ICGN
International Corporate Governance Network

Corporate Accounting, Disclosure and CSR
Policy Office
Economic and Industrial Policy Bureau, METI
1-3-1, Kasumigaseki, Chiyodo Ward,
Tokyo, 100-8901

By E-mail only: itoreview@meti.go.jp

Dated: 21st May 2014

Dear Sirs,

Re: The "Building Favorable Relationships between Companies and Investors" Project

The International Corporate Governance Network (ICGN) is an investor-led organisation of governance professionals with members including institutional investors responsible for assets under management in excess of US18 trillion. Our members are based in over 50 countries and, in addition to investors, represent all parties interested in the field of corporate governance including company directors and secretaries, professional advisors and academia.

Established in 1995, our mission to inspire and promote effective standards of corporate governance to advance efficient markets and economies world-wide. This is achieved through influencing public policy on corporate governance issues by engaging with regulators and responding to public consultations, connecting peers around through international events, and informing members on emerging issues through guidance and education programmes. For more information about ICGN please visit www.icgn.org.

The ICGN welcomes the opportunity to comment on METI's project entitled "Building Favorable Relationships between Companies and Investors" arising from the *Ito Review* and we draw upon the experience of our members in providing our response. In addition, ICGN has adopted statements of principles and best practice guidance that bear on a number of the questions raised in the consultation. In particular we refer you to the recently published ICGN Global Governance Principles which apply to both companies and investors and are accessible on our website. The ICGN Statement of Principles of Institutional Investor Responsibilities also clarifies the responsibilities of investors both in relation to their internal governance and their external role as investors in companies and other assets.

We would like to refer METI to the ICGN response to the Council for Experts on the publication of the Japanese Stewardship Code dated 8 February 2014. In the letter we respectfully recommend that a review of the 2004 Principles of Corporate Governance (published by the Tokyo Stock Exchange) be undertaken. This is particularly appropriate given the introduction of the Stewardship Code and would be helpful in making further formal progress in building consensus around governance standards for companies as well as investors. By encouraging and facilitating open and constructive discussions on a wide range of issues including those presented in this Ito Review. A Corporate Governance Code that reflects local characteristics and key issues would play a crucial role and add real value in the market.

In addition, the ICGN welcomes the increasing number of independent directors being appointed to boards in Japan and we encourage all companies to embrace this trend. ICGN strongly believes that an effective board should comprise a majority of non-executive directors, many of whom are independent. There should be a sufficient mix of individuals with relevant knowledge, independence, competence, industry experience and diversity of perspectives to generate effective challenge, discussion and objective decision-making.

The *Ito Review*, with its emphasis on competitiveness and incentives for sustainable growth through building favorable relationships between companies and investors, is a welcome body of work at this critical time for Japanese markets for two reasons. One, investors want stability in global financial markets, such as Japan, and two, they are generally long-term investors in Japanese companies. Investors make sophisticated investment decisions across global markets every day and the investment opportunities in Japanese companies is an important element to be considered. When an investor has a choice between investing in companies located in countries with strong corporate governance standards, and those where there are no standards, there is an incentive to select the place where robust corporate governance standards exist. An environment in which companies and investors may mutually work together for the long-term interests of the company creates a competitive advantage, one that has been studied and supported by academics.

One striking example of the role that relationships play in company performance was the study on Japanese companies over the last twenty years[1]. In the findings, the report determined that companies that displayed strong performance during this tough period had the following shared characteristics:

1) pricing power through differentiation and providing value to customers;
2) a relentless focus on generating an indispensable position and business portfolio optimisation;
3) continuous open innovation including collaboration with other companies; and
4) a fearlessness towards change and the ability to rationally and proactively carry out reforms as part of that change.

Clearly, the report shows that in order for Japanese companies to thrive and return value for their investors, it is for them to embrace change and enhance collaboration with others.

In addition, the ICGN is pleased to note that the report recommends engaging company executives and directors by investors. The topics for a “constructive dialogue such as governance, corporate strategy, performance, capital structure, and risk management,” are relevant and appropriate for investors and companies. ICGN also supports “engagement and disclosure, building networks within the investor community, and annual shareholder meetings as a forum for dialogue” (Id, p. 7).

Overall, the report highlights six areas for further review and direction.

[1] The ITO Review of Competitiveness and Incentives for Sustainable Growth– Building Favorable Relationships between Companies and Investors Interim Report Executive Summary, p.1

Companies and shareholders cooperative value creation as the foundation of sustainable growth.
The report comments that, “An international comparison of return on equity (ROE) – a metric that investors regard as an important profitability indicator – shows that Japanese companies have had a low ROE over the long-term despite a recent increasing trend.” ICGN recognises that investors rely upon company executives to make the day to day decisions that are necessary. Investors wish to see more independent board members serving on Japanese companies, which in turn, may provide additional ideas to spur economic growth and prosperity.

Shift from passive investment to stock selection based on deep analysis.
The ICGN recognises that some investors are invested in Japanese companies based upon passive index holdings. This is not only happening in Japan, it’s a global trend for investments. However, these holdings are significant and should be given the same consideration with regard to corporate governance best practices. Engagement may still occur between companies and their investors that hold passive investments. In fact, one might suggest that this kind of engagement is even more important because investors are required to invest in the companies listed on an index; therefore engagement may be the only way to distinguish the relationship. Other investors may hold Japanese companies in combination of active management and other vehicles. Best practices of corporate governance apply in any circumstance that an investor is a shareholder in a public company.

Corporate value management based on capital efficiency and not on short-termism.
Short-termism has become a concern across global markets. As new investment modes are developed, some investors are looking toward short term horizons for financial gain. In the main, institutional investors are longer term holders of Japanese companies and even those with passive index portfolios provide the needed balance for Japanese companies to maintain a long-term focus.

Sound corporate governance can help to change the views of investors. If legislation encourages investors to engage more with companies they invest in, and to take a longer-term perspective of their investment, all stakeholders and the real economy will benefit. A longer term perspective creates better operating conditions for companies and improves their competitiveness.

Capital market reform to transform under-used financial assets into national wealth (value).
The ICGN supports a robust and transparent capital market in which all financial assets can be utilised to create wealth for investors and institutional investors, and for their members for whom they provide benefits.

Promoting true dialogue between companies and investors through “cooperation and tension.”
The ICGN is an organisation that was founded to inspire and promote effective corporate governance standards across the world. A “true dialogue” is one in which there is mutual respect and understanding, which can be achieved over the course of time and effort. A natural tension may exist, given that investors are seeking a return on their investment and rely upon boards of directors to represent them in the board room. Investors do not wish to make day to day decisions for companies.

As stated in the ICGN Statement of Principles of Institutional Investor Responsibilities, institutional investors should engage intelligently and proactively, based on publicly known policies, as appropriate with investee companies on risks to long-term performance in order to advance beneficiary or client interests. It is clear that from the perspective of their beneficiaries or their own interests, institutional investors start a dialogue or engagement. Dialogue and engagement first of all aim at the executive directors or management. Both sides of the table should prepare and approach dialogue and engagement professionally. Conducting a dialogue as a purpose of itself is not in the interest of investors or companies. The observation in the *Ito Review* that only investors have to be aware of this seems very one-sided (Id, p. 93&95).

Reviewing corporate disclosures to promote sustainable corporate value.
The ICGN supports transparency of company financial records and non-financial information so that investors will be able to make informed decisions in the best interests of the members they serve and as fiduciaries. In this regard, boards should provide an integrated report that puts historical performance into context, and portrays the risks, opportunities and prospects for the company in the future, helping shareholders understand a company's strategic objectives and its progress towards meeting them.

In the *Ito Review* one of the reasons for Japanese short-termism is the lack of effectively disclosing information by companies necessary for investors to make long-term investment decisions. ICGN is aware of the controversy on quarterly reports. However, the quarterly reports are in fact one of the few moments each year that all stakeholders get the same information about the company. Furthermore, we assert that ongoing disclosure obligations are even more important. Ongoing, timely and effective disclosure by companies is essential for making informed investment decisions, particularly for institutional investors. This topic could be addressed under the discussion in point 11.2 of the report.

Investors seek stability in the capital markets. Efficient markets lend themselves to value creation for investors. Investment in global markets, including Japanese companies, provides investors with diversified portfolios and risk management strategies. More disclosure on risk or risk assessments is very welcome. It is to be savored when in the annual report or annual financial statements, the risks are also weighted by the company. In-depth research of the company will help institutional investors when they consider investments for the long-term.

Thank you for the opportunity to provide comments to the interim report. Should you wish to discuss our comments further, please contact Kerrie Waring, ICGN's Managing Director, by email at kerrie.waring@icgn.org or by telephone on +44 (0) 207 612 7079.

Yours faithfully,

Michelle Edkins, Chair
ICGN Board of Governors

Carol Drake, Co-Chair
ICGN Shareholder Responsibilities Committee

Niels Lemmers, Co-Chair
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