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The reality of Corporate Governance Code compliance in Japan

Chie Mitsui

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Nomura Research Institute, Ltd.

Executive Summary

Chie Mitsui
Senior Researcher
Digital Financial Business Planning Department I

Japan's Corporate Governance Code is now in the third year since its inception. In July 2017, NRI surveyed companies on how they are putting the Code into practice. The Code seeks to promote engagement between companies and institutional investors but such engagement may not be worthwhile for all companies at present.

Japan's Corporate Governance Code (CGC), adopted in June 2015 to promote better corporate governance in the aim of revitalizing the Japanese economy, has been lauded as a catalyst of positive change in Corporate Japan. Some IR (investor relations) consultants, however, have reported that companies' CGC compliance initiatives to date has been largely confined to administrative and shareholder relations (SR) departments[1], with many companies yet to effectively put the CGC into practice in their IR activities.

At NRI, we surveyed publicly traded companies about what they are actually doing in response to the CGC[2]. Our survey queried respondent companies about their degree of satisfaction with their CGC compliance initiatives, topics of particular interest or concern, weaknesses they plan to rectify going forward, the size of their budgets for IR/SR services and their IR/SR staffing levels. The survey revealed that the CGC's emphasis on engagement with institutional investors is not a good fit for many companies. Such companies generally seem to be trying to figure out how to comply with the CGC in a manner compatible with their own situations and within the resource constraints to which they are subject.

Companies communicating with institutional investors are mostly large-caps

We compared the survey respondents' IR/SR programs/staffing after classifying the respondents into three groups: large-cap[3] (market capitalization of over ¥250 billion), mid-cap[4] (¥50-250 billion) and small-cap[5] (below ¥50 billion) companies.

The topic of interest or concern cited most frequently across all three groups was "engagement with institutional investors." However, the respondents that have proxy voting outreach programs or are otherwise spending money on IR targeted at institutional investors are predominantly large-cap companies. The percentage of respondents whose IR/SR budgets include funding for proxy voting outcome simulations or perception studies[6] is sharply lower in the small- and

NOTE

1) Some companies have recently set up shareholder relations (SR) departments dedicated to proxy voting matters, shareholder general meetings, etc.

2) The survey was distributed to all publicly traded companies, approximately 430 of which returned completed surveys. Relative to the distribution of all publicly traded companies by market capitalization, companies with market caps in excess of ¥100 billion were somewhat overrepresented in the survey sample while companies with market caps below ¥100 billion were somewhat underrepresented. Nonetheless, the survey responses spanned nearly the entire market capitalization spectrum.

3) The top 430 or so publicly traded companies ranked by market cap as of early July 2017, 83 of which responded to our survey.

4) Companies ranked between roughly 431st and 1,200th by market cap as of early July 2017, 106 of which responded to our survey.

5) Companies ranked below 1,200th or so by market cap as of early July 2017, 240 of which responded to our survey.

6) Perception studies are surveys conducted by third-party research firms to ascertain institutional investors' image of the company commissioning the survey. They are used to strategically craft IR messages in response to investor perceptions.

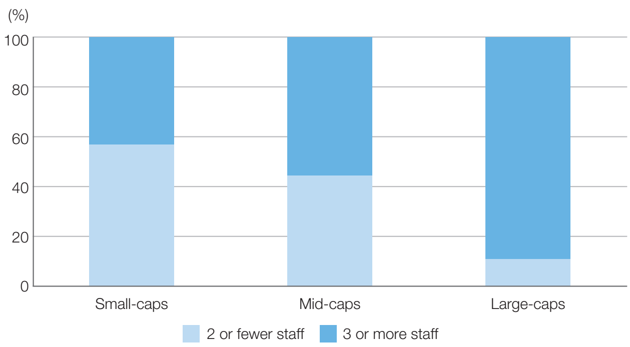
mid-cap groups than in the large-cap group. One likely reason for this disparity is that institutional investors generally invest mostly in large-cap companies. The equity indices that overseas institutional investors typically use to passively invest in Japanese equities include only a few hundred of the largest-cap Japanese companies. This large-cap subset of companies coincides with sell-side analysts' coverage universe also. Even the ESG indices that Japan's Government Pension Investment Fund recently added to its domestic equity allocation are likewise made up of hundreds of the largest-cap companies. Perhaps not coincidentally, the survey respondents that publish ESG reports or integrated reports were predominantly large-cap companies.

Small- and mid-cap companies' IR programs are targeted mainly at retail investors

Small- and mid-cap companies do not seem to be allocating enough resources to their IR/SR programs. Whereas a vast majority of large-cap respondents have an IR/SR staff of at least three strong, most small-cap respondents and many mid-cap respondents have two or fewer personnel assigned to IR/SR (Exhibit 1). A similar pattern is evident in IR/SR budgets. Over 90% of large-cap respondents but less than half of small-cap respondents budget at least ¥2 million for externally sourced IR/SR services (Exhibit 2). Respondents that reported they are already in compliance with the CGC included 80% of the large-cap group but less than half of the small-cap group. The latter, however, had the highest percentage of respondents that reported wanting to increase their IR/SR budgets in the future.

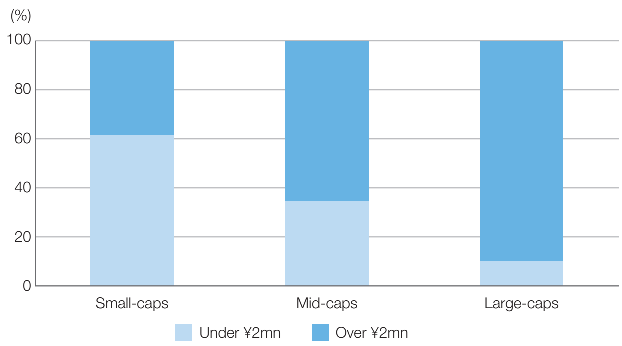
Many small- and mid-cap respondents spend a relatively large share of their IR/SR budgets on communicating with retail investors, particularly through presentation events. In other words, such companies are devoting resources to the traditional "information dissemination" model of IR. NRI spoke to one portfolio manager

Exhibit 1: IR/SR staffing



Source: NRI

Exhibit 2: Total budget for externally sourced IR/SR services



Source: NRI

employed by a foreign asset management company who considers small- and mid-cap companies to be disadvantaged by a lack of institutional interest in them. He remarked, "Japanese small- and mid-cap stocks tend to be illiquid, so few institutional investors invest in them." Consequently, if small- or mid-cap companies unwind their cross shareholdings as recommended by the CGC, they would have to rely mainly on retail investors to absorb the divested shares. A nonexecutive director of a publicly traded Japanese company explained, "Investors have definitely become more outspoken since the CGC's advent. Companies have no choice but to expand their investor 'fan bases'." Given such a reality, smaller companies may indeed be compelled to devote the bulk of their available IR/SR resources to growing a loyal following of investors that believe in their long-term growth prospects and will remain long-term shareholders through thick and thin, even if they happen to be retail, not institutional, investors.

Improvement in governance and CGC's role

In sum, even in the third year since the CGC's advent, many companies not ranked among the top few hundred by market cap are still running thinly staffed IR/SR programs with skimpy budgets. Additionally, few such companies are adequately engaging with institutional investors despite the CGC's emphasis on such engagement. Small- and mid-cap companies' IR/SR programs are targeted predominantly at retail investors. Numbering over 3,000, such companies make up the lion's share of the Japanese equity market.

Is there some way that all companies can currently comply effectively with the CGC? The CEO of a small-cap company involved in a broad range of IR support services contends that preparing highly transparent regulatory disclosure documents such as annual Securities Reports ultimately constitutes de facto engagement with investors. The process of preparing such disclosures undeniably requires a high-quality governance regime. Moreover, such disclosure documents are also a key information source for data services that investors use to analyze companies. Improving regulatory disclosures' quality and intercompany comparability may be a first step.

With the CGC now in its third year, regulatory authorities will likely start talking about revising it before long[7]. However, for the CGC to be universally applicable to all companies, it needs to provide guidance on upgrading governance at small- and mid-cap companies and persuade such companies that better governance will definitely benefit them. Adding guidelines for improving governance through

7) This was written in late September.

engagement with retail investors may also be a good idea. Meanwhile, if the CGC aims to help revitalize the Japanese economy, the authorities need to also look into developing an institutionally investable small/mid-cap equity market to enable even small-cap companies to engage meaningfully with institutional investors.

about NRI

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Inquiries to : Business Planning & Financial IT Marketing Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

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