Provisional translation

November 30, 2016

Effective Stewardship Activities of Institutional Investors

– To Enhance Constructive Dialogue toward Sustainable Corporate Growth –

The Council of Experts Concerning the Follow-up of Japan's Stewardship Code
and Japan's Corporate Governance Code
Opinion Statement No. 3

I. Introduction

Sustainable growth of companies serves as the source of the wealth of the entire nation through increased employment opportunities, higher wages, and higher returns on investment. In order for a company to achieve sustainable growth while coping with the ever-changing operating environment, the management needs to make correct foresighted business decisions, and the board needs to set an effective strategic direction for business management and carry out effective oversight of management. Under such leadership by the management and the board, it is important for companies to work appropriately with various stakeholders, make capital investments, carry out research & development, and grow human resources in line with its management strategy, managing the company from a mid- to long-term perspective.

To promote such business management, it is important to further Japan's advance corporate governance reform efforts. In response to the implementation of the Stewardship Code and the Corporate Governance Code, as well as the public release of this Follow-up Council's opinion statement on corporate boards, the necessary framework for reform has been developed. The key challenge now is to deepen reform, moving its focus from Form to Substance.

To this end, institutional investors (i.e., asset managers and asset owners, including pension funds), need to recognize each other's respective roles in the investment chain that extends from ultimate beneficiaries to investee companies and have in-depth constructive dialogue with investee companies with respect to the companies' business strategies and challenges in creating sustainable growth, taking into account company-specific circumstances and the surrounding operating environment.

This Opinion Statement offers recommendations for both asset managers and asset owners with regard to efforts to be made in order to deepen corporate governance reform and move its focus from Form to Substance.

II. Effective Stewardship Activities of Asset Managers

Institutional investors – especially asset managers who are mandated to manage the funds of pension funds and other asset owners and who directly carry out dialogue with investee companies – should be expected to conduct effective stewardship activities based on in-depth corporate valuations and taking a mid- to long-term perspective, instead of merely focusing on short-term performance. Furthermore, in doing so, it is important for institutional investors to make careful judgments by taking note of the particular circumstances of individual companies, instead of mechanically applying formal criteria or depending on proxy advisors.

1. Asset Managers' Governance and Management of their Conflicts of Interest

When asset managers undertake effective stewardship activities, it is essential for the asset managers to place priority on the interests of asset owners and ultimate beneficiaries, thus ensuring that their activities are client-centered. Moreover, with respect to asset managers which belong to financial groups, although they may have in place measures to avoid conflicts of interest between their parent companies and their own clients and eliminate the influence of such conflicts, there are many cases where such measures are not necessarily working well. Accordingly, it has been pointed out that they need to address conflicts of interest in a more finely-tuned manner. The same need for conflict management was also pointed out with respect to the case of financial institutions who are engaged in both asset management and non-asset management businesses within the same entity.

Asset managers, therefore, should make the following efforts in order to improve their own governance and manage potential conflicts of interest between asset managers and their parent companies (and any other parties).

(1) Enhancement of Asset Managers' Governance

In order to secure the interests of ultimate beneficiaries and prevent conflicts of interest, asset managers should have in place, for instance, such governance structures as independent boards and/or third-party committees for making proxy voting decisions and carrying out oversight.

Enhancing asset managers' governance would serve the interests of ultimate beneficiaries and also build trust in asset managers when discussing corporate governance with investee companies, thus increasing the effectiveness of dialogue.

(2) Management of Conflicts of Interest

Asset managers should identify specific circumstances that may give rise to conflicts of interest which may significantly influence the exercise of voting rights and/or dialogue with companies, and set out and disclose specific policies on measures for avoiding such conflicts and/or nullifying the effects of such conflicts, thus securing the interests of ultimate beneficiaries.[1]

---

[1] Although the Stewardship Code includes the principle which requires institutional investors to set and disclose a policy to manage conflicts of interest, there are cases where such policies lack details or specifics.

(Notes)

- For example, the following circumstances may give rise to potential conflicts of interest, which may significantly influence the exercise of voting rights and/or dialogue:
  - Where another company in the same financial group as the asset manager or another department within the asset manager offers financial products/services to the investee company
  - Where the asset manager is mandated to manage a pension fund of an investee company

- The following are examples of measures taken in other countries in cases where there are conflicts of interest in the exercise of voting rights:
  - An independent body in the asset manager deliberates and decides on the proxy vote and retains a record of the deliberation
  - The provision by the asset manager of its own proxy voting guidelines to an independent third-party and then relying upon the independent third-party's judgement in the proxy vote

(3) Capabilities/Experience and Responsibilities of Asset Manager's Senior Management Team

An asset manager's senior management team should have adequate capabilities and experience to effectively fulfill stewardship responsibilities, and the team composition should not be based on the internal logic of the financial group to which the asset manager belongs.

The senior management team of an asset manager should also recognize that they have the responsibility to carry out the important tasks of enhancing dialogue with companies, strengthening corporate governance, and managing conflicts of interest, as well as establishing an organizational structure and developing human resources for the implementation of these tasks.

2. Enhanced Disclosure of Voting Results

With the intent to enhance the visibility as to whether institutional investors properly exercise their voting rights, the Stewardship Code requires institutional investors to disclose their voting records, by aggregating them by major categories of proposals. It has, however, been pointed out that in some business segments, only a small percentage of institutional investors disclose aggregate voting results. To secure the transparency of the exercise of voting rights, it is important that both asset managers and asset owners carry out this disclosure.

Furthermore, to fulfill their accountability to ultimate beneficiaries with regard to their activities and to enhance their transparency, it is important that both asset managers and asset owners disclose their voting results at the company/proposal level, taking a step forward from aggregate voting disclosures. In this respect, in the United States, the U.S. Securities and Exchange Commission (SEC) rules on investment funds require disclosures of voting results at the company level with the intent to enhance the transparency of voting activities. In the UK, while there is no such regulatory requirement, for the purposes of enhancing accountability and managing conflicts of interest, institutional investors' company-level disclosures of their voting results are not uncommon. In light of this trend in other countries, company-level voting disclosure can be considered an effective way of ensuring that both asset managers and asset owners exercise their voting rights truly in the interest of ultimate beneficiaries. Moreover, such a practice where both asset managers and asset owners clearly explain in public their reasons for voting “for”, “against” or “abstain”, as necessary, can contribute to increasing transparency.

In contrast, some argue that it is sufficient that company-level voting disclosures be made to pension funds and other asset owners who have given mandates to asset managers.[2] Some also express concern that company-level voting disclosures may result in attracting excessive attention solely to whether they cast “for” or “against” votes, encouraging asset managers to exercise their voting rights for form’s sake and emphasizing adversarial positions that interfere with positive dialogue between companies and investors.

However, the ultimate beneficiaries of asset owners consist of a wide range of individuals, including pensioners. In many cases, it could be said that the ultimate beneficiaries, including potential beneficiaries, are the Japanese citizenry itself. And it has been pointed out that the latter concern should be resolved through clear explanation by asset managers of the policies that underpin their voting decisions.[3] Furthermore, while many Japanese asset managers belong to financial groups, some have expressed concerns that there seem to be many cases where such asset managers do not adequately address the issue of conflicts of interest in the exercise of voting rights. In order to dispel such concerns, it is considered important that asset managers move toward company-level disclosures of voting results.

Therefore, in order to secure the interests of ultimate beneficiaries and to enhance transparency, both asset managers and asset owners should make it a general rule that they disclose company-level voting results to the public, not merely to asset owners, at a minimum based on a “Comply or Explain” approach. If it is not appropriate to disclose company-level voting results to the public based upon the specific circumstances of certain asset managers and asset owners, they should actively explain the reasons why.

3. Engagement in Passive Management

Recently, with the increase of Exchange Trade Funds (ETFs) and the proportion of passive strategies in equity investments by pension funds, passive management has constituted an increasing proportion of investing.

Unlike active management, passive management provides limited choice in

[2] In this regard, considering the fact that some asset owners concluded discretionary investment contracts with asset managers which do not provide for public disclosures of their company-level voting results, it has been pointed out that it is necessary to confirm the intention of such asset owners.

[3] It has been pointed out that companies should also make use of such proxy voting results and explanations on such voting decisions for constructive dialogue in the future, taking into account the intent of Supplementary Principle 1.1.1 of the Corporate Governance Code.

terms of selling shares of investee companies and greater need to facilitate increases in corporate value over the mid- to long-term. Accordingly, both asset managers and asset owners should conduct engagement activities (dialogue) more proactively and exercise voting rights from a mid- to long-term viewpoint. In doing so, it has been pointed out that concerned parties should consider specific methods of engagement in passive management as well as cost-sharing with respect to engagement activities.

From the perspective of enhancing effectiveness of passive management, the relevant parties are expected to consider appropriate investment processes, taking into account the actual market conditions – for example, by removing stocks which are deemed obviously inappropriate for investment from their passive index.

4. Self-Evaluation of Asset Managers

Asset managers should regularly conduct self-evaluations of their implementation of the Stewardship Code toward continued improvement of their governance structures, etc. and disclose the results to the public. Such self-evaluations are expected to help asset owners select and/or evaluate asset managers.

III. Effective Oversight by Asset Owners

In the investment chain asset owners are positioned closer to ultimate beneficiaries and have a direct responsibility to secure the interests of the ultimate beneficiaries. Taking this position into account and paying careful attention to ensure that asset managers' stewardship activities become more effective, asset owners need to move forward with the following efforts:

1. Asset Owners' Initiatives to Ensure Effective Stewardship Activities

Asset owners should conduct their own stewardship activities to the greatest extent possible in order to secure the interests of ultimate beneficiaries. Furthermore, in cases where they do not conduct stewardship activities involving their direct exercise of voting rights, they should require asset managers to carry out effective stewardship activities.

It is important for companies to make capital investments, carry out research & development, and grow human resources via mid- to long-term management strategies, while appropriately working with various stakeholders and taking into account various factors, including environmental and social factors[4], which may affect their sustainable growth. When asset owners and asset managers conduct stewardship activities, it is necessary to have in-depth constructive dialogue on various corporate challenges, including management strategies, in a way that facilitates such corporate efforts.

[4] Together with governance, these are often referred to as ESG (environmental, social and governance) issues.

Moreover, asset owners should realize that asset managers have stewardship responsibilities not only to the asset owners (and their ultimate beneficiaries), but also to other clients and other ultimate beneficiaries, and pay attention not to interfere with appropriate activities of the asset managers.

2. Clarifying What Asset Owners Expect from Asset Managers

When selecting and/or issuing mandates to asset managers, asset owners should clearly specify issues and principles with regards to their expectations for asset managers vis-a-vis stewardship activities, including the exercise of voting rights, in order to ensure effective stewardship activities. Large asset owners especially should keep in mind their positions/roles in the investment chain and articulate these stewardship issues and principles, including the exercise of voting rights, and proactively include their own considerations, instead of mechanically accepting asset managers' policies without any verification.

3. Effectively Monitoring Asset Managers

Asset owners should effectively monitor asset managers to ensure that their stewardship activities are aligned with their own policies, making use of the asset managers' self-evaluations. In conducting such monitoring, they should look at the quality of dialogue between asset managers and investee companies, instead of merely checking the number of meetings held between them and the duration of such meetings.

IV. Closing Remarks

Asset managers and asset owners play significant roles in facilitating companies to achieve sustainable growth. Asset managers and asset owners are expected to take into account the recommendations of this Opinion Statement and move forward with 'constructive dialogue' and efforts to deepen such dialogue. It is further expected that such dialogue will lead to sustainable corporate growth and improvement of the well-being of the Japanese people. These positive effects will lead to further corporate growth, thus supporting a virtuous cycle for the entire Japanese economy.

We believe that all of the recommendations in this Opinion Statement are important for institutional investors in order for them to effectively perform their stewardship responsibilities. The Follow-up Council expects that the Stewardship Code will be reviewed/revised, taking into account this Opinion Statement together with international discussions on stewardship responsibilities[5] as well as market practices under the Code.

[5] In June 2016, ICGN (International Corporate Governance Network), an international organization of institutional investors, issued "ICGN Global Stewardship Principles", which refers to governance of institutional investors. We consider it important to take such international discussions into consideration.