



**ICGN**

International Corporate Governance Network

The Council of Experts  
Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code

10<sup>th</sup> April 2019

Dear Fellow Council Members,

**ICGN Statement to the Council of Experts for the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code (the "Council")**

I have pleasure in sending you ICGN comments on the items noted in the Agenda for the next Council Meeting which will take place on 10<sup>th</sup> April 2018. Regrettably, I will not be able to join you in person on this occasion and hope that the comments presented in this letter can serve as a contribution to the Council's discussion.

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. Our policy positions in this submission are based on the ICGN Global Stewardship Principles, the ICGN Global Governance Principles and the ICGN Model Disclosure on Voting.

ICGN generally supports the issuance of the Opinion Statement issued by the Follow-up Council based on the discussions made at the Council Meeting held in November 2018. Our comments relate to some of the issues raised in the Opinion Statement and focus on:

- Investor stewardship with recommended amendments to the Principles for Responsible Institutional Investors (Japan); and
- Corporate governance with specific reference to the quality of internal control systems and the governance of listed company subsidiaries.

**Investor Stewardship**

**Stewardship scope across all asset classes and capital allocation**

We recommend that the FSA consider applying the concept of stewardship across all asset classes. We note that the UK Financial Reporting Council is also proposing to introduce stewardship responsibilities for all asset classes, noting that 'capital is allocated to a range of asset types over which investors have different terms, rights and levels of influence.'

ICGN's Principles state that stewardship policies should address the scope of assets held in an investment portfolio including but not limited to, listed equities and debt obligations. In particular, fixed income is an important asset class, reflecting both the size of the global fixed income market and the role that creditors play in providing risk capital to companies and governments.

In a stewardship capacity, investors should engage with investee companies on capital allocation practices where appropriate. This may help support a fair and sustainable equilibrium in a company's capital structure and allocation to achieve long-term corporate success, while meeting the needs of shareholders and creditors for risk adjusted returns on capital.

### Review of stewardship policies and practices

The Preamble to Japan's Stewardship Code states, under bullet 2 of paragraph 13, that 'institutional investors should annually review and update disclosed information and publicly disclose any such updates taken place'. ICGN recommends that this reference be moved into the Code itself. Following ICGN's analysis of investor stewardship disclosures in 2018 for the ICGN Global Stewardship Awards, it is apparent that many investors do not regularly review or update their publicly disclosed policies. ICGN advocates that this exercise should be conducted periodically and include a review of whether the stewardship approach undertaken is effective.

### Engagement purpose

Investors are responsible for preserving and enhancing the value of the assets they manage on behalf of beneficiaries or clients. This requires purposeful engagement with companies to help mitigate risk on the one hand, while identifying opportunities to help improve long-term performance on the other.

Principle 4, Guidance point 4.1 of Japan's Stewardship Code refers to the actions that investors should take in the event there is a 'risk of possible loss in corporate value.' We emphasise that it is also important for investors to engage with companies to consider opportunities to 'add long-term value' to their investments. Guidance point 3.3 notes the importance of investors engaging with companies on ESG factors and this notion should also be emphasised under guidance in Principle 4 associated with constructive engagement.

### Investor collaboration

ICGN Members would welcome further clarity around their ability to act collaboratively with other investors without being considered a 'concert party'. It would therefore be helpful for the FSA to publish guidance on what constitutes acceptable engagement subjects to ensure they will not breach rules regarding collective holding thresholds above which would trigger onerous reporting requirements.

We refer the FSA to the public statement issued by the European Securities and Markets Authority (ESMA) which clarifies information on shareholder co-operation and acting in concert under the Takeover Bids Directive. In particular, we refer to the 'White List of Activities' which provides guidance defining concert parties as 'having the purpose of desiring to "acquire or exercise control" to implement a common policy or strategy or to exercise a dominant influence over it.'

The White List also indicates a list of activities that co-operation by investors will not lead to a conclusion that the shareholders are acting in concert. This includes voting on proposals relating to directors' remuneration, capital and financial policies, the environment or any other matter relating to social responsibility. It is our view as well that investors should be able to collaborate with regard to voting on the election of director candidates – as long as the intent is to promote board effectiveness, and not to "acquire or exercise control" as per the ESMA framework.

## Voting policy and rationale

Principle 5 of Japan's Stewardship Code would benefit from additional guidance around voting decision making. ICGN would emphasize the importance of delineation in the process of voting decision-making and that investors should clarify due diligence in their decision-making process, acknowledge accountability over vote decision-making, and clarify if this differs depending on the nature of the resolution, geography or scale of holdings.

Guidance 5.1 could also refer to the rationale for voting decisions, noting that ICGN's Global Stewardship Principles state that "Investors should seek to explain to companies the reasons underlying their voting decisions, preferably before the shareholders meeting."

Guidance point 5.4 regarding the use of proxy advisor research could be strengthened. The ICGN Global Stewardship Principles note that 'investors should disclose the extent to which they use proxy advisor research and voting services, including the identity of the provider and the degree to which any recommendations are followed. 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 also note the importance of investors overseeing the advisor's performance and capabilities on a regular basis.

## Stock lending

Japan's Stewardship Code makes reference to stock lending as footnote 14. This should be elevated to Guidance and 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. In order to preserve the integrity of the shareholders meeting, shares should not be borrowed or lent for the primary purpose of voting them.

## Reporting

ICGN recommends that reference to reporting responsibilities be strengthened by removing the words 'in principle' noted in guidance points 6.1, 6.2. This will bring Japan's Stewardship Principles in line with European requirements and ICGN's Global Stewardship Principles.

## Incentives

ICGN recommends, possibly under Principle 7 of Japan's Stewardship Code that new guidance be added to refer to how incentives align with investment strategies and stewardship obligations. In particular, asset owners should provide clarity to their managers on how stewardship performance will be measured, evaluated and incentivised.

The ICGN's Global Stewardship Principles note that 'Investors should reinforce their stewardship obligations to act fully in the interests of the beneficiaries or clients by setting fee and remuneration structures that provide appropriate alignment over relevant time horizons. Investors should disclose how their remuneration structures and performance horizons for individual staff members advance alignment with the interests of beneficiaries or clients.'

## ESG integration and systemic risk

ICGN advocates that more specific reference be made in the Japan Stewardship Principles to the importance of integrating material environmental, social and governance (ESG) factors in stewardship activities to promote a company's long-term success and sustainable

value creation. Investors should consider ways to analyse, monitor, assess and integrate ESG related risks and opportunities as part of their stewardship obligations.

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.

ICGN Guidance on Investor Fiduciary Duties (2018) articulates systemic risk as macro-economic (e.g. political, legal, regulatory, fiscal), environmental (e.g. climate change, water scarcity, pollution), social (e.g. human rights, income inequality, populism), governance (e.g. shareholder rights, corporate culture, board quality) and technological (e.g. artificial intelligence, cyber security).

## **Corporate Governance**

The Opinion Statement also refers to the subjects of internal audit; and the governance of subsidiary companies.

### **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.

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 welcoming many Council colleagues at the ICGN Annual Conference hosted by the Tokyo Stock Exchange at the New Otani Hotel which will take place between 16<sup>th</sup> – 18<sup>th</sup> July 2019.

Yours faithfully,



Kerrie Waring  
**Chief Executive Officer, ICGN**

## **Annex 1: ESMA List on shareholder cooperation**

### ESMA White List on shareholder cooperation

“4.1 When shareholders cooperate to engage in any of the activities listed below, that cooperation will not, in and of itself, lead to a conclusion that the shareholders are acting in concert:

(d) other than in relation to a resolution for the appointment of board members and insofar as such a resolution is provided for under national company law, agreeing to vote the same way on a resolution put to a general meeting, in order, for example:

(A) to approve or reject:

- (i) a proposal relating to directors' remuneration;
  - (ii) an acquisition or disposal of assets;
  - (iii) a reduction of capital and/or share buy-back;
  - (iv) a capital increase;
  - (v) a dividend distribution;
  - (vi) the appointment, removal or remuneration of auditors;
  - (vii) the appointment of a special investigator;
  - (viii) the company's accounts; or
  - (ix) the company's policy in relation to the environment or any other matter relating to social responsibility or compliance with recognised standards or codes of conduct;
- or

(B) to reject a related party transaction.

### Financial Conduct Authority letter on shareholder engagement

In the UK, the Financial Conduct Authority issued a letter in 2009 stating that there were no fundamental inconsistencies regarding the extent to which active shareholder engagement relates to market abuse, disclosure of substantial shareholdings and changes in control rules. This clarified that ad-hoc discussions with the management of investee companies regarding legitimate concerns on corporate issues, events or matters of governance would not trigger restrictions or disclosures imposed by UK FCA rules.

“We are satisfied that there is no fundamental inconsistency. In the three areas mentioned above [market abuse, disclosure of substantial shareholdings and changes in control rules] we do not believe that our regulatory requirements prevent collective engagement by institutional shareholders designed to raise legitimate concerns on corporate issues, events or matters of governance with the management of investee companies. Ad-hoc discussions or understandings of this nature would not, in our view, trigger the restrictions or disclosure rules imposed by our rules.”