The Right Direction

George Dallas, Policy Director at the ICGN, runs us through the key takeaways of the recent ICGN conference in Tokyo.

What impact have recent updates to the Japanese Corporate Governance and Stewardship Codes had so far? What further changes can we expect to see over the next few years?

A lot has been going on in Japan. Just as a bit of background, we were first in Tokyo for an ICGN conference in 2001, in the wake of Enron and other US governance fiascos. At that time, issues of corporate governance were only just beginning to take shape in many markets around the world.

A lot of these issues, at least from the perspective of international investors, were still quite new to Japanese companies. In fact, the CEO of Toyota surprised the mainly investor delegates at the time by saying he cared about employees more than investors!

If we fast forward to the last five or six years, we have seen the introduction of first the Stewardship Code and then the Corporate Governance Code in Japan. That alone is a significant burst of activity, and I think if nothing else it has had the impact of raising awareness about corporate governance, in particular the government's intent to improve governance and stewardship in Japan. It has

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also enhanced awareness of the fact that substantial amounts of Japanese companies have significant ownership from overseas investors who often have different perspectives on what good governance looks like.

I think Japan is an interesting country because it has had its own very distinctive traditions in governance, and in some ways, they clash with certain attitudes in Western countries. But I think we are beginning to see a greater awareness of the differences between governance in Japan and in Western Europe or North America.

I think we are also seeing attempts by Japanese companies and investors to respond to some of these gaps, or at least address some of the issues that have been on the table such as board independence.

There was a consensus at the conference that it has been impressive to see what has been going on in Japan, with the introduction of the new Codes, greater focus on independent directors and other positive moves. The other point of consensus is that this work is not finished. It is still a work in progress and this is something that we can expect to see continue over the coming years.

What progress has been made in Japan on board independence, and is there still work to be done?

Japan traditionally has what some people might call more inward-focussed governance, where you are looking inward at the company for oversight rather than looking for external influences. Now that is beginning to shift.

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Before I joined ICGN I was at an asset management firm voting on Japanese companies. It would not be at all uncommon to see Japanese boards that were

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all-male and completely non-independent. In those cases, we would vote against all director candidates! I don’t know the statistics now because I have not been voting in recent years, but as I said it is beginning to change.

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That change has been very incremental, starting out with just one independent director. And then the most recent update of the Governance Code calls for two independent directors. That is twice as good as one I suppose, but from a Western viewpoint, particularly for widely held companies, the question is why not over 50%? That is something that one can and should aspire to. We are far from that right now, but I think we will continue to see some incremental improvement.

Our own policy position in Japan, while recognising that the Japanese Code calls for two independent directors, urges companies to go for at least three independent directors. If they get a majority that is even better.

The direction of travel is positive, and I think there is a general openness to exploring this. It has not been a radical pace of change, but I hope and believe we will be seeing three independent directors as a fairly normal practice in coming years. Hopefully over time that will continue to grow.

What challenges do Japanese companies face on board diversity, and how do these differ from other markets?

A common theme that came out in the conference which is relevant pretty much around the world is gender diversity. Again, just a few years ago you would see all-male, all-insider boards. Now we are starting to see more independence and I think gender diversity awareness is building too. I know there are some examples of women directors, and I hope that will continue to grow.

Another aspect of diversity which I think is a challenge for Japan, and in fact many countries whose languages may be difficult for others to learn, is international diversity. This is about putting people on the board who know about other markets where the company may have either customers or investors. Like gender diversity, it is also a way to break up potential groupthink and to provide more wide-ranging board conversations.

I saw several people in Tokyo who speak very good Japanese as a second language, but it is still a relative rarity. I think one of the advantages for boards of directors in the US and the UK, where English is an accepted international language, is that it is easier to get international diversity onto the board because you have a bigger base of people willing to speak English. That may be an issue that hopefully over time will begin to diminish, but I think it is a challenge.

Do Japanese investors prefer to engage with issuers publicly or privately? Are Japanese companies more receptive to one approach over the other?

I don’t present myself as a Japanese investor so I can only respond indirectly. My impression as an investor generally, and the Japanese probably fall into this boat as well, is that the general preference is for private engagement because public engagement is sometimes less of a dialogue than a one-way conversation.

One of the challenges for Japanese companies is having engagement continue to build not only with managers but also, as the pool continues to grow, directly with independent directors.

It is not just a Japanese issue, I think it is more universal, but generally speaking companies prefer to meet with investors on a private basis as opposed to doing something in a public forum. There can be confidentiality issues and I think it is also the case that you can have a less inhibited dialogue in private.

Japanese companies are hopefully getting themselves more accustomed to the idea

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of shareholder engagement as well as to the idea of collective engagement, where multiple investors that share a particular issue or concern can present themselves collectively to the company. That is another aspect of stewardship that we are encouraging. Again, collective engagement has not been the Japanese tradition but I think it is starting to pick up and we hope it continues to do so. Collective engagement can still take place behind closed doors, and most people would rather meet in a confidential setting where views can be exchanged.

What actions are Japanese investors taking in order to push for better governance at issuers? How has their approach changed in recent years?

Generalising is always difficult, but I can certainly observe that the largest pension fund in the world, Japan’s Government Pension Investment Fund (GPIF), is really showing leadership, not just in Japan but I would say globally. As a large asset owner, they have a huge portfolio of assets under management. They do a lot of passive investing but they recognise that, particularly given that investment style, it is important to engage for better corporate governance.

Japan’s Pension Fund Association (PFA) is another leading Japanese pension fund that consistently presses for high standards of stewardship by asset managers.

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They are certainly making it clear to asset managers that would like to be employed by them that stewardship is part of the asset manager relationship. I think that will continue to build. Nissay Asset Management is a good example of an asset manager that is picking up the ball and being very active in promoting good corporate governance and stewardship in Japan.

Is there much difference between the way passive and active managers approach engagement?

In some ways yes and in some ways no. Clearly the active manager has the ability to decide whether or not to invest in a company, to value it and to ask whether the company is worth its valuation. Then later they have the ability to do things like selling the stock or increasing their position. This probably adds a dimension of dialogue involving the portfolio managers and some of the specific concerns that they might have as active managers.

But in terms of the substance of many issues that would be discussed in investor engagement with companies, I think you would find a similar dialogue. In Japan these would cover many of the same points that we are raising with Japanese companies in our own policy priorities – such as independent nomination and evaluation processes, promoting capital efficiency and encouraging both disclosure and explanation of cross-shareholdings.

We have also been pressing for a change in regulation to require publishing of the company’s “Yuho” (securities report) to take place before the company’s annual shareholder meeting. These are some of the meaty issues that are being discussed in Japan, and the policy priorities that ICGN has laid out for Japan spell an investor agenda for ongoing improvement.

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I don’t think there is necessarily a difference between how an active versus a passive manager would approach those sorts of questions. Again, the big difference is that if you are a passive manager you are sort of stuck with the company in some ways. If you are an active manager, you have more discretion and that might influence certain aspects of the engagement process.

Thank you George.