Corporate governance in Japan

Do events in 2018 demonstrate meaningful change?

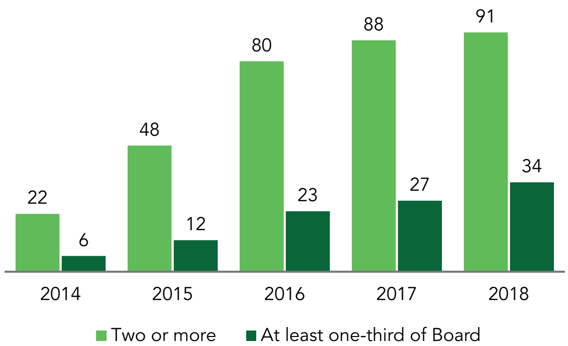
2018 saw both another major corporate governance scandal and the revision of the corporate governance code in Japan. We discuss the areas in which significant change has been achieved, and those in which there is still more work to be done.

The corporate governance scandal that erupted at Nissan in 2018 captured headlines around the world and with memories of scandals at Toshiba and Kobe Steel still fresh in people's minds, led many to question whether anything had really changed in Japan. However, 2018 also saw the revision of the Japanese corporate governance code and a marked increase in support for shareholder proposals. Improving corporate governance in Japan has been a priority for the government in recent years, as a mechanism to enhance balance sheet efficiency and capital allocation decisions with the aim of increasing corporate value and ownership by foreign investors.

Ruffer has invested in Japanese companies for over a decade and good corporate governance practices are something we take seriously. While real change takes time, with inevitable setbacks along the way, we believe there has been a meaningful shift in Japan.

Improvements in corporate governance are undoubtedly difficult to measure, but recent trends in important indicators show progress has been made, albeit from a low starting point. Of all Japanese listed companies, the number with at least two independent directors has increased from 22% in 2014 to 91% in 2018, and companies where at least a third of the board are independent has increased from 6% to 34% over the same period.[1]

Percentage of companies with independent directors

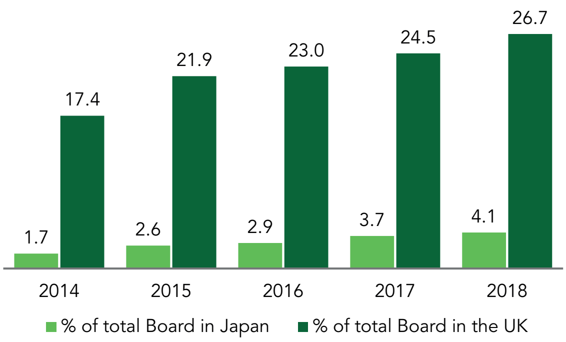


Source: TSE from Japan Exchange Group: Progress on Japanese Governance Reforms, p14

In most developed countries, it is expected that the majority of directors on a board are independent, to provide a robust counter-balance to, and effective oversight of, management. However, the Japanese corporate governance code only recommends that companies appoint at least two independent directors to the board, while acknowledging that, if a company believes that having at least a third of its board made up of independent directors is beneficial, it should appoint them. This is still a long way off the expectations of other corporate governance codes, including the UK code, and what is considered best practice in many countries. Therefore, while there has been a considerable rise in the number of companies where at least a third of the board members are independent, we would hope this figure will continue to increase in the years ahead.

The reform of the corporate governance code in 2018 made more substantial amendments in a number of important areas. One of these is gender diversity, which is particularly important in Japan due to its population demographics: the country has the world's oldest and most rapidly shrinking population.[2] As the Japanese workforce is predicted to fall sharply in the next few decades, Prime Minister Abe has made female empowerment a priority since 2013 in his efforts to revitalise the Japanese economy. However, gender diversity continues to be an issue on boards, with the percentage of female directors increasing from just 1.7% in 2014 to 4.1% in 2018.[3] In response, the revised code specifically references gender diversity for the first time, as part of a broader push to increase diversity. Although the statistics are more encouraging when only the largest Japanese companies are considered, the chart below shows that much more still needs to be done and so investors, like us, should continue to put pressure on companies to do so.

Proportion of female directors



Source: Gender Equality Bureau from Japan Exchange Group: Progress on Japanese Governance Reforms, p42 and Hampton-Alexander Review, 2018 Report, p44. Proportion of listed companies in Japan and FTSE 350 companies in the UK

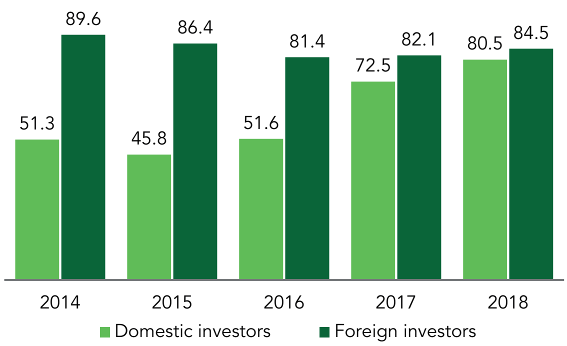
Another important area, which is of particular significance in Japan, is the continued existence of cross-shareholdings.

Of the companies in the MSCI ACWI index that hold cross-shareholdings, 72% are Japanese.[4] The revised code states that companies should now assess these holdings on an annual basis, taking into account their cost of capital. Including the cost of capital in the code has already had a marked effect on companies, moving it from a largely ignored concept to one in which most now recognise its significance. This has broader implications as research shows that it is a key area of importance for shareholders which has, until now, often been ignored by companies. This could therefore lead to the better alignment of management performance indicators in remuneration policies with investors' expectations in the future. 18 shareholder resolutions relating to capital efficiency were filed in Japan in 2018, a significant increase from 11 in 2017, demonstrating the importance of this issue to investors.[5]

Takeover defence measures, including 'poison pills', are still common in Japan.

Many of these controversial measures were instigated in response to the perceived threat of hostile takeovers from foreign companies in the middle of the last decade. However, consensus opinion has changed dramatically in recent years, initially led by foreign investors but more recently also supported by domestic investors. Their concerns are that these measures are not the best way to protect the interests of minority shareholders and instead are being used to protect underperforming management teams and therefore hinder the maximisation of corporate value. Initially, pressure was applied to put these measures to a shareholder vote on a regular basis, but feedback from investors also led to them being dropped by a number of companies, including Panasonic and Yamaha Motor. At Ruffer, we have engaged with a number of companies on this issue and have predominantly voted against takeover defence measures at company meetings. In order to strengthen our response to companies, we have recently updated our internal voting guidelines to state that, unless there is a compelling reason not to do so, we will vote against takeover defence measures.

Votes against management on takeover defence measures



Source: ICJ from Japan Exchange Group: Progress on Japanese Governance Reforms, p47

In conclusion, we have seen considerable progress in improving corporate governance practices in Japan in recent years, but there is still much to be done. We support the commitment of the Japanese government and others to the importance of corporate governance. We will continue to raise our concerns and stress the importance we attach to strong corporate governance practices in our engagement with companies, which will also inform our voting at company meetings. ●

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References

1 Japan Exchange Group: Progress on Japanese Governance Reforms, p14

2 www.bloomberg.com/news/articles/2018-09-19/what-is-womenomics-and-is-it-working-for-japan-quicktake

3 Japan Exchange Group: Progress on Japanese Governance Reforms, p42

4 MSCI ESG Research report, 'Topics in Governance: Cross Shareholdings', September 2018, p5

5 ISS presentation, 'Japan corporate governance development', p11

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