SLOWLY, BUT SURELY: AN INTERVIEW WITH NISSAY ASSET MANAGEMENT

REFORMING JAPAN’S CORPORATE CULTURE

VOTING NEWS
T
his month has proved an exciting time for the world of proxy voting, with its fair share of both controversy and indications of future corporate upheaval.

The Australian proxy season continues to entertain, with investor dissent over executive pay translating into ‘strikes’ on numerous remuneration votes at Australian companies, including Mineral Resources, Goodman Group, Commonwealth Bank, Boral and UGL. This shareholder resistance has subsequently boiled over into a very public dispute between Australian issuers and proxy advisers over the supposed influence of the latter’s recommendations in inciting investor dissent.

Elsewhere in the world, Prime Minister Theresa May seems to have reversed her position on employee representation on boards after extensive talks with UK businesses. Although it seems that UK corporate reform has not entirely been removed from the agenda, with Business Secretary Greg Clark declaring after its collaboration with the Confederation of Business Industry that the UK government is committed to publishing its reform proposals by the end of the year.

Finally, the ascent of Donald Trump to the position of President-Elect has led to speculation that the reforms of the Dodd-Frank Act could soon be consigned to the pages of history.

According to Mr Trump’s official transition website, the Dodd-Frank Act will be scrapped and replaced with “new policies to encourage economic growth and job creation.” Nonetheless, it is yet to be seen what form these policies will take or whether his rhetoric will be translated into decisive action, some experts instead predicting a gradual eroding of the Act’s fundamental principles.

Nonetheless, this month’s issue will temporarily sidestep the various controversies and upheavals that have recently shook much of the Anglosphere, and instead focus on Japan – a country that has been quietly attempting to reform its corporate governance as part of a larger effort to revitalize the country’s long-suffering economic vitality.

November’s headline interview is with the Head of Corporate Governance at Nissay Asset Management, George Iguchi. In the interview, we discuss contemporary developments in Japanese corporate governance, as well as the main challenges that currently face Japanese companies.

By contrast, this month’s article will focus more on the unique idiosyncrasies of Japanese corporate culture and their ensuing ramifications for recent attempts to reform Japan Inc. The article will also examine the voting data of foreign investors and the clash of corporate cultures that follows, largely due to the different corporate governance expectations of foreign investors and the Japanese companies in which they invest.

November has also seen Proxy Insight’s synthetic recommendations model go live. The model replicates what we believe to be the ISS and Glass Lewis recommendations, providing new intelligence, including which adviser each investor follows most closely, and whether ISS’ and Glass Lewis’ influence varies by resolution type.

Proxy Insight is the only tool to offer the voting intelligence necessary to navigate today’s investor relations market. If you are not a client and would like to take a look, we would be delighted to offer you a trial. Please get in touch.

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Could you tell us a little about Nissay Asset Management and how you approach corporate governance?

Nissay Asset Management (NAM) is a leading asset management firm in Japan. As we are a long-term investment manager, we focus on the long term intrinsic value of companies derived from a ‘Discount Cash Flow’ (DCF) approach in making investment decisions over the past 10 years.

Because of our long-term approach, Nissay’s engagement with the management of companies is essential, especially in securing non-financial information, i.e. ESG information. We have integrated ESG factors into our research process since we signed the Principles of Responsible Investment (PRI) in 2006, and have ESG ratings for over 500 Japanese companies, which cover more than 90 percent of market capital in the TOPIX index.

In terms of evaluating corporate governance, metrics include: if a company’s management structure is reasonable to create value; if the philosophy of the company is widely shared by its employees; if the company’s strategy is geared towards creating value; and if the management focuses on the efficient use of capital. Although we keep an open dialogue with which to engage with a company’s management, we express our own thoughts through proxy voting.

There has been a lot of attention on the changes to the relationship between Japanese companies and their shareholders. Could you summarize what the situation was before the Abe government came in, and what has changed?

Before Prime Minister Abe’s government came in, the concept of ‘dialogue between companies and shareholders’ had not been well developed in Japan. The introduction of the Japanese Stewardship code in 2014 and the Corporate Governance Code in 2015 by Abe’s government brought the potential for significant changes in this situation.

The codes require both sides to consider the concept of shareholder value, as well as the benefits of constructive dialogue to increase shareholder value. Today, we see more discussions are focusing on long-term issues than before. Such as how to achieve sustainable growth, rather than asking about short-term earnings fluctuation. We believe that this is the first step in making such dialogue commonplace throughout the Japanese investment chain.

What changes have had the biggest impact and are they the ones you expected?

The Japanese government’s introduction of the Corporate Governance code in 2015 had a large impact on governance standards in Japan. The introduction of the stewardship code in 2014 has also had the effect of making investors more active. These are currently the main changes promoting governance reform.

How important is voting to NAM, as opposed, say, to private meetings with management teams?

Voting is important for fulfilling Nissay’s stewardship responsibilities. Private meetings with management are also important in that we can engage with companies and change their direction by expressing the voices of the market.

Are proxy advisers (such as ISS and Glass Lewis) important in Japan?

Yes and No. Japan’s stewardship code requires asset managers to take considerable care with regards to proxy voting.
Small/medium asset managers who do not have capacity to fulfil their fiduciary voting duties must rely on proxy advisers for voting. That is why proxy advisers are currently increasing their business in Japan.

However, large asset managers which have the capacity to make their own votes do not rely on proxy advisers, merely taking their recommendations into account. This is partly because the analysis of proxy advisers sometimes lacks an understanding of Japanese corporate culture. As a result, large asset managers can often find better ways to increase shareholder’s value through constructive dialogue.

The management of Japanese companies is less incentivized than those of their Western counterparts.”

Is remuneration as big an issue in Japan as it is other markets?

Yes, it will soon become one of the most important issues in the Japanese corporate governance landscape. Currently, the typical Japanese remuneration structure is flat, but it is expected that the linking of variable pay with mid-term performance will increase.

Do you favor more incentive-based pay structures?

The answer is overwhelmingly YES. Most data shows that the management of Japanese companies is less incentivized than those of their Western counterparts.

Today, most listed companies share mid-term management targets with shareholders. We believe that more incentive-based pay structures linked with mid-term performance targets will increase the commitment of the management team to the company, and lead to increased conviction among shareholders to hold the management to account.

Would you vote against management nominees for director positions? If so, on what grounds?

In most cases our vote against nominating directors relates to the ‘Independence of outside directors.’ We still see a lot of nominees from the main banks, large shareholders and even some from the corporate world who are difficult to regard as ‘independent’, since we focus on the monitoring function of the Board, which will get more important over next few years. Japan’s corporate governance is still in its early stages. As a result, it is proving difficult to find appropriate candidates that have enough experience to act as outside directors. However, we are hoping to see this lack of experienced outside directors disappear in the coming years.

Do portfolio managers have an influence on voting decisions?

As we manage a lot of products, our analysts are the first to look at each agenda. The Head of Corporate Governance then makes the final decisions on such matters. However, our decision-making process is open to portfolio managers, and they do discuss issues when required.

Are there sufficient outside directors on Japanese boards, and have the recent increases started to have an impact?

As discussed above, the number of outside directors has increased due to the recent introduction of the Corporate Governance code. Currently approximately 80 percent of companies listed in the First Section of the Tokyo stock exchange have installed two or more outside directors as of July 2016, as opposed to 21 percent in 2014.

This increase of outside directors is hopefully only just the beginning of a comprehensive overhaul of Japanese boards. Also we think not only the number, but substance of outside directors, is vital for Japanese corporate governance.

In terms of impact, Japanese companies are starting to be aware of the importance of outside directors. We believe these changes will lead to more shareholder consciousness in Japanese companies and ultimately sustainable value creation.

What would you say is the main challenge for Japanese corporate governance today?

Corporate governance reform is a structural change for both Japanese companies and their investors. If it were to be rushed, it would likely fail in a similar fashion to the swift introduction of foreign activism in Japan during 2004. We therefore should take steps towards improving Japanese corporate governance gradually, but firmly.

Thank you George.
SHAREHOLDER ACTIVISM 2
Unlocking Shareholder Value
Unlocking Shareholder Value Tops the Agenda for Activists, Practice Experts, Directors and Executives of Public Companies

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To many external observers, Japanese corporate culture often seems opposed to the norms of corporate governance elsewhere in the world. The examples are numerous: while global business often involves an element of high-stake investment, Japan Inc. is renowned for being notoriously risk-adverse; while in much of the world activism has become a fact of corporate life, Japan’s domestic shareholders are only recently beginning to reap the benefits of active engagement in corporate reform. The evidence suggests that the answer to Japan’s unique corporate culture lies somewhere in the broader idiosyncrasies of Japanese society. In this article, we intend to analyze some of these cultural behaviors alongside relevant voting data.

Corporate Governance Reform

Japan has made considerable improvements to its corporate governance in recent years, in no small part due to the efforts of Japan’s current Prime Minister, Shinzo Abe, who has made corporate governance part of his ‘third arrow’ of Abenomics reform. In 2014, a Japanese stewardship code was introduced in order to outline guidelines of best practice for asset managers engaging with Japanese companies. In 2015, the Tokyo Stock Exchange adopted a corporate governance code, which, among other requirements, compels Japanese listed companies to have at least two independent external directors. Since the introduction of the two codes there have been encouraging signs of improvement. According to the Associate Director of Governance and Sustainable Investment at BMO Global Asset Management, Yo Takatsuki, the Corporate Governance Code has played a key role in lifting overall standards of governance which had fallen considerably behind governance practices in other developed markets and some other Asian markets.” Over 90 percent of listed Japanese companies now have at least one external director and such companies have begun to address domestic problems, such as cross-shareholdings and poor return on equity (ROE).

Overcoming […] Japan’s entrenched corporate culture will necessitate a concerted effort.”

However, many critics question the sincerity of Japan Inc., arguing that some companies simply pay lip service to corporate reform, whilst at the same time circumventing its spirit by, for instance, appointing associated individuals to the position of external independent director.

Consequently, although many investors welcome the introduction of corporate guidelines and requirements, overcoming the afflictions of Japan’s entrenched corporate culture will necessitate a concerted effort over a long period of time. Indeed, it would be naïve to believe that the traditions of Japanese corporate culture will give way at merely the gentlest of pushes.

Japanese Board Independence

The fact that Japanese investors generally do not reveal their voting is just one more reflection of the current opacity of corporate Japan, especially with regards to disclosure practices.

Fortunately, there is no such lack of data for foreign investors voting in Japanese companies, which is, if anything, more interesting, as it provides an ideal opportunity to compare the expectations of different corporate cultures.

For instance, while one independent director is often considered laudable in Japan, for many foreign investors one is far from satisfactory, some investors going as far as to expect Japanese boards be majority independent.
This is reflected in the voting data, where opposition to director elections on the grounds of a lack of board independence is by far the most commonly disclosed rationale for a vote against a director in Japan (see Graph 1).

However, it must be noted that many investors recognize this chasm between the corporate expectations of Japanese companies and those of foreign investors, and adjust their voting policies accordingly.

BMO Global Asset Management is a prime example of this. According to Mr Takatsuki “until relatively recently, the majority of [Japanese] companies did not have even a single external director on the board.” As a result, BMO’s “current expectation in Japan is that companies should strive for one-third independence on the board.”

Moreover, this difference in expectations with regards to board independence seems to be lessening in recent years. Although the average level of support for director elections in Japan for all investors has remained remarkably stable – 88.6 percent in 2014, 88.0 percent in 2015 and 88.2 percent in 2016 – as Table 1 illustrates, there has been a marked decline in ‘board independence’ as the disclosed rationale for a vote against over the last couple of years.

It therefore seems that as board independence improves, it is slowly being replaced by other concerns, such as committee independence, ROE and diversity.

Executive Remuneration in Japan

In the realm of executive pay, Japan also stands out as an exceptional case. While much of the world is currently reflecting on how to reign in executive remuneration, Japan, by contrast, is contemplating its own frequently underpaid and inexperienced executives. The explanation for this difference lies in both the structure of Japanese companies and the wider cultural norms of Japanese society.

Structurally speaking, there is little incentive for Japanese executives to become a chief executive. The remuneration of Japanese executives, as a ratio of worker’s pay, is miniscule by international standards, and unlike their foreign counterparts, Japanese executives traditionally live in modest houses and travel by train to work alongside their employees.

Moreover, Japan Inc.’s reputation for overly-cautious investing can be partially explained by the paid advisory positions that Japanese executives receive post-retirement. Why would Japanese executives endanger such positions by introducing risky new investments, when they can instead quietly accumulate more capital?

However, it would be wrong to reduce problems with Japanese executive pay to merely corporate structure, as Japanese executives must also be wary of the social customs of wider Japanese society. Indeed, the low executive remuneration in Japan is also partially explained by the widespread aversion of Japanese individuals to deviate from perceived norms and values of Japanese society.
For instance, in a well-meaning attempt to improve remuneration disclosure, Japan’s financial regulator in 2010 released a list of all Japanese executives who annually received over ¥100m. Although similar disclosures in Western states had the effect of increasing the remuneration of all executives to the level of their most rewarded peers, in Japan it had the opposite effect.

To be on such a list was considered shameful and embarrassing, some Japanese executives even taking a pay cut to remove themselves.

Given the social restraints imposed by Japanese society, it is perhaps unsurprising that of the top ten remunerated executives in Japan, eight were born overseas.

Culture is also partially culpable for the risk-adverse nature of Japanese executives, who not only fear the material loss of their comfortable adviser positions post-retirement, but also the social consequences of corporate failure, which can lead to the losing of face, the letting down of one’s employees and, in extreme cases, being treated like a social pariah.

Given the uncontroversial nature of executive pay in Japan, there is little need for a regular say-on-pay vote, investors in Japanese companies only voting on pay when either the board or the supervisory board of statutory auditors intend to increase their annual pay. Despite poor Japanese disclosure practices – Japanese companies being legally obligated to disclose only the aggregate amount of pay – such votes are usually a rubber-stamping exercise, with the average level of support for approving increases in aggregate director and statutory auditor remuneration being 98.4 and 99.1 percent respectively.

A more controversial proposal in Japan is the approval of stock option plans, which for foreign investors requires far more comprehensive disclosure practices than those legally mandated in Japan.

Once again in the voting data we can observe a rift opening between the different expectations of corporate cultures – the average level of support for stock option plans among foreign investors in Japan being only 84.2 percent. As Table 1 illustrates, if we take the ten investors voting most frequently on stock option plans in Japan, this falls even further to 73.7 percent.

As a result, the continued existence of this gap between the expectations of different cultures on various issues of corporate governance largely explains the more aggressive stance of investors in Japan, as opposed to many Western countries. According to Proxy Insight, the average level of support for all resolutions in Japan is 86 percent, considerably less than the 92 percent of the US and the 95 percent of the UK.

This trend will likely continue for the near future, as Japan attempts to reform its corporate governance in the teeth of both the traditions of Japanese corporate culture and the wider cultural norms and values of Japanese society.

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**Table 1: Percentage support of the ten investors voting most frequently on stock option plans in Japan.**

*Source: Proxy Insight*
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UK binding say-on-pay possibly not universal

It seems that Prime Minister May’s binding say-on-pay vote reform may not apply to all elements of pay and only some companies, according to the green paper published on Tuesday.

The paper declared that the binding say-on-pay vote could apply to the full remuneration report. Alternatively, it might just apply to the “variable pay elements” such as the bonus, long-term incentive plan and any pay rise, not the actual salary.

In addition, the binding vote may only be applied to companies which encountered considerable investor dissent the year before or companies that had lost their existing annual advisory vote.

Another proposal suggested that an upper threshold could be set for total annual remuneration, where pay that exceeded the threshold must have a binding say-on-pay vote.

Commonwealth Bank receives first strike

The Australian Commonwealth Bank has become the first of the four big lenders in Australia ever to receive a first strike, with 49 percent of votes being cast against the bank’s remuneration report.

It is believed that the causes of such investor dissent are the linking of chief executive Ian Narev’s long-term bonus to new soft targets, and concerns about the payment of multimillion-dollar bonuses despite a series of scandals at the bank.

Hours before the result of the AGM the bank withdrew the resolution, which would have linked 25 percent of Mr Narev’s bonus to progress in areas including “diversity and inclusion, sustainability and culture,” with the remainder linked to shareholder returns and customer satisfaction. The Commonwealth Bank has now reverted to its traditional method of calculating Mr Narev’s long-term bonus - a 75 per cent weighting on shareholder returns and a 25 per cent weighting on customer service.

News Corp keeps dual-class structure

Rupert Murdoch has once again prevented News Corp’s investors eliminating the company’s dual-class structure. News Corp’s dual-class structure allows the Murdoch family to control approximately 40 percent of the company’s voting power with only 14 percent of the company’s capital.

This year an advisory proposal to remove News Corp’s dual-class structure only received 32.2 percent of votes in favor, as opposed to a similar proposal last year, which only just fell short of a majority with 49.5 percent in favor. Jose Maria, News Corp’s nominating and corporate governance committee chairman, asked the company’s shareholders to vote against the proposal because it was “not in the best interests of the company and stockholders.”

A representative from the Nathan Cummings Foundation has urged News Corp to rid themselves of the dual-class voting structure: “Ask yourselves what’s right for all of your shareholders and not just those with the last name Murdoch.”

AustralianSuper issue warning on exec pay

Australia’s largest superannuation fund, AustralianSuper, has issued a warning declaring that investor dissent against remuneration reports is too high and that boards need to take a tougher line with regards to executive pay.

The chief executive of AustralianSuper, Ian Silk, has said not only that some companies still see their investors as a nuisance, but also that such companies should leave the share market unless they accept both the rights of their shareholders and their responsibility as active owners.
Mr Silk went on to say that “It is one thing to criticize greedy executives but greedy executives don’t write their own pay checks. It is boards that should be acting on behalf of the company and shareholders. A lot of boards, a lot of chairs, a lot of remuneration committees and a lot of remuneration committee chairs need to ensure they have the balance right rather than acquiesce to the demands - as they often do - of management.

UK Stewardship Code introduces ranking

Fund managers in the UK that follow the UK Stewardship Code are now ranked by a three tier system depending on how well they comply with the code’s requirements.

Moreover, those fund managers in the third tier, where significant reporting improvements are required, are given six months to better comply with the code’s requirements or face being removed from the list altogether.

According to ShareAction Chief Executive Catherine Howarth, “The Financial Reporting Council’s decision to remove underperforming signatories of the Code that do not demonstrate improvement within six months is a welcome move with real teeth, and one that we hope will spur action among the lowest ranked fund managers.”

Dodd-Frank Act to be dismantled?

President-Elect Trump’s Transition Team has pledged to scrap the Dodd-Frank Act on the grounds that it has made Wall Street banks an even bigger threat to the nation’s economy and working families.

The stock prices of US banks rose as investors bet that a Trump presidency will lead to less regulation and the sidelining of industry critics in Congress.

According to a statement on Trump’s official transition website: “The Financial Services Policy Implementation team will be working to dismantle the Dodd-Frank Act and replace it with new policies to encourage economic growth and job creation.”

Board spill at Zeus Resources

There was enormous opposition at Zeus Resources’ AGM, with the company receiving a second strike, the company’s investors casting 99.81 percent of votes against the remuneration report. The resulting board spill was passed with 99.97 percent of votes in favor.

The only good news for the company was that Mr Jiangang Zhao was re-elected as a director. Although due to the board spill he will need to undergo another re-election process in the near future.

Employee representation under threat

The UK government has dropped Theresa May’s demand for employee representation on boards and plans to downplay the proposed reform. This follows the cool response that the idea received from UK business, with various groups, including the Institute of Directors, endeavoring to persuade the Prime Minister to water down the reform.

This apparent U-turn was hinted in one of Chancellor Philip Hammond’s ambiguous statements recently, in which Mr Hammond said “we want to ensure the voices of consumers and workers are heard in the boardrooms and we’re having conversations about how that can be achieved.” This reversal was given more credence by Business Secretary Greg Clark’s earlier declaration that he would not press ahead with plans to put workers on company boards.

Universal Proxy for funds?

The SEC has requested opinions of whether to extend universal proxy rules to registered funds and business development companies (BDCs). The SEC has acknowledged that contested elections are a rarity at open-ended funds. Although contested elections are more common at exchange-listed closed-end funds and BDCs, dissidents in the elections of such entities have generally not sought split-ticket voting, but rather attempted to either gain control of the board of directors or replace the adviser.

Other questions have been released for the investment community to reply to, including: Should any aspect of the proposed universal proxy system be modified to account for the unique characteristics of investment companies?; Would a universal proxy system affect funds and BDCs differently than operating companies?; How would a universal proxy system affect unitary or cluster boards?
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