Mizuho Custody Newsletter

July 2022 | Japan

We wish to express our deepest condolences that Mr. Shinzo Abe, former Prime Minister of Japan passed away on 8th July 2022.

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I. Market News

1. TSE will be open to active ETFs

Tokyo Stock Exchange ("TSE") will be open to ETFs that are not linked to index as early as in 2023, reports Nikkei Shimbun, Japan's leading financial daily. It is "Active ETFs" , products allowed to be designed with more flexibility than existing ETFs, such as investing in ESG related companies and/or high-dividend companies or aiming for a certain level of yield by investing in bonds with lower credit rating. Trading of active ETFs are expanding in Western countries and in Asia, and TSE hopes to catch up and attract investment money from both domestic and overseas markets.

ETFs currently listed on the TSE are passive ETFs that are linked to specific indices such as Tokyo Stock Price Index (TOPIX) and S&P 500 Stock Index (S&P500).

Under the TSE's listing rules, ETFs must be linked to the eligible indices, which rules out active investment. TSE will review the rules to allow listing of ETFs not linked to index within one to two years from now. TSE will be coordinating with the relevant ministries and agencies because the said change requires revision of the applicable laws. Many asset management firms take this change positive as they are keen on expanding their products line-up.

Active ETFs allow asset management firms to decide what to invest at their discretion, as well as their asset allocation. Investment performance of active ETFs strictly reflects the ability of the asset management firms.

An active ETF, which manages a mix of US large-cap stocks and stock options, posted a total return of 21.6% in 2021, including price fluctuations and distributions. Impacted by the recent global sell-off, current market prices are down 11% from the end of last year, but while US-listed passive ETFs linked to S&P500 are down 20% over the same period, the said active ETF outperformed the passive ETFs.

On the other hand, the total return of an ETF, which invests in companies that provide highly innovative products and services, dropped sharply to negative 23.4% in 2021. US technology stocks have been in a correction phase, which puts these products under tough situation for some time.

Assuming these risks, some active ETFs place emphasis on predetermined rules. For example, an ETF that invests in short-term, investment-grade corporate bonds would automatically buy corporate bonds, if there are any appropriate bonds. TSE, on the other hand, aims for ETFs in which asset management firms make investments at their discretion, under certain rules and disclose requirements about asset management structure and policies. TSE aims to gain investors' confidence by enhancing transparency on investment such as implementing daily disclosure requirement of all holdings and its quantities.

Active ETFs have advantages over unlisted active mutual funds. ETF price is determined by an exchange like listed shares. This feature allows flexible trading for investors and transparency in prices. Trust fees are paid only to the asset management firm based on the balance of the fund, which helps saving costs for investors in comparison with investment trust funds in which investors are charged by the asset management firm and the sales company.

The global market for active ETFs is on the rise. In April 2022, global net assets stood at about USD 443 billion, which is more than 5 times the amount 5 years ago. Transaction volume has been growing in the United States, Canada and China.

ETF market is still immature in Japan. Net assets of passive ETFs listed on the TSE is around JPY 59 trillion as of July 2021, JPY 49 trillion of which are held by trust banks. Most of the ETFs held by trust banks are owned by the Bank of Japan. Only about JPY 10 trillion are held by private sectors such as financial institutions, corporations and individuals.

This is because sales companies are not willing to sell ETFs due to insufficient sales commission, and partly because products with a certain transaction volume are concentrated to leveraged-type products (ETFs linked to a certain multiplier of the underlying index). It is essential for the ETF market to expand its product lineups and gain public recognition of its convenience to invigorate the market itself.

Information compiled from Nikkei Shimbun & Mizuho research

2. Companise disclosing the reduction status of cross-shareholdings before the AGMs are increasing

There has been a growing trend for companies to state information on the status and policy how they would reduce cross-shareholdings in the convocation notices of AGMs, reports Nikkei Shimbun, Japan’s leading financial daily. About 30% of leading companies with fiscal year end in March disclosed it before their AGMs in June, up from 20% last year. Companies hope to gain support from investors for their meeting proposals by updating them on cross-shareholdings status at earlier timing than before.

It has been pointed out that cross-shareholdings, in which financial institutions and its business partners hold their shares with each other, can result in low asset efficiency, because such a structure creates “a stable and silent shareholder” for each other, which causes lack of tension among the management. Cross-shareholdings have been unwinded since the introduction of the Corporate Governance Code in 2015, which required companies to present their policies on cross-shareholdings.

Of the 225 companies that make up the Nikkei Stock Average, the data were collected from 187 companies with fiscal year end in March that disclosed their convocation notice of their AGMs in June. 55 companies, or 29% of the total, state the number of issues that are cross held and the number of cross held issues to be reduced, which is up by 15 companies from the previous year.

This year, leading construction companies disclosed the status of their cross held shares before their AGMs, which attracted attention in the market.

Many construction companies have held shares of their business partners with each other to win orders of construction projects, and unwinding this cross-shareholding practice has been slow in comparison with other industries. Investors have been getting stricter on this issue as they have been getting more conscious about corporate governance. A major construction company revealed, "We got a request from institutional investors to disclose the status of our cross-shareholdings before the AGM."

Some companies have announced plans to reduce cross-shareholdings. A leading real estate developer announced to reduce the ratio of their cross held shares against their net assets from the current 18% to below 10% by FY2030.

More and more institutional investors come to look at the status of reduction of cross-shareholdings for their decision making of whether to vote for or against a proposal of board members selection. This have been urging many companies to disclose on their cross shareholding statuses.

A U.S. proxy advisory firm recommends to oppose to the election of the top management of companies whose total amount of cross held shares account for 20% or more of their net assets.

A major food company cross held shares more than 20% in its capital as of the end of fiscal year 2020, but it has cut it down to 17.5% as of the end of fiscal year 2021. The company described the fact in its convocation notice to show that it has achieved the standards of some proxy advisory firms.

Domestic institutional investors have also been following suit, and they are now driven to revise their voting standards, discarding the old practice of seeking to reduce cross-shareholdings through behind-the-scenes dialogues with companies.

A major asset management firm has announced that it would stipulate in its voting standard that it would not support excessive cross-shareholdings, and will in principle oppose to a proposal to elect the top management if the cross-shareholdings ratio of investee companies to net assets exceeds 50%. Another major asset management firm will, from the AGMs in January 2023, oppose to the appointment of directors, if it would find the company's explanation of its policy on reducing cross-shareholdings, its track records and reasons insufficient.

The "Working Group on Corporate Disclosure of the Financial System Council" of Financial Services Agency is discussing further expansion of description on companies' cross-shareholdings in their Annual Securities Report. A chief equity strategist at a major securities firm said, "Although some companies had explicitly refused to reduce their cross-shareholdings, disclosure requirements and strict monitoring from institutional investors would drive them to unwind more cross-shareholdings."

Information compiled from Nikkei Shimbun & Mizuho research

3. FSA released an exposure draft of the Code of Conduct for ESG Evaluation and Data Providers

Financial Services Agency ("FSA") has compiled an exposure draft of the Code of Conduct for ESG Evaluation and Data Providers (the "Code") for organizations that evaluate companies' ESG initiatives. Since ratings would directly affect investment in companies, the FSA proposed six measures to ensure transparency and fairness, including disclosure of rating method. FSA plans to publicize the list of organizations that support the Code by the end of FY 2022, according to Nikkei Shimbun, Japan's leading financial daily. It will be the first in the world to develop a code that enhances reliability of the rating given in a unilateral manner, with an aim of promoting ESG investment.

The Code presents ESG evaluation principles. It is based on the proposal announced by the International Organization of Securities Commissions (IOSCO) in autumn 2021. The United Kingdom and other countries are working to draw up similar standards, but Japan will be the first country to announce such standards. The government plans to formally compile a report this summer following public consultation.

It will take "comply or explain" approach, in which rating agencies will make clear whether to comply with each of the six code of conduct criteria and, if not, they would have to tell why.

Of the six items, the disclosure of evaluation policies and methods is the matter of importance. There are many elements that make up ESG, such as working conditions and poverty in the "social" area. The rating agencies are required to identify specific factors and sources of information so that reasons of the ratings are clear to the companies.

The Code states that it is important to segregate the department in charge of the evaluation and the one in charge of the sales, and to block exchange of information between those departments in order to prevent arbitrary ratings, if a rating agency would provide ESG related consulting services with a company in addition to rating services.

The main targets of the Code are companies and research institutions that conduct ESG ratings. In Japan, about 10 companies have a high profile. The FSA will announce a list of rating agencies that support the Code by the end of this fiscal year. There will be no penalties for those who do not support, but that may harm confidence of the ratings those agencies issue.

As ESG investment expands globally, those ratings could be an important factor for investors' decision making. Although rating agencies collect data from companies' public information and responses to their questionnaires, it is not clear what factors they watch closely to calculate scores. As a result, a company may receive a rating significantly different by each rating agency.

Ratings given on a unilateral judgement of a rating agency have been a pain in the neck for many companies, as those ratings have been affecting investors, and the companies had been struggling to find solutions for the problem in the ratings which had been given out of unclear evaluation process and method. The more rating agencies become compliant with the Code, the more investment opportunities there would be for investors as companies would be able to see what need to be changed for the better.

The exposure draft of the Code released by the FSA is available from the following URL:
https://www.fsa.go.jp/news/r4/singi/20220712/20220712_6.pdf

FSA is soliciting comments from the public on the exposure draft of the Code, and accepts comments until 5:00pm JST on Monday, 5 September. For details, please visit the announcement from the FSA at their website:
https://www.fsa.go.jp/en/news/2022/20220712-2.html

Information compiled from Financial Services Agency, Nikkei Shimbun & Mizuho research

4. Analysis of the AGMs held in June 2022

Most of AGMs of the companies with their fiscal year end in March are over. In the midst of drastic changes in business environment, such as the situation in Ukraine and global inflation, companies' management and shareholders debated what to do for future. Institutional investors have been coming to scrutinize the contents of shareholders' proposals and make decisions on a case-by-case basis. Under the circumstance, proposals calling for information disclosure and capital efficiency gathered some support, according to Nikkei Shimbun, Japan's leading financial daily.

According to a leading trust bank, 77 companies that held AGMs in June received 292 shareholders proposals. Proposals to revise the articles of incorporation amounted to 184 cases. Other items on the proposals were disbursements of retained earnings, share repurchases and retirement of own shares.

This time, proposals that called for disclosure on individual compensation of the board members collected high rate of supportive votes at AGMs.

At some AGMs, proposals to disclose directors' remuneration on individual basis collected around 40% of supportive votes. At the AGM of a metal manufacturing company, a proposal referred to amendment of the company's articles of incorporation to define disclosure of remuneration by each director.

Amendments to the articles of incorporation is categorized to "special resolution", which requires approval of 2/3 or more of the voting rights of shareholders present. Recently, it is often seen that a proposal by one particular shareholder gains support from other shareholders. Many asset management firms have been coming to stipulate in their voting standards to vote in favor of proposals to disclose individual remuneration in principle, even it if is a shareholders proposal.

More shareholders are making proposals at AGMs. A British fund, who has been investing in Japanese companies for nearly 30 years, has made its first shareholders' proposal this year. The firm said, "If there would be no improvement in capital allocation at the companies we proposed, we would consider submitting a new proposal at AGMs in future."

Proposals calling for measures to address climate change, which now forms a global trend, received support from around 30% of shareholders.

As a result of the recent reforms of corporate governance, cross-shareholdings have been unwinded and the number of corporate shareholders has been declining. Institutional investors are now required by the Stewardship Code to disclose the result of their voting rights exercised by each agenda item. Their voting standards have been getting stricter year by year, making it difficult for asset managers to say no to a sound argument, even if it is a shareholders proposal.

Though some shareholders proposals have been supported by other shareholders, most of proposals have collected small support from only a few percent of shareholders.

Investors are paying close attention to the impact investees' Russian businesses have on ESGs, even for those which seem to have small impact, and they require detailed explanations. In addition, how corporations were governed and managed during the global pandemic gathered shareholders' attention at AGMs in 2022.

In 2020 and 2021, when a lot of businesses were hit hard by the global pandemic, shareholders took such impact into consideration and tried not to be too strict with companies in exercising the voting rights. However, in 2022, "Shareholders do not make allowance for effects from the global pandemic any longer, and they now cast nay votes to them if they do not perform well," said an expert on transfer agent business at a trust bank.

Now that disclosure of voting results have become common practice, investors have been getting stricter on companies that caused scandal from viewpoint of corporate governance. To date, some investors dared not vote against the companies if the scandal has had just small impact on their business performance. But no more. "We vote against at least once at the AGM to a company that caused a scandal," said a domestic institutional investor.

Full online AGM was allowed in 2021 to avoid congestion at the venue of AGMs under the pandemic. While some fund management firms agrees to hold online AGMs in principle, a U.S. voting advisory firm recommended to vote against it in principle, except that a company holds online AGMs under circumstances of a pandemic or natural disaster. This opinion appears to be out of concern that online AGMs may allow companies to run AGMs to its favor, for example, by not taking questions from certain shareholders.

This has not been the case at any full online AGMs to date. However shareholders are concerned that companies may take to protect themselves by excluding shareholders' opinions that are not to their favor. Among the proposals at the AGMs, proposals on takeover defense measures are the ones that intensify such concerns. Shareholders strongly oppose to such proposals, as it could result in losing potential buyers who may maximize shareholders profits.

At the AGMs in 2022, proposals that called for continuation or introduction of anti-takeover measures were approved by a very narrow margin. Shareholders are getting increasingly strict on these issues.

A major asset management firm changed its voting standards in 2022, and it has made clear that it would opposes, in principle, to prior-warning type rights plans. The firm says, "If it is used to protect managements' interest, it could harm the interests of minority shareholders."

As the number of cross-shareholdings continues to decline, AGMs now become places for active debate between the management and the shareholders. Accountability is now required for management to explain more precisely and more in detail than ever on proposals and policies that may potentially harm shareholders' interests.

Information compiled from Nikkei Shimbun & Mizuho research

New Equities Listing Approvals

Listing Date	Name of Company	ISIN Code	MKT
Jul-22	Fulltech	JP3828350003	S
Jul-25	Nissou	JP3679840003	G
Jul-28	HOUSEI	JP3839500000	G
Jul-28	unerry	JP3157800008	G
Jul-29	airCloset	JP3160640003	G
Aug-02	Japan Business Systems	JP3746810005	ST
Aug-05	Kurashicom	JP3268790007	G

**Information compiled based on postings from the Prime (PR), Standard (ST), Growth (G), Tokyo Pro Market (P), NSE (N)、FSE (F) & SSE (S).*

***Board lot size is unified to 100*

III. Foreign Ownership Limit Ratio

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http://www.mizuhobank.com/service/custody/actions.html

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http://www.mizuhobank.com/service/custody/index.html