Response to your Request for Comments on the 5% ROE Policy for Japan

Response to question:

2) Are there any scenarios other than a bailout or restructuring that warrant an exception to the proposed policy?

a) While the concept of factoring ROE or other capital efficiency measures into director elections as a message to management is an excellent one, we are concerned that the policy as currently proposed may be viewed as a crude "one size fits all" approach, since there are companies that are in investment mode (or asset write-off/write-down mode) for which it would not necessarily be good management to cut back on investments and/or other costs that build future value in order to be sure of hitting a 5% target. For instance, companies in industries such as biotech, pharmaceuticals, robotics, semiconductors, internet businesses, or various other industries that are expanding fast, replacing plant, or redirecting strategy, could fall in this category. Indeed, continuing fast expansion in a number of industries could lead to depreciation and other costs that could weigh down after-tax ROE for a number of years. At the same time, the rule could easily be "gamed" by simply selling real estate and other assets to generate extraordinary income gains sufficient to book a 5.1% ROE every fifth year.

For this reason, we agree with the concerns that presumably prompt the question being put out for public comment (question #2), to which we are responding. We believe that ISS needs a way insert some flexibility in its ROE rule without attempting to list out all the aforementioned types of possible situations as exceptions (since it is impossible to anticipate all of them). Further, ISS needs to do so without eviscerating the ROE policy's commendable goal of encouraging companies to focus more on overall return on investment and capital efficiency. It would be even better if ISS could at the same time send a message to the market that is constructive and actually helps achieve better returns, and is perceived in that way.

b) Related to this, now is an excellent time for ISS to confront the reality that under its present policies in Japan, in almost all cases it is recommending the approval of approximately 85% of new internally-promoted "inside directors" on no basis whatever other than the fact that a CEO-dominated nominations process arrived at those names. (This is the case because such persons almost never have any prior board experience, or anyt working experience at other companies, and there is not enough disclosure to determine their qualifications in terms of knowledge.) Obviously this group dominates each company's board, given its numbers.

Precisely because (unfortunately) this domination of boards by insiders is likely to continue at most companies for the foreseeable future, ISS's clients and their beneficiaries need to encourage Japanese companies to: a) create a fully-independent, objective nominations committee that is accountable for selecting the best possible board members with a forward-looking view; and b) train those candidates that they *can* easily train (the internal ones) in the skill sets that are most essential for good directorship - corporate law, governance best practice, finance, and reading financial statements, - prior to their approval as board members. If this could be done, ISS and its clients would have a rational basis for approving appointments, which at present they do not have. Moreover, since at present many Japanese executives do not have a firm base of knowledge about these topics when they join their company's board, ISS' policy would then be one that promotes the best conditions for generating higher shareholder value and ROE.

c) Therefore, we propose that ISS modify its proposed rule as follows:

"ISS proposes to recommend against top executive(s) at companies that have exhibited poor capital efficiency, defined as ROE of less than 5 percent in each of the last five fiscal years. However, it will not apply this rule for any company that:

a) has more than three independent outside directors who compose a fully independent nominations and compensation committee advising the board; and

b) has disclosed on its web site: (i) a corporate policy requiring the provision of substantial training and ongoing education for all directors and statutory auditors, which includes finance and governance best practices; and (ii) the general content and length of the training given in the prior fiscal year, and the names of all persons who received training."

We believe that this would be viewed as a very constructive way to send a message about the importance of increasing ROE and improving governance practices at the same time. In fact, as to disclosure about director training policy, the LDP Growth Strategy committee proposed something very similar in May of 2013.

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