Standard Life Investments

Japan

International investors call for minimum one-third board independence: the benefit of collaborative engagement
June 2017

Authors

Yo Takatsuki, BMO Global Asset Management. Meryam Omi, Legal & General Investment Management. Alison Kennedy, Standard Life Investments

Introduction

This brief report is published jointly by BMO Global Asset Management, Legal & General Investment Management and Standard Life Investments. It explains why board independence is such an important issue for global investors and asset owners and describes a collaborative engagement undertaken by a group of 20 investors and asset owners with Japanese companies which has been underway for the past 3 years. The aim of this engagement is to encourage Japanese companies to improve board composition by moving to a minimum of one third independent directors.

Summary

Corporate governance in Japan has undergone a tremendous transformation in the last five years. Stimulated by the new standards set out in the Corporate Governance and Stewardship Codes, **the conversations between investors and corporates have shifted from WHY governance matters to HOW governance practices can be improved**.

Many overseas and long term investors in Japanese corporations, including the group involved in this engagement, have been ardent supporters and advocates of these corporate governance developments. We believe that companies with a robust governance approach and a sustainable business model will deliver enhanced shareholder returns in the long run, helping the overall Japanese economy in the process.

This engagement focused on independence because having a significant number of **independent individuals around the table who can challenge and strengthen board level discussions is the foundation which will drive many other governance improvements**.

The **collective engagement and discussion on this issue between investors, corporates and regulators has borne fruit, consolidating many divergent views and giving focus** to a complicated matter. Many of the companies engaged with have significantly increased the number of independent directors in the last three years and have highlighted to us the value that these outside directors have brought to the table. They have encouraged us to keep supporting their reforms and changes.

Not all our conversations have had such positive outcomes. As a result, some investors have voted against directors of companies who fail to meet the minimum threshold of board independence, sending a powerful message about the importance of this issue. Voting decisions are made individually by investors, but the commitment to exercise their respective shareholder rights for the benefit of the market, and therefore their ultimate clients, is crucial.

Many challenges remain. In addition to the need to appoint more outside directors, further progress requires appointing directors with the right skills and experience, reviewing the format of board meetings and, perhaps most importantly, cultural change.

As long term investors, we are committed to continuing this dialogue as we believe Japan has a tremendous opportunity to benefit from this ongoing transformation.

The report

Board independence in a Japanese context

Corporate governance is a critical consideration for asset owners and for long-term investors who manage assets on behalf of pension funds, insurance companies and other asset owner beneficiaries. As global investors, we have a long-held interest in ensuring good corporate governance practices at the companies in which we invest. This is based on the belief that those with a robust governance approach and a sustainable business model will deliver enhanced shareholder returns in the long run.

Japan is one of the most important markets for institutional investors. It is one of the biggest and deepest capital markets in the world with thousands of issuers and numerous world class corporations. We have been shareholders in Japanese corporations for many years. However, despite these strengths, one long standing weakness in the Japanese market has been corporate governance practices.

The core area of concern has been the structure and composition of Japanese boards. Traditionally, Japanese boards consisted almost solely of senior executives with no external representation. Due to investor pressure, particularly from outside of Japan, and government initiatives to stimulate the market, we have seen significant changes in this area in the last three years. The vast majority of Japanese companies now have at least one outsider on the board. We welcomed the establishment of the Corporate Governance Code in 2015 which recommended a minimum of two independent directors on the board.

We believe that the time is ripe for Japanese corporations to move to a standard that is more aligned to global practices. Our expectation is that companies should appoint a minimum of one third independent[1] directors (excluding Kansayaku). We consider this to be an achievable and reasonable target. To put this into context, in other developed markets, boards are expected to have majority independence. The call for one third board independence is a reflection of the stage of corporate governance development in Japan.

As shareholders, we look to the composition of the board to gain confidence in its ability to oversee management, provide challenge on the development of strategy, oversee risk management, and ensure high standards of business practice. This is for the benefit of not just shareholders but all stakeholders. To be effective, it is crucial that the board comprises a balance of executives and non-executives who are independent from management. This balance ensures that no single individual, or group of individuals, dominates decision-making to the detriment of others, and helps provide the diversity needed to cultivate healthy debate in the board room. A truly independent director can bring fresh ideas as a result of external experience and challenge management constructively without the constraint of a vested interest in the business. We also look to independent directors to represent our interests as minority shareholders who, like management and company employees, are committed to ensuring the long term success of Japanese companies.

Many investors, one message

In 2014, a group of 20 global institutional investors and asset owners[2] led by BMO Global Asset Management (formerly called F&C Investments), Legal & General Investment Management and Standard Life Investments came together with the goal of engaging with Japanese companies to aim for a more ambitious board independence standard. We believed that a minimum of one third independence was feasible and necessary in Japan and could become the accepted norm in the market within three years. The expectation was that Japanese corporates, particularly those with global outlook and reach, would achieve that level of independence by the 2017 annual shareholder meeting. In addition to individually engaging with various Japanese companies to push for this agenda, collectively we decided to target 33 of Japan's leading companies to accelerate this trend. They were chosen on the basis of factors such as market capitalisation and weightings in Japanese equity benchmarks as well low levels of board independence.

To ensure that our message was clearly understood by the market, we also wrote to the office of Prime Minister Shinzo Abe, the Financial Services Agency (FSA), Tokyo Stock Exchange (TSE), Keidanren, and the Ministry of Economy, Trade and Industry.

In the past three years, many of us visited companies in Japan for face to face meetings, met companies during their visits overseas, and followed up with various calls and letters, both collectively and individually.

We have noticed, during this time, a significant shift in the overall quality and depth of conversation with Japanese companies on governance issues. Many companies welcomed meeting us and hearing our views on why, and how, our engagement can add value. Regulators, such as FSA, have been responsive to our views and incorporated them in the Corporate Governance Code.

The expectation of one third board independence, which was considered almost impossible when we started, is often quoted now as the minimum target by the companies we meet. Even for those which have not yet achieved this, it is no longer seen as a foreign and unattainable goal. Most importantly, many companies openly voice the positive impacts they have had from having independent directors join their boards.

Using votes, but individually

Using votes to bring about positive change is a powerful tool for shareholders. While individual voting polices vary from investor to investor within the collaborative engagement group, there has been a general move to tighten the independence requirement over the past three years. A critical mass of investors have updated their voting policies in Japan ahead of the 2017 AGM season reflecting our expectations of one third independence on the board.

However, each firm retains the right to review each case on its own merits, and the final decision to vote will never been dictated by this collective message. Most investors are mindful of the challenges for newer and smaller companies in the market and as such, would look to tailor their policies accordingly.

The advantage of this collective message for Japanese companies is that they hear one clear voice, not various views that contradict each other. As a group who are interested in the growth of the Japanese market and are willing to invest for the long term, we are sending a joint message while individually exercising our shareholder rights through the use of votes.

Positive outcome, but challenges remain

Of the 33 companies which we originally reached out to in 2014, we are pleased to report, at the time of writing, six companies have reached the one third board independence level. These companies are: **Mitsubishi Electric, Mitsubishi Estate, Mitsui Fudosan, Nintendo, Sumitomo Mitsui Financial Group** and **Takeda Pharmaceutical**.

Many of the others are also very close to the 33% independence ratio and we are hopeful that those companies will reach this level at the 2017 or 2018 annual shareholder meeting.

Unfortunately, there are still ten companies which fall short and where we have only seen minimal progress in the past three years. These are companies with an independence ratio of 10% or lower. Some of these companies have made other governance related reforms which we note and value.

So, our work is not done. And the companies' work is not done. Where necessary, we plan to engage with these companies again following the 2017 annual shareholder meetings in June. We are confident that they will look to establish clear plans for increasing board independence. Going forward, there will be increasing consequences for not doing so quickly enough and lagging behind not just global standards but the Japanese "new norm".

[1] Although there are differences in their individual definition of independence, the standards used by global investors are generally more stringent than what is currently mandated in the Tokyo Stock Exchange's listing rules

[2] Investors and asset owners in the group include: Andra AP-fonden; APG Asset Management Asia; Baillie Gifford; British Columbia Investment Management Corporation; California State Teachers' Retirement System; Columbia Threadneedle Investments EMEA; Investec Asset Management; Mn Services BV; Ontario Teachers' Pension Plan; PGGM; State Board of Administration (SBA) of Florida; The California Public Employees Retirement System

INVBGEN_16_1833_Japan_The_Benefit_Of_Collaboration_Engagement_TCM 0617