Responsible Investing

Perspectives

ESG Viewpoint

Transforming the board room culture of Japan Inc.

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- **Goal:** Establish one-third board independence in Japanese companies
- **Engagement since:** 2014

Key summary

- There has been a marked improvement in Japanese corporate governance practices in recent years — but despite these changes, it still lags standards seen in other developed world markets
- Since 2014, we have co-led a collaborative engagement initiative calling for Japanese companies to improve board composition by moving to a minimum of one-third independent directors by 2017.
- BMO's position is that a critical mass of independent directors will drive culture change in the traditionally closed board rooms of Japan Inc. and improve market-wide shareholder returns.
- This Viewpoint was co-authored with the co-leads of the engagement initiative Meryam Omi of Legal & General Investment Management and Alison Kennedy of Standard Life Investments. The report was also sent to the leading Japanese companies, which we have focused our engagement with over the past three years.

Background

The purpose of this report is to explain to Japanese companies' board directors, senior management, investors, regulators and wider interested stakeholders why board independence is such an important issue for global investors and asset owners. It describes the collaborative engagement undertaken by a group of 20 investors and asset owners with Japanese companies, which has been underway for the past three years. The aim of the engagement is to encourage Japanese companies to improve board composition by moving to a minimum of one-third independent directors. This is a much higher standard than is mandated in the Japanese Corporate Governance Code of two outside directors on the board.

Corporate governance in Japan has undergone a tremendous transformation in the past five years. Stimulated by the new standards set out in the Corporate Governance and Stewardship Codes, the conversations between investors and corporations have shifted from why governance matters to how governance practices can be improved.

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Many international, long-term investors in Japanese corporations, including the group involved in this engagement, have been ardent supporters and advocates of these corporate governance developments. BMO Global Asset Management has been engaging with Japanese corporations on the issue of governance since 2008 when we co-wrote the Asian Corporate Governance Association's white paper on the issue.[1] We have been travelling to Tokyo in most intervening years pressing for reform.

Since then, we have believed that companies with a robust governance approach and a sustainable business model will deliver enhanced shareholder returns in the long run, helping the overall Japanese economy in the process. This engagement focused on independence because having a significant number of independent individuals around the board room table who can challenge and strengthen board level discussions is the foundation that will drive many other governance improvements.

The collective engagement and discussion on this issue between investors, corporates and regulators has borne fruit, consolidating many divergent views and giving focus to a complicated matter. Many of the companies we engaged with have significantly increased the number of independent directors in the last three years and have highlighted to us the value that these outside directors have brought to the table. They have encouraged us to keep supporting their reforms and changes.

Not all our conversations, however, have had such positive outcomes. As a result, some investors within the group are now voting against directors of companies who fail to meet the minimum threshold of board independence. This sends a powerful message about the importance of this issue.

Many challenges remain. In addition to the need to appoint more outside directors, further progress requires appointing directors with the right skills and experience, reviewing the format of board meetings and, perhaps most importantly, cultural change.

As long-term investors, we are committed to continuing this dialogue as we believe Japan has a tremendous opportunity to benefit from this ongoing transformation.

Board independence in a Japanese context

Japan is one of the most important markets for institutional investors. It is one of the biggest and deepest capital markets in the world with thousands of issuers and numerous world-class corporations. We have been shareholders in Japanese corporations for many years. However, despite these strengths, one long-standing weakness in the Japanese market has been corporate governance practices.

The core area of concern has been the structure and composition of Japanese boards. Traditionally, Japanese boards consisted almost solely of senior executives with no external representation. Due to investor pressure, particularly from outside of Japan, and government initiatives to stimulate the market, we have seen significant changes in this area in the last three years. The vast majority of Japanese companies now have at least two outsiders on the board.

We believe that the time is ripe for Japanese corporations to move to a standard that is more aligned to global practices. Our expectation is that companies should appoint a minimum of one-third independent[2] directors (excluding Kansayaku). We consider this to be an achievable and reasonable target. To put this into context, in other developed markets, boards are expected to have majority independence. The call for one-third board independence is a reflection of the stage of corporate governance development in Japan.

As shareholders, we look to the composition of the board to gain confidence in its ability to oversee management, provide challenge on the development of strategy, oversee risk management and ensure high standards of business practice. This is for the benefit of not just shareholders but all stakeholders. To be effective, it is crucial that the board comprises a balance of executives and non-executives who are independent from management. This balance ensures that no single individual, or group of individuals, dominates decision-making to the detriment of others, and helps provide the diversity needed to cultivate healthy debate in the board room. A truly independent director can bring fresh ideas as a result of external experience and challenge management constructively without the constraint of a vested interest in the business. Independent directors also represent our views and interests as minority long-term shareholders in the boardroom.

[1] Asian Corporate Governance Association "White Paper on Corporate Governance in Japan" 2008.

[2] Although there are differences in their individual definition of independence, the standards used by global investors are generally more stringent than what is currently mandated in the Tokyo Stock Exchange's listing rules.

Engagement action

In 2014, a group of 20 global institutional investors and asset owners[3] led by BMO Global Asset Management (formerly called F&C Investments), Legal & General Investment Management and Standard Life Investments came together with the goal of engaging with Japanese companies to aim for a more ambitious board independence standard. We believed that a minimum of one-third independence was feasible and necessary in Japan and could become the accepted norm within three years.

The expectation was that Japanese corporations, particularly those with global outlook and reach, would achieve that level of independence by the 2017 annual shareholder meeting. In addition to individually engaging with various Japanese companies to push for this agenda, collectively we decided to target 33 of Japan's leading companies to accelerate this trend. They were chosen on the basis of factors such as market capitalization and weightings in Japanese equity benchmarks as well low levels of board independence.

To ensure that our message was clearly understood by the market, we also wrote to the office of Prime Minister Shinzo Abe, the Financial Services Agency (FSA), Tokyo Stock Exchange (TSE), Keidanren, and the Ministry of Economy, Trade and Industry.

In the past three years, the group's members visited companies in Japan for face-to-face meetings, met companies during their visits overseas and followed up with various calls and letters, both collectively and individually. BMO Global Asset Management traveled to Tokyo in 2014, 2015 and 2017 to reinforce the message.

We have noticed, during this time, a significant shift in the overall quality and depth of conversation with Japanese companies on governance issues. Many companies welcomed meeting us and hearing our views on why, and how, our engagement can add value. Regulators, such as the FSA, have been responsive to our views and incorporated them in the Corporate Governance Code.

The expectation of one-third board independence, which was considered almost impossible when we started, is often quoted now as the minimum target by the companies we meet. Even for those which have not yet achieved this, it is no longer seen as a foreign and unattainable goal. Most importantly, many companies openly voice the positive impacts they have had from having independent directors.

Voting approach

Using votes to bring about positive change is a powerful tool for shareholders. While individual voting policies vary from investor to investor within the collaborative engagement group, there has been a general move to tighten the independence requirement over the past three years. A critical mass of investors updated their voting policies in Japan ahead of the 2017 annual shareholder meeting season, reflecting our expectations of one-third independence on the board.

BMO Global Asset Management further tightened its Japanese market voting policy at the start of 2017. In companies that have lower than one-third independence, we now vote against the re-election of all directors except the president and the independent directors.

Engagement case study—Toyota

Automaker Toyota is Japan's most influential company. It has a long-standing leadership position within the powerful Keidanren business lobby, which for many years was the front for resisting corporate governance reform in the closed board rooms of Japan Inc. Despite, being a global leader in the car industry, it persisted for years with an insular and ineffective approach to corporate governance. As recently as 2011, Toyota had an excessively large 27-member board with not a single external director represented. It finally appointed its first independent director in 2013. BMO has been engaging Toyota on corporate governance issues since 2010. This includes a number of meetings in Tokyo. Toyota was initially unreceptive to the calls for one-third independence on the board when we reached out to the company as a part of the collaborative initiative in 2014. It has, however, adopted a more constructive tone and approach to investor engagement on this topic more recently. This was reflected in the company reducing its board size to nine from 11 at the 2017 annual shareholder meeting. This now means that Toyota has one-third external representation on the board. The three external directors are currently composed of one independent director and two external directors with some affiliation to the company. We had little confidence initially that Toyota would reform board structure but the persistent engagement on this topic through the joint investor initiative contributed to the welcome changes. The next step for Toyota is to ensure that it identifies and nominates to the board outside directors who are genuinely independent.

[3] Other investors and asset owners in the group include: Andra AP-fonden; APG Asset Management Asia; Baillie Gifford; British Columbia Investment Management Corporation; California State Teachers' Retirement System; Columbia Threadneedle Investments EMEA; Investec Asset Management; Mn Services BV; Ontario Teachers' Pension Plan; PGGM; State Board of Administration (SBA) of Florida; The California Public Employees Retirement System.

Conclusion and next steps

The advantage of the collective engagement initiative for Japanese companies has been that they heard one clear voice, not various views that contradict each other, from well-established international institutional investors in the Japanese market.

Of the 33 companies that we originally reached out to in 2014, we are pleased to report, at the time of writing, 10 companies have now reached the one-third board independence level. These companies are: **FUJIFILM Holdings, Honda Motor Company, JFE Holdings, Mitsubishi Electric, Mitsubishi Estate, Mitsubishi UFJ Financial Group, Mitsui Fudosan, Nintendo, Sumitomo Mitsui Financial Group** and **Takeda Pharmaceutical**.

Many of the others are also close to the 33% independence ratio and we are hopeful that those companies will reach this level at the 2018 annual shareholder meeting.

Unfortunately, there are still 10 companies that fall short and where we have only seen minimal progress in the past three years. These are companies with an independence ratio of 12.5% or lower. This only amounts to one independent director in a board of eight directors, which is far short of the critical mass of independent directors we believe is required to drive genuine culture change in Japanese board rooms. Some of these companies have made other governance related reforms, which we note and value.

So, our work is not done and the companies' work is not done. Where necessary, we plan to engage with these companies again following the 2017 annual shareholder meeting in June. We are confident that they will look to establish clear plans for increasing board independence. Going forward, there will be increasing consequences for not doing so quickly enough and lagging behind not just global standards but the Japanese "new norm."

BMO Global Asset Management