Shareholder activism in Japan

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The perception of shareholder activism is undergoing rapid change in Japan. Traditional financial shareholder activists and their familiar tactics that have been well-known to US and European companies were largely unheard of in Japan until recently. Traditional activists have historically been seen as "foreign vultures" that lacked understanding of corporate culture and the support of Japanese stakeholders. Now, traditional financial activism is being heralded in some circles as bringing positive change to a corporate landscape in need of change.

Key takeaways

- The perception of shareholder activism in Japan is changing – from activists being seen as "foreign vultures" to agents of positive change.
- Whilst there is no data available, it has been widely reported that a large portion of activist interventions are closed engagements. Few make it so far as a proxy fight.
- Of those that do proceed to a proxy contest, few are pursued by foreign activists. Possible reasons include:
  - cultural differences (which are slowly beginning to dwindle); and
  - foreign activists "learning" how to proceed with a new kind of activism in Japan.

Part 1 – the history of shareholder activism in Japan

Japanese public companies typically have a **complex corporate governance structure** that is unique to Japan. This structure is largely a hangover from a bank-based economy where multiple stakeholders are shareholders and cross-shareholding is common. The stakeholder model that is trending in the United States is interwoven in the fabric of the Japanese corporate ecosystem – public companies routinely have their suppliers, customers, banks and other affiliated entities also listed on their shareholder register. Shareholders have dual interests – returns as an investor, but also maintenance of good business relationships, which often trumps their investor interests. As a result, corporate governance has been deprioritized for years.

Traditional financial activists, therefore, have had **difficulty gaining acceptance** and footing. The perception that financial shareholder activists have a short-term focus has been an impediment to gain the support of shareholder bases that prioritize long-term relationships, even at the detriment of short-term gains, and in fact, in some cases, with tolerance of potential shorter-term inefficiency. For instance, calls to return capital through dividends or share buybacks, common tactics in particular of US-style activists, do not resonate with companies or their stakeholders and have not customarily been heard in the Japanese shareholder community, let alone heeded by Japanese corporations.

Breaking the mould

The first significant rupture to the traditional corporate-stakeholder model occurred in 2015 under former Japanese Prime Minister Abe's administration. One of Abe's key pledges was to make Japan a global economic powerhouse and, he argued, Japanese companies had to improve their corporate governance to compete on a global stage and attract global investment. There have been four significant regulatory changes in the last five years that have signalled a movement towards independent governance oversight and structures.

Companies Act (CA) – 2015 amendments

In 2015, the CA was amended primarily with a view to enhancing corporate governance. This was the first large-scale amendment of the CA since it was enacted in 2005.

There were two key changes affecting corporate governance:

- An enhanced definition of **independent directors** was established and if large companies do not have any independent directors, they need to explain why.
- A new governance structure became available to companies, comprising an **audit/supervisory committee**. The role of the audit/supervisory committee is to audit the activities of the directors, and the majority of its members have to be independent directors.

Corporate Governance Code (CGC) – enacted in 2015, revised in 2018

Similar to the UK's code, the CGC was designed to have a principle-based, not a rule-based, approach. The CGC was not legally binding but introduced the concept of 'comply or explain' – listed companies should disclose policies regarding cross-shareholdings and conflicts, for example. In 2018, the CGC was revised and now states more plainly that "policy and concepts concerning **reduction of cross-shareholdings** etc. should be disclosed." The 2018 revisions to the CGC also introduced the concept of shareholder engagement under a Japanese framework, encouraging companies to engage with shareholders (if reasonable). Additionally, boards of directors should establish related engagement and other governance policies and organizational structures.

Japanese Stewardship Code (SSC) – enacted in 2014, revised in 2017

While the amended CA and CGC focus on company structure and behavior, the SSC focuses on expectations for investors. The SSC states that institutional investors should disclose each company they invest in and how they exercised their voting rights on each proposal in its immediately preceding fiscal year. It also specifies that it would be beneficial for institutional investors to engage with investee companies in collaboration with other investors (collective engagement) as necessary.

Corporate Office Decree on Disclosure of Corporate Details – revised in 2019

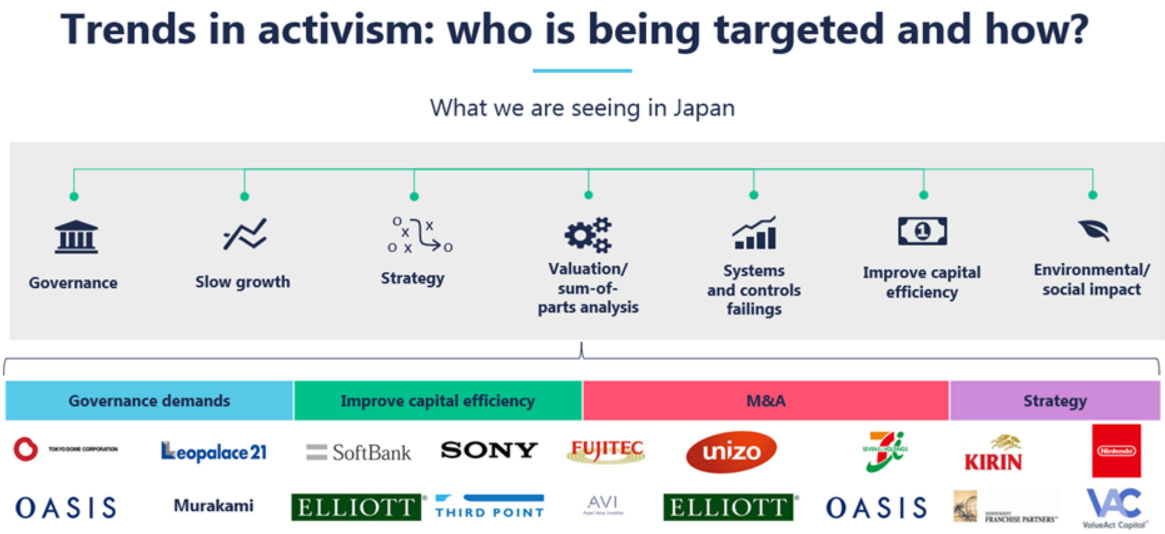
This decree requires disclosure in the company's annual securities report of methods for examining the rationale of cross-shareholdings. The securities reports must also include the 60 largest stakes a company holds, up from 30 previously, in addition to stating whether any of these stakes are cross-shareholdings.

Part 2 – the changing face of shareholder activism in Japan and recent trends

Japan is at a pivotal cultural moment in terms of shareholder activism. In this second part of our blog series, we do a deep dive and chart how the landscape is rapidly changing.

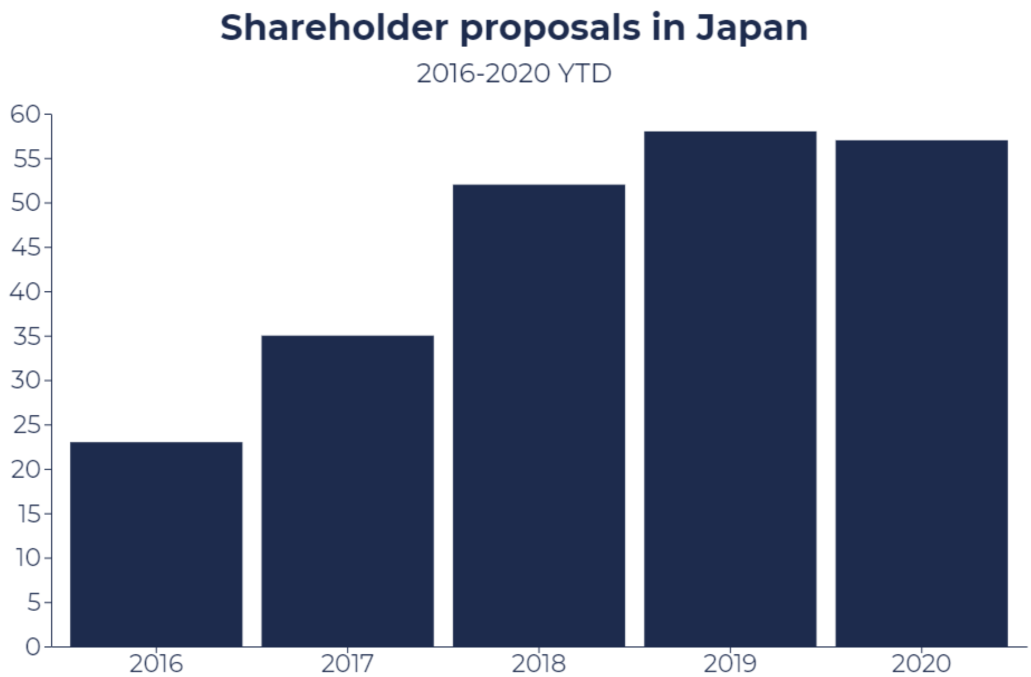
Shareholder activists have historically been seen in a negative light in Japan, likened to "foreign vultures". In the early days of activism in Japan, "outsider" tactics included acquisitions of large shareholdings. Recently, however, activists are progressively viewed as being **agents of positive change**.

The diagram below shows the developing trend and the issues shareholder activists claim they are attempting to address.



Japanese companies have carried out record levels of share buybacks, undervalued companies have been subject to bidding wars, and investors have been emboldened to increasingly vote their shares. Though it would be hard to argue that shareholder primacy now prevails, positive outcomes from high profile activist interventions have reportedly won some hearts and minds.

Tools and tactics used by activists are increasingly in line with, for example, US shareholder activism, often featuring meetings with key stakeholders. In addition, we are seeing more shareholder proposals.



In the United States, shareholder approvals are precatory and are generally disfavored by shareholder activists. However, the number of proposals that have received shareholder approval has been low over recent years, with the following being the only cases:

- RISE in 2016.
- Kuroda Electric in 2017.
- JP-Holdings and 21LADY in 2018.

No proposals from shareholder activists were approved in 2019.

We have not seen a swing or uptick in proxy fights either and most of the campaigning still appears to be behind closed doors. But, with the rise of activism in Japan, and the increasing openness of shareholders to support activism tactics, it is likely that Japanese companies have been willing to engage in **informal, private and undisclosed settlements**, agreements, or otherwise make concessions.

For now, at least, some of the most aggressive tactics, including takeover bids and complex litigation, continue to be uncommon. One theory seeking to explain this phenomenon is that Japanese companies make concessions prior to shareholder meetings that are not subject to disclosure obligations for listed companies. There is no evidence to back this up though as meetings between activists and companies typically take place behind closed doors.

Activism in Japan vs the rest of the world

Arrival of US activists

Japanese companies have been traditionally targeted by a small set of activists, but well-known US hedge fund activists have emerged in the shareholder bases of some global Japanese large cap companies.

Third Point, for example, acquired a 0.06 percent stake in Sony in June 2019. Elliott acquired a 5.51 percent stake in Unizo in August 2019 and around a 3 percent stake in SoftBank in February 2020..

Proxy contests

Foreign activists have rarely escalated their campaigns to public proposals, with no successful foreign activist campaigns to date.

Since 2014, there have been 34 public proposals in Japan by Asia-based or domestic activists. In comparison, only six public proposals were submitted by non-Asia based foreign activists. In June 2020, for example, Chicago-based RMB Capital submitted a share buyback proposal to TV Asahi Holdings, Nishikawa Rubber and Musashi In each instance, shareholders voted against RMB Capital's proposal.

This does not mean to say that activist campaigns are unsuccessful as their demands may have been met behind closed doors. For example, RMB Capital reportedly asked six other firms to improve shareholder returns and all supposedly raised their dividend or repurchased shares although it is not clear whether this was indeed caused by RMB Capital's lobbying.

Shareholder base

In general, the institutional investor base in Japan is less influential than in other global markets.

As stated above, the shareholder bases of constituents of the TOPIX, one of Japan's key stock market indices comprising over 2,100 companies, are fundamentally different from key foreign indices. Institutional investors generally have a much lower percentage of common stock than in, say, US-listed companies. Sixty-one percent of the shares of all Russell 3000 companies in the United States are owned by institutions, whereas the figure is only 27 percent for TOPIX.

In the United States and in Europe, activist strategies have evolved to include reliance on significant levels of institutional investor support from a small absolute number of investors. It is common, for instance, for the largest 10 shareholders of some S&P 500 companies to comprise 30 to 40 percent, or more, of the shareholder base. One significant activist investor and 10 shareholders may comprise a majority of holders.

Other global trends

- There has been a **general global slowdown** in activist behavior during COVID-19. However, activists are expected to quickly re-engage when there is an opportunity to do so. As matter of fact, some activists are using the current environment to **build toehold investments**. This certainly also applies to shareholder activism in Japan.
- Small/medium cap companies continue to be at risk **but are becoming an attractive target** as well due to depressed valuations, easy exit options and the ability to leverage relatively small stakes and significant liquidity via connections with institutional investors. In 2019, large caps made up 25 percent of new positions but YTD 2020 that figure is 12.7 percent. Conversely, nano-, small- and micro-caps accounted for 65 percent of new positions YTD 2020 vs 53 percent in 2019. In Japan, small- and mid-cap companies are also increasingly targeted by activists but for different reasons – many of these companies are cash rich and appeal to activists seeking short-term benefits, such as increased dividend payments and share buybacks.

In Japan, the dynamic among institutional investors and activists is being shaped by the relative individual influence even the largest shareholders yield.

Balance sheet-related demands

Japanese companies have historically been more likely to face balance sheet-related demands than US and European peers. The proportion of balance sheet public demands at Japan-headquartered companies since 2013 is 32 percent, whereas the figures for United States and continental Europe are 10 percent and 11 percent respectively.

The high proportion of such demands in Japan is mostly attributed to the traditionally high cash reserves of many Japanese companies. The fact that these cushions may be helping Japanese companies to better weather the COVID-19 pandemic may well lead to balance sheet-related activism losing popularity.

Conversely, requests for increased dividends or share buybacks have been deprioritized in recent campaigns, which seems to follow a global trend of activists avoiding being perceived as merely raiding the war chests of cash-rich companies.

Board-related activism

As activism matures and US activist hedge funds are progressively targeting Japanese companies, there has been an increase in board-related activism. The figure was 21 percent for 2013 through 2018 but increased sharply by 12 percentage points to 33 percent between 2019 and today.

However, despite this sharp increase, most proposals continue to be unsuccessful or withdrawn. Of the 88 board-related demands that were raised and settled between 2019 to the present, 80 percent have been unsuccessful.

In what is considered a "landmark" win, shareholders at JASDAQ-listed technology conglomerate Sun Corp voted with Oasis Management to overhaul the board in April of this year. The successful proposal saw the activist install its own three-person slate, including Oasis director Yonatan Domnitz, while ousting four of Sun Corp's directors. The news was greeted positively by the market with the share price up 9 percent on the week and 47 percent year-to-date.

- In Europe, there is a growing clear divergence between collaborative "operational" vs confrontational "economic" activists. **Director candidates** for appointments (e.g. ex-CEOs) are being proposed by "operational" activists behind the scenes as a **preventative defensive measure** for the company.
- **First-time activists continue to emerge** with a willingness to engage in brand-building situations – particularly in the United States.
- Along with environmental, social, and governance (ESG) considerations, US activism continues to **have M&A considerations as a core focus** with activists becoming more comfortable advocating for immediate M&A solutions.

Part 3 – the Japanese legal landscape

Threshold	Legislation	Right/obligation
Having 1% or more voting rights, or 300 or more voting rights, consecutively for the preceding six-month (or more) period prior to the proposal (unless otherwise stated in the articles of incorporation)	Articles 303 and 305 CA	Ability to **propose a matter** to be discussed at a general shareholders meeting and to request directors to notify other shareholders by sending a summary of shareholder proposals (subject to restrictions)
No specific threshold	Article 125(2-3) CA	Right to request access to inspect or copy **shareholder registry** (subject to restrictions)
No specific threshold	Article 371(2) CA	Right to request access to inspect or copy **minutes of board of directors meetings**
1% or more of shares or voting rights in a Japanese listed company engaged in a "sensitive sector" (e.g. weapons, aircraft, nuclear facilities, electricity, gas)	Foreign Exchange and Foreign Trade Act	**Notification required** to Bank of Japan prior to investment, unless an exemption applies
3% or more of all voting rights or 3% or more of outstanding shares (unless otherwise stated in the articles of incorporation)	Article 433 CA	Right to request access to inspect or copy **accounting books** (subject to restrictions)

The Japanese laws relevant to shareholder activism are extensive. The following seeks to summarize the key points:

- As with other jurisdictions such as the UK, shareholder activists are not generally subject to stringent regulations or **disclosure requirements** as long as their stakes are within the relevant regulatory thresholds (summarized in the table below). The percentage threshold for disclosure requirements ("possession of a large volume of shares") for example is 5 percent (i.e. larger than, say, the 3 percent threshold in the UK, but commensurate with the United States). Activists usually go below this threshold through a combination of "secret purchases" (i.e. below the threshold so that the acquisitions are unknown to the company) and the use of equity derivatives that are not required to be counted towards their holdings.
- Unlike other jurisdictions where shareholders cannot give instructions to the management of a stock corporation but are confined to appointing (supervisory/non-executive) board members who in turn cannot give instructions either, shareholders in Japan have much more power. For example, directors are appointed and dismissed by a resolution of shareholders and (subject to the articles of incorporation), shareholders can make significant business decisions at shareholders' meetings that would bind the board. This may, theoretically, include withdrawing from a certain type of business, although we are not aware of any such examples.
- Under the recently amended **Foreign Exchange and Foreign Trade Act**, any foreign

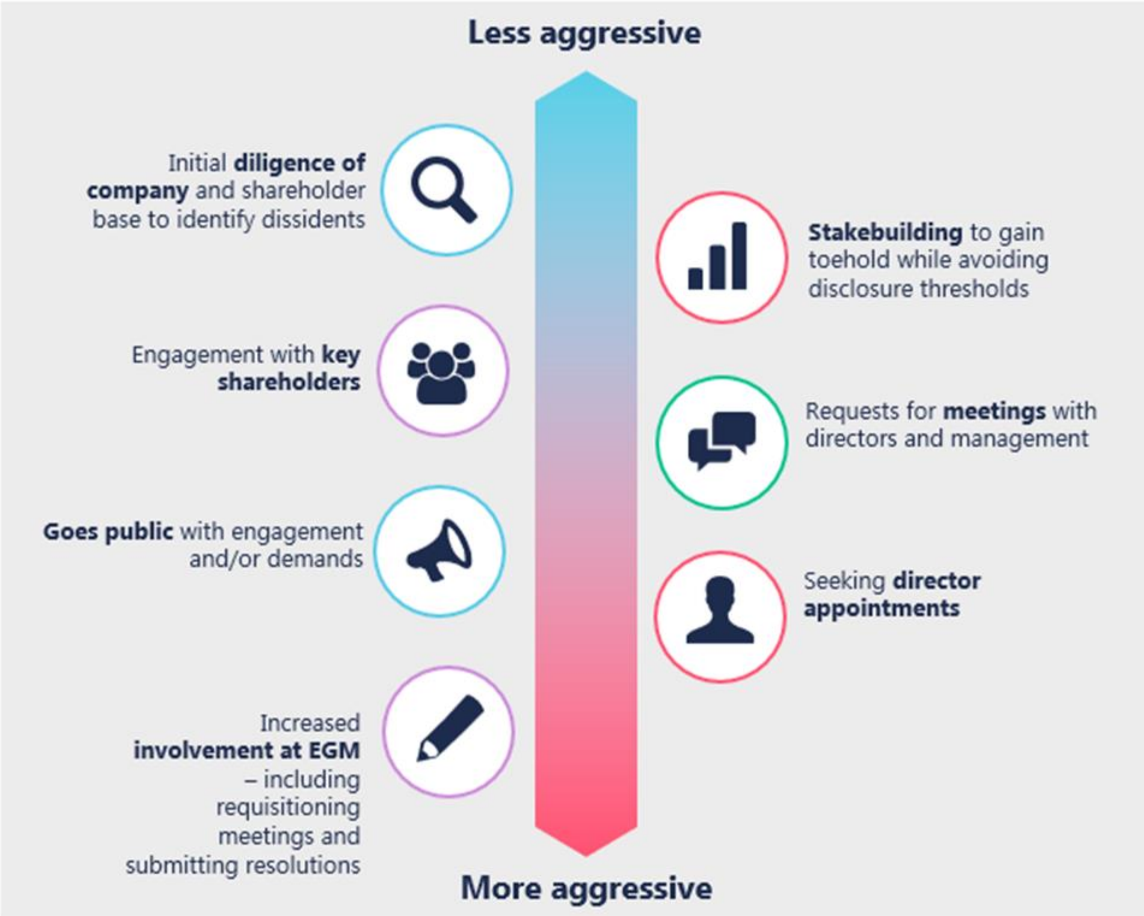
Having 3% or more of all voting rights consecutively for the six-month (or more) period immediately preceding the proposal to call an extraordinary shareholders meeting (unless otherwise stated in the articles of incorporation)	Article 297 CA	Ability to **call an extraordinary shareholders meeting**	investor contemplating an acquisition of 1 percent or more of the shares or voting rights of a Japanese listed company engaged in "sensitive sectors" (e.g. wholly regulated – weapons, aircraft, nuclear facilities, space, and dual-use technologies; and partially regulated – cyber security, electricity, gas, telecommunications, water supply, rail and oil) will have to notify the Bank of Japan prior to making the investment (i.e. it is a suspensory regime) unless exemption rules apply. • The adjacent table summarizes the key rights and obligations of shareholders at the various levels of shareholding typically exceeded (depending on the scenario) by activist shareholders.
More than 5% shareholder ratio (and any subsequent increase or decrease of 1% or more from the previous reporting)	Article 27-23 FIE Act	**Large-scale shareholding report** – shareholder required to file report re. "possession of a large volume of shares"	

Proxy regulations

- Any person who intends to solicit a proxy regarding shares in a listed company must deliver to the person solicited **a proxy form and reference documents** containing information specified in the Cabinet Office Ordinance (i.e. regulations relating to proxies).
- The information does not have to be provided if the same information is disclosed in the reference documents that are typically enclosed with the convocation notice of a shareholders meeting where proxies are solicited.
- The solicitation may be **exempt** from proxy regulations if made by persons other than the company or the officers (including directors and executive officers) and if the persons are fewer than 10.
- A company soliciting proxies by, for example, offering certain economic benefits to shareholders to facilitate favorable voting results **may violate regulations on giving benefits under the CA Article 120(1)**.
- **Social media platforms (e.g. Twitter and LinkedIn) are not commonly used** as communication tools during campaigns between targeted companies and activists.

Part 4 – Strategies, defenses and outlook

Activist strategies in Japan are increasingly reflecting the "playbook" employed by activist shareholders in other jurisdictions. Pressure usually starts in private following the acquisition of shares in addition to the activists' existing stake. We do see, however, a spectrum of shareholder activism, from the "active" shareholder to the "activist" shareholder, as illustrated in the chart below.



We believe that:

- The lines between **activism** (waging war) and **stewardship** (engaging) in Japan may become blurred, particularly as it relates to global trends such as environmental, social and governance (ESG) considerations. In particular, we expect there will be more of an emphasis on **human capital management** (HCM), especially in light of COVID-19, as poor HCM practices have been associated with higher employee attrition rates and reduced productivity and product quality. We are already seeing this trend in Europe and the US.
- As these trends grow, we expect that there will be a more collaborative view among investors, increased willingness to conduct engagement, and more vigorously voiced expectations regarding how companies engage with their shareholder base. There will be an increase in campaign by **"wolf pack"** activists who seek institutional support early on.
- At the same time, some of the old ways of companies relying on their shareholder bases are eroding – long-standing relationships between **stakeholders** (e.g. suppliers, customers, banks and other affiliated entities) in Japan will eventually diminish given the recent momentum to reduce conflicted interests.
- In line with recent trends in the United States and Europe, but reinforced by Japanese culture, we will continue to see more **private outreach** to companies before activists seek publicity. Sometimes this even takes place before a big stake is acquired as a "feeling out" strategy. At the same time, there will be a moderate increase in **hostile public campaigns** as the activist shareholder culture becomes more accepted in Japan.

Taken together, these trends will force Japanese companies to face changes head on, and it is likely that significant change is on the horizon and moving quickly. The companies that are prepared, understand the risks, challenges and opportunities, and begin preparation in the near term will be best suited to adapt. It is also likely that, as a company falls further behind in its own adaptation, the failure to change will be its own self-fulfilling prophecy, and attract the kind of attention and investment that is most disruptive.

We have found in the United States and Europe that the companies that view activism preparedness as an opportunity to focus and engage on a well-communicated long-term strategy plan are in the best position to have the support of their shareholders and are overall best prepared for potential public activist engagement. However, Japanese corporate culture remains reactive in the face of shareholder activism and, in many cases, management does not prepare the company for potential attacks.

This may change given the increasing volume of activity and Japan Inc's growing awareness of activism. We recommend Japanese companies adopt and engage in a tested, and well-proven preparatory plan. It will require a shift in the expectations of boards and management in the short-term, but it is likely that the shift is coming and can be driven through company initiative or third parties.

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