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Jamie Allen
Asian Corporate Governance Association, Hong Kong
May 8, 2008

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Executive Summary

We believe that sound corporate governance is essential to the creation of a more internationally competitive corporate sector in Japan and to the longer-term growth of the Japanese economy and its capital markets. While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large in three ways**:**

- By not providing for adequate supervision of corporate strategy;

- By protecting management from the discipline of the market, thus rendering the development of a healthy and efficient market in corporate control all but impossible;

- By failing to provide the returns that are vitally necessary to protect Japan's social safety net—its pension system.

This White Paper focuses on, and makes recommendations with regard to, six key corporate governance issues:

1: Shareholders as Owners:

The portrayal of the Japanese system as "stakeholder capitalism" is outdated and fundamentally inaccurate. The rights of shareholders as owners of listed companies need to be better recognised and protected. The interests of shareholders and other stakeholders can best be aligned through an enlightened adherence to the rules and conventions of international capital markets.

We believe that the fair treatment of shareholders can and should be aligned with the fair treatment of other stakeholders.

2: Utilising Capital Efficiently:

Demographic and social change will increase the pressure on listed companies in Japan to generate income for pension funds. Improved shareholder value will be vital in order to achieve positive social outcomes.

Managers should strive to maximise long-term corporate value by implementing rigorous financial and business disciplines.

There is strong evidence that, over the medium to long term, the total shareholder returns of Japanese companies that pay higher dividends outperform those that pay lower dividends.

3: Independent Supervision of Management:

There should be a transparent process of independent, external supervision of management on behalf of all shareholders. We recommend that all companies, even those with traditional board structures, make a commitment to appoint a minimum of three independent external directors as soon as practicable. Over the medium term, such directors should ideally comprise a third of the board. Over the longer term, we recommend that they comprise one half of the board. These ratios are based upon practical experience in other developed markets regarding the minimum number of independent directors required for the effective functioning of boards.

4: Pre-emption Rights:

Pre-emption rights should be introduced for shareholders, so that they have adequate protection against dilution from the issuance of new shares or convertible securities to third parties or a small number of select shareholders.

5: Poison Pills and Takeover Defences:

The adoption of poison pills that have been structured to protect management and to stop takeover bids from succeeding is in the interest neither of shareholders nor the company (and companies should consider revoking these). “Shareholder rights plans” offer a workable and fair alternative.

6: Shareholder Meetings and Voting:

The timing of shareholder meetings and the process of shareholder voting should accessible, fair and transparent. New and unpredictable cross-shareholding structures are distorting the voting results at shareholder meetings, particularly EGMs. Votes should be conducted by poll for all resolutions at the AGM and any other shareholder meeting. We recommend that full voting results be published as soon as possible, ideally the following day or no later than five calendar days after the meeting.

Introduction

We believe that sound corporate governance is essential to the creation of a more internationally competitive corporate sector in Japan and to the longer-term growth of the Japanese economy and its capital markets. While a number of leading companies in Japan have made strides in corporate governance in recent years, we submit that the system of governance in most listed companies is not meeting the needs of stakeholders or the nation at large in three ways: by not adequately supervising corporate strategy; by protecting management from the discipline of the market, thus rendering the development of a healthy and efficient market in corporate control all but impossible; and by failing to provide the returns that are vitally necessary to protect Japan's social safety net—its pension system.

Although the main touchstones of the arguments in this White Paper relate to the efficient use of capital by listed companies and the appropriate treatment of shareholders, we fully recognise that these objectives must be aligned with fair treatment of other stakeholders and responsible corporate citizenship. We believe that this can be best achieved through adherence to the rules and conventions of international capital markets rather than by reinforcement of management protectionism.

This White Paper identifies six key issues in Japanese corporate governance, analyses their relevance, and makes recommendations for improvement. It has been compiled with the support and input of a large number of global institutional investors, most of which have been investing in Japan for many years. The combined funds under management of these investors is approximately US$5 trillion and they account for a significant portion of foreign shareholdings in Japan. Input has also been received from Japanese institutional investors, fund managers and analysts.

The contributors to this paper have the greatest respect for what Japanese companies and managers have achieved in recent decades and the world-class brands and products they have created. We also recognise that the corporate governance systems of some leading companies continue to evolve and improve.

The current Japanese model of corporate governance has, however, emerged from a corporate model that has its roots in the period of rapid reconstruction and growth in the 1950s and 1960s. This was a time when the population of the country was much younger, when few, if any, Japanese companies had achieved the dominant positions that so many now enjoy, and when investment capital was comparatively scarce. It was a model that was often driven by a uniquely Japanese pattern of intense, oligopolistic competition and a resolute pursuit of the internal generation of capital. This served Japan well at that time but it is less appropriate to the needs of the nation in the circumstances prevailing today, in which companies are not starved of capital and a more open model of corporate capitalism is required. We therefore believe that it is time to re-examine the tenets of Japan's corporate culture and, particularly, the system of corporate governance which stems from it.

The high water mark of confidence in the old Japanese model of corporate strategy was seen in the early 1980s, but public confidence in it declined sharply from 1990 onwards and this has been felt nowhere more strongly than in Japan itself. This was illustrated on March 26, 2008, when *Nihon Keizai Shimbun* carried a front-page article which reported that large Japanese corporate pension funds, dissatisfied with returns from the domestic equity market, were increasing their weightings of foreign equities and other asset classes. A symptom of the longer term decline in domestic investor confidence can also be seen in the fact that the majority of net buying of stocks over the past five years has been by foreign funds. Yet since late 2007 even foreign confidence has fallen sharply, helping to drive the Nikkei Index down by more than 20%. This has significant implications for the Japanese economy as a whole.

Improved corporate governance is not a panacea for the problems of Japan's stock markets or economy, but it will be an essential element in the rebuilding of confidence. Improved investor confidence will bring funds flowing back into Japan; it will encourage Japanese domestic investors, both retail and institutional, to re-enter the market; and it will assist the development of the financial services sector, an important new area of growth for the Japanese economy and a provider of employment in future. It is in Japan's national interest, therefore, to converge towards global best practice in corporate governance—and this trend will become more important as the government seeks to turn Tokyo into a leading international financial centre. The recent announcement of a joint venture between the Tokyo and London stock exchanges to create a new trading platform for smaller companies in Japan illustrates the tendency towards a more globally oriented view.

Fairer treatment of shareholders is an integral part of this process. It is important to restore shareholders to their rightful, legal place as the owners of companies and to ensure that their interests are protected alongside other stakeholders. Shareholders invest their savings in companies because they trust that management will look after these funds and provide a fair return. When managers fail to do so, they effectively break their most fundamental contract with shareholders.

The provision of healthy returns to shareholders requires that capital is utilised efficiently. Inflated balance sheets and undisciplined acquisitions and diversification are signs of management inefficiency and corporate weakness, not strength. This White Paper will provide evidence that, over the medium to long term, the total shareholder returns of Japanese companies that pay higher dividends outperform those that pay lower dividends. A healthy dividend policy, therefore, reflects a healthy company and does not, as many managers appear to believe, mean that a company is simply "giving money away".

There are also long-term demographic and social factors that will necessitate higher investment returns in Japan, namely the ageing of the population and the rapid rise in the number of pensioners. It is estimated that by 2025, the percentage of Japanese people over the age of 65 years will be approximately 30%—one of the highest ratios among developed countries. The pressure on listed companies to generate income for pension funds in Japan, therefore, will likely increase. Improved shareholder value will be vital in order to achieve positive social outcomes.

We believe that the fair treatment of shareholders can and should be aligned with the fair treatment of other stakeholders. Most of the institutional investor members of the Asian Corporate Governance Association (ACGA), and other investors supporting this White Paper, are long-term shareowners who seek to invest in well-managed companies that are both profitable and good corporate citizens. Indeed, many ACGA investor members have explicit policies with regard to environmental and social, as well as governance, issues. While the interests of different stakeholders may differ over the short term, they can be aligned over the medium to long term through sound management and good governance. Indeed, this is one of the primary tasks of a board of directors and senior management. Successful companies perform this balancing act well.

This paper is primarily addressed to the managers and directors of listed companies, legislators, financial regulators, stock exchanges, and investors in Japan. It is also hoped that it will provide useful information to, and stimulate discussion among, related groups such as financial intermediaries, professional and business associations and the media.

Part A: Broad Principles of Corporate Governance

Issue 1: Shareholders as Owners

Shareholders – not managers – are the owners of listed companies.

It is sometimes asserted that the Japanese model of capitalism is one of “stakeholder capitalism” and not “shareholder capitalism”. This reflects a still widely held view that the management of Japanese companies can safely be entrusted not only with control of operations, but also with guardianship of the interests of the key stakeholders (employees, suppliers, customers, creditors and shareholders). This perception of management as the ultimate arbiters of all stakeholder interests—a system in which shareholders do not hold primacy—reflects current realities. For example, labour union negotiation in Japan is undertaken at the company rather than industry level, while shareholders are essentially passive in their relationship with management, being for the most part prepared to accept little or no dividend income in return for implicit management promises of superior capital gains in future.

However, the nature of this implicit contract with shareholders has changed—a fact that management has typically been slow to recognise. During the last 20 years, the importance and function of share ownership in society has changed, both in Japan and around the world. Not only have individuals come to participate in stock markets in greater numbers than before around the world, through mutual funds or directly, but state and private pension funds have grown exponentially.

Japan is a part of a global financial system which recognises that shareholders have legitimate legal and economic rights and all listed companies, by virtue of their participation in a public market, are therefore obligated to conduct their affairs in accordance with international rules. The portrayal of the Japanese system as stakeholder capitalism is, therefore, outdated and fundamentally inaccurate.

It is nonetheless still common for listed companies in Japan to be run as if management, not shareholders, were the owners. Although some stakeholder groups are treated fairly, the interests of public (i.e. independent) shareholders are often neglected. The obstructive and opaque manner in which many shareholder meetings are run, and the imposition of poison pills, cross-shareholdings and private placements at the behest of management are all symptoms of this outdated thinking.

The perception of shareholders as a group whose views can effectively be ignored also reflects the often-expressed opinion that shareholders are not competent to comment on, let alone intervene in, board decision-making. Here again, thinking conflicts with reality. While individual pension fund beneficiaries and most private investors may indeed be ill-equipped to voice informed opinions on the strategic direction of the companies of which they are the ultimate owners, the professional intermediaries whom they employ are often very well qualified to do so. The increasingly professional and specialised investment community has for many years possessed a collective intelligence and wisdom that has a legitimate place in board and management decision-making. This is, however, a place which is effectively denied to investors under the Japanese system.

Safeguarding stakeholder interests

It should be emphasised that, even in systems where the right of public shareholders to influence the strategic direction of companies is recognised, it is important that the interests of other stakeholders be safeguarded in accordance with the law and best corporate practice. Under the current Japanese system, however, it is the shareholders who are unfairly disadvantaged. Unlike other stakeholders, whose relationship with the company is strongly underpinned by custom and governed by contract, shareholders often seem to be the last to be considered when corporate strategy is formulated. They are, of course, also last in line to receive any residual benefit if a company goes into liquidation, since employees, creditors, and suppliers will be paid first. It is right and fair that shareholders should bear the risks associated with equity ownership, but they should not be asked to do so without a commensurate right to supervise and, where necessary, to help shape corporate decision-making. In Japan today they are often effectively unable to exercise such rights.

While it may be true that the changes required to enhance the role of shareholders could cause some friction over the short term, we believe that the longer term interests of companies and the Japanese economy would be best served by a more balanced and open system of governance. Ultimately, all stakeholders would benefit from such a system, since it would also entail more transparent and detailed reporting on company activities, plans and aspirations, thus helping all concerned parties to engage with companies and serve their constituents and beneficiaries better. Such an approach would allow stakeholders to be better informed, to have a genuine understanding of the challenges facing companies, an appreciation of their vision and strategy and confidence in the quality of management.

An example of the success of such an approach can be seen in TDK Corporation, which was one of the pioneers of good corporate disclosure in the early 1980s and which has, as a result, been held in high esteem by shareholders, employees and other stakeholders alike for its transparency. Mitsui & Co. is another example of the success of the policy of transparency. Its commitment to timely, detailed and relevant reporting of its financial and operational performance to all stakeholders has received global recognition: the company is a member of both the FTSE4Good and Dow Jones Sustainability Indices, and has enjoyed a steady increase in the number of foreign investors holding its shares.[*]

Recommendations

In order to restore shareholders to their rightful and legal place as owners of companies, while at the same time safeguarding the interests of other stakeholders, we recommend that listed companies in Japan implement the following measures (if they are not already doing so):

1.1. Develop, disclose and implement corporate policies that explicitly recognise the overarching principle of "shareholders as owners" and seek to balance the interests of all stakeholders. Highlight these policies in annual reports, websites and other corporate communications; and explain the rationale for the policies.

1.2. Improve written communications to shareholders in the following ways:

- Ensure that published reports and announcements are clear, timely and sufficiently detailed to allow both existing and new investors to understand the content. The more effective the disclosure, the less likely that investors will need to ask management questions about it.

[*] The two examples in this paragraph are intended only to highlight companies with good transparency. They should not necessarily be read as an endorsement of all aspects of their governance systems.

This can have a powerful impact on the productivity of the investor relations department.

- Produce annual reports that are balanced and comprehensive, offer a transparent explanation of performance, and disclose the key performance indicators that drive business performance.

- Include a detailed Management Discussion and Analysis section in annual reports that outlines the strategic direction of the company, its operations and major risks and opportunities (including key environmental and social challenges).

- Insert a detailed Corporate Governance Statement into the annual report that describes the composition and functioning of the board of directors, the work of board committees, the company's internal controls and its approach to risk management.

- Wherever possible—and especially for companies with significant foreign ownership—translate financial reports and company announcements, circulars and notices into English. While the costs of translation may be high, companies are well advised to consider the advantages of a better informed and satisfied shareholder base. For example, shareholders are more likely to vote in favour of management at shareholder meetings if they feel that the reasons for management decisions are fully explained.

1.3. Engage in a productive and continuous dialogue with shareholders and recognise their competence, and right, to express views which may affect the strategic direction of the company. In practical terms this would include such things as the following:

- Make reasonable efforts to meet with institutional shareholders upon request. Such meetings should include senior as well as middle management.

- Arrange telephone conference calls with overseas shareholders who may not be able to travel to Japan in person.

- Staff the investor relations departments with officers of sufficient seniority and knowledge, so that they are able to answer questions from shareholders about the strategic issues affecting the company.

> "We generally get meetings (with Japanese companies) when we ask, but access to true decision makers is often limited. We frequently get fobbed off with IR people whose knowledge of some areas of the company, particularly for big-picture, longer-term issues, can be weak."
>
> A US fund manager based in Hong Kong

Issue 2: Utilising Capital Efficiently

Managers should strive to maximise long-term shareholder value by implementing rigorous financial and business discipline. This is the best way to enhance corporate value over time and allow all stakeholders to share in a company's success.

If the principle of shareholders as owners is recognised, it is axiomatic that managers should seek to maximise shareholder value *in addition to* protecting the legitimate interests of other stakeholders. Japanese corporate policy frequently fails to satisfy this criterion, however, in two ways in particular—through balance sheet inflation and inappropriate acquisition and diversification strategies.

Balance sheet inflation

The manner in which many Japanese companies manage their balance sheets is reflective of a management orthodoxy of the 1950s-60s that is no longer appropriate today. Many institutional shareholders (particularly foreign funds) have in recent years taken issue (usually unsuccessfully) with companies whose balance sheets have become inflated with cash and marketable securities. In most cases, the management has no plans to use these funds and they should be returned to shareholders, either through increased dividends or share repurchases or both.

When challenged on this point, many managers cite either a general precautionary motive for cash accumulation or suggest that the company may wish to make acquisitions at some point in the future. These assertions are seldom supported by plausible scenarios and it is evident that this strategy, in reality, is intended both to promote the company as a kind of corporate "savings box" and to protect the position of management. Such behaviour is counter-productive and leads to distortions in the market for capital. By way of illustration, the following two examples show companies that are destroying shareholder value and stakeholder wealth in this manner (both are real companies whose identities have been disguised).

Company A is a corporation whose current operations are spectacularly successful. It has an operating profit margin in excess of 50% and no need for additional investment, over and above its normal depreciation and R&D budgets. There is no company in any related area whose profitability is as high as that of Company A and, therefore, any acquisition would likely reduce its profitability. The management, rightly, has no plans to make acquisitions. In spite of this, however, more than 75% of the company's assets are held in cash and marketable securities. This means that an operating profit margin of more than 50% is reflected in a return on equity (ROE) of just 15%. Furthermore, the company's dividend payout ratio is less than 5%, which means that its cash pile will continue to grow and the ROE will continue to decline. The directors of this company are managing the operations extremely well but the enterprise value extremely poorly, resulting in the destruction of a large amount of shareholder (hence corporate) wealth.

Company B is a corporation whose current operations are, in contrast, extremely inefficient and only minimally profitable. Its operations are so inefficient that even the poor returns on the investments in its inflated balance sheet (in which cash and investments account for 30% of total assets) boost the pre-tax profits of the company. In this case, a balance sheet inflated with the proceeds of profitable operations in the past protects the position of a weak management team whose poor current performance would otherwise be more clearly exposed to scrutiny.

In both of the above cases, the surplus cash should be returned to the market, where it can most efficiently be employed. If this were done by Company A, for example, it would have no difficulty raising cash to fund its activities at some time in the future. That is the purpose of the company's stock exchange listing. The management of Company B, meanwhile, would become more exposed to market discipline—and the chances that this might bring about a beneficial change in management or control would be enhanced. Here again, some stakeholders might suffer disruption in the short term, but this should be offset by longer term benefits in corporate efficiency. Management should not be allowed, in any case, to destroy shareholder value in this way. Nor should shareholders be forced to accept that substantial portions of the assets of their companies amount to collective investment vehicles (which the managers are neither licensed nor, arguably, well qualified to manage).

> "I think most managements are finally starting to understand the concept of ROE and ROA. But for the majority of managements it is just a number target (i.e. 10% ROE target in 3 years) that I have been seeing forever. So, to them, it is just a concept and something that they think fund managers want to hear, but it doesn't really mean anything. And, if they really understood the concept of returns, they wouldn't be sitting on so much cash."
>
> A Japanese analyst in Hong Kong

Dividends and performance

Statistical evidence from around the world indicates that, over the medium to long term, the Japanese "savings box" model of balance sheet management, in which cash and securities are indefinitely retained as a store of value, is fundamentally flawed. This is because the total returns provided by companies that pay high dividends are generally superior to those that pay low dividends. As can be seen from the data below—which have been calculated by Capital Strategy Research, a division of a major global fund manager, for this paper—this correlation is strongly apparent among large companies in Japan. (For data based on MSCI World and MSCI World ex US indices, see Appendix 1.) While the table below focuses on dividend yield—a function of both payout amount and the market valuation of share price—the payout decision of management is a key driver of the yield.

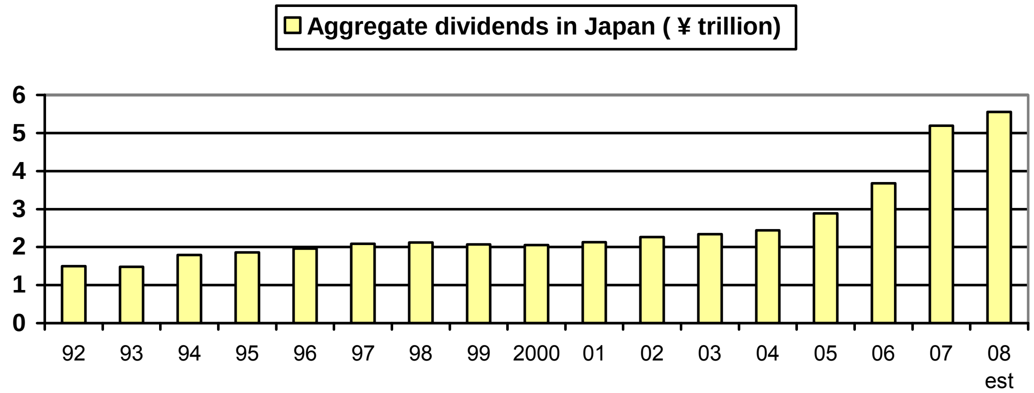
MSCI Japan Yield Quintiles **Data as of December 31, 2007**	**Annualised total shareholder return**			
	1 Yr	**3 Yrs**	**5 Yrs**	**10 Yrs**
MSCI Japan	-10.06	11.73	13.76	3.05
MSCI Japan - Yield Quintile 1 (Highest) (2.09% plus)*	-1.04	17.17	18.58	9.69
MSCI Japan - Yield Quintile 2 (1.6-2.09%)*	-11.06	12.81	14.83	7.90
MSCI Japan - Yield Quintile 3 (1.21-1.6%)*	-12.49	10.09	12.46	1.72
MSCI Japan - Yield Quintile 4 (0.85-1.21%)*	-13.75	10.35	12.55	-4.34
MSCI Japan - Yield Quintile 5 (Lowest/Zero) (0.00-0.84%)*	-12.47	7.19	9.38	-2.19
Pearson correlation	0.72	0.94	0.96	0.86

(*quintile break points)

(Source: Capital Strategy Research, based on MSCI data. Pearson correlation by Hermes.)

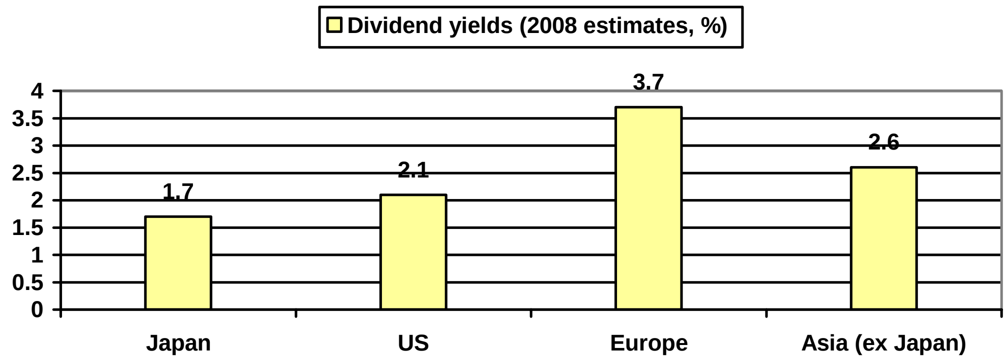
Evidence from the US suggests that managers often signal their earnings expectations through dividends: the higher the dividend payout, the higher their expected future earnings (and vice versa).[1] A higher dividend can therefore be a reflection of strength, not weakness. This can also be seen to apply to major Japanese companies. (Higher payouts can also reflect a lack of alternative investment opportunities.)

Indeed, listed companies in Japan have, as a group, been increasing their dividends. Aggregate dividend payments for first section companies on the Tokyo Stock Exchange have risen from a low of around ¥1.5 trillion in fiscal years 1992 and 1993 to more than ¥5 trillion in FY 2007, with a noticeable increase from FY 2005 onwards, as the following chart shows. (Note: The figure for 2008 is an estimate.)



Source: CLSA Asia-Pacific Markets, based on Bloomberg and Tokyo Stock Exchange data.

While total dividend payments have been increasing, however, dividend yields remain comparatively low in Japan, as the following estimates for 2008 show:



Source: CLSA Asia-Pacific Markets, based on IBES and MSCI data.

Yields are low in Japan because dividends have not increased in line with increases in earnings. Few companies have defined their dividend-payout ratio.

> "With some companies starting to pay out healthier dividends, we are finally starting to see a divergence in some share prices for companies in the same industry."
>
> Japan-based ACGA member

Share repurchases

It is often advisable for excessively cash-rich companies to return cash to their shareholders by repurchasing shares for cancellation. The argument for doing so is particularly compelling when shares are trading below a company's book value and when repurchases would therefore enhance shareholder value (and would signal to investors that a company believed its shares were undervalued). Conversely, when the shares are trading at a substantial premium to book value, there may be a stronger case for distributing cash in the form of increased dividends instead.

As with dividend payments, the volume of share buybacks and cancellations in Japan has been increasing steadily. According to data from CLSA Asia-Pacific Markets, a broker and investment bank, the aggregate value of buybacks from all first section companies on the Tokyo Stock Exchange has risen from zero in the early 1990s to ¥1.2 trillion in FY 2001 and then ¥3.8 trillion in FY 2007. Companies did not start cancelling shares until FY 2002, when a modest ¥200 billion in value were cancelled. This figure grew quickly in subsequent years, reaching ¥2.35 trillion in FY 2007.

> "Companies trading below book value should, in principle, be buying back their stock. In addition to improving corporate returns, we think this will support a strong and stable shareholding base because short-term investors will exit, while long-term investors will stay in."
>
> A Tokyo-based investor

Inappropriate acquisitions / diversifications

The unwillingness of the management of cash-rich companies to return cash to shareholders is often accompanied by a policy of inappropriate acquisitions and diversification away from the company's main areas of competence, resulting in the erosion of profitability and shareholder value. The managers of such companies typically expand the businesses in questionable ways in order to retain control of excess funds, boost the company's top line or protect employment. They expand and diversify, in other words, because they can, not because they should.

Conversely, where diversification from a declining mainstream business into a new growth area would be beneficial, there have often been cases in which excessive concern for shorter term stakeholder interests has made managers reluctant to diversify or, more particularly, to divest themselves of declining businesses as quickly as they should. In both cases it is clear that corporate strategy is being driven by the interests of stakeholders other than shareholders and in the absence of rigorous financial disciplines.

Sound financial practice requires that excess cash that is not being efficiently utilised should be returned to shareholders through higher dividends or share buybacks. Shareholders are not only the owners of companies; they also own the residual cash of those companies. The directors of some companies view dividends as little more than financial leakage, while others argue that excess cash is always better invested in new projects, in the (sometimes ill-founded) hope of generating higher earnings growth in future. We would like to see more discipline being applied in these areas.

Recommendations

In order to utilise capital more efficiently, and thereby avoid inflated balance sheets and inappropriate acquisitions and diversification, we recommend that listed companies implement the following measures (if they are not already doing so):

2.1 Manage balance sheets more efficiently and set sensible ROE thresholds for new investments. Define ROE / ROA targets and give indications as to how these will be achieved. Also consider setting return-on-invested-capital targets as an additional metric, in particular for executive compensation purposes.

2.2 Set dividend-payout ratios at fair and reasonable levels, with reference to peers in the same industry in Japan and overseas.

2.3 Undertake share repurchases when the company's share price falls below its book value or when a buyback would produce a higher expected return for shareholders than other investment alternatives.

2.4 Consider the financial impact of divisional and diversification strategies and consult the board of directors, in particular independent external directors, about these strategies.

2.5 Ensure that annual and interim reports, other relevant announcements and presentations to investors contain a detailed explanation of each of the above items, so that investors can make an informed judgement of investment risks. Where payout ratios remain relatively low compared to peers, provide an explanation of the strategy that this serves.

Issue 3: Independent Supervision of Management

There should be a transparent process of independent, external supervision of management on behalf of all shareholders.

The type of strategic thinking described above not only impinges upon corporate value, but is also likely to harm Japan's longer term competitiveness, with negative implications for all stakeholders. We believe that this situation persists because corporate governance in Japan is systematically weak. While Japanese management is often excellent in its handling of operational matters, we submit that a more open and candid discussion between management and outside board members would, by encouraging appropriate external viewpoints, improve the efficient use of capital and help companies to become more competitive and adept at risk management.

Under current Japanese corporate law, companies may choose between two distinct systems of corporate governance: the *kansayaku* (statutory auditor) system or the "company-with-committees" system. In practice, as data from the Tokyo Stock Exchange's "White Paper on Corporate Governance 2007" shows, some 97% of listed companies elect for the *kansayaku* system, which effectively gives management almost total autonomy and, in our opinion, seldom provides for real, independent supervision of senior management decisions.

The broadly consensual style of management in most Japanese companies means that the decisions of an inner circle of directors, or of the company's president, will seldom be challenged, even if they may not be in the best interests of the company and its stakeholders. There have been cases in which a particularly strong-minded *kansayaku* has exceeded his nominal authority and become involved in strategic decision-making, but these are exceptional. The norm is for the statutory auditors to act in a quasi-compliance officer function and, provided the company is not breaking the law or failing to comply with reporting standards, they will not or cannot intervene. It is also important to note that the statutory auditors are not part of the formal management decision process. Their role, in most respects, is purely advisory and they have no *jinjiken.* That is to say, they have no power to hire and fire within the company and have little or no authority over the senior management.

> "Boards should become more separate from and exert more influence over management than they do at present. They should also make more effort to represent shareholders' interests. There has to be more accountability for management."
>
> "With minimal accountability, since managers move around so much, you really do not get them willing to stand up and do something different".
>
> Japanese fund manager, Tokyo

Hybrid boards
A positive trend in Japan is the emergence of "hybrid" board structures, in which one or more external directors are invited onto the boards of companies that still follow the *kansayaku* system and/or where such companies are establishing functional board committees. We believe that this is a helpful development, but it is only meaningful if the external directors are genuinely independent (i.e. independent of management and any controlling shareholder) and are fully conscious of the fiduciary duty that they owe as representatives of the shareholders. In too many cases, nominally external directors are neither genuinely independent nor have a clear

understanding of their duty to shareholders. As such they are, for all practical purposes, incapable of exercising effective supervision of management.

There is a marked reluctance among the senior managers of most Japanese companies to appoint genuinely independent directors and to allow them real influence in the affairs of their companies. Two reasons for this are often cited: that candidates with suitable experience and knowledge are not available in Japan; and that outsiders may bring a confrontational attitude to the board's deliberations. In our opinion, neither of these objections is valid.

The assertion that such personnel are not available in Japan betrays a lack of understanding of what the role of external directors entails and how they should be recruited. It is not necessary for an external director to have an intimate understanding of the operations of the company, since that is the responsibility and job of the full-time executive directors. The external director should bring an independent mind and an external perspective to boardroom discussions and raise issues and suggestions that he or she believes are important for the company, but which inside directors may not have thought of or may be reluctant to address.

An appropriately qualified and experienced independent director may, and arguably should, influence the style of decision taking in the company and should certainly be in a position to avoid the unfortunately common pattern of rubber-stamping decisions of the president or of an inner circle of senior managers. Such a role may be regarded by some as confrontational. On the contrary, we believe it should embody a constructive and detailed dialogue between senior management and the external directors—something that all stakeholders should welcome. The presence of genuinely independent directors also provides an important safeguard against the potential for managerial self-interest and weak execution of company strategy.

At ACGA's 7th Annual Conference held in Tokyo in November 2007, the opening keynote speaker, Mr. Yoshihiko Miyauchi, Chairman and CEO, ORIX Corporation, described Japan's traditional system of corporate governance, in which senior executives play both a managerial and supervisory role, as being like "a car with an engine but without any brakes". Today, however, global competition was forcing the adoption of new checks and balances, in particular the separation of management and supervision, he argued.[2]

We believe that independent external directors would perform a useful and positive role if introduced into traditional board structures in Japan (although their function and value needs to be better understood than it is at present). We also believe, contrary to what is sometimes asserted, that there is a plentiful supply of suitably qualified candidates in Japan who would be both willing and able to fill such positions. (See the box on p23 for a description of independent directors and suggestions for recruiting them. See also Appendix 2 for a more detailed definition of independent directors.)

Indeed, genuinely independent directors have already been appointed to the boards of some Japanese companies, to the acclaim of the investment community. A recent study by Goldman Sachs of the positive links between corporate governance and enterprise value in Japanese companies gave top marks to, for example, Eisai and Showa Shell Sekiyu for currently having strong board composition. Eisai in particular received a high score for the number of external directors, and has been seen to have strong overall performance.[3]

Board effectiveness depends in large part on the quality of the directors; and this is as true of the external directors as it is of the full-time executives. External directors should be recruited with care and through an objective and transparent recruitment process. Shareholders should be informed about the qualifications and backgrounds of candidates and the way in which they have been selected, both in annual meeting circulars and company reports. External directors should be offered training and familiarisation in relevant areas of the company's business. Training should, in addition, acquaint external directors with their regulatory obligations, the principles of corporate governance, and the nature of their fiduciary duty to shareholders and other stakeholders. Where the company's internal infrastructure is inadequate for this purpose, directors might be tutored by external agencies, such as Japan Association of Corporate Directors, a leading body in Japan for director training.

Companies with Committees

Although "hybrid" board structures potentially provide some degree of supervision of management, we believe that independent boards of directors with a committee system (ie, committees for audit, nomination and remuneration) are inherently superior to the traditional board and statutory auditor system. Even boards in which external directors are predominant, however, only work well if these directors are genuinely independent, ethical, competent, sufficiently empowered and bring diverse viewpoints, experiences and skill sets to the board. Proper implementation of the system, in other words, is essential if it is to be meaningful.

Audit committees are a fundamentally important part of an independent board and we believe that all companies should have them. Nomination and remuneration committees can also be valuable, if properly structured and comprised mostly of independent directors. If poorly structured, however, they will likely provide little or no real benefit. It is important that companies should not set up such board committees without careful consideration as to how they will work, the value they will add, and who should sit on them.

We have observed cases in which Japanese companies that have adopted the "company-with-committees" system have allowed executive directors to chair all the committees. The chairman of any committee has a disproportionate influence within it, and this is probably more so in Japan than in most countries. We regard this practice to be wholly at variance with the intended spirit of the system and believe that it fatally undermines its efficacy. Audit, nomination and remuneration committees, at least, should always be chaired by external directors. As the audit committee plays a vital role in the oversight of the company's risk controls, it should, ideally, be composed exclusively of independent and suitably qualified directors to ensure its impartiality and objectivity.

We further recommend that the committee system be implemented in a flexible and pragmatic manner in order that it may best serve the specific needs of companies. Companies may, for example, wish to extend its scope beyond the basic three-committee structure and, depending on their organisational maturity, business needs and the risks they face, to establish other committees to deliberate on more pressing issues (such as, for example, risk management or related-party transactions).

In this context, it is worth noting that Japan is the only major market in Asia that does not mandate some degree of board independence for listed companies (i.e. a minimum requirement for independent directors and an audit committee). The US and the UK also mandate such standards in their listing rules and codes.

Auditors

A company's auditors are another essential feature of an effective and transparent system of external supervision. In order that potential conflicts of interest be avoided or minimised, 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, and shareholders should therefore be given an opportunity to vote on their appointment or re-appointment at each annual general meeting. While this is not a mandatory requirement in Japan, we believe that it should be.

Executive remuneration

Although listed companies in Japan have begun to provide some information on the compensation paid to the board and senior executives, this generally remains restricted to disclosure of aggregate sums paid in the course of a year. Better disclosure, including details of individual pay packages, would help ensure public accountability and incentivise individual performance. Where possible, pay arrangements should be overseen by the remuneration committee, so as to safeguard against the setting of inappropriate performance targets or pay levels that are incongruent with peers. This committee should also oversee the awarding of executive compensation packages, particularly stock option schemes or other long-term performance incentive plans, in order to ensure performance targets are genuinely met. All remuneration arrangements should be disclosed to stakeholders in the annual report or other relevant materials, and should be routinely included in resolutions to be approved at the general shareholders' meeting.

Performance-based and long-term incentive schemes, such as performance share plans, would help executives to consider the implications of their decisions on the company's current and future value. Indeed, the number of companies adopting such schemes in Japan is increasing. We recognise the risk that such schemes, if not properly implemented, could lead to distortions in short-term corporate strategy and/or inappropriate increases in pay levels. We therefore recommend that these elements of the pay package be firmly linked to well-considered and genuinely demanding performance conditions.

Recommendations

In order to ensure effective external supervision of management and improvement in the operations of boards, we recommend that listed companies implement the following measures (if they are not already doing so):

3.1 Appoint properly qualified external directors through a rational and transparent process and demonstrate their independence and suitability to shareholders in corporate disclosure documents. We recommend that all companies, even those with traditional board structures, make a commitment to appoint a minimum of three independent external directors as soon as practicable. Over the medium term, such directors should ideally comprise a third of the board. Over the longer term, we recommend that they comprise one half of the board. It is important, however, that the quality of people appointed as independent external directors is high and that quality is not sacrificed for quantity. (Note: These ratios are based upon practical experience in other developed markets regarding the minimum number of independent directors required for the effective functioning of boards.)

3.2 Over the longer term, move towards a genuinely independent board system, with fully independent directors and board committees.

3.3 Establish board committees on a pragmatic basis, in order to address the practical business and strategic needs and risks of the company.

3.4 Whichever board system is established, explain clearly to shareholders the decision-making processes and allocation of responsibilities within it.

3.5 Disclose executive remuneration packages in detail, including information on incentive schemes and performance targets. These should be suitably demanding in order to incentivise superior performance over the short, as well as the long, term.

The independent director: What? Who? Who not? How?

What
The key role of external directors is to ensure that the chief executive and the board as a whole concentrate on maximising long-term corporate value.

Who
Executives or former executives of other companies (though not of directly related companies or direct competitors) often make very good external directors. They have the relevant skills and experience to bring a wider perspective to board deliberations. Their current employers often welcome their involvement because it strengthens specific ties and encourages more general inter-corporate communication, which can be valuable. Lawyers and academics bring different skills and perspectives.

Japanese companies with global operations may also benefit from appointing foreign directors to their board. This is something that large Asian firms are increasingly doing, since it can significantly expand the range of expertise on their boards and can assist global strategy development and risk management.

Who Not
External directors should be free of conflicts of interest, such as those which might arise should they, for example, be former employees, hold consultancy contracts with the company or otherwise potentially stand to benefit or suffer loss as the result of any board decision over which they might have influence. It is also suggested that long service on boards causes external directors to lose their independent perspective and, accordingly, limits on tenure of perhaps 7-10 years might be appropriate. (See Appendix 2 for a more detailed definition of independence.)

How
There are three aspects of supervision for which external directors should expect to be held accountable:

- Strategic function: Bringing their independent judgement to strategic decision-making.
- Expertise: Providing skills and experience that may not otherwise be readily available to the company. This applies particularly to small and medium-sized companies.
- Governance function: Ensuring compliance with best practice, participating in the appointment of new directors and monitoring the performance of executive directors. Also ensuring that the governance systems of the company are continuously improving—global governance standards are evolving, not static.

The number of such positions held by any individual should reflect the need to ensure that adequate attention can be given to every office, particularly at times of corporate turbulence.

External directors should work co-operatively with their executive colleagues and demonstrate objectivity and robust independence of judgement in their decision-making.

The role of the external director should be discharged in a positive and collaborative manner, which reflects a recognition that the executives of the company are generally striving to improve corporate performance and value. External directors must, however, recognise that they have particular fiduciary obligations to the shareholders and that they should therefore continuously monitor management decisions and performance with the interests of the shareholders foremost in their minds.

Part B: Shareholder Rights and Protection

Issue 4: Pre-emption Rights

Pre-emption rights should be introduced for shareholders, so that they have adequate protection against dilution from the issuance of new shares or convertible securities to third parties or a small number of select shareholders.

It has become increasingly evident in recent years that some Japanese companies are utilising third-party share placements not as a legitimate means of raising necessary capital, but rather as a way of manipulating their shareholder registers in order to ward off unwelcome corporate bidders.

In one recent case, a company sought to protect itself from what the management considered to be an unwelcome merger proposal by bringing in a "white knight" investor and then issuing a substantial tranche of new shares to a third party at a below-market price. The defensive purpose of this third-party placement was clear, and it was done solely on the authority of the board, without any consultation with shareholders. This action diluted the value of equity held by existing shareholders and, in effect, forced long-term shareholders to finance the company's defence strategy without being consulted on the matter or permitted to buy the new shares on a pro-rata and pre-emptive basis.

In order that injustices of this kind might be avoided in future, third-party share allotments in Japan should be subject to tighter rules, including limits on the quantity which may be issued in any 12-month period (as a percentage of share capital), rules on price discounts, and generally closer regulatory scrutiny.

Institutional shareholders in other developed markets, in particular the UK and Hong Kong, have become extremely sensitised in recent years to the negative effects of such third-party or "private" placements—although mainly because of their dilutive impact on equity value, rather than as anti-takeover mechanisms. Since many of these same global investors are participating in the Japanese market, and since the issue of pre-emption rights is likely to gain more attention in Japan in the near future, we outline below two contrasting solutions to this problem—one that is largely effective (the UK) and one that is much less effective (Hong Kong).

UK guidelines
The UK has a well-developed system for protecting the pre-emption rights of shareholders. This right is enshrined in company law and can only be removed if a super-majority of votes (75%) are cast in favour of "disapplication" at an annual shareholder meeting. After 1987, any decision by a listed company to issue new shares on a non pre-emptive basis was subject to a set of guidelines issued by the Pre-Emption Group, a body formed in that year by the London Stock Exchange and comprising representatives of investment institutions, listed companies and corporate finance practitioners. Significantly, these guidelines were not rules, yet became accepted and established in the UK market.

The guidelines stated that companies should not issue more than 5% of their issued ordinary share capital in new shares for cash and on a non pre-emptive basis in any one year. Second, companies should not issue in this way more than 7.5% of their issued ordinary share capital over a rolling three-year period, without prior consultation of the major institutional investor representative bodies in the UK (namely the Association of British Insurers and the National Association of Pension

Funds). Third, the amount of discount at which such new equity is offered for cash should not exceed 5% of the most recent market price.[4]

In recent years there has been debate in the UK as to whether these guidelines should be relaxed so as to allow listed companies, especially those from new industries such as bio-technology, to raise capital more easily. The UK Government therefore formed a new advisory group in late 2004 to canvas the market and assess if any changes were necessary. The following year the group produced its report, which essentially reaffirmed the importance of pre-emption rights, but recommended that some flexibility be allowed companies if they wished to exceed the guidelines and, more importantly, if they explained their reasons to shareholders.

Shortly after, also in 2005, a new Pre-Emption Group was formed to produce an updated set of principles and to monitor how this guidance was applied in the market. The Group published its Statement of Principles in 2006 and likewise reaffirmed the validity of the basic percentage thresholds in the 1987 guidelines. But it also noted that "a degree of flexibility is appropriate in circumstances where new equity issuance on a non pre-emptive basis would be in the best interests of companies and their owners".

The main difference in the new Principles is an emphasis on dialogue between companies and shareholders, such that companies have a responsibility to signal their intentions "at the earliest opportunity" and keep their shareholders informed, while shareholders have a responsibility to "engage with companies to help them understand the specific factors that might inform their view on a non-pre-emptive issue by the company". Proxy voting advisory agencies should also be prepared to listen to company arguments on this issue and provide a balanced report to their investor clients.

Hong Kong rules

In Hong Kong, the regulatory situation is quite different. While pre-emption rights are provided for in company law, most listed firms on the Stock Exchange of Hong Kong (SEHK) are not incorporated in Hong Kong, hence are not subject to the company law. This situation is remedied to a small extent by pre-emptive rights being included in the listing rules of SEHK. However, these rights are easy to over-ride: listed issuers need only put an ordinary resolution to an AGM seeking a "general mandate" to issue new shares on a non pre-emptive basis in the subsequent 12 months. Since most issuers in Hong Kong have large controlling shareholders, mustering the required 50% of votes to ensure the resolution passes is not difficult.

What is particularly interesting in Hong Kong—and relevant for this White Paper—is the way in which institutional and other public shareholders have been voting against these general-mandate resolutions at company annual meetings in recent years. Whereas most meeting resolutions pass with only a tiny vote against (usually a fraction of one percent), the general mandate is regularly attracting votes of between 5-30% against. When the number of these shares are analysed, it becomes apparent that the vast majority of votes cast by public shareholders at these meetings are opposed to the general mandate.

The key reasons for the opposition of public shareholders are as follows:

- The listing rules allow for as much as 20% of issued capital to be issued in new shares on a non pre-emptive basis in any one year. This is considerably higher than the 5% standard in the UK.

- The rules also allow for the new shares to be offered at a discount of up to 20% of the market price—again, four times higher than the UK.

- The 20% mandate can be further extended by adding repurchased shares, up to a limit of 10% of issued capital. In other words, potentially increasing the total size of non pre-emptive issuances by 50% in one year.

- The 20% mandate can also be refreshed within the 12 months (ie, a new 20% mandate granted) if the company organises an extraordinary general meeting at which only the public (independent) shareholders can vote. This provision was introduced to limit abuse of the general mandate, but to date has provided less protection than one might think (since smaller listed companies do not seem to have difficulty getting such requests approved).

One positive development in Hong Kong, however, is that the Stock Exchange is consulting the market on its views regarding the 20% threshold and whether this should be reduced. Another is that several leading companies have responded by voluntarily cutting the size of the mandates that they seek each year from shareholders (eg, from 20% to 10% or 5%). A few companies have eliminated their mandates altogether, arguing they have no pressing need for additional cash.

Recommendations
In order to ensure that the pre-emption rights of shareholders are adequately protected, we recommend that companies implement the following measures:

4.1 Allow shareholders the opportunity to approve mandates for the issuance of new shares on a non pre-emptive basis at each annual shareholders' meeting.

4.2 Set finite thresholds for the maximum amount of shares that can be issued in this way in any 12-month period (i.e. between each annual shareholders' meeting). We believe that the UK standard of 5% in any one year is reasonable, as is the maximum 5% discount.

4.3 Where share issuance requests exceed standard thresholds, provide shareholders with an explanation for the request and the purpose of the issuance. In particular, refer to the 2006 Statement of Principles from the UK Pre-Emption Group and the advice it provides on how best to communicate with shareholders. For example, it states that requests for "non routine" issuances (i.e. above the normal 5%) are more likely to be successful if a company explains critical considerations such as:

    - The strength of the business case for the issuance.
    - The size and stage of development of the company (eg, shareholders could be more sympathetic to a request from a small company that is growing quickly than a large, mature company that has a more stable business).
    - The stewardship and governance of the company.
    - Why this financing option is preferable to other options.
    - How dialogue with shareholders will be carried out.
    - Contingency plans in case a request is not granted.[5]

4.4 Engage with business associations in Japan and key regulatory bodies to produce a common set of guidelines on pre-emption rights for all listed companies. This will make the task of choosing thresholds considerably easier for individual companies.

Issue 5: Poison Pills and Takeover Defences

The adoption of poison pills that have been structured to protect management and to stop takeover bids from succeeding is in the interest neither of shareholders nor the company. "Shareholder rights plans" offer a workable and fair alternative, although the best defence against takeover is usually a strong share price and a well-managed company.

The past three years has brought an exponential rise in the adoption of "poison pills" by listed companies in Japan. Whereas only 21 companies adopted poison pills in 2005—the year when the Japanese government first issued guidelines—the number rose rapidly to 165 in 2006 and to 266 by late 2007. This total is expected to rise to around 400 in 2008.

The main reason for the sudden emergence of poison pills is a largely exaggerated fear of hostile takeover, especially by foreign firms and investment funds. But whether such takeover-defence measures genuinely protect the interests of the company and its shareholder during a takeover depends very much on how fairly they are structured and implemented. If this process is badly managed, poison pills can just as easily undermine corporate value as enhance it.

Shareholder rights plans

Shareholders will generally be willing to support poison pills if they are sensibly structured and take their interests into account. In assessing the validity of such measures, investors often ask the following questions:

1. What is the reason for the measure?
2. What are its provisions?
3. Is the measure being put to a shareholder vote?

The Canadian-style poison pill, which is less dramatically referred to as a "shareholder rights plan", is seen by many investors as an example of a reasonable and fair takeover-defence measure. According to Canadian commentators, there are "only two legitimate purposes of a shareholder rights plan from a corporate governance viewpoint":

1. To ensure equal treatment of shareholders in connection with a change in control of a company;
2. To provide the board with sufficient time to "evaluate a bid and take steps to maximise shareholder value in the face of such a bid".[6]

An important feature of the Canadian model is a regulatory requirement that shareholder approval be obtained for all rights plans. Other basic features include[7]:

- **Triggering threshold**: The plan is triggered when an "acquiring person" acquires 20% of the voting shares of a company.
- **"Permitted bid period":** Plans generally set a maximum period of 60 days for shareholders and boards to analyse the terms of takeover bids.
- **"Permitted lockup agreement":** Any agreement between a potential bidder and a significant shareholder (and permitted by the board) must "not be structured to deter bids or to prevent competing bids".
- **No unilateral redemptions or waivers:** Boards should not have the discretion to "redeem the rights or waive the plan" in such a way that shareholders are prevented from "approving the bid of their choice".

- **Supplementary approval:** Any "substantive supplements or amendments" to a plan must be approved by shareholders before they take effect.
- **Duration:** Plans must have a three-year "sunset provision" to allow shareholders to review the terms of the plan "in light of recent market developments and management's use of the plan during that period".

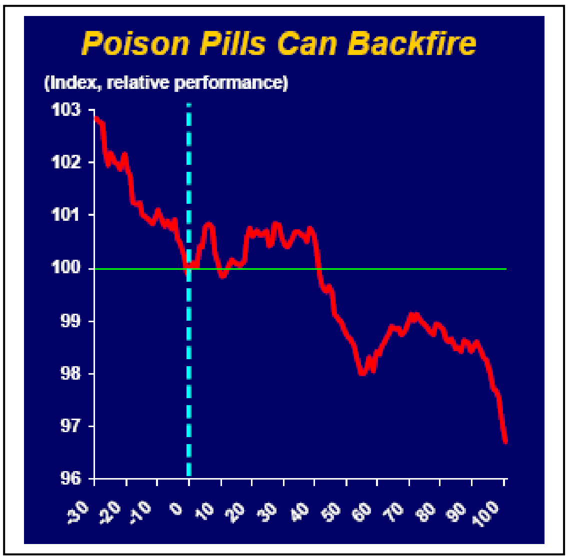
Trends in Japan
Some of the above features of the Canadian plan are reflected in Japan. For example, even though listed companies are not legally required to seek the approval of shareholders for poison pills, the number of issuers putting forward such resolutions at annual shareholder meetings is increasing. In 2005, only 36% of companies that adopted poison pills sought prior shareholder approval, but this jumped to 62% in 2006 and 94% in 2007.[8]

Proxy voting agencies have responded to the emergence of poison pills in Japan by setting down minimum conditions before they will recommend a vote in favour. RiskMetrics Group, a US firm with a presence in Japan, has set the following criteria, many of which are similar to the Canadian plan:

1. A sunset provision of no more than three years.
2. A trigger threshold of 20% or more.
3. The annual election of all directors.
4. An independent "special committee" to evaluate takeover offers.
5. The presence on the board of at least two independent directors, who must make up at least 20% of the board.
6. The absence of other takeover defenses (such as increasing the required voting threshold to remove a director from office).
7. Proxy circulars released at least three weeks before the annual meeting date.

RiskMetrics describes these conditions as necessary but not sufficient. It also wants to see companies present shareholders with a sound plan to increase shareholder value.

Whether poison pills are actually helping to enhance corporate value in Japan, as intended by the 2005 government guidelines and ostensibly sought by management, is questionable. The following chart from Goldman Sachs Japan shows the falling share prices of 126 listed companies that announced poison pills between January and June 2006:



Source: Goldman Sachs Research calculations, based on Datastream, Nikkei Shimbun, RECOF.
Note: Equal-weighted, relative performance.

The zero value on the X axis of the above graph refers to the day on which announcements were made.

One reason why the share prices of these companies may have fallen is that many of them had weak financials to begin with. In fact, according to Nomura Securities, a majority of companies that have adopted takeover-defence measures have below-average ROE and price-to-book (P/B) multiples relative to the universe of listed companies. "We surmise the prevalence of low ROE and P/B multiples among companies that have adopted takeover defense measures is one factor behind suspicions Japanese companies are adopting takeover defense measures solely for the sake of self-preservation," Nomura said in a February 2008 report.[9]

The irony is that companies in Japan are turning to poison pills just at a time when they are becoming less popular in their place of origin, the US. In 2004, a total of 45 companies terminated their poison pill arrangements (a record high), while 41 companies did so the following year. Between 2001 and 2007, there was a 30% decline in the number of US companies with poison pills. And the ratio of S&P 500 companies with poison pills fell from a high of around 60% in 2001 to 40% in 2006.[10]

Indeed, the best defence against a hostile takeover is not a poison pill, but a strong share price resulting from disciplined financial management (including the paying down of excess cash through higher dividends), a sound business and investment strategy (one that sets clear targets for expected returns before new projects are embarked upon), and a management team that has the trust of shareholders.

Significantly, one leading company, Shiseido, announced in late April 2008 that it would shed its poison pill after it expired in June 2008. According to the Nikkei Business Daily, the cosmetics giant concluded that the best anti-takeover tactic was reaching its profitability goals. Fulfilling those targets would help enhance enterprise value, thereby securing shareholder returns, the firm said.[11]

Recommendations

In order to avoid the adoption of poison pills that damage corporate value and do not recognise the rights of shareholders, we recommend that companies implement the following measures:

5.1 Consider in the first place whether a takeover-defence measure is necessary. Would other alternatives be more effective, such as defining and communicating corporate strategy more clearly, or deflating balance sheets by raising dividends and share repurchases? As the discussion above shows, poison pills can signal financial weakness, not strength. Companies with disciplined financial management (and higher dividends) are generally rewarded by the market with a higher share price.

5.2 If a poison pill is deemed to be necessary, follow the example of the Canadian shareholder rights plan and, among other things, ensure that shareholders are given the opportunity not only to approve the adoption of the pill, but any subsequent changes to it.

5.3 In takeover bids, provide shareholders with complete information as well as time to deliberate and vote. Shareholders must be properly represented in any independent evaluation committee formed to assess takeover offers. This committee should have the authority to administer the defence and communicate with shareholders without having to go through the board.

5.4 Bring more independent external directors onto the board, so as to avoid the chances of a poorly devised poison pill being adopted. Where the board of a company is comprised largely or entirely of insiders, the chances of a bad poison pill increases.

Issue 6: Shareholder Meetings and Voting

The timing of shareholder meetings and the process of shareholder voting should be re-examined to ensure they are accessible, fair and transparent. The re-emergence of unpredictable cross-shareholding structures is distorting the voting results at shareholder meetings, particularly EGMs.

The clustering of annual shareholder meetings in Japan continues to act as a major obstruction to the exercise of shareholder rights and good corporate governance, and is unnecessary. This phenomenon occurs because a large number of listed companies—around 1,800—have March year-ends and must, according to the corporate law, hold their annual general meetings (AGMs) within 90 days of their record date (which for most of them is March 31). The vast majority of these companies take full advantage of this 90-day window and hold their meetings in the last week of June. Typically, around 160-175 issuers hold their meetings on the last Tuesday in June, a further 220-260 on the last Wednesday, and then a massive 960-1,000 schedule their annual meetings for the last Thursday in June.[12]

A minority of companies hold their meetings in the third week of June—typically 30-40 on the second last Tuesday, 70-80 on the second last Thursday and 170-180 on the second last Friday—while an even smaller number, usually around 40 issuers, organise their meetings for the second week. Only about half a dozen companies arrange their AGMs for the first week of June. And a few companies even schedule their meetings for a Saturday or Sunday during the month.[13]

Clustering to this degree not only makes it impossible for shareholders to attend more than a few AGMs, but it also impedes their ability to vote effectively. This is because AGM agendas and proxy forms only need to be released 14 days before the meeting—and most companies follow the letter of the law. While this may seem sufficient time for shareholders to cast a vote, it should be remembered that cross-border and foreign institutional investors must vote according to deadlines set by their global custodian banks. These are typically 8-10 days before the meeting, meaning that such shareholders have only a short window of three to five days in which to vote (since they rarely receive agendas any earlier than 13 days before).

This short window becomes more problematic when one takes into account the high number of stakes that foreign institutional investors hold in Japanese listed companies (some of the larger foreign funds invest in between 400-500 listed companies). And it is intensified by the fact that many companies do not translate their agendas and detailed circulars into English.

The combination of clustering and late notice of meetings means that foreign investors often find it difficult vote in an informed manner across all their holdings in Japan—and makes the job of intermediaries such as proxy voting advisors that much more difficult. Indeed, the many impediments to voting result in a large number of withheld votes or abstentions.

Meanwhile, a major weakness in the organisation of the voting process at AGMs is the absence of both voting by poll and the publication of clear and detailed vote results that state the total number of votes for and against each resolution, and any abstentions. Although many companies in Japan do count all proxy votes received before their AGM, very few publish the full voting results of the meeting (including votes cast in person at the meeting). Since the proxy votes have already been counted, it is a relatively small and inexpensive step to then count the remaining votes cast in the meeting.

We believe that voting by poll and the immediate publication of results would significantly enhance the quality and transparency of shareholder meetings in Japan and the reputation of companies for good governance. Such a development would be greatly welcomed by all shareholders, domestic as well as foreign. Given the considerable increase in foreign ownership of Japanese shares in recent years, and the subsequent rise of cross-border voting, we believe that the common practice of not fully voting by poll and not disclosing AGM results is disrespectful to these shareholders. It is also disrespectful to domestic investors who take the trouble to vote their shares.

In this context, it is worth noting that Japan is the only major economy in Asia with a functioning system of electronic voting for listed companies. A major advantage of this system is that it allows cross-border institutional investors considerably more time in which to vote—up to one day before a meeting rather than the usual deadline of 8-10 days. A limitation at present is that so far only around 300 listed companies (mostly large ones) have signed up to use the system. Moreover, while some corporate members publish their AGM voting results, this data is only made available to other members and users of the system; it is not made public. It is to be hoped that electronic voting, in whatever format, continues to develop in Japan. Indeed, this is one area where Japan could set the regional benchmark.

Cross-shareholdings and vote trading

Another voting-related problem that is chronic in Japan is the use of cross-shareholding structures for “vote trading” purposes, especially when management wants to shore up corporate defences in the event or threat of a takeover. This often disenfranchises minority shareholders.

Japanese firms frequently form cross-shareholding pacts, in which they agree to vote their shares for each other. Thus, Company A holds Company B's shares and agrees to vote with Company B's management on all issues before shareholders, and in return Company B owns Company A's shares and agrees to vote with Company A's management. Not only do these cross-shareholdings represent an extremely poor use of corporate funds (bloating asset bases and draining finances away from core businesses), but they represent a deep conflict of interest and disenfranchisement of independent shareholders. Independent shareholders face rigged outcomes in these shareholder votes and, even when a majority of them vote for a certain outcome, they can lose the vote because of the large number of cross-shareholders who are voting their own self-protective and conflicted interests.

One extremely positive outcome of the "Big Bang" reforms of the 1990s was that cross-shareholdings decreased significantly in the early years of the new century. Unfortunately, they began to increase again from 2006, with leading Japanese steel firms being a prime example. Measures to reduce cross-shareholdings and vote trading would be very welcome, both to support higher corporate returns and to allow genuinely fair voting systems to flourish in Japan.

Recommendations

In order to improve the management and transparency of shareholder meetings, and to allow shareholders sufficient time to make an informed vote and participate, we recommend that companies implement the following measures (if they are not doing so already):

6.1 Arrange to hold the annual general meeting earlier in June or change the fiscal year-end (eg, from end-March to end-December). Additionally, companies could also engage regulatory bodies to seek an extension of the 90-day rule in the corporate law, so that they may be permitted to hold their AGMs within 120 or 150 days of their year-end. This would give companies more flexibility in the timing of their meetings and would spread out the AGM season.

6.2 Release final agendas and circulars at least 21 calendar days before the AGM—although preferably this should be done 28 days before.

6.3 Translate final agendas and circulars into English, especially for companies with significant foreign ownership.

6.4 Vote by poll for all resolutions at the AGM and any other shareholder meeting. Engage an independent scrutineer for the poll (eg, a share registrar or auditor) and publish full voting results by the following day.

Meanwhile, we believe that regulators should require institutional investors, both domestic and foreign, to disclose their voting records so as to minimise potential conflicts of interest. One model to follow could be that of the US, where the Securities and Exchange Commission brought in new regulations in early 2003 requiring mutual funds and other registered investment companies to disclose their proxy voting policies and procedures (including how they handle conflicts of interest) from July 2003 and their actual proxy voting records from August 2004. A different system can be found in Australia, where an investment industry body, the Investment and Financial Services Association (IFSA), published a standard on proxy voting disclosure in late 2004 that all its members were required to follow.

"Without ERISA-type legislation, it's hard to hold trust banks (who manage the lion's share of pension assets in Japan) and other asset managers accountable for their voting behaviour. Some have confessed to me that while they were inclined to vote in favor of some of the activists' proposals for higher dividends in 2007, there were occasions when the parent bank of insurance firm "interfered" with the final vote."

Japanese analyst, Tokyo

Postscript

There is a high degree of consensus among institutional investor members of ACGA that these are the most pressing issues which relate to corporate governance in Japan today. The issues are pressing because they impact the fundamental strength, stability and investment attractiveness of the companies in which our members invest.

ACGA and its members hope that this paper will be viewed as a constructive and supportive contribution to corporate governance in Japan. Our intention is to respectfully persuade directors, managers, regulators, legislators and other market participants to consider the essential corporate governance reforms that Japanese companies must adopt to stay competitive in a global framework. We would like to cultivate a thoughtful, long-term approach to corporate governance reform, and our goal is to seek optimal solutions for Japan, in order that all may benefit from a strong and dynamic economy.

Appendix 1: Annualised Total Shareholder Return data for MSCI World and MSCI World ex USA Yield Quintiles

MSCI World Yield Quintiles
Data as of December 31, 2007

	Annualised Total Shareholder Return				
	1 Yr	**3 Yrs**	**5 Yrs**	**10 Yrs**	**15 Yrs**
MSCI World	9.56	13.25	17.47	7.45	10.19
MSCI World - Yield Quintile 1 (Highest) (3.67% plus)*	3.16	13.33	19.85	9.72	13.01
MSCI World - Yield Quintile 2 (2.4-3.67%)*	9.94	14.36	17.69	6.85	9.41
MSCI World - Yield Quintile 3 (1.57-2.4%)*	14.68	15.34	17.51	8.58	9.37
MSCI World - Yield Quintile 4 (0.83-1.57%)*	8.08	12.61	15.80	4.52	5.29
MSCI World - Yield Quintile 5 (Lowest/Zero) (0.00-0.83%)*	12.18	10.24	15.99	3.85	3.70

Quintiles calculated based on quarterly rebalance

(*quintile break points)

(Source: Capital Strategy Research, based on MSCI data.)

MSCI World ex USA Yield Quintiles
Data as of December 31, 2007

	Annualised Total Shareholder Return				
	1 Yr	**3 Yrs**	**5 Yrs**	**10 Yrs**	**15 Yrs**
MSCI World ex USA	12.85	17.93	22.64	9.37	10.21
MSCI World ex USA - Yield Quintile 1 (Highest) (3.85% plus)*	8.29	17.05	25.41	12.73	15.07
MSCI World ex USA - Yield Quintile 2 (2.64-3.85%)*	13.54	17.81	21.69	8.75	10.70
MSCI World ex USA - Yield Quintile 3 (1.84-2.64%)*	19.63	21.02	24.04	11.55	11.36
MSCI World ex USA - Yield Quintile 4 (1.13-1.84%)*	16.68	19.64	22.25	8.24	7.79
MSCI World ex USA - Yield Quintile 5 (Lowest/Zero) (0.00-1.13%)*	7.79	13.68	19.11	4.35	4.03

Quintiles calculated based on quarterly rebalance

(*quintile break points)

(Source: Capital Strategy Research, based on MSCI data.)

Appendix 2: Definition of "Independent Director"

Independent directors should not:

• Have close family ties with any of the company's advisors, directors or senior employees.

• Be former employees or senior managers of the company.

• Hold cross-directorships or have significant links with other directors where there is a power imbalance between the directors.

• Be representatives of major shareholders connected to the controlling shareholder or management, or be representatives of any special interest group, or former employees of such groups.

• Have commercial involvement with the company as professional advisers or major suppliers or customers.

• Be entitled to performance-related pay, stock options, or pensions.

• Hold other directorships in competing companies in a closely related industry.

Appendix 3: Reference Material

Corporate Governance Principles and Guidelines
The following is a list of statements of principle and guidelines on corporate governance from institutional investors that have endorsed this White Paper.

BC Investment Management Corporation (bcIMC), Canada

"Corporate Governance Principles and Proxy Voting Guidelines"
http://www.bcimc.com/ResponsibleInvesting/Standards.asp

"Shareholder Engagement Guidelines"
http://www.bcimc.com/ResponsibleInvesting/Approach.asp

California Public Employees' Retirement System (CalPERS), USA

"Global Principles of Accountable Corporate Governance"
http://www.calpers-governance.org/principles/default.asp

F&C Asset Management, UK

"Corporate Governance: Operational Guidelines"
http://www.fundnets.net/Fundnets_uploadfiles/co_gsri_cgo_guidelines_general.pdf

Hermes Fund Managers Ltd, UK

"Hermes Corporate Governance Principles"
http://www.hermes.co.uk/pdf/corporate_governance/Hermes_Corporate_Governance_Principles_web_030306.pdf

"The Hermes Principles"
http://www.hermes.co.uk/pdf/corporate_governance/Hermes_Principles.pdf

"Hermes' Approach to Engagement"
http://www.hermes.co.uk/pdf/corporate_governance/hermes%27_approach_to_engagement_250804.pdf

"Hermes' Approach to Engagement" (Japanese)
投資家としてのハーミーズの取り組み方
http://www.hermes.co.uk/pdf/corporate_governance/hermes_approach_to_engagement_japanese.pdf

"Shareholder or shareowner?"
http://www.hermes.co.uk/pdf/corporate_governance/shareowner_or_shareholder_311003.pdf

Railway Pension Investments Limited (RAILPEN Investments), UK

"Japan Corporate Governance Policy"
http://www.railwaypensions.co.uk/SiteResources/MediaArchive/RailPenInvestments/pdfs/JapanCorpGovPolicy2007.pdf

"Japan Corporate Governance Policy" (Japanese)
日本企業についてのコーポレートガバナンス原則
http://www.railwaypensions.co.uk/SiteResources/MediaArchive/RailPenInvestments/pdfs/070817_Revised_2007_Final_Japan_CG_Policy_Latest_Japanese.pdf

Appendix 4: About ACGA

The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership association dedicated to promoting long-term improvements in corporate governance in Asia through research, advocacy, and education.

ACGA carries out independent research in 11 major Asian markets. It engages in a constructive and informed dialogue with regulators, issuers, institutional investors and other key interest groups on significant corporate governance issues affecting the region. And it organises educational events, including an annual conference, to raise awareness and contribute to the reform momentum.

ACGA is best known for its regular "CG Watch"* survey of corporate governance in Asia—first undertaken in 2003—and for carrying out a landmark survey of proxy voting issues and impediments in Asia in 2006. It has also developed a website, **www.acga-asia.org**, that provides a wide range of data and analysis on corporate governance conditions and regulations in major Asian markets.

(*Carried out in collaboration with CLSA Asia-Pacific Markets, a Founding Sponsor of ACGA)

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Appendix 5: About the Endorsers

Aberdeen Asset Management
Aberdeen is an independent asset management company listed on the London Stock Exchange and has funds under management across equities, fixed income and property of more than US$204 billion as of December 31, 2007. The Group's largest offices are located in London, Philadelphia and Singapore, with additional offices across the globe including Bangkok, Hong Kong, Kuala Lumpur, Sydney, Taipei and Tokyo. Its largest clients are institutional investors, including governments, national pension schemes, listed investment companies and charities as well as retail investors.

Alliance Trust Asset Management (Asia-Pacific)
The Alliance Trust is one the oldest investment trusts in the world and the largest generalist investment trust company listed on the London Stock Exchange, managing more than £2.7 billion of assets as of January 2008. It aims to be a core investment for long-term investors, with its assets invested world-wide to give a diverse portfolio spread across different industries and sectors. The company has approximately 60,000 shareholders and over 80% is held by ordinary savers. All investment operations were located in the UK until 2005 when some of its investment team were relocated to Asia. Its Asian headquarters is in Hong Kong.

British Columbia Investment Management Corporation (bcIMC)
bcIMC is based in Victoria, British Columbia and is one of Canada's largest institutional investors with assets under administration of CAD$85 billion (as of March 31, 2008). Its investment portfolio covers all major world markets and security types, including public and private equity, real estate and fixed income securities. Its clients include public pension funds, public trusts, and insurance funds.

California Public Employees' Retirement System (CalPERS)
CalPERS is the largest public pension system in the United States whose mission is to advance the financial and health benefit security for approximately 1.5 million California public employees, retirees, and their families. CalPERS has more than US$240 billion in assets under management as of March 31, 2008, comprised of a global portfolio of investments, including real estate, private and public equities, fixed income, inflation linked assets and cash. As a fiduciary, CalPERS advocates constructive shareowner activism to protect the pension system's interests as an investor. CalPERS firmly embraces the belief that accountable corporate governance will optimize long-term sustainable shareowner investment returns and implements a number of initiatives to improve corporate governance at companies and in the global marketplace.

California State Teachers' Retirement System (CalSTRS)
CalSTRS is a pension fund for state teachers in California and one of the largest public pension systems in the US. It manages US$169 billion in assets on behalf of its 812,784 members and benefit recipients. CalSTRS invests in a wide range of asset classes, including private and public equities, fixed income, property and cash. CalSTRS is an active proponent of corporate governance initiatives in the United States and around the world. The fund has committed over US$3 billion to the relational/activist investment space in both the US and non-US markets.

F&C Asset Management
F&C, headquartered in London and one of the largest and oldest asset management firms in Europe, had almost £104 billion (US$ 207 billion) of assets under management as of end 2007. It invests in equities, fixed interest and property, but also specialises in niche areas such as Governance and Socially Responsible Investment, Emerging Market Debt, Liability Driven Investment, Global Tactical Asset Allocation, fund of private equity funds, and Multimanager Fund of Funds. F&C is active on corporate governance issues, engaging its investee companies on corporate governance issues through its reo® (responsible engagement overlay) programmes.

Hermes Fund Managers
Hermes is one of the largest pension fund managers in London; the principal manager of the BT Pension Scheme and the Royal Mail Pension Plan, and a provider also of ownership advisory services to the British Coal Staff Superannuation Scheme, Ireland's National Pension Reserve Fund, Denmark's PKA and the BBC Pension Trust. It had more than £34 billion under management as of December 31, 2007. Hermes is well-known for its active approach to share ownership: it always seeks to exercise its clients' voting rights at all general meetings of companies in which it invests, and emphasises the importance of dialogue between the company and its shareholders. It believes that a relationship based on mutual understanding and trust is central to good corporate governance.

PGGM
PGGM is a Dutch pension administrator and asset manager acting on behalf of, amongst others, Pensioenfonds Zorg en Welzijn, the Dutch pension fund for the healthcare and welfare sector and the second largest pension fund in Europe. PGGM currently has EUR 90 billion under management for over two million employees and former employees in the healthcare and welfare sector. Acting on the belief that financial and social returns go largely hand-in-hand, PGGM sees it as its duty to incorporate responsible investment principles into its investment process, thereby helping to secure a high and stable return. PGGM defines 'responsible investment' as: 'investment activities which explicitly take into account environmental, social and corporate governance (ESG) issues'. Furthermore, PGGM sets minimum ethical limits on its investments, such as a clear Exclusions Policy. On 27 April 2006, PGGM signed the Principles for Responsible Investment (PRI), which were developed by a group of leading institutional investors (including PGGM) in conjunction with the United Nations. PGGM attaches great importance to good corporate governance and raising corporate governance standards. This is the reason why, for example, PGGM is one of the co-founders of and is actively involved in Eumedion, the Dutch organisation representing the interests of institutional investors, and is a member of the Asian Corporate Governance Association (ACGA).

Railway Pension Investments Ltd (RAILPEN)
RAILPEN is an investment management firm and Occupational Pension Scheme (OPS) member, whose sole client is the Railway Pension Trustee Company Ltd (RPTCL), a trustee of four pension schemes. RAILPEN's principal role is to act as a manager of managers, advising on the range of assets to be deployed, investment manager appointments and monitoring investment management performance. In total RPTCL owns approximately £20 billion of assets. The assets attributable to each section are invested through a pooling arrangement in public equity, private equity, global bonds, index linked bonds, property, infrastructure, hedge funds and commodities. The assets are managed for RPTCL by a combination of RAILPEN and externally appointed fund managers.

Universities Superannuation Scheme (USS)
USS is the principal pension scheme for academic and senior administrative staff in UK universities, higher education and research institutions. Today USS, which has around 400 participating institutions and more than 240,000 members, is the one of the largest pension schemes in the UK by fund size, with a total value of around £30 billion. USS is a committed long-term and responsible investor, using shareholder engagement strategies to encourage environmentally and socially responsible corporate behaviour and good standards of corporate governance.

Endnotes

[1] See for example Robert D. Arnott and Clifford S. Asness, "Surprise! Higher Dividends = Higher Earnings Growth", AIMR Journal, January/February 2003, pp70-87.

[2] Yoshihiko Miyauchi, "The Value of Corporate Governance to Japanese Business", Opening Keynote Speech at the "Asian Business Dialogue on Corporate Governance 2007", ACGA 7th Annual Conference, Conrad Tokyo, November 8, 2007. See ACGA website (www.acga-asia.org) for the full version of the speech. Look under ACGA Archives / Events.

[3] "Corporate governance and enterprise value", Goldman Sachs Strategy Research, 15 September 2006, p. 17

[4] Strictly speaking, the UK pre-emption guidelines discount is 5% of "the middle of the best bid and offer prices immediately prior to the announcement of an issue or proposed issue".

[5] "Disapplying Pre-emption Rights: A Statement of Principles", Pre-Emption Group, May 2006. For a copy, go to: www.pre-emptiongroup.org.uk

[6] Debra Sisti, "Poison Pills Revisited", *Corporate Governance Review,* December/January 2003, p8.

[7] All of the subsequent information and quotes on the Canadian plan is taken from Sisti, 2003.

[8] Nomura Securities, "Shareholder Activism back for Act 2", February 14, 2008, p6.

[9] Nomura Securities, as above.

[10] All data on US poison pills from Taiyo Pacific Partners LP, "Anti-Takeover Measures: Poison Pills and Stock Acquisition Rights", June 2007 (an internal company presentation)

[11] Nikkei Business Daily (Thursday edition), "Shiseido To Drop Takeover Defense Program, Focus On Profit", May 1, 2008

[12] Tokyo Stock Exchange (TSE) data, based on 2006 and 2007 annual meetings. The universe is 1,818 companies listed as of March 31, 2007, plus six companies newly listed after April 1, 2007. This group includes issuers on the TSE First Section, Second Section, and Mothers.

[13] TSE data, as above.