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Corporate Accounting and Disclosure Division
Financial Services Agency

By email: stewardship2017-2@fsa.go.jp

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Dear Sir or Madam,

We are pleased to have the opportunity to provide comments on the proposed revision of Japan's Stewardship Code. Hermes Investment Management is an asset manager in the City of London, and is wholly owned by the BTPS, one of the UK's largest corporate pension schemes. As part of our Equity Ownership Services (Hermes EOS), we also respond to consultations on behalf of many. In all, Hermes EOS advises over 40 clients with regards to assets worth a total of £264bn (JPY36.6tn) as at 31st March 2017.

We largely welcome the proposed amendments to the Code as we believe they will assist in promoting more effective stewardship activities among institutional investors. We think that the additional guidance on asset owners' responsibilities as well as how asset managers should manage conflicts of interest will be helpful particularly for those investors who may be new to the idea of stewardship. On the other hand, we find some of the wording rather prescriptive – particularly compared to the UK code – and may be drifting away from a 'comply or explain' model. It would be helpful if the code is written in a way to give more encouragement rather than instruction.

We firmly welcome the additional note on collective engagement, which we have voiced strong support for as we believe that collaboration is an effective tool for institutional investors in carrying out their stewardship activities, particularly in light of the significant presence of cross-shareholders. We however have some suggestions on this matter, which we have detailed below along with comments on other specific changes.

Asset owners' responsibilities (1-3 to 1-5)

We welcome the additional emphasis on asset owners' responsibilities. While we welcome the market leading work of public pension funds such as the GPIF and the PFA in promoting stewardship activities across the investment chain, only a small number of Japanese corporate pension schemes have signed up to the Stewardship Code thus far. This suggests potentially insufficient understanding among some asset owners about their fiduciary duty, which may be directly or indirectly related to potential conflicts of interest between corporate pension schemes and their respective sponsor companies. It is common for corporate pension funds to outsource asset management rather than having in-house portfolio managers, but this does not mean they should not be involved or play a minor role in stewardship activities. Asset owners should be proactive in designing engagement and voting activities in line with their own stewardship policies, irrespective of their sponsor companies' agenda.

We feel that asset owners currently disclose a limited amount of information on their stewardship activities to their beneficiaries and that this should be enhanced. The added emphasis on asset owners' responsibilities will help place some pressure on them and raise awareness about stewardship, which will result in improving stewardship across the investment chain.

However, we are concerned that the wording of the guidance may be overly prescriptive, drifting away from comply-or-explain towards requirements. We fear this may further deter asset owners from taking up the code. We think it would benefit from being worded more along the lines of: "Asset owners should recognise their important role in the ownership chain and their duties towards their clients. In so doing, they should recognise that they have a responsibility to signal their wishes and beliefs to those whom they act on behalf of". The guidance 1-3 to 1-5 could also be phrased more as "should consider doing…" rather than "should do" and recognise the scale and resource issues asset owners may face.

Conflict of interests (2-2 to 2-4)

We appreciate that the addition of the more detailed guidance on managing conflicts of interest may be helpful for some asset managers to put in place robust measures to manage these conflicts and provide assurance for their clients and ultimate beneficiaries. However, we feel that the wording of the guidance is rather prescriptive and some investors may find other approaches more effective than those listed in the guidance.

Passive/index investors (4-2)

We welcome new guidance to encourage index investors to play active roles in engagement and voting. Some question the role and influence of index investors in this sphere because of their limited options to sell investee companies' shares. However, we do believe that appropriate engagement and voting activities are all the more important for index investors because of their limited ability to exercise their influence otherwise.

On the other hand, we should not downplay the importance of stewardships activities by active investors. While some of them may have shorter investment cycles than most passive investors, it is important that active investors conduct engagements with a long-term view. In other words, all investors irrespective of whether they be active or passive owe a responsibility to the company as engaged owners.

Collective engagement (4-4)

We are particularly pleased to see the note of collective engagement, following our requests. As we believe that collective engagement is a relatively new idea for Japanese investors, we think it is imperative that the Code encourages such activities explicitly among investors. We therefore have some recommendations in relation to this.

1. We think the wording of guidance 4-4 in the Japanese version of the Code sounds rather weak, which may not be seen as an encouragement for collective engagement. We therefore suggest that the Japanese version should be re-worded to more clearly and explicitly encourage collective engagement by investors.

2. We note that the Code references the 2014 document 'Clarification of Legal Issues Related to the Development of the Japan's Stewardship Code', which may be intended to assist investors to understand legal issues related to collective engagement. However, this document has been considered insufficient in giving investors assurance that collective engagement can be carried out without infringing regulations.

   Hermes EOS has been fortunate enough to have opportunities to directly meet FSA representatives and obtain verbal clarification that investors are allowed to engage collaboratively as long as they do not form agreement on how they exercise their voting rights. However, this has not been known to many other investors in different jurisdictions who may interpret the document differently which we believe has discouraged some from working collaboratively. We therefore strongly encourage the FSA to provide further clarification in the Stewardship Code in writing, to establish the verbal communications we had, as to the circumstances under which investors may or may not be able to act collectively. In the absence of clearer guidance on the legal aspect, the impact of the additional guidance in the Code may be very limited in promoting collective engagement in reality.

Voting disclosure (5-3)

We welcome the stronger encouragement for the disclosure of voting decisions which we believe will enhance investors' accountability and help ensure that their voting policies are upheld.

Investors' capabilities (7-4)

While we agree with the added emphasis on expectations for asset managers to evaluate their implementation of the code and report on it, we believe that the roles of asset owners in this respect are equally important. They should have the resources to hold asset managers accountable on all matters, including stewardship. They should have the ability to evaluate the quality of the stewardship activities carried out by asset managers and reflect it in their dialogue with the asset managers and the selection process for asset managers. This should not be formalistic, as noted in guidance 1-5. It is important that asset owners are empowered and sufficiently resourced so that the investment chain works effectively.

Lastly, we would like to highlight that the revision of the Stewardship Code and institutional investors' efforts to implement its principles will need to be matched with reforms in other part of the capital markets, in order to for stewardship activities to be effective. We are particularly concerned that cross-shareholdings (or strategic holdings) by companies continue to account for a significant part of the Japanese equity market and that these shareholders are not held accountable in the same way as institutional investors who sign up to the Stewardship Code. In other words, the level of influence institutional investors may be able to exercise will be limited without a swift and substantial reduction in cross-shareholdings. This point has also been addressed in the recent publication "Fiduciary Duty in the 21st Century – Japan Roadmap" (http://www.unepfi.org/wordpress/wp-content/uploads/2017/04/Fiduciary-duty-in-the-21st-century-Japan-roadmap.pdf). In addition, we expect companies to fully respect investors' willingness to engage and do their best to facilitate stewardship activities.

We hope that our comments and suggestions are of assistance. Should you have any questions, please do not hesitate to contact me at Sachi.Suzuki@hermes-investment.com or +44(0)20 7680 2196.

Yours faithfully,

Masaru Arai
Senior Advisor

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