

# **Japan's Corporate Governance: What Still Need To Be done**

**Hands-on Perspective of the Practitioner  
- Challenges that Asset Owners are facing -**

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Long, Long Time Ago...

New Hope... But...

Corporate Empire Strikes Back...

Return of the Shareholders' Rights...

# Historical Context

- Japan is believed to be a very old country where the same sovereign/ dynasty has continued to this day for thousands of years.
- One study found that more than 3000 businesses have longer than 200 years of history today (all alive).  
=> With such longevity comes with slightly different perspective on “sustainable growth”.
- Long before the stock exchange, businesses were connected through personal introduction and trust, often with marriage, employees working for the same business for generations, etc... and then formed guilds which grew over time across the industry today – Keidanren (the Federation of Economic Organization, or KDR).
- With the advent of the “incorporation”, such long-term tightly-knitted business network was replaced by “cross shareholding” and more emphasis on the “stakeholders’ value” than on the “shareholders’ value”.

**This is the starting point of understanding “Corporate Governance in Japan”.**

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# Stewardship Code and Corporate Governance Code

- In 2014, the first Stewardship Code was introduced.
- In 2015, the first Corporate Governance Code was introduced.
- These two are often referred to as the “twin-engine” for the “make-over” of Japanese corporate governance, included in the last of “three arrows” (growth strategy) in the “Japan Revitalization Strategy” initiated by Prime Minister Abe.
- **Stewardship Code** took 18 experts for several months to come up with it – although the result was mostly copied from UK’s Stewardship Code 2012.
- **Corporate Governance Code** also came mostly from OECD’s, ICGN’s, again, with lots of “experts” in the “Experts Council”.
- **SSC** requires investors to comply or explain to do what is called “responsible investment” (if you sign up), while **CGC** requires the listed companies to comply or explain to do what is required in the **CGC**. Everyone is very good at “looking good”.
- Some media say those codes made tremendous difference – REALLY?

# Flaws of the Codes

- Current (as well as the revised) Stewardship Code of Japan, although it is mostly copied from UK Stewardship Code, has intentionally omitted the “**explicit encouragement**” for collaboration with other investors – very unique and rare - one of the, if not THE only, Stewardship Codes in the world that does NOT explicitly encourage collaboration among investors. Even PRI does so.
- Collective Engagement is absolutely essential to get minority holders like pension funds or foreign investors heard and taken seriously. Because significant shares are often held by the “shareholders who always vote FOR the management ≈ cross shareholders ≈ **Allegiant Shareholders**”. More on this later.
- Why hold other companies’ shares? => In order to obtain or maintain business relationship – hostage to maintain business. **Companies choose the shareholders, thus “buy” and secure the “yes” votes.** Remnant of old, traditional Japanese way of business relationship, but from today’s global perspective, this is the major challenge to the global capitalism and healthy function of the stock markets.

# True Magnitude of Cross-Shareholdings

- One study\* shows that, on average, 35-40% of all the listed companies (TOPIX) are held by those “Allegiant Shareholders”.

\* By Japan Investor Relations and Investor Support, Inc. (J-IRIS). Derived from all of the TOPIX listed companies’ official “Annual Security Report” filing data on the “type of the shareholders”, and some further breakdown of the shareholder type provided by the database vendor.

- In many higher cases, that percentage can be 50% or 60% (e.g. Takata – the founder’s family and family office alone held more than 60%).

- Breakdown of Allegiant Shareholders:

- Insurance companies (Life or Property) 5%
- Banks 5%
- Companies 25%

-> Companies include trading companies, Keiretsu companies, old Zaibatsu group companies, suppliers, distributors, founder’s family office, etc.

- Comparison to strategic holdings in other markets:

- In U.S., U.K. - less than 10%
- In continental Europe - 10-20%

-> Japan is close to the level of some of emerging markets.

- ✓ However in other markets, strategic shareholders are truly strategic like governments or a few major controlling shareholders, who govern the investee companies well.

# True Nature of Allegiant Shareholders

- Taking into account those held by retail investors (except for the founders or their family) who typically submit blank proxy, when it comes to voting at AGM, the management know that they would always win.
  - No need to worry about their positions in the board and even after-retirement positions
  - No need to worry about take overs
  - No need to worry about electing family/ friends as outside directors
  - No need to worry about NOT taking risks or overpaying for M&A (no wonder ROE is low)
  - No need to worry about accountability, strategies, leadership quality or lack thereof.....
  - **=> How many CEOs have been let go because of the poor performance, mis-management in Japan? How many board members were elected by the shareholders' proposal? (only one, just happened this year)**
- ✓ **AGMs in Japan are generally just for formality sake.**
- ✓ **Mandatory disclosure of voting by the institutional investors ONLY does NOT mean much.**
- ✓ **This “tradition” is hard to get rid of – change is too slow. Regulatory regime change and policy-level push are needed to speed up. No longer the time for “comply or explain”, but “comply or DELIST”. Tokyo market is getting less and less relevant.**

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# Business Community Strikes Back

- Totally defensive against the take-over threat.
- T. Boone Pickens, Steel Partners, The Children's Investment Fund, ....
- “Murakami” incident.
  - ⇒ All “BAD” memory or trauma for the business community.
- They now have made sure these incidents do not happen again (made it legally very difficult for investors to collaborate). Japanese are diligent, careful, but afraid of changes.
- Therefore, they do not want “collaboration” among investors, and advertise that cross-shareholding is no longer an issue – essentially, “shareholders, back off!”.
- Now the trade/ commerce is global, but they still maintain “island mentality”, believing it is okay to act as if Japan were the only country on the planet.
- “Engagement fund” – Activist fund à la Japonaise, they claim. Please....

# Business Community's Resistance

- Some believe that the cross-shareholding or Allegiant Shareholding has substantially decreased because Nikkei has run a few times an article which has spread the words that “Japan’s cross shareholding has now dropped below 10%.”
- This is intentionally misleading. The source is only “The Security Report”, equivalent of 10-K, which CGC requires to list “30 or more” such “security investment” while many companies hold hundreds or thousands of such “security investment” companies’ shares. The regulator likes the research paper by a prominent security firm of Japan. Surely because they want the world to think that SSC/ CGC is making great progress (said research analyst is sometimes chosen as a member of the “expert council” and it is natural to write whatever the regulator wants him to – big career boost).
- The TRUE number is as on the previous pages. Business community just can’t get rid of these “strategic security holding” as they would really lose business – still happens today.

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# Results of this Peculiar Japanese System of Cross/ Allegiant Shareholdings

- Nullifying the fundamental function of normal/ sound stock market
  - ✓ Companies control the votes. Even the management of the companies which are very poorly run are approved by their Allegiant Shareholders – Takata, Toshiba....
  - ✓ Allegiant Shareholders protect management from take-over threats. This is the main reason why as many as a third of all the listed companies trade below their book value. Serious lack of interest in the stock, thus little expectation for growth.
  - ✓ Nullifying the stock market function of efficiently allocating capital or labor force.
- Serious conflict of interest between Allegiant Shareholders and Institutional Investors.
  - ✓ Allegiant Shareholders benefit from business by voting “yes”, while Institutional Investors profit only from stock return. They are not seeking common interest of shareholders. Against the Company Act principle – All the shareholders must be treated equally.

# What can be done? – Need to keep pressing from outside

- Allegiant Shareholders:
  - ✓ Engagement with companies about this issue will take a long time, if ever. Policy action is needed, e.g. what Germany did as one of the “Shroeder Reform (Agenda 2010)” where “capital gain tax” was substantially reduced so that those holding other companies’ shares could sell them easily/ cheaply. With the money, buy back the shares other companies hold -> higher ROE instantly.
  - ✓ Disclose the details of the shareholders’ true identities (they must know – they calculate how much “Yes” votes are expected on any agenda at AGMs) and their voting results, so that the prospective investors and analysts can identify who are and how much are held by the Allegiant Shareholders.
- Collective Engagement:
  - ✓ To form alliance with (passive) asset managers to start collective engagement (it is not illegal, per se) with utmost care NOT to step on the land mines. Foreign investors may join once it is confirmed safe.
  - ✓ Little by little, the activity will be recognized by both the investors’ community and business community and both sides start to think “it is okay to collectively engage”. Start from the “okay” topics.

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