

[Exposure draft]

## **Principles for Responsible Institutional Investors**

### **《Japan's Stewardship Code》**

**— To promote sustainable growth of companies through  
investment and dialogue —**

**The Council of Experts Concerning  
the Japanese Version of the Stewardship Code**

**December 26, 2013**

List of members of the Council of Experts Concerning the Japanese Version of the Stewardship Code

As of December 26, 2013

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(In Japanese alphabetical order)

## **“Stewardship responsibilities” and the role of the Code**

In this Code, “stewardship responsibilities” refers to the responsibilities of institutional investors to enhance the medium- to long-term investment return for their clients and beneficiaries (including ultimate beneficiaries; the same shall apply hereafter) by improving and fostering the investee companies’ corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge on the companies and their business environment.

This Code defines principles considered to be helpful for institutional investors who behave as responsible institutional investors in fulfilling their stewardship responsibilities with due regard both to their clients and beneficiaries and to investee companies. By fulfilling their stewardship responsibilities properly in line with this Code, institutional investors will also be able to contribute to the growth of the economy as a whole.

## **Background**

1. In December 2012, the government established the Headquarters for Japan’s Economic Revitalization within the cabinet to formulate necessary economic policy measures and growth strategies, aiming to revitalize the Japanese economy, breaking it away from the prolonged yen appreciation and deflation. In January 2013, the government established the Industrial Competitiveness Council under the auspices of the Headquarters, with the mandate to deliberate on growth strategies and their implementation, which would strengthen Japan’s industrial competitiveness and business activities abroad. Based on the discussions in the Council, and at a meeting of the Headquarters, the Prime Minister, in his role as the chief of the Headquarters, instructed the Minister for Financial Services to coordinate with other relevant ministers and consider, with the aim of promoting the sustainable growth of companies, principles for a wide range of institutional investors to appropriately discharge their stewardship responsibilities.<sup>1</sup>
2. The Cabinet approved in June 2013 the Japan Revitalization Strategy, which defines the growth strategy, or “the third arrow” of the economic policy of the current administration. The Strategy states that “principles (the Japanese Version of the Stewardship Code) for institutional investors to fulfill their fiduciary responsibilities, e.g. by promoting medium- to long-term growth of companies through engagements,” that is, “the principles for a wide range of institutional investors to appropriately discharge their stewardship responsibilities,

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<sup>1</sup> The sixth meeting of the Headquarters for Japan’s Economic Revitalization (April 2, 2013)

with the aim of promoting sustainable growth of investee companies, through constructive dialogue with them” should be discussed and drafted by the end of the year.

3. Implementing the instruction by the Prime Minister and the Strategy, the Financial Services Agency established the Council of Experts Concerning the Japanese Version of the Stewardship Code (hereafter, the “Council”) in August 2013. The Council has met five times since August, and it has now produced draft “Principles for Responsible Institutional Investors” 《Japan’s Stewardship Code》 (hereafter, the “Code”). The Council hereby publishes the draft to seek comments from all interested parties.

### **Aims of the Code**

4. As stated in the box at the beginning of this report, in this Code, “stewardship responsibilities” refers to the responsibilities of institutional investors to enhance the medium- to long-term investment return for their clients and beneficiaries by improving and fostering the investee companies’ corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge on the companies and their business environment. This Code defines principles considered to be helpful for institutional investors who behave as responsible institutional investors in fulfilling their stewardship responsibilities with due regard both to their clients and beneficiaries and to investee companies.

5. At a company, the board of directors has the responsibility to enhance the corporate value by exerting adequate governance and proper oversight on the management, taking decisions on key policy and business matters. The function of the board and that of institutional investors as defined in the Code are complementary and both form essential elements of high-quality corporate governance, which are indispensable in ensuring the sustainable growth of the company and the medium- to long-term investment return for the clients and beneficiaries. With due regard to the roles of both the board and institutional investors, the Code promotes constructive engagement, or purposeful dialogue, between institutional investors and investee companies. The Code does not invite institutional investors to interfere with the finer points of managerial matters of investee companies.

6. Activities by institutional investors done to discharge their stewardship responsibilities (hereafter “stewardship activities”) should not be seen to be confined to voting, although voting is an essential element of stewardship activities. Stewardship activities include proper monitoring of the investee companies and constructive engagement with them done to discharge the stewardship responsibilities to foster sustainable growth of the companies.

7. In the Code, two categories of institutional investors are identified: “institutional investors

as asset managers” (such as investment managers), which are entrusted to manage funds and invest in companies; and “institutional investors as asset owners” (such as pension funds and insurance companies), including providers of funds.

The “institutional investors as asset managers” are expected to contribute to the enhancement of the corporate value of investee companies through day-to-day constructive dialogue with them.

The “institutional investors as asset owners” are expected to disclose their policies on fulfilling their stewardship responsibilities and contribute to the enhancement of the corporate value of investee companies through their own actions and/or the actions of the asset managers, to which they outsource their asset management activities.

The asset managers should aim to know the intention of the asset owners so that they can provide services as expected, and the asset owners should aim to assess the asset managers in line with the Code, not placing undue emphasis on short-term performance.

Effective and appropriate stewardship activities by institutional investors ultimately aim at the enhancement of the medium- to long-term investment return for the clients and beneficiaries. Institutional investors and their clients and beneficiaries should both recognize that costs associated with stewardship activities are an indispensable element in asset management.

8. The Code primarily targets institutional investors investing in Japanese listed shares. The Code also applies to proxy advisors commissioned by the institutional investors.

### **“Principles-Based Approach” and “Comply or Explain”**

9. The principles in the Code should be applied in a manner suited to each institutional investor’s specific conditions and situations. For example, the manner in which the Code is implemented may differ, depending on such factors as the investor’s size and investment policies (e.g., whether the policies are oriented toward long-term or short-term returns, or active or passive strategies).

10. To allow for such flexibility, the Code adopts a principle-based approach instead of a rule-based approach; a principle-based approach in this context expects institutional investors to fulfill their stewardship responsibilities focusing on substance, while a rule-based approach would prescribe actions to be taken by investors in detail.

A principle-based approach may not be well known in Japan yet and some elaboration, such as the following, may be in order: even if principles may look abstract and broad on the surface, they can work effectively if relevant parties confirm and share the aim and spirit of the principles, and review their activities against the aim and spirit, not necessarily against the letter of the principles. In implementing the Code, institutional investors should respect such intent of the principle-based approach.

11. The Code is not a law or a legally binding regulation. The Council expects those institutional investors who support the Code and are prepared to accept it to publicly disclose their intention.

12. The Code adopts the “comply or explain” (comply with the principles or explain why they are not complied with) approach. If an institutional investor finds that some of the principles of the Code are not suitable for it, then by explaining a sufficient reason, the investor can choose not to comply with them. In other words, an institutional investor who made its intention to accept the Code public does not have to comply with all of the principles uniformly. Institutional investors, when they make the aforementioned explanation, should aim to articulate to clients and beneficiaries the approach they chose to adopt in lieu of the principles they have decided not to comply with.

13. The “comply or explain” approach may not be well known in Japan yet either. Both institutional investors and clients and beneficiaries are encouraged to familiarize themselves with the approach. In particular, due regard should be paid to the specific situations of the institutional investors who made their intention to accept the Code public; it is not appropriate to focus on the letter of the Code and automatically consider that an investor who does not comply with a part of it is not fulfilling its stewardship responsibilities.

14. To make institutional investors’ acceptance of the Code transparent, the Council expects institutional investors who accept the Code to:

- publicly disclose on their website their intention to accept the Code and information that are required to be disclosed by the principles of the Code, including the policy on how they fulfill the stewardship responsibilities and, if they do not comply with some of the principles, an explanation of the reason;
- annually review and update the disclosed information; and
- notify the Financial Services Agency of the address of their website (the URL) used to disclose the information above.

The Council also expects the Financial Services Agency to publish the information about the institutional investors who have made the disclosure in a tabular form.

15. The Council expects that the Code will continue to be improved in response to the progress in the implementation of the Code (including progress in acceptance and disclosure of required information) and in light of global developments. The Council expects the Financial Services Agency to take appropriate steps so that the Code will be reviewed periodically, about once every three years. Reviewing the Code periodically is supposed to enable institutional investors and their clients and beneficiaries to be better versed in the stewardship responsibilities, and help the Code to become more widely accepted in Japan.

## The Principles of the Code

So as to promote sustainable growth of the investee company and enhance the medium- and long-term investment return of clients and beneficiaries,

- 1. Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities, and publicly disclose it.**
- 2. Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.**
- 3. Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities and support the sustainable growth of the companies.**
- 4. Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.**
- 5. Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.**
- 6. Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.**
- 7. To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge on the investee companies and their business environment and capabilities to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.**

<b>Principle 1 Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities, and publicly disclose it.</b>
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### **Guidance**

- 1-1. Institutional investors should aim to enhance the medium- to long-term return on investments for their clients and beneficiaries by improving and fostering investee companies' corporate value and sustainable growth through constructive engagement based on in-depth knowledge on the companies and their business environment.
  
- 1-2. Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities (hereafter "stewardship policy") and publicly disclose it. The stewardship policy should cover how they define the responsibility and how they fulfill it, in view of their role in the investment chain running from their clients and beneficiaries to the investee companies.<sup>1</sup>

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<sup>2</sup> The policy may differ depending on the role of the investors. For example, it may differ between institutional investors who mainly manage funds, and those who mainly act as asset owners.

**Principle 2 Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.**

### **Guidance**

- 2-1. In conducting stewardship activities, an institutional investor inevitably faces the issue of conflicts of interest from time to time, for example when voting on matters affecting both the business group the institutional investor belongs to and a client or beneficiary. It is important for institutional investors to appropriately manage such conflicts.
- 2-2. Institutional investors should put the interest of their client and beneficiary first, and put in place and publicly disclose a clear policy on how they manage key categories of possible conflicts of interest.

**Principle 3 Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities and support the sustainable growth of the companies.**

### **Guidance**

- 3-1. Institutional investors should appropriately monitor investee companies so that they can fulfill their stewardship responsibility with the aim of enhancing the medium- to long-term corporate value and capital efficiency and supporting the sustainable growth of the companies.
- 3-2. Institutional investors should monitor investee companies continuously and review as appropriate the effectiveness of the monitoring.
- 3-3. When investors monitor investee companies, a variety of factors may be considered as relevant. Factors may include, for example, governance, strategy, performance, capital structure, and risk management (including how the companies address risks arising from social and environmental matters) of the investee companies. Relevance of a factor may depend on each investor's investment policy and may differ according to specific investee companies. Institutional investors need to use their own judgment in choosing which factors to focus on in light of their stewardship responsibilities. They should endeavor to identify at an early stage issues that may result in a material loss in the value of investee companies.

**Principle 4 Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.**

**Guidance**

- 4-1. Institutional investors should endeavor to arrive at an understanding in common with investee companies through constructive dialogue with the aim of enhancing the companies' medium- to long-term value and capital efficiency, and promoting their sustainable growth.<sup>3</sup> In case a risk of possible loss in corporate value is identified through the monitoring of and dialogue with companies, institutional investors should endeavor to arrive at a more in-depth common understanding by requesting further explanation from the companies and to solve the problem.<sup>4</sup>
- 4-2. Institutional investors should have a clear policy in advance on how they design dialogue with investee companies in various possible situations.<sup>5</sup>
- 4-3. The "OECD Principles of Corporate Governance" and the Tokyo Stock Exchange's "Principles of Corporate Governance for Listed Companies" set the principle of the equitable treatment of shareholders, which applies to the handling of undisclosed material facts. Institutional investors that have dialogue with investee companies should be aware that the companies are expected to abide by the principle and should in essence be discreet in receiving information on undisclosed material facts.<sup>6</sup>

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<sup>3</sup> Institutional investors should not to fall into formalism, such as to regard having a dialogue itself as the aim.

<sup>4</sup> Institutional investors may select investee companies with which they intend to engage with more in-depth dialogue in light of the outcome of previous dialogue.

<sup>5</sup> The policy can differ between, for example, asset managers and asset owners.

<sup>6</sup> When an institutional investor needs to receive information on undisclosed material facts due to a special relationship with an investee company, it should first take necessary steps to secure compliance with insider trading regulations, such as the suspension of trade of the company's stocks, before having a dialogue with the company.

**Principle 5 Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist: it should be designed to contribute to sustainable growth of investee companies.**

## Guidance

- 5-1. Institutional investors should seek to vote on all shares held. They should decide on the vote in light of the results of the monitoring of investee companies and dialogue with them.
- 5-2. Institutional investors should have a clear policy on voting and publicly disclose it.<sup>7</sup> Institutional investors should try to articulate the policy as much as possible. The policy should not be comprised only of a mechanical checklist: it should be designed to contribute to sustainable growth of the investee company.
- 5-3. Institutional investors should aggregate the voting records into each major kind of bill, and publicly disclose them. Such a disclosure is important in making more visible the consistency of their voting activities with their stewardship policy. However, the types of activities institutional investors give priority to in fulfilling their stewardship responsibilities can vary depending on such factors as their stewardship policy and investment policy, and the types of their clients and beneficiaries. If there is a reason to think a disclosure approach different from the disclosure in aggregate mentioned above would portray an investor's whole stewardship activities more appropriately, the investor may choose the approach while explaining the reason.
- 5-4. When institutional investors use the service of proxy advisors, they should not mechanically depend on the advisors' recommendations but should exercise their voting rights at their own responsibility and judgment and based on the results of the monitoring of the investee companies and dialogue with them. When disclosing their voting activities, institutional investors using the service of proxy advisors should publicly disclose the fact and how they utilize the service in making voting judgments.

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<sup>7</sup> When they have a practice of lending stocks across the determination date of the voting right, their voting policy should include a policy on lending stocks.

**Principle 6 Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.**

## **Guidance**

- 6-1. “Institutional investors as asset managers” should in principle report periodically to their direct clients on how they fulfill their stewardship responsibilities through their stewardship activities.<sup>8</sup>
- 6-2. “Institutional investors as asset owners” should in principle report at least once a year to their beneficiaries on their stewardship policy and on how the policy is implemented.<sup>8</sup>
- 6-3. When reporting to their clients and beneficiaries, institutional investors should choose the format and the content of the reports in light of any relevant agreement with the recipients and the recipients’ convenience, and the costs associated with the reporting, and should aim to deliver effective and efficient reports.<sup>9</sup>
- 6-4. Institutional investors should maintain a clear record of their stewardship activities, including voting activities, to the extent necessary to fulfill their stewardship responsibilities.

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<sup>8</sup> However, this shall not apply in the case where recipients of an individual report indicate that they do not need it. Also, if issuing an individual report to clients and beneficiaries is impractical, institutional investors may choose to publicly disclose the information in place of sending a report.

<sup>9</sup> Disclosure of secrets in asset management is not expected in the report.

**Principle 7 To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge on the investee companies and their business environment and capabilities to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.**

## **Guidance**

- 7-1. To make dialogue with investee companies constructive and beneficial, and to contribute to the sustainable growth of the companies, institutional investors should develop capabilities to appropriately engage with the companies and to make proper judgments based on in-depth knowledge on the companies and their business environment.
- 7-2. Institutional investors should have the necessary internal structure to have appropriate engagements and make proper judgments.
- 7-3. Exchanging views with other investors and having a forum for the purpose may help institutional investors conduct better engagement with investee companies and make better judgments. Institutional investors should review at an appropriate time samples of their previous engagements with investee companies and the judgments they made, and improve their stewardship policy and voting policy based on such review. Institutional investors should continually endeavor to improve the quality of their stewardship activities.