ESG Spotlight.

Japan's untapped opportunities

We aim to highlight Japan's latest developments in addressing board diversity and increased recognition as a value adding strategy for global competitiveness. Moving beyond legal requirements, new approaches can present opportunities for enhanced communication with stakeholders. While significant challenges remain, new trends encourage us to accelerate this momentum, in order to enhance our clients' assets.

Contribution by Meryam Omi – ESG Engagement Manager

Meryam has overall responsibility for engaging on sustainability topics at Legal & General Investment Management. She also carries out voting and engagement activities on governance issues in the Asia Pacific region as well as lead the project to integrate ESG (Environmental, Social and Governance) aspects in the mainstream funds.

Meryam has over eight years of asset management experience, including managing teams of new business proposal writers and carrying out marketing and sales projects across a wide range of LGIM's products and capabilities.

After completing a Masters of Science in Environmental Decision Making in 2010, she joined the Corporate Governance team to lead the ESG engagement effort as LGIM signed up to the UN PRI (Principles of Responsible Investment) and the UK Stewardship Code.

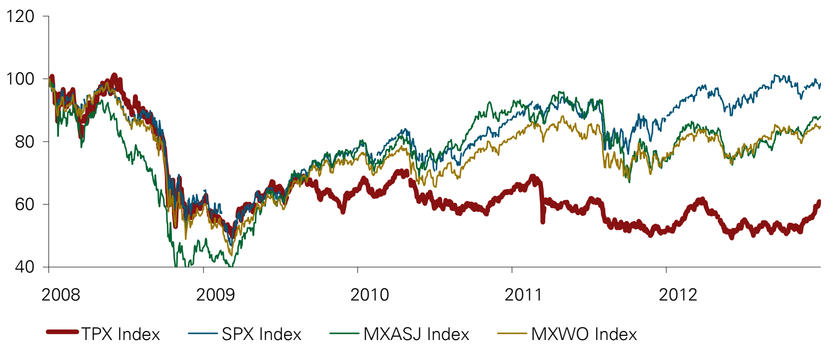
At Legal & General Investment Management (LGIM), we believe that robust corporate governance contributes to better management practices and result in enhanced company performance.

We manage over US$600bn of assets (as at 30 September 2012), of which 60% are in index-tracking funds. As such we are concerned with long-term issues that affect companies' valuations and are fully committed to addressing them by engaging with companies, regulators and industry bodies to build sustainable models.

We have been at the forefront of corporate governance developments in the UK, working directly with companies in their efforts to achieve sustainable growth. In line with our growing international presence, we have expanded our scope to international companies, adapting our policies to address the economic, political and cultural differences in corporate governance practices globally.

Our assets are invested in over US$14billion of Japanese equities. Exacerbated by the strong yen, Asian competition and natural disasters, the Japanese equity performance has stagnated in recent years with Topix underperforming other major indices by just over 30% in the five years to the end of 2012, as illustrated in **Figure 1**.

Figure 1: Japanese equity performance compared with other worldwide indices



Source: Bloomberg

TPX Index	Tokyo Stock Exchange Tokyo Price Index
SPX Index	S&P 500 Index
MXASJ Index	MSCI Asia Excluding Japan Index
MXWO Index	MSCI World Index

Legal & General INVESTMENT MANAGEMENT

During the rapid growth of the economy in the post-war period, a distinctive system of governance was developed in Japan whereby companies formed groups centred around a core bank with member companies owning shares in each other and maintaining strong business ties. This was further reinforced by the deregulation of capital holdings and fear of foreign purchases. The system successfully built foundations of stability and group solidarity, with a pool of trusted insiders from which candidates were appointed to company directorships, delivering growth and development of the Japanese economy.

However, the flipside to this type of corporate management is a tendency towards management entrenchment and inward focus. This resulted not only in limited communication and information provided to investors, but also general questions raised by foreign investors about the strength of external checks and balances and the ability to voice concerns without fear of consequences.

Today, as the third largest economy in the world, Japan faces the challenges of tackling these issues to stay competitive in the globalised economy. This is going to require flexibility and openness to new ideas which would require a change of approach at the top.

We continue to believe that Japan has an abundance of untapped opportunities to offer. To start exploiting these opportunities, company strategy should be subjected to a healthy debate mediated by diverse and well-balanced boards.

We believe that diversity adds substantial value to the quality of company management by:

- challenging strategic decisions and thus helping to build robust business plans
- helping create a responsive business that caters to wider stakeholders
- building favourable international relationships and revitalising Japan as a competitive investment market amongst its Asian counterparts
- improving the sustainability of company growth and maximising shareholder value

In short, board diversity is a not compliance issue of ticking boxes to satisfy a few investors, but something that companies have come to recognise as a value-adding component of corporate structure.

In this research, we aim to highlight some of the positive trends within Japan aimed at addressing the board composition and diversity, while recognising the enormous challenges that still remain. The discussion will mainly centre around the question of independent non-executive board members, whose input into the board discussion is crucial in addressing the wider question on capital management and business strategy, while highlighting the value of other aspects of diversity.

RULES THAT DON'T RULE

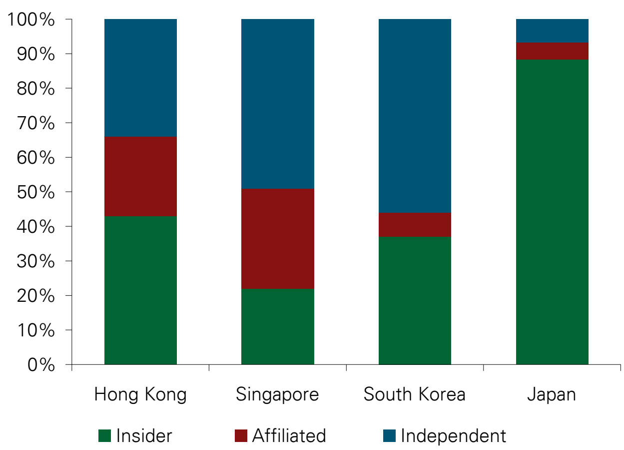
The traditional structure of two-tier Japanese boards consists of a board of directors and statutory auditors (Kansayaku). Kansayaku's role is to audit the directors' conduct and processes, but they operate separately from internal or external auditors and have no voting rights.

Majority independent boards are the norm in developed markets and are often mandated by listing authorities and exchanges, based on a defined governance code. In Japan, the Company Act requires companies of a certain size to have at least half of the Kansayaku committee members to be outside directors. This outsider, however, is defined as anyone who is not or has not worked for the company or its subsidiaries in the past. In addition, the Tokyo Stock Exchange listing rule requires companies to have at least one independent director or Kansayaku. Their definition goes beyond outsider concept and rules out close relatives, clients, service providers or significant business partners.

This relatively mild exhortation means that Japan shows a stark difference in board composition even compared to its Asian neighbours, as outlined in **Figure 2**.

Definitions
Insider: works for the company
Outsider/affiliated: doesn't work for the company but has affiliation to the company or its parent/subsidiaries that can pose potential conflicts of interest
Independent: has no direct affiliation to the company

Figure 2: Board composition in Asian developed markets



Source: LGIM, using ISS data

It is important to note, however, that even in markets like South Korea where the directors that can be defined to be independent, they can potentially bring business conflicts due to the indirect affiliation; hence the quality of independence is an issue in all markets.

POSITIVE MOMENTUM

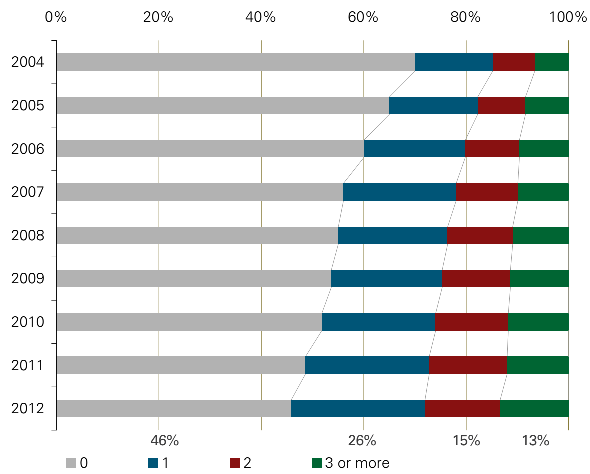
Over the last decade, there has been a growing trend of some companies voluntarily recruiting outside directors, as shown in **Figure 3**. More than half of the companies now listed in the Tokyo Stock Exchange have at least one or more outside directors on the board.

Cumbersome board sizes that exceed 15 members have also been steadily decreasing, with 5.5% of boards having more than 15 directors in 2009 to the current number of 3.4% in 2012 .

In addition, approximately 2% have opted for a board structure with committees (as opposed to Kansayaku). These companies adhere to a more stringent independence requirement of having at least two directors from outside the company.

The incremental changes may be small in size, but recognition of corporate governance strength is gaining momentum in many progressive companies.

Figure 3: Japanese companies' board composition by number of outsider directors



Source: Japan Association of Corporate Directors, Corporate Governance Report of Listed Corporations, 2012

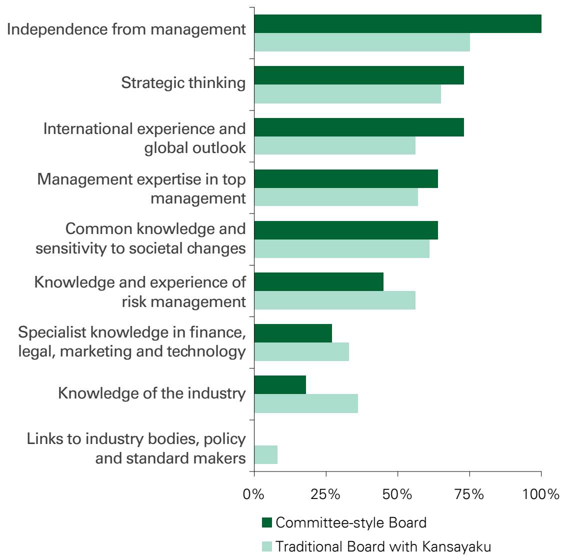
HEALTHY SCRUTINY

Independent board members' primary role is to provide external experience and to challenge the status quo without the constraint inherent in having a vested interest in the business. Their contribution to the top-level decision making process should serve as a check on the management, test the strength of their risk management model and identify business opportunities that may yet be realised. The long-term nature of the relationship means that, unlike external consultants or experts that are brought in at the request of the company, their non-conflicted views should help build competitive business models.

The survey conducted by ProNed 2011[1], on a sample of 83 currently serving Japanese independent directors, outlined the most important characteristics of an effective independent director, summarised in **Figure 4**.

These findings stress the importance of independence of such directors as well as their ability to think strategically and bring an international outlook, rather than the often cited importance of 'in-depth industry knowledge'. The same research reveals that the biggest obstacles for independent directors to be effective are 'enough information can not be obtained to make adequate judgement', 'not enough time is given to voice opinions freely during the board meeting' and 'knowledge of the company operations is lacking'.

Figure 4: Survey on characters required for independent directors on the board and Kansayaku



Source: ProNed, Promotion of Non Executive Directors, Independent Questionnaire.

This domestic voice highlights the crucial value of outside thinking to be presented on the Japanese boards, but importantly, such independent directors need to be given the time, information and the channels for effective communication with the company, bring a meaningful discussion. When done effectively from both sides, companies benefit from an enriched dialogue that stimulates efficiency in the decision making process, rather than just being seen as a stifling process.

PENDING GIRL POWER

While the main discussion on corporate governance is on independent directors and the specific skills they bring, it is important to recognise the multifaceted value of diversity among the insider directors. Gender is one component of such discussion, which is attracting attention globally. A growing body of academic research indicates the financial benefits of having women on boards[2].

A glance at **Figure 5** clearly indicates the level of scope for Japanese companies to address this problem; women are represented on only 1% of boards, compared to, the average of 11% and 7% for developed and emerging markets respectively among the top 17 economies by GDP.

Japan, however, has come a long way in promoting women in the workplace since the Gender Equality in Employment Act passed in 1986. The overall female employment rate has risen from 53% in 1986 to 61% in 2011, which is slightly higher than the OECD average of 60%[3].

Since this encouraging trend has not yet reared enough female candidates for the board or executive level, companies should actively look to provide appropriate mechanisms to train and recruit female talent to develop the under-explored opportunities. Crucially, this should be seen as a business opportunity by the companies.

WISDOM vs. NEW IDEAS

Japan is also characterised by an ageing population. Those aged over 65 years make up 23.3% (2011)[4] of Japan's total population and these levels are expected to increase further in the future – nearly reaching 40% by 2050 (see **Figure 6**).

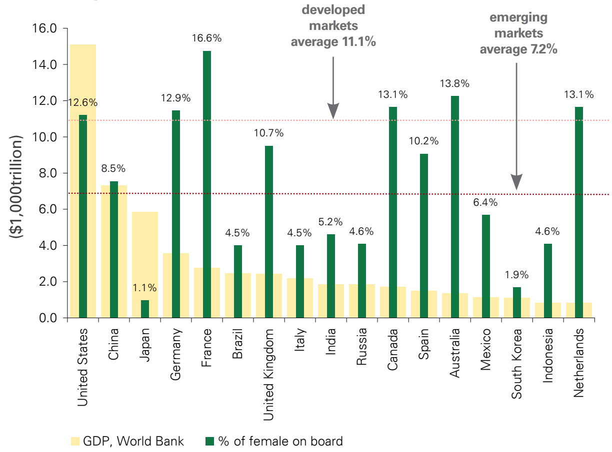
It is perhaps little surprise that 42% of company boards are also over 60[5]. The elderly exert influence and respect in Japan, and it can be culturally difficult to challenge or contradict such experienced views. The challenge lies in striking the balance between harnessing the experience associated with seniority and incorporating the fresh ideas by gradually recruiting new board directors who are not bound by the company's history and hierarchy.

OUTSIDE PRESENCE

Japan, like many others countries, has been steadily increasing both production and customer base in overseas markets. According to available company figures, companies earn roughly a quarter of their revenues from international marketplaces[6]. Overseas production, especially given the strong yen, plays an important part of many companies' operations (see **figure 7**).

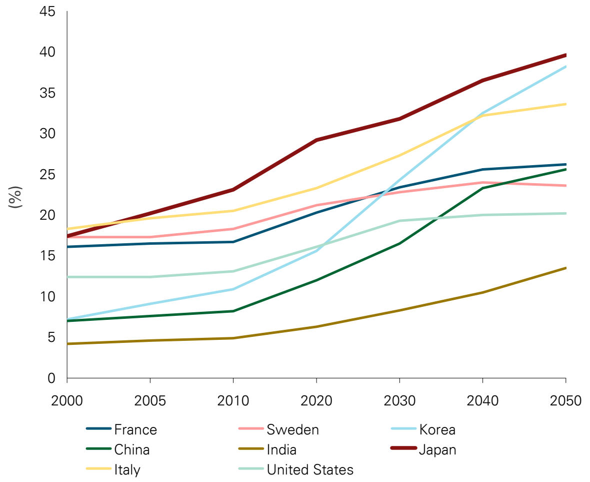
In order to maximise the opportunity set from such exposures, different nationalities and backgrounds on the board can bring vital insight and expertise into the process of shaping the company strategy. Our analysis of proxy filings, however, indicates that only about 1% of all company directors are non-Japanese, with the percentage dropping to 0.5%[7] when looking specifically at independent directors.

Figure 5: Gender representation on company boards by country



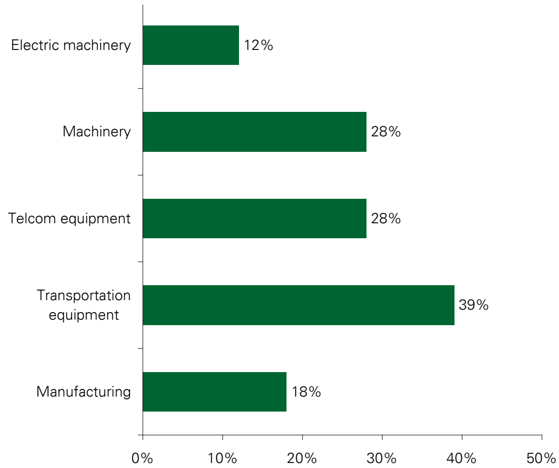
Source: OECD for GDP data and GMI for female presentation on company boards

Figure 6: Percentage of elderly (65+) population by country



Source: OECD

Figure 7: Overseas production ratio



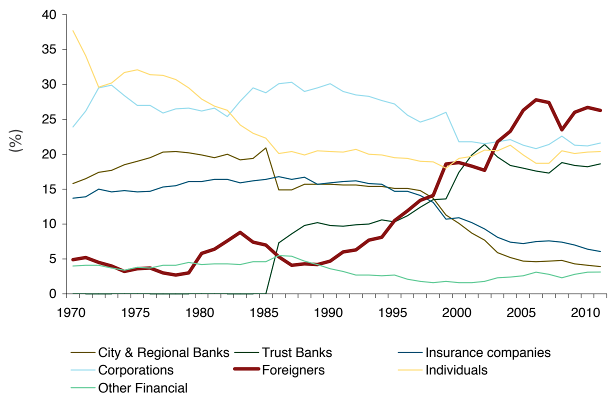
Source: BOAM[8], Nihon Kokusei Zue

FOREIGN ATTRACTION

In addition to the companies' exposure to the global market, the ownership model of companies has changed significantly over the last 40 years. As shown below, foreigners' stake in the stock market has increased from 5% to over 20% by 2011, making them the biggest investor group in Japan.

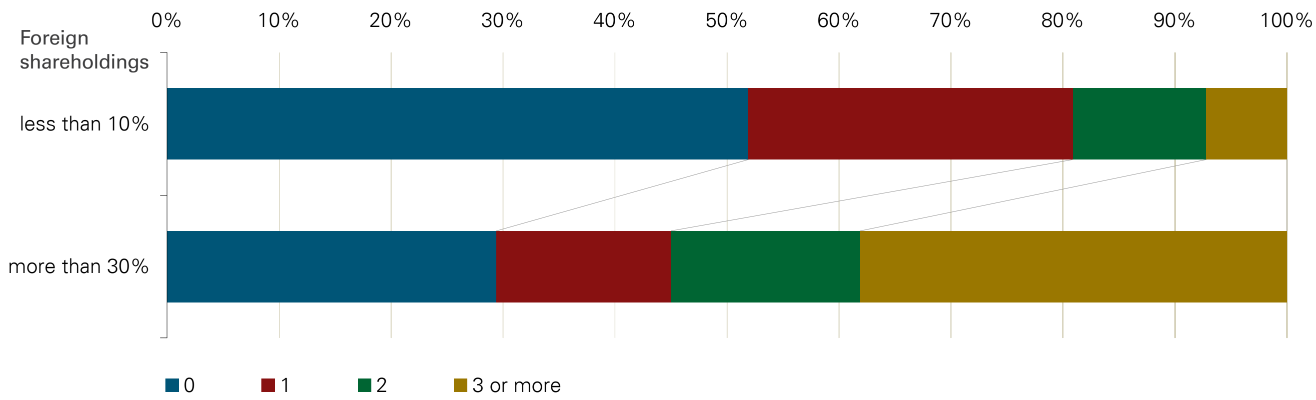
With increased ownership comes an equivalent responsibility, which is why foreign investors have been among the most vocal proponents of corporate governance standards. Overall, as the biggest buyer of stocks in Japanese companies, there is evidence their voice is gaining more weight in the ongoing diversity debate. Research carried out by the Japanese Boards Association suggests that there is a positive link between the levels of foreign shareholding and increases in the level of board independence (**Figure 9**).

Figure 8: Holding structure of Japanese companies 1970 - 2011



Source: TSE

Figure 9: Relationship between percentage shareholding of foreigners and presence of outside directors



Source: Japan Association of Corporate Directors, Corporate Governance Report of Listed corporations, Outside Directors, 2012

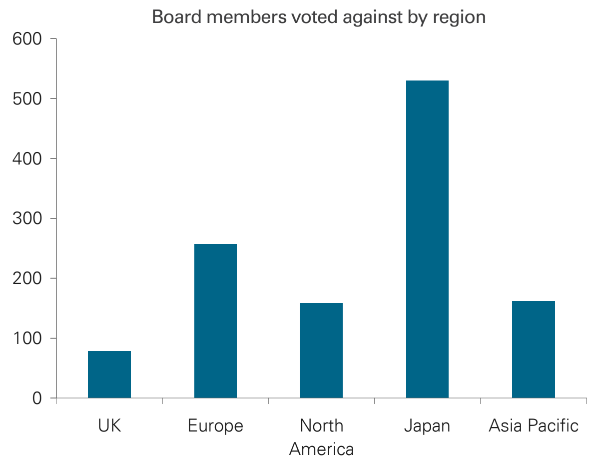
LGIM STANCE

We believe that raising the bar of corporate governance in every market we invest in is an integral part of our efforts to preserve and enhance the returns for our clients. For this reason, we have been pushing for progressive changes through dialogues with Japanese companies, listing authorities and regulatory bodies.

Our voting record (**Figure 10**), shows that our Against votes on directors and Kansayaku are exceptionally high in comparison to other developed markets. Following the voting season, we communicate the rationale and reasoning behind such decisions to each company individually through letters written in both Japanese and English to encourage dialogue.

We have seen encouraging results come out from these conversations. Many companies talk of actively looking for fully independent directors to join their boards, as they have benefited from having more outsiders represented. Our Against votes have also decreased by 15% between 2011 and 2012, reflecting the increased representation of the independent directors on company boards.

Figure 10: Number of director candidates LGIM voted against in 2012 by region



Source: LGIM voting records, 2012

In the near term, encouraged by these developments, we will advocate that company boards consist of at least one third of completely independent directors. We strongly believe the true value of independence is best demonstrated at the board level; therefore the independence of Kansayaku is excluded from this requirement.

However, we are cognisant of the fact that this would be a significant departure for many companies and that attracting the right talents can take time. As such, for the top 100 companies by market capitalisation, our 2013 voting policy has therefore been adjusted to push for a third of the board consisting of outside directors. For the rest of the companies in our invested universe, we are targeting 20% of the board. Such outside directors do not have to be completely independent of the companies, but the relationship should not cause conflicts through large shareholdings or significant business relationships. More details of this stance are available in our voting policy.

Our aim is to strengthen this policy to bring it closer to the intended level of a one third fully independent board in the next three to five years. In the meantime, we are strongly encouraging companies to employ outside directors that truly add value to the conversation and to ensure they are given adequate information, time and training to be effective in their roles.

DISCOVERING ONE BY ONE

In this paper, we aim to demonstrate the importance of diversity in adding value to business strategy, investor attractiveness and global competitiveness. The purpose of having independent directors is not to satisfy legal requirements, but to help businesses discover unrealised opportunities.

Despite the tremendous challenges, we are encouraged by the latest developments in Japan and we will continue to be a constructive shareholder. Healthy discussion at the board level should lead to sustainable business growth and in return enhance the value of our clients' assets.

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[3] http://www.oecd-ilibrary.org/employment/employment-rate-of-women_20752342-table5

[4] OECD Factbook 2011: Economic, Environmental and Social Statistics

[5] ISS data

[6] Bloomberg

[7] Japan Investment Strategy - Japan equity primer: Key context for investing in Japan, Bank of America Merril Lynch, 17 January 2013

[8] ISS data

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IMPORTANT INFORMATION