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A New Era Of Japanese Corporate Governance

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The end of June is the start of the annual ritual of Japanese shareholder meetings, which are held on only a few select days of late June, traditionally to prevent vocal shareholders from attending multiple meetings.[1] For foreign institutional shareholders who have recently invested billions of dollars in the Japanese market and led the surge in the Japanese stock market under Abenomics, this shareholder meeting season draws special attention.

While the conventional view is that shareholders in Japan have only limited rights and influence over corporations, large foreign investors and hedge funds are scrutinizing these meetings to see if there are signs of change allowing shareholders to exert more influence on corporate management and performance.

The stakes are high not only for foreign shareholders. This season and the months that follow provide a unique opportunity for the Japanese political and business leadership to show its commitment to improving the Japanese investment environment and corporate governance standards as a means of assuring foreign investors and giving them more incentives to keep their Abenomics-driven dollars in Japan — not just for their short term — but also for their mid- to long-term contribution to a new era of Japanese economic growth.

The Abe administration's use of the Nikkei stock averages as a public barometer of its policy successes is further reason to use the shareholder-meeting setting to boost foreign shareholder confidence and renew their long-term connection to Japan.

As discussed below, the changes in corporate governance will not have immediate impact this shareholder season; however, with Japanese government support, foreign shareholders may see more concrete opportunities develop over the post-shareholder season months.

It is hoped that Japanese corporate management in response to substantive shareholder input will improve corporate performance or undertake difficult restructuring. This season may be the start of a rare window of opportunity in Japan for foreign institutional investors to push forward proposals for stronger corporate action, with careful and deliberate planning.

Increased Scrutiny of Management

In May 2014, 20 institutional investors — including the California Public Employees' Retirement System (Calpers), the U.K.'s Baillie Gifford and the Ontario Teachers' Pension Plan — cosigned letters reportedly sent to over 30 leading Japanese companies. They asked that the number of independent outside directors rise to at least one-third of Japanese corporate boards in three years. If the goals are not met, they may vote against the appointment of directors at shareholders meetings in fiscal 2017.

This demand for more outside directors is not merely academic. Substantive risk and concerns exist for foreign institutional investors looking back at Japanese incidents involving Kanebo, Olympus, Daio Paper and Tokyo Electric to name a few. Even individual Japanese investors have demanded major reform as a result of these well-publicized cases.

Traditionally, Japanese boards are mostly insider-controlled with longtime company managers often accounting for 90 percent of board directors. These board directors must deftly oversee themselves. While Japanese corporations have a high sense of social responsibility and concern for employee welfare, there have been few legal mechanisms or incentives to protect the best interests of shareholders, especially when resolving situations where managerial self-interest might adversely influence a corporate decision.

Most notable is that outside directors as a component of increased corporate governance is a central part of Abenomics reform. The ruling Liberal Democratic Party (LDP) has recognized the active use of outside directors as a core issue.

In addition, amendments to the corporation code provide concrete measures to promote the introduction of independent outside directors. The direction this year is thus clear with the Nikkei newspaper reporting that the number of Tokyo Stock Exchange-listed companies with at least one outside director shall increase from 60 percent to nearly 70-80 percent this year. In Japan, the support of the Japanese government is critical for change and though these are small steps, they should eventually show substantive effect.

Hope for the Stewardship Code

Another component of the Abenomics "third arrow" is the stewardship code for institutional investors released in February and which by early June 2014 has reportedly been adopted by more than 100 institutional investors in Japan, including the huge Government Pension Investment Fund (GPIF).

Modeled after the U.K. stewardship code and implemented by the Financial Services Agency, the code states that Japanese institutional investors should seek to contribute to the sustainable growth of their portfolio companies. Its seven principles seek greater transparency in institutional investors' policies in stewardship, conflicts of interest and voting policy. It places a burden on institutional investors to take more responsibility and undertake detailed due diligence of their portfolio companies with the objective of more active engagement with these companies.

The creation of a stewardship code is part of a broader set of reforms, including the reform of the $1 trillion GPIF. Thus, foreign shareholders should be emboldened by this FSA action, which gives visible legitimacy to those investors who have in the past actively worked together with Japanese corporate management, sharing analytical research and industry insight, to achieve the ultimate objective of improved ROE, transparency and governance.

While past “activist” cases involving some foreign hedge funds had received extremely bad press and created Japanese public suspicion of such activism, foreign investors may now have more room to be “affirmative” in their approaches for badly needed change using the parameters of the stewardship code.

JPX Nikkei 400 and Stock Buybacks

Another hopeful trend is the launch of the new JPX Nikkei 400 stock index, which rewards corporations included in the index for their high return on equity, operating profits and corporate governance. Especially this shareholder season, stock buybacks by companies like Mitsui & Co. have received glowing press coverage and triggered a large number of 2014 shareholder proposals for more buybacks.

During Japan’s “lost decade,” commentators pointed to the Japanese corporate sector’s large holdings of cash. This horde of Japanese corporate cash invested at nearly zero rates is far less than each corporation’s cost of capital.

With the Bank of Japan market actions in support of Abenomics, cash holdings have soared further. With better corporate governance, the productive use of this corporate cash should further support Abenomics-triggered Japanese economic growth.

While the misallocation of assets had not been penalized in the past, the attempt to reward a better bottom line and governance through the JPX Nikkei 400 is certainly a good sign. The hope is that listed Japanese corporations motivated to be a part of the JPX Nikkei 400 will be more open to engage with all institutional shareholders.

An Opportunity for Foreign Shareholders in Japan?

How can foreign shareholders take advantage of the foregoing trends after this shareholders season?

Due to numerous institutional barriers and societal disdain, in the past proxy fights were rare in Japan and even shareholder proposals were not numerous.[2] This will likely remain unchanged.

However, this year’s subtle but broad shifts in corporate governance may lead to fundamental reform. If these trend lines continue, foreign institutional shareholders can possibly be more aggressive in bringing about corporate action that should help Japanese economic growth. Of course, any such aggressiveness must be coupled in Japan with openness to constructive dialogue.

While Japanese management will continue to have distaste for difficult questions raised during shareholder meetings, the government and even individual investors see the need for more transparency and engagement. Combine this with the pressures to increase independent directors and implementation of the stewardship code as well as the pursuit of higher ROE, and Japanese management realizes it cannot ignore shareholder demands as it may have in the past.

Behind the scenes, some major funds and pension funds have taken the subtle strategy of cooperative but firm demands on Japanese management with some success. Shareholders should re-review their strategy and reexamine what is realistic under Japanese shareholder laws, use public opinion and media, as well as “lobby” company’s main banks and business affiliates to navigate this changing governance environment. The following should be considered if this is to become a new era of Japanese corporate governance:

1. Be aggressive while maintaining cooperative dialogue;
2. Be specific as to demands;
3. Interface with the main bank and corporate affiliates;
4. Use public opinion and cultivate the Japanese media;
5. If necessary, submit shareholder proposals or consider a proxy battle, but understand that this may just be a last resort tool for negotiation, until there is further major governance reform.

While the above observations are common sense, they will be especially critical after the current shareholder meeting season in Japan. Foreign shareholders should continue pressing demands for better corporate results and increased corporate governance oversight.

If decisive corporate action through reasoned shareholder activism is achieved, it will set invaluable precedent and should help Japan Inc. become more competitive. The opportunity now is that Japan Inc. and its Abenomics-driven government have come to realize that a key part of their success may hinge on better oversight and corporate governance, with a healthy amount of activism mixed in.

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[1] The Nikkei reports that approximately 2130 public companies will hold shareholder meetings in June 2014 and 820 of them will be on the same day, June 27, 2014.

[2] IR Japan reports that in 2013 there were 144 shareholder proposals made among the surveyed 2,473 public companies, compared to 98 proposals in 2010. However, only two such proposals were passed.