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Japan's Stewardship Code: issues facing asset management companies

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Executive Summary

If stewardship initiatives conducted in compliance with Japan's stewardship code are to lead to sustained corporate growth, asset management companies that have a large number of stockholdings and place priority on shareholder voting and governance-focused dialogue must play a key role. How such asset managers can qualitatively improve their engagement with investee companies is a crucial issue.

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NOTE

1) http://www.fsa.go.jp/status/stewardship/kikan.pdf (in Japanese).

As of August 31, 2014, the Financial Services Agency (FSA) released a list of 160 institutional investors that have adopted Japan's stewardship code (JSC). When announcing this number, the FSA issued a message to institutional investors[1], asking them to embrace the JSC substantively instead of superficially. Recognizing that some asset management companies prefer to comply with the JSC in form only or have hitherto exhibited a "box-ticking approach" to exercising their shareholder voting rights, the FSA is advocating "investor engagement in investee companies' sustained growth" as the appropriate approach to stewardship.

While a diverse range of institutional investors have announced adoption of the JSC, the FSA's concerns about superficial compliance with the JSC are directed mainly at asset management companies that are long-term holders of many stocks and place priority on voting and governance-focused dialogue with their investee companies[2]. However, such asset management companies are facing various issues even without attempting to upgrade their voting and engagement programs for the sake of investee companies' growth.

2) Some asset management companies that manage investment trusts and pension fund mandates exercise voting rights for and engage in dialogue with some 1,000 investee companies. Such asset management companies typically have one voting policy and have established an organizational unit dedicated to voting.

Issues related to gathering information on investee companies

Such issues can be broadly classified as issues related to (1) gathering information on investee companies and (2) cooperating with other asset management companies.

The first issue is gathering information required to make investment decisions on specific companies. In some respects, this task is much more difficult in Japan than overseas. The asset management companies described above generally do not engage with investee companies if they consider the companies to have good earnings, good governance and no management problems. They tend to pursue engagement only with companies for which their information screening has identified significant signs of earnings deterioration, sudden management changes or other such concerns. Their overseas peers use the same approach.

The focus of asset management companies' screening processes sometimes includes the quality of independent directors whose role is to help improve governance and incentive compensation for directors that are instigators of growth. When doing such screening, asset management companies have difficulty gathering a wide variety of information to make more objective and consistent decisions. For example, to evaluate the quality of directors' independence, asset management companies must identify company stakeholders. Ideally, asset management companies should be able to obtain clear information, including information that a company would prefer to keep quiet, from statutory disclosure documents. However, required information contained in securities reports filed pursuant to the Financial Instruments and Exchange Act and shareholder general meeting agendas issued pursuant to the Companies Act sometimes differs. Additionally, information not subject to explicit legal disclosure requirements is sometimes disclosed in vague terms or omitted from statutory disclosure documents. Asset management companies consequently must search various other publicly disclosed documents to ensure the accuracy of information[3]. The quality of gathered information varies depending on the amount of time spent on these tasks. The quality of asset management company's decisions may also be affected as a result. Moreover, Japanese companies hold their shareholder general meetings before filing their securities reports. Shareholder general meetings consequently tend to be held much sooner after fiscal year-end than in the US or Europe. Shareholder general meetings also tend to be densely clustered on certain dates. Asset management companies have little time to gather information about the previous fiscal year's earnings or the current fiscal year's lineup of directors. This situation must change to enable asset management companies to avoid a box-ticking approach, engage with investee companies for the sake of sustained growth, and qualitatively improve their engagement with investee companies. However, the necessary changes cannot be accomplished by asset management companies alone.

3) For example, some asset management companies refer to information on the company's main bank, suppliers and customers to confirm directors' independence, but some companies no longer disclose their main banks. Asset management companies therefore identify the major banks with which companies have stakeholder relationships from multiple sources such as financial statement notes on borrowings.

The UK, the first country to adopt a stewardship code for institutional investors, differs from Japan in two major respects in terms of how investors gather information on companies. First, companies distribute a draft of their shareholder general meeting agenda to investors and obtain feedback from them before the agenda is finalized. Investors often question directors' compensation in particular. Discussion of compensation is one means by which investors evaluate management. Second, shareholder general meetings are held four to five months after fiscal year-end, after the previous fiscal year's financial statements have been released. If both of these practices were adopted in Japan, asset management companies would have much more time to gather information. Even in Japan, individual companies can take the initiative to adopt these practices[4]. If companies proactively did so, investors would have more time to gather information and make voting decisions.

4) Like in the UK, some Japanese companies seek feedback from asset management companies as they prepare their shareholder general meeting agendas. Additionally, companies can hold their shareholder general meetings after filing their securities reports by changing their base date.

Issues related to cooperation among asset management companies

To help investee companies grow through voting and engagement and to benefit from such growth in the form of enhanced investment returns, the asset management industry as a whole must improve its decision-making. To do so, cooperation among asset management companies is desirable. Such cooperation is difficult, however. Therein lies the second issue.

First, widespread low-quality decision-making on voting matters undermines the asset management industry's influence on investee companies. Additionally, an increase in asset managers that keep score solely on the basis of number of meetings with investee companies would impede productive dialogue by taking up too much of companies' time available for meetings with investors. If a company says different things to every asset management company it meets with and problems with its management approach surface after its shareholder general meeting agenda has been finalized, asset management companies' dialogue with the company would be for naught.

In response to such issues, collective engagement[5] is often utilized in the UK. During the shareholder general meeting season, some companies hold weekly conference calls with 40-50 investors. The information shared in these conference calls pertains to the company's fundamentals, not voting matters. Although voting matters are not discussed, conference call participants can deepen their knowledge of the company on equal footing with each other.

5) Collective engagement means that investors cooperate with each other in the aim of effectively engaging with investee companies through such means as exchanging opinions to create long-term value and promote companies' sustained growth.

Regrettably, such cooperation is difficult in Japan for several reasons. One reason is that Japanese asset management companies customarily do not disclose their portfolio holdings. Overseas, asset management companies disclose their stockholdings even if the stocks are not held in public mutual funds. Some countries have regulations mandating public disclosure of stockholdings[6] while other countries have a custom of voluntary disclosure. Even in Japan, however, it is important for

6) In the US, institutional investors with $100 million or more of assets under management are required to disclose their stockholdings on a quarterly basis. Additionally, EU pension funds voluntarily disclose their status as beneficial shareholders before companies' shareholder general meetings.

investors to cooperate with each other to deepen their understanding of companies and increase their effectiveness on an industry-wide basis.

Ensuring the JSC's success

There are a number of other issues other than the two discussed above. Some pension funds currently authorize asset management companies to vote on their behalf based on their own voting policies. If asset management companies have to vote separately on a client-by-client basis they would incur new costs and their engagement with investee companies would diminish. In the UK, pension funds that originally voted themselves have been outsourcing voting and investee engagement to asset management companies as the number of asset managers that have adopted the UK stewardship code has increased. UK pension funds also evaluate how asset managers vote on their behalf and take the evaluations into consideration when selecting asset managers.

The JSC's ultimate objective of sustained corporate growth cannot be achieved by asset management companies alone. If companies themselves need to take proactive action and/or asset management companies need to cooperate with each other to realize this objective, the JSC will not be able to have its desired effect unless various initiatives are undertaken, including regulatory reforms and pension fund evaluations of asset managers to promote qualitative improvement in the asset managers' voting and engagement with investee companies.

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