Insights

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Institutional Investor Perspectives on Executive Compensation Practices in Japan

Findings from Interviews with Institutional Investors

Authors – Takaaki Kushige, Johnathon Brown

A number of regulatory changes have taken affect in Japan during 2021, and the updated Company's Act and Corporate Governance Code places further pressure on Japanese companies to take action on improving their corporate governance, sustainability and ESG practices. This is particularly the case for companies undergoing shareholder engagement activities and explaining their corporate governance structures to institutional investors who hold interests in their company. Moreover, due to changes to the Companies Act in 2021, new and expanded disclosures have started to take hold within the market leading to substantial attention been placed on the executive compensation practices of Japanese companies.

To better understand the perspectives that investors hold on the changing market expectations for executive compensation disclosures, Willis Towers Watson launched a survey of 23 institutional investors covering four executive pay topics of: (1) Views on current executive compensation disclosure practices; (2) Expectations for executive compensation disclosures going forward; (3) Tying ESG metrics to incentive pay packages; and (4) Non-executive director / outside director pay.
Responses were collected via written survey or a directed interview with Willis Towers Watson.

Current Executive Compensation Disclosures of Japanese Companies

Updates to the Japanese Company's Act (effective March 2021) made direct changes to executive compensation reporting requirements. Companies must now include a specific executive pay policy that is used to guide the design of executive compensation plans and determining pay levels. In addition, companies must also disclose how executive pay plans are managed and governed throughout the year. Willis Towers Watson asked institutional investors how they have responded to changes in executive compensation disclosures and whether they intend on making changes to their proxy voting guidelines.

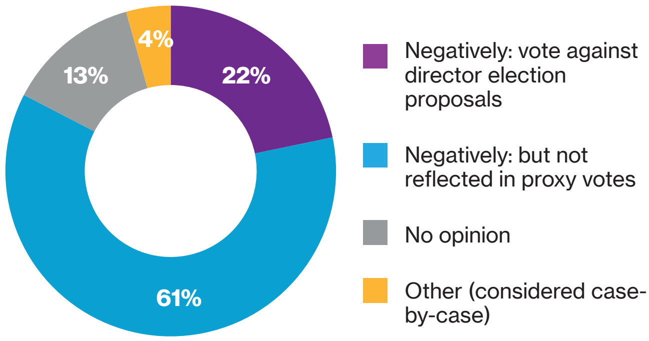
Overall, only a handful of investors answered that they have made changes to their proxy voting guidelines in response to expanded disclosure requirements, but some noted that they will consider doing so going forward suggesting that companies may have to respond to new reporting expectations from investors as they adapt their voting policies. On the other hand, there was a clearer response to more specific pay practices that have become evident due to expanded disclosures. One example is the practice of entrusting the determination of compensation levels for each executive to the representative director (a practice specific to Japan, whereby compensation of company executives are determined solely by the representative director of the applicable company.

Willis Towers Watson

> **In cases where the determination of individual directors' compensation is entrusted to the representative director, a conflict of interest with general shareholders may occur due to concerns that the board of directors is not effectively monitoring the representative director etc., thereby leading to excessive concentration of power in top management.**
>
> Fidelity International (Japan)

Referred to as "entrustment" hereinafter), to which 80% of respondents expressed a negative view (figure 1) citing a lack of transparency, independence, and objectivity in the process of determining executive pay. Moreover, 20% of investors responded that they would vote against the re-election of director proposals in cases where the practice of entrustment is used. Fidelity International (Japan) made clear their stance on the issue, stating that "In cases where the determination of individual directors' compensation is entrusted to the representative director, a conflict of interest with general shareholders may occur due to concerns that the board of directors is not effectively monitoring the representative director etc., thereby leading to excessive concentration of power in top management. Accordingly, [Fidelity International (Japan)] will vote against the re-election of the relevant representative director to which the determination of pay has been entrusted". The practice of entrustment and the market response to this practice thereof will continue to be a point of interest going forward.

Figure 1: **Views regarding the entrustment of determining individual executive pay to the representative director**



In contrast to the overall negative response investors had to entrusting the determination of pay to the representative director, most respondents express a positive view of companies entrusting the determination of individual pay to the members of an advisory compensation committee appointed by a company on a voluntary basis (companies in Japan have the option of electing corporate structures that do not legally require the appointment of compensation and nomination committees. However, some companies voluntarily appoint advisory committees to bolster their internal corporate governance practices). However, institutional investors expect advisory compensation committees to be appropriately independent from management so that they can maintain objectivity throughout the process of discussing and setting pay for executives. More specifically, more than half of the positions within the advisory committee, including the position of chair, should be held by independent outside directors. Furthermore, some institutional investors such as Asset Management One expressed that "detailed disclosure of the advisory committee's activities (e.g., number of meetings, the main themes of matters discussed) is required", suggesting that active disclosure pertaining to the process of determining individual pay, including an explanation of why the compensation policy is appropriate, is prerequisite for entrusting the determination of pay to an advisory compensation committee.

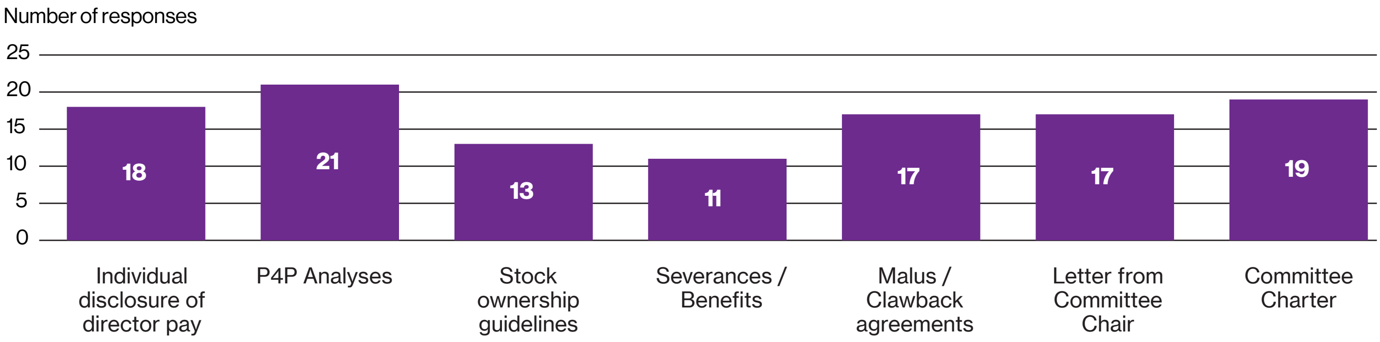
Executive Compensation Disclosure Going Forward

It is increasingly likely that institutional investors will begin analyzing executive compensation disclosures with further detail and scrutiny in response to new disclosure requirements. Willis Towers Watsons asked respondents of the survey whether there are any pay disclosures commonly used in Western markets that would be beneficial for Japanese companies to adopt.

As shown in figure 2, pay-for-performance (P4P) analyses and individual disclosure of director pay were among the most common disclosures that the institutional investors surveyed believe should be adopted by Japanese companies. Furthermore, several respondents stated that stronger disclosure surrounding pay governance such as the roles, responsibilities, and activities of the compensation committee would be beneficial. Mr. George Iguchi (Nissay Asset Management) stated: “In regard to the activities / actions of compensation committees, it is necessary for companies to expand disclosure to include a summary of what steps were taken to finalize an executive pack package and verify its appropriateness thereof. Furthermore, disclosures concerning the reasons why a certain compensation structure was adopted would be useful”.

In response to questions asking what information institutional investors seek from companies during engagement meetings, SOMPO Asset Management provided a response of “What are the specific KPI’s tied to executive compensation, why were those KPI’s chosen and what is the balance between the quantitative and qualitative KPI’s thereof. Whether the executive compensation plan is linked to business strategy. Whether the determination process for executive pay is consistent with strategy”, a response which highlights the need for companies to provide a compelling rationale as to how their executive pay plan supports their corporate strategy. Furthermore, some investors stated that it is important for outside directors who serve on the compensation committee to take the lead on explaining their company’s executive compensation plan. Asset Management One noted the following: “If outside directors that are compensation committee members provide explanations to investors, as a part of the integrated report etc., it would lead to deeper understanding of executive pay plans. Depending on the company, there are times when direct engagement / discussion between outside directors and investors are set up, and we believe it is effective / useful to discuss executive compensation matters on these occasions”.

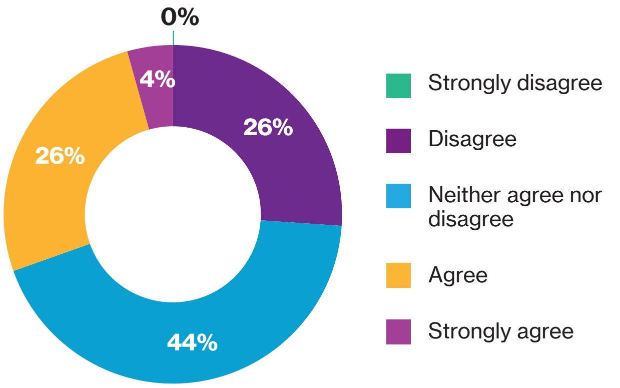
Figure 2: **Compensation disclosures that investors believe Japanese companies should adopt going forward**



The effectiveness and practicality of using Say on Pay (SoP) proposals in Japan rendered a number of differing opinions among respondents. The most common response to a question asking investors whether SoP agendas should be actively used in Japan was "neither agree nor disagree" with 44% of all responses. "Strongly disagree" and "disagree" made up 26% of responses while just under one-third of responses (30%) signaled positive views of "strongly agree" or "agree" to the active use of SoP within Japan (Figure 3). Many of the respondents held concerns of whether SoP would be an effective agenda in Japan, with some investors raising the point that there was no guarantee that SoP agendas are effective in ensuring that companies maintain sound executive pay plans, and that given the time constraints of the concentrated June AGM season in Japan, it would be difficult to thoroughly analyze compensation structures of all companies that they hold interests in. Conversely, some investors believe that SoP leads to improved transparency and additional chances for shareholders to express their thoughts and opinion to management, and thereby view the use of SoP agendas positively.

Regardless of whether SoP agendas are adopted, should compensation practices in Japan continue to evolve and begin to mirror practices / pay levels in Western markets like the U.S. and Europe, it will become increasingly necessary for companies to expand their engagement strategies to include explanations on why their executive pay plans are appropriate and effective.

Figure 3: **Views on whether Say on Pay (SoP) should be actively used in the Japanese market**



ESG Metrics and Executive Compensation

Reflective of the rise in discussions concerning the use of ESG metrics within executive compensation plans, all respondents of this survey stated that they believe it is appropriate / positive to harness ESG metrics as a KPI for incentive-based pay. However, a sizeable sample of responses noted that it is important that ESG metrics within compensation plans be material to, and aligned with, the company's business and strategy. In addition, as noted by Ms. Naoko Ueno (Glass Lewis Japan), "It is good to implement the same KPI across all executives if it is a matter that is important to the entire company, but if a metric is applicable only to the responsibilities of a particular executive, it is desirable that that KPI only be applied to that particular executive", accountability for assessing ESG matters can only be achieved when there is a clear line of sight between the roles and responsibilities of the executive and the particular ESG metric used.

> **"While it is a positive thing to use ESG as a KPI, [we] communicate to companies that it is preferable to avoid using indexes like MSCI as an ESG metric within some engagement meetings. When using indexes to assess performance, it is unclear whether simply adhering to the criteria of such indexes actually leads to corporate value. There are some companies that explain 'we use indexes in order to maintain objectivity and transparency', but if they do place importance on transparency and objectivity, it would be more appropriate for them to assess performance and compensation within the compensation committee while clearly disclosing the committee's roles and responsibilities and also disclosing the details of how performance was assessed.**
>
> Mr. George Iguchi, Nissay Asset Management

Moreover, it is difficult to measure whether hurdles attached to ESG metrics are sufficiently challenging. If not managed appropriately, assessments of ESG-based KPI's can be in large part an arbitrary process, which leads to concerns that objectivity and independence cannot be maintained in the process of determining pay when using ESG metrics. While some investors noted that the use of third-party evaluations for ESG performance is an effective way to objectively assess ESG performance, other respondents noted that it is important for companies to define specific ESG metrics that are applicable to their business while also maintaining transparency on what actions the compensation committee took to objectively assess the relevant metrics. "While it is a positive thing to use ESG as a KPI, [we] communicate to companies that it is preferable to avoid using indexes like MSCI as an ESG metric within some engagement meetings. When using indexes to assess performance, it is unclear whether simply adhering to the criteria of such indexes actually leads to corporate value. There are some companies that explain 'we use indexes in order to maintain objectivity and transparency', but if they do place importance on transparency and objectivity, it would be more appropriate for them to assess performance and compensation within the compensation committee while clearly disclosing the committee's roles and responsibilities and also disclosing the details of how performance was assessed" (Mr. George Iguchi, Nissay Asset Management)

With the increasing interest in ESG matters, environmental initiatives are also gaining strong traction and many respondents noted that they view linking environmental metrics to compensation positively. Some investors added that, to view the use of environmental metrics within pay plans positively, it prerequisite for companies to have an appropriate roadmap that define goals for their environmental initiatives and demonstrates companies can track their progress towards the applicable goals on an ongoing and annual basis. Asset Management One also noted that compensation disclosures should cover "why the applicable company included 'E' as an assessable metric and information that would allow [the reader] to determine whether the set KPI"s are appropriate".

Non-Executive Director (NED) / Outside Director Pay

The survey also included questions on outside director pay levels and potential grants of stock compensation to NED / outside director positions. Where outside director pay is deemed too high, the independence of outside directors is often called into question and is often cited as a reason why outside director pay should be set at modest levels. However, the roles, responsibilities, and expectations of independent outside directors in Japan continues to rise, which was the basis for a question within the survey of whether increasing outside director pay in Japan is warranted. Furthermore, while performance-linked stock compensation runs the risk of hindering and outside director's ability to perform their oversight / monitoring function, the survey queried investors on whether grants of stock that are not linked to performance are viable for outside director pay.

Several investors signaled that they view increasing pay levels for outside directors favorably, provided an appropriate rationale is provided and as long as there is a clear link between increasing outside director pay and the expanded responsibilities they hold. Some responses pertaining to this matter included: "If there is legitimacy in doing so, we do not view increased pay for independent outside directors negatively. In actual practice, it is becoming difficult to appoint independent

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If there is legitimacy in doing so, we do not view increased pay for independent outside directors negatively. In actual practice, it is becoming difficult to appoint independent outside directors that satisfy the relevant diversity and skill requirements. However, when increasing pay, it is prerequisite that the role of the independent outside director and the time commitment they make to the company is made clear, similar to disclosures seen in the U.S. and Europe.

Ms. Naoko Ueno, Glass Lewis Japan

outside directors that satisfy the relevant diversity and skill requirements. However, when increasing pay, it is prerequisite that the role of the independent outside director and the time commitment they make to the company is made clear, similar to disclosures seen in the U.S. and Europe" (Ms. Naoko Ueno, Glass Lewis Japan), "If a company appoints an independent outside director as chair of the board, they need to offer a certain level of compensation to secure an appropriate candidate. Therefore, we do not view high levels of pay negatively" and "Disclosure of fees for board and committee chairs and pay for individual independent outside directors are important. Furthermore, transparency should be maintained through indicating the expectations for each director and reviewing whether said expectations were achieved" (Invesco Asset Management).

At this stage, there appears to be a stronger focus on securing talent that can reliably meet the expectations of the outside director role than concerns that increased pay may impact the independence of a director.

In regard to granting stock-based compensation to outside directors, Invesco Asset Management noted "we endorse the grant of stock compensation to outside directors. There is a need [for outside directors] to align interests with long-term investors. It is desirable that [stock plans] be designed in a way that takes into account the expansion of corporate value over the long-term", with a number of other institutional investors responding in a similar way. Outside directors are increasingly expected to assist in the design and achievement of a company's long-term strategy and accordingly, provided stock awards are not linked to performance and the value of awards fluctuate based only on share price, grants of stock compensation may be an effective pay structure for outside directors. On the other hand, some respondents stated that grants of stock awards, or any other variable pay thereof, to outside directors whose main responsibilities are in the areas of compliance or risk management, (e.g., directors that serve as audit committee members), is not desirable or appropriate.

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>
> Invesco Asset Management

Another matter of concern in the process of setting independent outside director pay, is that even in cases where a compensation committee is present, outside directors will inevitably have to assess their own performance to determine appropriate pay levels. Institutional investors had a number of thoughts in relation to this issue including "objectivity can be maintained by determining pay based on objective market data provided by an external consultant" and "concerns about outside directors and the compensation committee assessing and determining their own pay wouldn't be so material if companies disclosed their specific policies for setting independent outside director pay, including the responsibilities of the outside directors and the relevant fees paid for each role. In addition, if individual pay for outside directors was disclosed, it would be possible to assess whether pay was calculated in an appropriate manner". Further to these opinions, one respondent commented on outside director pay in the following manner: "In cases where outside directors are paid excessively in comparison to the role they perform, it may be possible for shareholders to express their concerns through director election proposals or SoP type proposals and thereby deter bad practices".

Summary

As corporate governance and executive compensation practices rapidly change within the Japanese market, it is desirable for companies to not just undergo disclosures within the bounds of the relevant legal frameworks and meet best practices but to go above and beyond by adopting best practices in the U.S. and European markets that improve transparency of director pay. Going forward, it is expected that executive compensation will become a common topic of engagement between companies and institutional investors, and it may be necessary for companies to consider and evaluate their compensation frameworks and initiatives towards pay governance to meet the ongoing changes to executive compensation in Japan.

***All quotes within the above survey findings were used with the permission of the relevant respondent.**

***This article is a translation of the Japanese Release dated October 26, 2021. All quotes from respondents have been translated from Japanese and thereby may not necessarily reflect the exact Japanese quoted by respondents of this survey.**

Institutional Investors that Participated in this Survey (23 Companies)

Institutional Investor

- Asset Management One
- Invesco Asset Management (Japan)
- Wellington Management Japan
- Capital Group
- Glass Lewis Japan
- Goldman Sachs Asset Management
- Schroders Investment Management
- State Street Global Advisers
- Nissay Asset Management Company
- Fidelity International (Japan)
- Blackrock Japan
- Misaki Capital
- Lazard Asset management
- Sumitomo Mitsui DS Asset Management Company
- Sumitomo Mitsui Trust Asset Management
- Nomura Asset Management
- BNY Mellon Investment Management Japan
- JPMorgan Asset Management (Japan)
- PGIM Japan
- Sompo Asset Management

***3 other asset managers undisclosed**

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