Vanguard Investment Stewardship

# Japan Regional Brief

This Regional Brief reports on the corporate governance topics and trends Vanguard's Investment Stewardship team observed across Japan during the 2023 proxy year; it includes data on the proxy votes cast by the Vanguard-advised funds during the period.[1] We provide this brief, and other publications and reports, to give Vanguard fund investors and other market participants an understanding of the engagement and proxy voting activities we conduct on behalf of the Vanguard-advised funds.

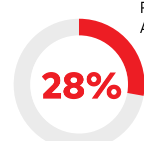
Vanguard's Investment Stewardship team conducts proxy voting and engagement on behalf of the Vanguard-advised funds. Our approach to evaluating portfolio companies' corporate governance practices is centered on four pillars of good corporate governance, which are used to organize this brief: board composition and effectiveness, board oversight of strategy and risk, executive compensation, and shareholder rights.

During the past proxy year (July 1, 2022, through June 30, 2023), the team conducted 68 engagements with 50 companies in Japan, representing $44.2 billion in equity assets under management in the region. The funds voted on 15,581 proposals across 1,440 companies in the region.

## At a glance

| **50** | **68** | **1,440** | **15,581** | **$44.2B** |
|---|---|---|---|---|
| companies engaged | total engagements | companies where a proposal was voted on | proposals voted on | equity assets under management engaged |

## Regional AUM engaged


Percentage of regional AUM engaged

68 Total engagements in the region

$44.2B Total engaged equity AUM in the region

$159.8B Vanguard's total equity AUM in the region

1 Vanguard's Investment Stewardship program is responsible for proxy voting and engagement on behalf of the quantitative and index equity portfolios advised by Vanguard (together, "Vanguard-advised funds"). Vanguard's externally managed portfolios are managed by unaffiliated third-party investment advisors, and proxy voting and engagement for those portfolios are conducted by their respective advisors. As such, throughout this document, "we" and "the funds" are used to refer to Vanguard's Investment Stewardship program and Vanguard-advised funds, respectively.

# Board composition and effectiveness

Our primary interest when evaluating a company's corporate governance profile is ensuring that the board of directors has the appropriate level of independence and mix of backgrounds, skills, experience, and diversity of personal characteristics to effectively provide independent oversight of management, company strategy, and material risks.

**Director election and board structure.** In Japan, directors are generally elected every two years, unless the company's articles of association stipulate a shorter term. In recent years, we have seen some Japanese companies adopt annual election of directors, and we welcome that evolution, as it enables shareholders to evaluate the performance of directors annually and use their vote to either support the status quo or encourage change.

Three types of board structures are permitted under Japanese corporate law:

- a one-tier board with three committees (audit, nominations, and compensation);
- a one-tier board with an audit committee; or
- a two-tier board (a board of directors and a board of statutory auditors).

The funds do not advocate for one structure over another; instead, we believe that boards are generally better positioned to determine which structure best enables appropriate oversight of risks and opportunities and therefore is in the best interests of a company and its shareholders.

**Board independence.** In Japan, a primary area of focus in our analysis has been the level of board independence. Japanese boards have historically been dominated by executive directors, known in the market as "inside directors." Over recent years, companies have been increasing the number of non-executive directors, known as "outside directors." However, outside directors still do not make up a majority of the board at most companies, and they often have relationships or affiliations with the company that could call into question their independence.

In 2023, the funds introduced a new voting policy related to board independence that aligns with the principles set out in the Japanese Corporate Governance Code. As a result, director and board independence was frequently discussed in our engagements with company leaders over the past year. Specifically, we were interested in whether certain relationships, transactions, or situations affected an outside director's independence. Listening to company leaders explain how the board evaluated outside directors' independence and why the board considered outside directors to be independent was helpful and factored into our overall analysis ahead of voting at many Japanese annual meetings.

We found that Japanese outside directors often had previous relationships, through either former employment with the company, a current or former advisory relationship (such as being employed at the company's audit firm), a current or former business transaction with the company, or being on the board of or affiliated with a cross-shareholding of the company.[2] Companies' disclosure often provided limited details about these relationships, which made it difficult to evaluate whether an outside director was in fact independent.

**2** In Japan, listed companies often own shares in other listed companies that they do business with and vice versa; this is known as cross-shareholding.

In our engagements, we encouraged Japanese company leaders to provide enhanced disclosure of any potential relationships that could call into question an outside director's independence, and to also provide disclosure about how the board determined outside directors to be independent, so that shareholders can make an informed decision on each director's independence when voting.

**Proxy contests.** In proxy year 2023, the number of proxy contests at Japanese companies increased, in the form of shareholder proposals that proposed new director candidates and asked shareholders to remove existing directors. This increase was largely fueled by investor activism in the market, which focused on Japanese companies' strategy, valuation, and capital allocation approach as well as concerns about corporate governance practices. When evaluating proxy contests, we assess the economic and strategic case for change at the company, the quality of the nominees proposed by the board as well as by shareholders, and the quality of the company's existing corporate governance practices.

## Notable votes from the 2023 proxy year include:

At the June 2023 annual meeting of **Toyota Motor Corp.**, a multinational automotive manufacturer, the funds voted against the chair because of concerns about board independence. One of the outside directors is an executive at a company with which Toyota maintained a business relationship. We engaged with Toyota leaders to better understand the nature of that relationship. Because the total transactional value of the relationship was not disclosed, it was difficult to ascertain whether the director was independent. Although Toyota does have other outside directors who are independent, the board was less than 33% independent when taking into account this particular outside director's affiliation. As a result, and in line with the funds' **Japan proxy voting policy**, the funds voted against the chair to reflect our concerns regarding the board's overall level of independence.

**Fuji Soft Inc.**, an information technology software and solutions company, had a proxy contest in December 2022 at which the funds supported five new independent director candidates for the board. Three of these candidates were proposed by the company, and two were jointly proposed by the company and the activist. The activist also proposed two other candidates whom the funds did not support. We engaged with Fuji Soft ahead of the extraordinary general meeting in December. During our engagement, we received an update on work by a company committee focused on enhancing corporate value—a committee that was established after a separate proxy contest in March 2022. We inquired about the outside directors' involvement in the committee. Although we noted steps the company had taken to address concerns that the activist raised—which centered on claims of inefficient capital allocation—we had reservations about the level of independent oversight on the board and the committee looking at this issue. We ultimately decided that increasing the level of board independence by bringing outside perspectives to the board would be beneficial and aligned with long-term shareholders' interests. The funds thus supported the five candidates, who we assessed offered the most appropriate combination of independence, skills, and experience to complement the existing board members.

# Board oversight of strategy and risk

On behalf of the funds, we evaluate board oversight and disclosure of material risks case by case, in accordance with each company's unique profile, taking into account the board's assessment of material risks and regional and sector-specific context.

**Shareholder proposals**. In Japan, shareholder proposals can be filed only in relation to items that normally get approved by shareholders. Therefore, a shareholder proposal asking for the company to make additional disclosures, for example, is often on the annual meeting agenda as a proposal that asks to amend the company's articles of association to state that the company will produce a report and disclose information. During the 2023 proxy year, we saw a larger number of director-related shareholder proposals (that is, proxy contests) as well as proposals relating to capital allocation.

Also in the 2023 proxy year, Japanese companies came under pressure from increased levels of activism. The funds voted on 351 shareholder proposals at 67 companies, compared with 227 shareholder proposals at 48 companies in the 2022 proxy year. We assessed that many shareholder proposals were inherently prescriptive, in that they requested amendment of a company's articles of association. The Vanguard-advised funds do not seek to dictate company strategy or operations, so in our analysis of the shareholder proposals in 2023, we focused on each proposal's specific ask and the degree of latitude that boards and management would have in determining how to implement each proposal's request. Paramount to evaluating these shareholder proposals was understanding a company's existing reporting and disclosures on material risks and whether there appeared to be adequate independent oversight of company management, strategy, and material risks.

Earlier in 2023, the Tokyo Stock Exchange (TSE) began looking at ways to promote greater consideration of cost of capital and profitability of Japanese companies with the aim of increasing corporate value over the middle to long term. Guidance from the TSE now asks companies with a price-to-book ratio of less than one to disclose targets related to increasing profitability and policies that address this. The number of capital allocation-related shareholder proposals rose from 25 in the 2022 proxy year to 46 in the 2023 proxy year. We will continue to monitor developments on the number and nature of these proposals.

Although environmental and social shareholder proposals remained present on companies' annual meeting agendas, especially in the utilities and banking sectors, these types of shareholder proposals did not experience pronounced growth from 2022. Most of the proposals focused on climate risk management. Generally, we found that Japanese companies had improved their disclosure and reporting on climate risk management, most likely driven by 2023 changes in regulation that mandated sustainability disclosures in companies' annual securities report.

## Notable votes from the 2023 proxy year include:

**Electric Power Development Co., Ltd. (J-Power)**, an electric utilities company, received several climate-related shareholder proposals at its annual meeting in June 2023. One proposal asked the company to disclose a business plan to achieve science-based short- and medium-term greenhouse gas emissions reduction targets aligned with the goals of the Paris Agreement. We engaged with J-Power ahead of the meeting and discussed its approach to managing material climate risks. Overall, while we felt that the company could provide clearer information about its processes and structures to support independent board oversight of climate risk, we determined that the company's disclosure was sufficient. We also noted that J-Power had increased its disclosure since its previous annual meeting, aligning its targets with Japan's greenhouse gas emissions reduction target. As a result, the Vanguard-advised funds did not support the shareholder proposal. A separate proposal sought more disclosure on how J-Power's remuneration policies would facilitate achievement of its greenhouse gas emissions reduction targets. Japanese companies do not typically disclose in-depth information about executive pay, as Japanese regulation does not require such disclosure. As a result, the company's current disclosure was in line with market standards. The Vanguard-advised funds thus did not support this proposal.

At the June 2023 annual meeting of **Toyota Motor Corp.**, a multinational automotive manufacturer, a shareholder proposal called for the company's articles of association to be amended; it sought to require that Toyota issue an annual report on its climate lobbying activities and how those activities align with the goals of the Paris Agreement and the company's carbon neutrality goal for 2050. We noted that Toyota already provided a report to shareholders on its climate lobbying activities, and through our engagement with company executives, we learned more about Toyota's ambitions to enhance its oversight of and reporting on these activities. As a result, the Vanguard-advised funds voted against the shareholder proposal, as the company's current reporting seemed to appropriately provide disclosure to shareholders on this topic.

# Executive compensation

When reviewing executive compensation plans, we assess how compensation practices are linked to long-term investment returns.

In Japan, shareholders do not vote on executive compensation outcomes—known as "Say on Pay" in other markets—nor do Japanese companies disclose detailed information about executive compensation arrangements or outcomes, as Japanese regulation does not require it. Occasionally, shareholders may vote on the approval of an equity compensation plan, but these plans are not common in the market. During the 2023 proxy year, we observed a minority of Japanese companies provided disclosure on executive compensation structures and arrangements to shareholders, and we welcomed the additional information to better understand how companies were thinking about integrating strategic goals into compensation arrangements.

# Shareholder rights

We assess structures that boards put in place to allow shareholders to effectively exercise their foundational rights.

**Engagement with independent directors**. One of the key corporate governance challenges in Japan is companies' reluctance to provide engagement opportunities with independent directors serving on the board. Most Japanese companies offer executives or investor relations professionals for shareholder engagements. While we value conversations with company leaders, we prefer to speak with independent directors on certain matters so that we can better understand boards' corporate governance structures and processes and how independent directors, who serve on behalf of all shareholders, participate in the oversight of management, strategy, and material risks. We were encouraged this year to have more discussions with independent directors than in previous years, but we note that the market has opportunities to improve shareholder access to independent directors.

**Poison pills**. The prevalence in Japan of takeover defense plans (also known as poison pills) has been declining over recent years, but they remain part of market practice. After extensively engaging with portfolio companies in 2022 about poison pills, the Vanguard-advised funds' voting policy was updated to state that the funds would look for a clear and compelling rationale to support a poison pill that is being renewed. Many poison pills at Japanese companies are effectively rolling, with the company seeking shareholder approval every three years to renew the pill, often with no specific reason or rationale other than concerns about potential hostile takeovers. We encouraged companies to provide clear disclosure to shareholders on the specific reasons they are seeking renewal of the pill, along with ensuring that they have the appropriate level of independent board oversight and processes in place to manage the use of the pill.

## Notable votes from the 2023 proxy year include:

At the 2023 annual meeting of **Nachi-Fujikoshi Corp.**, a machinery manufacturing company, shareholders were asked to approve the renewal of the company's takeover defense plan. The funds voted against this proposal. One of the deciding factors in our analysis was the composition of the special committee that evaluates the appropriateness of transactions, which then may or may not warrant the use of the poison pill. Generally, we look for this special committee to fully consist of independent outside directors. In this case, a number of directors on the special committee could have been deemed non-independent, so we had concerns about the level of independent oversight if the use of the poison pill needed to be assessed.

At the 2023 annual meeting of **Cosmo Energy Holdings Co., Ltd.**, an integrated oil company, the company asked shareholders to approve a poison pill against a certain shareholder and related parties. This was unlike most pills in Japan, which are often general and outline the circumstances under which a company could issue warrants to dilute a bidder's holding if they tried to initiate a hostile takeover bid. In this case, upon engaging with Cosmo Energy's leaders and reviewing its disclosures, we did not find that the company had a compelling rationale for why it should be able to block a takeover bid from this shareholder. Therefore, the funds did not support the company's introduction of the pill.

# Proxy voting data

The type and volume of management proposals voted on in Japan during proxy year 2023 remained consistent with previous years. However, the Vanguard-advised funds voted against more directors because of concerns about the level of board and key committee independence, in part as a result of aligning our views on board independence with the Japanese Corporate Governance Code.

The other key observation from the 2023 proxy season was the increase in shareholder proposals. The funds voted on 351 unique shareholder proposals at 67 companies—an increase of over 50% from 2022. We saw similar levels of environmental- and social-related proposals and higher numbers of capital allocation-related proposals. In the 2023 proxy year, the funds supported a total of nine shareholder proposals at Japanese companies; these proposals largely related to the proxy contest at Fuji Soft discussed in the board composition and effectiveness section.

**Japan**

| | | Management | | Shareholder | |
|---|---|---|---|---|---|
| **Alignment with our pillars** | **Proposal type** | **Number of proposals** | **% for** | **Number of proposals** | **% for** |
| Board composition and effectiveness | Elect directors | 11,985 | 95% | 39 | 10% |
| | Other board-related | 1,315 | 92% | 68 | 4% |
| Board oversight of strategy and risk | Approve auditors | 28 | 100% | – | – |
| | Environmental and social | – | – | 49 | 0% |
| Executive compensation | Other compensation-related | 468 | 92% | 43 | 5% |
| Shareholder rights | Governance-related | 480 | 88% | 1 | 0% |
| Other proposals | Adjourn/other business | 19 | 100% | – | – |
| | Capitalization | 912 | 100% | – | – |
| | Mergers and acquisitions | 23 | 91% | – | – |
| | Other | – | – | 151 | 0% |



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