

**Japanese Unique AGM Case of LIXIL GROUP CORPORATION:
Analysis of Appointments of All Director Candidates Proposed by Shareholders and of Institutional Investor Decisions**

Short Review
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1. An Unusual Event Occurred at LIXIL Group's Appointment of Directors in 2019, Even from a Global Perspective

At LIXIL GROUP CORPORATION's (5938, LIXIL Group) annual general shareholders meeting (AGM) in June 2019, all six director candidates proposed by shareholders were appointed. The group, which included two common candidates who were originally proposed by shareholders but also were proposed by the company, became the majority on the Board of Directors. This was a rare occurrence, even from a global perspective.

In the United States, it is difficult for shareholders to make any proposals related to management matters. Moreover, shareholder proposals are non-binding resolutions in the U.S. and conducting a proxy contest can be quite expensive. In recent years, an increasing number of U.S.-based companies have amended in their Articles of Incorporation to allow for director candidates proposed by shareholders to be placed on proxy solicitation documents (i.e. "proxy access"). However, up until now, no director candidates have been nominated by shareholders at those companies.

Conversely, in Japan, shareholders possess strong authority and, through the AGM, can participate in decisions related to important management matters. For this reason, it has long been possible in Japan for shareholders to have great influence on makeup their companies' Board of Directors based on shareholder proposals. However, listed companies in Japan often have a controlling shareholder such as a parent company or a group of founding family members that hold the majority of voting rights. There are also companies that secure the majority of voting rights through cross-shareholdings, including life insurance company holdings. Moreover, some companies have secured more than the two-thirds of votes necessary to amend the Articles of Incorporation. Therefore, even if director candidates are proposed by shareholders, there is little chance of getting the required majority of votes for approval at the AGM. This is the reason that shareholder-backed candidates are hardly ever elected.

The LIXIL Group's shareholder proposal of director candidates has been covered at great length by Japanese media sources, so the description of that event has been kept to a minimum

in this report. Instead, this report focuses on the impact of the voting decisions made by institutional investors and the effects of proxy advisory firms.

2. Circumstances Leading to Shareholder Proposals

In October 2018, Mr. Ushioda, the chair of the Board of Directors, when convening the nominating committee, made the possibly misleading statement that Mr. Seto, the CEO, had a specific and definite intent to resign from his position. At the subsequent nominating committee meeting, which was held on October 26, a proposal appointing Mr. Ushioda as CEO and Mr. Yamanashi as COO was offered for consideration at the October 31 Board of Directors meeting. The proposal was based on Mr. Seto's expressed intention to resign from both his CEO and Executive Officer positions.

On October 27, Mr. Ushioda called Mr. Seto and explained that the nominating committee had decided by consensus to request his resignation as CEO. Mr. Seto ultimately made the decision to resign as CEO, after taking into account the explanations from Mr. Ushioda that the decision by the nominating committee would be difficult to overturn.

Although Mr. Seto was under the misconception that all nominating committee members wanted him to resign, his resignation as CEO was duly submitted at the board meeting on October 31. It was also decided at the meeting that Mr. Ushioda would become the CEO and Mr. Yamanashi would become the COO. However, when Mr. Seto later understood the true circumstances leading to his resignation as CEO, he stated that if he had known all of the relevant information, he might have made a different decision.

In December 2018, Marathon Asset Management sent a questionnaire and requested the disclosure of the minutes from LIXIL Group, citing a lack of governance regarding company procedures. In response to these developments, LIXIL Group commissioned a third-party lawyer to conduct an investigation and verification. In February 2019, LIXIL Group released the investigative report about the personnel change. The report explained that although there were problems with the sequence of the procedures and with its background, the resolution by the Board of Directors was legal and there were no reasons to invalidate it.

In March 2019, four institutional investors, which included Marathon Asset Management, and domestic individual shareholders jointly requested an extraordinary general shareholder meeting to dismiss Mr. Ushioda (Director and CEO) and Mr. Yamanashi (Director and COO) as directors, because they were dissatisfied with the situation. In April, Mr. Ushioda announced that he would resign from the Board of Directors before the regular AGM scheduled for June. In response, the four institutional investors and the domestic individual shareholders withdrew

their request to convene an extraordinary general shareholders meeting.

Meanwhile, in order to company growth and strengthen corporate governance, Mr. Seto and Mr. Ina, who was the director of LIXIL Group and an empathy for Mr. Seto, submitted a shareholder proposal to nominate eight director candidates, including themselves, in preparation for LIXIL Group's AGM in June. The proposal asked shareholders to decide whether Mr. Seto should be reappointed as CEO of the company.

3. LIXIL Group's Decentralized Stockholding Structure Was a Key Element

Considering that all of the director candidates under the shareholder proposal would be elected, an important factor that seemed to influence the outcome was that shares of LIXIL Group were widely diversified at the time of the AGM in June 2019. LIXIL Group had neither a parent company nor a controlling shareholder. According to the securities report for the fiscal year ending March 31, 2019, the shareholder composition of LIXIL Group was as follows: domestic financial institutions accounted for 30.9% of shareholders; foreign corporations accounted for 34.6%; individuals and others accounted for 26.4%; and rest treasury stock. In terms of major shareholders, the trust account of The Master Trust Bank of Japan was the largest but held only 5.76% of total company shares, and there was no structure for large quantities of shares being held by specific institutional investors.

In this case, where shares are widely dispersed among shareholders, if institutional investors hold the majority of voting rights, they will cast the deciding votes.

Japan's current Corporate Governance Code calls for the elimination of cross-shareholdings that are effectively stable shareholders. The intention behind this principle is to increase corporate value over the medium to long term by creating a strained relationship between shareholders and the Board of Directors.

4. Decision of Domestic Institutional Investors

4.1 Many Domestic Institutional Investors Supported the Candidates Proposed by Shareholders

In the directors election, with the exception of Ms. Onimaru and Mr. Suzuki who were nominated as candidates by both the company and the shareholders, there were eight candidates proposed by the company: Mr. Uchibori; Mr. Kawahara; Mr. Campbell; Mr. Takeuchi; Mr. Fukuhara; Mr. Matsuzaki; Mr. Miura; and Mr. Otsubo. There were six candidates proposed by the shareholders in addition to Ms. Onimaru and Mr. Suzuki. They included: Mr. Nishiura; Mr. Hamaguchi; Mr. Ina; Mr. Kawamoto; Mr. Yoshida; and Mr. Seto.

The voting decisions of the 26 domestic institutional investors, excluding the life insurance companies and including foreign institutional investors that are assumed to have voting rights in Japan, were broken down this way: 5 investors (Group A) agreed to all the candidates proposed by the company and opposed all the candidates proposed by shareholders, 14 investors (Group B) agreed to all the candidates proposed by shareholders and opposed all the candidates proposed by the company, and 7 investors (Group C) made decisions based on different standards than Group A and Group B. The majority of domestic investors were part of Group B (Table 1).

Table 1: Domestic Institutional Investors For/Against Candidates Proposed by the Company and by Shareholders

	26 Domestic institutional investors	
	Number	Composition ratio
<ul style="list-style-type: none"> • Group A agreed to all the candidates proposed by the company and opposed all the candidates proposed by shareholders 	5	19.2%
<ul style="list-style-type: none"> • Group B agreed to all the candidates proposed by shareholders and opposed all the candidates proposed by the company 	14	53.8%
<ul style="list-style-type: none"> • Group C made decisions based on different standards than Group A and B 	7	26.9%

Source: Created by Nikko Research Center from websites of domestic institutional investors

4.2 Domestic Institutional Investors' Decisions Were Based on Shareholder Value of LIXIL Group

Only 12 out of the 26 domestic institutional investors, lower than 50%, disclosed the reasons behind their decisions regarding the appointment of LIXIL Group directors. Financial Services Agency will likely further encourage investors to disclose voting reasons at the next revision of the Japan's Stewardship Code.

Two out of 5 in Group A disclosed the reasons for voting as they did. Both companies said that decisions were made from the standpoint of shareholder value. Six out of 14 in Group B revealed their reasons. Increasing shareholder value was the primary reason for their votes but some also cited the strengthening of corporate governance.

Five out of 7 in Group C made known the reasons behind exercising their voting rights. One investor approved of only independent outside directors, while other investors made decisions

from the perspective of improving corporate governance and increasing shareholder profits; still other investors made their voting decisions based on increasing corporate value and avoiding potential conflicts of interest with general shareholders. One investor in Group C opposed all candidates, no matter how they were nominated by. In this case, dividend standards was the reason cited for opposing the candidates proposed by the company and shareholder value standards was the reason for opposing the candidates proposed by shareholders.

In reviewing the details of all explanations, it was found that only a few investors made decisions based on the belief that LIXIL Group's governance system and procedures for Mr. Seto's resignation as CEO was problematic. Meanwhile, many of the domestic institutional investors based their voting decisions on which side could best be trusted to work with management to improve corporate value.

5. Analysis of Support for/Opposition to Director Candidates

5.1 The Election of Candidates Proposed by Shareholders Was Considerably Influenced by the Judgment of Domestic Institutional Investors

The overall approval rate of company-proposed candidates at the AGM was approximately 44-58%, while the approval rate among domestic institutional investors was approximately 27-42%, so there is a divergence of roughly 16 points on average between the two. On the other hand, the approval rate of shareholder-proposed candidates at the AGM was approximately 51-65%, while the approval rate among domestic institutional investors was approximately 58-69%; the divergence between these two rates is small, only about 5 points on average (Table 2).

Table 2: Approval ratios for LIXIL GROUP's director candidates

	Company-proposed candidates							
	Uchibori independent	Kawahara independent	Campbell independent	Takeuchi independent	Fukuhara independent	Matsuzaki independent	Miura independent	Otsubo
Approval rate at AGM	57.9%	51.5%	53.1%	44.4%	44.9%	52.5%	51.3%	51.3%
Approval rate of domestic 26 institutional investors	42.3%	38.5%	38.5%	26.9%	30.8%	30.8%	34.6%	34.6%
Foreign institutional investors								
CalPERS	for	for	for	for	for	against	for	for
CalSTRS	for	for	for	for	for	against	for	against
Platinum Asset Management	against	against	against	against	against	against	against	against
Norges Bank Investment Management	for	for	for	against	against	for	for	for
Proxy advisory firms								
ISS's recommendation	for	for	for	against	against	for	for	for
Glass Lewis' recommendation	for	for	for	for	for	for	for	for

	Company/Shareholder -common proposed candidates		Shareholder-proposed candidates					
	Onimaru independent	Suzuki independent	Nishiura independent	Hamaguchi independent	Ina	Kawamoto	Yoshida	Seto
Approval rate at AGM	94.5%	94.4%	52.0%	64.6%	58.7%	50.8%	51.4%	53.7%
Approval rate of domestic 26 institutional investors	96.2%	92.3%	57.7%	69.2%	61.5%	57.7%	57.7%	57.7%
Foreign institutional investors								
CalPERS	for	for	against	for	for	against	against	against
CalSTRS	for	for	against	for	against	against	against	against
Platinum Asset Management	for	for	for	for	for	for	for	for
Norges Bank Investment Management	for	for	against	for	against	against	against	against
Proxy advisory firms								
ISS's recommendation	for	for	against	for	for	against	against	against
Glass Lewis' recommendation	for	for	against	for	against	against	against	against

Note: Honorific titles omitted

Source: Created by Nikko Research Center based on the extraordinary report and institutional investor websites

There are two points to consider:

- (1) Although some life insurance companies were in favor of both company-proposed and shareholder-proposed candidates, overall, they tended to lean toward the company-proposed candidates.
- (2) The major U.S. pension funds—CalPERS and CalSTRS—, that cast their votes after independently considering the shareholder proposal toward Japanese companies, did not easily support the candidates proposed by the shareholders.

These points suggest that the decisions of domestic institutional investors carried significant and determining weight in getting the shareholder-proposed candidates elected to LIXIL Group's Board of Directors.

5.2 Advice from Proxy Advisory Firms Also Had an Impact

In this director election, many domestic institutional investors based their decisions on whether the company-proposed candidates or the shareholder-proposed candidates should be entrusted with the management of LIXIL Group. Whereas, Institutional Shareholder Services (ISS), a proxy advisory firm that offers advice about exercising votes, interviewed all candidates and made recommendations based on a comprehensive assessment of the individual candidates' suitability as directors. As to whether the company-proposed candidates or shareholder-proposed candidates were more qualified, ISS avoided a judgement or direct comparison between the two groups. ISS recommended all the candidates except Mr. Takeuchi and Mr. Fukuhara among the company-proposed candidates and the two common candidates, and recommended only Mr. Hamaguchi and Mr. Ina among the shareholder-proposed candidates.

Similarly, the proxy advisory firm Glass Lewis recommended voting for all of the company-proposed candidates and the two common candidates but recommended only Mr. Hamaguchi from the shareholder-proposed candidates, based on the view that more independent directors are better. Notably, both ISS and Glass Lewis opposed the election of Mr. Seto as director. So, both proxy advisory firms supported the company-proposed candidates on a broad scale.

Some foreign investors are not entirely familiar with the unique circumstances within Japanese companies, due to language barriers and lack of information. In voting for the directors, foreign investors could have chosen one of the options below:

- (1) used a proxy advisory firm and voted based on the recommendations,
- (2) used a proxy advisory firm and, while mostly following the firm's recommendations, made some considerations independently,
- (3) used a proxy advisory firm but voted without following the recommendations, or
- (4) did not use a proxy advisory firm and voted through an independent survey.

Since it was not possible for domestic institutional investors alone to provide a majority to elect shareholder-proposed candidates, it can be inferred that there were a sufficient number of foreign investors that voted for the full panel of shareholder-proposed candidates—following options (3) and (4), including Platinum Asset Management and the four overseas investors that made the request to hold the extraordinary general shareholders meeting.

Meanwhile, Mr. Takeuchi and Mr. Fukuhara, the two company-proposed candidates that ISS recommended to oppose, were not able to obtain a majority. The approval ratios for Mr. Hamaguchi and Mr. Ina, whose elections were recommended by ISS among the shareholder-proposed candidate group, were relatively high. We can hypothesize that there were also many

foreign institutional investors that voted according to option (1) or option (2), such as Norges Bank Investment Management.

A combination of institutional investors' judgements and ISS recommendations led to the election of all six shareholder-proposed candidates and the two candidates proposed by both the company and the shareholders. As a result, the shareholder-proposed candidates along with two common candidates now have a majority on the 14-member Board of Directors.

6. Summary and Considerations

At LIXIL Group's AGM in June 2019, minority shareholders elected directors who would become the majority on the board; consequently, it was minority shareholders who literally chose the CEO. In the U.S., shareholder proposals are non-binding. In the UK, the requirements for shareholder proposals are stricter than in Japan. In the LIXIL Group's case, all director candidates proposed by shareholders were appointed in a legally binding manner. Moreover, shareholder-proposed candidates became the majority on the Board of Directors. This event was not only extraordinary but also unique to Japan.

Some view what happened at LIXIL Group as a sign of progress made in corporate governance reform in Japan. However, under corporate governance standards, it is the responsibility of the Board of Directors to decide who to appoint as CEO. Having the CEO appointed by minority shareholders is out of the usual scope of corporate governance.

LIXIL Group's closing stock price on June 25, 2019—the day it held its AGM—was 1,478 yen, when the TOPIX was 1,543.49. The company's closing price on October 23, 2019, was 2,019 yen, when the TOPIX was 1,638.14. The stock price of LIXIL Group after the AGM has greatly outperformed the TOPIX. Thus, although not much time has passed since the transition, it appears that the institutional investors in favor of the shareholder-proposed candidates have been able to achieve positive results from the perspective of the fiduciary duty to maximize shareholders' value.

The minority shareholders that appointed Mr. Seto as CEO also expect a sustainable increase of LIXIL Group's shareholder value. Therefore, the future focal points for Mr. Seto as CEO will be (1) what type of initiatives to put in place to increase and sustain shareholder value, and (2) how to manage the company while being cognizant of stock price and shareholder returns.

(END)