FIDUCIARY DUTY IN THE 21ST CENTURY

JAPAN ROADMAP

generation foundation

UNEP FINANCE INITIATIVE

PRI Principles for Responsible Investment

THE PROJECT

Fiduciary duty in the 21st century concluded that failing to consider long-term investment value drivers, which include environmental, social and governance (ESG) issues, in investment practice is a failure of fiduciary duty[1]. Despite significant progress, many investors have yet to fully integrate ESG issues into their investment decision-making processes.

This document was developed through extensive industry consultation and sets out recommendations to ensure that the modern interpretation of fiduciary duty is reflected in investment practice in Japan. It also sets the Japanese capital market in a broader international context as regulators and investors respond to a rapidly-changing investing environment.

RECOMMENDATIONS:

1. **Stewardship and engagement:**
   The FSA should provide enhanced oversight of the Stewardship Code. Japanese regulation should provide for mandatory disclosure of proxy voting records. Corporate plans should be encouraged to sign the Stewardship Code.

2. **Corporate governance:**
   The FSA should review the Corporate Governance Code on a triennial basis. It should seek improved disclosure of key ESG issues under the code (such as cross-shareholdings) and continue pressure to enhance corporate governance expectations.

3. **ESG disclosure and guidance for pension schemes:**
   The Ministry of Health, Labour and Welfare (MHLW) should require pension schemes to disclose how they consider ESG issues in their investment processes and whether they are signatories to the Stewardship Code.

4. **Corporate disclosure:**
   a. The Ministry of Economy, Trade and Industry (METI) and the FSA should review the quality and comparability of the corporate disclosure of material ESG information.
   b. JPX should issue ESG guidance for listed companies.

5. **Asset owner leadership:**
   GPIF, given its scale, size, and influence, should lead in establishing market norms on stewardship, engagement and corporate governance.

It is an opportune time to engage with Japanese stakeholders on ESG integration and fiduciary duty. The Government of Japan's policy priorities – under the label 'Abenomics' – include improving investor stewardship and corporate governance. GPIF has signed up to the Principles for Responsible Investment and Japan's sustainable investment sector is currently growing faster than any other country or region[2].

ESG integration is defined as: "the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions". It is an approach to investment analysis applicable across asset classes, including equities, fixed income and private equity.

PROJECT STEERING COMMITTEE

- Peter Knight, Partner, Generation Investment Management
- Fiona Reynolds, Managing Director, PRI
- Nick Robins, Co-Director, UNEP Inquiry into a Sustainable Financial System
- Eric Usher, Head, UNEP Finance Initiative

1 The term 'fiduciary duty' is commonly translated by law scholars in Japan as 'Jyutakusha-Sekinin' and is a widely-recognised concept among regulators, investors and companies. Japanese law refers to duties of care and loyalty; this broadly corresponds to fiduciary duty.

2 Global Sustainable Investment Review, 2016: http://www.eurosif.org/wp-content/uploads/2017/03/GSIA_Review2016.pdf

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This roadmap is prepared by the PRI, UNEP FI and The Generation Foundation and does not necessarily represent the views of interviewees and reviewers.

Name	Title	Organisation
Nicholas Benes	Representative Director	Board Director Training Institute of Japan
Amane Fujimoto	Deputy Director, Corporate Accounting and Disclosure Division	Financial Services Agency
Arisa Kishigami	Head of ESG, Asia Pacific	FTSE Russell
Toshiaki Oguchi	Representative Director	Governance for Owners Japan
Sachi Suzuki	Manager - Engagement	Hermes EOS
Chad A. Cecere	Vice President, Client Relations	Japan Exchange Group (JPX)
Hitoshi Izumi	Head, Global Strategy	Japan Exchange Group (JPX)
Takeshi Okazaki	General Manager, Planning Division	Japan Investment Advisers Association (JIAA)
Tomohiro Yamada	Manager	Japan Investment Advisers Association (JIAA)
Takeru Shimizu	Special Officer for Research	Japan Investment Advisers Association (JIAA)
Masaru Arai	Chair	Japan Sustainable Investment Forum (JSIF)
Chihiro Kawashima	Executive Director, Economic and Social Policy Department	Japanese Trade Union Confederation (JTUC-Rengo)
Yuichi Haruta	Director, Economic Policy Division, Economic and Social Policy Department	Japanese Trade Union Confederation (JTUC-Rengo)
Kentaro Shigetomi	Section Chief, Welfare Policy Division	Japanese Trade Union Confederation (JTUC-Rengo)
Yasuyuki Kato	Professor, Graduate School of Management	Kyoto University
Yuka Akiwa	Consultant, Investments	Mercer
Masaya Okuyama	Director, Environment and Economy Division, Environmental Policy Bureau	Ministry of the Environment
Shin Izumi	Deputy Director, Environment and Economy Division, Environmental Policy Bureau	Ministry of the Environment
Minako Takaba	Vice President, ESG Research	MSCI
Seiichiro Uchi	Managing Director, Japan Index Coverage	MSCI
George Iguchi	Head of Corporate Governance	Nissay Asset Management Corporation
Toshikazu Hayashi	Senior Analyst	Nissay Asset Management Corporation

Name	Title	Organisation
Sadayuki Horie	Senior Researcher, Financial Technology and Market Research Department	Nomura Research Institute
Daisuke Hamaguchi	Chief Investment Officer	Pension Fund Association (PFA)
Ken Hokugo	Director, Head of Corporate Governance	Pension Fund Association (PFA)
Teruo Katsura	Advisor, Compliance Officer	Pension Fund Association (PFA)
Minoru Matsubara	Chief Manager	Resona Bank
Hiroichi Yagi	Managing Director	Secom Pension Fund
Masafumi Hikima	Professor	Sophia University
Kazutaka Kuroda	Sustainable Finance Specialist	The Japan Research Institute, Limited (JRI)
Eiichiro Adachi	Counselor and Head of ESG Research Center	The Japan Research Institute, Limited (JRI)
Keiichi Fukuyama	Executive Managing Director	The Research Institute for Policies on Pension and Aging (RIPPA)
Ryujiro Miki	Specially Appointed Researcher	The Research Institute for Policies on Pension and Aging (RIPPA)
Charles J. Yang	Managing Director	Tokio Marine Asset Management
Yasuhiro Yonezawa	Professor	Waseda Business School

ESG ISSUES AND FIDUCIARY DUTY IN JAPAN

ESG policy developments and Japan's economic priorities

The policies introduced through Japan's Revitalization Strategy – often known as "Abenomics" – have created changes in corporate and investment practices across Japan's capital market.

Government ministries and agencies have been constructively engaging on ESG issues across several themes.

- The Ito Review commissioned by METI identified the importance of sustainable value creation and a well-functioning investment chain in the context of Japan's broader economic challenges[3]. It concludes that corporate value comes from the "collaborative creation" of companies and investors[4]. In that context, stewardship and asset owner interaction with their service providers continues to be a core priority for The Government of Japan. METI has also established a study group on sustainable value creation[5] which will review the measures that both corporations and investors can take to generate and evaluate corporate performance on sustainability.

- Japan's Financial Services Agency (FSA) has developed the Stewardship Code (recently revised and updated) and Corporate Governance Code and has established the Council of Experts to oversee, monitor, update and provide guidance for both[6]. This reflects the FSA's overriding mandate which expressly seeks to promote the "sustainable growth of business activities and the wider economy" in Japan and to cope with "uncertainties in the global economy" including arising from technological change[7].

- The Ministry of the Environment has conducted long-term awareness raising on the environmental impacts of business activity. It co-ordinated the drafting of the Principles for Financial Action towards a Sustainable Society (Principles for Financial Action in the 21st Century; PFA21)[8], produced a web portal for "Eco-Minded Business" directed at different elements of the investment chain;[9] and has built a one-stop-shop reporting platform for corporate environmental disclosures, supplementing its environmental reporting guidelines to Japanese corporates[10]. The reporting guidelines were scheduled to be updated to be consistent with the findings of the Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures (TCFD)[11].

- The Cabinet Office has focused on improving the working environment within Japanese corporations, with a particular emphasis on the female labour force participation rate through the 2020/30 initiative[12]. As of 2016, corporations with more than 300 employees are required to have a strategy to advance women's role in the workplace (though without enforcement)[13].

This points to a steady evolution of the Government of Japan's regulatory approach from a strict rules-based regime to principles-based regulation. This can be seen in the FSA's codes and recent fiduciary duty initiatives described below. This allows for a focus on industry best practice rather than just compliance around minimum standards and facilitates thematic reviews by regulatory agencies into priority issues, such as sustainability.

3 The Ito Review, Executive Summary: http://www.meti.go.jp/english/press/2014/pdf/0806_04c.pdf
4 METI journal, Ito Review: http://www.meti.go.jp/english/publications/pdf/journal2015_01b.pdf
5 METI Study Group: http://www.meti.go.jp/english/press/2016/0822_03.html
6 FSA Council of Experts: http://www.fsa.go.jp/en/refer/councils/follow-up/index.html
7 Strategic Directions and Priorities, JFSA: http://www.fsa.go.jp/en/news/2015/20151019-2/01.pdf
8 PFA21: https://www.env.go.jp/en/policy/finance/principles/financial_action.pdf
9 The web portal: https://www.env.go.jp/policy/keiei_portal/index-en.html
10 Environmental Reporting Guidelines: http://www.env.go.jp/en/policy/economy/erg2012.pdf
11 An approach which incorporates other voluntary reporting frameworks such as CDP, GRI, SASB
12 Womenomics, FT: https://www.ft.com/content/6b4460d0-1992-11e5-8201-cbdb03d71480
13 Japan: Women in the Workforce, FT: https://www.ft.com/content/60729d68-20bb-11e5-aa5a-398b2169cf79

All these measures generate signficiant momentum for corporations and investors to engage with ESG themes and highlight the importance of sustainability issues to the wider Japanese population.

Overcoming ESG misconceptions and knowledge gaps

While Japan lags equivalent developed markets in the extent and volume of ESG integration in investment processes[14], there is increasing market focus on ESG themes, particularly corporate governance[15]. There is also growing investor awareness of the value-relevance of ESG issues, as well as some of the relevant international research on the matter[16]. However, there remains an urgent need for research on the financial materiality of ESG issues in Japan.

Our stakeholders recognised that misconceptions remain in market awareness of ESG issues and the implications of ESG issues for investment practice. In that context, it was important to confirm that ESG integration referred to "the systematic and explicit inclusion of material ESG factors into investment analysis and investment decisions." It is not a separate product or separate investment approach, but part of the broader process and technology of investment analysis.

ESG integration also does not involve a narrowing of the available investment universe (unlike negative screening). Neither does it involve subordinating the pursuit of a financial return to unrelated objectives (social or ethical).

Also, ESG issues are not uniform or hard to identify. The value-relevance and materiality of an ESG factor will not be symmetrical across sectors[17]. In fact, materiality varies systematically across sectors[18]. What is material for understanding the operational performance and financial prospects of a bank (risk management, cyber security), won't be the same for an extractives firm (water use, GHG emissions).

ESG factors may be some of the most consequential that an investor has to consider in relation to investee companies. Neglecting ESG factors may cause the mispricing of risk and poor asset allocation decisions—making it a fundamental component of financial analysis. Corporate "ESG failures" have proved capable of destroying significant accounting and stock value, across jurisdictions[19] and sectors[20].

Importantly, the materiality of ESG issues also varies across economies. We see this in The Government of Japan's focus on issues related to the workplace and corporate governance. This reflects the fact that Japan has a rapidly-aging and declining population. Japan urgently needs more women to enter and remain in the workforce and for people to remain in work longer prior to retiring – which will require better management of human capital in Japanese workplaces. These measures are vital to the financial sustainability of Japan's retirement plans in addition to the financial health of its public institutions.

14 Scale of ESG investment in Japan, Nikko Research Centre: http://www.nikko-research.co.jp/en/wp-content/uploads/sites/2/2016/04/ResearchReport201604E.pdf

15 MSCI 2017 trends: https://www.msci.com/documents/10199/cbc27309-8157-4589-9cc0-00734bca6a6b

16 Corporate Sustainability: First Evidence on Materiality: http://hbswk.hbs.edu/item/corporate-sustainability-first-evidence-on-materiality

17 Corporate Sustainability: First Evidence on Materiality: http://hbswk.hbs.edu/item/corporate-sustainability-first-evidence-on-materiality

18 Why and how investors use ESG information, Serafeim, HBS: http://www.hbs.edu/faculty/Pages/item.aspx?num=52392

19 VW settlement, Fortune: http://fortune.com/2016/10/26/settlement-vw-diesel-scandal/

20 Financial Impact of Dam Collapse, WSJ: https://www.wsj.com/articles/dam-burst-costs-could-break-1-billion-analyst-says-1447043902

Additionally, corporate governance is a major focus for institutional investors (domestic and foreign) who consider its impact on investment returns and corporate purpose. This includes concerns regarding conflicts of interest related to the corporate governance practices of Japan's insurance companies and asset managers, in addition to long-standing concerns regarding cross-shareholdings. These are critical issues for Japan and are also critical issues for the productivity, profitability and sustainability of Japanese corporations.

Developments in fiduciary duty

Internationally, regulators and government agencies have confirmed interpretations relevant to fiduciary investment practice.

- In the US, the Department of Labor asserted that the consideration of material ESG factors was an appropriate component of the primary analysis of a prudent investment decision[21].
- In Canada, the Financial Services Commission of Ontario noted that the decision to incorporate ESG factors in investment processes of pension funds is in line with pension administrators' fiduciary duty to monitor and mitigate risk[22].
- In the UK, the Law Commission, in its report Fiduciary Duties of Investment Intermediaries, stated that "there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material"[23]. This clarifies that it is not the origin of the factor (or the label given to it), but rather its financial materiality that is relevant to whether it should be considered.

The FSA has identified work on fiduciary duty as a strategic priority[24]. Fiduciary duties tend to include the duties of prudence and loyalty. This requires institutional investors to avoid conflicts of interest and provide services and advice in the best interests of their beneficiaries. The FSA is currently focusing on the advice and services provided by intermediaries not formally subject to fiduciary duties. This work reflects some of the themes of the Fiduciary Rule issued by the Department of Labor in the US[25].

The FSA released its Principles for Customer-Oriented Business Conduct[26] in January 2017,[27] an initiative we welcome. Having investment firms issue statements concerning their fiduciary responsibilities to investors can assist in the development of pro-beneficiary market norms.

However, there is a role for regulatory clarification that the consideration of material ESG factors is a core part of a prudent investment process, equivalent to that provided by regulators in the UK, US and Canada. Given this, we would expect the FSA to issue equivalent principles to enable investment managers and other regulated entities to confidently understand the scope of their fiduciary responsibilities in relation to the consideration of material ESG factors in investment processes and decision-making.

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21 Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments – also known as the ETI Bulletin

22 Financial Services Commission of Ontario, Investment Guidance Notes: IGN-004: Environmental Social and Governance (ESG) Factors, https://www.fsco.gov.on.ca/en/pensions/policies/active/Documents/IGN-004.pdf

23 Fiduciary Duties of Investment Intermediaries, UK Law Commission 2014: https://www.gov.uk/government/publications/fiduciary-duties-of-investment-intermediaries

24 FSA Agenda for financial markets: http://www.fsa.go.jp/en/news/2016/20160513-1/01.pdf

25 The US Fiduciary Rule is under review by the current administration

26 FSA release, Principles for Customer-Oriented Business Conduct: http://www.fsa.go.jp/en/newsletter/weekly2017/228.html

27 Draft principles for fiduciary duty: https://www2.deloitte.com/jp/en/pages/legal/articles/dt-legal-japan-regulatory-update-17february2017.html

RECOMMENDATIONS

1. Stewardship and engagement: The FSA should provide enhanced oversight of the Stewardship Code. Japanese regulation should provide for mandatory disclosure of proxy voting records. Corporate plans should be encouraged to sign the Stewardship Code.

Expectations around how and how often institutional investors engage with their investee companies have significantly increased over the past decade. This has been led by two developments:

- soft-law encouragement from financial regulators; and
- institutional investors increasingly understanding and creating capacity to act upon the stewardship responsibilities within their fiduciary duties.

The Stewardship Code: The Principles for Responsible Institutional Investors, developed by the FSA in 2014 – known as the Stewardship Code – has helped legitimise shareholder engagement practices in a market where corporates and investors have been reticent about active ownership (particularly if publicly disclosed). The volume and quality of institutional investor stewardship has significantly improved following the FSA's launch of the code. The code has been signed by investment managers and public funds (though only by a very limited number of corporate pension plans). It has implications for market participants beyond its signatories by framing the normative expectations for stewardship practices. There is no legal enforcement mechanism for the compliance or quality of reporting against the code – signature of which is voluntary. However, as the FSA administers the code, it is viewed as an important instrument by market participants.

The Council of Experts, convened by the FSA to oversee the code and suggest improvements, says that institutional investors are expected to conduct "effective stewardship…taking a mid to long term perspective" structured around a deep evaluation of an investee company's business model and commercial objectives[28].

In its revised code (subject to public comment)[29], the Council of Experts, following extensive deliberation[30], significantly expands its guidance under the code to emphasise the importance of ESG factors and the interests of the ultimate beneficiary in conducting stewardship activities. The revised guidance also encourages signatories to explain the implementation of the code's principles – in addition to explanations provided where the signatory chooses not to comply with a principle or related guidance. This reinforces the FSA's intent that the code be an instrument that has practical implications for institutional investors. The revised code also provides expanded guidance on: investment mandates, conflicts of interest, proxy voting disclosure, manager self-evaluations and collective engagement (see below).

The code closely tracks the stewardship code issued by the Financial Reporting Council (FRC) in the United Kingdom[31]. It deviates from that code in only one material respect; the Japanese code fails to indicate, in its principles, that investors should work with other investors where they consider appropriate. Collaborative engagements[32] are a key strategic tool for institutional investors, particularly for engaging on ESG issues.

28 FSA Council of Experts on Stewardship Code, opinion statement no 3: http://www.fsa.go.jp/en/refer/councils/follow-up/statements_3.pdf

29 Revised Stewardship Code, for public consultation: http://www.fsa.go.jp/en/news/pub/03.pdf

30 FSA Council of Experts discussion materials: http://www.fsa.go.jp/en/refer/councils/stewardship/material/20170217_1.pdf

31 UK Stewardship Code: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx

32 Collaborative Engagement and Collective Engagement are used synonymously

Such engagement can reduce the cost of engagement for both investors and corporations and focus it on value-relevant factors. Given this, we strongly welcome the guidance issued by the Council of Experts in the revised code which identifies that collective engagement by institutional investors can be beneficial in conducting stewardship activities[33].

In Japan, collaborative engagements have been discouraged by asset manager concerns around the ease with which investors may be considered to be either "acting in concert" or "making important suggestions" under existing securities regulation. Collective engagement is a relatively new concept to Japanese institutional investors and asset managers have been considering how such engagements can be structured. It is also a sensitive and important issue for Japanese institutional investors and regulators. Our commentary seeks to identify the balance of feedback received from the stakeholders we engaged with rather than to form a definitive view. The FSA provided guidance on this subject in 2014[34]. Some stakeholders considered that the FSA's guidance provided a useful benchmark for structuring collaborative engagements in Japan. However, many of our stakeholders thought that the issued guidance provided insufficient clarity on the scope of collaborative engagement activities that could be conducted without tripping over reporting requirements. Regulatory clarification had also been provided in the UK, which had explicitly sought to provide greater comfort to investors wanting to work collaboratively (as reflected in the UK stewardship code)[35]. Given the revised code's reference to the potential benefit of collective engagement, we expect Japanese asset managers to consider collaborative engagement strategies as part of their potential mix of stewardship approaches. As a degree of uncertainty remains, the FSA should issue revised and updated guidance in relation to "acting in concert" or "making important suggestions" regarding collective engagement.

Stewardship codes are relatively new market instruments. However, it is clear that broad adoption and effective reporting against the code are key to a code having impact. For a code to be truly effective, the quality of reporting against it ought to become a tool for competitive differentiation between asset managers (and a relevant source of information for asset owners in manager selection procedures). In this context, we highlight the FRC's recent "tiering" exercise of signatory reporting quality against the UK code[36]. This categorised code reporting into three categories, the lowest of which indicated poor performance against the code[37].

At the core of stewardship is the responsibility of asset owners and investment managers to be mindful and effective stewards of the assets they hold for their beneficiaries. There was an expectation that major asset owners, such as GPIF, can provide a useful oversight and monitoring function of other code signatories through its broad arrangements with Japan's asset managers. As such, the role of the regulator can only be an overlay to institutional investor stewardship. Nonetheless, we expect the FSA to continue to closely monitor the code to ensure that it is an effective instrument in driving the adoption of stewardship practices.

Market practice: Engagement with investee companies has tended to be conducted mainly by overseas investors, who play a major role in the market for Japanese equities (around 30% of tier one JPX equities are internationally owned). International investors, supported by domestic managers, have led high-profile engagements, such as the initiative around independent board representation in 2014[38].

33 See guidance issued under Principle 4 in the revised Code

34 FSA guidance on stewardship code: http://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf

35 FRC guidance to UK investors: https://www.frc.org.uk/FRC/media/Documents/shareholder_engagement_FSA_letter.pdf

36 FRC tiering: https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2016/November/Tiering-of-signatories-to-the-Stewardship-Code.aspx

37 FRC ranks fund managers: https://www.companysecretarialpracticeonline.co.uk/events/frc-ranks-fund-managers-reporting-on-the-stewardship-code/780

38 Investor letter on board composition: http://www.standardlifeinvestments.com/CG_Letter_Regarding_Board_Independence/getLatest.pdf

However, Japanese asset managers are building their stewardship capacity and considering how best to structure engagements with investee companies. Groupings of Japanese investors, such as the Pension Fund Association, have hired international investment managers (like Hermes EOS) to conduct corporate engagement. Specialist Japanese engagement platforms (like Governance for Owners Japan) can also demonstrate positive track records from deep-dive engagement efforts with Japanese corporations across a range of value-relevant issues, including ESG factors.

Central to engagement with Japanese corporations was an understanding of the culture and history of each corporation and taking the time to build the trust upon which effective engagement depended – an expectation highlighted in Principle 7 of the Stewardship Code[39]. Engagement also had to be perceived as useful to investee companies. This meant structuring engagement by reference to key corporate objectives based on an understanding of its business model. Pro-forma engagements were less likely to receive attention, except where these were focused on core corporate governance themes.

Japanese corporations have become less reluctant to engage with investors and have begun to build investor relations teams. It is understood that corporations often welcome the insights of investors, expanding the evidence to which corporations have access in strategy development. This was supported by emerging evidence that engagement by investors could produce value upside over the long term[40], confirming studies from other markets such as the US[41].

Recommendations:

- **Oversight of the code:** The FSA should continue to monitor the reporting against the code and consider adopting a "tiering exercise" of code signatories (as conducted by the FRC in the UK) to enable it to be a tool of competitive differentiation among asset managers.

- **Proxy voting disclosure:** The FSA should ensure that Japanese institutional investors (including insurance companies and corporations that own Japanese equities) provide specific, by corporation and by proposition, disclosure of proxy voting records (equivalent to disclosures mandated in the US). The disclosure guidance in the revised code is very welcome. However, statutory changes should be made to mandate such disclosures for institutional and corporate holders of Japanese equities. Such disclosure is a vital market signal and should not be a matter of voluntary disclosure.

- **Acting in concert and the act of making important suggestions:** Given the welcome guidance note in the revised code regarding the potential benefits of collective engagement, we expect Japanese asset managers to consider collaborative engagement strategies where they have not already done so. Given stakeholder uncertainty, the FSA should continue to consult with institutional investors and update its guidance regarding available collective engagement strategies.

- **Corporate pension plans:** Corporate pension plans should be further encouraged to become signatories to the code. We support the initiative of the Pension Fund Association on this issue. Following this, corporate pension plans should be required to set out stewardship policies in their "Basic Investment Policy", and disclose to beneficiaries whether or not they have signed the code, and if not, explain why (discussed in Recommendation 3).

39 Keys to success of Japan's stewardship code, NRI (page 3): https://www.nri.com/~/media/PDF/global/opinion/lakyara/2014/lkr2014199.pdf

40 The Power of Engagement: http://www.top1000funds.com/news/2015/06/17/the-power-of-engagement/

41 Valuing the Vote, SBA: http://www.valuewalk.com/wp-content/uploads/2015/06/SBAValuingtheVote20151.pdf

2. Corporate governance: The FSA should review the Corporate Governance Code on a triennial basis. It should seek improved disclosure of key ESG issues under the code (such as cross-shareholdings) and continue pressure to enhance corporate governance expectations.

Corporate governance is the dominant theme on which investors are engaging with Japanese corporations.

Since the Corporate Governance Code was released by the FSA in 2015, Japan has been identified as having the most rapidly-improving corporate governance of any mature market. However, this improvement is from a very low base.

The Corporate Governance Code has sought to erode negative board practices, placing an emphasis on board independence, dialogue with shareholders and more corporate transparency. The percentage of large Japanese corporates with independent director representation has expanded significantly since the code's launch, also reflecting pressure from external investors.[42]

The code now has solid compliance rates from reporting companies.[43] However, there is concern about rhetorical or formalistic adoption of the code by some companies. This treats the code as a box-tick minimum standard rather than seeing the code as an instrument to adaptively apply to make governance more transparent and effective.

It is acknowledged that the concepts in the code will take time to be well understood and viewed as having practical value by corporations. For instance, independent directors could become a crucial point of engagement for shareholders but are generally not being used in this way. However, corporate governance should not be viewed too mechanistically. Well-functioning boards often have very different characteristics which may not fit a one-size-fits-all set of corporate governance requirements.

There was concern among our stakeholders that the rate of progress in Japanese corporate governance since the launch of the code should not slow down or plateau. To avoid this, many thought that the code must be regularly reviewed and an upward ratchet applied to its requirements for governance standards.

The scandals over the past decade have drawn attention to corporate governance failures at Japanese corporations (such as Olympus[44], Tepco[45] and Toshiba[46]). Investors have expressed frustration at the comparatively low investment returns of Japanese corporations, reflecting a broader policy concern of The Government of Japan. Corporations have also tended to collectively structure the schedule of general meetings to discourage shareholder engagement, often holding the majority of their shareholder AGMs tightly clustered in the latter part of June (though meetings have become slightly more dispersed in recent years).

Stakeholders identified key themes on which they were engaging with Japanese corporations, many of which have a strong ESG focus:

- capital efficiency;
- cross-shareholding;
- CEO compensation (long-term, performance-linked incentive structures), appointment and succession;[47]
- board diversity and the independence of nominally "independent directors";
- informal retired senior executive positions.

42 Corporate Governance in Japan by Nick Benes: https://ethicalboardroom.com/corporate-governance-in-japan-now/

43 http://www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jdy-att/20170116.pdf

44 Olympus scandal: http://www.nytimes.com/2011/12/09/business/deep-roots-of-fraud-at-olympus.html

45 Tepco scandal: http://www.japantimes.co.jp/opinion/2016/03/26/commentary/tepco-executives-get-taste-citizens-wrath/#.WOqAlVPyuRs

46 Toshiba scandal: http://www.japantimes.co.jp/news/2015/07/26/business/corporate-business/toshiba-scandal-exposes-continued-flaws-governance-japan-inc/#.WOqPkFPyuRs

47 FSA Council of Experts opinion statement No.2 - on transparency, timeliness and objectivity in CEO appointment and succession planning: http://www.fsa.go.jp/en/refer/councils/follow-up/statements_2.pdf

Cross-shareholdings – Our stakeholders consistently raised cross-shareholding or "allegiance shareholdings" as a critical issue in Japanese corporate governance, which could erode shareholders' ability to engage with corporations on ESG issues. Japanese corporations often view such arrangements as a natural and expected feature of the business environment. However, they result in very different accountability dynamics for Japanese corporations as these shareholdings can account for a significant slice of a corporation's shareholder base, though divided among many small holdings by corporations. Investors have several concerns about cross-shareholdings:

- lack of transparency on the rationale for such holdings;
- their effect on capital efficiency;
- conflicts of interest;
- dangers for "pure" minority shareholders;
- anti-takeover effects;
- emerging evidence that the size of cross-shareholding is negatively correlated with corporate performance[48].

Shareholder engagement is the most effective way to unwind cross-shareholdings. In other markets, consistent shareholder engagement on corporate governance themes has proved effective in changing corporate governance practices. The volume of cross-shareholding relationships in Japanese equities has decreased over recent decades and major banks[49] have begun to unwind these positions[50]. We expect this trend to continue with increased speed. Nonetheless, given that cross-shareholdings remain an assumed (though increasingly controversial) feature of the Japanese business landscape, corporations will expect shareholders to explain their rationale for unwinding them.

Recommendations:

- **Formal code review:** The Corporate Governance Code should be subject to a formal triennial review to keep it current and oversee substantive compliance. Companies should continue to work with their stakeholders to improve their corporate governance.

  The Council of Experts should also review how sustainability is considered in corporate reporting against the code, to work towards the adoption of mandatory statutory reporting of ESG issues.

  The Council of Experts should seek to strengthen the code's requirements on independent directors (in number, proportion and position on key committees (such as audit and compensation) and the definition of "independence" to ensure that Japanese corporate governance reflects expected market norms. It should review the problem of "over-boarding" of "trophy" independent directors and could seek to identify broad in-principle limits to avoid over-boarding concerns equivalent to those used by leading asset managers[51].

- **Disclosure of "strategic holdings":** To enable investors to analyse the rationale for allegiance, cross or "strategic" shareholdings, they require more than pro-forma disclosures across countless strategic holdings. Current disclosures often simply reference "to maintain a strategic relationship" as the only rationale. The code should provide more granular guidance on disclosing the rationale for cross-shareholding or allegiance shareholder positions to enable deeper and informed investor analysis. The code should also require full disclosure of proxy voting of cross-shareholding positions to enable investors to assess the rationale and purpose of the relevant cross-shareholding.

- **Shareholder engagement:** The FSA should review board and corporate practices and provisions of corporate law that may conflict with the principles of the Stewardship and Corporate Governance Codes (such as the role of the board and fair treatment of shareholders).

48 What Correlates with Superior Corporate Performance? by Aki Matsumoto of METRICAL and Nicholas Benes of BDTIJ: https://bdti.or.jp/en/blog/en/whatcorrelates/

49 Council of Experts, re cross-shareholding, notes concerns raised regarding pro-cyclicality and capital adequacy in bank holdings: http://www.fsa.go.jp/en/refer/councils/follow-up/minutes/20151124-1.pdf

50 Unwind cross-shareholdings, FT: https://www.ft.com/content/bf714ea6-8b76-11e5-8be4-3506bf20cc2b

51 Blackrock's proxy voting guidelines suggest that four or more directorships amounts to over-boarding (page 4): https://www.blackrock.com/corporate/en-cl/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf

3. ESG disclosure and guidance for pension schemes: The Ministry of Health, Labour and Welfare (MHLW) should require pension schemes to disclose how they consider ESG issues in their investment processes and whether they are signatories to the Stewardship Code.

Disclosure of investment practices can be a means of improving pension scheme practice and deliberation. A disclosure requirement can support minimum standards on the integration of ESG issues. It can identify an issue as a legitimate concern for scheme managers and initiate a discussion between an asset owner and its advisors (lawyers, investment consultants, investment managers and actuaries) on how to comply with the regulation.

A better flow of information from a scheme to both its regulator and its stakeholders may also serve to build trust with beneficiaries by providing context for investment decisions and the broader management of beneficiary assets. This can be achieved through disclosure requirements without materially raising compliance costs as additional information can be included in existing statutory disclosures.

Such disclosures have been part of UK pensions regulation for over a decade.[52] They have recently been strengthened with supporting guidance[53] and public commentary from The Pensions Regulator on the importance of ESG issues to prudent scheme practice[54].

Since January 2016, pension plans registered in Ontario (in Canada) are required to indicate in their Statement of Investment Policies and Procedures (SIPP) and in a prescribed statement to plan members whether ESG factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated. This also reflects the extensive disclosures that are required in securities regulation of policies on use of proxy rights and annual disclosures of proxy voting records, as mandated by the US Securities and Exchange Commission[55].

To date, pension schemes regulated by the MHLW have received very limited guidance regarding the consideration of ESG factors. The Study Group on Basic Fund Guidelines[56], hosted by MHLW, referred to ESG factors as "non-financial elements" to be considered in addition to financial elements.

This is in contrast to significant examples of international regulators providing assertive guidance around the consistency between the consideration of ESG factors and fiduciary responsibilities. This includes guidance provided by the Department of Labor in the United States,[57] as well as guidance issued by the UK pensions regulator.

Pension scheme behaviour is often strongly influenced by the advice of their service providers. In the US and the UK, asset consultants strongly influence the investment strategies and resulting asset allocation decisions of their asset owner clients. In Japan, an equivalent role is played by the major trust banks for many of Japan's pension schemes, with the major international investment consultants also providing services to many Japanese pension schemes. These intermediaries often act as a selection mechanism for scheme investment managers and often provide training and policy insight to asset owners on investment approaches and emerging investment trends.

Many of our stakeholders indicate that asset owners often lean heavily on the advice and infrastructure of their trust bank or investment consultant. There are concerns that asset owners are receiving generic advice and policy documents; not receiving advice on ESG approaches or sustainability issues; and are not in a position to assess the quality of the advice they receive. This limits the ability of asset owners to be an effective voice in the investment chain.

52 The Occupational Pension Schemes (Investment) Regulations 2005: http://www.legislation.gov.uk/uksi/2005/3378/regulation/2/made

53 Guide to Investment Governance – The Pensions Regulator: http://www.thepensionsregulator.gov.uk/docs/dc-investment-guide.pdf

54 http://www.professionalpensions.com/professional-pensions/news/2470190/tpr-trustees-must-wake-up-and-smell-the-coffee-on-esg

55 Form N-PX: https://www.sec.gov/edgar/searchedgar/n-px.htm

56 Informal MHLW document, in Japanese only

57 In interpretive bulletin 2015-01 the Department of Labor clarified that ESG factors were "an appropriate component of the primary analysis of a prudent investment decision": http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=28547&AgencyId=8&DocumentType=1

58 The Risk and Opportunity for America's Corporate Pension Plans, Forbes: https://www.forbes.com/sites/bobeccles/2017/01/10/the-risk-and-opportunity-for-americas-corporate-pension-plans/#6844cdd72c9a

Focus on corporate plans: As we have seen in other markets, such as the US[58], corporate pension plans tend to be laggards in relation to the adoption of ESG practices. This makes the lack of effective guidance around ESG issues in investment processes a particular concern. Corporate plans are significantly smaller than public plan equivalents. With no or limited full time investment staff, corporate plans tend to fully out-source investment functions. These capacity constraints make corporate plans product takers in terms of services with their managers and consultants. This limits their role in framing and structuring the services they receive.

Only a very limited number of Japanese corporate plans have signed the Stewardship Code[59] suggesting they have a limited understanding of the extent of the stewardship responsibilities within their fiduciary duties[60]. Of more than 200 code signatories, only 26 are pension schemes and of that number only a fraction are corporate plans (such as Secom – the only non-financial sector corporate plan to have signed the code). Our stakeholders pointed out that Japanese corporations have a proud and strong commitment to their workforce and that effective stewardship of employee benefit assets should be understood as an important element of that commitment.

There was little appetite among our interviewees or any perceived opportunity for consolidating or pooling plan assets to bolster capacity and scheme governance[61]. Given this, Japanese corporate plans require guidance to enable effective interaction with their intermediaries (investment managers and consultants), to ensure that their fiduciary responsibilities and investment objectives are being effectively and prudently met. MHLW had an important role to play in this.

Recommendations:

Disclosure: Japanese pension schemes, subject to the regulatory oversight of MHLW, should be required to publicly disclose in their statements of investment principles[62] and communications with beneficiaries:

- how they consider material ESG issues in their investment processes, including their policy on stewardship; and
- whether they are signatories to the Stewardship Code (and if not, why not).

Guidance: MHLW should issue guidance to its regulated pension schemes to clarify that the consideration of material ESG factors in investment processes is required by the fiduciary duties to which they are subject. MHLW should also clarify that shareholder rights are assets to be used in the best interests of beneficiaries and require disclosure of the use of those rights by the scheme (and its managers)[63] – as recommended by the report of the Japan Financial System Council[64].

In addition, MHLW should:

- publicly encourage regulated plans to sign the Stewardship Code to confirm that effective asset stewardship is a core element of fiduciary responsibilities;
- clarify that schemes are expected to have fully developed policy development processes, not merely the repetition of advisor pro-forma policy templates;
- work with stakeholders, such as the PRI, to develop guidance to enable the effective interaction of pension schemes with their advisers (particularly trust banks and investment consultants) on the consideration of ESG factors, and relevant questions to ask in selection, appointment and monitoring processes for asset managers and other scheme advisers;
- encourage pension schemes to become PRI signatories (like GPIF).

59 Signatories to the stewardship code, year end 2016: http://www.fsa.go.jp/en/refer/councils/stewardship/20160315/01.pdf

60 Companies fail to buy into Japan's Stewardship Code, FT: https://www.ft.com/content/138e73b4-98d3-11e6-8f9b-70e3cabccfae

61 This has been recently considered by the Financial Conduct Authority in the UK

62 Generally referred to as the Basic Investment Policy.

63 Equivalent provisions can be found in ERISA applicable to US corporate pension plans

64 Report of the Japan Financial System Council: http://www.fsa.go.jp/en/news/2009/20090618-1/01.pdf

4. Corporate disclosure:

a. METI and the FSA should review the quality and comparability of the corporate disclosure of material ESG information.

As in other markets, limited, non-standardised corporate disclosure of material ESG information (in both mandatory securities disclosures and under voluntary reporting frameworks) raises the costs for investors seeking to conduct ESG analysis on Japanese corporations. It also reduces the ability for investors and corporations to engage in constructive dialogue on sustainability topics. Poor quality reporting of material ESG factors was highlighted as a market problem in the Ito Report.

As in other markets, there are concerns around "questionnaire fatigue", with corporations being asked to respond to pro-forma questions from ESG research firms, rating agencies and investors that often seem unrelated to value creation or the specifics of a corporation's business model.

For disclosures of material ESG information to investors, there was much interest in the reporting framework developed by the Sustainability Accounting Standards Board (SASB)[65] and its industry standards for key sustainability disclosures. Japanese corporations tended to frame their integrated reports[66] by reference to GRI standards and ISO26000[67]. Our stakeholders identified that there were several examples of Japanese corporations with advanced disclosure practices[68], such as Omron and Ajinomoto.

The report by the Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures (TCFD) allows regulators to review the quality and comparability of corporate disclosure around climate risks, and ESG issues more broadly.

The FSA's transition to a more principles-based regulatory approach provides more capacity to conduct reviews of this nature[69]. Such a review would support the METI study group on this issue and be consistent with the revised Stewardship Code's reference to the risks and opportunities arising from ESG factors[70]. This would also build on the report of the Working Group on Corporate Disclosure of the FSA's Financial System Council which sought to enable constructive dialogue between corporations and investors through adjusting approaches to corporate reporting.[71] Such work would further reflect the US Securities and Exchange Commission's concept release on Regulation S-K[72] conducted last year, in addition to the thematic review into climate change disclosures announced by the Canadian Securities Administrators[73].

Recommendation:

Following the report of the FSB TCFD, METI and the FSA should conduct a review into the quality and comparability of corporate reporting of material ESG issues by Japanese corporations and its usefulness to institutional investors.

65 https://www.sasb.org/

66 Integrated reports were issued by around 200 Japanese corporations

67 https://www.iso.org/iso-26000-social-responsibility.html

68 Survey of Integrated Reports, KPMG: https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/jp-en-integrated-reporting-20160426.pdf

69 Financial services forum white paper, ACCJ: http://www.accj.or.jp/uploads/4/9/3/4/49349571/160511_accj_fsf_white_paper_e.pdf

70 Principle 3, guidance note 3 – 3, revised Stewardship Code: http://www.fsa.go.jp/en/news/pub/03.pdf

71 Working Group on Corporate Disclosure of the financial system council: http://www.fsa.go.jp/en/refer/councils/singie_kinyu/20160719-1/01.pdf

72 UNPRI response to SEC concept release consultation: https://www.unpri.org/download-attachment/21003

73 CSA review of climate change disclosure: https://www.securities-administrators.ca/aboutcsa.aspx?id=1567

4. Corporate disclosure:
b. JPX should issue ESG guidance for listed companies.

As with other mature markets, stock exchanges play a crucial role in enhancing corporate disclosure and transparency. Exchanges can also help direct liquidity towards particular ESG focused corporate practices. JPX has enabled this through its sustainability index[74] and through the JPX/Nikkei 400 index that has proved influential with its focus on ROE and corporate governance[75] [76]. However, Japanese stock exchanges do not currently offer any guidance on ESG disclosure, unlike other leading exchanges such as the London Stock Exchange Group[77]. JPX is also not a signatory to the UN Sustainable Stock Exchanges initiative[78].

Through hosting corporate disclosures under the Corporate Governance Code, JPX has advanced corporate transparency. Guidance by JPX can reflect and address the distinctive material ESG issues particularly relevant for the Japanese market.[79] JPX can further this by providing best practice examples of contentious disclosure issues to create a strong norm for expected disclosure quality. This could be usefully implemented on key investor issues such as cross-shareholdings and informal senior executive positions.

Recommendation:
JPX should provide ESG disclosure guidance in common with other mature market stock exchanges as an interim measure, in advance of developing formal ESG listing requirements.

74 http://us.spindices.com/indices/equity/sp-topix-150-carbon-efficient-index

75 New Japan index vaunts return on equity, FT: https://www.ft.com/content/516dc144-477d-11e3-9398-00144feabdc0

76 See chart 4: http://www.jpx.co.jp/english/equities/listing/cg/tvdivq0000008jb0-att/2015.pdf

77 Revealing the full picture: your guide to ESG reporting: http://www.lseg.com/sites/default/files/content/images/Green_Finance/ESG_Guidance_Report_LSEG.pdf

78 SSEi list of partner exchanges: http://www.sseinitiative.org/sse-partner-exchanges/list-of-partner-exchanges/

79 Such as the labour force participation rate among other Social issues on the ESG spectrum

5. Asset owner leadership: GPIF, given its scale, size, and influence, should lead in establishing market norms on stewardship, engagement and corporate governance.

Asset owners, both public and corporate plans, often lack internal capacity to carry out stewardship activities. As highlighted in the Ito Report, they tend to outsource investment management, and generally have low awareness of ESG integration approaches and how to embed them in their relationships with investment managers. However, expectations of the capacity of institutional investors have grown rapidly in recent years.

The initiatives of GPIF have sent a positive market signal about the expected capacity and approach of institutional investors. GPIF has signed the PRI, indicating that the six Principles are consistent with its fiduciary responsibilities. GPIF is developing ESG indices through a call for applications, building out its capacity to oversee and monitor the stewardship activities of its investment managers[80] and asserting itself with investee companies (within the confines of its legal restrictions)[81]. They have also re-balanced their portfolio asset allocation toward equities, a development which made effective ESG integration essential[82].

As with other asset owners operating exclusively through investment managers, GPIF needs to ensure that its long-term investment time horizon is reflected in the mandates, incentive structure and performance reviews that it conducts with its asset managers. It also needs to ensure that managers are adequately engaging with investee companies on corporate governance priorities.

In addition, given its scale and interaction with asset managers, GPIF can perform a crucial role in examining the governance structures of investment managers and ensuring that managers avoid conflicts of interest and put in place appropriate control mechanisms[83]. This builds on the work of the Council of Experts who have proposed enhancements to institutional investor governance, such as independent boards and third party committees for proxy voting decisions[84] - including in the terms of the revised Stewardship Code. This was a theme that had also been addressed in the UK through the FCA Asset Management market study[85].

GPIF's position and scale gives it a special capacity and role in influencing the formation of market norms, fulfilling a role equivalent to that which CalPERS and CPPIB have performed in their home markets (and globally). Its activities should provide strong encouragement to other Japanese asset owners, particularly public plans, to explore ESG integration and responsible investment.

Recommendations:

- **ESG tool-kits:** As a PRI signatory, combined with its scale, GPIF should develop best practices on ESG integration to support other market participants. It should do this in its selection, appointment and monitoring procedures for managers, its policy development process, its governance structures and the themes it selects for engagement with investee companies. GPIF should strongly support collective engagement as well as take a leadership role in solving a number of corporate governance problems which arise from allegiance, cross or "strategic" shareholdings. GPIF's capacity enables it to hold managers to account and develop products (rather than be a product-taker). Reflecting the practice of leading asset owners, GPIF should seek to fully disclose its approaches to ESG integration and refer to the Corporate Governance Code in its Investment Principles.

- **GPIF's role in awareness raising:** many of our stakeholders wanted to see GPIF making enhanced efforts to engage with, and raise awareness with, the wider public (the ultimate beneficiaries of the fund) of its approach to ESG integration in line with global best practice. It could do this through enhancing its web presence and its communication with the wider public as part of a broader government focus on financial education[86].

80 GPIF summary report of stewardship activities 2016: http://www.gpif.go.jp/en/topics/pdf/20170203_report_of_stewardship_activities_2016.pdf

81 GPIF sues Toshiba: https://www.ft.com/content/e275fa00-3922-11e6-9a05-82a9b15a8ee7

82 GPIF reform: https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/performancemagazine/articles/lu-gpif-reform-012015.pdf

83 Fiduciary best practices for Japanese asset management companies, NRI: https://www.nri.com/~/media/PDF/global/opinion/lakyara/2016/lkr2016250.pdf

84 FSA Council of Experts, Opinion No 3: http://www.fsa.go.jp/en/refer/councils/follow-up/statements_3.pdf

85 FCA Asset Management market study, interim report: https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

86 OECD principles for financial education: http://www.oecd.org/finance/financial-education/OECD_INFE_High_Level_Principles_National_Strategies_Financial_Education_APEC.pdf

About the PRI

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance issues and to support signatories in integrating these issues into investment and ownership decisions. The six Principles were developed by investors and are supported by the UN. They have more than 1,700 signatories from over 50 countries representing US$62 trillion of assets. They are voluntary and aspirational, offering a menu of possible actions for incorporating ESG issues into investment practices. In implementing the Principles, signatories contribute to developing a more sustainable global financial system. For more information, see www.unpri.org.

About UNEP FI

The United Nations Environment Programme Finance Initiative (UNEP FI) is a unique global partnership between the United Nations Environment Programme (UNEP) and the global financial sector founded in 1992. UNEP FI works closely with over 200 financial institutions who have signed the UNEP FI Statements as well as a range of partner organizations to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations. For more information, see www.unepfi.org.

About The Generation Foundation

The Generation Foundation ('The Foundation') is the advocacy initiative of Generation Investment Management ('Generation'), a boutique investment manager founded in 2004. The Foundation was established alongside Generation in order to strengthen the case for Sustainable Capitalism. Its strategy in pursuit of this vision is to mobilise asset owners, asset managers, companies and other key participants in financial markets in support of the business case for Sustainable Capitalism, and to persuade them to allocate capital accordingly. For more information, see www.genfound.org.

CREDITS

Written by: Brian Tomlinson, Will Martindale and Megumi Terayama