

CONSULTATION RESPONSE

FSA: PROPOSED REVISION TO THE JAPANESE STEWARDSHIP CODE

January 2020

For more information, contact

Will Martindale
Director of Policy and Research
Will.Martindale@unpri.org

Emmet McNamee
Senior Policy Analyst
Emmet.McNamee@unpri.org

PRI Association

Registered office: 5th floor, 25 Camperdown Street
London, UK, E1 8DZ Company no. 7207947
T: +44 (0) 20 3714 3220 W: www.unpri.org E: info@unpri.org



United Nations
Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

INTRODUCTION

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. Originally set up by the UN in 2005, the PRI now has over 2,600 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles globally with approximately US \$89 trillion in assets under management. 78 of these signatories, representing \$6 trillion, are based in Japan.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that ESG factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

SUMMARY OF THE PRI'S POSITION

The PRI welcomes the revised version of the Stewardship Code, which explicitly recognises the importance of sustainability (including ESG issues) in creating long-term value. In particular, the PRI welcomes:

- The inclusion of sustainability factors within the stewardship responsibilities of signatories
- The recognition that asset owners should take beneficiaries' viewpoints into consideration
- The extension of the Code to include other asset classes beyond listed equity

The PRI recommends that the FSA:

- (1) **Clarify definitions.** Interpretations of "sustainability" and "long-term" are often disputed. The Code should be clear that sustainability includes the impacts and externalities generated by investee companies, and that long-termism is defined by reference to the interests of beneficiaries rather than market participants.
- (2) **Ensure proxy advisor expectations are balanced.** The provision under Guidance 8-3 that advisors should provide the company's submitted opinion alongside its recommendation risks undermining advisors' ability to produce timely independent advice and should be removed.
- (3) **Encourage outcome-oriented engagement.** Including expectations that signatories set objectives in advance of engagements and be prepared to escalate when appropriate could improve outcomes from investor-company dialogue and contribute to long-term value creation.

(4) Include engagement with policymakers within investors' stewardship responsibilities.

Public policy has a substantial effect on the sustainability and stability of financial markets, and an investors' "policy footprint" is increasingly as important as their carbon footprint.¹

(5) Clarify legal guidance on collaborative engagement and acting in concert. Existing guidance² has led to some uncertainty as to the scope of engagement that would be subject to reporting requirements. The FSA should clarify that collaborative engagement on sustainability issues is permitted.

¹ <https://preventablesurprises.com/wp-content/uploads/2019/07/2019-07-19-Greenwish-Essay.pdf>

² <https://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf>

RESPONSE TO DETAILED QUESTIONS

PROPOSED REVISIONS TO THE CODE - GENERAL

Q1-1. What do you think about the new provision stipulating that “The Code primarily targets institutional investors investing in Japanese listed shares. In addition, the Code may also apply to other asset classes as far as it contributes to fulfilling the stewardship responsibilities mentioned in the heading of this Code.” (Preamble: “Aims of the Code”), revising the current Code assuming that institutional investors will invest in Japanese listed equities? And why do you think so?

The PRI supports the expansion of the Code to encompass other asset classes beyond listed equity.

The PRI’s view is that stewardship responsibilities extend to all asset classes. While different ownership rights attach to different asset classes, all provide opportunities for investor engagement and ‘pressure points’ where investors can influence outcomes and mitigate risks. The PRI requires signatories to report on various aspects of their responsible investment policies and activities for listed equity, fixed income, private equity, hedge funds forestry, farmland, infrastructure, property, commodities, cash and inclusive finance products, and provides a range of guides setting out how investors can incorporate ESG and be active owners.³

Q1-2. Are there any points to be noted when institutional investors apply the Code to other asset classes? Please provide reasons, if any.

No answer.

Q2. What do you think about incorporating issues of “sustainability (medium- to long-term sustainability including ESG factors)” in the Revision Draft? If such a phrase is incorporated, how should it be incorporated?

In addition, what do you think about the text of the Revision Draft expecting consideration of this issue in Principle 1 regarding the policy to fulfill their stewardship responsibilities? Please provide reasons, if any.

The PRI welcomes the inclusion of sustainability issues in the Revision Draft. Sustainability issues are fundamental to long-term value creation, a trend set to increase over time. The PRI recommends that the precise meaning of the terms “sustainability” and “long-term” are defined more clearly.

³ <https://www.unpri.org/investor-tools>

(i) *Sustainability*

The Stewardship Code notes that signatories should consider sustainability issues, which include ESG factors. The Code should clarify that sustainability issues also include the impacts and externalities generated by investments.

Principle 1 of the Principles for Responsible Investment states that signatories to the PRI “will incorporate ESG issues into investment analysis and decision-making processes.” This policy proposal is aligned with the intentions of over 2,600 signatories to the PRI which indicates widespread support for the integration of ESG factors in investment decision-making. The evidence is clear that ESG influences investment risk and return,⁴ but incorporation by investors remains mixed. The Code’s explicit references to ESG and sustainability are thus welcome.

Yet limiting sustainability to considerations of ESG issues on a company-by-company basis will often be too narrow a scope. A sustainable financial system should support sustainable and equitable economic development. Beneficiaries’ interest in financial returns relates to the usefulness of their savings in future. If the future is severely resource constrained, inequitable and insecure, beneficiaries are unlikely to receive the intended benefits of their savings.⁵

Consideration of the impacts and externalities of portfolio companies is therefore crucial for both long-term value creation and alignment with the interests of ultimate beneficiaries. Investors should seek to eliminate risks related to the market or economy as a whole, such as:

- An investee company strengthening its position by externalising costs onto others. The net result for the investor can be negative when the costs across the rest of the portfolio (or market/economy) outweigh the gains to the company
- An investee company or sector securing regulation that favours its interests over others. This can impair broader economic returns when such regulation hinders the development of other, more economic companies or sectors
- An investee company or sector successfully exploiting common environmental, social or institutional assets. Notwithstanding greater harm to societies, economies, and markets on which investment returns depend, the benefits to the company or sector can be large enough to incentivise and enable them to overpower any defence of common assets by others.

This is set out in further detail in the PRI’s recent discussion paper *Active Ownership 2.0 – the evolution stewardship urgently needs*, setting out the key shifts in investor behaviour necessary to preserve and enhance long-term value.⁶

⁴ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

⁵ <https://www.unpri.org/sustainable-financial-system/how-the-pri-is-contributing-to-a-sustainable-financial-system/199.article>

⁶ <https://www.unpri.org/download?ac=9721>

(ii) Long-term

The Code should clarify that “long-term” sustainability indicates sustainability over the time horizons of the ultimate beneficiaries of investments.

As noted in the Ito review⁷, Japan has a long-standing issue of both management and investor short-termism. Corporate CEO tenures tend to be between 4-6 years, while the incentives of asset managers, asset owners and sell-side analysts promote short-termism.⁸ In such a context, market participants’ understanding of what constitutes “long-term” may be warped. As such, the relevant provisions of the Code should be amended to “medium- to long-term sustainability consistent with the time horizons of beneficiaries”.

This mismatch in time horizons is particularly pronounced regarding climate change, which has come to be known as the “tragedy of the horizon”⁹. While long-term climate-related risks are financially material, financial intermediaries have shorter-term time horizons, leading to a failure to consider these risks and take corrective action.

Q3. What kind of measures should be stipulated to encourage asset owners, such as corporate pensions, to participate in stewardship activities?

Japanese pension schemes, subject to the regulatory oversight of the Ministry of Health, Labour and Welfare (MHLW) should be required to publicly disclose in their statements of investment principles and communications with beneficiaries:

- how they consider material ESG issues in their investment processes, including their policy on stewardship
- whether they are signatories to the Stewardship Code (and if not, why not).

While noting the encouragement given by MHLW to corporate pensions to sign the Stewardship Code in 2018 guidance, the PRI believes MHLW should further issue guidance to its regulated pension schemes to clarify that the consideration of material ESG factors in investment processes is required by the fiduciary duties to which they are subject. MHLW should also clarify that shareholder rights are assets to be used in the best interests of beneficiaries and require disclosure of the use of those rights by the scheme (and its managers) – as recommended by the report of the Japan Financial System Council.¹⁰

⁷ *Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors*, https://www.meti.go.jp/english/press/2014/0806_04.html

⁸ *Ibid.*, page 22.

⁹ <https://www.bankofengland.co.uk/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability>

¹⁰ <http://www.fsa.go.jp/en/news/2009/20090618-1/01.pdf>

The PRI has set out how corporate pension plans can be made more sustainable in its guide *Why corporate pension plans should mirror their sponsor's values* (価値観を一致させる- 企業年金基金にスポンサーを反映すべき理由).¹¹

Q4. What do you think about expecting asset managers to explain their reasons of “for” or “against” at proxy voting when they disclose voting results by individual company and agenda basis?

What do you think about Guidance 5-3 in the Revision Draft requesting institutional investors to “disclose the reasons of votes on the agenda of investee companies, either “for” or “against”, which are considered important from the standpoint of constructive dialogue with the investee companies, including those suspected to have conflicts of interest or those which need explanation in light of their voting policy?” And why do you think so?

The PRI supports this expectation under the Code.

Voting is an important aspect of stewardship; engagement and voting practices are interlinked and feed into each other. The voting policies and practices of asset managers are a key part of asset owners' selection process and should be sufficiently clear for asset owners to determine how aligned these are with their beneficiaries' interests.

Clear disclosure of the rationale for significant voting decisions will better enable the consideration and reflection of beneficiaries' viewpoints in stewardship activities foreseen in Guidance 1-3 as well as reduce concerns around conflicts of interest.

Q5-1. What do you think about the creation of the new Principle 8, concerning “service providers for institutional investors”, which requests that service providers for institutional investors develop structures for conflicts of interest management etc. (Guidance 8-1), and that proxy advisors develop human and operational resources as well as disclose their voting recommendation process (including the resources) (Guidance 8-2) and exchange views actively with companies upon necessity (Guidance 8-3)? And why do you think so?

The PRI welcomes the introduction of a Principle recognising the important influence that service providers such as investment consultants and proxy advisors may have on outcomes for clients and beneficiaries, and their duty to improve stewardship in Japan. The PRI recommends that aspects of Guidance 8-3 be amended to reduce the burden that they would place on proxy advisers and avoid hindering their ability to provide timely advice to investors.

Proxy advisory firms conduct important and necessary work of providing high quality, impartial analysis on ESG issues and link this analysis to voting recommendations based on institutional investors' stated priorities. The PRI's signatories use proxy advisory firms' recommendations to

¹¹ <https://www.unpri.org/download?ac=2989>

supplement their research and understanding of multiple, detailed and sometimes dense, proxies for their portfolio.

The PRI recommends removing the expectation under Guidance 8-3, in particular, that advisors “provide the submitted opinion of the company to its clients together with the recommendation”, on the following grounds:

- **It risks introducing further delays into an already compressed process.** Though an issue in many markets, the concentration of Annual General Meetings (AGMs) over a short period is particularly pronounced in Japan. Delays in receiving the company’s opinion could exacerbate investor difficulties in receiving proxy advice with adequate time to come to an informed decision about how to cast their vote.
- **It would rarely furnish investors with additional information.** Investors will already be furnished with investee companies’ filings and AGM documents and as such will be familiar with companies’ perspectives on why investors should support a given AGM proposal.
- **It encourages deference to management.** Companies will naturally be most interested in submitting their opinion with proxy advice when the advisor’s recommendation differs from that of management. This creates an asymmetrical effect whereby advisors can avoid additional costs by recommending a supportive vote for management.

Q5-2. What are the points to be noted regarding the scope of “service providers for institutional investors” when they include not only proxy advisors and investment consultants for pensions, but also may widely include institutions which have a function to contribute to asset managers and asset owners in carrying out effective stewardship activities? And why do you think so?

No answer.

Q6. Please provide comments and their reasons on revised provisions of the Revision Draft beside the above issues.

(i) *Encouraging outcome-oriented engagement*

A frequent criticism of shareholder engagement in Japan is that it is often formulaic and focused more on the quantity of engagements than their quality. This fails to support long-term value creation; as noted in the Ito review, “if the act of dialogue in and of itself becomes the purpose or if investors are not capable of having dialogue that contributes to a portfolio company’s sustainable growth, then institutional investors should bear in mind that such engagement may impede enhancement of corporate value and sustainable growth by wasting precious time of management.”¹²

¹² *Ibid.* note 7, page 114.

The Code could encourage better quality dialogue by encouraging investors to set objectives for their engagements where appropriate. Setting objectives in advance of engagements will lead to a greater focus on achieving outcomes. It will also provide asset owners with improved inputs for the selection and appointment of asset managers – in assessing a manager’s stewardship activities, asset owners would be able to consider the level of ambition of managers’ engagement objectives and the outcomes these managers contribute to, rather than the number of meetings held. This is a key focus of the PRI’s *Active Ownership 2.0* strategy.¹³

The Code should also explicitly encourage investors to escalate their concerns in the event of unsuccessful engagement. Shareholders in particular have a suite of options at their disposal where dialogue has not brought about the desired outcomes after a certain period of time; an unwillingness to use these tools can undermine the overall effectiveness of their engagement activities. 14% of the PRI’s Japanese signatories do not have an escalation strategy.¹⁴

Possible next steps after an unsuccessful engagement include¹⁵:

- communicating with the board: expressing concerns to corporate representatives or non-executive directors, either directly or in a shareholders’ meeting
- collaborating with other investors to increase pressure on the company
- issuing a public statement and organising a media campaign
- submitting shareholder resolutions in relation to the ESG issues of concern
- voting against the re-election directors who are responsible for the topic of engagement (i.e. risk and audit committee members)
- voting against the board of directors or the annual financial report
- submitting one or more nominations for election to the board
- seeking legal remedies or arbitration
- threatening to reduce exposure or divest

Ensuring the effectiveness of engagements is not a matter for asset managers alone; asset owners also have a fiduciary responsibility to ensure alignment between their beneficiaries’ interests and the stewardship activities undertaken on their behalf. Asset owners can do this by direct communications with their managers and by publicly endorsing initiatives which they regard as beneficial to long-term value. Where there is a disconnect between managers’ activities and beneficiaries’ interests, it is the responsibility of the asset owner to rectify this.

(ii) *Collaborative Engagement*

The FSA should update its legal guidance to clarify that investors seeking to collaboratively engage on sustainability/ESG issues will not be deemed to breach acting in concert rules or the “act of making important suggestions”.

¹³ <https://www.unpri.org/investor-tools/stewardship>

¹⁴ Based on responses to LEA 06.1 in the PRI’s 2019 Reporting Framework.

¹⁵ <https://www.unpri.org/listed-equity/a-practical-guide-to-active-ownership-in-listed-equity/2717.article> , p. 37.

The FSA provided initial guidance on this subject in 2014.¹⁶ In a previous stakeholder engagement process undertaken by the PRI,¹⁷ some stakeholders considered that the FSA's guidance provided a useful benchmark for structuring collaborative engagements in Japan. However, many stakeholders thought that the issued guidance provided insufficient clarity on the scope of collaborative engagement activities that could be conducted without tripping over reporting requirements.

While the FSA has clarified in communications with some individual investors that they may engage collaboratively,¹⁸ the absence of a written statement of this fact in the Code or FSA guidance has discouraged investors from collaborating. The PRI strongly encourages the FSA to provide a written clarification of the circumstances under which investors may engage collaboratively on sustainability issues.

(iii) *Encouraging policy engagement*

The FSA should include engagement with policymakers under the stewardship responsibilities of investors.

Public policy critically affects the sustainability and stability of financial markets, as well as social, environmental and economic systems. Public policy engagement by investors is therefore a natural and necessary extension of an investor's responsibilities and duties.

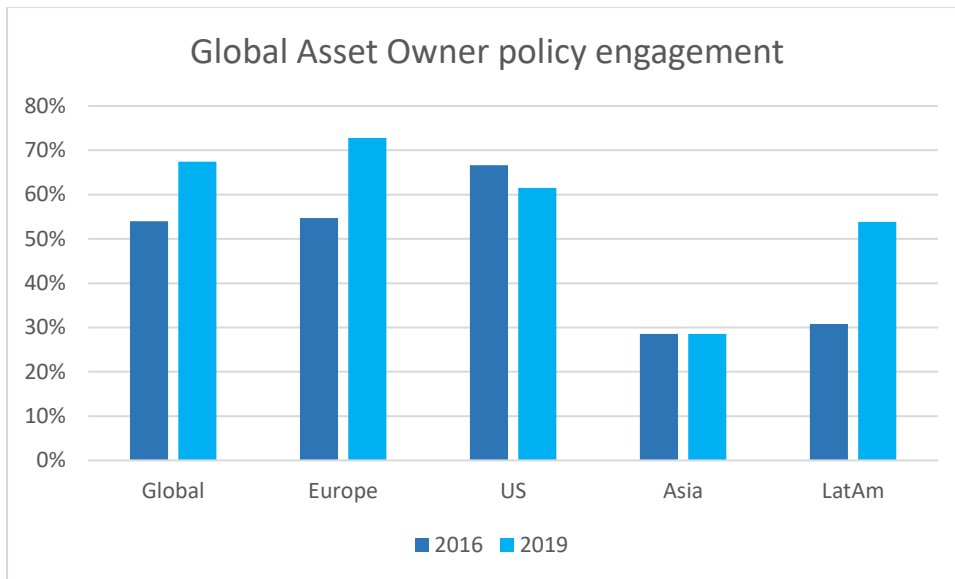
There is increasing recognition among investors of the importance of public policy engagement, with 61% of PRI signatories having engaged policymakers on sustainable finance issues in 2019, up from 44% in 2016.¹⁹ However, Asian asset owners were the least likely group to engage, despite their natural alignment with and responsibility for the long-term interests of beneficiaries.

¹⁶ <https://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf>

¹⁷ <https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-japan-roadmap/262.article>

¹⁸ <https://www.hermes-investment.com/wp-content/uploads/2018/10/revision-of-japans-stewardship-code-may-2017.pdf>

¹⁹ Based on responses to PRI's Reporting Framework.



The PRI has previously set out best practice on policy engagement;²⁰ to summarise:

- Commit resources to public policy engagement.
- Construct a strategic process for policy engagement.
- Clarify public policy positions.
- Collaborate on public policy engagement.
- Communicate to stakeholders regarding public policy engagement.

(iv) *Tiering*

The FSA should consider adopting a tiering exercise for signatories to the Code, similar to that undertaken by the Financial Reporting Council for the UK Stewardship Code.

For a code to be truly effective, the quality of reporting against it ought to become a tool for competitive differentiation between asset managers (and a relevant source of information for asset owners in manager selection procedures). The introduction of an accountability mechanism, such as annual reporting by signatories on the outcomes of their stewardship activities, accompanied by a tiering exercise by the FSA,²¹ could drastically improve the quality of engagement under the Stewardship Code, leading to sustained long-term value creation.

²⁰ <https://www.unpri.org/investor-engagement-in-public-policy-guidance-for-investors-and-policymakers/294.article>

²¹ The UK Financial Report Council under the previous Stewardship Code evaluated signatories' stewardship reporting in compliance with the Code. Depending on the quality of that reporting, signatories were ranked as Tier 1, Tier 2 or Tier 3. This assisted market participants to evaluate the stewardship quality of asset owners and asset managers, and sought to create a competitive advantage for good stewardship.