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Keys to success of Japanese Stewardship Code

Sadakazu Osaki

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Nomura Research Institute, Ltd.

Adoption of Japanese Stewardship Code is proceeding apace

Sadakazu Osaki
Head of Research
Center for Strategic Management and Innovation

NOTE

1) The 127 include six trust banks, 86 investment managers, 14 life insurers, five nonlife insurers, 12 pension funds, and four proxy voting advisory firms.

On June 10, 2014, Japan's Financial Services Agency (FSA) disclosed the extent to which the Japanese Stewardship Code (JSC), which was unveiled in February 2014, has been adopted by institutional investors as of May 31, 2014. According to the FSA, 127 Japanese and foreign institutional investors and proxy voting advisory firms have already announced that they have adopted the JSC[1].

The JSC is modeled after the UK Stewardship Code (UKSC), which was first adopted in 2010 based on a preexisting voluntary code for institutional investors. Although the UKSC was embraced by a considerable number of institutional investors from the outset, it has fewer than 300 signatories as of December 31, 2013. In contrast to the UKSC, the JSC's adoption was spearheaded by the government instead of by institutional investors' own initiative. Given how many institutional investors have adopted the JSC in its first three months, we can say that the JSC has gotten off to a successful start.

However, a stewardship code's success or failure cannot be adequately measured solely by the number of institutional investors that have adopted the code. The JSC's objective is to help investee companies realize medium/long-term growth through engagement and other stewardship activities in accord with the JSC's principles, thereby enabling institutional investors to deliver high medium/long-term returns to the clients and beneficiaries on whose behalf they manage assets. To realize this objective, institutional investors must conduct appropriate stewardship activities, which in turn must sufficiently influence their investee companies' management. From such a perspective, following is a discussion of issues relevant to realization of the JSC's intended benefits, taking into consideration the UKSC's implementation status and criticisms of its underlying approach.

Substance over formalism

For the JSC to have its intended effect, engagement and other stewardship activities must not be a perfunctory exercise focused only on quantitative measures such as the amount of time spent or number of contacts with management. The JSC's fourth principle contains a footnote admonishing against such superficiality[2].

2) The footnote states, "Institutional investors should not fall into formalism, such as to regard having a dialogue itself as the aim."

Even in the UK, institutional investors have been criticized for a tendency to conduct stewardship activities superficially. Some have questioned how effectively institutional investors monitor investee companies in the UK. One commentator reports that such monitoring often consists solely of box-ticking, where the investor mechanically goes through a checklist of potential deficiencies and/or requirements[3]. He also notes that engagement with investee companies is often focused exclusively on voting at shareholders general meetings.

3) A. Keay, "Comply or Explain: In Need of Greater Oversight?", 34 Legal Studies 279 (2014).

In Japan as well, institutional investors that conduct stewardship activities should be cognizant of the activities' cost and cost-effectiveness. Engagement must not be reduced to a formulaic routine, where investors meet with all of their investee companies at roughly equal intervals and for roughly the same amount of time. Additionally, regulators that oversee pension funds and investment managers should avoid superficially checking whether stewardship activities are being conducted.

Significance and limitations of "comply or explain"

Unlike a law, the JSC is not legally binding. It applies only to institutional investors that have affirmatively adopted it of their own volition. Moreover, even if an institutional investor has adopted the JSC, it need not strictly comply with all of the JSC's principles and guidance. The JSC's effectiveness hinges on the principle of "comply or explain." In other words, the JSC gives institutional investors the choice of complying with it or explaining why not.

Such a regulatory approach has never been used before in Japan. The JSC's comply-or-explain option was reportedly copied from the UKSC. In the UK, use of the comply-or-explain approach to ensure the effectiveness of corporate governance standards has gained widespread prevalence since the 1992 Cadbury Report[4].

4) Report of the Committee on the Financial Aspects of Corporate Governance (1992).

The comply-or-explain approach's application to standards for stewardship activities has positive significance beyond the mere fact that it has previously been similarly applied to corporate governance standards. Specifically, some institutional investors utilize investment strategies in which fulfilling stewardship responsibilities could never be rationally justified. For example, a long/short hedge fund that employs a strategy of buying stocks deemed to be undervalued and shorting stocks deemed to be overvalued would be irrational to conduct engagement activities in the aim of enhancing the value of a company whose stock it has sold short.

Additionally, institutional investors that passively manage portfolios benchmarked against an equity index have legitimate reason to question how actively they should fulfill stewardship responsibilities, if at all. If the advantage of passive management is low management costs, passive managers arguably should not spend any time or money on engagement with investee companies. On the other hand, considering that index funds are often unable to readily sell portfolio holdings lest their returns deviate from their benchmark index's returns, institutional investors that are passive managers arguably should be especially proactive in engaging with index-constituent companies in the aim of enhancing their value.

In sum, involvement in stewardship activities is by no means universally desirable for all institutional investors. From such a perspective, the comply-or-explain model is well-suited to regulation of stewardship activities. The flipside, however, is that the comply-or-explain model basically lets institutional investors voluntarily decide whether to abide by the stewardship code's provisions. Consequently, the comply-or-explain model has limitations in terms of regulatory effectiveness.

Even in the UK, commentators have identified shortcomings of the comply-or-explain model, albeit mainly with respect to corporate governance codes. Such shortcomings include that when companies do not comply with the code, their explanations of the rationale behind their noncompliance are often not substantive and there is no institution to verify the validity of their explanations[5]. Noncompliance is consequently allowed to persist unchallenged. In Japan, institutional investors' disclosures concerning their compliance with the JSC are likewise not subject to an adequate reasonableness check. Concerns that institutional investors will conduct stewardship activities in a perfunctory manner cannot be dismissed.

5) Keay, supra note 3.

Doubts about investors' competence

While both the JSC and UKSC comprise seven principles, the JSC's seventh principle is unique to Japan and has no counterpart in the UKSC[6]. The JSC's seventh principle states that institutional investors should possess the ability to appropriately engage with investee companies and make proper judgments in the course of stewardship activities based on an in-depth knowledge of the investee companies and their business environment (see exhibit).

6) Additionally, the JSC has no principle corresponding to the UKSC's fifth principle, which calls upon institutional investors to act collectively with other investors. However, the JSC does not dispute the value of stewardship activities conducted in concert by multiple investors. In a summary of legal interpretations incorporated into the JSC that was released by the FSA at the time of the JSC's publication, the FSA attempted to define how institutional investors can conduct engagement or other stewardship activities in concert with other investors without becoming a "co-owner" under large-stake ownership reporting regulations or a "specially related party" under tender offer regulations.

In fact, many Japanese companies are skeptical of the extent to which outsiders, including institutional investors, are knowledgeable about and understand their businesses, operating environments, and management strategies. Such skepticism is evident in the continued existence of listed companies that refuse to appoint

Exhibit: Comparison of JSC's content with UKSC

Principle 1	Institutional investors should have a clear policy on how they fulfill their stewardship responsibilities and publicly disclose it.	Nearly identical to UKSC's Principle 1
Principle 2	Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it.	Nearly identical to UKSC's Principle 2
Principle 3	Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies.	More detailed than UKSC's Principle 3
Principle 4	Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.	More detailed than UKSC's Principle 4
Principle 5	Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.	More detailed than UKSC's Principle 6
Principle 6	Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, including their voting responsibilities, to their clients and beneficiaries.	Nearly identical to UKSC's Principle 7
Principle 7	To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.	Unique to JSC

Source: NRI

nonexecutive directors on the grounds that "amateur outsiders' have no meaningful role in management." When the JSC was being developed, representatives of listed companies told the JSC's drafting body that their investor relations staff often field questions from investors ignorant of the nature of the companies' businesses[7]. As a result, Principle 7 was included in the JSC as a Japan-specific provision.

7) See the minutes of the first and second meetings of the Council of Experts Concerning the Japanese Version of the Stewardship Code (http://www.fsa.go.jp/en/refer/councils/stewardship/index.html).

Such skepticism on the part of Japanese companies has likely intensified due to the fact that many activist investors that have gained notoriety in the markets, most notably the Murakami Fund, have a habit of selling their shareholdings relatively soon after applying strong pressure on investee companies and seem, at least in hindsight, to never have had any intention of being a medium- or long-term investor. Whether or not such skepticism is justified, institutional investors that conduct stewardship activities must establish a rapport with investee companies and always engage with management with an authentically medium- to long-term mindset based on thorough research and preparation.

JSC's application to foreign institutional investors

If there are listed companies that have corporate governance deficiencies and manage their operations in a manner inconsistent with the JSC, those companies' management teams need to feel a certain degree of pressure and change their companies' corporate conduct for the JSC to have its intended effect. Management will not feel pressured to change unless the investors that have adopted the JSC own a substantial share of the overall Japanese equity market.

The UKSC was in fact criticized from such a standpoint in its first couple of years. The specific criticism was that the UKSC may have worked well back when domestic institutional investors owned a majority of UK-listed stocks more than two decades ago, but with non-UK investors owning over 40% of the overall UK equity market in recent years, the UKSC cannot possibly be effective enough if its signatories are limited mainly to UK institutional investors[8].

8) B. R. Cheffins, "The Stewardship Code's Achilles' Heel," 73 Modern Law Review 1004 (2010).

When the UKSC was subsequently amended in 2012, the amended version reaffirmed that it applies also to non-UK institutional investors that own UK listed equities. The UK Financial Reporting Council continues to try to internationalize the UKSC through such means as encouraging non-UK pension funds and other asset owners to make adoption of the UKSC a prerequisite for asset managers to be eligible to win asset management mandates.

The JSC applies to not only domestic but also overseas institutional investors, reflecting the large share of the Japanese equity market owned by foreign investors as of the JSC's inception and the major role played by foreign investors in stewardship activities also. Japanese authorities are strongly committed to spreading the JSC internationally. For example, when the JSC was first unveiled, the FSA published an English translation of it at the same time as the Japanese version. The FSA's recently released list of institutional investors that have affirmatively adopted the JSC includes overseas investment managers and pension funds also.

US institutional investors, the most influential nationality of foreign investors in the Japanese market, are sometimes perceived as unenthusiastic about engaging with investee companies, partly because stewardship is a largely foreign concept to US investors in the first place. Another reason for this perception is that US beneficial ownership reporting requirements grant a "passive investor" exemption. Whether US and other foreign institutional investors exhibit a commitment to actively engage in stewardship activities will likely be an important determinant of the JSC's effectiveness.

Application to cross-shareholdings and strategic shareholdings

From the standpoint of effectively applying pressure on investee companies, another important point is application of the JSC to cross-shareholdings and strategic shareholdings.

The JSC is intended to apply to "institutional investors." However, reciprocal cross-holding of shares and strategic corporate ownership of shares are widespread in the Japanese market (banks in particular own many strategic equity stakes in major client companies). Even insurers, which are a subset of institutional investors, have extensive strategic shareholdings acquired not for purely investment reasons. If the JSC does not apply to such strategic and cross-shareholders, it is unlikely to be adequately effective.

Ordinary non-financial companies with shareholdings better characterized as business investments than financial investments are a different story, but banks and insurers that acquire cross-shareholdings and/or strategic shareholdings in the course of investing depositors or policyholders' funds rightfully should be treated as institutional investors subject to the JSC.

The purpose of cross-shareholdings and banks and other companies' strategic shareholdings is typically to establish a stable shareholder base or strengthen transactional relationships, not to boost pure investment returns. However, even when a stock is owned as a strategic or cross-shareholding, share price appreciation is preferable to share price depreciation for both the stock's owner and its shareholders, depositors or policyholders that provided the funds to acquire the stock. Sustained growth of the strategically or cross-held shares' issuer is highly desirable. The JSC's aim is thus not at odds with the objective of strategic and cross-shareholdings.

Of course, one aim of strategic and cross-shareholdings is to gain a reliable shareholder–i.e., a shareholder that will basically always support management. This aim is in fact incompatible with complete compliance with the JSC. For example, the guidance accompanying JSC's fifth principle, which pertains to voting, instructs investors to decide whether to vote for or against proposed resolutions based on factors such as the investee company's status and dialogue with the investee company. This guidance is incongruous with strategic and cross-shareholdings, which are regarded as an automatic vote in favor of management.

Nonetheless, I do not think that strategic and cross-shareholders should be directly excluded from the JSC's purview for this reason. On the contrary, I believe that the JSC's comply-or-explain option should apply to such situations in particular. In other words, as strategic or cross-shareholders, banks and insurers should engage in constructive dialogue with the issuers of their strategic and cross-shareholdings after disclosing and explaining that complete compliance with the JSC's fifth principle is incompatible with said shareholdings' objectives[9]. The institutional investors that have already announced adoption of the JSC include life and nonlife insurers that presumably own substantial strategic shareholdings. Such institutional investors' yet-to-be-disclosed policies for conducting stewardship activities and the content of their actual stewardship activities bear monitoring going forward. Additionally, full-fledged application of the JSC to banks should also be considered.

9) Some readers may doubt that a single insurance company would act differently in terms of stewardship activities depending on whether it owns the stock in question as a pure investment or a strategic shareholding, but such skepticism is misplaced. As noted above, a uniform approach to conducting stewardship activities is not appropriate for, e.g., hedge funds. It is by no means unusual for an asset manager to manage long-only funds with a medium/long-term investment horizon in addition to hedge funds. In such cases, there should be no problem if a single company adopts a different approach to compliance with the JSC for each of the funds it manages.

Conclusion

I have discussed issues related to realization of the JSC's intended benefits, mainly from the standpoint of institutional investors that will conduct stewardship activities. Needless to add, however, the response of investee companies targeted by stewardship activities is another key factor for the JSC to have a meaningful impact.

Currently, more than a few listed companies are presumably somewhat dismayed that the JSC was adopted and is being embraced by many institutional investors. The UKSC, the template for the JSC, was first adopted in response to concerns about a single-minded focus on maximizing short-term earnings among many large corporations, particularly major banks. Such short-termism was cited as one cause of the global financial crisis. In contrast, many Japanese corporate executives are no doubt aware that they have been criticized by institutional investors, including activist shareholders, for their reluctance to maximize short-term earnings and distribute them as shareholder returns in the form of dividend increases and/or share buybacks.

If told that Japanese corporate management lacks a medium/long-term mindset and the JSC is necessary to rectify this shortcoming, many Japanese executives would likely strongly disagree. As noted above, Corporate Japan is distrustful of institutional investors' intentions and skeptical of their knowledge and competence. How well institutional investors engage in dialogue in a manner to which investee companies are actively receptive and how candidly the companies' management talk with institutional investors will be key focal points going forward.

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Inquiries to : Financial IT Marketing Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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