ICGN
International Corporate Governance Network

Ministry of Economy, Trade and Industry,
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Tokyo, Japan,
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By email: callforevidence@meti.go.jp

16th December 2013

Dear Sirs

Re: "Competitiveness and Incentives for Sustainable Growth: Building Favourable Relationships between Companies and Investors"

The International Corporate Governance Network (ICGN) welcomes the opportunity to comment on above consultation as initiated by the Ministry of Economic Trade and Industry (METI).

As an investor-led organisation of governance professionals, ICGN's mission is to inspire and promote effective standards of corporate governance to advance efficient markets and economies world-wide. We achieve this through: influencing corporate governance policy; informing dialogue through guidance and education; and connecting peers at international conferences. ICGN members are based in over 50 jurisdictions and include investors responsible for assets under management in excess of US$18 trillion. For more information on the ICGN, please visit www.icgn.org

We support the efforts of METI in reviewing the competitiveness of Japanese companies for sustainable growth and capital market efficiency. As a global investor-led organisation we have taken the liberty of responding to questions of most relevance to ICGN members using existing ICGN Guidance as follows:

- ICGN Global Corporate Governance Guidelines (2009)
- ICGN Statement and Principles of Institutional Investor Responsibilities (2013)
- ICGN Executive Remuneration Guidance (2012)
- ICGN Model Mandate: terms between asset owners and asset managers (2012)

Alignment of interest, incentives and management policies for corporate value creation between company management and investors

Asset owners are increasingly considering how they can more fully align the interests of their fund managers with their own obligations to beneficiaries and participants. The ICGN produced the Model Mandate in 2012 to assist such asset owners in considering the expectations which they can have of their fund managers and in how they can formulate their contracts, or mandates, with those managers such that they deliver on client expectations.

Given the importance of fund manager relationships to successful long-term asset owner performance, these are issues in which many asset owner boards will take a close interest and they may wish to have specific discussions about the contractual terms that they will require of fund managers and of the outcomes of negotiations regarding these clauses.

Key areas of focus for asset owners which are seeking to align the activities of their fund managers more closely with the long-term interests of their beneficiaries are:

- ensuring that the timescales over which investment risk and opportunity are considered match those of the client;
- setting out an appropriate internal risk management framework so that the risks which matter for clients are managed effectively;
- effectively integrating relevant environmental, social and governance factors into investment decision-making and ongoing management;
- aligning interests effectively through fees, pay structures and culture;
- where engagement is delegated to the fund manager, ensuring adherence to the highest standards of stewardship;
- commission processes and payments which reward appropriate research;
- ensuring that portfolio turnover is appropriate to the mandate, in line with expectations and managed effectively; and
- providing appropriate transparency such that clients can gain confidence about all these issues.

In addition to the ICGN Model Mandate, there are a significant number of existing and emerging standards, some of them intended to apply across all investment such as the Principles for Responsible Investment (PRI) and others specific to particular asset classes, for example the Institutional Limited Partners Association Principles and the Hedge Fund Standards Board Standards.

Incentives for investors

The pay structures for investors should reinforce their culture and focus on advancing beneficiary or client interests over appropriate time-horizons, and should be transparently communicated to beneficiaries or clients.

Investors should reinforce their obligations to act fully in the interests of beneficiaries or clients by setting fee and remuneration structures that provide appropriate alignment over relevant time-horizons. In large part this will require the structure for fees paid to parties in the investment chain to be more associated with the long-term perspectives which will generate returns over the time-horizon that beneficiaries and clients are seeking.

In particular, they may wish to assure themselves that pay structures for individuals do not inappropriately incentivise risk-taking behaviours. Consideration should be given to including a long-term performance incentive that reflects long-term investment results or is in the form of an interest in the fund that extends through the period of responsibility for the investments. Best practice is for institutional investors to disclose to their beneficiaries and clients an explanation of how their remuneration structures and performance horizons for individual staff members advance alignment with the interests of beneficiaries and clients. Asset owners may wish to ensure that remuneration frameworks do not unduly constrain their ability to attract and retain well-qualified personnel.

Conflicts of Interest

The ICGN encourages investors to understand, minimise and manage the conflicts of interest that they face and behave ethically, ensuring that they maintain focus on advancing beneficiary or client interests and disclosing any conflicts transparently to them. In particular, asset owners should encourage their fund managers to have in place an effective conflicts of interest policy; have appropriate mechanisms, training and procedures to ensure that the policy is carried out in practice; and promptly report to clients when it is materially changed or waived.

Those acting as agents should disclose all known potential conflicts of interest to their principal and explain how these are dealt with so as to protect their beneficiaries' or clients' interests. The responsibility for disclosure of conflicts extends at least to the next level up in the investment chain. All investors should have clear policies for managing conflicts in the interests of the beneficiaries and ensuring that they are adhered to.

Incentives for management

Remuneration structures for senior management should be appropriately aligned with the drivers of value-creation over time-scales appropriate both for a company's business and for its shareholders.

Executive pay should incentivise value creation within companies and should effectively align the interests of executives with those of shareholders. Remuneration structures and frameworks should reinforce, not undermine, the corporate culture. Performance measurement should incorporate risk considerations so that there are no rewards for taking inappropriate risks at the expense of the company and its shareholders, and performance should be measured over timescales, and with methodologies, which help ensure that performance pay is directly correlated with sustained, superior long-term value creation.

Corporate disclosure and reporting

The ICGN encourages investors to take environmental, social and governance (ESG) factors into account and consider the riskiness of a company's business model as part of their investment decision-making. Since being awarded a mandate from the European Commission in 2011 (in partnership with PRI), the ICGN has been actively teaching investors how to integrate GES through training programmes. Over 200 people have participated in the programme to date from six different jurisdictions.

This responds to comments from the European Commission as follows: "If there is a trend towards better disclosure of ESG information, and also towards integrated reporting, then it is important that the investment community builds a corresponding capacity to better use ESG information in their investment decision making process….. The more attention that asset owners, managers and analysts pay to ESG, the greater the influence they will have on the behaviour of companies in driving more responsible and sustainable business."

The ICGN believes that companies should report information necessary for responsible investment decision making. This is based on a proper understanding of the company's strategic objectives and disclosure should integrate consideration of financial and non-financial risks and factors which should:

- Be genuinely informative and include forward-looking elements where this will enhance understanding;
- Be material, relevant and timely;
- Describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities;
- Be accessible and appropriately integrated with other information that enables investors to obtain a whole picture of the company;
- Use key performance indicators that are linked to strategy and facilitate comparisons;
- Use objective metrics where they apply and evidence-based estimates where they do not;
- Be strengthened where possible by independent assurance that is carried out having regard to established disclosure standards applicable to non-financial business reporting, such as those issued by the IASB.

Dialogue and engagement

ICGN encourages the investment community to engage intelligently and proactively as appropriate with investee companies on risks to long-term performance in order to advance beneficiary or client interests.

Effective engagement requires an adequate skillset and framework to encourage and effect necessary change. Engagement is an extension of an investor's responsibility to monitor investee companies and arises when investors have a full understanding of the specific circumstances of the company and has identified concerns about its performance, governance or risk management. Voting is an element of engagement, and responsible investors should make use of their voting rights, but it is only one element of the appropriate activities. The ability to engage board members directly enhances engagement efforts.

ICGN encourages investors to have a clear approach for dealing with situations where dialogue is failing and this should be communicated to companies as part of their corporate governance policy. Steps that may be taken under such an approach include: expressing concerns to other corporate representatives or non-executive directors, either directly or in a shareholders' meeting; making a public statement; submitting one or more nominations for election to the board as appropriate, including seeking the nominations of independent directors with diverse backgrounds, and convening a shareholders' meeting.

In Japan in particular we think it would be helpful if mechanisms were encouraged that facilitated better cooperation between foreign and local shareholders on engagement matters. To that end the ICGN is delighted to be holding a Tokyo Connection Day hosted by the Tokyo Stock Exchange and the Japan Exchange Group in March 2014 to help facilitate engagement between global investors and local companies but also to help create more alignment between local and global investor themselves.

The ICGN has been convening Connection Days to enhance dialogue around corporate governance matters for many years and we welcome engagement in Japan with Board level individuals from Mitsubishi, Sony and HOYA who will meet with global investors including TIAA-CREF, BlackRock, Legal and General, CalPERS Hermes, F&C and many others. It follows successful meetings in Paris, Rio de Janeiro and Milan which included participation from Goldman Sachs, Societe Generale, Lafarge and GDF Suez, Telecom Italia, Pirelli, ENI, Prysmian, BR Foods and many more.

For companies, the Connection Day provides an opportunity to communicate with the world's most experienced investors in one place, at one time. It provides an excellent investor-relations experience and enables dialogue beyond a handful of the company's largest investors to a broader, more international group. For investors, the Connection Day provides a platform for meaningful conversation around governance issues in a forum where questions can be posed and direct feedback received from companies. The forum also provides an efficient and cost effective mechanism for collaborative dialogue and helps to create alignment on corporate governance issues between investors themselves.

Once again, we applaud the efforts of METI in conducting this project and we would be happy to discuss any of the points that we have raised by contacting Kerrie Waring, ICGN Managing Director, at: kerrie.waring@icgn.org or by telephone on: +44 (0) 207 612 7098.

Yours faithfully,

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Chairman, ICGN Board

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