

The Global Progress of Stewardship and Corporate Governance by Passive Investors

*Akio Otsuka**

I. INTRODUCTION.....	206
II. PERSPECTIVE OF INSTITUTIONAL INVESTORS.....	210
<i>A. Separation of Ownership from Control.....</i>	<i>210</i>
<i>B. Emergence of Institutional Investors</i>	<i>210</i>
<i>C. Features of Passive (Index) and Active Funds</i>	<i>212</i>
<i>D. Engagement</i>	<i>213</i>
<i>E. Several Impediments to Engagement</i>	<i>215</i>
(i) Collective Action (Free-Rider) Problem.....	215
(ii) Legal Concerns.....	215
(iii) Liquidity Concerns.....	218
(iv) Lack of Incentive for Engagement.....	218
<i>F. Rethinking the Features of Passive Funds.....</i>	<i>219</i>
III. U.K. STEWARDSHIP CODE.....	226
IV. JAPAN STEWARDSHIP CODE	234
<i>A. Significance of the Code</i>	<i>234</i>
<i>B. The 2017 Revision</i>	<i>236</i>
<i>C. Comparison of U.K. Stewardship Code with Japan's</i> <i>Stewardship Code</i>	<i>236</i>
<i>D. Legal impediments to collective engagement under Japan Code</i> <i>.....</i>	<i>238</i>
<i>E. Problems remaining in the Japan Stewardship Code.....</i>	<i>240</i>
V. THE GOVERNMENT PENSION INVESTMENT FUND (GPIF).....	241
<i>A. Investment Principles.....</i>	<i>242</i>
<i>B. Stewardship Principles</i>	<i>244</i>
<i>C. Policy to Fulfil Stewardship Responsibilities</i>	<i>246</i>
<i>D. Voting Principle</i>	<i>247</i>
<i>E. 2018 GPIF Stewardship Activities Report</i>	<i>248</i>
<i>F. Pension Reform Act of 2016</i>	<i>249</i>
<i>G. Further concern held by the GPIF</i>	<i>249</i>
VI. CURRENT AND HEREAFTER STEWARDSHIP IN THE UNITED STATES	
.....	250
<i>A. ISG Stewardship Code.....</i>	<i>251</i>

* Professor of Law, Chair of Law School Program (4/2013-3/2015), Dean of Graduate School of Business Science (4/2018-3/2020), University of Tsukuba Law School; LL.M. 1990, MBA 1991, Southern Methodist University, Ph.D. in law 2001, University of Tsukuba, Tokyo.

<i>B. Enhance the Stewardship in the United States</i>	254
(i) Collective Engagement between Passive and Active Funds	
.....	254
(ii) Voting Advisory.....	255
(iii) ESG Investment.....	258
(iv) Commitment to or Tiering in Stewardship	259
(v) Implication for Corporate Governance Theory	261
VII. CONCLUSION.....	265

I. INTRODUCTION

In the United States, firms' institutional ownership¹ has seen a marked increase in the past few decades. In the 1980s, a firm's average share of institutional ownership increased from 20% to 30% to more than 65% of the total by the 2010s, whereas a firm's residual retail ownership² correspondingly declined from 80% to less than 35%.³ During the same period, the fraction of the average firm held by institutions holding blocks⁴ of same-industry rivals increased approximately from 10% to 60%.⁵

The institutional investor has very different structures, strategies, and incentives categorized as follows. First, public employee pension funds, such as CalPERS, whose boards are appointed by politicians or directly elected by voters, and which are thus generally responsive to political pressure. Second, mutual and nonprofit management companies such as Vanguard, whose management company is owned by Vanguard funds and is indirectly owned by Vanguard investors. Third, for-profit asset managers, some of which are publicly held, such as BlackRock.

Two types of management of funds exist: active and passive. An actively managed mutual fund is empowered to buy securities that are undervalued and/or sell securities that are overvalued subject to the goals of the specific investment portfolio, whereas a passive fund (alternatively, an "index" fund) is a mutual fund designed to track an underlying index.⁶ The passive fund has

¹ Institutional ownership means any equity owned by institutional investors.

² Retail ownership means any equity owned by retail investors, also known as individual investors, or non-professional investors.

³ Paul Borochnin & Jie Yang, *The Effects of Institutional Investor Objectives on Firm Valuation and Governance*, 126 J. FIN. ECON. 171, 171 (2017).

⁴ A block is a large number of shares in a stock company, sold and bought in a lump.

⁵ See Jie He & Jiekun Huang, *Product Market Competition in a World of Cross-Ownership: Evidence from Institutional Blockholdings*, 30 REV. FIN. STUD. 2674, 2675 (2017).

⁶ Passive funds include index mutual funds and exchange traded funds (ETFs). Both seek to replicate stock indices and to minimize cost ratios, but they are technically different - index funds are traded only once a day after markets have closed and ETFs can be bought and sold continuously during the entire trading day. See Giovanni Strampelli, *Are Passive Index Funds*

had an increasingly important role in recent years that has been particularly concentrated in U.S. equity assets, where in the last twenty years, the share of total U.S. market capitalization held by passive funds has quadrupled,⁷ and passive funds now comprise 43% of total U.S. equity fund assets,⁸ with trillions of dollars in investments.⁹

These patterns are also present in Europe to some extent. The top passive fund managers, such as BlackRock, Vanguard, and State Street (the “Big Three”),¹⁰ hold substantial blocks in many public companies in the United States. BlackRock has more than \$5 trillion assets and is now the biggest shareholder of thirty-three of the FTSE 100 index companies.¹¹ Vanguard, with more than \$4 trillion assets under management, is not far behind globally and is growing even faster than BlackRock.¹² It is predicted that they will likely hold more than 50% of the market by 2024.¹³ A new legal problem is arising out of the increase in passive funds. During the past two decades, many investee companies competing in the same industry have become jointly held by a small number of institutional investors. For that reason, potential anticompetitive effects have happened when large passive investors including Big Three own large blocks of shares in such competing companies.¹⁴

During these past few years, some commentators have also examined the influence of passive investing on market efficiency. Legal and financial scholars have started to turn their attention to the corporate governance issues

Active Owners? Corporate Governance Consequences of Passive Investing, 55 *SAN DIEGO L. REV.* 803, 809 (2018); see also SEC, *MUTUAL FUNDS AND ETFs: A GUIDE FOR INVESTORS* 19–20 (2019), <https://perma.cc/6DE4-5VDA> (discussing index-based funds and actively managed funds).

⁷ Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 *J. FIN. ECON.* 111, 112 (2016).

⁸ Vladyslav Sushko & Grant Turner, *The Implications of Passive Investing for Securities Markets*, *BIS Q. REV.* 133, 115 (2018).

⁹ The Investment Company Institute indicates that index mutual funds had net assets of almost \$3,365 billion at the close of 2017, more than \$ 2,740 billion of which was in index equity mutual funds. See *INV. CO. INST.*, 2018 *INVESTMENT COMPANY FACT BOOK* 125 (2018), <https://perma.cc/NYK6-AHW2>.

¹⁰ See, e.g., Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-concentration of Corporate Ownership, and New Financial Risk*, 19 *BUS. & POL.* 298, 304 (2017).

¹¹ FTSE 100 Index is the Financial Times Stock Exchange 100 Index, which is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization. See *LONDON STOCK EXCH.*, *News and Prices, FTSE Indices, FTSE 100*, <https://www.londonstockexchange.com/indices/ftse-100/constituents/table> (last visited Oct. 6, 2020).

¹² See *CAP. IQ*, <https://www.capitaliq.com/ciqdotnet> (last visited Oct. 8, 2020).

¹³ See Trevor Hunnicutt, *Index Funds to Surpass Active Fund Assets in U.S. by 2024: Moody's*, *REUTERS* (Feb. 2, 2017), <https://www.reuters.com/article/us-funds-passive/index-funds-to-surpass-active-fund-assets-in-u-s-by-2024-moodys-idUSKBN15H1PN>.

¹⁴ See, e.g., Einer Elhauge, *Horizontal Shareholding*, 129 *HARV. L. REV.* 1267, 1267 (2016) (“A small group of institutions has acquired large shareholdings in horizontal competitors throughout our economy, causing them to compete less vigorously with each other”); see also Eric A. Posner et al., *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 *ANTITRUST L.J.* 669, 669–700 (2017).

of passive funds.¹⁵ As the number of investment investors has increased, commentators have focused on the corporate governance role that institutional investors will play, and carefully analyzed their deficiencies in order to improve corporate governance and performance.¹⁶ The commentators have focused on several factors that weaken asset managers' incentives to monitor investee company's management, including collective action problems and fee structure.¹⁷ This article addresses overlooked implications of the emergence of the debate on institutional investors and explores the analysis on institutional investors' stewardship, including comparative analysis of the viewpoints of the United Kingdom, Japan, and the United States.

In 2010, the U.K. introduced the Stewardship Code in consequence of the global financial crisis of 2008–2009. The Stewardship Code is a set of best practice principles designed to encourage institutional investors to engage in stewardship of their portfolio companies and is enforced on a "comply or explain" basis. The Code ultimately aims at fostering the long-term success of investee companies through active engagement by institutional investors. In 2014, Japan followed the U.K. by introducing Japan's Stewardship Code to encourage 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."¹⁸ Among monetary and fiscal policy reforms introduced by the Abe Cabinet (so-called "Abenomics") and aiming at improving corporate productivity and "earning power," Japan's Stewardship Code was introduced as Abenomics' "third arrow," which included other significant corporate governance reforms.¹⁹ This means the aim of Japan's stewardship is more active in terms of economic policy, as compared to the U.K. stewardship. In Japan, the world's largest pension fund which manages public pension (social security) funds - the Government Pension Investment Fund (GPIF)²⁰ - is a part of the national government and is subjected to heavy

¹⁵ See, e.g., Hortense Bioy et al., *Passive Fund Providers Take an Active Approach to Investment Stewardship*, MORNINGSTAR, 3 (2017), <http://www.morningstar.com/content/dam/morningstar-corporate/pdfs/Research/Morningstar-Passive-Active-Stewardship.pdf>; see also Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 493, 527–28 (2018).

¹⁶ See Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 525 (1990); see also Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452 (1991) (analyzing potential promise of institutional investors).

¹⁷ See, e.g., Jill E. Fisch, *Relationship Investing: Will It Happen? Will It Work?*, 55 OHIO STATE L.J. 1009, 1024 (1994). In the line of passive investments see Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders 16* (N.Y. Univ. Working Paper, Paper No. 18-39, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3295098.

¹⁸ FIN. SERVS. AGENCY, COUNCIL OF EXPERTS ON THE STEWARDSHIP CODE, art. 1 (2017), <https://www.fsa.go.jp/en/refer/councils/stewardship/20170125-1.pdf>.

¹⁹ Jennifer G. Hill, *Good Activist/Bad Activist: The Rise of International Stewardship Codes*, 41 SEATTLE U. L. REV. 497, 515–16 (2018).

²⁰ See, e.g., Keiko Ujikane & Shigeki Nozawa, *World's Largest Pension Fund Loses \$136 Billion in Three Months*, BLOOMBERG: MARKETS (Feb. 1, 2019, 12:42 AM), <https://www.bloomberg.com/news/articles/2019-02-01/world-s-biggest-pension-fund-reports-record-136-billion-loss>.

political pressure. GPIF defines itself a “super long-term investor” managed as a part of a hundred-year sustainable pension scheme and shall fulfill its responsibilities as an asset owner in line with the Japan’s Stewardship Code.²¹ On the other hand, no U.S. regulatory body has established any stewardship code or similar, and instead, individual or group institutional investors promise to share responsibility for the long-term economic success of portfolio companies.²² For the long-term economic success of portfolio companies, it is crucial to encourage the companies to establish better corporate governance structure within it. This legal duty requires directors to promote the long-term success of the corporation for the benefit of shareholders as a whole; however, in doing so, directors must consider the list of stakeholder interests including ESG (Environmental, Social and Governance) factors.²³ I will refer to this as the “enlightened shareholder value” approach, which the U.K. Companies Act 2006 has accepted as a fundamental principle in corporate governance. This change in the law will force the notion of fiduciary to be changed so that institutional investors will be focused on maximizing their client’s financial returns.

To achieve this aim, this Article proceeds as follows. Part II describes the emergence of institutional investors, including a variety of institutions, such as insurance companies, mutual funds, and pensions which are categorized as passive or active. Institutional investors are expected to engage with their investee companies for monitoring and governance, but such an engagement faces several impediments. In particular, passive funds that have occupied a large share of the market are supposed to have no financial incentive to incur the costs during such an engagement because passive funds track stock market indices and in general do not require portfolio managers. Parts III through V refer to the institutions’ stewardship developed abroad in the U.K. and Japan. Part III presents the development of stewardship in the U.K., and Part IV describes Japan’s Stewardship Code, which is significantly influenced by the U.K. Code. Part V introduces GPIF’s stewardship activities in Japan. Part VI argues the present development of stewardship in the United States and several problems to be solved for better stewardship and corporate governance. Finally, Part VII sets out concluding remarks.

²¹ GOV’T PENSION INV. FUND, DESCRIPTION FOR INVESTMENT PRINCIPLES art. 4, (2020), https://www.gpif.go.jp/en/about/Description_for_Investment_Principles_2020.pdf.

²² See discussion *infra* Part V. Section A.

²³ Environmental factors include climate change, carbon emissions, pollution, energy efficiency, deforestation, and water use related to water scarcity. Social factors include labor conditions, employee engagement, human rights, gender and diversity policies, and community relations. Governance factors include diversity on the board, executive compensation, audits and transparency for shareholders and other stakeholders, corruption policies, and political contributions. Especially after the global financial crisis of 2008–09, the demand for sustainable investment including ESG investment has increased rapidly.

II. PERSPECTIVE OF INSTITUTIONAL INVESTORS

A. *Separation of Ownership from Control*

Many publicly traded corporations have widely dispersed shareholders and consequently have no large shareholders. In their milestone book, *The Modern Corporation and Private Property*, Adolf Berle and Gardiner Means found that many public corporations had dispersed ownerships, with no single shareholder owning a large portion of shares in the U.S. market.²⁴ They observed the phenomenon as a "separation of ownership from control" (the "Berle-Means Corporation").²⁵ Under the Berle-Means Corporation, a large number of dispersed shareholders jointly owned shares in a large corporation.²⁶ Ownership usually implies control. However, because of the dispersed ownership structure and no dominant shareholders in a public corporation, corporate managers who are under little monitoring by shareholders have de facto control over the public corporation, and thus, shareholders of most public corporations are passive.²⁷

The separation of ownership from control is advantageous when the management operates the business in a way that benefits all shareholders. "Separation of ownership from control" is justified by the notion that managers serve as specialists with expertise to increase the whole value of the corporation, whereas diversified shareholders are highly passive, that is, they supply substantial capital in exchange for gains from increase in corporate value.²⁸ Corporate governance in the United State is primarily focused on reducing agency costs as much as possible, that is, by balancing the costs and benefits arising out of this separation of ownership from control.

B. *Emergence of Institutional Investors*

For most of the twentieth century, public corporations were primarily owned by private individuals. After the collapse of the banking system and the Great Depression of the 1930s, the Glass-Steagall Act was enacted by the U.S.

²⁴ See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 2-3, 47-65 (1932).

²⁵ *Id.* at 6 (noting that the separation of ownership from control causes a condition where the interests of the owner and manager may diverge, and where the check functions to limit the use of power disappear).

²⁶ See John C. Coffee Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and its Implications*, 93 NW. U. L. REV. 641, 641 (1999).

²⁷ See ROBERT C. CLARK, *CORPORATE LAW* 390-96 (1986) (explaining that smaller shareholders are rationally apathetic because of cost concerns and free riding).

²⁸ See also Arthur R. Pinto, *Globalization and the Study of Corporate Governance*, 23 WIS. INT'L. L.J. 477, 491-94 (2005) (explaining the prevalence of separation of ownership from control, including different legal systems, cultural differences, and history and politics).

Congress.²⁹ Congress recognized that certain abuses in the financial community contributed to the banking panic of the late 1920s and early 1930s and sought to rectify those abuses through preventative legislation that created a "wall" between investment and commercial banking activities.³⁰ In the early 1900s, U.S. financial institutions actively contributed to corporate governance, but in the 1930s the establishment of securities laws limited financial intermediaries' power and, as such, reduced their governance role. In 1942, the U.S. Securities and Exchange Commission (SEC) established under Section 14(a) of the 1934 Securities Exchange Act the Shareholder Proposal Rule, which requires corporate management to include shareholder proposals in its proxy materials for a vote, at no cost to the proponent.³¹ Since then, activist shareholders have used the proxy process to pressure boards and managers to achieve business policy and strategy change. During the mid-1980s with the emergence of public pension fund activism, large institutional investors were involved intensely.³²

Institutional investors started participating in corporate governance by engagement of several large public pension funds – most noticeably the California Public Employees Retirement System (CalPERS). CalPERS is one of the first institutional investors that engaged extensively in corporate governance. CalPERS' investment has been indexed with its strategy focused on underperforming companies, and several studies showed that firms intervened by CalPERS experienced improved performance.³³ However, both passive and active funds did not participate in enhancing corporate governance of their portfolio companies in the initial stages.

During the past few decades, the structure of share-ownership in the equity market has changed with the increase in ownership by institutional investors that are made up of private/public pension funds, insurance companies, bank-managed trusts, universities, endowments, foundations, mutual funds and private equity and hedge funds.³⁴ Whereas the Berle-Means Corporation with widely dispersed shareholders continues, large institutional investors often hold a larger number of shares in investee companies. If these

²⁹ The Glass-Steagall Act is the common name for the Banking Act of 1933. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified in scattered sections of 12 & 18 U.S.C.).

³⁰ Other statutes regulating financial markets included the Securities Act of 1933: 15 U.S.C. §§77a–77aa (2012), Securities Exchange Act of 1934, 15 U.S.C. §§78a–78pp (2012), and Public Utility Holding Company Act of 1935, ch. 687, tit. I, Pub. L. No. 74-333, 49 Stat. 803 (repealed 2005).

³¹ See 17 C.F.R. § 240.14a-8 (2011).

³² Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 55 (2007).

³³ See Mary E. Kissane, *Global Gadflies: Applications and Implications of U.S.-Style Corporate Governance Abroad*, 17 N.Y. L. SCH. J. INT'L & COMP. L. 621, 634–38 (1997) (noting that CalPERS has stated "shareholder activism improves economic returns in the U.S.").

³⁴ See Thomas C. Pearson & Julie L. Pearson, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33 N.C. J. INT'L L. & COM. REG. 1, 14–16 (2007).

institutions act collectively, they can impact management in their companies, but will face so-called collective action problems in monitoring corporate managers.³⁵ The increase of institutional ownership, however, does not mean that any single institution is likely to dominate a corporation. Many of these institutions exist, but most are not interested in increased control over the corporation because these active roles would incur increased costs that might not produce benefits to these institutions.³⁶

C. Features of Passive (Index) and Active Funds

Institutional investors today own most of the stocks issued by U.S. corporations, and their shares continue to grow.³⁷ Examples include insurance companies, mutual funds, and pensions. The two types of institutional investors that exist are active and passive fund managers. Passive investment funds, or "index funds," track stock market indices, such as the Standard & Poor's 500 Index (S&P 500), with the goal to match the index's returns.³⁸ In general, passively managed index funds do not use portfolio managers and do not involve any complicated research on the part of an investor.³⁹ Because they do not require portfolio managers, index funds often cost much less than actively managed funds.⁴⁰ In addition, a commentator classifies some actively managed mutual funds as "quasi-indexers," meaning that they have "diversified holdings and low portfolio turnover."⁴¹ In contrast, active fund managers aim to outperform a relevant benchmark market index because they have the incentive to influence an investee company's management and improve performance which will affect net inflows into the fund, and in turn increase management fees. Passive fund managers aim only to deliver returns to their investors in a benchmark market index. As a result, active fund managers regularly rebalance the weights of individual stocks in their portfolio companies, whereas passive fund managers aim to continuously keep the weights of individual stocks to track stock market indices in their portfolio companies. Consequently, passive fund managers refuse frequent share buildup or divestment in their portfolio, because doing so leads to deviations

³⁵ See Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 815–16, 821–22 (1992).

³⁶ Randall S. Thomas, *The Evolving Role of Institutional Investors in Corporate Governance and Corporate Litigation*, 61 VAND. L. REV. 299, 300 (2008).

³⁷ See *supra* text accompanying note 3.

³⁸ A stock market index represents an aggregate value that is produced by combining several stocks or other investment vehicles and expressing their total values against a base value from a specific date. The result can then be used as a benchmark for investors.

³⁹ See K.J. Martijn Cremers & Quinn Curtis, *Do Mutual Fund Investors Get What They Pay For? Securities Law and Closet Index Funds*, 11 VA. L. & BUS. REV. 31, 37–38 (2016).

⁴⁰ See Norm Alster, *The Ease of Index Funds Comes with Risk*, N.Y. TIMES (Oct. 9, 2015), <https://www.nytimes.com/2015/10/11/business/mutfund/the-ease-of-index-funds-comes-with-risk.html>.

⁴¹ German Gutierrez & Thomas Philippon, *Investment-Less Growth: An Empirical Investigation*, 3 n.2 (Nat'l Bureau of Econ. Rsch., Working Paper, Paper No. 22,897, 2016), <https://perma.cc/UXY2-D6DF>.

from the weight of the stocks in the portfolio.⁴² In contrast, activist hedge funds use proxy fights and other approaches to pressure public companies into making changes in their business and governance.⁴³ For instance, reports state that 131 activist investors targeted 226 companies and won 161 board seats in 2018.⁴⁴

How about the real market? Index funds and ETFs hold a 43% market share in the United States.⁴⁵ The index fund industry remains highly concentrated in the United States. In 2015, passive index funds owned approximately \$4 trillion assets under their management, which exceeded the hedge funds' assets under management.⁴⁶ Global assets held by passive index funds exceeded \$5 trillion for the first time in January 2018. Some commentators suppose this figure will soon reach \$10 trillion⁴⁷ and may surpass U.S. assets held by active funds by 2024.⁴⁸ During one decade, the total share held by passive index funds in the U.S. capital market has "quadrupled to more than 8%, or 12% of the S&P 500 companies."⁴⁹ The Big Three own nearly 90% of public companies in the S&P 500 and at least 40% of all U.S. listed companies.⁵⁰

D. Engagement

In the United States, activist shareholders are arguably the capital market's endogenous response to the agency gap that has resulted from the emergence of institutional intermediaries.⁵¹ Typically, activist shareholders first own non-controlling stakes in target companies and then try to influence the companies' management. According to this structure, activist shareholders are expected to play a certain monitoring role by exercising governance rights

⁴² Russell Stanley Q. Geronimo, *Unbundled Shares: Circumventing Corporate Nationality Rules Through Swaps, Options, and Other Devices*, 19 *ASIAN-PAC. L. & POL'Y J.* 84, 117 (2018).

⁴³ See generally Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 *U. PA. L. REV.* 1021 (2007) (discussing activist hedge funds).

⁴⁴ LAZARD'S SHAREHOLDER ADVISORY GRP., 2018 REVIEW OF SHAREHOLDER ACTIVISM 1 (2019), <https://www.lazard.com/media/450805/lazards-2018-review-of-shareholder-activism.pdf>.

⁴⁵ Bioy et al., *supra* note 15, at 8.

⁴⁶ *Id.* at 6–8.

⁴⁷ Chris Flood, *ETF Market Smashes Through \$5tn Barrier After Record Month*, *FIN. TIMES* (Feb. 10, 2018), <https://www.ft.com/content/5cf7237e-0cdc-11e8-839d-41ca06376bf2>.

⁴⁸ See Trevor Hunnicutt, *Index Funds to Surpass Active Fund Assets in U.S. by 2024: Moody's*, *REUTERS* (Feb. 2, 2017, 8:31 AM), <https://perma.cc/Q3KH-Y4DW>.

⁴⁹ Lund, *supra* note 15, at 507 (citing Ian R. Appel et al., *Passive Investors, Not Passive Owners*, 121 *J. FIN. ECON.* 111 (2016)).

⁵⁰ Fichtner et al., *supra* note 10, at 313 ("Large companies where the Big Three are not the main shareholders are typically dominated by private individuals" including Amazon (Jeff Bezos), and Facebook (Mark Zuckerberg)).

⁵¹ See, e.g., Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 *COLUM. L. REV.* 863, 867 (2013) (arguing that activist hedge funds offer a response to the shortfall in monitoring institutional intermediaries).

vested in shareholders.⁵² Thus, activist shareholders often perform a stewardship function.⁵³

As posited by Fairfax, shareholders' increased voice in management gives priority to engagement for several reasons.⁵⁴ As a result of shareholder engagement, management in companies has the opportunity to explain their business policies and strategies, which could prevent misunderstandings between management and shareholders.⁵⁵ Moreover, because of enhanced shareholder engagement, company management will be able to educate their shareholders,⁵⁶ which will allow shareholders to make more informed decisions.⁵⁷ In the next stage, shareholder engagement may enable companies to gain support for their business policies, and the directors and officers who execute those business policies.⁵⁸ When shareholders have a greater power to reject executive pay packages and remove directors, such support is apparently crucial. According to a certain proxy study, one vital difference between corporations that have acquired shareholder support and those that have failed to do so is whether the corporations have motivation to make direct engagement with their shareholders.⁵⁹ Thus, shareholder engagement may, among other things, avoid costly conflicts and confrontations with shareholders. According to some governance experts, much of shareholder activism may be avoided by effective shareholder engagement.⁶⁰ In contrast, the recent rise of passive funds may be going back to the Berle-Means Corporation world.⁶¹

⁵² See *id.* (framing the role of activist shareholders - this approach contrasts with the raider-like takeover attempts of the 1980s).

⁵³ See *id.* (describing how activists can perform a stewardship function).

⁵⁴ Lisa M. Fairfax, *Mandating Board-Shareholder Engagement?*, 2013 U. ILL. L. REV. 821, 832 (2013).

⁵⁵ *Id.* at 833; see also Lisa M. Fairfax, *SHAREHOLDER DEMOCRACY: A PRIMER ON SHAREHOLDER ACTIVISM AND PARTICIPATION* 124 (2011).

⁵⁶ See *id.* at 115; Memorandum from Ira M. Millstein, Holly J. Gregory, & Rebecca C. Grapsas, to WEIL, GOTSHAL & MANGES LLP, *Ten Thoughts for Ordering Governance Relationships in 2010* 2 (Jan. 2010), https://www.weil.com/~media/files/pdfs/alert_ordering_governance_relationships_in_2010.pdf.

⁵⁷ See Fairfax, *supra* note 54, at 833; see also Millstein et al., *supra* note 56, at 2.

⁵⁸ See *Dangerous Talk? When/How Should Directors Communicate with Shareholders?*, LATHAM & WATKINS LLP at 2, <https://www.yumpu.com/en/document/read/52351925/1-dangerous-talk-when-how-should-directors-communicate-with/4>.

⁵⁹ See Jeremy L. Goldstein, *Say on Pay 2012*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 14, 2012), <http://blogs.law.harvard.edu/corpgov/2012/07/14/say-on-pay-2012>.

⁶⁰ See LATHAM & WATKINS LLP, *supra* note 58, at 2–3 (quoting Millstein) ("[A]most every hot button governance issue can be addressed through constructive communication between boards and management with shareholders.").

⁶¹ Several commentators indicate that the increase of passive funds will cause agency costs to increase. See, e.g., Lund, *supra* note 15, at 495.

E. Several Impediments to Engagement

Institutional investors still face several engagement impediments, including principally collective action problems, legal concerns, liquidity concerns, conflicts of interest, and a business model fundamentally incompatible with activism.

i. Collective Action (Free-Rider) Problem

Most shareholders are passive investors with a single aim to receive a fractional monetary return from the investee company. If institutional investors expend resources to monitor management, they will incur high monitoring costs that would be borne solely by the activist investors; however, any benefit from the activities, including monitoring, would be spread out and enjoyed among all investors. Hence, a passive fund's market-wide efforts are likely to benefit not only activist investors but also all passive funds. This asymmetry will cause the inevitable collective action problem that dissuades institutional investors from engaging in corporate governance.⁶² Thus, free-riders benefit at no cost from the activist investors' monitoring activity,⁶³ and, therefore, large investors have no incentive to become activists.⁶⁴ That is to say, rational institutions will generally make investment decisions not to maximize absolute returns but to maximize returns relative to market indexes.

ii. Legal Concerns

Compliance with regulatory restraints likely reduces investors' incentives to monitor corporate management.⁶⁵ For instance, subject to diversification requirements for mutual or pension funds, investors may not acquire a block that is large enough to have an incentive for engagement. That is to say, to qualify for substantial tax advantages under subchapter M of the Internal Revenue Code and "diversified" status under the Investment Company Act, mutual funds must uphold high levels of diversification.⁶⁶ Regarding pension funds, regulatory constraints require diversification as well.⁶⁷ Moreover, the rule on "acting in concert" under Section 13(d) of the U.S. Securities Exchange

⁶² Competitors are able to free ride on an institutional investor's monitoring. *See generally* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 *YALE L.J.* 269, 271, 275 (2003).

⁶³ Fisch, *supra* note 17, at 1021–22.

⁶⁴ Gilson & Gordon, *supra* note 51, at 868–69; *see also* Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 *Iowa J. Corp. L.* 647, 678 (2016).

⁶⁵ *See* Kahan & Rock, *supra* note 43, at 1049.

⁶⁶ 15 U.S.C. § 80a-5(b)(1) (to be a "diversified company" under the Act, 75% of a mutual fund's assets must comply with the limitation that (a) the fund may own no more than 10% of the outstanding securities of a portfolio company, and (b) the stock of one portfolio company may not constitute more than 5% of the value of the fund's assets).

⁶⁷ For instance, pursuant to the Employee Retirement Income Security Act of 1974 (ERISA), private pension funds are required to be diversified. *See* 29 U.S.C. § 1104; *see also* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 *COLUM. L. REV.* 10, 19–25 (1991) (summarizing the various limits imposed on U.S. mutual funds and private pension funds).

Act may discourage engagement since it will cause a legal risk when investors make collective engagement.⁶⁸ That is, shareholders are concerned with assuming potential liability by being held to have "acted in concert" through engagement in any wide-scale shareholder communication and, thereby, not filing the required Schedule 13D to the extent that a group owns, in aggregate, more than 5% of the company's equity.⁶⁹ Finally, disclosure regulations, such as the Regulation Fair Disclosure, will discourage investors or managers from engagement, which is subsequently described in greater detail. Mutual funds must also report semiannually to shareholders the quantities and values of the funds' securities,⁷⁰ so that such fund disclosure primarily aids mutual fund investors in selecting among funds.⁷¹

According to existing research, many corporate directors and officers observe the Regulation Fair Disclosure (Reg FD) as a substantial impediment to vigorous communication with shareholders.⁷² To maintain confidence in securities markets and to prevent the use of inside information for trading purposes, the SEC promulgated Reg FD in October 2000, which prohibits listed companies from making selective disclosures in a manner that could result in insider trading.⁷³ Reg FD was, on the other hand, designed to encourage the full and fair disclosure of vital issues on business.⁷⁴ When a public company or someone acting on its behalf discloses material nonpublic information to market professionals or its shareholders who may trade on the information, the company is obliged to disclose.⁷⁵ In this line, Reg FD requests a public company to make a public disclosure, simultaneously with the selective disclosure in the case of intentional disclosure or promptly in the case of

⁶⁸ See 15 U.S.C.A. § 78m(d) (2012). Section 13(d) of the Act requires persons acquiring more than five percent of a company's equity securities to file certain disclosures and expose themselves to certain potential liabilities for failure to provide such disclosure filings. See *id.* Additionally, Section 13(d) of the Act also provides that two or more persons who "act as a partnership, limited partnership, syndicate or other group ... shall be deemed a 'person' for the purposes of [Section 13(d) of the Act]"; see *id.* § 78m(d)(3).

⁶⁹ See Eric M. Fogel et al., *Public Company Shareholders Acting as Owners: Three Reforms-Introducing the "Oversight Shareholder"*, 29 DEL. J. CORP. L. 517, 533 (2004); see also Robert G. Vanecko, *Regulations 14A and 13D and the Role of Institutional Investors in Corporate Governance*, 87 NW. U. L. REV. 376, 385 (1992).

⁷⁰ See 15 U.S.C.A. § 80a-29(e) (2012).

⁷¹ Joseph A. Franco, *A Consumer Protection Approach to Mutual Fund Disclosure and the Limits of Simplification*, 15 STAN. J. L. BUS. & FIN. 1, 78 (2009).

⁷² Stephen Davis & Stephen Alogna, *Talking Governance: Board-Shareholder Communications on Executive Compensation*, 2 YALE SCH. OF MGMT. 1, 5 (2008), [https://web.law.columbia.edu/sites/default/files/microsites/millstein-center/2008%2012%2008%20talking%20governance%20v2%20\(4\).pdf](https://web.law.columbia.edu/sites/default/files/microsites/millstein-center/2008%2012%2008%20talking%20governance%20v2%20(4).pdf).

⁷³ *Fact Sheet: Regulation Fair Disclosure and New Insider Trading Rules*, U.S. SEC. & EXCH. COMM'N (Aug. 10, 2000), <http://www.sec.gov/news/extra/seldsfct.htm>.

⁷⁴ *Selective Disclosure and Insider Trading*, 65 Fed. Reg. 51,716-01 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249).

⁷⁵ See *id.*

inadvertent disclosure, as the case may be.⁷⁶ Hence, public companies must understand Reg FD during communications with selective shareholders or during meetings that are closed to the public. According to certain research, concerns about potential violations of Reg FD will reduce corporations' incentive to disclose.⁷⁷ From this viewpoint, one commentator criticizes that taking into consideration the insider trading law, Reg FD's restriction on free flow of information is questionable.⁷⁸

With the aim of reducing such concern, the SEC issued guidance in 2010 on Reg FD.⁷⁹ The SEC emphasized in the guidance that Reg FD is not to prohibit directors or officers from engaging in private meetings with shareholders,⁸⁰ and that companies can discuss material nonpublic information with shareholders who expressly agree to keep such information confidential.⁸¹ Moreover, even though companies unintentionally disclose material nonpublic information, they can avoid violating Reg FD by promptly disclosing such information to the public, as described above.⁸² In total, the SEC has attempted to make clear that, with appropriate planning, Reg FD should not discourage a company's communication with shareholders.⁸³ Only the SEC can bring an action under Reg FD, and there is no private enforcement right.⁸⁴ According to a study, the number of Reg FD enforcement actions is less than 10, and there are no enforcement actions or investigations against the companies that have had private meetings with shareholders.⁸⁵ Furthermore, the SEC's recommendations have mitigated the risk of companies attempting to engage with their shareholders.⁸⁶ As such, the SEC has tried to make clear that Reg FD does not discourage communication between shareholders and boards.⁸⁷

⁷⁶ 17 C.F.R. § 243.100 (2011).

⁷⁷ *See id.*

⁷⁸ Susan B. Heyman, *Rethinking Regulation Fair Disclosure and Corporate Free Speech*, 36 CARDOZO L. REV. 1099, 1101 (2015).

⁷⁹ *See Compliance and Disclosure Interpretations: Regulation FD*, U.S. SEC. & EXCH. COMM'N (June 4, 2010), <https://www.sec.gov/divisions/corpfin/guidance/regfd-interp.htm>.

⁸⁰ *See id.*

⁸¹ *See id.*; *see also* DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION 1:1 (2016), Westlaw (database updated April 2020) (arguing the Reg FD sought to prevent corporate insiders from disclosing material nonpublic information to select shareholders and market professionals).

⁸² *See id.*

⁸³ Fairfax, *supra* note 54.

⁸⁴ *See* Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,726 (Aug. 24, 2000) (to be codified at 17 C.F.R. pts. 240, 243, and 249); *see also id.* at 836.

⁸⁵ Davis & Alogna, *supra* note 72, at 10.

⁸⁶ Fairfax, *supra* note 54, at 836.

⁸⁷ *Id.*

iii. Liquidity Concerns

Many arguments and studies have been made regarding the reason that investors do not engage more actively with their portfolio companies. According to some research, investors concerned about liquidity use their voices less intensively.⁸⁸ This result is consistent with Coffee, who argued that market liquidity encourages investors to adopt the "cut and run" strategy instead of intervening.⁸⁹ Similar arguments are made by "exit" theories, which indicate that market liquidity increases the trustworthiness of the exit threat, reducing the necessity for governance through direct intervention.⁹⁰ Investors first attempt to directly engage in conversations with investee companies behind the scenes and then take public actions (e.g., shareholder proposals) only after the private interventions have failed.⁹¹

iv. Lack of Incentive for Engagement

The vital reason that mutual and pension funds are reluctant to engage in activism is based on their business model, which highlights the pursuit of relative returns.⁹² Mutual and pension funds' managers are evaluated periodically based on their performance relative to their peers.⁹³ Managers engaging in activism must assume all the costs of such engagement but share the increased returns with their competitors who hold shares in the investee companies.⁹⁴ Traditional institutional investors understand that the costs arising out of exercising their governance rights are simply too expensive, as compared with the increase in performance value realized from such exercise.⁹⁵ Thus, institutions are mostly concerned with comparatively better investment

⁸⁸ Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905, 2905 (2016); see also Alex Edmans et al., *The Effect of Liquidity on Governance* 1–8 (Eur. Corp. Governance Inst., Finance, Working Paper, Paper No. 319/2011, 2012), <http://ssrn.com/abstract=1905224> (Edmans, Fang, and Zur indicate that liquidity will affect the choice of governance mechanism, with high (low) liquidity tilting governance towards exit (voice)).

⁸⁹ John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1281 (1991).

⁹⁰ See, e.g., Alex Edmans & Gustavo Manso, *Governance Through Trading and Intervention: A Theory of Multiple Blockholders*, 24 REV. FIN. STUD. 2395 (2011) (explaining that institutional investors' power of governance depends on liquidity).

⁹¹ McCahery et al., *supra* note 88.

⁹² See JOHN KAY, THE KAY REVIEW OF U.K. EQUITY MARKETS AND LONG-TERM DECISION MAKING: FINAL REPORT 39–42 (2012), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

⁹³ See *id.* at 43.

⁹⁴ Gilson & Gordon, *supra* note 51, at 890–93.

⁹⁵ Coffee, *supra* note 89, at 1283 ("The primary explanation for institutional passivity is not overregulation, but the insufficiency of existing incentives to motivate institutional money managers to monitor.").

performance during relatively short periods while minimizing costs and risk.⁹⁶ The performance of funds is often monitored on a quarterly basis relative to similar funds.⁹⁷ This criteria of evaluating investment performance does not simply match long-term engagements even though it may profit shareholders in the long run.⁹⁸ For instance, a mutual fund may engage in analyzing its portfolio companies to identify, from among them, poorly performing companies caused by poor governance.⁹⁹ When this analysis shows low-level performance or low-level governance among portfolio companies, then the fund manager has two options: attempt to intervene in the board's governance, or sell the fund's shares and exit.¹⁰⁰ However, the fund manager has no incentive or expertise to vigorously engage with the portfolio companies.¹⁰¹ Thus, even if aiming at long term profits, institutional investors specialize in providing comparatively higher investment performance during relatively short periods while minimizing costs and risks.¹⁰²

F. Rethinking the Features of Passive Funds

The understanding of engagement particularly by passive funds, as previously introduced, has deepened recently, mainly through two articles. One proposes to restrict passive funds from voting while the other underscores the advantages of passive funds.¹⁰³ Dorothy Lund proposes that lawmakers should consider restricting passive funds from voting at shareholders' meetings. She argues that passive funds will have harmful consequences for corporate governance, shareholders and the economy for several reasons.¹⁰⁴ First, passive index funds lack a financial incentive to ensure that their investee companies improve performance in their portfolio companies because they only seek to match the index. Second, passive funds face a serious collective action problem. Any activities that improve a company's performance will equally benefit all funds that track the index. Third, engagements are particularly costly for passive index funds, which do not produce firm-specific information from such activities and therefore, must disburse additional resources to identify underperforming companies. Such expenses would spoil

⁹⁶ See Gilson & Gordon, *supra* note 51, at 889.

⁹⁷ Simon C.Y. Wong, *Why Stewardship is Proving Elusive for Institutional Investors*, 7 *BUTTERWORTHS J. INT'L BANKING & FIN. L.* 406, 407 (2010).

⁹⁸ See Gilson & Gordon, *supra* note 51, at 890.

⁹⁹ See *id.*

¹⁰⁰ See *id.*; see also Coffee, *supra* note 89, at 1281 (highlighting this "trade-off" faced by institutional investors).

¹⁰¹ See Gilson & Gordon, *supra* note 51, at 890.

¹⁰² David William Roberts, *Agreement in Principle: A Compromise for Activist Shareholders from the U.K. Stewardship Code*, 48 *VAND. J. TRANSNAT'L L.* 543, 556 (2015).

¹⁰³ Lund, *supra* note 15; see also Jill E. Fisch et al., *Passive Investors 5* (Univ. of Pa. Inst. for L. & Econ., Working Paper, Paper No. 414, 2018), <https://perma.cc/MU3S-59HK> (explaining that "passive investors can exploit economies of scale to improve governance across their portfolios.").

¹⁰⁴ Lund, *supra* note 15, at 495.

the very cost savings that attracted investors to the passive funds in the first place.¹⁰⁵ For these reasons, even if they choose to intervene, passive funds will stick to a low-cost, one-size-fits-all governance strategy that is unlikely to be in the company's best interest. Lund argues, however, that such a strategy, as well as the current status of passive funds, has substantially influenced and even controlled the overall outcomes of shareholder interventions, and created harmful consequences for corporate governance.¹⁰⁶

Lund's proposal would "restrict passive funds from voting their shares" if such funds are truly passive without exercising governance rights.¹⁰⁷ This proposed rule presumes that any fund using indices as an investment strategy is a passive fund, although such a presumption is rebuttable according to Lund.¹⁰⁸ A passive fund that desires to retain its voting rights could do so by strengthening the implementation of governance for investee companies (e.g., showing its strategy through which it will monitor and analyze the portfolio companies), which will cause the funds to be "certified."¹⁰⁹ Investors who care about governance could choose such a "certified" fund by paying a higher fee to the certified fund.

Lund acknowledged that her proposal appears to be a substantial departure from shareholder democracy, but she denied the drawback of these assertions stating that:

It [the voting right] originated as a protection for the residual claimants and has been justified as efficient because it allocates voting control to those who have the best incentives to use their vote to maximize the firm's value. In other words, voting is instrumental to corporate welfare only, and there is therefore a principled basis for depriving uninformed shareholders of the right to vote if doing so would improve firm efficiency¹¹⁰

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* at 521–22. Considering their dominant status in the market, passive funds are likely to determine the outcome of an activist's campaign. That is the problem with passive funds. If a campaign is harmful for a company, passive funds are likely to support such campaign. In contrast, if such campaign is beneficial to a company, passive funds are likely to spoil it. However, such a hypothetical problem should be evidenced by empirical studies in the future.

¹⁰⁷ Lund, *supra* note 15, at 528. The author states that the law would make all parties better off by restricting passive funds from casting uninformed votes. *Id.* at 529. Two other proposals are the "Pass-Through Voting for Passive Funds" and the "Pass-Through Voting as a Default." *Id.* at 530–31. However, as Lund describes the burden of passing voting authority for hundreds of companies to investors would not only be overwhelming for the fund, but also for investors. *Id.* at 530. Moreover, the problem regarding the burden of calculating the exact number of voting rights for each investor will exist. *See also* Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 STAN. L. REV. 687 (2019).

¹⁰⁸ Lund, *supra* note 15, at 529.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 532. According to most contractarians, non-shareholder participants in the firm demand contracts that require them to be fully compensated out of the revenues earned by the firm before any payments is made to shareholders. Thus, shareholders are said to be the firm's "residual

Additionally, Lund proposes using derivative action by a shareholder to address the agency cost problem and reduce conflicts between managers and shareholders.¹¹¹ However, winning the action is considerably difficult, if based on the *ALI Principles of Corporate Governance* approach, for example, which focuses primarily on the conduct or transaction on which the derivative action is based, and applies a business judgment standard to duty of care cases and a "reasonableness" or judicial balancing standard to duty of loyalty cases.¹¹²

Prior criticism, as described in section E, focused on two key features of passive index funds. First, because of their investment strategy, passive funds are locked into the portfolio companies and, as such, they cannot increase their investments in understated companies or exit from underperforming companies.¹¹³ Second, passive index funds compete primarily on costs against each other, and as a result, have no financial incentive to assume the costs related to any intervention in the corporate governance of their portfolio companies.¹¹⁴ Therefore, institutional investors often find themselves as a low-cost channel and an ineffective monitor for excessive diversification.¹¹⁵ Accordingly, passive index funds cannot overcome the collective action problems facing institutional investors.¹¹⁶

However, mutual funds have more direct communication with the management of their portfolio companies. A recent study indicates that during the past five years, 63% of large institutional investors have had direct discussions with management and that 45% have had private discussions with a company's board outside of the management's presence.¹¹⁷ Moreover, a number of empirical studies indicate that this engagement has improved both

claimants," and supposedly have the most need to pay the highest price for control over the firm. Accordingly, shareholders get to elect corporate directors because they implicitly bargained for these interests by assuming a higher degree of risk than other stakeholders in the exchange. See generally FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATION LAW* 67–8 (1991) (noting that because shareholders are residual claimants, they have control over the company, albeit indirectly through the selection of directors). The above theory gives common shareholders control power over the board and permits them to use this control to advance their own interests. Voting restricts their control power under the laws. Apart from this theory, those in control of a corporation, such as its officers, directors, and controlling shareholders, owe fiduciary duties to the corporation and other shareholders. Thus, a theory of controlling shareholders' fiduciary duty might exist, which might restrict voting rights, but practically, this is not the case.

¹¹¹ Lund, *supra* note 15, at 534.

¹¹² AM. L. INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS* § 7.02 (1993).

¹¹³ See Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 *REV. FIN. STUD.* 2645 (2009) (explaining how shareholders can respond to poor performance through exit).

¹¹⁴ Lucian A. Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 *J. ECON. PERSPS.* 89, 90 (2017) (arguing that "index funds have especially poor incentives to engage in stewardship activities that could improve governance and increase value.").

¹¹⁵ See, e.g., Wong, *supra* note 97, at 409.

¹¹⁶ Fisch et al., *supra* note 103, at 12–13.

¹¹⁷ McCahery et al., *supra* note 88, at 2906.

corporate governance and performance of portfolio companies.¹¹⁸ Furthermore, according to Appel, Gormley, and Kim, the increase in level of passive ownership is linked with a growing number of independent directors and expanding one-share, one-vote ownership rights, and decreased takeover defenses.¹¹⁹ Do prior criticisms, including incentive and cost problems, accordingly need to be re-examined based on the recent progress of engagement by mutual funds?

First, regarding an existing incentive problem, the collective action problem may constrain costly engagement efforts. However, governance improvements are an efficient mechanism for a passive investor's engagement. Passive funds have large portfolio sizes and very limited firm-specific information. Jill Fisch, Assaf Hamdani, and Steven Solomon argued that, because governance is passive, funds' single effective channel to improve underperforming companies will become their comparative advantage.¹²⁰ Passive funds cannot withdraw their investment in underperforming companies, whereas they have an incentive to ensure that their portfolio companies should be more sensitive to shareholder demands.¹²¹ Moreover, the passive funds' growth causes greater voting power to demand that sensitivity.¹²²

Second, costs are a concern. Given their economies of scale,¹²³ large passive funds can charge lower fees, thereby becoming more attractive to investors. On the other hand, in contrast to previous criticisms, because passive investors hold the market, they do not need to engage in firm-specific monitoring but are more likely to engage in market-wide activities to improve corporate governance. In other words, passive investors can exploit economies of scale to improve governance across their portfolios. Another commentator indicates that the increase in money managers' power is changing the nature of shareholder activism, meaning that they need not resort to aggressive tactics

¹¹⁸ Fisch et al., *supra* note 103, at 8.

¹¹⁹ Appel et al., *supra* note 7, at 132–36 (finding that increased ownership by passive investors results in more independent directors, removal of takeover defenses, and more equal voting rights as well as better long-term performance).

¹²⁰ Fisch et al., *supra* note 103, at 15.

¹²¹ Jill E. Fisch, Assaf Hamdani, and Steven D. Solomon do not argue that passive investors have perfect incentives to engage in stewardship because passive funds, like all institutional investors, face inevitable collective action problems that limit their incentives to engage in stewardship; their claim is simply that passive investors have stewardship incentives that are as strong or arguably superior to those of active funds. See Fisch et al., *supra* note 103, at 5–6.

¹²² See *id.* at 1, 10–13 (noting “Because they cannot compete by exiting underperforming companies, passive investors must compete by using ‘voice’ to prevent asset outflow.”); see also Kahan & Rock, *supra* note 17, at 14–22 (arguing that the large passive index fund providers have better incentives to vote intelligently than most other shareholders).

¹²³ See, e.g., Stewart L. Brown, *Mutual Fund Advisory Fee Litigation: Some Analytical Clarity*, 16 J. BUS. & SEC. L. 329, 351 (2016) (“Economies of scale exist and are substantial in the portfolio management process.”).

to influence companies' management.¹²⁴ As a result, the argument is that even well-incentivized institutional investors are unlikely to pursue some activist interventions (e.g., appointment of activist directors to implement their strategy) and thus, are unlikely to displace activist hedge funds.¹²⁵ Active funds will benefit from the market-wide governance expertise of passive funds, and passive funds will, in turn, rely on the company-specific information generated by active investors. Thus, passive investors benefit from activists and constrain destructive hedge fund activism, thus mediating their influence.¹²⁶ While index funds are locked into their portfolio companies, *investors* in such index funds can exit by using the Wall Street rule.¹²⁷ Fisch, Hamdani, and Solomon suggested that, as such, passive funds compete for investors, not only with other passive funds but also with active funds and they compete for investors on both cost (i.e., fees) and performance.¹²⁸ Further, they argued that as a result of passive funds competing with active funds, passive fund sponsors have an incentive to defuse the comparative advantage enjoyed by active funds.¹²⁹ Because of this competition, passive funds will engage in stewardship and, in particular, be willing to improve governance in underperforming companies in their portfolios. Consequently, the total cost of passive investors' effective engagement will be reduced, and passive investors are more likely to invest in governance.¹³⁰

Regarding the corporate governance implications of passive investing, the fundamental questions are whether passive funds create widespread economic harm that requires the enactment of depriving passive funds of voting rights and whether passive investors can play an active role in corporate governance in investee companies. Recently, the ability of passive investors to effectively oversee investee companies and perform an active stewardship role over investee companies has been pointed out to be limited, for example, in terms of the limited number of stewardship teams.¹³¹ According to a statistical study, they have voted in favor of the management's proposal in most cases,¹³² while

¹²⁴ Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 999–1000 (2019).

¹²⁵ *Id.* at 1000.

¹²⁶ Fisch et al., *supra* note 103, at 24.

¹²⁷ *Id.* at 1, 3.

¹²⁸ *Id.* at 4, 12.

¹²⁹ *Id.* at 12–13.

¹³⁰ *Id.* at 18–19.

¹³¹ Strampelli, *supra* note 6, at 820 (noting “the investment stewardship teams at the Big Three are clearly too small”).

¹³² For example, all the Big Three have backed the management in more than 90% of votes. Fichtner et al., *supra* note 10, at 317–18 (noting that the Big Three usually support management against activist shareholders' proposals and that more than half of the Big Three votes against management concern directors' re-elections).

the number of dissenting votes has been increasing to some extent.¹³³ As Edward Rock noted, it is an enormous task for the Big Three stewardship teams to simply vote their shares, without even considering how to vote them.¹³⁴ Therefore, the Big Three stewardship teams have established almost the same voting guidelines.¹³⁵ However, because the Big Three are simply too big to be passive,¹³⁶ their managers are expected to play an active engagement role.¹³⁷

Especially during these past few years, the relationship between passive funds and activist funds has changed significantly.¹³⁸ For instance, within proxy contests, the Big Three support activists in a significant number of cases.¹³⁹ In particular, BlackRock voted in favor of the activist Nelson Peltz in his proxy fight with Procter & Gamble and also in favor of Bill Ackman against ADP.¹⁴⁰ In contrast, activists are increasingly demanding the support of passive investors, which often substantially affects the success of activist campaigns.¹⁴¹ As a result, activist investors seem to have a tendency to tailor their interventions to satisfy passive investors¹⁴² by appealing to their longer-

¹³³ See, e.g., Vanguard, *Investment Stewardship 2017 Annual Report* 28–33 (2017), <https://preventablesurprises.com/wp-content/uploads/2017/09/Vanguard-Investment-Stewardship-Report-2017.pdf>.

¹³⁴ Edward B. Rock, *Institutional Investors in Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 364, 370 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018); see also Asaf Eckstein, *Great Expectations: The Peril of an Expectations Gap in Proxy Advisory Firm Regulation*, 40 DEL. J. CORP. L. 77, 93 (2015) (noting that Michelle Edkins, Managing Director and Global Head of Investment Stewardship at BlackRock, Inc., stated “There are days when we are voting 25, 30 meetings across our team.” (citation omitted)).

¹³⁵ See, e.g., Lund, *supra* note 15, at 516 (“[T]he Big Three have adopted nearly identical voting guidelines”).

¹³⁶ Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective*, 14–15 (Eur. Corp. Governance Inst., Working Paper No. 393/2018, 2018).

¹³⁷ See Bioy et al., *supra* note 15, at 8 (noting that with pressure from various stakeholders, asset managers have little choice but to increase their level of engagement with their investee companies and better demonstrate to a diverse group of stakeholders their commitment to driving change for the better).

¹³⁸ See Fisch et al., *supra* note 103, at 24.

¹³⁹ See Alon Brav et al., *Picking Friends Before Picking (Proxy) Fights: How Mutual Fund Voting Shapes Proxy Contests* 20 (Eur. Corp. Governance Inst. Working Paper, Paper No. 601/2019, 2020), http://ssrn.com/abstract_id=3101473 (showing the support rate for dissidents ranges from 16.3% by Vanguard to 37.3% by BlackRock).

¹⁴⁰ Andrew Ross Sorkin, *BlackRock's Message: Contribute to Society, or Risk Losing Our Support*, N.Y. TIMES (Jan. 15, 2018), <https://www.nytimes.com/2018/01/15/business/dealbook/blackrock-laurence-fink-letter.html>.

¹⁴¹ See Ethan A. Klingsberg & Elizabeth Bieber, *Activism in 2018*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REGUL. (Jan. 29, 2018), <http://perma.cc/GPX2-9GSR>.

¹⁴² See Fisch et al., *supra* note 103, at 24–25 (arguing that passive funds have a potentially critical role in screening activism and activists' incentives are likely to make passive investors take a more cautious approach and be less willing to support activists than actively managed funds).

term and governance concerns.¹⁴³ As such, the interplay between passive and active funds has been enhanced significantly.

Assuming that recognition of these situations is correct, Fisch, Hamdani, and Solomon, authors of the other influential article mentioned at the beginning of II.F., clearly explained that a passive fund has an advantage in having market-wide knowledge and influence, and that an active fund has an advantage in having firm-specific knowledge and a power over individual investee companies. Such market-wide knowledge and influence of passive funds will enable each of these passive funds with large market-scale to effectively advance stewardship. It must be stressed that most passive funds represent long-term investors and, as such, they have an incentive to monitor and steward managers to improve an investee company's governance. However, without the voting rights that a passive fund holds with investee companies, such funds cannot influence investee companies through engagement, dialogue, or "voice," because they cannot pressure companies by "exit." Moreover, passive funds, without voting rights that allow them to use their voting power more effectively, cannot influence the voting policies of proxy advisory firms. *No voting rights, no voice*. Therefore, voting rights are crucial and should not be withdrawn easily. Additionally, the discussion on "common ownership," which is a structure in which large institutional investors have significant shareholdings in corporations in the relevant industry that are horizontal competitors, is somewhat helpful to think about divesting passive funds of their voting rights. Section 7 of the Clayton Act contains an exemption for acquisitions that are "solely for investment."¹⁴⁴ The provision is designed to apply to passive investors who do not "by voting or otherwise" bring about or attempt to bring about a non-competitive result.¹⁴⁵ Therefore, even though so-called passive funds vote on their shares, they are not exempted under the "solely for investment" rule because of their significant shareholdings in the relevant industry when they try to bring about a non-competitive result. However, Elhauge, a supporter of common ownership theory, is reluctant to use the exemption to deprive institutional investors of voting on account of effective corporate governance.¹⁴⁶ Through the discussion of common ownership, the conflict of corporate governance and anti-competitive law has become a sensitive concern.¹⁴⁷ As Lund described, if a passive fund is deprived

¹⁴³ Klingsberg & Bieber, *supra* note 141; *see also* LAZARD'S, *supra* note 44, at 1.

¹⁴⁴ 15 U.S.C. § 18 (2012) ("This section shall not apply to persons purchasing such stock solely for investment and not using the same by voting or otherwise to bring about, or in attempting to bring about, the substantial lessening of competition.").

¹⁴⁵ *Id.*

¹⁴⁶ Elhauge, *supra* note 14, at 1315 ("This alternative [committing not to vote their stock] also seems likely to be less desirable than refraining from horizontal investments because having institutional investors refrain from voting increases the separation of ownership and control in a way that harms corporate governance and efficiency. . .").

¹⁴⁷ *See* José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73(4) J. FIN. 1513, 1559–60 (2018), <https://onlinelibrary.wiley.com/doi/pdf/10.1111/jofi.12698> ("[T]he three goals of (i) perfect shareholder diversification, (ii) firm maximization of shareholder interests ('good governance'), and (iii) preservation of competitive product markets cannot be

of a voting right, actual minority shareholders might become a controlling shareholder by comparative advantage. Such a scenario is not expected by any investee company or the market. A question might be which is better, let a passive fund with less incentive and ability, vote, or (as a result of eliminating the passive fund) let a majority group of minority shareholders vote, which will cause them to substantially control the corporation. The voting rights should not be easily dismissed because they are a core of shareholder democracy. Rather, passive funds' engagement alone or together with active funds should be promoted.

The following are examples of institutional investors' stewardship in the U.K. and Japan where the stewardship codes have been enacted and well-spread in the market.

III. U.K. STEWARDSHIP CODE

The U.K. Stewardship Code was introduced in 2010 and the Japan Stewardship Code was introduced in 2014 under influence of the U.K. Code. Both are very similar in terms of the contents (i.e., Principle of each Code) and in terms of the form (i.e., adopting not a regulation approach, but a principle-based approach, in other word, the "comply or explain" approach).¹⁴⁸ However, there are some differences between the two including a collective engagement issue due to different legal and practical backgrounds.

The conclusions and recommendations of the Cadbury Report (1992)¹⁴⁹ and the Hampel Report (1998)¹⁵⁰ provided the foundation for most subsequent reports regarding institutional investors' engagement and even for the Stewardship Code.¹⁵¹ In the early 2000s, the ideals of institutional investors engagement obtained support through the publication of the Myners Report (2001)¹⁵² and the Higgs Report (2003),¹⁵³ and guidance from the Institutional

simultaneously achieved . . . What the optimal trade-off is between the three goals above is thus a hotly debated question in the public domain.").

¹⁴⁸ See generally FIN. REPORTING COUNCIL, UK STEWARDSHIP CODE (2012), [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf) [hereinafter UK Stewardship Code (2012)]; see also COUNCIL EXPERTS ON STEWARDSHIP CODE, PRINCIPLES FOR RESPONSIBLE INSTITUTIONAL INVESTORS (2014), <https://www.fsa.go.jp/news/25/singi/20140227-2/05.pdf> [hereinafter Japan's Stewardship Code (2014)].

¹⁴⁹ FIN. REPORTING COUNCIL COMM., THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (1992), <http://www.ecgi.org/codes/documents/cadbury.pdf>.

¹⁵⁰ See HAMPEL COMM., COMMITTEE ON CORPORATE GOVERNANCE FINAL REPORT (1998), http://www.ecgi.org/codes/documents/hampel_index.htm.

¹⁵¹ See Konstantinos Sergakis, *The U.K. Stewardship Code: Bridging the Gap Between Companies and Institutional Investors*, 47 REVUE JURIDIQUE THÉMIS 109, 121 (2013).

¹⁵² PAUL MYNERS, INSTITUTIONAL INVESTMENT IN THE UNITED KINGDOM: A REVIEW (2001), <http://www.hm-treasury.gov.uk/media/843F0/31.pdf>. [hereinafter Myners Report].

¹⁵³ Derek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (2003), <https://webarchive.nationalarchives.gov.uk/20090609051856/http://www.berr.gov.uk/files/file23012.pdf>.

Shareholders' Committee.¹⁵⁴ After the global financial crisis of 2008–2009, the argument for such support on investor engagement became active again. The U.K. regulatory authorities blamed institutional investors for apathetic monitoring and referred to them as being "asleep."¹⁵⁵ Indeed, many commentators argued that institutional investors were a part of the problem because they failed to intervene and even actively pushed management for short-term performance without regard for increased risk and exposure.¹⁵⁶ In the Walker Review (2009), Sir David Walker concluded that institutional investors' apathy and acquiescence in risky management decisions was not a key cause of the financial crisis but likely worsened it.¹⁵⁷

After the global financial crisis, based on a recommendation from the Walker Review, the U.K. became the first country to regulate a Stewardship Code.¹⁵⁸ In July 2010, the Financial Reporting Council (FRC) issued the Stewardship Code to encourage active engagement by institutional investors through enhancing transparency and disclosure.¹⁵⁹ The FRC introduced a "soft law" approach in the Stewardship Code, which is a set of best practice principles on a "comply or explain" basis.¹⁶⁰ The Code only applies to voluntary signatories.¹⁶¹ Those signatories to the Code that choose not to comply with one of the principles or the relevant guidance are urged to publish meaningful explanations concerning such non-compliance.¹⁶² The Stewardship Code is intended to encourage institutional investors to actively engage in the stewardship of their portfolio companies,¹⁶³ and, as inserted in the revised Stewardship Code of 2012, to additionally and ultimately "promote the long-

¹⁵⁴ See generally INSTITUTIONAL SHAREHOLDERS' COMMITTEE, THE RESPONSIBILITIES OF INSTITUTIONAL SHAREHOLDERS AND AGENTS – STATEMENT OF PRINCIPLES (2007), [https://uk.practicallaw.thomsonreuters.com/2-106-5706?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/2-106-5706?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1).

¹⁵⁵ See, e.g., Jennifer Hughes, *FSA Chief Lambasts Uncritical Investors*, FIN. TIMES (Mar. 11, 2009), <https://www.ft.com/content/9edc7548-0e8d-11de-b099-0000779fd2ac> (quoting the chief executive of the Financial Services Authority who accused institutional shareholders of inadequate monitoring).

¹⁵⁶ See, e.g., Natasha Burns, Simi Kedia & Marc Lipson, *Institutional Ownership and Monitoring: Evidence from Financial Misreporting*, 16 J. CORP. FIN. 443, 444 (2010) (arguing that institutions can be influenced by investor reactions and are focused on short-term performance).

¹⁵⁷ DAVID WALKER, A REVIEW OF CORPORATE GOVERNANCE IN U.K. BANKS AND OTHER FINANCIAL INDUSTRY ENTITIES: FINAL RECOMMENDATIONS, at 72 (2009), https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf [hereinafter WALKER].

¹⁵⁸ See FIN. REPORTING COUNCIL, THE UK STEWARDSHIP CODE (2010), <https://www.frc.org.uk/getattachment/e223e152-5515-4cdc-a951-da33e093eb28/UK-Stewardship-Code-July-2010.pdf> [hereinafter UK Stewardship Code (2010)].

¹⁵⁹ *Id.* at 10 ("Transparency is an important feature of effective stewardship.").

¹⁶⁰ *Id.* at 1, ¶ 3 ("The U.K. Stewardship Code sets out the principles of effective stewardship by investors. In so doing, the Code assists institutional investors in exercising their stewardship responsibilities, which in turn gives force to the 'comply or explain' system.").

¹⁶¹ ERNST & YOUNG, Q&A ON STEWARDSHIP CODES, at 2 (2017), <https://pdfslide.net/documents/qa-on-stewardship-codes-ey-stewardship-codes-principles-and-guidelines-.html>.

¹⁶² UK Stewardship Code (2010), *supra* note 158, at 4.

¹⁶³ *Id.* at 1, ¶ 6.

term success of companies in such a way that the ultimate providers of capital also prosper" for the benefit of the economy as a whole.¹⁶⁴ As such, the key notions in "stewardship" seem to be long-termism, and taking a more holistic view of the well-being and performance of the company.

Institutional investment practice mainly comprises of two legal relationships: the first between an institution and investors that will create fiduciary duties in investment management relationship between trustees and beneficiaries, and the other between the investment institution and investee companies in which equity is held by the institution that will establish the corporate governance relationship. The Stewardship Code addresses the ownership role of the institution, which is essentially concerned with the corporate governance relationship between shareholders and their companies. For instance, Principles 2, 6, and 7 of the Code address institutions' relationship with beneficiaries, not lessening the legal framework for the investment management. Principles 2 and 6 require institutions to disclose their conflicts of interest policy and voting activity, and Principle 7 requires them to make periodical reports on their stewardship and voting activities available to beneficiaries.¹⁶⁵ Moreover, in addition to discharge of their fiduciary duties to their beneficiaries, the Code compels institutions to engage with their investee companies. Most institutions deem selling out and exiting as being in beneficiaries' best interests especially if the relevant fund is passively managed. Hence, staying on to engage with their companies may not conform with the beneficiaries' best interests. Namely, there likely occurs a conflict between encouraging engagement and following the beneficiaries' best interests.¹⁶⁶ As such, the Code's concern for the corporate governance role of stewardship seems to extend beyond the investment management relationship. A problem with the initial Code was that the notion of stewardship was not clarified to understand the range of stewardship responsibilities for all stakeholders of the investment. The revised Code, while encouraging most market participants involved in the investment chain to engage in stewardship, satisfies this necessity for the clarification by describing that:

[t]he Code is directed in the first instance to institutional investors, by which is meant asset owners and asset managers with equity holdings in UK listed companies. Institutional investors may choose to outsource to external service providers some of the activities associated with stewardship. However, they cannot delegate their responsibility for stewardship. They remain responsible for ensuring those activities are carried out in a manner consistent with their own approach to stewardship. Accordingly, the Code also applies, by extension,

¹⁶⁴ The UK Stewardship Code (2012), *supra* note 148 at 1, ¶ 1.

¹⁶⁵ Iris H-Y Chiu, *Turning Institutional Investors into 'Stewards': Exploring the Meaning and Objectives of 'Stewardship'*, 66 CURRENT LEGAL PROBLEMS 443 (2013).

¹⁶⁶ *Id.*

to service providers, such as proxy advisors and investment consultants.¹⁶⁷

As such, the revised Code provisions distinguish between 'asset owners' and 'asset managers' and to some degree clarify the roles and responsibilities to be undertaken by each.¹⁶⁸ Moreover, the Code indicates that institutional investors can outsource some of their activities to external participants (but not the stewardship itself) and need to ensure that other interconnected service providers keep stewardship standards intact. Thus, the revised Code ensures the official enlargement of stewardship responsibilities and indicates that other potential market participants involved in the investment chain become jointly responsible for stewardship. The revised provisions of the Code describe in more detail what is meant by stewardship as follows:

[f]or investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.¹⁶⁹

The Code contains seven principles designed to encourage institutions to engage with their investee companies and accountable for such engagement.

With Principle 1, the Code requests that the investment institutions develop stewardship policies to explain how they intend to integrate stewardship into their investment management and implement stewardship responsibilities and also requests that they publicly disclose the policies.¹⁷⁰ According to the Kay Review (2012), the distance between institutional investors and investee companies was extended substantially, thus causing difficulties in their communication efficiency, as well as possible interfaces through dialogue and collective agreements on corporate governance.¹⁷¹ Therefore, the public disclosure requirement regarding institutions' activities within the overall investment chain and its stewardship responsibilities is highly useful.

According to Principle 2 of the Code, to protect the interests of their clients or beneficiaries under any possible situations in which conflicts of interest are likely to arise, institutional investors should adopt a robust policy to manage such conflicts of interest with respect to their stewardship role and, then, should publicly disclose this policy.¹⁷² This framework can create delicate

¹⁶⁷ UK Stewardship Code (2010), *supra* note 158, at 2, ¶ 2.

¹⁶⁸ *Id.* at 1, ¶ 6.

¹⁶⁹ *Id.* at 1, ¶ 4.

¹⁷⁰ *Id.* at 6 (Principle 1).

¹⁷¹ KAY, *supra* note 92, at 30.

¹⁷² UK Stewardship Code (2010), *supra* note 158, at 6.

situations in which such conflicts of interest may arise, creating huge difficulties in the effective exercise of stewardship responsibilities.¹⁷³ Moreover, the guidance has been changed to encourage investors to take all reasonable steps to protect the interests of the investors' clients or beneficiaries first.¹⁷⁴ Nevertheless, it is interesting to note that the 2007 ISC Statement of Principles requires institutional investors to explain how they would minimize or deal with such conflicts of interest,¹⁷⁵ whereas the current U.K. Stewardship Code refers only to the requirement of explaining how such conflicts are managed.¹⁷⁶ A potential resolution of this issue is to change the relevant guidance to engage institutional investors to disclose information about their strategies aiming at minimizing such situations.¹⁷⁷

Principle 3 requires institutions to "monitor" their companies by illustrating examples of monitoring activities, such as keeping up with corporate development, meeting company representatives, and attending the general meetings.¹⁷⁸ The monitoring role that is required by the Stewardship Code may be difficult to play effectively because of the nature of institutional investors' business strategies, as previously described.¹⁷⁹ The passive investment model will actually weaken the active stewardship because its strategy is restricted to enable asset managers to remain in matching the index's returns rather than to engage in a more active exercise of their stewardship responsibilities and to make contributions to their clients and beneficiaries in the long term. Therefore, fundamentally, changing the passive investment model is critical to encourage both investors and managers to engage in more active stewardship.

Principle 4 describes a normative principle that institutional investors should be concerned about corporate, social and environmental responsibility. Under Principle 4, social and environmental issues are not necessarily associated with investment interests. However, it is now widely accepted that social and environmental factors will affect corporate performance and

¹⁷³ See Bernard Black & John Coffee, *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 MICH. L. REV. 1997, 2068 (1994).

¹⁷⁴ UK Stewardship Code (2010), *supra* note 158, at 6.

¹⁷⁵ INSTITUTIONAL SHAREHOLDERS' COMMITTEE, *supra* note 154 (requiring institutional investors to explain their policy on how "situations where institutional shareholders and/or agents have a conflict of interest will be minimized or dealt with.").

¹⁷⁶ UK Stewardship Code (2010), *supra* note 158, at 6, Principle 2.

¹⁷⁷ Simon C.Y. Wong, *The U.K. Stewardship Code: A Missed Opportunity for Higher Standards*, RESPONSIBLE INV., July 13, 2010, at 1–2; see also Wong, *supra*, note 97.

¹⁷⁸ UK Stewardship Code (2010), *supra*, note 158, at 7, Principle 3.

¹⁷⁹ See Jose Miguel Mendoza et al., *Entrepreneurship and Innovation: The Hidden Costs of Corporate Governance in Europe* 29–34 (Lex Research Topics in Corporate Law & Economics Working Paper, Paper No. 2/2010, 2010), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1698352 (addressing a more general analysis on the correlation between regulatory reforms and the actual improvement in shareholder activism, which does not always seem so obvious); see also FIN. REPORTING COUNCIL, DEVELOPMENTS IN CORPORATE GOVERNANCE 2011, THE IMPACT AND IMPLEMENTATION OF THE U.K. CORPORATE GOVERNANCE AND STEWARDSHIP CODES 26 (2011).

therefore consideration of such factors is more and more regarded as part of essential risk management. Therefore, institutional investors' concern for social and environmental responsibility is completely within the territory of their investment interests.

Principle 5 foresees that institutions may improve engagement in collective terms especially "at times of significant corporate or wider economic stress, or when the risks posed threaten to destroy significant value." This Principle 5 premises Principle 4 which describes "intervening jointly with other institutions on particular issues" as an example of escalating their stewardship actions and describes the details of such collective activities.

Under Principle 6, the Code requires the institutions to have a clear voting policy and a disclosure policy of voting activity.¹⁸⁰ With respect to features of disclosure in the U.K. Stewardship Code, the notion of stewardship not only covers transactional accountability within the chain of investment management, but also extends to public accountability, namely public disclosure.¹⁸¹ As such, Principles 1, 2, 5, and 6 require public disclosure by institutions in relation to stewardship responsibilities.

Principle 7 requires institutions to periodically report to their clients or beneficiaries the discharge of stewardship responsibilities in details but does not request such reporting to be publicly made.¹⁸² Indeed, the relevant guidance describes that confidentiality in specific situations may be crucial, and that asset managers should regularly report their clients or beneficiaries, while asset owners should report their policy and its execution at least annually.

The extended distance between investors and investee companies previously addressed may be caused by the predominant presence of financial intermediaries including asset managers, advisors, and consultants concerning some investments.¹⁸³ A number of reasons would cause a substantial need to increase the number of specialized intermediaries in the investment chain whose main responsibility is to undertake a specific task entrusted originally by the ultimate beneficiary. The various duties to be performed in the investment chain have generated an enormous number of such consultants, advisors, managers, and trustees who are to function in a collective and harmonious manner, which often causes an out-of-control situation. Furthermore, the notion of fiduciary duty must be stressed on satisfying their clients' best financial interests, but the best interests have been erroneously interpreted because of a strict interpretation of "fiduciary

¹⁸⁰ UK Stewardship Code (2010), *supra* note 158, at 9, Principle 6.

¹⁸¹ *See id.* at 2, ¶3.

¹⁸² *See id.* at 9, 10, Principle 7.

¹⁸³ *See* Franklin Allen & Anthony Santomero, *What Do Financial Intermediaries Do?*, 25 *J. BANKING FIN.* 271 (1998); EVA MICHELER, *FACILITATING INVESTOR ENGAGEMENT AND STEWARDSHIP* 11–13 (2012); *see also* Usha Rodrigues, *Corporate Governance in an Age of Separation of Ownership from Ownership*, 95 *MINN. L. REV.* 1822 (2010).

duties.”¹⁸⁴ For instance, it has been often interpreted that fiduciaries’ main priority is to secure the short-term profit maximization or an immediate return, rather than allowing for a more extensive interpretation such as the achievement of the long-term objectives that will help investee companies grow more.¹⁸⁵ Therefore, it would be most important to change this perception of the notion “fiduciary duties” in this specific framework and to convince asset managers that they can discharge those duties while expanding their objectives and still satisfying their clients’ best interests.¹⁸⁶ Such long-term objectives should be included at least in the notion of “fiduciary duties” to enable asset managers and asset owners to not only change their said perception but also be more beneficial to the participants in a more sophisticated and stable framework of the investment chain.¹⁸⁷

The FRC published the U.K. Stewardship Code 2020¹⁸⁸ (2020 Code) on October 24, 2019 and made effective on January 1, 2020. In a change from the consultation version, the final 2020 Code consists of 12 Principles with which asset owners and managers who sign up must comply. The 2020 Code now targets asset owners, such as pension funds, insurance companies, and service providers, as well as asset managers. The FRC states that this will help align the approach of the whole investment community in the interests of end-investors and beneficiaries.¹⁸⁹ The introduction to the 2020 Code specifically describes that environmental factors (particularly climate change) and social factors have become material issues for investors when undertaking stewardship and making investment decisions.¹⁹⁰ A new principle, Principle 7, states that signatories are expected to consider material ESG issues, including climate change, as part of their investment, monitoring, engagement and voting activities.¹⁹¹ Additionally, the 2020 Code defines stewardship as “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the

¹⁸⁴ KAY, *supra* note 92, at 66–69.

¹⁸⁵ See Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 733, 795 (2019).

¹⁸⁶ Emeka Duruigbo, *Stimulating Long-Term Shareholding*, 33 CARDOZO L. REV. 1733, 1797 (2012) (“Institutional investors that have a long-term activist posture may face the complaint that ‘fiduciary duties require asset managers to stay away from long-term investment decisions whose financial return is not clearly assessable.’”).

¹⁸⁷ See Max Matthew Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 452–53 (2020).

¹⁸⁸ See FIN. REPORTING COUNCIL, THE U.K. STEWARDSHIP CODE (2020), https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf [hereinafter UK Stewardship Code (2020)].

¹⁸⁹ FIN. REPORTING COUNCIL, PROPOSED REVISION TO THE UK STEWARDSHIP CODE, at 2–3, ¶8, <https://www.frc.org.uk/getattachment/8caa0e9c-58bb-41b2-923e-296223755174/Consultation-on-Proposed-Revisions-to-the-UK-Stewardship-Code-Jan-2019.pdf> [hereinafter Proposed Revision to the UK Stewardship Code (2019)].

¹⁹⁰ See UK Stewardship Code (2020), *supra* note 188, at 4.

¹⁹¹ *Id.* at 15, Principle 7.

economy, the environment and society.”¹⁹² As such, signatories are expected to take ESG factors into account and to ensure their investment decisions are aligned with the needs of their clients. The proposed version of the definition describes the purpose of stewardship as creation of sustainable value “for beneficiaries, the economy and society.”¹⁹³ The final definition is a compromise of sorts. The purpose of the steward is “to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.”¹⁹⁴ While governance issues have always been a mainstay of investment stewardship, this 2020 Code also places environmental issues (including climate change), social issues, and the economy in apposition to governance as factors of good stewardship.¹⁹⁵ Reporting each year on both stewardship activity and its outcomes is required.¹⁹⁶ As such, signatories must report annually what has been done in the previous year and what the outcome was, along with their engagement with the assets they invest in, their voting records and finally how they have protected and enhanced the value of their investments for the benefit of their clients; and the outcomes these activities have had.¹⁹⁷ Reporting obligations are more burdensome than in the earlier versions of the Stewardship Code, which requires a great focus on communications with clients.¹⁹⁸ Moreover, signatories will be required to explain their organization's purpose, investment beliefs, strategy and culture, and how these enable them to practice effective stewardship.¹⁹⁹ They are also expected to show how their governance arrangements, resourcing, and staff incentives demonstrate their commitment to stewardship.²⁰⁰

In order to enhance the stability and sustainability of EU companies, in May 2017, the European Parliament and Council agreed to an amendment to the 2007 Shareholder Rights Directive (Directive).²⁰¹ The aims of the Directive are to enhance transparency in the investment chain and to hold investors accountable for (i) the amalgamation of environmental, social, and governance (ESG) factors in investment decisions, (ii) the level and quality of long-term shareholder engagement, and (iii) the association of investors' investment strategy and remuneration structures with the medium to long-term

¹⁹² *Id.* at 4, ¶ 1.

¹⁹³ See Proposed Revision to the UK Stewardship Code (2019), *supra* note 189, at 10, ¶ 42.

¹⁹⁴ UK Stewardship Code (2020), *supra* note 188, at 4, ¶ 1.

¹⁹⁵ See *id.* at 5, Principle 7.

¹⁹⁶ See Proposed Revision to the UK Stewardship Code (2019), *supra* note 189, at 2 (“Key changes to the Code.”).

¹⁹⁷ *Id.* at 13, ¶ 65–66; see also UK STEWARDSHIP CODE (2020), *supra* note 188, Principles 9, 12.

¹⁹⁸ See UK Stewardship Code (2020), *supra* note 188, at 14.

¹⁹⁹ See *id.* at 8, Principle 1, Context.

²⁰⁰ See *id.* at 9.

²⁰¹ Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement, 2017 O.J. (L 132), 1, <http://data.europa.eu/eli/dir/2017/828/oj>.

performance.²⁰² All asset owners and managers operating in Europe will be required to comply with the national laws that will implement the amended Directive.²⁰³ The new policy has a particular focus on increasing transparency and encouraging a long-term shareholder's interest. In summary, the amendments include disclosing directors' remuneration, enhancing transparency of voting and engagement policies of asset managers and of voting recommendations of proxy advisors, encouraging identification of a company's shareholders through intermediaries, and improving shareholders' lapse of a company's related party transactions.

IV. JAPAN STEWARDSHIP CODE

To revitalize the Japanese economy, the Japanese government is adopting various economic policy measures against the lengthy appreciation and deflation of the yen. With the aim of realizing such policy, in June 2013, the Abe Cabinet approved the Japan Revitalization Strategy, which states that "principles for institutional investors to fulfill their fiduciary responsibilities, e.g. by promoting medium to long-term growth of companies through engagements (Japanese version of the Stewardship Code)"²⁰⁴ should be discussed and drafted. To this end, in August 2013 the Financial Services Agency (FSA) established the Council of Experts Concerning the Japanese Version of the Stewardship Code (Council of Experts on the SS Code).²⁰⁵ The Experts Council held several discussions to prepare for the principles of stewardship and published "Principles for Responsible Institutional Investors (Japan's Stewardship Code)" (Code) on February 26, 2014.²⁰⁶ Under the Code, the FSA is required to publish and periodically update the list of institutional investors who have announced acceptance of the Code.²⁰⁷

A. Significance of the Code

"Stewardship responsibilities" in the Code refer to the responsibilities of institutional investors to enhance the medium to long-term investment returns for their clients and beneficiaries by improving and enhancing the corporate value and sustainable growth of investee companies through constructive

²⁰² *Id.* at 1–25.

²⁰³ See PRICEWATERHOUSECOOPERS, THE NEW SHAREHOLDER RIGHTS DIRECTIVE 4 (2019), https://www.pwc.ch/en/publications/2019/The-new-Shareholder-Rights-Directive_EN-web.pdf.

²⁰⁴ *Japan Revitalization Strategy*, KANTEI 16 (June 14, 2013), https://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/en_saikou_jpn_hon.pdf.

²⁰⁵ See FIN. SERVICES AGENCY, ON THE COUNCIL OF EXPERTS CONCERNING THE JAPANESE VERSION OF THE STEWARDSHIP CODE (2013), <https://www.fsa.go.jp/en/refer/councils/stewardship/20130805.pdf>.

²⁰⁶ Japan's Stewardship Code (2014), *supra* note 148.

²⁰⁷ See generally *The Council of Experts on the Stewardship Code*, FIN. SERVICES AGENCY (last visited Feb. 4, 2021), <https://www.fsa.go.jp/en/refer/councils/stewardship/index.html> (reviewing the substance and revision history of Japan Stewardship Code).

engagement or purposeful dialogue²⁰⁸ based on in-depth knowledge of the companies and their business environment.²⁰⁹ This Code defines principles considered to be helpful to institutional investors who behave as responsible institutional investors in fulfilling their stewardship responsibilities with due regard to their clients, beneficiaries, and investee companies.

With respect to the functions of the board and institutional investors, and engagement between them, the Code describes them as follows:

The function of the board [as defined in Japan's Corporate Governance Code (effective June 1, 2015)] and that of institutional investors as defined in the Code are complementary, and both form essential elements of high-quality corporate governance, which are indispensable in ensuring the sustainable growth of the company and the medium to long-term investment return for the clients and beneficiaries. With due regard to the roles of both the board and institutional investors, the Code promotes constructive engagement, or purposeful dialogue, between institutional investors and investee companies.²¹⁰

In contrast, the Corporate Governance Code describes their function as:

Companies should fully recognize that their sustainable growth and the creation of medium- to long-term corporate value are brought as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities. As such, companies should endeavor to appropriately cooperate with these stakeholders "in order to contribute to sustainable growth and the increase of corporate value over the medium- to long-term, companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting."²¹¹

The practice of the Stewardship Code and the Corporate Governance Code and constructive dialogue with investee companies would bring benefits to a country's investee companies, shareholders, stakeholders, and finally economic and financial systems.

The scope of targeted institutional investors under Japan's Code includes "institutional investors as asset managers" (such as an investment managers), "institutional investors as asset owners" (e.g., pension funds, insurance

²⁰⁸ See FIN. SERVICES AGENCY, *supra* note 205, at 7, n.4 (stating "purposeful dialogue" in the Code refers to "constructive dialogue with the aim of enhancing the companies' medium-to long-term value and capital efficiency, and promoting their sustainable growth.").

²⁰⁹ *Id.* ¶4.

²¹⁰ *Id.*

²¹¹ TOKYO STOCK EXCHANGE, INC., JAPAN'S CORPORATE GOVERNANCE CODE ¶5 (2018).

companies), and voting advisors (those who provide advisory service to institutional investors).²¹²

B. *The 2017 Revision*

To publicly announce the acceptance of the Code by institutional investors, those who accept the Code are required to publicly disclose their acceptance on their website, and to annually review and update the disclosed information.²¹³ The number of signatories as of December 2016 was 214 and consisted of 159 asset managers (seven trust banks and 152 investment managers), 48 asset owners (18 life insurance companies, four non-life insurance companies, and 26 pension funds), and seven service providers.²¹⁴

Under these circumstances, on November 30, 2016, the Council of Experts Concerning the Follow up of Japan's Stewardship Code and Japan's Corporate Governance Code published an opinion statement entitled "Effective Stewardship Activities of Institutional Investors; To Enhance Constructive Dialogue toward Sustainable Corporate Growth" (Opinion Statement).²¹⁵ The Opinion Statement requested that institutional investors engage in an in-depth constructive dialogue with investee companies and proposed a revision of Japan's Stewardship Code.²¹⁶ The FSA prepared and published the revised Stewardship Code in 2017, which highlighted the five issues, after the Council of Experts on the SS Code discussed revising the Code.²¹⁷

C. *Comparison of U.K. Stewardship Code with Japan's Stewardship Code*

The U.K. Code of 2012 significantly influenced the Japan Code. However, some differences exist between principles of the U.K. Code and those of the Japan Code.²¹⁸ A major difference between the Codes is how they treat collective activism. The 2014 Japanese Stewardship Code includes no principle endorsing collective activism, although its 2017 revisions contemplate some

²¹² See FIN. SERVICES AGENCY, *supra* note 205, ¶ 7.

²¹³ *Id.* ¶14.

²¹⁴ See Fin. Services Agency, Kin'yū-chō (金融庁), Suchuwādoshippu kōdo o meguru jōkyō to forōappu kaigi iken-sho ni tsuite (スチュワードシップ・コードをめぐる状況とフォローアップ会議意見書について) [Stewardship Code Situation and Follow up Meeting Opinion Statement] 5 (Jan. 2017), <https://www.fsa.go.jp/singi/stewardship/siryō/20170131/03.pdf>.

²¹⁵ See generally Council of Experts Concerning the Follow Up of Japan's Stewardship Code and Japan's Corporate Governance Code, Effective Stewardship Activities of Institutional Investors – To Enhance Constructive Dialogue toward Sustainable Corporate Growth – Opinion Statement No. 3 (2016), https://www.fsa.go.jp/en/refer/councils/follow-up/statements_3.pdf [hereinafter Follow-up Council of Experts].

²¹⁶ *Id.* § IV.

²¹⁷ The Council of Experts on the Stewardship Code, Principles for Responsible Institutional Investors: Japan's Stewardship Code, ¶¶ 3, 4 at 1 (2017), <https://www.fsa.go.jp/en/refer/councils/stewardship/20170529/02.pdf>.

²¹⁸ This paper compares principles of the 2012 version of the U.K. Code with those of the 2017 version of the Japan Code because the Japan Code is modeled after the U.K. Code and accordingly is significantly influenced by it.

form of collaborative engagement between institutional investors.²¹⁹ In contrast, Principle 5 of the U.K. Stewardship Code explicitly refers to collective activism by stating that "[i]nstitutional investors should be willing to act collectively with other investors where appropriate."²²⁰ In reality, U.K. institutional investors have long experienced engagement in coordinated action, not only to directly influence the corporate management, but also to impact the legal rules regulating the balance of power between shareholders and management.²²¹ The FRC has likewise encouraged more alliance between international and U.K. based institutional investors as a solution to the low level of equity held by domestic investors.²²²

Many people imagined that the same principle as Principle 5 of the U.K. Code will be introduced to the Japanese version of the code. However, the business world voiced its doubt, because in Japan it is not considered typical corporate behavior for institutional investors to cooperate with other institutional investors and share actions in exercising shareholders' rights. Thus, an equivalent to Principle 5 of the U.K. Code was not introduced to the original Japanese code.²²³ This failure is partly due to Japanese tradition that distastes confrontation and criticism, and is also due to the dominance of passive shareholders in Japan.²²⁴ Surprisingly, shareholders in Japan hold strong legal rights under the Companies Act.²²⁵ These shareholders rights include statutory rights to alter the corporate constitution without board consent, elect directors by a majority vote and nominate directors on the company's ballot.²²⁶ However, historically, investor activism has been rare. The most significant reason for suppression and restraint on investor activism has been the existence of cross-shareholding (in Japanese "*kabushiki mochiai*"),²²⁷ which has protected management from outside shareholder influence. "In spite of the progress in unwinding cross-shareholdings of Japanese banks, there has

²¹⁹ Follow-up Council of Experts, *supra* note 215, ¶ 4-4 ("In addition to institutional investors engaging with investee companies independently, it would be beneficial for them to engage with investee companies in collaboration with other institutional investors (collective engagement) as necessary.")

²²⁰ See UK Stewardship Code (2012), *supra* note 148, at 8.

²²¹ See Paul Davies, *Shareholders in the United Kingdom*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER 355, 356 (Jennifer G. Hill & Randall S. Thomas eds., 2015).

²²² See, e.g., FIN. REPORTING COUNCIL, DEVELOPMENTS IN CORPORATE GOVERNANCE 2013: THE IMPACT AND IMPLEMENTATION OF THE UK CORPORATE GOVERNANCE AND STEWARDSHIP CODES 23 (2013); see also Davies, *supra* note 221, at 356.

²²³ Hiroyuki Kansaku, *Japan's Stewardship Code: Comparative with U.K. Code*, in 6 JPX FIN. INSTRUMENTS AND EXCHANGE ACT STUDY, 192, 205–06, 238 (2016).

²²⁴ See *id.* at 206.

²²⁵ See Gen Goto, *Legally "Strong" Shareholders of Japan*, 3 MICH. J. PRIV. EQUITY & VENTURE CAP. L. 125 (2014); see also Zenichi Shishido, *Japanese Corporate Governance: The Hidden Problems of Corporate Law and Their Solutions*, 25 DEL. J. CORP. L. 189 (2000); Kaisha hō [Companies Act], Act No. 86 of 2005, translated in (Japanese Law Translation [JLT DS]), <http://www.japaneselawtranslation.go.jp/law/detail/?vm=04&re=02&lv=02&id=2052> (Japan).

²²⁶ See Goto, *supra* note 225, at 128–36.

²²⁷ *Id.* at 126, 128.

been a concomitant increase in shares owned by other ‘silent’ shareholders, e.g. the Bank of Japan, nonfinancial corporations, and passive investment vehicles such as ETFs and index funds.”²²⁸

Regarding institutional investors, the goal of the U.K. Code is to restrain excessive short-termism by being more responsible to the public,²²⁹ whereas the Japan Code aims to orient Japanese corporate governance toward shareholder rather than stakeholder interests.²³⁰ In other words, under the U.K. Code, institutional investors will consider the interests of the public and of stakeholders rather than just shareholders; however, under the Japan Code, they act in the interest of their ultimate beneficiaries.²³¹ However, the FRC clearly states, “The 2012 UK Stewardship Code . . . aims to enhance the quality of engagement between investors and companies to help improve long-term risk-adjusted returns to shareholders.” Moreover, Section 172 of Companies Act of 2006 provides that a company’s director must act in a manner that he considers most likely to promote the company’s success for the benefit of its members as a whole and, in doing so, considers the interests of the company’s stakeholders. Moreover, the criticism of short-termism was based on reflection on the financial crisis caused by the Lehman shock.²³² Overall, the criticism of short-termism was understood throughout the history of the U.K. Code and positively affirmed shareholders activism.²³³

D. Legal impediments to collective engagement under Japan Code

Several regulations interfere with active oversight by investors of investee companies²³⁴ and have prevented the development of collective engagement in Japan. First, the “Report of the Possession of Large Volume” (Report), requires investors whose ownership of a given listed company exceeds 5% to file notice within five days of breaching this level, and then file additional notice of any change exceeding 1% (by either increasing or decreasing its ownership) within five days.²³⁵ In recognition of an onerous burden on large-scale shareholders,

²²⁸ See Ken Hokugo & Alicia Ogawa, *The Unfinished Business of Japan’s Stewardship Code 4* (Colum. Bus. School, Working Paper, Paper No. 1, 2017), <https://academiccommons.columbia.edu/doi/10.7916/D8D79PTM>.

²²⁹ UK Stewardship Code (2012), *supra* note 148, at 8.

²³⁰ See Gen Goto, *The Logic and Limits of Stewardship Codes: The Case of Japan 52* (The Univ. Tokyo Bus. L., Working Paper No. 2018-E-01, 2018).

²³¹ FIN. SERVICES AGENCY, *supra* note 205, at 1.

²³² A central policy factor underpinning the U.K. Stewardship Code was the need for effective risk control in the post-crisis era. See WALKER, *supra* note 157, at 6, 12, 24–25.

²³³ Kansaku, *supra* note 223, at 201.

²³⁴ See generally FIN. SERVICES AGENCY, CLARIFICATION OF LEGAL ISSUES RELATED TO THE DEVELOPMENT OF JAPAN’S STEWARDSHIP CODE (2014), <https://www.fsa.go.jp/singi/stewardship/siryout/20140227/06.pdf>; see also Hokugo & Ogawa, *supra* note 228, at 7–10.

²³⁵ Cf. 17 C.F.R. § 240.13d-1(a) (2012) (this report system is similar to U.S. Section 13(d) and Rule 13d1 - 13d7, that is requiring any person acquiring beneficial ownership of 5% or more of any equity security to file with the SEC a statement on Schedule 13D within ten days after such as acquisition).

the FSA set out an exemption for such investors, and requires them only to report changes of ownership twice a month.²³⁶ An investor might be stripped of the filing exemptions specified under the “Report” if the investor’s act falls within the concept of the “Important Proposal Act.”²³⁷ This designation arises when the investor in question has interacted with a company in such a way which can be construed as giving advice or opinions to a company that might result in “material changes or materially influence the issuer’s business activities at the general shareholders meeting”²³⁸

Second, certain circumstances that can trigger compliance with the Report lie with the FSA’s definition of “joint holder.” If any “joint holder” in the calculation of the “holding ratio,” the shareholder must also add up the holding ratio of the “joint holder.” A “joint holder” includes one who *agrees* “to jointly exercise voting rights and other shareholder rights” with another.²³⁹ Moreover, even in the Tender Offer System, adding up the ownership of “specially related persons” is necessary when calculating the “ownership ratio” of the acquirer of shares. This “specially related party” refers to “a person who has *agreed* to jointly exercise voting rights and other rights as a shareholder” with the acquirer.²⁴⁰ In this way, when institutional investors who act in concert with “other investors” and act on individual investee companies, agree “to jointly exercise voting rights and other shareholder rights” with another, then responding to the Report system and the Tender Offer system is necessary, while also considering the holding ratio and the ownership ratio held by the “other investors.” However, the FSA has stated that the “*agreement*” under both systems is different from a mere exchange of opinion, which does not trigger either system.²⁴¹

Third, “Insider Trading Regulations” prohibit corporate insiders who have known “unpublished material facts” about the business of listed companies or persons who have been informed by these corporate insiders and, thus, have known these facts from buying and selling the stock of the relevant companies before such facts are publicly announced. In addition, “information

²³⁶ See Kin’yū shōhin torihiki-hō [Financial Instruments and Exchange Act], Act No. 25 of 1948, art. 27-23 (Japan).

²³⁷ See Kin’yū shōhin torihiki-hō no shikō meirei, [Order for Enforcement of the Financial Instruments and Exchange Act], Cabinet Order No. 321 of 1965, art. 14-8-2 (1) (Japan); Kin’yū shōhin torihiki-hō [Financial Instruments and Exchange Act], Act No. 25 of 1948, art. 27-26 (1) (Japan); see also FIN. SERVS. AGENCY, CLARIFICATION OF LEGAL ISSUES RELATED TO THE DEVELOPMENT OF THE JAPAN’S STEWARDSHIP CODE (2014), *supra* note 234.

²³⁸ Kin’yū shōhin torihiki-hō no shikō meirei, [Order for Enforcement of the Financial Instruments and Exchange Act], Cabinet Order No. 321 of 1965, art. 14-8-2 (1) (Japan).

²³⁹ Kin’yū shōhin torihiki-hō [Financial Instruments and Exchange Act], Act No. 25 of 1948, art. 27-23 (5)(6) (Japan).

²⁴⁰ See Kin’yū shōhin torihiki-hō [Financial Instruments and Exchange Act], Act No. 25 of 1948, art. 27-2 (1)(7) (Japan).

²⁴¹ Fin. Services Agency, Arrangement of Ideas on Legal Issues Based on the Formulation of the Japanese Stewardship Code, 11 (Feb. 26, 2014), <https://www.fsa.go.jp/singi/stewardship/legalissu e.pdf>.

transmission / trading recommendation regulations” prohibit a company related person who knows “unpublished material facts” about the business of listed companies from transmitting information or making transaction recommendations to enable another person to gain profits by making him or her buy or sell before the facts are publicly announced. These two regulations may have unnecessarily dampened the in-depth dialogue between institutional investors and investee companies. Therefore, if the institutional investor believes that receiving “undisclosed material facts” is necessary to engage in in-depth dialogue with the investee company, the institutional investor must start engaging in a dialogue after taking measures, such as stopping the trading of the company's stock to prevent conflicts with such regulations. Based on this information, Japan's original Code provides that when receiving undisclosed material facts based on special relationship, etc. with an investee company, the measures to prevent infringement of insider trading regulations should be taken before a dialogue with such a company.²⁴²

E. Problems remaining in the Japan Stewardship Code

The number of signatories has increased, and at the end of June 2017, 17 signatories provided voting records on an agenda basis. Thirteen²⁴³ out of the 17 signatories are non-Japanese signatories famous for excellent disclosure such as AXA Investment Managers and Henderson Global Investors as asset managers, and CalPERS and Railpen as asset owners. Two years later, the number of signatories as of June 28, 2019, was 251 consisting of 184 asset managers (six trust banks and 178 investment managers), 60 asset owners (23 insurance companies and 37 pension funds), and seven service providers and still increasing.²⁴⁴

When stewardship is demonstrated, constructive dialogue with investee companies can bring benefits to the investee company, shareholders, stakeholders, and the national economy. The conclusions of empirical studies on shareholder activism are not consistent in Japan. With introduction of the Stewardship Code (2014), there were many opinions from investee companies that there were positive changes such as more questions from a medium to long-term perspective and questions about ESG at meetings with investors. On the other hand, a considerable proportion of the companies described that there were unfavorable changes, such as more stereotyped and standardized questions and more questions about capital policy and capital efficiency.²⁴⁵

²⁴² See Japan's Stewardship Code (2014), *supra* note 148, at 12, n.1015.

²⁴³ See Kazutaka Kuroda, Japan's Financial Services Agency has Revised the Stewardship Code: A Look at the Highlights, (2017), https://www.jri.co.jp/MediaLibrary/file/english/periodical/ESGR_eSearchReport/170803_kuroda.pdf.

²⁴⁴ FIN. SERVICES AGENCY, LIST OF INSTITUTIONAL INVESTORS SIGNING UP TO “PRINCIPLES FOR RESPONSIBLE INSTITUTIONAL INVESTORS (2019), https://www.fsa.go.jp/singi/stewardship/list/2019_0628/list_01.pdf.

²⁴⁵ Gov't Pension Inv. Fund, RESULTS OF A SURVEY OF LISTED COMPANIES REGARDING STEWARDSHIP ACTIVITIES OF INSTITUTIONAL INVESTORS 3 (April 2016), https://www.gpif.go.jp/investment/stewardship/pdf/summary_report_of_stewardship_activities.pdf.

Furthermore, among the funds that held dialogue, investee companies described that some funds were not worth the dialogue, and half of the reasons were that "the content of the proposal to the company pursues only the profit of the fund itself and the short-term profit."²⁴⁶ Alternatively, an empirical study found that, by focusing on the stock prices of investee companies in which CalPERS has deeply engaged, medium to long-term added value has been created through such engagement (five years after the start).²⁴⁷ Whether or not the engagement is successful mainly depends on the insights of the directors/executive officers and the institutional investors who face each other, and it is expected that the engagement will be more effective due to the accumulation of experience between them.²⁴⁸

V. THE GOVERNMENT PENSION INVESTMENT FUND (GPIF)

The GPIF was established in April 2006 as a corporation that manages public pension reserve funds. These funds consist of annual welfare and national insurance and excluding corporate annuities and private school mutual annuities. Initially, the fund management department of the Ministry of Finance (the present Ministry of Finance) managed the pension reserves.²⁴⁹ In 1961, Pension Welfare Service Public Corp. took over these reserves.²⁵⁰ Then, pension reserves were managed by the pension fund management fund established in 2001,²⁵¹ after which the GPIF took over.²⁵² The GPIF was established as part of the pension reform enacted in 2001 primarily to change the management of public pension fund investments from a trust associated with the Ministry of Finance to new, independent, and professional management. The public pension premium paid by the people is collected by the Japan Pension Service (started in 2010, the former Social Insurance Agency), which was commissioned by the Minister of Health, Labor and

²⁴⁶ Gov't Pension Inv. Fund, RESULTS OF THE 5TH SURVEY OF LISTED COMPANIES REGARDING STEWARDSHIP ACTIVITIES OF INSTITUTIONAL INVESTORS 5 (May 2020), https://www.gpif.go.jp/investment/stewardship_questionnaire_05.pdf.

²⁴⁷ Steven Nesbitt, *Long-term Rewards from Shareholder Activism: A Study of the "CalPERS" Effect*, 6 J. Applied Corp. Fin. 75, 78 (1994) (finding an increase averaging 41.3% for each company over a five-year period after CalPERS's intervention).

²⁴⁸ See Toshio Tamura, *Does Stewardship Promote Growth?: New Developments in Agency Capitalism*, 32 Cap. Mkt. Rsch. 140 (2014) (Japan), <http://hermes-ir.lib.hit-u.ac.jp/rs/bitstream/10086/31020/1/0101909301.pdf>.

²⁴⁹ See generally, *About Government Pension Investment Fund (GPIF)*, ASTERISK REALTY & PLACEMENT AGENCY (last visited Mar. 10, 2021), <http://japanplacementagent.com/en/research/about-government-pension-investment-fund-gpif/>.

²⁵⁰ See generally *Nenkinfukushijigyōdan no setsuritsu ni tsuite* [Establishment of the Pension Welfare Corporation] Act No. 75 of 1952 (Japan), https://www.mhlw.go.jp/web/t_doc?dataId=00ta3725&dataType=1&pageNo=1.

²⁵¹ See generally *Nenkin shikin un'yō kikin-hō* [Pension Fund Management Fund Act] Law No. 19 of 2020 (Japan), http://www.shugiin.go.jp/internet/itdb_housei.nsf/html/housei/h147019.htm.

²⁵² See generally *GOVERNMENT PENSION INVESTMENT FUND*, <https://www.gpif.go.jp/about/history.html> (last visited Mar. 10, 2021).

Welfare, and the collected pension funds are deposited by the Minister of Health, Labor and Welfare.²⁵³

First, with respect to the relationship with the Japan Code, in 2014 the GPIF made the following announcement: “To maximize medium- to long-term investment return for the beneficiary by improving and fostering investee companies’ corporate value and sustainable growth . . . , GPIF has adopted the Code, and will fulfill the stewardship responsibilities.”²⁵⁴ Based on this statement, the foundation of stewardship activities consists of an investment principle, a policy for fulfilling stewardship responsibilities, and stewardship and voting principles. That is, the GPIF fulfills stewardship responsibilities as an asset owner²⁵⁵ based on “investment principles” and “policies for fulfilling stewardship responsibilities,” and seeks compliance with “stewardship principles” of operation and “voting principles” from asset management organizations.²⁵⁶ As such, the GPIF finds itself as a sincere enforcer of the Japan Code.

A. Investment Principles

The GPIF’s mission is to contribute to stabilizing public pension programs’ operations by earning the investment returns required to secure rigorous pension finances in accordance with the government’s fiscal forecasts. In other words, the GPIF’s most significant risk is failing to achieve this required rate of return in the long term. The GPIF’s investment is made subject to four fundamental principles that describe the GPIF’s basic approach to its investing as follows:²⁵⁷

1. The GPIF’s overarching goal is to achieve the investment returns required for the public pension system with minimal risks and solely for the benefit of pension recipients from a long-term perspective, which are, as a whole, expected to contribute to the stability of the system.

2. The GPIF’s primary investment strategy is diversification. In spite of fluctuations in short-term market prices, the GPIF will achieve investment returns in a more stable and efficient manner by taking full advantage of its long-term investment horizon.

²⁵³ See *Status of Japan Pension System*, JAPAN PENSION SERV., <https://www.nenkin.go.jp/info/ichiduke.html> (last visited Mar. 10, 2021).

²⁵⁴ *Adoption of Japan’s Stewardship Code*, GOV’T PENSION INV. FUND (May 30, 2014), https://www.gpif.go.jp/en/investment/pdf/adoption_Japans_stewardship_code.pdf.

²⁵⁵ GPIF is also an institutional investor as an asset owner under the Japan Stewardship Code.

²⁵⁶ On a global level, pension funds have shown substantial development. Simon C. Y. Wong, *Is Institutional Investor Stewardship Still Elusive?*, 8 J. INT’L BANKING & FIN. L. 508, 508 (2015) (“Promising developments in recent years have occurred principally at the asset owner level—particularly pension and sovereign wealth funds—rather than among the ranks of for-profit asset managers.”).

²⁵⁷ See GOV’T PENSION INV. FUND, DESCRIPTION FOR INVESTMENT PRINCIPLES 1-7 (2017), https://www.gpif.go.jp/en/about/pdf/description_for_investment_principles.pdf#search=GPIF+Investment+Principles+2017.

3. The GPIF formulates the fundamental asset portfolio, by which the GPIF manages and controls risks at the levels of each asset class and each investment manager. It employs both passive and active investments to achieve the benchmark returns (i.e., average market returns) set for each asset class, while seeking untapped profitable investment opportunities.

4. By fulfilling its stewardship responsibilities (including the consideration of ESG factors), the GPIF continues to maximize medium-to-long-term investment returns for the benefit of pension recipients.

Since its acceptance of Japan's Stewardship Code, the GPIF has quickly and aggressively implemented and encouraged these activities, including setting up the "Business and Asset Owners' Forum" and the "Global Asset Owners' Forum" and establishing the "Stewardship & ESG Division."²⁵⁸ Moreover, in September 2015 the GPIF became a signatory to the United Nation's Principles for Responsible Investment (UN-PRI) to express it will make investment in consideration of ESG factors.²⁵⁹ The UN-PRI has six principles, the fourth of which states that "We will promote acceptance and implementation of the Principles within the investment industry."²⁶⁰ As a signatory, the GPIF's plan regarding this principle states that "[t]he GPIF asks external asset managers whether they are signatories to the UN-PRI" and "[t]he GPIF ask[s] the signatories to report their ESG activities, and also ask[s] the non-signatories to explain the reason for not signing."²⁶¹ At the same time, the GPIF conducted interviews with asset managers regarding stewardship activities and how to exercise the voting rights.²⁶² As of September 2019, the UN-PRI had 74 signatories in Japan, of which 45 are investment managers, 20 are asset managers, and 12 are service providers.²⁶³ In 2006, when the UN-PRI was established, it had three Japanese asset managers.²⁶⁴ However, subsequently, it had one to four asset managers each year, which increased by

²⁵⁸ See GOV'T PENSION INV. FUND, REPORT OF GPIF'S STEWARDSHIP ACTIVITIES IN 2016, at 4 (2017), https://www.gpif.go.jp/en/investment/pdf/summary_report_gpifs_stewardship_activities_in_2016.pdf.

²⁵⁹ See GOV'T PENSION INV. FUND, GPIF HAS BECOME A SIGNATORY TO THE UN-PRI 1 (2015), https://www.gpif.go.jp/en/investment/pdf/signatory_UN_PRI_en.pdf.

²⁶⁰ See *What Are the Principles for Responsible Investment*, PRINCIPLES FOR RESPONSIBLE INV., <https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment> (last visited Mar. 10, 2021).

²⁶¹ NENKIN TSUMITATE-KIN KANRI UN'YŌ DOKURITSUGYŌSEI HŌJIN [GOV'T PENSION INV. FUND], KOKUREN SEKININ TŌSHI GENSOKU E NO SHOMEI NI TSUITE [RE SIGNING THE PRI] (2015), <https://www.gpif.go.jp/investment/pdf/signatory-UN-PRI.pdf>.

²⁶² See GOV'T PENSION INV. FUND, GPIF STEWARDSHIP ACTIVITIES REPORT IN 2017, at 19 (2018), https://www.gpif.go.jp/en/investment/pdf/gpif_stewardship_activities_report_in_2017.pdf [GPIF REPORT 2017].

²⁶³ *Search Results for Signatories*, PRINCIPLES FOR RESPONSIBLE INV., <https://www.unpri.org/search/results?qkeyword=¶meters=WVSECTIONCODE%7c1018> (searching signatories by country and by category).

²⁶⁴ See *Founding Signatories*, subheading of *About the PRI*, PRINCIPLES FOR RESPONSIBLE INV., <https://www.unpri.org/pri/about-the-pri> (last visited Mar. 10, 2021).

five to eight each year from 2016.²⁶⁵ This situation seemed naturally influenced by the UN-PRI signature by the GPIF in September 2015.

B. Stewardship Principles

The GPIF established its Stewardship Principles on June 1, 2017, in which it requires its external asset managers to comply with the following “Stewardship Principles” for domestic and foreign equity investments.²⁶⁶ If an asset manager decides not to comply with any of the principles, it is required to explain the rationale for its non-compliance to the GPIF (the “comply or explain” principle).²⁶⁷ To perform its own stewardship responsibilities, the GPIF continuously monitors the stewardship activities of asset managers such as the exercise of voting rights, and actively conducts dialogue with them.²⁶⁸ The Stewardship Principles cover the following five principles:

(1) Corporate Governance Structure of Asset Managers

Asset managers should adopt Japan’s Stewardship Code and have a strong corporate governance structure.²⁶⁹ In particular, asset managers should develop a supervisory system through measures such as appointing outside directors with a high degree of independence to enhance their independence and transparency.²⁷⁰

(2) Management of Conflicts of Interest by Asset Managers

Asset managers should appropriately manage conflicts of interest to put beneficiaries’ interests first when conducting activities.²⁷¹ Asset managers should classify types of conflicts of interest and develop and publicly disclose a policy for the management of conflicts of interest.²⁷² Asset managers should manage conflicts of interest through measures such as establishing a third-party committee with a high degree of independence.²⁷³

²⁶⁵ See PRINCIPLES FOR RESPONSIBLE INV., *supra* note 260.

²⁶⁶ NENKIN TSUMITATE-KIN KANRI UN’YŌ DOKURITSUGYŌSEI HŌJIN [GOV’T PENSION INV. FUND], *Suchuwādoshippu Katsudō Gensoku [Stewardship Principles]* (2017), https://www.gpif.go.jp/investment/stewardship/pdf/stewardship_activity_principle.pdf; GOV’T PENSION INV. FUND, STEWARDSHIP PRINCIPLES (June 1, 2017, last revised Feb. 6, 2020), https://www.gpif.go.jp/en/investment/pdf/stewardship_principles_and_proxy_voting_principles.pdf [hereinafter GPIF Stewardship Principles].

²⁶⁷ *Id.* § 3.

²⁶⁸ *Id.* § 5.

²⁶⁹ This corresponds to asset owners’ stewardship responsibility under the Japan Stewardship Code, “Aims of the Code” item 8. *See id.* § 1.

²⁷⁰ Additionally, GPIF requests commitment to sufficient internal resources and effective remuneration and incentive systems. *See id.* § 1.

²⁷¹ This corresponds to asset managers’ stewardship responsibility under the Japan Stewardship Code, Principle 2, Guidance 2-2. FIN. SERVICES AGENCY, *supra* note 205, at 8.

²⁷² GPIF STEWARDSHIP PRINCIPLES, *supra* note 266, § 2.

²⁷³ In the case of a company, such as Google, with a controlling shareholder, Lucian Bebchuk and Assaf Hamdani proposed a new type of independent director (called “enhanced-independence director”), who should be accountable to public investors during controllers’ conflicts. *See* Lucian

(3) Policy for Stewardship Activities, including Engagement

Asset managers should develop and publicly disclose a policy of their stewardship activities including engagement.²⁷⁴ They should focus on ensuring that their stewardship policy and activities contribute to medium to long-term shareholder value.²⁷⁵ They should consider non-financial information (including Corporate Governance Reports and Integrated Reports) when engaging investee companies.²⁷⁶ Given the significance of passive investment of GPIF equity portfolios, the GPIF's performance depends upon medium to long-term sustainable capital market growth. Asset managers for passive investments should develop and effectively implement a suitable engagement strategy for such investments.²⁷⁷

(4) ESG Integration into the Investment Process

The GPIF states that it is vital to integrate ESG factors into the investment process to promote the sustainable growth of corporate value and better medium to long-term risk adjusted returns for the GPIF.²⁷⁸ Asset managers should consider the materiality of ESG issues and deal with them accordingly.²⁷⁹ Asset managers should proactively engage with investee companies on critical ESG issues and become a signatory of the Principles for Responsible Investment (PRI).²⁸⁰

(5) Exercise of Voting Rights

Asset managers should exercise voting rights exclusively in the best interests of the GPIF and its beneficiaries, and exercise voting rights in accordance with the "Proxy Voting Principles."²⁸¹ When using a proxy advisor, asset managers should conduct proper due diligence prior to selection.²⁸² "After

A. Bebchuk & Assaf Hamdani, *Independent Directors and Controlling Shareholders*, 165 U. PA. L. REV. 1271, 1274–75 (2017).

²⁷⁴ GPIF Stewardship Principles, *supra* note 266, § 3.

²⁷⁵ This corresponds to asset managers' stewardship responsibility under the Japan Stewardship Code, Principle 4. Fin. Services Agency, *supra* note 205, at 6.

²⁷⁶ The GPIF's external asset managers entrusted with domestic equity investments selected excellent integrated reports and most-improved integrated reports, and excellent corporate governance reports. GPIF Report 2017, *supra* note 262, at 3.

²⁷⁷ *Id.*; see also Council of Experts Concerning the Follow Up of Japan's Stewardship Code and Japan's Corporate Governance Code, *supra* note 215, at Guidance 4-3 (corresponding to asset managers' stewardship responsibility under the Japan's Stewardship Code).

²⁷⁸ GPIF Stewardship Principles, *supra* note 266, § 4.

²⁷⁹ The "stewardship responsibilities" should be performed to enhance the medium- to long-term investment return by improving and fostering the sustainable growth under 2014 SS Code, but additionally they should be done based on consideration of sustainability (medium- to long-term sustainability including ESG factors) under 2020 SS Code.

²⁸⁰ See also Gov't Pension Inv. Fund, *GPIF has Become a Signatory to the UN-PRI*, (Sept. 28, 2015), https://www.gpif.go.jp/en/investment/pdf/signatory_UN_PRI_en.pdf.

²⁸¹ GPIF Stewardship Principles, *supra* note 266, § 5.

²⁸² *Id.*; see FIN. SERVICES AGENCY, *supra* note 205, at 11 (Guidance 5-4 explaining how this corresponds to asset managers' stewardship responsibility under the Japan Stewardship Code).

selection, asset managers should continuously monitor service quality and engage with the proxy advisor as necessary.”²⁸³

C. Policy to Fulfil Stewardship Responsibilities

The GPIF established the policy on May 30, 2014, and revised it on September 10, 2015, and Aug 1, 2017.²⁸⁴ The policy consists of the following five “Basic Policies” and “Measures on Each Principle of the Code” corresponding to them:

(1) Concepts of Stewardship Responsibilities

- The GPIF is a universal owner, a widely diversified portfolio across the overall capital market, and a “super long-term investor” designed as a part of a 100-year sustainable pension scheme. Given such features, the sustainable and stable growth of the overall capital market is essential for the GPIF to secure its long-term investment returns.

- Because the GPIF invests in equities and exercises voting rights through its external asset managers, it promotes constructive dialogue (engagement) between asset managers and investee companies. Thus, the GPIF will perform its stewardship responsibilities by promoting engagement between asset managers and investee companies and building a win-win relationship in the investment chain.²⁸⁵

- As an “asset owner” defined by Japan’s Stewardship Code, the GPIF is directly engaged in initiatives that it can execute on its own as stated in (2) below, while as stated in (3) below, the GPIF monitors the implementation status of the initiatives promoted by the asset managers and actively engages with them. With respect to the outline of the activity status of the above, the GPIF publishes the “Report of GPIF’s Stewardship Activities” for each fiscal year, thus fulfilling its stewardship responsibilities.

(2) Policies Concerning Initiatives Undertaken by the GPIF

– The GPIF will fulfill its roles and responsibilities as an asset owner in line with the Code and will promote stewardship activities with a study of appropriate stewardship responsibilities in an attempt to maximize medium to long-term investment returns for the beneficiary.

– From the viewpoint of fiduciary responsibilities, the GPIF will examine various activities that are intended to maximize medium to long-term investment returns for the beneficiary.

(3) Policies Concerning Initiatives Conducted by Asset Managers

²⁸³ GPIF STEWARDSHIP PRINCIPLES, *supra* note 266, § 5.

²⁸⁴ GOV’T PENSION INV. FUND, POLICY TO FULFILL STEWARDSHIP RESPONSIBILITIES (2014) at https://www.gpif.go.jp/en/investment/Policy_to_Fulfill_Stewardship_Responsibilities_201911.pdf.

²⁸⁵ *See id.* at 3.

– The GPIF shall require asset managers for equity investments to comply with its “Stewardship Principles” and “Proxy Voting Principles.” Should an asset manager decide not to comply with any of the principles, it is required to explain to the GPIF its rationale for the non-compliance (the “comply or explain” principle).²⁸⁶

– The GPIF will continuously monitor the stewardship activities of asset managers, including the exercise of voting rights, and proactively engage in dialogue (engagement) with them.

– During the evaluation of asset managers, the GPIF shall highly value asset managers that are considered to have better fulfilled stewardship responsibilities, other conditions being the same.

D. Voting Principle

The GPIF established Proxy Voting Principles on June 1, 2017.²⁸⁷ When exercising voting rights, the GPIF will ask asset managers to do as follows: (i) to develop a proxy voting policy and guidelines to maximize shareholders’ long-term interests, which should be publicly disclosed in a way to make clear their basis of judgment; (ii) to sufficiently communicate with investee companies to help inform proxy voting decisions and to ensure that all voting rights are exercised with thoughtful consideration; (iii) to carefully consider ESG issues when exercising voting rights with the objective of enhancing investee companies’ corporate value over the medium to long-term; (iv) to apply due diligence when exercising voting rights on proposals that could undermine minority shareholders’ interests; (v) to exercise voting rights in accordance with Corporate Governance Codes established by individual countries that investee companies must follow; and (vi) if asset managers use a proxy advisory service, to exercise voting rights and not mechanically follow the advisor’s recommendations.²⁸⁸ It is the sole responsibility of asset managers to exercise voting rights in the best interests of the GPIF and its beneficiaries. In contrast, after the general meeting of shareholders, the GPIF will ask asset managers to do as follows: to publicly disclose all voting records for each investee company on an individual agenda item basis,²⁸⁹ to explain to investee companies or publicly disclose the voting records and rationale depending on the importance and relevance, and to periodically review their voting records and process and make necessary updates to the policy.

²⁸⁶ See GPIF STEWARDSHIP PRINCIPLES, *supra* note 266, § 2. This policy is the same as that of the Japan Stewardship Code.

²⁸⁷ GOV’T PENSION INV. FUND, GIKETSUKEN KŌSHI GENSOKU [VOTING RIGHTS PRINCIPLE] (2020), https://www.gpif.go.jp/investment/stewardship/pdf/voting_rights_principle.pdf.

²⁸⁸ *Id.*

²⁸⁹ GPIF asks its external asset managers to publicly disclose proxy voting records for each investee company. 17 asset managers for domestic equities have already disclosed them publicly. See GPIF REPORT 2017, *supra* note 262, at 11–12.

*E. 2018 GPIF Stewardship Activities Report*²⁹⁰

In March 2017, the GPIF “started to call for the application of passive managers for domestic equities” to enhance stewardship activities.²⁹¹ The GPIF expected that it would contribute to improving the sustainability of all markets through such activities and diversifying the manner in which stewardship activities are approached.²⁹² Regarding engagement (communication) with external asset managers, the “GPIF has shifted from [a] one-way annual monitoring model to [an] ‘engagement’ model, focusing [on] two-way communication and exchanging views on stewardship responsibilities.”²⁹³

According to the GPIF’s Assessment of “Stewardship Activities,” “approximately 90% of GPIF’s equity is passively managed, and GPIF invests in a wide range of listed companies.”²⁹⁴ Because the sustainability of the entire market is crucial, “the GPIF believes that it is critical for passive managers to implement engagement activities, which would encourage investee companies to increase corporate value and sustainable growth from the medium- to the long-term perspective.”²⁹⁵ Moreover, the GPIF states that “passive managers were assessed in terms of their contribution to the sustainability of the whole market, whereas the active managers were assessed in terms of their contribution to increasing shareholder value of the investee companies in the 1.”²⁹⁶ Regarding engagement with index providers, the GPIF “believes that the governance of index providers is essential for ensuring neutrality and transparency.”²⁹⁷ Consequently, the GPIF states that “all asset managers for domestic and foreign equities answered that they have taken measures for ESG issues.”²⁹⁸ With respect to the exercise of voting rights, “many asset managers, however, make quarterly disclosures so that the announced results will be of use in the dialogue after the general meeting of shareholders.”²⁹⁹ As a result, the GPIF introduces its action plans for moving ahead.³⁰⁰

²⁹⁰ GOV’T PENSION INV. FUND, GPIF STEWARDSHIP ACTIVITIES REPORT 2018 (2019), https://www.gpif.go.jp/en/investment/gpif_stewardship_activities_report_2018.pdf [hereinafter GPIF REPORT 2019]

²⁹¹ *Id.* at 10.

²⁹² *Id.*

²⁹³ *Id.* at 11.

²⁹⁴ *Id.* at 13.

²⁹⁵ GPIF REPORT 2019, *supra* note 290.

²⁹⁶ *Id.*

²⁹⁷ *Id.* at 14.

²⁹⁸ *Id.* at 25.

²⁹⁹ *Id.* at 26.

³⁰⁰ GPIF REPORT 2019, *supra* note 290, at 32.

F. Pension Reform Act of 2016

Laws have reformed the corporate governance of the GPIF. In December 2016, the Japanese Diet enacted the “Act for Partial Revision of the National Pension Law to Improve Sustainability of the Public Pension System” (Pension Reform Act).³⁰¹ The Act’s purposes are, with respect to the public pension system, to increase the sustainability of the system and ensure benefits for future generations. The Act also strengthens the security function in response to changes in the socio-economic situation based on the “Act on Promotion of Reform to Establish a Sustainable Social Security System” and reviews the GPIF as an organization for safer and more efficient management of pension funds. To strengthen the auditing function, GPIF also introduces an audit committee to audit and monitor both the executive committee and the executive department.³⁰² Derivative transactions are widely used for risk management purposes by pension funds and institutional investors to control price fluctuation risks, such as exchange rates and stocks. However, given the possibility of speculative transactions, the GPIF prohibits certain derivative transactions (market derivatives transactions, stock index futures transactions among foreign exchange futures transactions) by law.³⁰³

G. Further concern held by the GPIF

The GPIF holds many voting rights as an individual company and is still a highly powerful entity that has effectively encouraged institutional investors to accept the Japan Stewardship Code. However, the GPIF explains that its effect on the stock market is limited because it is an extremely long-term investor, and any effect on the market of disclosing the holdings has not yet been confirmed.³⁰⁴ The GPIF does not directly exercise voting rights to ensure that it does not raise concerns that it directly affects the management of a business.

As previously observed, the GPIF requires asset managers to exercise voting rights to realize long-term shareholder benefits and to engage in stewardship responsibilities. With respect to the status of the exercise of voting rights (April to June 2018) by trustee organizations, approximately 10% of the

³⁰¹ See *Nenkin Kaikaku-Hō (Heisei 28-Nen Hōritsudai 114-Gō) Ga Seiritsu Shimashita [The Pension Reform Act (2016 Act No. 114) passed Japanese Diet]* MINISTRY OF HEALTH, LAB., & WELFARE, (Dec. 14, 2016), <https://www.mhlw.go.jp/stf/seisakunitsuite/bunya/0000147284.html>.

³⁰² See *Kokumin Nenkin-Hō-Tō No Ichibu O Kaisei Suru Hōritsu-Tō No Gaiyō [Outline of the Act on the Partial Revision of the National Pension Act, Etc. to Strengthen the Country’s Pension System]* MINISTRY OF HEALTH, LAB., & WELFARE (June 22, 2017), https://www.kantei.go.jp/jp/singi/syaka_ihosyou_kaikaku/dai7/shiryō3.pdf.

³⁰³ See Sadayuki Horie, *Public Pension Fund Governance and Investment: Update and Critique Comparing Japan’s GPIF with Foreign Peers* 34–35 (Columbia Bus. Sch., Ctr. on Japanese Econ. & Bus., Working Paper, Paper No. 2, 2017), <https://pdfs.semanticscholar.org/42ed/58768e3eedf5e849c2772c5f5d70498b5e9d.pdf> (analyzing GPIF’s actual investment policy).

³⁰⁴ See GOV’T PENSION INV. FUND, NI YORU KOKUNAI KABUSHIKI NO UN’YŌ NI TSUITE 3 [Management of Domestic Stocks by GPIF] (2017), <https://www.gpif.go.jp/operation/committee/pdf/kanri02iinka11155.pdf>.

votes were cast against all proposals, specifically 58% cast against director retirement bonuses proposal, and 91% cast against poison pills (warning type).³⁰⁵ During the period from 2014 (the year that the GPIF endorsed the Code) to 2018, 7.9% to 10.3% were cast against the proposals.³⁰⁶ This range indicates that a certain degree of opposition was cast, and that the institutional investors to which the GPIF has outsourced did not simply vote in favor. Thus, the exercise of voting rights and dialogue with investee companies are not conducted by the asset owner, the GPIF, but by an agency (asset manager) commissioned by the GPIF—yet, the GPIF monitors such asset managers. Then, the GPIF is said to have an indirect influence.

There is an existing concern that engagement might be reduced given the high rate of passively managed funds because such funds have less incentive for engagement. The total market capitalization held by the GPIF as of the end of 2018 was as follows: 35.56 trillion yen in total (for domestic equity only), 3.22 trillion yen for active management (9.1%), and 32.33 trillion yen for passive investment (90.9%).³⁰⁷ Conducting a dialogue with the investee company is difficult because of the cost and incentive aspect of passive management, and because the GPIF, which mainly operates through such passive management, cannot directly influence the governance of the investee company. The GPIF, however, realizes this task. According to one study, GPIF-owned stocks have a higher governance evaluation than non-owned stocks.³⁰⁸ Whether this results from the investment trustee's approach to investee companies, or that of the GPIF, or rather asset managers have from the outset only selected stocks of companies with high governance is unclear. Even if stocks of companies with high governance are selected, from the investee company's point of view, the company's decision to raise these indicators by having the GPIF hold shares is necessary, which may contribute to the higher governance evaluation as a result.

VI. CURRENT AND HEREAFTER STEWARDSHIP IN THE UNITED STATES

Recently, most institutional investors put the ESG risks and opportunities in the investment decision factor.³⁰⁹ BlackRock Chairman and CEO Larry Fink

³⁰⁵ GPIF REPORT 2019, *supra* note 290, at 36.

³⁰⁶ *Id.* at 38.

³⁰⁷ See GOV'T PENSION INV. FUND, ANNUAL REPORT FISCAL YEAR 2019, at 81 (2020), https://www.gpif.go.jp/en/performance/annual_report_fiscal_year_2019.pdf.

³⁰⁸ Yosuke Torii, *Ni Yoru Kabushiki Hoyū To Tōshi-Saki Kigyō No Gabanansu* [Stocks Owned by GPIF and Governance of Investee Companies], 34 KEIEI BUNSEKI KENKYŪ [J. BUS. ANALYSIS] 115, 119–21 (2018). The indicator is classified into eight evaluation categories, and detailed items are set and scored for each. The eight categories and detailed items are the following: 1) capital efficiency, 2) stock market evaluation, 3) external disciplines, 4) board of directors, 5) executive compensation, 6) information disclosure, 7) capital policy, and 8) effectiveness. Very few articles exist in Japan on the GPIF.

³⁰⁹ See Jackie Cook & Jon Hale, *2019 ESG Proxy Voting Trends by 50 U.S. Fund Families*, HARV. L. SCH. F. CORP. GOVERNANCE (Mar. 23, 2020), <https://corpgov.law.harvard.edu/2020/03/23/2019-esg-proxy-voting-trends-by-50-u-s-fund-families/>.

made it clear that boards seeking support from the investment giant will have to prioritize ESG issues moving forward, as well as stress board diversity and articulate their long-term strategies. In January 2018, Fink highlighted those priorities in a letter to CEOs.³¹⁰ Moreover, in a press release issued on August 19, 2019, the Business Roundtable announced the adoption of the new “Statement on the Purpose of a Corporation,” signed by 181 renowned, high-powered CEOs.³¹¹ The Statement clarifies moving away from shareholder primacy as a guiding principle and instead adopting a new standard for a fundamental commitment to all stakeholders, and further incorporates some of the ESG concepts.³¹² Under the Statement of Purpose, each signatory commits to all of the following: (1) delivering value to its customers, (2) investing in its employees, (3) dealing fairly and ethically with its suppliers, (4) supporting the communities in which it works, and (5) generating long-term shareholder value.³¹³ These commitments seem very similar to the policy outlined in Section 172 of the U.K. Companies Code of 2006, as previously argued.

A. *ISG Stewardship Code*

The Investor Stewardship Group (ISG) is a private initiative entirely independent of any regulatory body, made up of a group of some of the largest and most influential institutional investors and global asset managers, with a clear aim of establishing a framework of essential standards of stewardship and corporate governance for U.S. institutional investors and boardroom conduct. The ISG is not a governmental or public organization, such as FRC in the U.K. or FSA in Japan. Founding members of the ISG are made up of U.S. and international institutional investors with large investments in the U.S. equity market. Since its founding in January 2017, membership in the ISG has grown considerably.³¹⁴ The ISG’s signatories include BlackRock, Vanguard, State Street Global Advisors, TIAA Investments, T. Rowe Price and CalSTRS, among others. The present signatories are made up of 50 institutional investors representing more than \$22 trillion worth of investment in U.S. markets.³¹⁵

³¹⁰ See Letter from Laurence D. Fink, Chairman & Chief Exec. Off., BlackRock (Jan. 12, 2018), <http://www.wlrc.com/files/2018/BLKCEOletter2018.pdf> (“To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.”).

³¹¹ See *One Year Later: Purpose of a Corporation*, BUS. ROUNDTABLE, <https://purpose.businessroundtable.org> (last visited Mar. 10, 2021).

³¹² See Cydney Posner, *So Long to Shareholder Primacy*, HARV. L. SCH. F. CORP. GOVERNANCE (Aug. 22, 2019), <https://corpgov.law.harvard.edu/2019/08/22/so-long-to-shareholder-primacy/>.

³¹³ See Wheeler et al., *Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE, <https://opportunity.businessroundtable.org/ourcommitment/> (last visited Mar. 10, 2021).

³¹⁴ See Anne Meyer et al., *The Investor Stewardship Group’s Governance Principles*, HARV. L. SCH. F. CORP. GOVERNANCE (May 11, 2018), <https://corpgov.law.harvard.edu/2018/05/11/the-investor-stewardship-groups-governance-principles/>.

³¹⁵ *Id.*

At the launch in January 2017, the ISG announced its framework for U.S. stewardship and governance consisting of elementary corporate governance principles for U.S. listed companies (ISG Governance Framework) and parallel stewardship principles for U.S. institutional investors (ISG Stewardship Framework) collectively the “Framework.”³¹⁶ The immediate publication of governance and stewardship principles conveys a message that institutional investors and investee companies share entire responsibility for the economic success of portfolio companies.³¹⁷

The Framework’s effective date was set as January 1, 2018, so that U.S. listed companies will be given enough time to adjust to the ISG Governance Framework before the 2018 proxy season.³¹⁸ The ISG encourages companies to evaluate their compliance with the corporate governance principles. In fact, in December, the ISG published a press release “encouraging companies to articulate how their governance structures and practices align with the ISG Governance Framework and where and why they differ in approach.”³¹⁹ In response to that, the State Street Global Advisors highlighted that it would screen portfolio companies for compliance with the principles.³²⁰

The ISG Governance Framework is based substantially on the U.K., Continental European, and other non-U.S. frameworks that are principles-based corporate governance standards with a “comply-or-explain” basis, rather than the rules-based, strict-compliance governance system found in the United States. Thus, the ISG Governance Framework seems to avoid concerns over strict compliance and “one-size-fits-all” criticism. Advocates for the principles-based approach emphasize the flexibility which will be given when companies must explain why they differ in approach in response to important principles. The Framework’s principles-based approach is likely to be a device for both

³¹⁶ *The Principles*, INV. STEWARDSHIP GRP., <https://isgframework.org/stewardship-principles/> (last visited Mar. 11, 2021); see also *Corporate Governance Principles for US Listed Companies*, INV. STEWARDSHIP GRP., <https://isgframework.org/corporate-governance-principles/> (last visited Mar. 11, 2021) [hereinafter *Corporate Governance Principles*].

³¹⁷ John C. Wilcox & Morrow Sodali, *The Investor Stewardship Group: An Inflection Point in U.S. Corporate Governance?*, HARV. L. SCH. F. CORP. GOVERNANCE (March 30, 2017), <https://corpgov.law.harvard.edu/2017/03/30/the-investor-stewardship-group-an-inflection-point-in-u-s-corporate-governance/>.

³¹⁸ See INV. STEWARDSHIP GRP., *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, <https://isgframework.org/>; see also Martin Lipton, *Promoting Long-Term Value Creation—The Launch of the Investor Stewardship Group (ISG) and ISG’s Framework for U.S. Stewardship and Governance*, HARV. L. SCH. F. CORP. GOVERNANCE (Feb 1, 2017), <https://corpgov.law.harvard.edu/2017/02/01/promoting-long-term-value-creation-the-launch-of-the-investor-stewardship-group-isg-and-isgs-framework-for-u-s-stewardship-and-governance/>.

³¹⁹ See Andrew Healy, *As Corporate Governance Principles Take Effect, The Investor Stewardship Group Calls on Companies to Explain their Practices*, BUSINESSWIRE (Dec. 5, 2017, 9:40 AM), <https://www.businesswire.com/news/home/20171205005960/en/Corporate-Governance-Principles-Effect-Investor-Stewardship-Group>.

³²⁰ Meyer et al., *supra* note 314.

institutions and investee companies to promote mutually agreeable objectives, particularly given the lack of rulemaking or legislation.³²¹

The principles of the ISG Governance Framework highlight the importance of boardroom effectiveness (see Principle 5), alignment of executive compensation with long-term financial results (see Principle 6), and board accountability (see Principle 1) that are demonstrated in part through the adoption of governance best practices (see Principle 3), including a one-share one-vote capital structure (see Principle 2) and independent board leadership (see Principle 4).³²² As previously mentioned, regarding Principle 1, BlackRock's CEO Larry Fink recently published a letter to the CEOs in which he argued that boards are accountable to other stakeholders, such as employees and customers, in addition to shareholders.³²³ Moreover, regarding Principle 4, independent board leadership is essential to provide a voice independent from management that is accountable directly to shareholders and other stakeholders. Moreover, regarding Principle 6, the board is responsible for ensuring that motive force supporting the company's *long-term strategy* should be adequately set in a company's management incentive structure, and for communicating such motive force to shareholders.³²⁴

In contrast, the ISG Stewardship Framework emphasizes that these institutional investors have a vested interest and responsibility for the long-term economic success of their portfolio companies, and these principles are essential to preserving and increasing long-term shareholder value. The ISG Stewardship Framework encourages institutional investors to articulate a set of fundamental stewardship responsibilities and is designed to affirm investment managers' responsibility for engagement and proxy voting policies and decisions, regardless of how they may use outside servicers. Some guidelines that support each simple principle in the ISG Stewardship Framework have been articulated in detail.³²⁵ However, in the United States, the ISG's new stewardship principles are more tentative and ambiguous than the U.K. Stewardship Code. Noteworthy is that the concept "stewardship," rather than "fiduciary" is articulated by the ISG in the Framework, which mainly focus on monitoring portfolio companies, and include not only financial performance and legal compliance but also the ESG and non-financial factors. The ISG's governance and engagement principles under the Framework, which take a principle-based approach,³²⁶ do not expand shareholder rights or create new obligations for either investee companies or institutional investors.

³²¹ *Id.*

³²² *Id.*

³²³ Larry Fink's Annual Letter, *infra* note 358.

³²⁴ See *Corporate Governance Principles*, *supra* note 316.

³²⁵ Michael McCauley, *An Investor Consensus on U.S. Corporate Governance & Stewardship Practices*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 9, 2018), <https://corpgov.law.harvard.edu/2018/05/09/an-investor-consensus-on-u-s-corporate-governance-stewardship-practices/>.

³²⁶ Wilcox & Sodali, *supra* note 317.

B. Enhance the Stewardship in the United States

Parts III through V have argued on stewardship codes by U.K.'s and Japan's regulatory bodies and fulfillment of stewardship by "world's largest pension fund" in Japan. This section B. argues that as a result of the comparative analysis concerning stewardship between the U.K./Japan and the United States, substantial issues concerning investment and engagement by institutional investors and their intermediaries should be discussed and resolved even without stewardship code by a U.S. regulatory body, and, lastly, that the enlightened shareholder value approach taken by the U.K. Companies Act 2006 should be pursued as corporate governance theory of investee companies with long-term and sustainable success.

i. Collective Engagement between Passive and Active Funds

As previously argued, passive index funds tend to adopt a low-cost investment strategy by focusing on the long-term shareholder value to reduce costs associated with engagement with investee companies. Taking advantage of this tendency, they can have a positive influence on corporate governance issues for which low-cost interventions may be more effective, such as voting according to a pre-defined policy at annual meetings,³²⁷ rather than high-cost governance activities, such as monitoring and reviewing of M&A, and the choice of board members.³²⁸

Engagement in collective activism between positive/active investors may occur under certain circumstances. Although the ISG Stewardship Framework refers to collaboration between institutional investors, this type of collaboration appears aimed at encouraging practice of stewardship principles under the Framework, rather than actually engaging in collective activism.³²⁹ In contrast to the belief that activism is destructive to long-term shareholder value, some empirical studies on hedge funds have found that activists are in fact able to create sustainable, long-term improvements in the company's shareholder value and operational performance.³³⁰ The reasons are as follows. Activist hedge funds are usually not majority shareholders who are able to thrust their desired changes into the company's strategy but they are still influential shareholders who engage in monitoring the target company and propose value-enhancing changes to other investors.³³¹ The active hedge funds propose such changes particularly to traditional institutional investors such as

³²⁷ See Fisch et al., *supra* note 103, at 13, 17 ("Passive investors own the entire market and therefore also enjoy economies of scale in evaluating governance provisions . . .").

³²⁸ See Fisch et al., *supra* note 103, at 15 ("Because of the large size of their portfolios and their limited firm-specific knowledge, passive investors are poorly-positioned to identify the firm-specific operational qualities that would enable them to prompt individual companies to outperform.").

³²⁹ See *Corporate Governance Principals*, *supra* note 316, Principle F.

³³⁰ See Lucian A. Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1, 16 (2013).

³³¹ *Id.* at 12 (documenting that the average activist stake reaches 8.8% with a median of 6.3%).

mutual funds and pension funds with long-term investment horizons and with little incentive for engagement.³³² Although such mutual funds and pension funds are reluctant to engage in activism, they increasingly adopt transparent voting policies and scrutinize proposals submitted for a vote subject to such policies.³³³ As such, institutional investors have a limited incentive to play an active governance role in an investment chain. In contrast, hedge funds typically act as "catalysts" in facilitating shareholder activism.³³⁴

ii. Voting Advisory

Monitoring all portfolio companies is costly and practically impossible, and many investors lack enough time and money to engage in this activity. However, the increasing importance of voting rights strengthens the ability of passive investors to exercise significant influence through voting based on a voting policy. In addition to exercising their voting rights, passive investors have various mechanisms to make their voting power more effective. For instance, they will influence the voting policies of proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis. A second mechanism is engagement. Moreover, through their market-wide shareholdings, passive investors force corporate management to be responsive to their requests for engagement.

Although proxy voting is a relatively low-cost intervention for investors, voting still entails costs, as previously noted, particularly because many institutional investors must exercise their voting rights on several thousand securities. Institutional investors exert substantial voting power, as previously argued, but lack appropriate incentives to cast informed ballots with their portfolio companies. As a result, numerous institutional investors employ the services of proxy advisors to help them exercise their voting rights,³³⁵ and often even delegate their voting decisions to proxy advisors. Accordingly, the proxy advisory industry has grown substantially during the past decade,³³⁶ however the proxy advisory industry has been dominated by a small number of players, which has caused an overwhelming lack of competition in the industry and

³³² See John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 IOWA J. CORP. L. 545, 572 (2016).

³³³ See Jessica Toonkel & Soyoun Kim, *Activist Investors Find Allies in Mutual, Pension Funds*, REUTERS (April 9, 2013, 7:11 AM), <https://www.reuters.com/article/us-funds-activist/activist-investors-find-allies-in-mutual-pension-funds-idUSBRE9380DU20130409>.

³³⁴ See generally Rock, *supra* note 16; Rock, *supra* note 134, at 371–74; see also Bebhuk et al., *supra* note 114, at 100–01; Gilson & Gordon, *supra* note 51, at 895; see generally Kahan & Rock, *supra* note 43.

³³⁵ U.S. GOV'T ACCOUNTABILITY OFF., GAO-07-765, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING 7–13 (2007), <http://www.gao.gov/new.items/d07765.pdf> (exploring competition and potential conflicts of interest in the proxy advisor market, as well as describing ISS's client base as consisting of an estimated 1,700 institutional investors).

³³⁶ See Sagiv Edelman, *Proxy Advisory Firms: A Guide for Regulatory Reform*, 62 EMORY L.J. 1369, 1375 (2013).

concentration of voting influence into just a few firms.³³⁷ The Big Three rely heavily on proxy advisors - mainly ISS and Glass Lewis³³⁸ - that, in turn, adopt standardized voting policies.³³⁹ Comparing the U.S. and U.K. proxy advisors, some commentators concluded that proxy advisors in the U.K. exert significantly weaker influence than they do in the United States.³⁴⁰

In 2010, the SEC published the Concept Release on the U.S. Proxy System,³⁴¹ which raised issues on proxy advisory firms that could harm shareholder voting: first, a lack of accountability for information accuracy in the voting standards and, second, insufficient disclosure and management of conflicts of interests.³⁴² The proxy advisors' recommendation criteria involve a lack of transparency, which makes it difficult to assess the quality of voting recommendations, whereas proxy advisors may have incentives to conduct only low-cost activities.³⁴³ Regarding the second issue, for example, ISS also serves as a consultant who advises on how they can improve their corporate governance and simultaneously recommends how investors should vote.³⁴⁴ Some commentators argued that this dual role may give rise to conflicts of interest.³⁴⁵

The expanded fiduciary duties enforced by the SEC in 2003 request institutional investors to vote in the best interest of their clients.³⁴⁶ The SEC announced that the mere employing of a proxy advisory firm is insufficient to satisfy fiduciary obligations assumed by institutional investors, and further that they must exercise some level of due diligence even when subscribing to a proxy advisor's voting recommendations.³⁴⁷ Simultaneously, the SEC adopted

³³⁷ David A. Katz & Trevor Norwitz, *Congress Increases Pressure on Proxy Advisory Firms*, HARV. L. SCH. F. CORP. GOVERNANCE (May 23, 2018), <https://corpgov.law.harvard.edu/2018/05/23/congress-increases-pressure-on-proxy-advisory-firms/> (arguing that said two firms control ninety-seven percent of the proxy advisory industry).

³³⁸ Bioy et al., *supra* note 15, at 14.

³³⁹ See Gaia Balp, *Regulating Proxy Advisors Through Transparency: Pros and Cons of the EU Approach*, 14 EUR. CO. & FIN. L. REV. 1, 9 (2017).

³⁴⁰ Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 B.U. L. REV. 1459, 1470, 1507 (2019) ("proxy advisors in the United Kingdom exert significantly weaker influence than they do in the United States", and then suggesting "institutional investors have lacked strong trade groups for coordinating their stewardship efforts, which has allowed space for proxy advisors").

³⁴¹ Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42982 (July 22, 2010).

³⁴² *Id.* at 43011.

³⁴³ See David Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J. L. & ECON. 173, 201–02 (2015).

³⁴⁴ See, e.g., Robert J. Rhee, *Intrafirm Monitoring of Executive Compensation*, 69 VAND. L. REV. 695, 719 (2016).

³⁴⁵ See David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANN. REV. OF FIN. ECON. 103, 110 (2010).

³⁴⁶ See Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1–21 [hereinafter *Advisors Act*]; 17 C.F.R. § 275.206(4)-6 (2018); see also Stephen Choi, Jill E. Fisch & Marcel Kahan, *Director Elections and the Role of Proxy Advisors*, 82 S. CAL. L. REV. 649, 653 (2009).

³⁴⁷ Edelman, *supra* note 336, at 1407.

the proxy voting rule for advisors.³⁴⁸ The rule itself stipulates “it is a fraudulent, deceptive, or manipulative act, practice or course of business within the meaning of section 206(4) of the [Investment Advisors Act of 1940] for [an investment advisor] to exercise voting authority with respect to client securities,” unless the advisor follows the specific requirements of that rule.³⁴⁹ These words are strong and stress how important the SEC viewed investment advisors’ proxy voting obligations to their clients.

Nevertheless, partly because there are reputational and regulatory pressures on asset managers in terms of robust monitoring,³⁵⁰ some passive fund managers persistently contend that they should adopt a more nuanced approach to voting and should not habitually stick to proxy advisors’ recommendations.³⁵¹ Above all, BlackRock states that although it usually votes subject to voting policies,³⁵² a thorough in-house review is carried out whenever specific problems arise,³⁵³ and that it does not obey any single proxy advisor’s voting recommendations and instead mostly subscribes to two research providers.³⁵⁴ As such, BlackRock uses a proxy advisor as just one tool among others to make its voting decisions.³⁵⁵

In August 2019, the SEC approved new guidance concerning the fiduciary responsibilities of investment advisors with respect to (i) proxy voting, (ii) the use of proxy advisors, (iii) the assessment of such proxy advisors’ care and competency that may materially affect voting recommendations, and (iv) addressing the applicability of proxy solicitation and anti-fraud rules to proxy advisors and their voting recommendations.³⁵⁶ Thus, the new guidance offers direction to investment advisers on: (1) the ability for an investment advisor

³⁴⁸ See 17 C.F.R. § 275.206(4)-6 [Proxy Voting Rule]; see also “Proxy Voting by Investment Advisors,” Release No. IA-2106 (Jan. 31, 2003) (the “Proxy Voting Rule Release.”).

³⁴⁹ See 17 C.F.R. § 275.206(4)-6 (2018).

³⁵⁰ See Bioy et al., *supra* note 15, at 3.

³⁵¹ See Luca Enriques & Alessandro Romano, *Institutional Investor Voting Behavior: A Network Theory Perspective* 15 (Eur. Corp. Governance Inst., Working Paper, Paper No. 393/2018, 2018), <https://perma.cc/K4KR-8GCH>. (stating that, politically speaking, it would be unacceptable that the largest institutional investors cause their huge voting power to be exercised by an external advisor with no stakes in the company.)

³⁵² Bioy et al., *supra* note 15, at 26 (describing that BlackRock instructs routine votes to ISS, which then votes in line with the instructions outlined in BlackRock’s voting policy).

³⁵³ BLACKROCK, PROXY VOTING AND SHAREHOLDER ENGAGEMENT FAQ (2020), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-faq-global.pdf>; see also Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2069 (2019).

³⁵⁴ BLACKROCK, *supra* note 353, at 3 (emphasis omitted).

³⁵⁵ BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP -PROTECTING OUR CLIENTS’ ASSETS FOR THE LONG-TERM 13 (2020), <https://www.blackrock.com/corporate/literature/publication/blk-profile-of-blackrock-investment-stewardship-team-work.pdf>.

³⁵⁶ See SEC. AND EXCHANGE COMM’N, COMMISSION GUIDANCE REGARDING PROXY VOTING RESPONSIBILITIES OF INVESTMENT ADVISERS (2019), <https://www.sec.gov/rules/interp/2019/ia-5325.pdf>.

and client to shape the advisor's authority to vote proxies on the client's behalf; and (2) the responsibilities of investment advisers when using the services of proxy advisors to assist with voting, consistent with their fiduciary duties. The new guidance does not create any new obligations or require rulemaking. However, these announcements increase pressure on proxy advisors with respect to expectations around complying with this guidance. The SEC encourages investment advisers and proxy advisors to review their policies and practices subject to the new guidance in advance of next year's proxy season.

iii. ESG Investment

Investors demand a wide range of information useful to understand the long-term performance and risk management for portfolio companies. Disclosing information concerning the integration of ESG factors is now most important for institutional investors that are increasingly interested in aligning their investment portfolios with sustainability and ethical goals.³⁵⁷ In response to such pressure from investors, most of the largest public companies are attempting to provide additional information to meet these changing needs. Moreover, passive index funds, including the Big Three, are paying close attention to ESG issues as they aim to sustain the long-term growth of investee companies in the best interests of their clients.³⁵⁸ An ESG disclosure is mostly based on self-ruling, and most public companies today produce voluntary "sustainability reports" which are the primary source of non-financial information for investors beyond corporate annual reports.³⁵⁹ Thus, there has been a considerable increase in demands for voluntary reporting of ESG information by companies.³⁶⁰ However, there are substantial problems with the nature, timing, and extent of these voluntary disclosures. In April 2016, in response to these circumstances, the SEC issued the Concept Release on Business and Financial Disclosure Required by Regulation S-K (Concept Release), soliciting public opinions on the frequency and format of disclosure, company accounting practices and standards, and the substantive issues about which information should be disclosed.³⁶¹ The Concept Release addresses what many commenters refer to "a growing interest in ESG disclosure among

³⁵⁷ See, e.g., Sophie Baker, *Asset Owners Push to Satisfy U.N. Goals: Institutions Making Major Effort to Use Investment Acuity to Make World Better*, PENSIONS & INVS. (Oct. 16, 2017, 1:00 AM), <http://www.pionline.com/article/20171016/PRINT/171019887/asset-owners-push-to-satisfy-un-goals>.

³⁵⁸ See, e.g., Larry Fink, *Larry Fink's Annual Letter to CEOs: A Sense of Purpose*, BLACKROCK (Aug. 23, 2018, 9:13 PM), <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter> [<https://perma.cc/LZ2A-XRQT>].

³⁵⁹ See, e.g., *Flash Report: 81% of the S&P 500 Companies Published Corporate Sustainability Reports in 2015*, GOVERNANCE & ACCOUNTABILITY INST., INC. (Mar. 15, 2016), <http://www.gainstitute.com/nc/issue-master-system/news-details/article/flash-report-eighty-one-percent-81-of-the-sp-500-index-companies-published-corporate-sustainabi.html> [<https://perma.cc/R4YR-KVNM>].

³⁶⁰ See *id.* (indicating that compared to twenty percent in 2011, eighty-one percent of S&P 500 companies reported on ESG matters in 2015).

³⁶¹ See Business and Financial Disclosure Required by Regulation S-K, Release No. 33-10064 (Apr. 13, 2016), <https://perma.cc/D6ZK-CAH7> [hereinafter SEC Concept Release].

investors.”³⁶² The report addresses increasing use of ESG factors in financial analysis and a study regarding increasing shareholders’ concerns on sustainability issues than on financial results.³⁶³ Moreover, the demand has been increased that the SEC should clarify applicability of existing risk disclosure requirements to ESG information or prescribe a new rule for ESG disclosures.³⁶⁴ It might be an appropriate time to articulate a comprehensive framework for clearer disclosure of companies’ long-term risks and performance including ESG information.³⁶⁵ In response to change in investment circumstances, the new 2020 Stewardship Code published by the FRC defines stewardship as “the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.”³⁶⁶ The 2020 Code now reads like an ESG Code. Principle 4 thereof not only recognizes climate change as a systemic risk that investor signatories need to take into account, but also requests the signatories to respond to such a systemic risk and explain how they have worked with other stakeholders in the promotion of well-functioning markets. This context is consistent with the announcement by the U.S. Business Roundtable in 2019 about the true purpose of the corporation.

iv. Commitment to or Tiering in Stewardship

In the U.K., the FRC categorized signatories to the Stewardship Code into three tiers in accordance with the quality of the reporting in their statements based on the seven principles of the Code and the supporting guidance. At the end of 2016, the Stewardship Code had approximately 300 signatories.³⁶⁷ There are more than 120 in Tier 1, which increased from approximately 40 at the beginning of the exercise.³⁶⁸ The tiering exercise aimed to “improve the quality of reporting against the Code, encourage greater transparency in the market and maintain the credibility of the Code.”³⁶⁹ The tiering of signatories

³⁶² *Id.* at 206.

³⁶³ *Id.* at 211.

³⁶⁴ See Client Memorandum: SEC Studying Change of Regulation S-K to Require ESG Disclosures, William Thomas & Annise Maguire, to the clients of Willkie Farr & Gallagher LLP (Nov. 7, 2016), <https://perma.cc/53RA-7CHR> (summarizing ESG disclosure matters).

³⁶⁵ See Virginia Harper Ho, *Nonfinancial Risk Disclosure and the Costs of Private Ordering*, 55 AM. BUS. L.J. 407, 419 (2018) (arguing the material impact by ESG factors on financial performance can motivate investor demand for better ESG information and for information on material ESG risks).

³⁶⁶ UK Stewardship Code (2020), *supra* note 188, at 4.

³⁶⁷ *Tiering of Signatories to the Stewardship Code*, FIN. REPORTING COUNCIL (Nov. 14, 2016), <https://www.frc.org.uk/news/november-2016/tiering-of-signatories-to-the-stewardship-code>.

³⁶⁸ *Id.*

³⁶⁹ *Tiering of 2012 Stewardship Code Signatories*, FIN. REPORTING COUNCIL, <https://www.frc.org.uk/investors/uk-stewardship-code/uk-stewardship-code-statements> (last visited Mar. 3, 2021).

evidently resulted in a significant improvement in the quality of reporting under the Code. A category of each Tier is as follows:³⁷⁰

Tier 1 - Signatories provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary.

Tier 2 - Signatories meet many of the reporting expectations but report less transparently regarding their approach to stewardship or do not provide explanations when they depart from the provisions of the Code.

Tier 3 - Significant reporting improvements need to be made to ensure that the approach is more transparent. Signatories have not engaged with the process of improving their statements and their statements continue to be generic and provide no, or poor, explanations when they depart from provisions of the Code.

The assessment published in November 2016 establishes enhanced reporting against the Code and more transparency in the U.K. market.³⁷¹ According to such assessment, asset managers who have not achieved at least Tier 2 status (i.e., those are in Tier 3) after six months will be removed from the list of signatories unless they improve their reporting because their reporting does not satisfy their commitment to the objectives of the Code. In November 2016, 40 asset managers were categorized as Tier 3. The FRC consulted with Tier 3 signatories, approximately 20 of which improved their statements to Tier 1 or Tier 2 standard, whereas the other half chose to remove themselves from the list of signatories. In this way, Tier 3 category has now been removed.³⁷²

In contrast, in Japan, no tiering system exists in the Stewardship Code, that is, the quality of the reporting is not critical in Japan. The Financial Services Agency publishes a list of institutional investors who have "accepted" the Code.³⁷³ In addition to the elements previously disclosed to institutional investors classified as life insurance/non-life insurance companies, such as trust banks, investment trusts/investment advisory companies, and others, in the list of institutional investors that have accepted the Stewardship Code, new elements, such as announcement of whether or not to disclose the results of exercising voting rights and the reason for such voting and whether or not to disclose stewardship activity reports, and address of websites that disclose

³⁷⁰ *Tiering of Signatories to the Stewardship Code*, *supra* note 367.

³⁷¹ *See id.*

³⁷² *See* FIN. REPORTING COUNCIL, FRC Removes Tier 3 Categorisation for Stewardship Code Signatories (Aug. 3, 2017), <https://www.frc.org.uk/news/august-2017/frc-removes-tier-3-categorisation-for-stewardship>.

³⁷³ Stewardship Code: 293 institutional investors have signed up to the Principles for Responsible Institutional Investors as of December 31, 2020, FIN. SERVICES AGENCY <https://www.fsa.go.jp/en/refer/councils/stewardship/20160315.html> (last visited Mar. 11, 2021).

said if decided to be disclosed.³⁷⁴ Additionally, the GPIF have accepted the Stewardship Code as an asset owner, and requires asset managers for equity investments to comply with its “Stewardship Principles” and “Proxy Voting Principles.”

v. Implication for Corporate Governance Theory

As argued above, stewardship responsibilities refer to the responsibilities of institutional investors to enhance the medium to long-term investment return for their clients and beneficiaries by improving and strengthening the corporate value as well as sustainable growth of the investee companies through constructive engagement. To achieve the latter, improvement of the investee company’s corporate governance is crucial.

At a glance, shareholder empowerment could contribute more on corporate governance; in reality, boards of directors enjoy significant authority while shareholder control is tightly curtailed.³⁷⁵ This argument is based on the fact that centralized management under the direction of a board of directors has a cost advantage over shareholders’ decision making because corporate decisions are complex, and a relatively small group of people with good information, capabilities, and incentives to manage the firm can be more qualified and efficient to make such complex decisions, whereas direct control by firms’ owners is usually only workable in relatively small enterprises.³⁷⁶

Moreover, as some commentators pointed out, the interests of different groups of shareholders may strongly diverge, which is likely to create friction and prevent decision making in corporations.³⁷⁷ A varied type of shareholder exists in the market, including large investors or individual shareholders, controlling shareholders or minority ones, preferred or common stock shareholders with short or long-term views, and so on. It is often said that short and long-term shareholders have strongly different goals. If short and long-term shareholders have different interests in corporate decisions, every shareholder has a potential conflict with every other shareholder with a different investment horizon. If and when capital markets are not perfectly efficient and do not accurately reflect long-term firm values, some shareholders may be attracted to seek short-term profits by making decisions that are contrary to the firm’s long-term interests, thus undermining the firm’s

³⁷⁴ See *Finalization of Japan’s Stewardship Code (Second revised version)*, FIN. SERVICES AGENCY (Mar. 24, 2020), <https://www.fsa.go.jp/en/refer/councils/stewardship/20200324.html>.

³⁷⁵ See DEL. CODE ANN. tit. 8, § 141(a) (2018) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors....”).

³⁷⁶ See Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 491–92 (1999) (indicating that boards can be characterized as large, elite, and episodic decision-making groups which face complex tasks on strategic issues).

³⁷⁷ Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577–93 (2006) (arguing Short-term versus Long-term Shareholders and so on); see also Robert Anderson IV, *The Long and Short of Corporate Governance*, 23 GEO. MASON L. REV. 19, 48 (2015).

sustainable growth.³⁷⁸ As a result, the excessive weight on short-term market value has been criticized as nurturing managers who would not pursue long-term firm growth.³⁷⁹ Therefore, some commentators have argued that shareholders have good reasons to bind their hands and leave it to a small group of experts who possess superior information, good capabilities, and the incentives to avoid the mutual holdup of decision-making and produce better results than disputing among potentially diversified shareholders.³⁸⁰ As such, shareholder primacy theory has its own limits. Regarding corporate governance, the team production theory and director primacy theory, as existing models, are extremely useful for mediating the conflict of interests among a variety of shareholders previously indicated and a variety of stakeholders, including ESG concepts. After such an argument, I will refer to my opinion on corporate governance theory.

The board of directors arguably serves as the ultimate authority in assigning responsibilities, mediating disputes, and distributing profits; however, Blair and Stout do not claim that the goal of the corporation should be shareholder wealth maximization.³⁸¹ According to their claim, directors are not mere agents because "they are not subject to direct control or supervision by *anyone*," including the shareholders, and are also a unique form of fiduciary that most closely resembles trustees.³⁸² Firm-specific investments are essential for the creation of value in the firm. Therefore, it seems appropriate and necessary that team members making firm-specific investments will delegate exclusive authority to the board of directors as a mediating hierarch to organize the firm's inputs, distribute its outputs, and resolve interest conflicts among them.³⁸³ The board of directors are not a team member and must make any decisions independent of any of the team members,³⁸⁴ which implies that the board has no expectation of sharing in the firm value that the team has created. Given the fact that the team members have made firm-specific investments, the board serves similarly to a trustee³⁸⁵ ("trusted

³⁷⁸ Anabtawi, *supra* note 377, at 579–83.

³⁷⁹ Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1283 (1992).

³⁸⁰ *E.g.*, John Armour et al., *What Is Corporate Law?*, in THE ANATOMY OF CORPORATE LAW 1, 13 (Reinier Kraakman et al. eds., 2d ed. 2009); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 792–93 (2007).

³⁸¹ Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 251 (1999) [hereinafter *A Team Production Theory of Corporate Law*]. With respect to recent remarkable articles concerning application of the team production theory to a private company and startup governance, i.e., rather than public companies, see Elizabeth Pollman, *Team Production Theory and Private Company Boards*, 38 SEATTLE U. L. REV. 619 (2015); Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155 (2019).

³⁸² *A Team Production Theory of Corporate Law*, *supra* note 381, at 290–91 (emphasis omitted).

³⁸³ Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403, 421 (2001).

³⁸⁴ *Id.* ("[I]t is essential that the hierarch remain free from the command and control of any of the team members.").

³⁸⁵ *A Team Production Theory of Corporate Law*, *supra* note 381, at 291.

mediator")³⁸⁶ or fiduciary³⁸⁷ for the entire firm, but it remains insulated from any direct team member control. As "mediating hierarchs" standing among the stakeholders, including shareholders, directors assume the task of balancing conflicting interests among them and, if necessary, rearranging production factors.³⁸⁸ As such, Blair and Stout interpreted the board's duty to serve the interests of the corporation as a whole, not solely the shareholders' interests, through an aggregate welfare function.³⁸⁹

Proponents of the director primacy model argue that the boards must be mostly free of shareholder interference to serve shareholder interests.³⁹⁰ Bainbridge argues that shareholders alone, as opposed to other stakeholders, "are the appropriate beneficiaries of director fiduciary duties."³⁹¹ According to the director primacy model, directors are ultimately responsible for shareholder wealth maximization, rather than promoting stakeholder interests,³⁹² and the interests of shareholders should prevail over those of other constituencies.³⁹³ In addition, directors (rather than managers, shareholders, and stakeholders) are responsible for the overall control of the firm.³⁹⁴ He argues that the powers of the board of directors are original and undelegated, and neither shareholders nor courts should weaken the board's decision-making authority.³⁹⁵ Bainbridge also describes a core tension existing between the board's authority and the responsible exercise of such authority; shareholder voting rights are one of the significant mechanisms that hold directors accountable.³⁹⁶ An increase in shareholders' right to review board decisions might weaken the core of corporate governance, and shifting the decision-making power to shareholders is undesirable in itself in accordance with the theories of the director primacy model.³⁹⁷

I previously proposed that any corporate governance reform must focus primarily on promoting the long-term welfare of the corporation, balancing

³⁸⁶ *Director Accountability and the Mediating Role of the Corporate Board*, *supra* note 383, at 408.

³⁸⁷ *A Team Production Theory of Corporate Law*, *supra* note 381, at 291.

³⁸⁸ *Director Accountability and the Mediating Role of the Corporate Board*, *supra* note 383, at 421.

³⁸⁹ *A Team Production Theory of Corporate Law*, *supra* note 381, at 288–89.

³⁹⁰ See Peter C. Kostant, *Team Production and the Progressive Corporate Law Agenda*, 35 U.C. DAVIS L. REV. 667, 693–94 (2002).

³⁹¹ Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003).

³⁹² *Id.* at 572.

³⁹³ *Id.* at 577–85.

³⁹⁴ *Id.* at 550.

³⁹⁵ STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 11–12 (2008).

³⁹⁶ Bainbridge, *supra* note 391, at 555–60.

³⁹⁷ *Id.* at 557–59.

constituencies' interests, and ensuring accountability (or transparency).³⁹⁸ In light of this goal, I have examined a proposal for corporate governance reforms—the "enlightened shareholder value" (ESV) approach—which is currently accepted in the U.K. The core of the ESV approach is embodied in Section 172 of the U.K. Companies Act 2006. This Act attempts to reconcile shareholder wealth maximization with other long-term and stakeholder concerns.³⁹⁹ This legal duty requires directors to promote the long-term success of the corporation for the benefit of shareholders *as a whole*; however, in doing so, directors *must* consider the list of stakeholder interests described in Section 172(1) of the Companies Act.⁴⁰⁰ The "enlightened shareholder" is the yardstick for a hypothetical shareholder interested in the long-term well-being and performance of the corporation and its social and environmental impact,⁴⁰¹ referred to as the ESV approach⁴⁰² of corporate governance. The Company Law Review (CLR), which worked on the Companies Act, accepted the concept of the ESV as a fundamental principle in corporate governance.⁴⁰³ The ESV approach is analogous to the director primacy model in the light of a director being an agent (agency theory), and to the team production theory in the light of a director serving the entire firm value, that is a servant not for shareholder interest but for aggregate welfare. However, directors should still be responsible for the overall control of the corporation subject to the ESV approach. According to some commentators, in light of key differences between the dominant institutional investors in the U.K. (i.e., pension funds) and the United States (i.e., mutual funds), as well as the two countries' regulatory environments, it is less likely in the United States to achieve stakeholder-oriented corporate reform.⁴⁰⁴ However, I do not believe that these differences are crucial to introducing the ESV approach to the United States.⁴⁰⁵ Actually, the Roundtable Statement of August 2019 is nearly consistent with the ESV approach.

³⁹⁸ See Akio Otsuka, *Reforms of Corporate Governance: Competing Models and Emerging Trends in the United Kingdom and the European Union*, 14 S.C. J. INT'L. L. & BUS. 71 (2017).

³⁹⁹ See also Paul L. Davies, Cassel Professor of Commercial Law, London School of Economics and Political Science, W.E. Hearn Lecture at the University of Melbourne Law School: Enlightened Shareholder Value and the New Responsibilities of Directors (Oct. 4, 2005).

⁴⁰⁰ See Companies Act 2006, c. 46, § 172 (UK).

⁴⁰¹ See Andrew Keay, *Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little?*, 22 EUR. BUS. L. REV. 1, 40 (2011).

⁴⁰² See *id.*; Daniel Attenborough, *The Company Law Reform Bill: An Analysis of Directors' Duties and the Objective of the Company*, 27 CO. LAW. 162, 165 (2006).

⁴⁰³ See Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach'*, 29 SYDNEY L. REV. 577, 579 (2007).

⁴⁰⁴ Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 IOWA J. CORP. L. 59, 79–80 (2010).

⁴⁰⁵ Otsuka, *supra* note 398, at 101.

VII. CONCLUSION

The increase of passive investing has been associated with a growth of responsible investing, as shown by the increasing number of signatories to the Principles for Responsible Investment (PRI).⁴⁰⁶ Prominent passive index fund managers frequently assert their commitment to actively engaging with investee companies to take responsibility for their impact on society to "benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."⁴⁰⁷ Good corporate governance and effective stewardship can add long-term value for all shareholders. Different paradigms exist concerning corporate governance. One is that shareholders' participatory rights in corporate governance should be limited, and the other is that shareholder participation should be actively encouraged. When the number of institutional investors was on the rise, in terms of the solution for corporate governance, institutional investors have been viewed as a central accountability mechanism and essential to long-term sustainable corporate growth. Specifically, as Gilson and Gordon argued, institutional ownership by traditional "reticent" institutions is insufficient to overcome agency problems in portfolio companies. As such, activist investors who specialize in monitoring management and proposing policies and governance reforms to other institutional investors have been expected to play a substantial role.⁴⁰⁸ The recent proliferation of stewardship codes reflects the latter paradigm that, for example, reflects the 2017 ISG stewardship principles. ISG is a significant step forward in the evolution of corporate governance and investors' role therein in the United States and the development of the policy and practice of stewardship. Considering various engagement with institutional investors, however, the board of directors of the investee company should make decisions based on the ESV approach. Moreover, individual voluntary programs exist concerning corporate governance and stewardship proposed by institutional investors. In April of 2019, Vanguard announced the Investment Stewardship Commentary which is one such struggle.⁴⁰⁹ In it, Vanguard defined that the way a board governs a company should be aligned to create sustainable value long into the future. From the viewpoint that Vanguard is an ultimate long-term investor, it stated that good governance and effective stewardship can add long term value for all shareholders.

Stewardship is more challenging because of regulatory issues, cultural differences, and ownership structures such as cross-shareholdings. ESG investments will be extended globally, but local governance norms can differ widely. The establishment of a stewardship culture does not happen overnight and requires years of continuous, active investor-led engagement in the region.

⁴⁰⁶ See Bioy et al., *supra* note 15, at 9–10.

⁴⁰⁷ Fink, *supra* note 358.

⁴⁰⁸ Gilson & Gordon, *supra* note 51, at 896–902.

⁴⁰⁹ GLENN BOORAEM, *WHAT WE DO. HOW WE DO IT. WHY IT MATTERS: VANGUARD, INVESTMENT STEWARDSHIP COMMENTARY* (2019), https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/what_how_why.pdf.

Without any critical events, such as financial statement fraud or a financial crisis, regulators in the United States would not enact a corporate governance code, a stewardship code, or similar. To avoid any global crisis, long-term investments, namely, sustainable investments should be studied, defined, and advocated extensively and spontaneously among investors, asset owners, and asset managers. Accordingly, the notion of the fiduciary duty will extend to include the long-term returns for their clients, namely the long-term success of the investee companies.