COMMENTARY

September 13, 2019

Dear Clients and colleagues:

In November 2018, Carlos Ghosn, former chairman of Nissan Motor Co. was arrested on allegations of financial misconduct, including underreporting his income and misuse of company assets. Further, recently Nissan's in-house investigation found that CEO Hiroto Saikawa received excess payment as part of an incentive scheme. Mr. Saikawa apologized to the public and shareholders and subsequently resigned earlier this week. People familiar with the company were not surprised because of the many red flags surrounding Nissan's corporate governance. For example, it was one of only 11 companies in the Topix 500 that did not have two independent directors at the time Mr. Ghosn stepped down as CEO in 2017. Also, it did not have a separate remuneration committee at that time.

However, Nissan is not the only one with corporate misdeeds. Several other corporations such as Olympus and Toshiba were also involved with financial scandals in the past. Over the past decade, Japan has been trying to strengthen its corporate governance regime. It is a key pillar for Prime Minister Shinzo Abe's economic revival program.

Key milestones include:

Japan's Stewardship Code in 2014

In February 2014, the government published *Principles for Responsible Institutional Investors, Japan's Stewardship Code*, to encourage institutional investors to fulfill their fiduciary duties by engaging with the companies to enhance medium- to long-term investment returns.

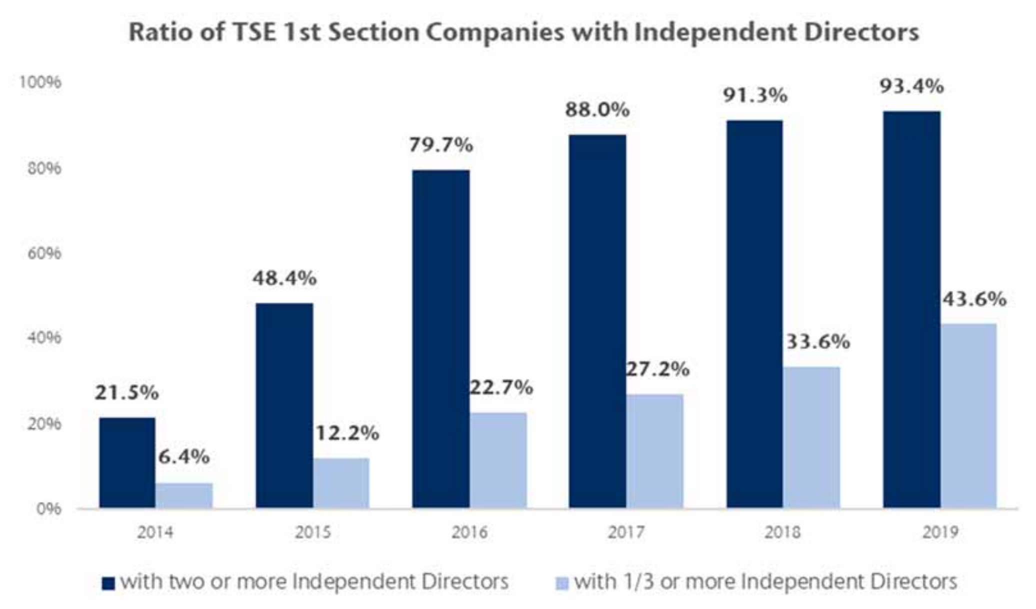
Japan's Corporate Governance Code in 2015

As the first corporate governance code in Japan, it requires a minimum of two independent directors, and encourages companies to adopt at least one-third independent boards and to increase the number of female directors.

Revised Japan's Corporate Governance Code in 2018

The key changes from the 2015 version of the Code include the requirement of more disclosure of cross-shareholdings, broader adoption of compensation and nomination committees, and greater diversity on the board.

There has been progress among Japanese corporations following these initiatives. The ratio of companies on the first section of Tokyo Stock Exchange that have independent directors has been increasing steadily. Now 93% of the companies have two or more independent directors, which was only 22% in 2014, and 44% companies have one third or more independent directors.



Source of data: Japan Exchange Group
https://www.jpx.co.jp/english/listing/others/ind-executive/index.html

A report published by CLSA Ltd., *Serving Notice, CG interplay: Returns spark rallies*, found that superior performance positively correlates with the adoption of best corporate governance practice (e.g. including more than 50% independent directors, independent committees, and focus on capital efficiency), as well as the presence of large shareholders and/or significant insider holdings. On the other hand, cross-shareholdings correlate negatively with performance.

While Japanese companies are making favorable changes in adopting independent directors, they have been slow or even resistant in some other aspects, cross-shareholding for instance. The main reason is that unlike laws and regulations, the Corporate Governance Code is not legally binding. It adopts a “principles-based” and “comply-or-explain” approach. Basically, companies can either comply or explain why they don’t, which leaves room for companies to remain status quo. To accelerate the corporate governance reform, investors’ engagements are needed.

At Global Alpha, engagement is done mainly in two ways: direct communication with companies and proxy voting. For example, we send out our *CEO Remuneration Guidelines* to companies that are added to the approved list. We believe CEO remuneration plans should be long term, transparent and clearly disclosed, and the level of CEO remuneration should be capped. Proxy voting is another tool we use for engagement. We take into consideration the recommendations from Institutional Shareholder Services Inc. (ISS), and will engage with the company when needed. To better engage the company and vote in the best interest of our clients, we are currently updating our own proxy voting policy, please stay tuned.

Have a great weekend.

The Global Alpha team