

# **Recent Capital Market Reforms in Japan and Their Effects on Corporate Behaviors**

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# Introducing myself

- Professor of Law, specialized in Capital Market Law
- Member: Council on Market Structure at TSE (2018-2019)
- Member: Council of Experts Concerning the Follow-up of Market Restructuring at TSE (Jul. 2022-present)
- Independent outside director: Nissay Asset Management Corp.(2017-present)

# Outline

- 1. Enactment of Japan's Stewardship Code (2014)
- 2. Enactment of Japan's Corporate Governance Code (2015)
- 3. Market Restructuring (2018-2020)
- 4. Revisions to Japan's Corporate Governance Code (2021)
- 5. Follow-up of Market Restructuring 1 (Apr. 2020 - Aug. 2023)
- 6. Follow-up of Market Restructuring 2 (Sept. 2023 – present)
- 7. Evaluations and Perspectives

# Japan's Stewardship Code (2014)

- Enacted by Financial Services Agency of Japan in 2014, modeled after UK Stewardship Code. Revised in 2017 and 2021.
- Stewardship responsibilities refers to the responsibilities of institutional investors to enhance the medium- to long-term investment return for their clients and beneficiaries by improving and fostering the investee companies' corporate value and sustainable growth.

## 8 Principles of Stewardship Code

- Having and disclosing a clear policy to fulfill stewardship responsibilities
- Having and disclosing a policy to manage conflicts of interest
- Monitoring investee companies appropriately
- Solving problems through constructive engagement with investee companies
- Having and disclosing a clear policy on voting and the voting results
- Reporting to their clients and beneficiaries periodically
- Developing skills and resources for contributing sustainable growth of investee companies
- Providing appropriate services for institutional investors by service providers

# Nature of Stewardship Code

- No legal obligation
- If an institutional investor accept the code and has a policy, it must behave on the policy.
- Institutional investors: Asset Managers, Asset Owners such as Corporate Pensions
- Service Providers: Voting Advisors, Pension Consultants
- Covered Investors: 6 trust banks, 210 investment managers & advisors, 24 insurance companies, 83 pension funds, 11 service providers incl. ISS and Glass Lewis

# Methods of exercising influence on listed companies by institutional investors

- Voting at a shareholders meeting
- Each investor has its own voting standard on individual bills.
- The voting standards stay one step ahead of Corporate Governance Code.
- e.g. No female director is recommended in CG Code.
- Most institutional investors oppose to director appointment proposals without a female candidate at large companies.

# Japan's Corporate Governance Code (2015)

- Enacted by Financial Services Agency of Japan and Tokyo Stock Exchange, in 2015, modeled after OECD's Principles of Corporate Governance.
- Principles that contribute the realization of corporate governance that reflects the interests of shareholders and stakeholders
- General Principles: Securing the Rights and Equal Treatment of Shareholders, Appropriate Cooperation with Stakeholders Other Than Shareholders, Ensuring Appropriate Information Disclosure and Transparency, Responsibilities of the Board, Dialogue with Shareholders
- Principles and Supplementary Principles



# Appointments of Independent Directors

- 3 governance types for listed companies
- A: Company with Auditor (*Kansayaku*) Board
- T: Company with Three Committees of Audit
- S: Company with Supervisory Committee
- A: traditional type with 2 outside auditors
- Outside directors are more qualified than outside auditors to supervise the management.
- Governance Code recommend appointment of one independent outside director for A type companies.

# 2019 Amendment of Companies Act

- Most listed companies followed the GC recommendation to appoint one independent outside directors.
- 2019 amendment of companies act mandated the appointment of one or more outside directors for listed companies with auditor board.
- Corporate Governance Code was revised in 2018 and 2021.
- 2021 revisions reflected Market Restructuring at TSE in 2020.

## TSE Market before 2018

- As a result of successive market consolidations in Japan, Tokyo Stock Exchange consisted of the First Section, the Second Section, Mothers, and JASDAQ : ambiguous market concepts, inconvenient for investors.
- TOPIX (Tokyo Stock Price Index) comprised only of stocks listed on the First Section. Institutional Investors invested money only in those stocks.
- Direct listing to the First Section required a market capitalization of 25-billion-yen, while market transfer from Mothers to the First Section required only 4-billion-yen capitalization. This made a lot of small caps listed on the First Section.
- Stocks of small caps invested by Institutional Investors are overpriced than their fair values: Fair pricing function of the market was destroyed.

## Compared to other markets

- The number of companies listed on the First Section of the market has roughly doubled over the past 30 years.
- As of 2019
- London's Premium Market had 504 listed companies.
- Germany's Prime Market had 307 companies.
- Euronext's Compartment A had 295 companies.
- The number of companies listed on the First Section of the TSE was 2,141.
- The median market capitalization was low at 48 billion yen.

# Market Restructuring

- Review of TSE market structure began in 2018 at TSE and FSA.
- Overview of Market Structure Review and Outline of the New Market Segments (Feb. 2020)
- Planned Measures for Review of Tokyo Stock Price Index (TOPIX)(Feb. 2020)
  - TOPIX components should be selected from broader bases regardless of market segments by an independent entity from TSE

# Prime Market

- The market oriented to companies which center their business on constructive dialogue with global investors.
- Listing requirements: Market capitalization of 25 billion yen
- Tradable shares market capitalization of 10 billion yen
- Tradable shares: outstanding shares other than shares held by financial institutions, major shareholders (10% or more), or business companies (other than held for pure investment purposes)
- Tradable share ratio: 35%
- This means that investors of a company prevent passing of a special resolution at the shareholders meetings.

# Growth Market

- The market oriented to companies with high growth potential
- Listing requirements: Tradable share market capitalization of 1 billion yen.
- Tradable share ratio: 25 %
- Can be a small cap when listed.
- Must has market capitalization of 4 billion yen at 10 years after IPO.

# Standard Market

- No clear concept.
- Market for companies without potential to growth, nor meeting requirements for prime market.
- Typical listed company: Traditional Japanese company with a long history of listing
- Listing requirement: Tradable share market capitalization of 1 billion yen
- Tradable share ratio: 25%



# Transitional Measures

- The market restructuring was implemented from Apr. 4, 2020.
- Transitional measures are taken.
- Relaxed requirements such as tradable share market capitalization of 1 billion yen is applied to a company which transit from the First Section to the Prime Market “for the time being”, if the company submit “Compliance Plan”.
- 2177 listed companies on the First Section ➡ Prime Market 1839  
Standard Market 338

# The End of Transitional Measures

- TSE set a deadline for transitional measures in January 2023.
- Requirements for continued listing will be applied to each company since its business year end on and after March 1 of 2025.
- If a company does not fulfill the standard, its shares will be delisted when the delisting procedure (6 months) completes. Before the beginning of the delisting procedure, the company has another year as an improvement period.
- If a company submits a compliance plan which ends after March 1 of 2025, the improvement period will not end before the plan completes.

## Measures to increase tradable shares

- Companies that do not meet the requirements for continued listing need to increase number of tradable shares or raise tradable share ratio.
- Because shares held for relational investment by business companies are excluded from tradable shares, eliminating cross-shareholding is a means to increase tradable shares.
- Some listed companies are moving to eliminate cross-shareholdings.

# Revision to Japan's Corporate Governance Code in 2021

- CG Code was revised in 2021 according to the Market Restructuring.
- Principles applicable to companies listed on the Prime Market
  - Use of the Electronic Voting Platform for foreign investors (Sup.1.2.4)
  - English language disclosure of necessary information (Sup.3.1.2)
  - Disclosure of climate change-related risk and opportunities based on the TCFD recommendations or an equivalent framework (Sup.3.1.3)
  - Appointment of one-third of their directors as independent directors (4.8)
  - Having a majority of members of nomination committee and remuneration committee be independent directors (Sup.4.10.1)

# Principles applicable to companies listed on the Prime Market or the Standard Market

- Addressing sustainability issues, such as taking care of climate change, respect of human rights, fair and appropriate treatment of the workforce including caring for their health and working environment, fair and reasonable transactions with suppliers, and crisis management for natural disasters positively and proactively (Sup. 2.3.1)
- Disclosing policies, goals and status for ensuring diversity in the promotion to core human resources, such as the promotion of women, foreign nationals and midcareer hires to middle managerial positions (Sup. 2.4.1)
- Disclosing their initiatives on sustainability and information on investments in human capital and intellectual properties in consistency with companies' own management strategies (Sup. 3.1.1)
- The board should develop a basic policy for those issues. (Sup. 4.2.2)

## Principles applicable to companies listed on the Prime Market or the Standard Market (continued)

- Identifying the skills of its board as managing strategies, disclosing “skill matrix” of the board which shows knowledge, experience, and ability of each director, and disclosing the combination of skills that each director possesses in an appropriate form according to the business environment and business characteristics (Sup.4.11.1)
- Implementation of business portfolio strategies (Sup.4.2.2, Sup.5.2.1)
  - This will promote companies which are stuck with unprofitable business divisions to cut out those divisions
- No change to principles applicable only to companies listed on the Growth Market, because only General Principles are applied to those companies.

# Governance of companies with controlling shareholders

- Controlling shareholders • • should not treat minority shareholders unfairly. (Note to General Principle 4)
- Companies that have a controlling shareholder should either appoint at least one-third of their directors (the majority of directors if listed on the Prime Market) as independent directors who are independent of the controlling shareholder or establish a special committee composed of independent persons including independent director(s) to deliberate and review material transactions or actions that conflict with the interests of the controlling shareholder and minority shareholders. (Sup.4.8.3)
- The issue is still being considered by TSE study group.

## Measures taken by Follow-up council at TSE (~Aug.2023)

- Background
  - Approximately half of the listed companies on the Prime Market and 60% on the Standard Market have ROE below 8% and P/B ratios below 1, indicating that there are issues in terms of profitability and growth potential.
- Purpose
  - To improve corporate value of each company
- TSE requested listed companies on the Prime Market and the Standard Market to implement management that is conscious of capital costs and stock price



# Request for management that is conscious of capital costs and stock price (1)

- Understanding of the company's cost of capital and profitability, analyzing the current situation around these and the market valuation by the board of directors
- Having board of directors discuss and develop policies, targets, planning periods, and specific initiatives for improvement and disclosing clear information on these, along with assessment of the current situation, to investors
- Implementing with management that is conscious of cost of capital and stock price, based on the disclosed plans, and engaging in proactive dialogue with investors based on this disclosure
- Conducting a progress analysis and updating disclosures at least once a year

## **Request for management that is conscious of capital costs and stock price (2)**

- Note: While share buybacks and dividend increases are considered effective means of improving profitability, TSE is not necessarily expecting companies to use only these or solve issues with a one-off response.
- The place where the information is disclosed was not specified. TSE suggested management strategies, management plans, financial results presentation materials, the company's website, or compliance plans to meet the continued listing requirements.
- Statement identifying where a company disclose the information must be made in the Corporate Governance Report.

# Request for management that is conscious of capital costs and stock price (3)

- Results
- As of Aug. 29, 2023, 31% of companies (whose fiscal year ends in March) listed on the Prime Market, 14% of companies listed on the Standard Market disclosed information.
- 11% of the Prime Market companies and 10% of Standard Market companies disclosed “under consideration”.
- Specific initiatives for improvement: growth investment, share buybacks and dividend increases, Investor Relations
- Obstacles against improvement: external factors, scant resources, inadequate governance

# Better dialogue with shareholders and related disclosure (1)

- Companies listed on the Prime Market are expected to improve their corporate value through constructive dialogue with investors.
- CG Code requires listed companies to engage in dialogue with investors and to disclose the results of those dialogue. (General P. 5)
- TSE requested companies listed on the Prime Market to disclose information about dialogue with investors.

# Better dialogue with shareholders and related disclosure (2)

- Suggested disclosure items:
  - Main personnel carrying out dialogue with shareholders
  - Overview of shareholders with whom dialogue was held, e.g. domestic/foreign, active/passive
  - Main topics of dialogue and items of interest to shareholders
  - Whether feedback was given to management or the board on shareholders' views and concerns learned through dialogue
  - Actions taken based on the dialogue and later feedback, if any

## Better dialogue with shareholders and related disclosure (3)

- Results
- As of Aug. 29. 2023, 34% of companies (whose fiscal year ends in March) listed on the Prime Market disclosed information.
- Listed companies' concerns: Most investors engage in dialogue by taking a short-term perspective.
- Investors' concerns: Insufficient involvement of listed company management in the dialogue
- The number of active investors targeted for dialogue is limited, compared to that of passive investors.
- Lack of resources necessary to achieve effective dialogue on the part of passive investors
- For small-sized companies, it is difficult to obtain opportunities for dialogue with investors.

# Effective implementation of CG Code

- CG Code adopts the "comply-or-explain" approach. But it has lost some of its substance.
- TSE requested each listed companies to carry out a self-review of their use of "explain."
- Typical insufficient explanations:
  - The description of what part of the Principle is not complied with is unclear.
  - Statements "under consideration" without giving the reasons for non-compliance
  - An entirely abstract explanation

## Measures taken by Follow-up council at TSE (~present)

- Follow-up of Cost of capital conscious management and Better dialogue with investors.
- TSE published the list of companies that disclosed information on action to implement management in Jan. 2024.
- TSE published the examples of specific initiatives for improvements highly evaluated by institutional investors in Jan. 2024.
- TSE published interviews with managements and opened seminars introducing better dialogue with investors in Jan 2024.
- TSE published interviews with investors and opened seminars introducing how investors engage in dialogue with managements, what kind of information and what kind of relationship they want.



# Expansion of English Disclosure in the Prime Market

- Listed companies on the Prime Market commit to dialogue with global investors.
- TSE publish the following rules on English disclosure. These rules are scheduled for implementation in April 2025.
- Prime Market listed companies should endeavor to simultaneously disclose the same material corporate information in Japanese and English. This will be stipulated in the "Matters Desired to be Observed" in the Code of Corporate Conduct.
- Prime Market listed companies will simultaneously disclose their financial results and timely disclosure information in Japanese and English. In this case, disclosure of an excerpt or summary in English is acceptable. This will be stipulated in the "Matters to be Observed" in the Code of Corporate Conduct.

# Appointments of female executives in the Prime Market listed companies

- Based on the government policy, TSE introduced a few rules in the Code of Corporate Conduct as "Matters Desired to be Observed".
- Companies shall strive to appoint at least one female executive by 2025.
- Companies shall aim to raise the ratio of female executives to at least 30% by 2030.
- It is recommended that companies formulate an action plan to achieve the above goals.
- Note: The above executives may include directors, company auditors, and executive officers as well as executives in charge of business administration and other equivalent officers.

# Issues on the Growth Market

- IPOs function as an Exits for former shareholders of a company, not as giving an opportunity to raise money for corporate growth.
- Individual investors rather than institutional investor trade and hold shares of listed companies on the Growth Market.
- Only 14 % of listed companies raise money by large public offerings after listing on the Growth Market. The growth Market comprises mostly of companies failed to grow up.

# Actions to address the issues on the Growth Market

- Add reasons for listing, timing of listing, and financing information to the disclosure item titled “Matters Relating to Business Plans and Growth Potential”
- Provide IR seminars for management in which institutional investors can share their perspective
- Continue to consider whether to raise the standard for maintaining the listing of 4 billion yen in market capitalization after 10 years of listing
  - About 30 % of the Growth Market-listed companies do not fulfill this standard.
  - Raising the standard in stages such as 5 years and 10 years after listing is an alternative.

## Evaluation and Perspective (1)

- At first, many companies listed on the First Section moved to the Prime Market, which disappointed market participants.
- By setting a deadline for transitional measures, the market restructuring is achieving its original purpose.
- It is highly evaluated that cross-shareholdings are being eliminated to fulfill the requirements such as the tradable shares market capitalization or tradable share ratio.
- Action to implement cost of capital and stock price conscious management is gradually accepted by listed companies. The action succeeded in changing the mindset of management.

## Evaluation and Perspective (2)

- Action to better dialogue with investors is helping small prime market listed companies secure opportunities for dialogue with institutional investors.
- Institutional investors and some listed companies are engaged in dialogue at reducing greenhouse gas emissions. This dialogue is for maintaining global sustainability.
- TSE's action is limited to dialogue with investors to improve corporate value, but this is acceptable as this is a limitation due to the role of an exchange.

## Evaluation and Perspective (3)

- Once the transitional measures for Market Restructuring are completed, it is expected that a significant number of listed companies will have to consider delisting.
- Simple delisting would be detrimental to shareholders and there is a high probability that management would be held legally accountable, so realistic methods include merger with another listed company, acquisition by a controlling shareholder, or MBO.
- In the US and EU, the market capitalization of the entire market is increasing, but the number of listed companies is decreasing.
- It is expected that M&A and MBOs will increase in Japan, and exchanges will need to respond with corporate codes of conduct to ensure that the interests of general shareholders are protected.