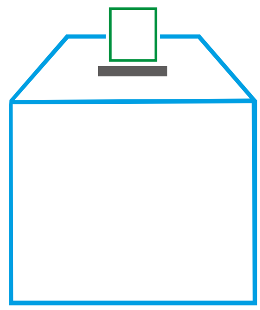
Corporate Governance & Responsible Investment Policy

Japan 2018

Legal & General
INVESTMENT MANAGEMENT

Introduction

This policy sets out Legal & General Investment Management (LGIM)'s expectations of investee companies in the Japanese market in terms of corporate governance and outlines how LGIM exercises its votes. It is supplemented by, and should be read in conjunction with, LGIM's main Corporate Governance and Responsible Investment Policy. This main framework provides a full explanation of LGIM's approach to voting and engaging with companies on environmental, social and governance (ESG) issues and is available on the website.



The Japanese corporate governance framework is set principally by the Company Law, the Financial Instruments and Exchange Act, the Tokyo Stock Exchange (TSE) Listing Rules and the Principles of Corporate Governance for Listed Companies.

In line with its increasing international presence, LGIM adapts its policies to address the economic, political and cultural differences in corporate governance practices globally. LGIM recognises that the move towards strong corporate governance in Japan begins with compliance with Japanese legislative and regulatory frameworks. Beyond this, LGIM considers that its voting policy should reflect LGIM's overarching corporate governance framework.

In Japan, positive trends in board composition and diversity are emerging. Yet significant challenges must still be overcome in order to ensure Japan stays competitive within the globalised economy. LGIM believes that Japan can benefit further from unrealised opportunities if company strategies are subject to a healthy debate, mediated by diverse and well-balanced boards.

A more diverse and effective board composition should not only deliver operational benefits to companies, but also lead to improvements for their shareholders who currently have limited access to information and are exposed to poor capital management practices.

Diversity in this context refers to the independence of directors, as well as the need for a representation across a wider spectrum of nationality, gender and age. Director independence should serve as a check on company management, test the strength of risk management models, and identify strategic business opportunities that will increase the future value of companies over the short, medium and long-term.

Company board

ROLE

THE CHAIRMAN AND THE CHIEF EXECUTIVE OFFICER

In Japan, the Company Law does not require the separation of the roles of chairman and CEO. In a company with a two-tier board structure, the board of directors is required to appoint a representative from within the board. In a company that adopts a unitary board structure, the board of directors appoints an executive officer (typically a CEO), and a representative executive officer (chairman or president), who represents the company and can legally bind it.

LGIM regards the separation of the principal roles of CEO and independent chairman as essential for the effective discharge of board duties. A board that is run by an insider may be less amenable to innovative approaches to company strategy.

LGIM supports the appointment of an independent director (gichou) to set the agenda for the meetings and lead the sessions, independently of the insider chairman.

Structure & operation

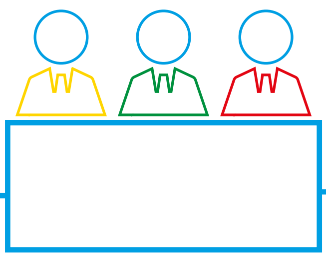
The vast majority of Japanese companies use the traditional two-tier board structure with Kansayaku.

TRADITIONAL TWO-TIER BOARD

The traditional two-tier board consists of a board of directors and a board of statutory auditors (Kansayaku). The role of Kansayaku is to audit the directors' conduct and processes. The legal position of Kansayaku is that of a fiduciary and their legal duties include: attendance of all board meetings, determination of audit policy, and methods for monitoring and investigating the company, accounts auditing, and reporting breaches of directors' duties.

Yet Kansayaku are not integrated into the board's formal decision-making process and do not have the authority of directors. Although they have the right to express their opinions on any matter at board meetings, they do not have voting rights. 'The de facto role of Kansayaku is to serve as an adviser to senior management on what is happening deep within the organisation and how to improve management' (ACGA, 2013, p. 12*).

An increasing number of Japanese companies are adopting the US-style unitary board.



UNITARY BOARD

This structure, also known as a 'three-committee board', consists of three committees responsible for audit, nomination and remuneration. Permission to adopt this model was granted in 2003 as an amendment to the Corporate Code. The role of the three committees is to audit the legal duties and compliance of directors and executive officers, and the financial statements of the company;

For auditing purposes, this structure is considered preferable because the audit committee is an integral part of the board. As board directors, committee members have the right to vote and the ability to exert direct influence on board decisions. As a result, they are considered to have greater capacity to positively influence the robustness of a company's internal controls.

Hybrid board structures have also emerged, wherein some companies have established the committees in addition to Kanyasaku. This is considered a positive development, providing the external directors are independent. In many cases, however, such committees are chaired by the CEO or other senior executives, which may undermine the purpose of independent oversight.

LGIM's voting policy may vary depending on the structure of the board.

INDEPENDENCE

The Japanese Company Law requires companies to have at least two outside directors or Kansayaku, whereas the TSE Listing Rules require at least one. Amendments to this Corporate Law are due to be come in force during 2014 where a 'comply or explain' rule would be imposed on companies to explain 'why they believe the appointment of outside directors is inappropriate'.

Under Japanese law, 'outsiders' are defined as having no previous employment history with the company or its subsidiaries. This definition is extended under the TSE Listing Rules to include candidates with close family ties, clients, service providers or significant business partners.

An outside director is someone who:

- Is not an employee of the company or group;
- Has not been an employee of the company or group within the last five years;
- Is an outsider that represents less than 10% of the company's voting common stock;
- Does not have close family ties with any of the company's advisers, directors, or employees.

An independent director is someone who:

- Is not an employee of the company or group;
- Has not been an employee of the company or group within the last five years;
- Is not an employee at the main lenders or banks to the company;
- Is not an employee at the lead underwriter(s) of the company;
- Has not worked at the company's audit firm;
- Is not offering, or has not previously offered, professional services such as legal advice, financial advice, tax advice or consulting services to the company;
- Does not have close family ties with any of the company's advisers, directors, or employees.

COMPANY BOARD

Unaffiliated outsiders should bring an independent mind and an external perspective to boardroom discussions. They should raise issues and suggestions that are pertinent to the company, but which inside directors may not have thought of or may be reluctant to address. A relevant and suitably diverse mix of skills and perspectives is critical to the quality of the board and the strategic direction of the company.

It is important that directors are independent of one another, and that any interlocking board relationships are disclosed and explained. In Japan, provision of biographical information on directors is sparse. This limits the ability of shareholders to make an informed decision about the appropriateness of nominee directors.

Once appointed, directors should be given appropriate training in order to familiarise themselves with company affairs, and pertinent environmental, social and governance issues. This is essential to effective contributions to internal discussions.

LGIM considers that Japanese companies should focus on establishing a board that meets the international 'best practice' trends in order to remain competitive and attractive to foreign investors. Notwithstanding, LGIM recognises that reaching the optimum level of independence will be a continuous, iterative process; and companies need time to test the dynamics of new board composition.

To balance these considerations, the short term target proposed by LGIM calls for a minimum of 1/3 outsiders and an outline of the steps to be taken to increase independence in the future. The selection of this target was based on LGIM's past experience, which demonstrates that a minimum of three outsider directors is necessary to engage the board in meaningful debate.

LGIM's requirement for outside directors is one third.

It should be noted that this target for both independence and the outside director requirement will be raised going forward, to bring it into line with other developed markets.

This rule applies to both two tier and unitary boards, and when the companies are controlled by majority shareholders.

RE-ELECTION OF DIRECTORS

LGIM has engaged in constructive dialogue with Japanese companies in order to express its views on board composition. The outcome of these engagements is expected to generate an increase in independence and disclosure of directors' associations. In the event that this does not occur, LGIM will signal disapproval by voting against the chairman. If the chairman is not present, LGIM will vote against the most senior member in the ballot. This strategy will apply to both two-tier and unitary board structures. In Japan, it is common to vote against the CEO in order to cast dissatisfactory votes. However, LGIM believes that, as the CEO is responsible for running the company, voting the CEO out due to inadequate board structure is not the most prudent course of action. Instead, it is preferable that the chairman be mandated to take responsibility for ensuring that the board structure is robust and competitive.

Target for board composition for Japan in 2016/2017

- For all companies, a third have to be outside directors who are truly independent from the company

RE-ELECTION OF KANSAYAKU

The Company Law stipulates that half of Kansayaku should be outsiders, but with no obligation for them to be independent. It is vital that true independence from the company is maintained in the Kansayaku committee, especially as half of the members are company executives and therefore are less likely to flag issues to outside shareholders. As such, LGIM votes against insider and affiliated outside directors, where Kansayaku committee are composed of less than 50% independent directors.

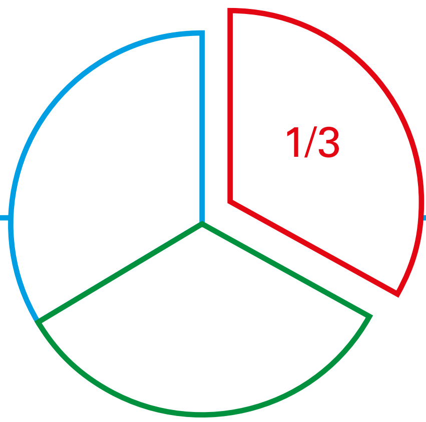
BOARD SIZE

LGIM considers that board effectiveness is optimised when membership sits between five and 15 members, depending on the size of the company. By their nature, small boards that are suitably diverse are better-equipped to facilitate active, constructive debate and agile decision making processes.

Although Japanese boards have historically been larger than in other markets, smaller boards are beginning to emerge. LGIM will generally support resolutions that intend to reduce the board size. The proportional percentage requirements in independence directors aim simultaneously to reduce the number of directors on the board.

ANNUAL ELECTIONS

In Japan, directors are to be elected every two years according to the Company Law. However, an increasing number of companies have put forward proposals to reduce the term to one year. LGIM would support such proposals from the companies and encourage others to do so.



Voting on structure & operation of boards

LGIM will oppose the election of the most senior member of the board if:

- The company does not qualify the abovementioned outsider requirements
- The company is a controlled company without at least 1/3 of independent directors, in addition to voting against the representative shareholder from the parent company; or
- The candidate is an inside director nominee who has attended less than 75% of board meetings during the year under review. This rule would be reviewed, case by case, for independent directors due to their difficulty in attending meetings at short notice, and in meeting the requirements of potentially excessive meeting frequencies

LGIM will oppose the election of Kansayaku if:

- They are all insider or affiliated Kansayaku, if the Kansayaku committee is not 50% independent; or
- They are insider or affiliated Kansayaku that have attended less than 75% of meetings of the board of directors or board of Kansayaku during the year under review; or
- The Kansayaku is judged to be responsible for mismanagement or shareholder-unfriendly behaviour.

LGIM will oppose the chairman if:

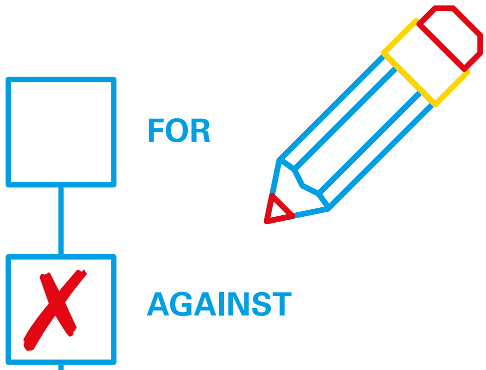
- The board has more than 15 members. This is applicable to both board structures.

Audit & Risk

INTRODUCTION

In Japan, the appointment of external audit firms is typically only put to a shareholder vote when companies intend to appoint a new audit firm. Auditors sit for a one year term, and can be reappointed without shareholder approval. In addition, audit firm rotations are not mandated by regulations. Accordingly this is not a matter that is frequently put to vote.

Auditors are an essential feature of an effective and transparent system of external supervision. To minimise potential conflicts of interest, the auditor's primary line of reporting should be to the audit committee, where one exists, and not to senior management. The auditors are ultimately employed to serve the shareholders, not the managers. Therefore, shareholders should be given an opportunity to vote on their appointment or re-appointment at each annual general meeting.



Voting on audit and risk

LGIM will oppose the appointment of a new auditing firm if:

- There are serious concerns relating to the appointment of auditors.

Remuneration

INTRODUCTION

LGIM regards appropriate remuneration levels as fundamental to recruit, incentivise and retain directors of the quality required to manage the company successfully. LGIM seeks disclosure and justification of chosen remuneration structures and levels.

In general, Japanese companies are less prone to excessive remuneration structures than companies in other markets. Due to the nature of long tenure of employees in the same company, the interests of executives in Japan are fundamentally long term.

However, the Japanese disclosure requirements associated with executive pay are weak. The requirement for individual disclosure is limited to directors and executives who receive above ¥100 million per annum.

Cash retirement bonuses constitute a significant portion of executive remuneration, and the majority of these are not reflective of performance. In addition, equity-based incentives, mainly stock options, have not yet gained traction among Japanese executives. LGIM considers that Japanese companies should adjust their executive remuneration structures to align with company performance and shareholder value creation. Accordingly, remuneration disclosure should focus on the structure of incentive arrangements

ANNUAL BONUSES FOR DIRECTORS AND KANSAYAKU

LGIM considers that outside directors should not receive annual bonuses. These bonuses should be limited to insiders and be awarded on the basis of performance. Receipt of bonuses can erode independence, and negatively influence the veracity with which management is scrutinised.

RETIREMENT BONUSES

Retirement bonuses are standard practice in Japan, and comprise a significant portion of lifetime remuneration for directors and Kansayaku. The details of bonus proposals, such as the amounts paid and the status of recipients, are seldom disclosed. This prevents shareholders from assessing the merits of bonus proposals, and potentially undermines investor confidence in the company's capital management practices.

SPECIAL PAYMENTS IN CONNECTION WITH ABOLITION OF RETIREMENT BONUS SYSTEM

LGIM considers that outsider directors should not receive special payments. Receipt of special payments can erode independence, and act as a disincentive for outside directors or Kansayaku to speak out against management.

DEEP-DISCOUNTED STOCK OPTION PLANS

It is common for Japanese executive remuneration to be based on fixed compensation, which does not expose directors to the risks or rewards faced by shareholders. In general, stock option plans should be promoted as a tool to better align the interests of directors with those of shareholders.

LGIM considers that the extent to which stock option plans can benefit or disadvantage independent shareholders is dependent on the way in which the plan is designed. LGIM's evaluation of these plans is conducted in terms of potential dilution, option recipients, exercise period and price, and the presence of performance hurdles.

DIRECTOR AND KANSAYAKU'S COMPENSATION CEILING

Japanese companies are less prone to excessive or misaligned remuneration structures than companies in other markets. Notwithstanding, the management of Japanese remuneration requires structural realignment.

Performance-based remuneration still occupies a relatively small portion of total pay. LGIM will generally support proposals calling for an increase in the director compensation ceiling if this increase is intended to introduce or increase the performance-based pay component. If proposals seek an increase in non-performance based director pay, or it is unclear whether pay is performance based, LGIM will examine these on a case-by-case basis. LGIM will vote against proposals seeking to increase director compensation in cases where there are concerns of mismanagement.

Voting on annual bonuses for directors/Kansayaku

LGIM will oppose the approval of annual bonuses for directors/Kansayaku if:

- Recipients are outside directors;
- There is clear evidence of mismanagement on the part of the recipient;
- The company's performance has been poor.

LGIM will oppose the approval of retirement bonuses or special payments if:

- Recipients are outsider directors;
- Neither the individual payments nor the aggregate amount of the payments is disclosed, or it is disclosed but it is not deemed appropriate;
- There is clear evidence of mismanagement on the part of the recipient.

LGIM will oppose deep discounted option plans if:

- Total dilution from proposed plan(s) and previous option plans exceeds 5% for mature companies, or 10% for growth companies;
- Recipients include individuals who are not in a position to influence the company's stock price, including employees of business partners or unspecified 'collaborators';
- The maximum number of options that can be issued per year is not disclosed;
- No specific performance hurdles are specified.

LGIM will support an increase in a director's compensation ceiling if:

- The specific reasons for the increase are explained and we believe it will create positive incentives; or
- The company is introducing or increasing a ceiling for performance-based compensation.

NOTE: LGIM recognises that companies that disclose their remuneration structures may be penalised in this policy. In order for the policy not to act as a disincentive to disclosure, LGIM will consider voting against company directors for inadequate disclosure.

Shareholders Rights

INTRODUCTION

Shareholder rights are a fundamental element of corporate governance as they ensure the protection of shareholders as well as allowing them fair access to a company. Below are the most relevant shareholder rights that are exercised within Japanese companies.

ARTICLE AMENDMENTS

It is common to see requests for amendments relating to various issues including capital increases, changes to capital structures, changes to board size and composition, as well as takeover and defence-related plans, bundled together as a single voting resolution.

Bundling potentially undermines the value of shareholder votes and may be a source of confusion. LGIM assesses bundled resolutions on a case-by-case basis, examining those resolutions that may compromise current or future shareholder interests.

ISSUANCE OF SHARES

Japanese boards have the discretion to issue shares within the authorised capital (a maximum of four times the current issued capital) on the condition that the issuance price does not constitute an advantage. In the event that a price is considered advantageous, shareholder approval will be required.

LGIM regards pre-emption rights as fundamental to protect shareholders' investment in a company, and to foster investor confidence. However, it is common for Japanese companies to undertake significant private placements without offering pre-emption rights to existing shareholders. Companies should consider alternative means of raising capital that does not expose minority shareholders to excessive dilution of their shares.

LGIM may consider voting against the re-election of directors, if need be after the event, if there are serious concerns with capital management.

SHARE REPURCHASE

In the Japanese market, companies often attempt to remove the requirement to seek shareholder approval for share repurchase schemes. Since 2005 when the Company Law was amended, Japanese companies have had the option of waiving the requirement for shareholder approval for share repurchases provided they are funded with retained earnings.

LGIM generally supports share buy back policies that deliver shareholder value.

TAKEOVER DEFENCE PLANS (POISON PILLS)

Japanese companies have frequently adopted powerful takeover defences. Well-designed poison pills may strengthen the board's negotiating position and allow it to obtain more favourable terms from an acquirer. However, it is vital that this process is controlled by a fully independent board that is more concerned with shareholder value than with protecting its own position.

LGIM will not support a poison pill if it entrenches management and protects the company from market pressures, which is not in shareholders' best interests. LGIM will assess each case carefully; although the lack of independence within many Japanese boards means that it is difficult to achieve a poison pill that is unaffected by bias.

CROSS HOLDINGS

Historically, cross holdings in Japanese companies have been high, but are in gradual decline. Cross holding may serve a strategic objective and enhance shareholder value, but can also increase risks. Therefore, management should be prepared to engage in an open dialogue with shareholders to demonstrate the value created through its cross holdings. We encourage companies to disclose the nature of the relationships in their top 30 crossing holdings and any position that exceeds 1% of its capital.

Cross holdings should not be used as a device to protect the company from the possibility of an unwelcome takeover bid.

ALLOCATION OF DIVIDENDS AND PROFITS

Dividend yields in Japan do not adequately reflect the high cash holdings in many Japanese companies. Increasingly, however, companies are starting to define their dividend payout ratios, which should be well balanced between the interests of shareholders and the capital investments required for the business to maintain competitiveness in the market.

LGIM will evaluate each resolution on a case-by-case basis. Particular attention will be paid to cases where a company proposes to pay a dividend exceeding its net profit, as such payments could damage the company's long-term financial health.

MERGERS AND ACQUISITIONS

LGIM will normally support a proposal that will create shareholder value, provided the financial terms, quality of management and benefits to synergy are superior. In a majority of cases LGIM will support management if the deal is value creative for shareholders, makes strategic sense, and is considered beneficial to both parties.

The impact of any pension deficits, which may arise through mergers and acquisitions, should be carefully managed as it can have significant impact on the company's financial health.

Voting on shareholder rights

LGIM will oppose all takeover defence plans:

- Unless management presents a robust case that the plan will not allow management entrenchment to provide an unbiased assessment of shareholder interests in a proposed deal. This should be supplemented with a board that is composed of a majority of independent directors;
- And the board is one third independent

LGIM will oppose a proposals if:

- It would remove the right for shareholders to approve dividend payments.

CONTACT US

For further information on anything you have read here or to provide feedback, please contact us at:

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