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Principles for Responsible Institutional Investors – Japan’s Stewardship Code

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Dear FSA team,

We very much welcome the opportunity to participate in the public consultation in relation to the revised Japan’s Stewardship Code (‘Code’).

Executive summary

- **We welcome the stronger emphasis on sustainability, including environmental, social and governance (ESG) considerations, in alignment with investment management strategies. We find, however, the reference to ‘in-depth knowledge of the [investee] companies’ (Principle 1) quite restrictive and infeasible in some instances, and we therefore advocate its removal. Also, a stronger emphasis on sustainability should be incorporated in Principle 3.**
- **The scope of the Code in relation to service providers needs to be clarified (in light of Principle 8).**
- **The Code should continue to focus on listed equity (at least for the time being).**



- **A refinement of the reporting requirements is necessary to stabilise the stewardship expectations, improve stewardship practices, and promote a ‘market for stewardship’. We support market-driven enforcement but advocate some refinement. For instance, the introduction of a Tiering system similar to the one adopted by the UK FRC could be one of the available options.**
- **The term ‘collaborative engagement’ needs to be clarified to avoid any ambiguity in light of the specificities of the Japanese context.**
- **Principle 8 on service providers is a welcome addition to the Code. The proposed requirement to set up a business establishment in Japan, however, is not practicable for smaller service provider firms. We also advocate that the Code could take inspiration from the Best Practice Principles Group for Shareholder Voting Research (BPP) to nudge – and not dictate – the dialogue between proxy advisors and companies.**

Short Biographies

Dr Dionysia Katelouzou is a Senior Lecturer in Law at the Dickson Poon School of Law, King's College London, specialising in the areas of comparative and transnational corporate governance, corporate law and financial market regulation, with a special interest in shareholder activism, investor stewardship and empirical legal studies. She holds a Ph.D. and an LL.M. from the University of Cambridge and an LL.B. from the University of Athens. Her articles have appeared in the *Journal of Business Law*, *Journal of Corporate Law Studies*, *University of Pennsylvania Journal of Business Law*, *Virginia Law and Business Review*, *Journal of Comparative Law*, among others. She is currently focusing on her forthcoming monograph, *Institutional Shareholders and Corporate Governance: The Path to Enlightened Stewardship* (Cambridge University Press, 2021) and is co-editing together with Professor Dan Puchniak (NUS) a Cambridge University Press Handbook on *Global Shareholder Stewardship: Complexities, Challenges and Possibilities*. Katelouzou is leading the [Global Shareholder Stewardship](#) research group, consisting of more than 60 members across 24 countries around the world.

Professor Konstantinos Sergakis holds an LL.B. from the National and Kapodistrian University of Athens, an LL.M. in International Business Law from University College London and a Ph.D. from the University Paris 1 Panthéon-Sorbonne. He is Professor of Capital Markets Law and Corporate Governance at the University of Glasgow. In 2017,



he was elected as a member of the Executive Board of the International Association of Economic Law (AIDE). He is the author of *The Transparency of Listed Companies in EU Law* (Sorbonne - IRJS Editions 2013) and of *The Law of Capital Markets in the EU* (Palgrave Macmillan 2018). His research interests are related to Corporate Law, Capital Markets Law and Corporate Governance.

Detailed comments on the proposed Japan's Stewardship Code (hereinafter 'Code')

1 We welcome the increasing emphasis on **sustainability**, including environmental, social and governance (ESG) considerations and the inclusion of such considerations in the definition of stewardship at the beginning of the revised Code (page 1, 'Stewardship responsibilities' and the role of the Code'). We also suggest that such considerations are clearly incorporated in the provisions accompanying Principle 3.¹

2 Para 10 – Scope of the Code

Following the introduction of the new **Principle 8**, we think that there is a mismatch between the scope of the Code as this is identified in **para 10** and the new Principle. We, therefore, suggest that you expand the scope of the code and specifically mention service providers with activities in Japan in para 10, but making clear that only Principle 8 is relevant for proxy advisors.

We also think that the reference to '**other asset classes**' in the second sentence of para 10 may not be appropriate given the way that the Code has been drafted. We agree that stewardship has an important role to play in investment beyond listed equity and this approach has been now adopted by the UK Stewardship Code 2020. But in the Japanese context, it seems that the regulatory emphasis on stewardship is focused on companies. This is reflected in the way that the revised Code defines stewardship (page 1) but also in **para 4** of the 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*

¹ For more on the potential of stewardship to promote sustainability, see Dionysia Katelouzou, 'Shareholder Stewardship: A Case of (Re)Embedding Institutional Investors and the Corporation?', in B. Sjøfjell and C. M. Bruner (eds), *Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability* (Cambridge University Press, 2019) 581-595.



investee companies' corporate value and sustainable growth through constructive engagement...?.

We suggest that for the time being the Code continues to focus on shareholder stewardship as a matter of corporate governance relations and once these expectations have been stabilised and stewardship practices in Japan have achieved the desired outcomes, the FSA considers the expansion of stewardship obligations to other assets.

3 **Para 14 – Enforcement and Reporting**

We agree with the upholding of the **'comply-or-explain'** principle in the Japanese context, despite the recent adoption of the 'apply-and-explain' principle by the UK Stewardship Code 2020. However, we share the concerns that have been previously expressed by Japanese academics in relation to the soft enforcement mode of the Code and the lack of a specific enforcement mechanism.² These are common concerns raised by the 'comply-or-explain' principle adopted by corporate governance codes and stewardship codes across the globe.³

To improve the enforcement of the Code we suggest that the FSA takes a more active role in supporting the enforcement of the Code and promoting a **'market for stewardship'**. While the assumption is that asset owners will monitor the stewardship statements and activities of asset owners, in reality Japanese pension funds tend not to sign to the Code due to collective action problems.⁴ While the introduction of hard law duties on pension funds to consider stewardship could be

² Hiroyuki Kansaku, *Nihon-ban suchuwadoshippu kodo no kihansei ni tsuite [On the Nature of the Japanese Stewardship Code as a Norm]*, in Etsuro Kuronuma & Tomotaka Fujita (eds.), *Kigyoho no shinro – Egashira Kenjiro sensei koki kinen [Future Courses of Enterprise Law - In Celebration of the 70th Birthday of Professor Kenjiro Egashira]* (Yuhikaku, 2017), 1005, at page 1014 and Mayumi Takahashi, *Sofuto ro to shiten no koporeto gabanansu kodo to suchuwadoshippu kodo [The Corporate Governance Code and the Stewardship Code as Soft Law]*, (2016) *JYU TO SEIGI*, Vol.67, No.7, 41, at 45, both cited in Gen Goto (2019) 'The Logic and Limits of Stewardship Code: The Case of Japan' 15 *Berkeley Business Law Journal* 365.

³ For the enforcement of stewardship norms see Dionysia Katelouzou and Konstantinos Sergakis, 'The Enforcement Dynamics of Shareholder Stewardship' in Dionysia Katelouzou and Dan Puchniak (eds.) *Global Shareholder Stewardship: Complexities, Challenges and Possibilities* (Cambridge University Press, 2020, Forthcoming). For an overview of the merits of social enforcement of shareholder duties, see Konstantinos Sergakis, 'Legal Versus Social Enforcement' in Hanne Birkmose and Konstantinos Sergakis (ed), *Enforcing Shareholder Duties* (Edward Elgar, 2019) 128.

⁴ For evidence, see Goto (n 2).



a way forward,⁵ an interim step would be for the FSA to introduce a **tiering exercise** following the example of the UK FRC.⁶ Such a public tiering could improve the transparency across the investment chain and promote the market for stewardship without any hard law being adopted. This is important if one considers that despite the high compliance rate with the Code's principles among the signatories,⁷ there is little change in actual practices.

We also recommend introducing a greater emphasis on **reporting on stewardship outcomes** rather than stewardship policies, following the UK Stewardship Code 2020. As an interim step you can refine the information provided in the list of signatories, putting more emphasis on the 'stewardship activity reports'.⁸ We also note that the 'stewardship activity reports' are not mentioned in the revised Code and this, in our view, impedes the creation of appropriate expectations in relation to transparency and reporting across the investment chain. You can also use the disclosure of voting results and the stewardship activity reports as benchmarks should you wish to include a public tiering exercise.

4 **Para 16**

We welcome in **para 16** the openness of the Code to periodic revision and improvement in light of global developments and in order to help the Code to gain wide acceptance. This is in line with our most recent research on the legitimacy and continuous importance of soft law stewardship norms, contained in codes or principles, that aim to justify such revision efforts on the basis of a harmonious symbiosis between soft law and semi hard law stewardship trends across the globe. As we show in our research, such efforts render even more legitimate stewardship codes or principles and assist market actors to a gradual improvement of their practices following a flexible and escalated absorption of requirements contained in soft law instruments.⁹ Our recommendations in this response help the Code to gain further legitimacy while aligning some of its critical features to national or international norm-setters.

⁵ I. H.-Y. Chiu and D. Katelouzou (2018) 'Making a Case for Regulating Institutional Shareholders' Corporate Governance Roles' *Journal of Business Law* 67.

⁶ On the benefits of such refinement of social enforcement, see Katelouzou and Sergakis, (n 3).

⁷ https://www.fsa.go.jp/en/refer/councils/stewardship/material/20170131_3.pdf

⁸ https://www.fsa.go.jp/en/refer/councils/stewardship/20191227/en_list_01.pdf

⁹ Dionysia Katelouzou and Konstantinos Sergakis (2020) 'When Harmonisation is not Enough: Shareholder Stewardship in the European Union' (in submission).



5 Principle 1

Principle 1-1: We welcome the inclusion of sustainability in alignment with investment management strategies. We nevertheless find the ‘in-depth knowledge of the [investee] companies’ quite restrictive as an underlying factor for institutional investor activities as such knowledge may not be feasible in all instances and can only be satisfied on an ad hoc basis.

Principle 1-2: We have a minor comment about footnote 6 (page 9), where we suggest that you explain the abbreviation ESG in the right order, that is ‘environmental, social and governance matters’. However, if you want to emphasise on governance, rather than environmental and social matters,¹⁰ then we suggest that you do not use the term ESG in the main text and you replace it with ‘social and environmental factors’ or ‘matters’ as you do in **Principle 3-3** (page 12). As the Code will continue to be improved in response to local, regional and global developments, you may want to consider the inclusion of climate change factors as one of the key environmental aspects of stewardship.

6 Principle 4

We propose that you incorporate some of the text included in **footnotes 13 to 17** to the main text. This will help investors to understand how you view ‘constructive dialogue’ and promote appropriate stewardship activities.

We welcome the proposed **Principle 4-2** related to the promotion of dialogue that leads to medium- to long-term increase of corporate value and the sustainable growth of companies.

We note that there is a change in the terminology and you now use the term ‘investment management strategy’ (see also **Principle 3-3**). We would like to see some more clarification in the use of this term as opposed to the terms (stewardship) ‘policy’ and ‘stewardship activity reports’ (see also Comment 3

¹⁰ See Dionysia Katelouzou and Eva Micheler ‘The Market for Stewardship in the UK: A Demand Side Analysis’ in Dionysia Katelouzou and Dan Puchniak (eds.) *Global Shareholder Stewardship: Complexities, Challenges and Possibilities* (Cambridge University Press, 2020, Forthcoming) (arguing that the combination of environmental and social factors with governance factors in the 2020 UK Stewardship Code may drown out the governance element – the cornerstone of stewardship – from the new Code).



above). Such a clarification could have a positive impact on the quality of stewardship reporting.

Principle 4-5: The change in the terminology from ‘collective’ to ‘**collaborative**’ engagement mirrors the revised UK Stewardship Code 2020. In the UK context, the use of ‘collaborative engagement’ prevents any misunderstanding as to the legal notion of ‘acting in concert’.¹¹ This is an issue that has been also addressed by the Japanese FSA in February 2014.¹² But the market and legal context in Japan is clearly different. The main aim of the Japanese FSA should be to solve the collective action problem (especially among pension funds). While we endorse the change in the terminology, we propose that the term ‘collaborative’ needs to be clarified to avoid any ambiguity. On the positive side, ‘collaborative engagement’, rather than ‘collective engagement’ may suggest the maintenance of individual identities and objectives and avoids triggering legal thresholds relating to ‘acting in concert’ activities. But, on the other hand, ‘collaborative engagement’ may imply an engagement that is supported not only by other institutional shareholders, but also the company itself. The latter, if adopted as the default option, may impede shareholder activism not only where there are disagreements amongst shareholders but also where there are disagreements between shareholders and companies (‘confrontational activism’).¹³ While ‘confrontational activism’ is not entirely compatible with the ‘hybridised’ Japanese firm or the ‘new community firm’,¹⁴ we find that dissenting opinions may be equally productive and constructive in terms of engagement outcomes and stewardship quality. We, therefore, propose that if ‘collaborative’ engagement’ is finally adopted following the public consultation period, the revised Code should provide more clarity on the term ‘collaborative’ in the Japanese context so as for the transition to this term (from ‘collective’) to be understood clearly by all investors and in a similar way. Such a clarification becomes even more necessary

¹¹ Iris H-Y Chiu and Dionysia Katelouzou, ‘In need of a revised Stewardship Code for ‘shareholder stewardship’ as a matter of corporate governance relations in UK listed equity’, Response to the FRC’s Proposed Revision to the UK Stewardship Code (January 2019), available at <https://www.frc.org.uk/getattachment/201c2704-302f-4fdd-a4d9-f1eb71b9539d/attachment.aspx>

¹² Financial Services Agency, Clarification of the Legal Issues Related to the Development of the Japan’s Stewardship Code (26 February 2014), available at <https://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf>

¹³ On ‘confrontational activism’ in the Japanese context, see John Buchanan, Dominic Heasang Dai and Simon Deakin, *Hedge Fund Activism in Japan: The Limits of Shareholder Primacy* (Cambridge University Press: Cambridge, 2012).

¹⁴ *Ibid*



if one considers that the first (2014) version of the Japanese Code deviated from the UK Code 2012 and did not make any reference to collective engagement.

7 **Principle 7**

We think that the updating of the wording of this principle is a step to the right direction. Requiring ‘**in depth knowledge** of the investee companies and their business environment’ is restrictive as an underlying factor for stewardship activities as such knowledge may not be feasible and can only be satisfied on an ad hoc basis. Requiring institutional investors to ‘develop’ the necessary skills and resources based among others on ‘in depth knowledge of the investee companies and their business environment’ allows for more flexibility, even though we still find the criterion of ‘in-depth knowledge of the investee companies’ to be difficult to be assessed and satisfied, especially for signatories with large portfolios.

8 **Principle 8**

We very much welcome the new **Principle 8** on service providers for institutional investors (proxy advisors) that depicts their importance within the investment chain and highlights the need to ensure transparency across this sector.

We advocate **Principle 8-1** on conflicts of interest (slightly amended to specify the public disclosure obligation). **Footnote 27** that specifies the various types of service providers could be inserted to the ‘Aims of the Code’ and further clarify the Code’s extended scope (see also Comment 2 above).

9 We find that **footnote 29** related to the disclosure of policy is a truly important component of the new proposed framework and should be integrated to the text of **Principle 8-2**.

Principle 8-2 can be reformulated as follows:

~~When~~ **Where** applicable, the proxy advisors **should** put in place **and publicly disclose** their policy for voting recommendations, ~~they should endeavor to articulate the policy as much as possible~~. The policy should not be comprised only of a mechanical checklist; **it should support clients’ stewardship and it should be designed to contribute to the sustainable growth of the subject company.**

The proxy advisors should develop appropriate and sufficient human and

operational resources, ~~including setting up a business establishment in Japan~~ in order to provide ~~asset managers~~ **their clients** with proxy recommendations based on accurate information on individual companies, and specifically disclose **to their clients** the voting recommendation process ~~including the above mentioned~~ to assure transparency.

We find the requirement to set up a business establishment in Japan not practicable for smaller proxy advisor firms that may well offer quality services even in the absence of such establishment and that may not have the capacity/resources to set it up locally.

10 Principle 8-3: Dialogue with companies

There are similar rules that aim to frame the dialogue between proxy advisors and investee companies across the globe. In Europe, for instance, the revised Shareholder Rights Directive (SRD II)¹⁵ that aims, among others, at improving corporate governance via encouraging effective and sustainable shareholder engagement and improving transparency along the investment chain, frames the *modus operandi* of proxy advisors via disclosure obligations. Proxy advisors are required to publicly disclose on an annual basis a variety of items related to the preparation of their research, advice and voting recommendations. One of the most relevant items for the purposes of this public consultation is the disclosure obligation on whether proxy advisors 'have dialogues with the companies which are the object of their research, advice or voting recommendations [...], and, if so, the extent and nature thereof'.¹⁶ The SRD II approach acknowledges therefore market reality and the need to maintain flexibility while nudging towards the maintenance of a dialogue with issuers.

In parallel, the Best Practice Principles Group for Shareholder Voting Research (BPP) has introduced, and recently revised, the Best Practices Principles, an international code of conduct with many interesting features that promotes transparency while acknowledging flexibility and the different profiles of proxy

¹⁵ Directive 2017/828/EU of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement [2017] OJ L132/1.

¹⁶ Ibid, Article 3j(2)(f).

advisory firms.¹⁷ Most importantly and in relation to the themes analysed on this occasion, Principle 3 of the BPP (Communications Policy) states that:

‘with regard to the delivery of Services, BPP Signatories should explain their approach to communication with issuers, shareholder proponents, other stakeholders, media and the public. BPP Signatories should disclose a policy (or policies) for dialogue with issuers, shareholder proponents and other stakeholders. BPP Signatories should inform clients about the nature of any dialogue with relevant parties in their research reports, which may also include informing clients of the outcome of that dialogue’.

Its guidance BPP further state that the disclosure of such policy should cover issues, such as ‘whether and how issuers are provided with a mechanism to review research reports or data used to develop research reports prior to publication to clients’. The BPP framework addresses in a targeted and efficient way such dialogue by carefully avoiding subjecting proxy advisors to a series of operational constraints.¹⁸

Contrary to the flexibility offered by the BPP norm, **Principle 8-3** implies that dialogue with companies should take place as a default option. Such a generalised approach may hinder the overall independence of the proxy advisory services. This risk becomes more apparent if one considers the recommendation of the same principle to ‘provide the submitted opinion of the company’ [at the latter’s request] to the proxy advisor’s clients together with the recommendation. Proxy advisors could instead develop such a dialogue where necessary and inform accordingly their clients of its outcome. Attaching the company’s opinion to the advisor’s recommendation without our recommendation (see below) may lead to a fragmented – and less useful – message to clients and misses the opportunity to convey educative messages to clients and enhance dialogue among market actors and companies.

We, therefore, propose that the Code could take inspiration from the respective BPP norm as mentioned above that allows for more flexibility in framing and

¹⁷ The Review Committee – Best Practices Principles Group, Best Practice Principles for Providers of Shareholder Voting Research & Analysis (2019), available at <https://bppgrp.info/wp-content/uploads/2019/07/2019-Best-Practice-Principles-for-Shareholder-Voting-Research-Analysis.pdf>

¹⁸ For an overview of the SRD II and BPP provisions on this topic, see Konstantinos Sergakis, *The Law of Capital Markets in the EU* (Palgrave Macmillan, 2018) 303.



developing dialogue with companies while allowing clients to be duly informed of the dialogue that may have taken place (if any).

We, however, welcome **footnote 28** in the proposed Code which mentions the disclosure requirement on whether proxy advisors 'have dialogues with companies, and the nature of such dialogues'. Nevertheless, the 'nature' does not necessarily include 'outcomes' of such dialogue which are even more informationally useful. We, therefore, suggest including 'outcomes' in the disclosure framework and **integrating footnote 28 in Principle 8-3** [based upon our recommendation above].

Principle 8-3 could be formulated as follows:

~~For example, in ordinary proxy recommendation processes,~~ **Proxy advisors should disclose the** major information sources, whether they have dialogues with companies, and the nature of such dialogues ~~are considered to be subject to disclosure.~~ Specific contents of dialogue for voting recommendations of specific agenda are not included herein.

The proxy advisors, in providing proxy recommendations, ~~should~~ **could** not only rely on the disclosed information of companies, but **may** exchange views ~~actively~~ with companies **and other relevant parties** upon necessity. **They should inform clients about the nature of any dialogue with relevant parties in their research reports, which may also include informing clients of the outcome of that dialogue.** ~~When a subject company for the recommendation requests, it is considered to contribute to secure accuracy of the information based on the recommendation and transparency that the proxy advisors provide the company with an opportunity to confirm whether such information is accurate, etc., and provide the submitted opinion of the company to its clients together with the recommendation.~~

- 11 In summary, **Principle 8 Guidance could be reformulated and restructured** as follows based on the above-mentioned recommendations (8-10):

Principle 8-1

The service providers for institutional investors including proxy advisors and investment consultants for pensions should identify specific circumstances that may give rise to conflicts of interest, put in place a clear policy how to manage



them effectively, develop structures for conflicts of interest management, and **publicly** disclose such measures.

Principle 8-2

~~When~~ **Where** applicable, the proxy advisors **should** put in place **and publicly disclose** their policy for voting recommendations, ~~they should endeavor to articulate the policy as much as possible.~~ The policy should not be comprised only of a mechanical checklist; **it should support clients' stewardship and it should be designed to contribute to the sustainable growth of the subject company.**

The proxy advisors should develop appropriate and sufficient human and operational resources, ~~including setting up a business establishment in Japan~~ in order to provide ~~asset managers~~ **their clients** with proxy recommendations based on accurate information on individual companies, and specifically disclose **to their clients** the voting recommendation process ~~including the above mentioned~~ to assure transparency.

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We hope that the comments provided in this letter are of interest for the consultation's purposes.

Yours sincerely,

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