JSS Newsletter International

（Vol.6　January 2017）

Effective Stewardship Activities of Institutional Investors

The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (the Follow-up Council) released Opinion Statement No.3 titled "Effective Stewardship Activities of Institutional Investors" on November 30, 2016.

The 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, the content of which is presented in this article.

<Gist>

- The Opinion Statement sets forth that asset managers should disclose company-level voting results to the public and identify circumstances that may give rise to potential conflicts of interest which may significantly influence the exercise of voting rights and/or dialogue with companies, and set out and disclose specific policies to manage conflicts of interest, etc.
- The content of the Opinion Statement shows the direction in which the Stewardship Code will be reviewed. In the future, the Stewardship Code is expected to be revised to require the disclosure of voting results at the company/proposal level.
- The Opinion Statement presents "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 judgment in the proxy vote" as an example from the viewpoint of managing conflicts of interest of asset managers in circumstances which may significantly influence the exercise of voting rights and/or dialogue, so the use of a proxy advisor as an independent third-party by asset managers is conceivable.

I. Effective Stewardship Activities of Asset Managers

Institutional investors should be expected to conduct effective stewardship activities based on in-depth corporate valuations and taking a mid- to long-term perspective. 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

- **Main Opinions Expressed in the Follow-up Council**
  - ✓ With respect to asset managers who 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, they need to address conflicts of interest in a more finely-tuned manner. The need for conflict management is the same with respect to the case of financial institutions which are engaged in both asset management and non-asset management businesses within the same entity.

- **Recommendations**

Enhancement of Asset Managers' Governance	✓ Asset managers should have in place governance structures in order to secure the interests of ultimate beneficiaries and prevent conflicts of interest. ✓ Examples given include independent boards and third-party committees for making proxy voting decisions and carrying out oversight.
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*. * Examples of measures taken in other countries in cases where there are conflicts of interest: ◊ 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 judgment in the proxy vote
Securing Adequate Capabilities and Experience	✓ 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 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, and should promote initiatives to address issues related to them.

2. Enhanced Disclosure of Voting Results

- **Main Opinions Expressed in the Follow-up Council**
  - ✓ 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 disclosures of aggregate voting results at the proposal level.
  - ✓ While some have expressed concern that company-level voting disclosures may result in attracting excessive attention solely to whether they cast "for" or "against" votes and interfering with positive dialogue, such concern should be resolved through clear explanation by asset managers of the policies that underpin their voting decisions.
  - ✓ 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, asset managers should move toward company-level disclosures of voting results.

- **Recommendations**

Disclosures of Voting Results at the Company Level	✓ 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

Given that passive management has constituted an increasing proportion of investing recently, the following recommendations were made.

Engagement in Passive Management	✓ Both asset managers and asset owners should conduct engagement activities (dialogue) more proactively and exercise voting rights from a mid- to long-term viewpoint. ✓ 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

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.

II. Effective Oversight by Asset Owners

Asset owners have a direct responsibility to secure the interests of the ultimate beneficiaries. Taking this 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.

Asset Owners' Initiatives to Ensure Effective Stewardship Activities	✓ Asset owners should conduct their own stewardship activities in order to secure the interests of ultimate beneficiaries. ✓ 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 necessary to have in-depth constructive dialogue on various corporate challenges, including management strategies. ✓ Asset owners should realize that asset managers have stewardship responsibilities also to other clients and other ultimate beneficiaries, and pay attention not to interfere with appropriate activities of the asset managers.
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.
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 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.