Daiwa SB Investments

PM'S PERSPECTIVES

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Three Rules on Executive Remuneration

Is JPY141.1 billion an Appropriate Amount as an Executive Remuneration?

On 13 July 2018, executives of **ZOZO**, an online clothes shop (formerly Start Today) were awarded JPY141.1 billion (approximately USD1.25 billion) in stock options[1]. How do you feel about this figure? Is it appropriate? Or is it too much? If you feel it is too much, then how should executive remuneration be determined? ZOZO have started heated discussions, making executive remuneration a big topic amongst Japanese investors. In addition, with the Corporate Governance Code amended in June 2018, the government's policy on executive remuneration was reinforced. Given that executive remuneration is now a focal point for discussions on corporate governance in the United States, we can infer that the same phenomenon will happen in Japan as well. However, I suspect that corporate managers and those responsible for corporate governance are having difficulties in gathering relevant knowledge and putting the knowledge into practice with all those contentions and jargons.

Changes in the Corporate Governance Code with regard to executive remuneration[2]

- Supplementary Principle 4.2.1 The board of directors should design management remuneration systems and determine specific amounts of remuneration through objective and transparent procedures so that they work as a healthy incentive for sustainable growth. In doing so, they should set an appropriate ratio of remuneration which is linked to mid- to long-term performances as well as strike a balance between cash and existing shares.
- Supplementary Principle 4.10.1 (omitted) …by establishing independent advisory committees under the board, such as voluntary nomination committees and remuneration committees...

As a fund manager who is actually involved in ESG investments, I pay attention to the following three principles when it comes to executive remuneration: 1) whether executive remuneration is coupled with performance, 2) whether it is determined by outside parties, and 3) whether it doesn't impair corporate values. Putting aside detailed points or forms, if a company virtually fulfils these three principles, I judge that it has superior corporate governance in terms of executive remuneration.

The writer's approach to "three principles" of executive remuneration.

	Three Principles on Executive Remuneration	Goal of Principles	Future Tasks
1	It is linked to performance.	Align the interests of executives and those of shareholders.	Establish a structure in which remuneration is paid in accordance with performance. ("Pay for performance")
2	It is determined by external parties.	Prevent executives from deciding amounts of their own remuneration.	Establish remuneration committees which keep independence and disclose information.
3	It does not impair corporate values.	Avoid excessive risk-taking behaviour and excessive remuneration.	Enact guidelines on ownership of existing shares and ceilings of remuneration.

Management executives are representatives of employees at traditional large companies in Japan, so although their position is considered as at the top of the corporate ladder, their salaries are fixed. In the era of the main-bank system, this system was effective enough to contain risk. However, as equity governance (corporate governance driven by shareholders) prevails among Japanese companies, the view on executive remuneration is changing. It is now considered as an important tool to align the interests of executives with those of shareholders, with many people beginning to think that remuneration should move in tandem with performances ('Pay for performance'). While 70-90% of remuneration[3] for Chief Executive Officers (CEO) is linked to performance in Europe and the United States, only 36% is linked to performance in Japan[3], which has a lot of room to increase. When we implement "pay for performance", we should introduce measures in phases. We first award performance-linked remuneration to executives. Then we have to check whether key performance indicators (KPIs) contribute to increasing corporate values from the perspective of the shareholders, or whether remuneration is not virtually fixed in forms such as shares with restriction on transfer or JPY1 stock options.

Specific measures for “three principles” of executive remuneration

Three Principles	Step 1	Step 2	Step 3
It is linked to performance	Expand the proportion of performance-linked remuneration. (fixed: short-term performance: long-term performance = 1:1:1)	Re-examine KPIs of performance-linked remuneration. (select 1-3 indicators, such as EPS and ROE)	Raise the proportion of performance-linked remuneration further. (shares with restrictions on transfer → stock options)
It is determined by external parties	Establish Remuneration Committee.	Improve independence of remuneration committee. (chairperson and the majority of members must be independent)	Enhance information disclosure. (set rules on committees and disclose reports on activities)
It does not impair corporate values	Set up guidelines on ownership of existing shares. (CEO to own at least three times basic annual income)	Set a ceiling on remuneration. (e.g. no more than 100 times the annual income of employees)	Reinforce risk management mechanism. (clawback clause, bonus malus clause)

Source: Daiwa SBI, based on JACD “Guidelines on Executive Compensation (4th edition) and other materials

A key point is that external parties should determine the amount of executive remuneration. It is needless to say that a system in which executives determine their own salaries lacks good governance, but it is much the same if it is determined by individuals or organisations that are under the influence of executives. In order to avoid such conflicts of interest, it must be independent individuals outside the company that determine the amount of remuneration. Another issue which I would like to mention is that I feel keenly that we need greater expertise to design and determine remuneration systems. We need deep discussions among experts and persons with rich practical experiences in forums such as committees to create a remuneration system which contributes to the enhancement of corporate values. I strongly feel that one or two meetings over a year are not enough.

Once performance-linked remuneration increases, the next challenge is to prevent the impairment of corporate values through excessive remuneration or risk-taking behaviour. With regard to ceilings on remuneration, I personally advocate two rules; a pay ratio (median CEO remuneration divided by median remuneration for officers and employees) has to be 100 or below and performance-linked remuneration for the management team must not exceed 10% of net profits. I set a pay ratio at 100 because there is intense criticism against excessive executive remuneration in the US[3] whose pay ratio is 287 while there is less criticism in the United Kingdom[3] where the ratio is 95 and in Germany[3] where the ratio is 67. We also have to set a ceiling on management remuneration because JPY500 million (approximately USD4.5 million) for executives as performance-linked remuneration is too much for a company whose net profits are only JPY1 billion (approximately USD9 million). Japanese companies are well positioned to set out mergers and acquisition for short-term profits because they have excess cash. But they have only poor track records in this area, so I keep paying attention to how they mitigate the risk of erosion in corporate values by mergers and acquisitions (e.g. clawback provisions).

References

*1 Calculated based on the security report by ZOZO (formerly Start Today). 300,215 equity warrants x 100 shares x JPY4,699 (closing price on 13 July 2018 minus exercise price) = approximately JPY141.1 billion.

*2 Tokyo Stock Exchange (2018) “Corporate Governance Code (showing revisions)” https://www.jpx.co.jp/english/news/1020/b5b4pj000000jvxr-att/20180602_en.pdf

*3 Japan Association of Corporate Directors (2013) “Guidelines on Executive Compensation (3rd edition)” http://www.jacd.jp/en/resources/130412_03.pdf

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