, namely ROE. As this ROE review will not be possible where audited financial statements are unavailable, and may not be appropriate this year, an ABSTAIN vote will be recommended in cases where the company has not clearly stated that the increase is intended to increase the proportion of performance-based compensation.

Explanation of ABSTAIN votes at Japanese meetings

Abstain is a valid voting option in Japan, and an ABSTAIN vote is not the same as the absence of a vote. When shareholders cast ABSTAIN votes at Japanese company meetings, the votes will be included in counting quorum and denominator to calculate the final result. Therefore, an ABSTAIN vote has a similar effect as a vote against the proposal. The potential ABSTAIN recommendations under ISS Japan policy this year noted above recognize the unique circumstances this year for shareholders of Japanese companies that select the adjournment option where insufficient information will be available to make fully informed voting decisions on some key voting items.

ISS Japan Policy Changes already announced for 2020

ISS announced two main changes for the ISS Japan benchmark policy as part of the policy updates for 2020. The first change related to director independence criteria, which was announced in 2018 with a one-year grace period, and the second change related to board independence requirements for controlled companies.

New Independence Criteria on Cross-Shareholding

Starting February 2020, ISS Japan policy considers outside director candidates who currently work or previously worked at a company whose shares are held by the company in question as "cross-shareholdings", as non-independent. Cross-shareholdings here refer not only to mutual shareholdings between two companies but also unilateral holdings where these are designated by the company as shareholdings for "non-investment purposes".

Traditionally, Japanese companies have often held shares of other companies for reasons other than pure investment purposes, such as to mutually strengthen business relationships. Such holdings may place the company's desire to strengthen its ties to a customer, supplier or borrower in conflict with its responsibility to create value for shareholders. Moreover, such holdings reduce normal market discipline as management-friendly shareholders typically support management resolutions and oppose shareholder proposals. In light of these potential conflicts, individuals representing cross-shareholding partner companies cannot be regarded as independent.

To collect ownership data, ISS will use information in Yuho annual securities filings usually disclosed after the shareholder meeting. Therefore, the ISS policy application will be based on information disclosed after the prior year's annual general meetings.

Board Independence Requirements for Controlled Companies

The overall board independence level of Japanese companies has improved in recent years, particularly in response to the introduction of the Japan Corporate Governance Code in 2015 and its revision in 2018. With this improving trend considered, in 2019, ISS implemented a new policy requiring Japanese companies with boards that have either an audit committee structure or a U.S.-type three-committee structure to have at least one-third of the board members being outside directors. As long as a company does not have a controlling shareholder, a minimum board composition of one-third outsider representation (regardless of independence) is considered to be a reasonable requirement given Japan's current stage of corporate governance development.

However, for companies with a controlling shareholder, concerns arise that the interests of the controlling shareholder could be prioritized over those of minority shareholders, and therefore one-third outsider representation may not be sufficient to protect the interests of minority shareholders. The Japanese stock market is known for its large number of parent-subsidary listings. Based on the ISS Japan research universe of 2,929 companies covered for the first six months in 2019, 436 companies had a controlling shareholder. The protection of minority shareholders of such companies is a critical concern.

To address such concerns, ISS has long employed a policy calling on companies with a controlling shareholder to have at least two independent directors. However, with increasing awareness of the need to protect minority shareholders at controlled companies and the overall improvement of Japanese corporate governance practices after the introduction of the revised Japan Corporate Governance Code in 2018, the new policy now additionally requires that at least one-third of the board members after the shareholder meeting are independent outside directors.

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