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The Unfinished Business of Japan's Stewardship Code

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The Unfinished Business of Japan's Stewardship Code

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Abstract

Japan's Corporate Governance and Stewardship Codes are potentially the most powerful of the initiatives constituting Prime Minister Abe's "third arrow" of his "Three Arrows" vision for revitalization of Japan's economy. The 2014 Stewardship Code seeks to hold institutional investors responsible for enforcing the new requirements for transparency and management oversight which are now required by the Corporate Governance Code and related legislation, such as the amendments to the Company Act. There has been a great deal of change in corporate organization and board structure in response to the Corporate Governance code---a great deal of it perfunctory and without strategy. On the stewardship side, even this level of progress has been slow by comparison. Impediments to more active engagement by investors with their investee companies include a persistent level of silent ownership of the market and conflicts of interest inherent in the financial conglomerates which dominate the Japanese market. While the Financial Services Agency has taken steps to address these issues, the legal and regulatory environment discourages institutional investors to act in concert with others to advance an agenda, and leaves investors open to legal risk of insider trading. The UK has developed a framework to encourage collective action by investors, while Japan and the United States have yet to do so.

* Disclaimer: The views and opinions expressed in this article are those of the authors and do not necessarily reflect the official policy or position of any institution with which they are affiliated.

Introduction

In December 2012, when Shinzo Abe was elected as prime minister for the second time, he presented his policies for economic revitalization, characterizing them as “Three Arrows”: easy monetary policy, responsible fiscal policy, and fundamental structural reform of the economy. Among the list of structural reforms, none is more powerful than the Corporate Governance Code and the Stewardship Code.

Japanese companies have long been less profitable than their global peers; they have lost global market share, and they have chosen to accumulate huge cash balances rather than invest in their businesses, indicating an attitude which favors the status quo rather than taking risk to spur innovation. They have been very resistant to transparency with outsiders (particularly shareholders) which has given rise to some recent examples of corporate malfeasance, such as Mitsubishi Motors, FujiFilm, Takata Corporation, and Toshiba Corporation. A large percentage of publicly-listed Japanese companies still trades at less than book value, indicative of investors’ assumption that management is not capable of creating new growth. These are the circumstances that the new codes strive to address, and the prime minister’s approach is a very ambitious attempt to encourage Japanese companies to be more innovative, more flexible and more accountable to shareholders for efficient use of their capital.

The Corporate Governance code outlines “a structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders and also [sic] customers, employees and local communities.”¹ The Stewardship Code imposes a responsibility on institutional investors to hold management of Japanese companies to the standards outlined in the governance code.

This paper attempts to make the case that for Japanese markets to become attractive and active again, more progress must be made on conformity to the spirit as well as the letter of the Corporate Governance Code, particularly relating to the continued existence of cross-shareholdings and other forms of passive ownership of shares. The main mechanism for progress in this goal is through investors’ embrace of the role outlined for them in the Stewardship Code. In the context of the persistence of significant blocks of “silent” shareholders, facilitating collective action² among investors is especially critical. Secondly, policymakers have been too cautious in granting the powers to investors necessary to promote activity to strengthen the new standards of corporate governance. Without resolving regulatory ambiguity which now pose obstacles to effective stewardship, there is little hope of improvement in the governance of Japanese firms.

¹ Financial Services Agency, “Japan’s Corporate Governance Code” (<http://www.fsa.go.jp/en/refer/councils/corporategovernance/20150306-1/01.pdf>)

² “Collective action” or “collective engagement” refers to two or more investors engaging in joint discussion about their investee companies, or in jointly exercising their rights as shareholders. Such cooperation is generally intended to advance an agenda for improvement in the investee company’s business strategy or governance.

The Historical Context of the Stewardship Code

...in December 2012), the government established the Headquarters for Japan's Economic Revitalization within the cabinet to formulate necessary economic policy measures and growth strategies....the Prime Minister instructed the Minister for Financial Services to coordinate with other relevant ministers and consider, with the aim of promoting the sustainable growth of companies, principles for a wide range of institutional investors to appropriately discharge their stewardship responsibilities.... The Cabinet approved in June 2013 the Japan Revitalization Strategy, which defines the growth strategy, or "the third arrow" of the economic policy of the current administration..... Implementing the instruction by the Prime Minister and the Strategy, the Financial Services Agency established the Council of Experts Concerning the Japanese Version of the Stewardship Code (hereafter, the "Council") in August 2013. The Council met six times since August, and it has now produced <<Japan's Stewardship Code>> (hereafter, the "Code")³...

The Stewardship Code was written by a committee designated by the Financial Services Agency (FSA)⁴, consisting of 18 academics and industry participants "experts". The panel of experts took six months to craft the Japanese Stewardship Code, largely based on the Stewardship Code of the U.K. The U.K. Financial Reporting Council (FRC) implemented its stewardship Code in 2010 after a series of earlier versions dating back to 2002. The FRC regularly revises its code, and the FSA committee of experts decided to model Japan's Stewardship Code almost entirely upon the British version extant at the time (2012). A comparison of the two (see Table 1) shows how closely the Japanese experts followed the lead of the U.K. There is only one substantial difference: Principle 5 in the U.K. version actively champions "collective activity"⁵ among investors. This has been replaced by Principle 7 in the case of Japan, which simply instructs investors to "have in depth knowledge of the investee companies" so that they may "make proper judgments in fulfilling their stewardship activities".⁶

³ Financial Services agency, "Principles for Responsible Institutional Investors", <http://www.fsa.go.jp/en/refer/councils/stewardship/20140407/01.pdf>

⁴ The Financial Services Agency is the Japanese government entity responsible for overseeing banking, insurance and securities and exchange.

⁵ The UK regulators accept that Institutional investors' ownership of large companies has become so fragmented that the ability of any given investor to make a board listen to its concerns and questions is now very limited. The financial crisis of 2008 raised concerns in the U.K. that investors had not done a good job in holding management of banks to account for their actions. The UK investor community reacted by giving evidence of the high costs associated with compliance requirements required of individual firms, and the tendency of a company to play investors off against each other. The UK response was to develop a framework (The Investor Forum) through which cost-sharing and group discussion of investor agendas could be facilitated, without triggering regulatory requirements that might otherwise apply.

⁶ Financial Services Agency, "Japan's Corporate Governance Code" (<http://www.fsa.go.jp/en/refer/councils/corporategovernance/20150306-1/01.pdf>)

This is a critical difference. The circumstances in the U.K. which led to recognizing the need for shareholder collective action, i.e., the inability of any single investor to have an influence on corporate governance, are only more compelling in Japan. This has partly to do with tradition---the distaste for confrontation and criticism---but it has just as much to do with the structural reality of the dominance of passive shareholders in Japan. In spite of the progress made in the unwinding of cross-shareholdings of Japanese banks, there has 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. Without specification of clear rules under which investors can jointly discuss their concerns about the management of any company in which they invest, the Stewardship Code lacks an effectiveness, and ultimately the Prime Minister’s goals for the Corporate Governance Code will not be realized.⁷

⁷ "The [Japan Stewardship] Code does not adopt the principle that encourages institutional investors to act collectively with other investors towards the individual investee companies as in the UK Stewardship Code. Of note, the Japanese Version of the Stewardship Code does refer to the benefit of exchanging views with other investors as a means for conducting better engagement with investee companies (Guidance 7-3, Principle 7)" the Stewardship Code <http://www.fsa.go.jp/en/refer/councils/stewardship/01.pdf>. This appears to be somewhat of a contradiction. In a recent opinion piece, the FSA’s council of experts indicated that “Dialogue between a company and multiple investors in collaboration (collective engagement) should be included in the Code as one option for engagement with companies”. One assumes that this is a goal for the future, but at present, as elaborated above, regulations discourage such activity. <http://www.fsa.go.jp/en/refer/councils/stewardship/material/20170322-01.pdf> (Principles for Responsible institutional investors)

Table 1. Comparison: UK Stewardship Code vs. Japan's Stewardship Code	
UK Code (Sept.2012)	Japan Code (Feb. 2014)
Principle 1	Principle 1
Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities	Institutional investors should have a clear policy on how they fulfil their stewardship responsibilities, and publicly disclose it
Principle 2	Principle 2
Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed	Institutional investors should have a clear policy on how they manage conflicts of interest in fulfilling their stewardship responsibilities and publicly disclose it
Principle 3	Principle 3
Institutional investors should monitor their investee companies	Institutional investors should monitor investee companies so that they can appropriately fulfill their stewardship responsibilities with an orientation towards the sustainable growth of the companies
Principle 4	Principle 4
Institutional investors should establish clear guidelines on when and how they will escalate their stewardship activities	Institutional investors should seek to arrive at an understanding in common with investee companies and work to solve problems through constructive engagement with investee companies.
Principle 5	Principle 5
Institutional investors should be willing to act collectively with other investors where appropriate	Institutional investors should have a clear policy on voting and disclosure of voting activity. The policy on voting should not be comprised only of a mechanical checklist; it should be designed to contribute to the sustainable growth of investee companies.
Principle 6	Principle 6

Institutional investors should have a clear policy on voting and disclosure of voting activity.	Institutional investors in principle should report periodically on how they fulfill their stewardship responsibilities, to their clients and beneficiaries.
Principle 7	Principle 7
Institutional investors should report periodically on their stewardship and voting activities	To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities.

Why the antagonism to Collective Engagement?

Despite discussing the formulation of the stewardship code for six months, the committee of experts were unable to come to any clear statement about collective engagement. By neither clearly allowing or disallowing this principle, they seem to have sidestepped the responsibility to equip the Stewardship Code with any real powers to be effective.

The squeamishness of the committee on this issue likely stems from the incidents of 2004 involving the Murakami Fund. Yoshiaki Murakami, a former METI official and founder and CEO of an asset management firm, was arrested and indicted for insider trading when his firm was found to be “in agreement”⁸ with a second fund, Livedoor, to acquire shares of a media company, Nippon Broadcasting. The case went as far as the Supreme Court, where Murakami was found guilty. Murakami himself, at the time, pointed out that the law failed to clearly define the line between insider trading and collective engagement---in this case, acting in concert with other investors whose ostensible goal was to improve the management of the target company, Nippon Broadcasting.

The incident gave rise to much anxiety among investors about the lack of clarity around the FSA’s definition of insider trading, which does not allow for the possibility that investors might act jointly, not for illegally taking advantage of non-public information, but for the purposes of enforcing better corporate governance. As a result, on one side of the controversy, investors became overly cautious about any discussions with others regarding strategies to improve profitability of companies in which they were mutual investors, for fear of being tagged with accusations of insider trading. On the other side, management teams at Japanese firms worried

⁸ The standard the FSA uses to find investors to be “in agreement” seems rather sweeping and rather difficult to predict clearly: “a mutual or unilateral promise to act in future (written or verbal and explicit or implied)”.

about their vulnerability to becoming targets of such activity, and lobbied regulators to prevent any clarification of law that would facilitate similar attacks on their independence by shareholders.

Even the judge hearing the case against Murakami raised the issue of the ambiguity of the law. “There is no doubt that the defendant is to be blamed for this particular case, where he manipulated the stock market, and it was both an act of betrayal for those involved and one condemned by society. However, there is still a lack of thorough discussion in our financial culture about how to evaluate the other aspect of the defendant — that is to press companies, as a shareholder, to reform their business,” presiding Judge Hiroshi Kadono said when deciding to suspend Murakami’s three-year jail sentence⁹.

Murakami has since re-emerged as an investor through two new funds, C&I and Minami Aoyama Fudosan. In his new re-incarnation, Murakami has behaved in the same way that any overseas activist fund might—he has acquired substantial stakes in companies he views as underperforming, and has lobbied for a position on the board of directors. In the case of one company in which several Murakami-linked funds have been investors, Kuroda electric, Murakami began to lobby for the power to elect at least one independent director. In June 2017, he was finally successful. For the first time in eight years, the proposal by a Murakami-linked fund to place an independent director of its choosing on the board was accepted by a majority vote of the shareholders.¹⁰

Legal hurdles to active stewardship: 1) Triggering the requirements of the “Report of Possession of Large Volume”

There are several regulations which interfere with the active oversight by investors of investee companies, all of which relate to the potential to prompt requirements specified in the “Report of the Possession of Large Volume” (hereafter referred to as “the Report”).¹¹ The Report

⁹ Japan Times, “Murakami’s sentence Suspended”, Feb. 4, 2009

¹⁰ Nikkei Asian Review, June 29, 1027, “Activist Investor’s Plea Brings Rare Board Change in Japan”

¹¹ This statute is somewhat similar to Section 13D of the US Securities act of 1934, which requires disclosure filings “When a person or group of persons acquires beneficial ownership of more than 5% of a voting class of a company’s equity securities” (<https://www.sec.gov/fast-answers/answerssched13htm.html>). An interesting difference between the US and Japan arises from the composition of the market players. Pension funds—both in Japan and in the US—are among the most eager to use collective engagement as a means by which to promote their agendas of long-term corporate sustainability. Because of the extreme degree of fragmentation of the US market, even the largest US pensions funds rarely own even 1% of the shares of a given firm; even a small group of funds acting in concert would probably not breach the 5% ownership level which prompts reporting requirements. For example, 3 of the US’ largest pension funds—New York City, New York State, and California State Teachers’ Retirement System—are now jointly challenging the executive pay packages at the pharmaceutical company Mylan. The three funds jointly own less than 1% of the firm’s shares. By contrast, because of the market dominance of the largest pension funds in Japan, any cooperation with another pension fund would likely automatically trigger reporting requirements. For example, the

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% (either by increasing or decreasing its ownership) within five days. This represents an onerous burden on large-scale shareholders who are active traders. Compliance costs and administrative burdens would clearly be onerous enough to interfere with the vitality and liquidity of the market. In recognition of this problem, the FSA carved out an exemption for such investors, and requires them only to report changes of ownership on a regular bi-monthly basis.

However, the FSA also describes various circumstances which would nullify this exemption, and would subject the investor to the reporting requirements outlined in the “Report”. Unfortunately, these circumstances specified by the FSA would apply to a great deal of activity that would otherwise define the essentials of responsible stewardship. By implicitly threatening to impose the onerous reporting requirement on them, the FSA is hindering the very responsibilities that the Stewardship Code seeks to encourage. At the same time, the FSA says it will decide whether investors have subjected themselves to reporting requirements on a case-by-case basis. It can on the one hand, hold investors to the standard of stewardship while on the other, expose them to legal liability by declining to define specific rules.

The first way in which an investor might be stripped of the exemptions from filings specified under the “Report” is in the concept of “Act of Making Important Suggestions”¹². This designation arises when the investor in question has had an interaction with a company which can be construed as giving advice or opinions to a company which might result in “material changes or materially influence the issuer’s business activities at the general shareholders meeting...”. When pressed by investors for clarification, the FSA responded with the following list of topics that it might (but might not) define as “Important Suggestions”¹³:

1. Disposal of and acceptance of assignment of important assets
2. Borrowing in a significant amount
3. Appointment or dismissal of Representative Directors
4. Material changes to the composition of corporate directors
5. Appointment or dismissal of managers or other important employees
6. Establishment, change, or abolition of branches or other important organizations
7. Share exchange, share transfer, company split or merger
8. Assignment, acceptance of assignment, suspension or abolishment of all or part of business
9. Material changes to the company’s dividend policy
10. Listing or delisting

Government Pension Investment Fund is estimated by Bloomberg to be the top owner in more than 100 listed firms.

¹² Financial Services Agency, “Clarification of Legal Issues Related to the Development of Japan’s Stewardship Code”, Feb 26, 2014

¹³ Financial Services Agency, Ibid.

11. Material changes to the company's capital strategy
12. Dissolution
13. Declaration to commence bankruptcy proceedings, rehabilitation proceedings, or reorganization proceedings

But the very point of the Stewardship code is to motivate investors to actively encourage their investee companies to consider recommendations that would enhance their performance. This is particularly true of large domestic pension funds who have especially strong voting rights and whose motives are clearly not short-term profit-taking. The FSA list covers many topics that any reasonable investor would want to discuss with the management of a company in which she/he is investing. To be sure, the FSA is not forbidding such conversations to take place; it is only imposing very burdensome reporting requirements on any large-scale investor who has such interactions. This contradicts the most fundamental aim of the Stewardship Code, which requires investors to actively engage in dialogue with their investee companies, by making it practically difficult for them to do so. The fact that the FSA states "the matter will ultimately be judged on a case-by-case basis" only serves to heighten investors' anxiety that performing the fiduciary duties that the Stewardship Code requires of them may create legal liability.

Legal hurdles to effective stewardship: 2) the issue of "Joint Holder" discourages collective engagement

Another circumstance that can trigger compliance with the Report lies with the FSA's definition of "joint holder". A "joint holder" is one who agrees "to jointly exercise voting rights and other shareholder rights"¹⁴ with another. Once there is an agreement on the way votes should be cast, or to jointly exercise any other shareholder rights, the shareholder "is required to calculate its shareholding ratio [in an investee company] by including the shareholding"¹⁵ of the joint holder. For example, if two or more investors wanted to oppose Toshiba's purchase of Westinghouse (some of whom voiced such opinions to the press before the acquisition¹⁶) and had reached an agreement to approach the firm jointly, had agreed to vote as a block, or had exercised any other shareholder rights as a group, they would very likely become subject to the reporting requirements specified in the Report. Obviously, in this case, making it easier rather than more difficult for them to do so might have resulted in Toshiba taking a different approach.

In the UK and elsewhere, investors have chosen to vote together in favor of issues they feel are key to the long-term sustainability and/or profitability of their investee companies. As indicated in Table 1, the UK Stewardship Code, upon which the Japanese Code is closely modelled, specifically invites collective action and joint debates among investors (Article 5). The UK FSA has clearly stated that collective voting and debate among groups of investors, so long as it is

¹⁴ Financial Services Agency, "Clarification of Legal Issues related to the Development of the Stewardship Code" <http://www.fsa.go.jp/en/refer/councils/stewardship/20140226.pdf>

¹⁵ Financial Services Agency, Ibid.

¹⁶ Financial Times, "Toshiba Nuclear Debacle Puts Governance in Spotlight", March 27, 2017

for the purposes of promotion of good corporate governance, is exempt from any rules regarding insider trading, takeover rules, and the like.¹⁷ By contrast, the Japan FSA has indicated that even in the case of investors having discussions amongst themselves about exercise of voting rights, they will be subject to the rules around “joint holdings”, which may trigger requirement to submit filings as specific by the Report.

The obfuscation is carried one step further. In responding to a question raised by investors during the FSA’s request for public comments, the FSA makes a rather confusing distinction between a “discussion” and an “agreement”:

(Q) Will the concept of Joint Holder apply if shareholders discuss the exercise of voting rights at the general shareholders meeting?

(A) As far as it is a discussion, the Joint Holder concept will not apply. However, if an agreement is reached to exercise voting rights jointly as a result of such discussion, the concept will apply.¹⁸

Conclusion: An Agenda for further reform

The Corporate Governance Code and the Stewardship Code are very powerful and ambitious tools for improving the profitability and the dynamism of Japan’s private sector. The Prime Minister and the authors of the codes deserve credit for endorsing changes to behaviors which are so ingrained and so often identified as core values of the society. Among these new standards would be the value of merit over seniority, of diversity of ideas and of people over uniformity, and of openness to radical change rather than embrace of the status quo. Finally, these new Codes challenge the current model which is based upon a narrow definition of stakeholders: customers, employees, and suppliers. However, there are areas in which the Codes need further strengthening and elaboration if they are to be effective.

Possibly the most potent improvement would be in beneficial reform would be a new approach to the rules concerning “Making Important Suggestions”. Filings to report changes in ownership as required under the Report seem to represent onerous compliance costs for large-scale investors. Realizing that such costs could interfere with smooth functioning of the market, the FSA has granted an exemption to large-scale investors. However, this exemption could be revoked if an investor has discussions with the investee company on any one of a wide range of topics. The list includes many issues which responsible fiduciaries should be discussing with their investee companies. Ambiguity about what specific topics might trigger reporting requirements serves as a deterrent to dialogue between investors and corporate management.

¹⁷ UK FSA: “However, it is not intended that the phrase ‘acting in concert’ – either in the Directive, FSMA or the Level 3 guidance - should capture ad hoc discussions and understandings in good faith solely aimed at exerting influence intended to promote generally accepted principles of good corporate governance. The FSA will apply this approach to changes in control. “

¹⁸ Financial Services Agency,” Clarification of Legal Principles Related to the Development of Japan’s Stewardship Code”, Feb. 2016

Some further clarification of permissible discussion topics and circumstances would clearly be helpful in encouraging engagement between investors and their investee companies. The UK approach embraces the general principle that when such discussions are undertaken to encourage better corporate governance, the usual reporting rules need not apply.

The second issue is that of the definition of “joint holder”. Under the current rules, investors are deemed to be “joint investors” if they engage in discussions which lead to voting jointly on shareholder proposals, exercising their right in concert to make proposals at the annual shareholders’ meeting, requesting access to an investee firm’s books and records, or cooperatively exercising any of their other rights as shareholders. Being defined as “joint holders” carries obligations not under the Report, but also under the rules relating to takeover bids and insider trading. The result is that the rules on “joint holders” make no distinction between collusion among investors for the purpose of share price manipulation, cooperation for the purpose of staging a hostile takeover, or collaboration for the improvement the governance and sustainability of their investee companies.

In fact, the issue of collective engagement in Japan is both especially important and especially difficult. It is important because of the continued preponderance of shares owned by investors who are unwilling or unable to actively engage with their investee companies. For example, one analysis indicates that over 36% of votes represented by TOPIX-listed companies are held by “friendly” shareholders, who are unlikely to vote against management.¹⁹ The Nikkei newspaper estimates that the Bank of Japan and the GPIF own more than 7% of the first section of the Tokyo Stock exchange²⁰. In this case, it would not be appropriate for BoJ itself to engage with private companies; in the case of GPIF, its role as an engaged investor may evolve in the future, but at present, its capabilities to exercise stewardship are limited by its enormous size and its small staff. If the Stewardship Code is to be effective at promoting good corporate governance, it must make it easier, not harder, for other investors who are eager to serve as responsible fiduciaries to collaborate in advancing their agendas.

There is one very good reason why the FSA may be slow to embrace the concept of collective engagement. While the FSA seeks to promote better stewardship principles, at the same time, it is also working hard to eliminate conflicts of interest among investors. Due to the concentration of Japan’s financial industry, conflicts of interest often arise between the various business units under the same financial holding company, the institution’s own pension fund, and/or the end client of the group’s management division. One obvious conflict arises when the asset manager invests in a company which is a major borrower of the same group’s bank, or for which the group’s securities arm is the major underwriter. The FSA has recently issued a report which recognizes this: “...with respect to asset managers which belong to financial groups, although they may have in place measures to avoid conflicts of interest between their parent companies and their own clients and eliminate the influence of such conflicts, there are many

¹⁹ “Allegiant Shareholders in Japan”, Governance, July 16

²⁰ Nikkei Asian Review, “Japan’s Public Sector is Top Shareholder in a Quarter of Tokyo Stocks”, November 29, 2016

cases where such measures are not necessarily working well. ²¹ To move towards an environment where investors can actively engage in group discussions and actions, the problem of conflicts of interests for asset managers must first be solved.

²¹ “Effective management of Stewardship Activities of Institutional Investors”, FSA Nov. 30, 2016. See also “Opinion Statement for the 10th Council of Experts Concerning the Follow-up of Japan’s Stewardship Code and Japan’s Corporate Governance Code”, Kengo Nishiyama, for a detailed discussion about the issue of conflicts of interest and asset managers. (FSA, November 8, 2016)