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INSIGHTS FROM CFA SOCIETY SINGAPORE

By Piotr Zembrowski

Osamu Nagayama's ouster from Toshiba Corp in June 2021 was a remarkable example of shareholder-driven action in a Japanese firm. PHOTO: AFP

Japanese companies are waking up to activist investors

Amid Japan's traditional corporate culture, shareholders are growing bolder in pushing governance, ESG agendas

DURING an annual general meeting (AGM) on Jun 25, 2021, shareholders of Toshiba Corp ousted Osamu Nagayama, the chair of the company's board of directors, who had been in his role less than a year.

Similar, if not as spectacular, shareholder actions took place in June 2021 at AGMs of Yakult Honsha, Kansai Electric Power, and SoftBank Group. At Yakult, foreign investors voted against the management's nominees for the board.

Shareholders of Kansai Electric Power put forward a proposal to decarbonise its business, although it was voted down. And a substantial number of SoftBank shareholders opposed an appointment of the company's former lawyer as a new board director.

Most such efforts fail, making Nagayama's ouster such a remarkable exception. Nevertheless, activist investors have been growing bolder in pushing their agendas in Japanese companies whose boards traditionally are dominated by insiders. Their voices contribute to the pressure being placed on Japan's companies to rethink and modernise their corporate governance practices.

Activists have focused their efforts most often on corporate governance and environmental, social, and governance (ESG) issues. As they represent mostly foreign firms, they tend to operate with global governance standards in mind, in particular regarding the presence and role of independent directors on boards – an area in which Japanese governance lags behind global best practices.

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Role of independent directors

Independent directors on boards add value by counterbalancing the influence of the company's executive management or that of its controlling shareholders. They ensure that decisions are made in the best interest of the company and with consideration of fairness to all shareholders. Underrepresentation or lack of independent directors, as well as their ineffectiveness, can lead to insider board control; disregard for the needs of shareholders; decision-making bias; and, in extreme cases, corporate misconduct. Academic research has shown that companies with independent boards perform better than those without.

Appointing majority-independent boards is a common practice in many major industrial markets. In the United States, both the New York Stock Exchange (NYSE) and Nasdaq require in their listing rules that independent directors constitute a majority of the board of a listed company. The UK Corporate Governance Code recommends that at least half of the board of a company in the Financial Times Stock Exchange (FTSE) 350 Index be independent.

In Asia-Pacific, however, Australia stands out as the only market with such requirements.

Japan's practices regarding independent directors differ from those in the US, UK, or Australia, chiefly in the average number of independent directors on boards of Japanese companies. Although around 60 per cent of directors on boards of Australian companies are independent, in Japan, the share is 39 per cent among the major companies included in the Nikkei 225 index; if smaller companies are included, it is even lower.

The reasons for these practices are tied to Japan's traditional business culture, in which a board directorship is a culmination of an executive's career, a director's company experience is valued higher than independent thinking, and oversight is delegated to the audit and supervisory board in a 2-tier board structure.

Board structures in Japan

The complexity of organisational forms that Japanese companies can adopt has been particularly vexing for foreign investors, and some domestic ones, too. Currently, companies can adopt one of 3 board structures. The traditional 2-tier structure, with a secondary audit and supervisory board, was the norm a couple of decades ago, and it is still the most common, with more than two-thirds of all listed companies adhering to that model.

The Western-inspired model of a 1-tier board with 3 committees – audit, compensation, and nomination – has been available to companies since 2002. Even today, however, only 2 per cent of listed companies have adopted this model. In 2014, a third model was introduced: a 1-tier board with a single audit-and-supervisory committee. Nearly a third of companies listed on the Tokyo Stock Exchange (TSE) have switched to this model, but doubts persist as to whether this represents genuine progress towards achieving global best practices.

Many companies found it convenient to 'flatten' their board structures by adopting the 1-committee model, as a shortcut to meeting the requirement of Japan's Corporate Governance Code to appoint at least 2 independent directors. They do so by bringing their existing members of the secondary board in the 2-tier model onto the board as directors.

Because at least 2 members of the secondary board already must be outsiders, and the company can deem them to be independent, this manoeuvre makes it easy for a company to follow the letter of the regulation. Doing so, however, does not follow the regulators' intention to foster better governance by including truly independent voices.

The value that independent directors bring to the board – that is, the ability to challenge the company's management and experience brought from other industries and professions or the academia – is not yet universally recognised. It is in this regard that foreign investors have been playing a significant role – whether directly, by voting against slates of directors who are insufficiently independent, or indirectly, by avoiding investing in Japanese companies with opaque governance practices.

Japan's financial regulators have recognised the need to promote global governance standards to make companies more attractive to foreign investors. The Corporate Governance Code, published first in 2015 by Japan's Financial Services Agency (FSA), required, for the first time, that listed companies appoint at least 2 independent directors to their boards. In June 2021, FSA amended the code, boosting this requirement to at least one-third of the board for companies listed on the Prime Market.

In Japan, the average number of independent board directors is 39 per cent among the major companies included in the Nikkei 225 index. If smaller companies are included, it is even lower. PHOTO: REUTERS

These changes, as well as others, which have included promoting gender diversity in human resources practices – another area in which Japan notoriously lags other industrial markets – have been met with general approval by investors. A survey of domestic and foreign investors who invest in Japan, conducted by CFA Society Japan in April 2021, showed that around two-thirds of respondents approved of the higher independence requirement, and many who disapproved said that it was insufficient.

The newest data published by the TSE in its *White Paper on Corporate Governance 2021* shows that in 2020, 48 per cent of companies listed on the exchange already met the one-third board independence requirement (the number was 59 per cent for those listed in TSE First Section) and 5 per cent had boards that were majority independent. This represents the substantial progress that has been made since 2018, when the respective numbers were 28 per cent and 3 per cent – but it underscores that majority independent boards are still rare.

Room for improvement

One issue not yet addressed in Japan in any substantial form is the separation of the roles of the board chair and the chief executive officer (CEO) in listed companies. CFA Institute recommends that the 2 roles be filled by 2 individuals, and that, ideally, the board chair should be an independent director.

In Japan, the CEO is the board chair in 83 per cent of companies. In a further 15 per cent of companies, the chair is the former CEO, leaving only 2 per cent of companies in which the roles are clearly separated.

If the board chair is also the CEO of the company, such concentration of power in the hands of 1 individual goes against the principle of checks and balances. According to the third edition of the CFA Institute manual for investors, *The Corporate Governance of Listed Companies*, a dual role may "impair the ability and willingness of board members to exercise their independent judgment". This issue, however, touches on governance practices so rigidly established in Japan's business culture that it does not even appear on the regulators' radar.

Additionally, board diversity (of background, experience, skills, and perspectives) can improve effectiveness and reduce the risk of groupthink. Gender diversity, in particular, recently has come into focus globally, and Japan stands out as a market in which much progress can be made in this regard. In 2020, only 5 per cent of officers (directors and members of the audit and supervisory board) on Japanese-listed companies were women, according to TSE.

Japan still has a long journey ahead to bring its corporate governance standards in line with global best practices. Its traditional corporate culture is deeply ingrained and not easy to change. Arguments are being made in favour of the established practices, such as the 2-tier board structure with a separate audit and supervisory board as the main oversight body. After all, these traditional practices have led to the recognition of the importance of sustainability and ESG issues well ahead of other markets in the region.

Nevertheless, evolution will not be stopped, and broader adoption of global best practices of corporate governance will only boost their overall performance, making Japan's companies even more competitive and more attractive to foreign investors.

Regulations aim to influence governance practices from the top down, but as the bottom-up agent of this change, investors have a significant role to play. Although some asset managers prefer to address governance issues by patient, low-key engagement with companies behind the scenes, others favour open confrontation and the spotlight of the AGM. Japanese companies will have to get used to activist investors being more visible, vocal, and persistent.

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