

Will the Reform of TSE Market Structure Improve Corporate Governance in Japan?

Complicated TSE's market structure

The Tokyo Stock Exchange (TSE) completed the market reforms which has been discussed since 2018, and trading started on April 4th under new 3 market segments. They are PRIME, STANDARD and GROWTH. It used to be TSE's the First Section, the Second Section, the Mothers, and JASDAQ (further divisions of the Standard and the Growth in JASDAQ). The difference between the latter three is difficult to understand because JASDAQ was initially an independent exchange acquired by the Osaka Stock Exchange (OSE) in 2010 and eventually became a part of TSE due to the integration of OSE and TSE in 2013. The Mothers is an emerging market created by the TSE in 1999, but JASDAQ was initially an independent exchange born from over-the-counter trading. Its history goes back to 1976 and became an exchange in 2004 due to various regulatory compliance. Therefore, in 2007, JASDAQ created a separate emerging market called the Neo (currently Growth). Even if it meets the listing criteria of the TSE, some companies prefer to stay at JASDAQ.

As of February 24, 2022, there were 3828 companies listed on the TSE: 2182 in the First Section, 473 in the Second Section, 429 in Mothers. Regarding JASDAQ, there were 657 companies in the Standard and 35 in the Growth. Many people were surprised that there were 2182 companies in the First Section. Especially after the integration with OSE in 2013, the number has grown. In fact, TSE has merged with local exchanges before that. For example, there used to be an exchange in the city of the Japan Sea called Niigata, and a company that provided frozen foods was listed. There was an episode when the Niigata Stock Exchange was merged with the TSE in 2000. The local organisations undertook a capital increase and supported it so that the company representing the local area could meet the criteria of the TSE Second Section.

In other words, on those historical backgrounds, TSE had to sort out the market structure.

Where is the problem?

TOPIX, which is the most widely used benchmark in Japan, was actually calculated from the floating stocks of all listed companies in the TSE First Section. From a company's perspective, if it is listed in the First Section, it can be a member of TOPIX, which is attractive because they benefit from being invested by the index passive funds. Index funds were asked for engagement with investee, since the introduction of the Stewardship Code, though previously they were “quiet investor”.

On the contrary, from investors' perspective, more than 2000 companies became the population when investing in TOPIX, and it was not possible to engage with all the companies, and the voting season became very busy. (In Japan, about 70% of listed companies hold a general AGM in the same month.) Why is TOPIX chosen? One of the reasons is that there was no other index calculated by floating stocks among the major indices. (Nikkei 225 is not) Even before the discussion of market reform began in 2018, there were occasional voices among market participants that "TOPIX should have a small number of companies like major overseas indexes."

Apart from that, when the Corporate Governance Code was introduced in 2014, there were opinions that "not all companies can apply such strict requirements", "Why don't we set the strict requirements for companies only in the First Section like other countries?" However, even the First Section (TOPIX) includes both a large company like Toyota with a market capitalisation of 34 trillion yen, and small companies with a market capitalisation of about 2 billion yen that might be difficult to comply with strict requirements.

From another point of view, with too many and various size companies included in the First Section, it is also not efficient to use it for the first screenings for the investment decisions. As a result of those issues above, the opinion that "the First Section should include fewer companies" was growing.

Market reform discussions so far.

Since the discussion of market reform began in 2018, some people have said that the top markets should be better to have "at most 500 companies" and "market capitalisation of over 200 billion", etc. It is not just for the conveniences described above. There was also a big reason, the desire to grow Japanese companies. If those conditions are high, the company will improve itself. Therefore, it will be an incentive for growth.

The equity investment money basically won't "redeem". Investors invest in the companies that they believe to grow, so the money should be utilised for growth. If you are listed in the First Section, investors may think of you as "qualified companies". Of course, investors are also not looking for only growth. They look for long-term sustainable growth, stability and responsibility for society. In case they just focus on growth, they would invest in young companies. That was the role of Mothers. If you are listed on the First section, you need to improve your governance as well and it must be at a higher level.

When the qualifications to belong to each section were announced, the companies on the border (mainly market capitalisation) became a big fuss. Given the market capitalisation (10 billion yen or more) and the tradable share ratio (35% or more), some companies ran around to decreasing their cross-shareholdings. Also, all requirements of the revised corporate governance codes would be applied when it came to PRIME. Some companies had run around to search for someone who could be the 3rd independent director.

This kind of companies' effort is expected by investors, but problem is that the hurdle seems not so high. Besides, what TSE has done has lowered the hurdle to be listed on the PRIME. Companies that do not meet the conditions can "remain" in PRIME as a transitional measure if they so desire. And the deadline has not been set. So it is unavoidable to be sceptical about the motivation for growth.

Competition is the essence of the company, and listing consists of growth.

So, In January 2022, it was discovered that 1841 companies were going to belong to PRIME, which disappointed many people. In addition, TSE still said that "The criteria of PRIME is not the same as former the First Section", but at the same time "STANDARD is not under PRIME". This might have confused investors...

Investors expect PRIME companies to be of higher quality than STANDARD companies. Otherwise, it will not be an incentive for companies to aim for PRIME. For some reason, Japan tends to set a goal of "allowing to fit lower ". If it seems that the criteria are loose (easy), it might be difficult to get the trust of serious investors.

I believe that companies aren't just about growth or competition. But companies might not be able to well feed their employees without winning the competition. Besides, since you are listed on the exchange, competing and being ranked is unavoidable.

Anyway, even though it seems too many companies, including small-size companies, listed in PRIME, it is the result of this reform. So now, if you choose to be listed in PRIME, you have to improve your corporate governance for your growth. Do some companies pretend to comply with code while remaining in PRIME? If so, the Japanese market will lose a chance to be trusted. Financial Services Agency Japan also should strictly require companies to comply with the corporate governance code. Of course, the investor needs to encourage PRIME companies to comply with the code and improve corporate value, even though it has still so many companies.



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