Japan

A Closer Look at Governance Reforms

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Key Takeaways

The 2015 proxy season will mark the beginning of a new chapter in governance in Japan. On March 5, 2015, Japan's Financial Services Agency ("FSA") published Japan's Corporate Governance Code (the "Code"), which is scheduled to be implemented in June 2015, immediately preceding Japan's annual proxy season. The publication follows a February 24, 2015 announcement by the Tokyo Stock Exchange ("TSE") that it would amend its listing rules, effective June 1, 2015, to require that listed companies comply with the Code or explain any reasons for non-compliance. The most notable implication of these revisions is that the approximate 2,400 companies listed on the 1st and 2nd sections of the TSE will face a "comply or explain" requirement to have at least two independent outside directors as of the effective date. The introduction of the Code is part of the so-called "third arrow" of Abenomics' structural reforms for revitalization, with arrows one and two addressing monetary policy and fiscal policy.

The publication of the Code capped a long list of capital market revitalization efforts which have included: (i) the launch of the JPX-Nikkei 400 index, a new stock index with key selection criteria of return on equity ("ROE"), operating performance, and market capitalization; (ii) the introduction of a Stewardship Code to encourage engagement between investors and issuers; (iii) Corporate Law amendments related to outside director appointments and board structure; (iv) the publication of the Ito Review as a roadmap for companies and investors to work together to create sustainable value; and (v) changes in the investment strategy of the 137 trillion yen ($1.1 trillion) Government Pension Investment Fund ("GPIF"). This paper provides a recap of these and other major developments shaping Japan's governance landscape.

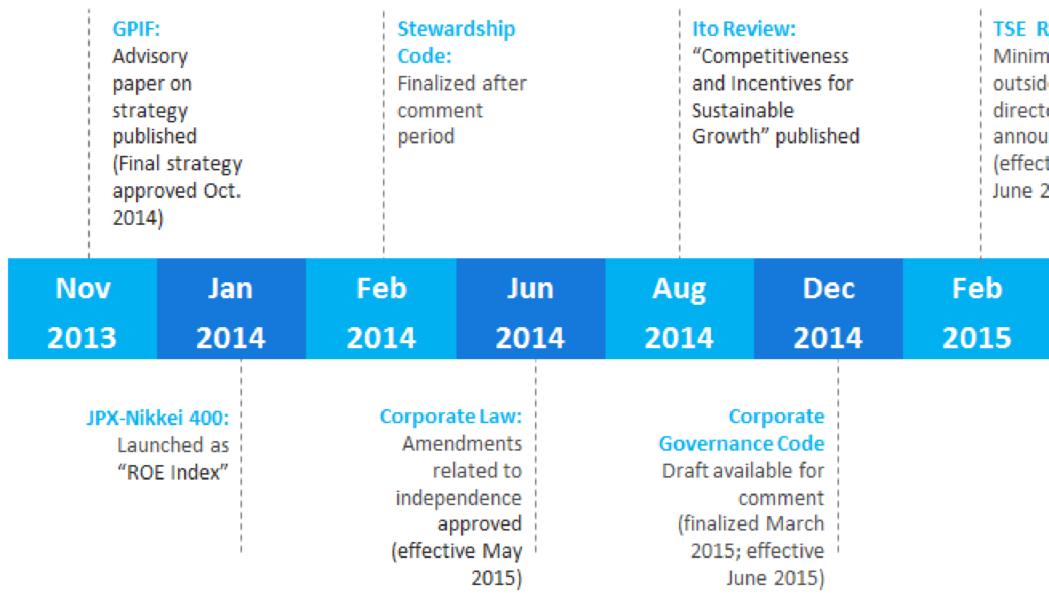
Introduction

The activities seen in Japan over the past two years related to corporate governance are significant. While developments are interrelated, each change or activity is distinct. The cumulative effect of all of these actions is a framework by which meaningful change can occur in Japan. This paper will provide a recap of the major changes by addressing the following questions:

1. What actions have been taken by the GPIF and why are these actions relevant to governance reform?
2. What is the JPX-Nikkei 400 Index and how is its formation expected to improve returns?
3. What are the key tenets of Japan's Stewardship Code?
4. What amendments were made to the Corporate Law to improve director independence?
5. What are the key themes of the Ito Review?
6. What are the key themes of Japan's Corporate Governance Code?
7. What recent changes have been made to TSE listing rules?

For reference, the below timeline of events has been provided.

Exhibit 1: Timeline of Key Developments in Japan's Corporate Governance Landscape



Rapid and Drastic Change: Questions and Answers

Question: What actions have been taken by the GPIF and why are these actions relevant to governance reform?

In November 2013, an advisory paper related to the GPIF investment strategy was published. Specifically, the advisory paper recommended review and consideration of the following:

- A reduction in the portfolio allocation to domestic bonds (which was heavily weighted at 60 percent);
- Investing in new asset classes;
- Increasing allocations to active management funds; and
- Using new benchmarks for passive investments.

The GPIF, administered by the Ministry of Health, Labour and Welfare, is the second largest pool of retirement savings in the world. With assets approximating $1.1 trillion, actions of the GPIF are closely watched by the market. The fund faces the challenge of generating sufficient returns to meet "promised" pension benefit levels. The conservative asset allocation of the GPIF has been well publicized in recent years, as Japan has continued to face demographic challenges with its aging population. Given the high-profile nature and magnitude of assets of the GPIF, a shift in GPIF asset allocation or strategy carries significant weight.

Market expectations in fall 2014 were for the GPIF to increase its asset allocation to Japanese equities from 12 percent to 20 percent. However, exceeding initial market expectations, at the end of October 2014, the GPIF announced the approval of its overall asset allocation plan, which included raising its allocation for Japanese equities to 25 percent and widening the range from +/- 6 percent to +/- 9 percent. This approved asset allocation allows for the GPIF to hold as much as 34 percent in Japanese equities. The allocation to international equities was also increased from 12 percent to 25 percent. The increases in domestic and international equity allocations are offset by a significant decline in the target asset allocation of domestic bonds, from 60 percent to 30 percent. International bonds received an increased allocation, up to 15 percent from 11 percent. Private equity and alternative investments can also now make up 5 percent of the assets under management of the GPIF. The GPIF has also made changes to its indexing strategy, reducing passive investments which track the TOPIX, and utilizing other indices, including the JPX-Nikkei 400.

In May 2014, the GPIF announced its acceptance of Japan's Stewardship Code, and, in accordance with its stewardship responsibilities, now posts information on its website regarding its activities. As the GPIF is prohibited from buying stocks directly, the principles apply to its external managers of Japanese shares. The first post was made on Jan. 30, 2015, and discusses engagement activities of the external asset managers.

These actions by the GPIF will be watched closely and are expected to have an impact on corporate governance in Japan. The GPIF needs to see performance in Japanese equities. Hence, the GPIF needs its selected asset managers to act as stewards and drive the dialogue that is deemed to be a requisite activity for change.

Question: What is the JPX-Nikkei 400 Index and how is its formation expected to improve returns?

In January 2014, the JPX-Nikkei 400 index was launched. Commentators have referred to this index as a "showcase of Japan's most shareholder friendly companies," an "ROE index," a "corporate governance index," and a "shaming index." Getting beyond the hype, the index scoring is based on a 3-year average ROE (weighted 40 percent), 3-year cumulative profit (weighted 40 percent), and market capitalization (weighted 20 percent). The emphasis placed on ROE is expected by many to be a wake-up call to corporations to focus on capital efficiency. The financial press frequently cites the abysmally low ROE performance of Japanese equities in comparison to global performance.

The index considers three qualitative "governance" factors: (i) appointment of at least 2 independent outside directors; (ii) adoption or scheduled adoption of IFRS; and (iii) disclosure of English earnings information via TDnet. However, it is clearly detailed that the scoring is performed such that "at most around 10 constituents are different from those chosen with only quantitative score." Hence, references to the index as a "governance" index may be overstated, unless, of course, the definition of governance is strong ROE, earnings, and market capitalization. A governance index may be more often thought of as an index which measures governance characteristics of the board, shareholder rights, executive compensation, and audit quality.

The JPX-Nikkei 400 is more diverse in number of companies and sectors than the Nikkei 225. In January 2015, the Nikkei 225 had over 20 percent of its index concentrated in four companies (Fast Retailing, Softbank, Fanuc, and KDDI), while the JPX-Nikkei 400 has no company above 2 percent. More than sixty firms on the Nikkei 225 index are currently not included in the JPX-Nikkei 400.

Certain investors have cited flaws in the JPX-Nikkei 400 index; for example, the impact of market capitalization can eclipse that of performance. In other words, smaller firms with superior ROE and operating returns could lose their place in the index to much larger companies with relatively weak performance metrics.

Due to the high profile nature of the index, certain companies which did not qualify for the index have announced or discussed an increased focus on improving performance and ROE to earn a spot.

Question: What are the key tenets of Japan's Stewardship Code?

In February 2014, the FSA released Japan's Stewardship Code (the "Stewardship Code"). The Stewardship Code is modeled after the U.K. Stewardship Code, with two major differences:

- The Stewardship Code does not have the U.K. principle related to collective engagement.
- The Stewardship Code has a principle which indicates that investors should have in-depth knowledge of investee companies.

Japan's Stewardship Code follows a "comply or explain" approach. This approach will allow for each institutional investor to apply the principles based on its specific circumstances. For example, it might be challenging for a smaller fund or a fund containing a large index (or subset thereof) to have in-depth knowledge of each company.

Exhibit 2: Comparison of UK and Japan Stewardship Code Principles

UK's Stewardship Code	Japan's Stewardship Code
1) Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.	1) Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities, and publicly disclose it.
2) Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.	2) Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.
3) Institutional investors should monitor their investee companies.	3) Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies.
4) Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.	4) Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.
5) Institutional investors should be willing to act collectively with other investors where appropriate.	
6) Institutional investors should have a clear policy on voting and disclosure of voting activity.	5) Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist: it should be designed to contribute to sustainable growth of investee companies.
7) Institutional investors should report periodically on their stewardship and voting activities.	6) Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.
	7) To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and the skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

At the end of May 2014, the FSA reported that 127 institutional investors had signed up to accept the Stewardship Code. On March 12, 2015, the FSA reported that this number had grown to 184 signatories. The current number includes 129 asset managers, 21 insurance companies, 21 pension funds, six trust banks, and seven classified as "other."

Question: What amendments were made to the Corporate Law to improve director independence?

Amendments addressing board independence were made to Japan's Corporate Law in June 2014 and will be effective May 1, 2015. The changes are intended to serve as one step towards greater board independence in Japan, as Japan trails every major market in terms of independence.

Key changes approved are as follows:

- The introduction of a "comply-or-explain" rule for the appointment of at least one outside director;
- The introduction of a newly-established “audit committee” board structure; and
- A change to the definition of "outsider" such that parent company affiliates (e.g., executives and employees of the parent company) and certain relatives no longer qualify as outsiders. Note: directors who have been or are affiliated with entities that have substantial business dealings with a company and those who are no longer executives or employees of the parent will continue to qualify as outsiders.

Outside Director Requirement

There are currently two types of board structures: a statutory auditor system and a three committee system. Under the statutory auditor system, which comprises 98 percent of listed companies in Japan, companies are not legally required to appoint outsiders to the board, while the remaining 2 percent of companies with a three committee system are required to have at least two outside directors.

Under the listing regulations at the TSE and Japan's other exchanges, companies have been required to appoint at least one independent outside director OR statutory auditor, who meets the *listing rules definition of independence*. Approximately 40 percent of listed companies satisfied the requirement through the appointment of statutory auditors. Statutory auditors do not have power to influence management policy.

While the corporate lobby was able to exercise sufficient influence so that a hard mandate requiring at least one outside director did not come to pass, the law dictates that companies must “comply or explain” where there is not at least one outside director. The company must provide a reason why it believes it is *inappropriate* to appoint an outside director. Boilerplate language offering a reason such as "the company already appoints two outside statutory auditors" will not be sufficient. At the time the law was approved, it was expected that the idea of a hard mandate would be revisited in the future.

New Audit Committee Board Structure

In addition to the two board structures listed above (statutory auditor system and a three committee system), companies will now be able to select a new audit committee board structure. The new audit committee board structure requires a minimum of a 3-person audit committee, the majority of whom must be outsiders. Hence, the audit committee board structure will require a minimum of two outside directors, as two of three audit committee members creates a majority and no other directors are required to be outsiders.

Corporate Japan did not embrace the "three committee structure" introduced in the 2003 Corporate Law reform. The US-style board system has been a challenge for Japanese companies, as most Japanese companies do not have enough independent outside directors to compose the committees. One blocking point for a US-style committee structure is that company presidents have been unwilling to release the reins on activities performed by the nominating committee (e.g., designating successors). While this may be a palatable, although "halfway," solution for certain companies, widespread adoption is not anticipated at this time.

Question: What are the key themes of the Ito Review?

Published in August 2014, METI's Ito Review is an extensive report based on input from a 53-member panel of academics, company representatives, investors, and government officials. The report was modeled after the 2012 UK's Kay Review. The goal of the report was to outline the way forward to extract the most value out of Japanese assets in a mature economy. The official title of the report is "The Ito Review of the Competiveness and Incentives for Sustainable Growth – Building Favorable Relationships between Companies and Investors."

The Ito Review provides the following five key recommendations:

1. Collaboration between companies and investors to create sustainable value;
2. Company focus on capital efficiency and value creation through generating ROE in excess of the cost of capital;
3. Reform and optimization of the investment chain;
4. Establishing trust through high quality disclosure, dialogue and engagement; and
5. The establishment of a Management Investor Forum to facilitate constructive dialogue between companies and investors.

Two key themes of the Ito Review are engagement and capital efficiency.

Engagement

Discussed in the context of "collaborative cooperation" and becoming a "dialogue-rich country," engagement is at the heart of the Ito Review, which deems that investors and companies need to work together to stimulate investment and growth. The report indicates that disclosure of non-financial information needs to improve, with investors responsible for communicating their needs and taking the focus off of short-term quarterly reports, and issuers providing information on their medium/long term plans. Companies are urged to change a deep-rooted belief that working with shareholders will come at a cost to other stakeholders. The paper calls for reforms to promote more active investment, and for more active investment to promote reforms. Furthermore, the paper calls for the establishment of a Management Investor Forum, which is to provide companies and investors additional opportunities to engage.

Capital Efficiency

The Ito Review highlights weak historical returns of Japanese companies relative to global standards, while noting a recent positive trend of increasing returns. Specifically, the report provides a global comparative chart of median ROE of companies in 13 countries, based on a 10-year period from 2000-2010, showing median ROE of Japanese companies at 4.97 (10th in performance). This is then followed by a 2012 analysis which shows 5.3 percent ROE for Japanese companies in comparison to 15.0 percent for European companies and 22.6 percent for U.S. companies.[1] Low ROE performance is also provided as a reason for the relatively low price-to-book ratio of Japanese companies.

The report proposes a *minimum* 8 percent ROE threshold, urges companies to understand their cost of capital, and reviews the concept that investments must generate returns above the cost of capital in order to be value-accretive.

The report finds that companies lack understanding of their cost of capital, noting that only 40 percent of Japanese listed companies are conscious of their cost of capital. Companies are also urged to review their capital policies. The role and use of retained earnings, cross-shareholdings, and parent-subsidiary listings are held out as key discussion points.

[1] *Comparison excludes financial and real estate companies.*

Structural reasons for excessive cash balances are cited and include cultural goals of longevity and stability, the framework of the main bank system, and a stigma surrounding filing for bankruptcy/no pre-packaged bankruptcy process. The report clearly states that investors expect that capital which cannot be deployed to generate value should be returned to shareholders. However, whether or not this economic rationale and understanding of shareholder expectations conveyed in the Ito Review will be accepted by Japanese executives remains unknown.

Question: What are the key themes of Japan's Corporate Governance Code?

On March 5, 2015, the FSA published Japan's Corporate Governance Code. The publication followed a comment period on the exposure draft of the Code, which was published in December 2014. Comments were received from 121 individuals/entities (80 in Japanese, 41 in English). The Code is not legally binding but follows a “comply-or-explain" approach. While this comply-or-explain approach is the same as the approach used for Japan’s Stewardship Code, it is an approach that is not well known in Japan, and an adjustment period may be required for the concept to take hold.

General principles from the Code include:

1. All shareholders should be provided with equal treatment;
2. Cooperation is necessary amongst all stakeholders (not only shareholders);
3. Appropriate information disclosure and transparency should occur;
4. Board responsibilities include setting strategy, allowing for appropriate risk-taking, and effective oversight; and
5. Companies should engage with shareholders throughout the year.

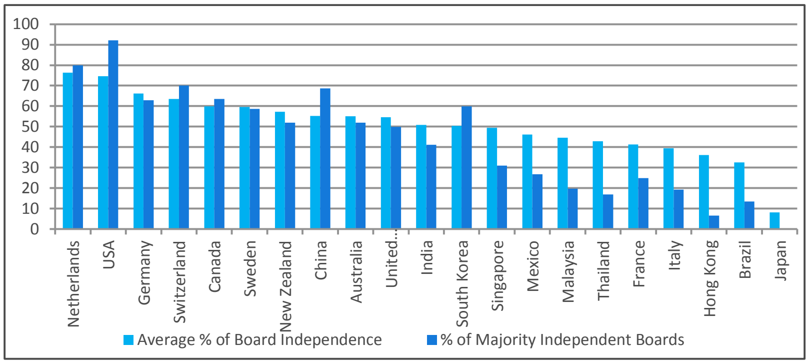
Selected principles and the supplementary principles call for:

1. The appointment of at least 2 independent[2] outside directors who can contribute to increasing corporate value (with guidance that certain companies (e.g., large, global) consider having one-third of the board be comprised of outside directors);
2. Diversity of personnel, including the active participation of women;
3. Director and *kansayaku* training and disclosure of director training policies;
4. An annual evaluation of the effectiveness of the board;
5. Oversight of succession planning for the CEO and other top executives;
6. Disclosure of basic strategy related to capital policy; and
7. Disclosure on policy related to and an annual evaluation of economic rationale for cross-shareholdings.

Points 1 and 2 above are meant to address concerns with the Japan's homogenous, male-dominated insider/affiliated board characteristics. As highlighted in the below chart, in terms of board independence, Japan significantly lags every other major market.

[2] *"Independence" will be based on Japan's rules and regulations (e.g., TSE rules).*

Exhibit 3: Global Comparison of Board Independence



Source: Institutional Shareholder Services data.

While a requirement of two independent outside directors does not bring Japan in line with global governance standards, it a step in the right direction and will require a staggering number of new director appointments (see next section on TSE listing requirements).

Regarding independence, the Code recognizes that simply appointing independent outside directors cannot be directly linked to corporate growth. Rather, the Code explains that leveraging these directors can provide timely, market-based information which can aid the company in making better decisions. If there is a larger number of independent outside directors on a board, the likelihood that their views will be expressed and heard should increase.

The importance of succession planning is worth exploring in the context of overall independence as well as in the context of independence for the Nominating Committee. Because companies are reluctant to hire senior executives from "outside the group," a failure to groom an appropriate successor from among the insiders can destroy significant value. Canon, where the CEO turns 80 this year, and Suzuki Motor, where the CEO is well into his 80s, have not been effective in succession planning and can be considered cautionary examples.

Additionally, the Code suggests timing AGMs to avoid the cluster of meetings on a few select dates in June, stating, "the period between sending the convening notice and the date of the meeting should be as long as possible," and, "companies with fiscal year-ends in March should consider holding their general shareholder meetings in July instead of June."

Question: What recent changes have been made to TSE Listing Rules?

On Feb. 24, 2015, the TSE announced revisions to its listing rules which will require listed companies to comply with the Code or explain any reasons for non-compliance in a designated section of a Corporate Governance Report ("Report") titled "Explanation of Reason for Non-Compliance with the Code." The rule revisions will be effective June 1, 2015. The most notable implication is that the approximate 2,400 companies listed on the 1st and 2nd sections of the TSE will face a "comply or explain" requirement to have at least two independent outside directors as of the effective date. For 2015, an interim measure was put in place which allows companies to submit their Report up to approximately 6 months after the AGM (by December 2015). Beginning in 2016, companies will have to submit the Report within a shorter time period, but the timing is still set to be *after* the AGM. The TSE is seeking public comments on its revised listing rule until March 26, 2015.

The below table reflects recent information on outside director and independent outside director levels in Japan. The table presents ISS Data showing the percentage of Japanese boards with one outsider, one independent outsider, two outsiders, two outsiders where one is independent, and two outsiders where both directors are independent for various indices and the ISS coverage universe. The classification of directors as outsiders or independent outsiders is presented, as outsider directors in Japan are not necessary deemed to be independent by ISS standards. Classification of directors as outside directors or independent outside directors in the table below is based on ISS Independence Criteria for Japan.

While many large-cap companies have already appointed multiple outside directors, or plan to do so in June 2015, a large number of companies will have faced challenges in identifying and recruiting outsiders by that time. It has been estimated that more than 2,000 director appointments will be required to bring listed companies in compliance with this requirement.

Exhibit 4: Board Composition in Japan – Outside Directors

Companies with At Least	One Outsider	Two Outsiders	One Independent Outsider	Two Outsiders (1 Indpt.)	Two Independent Outsiders
Nikkei 225	97%	72%	77%	64%	47%
JPX 400	88%	55%	68%	48%	36%
Topix	77%	36%	53%	28%	19%
ISS coverage	72%	32%	47%	23%	16%

Source: Instituional Shareholder Services data post 2014 AGM season.

Conclusion

After an extended period of limited change in corporate governance in Japan, material efforts, from changes in GPIF strategy to the introduction of a Stewardship Code and a Corporate Governance Code, have taken place. TSE listing requirements have been modified to require compliance with the Code under the "comply or explain" principle. Efforts are aimed at the revitalization of the Japanese economy, which faces significant demographic and other challenges. A roadmap for outside shareholders and Japanese companies to collaborate has been set forth. The premise is that, through mutual collaboration, companies can raise capital efficiency to more globally competitive levels. Certain deep-rooted values and engrained thinking need to be revisited in how their current application assists and/or undermines the overall stability of the Japanese economy and the future of all generations. These developments should provide a framework for the evaluation and consideration of necessary changes.

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