Guidelines on Executive Compensation 2013 and Requests for Revision of Regulations and Tax Systems 2013

Guidelines on Executive Compensation 3rd edition

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Japan Association of Corporate Directors
Dialogue with institutional investors Committee

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I Executive Compensation – The Status Quo

The following characters have been observed on Japanese executive compensation through changes over the last six years until 2013 following the publication of the Guidelines (2nd edition) and based on the comparison with other countries.

(1) There was no change in the total compensation levels over the last six years. This is the lowest level as compared to other developed countries (Appendix 1)

(2) There was also no change in the low proportion of performance-based compensation to overall compensation. Japan has the highest rate of fixed remuneration as compared to developed countries (Appendix 1).

(3) The number of companies having a Compensation Committee tends to increase.

(4) In terms of compensation disclosure, individual information on executive officers whose total compensation exceeds ¥100 million has been started to disclose. However, compensation policies and the type of compensation are not disclosed at the useful level for investors. The disclosure level is poor as compared to other countries.

The Dialogue Committee with Institutional Investors assigned researchers to conduct a survey titled "Study on the Actual Status of the Executive Compensation System" followed by that in FY2007. This study included (A) Survey on the executive compensation system in respondent companies and (B) Analytical examination of experimental study on executive compensation and corporate value. In addition, a questionnaire to investors regarding executive compensation was newly conducted.

The experimental study relating to (B) above, which was conducted simultaneously, demonstrated effects of executive compensation on corporate value.

(A) Survey on the executive compensation system showed the following significant results:

- (a) A large number of companies have determined compensation policies, policies on compensation levels and policies on combination of compensation constituents (fixed remuneration, performance-based bonuses, stock compensation, retirement allowances)
- (b) A majority of companies have established a Compensation Committee or an organization that can be alternative thereto
- (c) A large number of companies have a regulation in which rules, authority and purposes are clearly stated
- (d) About 80% of companies have a Compensation Committee or alternative organization in which external committee members (external directors, etc.) account for the half of total members

(e) About 70% of companies have a Compensation Committee that is headed by an external committee member (external director, etc.)
(f) A large number of companies have abolished retirement allowances
(g) A few responses regarding compensation disclosure were obtained in most questions
(h) About 60% of companies have linked performance-based bonuses with overall performance at 80% or higher
(i) About 80% of companies have linked compensation with corporate performance centering on financial indices
(j) About 80% of companies have implemented performance-based bonuses that occupy less than 40% of total compensation of CEO.
(k) About 60% of companies have implemented the long-tern incentive compensation system linked with mid- or long-term shareholder value
(l) A majority of companies have implemented stock compensation that accounts for 20% or lower of total compensation of CEO.

As stated above, issues presented in the "Guidelines on Executive Compensation," which was published by the Association in 2007, started being reflected (not adequately, though) to an executive compensation systems of individual companies. It is seen that executive compensation systems in Japan has been improving from the governance view point compared to the previous survey.
Moreover, the experimental study relating to (B) above, which was conducted simultaneously, indicated that executive compensations had a high probability to impact on corporate value.

A questionnaire to investors additionally indicates that a majority of investors are concerned about executive compensation systems of Japanese companies and pointed out the insufficiency of disclosure items regarding their executive compensations. Moreover, many respondents indicated the necessity to perform "say on pay" (a non-binding advisory vote regarding executive compensation at a shareholders meeting) and the preference to increase the proportion of performance-linked compensation to overall compensation.

II Summary- Guidelines on Executive Compensation

The following is the summary of the "Guidelines on Executive Compensation 2013 and Requests for Revision of Regulations and Tax Systems" (hereinafter, the "Guidelines"), which will be published with an aim to further promote the reform of developing executive compensation systems, in consideration of the result of the latest "Executive Compensation Survey."

[Enhancing short- and long-term incentive compensation to increase, at an early stage, the currently low proportion of performance-linked compensation as compared to other countries]

The Committee believes that companies should establish a framework allowing them to recognize their executive officers who make earnest efforts, take risks, achieve results and satisfy shareholders, and to grant appropriate recompense for their high business performance. Compensation levels for Japanese executive officers remain significantly low compared to other foreign countries, considering increasing expectations and pressure. It is essential that sufficient award should be given to executive officers who should be deemed as national resources achieving significant performance for company's progress and economic/social growth (Appendix 1). The Guidelines are formulated with the aim of encouraging executive officers to focus on improvement of business performance by enhancing performance-based compensation. Expanding the balance of short- and long-tern incentive compensation and setting a target of performance level not far behind other countries such as ROE 15% will help us to narrow the gap between Japan and the western countries. (First of all, we should target the mid value between Japan and the U.S., which is a value and a mixture in Europe) (Appendix 2).

[Strengthening disclosure of compensation details]

While publishing the Guidelines, we had been requesting revisions of laws/regulations and tax systems to further develop executive compensation governance. As a result, actual revisions were made in response to some of our requests. In order to urge a further progress, we will now propose the following: (1) using a uniform basic template of business report, annual report and corporate/governance report for compensation disclosure; (2) enhancing compensation disclosure in Item (1) by (a) requiring preparation and disclosure of compensation policies, (b) requiring individual disclosure of top management, (c) requiring disclosure of decision-making process regarding compensation, and (d) improving individual disclosure by type; and (3) considering implementation of so-called "say on pay" (advice regarding compensation at a shareholders meeting).

[Requesting revisions of laws/regulations and tax systems to unban restricted stocks]

In a bid to further develop performance-based compensation as stated above, we request authorities to remove the ban of restricted stocks, and to relax the preferential tax system (to defer tax payment until the time of selling) and the taxation rules applicable to inconvenient profit-related pay in order to avoid incentive compensation from being disturbed by disadvantages of laws/regulations and tax systems.

III Guidelines on Executive Compensation

The committee takes into consideration changes of management remuneration in Japan and the direction to be followed, and proposes the following Guidelines on Executive Compensation 2013(3rd edition). Although the guidelines are primarily targeted at public companies, the Committee believes that these guidelines will be equally effective within other corporations and organizations.
The Committee plans to carry out appropriate annual reviews of the contents of the Guidelines on Executive Compensation, taking into account opinions from a wide range of interested parties, both domestically and internationally.

1. Executive Compensation Policies

(1) Executive Compensation Policies adopted by individual companies (hereinafter “Compensation Policies”) and shall be built from both corporate and management points of view in order to support the creation of corporate value on both a short-term and a medium/long-term basis.

(2) Executive compensation should be regarded as consideration paid for executives’ role in managing the company, and determined at a level at which the executive receives compensation appropriate to his/her qualifications, ability, and performance results, taking global competition into consideration where appropriate.

(3) Attention should be paid to increasing annual incentive compensation (performance-based compensation) and stock compensation (long-term incentive compensation) to ensure the executive’s accountability by linking his/her compensation with corporate business performance both on a short-term and medium/long-term basis. The Compensation Scheme should be designed not only to allow a high degree of incentive to return good business performance, but also to decrease the level of payment for poor performance, with a view to avoiding any conflict of interest with stockholders.

In terms of the average CEO remuneration (the overall compensation, which is assumed to be defined as 100%, consists of 64% of basic remuneration, 20% of annual incentive compensation (performance-based bonuses) and 16% of long-tern incentive compensation), the proportion of annual incentive compensation (performance-based bonuses) and long-tern incentive compensation are at a lower level, compared to the western companies (refer to Appendix 1). Increasing the portion of annual incentive compensation (performance-based bonuses) and long-tern incentive compensation to the total average CEO remuneration increases, the relationship between risk and reward will be heightened in views of accountability to shareholders and achievement of business performance by executive officers. The percentage of performance-linked compensation for executive officers other than CEO should also increase by referring to CEO remuneration.

While maintaining the current level of basic remuneration unless the basic remuneration level is extremely high, we aim to attain roughly 1:1:1 ratio (basic remuneration: annual incentive compensation (performance-based bonuses): long-tern incentive compensation) in the short term (in 2-3 years), and 1: 2 to 3: 2 to 3 in the mid- or long-term (in 10 years). However, a transfer to the above percentage shall be made only when corporate scale, profit (rate), efficiency, shareholder's return of interest and other related business results are maintained at a level comparable to other countries (Appendix 2).

The above ratio is just an example. An appropriate ratio should be determined by individual companies based on their management strategies, particulars of the industry and other necessary factors.

A Compensation Committee of respective companies should discuss what compensation level and compensation component ratio are appropriate with reference to their management strategies and other factors, and then disclose the details of discussion. Moreover, the Compensation Committee should annually monitor the point on whether the actual compensation system is operated in line with the target direction.

(4) Non-executive directors with roles as overseers shall receive fixed compensation rather than performance-based compensation in principle. However, the provision of stock compensation (especially restricted stocks as discussed below) shall be made available. Moreover, someone who performs interlocking roles as both executive officer and director shall be paid a remuneration mainly for their role as a business executive.

Note: Restricted stock refers to a stock that a shareholder is not allowed to transfer (sell) for a certain period of time after he/she is granted.

(5) All public companies are required to disclose the following items from their Executive Compensation Policies under “Corporate Governance” in the company’s annual report:

(a) Policies on the purpose and levels of remuneration for executives in each category (fixed remuneration, performance-based bonuses, stock compensation, retirement allowances, etc.)

(b) Total compensation levels (aggregate amount on consolidated basis)

(c) The ratio used to combine components such as basic remuneration, annual incentive compensation (performance-based bonuses), long-tern incentive compensation and retirement allowances, etc. and company's policy on the ratio

(d) Types of indicators to evaluate performance for annual incentive compensation (performance-based bonuses), business target levels and units of payment that are linked to business performance. In addition, achievement levels against business target levels as of the end of fiscal term, which are determined at the beginning of fiscal term.

(e) Policy regarding types of long-tern incentive compensation and amounts allocated to individuals. The details (types of indicators to evaluate performance, fluctuating range, etc.) must be also disclosed when any condition of performance achievement is applied.

(f) Equation used to determine retirement allowances and policy for allocating these to individuals

(g) Process for deciding compensations, including particulars of the Compensation Committee members, clear statement of committee's authority and regulations, as well as statement of committee's activities for the each fiscal year (what, when, and how they were determined)

(h) Performance comparison charts over one year, five years and ten years against stock market index and competitors in the same industry, helping investors to check corporate business performance from the objective point of view.

2. Annual Incentive

(1) The measures used to evaluate business performance should be in agreement with the corporate strategy and consist mainly of financial indices rather than qualitative measurements. If qualitative measurements are applied, adequate transparency must be ensured in the course of decision-making process through deliberation at a highly independent Compensation Committee or other appropriate procedure.

(2) Target figures shall be set at the beginning of each fiscal year. Except in special circumstances, subsequent discretionary adjustments will not be allowed and the compensation shall be paid based on a predetermined formula. Business targets must be set to reflect corporate competition and the expectations of investors as a precondition for achievement.

(3) The Compensation Scheme should be designed to allow high incentive levels with a view to ensuring accountability to shareholders as well as enhancing management incentives; for example, several times the targeted performance-based bonus where achievements exceeded the target to a significant extent. .

(4) Where achievements were much lower than the target, the Compensation Scheme should be designed to reduce drastically the amount or to cut payment of compensation to management in order to share downside risks with shareholders.

(5) The remuneration of executive officers specializing in a specific business group must be linked to the performance of their individual business departments as well as the overall company-wide business performance.

(6) With regard to annual incentive compensation (performance-based bonuses), the long-term incentives listed below, including stock compensation and cash-based mid-term performance bonuses, shall also be paid to executive officers so that long-term corporate value will not deteriorate due to management’s focusing on short-term business achievements.

(7) For the purpose of clarifying accountability to stockholders for performance-based results, defined levels of compensation shall be classified and paid as fixed salaries and undefined ("variable") levels of compensation shall be paid for performance-based results (and no additional undefined levels of compensation shall be paid together with the fixed salaries within the framework of the defined level of compensation).

(8) Approval of Compensation Committee must be always obtained for target setting at the beginning of each fiscal term, performance evaluation at the end of each fiscal term and determination of amounts to be paid. Financial figures, which are used as the basis of evaluation, must be verified through an accounting audit.

(9) Amendment of the taxation system should be made again so that companies can easily record as deductible expenses relating to performance-based compensation/bonuses under the Corporate Tax Act.

3. Long-term Incentive

(1) The following long-term incentive compensation system linked with mid- and long-term shareholder value (hereinafter "Stock Compensation") should be introduced. A mixture of long-term incentive compensations should be implemented based on the status of individual companies and characteristics of long-term incentive compensations.

(a) Stock Options (Subscription Rights)

(b) Restricted Stocks (Being replaced with Stock Compensation-type stock options, which are derived from stock option with an exercise price at ¥1, due to no room to correspond in Japanese law and tax systems).

(c) A mid- to long-term cash-based alternative performance bonus with a three to four-year performance evaluation period.

(d) When the percentage of long-term incentive compensation is raised in the future, a certain performance condition should be attached on transferring Stock Compensation-type stock option to arouse further incentives (example: a condition that the company should achieve performance superior to that of an associate company in three years).

(2) A stockholding guideline requiring board members to hold stock in the company shall be established, and will set a non-binding challenge of "CEO, to hold company's stock about two to three times of fixed remuneration (annual amount)." In this case, the above-mentioned restricted shares may be included in the number of shares held. All executive officers other than the CEO will also have to hold similar number of shares as the CEO.

(3) Amendment of the Companies Act and the taxation system should be made so that companies would be allowed to grant restricted stocks.

4. Post-retirement compensation (compensation for advisers)

(1) Post-retirement compensations payable as compensation for advisers or consultants will not be provided when pre-retirement compensations are increased to the globally competitive level. Even though an appointment of adviser is required, post-retirement compensations will not be paid at a level superior to compensations for incumbent executive officers.

5. Compensation Committee

(1) All public companies must set up a Compensation Committee, not only companies who have the new committee system, but also the company with internal auditors.

(2) A Compensation Committee of a company with internal auditors should welcome external committee members and independent directors. The chairperson of the Compensation Committee should be elected among independent directors who have assumed office as members for a couple of years (except where the Committee is just established). Company's directors who also assume office as corporate officers, where applicable, must not occupy a majority of members and be given voting rights. The member's term of office shall not be extended for a long term (example: four years and longer). We aim to develop a framework of Committee that only consists of independent directors in the next five years.

(3) Full and objective internal and external information shall be provided to external committee members so that they are able to make informed decisions.

(4) The opportunity to discuss CEO remuneration shall be given only to external committee members.

(5) The purpose, authority, and regulations of the Compensation Committee shall be stipulated.

(6) The Compensation Committee will make decisions on suitable compensation levels for individual executives when they achieve good business performance using examples from the Guidelines on Executive Compensation in conformity with the creation of corporate value in the mid- and long-term.

(7) The Compensation Committee will submit a statement of activities for each fiscal year to both the Board of Directors and the Board of Auditors, also required to release an annual statement that discloses the following items on Executive Compensation under “Corporate Governance” in the annual report.

(a) Particulars of the Committee

(b) Authority and regulations of the Compensation Committee stipulated

(c) Statement of activities for each fiscal year (what, when, and how they were determined).

Dialogue with institutional investors Committee

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