

Opinion statement concerning “Constructive Dialogue between Companies and Institutional Investors”

June 1st, 2016

Kazuhiko Toyama

In lieu of my attendance at the Eight Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code held on June 1st, 2016, I submit my opinions on the approach to “the way in which conflicts of interest appear in reality,” “exercise of voting rights,” “responsibility of the entruster,” and “promoting qualitative competition in stewardship activities” for the purpose of achieving “constructive dialogue between companies and institutional investors” as shown below.

**General remarks: To make the basis of the investment chain in the capitalist system function properly**

Fiduciary duty is a fundamental social norm that ensures the optimal capital allocation of funds, particularly risk money, to the growth sectors and businesses in order to connect the capitalist system to the accumulation of national wealth, particularly, household assets.

Therefore, the contents and application of the Stewardship Code that govern this fundamental norm **should be more strict and also capture the actual situation based on the way in which malfunctions appear in reality.**

**No. 1 Way in which conflicts of interest appear in reality—Necessity for governing individuals**

Conflicts of interest should be understood in a way that includes not only conflicts of interest between organizations (business relationship or parent company-subsidary relationship) but also between organizations and individuals. It should be more clearly defined in the Codes that those who are in a position of being entrusted with the management of other people’s assets, no matter whether institutions or the individuals who work there, should give priority to their fiduciary duty to asset owners above all else.

In the Japanese-style employment practice (*salaryman*-ism > professionalism), there exist a delicate relationship between parent companies and their subsidiaries and a delicate relationship between the organization and individuals (incentives that work on the individual in an organization). **In reality, conflicts of interest in organizations with such “salaryman” culture, in most cases, cause by the individual employee or the subsidiary acting distortedly due to excessive “conjecture” rather than explicit pressure from the parent company or head of the**

**organization.** (In fact, almost all of the recent cases of fraudulent data and deceptive accounting occur in this pattern.) In such cases, even if the formal requirements are in place in the organization as a unit, it may become a watered down system without any effectiveness. Therefore, the most effective way is to apply public external pressure in the form of the Codes and their operation down to the level of individuals working on the ground within the organization.

Hence, for example, as a guiding principle of conflicts of interest, **a proposal is to make each asset manager (individual) sign in to the Codes.** (Asset managers should be “professionals” in the same way as doctors and lawyers, and it should be natural to declare their acceptance of stewardship as a professional.)

## **No. 2 Exercise of voting rights—Outsourcing to a third party is abandonment of stewardship activities**

**With regard to exercise of voting rights, leaving all decision-making to a proxy adviser should not be permitted in the Codes.**

Fiduciary duty is, so to speak, a fundamental obligation of institutional investors. For this purpose, partial outsourcing is permitted only in cases where a relevant institutional investor can do so if they want to but cannot due to shortage of time or manpower.

**It is only natural for institutional investors to carry out engagement activities and cultivate their engagement ability** after narrowing down the portfolio companies based on some kind of conditions. Otherwise one would not expect them to be able to evaluate proxy advisers.

## **No. 3 Institutional investors as asset holders—Stewardship responsibility of entruster of asset management**

With regard to “institutional investors as asset holders” (such as pension funds and insurance companies), **they cannot be considered to have fulfilled their fiduciary duty if they leave all the decision-making to “institutional investors as asset managers” who are the outsourcing companies.** To fulfill their stewardship responsibilities, they should not only disclose the state of their Compliance (or Explanation) and participate in engagement activities through the outsourcing companies, but also **strive to raise the quality and quantity of the activities of the outsourcing companies, and make regular disclosures of the status of such activities to the asset owners (pensioners in the case of pension funds).**

#### **No. 4 Sound qualitative competition among institutional investors through peer pressure**

In the list of institutions that have declared their acceptance of the Codes compiled by the Financial Services Agency, there is a list of websites that have made announcements of “Disclosure items based on each principle of the Codes,” but when one follows the links, one will find that the contents described there differ greatly. **After the phase of increasing the number of companies that have declared their acceptance, we enter the next phase of continuously encouraging improvements in the quality of stewardship activities. In this regard, instead of simply considering formal declarations of compliance and prototype explanations to be acceptable, it is important that declarations are based on contents that can be monitored in terms whether a company is actually carrying out appropriate activities in substance.**

Accordingly, it is necessary to make it possible to line up the contents of declarations by various institutional investors side by side and compare them. In the first place, the frequency of “dialogue” itself or the number of formal requirements that are fulfilled are not things that companies should be competing on, so these might not be items that should be summarized in a scorecard, but **simply making it possible to obtain and compare all the contents of declarations made by each company, including institutional investors that have not declared their acceptance, will become a form of peer pressure that will encourage qualitative competition among institutional investors.**

All of the above are the opinions I submit as a required perspective particularly in the “Japan version” of the Stewardship Code to prevent the actual application of the Codes being emasculated by companies even as they are satisfying the formal requirements, and increase effectiveness.