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Focus on Activism

Activism in Japan on the Rise

There is no question that activism is gaining traction in Japan. Reports indicate that as of the end of the 2019 proxy season, a record 54 Japanese companies received shareholder proposals for the 2019 annual meetings – a 29% increase from the previous year.[1] There have also been year-over-year increases in activism events since 2016. From a global perspective, activist demands at Japanese companies consisted of more than half of the demands made at Asia-headquartered companies in 2019,[2] and reports indicate that Japan ranks as the busiest market for activism outside of the United States.

Why is this happening? We discuss some of the contributing factors and what could be next. We will focus on how to prepare for and respond to an activist in an upcoming issue.

Factors Contributing to Increased Japanese Activism – Parallels to the Early U.S. Market

Corporate Governance Reforms

As part of an initiative to reform corporate governance, the Japanese government implemented the Stewardship Code in 2014, and the Tokyo Stock Exchange adopted the Corporate Governance Code in 2015. Both Codes have been revised and/or supplemented since that time. The Stewardship Code establishes a voluntary code of conduct for institutional investors and fund managers and aims to "promote sustainable growth of companies through investment and dialogue." As of the end of December 2019, 273 institutional investors and investment managers have adopted the Stewardship Code.[3] The Corporate Governance Code addresses public company governance and seeks "sustainable corporate growth and increased corporate value over the mid-to long-term." While many of its provisions are not mandatory, and instead establish a "comply or explain" regime, the Corporate Governance Code nevertheless introduced important governance concepts that had not been previously applicable to the Japanese market.

While perceived by many as only the first steps toward changes in Japanese corporate governance, these measures have paved the way for more shareholder activism in Japan in key ways, including:

- ***Decreased Cross-shareholdings.*** In the past, the established practice of cross-shareholding by Japanese companies made it challenging for an outside investor to garner enough support for their proposals. Under the Corporate Governance Code, "when companies hold shares of other listed companies as cross-shareholdings, they should disclose their policy with respect to doing so, including their policies regarding the reduction of cross-shareholdings." Company boards are also responsible for assessing various aspects of the cross-shareholding, such as whether the purpose is appropriate and what the benefits and risks are (including any harm to the interests of the company and its shareholders). According to *Nikkei*, the number of stocks held in cross-shareholding arrangements have declined by approximately 12% over the past five years, [4] and cross-shareholding arrangements as a percentage of total market capitalization have fallen by approximately two-thirds since 1990.[5]
- ***Increased Shareholder Focus.*** Japanese companies have historically taken a broader stakeholder focus than is typical in the United States, meaning that companies operate not only for the benefit of the shareholders but may also take into account other constituencies, such as the community at large, customers and employees. Under both the Stewardship Code and the Corporate Governance Code, however, Japanese companies are called to increase their focus on adding value for shareholders and therefore may be more inclined to listen to activist demands to enhance returns. Importantly, this move to focus more on returns and shareholder interests may be driven by investors who are demanding better performance from Japanese companies generally.
- ***Institutional Investor Responsibility and Increased Shareholder Engagement.*** Institutional shareholders in Japan have historically been passive when it comes to voicing their opinions, even at underperforming companies. Now, under the Stewardship Code, investors are obligated to monitor investee

companies' governance, strategy, performance, capital structure, business risks and opportunities (including risks and opportunities arising from social and environmental matters). The Corporate Governance Code also suggests a more "constructive" dialogue with shareholders beyond the general shareholders meeting. All of the foregoing drive increased investor engagement and create potential opportunities for activist investors.

- ***Enhanced Disclosure.*** The Corporate Governance Code states that companies should not only make disclosures in compliance with laws and regulations, but should also "strive to actively provide information beyond that required by law." In our experience, increased disclosure impacts activism by enhancing the information that shareholders have with respect to company performance, policies and procedures as well as incentivizing compliance with policies suggested by disclosure obligations, both of which provide ammunition for activist campaigns.

Similar to what happened in the United States, where calls for corporate governance reforms culminated in the Sarbanes-Oxley Act of 2002 and, later, the Dodd-Frank Act of 2010, the above changes may open routes for, and signal an awakening of, shareholder power and engagement.

Target-rich Environment

As the U.S. activism market has matured, activists have been looking abroad for more opportunities. There are more North American activist firms than in any other region, but many U.S. companies have either already been targeted or have adjusted their practices in response to (or in anticipation of) activist strategies.

Japanese companies, however, are at the beginning of the learning curve for activist engagements and may still be vulnerable to tactics that have become less effective in the United States. For example, more Japanese companies may have attributes that are attractive to activists, such as significant cash balances, low-yielding investments, non-core assets and capital structure opportunities. Furthermore, Japanese companies are perceived by some as having more potential for unrealized value in part because their valuations are still lower, on a relative basis, than U.S. companies.[6] Finally, their relative inexperience with activist campaigns may in and of itself make Japanese companies more attractive candidates as activists go global in their ambitions.

Changing Attitudes Towards Activists

At the outset of the U.S. activism experience, an almost universal criticism was that activists were outsiders who cared only about their own, short-term benefit at the expense of long-term corporate strategy and other shareholders. While those complaints still exist in the United States, certain activist investors have transcended these labels, becoming so-called "constructivists" who work with companies to revamp their strategies with a long-term view. Institutional investors are more willing to support these investors due to their proven track record, even doing so publicly from time to time. In some cases, the targets themselves have made complimentary comments about activists when announcing the resolution of a campaign. Even in Japan which has traditionally also been unwelcoming to activist investors, this last proxy season saw a record level of opposition to management proposals at annual meetings, indicating a growing appetite for change among investors and, therefore, a potential openness to the activist strategy.[7]

What's Next?

If the parallels between the U.S. and Japanese markets continue, what can Japanese companies expect to see next? Based on the U.S. experience, some possible trends are as follows:

No Company Is Immune

As *The Economist* noted back in 2016, "Neither age, status nor systemic importance offers any protection. Activists have removed the management of the oldest firm on the New York Stock Exchange, Sotheby's . . . won a board seat on Bank of New York Mellon, a too-big-to-fail bank . . . and attacked the world's most valuable company, Apple." Our experience is that activism can strike any company. Even mega-cap companies, companies that have positive stock performance and controlled companies have been targets, so no company is immune and every board of directors and management team should be prepared for an activist approach.

Important Role of Institutional Investors

Institutional investors hold a significant proportion of public equities in the United States, and such ownership can be highly concentrated in a few large firms. Recent statistics show that the top 10 institutional holders control approximately 31% of the S&P 500, with the top three alone controlling almost 20%. In the past, institutional investors as a group were not particularly vocal when it came to activism. However, some are now more willing to participate in campaigns by either working with the activist or the company privately on the issues or, in some cases, even showing support publicly.

While Japanese companies may continue to be protected by the effects of cross-shareholdings, some of the factors contributing to the rise of activism that we discuss above indicate that institutional holders may become more open to active engagement, especially if company returns continue to lag. Companies may not be able to count on shareholders to remain passive or loyal to management, even if they have historically been so.

Furthermore, if activists are able to marshal the support of institutional investors behind their campaigns, they would be able to exert significant presence without themselves owning large equity stakes.

Increasing Diversification and Sophistication of Campaigns

According to *Activist Insight*, about 31% of the activist demands lobbied at Japanese companies in 2019 involved balance sheet-related theses. In the U.S. market, however, only 8% of demands in 2019 included that thesis, with others, such as operations, strategy (including M&A) and managerial changes, making up the difference. Our experience is that balance sheet-related theses figure more prominently while activists are gaining traction in a market, and that activists will start to diversify and move away from those tactics as the market matures. We expect that activists will expand their avenues of attack at Japanese companies to include the other strategies more prevalent in the U.S. market, especially as some pivot to become the "constructivists" that we mentioned above.

Activism Campaigns as PR Offensives

In the U.S., activism campaigns have essentially become marketing campaigns. In addition to appealing to shareholders, the activist will run coordinated efforts to reach analysts and other market participants to bolster broad support for their theses. Activists are known to deploy tactics, such as broadly disseminated and splashy "white papers," videos or dedicated websites, to push for their objective. Increasingly, non-traditional media outlets, such as social media, play a role in these events. As such, U.S. companies have learned that defending against an activism campaign requires a holistic investor relations and public relations strategy. In addition to bankers and lawyers, public relations firms have become important advisors in this context because of their understanding of positioning and their knowledge of media outlets and practices. Japanese companies should also be prepared for this approach and embrace the need for "full-court press" strategies.

Greater Director Involvement

In the United States, it has become accepted that director-to-shareholder engagement is needed in certain contexts, for example, when an investor is concerned with CEO compensation, which is set by the board. According to the National Association of Corporate Directors, in 2017–2018, a majority of respondents to a survey of more than 500 public companies had a board representative meet with institutional investors in the prior year. Shareholders view independent directors as best able to represent their interests and will often request meetings with them on topics such as executive compensation or board views on company strategy.

According to *Nikkei*, outside directors accounted for more than 30% of the board members at public Japanese companies for the first time.[8] Boards should expect that activists or other shareholders will seek, first, to increase the presence of outside and/or independent directors on Japanese company boards and, second, to engage directly with them from time to time.

Settlements May Become the Norm

At the outset of activism in the United States, some boards often had a default "fight" attitude when it came to such campaigns. However, boards are much more willing to settle for multiple reasons, including a recognition that some activists may provide helpful insight and that the costs and distraction of a proxy contest are high. Consistent with this trend, in 2019, more than 90% of board seats gained by activists in the United States were through settlements rather than an actual proxy vote.[9] Further, the number of proxy fights has fallen since the peak of 2009 in the two- decade period.[10] We believe that the Japanese market may follow this same arc, and that settlements may increase as the market develops.

Conclusion

Activism has gained considerable momentum in Japan. Based on our U.S. experience, once activists enter a market, they are there to stay. As such, companies need to prepare and be ready to respond. We will discuss preparation and response strategies in our next issue.

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[1] "Financial Results – Fiscal Year Ending March 31, 2020," *IR Japan Holdings,* August 21, 2019.

[2] *Activist Insight*.

[3] "List of institutional investors signing up to 'Principles for Responsible Institutional Investors' (Japan's Stewardship Code)," *Financial Services Agency, The Japanese Government*, December 27, 2019.

[4] "Corporate Japan sheds more cross-shareholdings," *Nikkei Asian Review,* September 5, 2019.

[5] *Id.*, citing statistics from Nomura Institute of Capital Markets Research.

[6] "30 years since Japan's stock market peaked, climb back continue," *Nikkei Asian Review,* December 29, 2019.

[7] "Once-mum Japan shareholders crank up pressure on management," *Nikkei Asian Review*, July 6, 2019.

[8] "Japan's boards evolve as outside directors occupy 30% of seats," *Nikkei Asian Review*, October 2, 2019.

[9] *Activist Insight; FactSet Shark Repellent*.

[10] *FactSet Shark Repellent*.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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