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To Whom it May Concern:

Japan's Stewardship Code – Request for Public Comments December 2019

We write in response to the draft amendments to Japan's Stewardship Code (the "Code"), published for public comment on 20 December 2019.

General comments

As a general observation, save in relation to the proposed new Principle 8 (relating to service providers to institutional investors), the draft amendments to the Code are reasonable ones from our perspective. The emphasis on "ESG" and "sustainability" in the investment and stewardship policies of investors brings the Code up to date, while the recommendation for greater disclosure on voting decisions should provide more substance to this aspect of stewardship.

While the revised Code introduces a number of reforms that will enhance stewardship in Japan, the limited nature of several proposals means that the current consultation is perhaps a missed opportunity to fundamentally refresh the Code and better align it with global best practice. In particular, we believe that the Code should place a much greater emphasis on the activities and outcomes of stewardship, rather than on the production of policy statements and the like. In that regard, the current UK Stewardship Code provides a useful conceptual comparison. We would therefore urge the FSA to consider whether the proposed changes to the Code adequately reflect the standards of stewardship for asset owners and asset managers, and for service providers that support them, that currently prevail in some other developed capital markets.

In relation to the December 2019 consultation draft, we would like to highlight the following matters for your consideration.

Specific recommendations

Application to asset classes other than listed equities

A proposed amendment (renumbered paragraph 10 of the preamble) provides that "the Code may also apply to other assets classes as far as it contributes to fulfilling the stewardship responsibilities mentioned in the heading of this Code".

We fully support the proposition that stewardship should apply to the stewardship of capital in whatever form it is deployed and, therefore, that it rightly extends beyond listed equities. We would therefore welcome a more positive statement that the duty of stewardship should (not "may") apply to the owners and managers of capital however invested and that the Code is intended to be applied on that basis. Similarly, we recommend

that the somewhat tentative wording underlined above, starting with “as far as...”, be rephrased in firmer language. For example, “the Code is also intended to apply to other asset classes so that they fulfil their stewardship responsibilities to the best of their abilities”.

We suggest that for the Code to be of practical use in this regard it should provide guidance as to what stewardship activity might involve in relation to these other asset classes, such as fixed income, private equity and infrastructure. This would appear to be especially pertinent in Japan, given that many institutional asset owners, such as public and private pension funds, may well have a majority of their investments in such assets and securities.

We note, however, that the Code’s existing description of “stewardship activities” is quite limited and, as articulated in renumbered paragraphs 5 to 7, refers only in general terms to voting, engagement, and developing an in-depth understanding of companies. Indeed, the emphasis on voting highlights the strong public equities focus of the original Code. We recommend that the preamble to the Code and the elaboration of its Principles be recast to articulate in more granular fashion the concept of “stewardship activities” in relation to assets other than listed equities. For example, Principle 3 on the monitoring of investee companies could include additional guidance on the following factors:

- How the fixed income and equities teams in a particular financial institution could work together on engagement with companies, as already happens in many developed markets.
- The specific issues that bondholders should take into account when considering major sustainability and ESG risks, including climate change, and how these may be different or similar to the concerns of shareholders.
- How private equity investors could best utilise their greater access to management and company information, as well as stronger shareholder rights such as access to boards seats, to drive more effective corporate responses to governance and sustainability.

Meanwhile, while the Code references proxy voting in several sections, it says little about the value of the annual general meeting (AGM) as a potential platform for communication.

Size and capacity

The draft consultation text introduces, at 1-3, 1-4 and 1-5 of Principle 1, a qualification to the effect that stewardship activities by asset owners and asset managers should be undertaken in a manner “corresponding to their size and capacity, etc.”. We are concerned that this language may be interpreted as meaning that only large asset owners and asset managers need take their stewardship activities seriously. In our experience, some of the most assiduous stewards of client assets are managers with comparatively modest levels of assets under management. In any event, the nature of an asset manager’s stewardship activity is more likely to be a function of its chosen investment strategy, rather than size.

Moreover, we would submit that the purpose of the Code should be to promote and encourage higher standards of stewardship activity. In that context, a statement that it is acceptable for the intensity of stewardship activity of an asset manager or asset owner to be limited by its “capacity” is liable to be misinterpreted as meaning that those with modest capacity need not improve.

The effect of the new language, therefore, may be that some treat it as a signal not to invest as fully as they otherwise might in stewardship and instead “free-ride” on the efforts of others. This in turn would lead to an under-investment in stewardship, poorer standards and uneven coverage of stewardship across the market.

We suggest, therefore, that the proposed language on this point in 1-3, 1-4, and 1-5 be removed.

Development of skills and resources for engagement

We note that 7-1 of Principle 7 continues to provide that “institutional investors should develop skills and resources needed to appropriately engage with companies and to make proper judgments”. We also note that the Code has provided as such in substance since 2014. The present consultation draft emphasises the developmental nature of investors’ engagement efforts by adding to Principle 7 itself the word “develop”.

We think that the FSA’s purpose here is likely to be to encourage investors to further enhance their engagement activities, and to remind investors that they should not become complacent. However, there is a risk that the Code’s continued emphasis on “development” could be treated by some investors as grounds for going slow and not actually “implementing” effective engagement strategies.

We would therefore suggest that Principle 7 or the Guidance on it should be reframed to emphasise the need for investors to (a) continue to develop their skills and resources, and (b) ensure that those skills and resources are deployed in the effective implementation of their engagement activities.

Principle 8 – Service providers

We note the proposal to add a new Principle 8 to the Code that would apply to service providers. Conceptually, we agree with this proposal and believe that it is important that a broad range of service providers be brought within the scope of a stewardship code. In respect of the draft Principle 8 and the Guidance thereon, we would highlight the following issues:

- (a) The Principle correctly states that service providers for institutional investors should endeavour to contribute to the enhancement of the functions of the investment value chain. However, except in relation to proxy advisors, there is little in the draft to explain how service providers should go about this task. The production of a conflicts of interest policy, to which the draft refers, is clearly an important step, but on its own it is of limited value when forming a view about compliance with Principle 8. We would suggest that more guidance is necessary in order that “comply or explain” can be applied in a meaningful way. In particular, it would seem important for the Code to provide as a first step that service providers should articulate to their investor clients how their services best support their clients’ stewardship.
- (b) By way of service providers, the guidance refers to proxy advisors and to investment consultants that provide services to pension funds. A footnote further provides that other institutions, including other institutional investors, may be considered as service providers to institutional investors. We would suggest that the guidance be amended to include specific reference to providers of data and research – and to any other bodies which provide reporting frameworks. As the FSA will be aware, in devising and assessing the effectiveness of their stewardship strategy, asset owners and asset managers rely to some

extent on data provided by specialist third-party research firms. In addition, it is sometimes the case that third-party research firms provide reporting and benchmarking services for institutional investors who wish to articulate or assess the effectiveness of their stewardship strategies. Given their prominent and growing role in the stewardship value chain, we think that there is a good reason to separately identify data and research providers within the guidance to Principle 8.

- (c) In respect of proxy advisors, we note that 8-3 of the draft guidance envisages that the proxy advisor should submit to its clients both its recommendation in respect of voting, together with the listed company's opinion about that recommendation. In our view there may be practical challenges associated with such a process given the compressed nature of the AGM season in Japan. In addition, we are not aware of any major financial market that has implemented a provision to this effect, although we are aware that one such has been proposed in the United States. We are cognisant of the arguments for and against such a provision, and that the direction of travel globally is towards measures designed to increase accountability of proxy advisors. Nonetheless, we have three principal concerns with the proposal:
- First, the guidance advises proxy advisors, when formulating their recommendations, to obtain information from companies other than information that has been publicly disclosed by those companies. We do not see how a proxy advisor could provide a recommendation to its clients which is based in some way on non-public information disclosed to the proxy advisor by the company in question.
 - Secondly, it is not clear to us what sort of information the FSA envisages should be provided by the proxy advisor to the company for its review prior to submission of the voting recommendation to the proxy advisor's clients. While we can see merit in a system in which the data on which a recommendation is based are disclosed for the purpose of better ensuring the integrity of the data, we would not support a provision which envisages that the recommendation itself and any associated analysis of the data be exposed to the subject company's management before transmission to shareholders – any more than we would support a proposition to the effect that a research broker should be expected to share its investment recommendations with the subjects of that research.
 - Lastly, if it is intended that a listed company should be given the opportunity to submit to the proxy advisor's clients its opinion on the advisor's recommendation, we would be concerned that the consequence of that process would further embed a structural information asymmetry in which not all shareholders have access to the same information before casting their votes. In the FSA's proposal, the recipients of the listed company's opinion will be limited exclusively to the clients of the proxy advisor. In our view, as a matter of public policy, it is inherently undesirable to privatise discussion in this way on what may be fundamental matters of governance within a listed company.

As a general comment, therefore, while we support the application of a stewardship code to service providers, our view is that the guidance in relation to Principle 8 requires considerable refinement and elaboration for it to be capable of sensible practical application by service providers.

Potential additional considerations

Benchmarking

The draft Code appears to be largely silent on the steps that asset owners and asset managers, and their service providers, should take to benchmark those activities against best practice. We think that it would be desirable for the Code to include a reference to the importance of benchmarking and for it to record an expectation that adherents to the Code should explain their approach to this matter. In addition, some institutional investors may also wish to have external assurance, from an independent consultant or specialist auditor, as to the effectiveness of their stewardship activities. The FSA might therefore wish to consider whether to include a reference in the new Code to the potential benefits of obtaining external assurance from a third-party assessor.

An outcomes-based approach

While acknowledging that the Code has historically adopted a principles-based structure, we would suggest that the Code be re-oriented to focus on outcomes and on the effectiveness of stewardship activities. The draft revised Code continues to place weight on the production of policies and the implementation of processes. It devotes much less time to articulating what effective stewardship should look like or to how supporters of the Code might assess their compliance with it. While not advocating that the specifics of the current UK Stewardship Code be imported into the draft Code, the conceptual framework adopted in the UK Code, with a firm focus on stewardship outcomes, appears to us to be a sensible approach and one likely to be of considerable benefit to supporters of the Code.

We would be happy to discuss further any of the points raised in this letter.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'JA', is written over a horizontal line.

Jamie Allen
Secretary General

**Christopher Mead, Deputy Secretary General, ACGA contributed to this letter.*