Mizuho Custody Newsletter

March 2022 | Japan

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I. Market News

1. JSDA review practice which set opening price for the IPO

On 28 February, Japan Securities Dealers Association ("JSDA") released a report on reviewing the practices which set the opening price at the time of initial public offering ("IPO"). It has concluded that review and discussions are necessary on 19 items including establishment of the practices on tentatively set price range. It stressed the point to improve fair price discovery functions, reports Nikkei Shimbun, Japan's leading financial daily. The process will be reviewed so that the investors would find price formation process reasonable.

According to the report, issuers may set the opening price outside the tentatively set price range in response to investor demand, since the tentatively set price range is believed to hinder the opening price to go up. The number of shares to be offered will also be made change flexibly depending on investors' demand. The JSDA will sequentially revise its rules in June or later.

In response to the comment by the Fair Trade Commission ("FTC") that "the business practice in which securities firms unilaterally underprice securities may be violation of the Antimonopoly Act", the report urges issuers and lead underwriters to consider issuer's intention to change or add lead underwriters by holding sufficient dialogues between them. The person in charge of this issue at JSDA said, "Responses to the FTC's concern are fully covered by the improvement measures."

The focus this time was on fair pricing. The report specifies, "The opening price is not determined solely by the intention of the issuer and investor protection must also be well regarded." The report stated a different opinion from the government and the FTC's claim that the opening prices are too low.

Many recent IPOs involve private equity funds and venture capital firms as shareholders. A senior executive at a major securities firm said, "There are many cases in which the opening price is set higher than in the past."

However, in the IPOs in last December, there were a number of cases in which the initial share price fell below the opening price. As foreign investors continue to sell their shares, and with absence of new buyers, more companies decide to postpone IPOs for the time being.

Person in charge of this issue at a major securities firm points out, "Opening price is determined not only by valuation but also by market supply and demand." Under the new practice of setting the tentatively set price range, the initial share price would be higher if demand is strong, but the initial share price will be lower if demand is weak.

The series of discussions highlighted the irregular structure of Japan's IPO market. For years, the IPO market has been driven by small deals that are difficult to list overseas, relying on the purchasing power of individual investors. In order to attract institutional investors as overseas, it is necessary to review the irregular structure by changing the mindset of the related parties including TSE and issuers, as well as securities industry.

Information compiled from JSDA, Nikkei Shimbun & Mizuho research

2. Accepting outside directors from long-term investors are gaining attention

Market is now closely watching companies making efforts to accept outside directors from long-term investors and to increase the board's ability to gather information and negotiate with activists, according to Nikkei Shimbun, Japan's leading financial daily. The move is called "Board 3.0" in the United States. The number of outside directors at Japanese companies is increasing, but some critics say that they are not performing as good as they had been expected. The move is aimed to enhance corporate governance by having investment professionals in the board of directors. However, there are issues such as conflicts of interest.

In Japan, companies are having more and more outside directors due to the requirement of the corporate governance code. In that trend, companies' new attempts to have investors as outside directors is attracting attention in the market. In November last year, a study group at the Ministry of Economy, Trade and Industry ("METI") began discussion on the pros and cons of the attempts. The study group plans to put those discussion together and reflect them in a revised version of the Practical Guidelines for Corporate Governance Systems (CGS Guidelines) in next June.

Section manager of METI says, "The revision of the Corporate Governance Code in June 2021 does not seem to work to help companies improve corporate value. There seems to be flaws somewhere." An outside director with investment background is believed to have the following advantages: (i) he or she is strongly motivated to improve corporate value, and will use his or her knowledge and experiences as an investor to achieve the goal, and (ii) knowledge the outside director would bring to the board of directors would help the company negotiate with activists in equal strength.

A professor at a university in Japan says, "Outside directors in the Board 2.0 system, in which management and directors are separated, not only lack information necessary for the company and motivation, but also may become a hindrance to management's active risk taking." Many of them are busy with their main jobs, such as managing their own companies. Further, many of them assume the role of outside directors at the end of their careers, which consequently make them conservative in giving their business judgements.

On the other hand, it has been pointed out that having investors in the board of directors may cause inequalities among shareholders due to conflicts of interest and information gaps. It has also been called a "Model that one poison drives out another", and it remains to be seen whether it will be accepted by Japanese companies that have been tossed about by activists.

There will be a difference in the effectiveness in cases where a company accepts directors from an activist by a strong push or where the company accepts in a friendly way. But it's hard to clearly tell the difference.

The representative of an advisory firm of corporate governance said, "Even non-activist investors would vote against a proposal if there were no progress through an engagement. The only difference from activists is whether they wait until the management understand the cost of capital and turn around to enhance corporate value or not."

A study group of METI dares to raise a question to this trend by saying, "Conventional dialogues should be sufficient if a company wants to reflect investors' knowledge in management."

Executive Officer of a major trading company said, "It is very beneficial to learn from institutional investors about the cutting-edge topics of other companies, including governance. But having someone with investor background in our board of directors cannot be completely free from concerns around independence and conflicts of interest."

Meanwhile, the chairman of an electronic appliances manufacturing company, which in 2020 invited the president of an asset management company, one of its shareholders, as an outside director, said, "Outside directors are required to access internal information and make decisions based on a full understanding of what the company can and should do. Engagement is not the director's only job."

Companies expect them to share their wisdom by laying the company's cards on the table, but that also runs the risk of violating insider trading regulations. In addition, acting in a manner that does not violate the law may deprive freedom of investment from the investors, such as funds that have sent directors to a certain degree.

The above-mentioned president of an asset management company, which is one of the shareholders of the electronic appliances manufacturer, said "As we are convinced of the long-term value improvement of the company, it is not a big problem that the liquidity of our shareholdings is restricted in short term. Contributing to the sustainable improvement of corporate value as an outside director is in the interests of all shareholders of the company."

For Japanese companies, quality of outside directors matters more than their quantity to many of them. It should be a logical choice for a company to have someone with investment background as its outside director. It would be constructive to positively consider how they could remove obstacles.

Information compiled from Nikkei Shimbun & Mizuho research

3. Keidanren announce recommendations for developing startups

Japan Business Federation ("Keidanren") announced its recommendations for developing startups. It has set an ambitious goal to increase the number of unicorns (private companies with corporate value of USD 1 billion or above) from around 10 at present to 100 by 2027, reports Nikkei Shimbun, Japan's leading financial daily. Specifically, it calls for simplifying the procedures to set up a company and establishing a "Start-up Agency" to control related policies.

At a press conference in Tokyo, a Vice Chair of Keidanren pointed out that foreign countries are creating a virtuous cycle of economic growth by developing startups, and said, "Europe was very conservative until about five years ago, but it changed rapidly. Japan needs to feel a sense of urgency that this is the last chance."

It also set a target to increase the number of startups to 100,000. It called for creation of environment supportive to start a new business, including a complete one-stop system for setting up companies. It also included concrete measures to make it easier for startups to bid for public procurement.

It was also pointed out that it is not practical to implement policies in a unified manner under the circumstance where related policies in this regard have been administered in different ministries. Establishment of an organization that would function as a control center, such as the "Start-up Agency" was also proposed.

It also called for expanding investment through public funds, such as the Government Pension Investment Fund (GPIF). As a concrete measure, it raised an idea of setting up a special fund that makes LP investment assuming limited liability in overseas venture capital firms.

The recommendation calls on the government and Japanese companies to change their mindset over a wide range of issues, such as education and human resource recruitment, in addition to measures to develop startups in a narrow sense, such as improving the environment to start up a new business and attracting investment. The Vice Chair of Keidanren said, "People still have a sense of urgency that you have to join a top company as a new graduate to be an executive." The Vice Chair stressed importance of enhancing mobility of human resource.

Information compiled from Keidanren, Nikkei Shimbun & Mizuho research

4. Highlight of some ESG moves in the Japanese market

By the end of 2022, the Financial Services Agency ("FSA") will create a "code of conduct" for organizations that evaluate companies' ESG initiatives, reports Nikkei Shimbun, Japan's leading financial daily. So-called "rating agencies" will be required to disclose their evaluation procedures to prevent moral hazard arising from providing consulting services to the companies in parallel. FSA will take the initiative in creating a fair environment so that ratings that may affect stock prices do not deviate from reality.

The code of conduct provides principles for ESG evaluation, including Information disclosure. It shows rating agencies how they should be and disclose evaluation methods and policies. Information disclosure framework, established under the initiative of the FSA makes it easier for the rating agencies to evaluate things fairly under the supervision of the market.

The Financial System Council (Prime Minister’s advisory council) proposed formulation of a code of conduct in June 2021 and set up a special subcommittee for its practical studies in February 2022. Companies and research institutions that evaluate companies' ESG initiatives are subjects of their studies, including MSCI, which calculates stock price indices, and S&P Global in the U.S., and JCR and R&I in Japan.

The primary objective of information disclosure request is to confirm rating processes are conducted fairly. It will enable public to see whether a rating agency which issues a rating to a corporation from a neutral standpoint of a third party is also providing consulting services to the same entity in parallel. Consultants are appointed by the companies to provide advices in favor of the companies. If the rating agencies also provide these consulting services at a time, that could cause conflicts of interest with investors looking for fair value.

The recommendation published in November 2021 by the International Organization of Securities Commissions (IOSCO), which consists of securities regulators around the world may underpin FSA’s initiative. It calls for the “adoption of policies and procedures to ensure independence and appropriately deal with potential conflicts of interest”. As potential items for disclosure, it gives examples such as "measurement purpose", "standard to be used", "main source of qualitative and quantitative information", etc.

Rating agencies check the independence of board members and assess progress in decarbonization. If public does not find their credit ratings reliable, investors would lose their yardstick, which could result in proliferation of "greenwashing" in the market. In the subprime mortgage crisis, rating agencies’ failure of proper assessment of the risks of securitized products led global markets to the financial crisis. While urging ESG investment and encouraging decarbonization, it has also become necessary to monitor the above-mentioned risks.

Many rating agencies do not disclose their evaluation methods in detail. They collect data from responses to company questionnaires and public information, but it's not clear how they calculate the evaluation scores out of these information.

In 2010, Japan introduced a registration system for credit ratings of corporate bonds, etc., and has made it obligatory to prevent conflicts of interest with issuers and to disclose credit rating methods. FSA would carefully study whether to incorporate code of conduct of ESG ratings under the supervision of credit rating agencies, also carefully looking at its effectiveness. According to a financial information service firm, Japan's ESG bond issuance surged 56% to about JPY 4.3 trillion in 2021.

Tokyo Stock Exchange (“TSE”) announced a policy to establish an information platform with which a list of ESG-related bonds can be viewed as early as this summer. It is essential to ensure transparency of evaluations to revitalize ESG-related finance. Each party concerned should clearly understand what role one should play through discussions.

On the other hand, an increasing number of listed companies are issuing "integrated reports" that summarize financial information and non-financial information such as ESG activities. In 2021, there were 665 companies that issued “integrated reports”, 20% up from the previous year, according to the data provided by a research institute. In addition to investors’ demand, TSE also requires high levels of information disclosure at the Prime market, taking the opportunity of the implementation of the new market segment.

Integrated reports cover not only financial information such as sales and profits, but also contain non-financial information such as management strategy, corporate governance and environmental and social considerations. It is published on a voluntary basis with an aim of encouraging investors to understand the company from a medium- to long-term perspective.

The background of this trend is the increasing institutional demands for disclosure. Corporate governance code was revised in June last year, and listed companies are required to disclose ESG policies and initiatives. Listed companies on the Prime market are required to quantitatively and qualitatively enhance disclosure on climate changes, and the move will be linked to the TSE's new market restructure implemented in April this year.

While disclosure is expanding, challenges remain. There are a wide range of environmental and social issues, and each company has different ESG issues to tackle. Although 176 of the 225 companies comprising the Nikkei Stock Average mention important ESG issues in their integrated reports, only 84 companies (48%) describe how it relates to management strategies, and only 99 companies (56%) disclose their goals and performance of their relevant ESG standards.

Disclosure of climate changes that attract attention from investors is halfway there. As of the end of 2021, 184 of the 225 companies comprising the Nikkei Stock Average supported the recommendations of the Task Force on Climate-related Financial Disclosures (“TCFD”), which calls for disclosure on climate change impacts. However, about 20%, or 43 companies, did not provide disclosure information in their integrated reports in line with the TCFD recommendations.

In order to attract ESG money, which is expanding worldwide, to the Japan market, it is essential to provide investors with useful information. A partner of an accounting firm said, "Rather than presenting information that has high demands collected from everywhere in an integrated report, companies should impart to the public how ESG initiatives will lead to enhance corporate value to show what differences it would make on them.”

In addition, an increasing number of companies have been setting up internal committees to promote ESG. As of the end of December 2021, 118 out of 400 major companies established such committees, which more than doubled in a year and a half, according to a tally by a governance consulting firm. With TSE's market restructuring set to begin in April this year, such as the launch of the Prime market, companies will try to attract funds by taking accountability on the items that are of high interest for investors.

In the “Guidelines for Investor and Company Engagement (“Guidelines”)” which was revised in June last year, FSA added a phrase, "Does company have an established framework, such as a committee, to examine and promote sustainability initiatives across the company?" In the Guidelines attached to the Corporate Governance Code, the ESG framework was identified as an important dialogue item between investors and companies.

The focus will now be how a company would institute long-term ESG goals and would structure a mechanism to put them into practice. The president of the above-mentioned governance consulting firm said, "If the Sustainability Committee formulates issues important for the company and uses indicators to resolve them in executive compensation, the company can appeal its management story to the market."

The work to establish the system has just begun. A framework that evaluates performance in dialogue with the market and leads to better performance would be more appreciated.

Information compiled from Nikkei Shimbun & Mizuho research

New Equities Listing Approvals

Listing Date	Name of Company	ISIN Code	MKT
Mar-31	NOVAC	JP3762050007	T
Apr-01	Procrea Holdings	JP3833850005	T
Apr-04	SecondXight Analytica	JP3418800003	G
Apr-07	FB CARE SERVICE	JP3166980007	ST
Apr-12	circlace	JP3310220003	G
Apr-21	FULUHASHI EPO	JP3828600001	ST/N
Apr-21	ASNOVA	JP3119850000	N
Apr-25	Informetis	JP3153820000	G
Apr-27	moi	JP3922150002	G
Apr-27	STORAGE-OH	JP3399790009	G
Apr-28	Petgo	JP3836350003	G
Apr-28	CREAL	JP3269780007	G

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

***Board lot size is unified to 100*

III. Foreign Ownership Limit Ratio

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