IR Insight

Prepared by Tokyo consultancy Investor Impact, Inc., **IR Insight** provides analysis about the latest IR trends and recommendations on communications strategies that positively impact corporate value.

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INVESTOR IMPACT

Japan's Stewardship Code: Implications for Investor Relations

On April 7, 2014, Japan's Financial Services Agency officially announced the finalization of its stewardship code for investors, entitled "Principles for Responsible Institutional Investors: Japan's Stewardship Code to promote sustainable growth of companies through investment and dialogue[1]". The press release title indicates that the "publication of the final version is also an invitation to institutional investors to sign up for the Code." What, specifically, are the implications for IR?

An Increasingly Regulated Global Financial Markets Environment

Japan's Stewardship Code on balance represents a departure from previous practices in Japan, under which the authorities generally refrained from providing guidance for the behavior of institutional investors, Japanese or foreign. Over time, however, Japan's Stewardship Code can be seen as part of a chain of events aimed at increasing the transparency of relations between institutional investors and investee companies that began with the SEC's issuance of Regulation FD (Reg FD) in August 2000. Reg FD required companies to disclose immediately to all investors any non-public material information that is disclosed to any single investor. This regulation prevented companies from continuing to give any special advantage to favored analysts and investors.

The collapse of Lehman Brothers Holdings in September 2008 and the subsequent enormous loss of value in world financial markets, not to mention the opportunity losses caused by the subsequent worldwide downturn, set off a further wave of investigation of improper behavior among players in the global financial system. The upshot in the

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1 http://www.fsa.go.jp/en/refer/councils/stewardship/20140407.html

United States was the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which as its name suggests, calls for extensive financial reforms in the investment community and greater protection for investors.

Another significant development in one of the world's key financial centers was the realignment, under the U.K. Financial Services Act 2012, of the U.K. Financial Services Authority into three separate agencies, the third of which is named the Financial Conduct Authority (FCA). In a speech to the Investor Relations Society Annual Conference in 2013, which was titled "IR in an Increasingly Regulated and International World," David Lawton, FCA Director of Markets, stated "the separation of roles between a prudential and a conduct authority gives us more space to focus on conduct issues and get to the substance of the drivers of poor conduct." He also commented specifically regarding stewardship, "for the [London capital market] system to provide a meaningful tool to investors, it needs the participation of investors in the form of ongoing stewardship and consumer responsibility."

As these comments suggest, the trend in financial markets today is toward stronger regulation, in part because of issues in the financial community. However, as Lawton of the U.K. FCA also pointed out, "The growth in regulation is one component of having increasingly international financial markets."

Principles-Based Substance of Japan's Stewardship Code

The aim of the Code is well stated in the preamble, "In this 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 investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment."

Japan's Stewardship Code's aim is not to legislate or make rules for investors to follow. The Code states specifically, "The Code is not a law or a legally binding regulation." Instead, the Code is based on the distinction between principles-based and rules-based thinking. Under the principles-based approach, parties with a mutual interest aim to attain generally agreed upon objectives. Under the rules-based approach, regulatory authorities set specific rules that must be followed. Generally, the spirit of regulation in Japan and Europe is more principles-based, while the SEC in the United States is more rules-oriented. Both approaches have their strong points.

Japan's Stewardship Code also allows leeway for investors because it adopts the "comply or explain" approach, which allows investors to comply with the principles or explain why they are not complying. The Code is quite specific on this point, "If an institutional investor finds that some of the principles of the Code are not suitable for it, then by explaining a sufficient reason, the investor can choose not to comply with them. In other words, an institutional investor who made its intention to accept the Code public does not have to comply with all of the principles uniformly."

In other words, the substance of the Code is to increase the transparency of the actions of institutional investors, but not to box them in with rules that would interfere with the conduct of their fiduciary duties to beneficiaries. Notwithstanding, investors who accept the Code will be expected to…

- Publicly disclose on their website the acceptance of the Code and required disclosure, such as their policy on how they will fulfill their stewardship responsibilities,
- Annually review and update the disclosed information, and
- Notify the Financial Services Agency of their URL where the information is disclosed.

Japan's Stewardship Code Consistent with International Standards

Japan's Stewardship Code has seven principles, which are quite consistent with the principles of the UK Stewardship Code[2] of the UK Financial Reporting Council published in September 2012. According to Japan's Stewardship code, institutional investors:

1. Should have a clear stewardship policy that is made public
2. Should have a clear policy on managing conflicts of interest
3. Should monitor investee companies to appropriately fulfill their stewardship role with an eye toward promoting the investees' sustainable growth
4. Should have a common understanding with investee companies to solve problems through constructive engagement

[2] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf

5. Should clearly disclose their policy on proxy voting and their voting activity

6. Should issue periodic reports on how they are fulfilling their stewardship responsibilities

7. Should contribute positively to the sustainable growth of investee companies. This will require in-depth knowledge of the investee companies and their business environment as well as the skills and resources necessary to engage investee companies and make proper judgments.

Comments on the Code

The Code was prepared by the Council of Experts Concerning the Japanese Version of the Stewardship Code (the Council), which was established in August 2013 under the aegis of Japan's Financial Services Agency. An exposure draft was issued, and comments were solicited in January and February 2014[3].

Comments were both positive and negative. Positive comments quoted by the Council included:

- "The Code represents a comprehensive approach that is consistent with the UK Stewardship Code and similar codes being developed in other markets."

- "We commend the Council for focusing on a number of important concepts, including referencing the desired long-term focus and recommending 'follow through,' for example, annual updating, ongoing review of the effectiveness of monitoring and a statement that dialogue itself should not be regarded as the aim of engagement."

Negative comments, summarized by the Council, included

- "We are opposed to the Code at this early date because, if followed, it will not contribute to the sustainable growth of investee companies or to Japan's development."

- "If investors interfere excessively in investee companies, this would be a violation of the principle of 'separation of ownership and management.'" It would also

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[3] http://www.fsa.go.jp/news/25/singi/20140422-2/02.pdf

reduce the leeway for action by the management of investee companies. At worst, the management of investee companies would lose their diversity, and management practices would simply become copies of other companies' practices. We are concerned that this would reduce the competitiveness of the Japanese economy."

Implications of Japan's Stewardship Code

What are the implications and potential outcomes in terms of the behavior of Japanese corporations and institutional investors as well as the framework for engagement among stakeholders? Let us consider a few.

1 **Creating long-term value versus short-term gains:** With an eye to the behavior of non-Japanese institutional investors, the Code could promote a greater focus by institutional investors on fundamental analysis and long-term investment opportunities for sustainable growth, as opposed to concentration on short-term trading gains. In the spirit of stewardship, investors might take a longer investment horizon, spend more time on monitoring and analyzing their investee companies, provide high-valued-added advice to senior management, and make other valuable contributions.

2 **Linking resource allocation with cost of capital:** With regard to concerns often raised by non-Japanese institutional investors, the Code may encourage more focus by Japanese corporations on allocating strategic corporate resources to areas where returns exceed Japanese corporations' weighted average cost of capital (WACC). Please see Investor Insight Seminar Presentation "How Foreign Institutional Investors View Japanese Corporate WACC + IR."[4]

3 **Aligning with new stock index:** The JPX Nikkei 400 Stock Index[5] and Japan's Stewardship Code seem likely to reinforce each other. That is, launched in January 2014, the JPX Nikkei 400 Stock Index is "… composed of companies with high appeal for investors, which meet requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives…while encouraging continued improvement of corporate value, thereby aiming to revitalize the Japanese stock market."[6] Other performance factors for inclusion in the Index include the three-year average ROE and three-year cumulative operating profit, as well as meeting such governance-related benchmarks as having at least

4 http://investorimpact.tk/wp-content/uploads/2014/01/a064d41738e0413452b38edeee82aa85.pdf
5 http://www.tse.or.jp/english/market/topix/jpx_nikkei.html
6 http://www.tse.or.jp/english/market/topix/jpx_nikkei.html

two outside directors.

4 **Bridging the gap between corporate management and institutional investors:** For the best case scenario to play out, some Japanese companies would have to listen more to investors, provide them with in-depth information to keep them up to date, and not shy away from engagement. Also in a best case scenario, institutional investors could act as what we might label "constructive activist investor stewards." Such institutional investor stewards would identify promising companies in Japan and provide them with stewardship assistance, which might include comments on performance and strategies, help in business development, and provision of other support that would contribute to sustaining the growth and development of the investee companies.

5 **Looking toward new Japanese corporate governance code:** Japan is also drawing up a new principles-based Corporate Governance Code, which many argue is in the best interests of both management and shareholders. In point of fact, an assessment by Goldman Sachs of the top 40 corporate governance performers in Japan shows that better corporate governance is closely correlated to a higher average ROE over FY3/2013-FY3/2015E[7]: Top quartile, 8.8%; bottom quartile, 5.5%. While the scope of the Governance Code is not yet finalized, Japanese corporations will have to carefully consider how to respond.

Accordingly, it may be said that Japan's Stewardship Code is part of an evolving ecosystem of IR in Japan, which is becoming increasingly aligned with international standards and practices. In the context of this evolving IR ecosystem, Investor Impact will continue to assist its IR clients in terms of communicating effectively with investors, supporting the broadening of the scope of engagement between management and shareholders, and, in the process, positively impacting corporate value.

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[7] Source: Goldman Sachs Research

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