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**Self-regulation in Private Law
in Japan and Germany**

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Genuine Self-regulation in Japanese Capital Markets: The Stewardship Code

In Comparison to the Corporate Governance Code

*Hiroyuki Kansaku**

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I. INTRODUCTION

Japan's Stewardship Code (SSC) represents the fundamental principles of good practice for institutional investors in fulfilling their stewardship responsibilities. The SSC was created in 2014 and influenced by the Stewardship Code in the United Kingdom.¹ On the other hand, the Tōkyō Stock Exchange (TSE) incorporated Japan's Corporate Governance Code (CGC) into its Securities Listing Regulations in 2015.² The CGC aims to achieve effective and transparent corporate governance of listed companies. These two codes are expected to work as the two wheels of a cart, so that the sustainable growth of listed companies is promoted by both sides: Japanese institutional investors and listed companies.³

As forms of self-regulation in the capital market, the SSC and the CGC have characteristics in common. First, both codes are non-legally-binding norms. Second, they are non-autonomous, artificial soft laws. Third, both adopt a so-called "principles-based" approach and a "comply or explain" rule. Finally, the council of experts established by the Financial Services Agency of Japan drafted them both. The private and public sectors cooperated to create both of these codes.

Nevertheless, the codes also have their own characters, especially concerning binding effects and enforcement mechanisms. The SSC can be characterized as genuinely self-binding, and there is neither a contract nor an organization that oversees and enforces it apart from the CGC. This means that the binding effect of the SSC is very weak, and enforcing it would be difficult.

The binding effect of the CGC, however, is stronger, because a listed company agrees with the TSE to abide by the securities listing regulations in its

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- 1 NIHON-HAN SUCHUWĀDOSHIPPŪ KŌDO NI KANSURU YŪSHIKI-SHA KENTŌ-KAI [The Council of Experts Concerning the Japanese Version of the Stewardship Code], *Sekinin aru kikan tōshi-ka no sho-gensoku* [Principles for Responsible Institutional Investors (Japan's Stewardship Code)] (26 February 2014). English translation available at <http://www.fsa.go.jp/en/refer/councils/stewardship/20140407/01.pdf>.
 - 2 TŌKYŌ STOCK EXCHANGE, INC., *Yūka shōken jōjō kitei* [Securities Listing Regulations], *betten* [Attachment], Corporate Governance Code, English translation available at [http://www.jpx.co.jp/english/rules-participants/rules/regulations/tvdivq0000001vyt-att/securities_listing_regulations_\(r901-r1606\)_20161104.pdf](http://www.jpx.co.jp/english/rules-participants/rules/regulations/tvdivq0000001vyt-att/securities_listing_regulations_(r901-r1606)_20161104.pdf).
 - 3 KŌPORĒTO GABANANSU NO SAKUTEI NI KANSURU YŪSHIKI-SHA KAIGI [The Council of Experts Concerning the Corporate Governance Code], *Kōporēto gabanansu kōdo gen'an – Kaisha no jizoku-teki na seichō to chū-chōkitekina kigyō kachi no kōjō no tame ni* – [Japan's Corporate Governance Code [Final Proposal] – Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term] (5 March 2015), Background, paragraph 8, pp. 3–4. English translation available at <http://www.fsa.go.jp/en/refer/councils/corporategovernance/20150306-1/01.pdf>.

listing agreement and the CGC is incorporated into the TSE's securities listing regulations. Furthermore, the TSE is a self-regulatory organization according to the Japanese Financial Instruments and Exchange Act (FIEA).⁴ A financial instruments exchange is permitted to establish and enforce its self-regulation by the FIEA. The CGC is thus connected with the state, because the self-regulations of the TSE are, ultimately, state-supervised.⁵

In this paper I will focus on Japan's SSC, which was created in 2014 as a genuine approach to self-regulation in the capital markets, and compare it with the CGC, which was incorporated into the listing regulations of the TSE in 2015.

II. JAPAN'S STEWARDSHIP CODE

1. *Outline of the Stewardship Code*

Japan's SSC defines "stewardship responsibilities" as the responsibilities of institutional investors to enhance the mid- to long-term investment return for their clients and ultimate beneficiaries by improving and fostering the investee companies' corporate values and sustainable growth through constructive engagement or purposeful dialogue based on in-depth knowledge of the companies and their business environments.⁶ There is no definition of the term "institutional investors" in the SSC. Not only asset owners and investment managers, as institutional in a narrow sense, but also other players in the equity investment chain, which extends from ultimate beneficiaries to investee companies, could be covered, including proxy advisors or consulting firms that give advice or make recommendations for exercising voting rights or engagement.⁷

The SSC outlines seven principles of good practice for institutional investors.

Principle 1: Institutional investors should have a clear policy regarding how they fulfill their stewardship responsibilities,⁸ and publicly disclose it.

4 Articles 84 and 85 of *Kin'yū shōhin torihiki-hō* [Financial Instruments and Exchange Act], Law No. 25/1948.

5 Article 80, paragraph 1 and Articles 149, 153-3 and 153-4 FIEA.

6 SSC, *supra* note 1, "Stewardship responsibilities" and the role of the Code, p. 1.

7 SSC, *supra* note 1, Aims of the Code, paragraphs 7 and 8, p. 3.

8 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. SSC, *supra* note 1, Aims of the Code, paragraph 4, p. 2.

Principle 2: Institutional investors should have a clear policy regarding how they manage conflicts of interest when fulfilling their stewardship responsibilities and publicly disclose it.

Principle 3: Institutional investors should monitor investee companies, so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the companies' sustainable growth.

Principle 4: Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with them.

Principle 5: Institutional investors should have a clear policy on voting. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of the investee companies (5-1). Institutional investors should disclose their voting activities (5-2).

Principle 6: Institutional investors should, in principle, report periodically to their clients and beneficiaries on how they are fulfilling their stewardship responsibilities, including their voting responsibilities.

Principle 7: To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment, and skills and resources needed to appropriately engage with the companies to make proper judgments in fulfilling their stewardship activities.

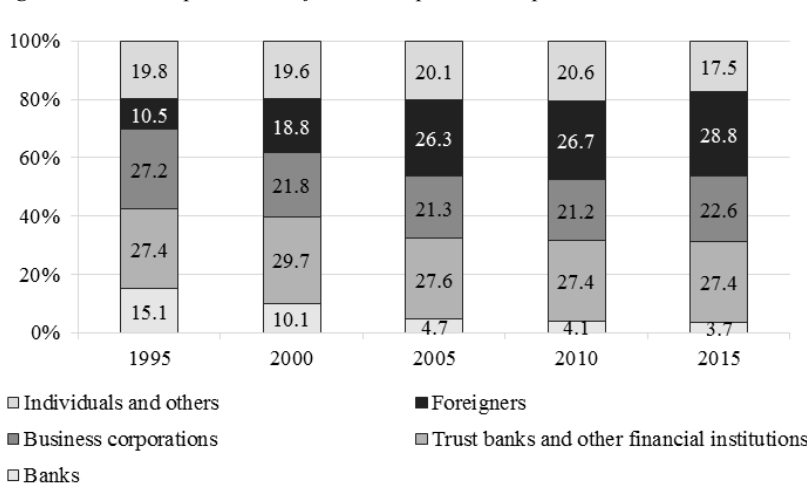
2. Background of the SSC

Figure 1 indicates the transformation of the ownership structure of listed companies in Japan since 1995.⁹ As of March 2015, the ratio of stocks held by foreign investors was 28.8 per cent, with 27.4 per cent held by financial institutions, 22.6 per cent by industrial companies, and 17.5 per cent by individuals and others. Most of the foreign investors are financial institutions. The percentage of shareholding by commercial and regional banks accounted for only 3.7 per cent. Nevertheless, the percentage of stocks held by financial institutions has been increasing, and is currently at 59.1 per cent. This means that the ownership of stocks in listed companies has become highly concentrated in financial institutions, and collective action on the part of financial institutions has become more feasible. In Japan, shareholding by financial institutions has contributed to the stability of ownership structures and thus the stability of these firms' management. One reason for this is an investment

9 NIHON TORIHIKI-JO GURŪPU [Japan Exchange Group], *Kabushiki bunpu jōkyō chōsa* [Research of ownership structure of listed companies in Japan], available at <http://www.jpx.co.jp/markets/statistics-equities/examination/01.html>.

strategy known as passive or index management, which large financial institutions usually adopt. Once a portfolio is structured, a fund manager has less incentive to monitor the individual companies in it. A second reason is the problem of conflicts of interest. The interests of the ultimate investors are not necessarily aligned with the interests of the financial institutions, which have another business connection with investee companies, such as loans transactions or insurance policies, or mutual shareholding relationships.

Figure 1: Ownership structure of listed companies in Japan



3. Statistics on the SSC

As of 27 December 2016, 214 institutional investors had signed up to Japan's SSC.¹⁰ The number of institutional investor signatories has been gradually increasing (Figure 2). A breakdown of these companies is provided in Figure 3: 151 investment companies and investment advisors, seven trust banks, eighteen life insurance companies, four non-life insurance companies, twenty-six pension funds, seven proxy advisors and other firms. More than half (57 per cent) of the signatories are domestic companies, while 43 per cent are foreign.¹¹

10 The Financial Services Agency of Japan (FSA) publishes the list of institutional investors who have notified it of their intention to accept the SSC on its website. It is available at <http://www.fsa.go.jp/en/refer/councils/stewardship/20160315.html>.

11 KIN'YŪ-CHŌ [Financial Services Agency], *Suchuwādoshippu kōdo o meguru jōkyō to forō appu kaigi iken-sho ni tsuite* [Status of the Stewardship Code and Opinion Statement of the Follow-up Council (31 January 2017), slide 5. English translation available at http://www.fsa.go.jp/en/refer/councils/stewardship/material/20170131_3.pdf.

Figure 2: Number of signatory institutional investors

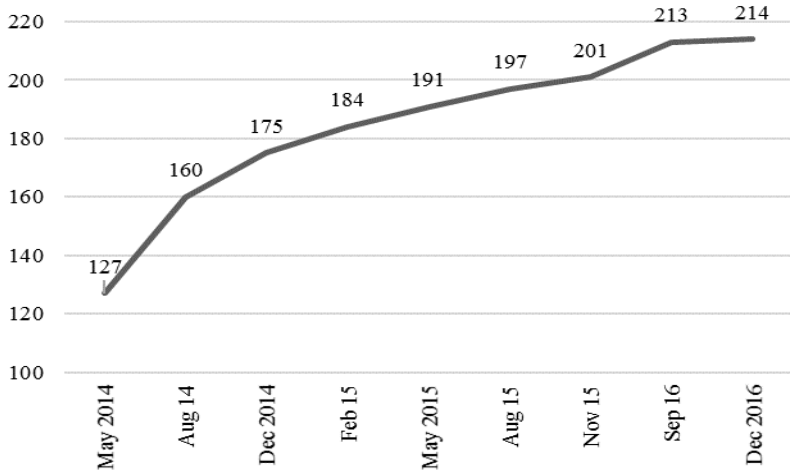
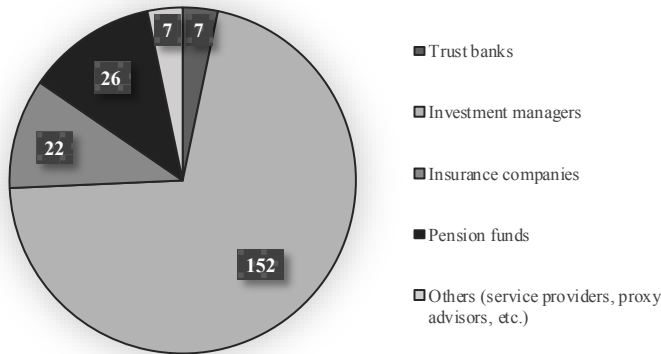


Figure 3: Attribution of signatory institutional investors (as of 27 December 2016)

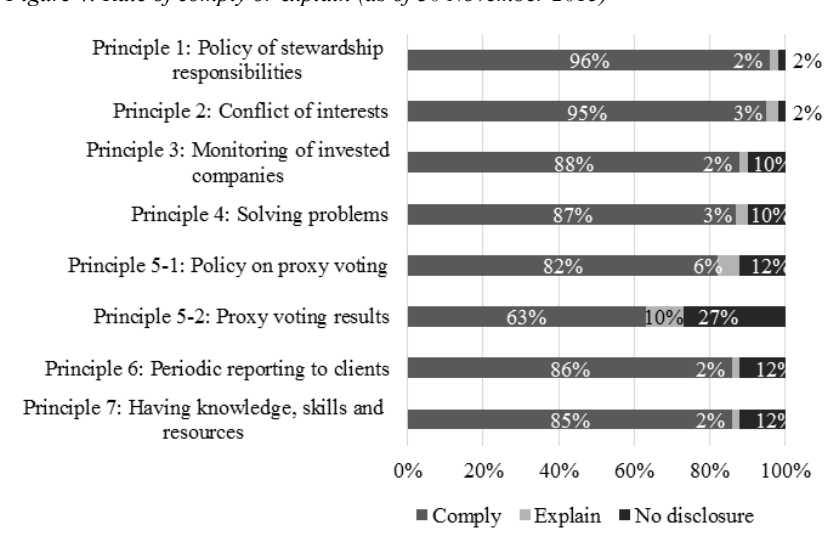


As of 30 November 2015, principles 3, 4, 5-1, 6, and 7 were being complied with by approximately 85 per cent of all signatory institutions, while principles 1 and 2 were being complied with by more than 95 per cent.¹²

12 KIN'YŪ-CHŌ, SŌMU KIKAKU-KYOKU KIGYŌ KAIJI-KA [Corporate Accounting and Disclosure Division, Planning and Coordination Bureau, Financial Services Agency of Japan], *Suchuwādoshippu kōdo uke'ire kikan no torikumi hōshin oyobi katsudō naiyō no kōhyō jōkyō* [Disclosure status of policies/activity contents of institutions that have accepted the Stewardship Code] (18 February 2016), slide 4. English trans-

Principle 5-2, which requires the disclosure of voting results, was being complied with by only 63 per cent of all institutions. Only 10 per cent of signatory institutional investors explained the reason why they were not complying with Principle 5-2, while 27 per cent did not disclose anything in terms of voting results (Figure 4).

Figure 4: Rate of comply or explain (as of 30 November 2015)



One year later, at the end of December 2016, more than 94 per cent of all signatory institutional investors were abiding by principles 1 to 7 of the SSC – with the exception of Principle 5-2 (Figure 5). Principle 5-2 was being complied with by only about 61 per cent of all institutions.¹³

Dialogues between institutional investors and the management officials of investee companies tend to focus on issues such as corporate strategy, corporate governance structures, corporate performance and long-term growth, shareholder return policy and risk factors, the CEO's leadership, and so on (Figure 6).¹⁴

lation available at <http://www.fsa.go.jp/en/refer/councils/follow-up/material/20160218-2.pdf>.

13 FSA, Status of the Stewardship Code and Opinion Statement of the Follow-up Council, *supra* note 11, slide 6.

14 NIHON TŌSHI KOMON-GYŌ KYŌKAI [Japan Investment Advisers Association (JIAA)], *Nihon-han suchuwādoshippu kōdo e no taiō-tō ni kansuru ankēto (dai ni-kai) no kekka ni tsuite* [2nd survey report on the JIAA member companies to the questionnaire for Japan's Stewardship Code] 14 and *Nihon-han suchuwādoshippu kōdo e no*

Figure 5: Rate of comply or explain (as of 31 December 2016)

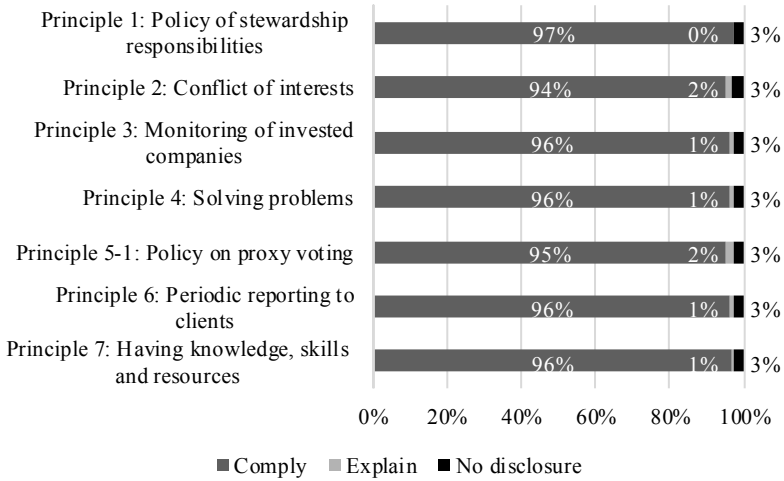
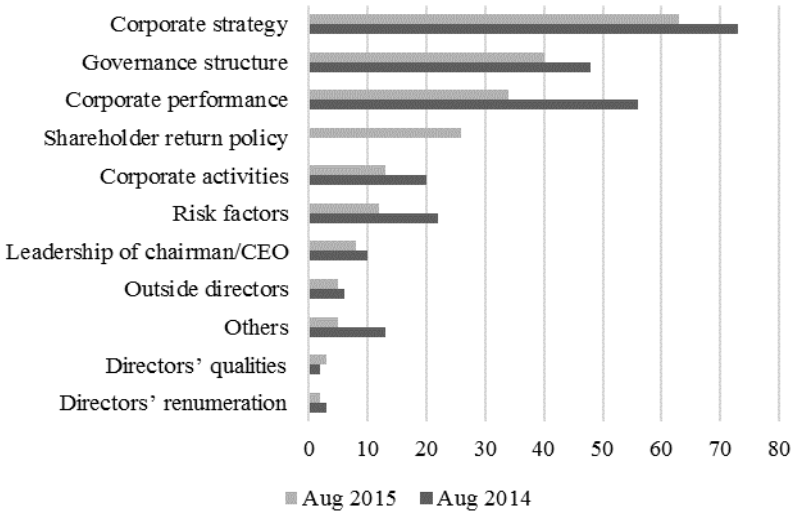


Figure 6: Matters discussed as part of shareholder engagement



taiō-tō ni kansuru ankēto (dai san-kai) no kekka ni tsuite [3rd survey report on the JIAA member companies to the questionnaire for Japan's Stewardship Code] 24–25.

III. JAPAN'S CORPORATE GOVERNANCE CODE

1. *Outline*

Japan's CGC defines "corporate governance" as a structure for transparent, fair, timely, and decisive decision-making by listed companies, with due attention paid to the needs and perspectives of shareholders and customers, employees, and local communities.¹⁵

The CGC consists of seventy-three principles – namely, five general principles, thirty main principles, and thirty-eight supplementary principles.¹⁶ The general principles state the most abstract norms, while the supplementary principles represent the most concrete and explicit norms. Self-regulated matters are broken down into five sections. The first calls for securing the rights and equal treatment of shareholders. The second deals with cooperation with stakeholders such as creditors, employees, the local community, and so on. The third deals with appropriate information disclosure and transparency in terms of corporate governance. The fourth focuses on the responsibilities of boards of directors. The fifth section addresses constructive dialogue between management and shareholders.

The fifth section is closely connected with the SSC, and states that the management should have constructive dialogue with shareholders in order to contribute to sustainable growth and the increase of corporate value. Concretely speaking, boards of directors are required to approve and disclose policies concerning the measures and organizational structures aimed at promoting constructive dialogue with shareholders (Principle 5.1). The management is also required to establish and disclose its business strategy and business plan (Principle 5.2).

2. *Statistics*

The TSE operates in five sections: the First Section, the Second Section, Mothers, JASDAQ, and the TOKYO PRO Market. The First and Second Sections are the main markets of the TSE, especially the former, which is the largest and most liquid capital market in Japan. All seventy-three principles of the CGC apply to the listed companies in the First and Second Sections. The Mothers section is a trading market for companies with growth potential that aim to be reassigned to the First Section in the near

15 Japan's Corporate Governance Code [Final Proposal], *supra* note 3, p. 1.

16 M. YUFU et al., *Kōporēto gabanansu kōdo gen'an no kaisetsu*, No. 1–4 [Outline of the Final Proposal of the Corporate Governance Code], *Junkan Shōji Hōmu* No. 2062 (2015) 47, No. 2063 (2015) 51, No. 2064 (2015) 35, No. 2065 (2015) 46; H. KANDA, *Kōporēto gabanansu kōdo ni tsuite* [Regarding the Corporate Governance Code], *Gekkan Kansayaku* No. 642 (2015) 4.

future. The JASDAQ was formerly an over-the-counter market operated by the Japan Securities Dealers Association that has been a stock exchange since 2004. Its listing requirements are more lax than those of the main markets. TOKYO PRO Market is a specified financial instruments exchange market (*tokutei torihiki-jo kin'yū shōhin shijō*) based on the Japanese FIEA where stock buying by general investors, excluding professional investors,¹⁷ is prohibited.¹⁸

Only five of the general principles apply to the listed companies in the Mothers and JASDAQ sections. As of 8 May 2017, the total number of listed companies on the TSE excluding TOKYO PRO Market stood at 3,540 (Table 1).¹⁹

Table 1: Scope of “comply or explain” in the TSE’s five sections

Market division	Number of companies	Scope of “comply or explain”
TSE 1st Section	2,017	All 73 principles (a) 5 general principles (b) 30 principles (c) 38 supplementary principles
TSE 2nd Section	531	
Mothers	238	Only 5 general principles
JASDAQ	754	
TOTAL	3,540	

Figures 7 and 8 provide an analysis of the corporate governance reports in the First and Second Sections of the TSE as of 31 December 2015 and 31

17 Professional investors who can purchase stocks in TOKYO PRO Market consist of specified investors (*tokutei tōshi-ka*) and deemed specified investors (*minashi tokutei tōshi-ka*) that meet certain requirements and become specified investors by filing with their securities companies. According to the FIEA, qualified institutional investors (financial institutions, etc.), the national government, the Bank of Japan, listed companies, and stock companies with capital of 500 million yen and more are appointed as specified investors. As of 8 May 2017 only 17 companies were listed in the TOKYO PRO Market.

18 Article 2, paragraph 32, and Article 117-2 of the FIEA. The TSE entrusts investigation of compliance with the criteria for listing or delisting and with listing eligibility requirements to an approved J-Adviser that meets certain qualifications under Article 85, paragraph 4 of the FIEA.

19 NIHON TORIHIKI-JO GROUP [Japan Exchange Group], *Jōjō kaisha-sū oyobi jōjō kabushiki-sū* [The number of listed companies and listed shares], available at <http://www.jpx.co.jp/listing/co/>.

December 2016 according to research by the TSE. As of 31 December 2015, the number of listed companies in the First and Second Sections which publicly disclosed corporate governance reports was 1,858. A total of 11.6 per cent, or 216 companies, declared full compliance with all seventy-three principles of the CGC, and 88.4 per cent, or 1,642 companies, explained their non-compliance with some of the principles. A total of 66.4 per cent, or 1,233 companies, complied with more than 90 per cent of all the principles, while 22.0 per cent (409 companies) complied with less than 90 per cent. We can note that the proportion of complying firms was much larger in the First Section than in the Second (Figure 7, Table 2).²⁰

Figure 7: Rate of compliance with the CGC (as of 31 December 2015)

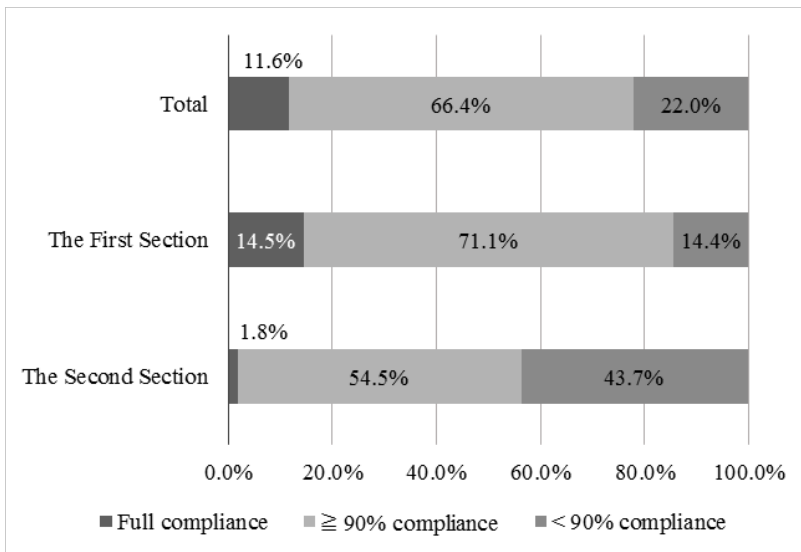


Table 2: Number of companies complying with the CGC

	Full compliance	≥ 90% compliance	< 90% compliance
Total	216	1,233	409
The First Section	209	1,025	242
The Second Section	7	208	167

20 TŌKYŌ STOCK EXCHANGE, INC., *Kōporēto gabanansu kōdo e no taiō jōkyō* (2015-nen 12-gatsumatsu) [How Listed Companies Have Addressed Japan's Corporate Governance Code (Status as of the end of December 2015)], available at <http://www.jpx.co.jp/news/1020/nlsgeu000001ei88-att/20160120-1.pdf>.

As of 31 December 2016, the number of listed companies in the First and Second Sections which publicly disclosed corporate governance reports was 2,530. A total of 19.9 per cent, or 504 companies, declared full compliance with all seventy-three principles of the CGC, and 80.1 per cent, or 2,026 companies, explained their non-compliance with some of the principles. A total of 64.8 per cent, or 1,639 companies, complied with more than 90 per cent of all the principles, while 15.3 per cent (387 companies) complied with less than 90 per cent. We can note here, too, that the proportion of complying firms was much larger in the First Section than in the Second (Figures 8, Table 3).²¹

Figure 8: Rate of compliance with the CGC (as of 31 December 2016)

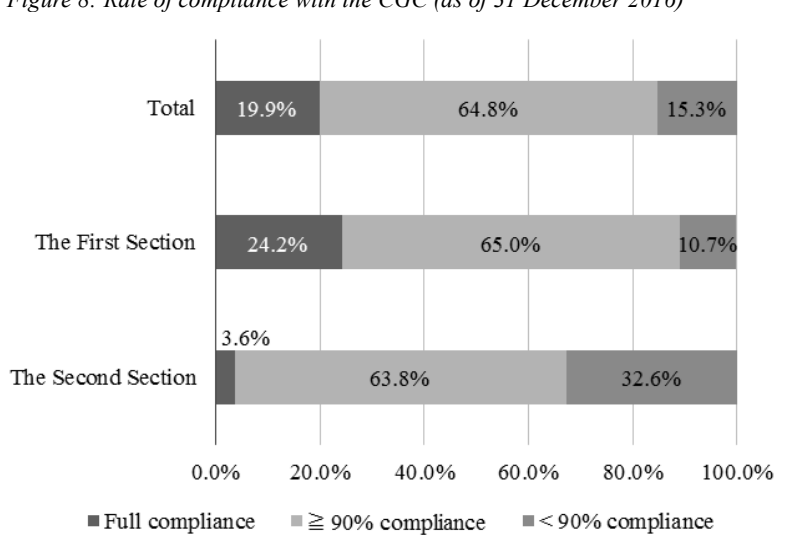


Table 3: Number of companies complying with the CGC

	Full compliance	≥ 90% compliance	< 90% compliance
Total	504	1639	387
The First Section	485	1302	215
The Second Section	19	337	172

21 TŌKYŌ STOCK EXCHANGE, INC., *Kōporēto gabanansu kōdo e no taiō jōkyō* (2016-nen 12-gatsumatsu) [How Listed Companies Have Addressed Japan's Corporate Governance Code (Status as of the end of December 2016)], available at <http://www.jpx.co.jp/news/1020/nlsgeu0000027kxe-att/nlsgeu0000027kzz.pdf>.

IV. THE STEWARDSHIP CODE IN COMPARISON TO THE CORPORATE GOVERNANCE CODE

1. *Who Initiated and Created it?*

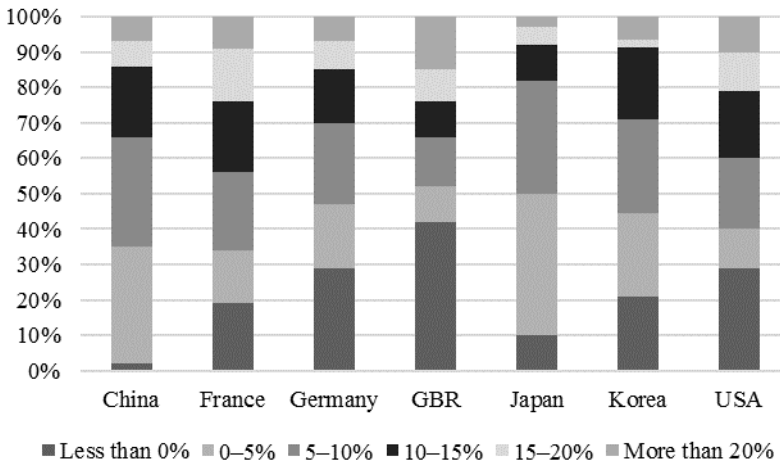
The Abe administration initiated the Japanese SSC as part of its economic growth strategy, the so-called “third arrow” of its economic policy.²² The stock prices of listed Japanese companies had long been stagnant after the economic bubble of the 1990s burst, and the median return on equity (ROE) of listed companies in Japan was evidently low in international comparison (Figure 9).²³ The reason for this is not apparent, but the weak control exerted on the part of shareholders, among others, over financial institutions may have been responsible to some extent. Nevertheless, there was little incentive for institutional investors to introduce the unified SSC because the business models are entirely different among various institutional investors, which include investment advisors, trust banks, life- and non-life insurance companies, pension funds, proxy agencies, and so on. The Council of Experts Concerning the Japanese Version of the SSC was therefore established within the FSA of Japan as part of the government initiative.²⁴

As for the CGC, the Council of Experts Concerning the Corporate Governance Code, which was established by the FSA, drafted the code,²⁵ and

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- 22 In June 2013 the Abe cabinet approved the Japan Revitalization Strategy [*Nihon saikō senryaku 2013*], which defined the growth strategy, or “the third arrow”, of the economic policy. The Strategy proposed considering and compiling principles (Japanese version of the SSC) for institutional investors to fulfil their fiduciary responsibilities, such as promoting the mid- to long-term growth of companies through dialogue. *Nihon saikō senryaku 2013* [Japan Revitalization Strategy – JAPAN is BACK], English translation available at http://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/en_saikou_jpn_hon.pdf.
- 23 International Comparison of ROE in: Ito Review of Competitiveness and Incentives for Sustainable Growth – Building Favorable Relationships between Companies and Investors – Final Report (August 2014), available at http://www.meti.go.jp/english/press/2014/pdf/0806_04b.pdf.
- 24 SSC, *supra* note 1, Background, paragraphs 1–3, p. 1–2. Concerning the SSC, M. KASAHARA, *Sekinin aru kikan tōshi-ka no sho-gensoku – nihon-han suchuwādoshippu kōdo no gaiyō* [Outline of the Principles for Responsible Institutional Investors – Japan’s Stewardship Code], Junkan Shōji Hōmu No. 2029 (2014) 59–71; H. KANSAKU, *Nihon-han suchuwādoshippu kōdo no gaiyō to shihon shijō* [Outline of Japan’s Stewardship Code and Capital Markets], in: Kansaku/Shihon Shijō Kenkyū-kai (eds.), *Kigyō hōsei no shōrai tenbō – Shihon shijō seido no kaikaku e no teigen (2015 nendo-han)* [Perspective of Business Law System in Future – Proposals for Capital Markets Reform (2015 edition)] (Tōkyō 2015) 103–138.
- 25 CGC [Final Proposal], *supra* note 3, Background, paragraph 4, p. 2.

the TSE then introduced it as a part of its self-regulation.²⁶ The FSA thus served as a venue for creating the SSC and for discussing the contents of the CGC in cooperation with various stakeholders and experts.²⁷

Figure 9: International comparison of ROE (2000 to 2010)



2. Degree of Binding Effect and Enforcement Mechanism

There is no organization or body charged with enforcing Japan's SSC. This means the code is difficult to effectively enforce.²⁸ Nevertheless, when an institutional investor is a fiduciary to clients or investors, it is occasionally obligated to conduct stewardship activities, such as having its engagement

²⁶ See *supra* note 2.

²⁷ The Council of Experts Concerning the Corporate Governance Code consisted of 13 members – three from listed companies, three from academic or research institutes, two from asset management companies, one each from a business revitalization company and a business law firm, the senior advisor of the Japan Audit & Supervisory Board Members Association, the chairman and president of the Japanese Institute of Certified Public Accountants, and the representative of a non-profit organization that aims to promote corporate governance in Japan.

²⁸ H. KANSAKU, *Nihon-han suchuwādoshippu kōdo no kihan-sei ni tsuite* [Concerning the Strength of the Norm of Japan's Stewardship Code, in: Kuronuma/Fujita (eds.), *Egashira Kenjiro sensei koki kinen, kigyō-hō no shinro* [Festschrift for Professor Kenjiro Egashira's 70th birthday, Direction of the Enterprise Law] (Tōkyō 2017) 1018–1019.

policy and disclosing the results of its exercise of voting rights to its beneficiaries, under both civil and regulatory law. If an institutional investor is a trust bank or investment advisor, it is subject to the duties of care and of loyalty to its clients under trust law and civil law. The regulatory law also obligates trust banks and investment advisors to the duties of care and of loyalty. Therefore, some of a body's stewardship responsibilities could also be legally binding. On the other hand, stewardship responsibilities cannot be applied as a legal norm for some types of financial institutions, such as insurance companies and proxy advisors.

The CGC can be more effectively enforced than the SSC because listed companies are required to respect the intent and spirit of the CGC and make efforts to enhance their corporate governance according to the listing regulations of the TSE.²⁹ When a listed company does not comply with a principle of the Code, it must explain its reasons for such non-compliance in the corporate governance report. Furthermore, it must explain the reasons for compliance with specific principles,³⁰ since the TSE requires all listed companies to do so for some of the principles. When a listed company violates this duty, the TSE has four alternatives as sanctions. First, it can order the submission of an improvement report.³¹ Second, it can make a public announcement.³² Third, it can impose a listing agreement violation penalty.³³ Fourth, it can delist the firm, the strictest of all sanctions.³⁴

3. *Legitimacy*

The SSC was created by the Council of Experts at the FSA, which consists of a total of fourteen members – seven from institutional investors, three from academic or research institutes, two from consulting companies, and one each from a proxy advisor and a listed company. Nevertheless, the representation of stakeholders on the council was very limited. Although the materials and minutes of the council were publicly disclosed on the FSA's website and public opinion procedures were carried out, these democratic processes do not seem to have sufficed to create a binding artificial norm. However, an institu-

29 TŌKYŌ STOCK EXCHANGE, INC., Securities Listing Regulations, Article 445-3.

30 TŌKYŌ STOCK EXCHANGE, Securities Listing Regulations, Article 436-3.

31 TŌKYŌ STOCK EXCHANGE, Securities Listing Regulations, Article 502, paragraph 1, item 2.

32 TŌKYŌ STOCK EXCHANGE, Securities Listing Regulations, Article 508, paragraph 1, item 2.

33 TŌKYŌ STOCK EXCHANGE, Securities Listing Regulations, Article 509, paragraph 1, item 2.

34 TŌKYŌ STOCK EXCHANGE, Securities Listing Regulations, Article 601, paragraph 1, item 12.

tional investor is entirely free to agree to and sign the SSC, unlike the CGC, which all listed companies have to abide by according to the TSE's listing agreement. Therefore, the SSC's lack or deficiency of legitimacy is not as serious as a similar failing in the CGC would be. This is because the CGC has an effective enforcement mechanism and all listed companies are automatically and comprehensively bound by it based on the listing agreement with the TSE. Furthermore, the CGC is not a simple contract because it is also a part of the listing regulations of a self-regulatory organization authorized by the state pursuant to the FIEA. The CGC is characterized as a soft law which is more closely connected with the state than the SSC is.³⁵

V. CRITICISMS OF THE STEWARDSHIP CODE

1. *Does Shareholder Engagement Really Contribute to the Enhancement of Corporate Governance and the Maximization of Shareholder Value?*

Fundamental doubt has been cast about whether stewardship responsibility contributes to the enhancement of corporate governance and the maximization of shareholder value. In Japan, corporate governance is expected to be enhanced by the involvement and engagement of shareholders – among others, institutional investors – via both the legal and soft-law systems.³⁶ This should allow capital market participants to implement a shareholder-oriented management approach.³⁷ The percentage of shareholding by institutional investors has been increasing in Japan (Figure 1). These institutional investors, such as pension funds and investment trusts, normally create investment portfolios in order to diversify their investment risk, as diversified portfolios can be insulated from the effects of firm-specific risks. Therefore, diversified shareholders must expect firms to take more risks. On the other hand, the managers of a company are an undiversified group, in contrast to institutional investors, because they have human capi-

35 S.L. SCHWARCZ, *Private Ordering*, 97 (2002) *Northwestern University Law Review*. 319, 324–329; T. FUJITA, *Kihan no shiteki keisei to kokka-hō no yakuwari* [Private Ordering and the Role of National Law], *Sofutorō Kenkyū* (2006) No. 6, 2–7.

36 H. KANSAKU, *The Role of Shareholders in Public Companies*, in: Fleischer/Kanda/Kim/Mülbert (eds.), *German and Asian Perspectives on Company Law* (Tübingen 2016) 263–268.

37 Also in Europe, see Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, COM(2014) 213 final, pp. 2 and 4; Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies, COM(2012) 740 final, p. 8.

tal tied up in their firms.³⁸ From the perspective of modern portfolio theory, the notion that corporate governance mechanisms consequently encourage managers to take risks through the exercise of shareholders' rights and engagement with management may be justified.

Empirical research data tells us that there is evidence that ownership by domestic and foreign institutional investors such as pension funds increases governance effects. On the other hand, the ownership ratio of banks and insurance companies has a significantly negative impact on all performance indices. The research suggests that the enhancement of investee companies' performance by foreign institutional investors and domestic pension and mutual funds results from pressure based on these investors' exits and voices, while domestic banks and insurance companies are bound by their business relationships – such as loan contracts, insurance contracts and *keiretsu* relationships.³⁹

Thus, corporate governance in Japan is expected to move from a traditional Japanese corporate governance model or stakeholder model in the direction of a shareholder-oriented model that aims at corporate value maximization.

2. *Not in Accordance with the Passive Investment Policy of Most Institutional Investors*

Most institutional investors in Japan, especially in recent years, have adopted a so-called passive investment policy which includes an index investment strategy based on the modern portfolio theory. Nevertheless, such passive institutional investors have followed the “Wall Street rule” of selling stocks when they disapprove of their firms' management – though they seldom challenge it openly. An investment policy according to the modern portfolio theory under which institutional investors consider the market as a whole may invite a decreased incentive to closely monitor individual corporations in the portfolio.⁴⁰ In short, the appropriate engagement may not be in accordance with the passive investment policy.

The costs of individual engagement would outweigh the benefits of a passive investment strategy if fund managers were to engage with the manage-

38 J. ARMOUR/J. N. GORDON, Systemic Harms and Shareholder Value, *Journal of Legal Analysis* 6 (2014) 35, 36, 50–53.

39 H. MIYAJIMA/T. TODA, Ownership Structure and Corporate Governance: Has an Increase in Institutional Investors' Ownership Improved Business Performance?, Policy Research Institute, Ministry of Finance, Japan, *Public Policy Review*, Vol. 11 No. 3 (2015) 361, 365.

40 M. BECHT/J. FRANKS/C. MAYER/S. ROSSI, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund, in: Bratton/McCahery (eds.), *Institutional Investor Activism* (Oxford 2015) 224.

ment of all investee companies.⁴¹ However, fund managers establish investment policies through formalized business contracts with their clients, including asset owners, according to their business model. Therefore, it is difficult for fund managers to act differently according to investors' attributes and characteristics, especially when they adopt a passive investment strategy.

3. *Weak Binding Effect and Enforcement*

As mentioned above, the binding effects and enforcement mechanisms of the SSC are weak, because no organization or body is charged with overseeing and enforcing the code and because it is difficult for general investors or the ultimate beneficiaries to oversee and enforce it.⁴²

4. *Focus on the Mid- to Long-term Investment Return*

The Japanese SSC focuses on mid- to long-term investment returns.⁴³ One critique of this focus argues that the premise is contrary to the efficient market hypothesis. If the hypothesis is correct, it would not make sense to distinguish short- from mid- to long-term investment returns, since the current market prices reflect all available information. This approach suggests that a focus on the mid- to long-term investment return would tend to weaken pressure on the management of an investee company, even when the current financial results are not good. This might lead to weakened corporate governance, which is contrary to the original intention of the code.

5. *Conflict with the Traditional Concept of Shareholder Value Maximization*

According to the prevailing opinion in Japan, the managers of a joint-stock company are subject to the duty of maximizing shareholder value. Nevertheless, shareholder engagement could conflict with the duty of institutional investors' management as a joint-stock company when the costs of such individual engagement outweigh the benefits and shareholder value is thus impaired.⁴⁴

41 T. EGUCHI, *Engējimento no jidai ni okeru kikan tōshi-ka no yakuwari* [The Role of Financial Institutions in the Era of Engagement], *Junkan Shōji Hōmu* No. 2109 (2016) 27.

42 KANSAKU, *supra* note 28, 1018–1019.

43 SSC, *supra* note 1, Aims of the Code, paragraph 5, p. 2.

44 W. TANAKA, *Kōporēto gabanansu no kanten kara mita nihon-han suchuwādoshippu kōdo* [Japan's Stewardship Code from the Viewpoint of Corporate Governance], *Shintaku Fōramu* (2014) No. 1, 38.

6. *Box-ticking for Stewardship Activities and Boilerplate Explanations*

There is some doubt about whether the stewardship activities and explanations and the public disclosure of the stewardship activities' results according to the SSC would be meaningful for the capital market and the ultimate beneficiaries. This is because the stewardship activities tend to become box-ticking under the binding force of the SSC and public disclosure of the stewardship activities tends to take the form of boilerplate explanations.⁴⁵

Furthermore, the explanation of stewardship activities could harm sound and constructive dialogue between the management of investee companies and institutional investors. It is suggested that such fruitful and constructive dialogues between them are not normally evident externally, unlike the conspicuous engagement activities such as voting against corporate proposals and the exercise of shareholders' proposal rights.⁴⁶ The disclosure and explanation of all stewardship activities would harm the establishment of a relationship of mutual trust between institutional investors and the management of investee companies.

VI. IMPROVEMENT OF THE STEWARDSHIP CODE

1. *The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code*

The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code was established at the FSA of Japan in 2015.⁴⁷ Regarding the SSC, the Council focused on four points, in response to the above-mentioned criticisms and in consideration of the implementation and practice of the SSC.

The first aim is to enhance the quality of shareholders' engagement. For example, the establishment of an independent committee of institutional investors is proposed to oversee conflicts of interest with investee compa-

45 H. NODA, *Kōporēto gabanansu ni okeru kisei shuhō no kōsatsu* [A Study on Regulatory Measures in the Field of Corporate Governance], *Junkan Shōji Hōmu* (2016) No. 2109, 18–19.

46 EGUCHI, *supra* note 41, 24.

47 SUCHUWĀDOSHIPPŪ KŌDO OYOBI KŌPORĒTO GABANANSU KŌDO NO FORŌ APPU KAIGI [The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code], *Kikan tōshi-ka ni yoru jikkō-teki na suchuwādoshippu katsudō no arikata – kigyō no jizoku-teki na seichō ni muketa kensetsu-teki na taiwa no jūjitsu no tame ni* – (30 November 2016) [Effective Stewardship Activities of Institutional Investors – To Enhance Constructive Dialogue toward Sustainable Corporate Growth]. English translation available at http://www.fsa.go.jp/en/refer/councils/follow-up/statements_3.pdf.

nies through other service or business connections. The professionalization of the shareholders' engagement and prudent use of proxy advisors are also recommended.⁴⁸

The second aim is to enhance disclosure through the provision of voting results for each investee company for each agenda and proposal. The current SSC requires institutional investors to disclose their voting records only by aggregating them by major categories of proposals. The Council recommended that both asset managers and asset owners be required to disclose not aggregation-level but company-level voting results to the public – not merely to asset owners – based, at a minimum, on a “comply or explain” approach in order to secure the interests of the ultimate beneficiaries and to enhance transparency.⁴⁹

The third aim is to strengthen the monitoring and overseeing of asset managers by asset owners. One of the most important problems of the SSC is its weakness in terms of enforcement, since there is no organization or body in Japan charged with overseeing and enforcing it.⁵⁰ Therefore, the Council expects asset owners to play this role and proposes that asset managers conduct self-evaluations of their implementation of the SSC and disclose the results to the public. Such self-evaluations by asset managers are intended to help asset owners select and evaluate asset managers.⁵¹

The fourth aim is to improve the shareholders' engagement with passive asset managers, although this would not be in accordance with passive investment policy.⁵²

2. *Proposal for Revised Stewardship Code*

The Council of Experts Concerning the Japanese Version of the Stewardship Code reconvened on 31 January 2017 in order to revise the Code. The Council drafted a revised version and publicly disclosed it on 28 March 2017.⁵³

In response to the first proposal of the Follow-up Council, paragraph 2-3 was added to the Guidance of the draft and stated that asset managers should establish governance structures, such as an independent board of directors or third-party committees for decision-making or oversight of

48 Effective Stewardship Activities of Institutional Investors, *supra* note 48, 2–3.

49 Effective Stewardship Activities of Institutional Investors, *supra* note 48, 3–4.

50 See IV.2.

51 Effective Stewardship Activities of Institutional Investors, *supra* note 48, 5.

52 See V.2.

53 The Council of Experts on the Stewardship Code, Principles for Responsible Institutional Investors “Japan’s Stewardship Code”—To promote sustainable growth of companies through investment and dialogue—(Draft) (28 March 2017), English translation available at <http://www.fsa.go.jp/en/news/pub/03.pdf>.

voting, in order to secure the interests of clients and beneficiaries and prevent conflicts of interest.⁵⁴

As for the second issue, the draft requires institutional investors to disclose voting records for each investee company on an individual agenda item basis.⁵⁵ Furthermore, the draft recommends that at the time voting records are disclosed, it would also be beneficial to explicitly explain the reasons why they voted for or against an agenda item in order to enhance transparency for institutional investors.

The draft also adopted the third recommendation of the Follow-up Council. According to the amendment of paragraph 7-4 in the Guidance of the draft, asset managers should regularly conduct self-evaluations with respect to the status of the implementation of each principle, including guidance, and disclose the results regarding the continued improvement of their governance structures, conflict of interest management, and stewardship activities, etc. The results of such self-evaluations should be used by asset owners to monitor whether their asset managers are conducting stewardship activities in line with the asset owners' policies.⁵⁶

As for the fourth point, the draft requires institutional investors who adopt a passive investment policy to actively take charge of engagement and voting with a view to the medium- to long-term perspective, since passive management provides limited options to sell investee companies' shares and to promote a medium- to long-term increase in corporate value.⁵⁷

VII. CONCLUDING REMARKS

The SSC is formally and genuinely self-binding. It was introduced as a part of the Abe administration's economic growth strategy, together with the CGC. Therefore, the SSC is in the shadow of the government.

One of the characteristics of the SSC is its weak binding effect and enforcement mechanism, because there is no organization or body charged

54 Paragraph 2-3 in the Guidance of the draft of the revised Japan's Stewardship Code. Furthermore, the following sentences will be added in paragraph 7-2 of the draft. "The management of institutional investors should have appropriate capability and experience to effectively fulfill their stewardship responsibilities, and should be constituted independently and without bias, in particular from their affiliated financial groups. The management of institutional investors should also recognize that they themselves have important roles and responsibilities to carry out stewardship activities such as enhancing dialogue, structure their organizations and develop human resources, and take action on these issues."

55 Paragraph 5-3 in Guidance of the draft of revised Japan's Stewardship Code.

56 Paragraph 1-5 in Guidance of the draft of revised Japan's Stewardship Code.

57 Paragraph 4-2 in Guidance of the draft of revised Japan's Stewardship Code.

with enforcing it. Nevertheless, institutional investors are obligated to exercise voting rights and to occasionally engage with investee companies under the dictates of both civil and regulatory law – for example, when they are trust banks or investment advisors. In some cases, the stewardship responsibility can be a legally binding norm. In contrast, insurance companies or proxy advisors are not deemed fiduciaries in Japan. If we look at the entire equity investment chain, it is necessary to close this loophole in order to ensure the trustworthiness of the entire chain for the ultimate beneficiaries. The concept of the SSC could play a role in this respect.

Asset owners in particular are expected to enforce the SSC by nominating and overseeing asset managers.⁵⁸ The Government Pension Investment Fund of Japan (GPIF) is the largest public pension fund in the world, with total assets under management equalling 129 trillion yen, or approximately 1 trillion euros. The GPIF doesn't make investment management decisions by itself, nor does it directly exercise voting rights, so as not to give rise to concerns that it could have a direct influence over the management of listed companies. The GPIF signed the Code and discloses its policy for performing stewardship activities.⁵⁹ According to the policy, the GPIF will ask external asset managers to submit their guidelines for the exercising of voting rights and to report on their status. It will also hold meetings with the managers about the results. The GPIF will consider the way in which an asset manager exercises his or her voting rights as part of the annual evaluation process. Such practices on the part of asset owners are expected to change asset managers' practice of seeking only short-term gains and to enhance the mid- to long-term investment return for the clients and ultimate beneficiaries by improving and fostering the investee companies' corporate values and sustainable growth.

58 Paragraphs 1-3 to 1-5 of the draft of revised Japan's Stewardship Code.

59 GOVERNMENT PENSION INVESTMENT FUND, JAPAN, Acceptance of the Japan's Stewardship Code, 30 May 2014, available at http://www.gpif.go.jp/en/fund/pdf/e_ukeirehyoumei.pdf.