Japanese reforms ignite investor optimism

The Japanese stock market has enjoyed a resurgence in recent months due to corporate governance reforms and a renewed focus on shareholder value. Shoa Hirosato and Haonan Wu explain some of the key changes and the likely benefits for investors.

Setting the scene

Shareholder activism has been on the rise in Japan over the last few years, as institutional investors have grown increasingly frustrated with some companies' poor governance practices and the slow pace of change. High-profile scandals, such as that at Toshiba, have heightened the pressure on companies to be more responsive to shareholders. Now an update to Japan's Corporate Governance Code, and encouraging announcements from the government and the Tokyo Stock Exchange, suggest there could be a greater focus on shareholder value in Japanese boardrooms.

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Japan's Nikkei index reached its highest level in 33 years in May 2023[1] as optimism rose that corporate governance reforms could unlock value in the previously underperforming market. Following an update to Japan's Corporate Governance Code and a restructuring of market segments by the Tokyo Stock Exchange (TSE) in 2022, overseas investors anticipate an acceleration in the pace of change around governance, cross-shareholdings, and gender diversity on the back of further announcements from the TSE and government.

For further information please contact:

Shoa Hirosato
Sector co-lead: Transportation
shoa.hirosato@FederatedHermes.com

Haonan Wu
Theme co-lead: Investor Protection and Rights
haonan.wu@FederatedHermes.com

[1] Japan stocks soar as global investors applaud governance changes - Nikkei Asia

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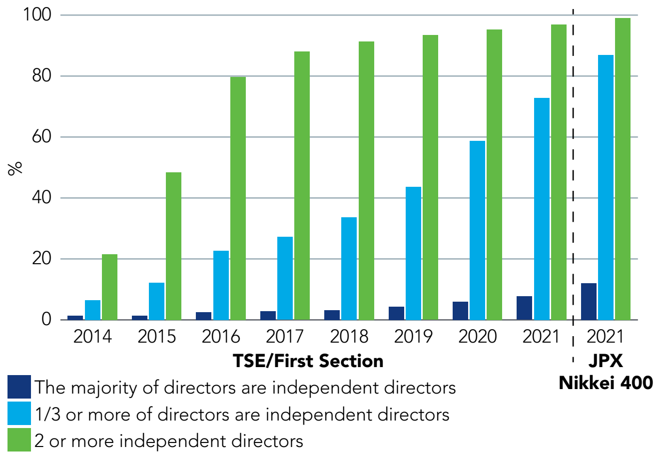
30% of directors on the boards of Japanese companies listed on the TSE's prime market, by 2030.

The latest revision to the Corporate Governance Code urged companies to improve their disclosure on ESG initiatives such as gender diversity targets, to adopt TCFD reporting, and to increase board discussions on ESG issues, in order to drive long-term sustainable value. In addition, Japan's Financial Services Agency (FSA) recently published its plans to progress governance reforms.

In January 2023, the TSE announced measures to improve the effectiveness of its prime market listing requirements, which could help to address the lingering issue of cross-shareholdings. In Japan, large companies often hold shares in other companies with which they have a business relationship, without giving a sufficient rationale for doing so. Overseas investors have argued that this is not an effective use of capital, particularly if these shares are held for an extended period of time. The TSE has addressed these capital efficiency concerns by urging companies to disclose specific initiatives and policies for improvement if their price-to-book ratio is consistently below a multiple of one. As around half of the stocks listed on the TOPIX trade below book value, we believe these guidelines will have a significant impact.

Other longstanding issues around board independence and gender diversity are also starting to be addressed. Independent directors now account for a third of board members (see chart below), and there are more female directors than in the past, when it was not uncommon to see boards of up to 25 directors, all of them male executives. In June, the Japanese government adopted a policy for women to account for over 30% of directors on the boards of Japanese companies listed on the TSE's prime market, by 2030.[2]

Change in proportion of companies with independent directors



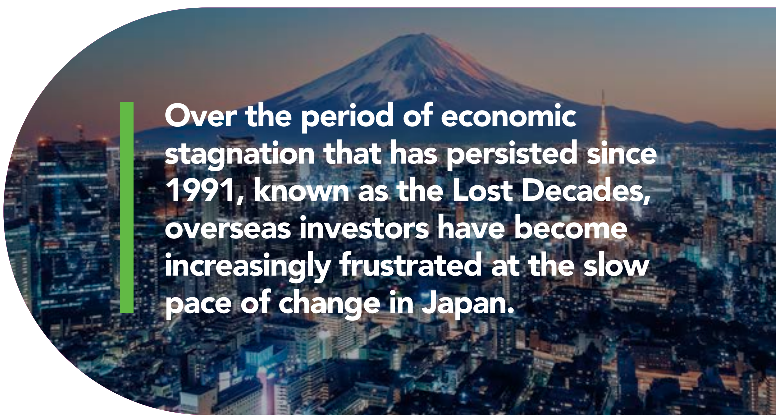
Source: Nikkei Asia.

At EOS, we have long advocated for improved gender diversity within Japanese boardrooms and senior management teams, given the body of evidence showing that this leads to better company performance. We have done this directly with company management teams and boards, and through public policy advocacy alongside the Asian Corporate Governance Association (ACGA), and with the FSA and the TSE, to progress this and other governance issues, including board independence and cross-shareholdings.

For example, in 2022, we co-signed a letter with ACGA that was sent to the TSE, outlining suggestions for enhancing gender diversity at prime market company boards. In 2023, we raised our minimum threshold for female directors to account for 15% of the board at TOPIX 100 companies, with an expectation of 30% board gender diversity by 2030, in line with our participation in the 30% Club Japan. This year, after several years of engagement, we welcomed that materials manufacturer Toray Industries had appointed its first female director and Mizuho Bank had appointed an additional female independent director. For board independence, our voting policies recommend a vote against directors when independence is below a third, and we have consistently encouraged companies to meet this threshold.

Over the period of economic stagnation that has persisted since 1991, known as the Lost Decades, overseas investors have become increasingly frustrated at the slow pace of change in Japan. Companies too often give the same responses to shareholders querying the lack of women on boards or in senior management positions, or the persistently low levels of board independence. However, with the fundamentals for governance reform now in place, we see these discussions increasingly moving from the hypothetical to something more substantial.

Accordingly, we have intensified our focus on aspects of board dynamics that we characterise as the 'software,' such as the effectiveness of independent directors, board meeting agendas, and director skill matrices. This year, in our engagements with independent directors at Fast Retailing, Seven & I Holdings, Mizuho and Toyota, we probed these topics to gain a greater understanding of the effectiveness and functionality of their boards.



[2] Japan sets goal to ensure 30% female execs at top firms by 2030 | NHK WORLD-JAPAN News

In light of the TSE's recent guidelines on capital efficiency, we have also stepped up our engagement on the unwinding of cross-shareholdings. We continue to recommend voting against top executives at companies with more than 10% of their net assets tied up in these - also sometimes referred to as 'allegiant' or strategic shareholdings. And we ask companies to disclose how they exercise their voting rights, to try to tackle the associated practices of allegiant shareholding, where companies support each other through their voting, stifling the impetus for real change.[3]

Investor engagement

The introduction of Japan's Stewardship Code in 2014, and its revision in 2017, encouraged institutional investors to promote sustainable growth at their investee companies through constructive engagement and voting. In recent years, overseas and domestic shareholders have become more willing to escalate engagement with companies that need to improve their governance practices. They are also voting against company bosses in greater numbers, to signal their discontent.

For example, at Canon's March 2023 annual shareholder meeting, the chair and CEO Fujio Mitarai, who has a 42-year tenure on the board, was re-elected on the narrowest of margins, receiving just 50.49% support from shareholders.[4] There are still no women on the board of the camera and office equipment manufacturer. We have engaged with the company on this topic and its succession planning.

We have also seen rapid growth in the number of shareholder proposals brought by institutional investors, mainly on governance and climate change issues. This voting season, shareholder proposals have been filed at over 80 companies, up from less than five in 2015. This has already led to some heated proxy battles.

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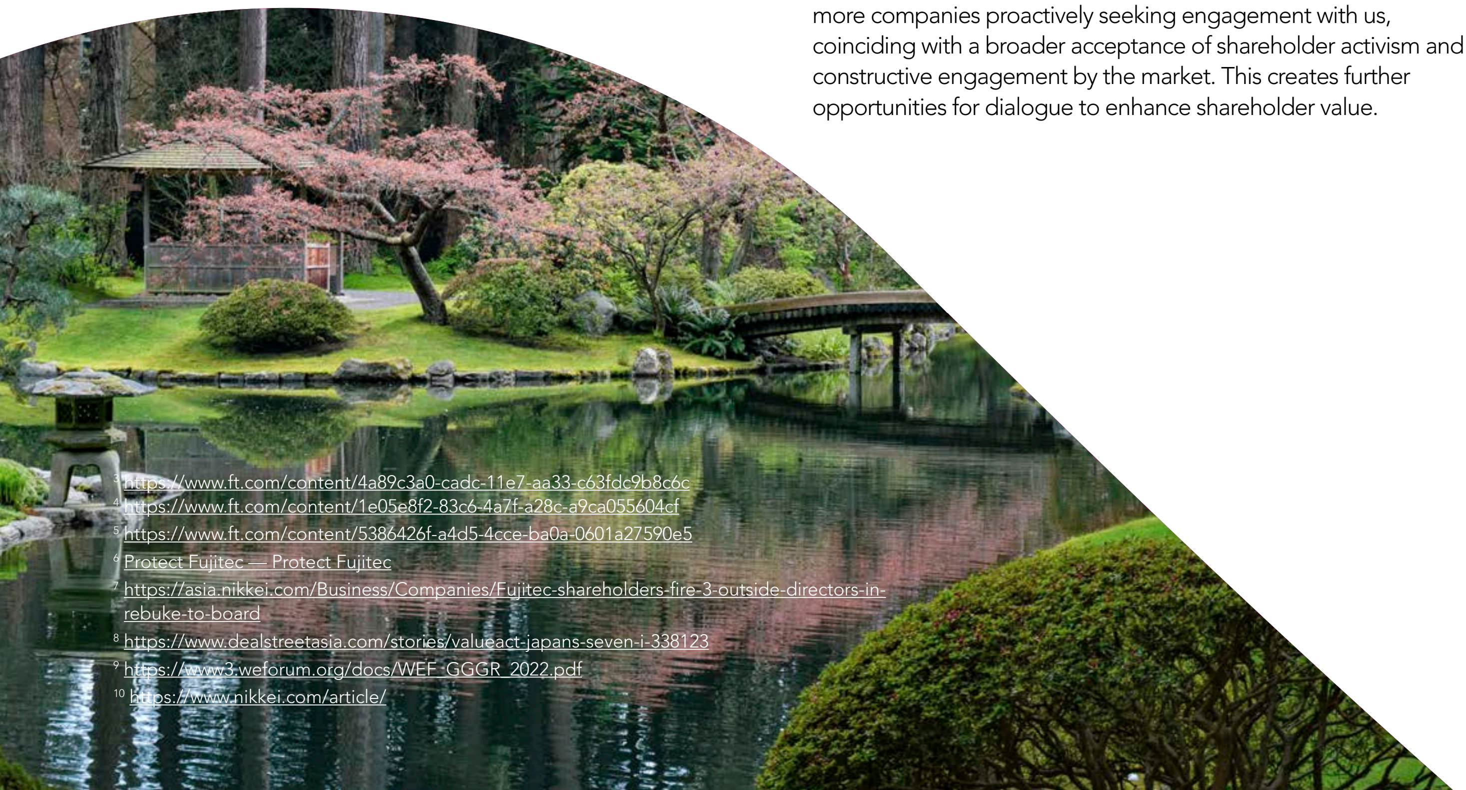
At the elevator and escalator maker Fujitec, a special meeting was called in February 2023 to initiate a board refreshment following major governance issues.[5] We recommended support for the shareholder proposals submitted by activist shareholder Oasis Management, which successfully removed three incumbent directors. In a report analysing certain real estate and other transactions carried out by Fujitec, Oasis had raised questions about how company assets were used and why shareholders were not given a chance to scrutinise or approve these transactions.[6] At the same meeting, investors also elected four out of six of the shareholder nominees put forward by Oasis.[7]

Seven & I Holdings, the parent of convenience store chain 7-Eleven, also received shareholder proposals for its 2023 AGM from activist shareholder ValueAct Capital. The US fund was aiming to appoint shareholder nominees to the board due to concerns about the retailer's business strategy.[8] After we had met the company's independent director to discuss board effectiveness and hear about its business strategy, we decided to recommend support for the nominees, as we believed they would add value to the company's board governance. The proposals ultimately failed but still attracted considerable support ranging from 25-35%, while the company's president received 76% support. Even when such proposals fail, proxy battles serve as a warning to other companies that they cannot expect to resist shareholder demands in perpetuity without coming under pressure.

Across the market, we are seeing how engagement and escalation from investors is having a positive impact on board structures and company commitments to key ESG issues such as climate change. Domestic and international investors are ready to challenge companies in pursuit of long-term value creation. We also see more companies proactively seeking engagement with us, coinciding with a broader acceptance of shareholder activism and constructive engagement by the market. This creates further opportunities for dialogue to enhance shareholder value.



[3] https://www.ft.com/content/4a89c3a0-cadc-11e7-aa33-c63fdc9b8c6c
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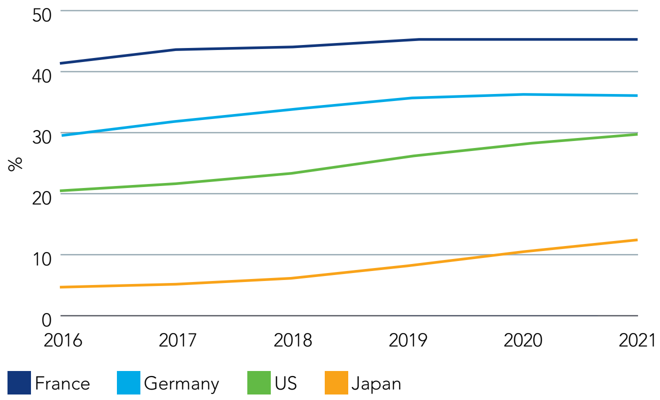
[8] https://www.dealstreetasia.com/stories/valueact-japans-seven-i-338123
[9] https://www3.weforum.org/docs/WEF_GGGR_2022.pdf
[10] https://www.nikkei.com/article/

Key challenges remaining

Despite these positive developments, there is still room for improvement. Board gender diversity remains a key concern for us, as Japan was ranked 116th on the 2022 Global Gender Gap Index,[9] and 18.7% of prime market companies still had no female directors as of July 2022.[10] To reach the target of 30% board gender diversity by 2030, we have been engaging with companies on the lack of female senior executives, which we see as the bottleneck for the development of female executive director candidates.

Percentage of women on boards of major companies



Source: OECD

As board composition improves, with more independent directors appointed, we also want to see the application of stricter criteria for independence. Currently, some directors who are classified as independent are in reality affiliated to the company through cross-shareholdings or another form of business relationship. In line with global best practice, we are also seeking better disclosure about who chairs the board, and the nomination, remuneration and audit committees, so that investors can identify the relevant individuals and hold them to account.

> **We continue to see scandals emerging in Japan due to poor governance practices linked to an unhealthy corporate culture, similar to those in the past, which tarnished Japan Inc's reputation.**

In line with our focus on the effectiveness of the board and its independent directors, we will continue asking companies to demonstrate the contributions made by independent directors to the board's decision-making and the company's business strategy, and seek to understand how the board chair effectively integrates these contributions into board discussions.

We continue to see scandals emerging in Japan due to poor governance practices linked to an unhealthy corporate culture, similar to those in the past, which tarnished Japan Inc's reputation. As Japanese companies increasingly embrace global governance standards, there needs to be a mindset shift among senior executives who have built their careers in traditional Japanese management settings, and may still believe that it is the employees who own the company. Embracing global standards should mean having respect for shareholder and stakeholder rights. This includes facilitating investor access to board members such as independent directors and statutory auditors, to contribute constructive views to board discussions.

Although we welcome the reduction in cross-shareholdings that we have seen at some companies in recent years, we will continue to communicate our strong stance on setting targets for a total unwinding. Instead of the boilerplate rationales for holding these that have been provided in the past, we encourage companies to provide compelling reasons explaining the need to maintain these holdings.

We also continue to seek improved transparency on how companies exercise their voting rights. Although we have noticed some companies disclosing their voting policies in relation to these holdings, they are usually lacking in detail, and we have not seen any disclosure on the outcomes of these votes.

Outlook

As shareholder activism in Japan has grown, helped by stewardship obligations under the code, and a growing awareness and acceptance of the importance of issues such as climate change and gender diversity, this year's voting season is likely to look a little different than in the past. Through our voting recommendations, we will continue to encourage Japanese companies to adopt appropriate governance frameworks in line with market best practice, and monitor the outcomes to ensure that some of the longed-for changes are finally realised.

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