



**ICGN**

International Corporate Governance Network

The Council of Experts on the Stewardship Code

8<sup>th</sup> November 2019

Dear Fellow Council Members,

**ICGN Statement to the Council of Experts on the Stewardship Code (the “Council”)**

The International Corporate Governance Network (ICGN) welcomes the opportunity to present this letter to the Council relating to Opinion Statement No. 4, published by the Japan Financial Services Agency (FSA) on 24 April 2019, with ‘recommended directions for further promotion of corporate governance reform.’

Led by investors responsible for assets under management in excess of USD\$34 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries and includes companies, advisors and other stakeholders. ICGN’s mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies world-wide.

Much of our commentary draws from the ICGN Global Stewardship Principles (“ICGN Principles”), which originally derive from ICGN’s Statement on Institutional Investor Responsibilities published in 2003. The ICGN Principles are currently being reviewed with proposed amendments shown as underlined text in this letter. The amendments are subject to ICGN Member consultation until the 22<sup>nd</sup> November 2019 and thereafter ICGN Member approval in 9 June 2020 at the ICGN Annual General Meeting taking place in Toronto.

Our comments outlined in this letter address the recommendations noted in Opinion Statement No. 4 related to investor stewardship and other matters as requested for discussion at previous Council meeting as follows:

1. Disclosure of process and rationale for voting decisions
2. Disclosure of stewardship activities and outcomes
3. Proxy advisor operations, disclosure and company dialogue
4. Stewardship scope across all asset classes
5. Integration of ESG factors in stewardship activities

ICGN makes further suggestions for consideration as addressed in the ICGN Principles as relevant for the Japan Stewardship Code as follows:

6. Integrated approach to stewardship
7. Escalating engagement with investee companies

ICGN’s position regarding the corporate governance issues discussed by the Council, specifically regarding internal audit and the governance of subsidiaries, remains unchanged as described in our letter to the Council on 10<sup>th</sup> April (Annex 1).

## **1. Disclosure of process and rationale for voting decisions**

ICGN agrees that investors should be encouraged ‘to improve the disclosure of voting processes and the reasons for voting decisions’ as described in the FSA summary paper of Opinion Statement No.4. This recommendation is aligned with proposed amendments to Recommendation 5.1 – 5.4 of the ICGN Global Stewardship Principles as follows:

### **5.1 Voting policies**

Investors should publicly disclose clear voting policies which should be reviewed periodically. The voting policy should outline the principles guiding voting decisions, highlight scope for derogation in specific cases and make clear any differences in approach between domestic and international holdings. Where an investor chooses not to vote in specific circumstances, for example where holdings are below a certain threshold, this should be disclosed.

### **5.2 Voting process**

Investors should disclose how individual voting decisions are reached including how potential conflicts of interest are addressed and the process for undertaking due diligence. Disclosure should clarify who (the department) is responsible for the vote decision, including if this differs depending on the nature of the resolution, geography or scale of holdings.

### **5.3 Decision-making**

Investors should be prepared to abstain or vote against management resolutions if such resolutions are regarded as inconsistent with good corporate governance practices. In doing so, investors should seek to explain to companies the reasons underlying their voting decisions, preferably before the shareholders’ meeting. Investors should also clarify the circumstances in which physical attendance at shareholder meetings is appropriate.

### **5.4 Voting records**

Investors should regularly disclose their actual voting records (by individual resolution as well as by aggregate) publicly on their website as well as directly to clients ideally with limited delay from the date of the vote itself. Voting records should indicate whether resolutions were cast for, against or abstained.

In terms of the degree to which investors disclose reasons for their voting decisions, ICGN acknowledges that this could be improved across the investment industry in all markets. It is for that reason that, for example, the 2018 Dutch Stewardship Code states that:

*“In the event that the asset owner or asset manager casts an against or a withhold vote on a management proposal, they should explain the reasons for this voting behaviour to the company’s board.”*

We also draw your attention to Principle 12 of the UK Stewardship Code 2020, published by the Financial Reporting Council on 25<sup>th</sup> October 2019 which expects more public disclosure as follows:

*“For listed equity assets, signatories should:.....explain their rationale for some or all of the voting decisions, particularly where: there was a vote against the board; there were votes against shareholder resolutions; a vote was withheld; or the vote was not in line with voting policy.”*

Finally, as recommended in our letter to the Council on 19<sup>th</sup> April, ICGN advocates that investors should disclose their approach to stock lending and any impact this has on voting. This should clarify the types of circumstances where shares would be recalled for voting purposes and a description of how stock lending could impact voting. The UK Stewardship Code also requires signatories to “state what approach they have taken to stock lending, recalling lent stock for voting and how they seek to mitigate ‘empty voting’.” It may therefore be appropriate for the Japan Stewardship Code to elevate reference to stock lending from footnote 14 to the Guidance.

## **2. Disclosure of stewardship activities and outcomes**

ICGN agrees that investors should be encouraged ‘to disclose their stewardship activities with companies in order to promote constructive dialogue’ as described in the FSA summary paper of Opinion Statement No.4. This is consistent with the newly proposed ‘Recommendation 7.3’ of the ICGN Principles as follows:

### **7.3 Stewardship effectiveness**

**Stewardship disclosures should communicate the effectiveness of stewardship activities on behalf of beneficiaries or clients. Such disclosure should focus on results, not just stewardship processes, and include examples of engagement successes (and failures) and relevant data.**

The UK Stewardship Code has been entirely restructured to focus signatory reporting on the effectiveness of stewardship activities and outcomes, rather than a focus just on the disclosure of stewardship policies. This is a comprehensive change to reporting obligations in the UK which requires signatories to annually produce ‘a simple document structured to give a clear picture of how the organization has applied the Code.’ Importantly, the report must be reviewed and approved by the applicant’s governing body and signed by the chair, chief executive or chief investment officer. The rationale for this is that this will help to ensure that disclosures are accurate and balanced and may also help to ensure there is senior level ‘buy-in’ for stewardship.

To provide evidence of stewardship outputs investors could use case studies to demonstrate how and when they engage with companies. This disclosure could focus on what actions were undertaken and the results of such action. Furthermore, ICGN encourages investors to provide data to summarize their overall engagement and voting activity at least annually. For example, this data could be presented by issue (for example related to company strategy, capital management or remuneration), by region or by business sector.

## **3. Proxy advisor operations, disclosure and company dialogue**

ICGN supports reference in the FSA summary paper of Opinion Statement No.4 that ‘proxy advisors should be encouraged to secure sufficient and appropriate organizational structures, disclose their process for developing voting recommendations and proactively engage with companies in order to support voting which promotes constructive dialogue.’

We note that paragraph 2 of Recommendation 5.4 of Japan’s Stewardship Code already addresses these points. Furthermore, we observe the growing focus by regulators on proxy advisor operations, notably the USA, and caution against the introduction of regulation which may impede investor voting focused on improving corporate governance practices.

Many investors are responsible for voting thousands of resolutions and this is efficiently facilitated via the use of research provided by a variety of service providers. While there may be a perception by some that investors ‘blindly’ defer to proxy advisory advice, we believe this not to be the case for the majority of ICGN Members. In fact, the policies that proxy

advisors adopt often reflect the consensus opinion of global investors and, in many cases, investors instruct their proxy advisors to vote specifically in alignment with their in-house voting policies.

We encourage constructive dialogue between proxy advisors and companies particularly when concerns are raised by companies that there may be factual inaccuracies in proxy advisor reports. ICGN advocates that proxy advisors should be accessible to companies to discuss any factual errors, noting that some disputes arise from differences in analytical approach which may then result in a different outcome. Where there is a factual error, the report should be corrected. However, ICGN does not advocate that proxy advisors should be required to mandatorily share advance copies of their reports with companies for regular review as has been proposed in the USA. Rather, this should be a matter of choice for the individual advisor.

To help in managing the responsibilities of investors to oversee the advice provided from proxy advisors it may be advantageous for the FSA to consider strengthening paragraph 1 of recommendation 5.4 to align with recommendation 5.6 of ICGN Principles as follows:

#### 5.6 Voting services

Investors should disclose the extent to which they use proxy research and voting services, including the identity of the provider and the degree to which any recommendations are followed. Use of a proxy voting advisor is not a substitute for the investor's own responsibility to ensure that votes are cast in an informed and responsible manner. Investors should clearly specify how they wish votes to be cast and should ensure that such votes are cast in a manner consistent with their own voting policies.

We note the renewed emphasis on service provider responsibilities in the UK Stewardship Code whereby six principles for service providers have been explicitly defined. Service providers can be defined as those who deliver services to enhance the efficiency and quality of stewardship. They offer engagement, vote recommendations and execution, research and data provision, advice, and provision of reporting frameworks.

We also refer the Council to the 'Best Practice Principles for Providers of Shareholder Voting Research & Analysis' which was published in July 2019 which requires proxy advisors to make various disclosures about their policies and practices. ISS and Glass Lewis are among the advisors who have signed up to the Principles and agreed to submit themselves to some independent oversight. More details can be found at: <https://bppgrp.info/the-2019-bpp-principles/>

### **4. Stewardship scope across all asset classes**

As noted in our statement to the Council submitted on 10<sup>th</sup> April, ICGN recommends that the FSA consider applying the concept of implementing stewardship across all asset classes, not just equities, in the Japan Stewardship Code. This would align with recommendation 2.2 of the ICGN Principles and a newly proposed ICGN recommendation 4.4 focused on capital allocation and the stewardship obligations of creditors as follows:

#### 2.2 Scope

Stewardship policies should disclose the scope of stewardship practices, as it may relate to differing asset classes, investment strategies and geographies. ICGN encourages stewardship beyond listed equities, and it is good practice to be clear on whether and how the investor approaches engagement in a range of asset classes.

#### 4.4 Capital Allocation

Long-term creditors and shareholders must communicate their preferences to company management and must recognise their mutual requirements. Creditors generally seek a stable and predictable credit risk profile and shareholders have a focus on upside potential and risk adjusted returns on capital. Effective engagement by creditors and shareholders reflects the understanding that a sustainable company must satisfy the basic and legitimate requirements of its capital providers.

The importance of applying stewardship across all asset classes is also emphasised in the UK Stewardship Code under principle 12 in reference to signatory reporting around exercising their rights and responsibilities. Specifically, the Code states that:

*“For fixed income assets, signatories should explain their approach to seeking amendments to terms and conditions in indentures or contracts; seeking access to information provided in trust deeds; impairment rights; and reviewing prospectus and transaction documents.”*

### **5. Integration of ESG factors in stewardship activities**

As noted in our letter to the Council on 10<sup>th</sup> April, ICGN advocates that more specific reference could be made in the Japan Stewardship Principles to the importance of integrating environmental, social and governance (ESG) factors in stewardship activities.

The ICGN Principles dedicate an entire section (Principle 6) to the importance of investors promoting the sustainable success of companies by integrating ESG factors in investment decision-making and stewardship activities. Key elements to this section focus on awareness, integration and reporting as follows:

- Investors should have awareness of ESG factors that may influence risks and opportunities affecting a company’s long-term performance and sustainable value.
- Investors should consider ways to analyse, monitor, assess and integrate ESG related risks and opportunities into investment processes across asset classes in alignment with their investment decision-making, voting and engagement practices.
- Investors should encourage integrated reporting by companies to link ESG and other qualitative factors more clearly with company strategy and operations, and ultimately long-term value creation.

ICGN’s Principles also highlight that investors should build an understanding of long-term systemic threats, including factors relating to overall economic development, financial market quality and stability. Investors should prioritise the mitigation of system-level risk and have respect for basic norms over short-term value. For example, climate change poses a level of risk which encompasses all markets, all sectors and all industries. ICGN Members increasingly engage with companies on how they embed the effects of climate change in their business models and risk management systems to ensure they are properly identified, measured, monitored and managed.

### **6. Integrated approach to stewardship**

ICGN has strengthened reference in the revised ICGN Principles to the importance of there being an integrated approach to stewardship activities throughout an investment institution. We refer to the importance of communicating priority issues consistently by all members of staff, including from both debt and equity teams when appropriate, when engaging with investee companies as indicated below under Recommendation 4.4 of the ICGN Principles:

### Integrated approach

Investors, from both stewardship and portfolio management teams, should be fully aligned to ensure consistent messages are relayed to companies. They should seek to engage, not only with company executive management, but also with board directors. When both equity and debt is held in a company, investors from both equity and fixed income teams should participate in the engagement, at least in areas of shared concern. In the case of controlled companies, investor engagement should extend to meeting with controlling shareholders, to explore where their interests may be aligned or at odds.

Effective stewardship relies on commitment from the leadership of the organisation to ensure sufficient resources are allocated, for example human capital, data and effective client communications tools and processes. It is imperative that there is a basic understanding of what investor stewardship entails and a genuine desire for it to be implemented throughout the investment decision-making process and embedded in the business case.

## **7. Escalating engagement with investee companies**

ICGN observes that Japan's Stewardship Code is silent on how engagement with investee companies might be escalated in the event dialogue is ineffectual. Many ICGN Members publish Engagement Policies which define the purpose of engagement, how engagement is prioritised and how it will be escalated in the event concerns are unresolved.

Approximately two-thirds of Stewardship Codes published around the world include explicit reference to engagement escalation, including the ICGN Principles, Recommendation 4.3, which states:

### Engagement escalation

Investors should clarify how engagement might be escalated when company dialogue is failing including: a) expressing concerns to corporate representatives or non-executive directors, directly, in writing or in a shareholders' meeting; b) expressing their concern collectively with other investors; c) making a public statement; d) submitting shareholder resolutions; e) speaking at general meetings; f) submitting one or more nominations for election to the board as appropriate and convening a shareholders' meeting; g) seeking governance improvements and/or damages through legal remedies or arbitration; and h) formally adding the company to an exclusion list or otherwise exiting or threatening to exit from the investment.

It may be advantageous for reference to escalation to be included in the Japan Stewardship Code in alignment with general practice.

To conclude, I would like to congratulate the leadership of the Council once again on the progress that is being made in Japan in terms of corporate governance and investor stewardship reform. I look forward to seeing many Council colleagues at the meeting held in Tokyo at the FSA Headquarters in Tokyo on 8<sup>th</sup> November 2019.

Yours faithfully,



Kerrie Waring  
**Chief Executive Officer**  
**International Corporate Governance Network**

## **Annex 1: Reference to Corporate Governance in ICGN letter to the Council, 10 April 2019**

### **Internal audit**

Internal audit is an important component in building trust and assurance in the governance, risk management and internal control systems of a company.

Guidance 7.6, the ICGN Global Governance Principles state that the board should oversee the establishment and maintenance of an effective system of internal control which should be measured against internationally accepted standards of internal audit and tested periodically for its adequacy. Where an internal audit function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the system of internal control has been obtained.”

While day to day management of the internal audit function normally sits with executive management, the board should be accountable for risk appetite, risk oversight and monitoring of risk systems. It is therefore important that there are open lines of communication between those responsible for internal audit and the board or audit committee. In particular, internal audit should report (and be accountable to) the audit committee of the Board to ensure independence from management.

### **Governance of Group Subsidiaries**

The Opinion Statement refers to the governance of listed Subsidiary Companies with minority shareholders and addresses risk management processes, board independence and accountability of the parent company as a controlling owner. While the Council has not deliberated on this subject in depth ICGN offers the following initial observations for consideration:

- Subsidiary Companies are separate legal entities and, as such, the duties of directors serving on subsidiary company boards are owed to the subsidiary, not to the parent company. This has the potential to create tensions between the Holding Company appointed directors and independent directors when taking decisions in the best interests of the Subsidiary. This tension might be resolved by there being a clear policy regarding the nomination and appointment process of independent directors and the influence that the Holding Company has over this process. There should also be a clear statement describing the primary duty of care of directors serving on the Subsidiary Company board.
- The Holding Company should develop a comprehensive ‘Governance Framework’ applied throughout the group which should include robust internal control and risk management procedures. More generally, high standards of corporate governance practices should be communicated through clear policies on matters such as bribery and corruption, whistleblowing, share dealing and data protection. Such policies should be regularly reviewed to ensure effectiveness. Independent directors, possibly as part of an audit committee and risk oversight process, should monitor how the holding company interacts with the Subsidiary Company and have the ability to challenge the Holding Company if they believe that the Holding Company is acting against the interests of minority shareholders.

- There should be clear communication regarding the overall strategic direction of the group, as set by the Holding Company, and how this relates and aligns with the purpose and performance of subsidiary entities. The purpose of Subsidiary Companies should therefore be clearly defined along with how they contribute to the overall strategic direction of the group. This should include how they engage with minority shareholders and key stakeholders.
- Conflicts of interest should be carefully managed, particularly with directors that are common to both the Holding Company and the Subsidiary Company. Information flows within the group should be governed by clear disclosure policies, particularly where information is sensitive. The ICGN Global Governance Principles note that “if a director has an interest in a matter under consideration by the board, then the director should promptly declare such an interest and be precluded from voting on this subject or exerting influence.”
- Minority shareholder rights (and the equitable treatment of shareholders holding the same class of share) must be protected where there is the presence of a controlling shareholder on the subsidiary board – i.e., the Holding Company shareholder. Minority shareholders must be able to effectively exercise their right to vote on major decisions which may change the nature of their investment in a company. These rights should be clearly defined in the company’s constitutional documents.