

Secretariat's Explanatory Material

(Points to consider in formulating the Japanese
version of the Stewardship Code)

October 18, 2013

1. General introduction (the Preamble to the Japanese version of the Stewardship Code)

(1) Background and purpose of the Japanese version of the Stewardship Code

- The Japan Revitalization Strategy states that “with the aim of promoting the sustainable growth of companies,” the government will compile by the end of the year “the principles for a wide range of institutional investors to appropriately discharge their stewardship responsibilities through constructive dialogues with invested companies.” (Cabinet decision on June 14, 2013)
- The UK Code also states that stewardship aims to “promote the long-term success of companies in such a way that the ultimate providers of capital (managed by institutional investors) also prosper” and that “effective stewardship benefits companies, investors and the economy as a whole.”
- These two statements do not contradict each other; therefore, it is possible that the Japanese version of the Code will incorporate the intent of both statements.

(2) Stewardship responsibilities

- With regard to the responsibilities of institutional investors, the UK Code uses the expression “stewardship responsibilities” as a concept that includes not only “fiduciary duties” based on direct trust/trustee relationships but broader responsibilities to the “ultimate providers” of funds that institutional investors manage.
- Since the term “stewardship responsibilities” is not a familiar expression in Japan, it is possible that the Japanese version of the Code will use a term such as “responsibilities of institutional investors” as an expression that represents a similar range of responsibility.

(3) Institutional investors that the Code targets

[The scope of institutional investors]

- The Japanese version of the Code is a soft law (guidelines that have no legally binding force) and it is not required to clearly define the scope of application, as it would be for a law.

Therefore, it may be possible that the Code intentionally does not clarify (i.e., not define) the scope of “institutional investors” that are subject to the Code so that a wider range of entities would be able to accept the Japanese version of the Code.

(Note) The UK Code does not define “institutional investors” either.

- The roles required of institutional investors may differ between:
 - Institutional investors as asset owners; and
 - Institutional investors as asset managers

Therefore, it is possible that the Japanese version of the Code will provide different descriptions for the two types of institutional investors as needed.

(Note) The UK Code also provides different descriptions as above.

- Although proxy advisors and investment advisory companies are not institutional investors, they have significant influence when institutional investors carry out their “responsibilities as institutional investors” such as when exercising voting rights and deciding investment strategies.

In view of such matters, it is possible that the Code will state that the application of the Japanese version of the Code is expected to be extended to proxy advisors and investment advisory companies as well.

(Note) The UK Code also states that service providers such as proxy advisors and investment advisory companies are subject to extended application of the Code.

- Fulfilling the “responsibilities as institutional investors” will incur a certain amount of cost, but the acceptance level for such costs are thought to differ depending on the institutional investor’s size and investment policy (long-term or short-term investment, active or passive investment).

Therefore, it is possible that the Code states that there may be differences in the manner of the implementation of the Code depending on the size and investment policy of the institutional investor.

(Note) The UK Code also states that not all aspects of the Code apply to every signatory organization.

[Domestic and international]

- The Japan Revitalization Strategy states that the Japanese version of the Code should be formulated from the perspective of promoting the sustainable growth of companies.

Therefore, it may be possible that the Code states that the Japanese version of the Code was formulated with institutional investors in Japanese listed shares in mind, from the perspective of promoting the sustainable growth of Japanese companies.

(Note) The UK Code also targets institutional investors that invest in UK equity.

(4) Positioning of the Code, etc.

[Comply or Explain, etc.]

- As in the UK Code, it is possible that the Japanese Code will take a 2-step approach that is:
 1. First, whether to accept the Code or not (whether to be a “signatory”); and
 2. Those who accept the Code are not required to comply with all aspects of the Code and it would suffice to explain the reason for not complying with a certain principle, etc. (Comply or Explain).

- Furthermore, it is possible that the Code will not apply “Comply or Explain” to all of its contents and might separate matters into the following two types:
 1. Matters that require explanation if they are not complied with (“should do xx”); and
 2. Matters that do not require explanation if they are not complied with, such as advanced efforts and matters that are not deemed appropriate to be currently uniformly applied by the Code (“it is desirable to xx” or “it is possible that xx,” etc.)

- From the perspective of visualizing institutional investors' acceptance of the Code and to increase public awareness of the Code, the following measure might be required from "institutional investors" that accept the Code:

- Announcement on the company's website that they accept the Code and their compliance with each principle (if they do not comply with a certain principle, an explanation of the reason); and
- Notification of the content of the announcement to the Financial Services Agency.

How about the Financial Services Agency announcing the list on this basis?

- Also, with regard to matters that require regular announcement such as the results of the exercise of voting rights, the following may be required:

- Announcement on the company's website; and
- Notification of the announcement URL to the Financial Services Agency.

How about the Financial Services Agency announcing the list of URLs on this basis?

[Periodic monitoring]

- It is expected that the Japanese version of the Code will seek to further improve its content according to its implementation status.

In view of such points, it is possible that the Japanese version of the Code will state that it will be periodically reviewed (every three years, for example).

(Note) The UK Code is regularly reviewed (every two years).

[Others]

- In Japan, where rules-based regulations are common, there is a concern that a principles-based approach, which contains matters that may sound obvious, might tend to be downplayed.

In view of such matters, it is possible that the Japanese version of the Code will state the significance of the principles-based approach.

Is it appropriate to consider that the significance of a principles-based approach is for the parties concerned to share and reconfirm the intentions and spirit of the principle, even if it seems obvious, and make judgment whether their own actions (not in the formal sense of the word) are truly appropriate or not in view of such intentions and spirit?

- In order to promote constructive dialogue between institutional investors and the investee companies, it is believed that not only the efforts of the institutional investor side but also the company side are important.

Therefore, the Japanese version of the Code might state that it expects companies to also make efforts for constructive dialogue such as securing time for investors to fully consider the agenda of the shareholders' general meeting.

Specifics (“Each principle” of the Code)

- What points should be noted in formulating the principles and guidance of the Japanese version of the Code?

■ Principle 1

Outline of the UK Code

Principle 1: Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities.	
Guidance	1. Institutional investors should disclose their policy on how they apply stewardship with the aim of enhancing and protecting the value for the ultimate beneficiaries and clients.
	<ul style="list-style-type: none">● The policy reflects the activities of each institutional investor within the investment chain and the responsibilities that arise from those activities● The policy regards the investment process broadly and describes arrangements for integrating stewardship within its process
	2. Where activities are outsourced, the statement should explain how this is compatible with the proper exercise of the institutional investor’s stewardship responsibilities and what steps the investor has taken to ensure that they are carried out in a manner consistent with the approach to stewardship.

- Would there be any problem in using the framework of the UK Code?
 - [Above 2.]: Would there be any problem in using the framework of the UK Code including points of attention in cases where an asset owner outsources operations to an asset manager or when an institutional investor outsources operations to a voting advisory or investment advisory company?

■ Principle 2

Outline of the UK Code

Principle 2: Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed.	
Guidance	1. Institutional investors should put in place, publicly disclose a policy for identifying and managing conflicts of interest with the aim of taking all reasonable steps to put the interests of their client or beneficiary first.
	<ul style="list-style-type: none">• They should also address how matters are handled when the interests of clients or beneficiaries diverge from each other

- Would there be any problem in using the framework of the UK Code?
 - In the hearings at the previous meeting (second meeting), there was an opinion stating that the principle (management of conflicts of interest) has already been addressed in general.

■ Principle 3

Outline of the UK Code

Principle 3: Institutional investors should monitor their investee companies.	
Guidance	1. Monitoring should take place regularly and be checked periodically for effectiveness.
	2. When monitoring companies, institutional investors should seek to:
	(a) keep abreast of the company's performance
	(b) keep abreast of developments, both internal and external to the company, that drive the company's value and risks
	(c) satisfy themselves that the company's leadership is effective
	(d) satisfy themselves that the company's board and committees adhere to the spirit of the UK Corporate Governance Code, including through meetings with the chairman and other board members
	(e) consider the quality of the company's reporting
	(f) attend the General Meetings of companies in which they have a major holding, where appropriate and practicable
3. Institutional investors should consider carefully explanations given for departure from the UK Corporate Governance Code and make reasoned judgements. They should be prepared to enter a dialogue if they do not accept the company's position.	
4. Institutional investors should endeavour to identify at an early stage issues that may result in a significant loss in investment value. If they have concerns, they should share the recognition with the management of the invested company.	
5. Institutional investors may or may not wish to be made insiders. An institutional investor who may be willing to become an insider should indicate the willingness to do so, and the mechanism by which this could be done.	

- While basically using the framework of the UK Code, it might be possible to make amendments in the following points:
- [Principle 3]: In view of the fact that the Japan Revitalization Strategy states that the Japanese version of the Code should be formulated with the aim of promoting the sustainable growth of companies, it is possible that the body text of Principle 3 states that institutional investors should monitor the companies they invest in based on the perspective of promoting the sustainable growth of the companies.
 - [Above 2.]: How to consider listing individual monitoring items as in the UK Code.
 - Listing individual monitoring items might lead to the misunderstanding that it would suffice to focus only on the listed items.
 - As to which of the various items should be paid attention to in monitoring the invested companies should be judged by the institutional investor itself and not by individually listing the items in the Code.
 - [Above 5.]: With regard to the handling of insider information (“undisclosed material facts”), the UK Code assumes that selective disclosure is made to certain shareholders who wish to become an insider. However, in the hearings at the previous meeting (second meeting), there was an opinion stating that there was no request to become an insider from the viewpoint of equitable treatment of shareholders.

The Japanese version of the Code might need to include a statement based on this point.

■ Principle 4

Outline of the UK Code

Principle 4: Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities.

Guidance	1. Institutional investors should set out the circumstances in which they will actively intervene.
	<ul style="list-style-type: none"> • Instances when institutional investors may want to intervene include when they have concerns about the company's strategy, performance, governance, remuneration or approach to risks, including those that may arise from social and environmental matters.
	2. Institutional investors should regularly assess the outcomes of intervention.
	3. Intervention should be considered regardless of whether an active or passive investment policy is followed.
	4. If companies do not respond constructively when institutional investors intervene, then institutional investors should consider whether to escalate their action, for example, by:
	(a) holding additional meetings with management specifically to discuss concerns
	(b) expressing concerns through the company's advisers
	(c) meeting with the chairman or other board members
	(d) intervening jointly with other institutions on particular issues
	(e) making a public statement in advance of General Meetings
(f) submitting resolutions and speaking at General Meetings	
(g) requisitioning a General Meeting, in some cases proposing to change board membership	

➤ How to consider the further escalation of intervention in the invested company based on the results of intervention as in the UK Code.

— [Principle 4]: Based on the results of institutional investors' involvement in the investee companies, it might be possible that the Japanese version of the Code states that institutional investors should place emphasis on making efforts to “arrive at an understanding in common with investee companies” and “solve problems” through purposeful dialogue with the investee companies, instead of further escalating involvement.

- In the hearings at the previous meeting (second meeting), there was an opinion stating that the investor addresses a problem that occurred at a investee company by requesting an explanation in more detail, etc., but they took no actions to further escalate involvement in the company.

— [Above 4.]: How to consider listing detailed methods of involvement in the invested company as in the UK Code.

- Listing methods of involvement in the invested company in detail may lead to routine handling of the matter.
- With regard to involvement in the invested company, which of the various methods investors should take could be up to the institutional investors themselves instead of listing individual methods in the Code.

Rather, it is possible that the Japanese version of the Code states that institutional investors should establish a clear policy on their method of involvement in the invested company according to actual stages of events.

■ Principle 5

Outline of the UK Code

Principle 5: Institutional investors should be willing to act collectively with other investors where appropriate.	
Guidance	1. Institutional investors should disclose their policy on collective engagement.
	2. Institutional investors should indicate their readiness to work with other investors if needed. The disclosure should also indicate the kinds of circumstances in which the institutional investor would consider participating in collective engagement.

- Cooperating with other investors and taking action toward individual investee companies, as in the UK Code, may not fit in the actual conditions of Japan.
 - In the hearings at the previous meeting (second meeting):
 - There was an opinion stating that investors exchange opinions regarding matters such as their general thoughts on voting instead of specific issues regarding individual companies they invest in.
 - There was also an opinion stating that cooperating with other investors to take some kind of action toward individual companies they invest in is not done in reality from the viewpoint of maintaining relations of trust with the investee company as well as confidentiality requirements.

■ Principle 6

Outline of the UK Code

Principle 6: Institutional investors should have a clear policy on voting and disclosure of voting activity.	
Guidance	1. Institutional investors should seek to vote all shares held. They should not automatically support the board. If they have been unable to reach a satisfactory outcome through active dialogue then they should register an abstention or vote against the resolution.
	2. Institutional investors should disclose publicly voting records.
	3. Institutional investors should disclose the use made, if any, of proxy voting or other voting advisory services. They should describe the scope of such services, identify the providers and disclose the extent to which they follow, rely upon or use recommendations made by such services.
	4. Institutional investors should disclose their approach to stock lending and recalling lent stock.

- Would there be any problem in utilizing the framework of the UK Code?
- [Principle 6]: With regard to the policy on voting, it is possible that the Code states that it should be clearly defined and that it should not only stipulate formal standards but also contribute to the sustainable growth of companies.
 - [Above 2.]: With regard to investee disclosure of voting activity, the UK Code does not require to disclose individual voting records. How should the Japanese version of the Code consider this matter?
In the hearings at the previous meeting (second meeting):
 - It was reported that in the UK, around 65% of investment institutions disclose the results of voting in some form, but only about 44% disclose the results for individual companies they invest in.
 - [Above 3.]: With regard to voting, it is possible that the Code states that even when using external voting advisory agents, investors should not automatically rely on their recommendations but vote under their own responsibility and judgment based on the content of the dialogue with the invested company and other matters.

■ Principle 7

Outline of the UK Code

Principle 7: Institutional investors should report periodically on their stewardship and voting activities.	
Guidance	1. Institutional investors should maintain a clear record of their stewardship activities.
	2. Asset managers should regularly account to their clients or beneficiaries as to how they have discharged their responsibilities.
	3. Asset owners should report at least annually to those to whom they are accountable on their stewardship policy and its execution.
	4. Asset managers should obtain an independent opinion on their engagement and voting processes. The existence of such assurance reporting should be publicly disclosed. If requested, clients should be provided access to such assurance reports.

- While basically utilizing the framework of the UK Code, it might be possible to make amendments in the following points:
 - [Above 2. and 3.]: While it should be report to entrusters in principle, considering that situations can be expected in practice where, for example, the entruster itself does not require reporting or there is no method to report individually to final beneficiaries, it may be necessary to state that institutional investors may choose to publicly disclose the contents in place of an individual report in such cases.
 - [Above 4.]: Obtaining an assurance report seems to be hardly done in reality even in the UK. In view of this, it may not be necessary to require an assurance report in the Japanese version of the Code.

■ The principles unique to the Japanese version of the Code

- What kind of principles unique to the Japanese version of the Code can be considered?
 - In the previous meeting (second meeting), there was an opinion stating that it was important for the investor side to possess a certain amount of knowledge in order to engage in fruitful dialogue with companies.
 - Based on this, it is possible that the Japanese version of the Code incorporates its own unique principles such as requiring institutional investors to possess the capabilities to carry out appropriate dialogue and judgment based on a high level of knowledge and deep understanding so that they will contribute to the sustainable growth of the investee companies.
 - In doing so, it may be possible that the Code states the following as a guidance of such principles:
 - Institutional investors should make efforts to gain a deep understanding of the investee company or the industry that the company belongs to;
 - Institutional investors should prepare a system necessary for carrying out appropriate dialogue and judgment based on a high level of knowledge and deep understanding; and
 - Institutional investors should carry out ex-post facto verifications on whether their dialogue and judgment were appropriate or not.
- What else can be considered other than the above examples?