

# Decentralized Discipline and the Roles for Principles

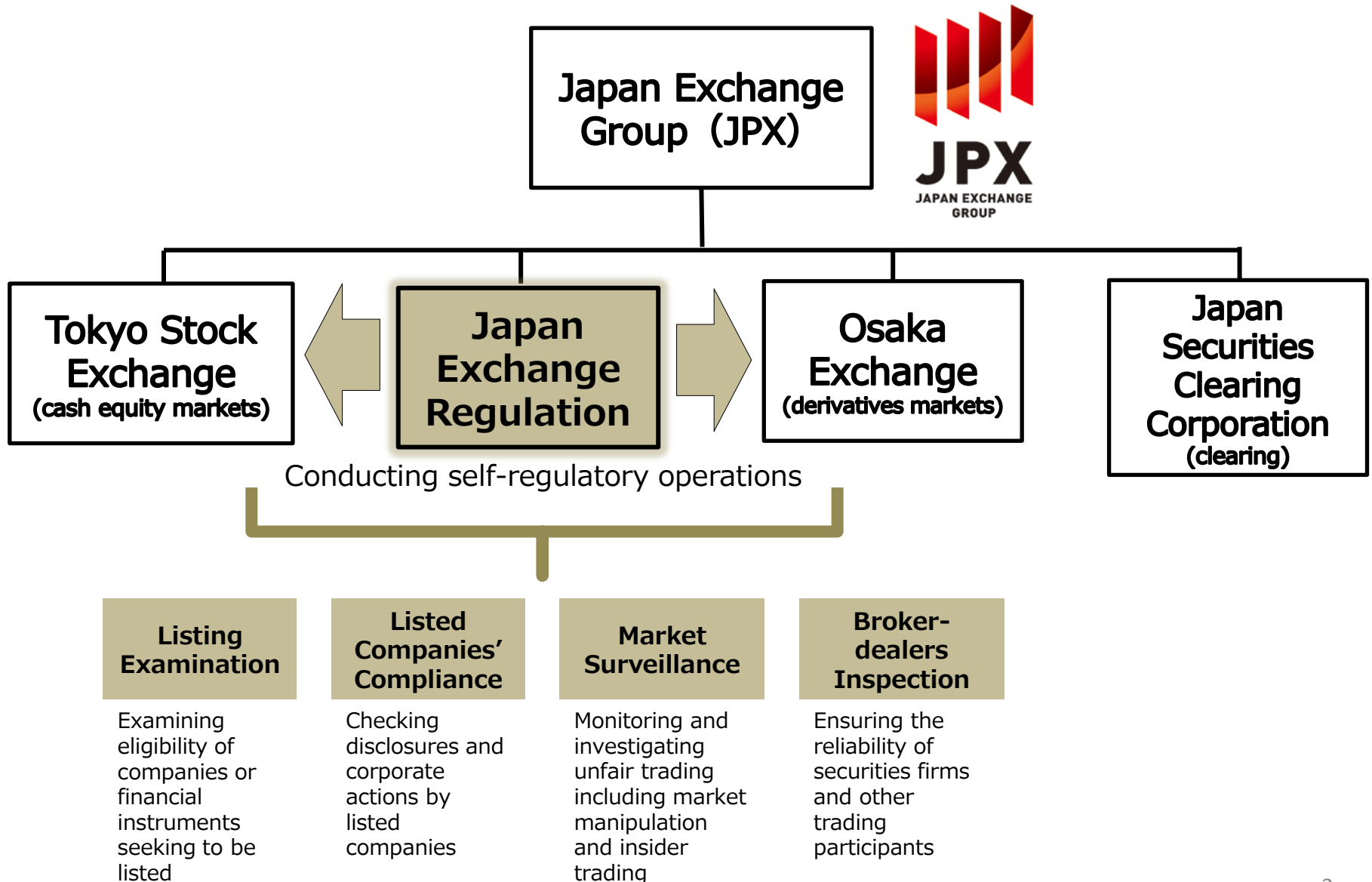
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# Decentralized Discipline and the Roles for Principles

- I. Decentralized Mechanism of the Capital Market
- II. Rules vs Principles
- III. Disciplining Capital Market through Principles
- IV. Recent Development in Japan with Principles-based Approaches

# 1. Where the speaker comes from



## 2. Diversity in participating entities of capital market

Participating entities		Role
<b>Major market players</b>	Listed companies	Maintaining good corporate governance Timely and appropriate disclosure (financial reports, etc.)
	Investors	Investment judgments based on the disclosed information Fiduciary duty
<b>Intermediaries</b>	Accounting standard setters	Establishing high quality accounting standards
	Auditors	Evaluating the appropriateness of financial reporting
	Analysts	Providing investors with meaningful analysis and reports
	Lawyers	Confirmation of consistency between customer needs and existing laws
	Securities companies	Appropriate investment solicitation Underwriting responsibility Management of customer asset Advising listed companies in financing
	Stock exchanges	Orderly market operation Maintaining transparency and fairness of market

### 3. Decentralized discipline

- The diversity in market participants leads us to recognize that the disciplining mechanism of capital market will inevitably be decentralized to some extent.
- The difficult challenge exists of how to let decentralized discipline work effectively to bring about overall consistency and market integrity.
  - ✓ We cannot solely rely on professional expertise and high moral on the part of each intermediary.
  - ⇒ Rules-based regulation and supervision are needed to provide common standards and guarantee minimum performance in each professional area.

**The performance of a capital market largely depends on how the decentralized discipline prevails.**

#### **Decentralized discipline**

A state where the sense of norm and compliance influences within each market participant or intermediary in line with their relevant professional requirements against the background of rational institutional framework and appropriate incentive mechanism, and the aggregation of thus motivated behaviors enhances the orderly functioning of the market as a whole

## 4. Better Regulation Initiative

The Better Regulation Initiative was launched and introduced in 2007 by the FSA, which illustrated the direction of evolving financial regulation in view of better regulatory environment.

### <Four Pillars of Better Regulation>

#### **1. Optimal combination of rules-based and principles-based approaches**

– rules-based and principles-based approaches are mutually complementary, rather than exclusive against each other

#### **2. Risk-focused, forward-looking approach: prompt & effective response to high-priority issues**

– promptly foreseeing and identifying the areas where serious problems could be hidden and where huge risks might materialize in the future, and effectively allocating resources to these areas so as to address such issues

#### **3. Encouraging voluntary efforts by financial institutions and placing greater emphasis on incentives for them**

– more incentive-compatible approaches and greater emphasis on voluntary efforts

#### **4. Improving the transparency and predictability of regulatory actions**

– enhancing the transparency and predictability of regulatory actions through dissemination of thoughts and information, etc.

## 5. Rules and principles

### **Rules and principles are complimentary to each other in financial regulation.**

- As financial innovation advances, it is impossible to forecast accurately future changes and cover all the cases by rules in advance. Principles are therefore expected to cover the gaps arising between old not-yet-revised rules.
- In applying rules to individual cases, principles could provide appropriate guidelines across various individual judgments and could help attain real equality and consistency.
- Principles encourages financial institutions to think on their own and to strive toward their best practice.

## 6. "The Principles in the Financial Services Industry"(2008)

- The FSA and the financial services industry reached agreement on 14 key principles in April 2008, which was the cornerstone of principles-based supervisory approaches.
- The principles are meant to induce financial firms to share the common social values and desirable business management, and encourage them to provide higher quality services to their customers.
- The 14 principles can be categorised as follows :

Principles 1	Social responsibilities of the financial services and the fundamental stance to fulfill its responsibilities
Principles 2、 9	Actions taken by market participants and market intermediaries in line with the aim to enhance the transparency, fairness and effectiveness
Principles 3~7	Customer protection
Principles 8	Establishment of business management system and functioning governance system
Principles 11、 12	Ensuring financial soundness and risk management system
Principles 10、 13	Safeguards against external factors (anti-social parties' access, large-scale disasters, etc.)
Principles 14	Interactive Dialogue between the financial firms and the FSA



## 6. – ② The Principles in the Financial Services Industry

Financial service providers are expected to:

1. Pursue greater customer benefits and fulfill expected roles through voluntary efforts with creativity.
2. Participate in the markets with the resolve to improve the functioning thereof as a whole and secure fairness and transparency therein.
3. Pay due regard to reasonable customer expectations and conduct business with integrity and professional prudence in order to meet their needs.
4. Pay due regard so as to provide customers with information and advice on a timely basis and in a clear and fair manner, thus enabling them to make economically rational judgments.
5. Respond to customer consultations and inquiries with integrity and provide needed information and advice, while making efforts to disseminate financial knowledge.
6. Prevent abuse stemming from conflicts of interest between one's self, including group firms, and the customers, or among different customers.
7. Manage customers' assets in an appropriate manner, corresponding to the responsibilities assumed.
8. Establish appropriate mechanisms for corporate governance, including by way of making necessary personnel allocations, and achieve effective corporate governance, to ensure financial soundness and proper business operation.
9. Conduct appropriate information disclosure, considering the significance of both setting market discipline to work and enhancing transparency of corporate management.
10. Establish mechanisms so as to avoid being exploited by financial crimes, including by way of blocking anti-social parties' access.
11. Maintain sound financial basis corresponding to risk profile.
12. Conduct appropriate risk management in accordance with the size and features of the business operation and inherent risk profile.
13. Establish countermeasures against large-scale disasters and other contingencies in accordance with the role it fulfils in the markets.
14. Provide accurate information with integrity upon reasonable requests from the FSA, and facilitate effective communication with the FSA, including by way of interactive dialogues.

## 7. Merits and demerits of rules and principles

Rules	Principles
<ul style="list-style-type: none"><li>○ Explicit common rules applied equally to a large number of unspecified entities</li><li>○ Basis of fair, transparent, and predictable regulatory actions</li></ul>	<ul style="list-style-type: none"><li>△ Discrepancies in the degree of achieved compliance (Interpretation of principles is often left to each individual entity.)</li><li>△ Third party evaluation might be necessitated to rectify the above discrepancies</li><li>△ Lack in strong enforcing powers (how to cope with committed wrong-doers)</li></ul>
<ul style="list-style-type: none"><li>△ Gaps between rules (the financial innovation and changing circumstances)</li><li>△ Disguised unfair trading pretending to be fully compliant to rules superficially</li><li>△ Limited availability of resources for regulatory/supervisory execution</li></ul>	<ul style="list-style-type: none"><li>○ Widely applied common behavioral norms</li><li>○ Appropriate response to cases where directly applicable rules can not be found</li><li>○ Focus on substance rather than on superficial form of individual cases</li><li>○ Prevalence of principles can provide broad coverage and can fill gaps between rules.</li></ul>

## 8. Principles-based approach

### Principles

The foundations of reasoning and standards of behavior

- ✓ Originally abstract and implicit sense of value or norm born by people in various corners of society obtains one day concrete and explicit expressions.
- ✓ Principles, if widely shared among relevant entities, could always be referred to as reliable common guidance in business judgment and execution.
- ✓ For example, “maintaining fair and transparent market”, “protecting investors” and “fair and efficient price formation” (fundamental spirits of written laws and rules)

### Principles-based approach

A regulatory method in which the authority directly appeals to each entity’s sense of norm through compiling sets of principles (explicit behavioral standards) and by incentivizing or persuading him that principles-consistent behaviors will enhance his own interest

- ⇒ Enhancing organic and effective functioning of the disciplining mechanism as a whole
- ✓ A framework where the sharing and recognition of common social benefits will induce each entity’s behavior to a socially desirable outcome
  - ✓ The approach requires the acceptance of the core values and norms, but it allows for different approaches and paths to reach the final target.

**The prevalence of principles would enhance the sense of norm and be widely incorporated in market practices, and thereby provide a basis for sustainable and effective decentralized discipline.**

## 9. Sustainable functioning of a competitive capital market

- Line-up and quality of financial products
- Fairness of trade and reliability of transaction execution
- Confidence in information disclosures
- Convenience for investors and fund raisers
- Vitality of the financial services business
- Reliable price-discovering function

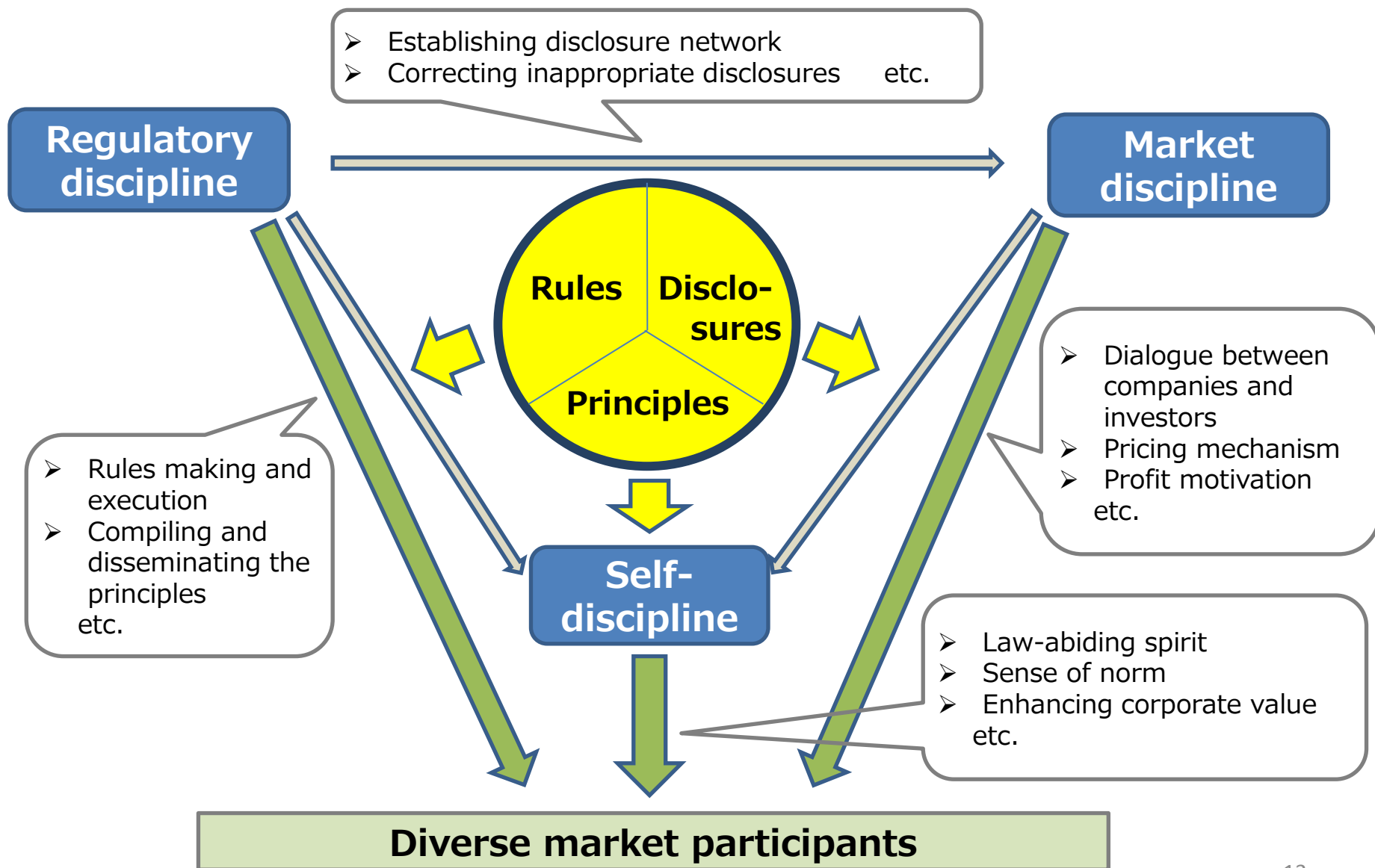
- Dignity of market
- International competitiveness
- Sustainable development

Sustainable functioning

### High quality disciplining mechanism

- Common sharing of norms
- Existence of appropriate incentives
- Transparency and predictability of regulation
- Effective and fair supervision
- Business evaluation through efficient market mechanism etc.

## 10. Image of decentralized discipline in capital markets



## 11. Regulatory discipline

Establishing the rules and compiling the principles (authorities and self-regulatory organizations)



Enforcement of the rules = Ensuring the effectiveness of regulations

Surveillance, inspection, correction and sanctions on unfair tradings and other inappropriate conducts (e.g., insider trading, inappropriate disclosure)



Sharing the sense of norm and the spirit of compliance = Preventing inappropriate conducts in advance

- Dissemination of the content and purpose of the rules through various channels such as website and speech
- Publishment of the principles

Enforcement of rules (post-event responses) and sharing of principles (pre-event guidance) are both necessary and complementary to each other.

## 12. Market discipline

### Some points on “Regulatory discipline”

- Enforcement of rules means individual cases oriented approach.
- Limited resources within regulators might create difficulty in addressing all cases.
- Heavy dependence on regulation might lead to excessive regulation.

### Merits of “Market discipline”

- Timely and appropriate disclosure enables the market discipline to function effectively and continuously.  
e.g., Deterioration of business performance of a listed company will be reflected swiftly in the share prices.
- Limited resources within the regulator may not be a problem.
- Market discipline continues to work seamlessly.

### Prerequisites for “Market discipline”

- Timely and appropriate disclosures
- Fair and efficient price formation



Importance for regulators to establish appropriate framework and environment

## 13. Self-discipline

Self-discipline is the prerequisite for all the economic activities to be carried out in sustainable and orderly manner.

### Self-discipline

- Self-discipline means that each entity disciplines itself with its own sense of norm.
- Self-discipline functions prior to “Regulatory discipline” or “Market discipline”, it functions in a more concrete manner if coupled with them.
- Each entity has a sense of norm either originally or acquires by experience. This sense becomes more tangible and clearer through the encounter with principles.

### Environment for the self-discipline to function effectively

- Compiling principles / Disseminating principles
- Conducting a survey about the effectiveness of the principles
- Self-evaluation through “comply or explain” approach / Evaluation by other market participants

\* In reality, some market participants have less sense of norm and therefore self-discipline does not function well with them. In such cases the regulators need to take rigorous actions according to the rules.



## 14. Principles-based approaches introduced in Japan

<p><b>1. The Principles in the Financial Services Industry (FSA)</b></p>	<ul style="list-style-type: none"> <li>Aiming to improve the business and regulatory environment so as to enable financial firms to provide high-quality financial services to meet user needs. (Apr. 2008)  <a href="http://www.fsa.go.jp/en/news/2008/20080424.html">http://www.fsa.go.jp/en/news/2008/20080424.html</a> (English page)</li> </ul>
<p><b>2. Principles for Responsible Institutional Investors</b>  <b>«Japan's Stewardship Code»</b>  <b>(FSA)</b></p>	<ul style="list-style-type: none"> <li>The principles for the responsibilities of institutional investors to enhance the mid- to long-term return for their clients and beneficiaries by improving the investee companies' corporate value and sustainable growth through constructive engagement.</li> <li>"Comply or Explain" approach (Feb. 2014, revised in May 2017)  <a href="http://www.fsa.go.jp/en/refer/councils/stewardship/20170529.html">http://www.fsa.go.jp/en/refer/councils/stewardship/20170529.html</a> (English page)</li> </ul>
<p><b>3. The Principles for Equity Financing (Japan Exchange Regulation)</b></p>	<ul style="list-style-type: none"> <li>Encouraging and facilitating high-quality equity financing</li> <li>Response to some cases of equity financing that could potentially undermine the interests of shareholders and investors. (Oct. 2014)  <a href="http://www.jpx.co.jp/english/regulation/ensuring/listing/equity-finance/index.html">http://www.jpx.co.jp/english/regulation/ensuring/listing/equity-finance/index.html</a> (English page)</li> </ul>
<p><b>4. Japan's Corporate Governance Code (Tokyo Stock Exchange)</b></p>	<ul style="list-style-type: none"> <li>The principles for effective corporate governance so as to stimulate healthy corporate entrepreneurship, support sustainable growth and increase corporate value over the mid- to long-term</li> <li>"Comply or Explain" approach (Jun. 2015)  <a href="http://www.jpx.co.jp/english/equities/listing/cg/index.html">http://www.jpx.co.jp/english/equities/listing/cg/index.html</a> (English page)</li> </ul>
<p><b>5. The Principles for Responding to Serious Scandals at Listed Companies (Japan Exchange Regulation)</b></p>	<ul style="list-style-type: none"> <li>Promoting self-purification (detecting root causes, preventing recurrence, and disclosure of related information) so as to restore the corporate value of the company facing serious scandals. (Feb. 2016)  <a href="http://www.jpx.co.jp/regulation/listing/principle/index.html">http://www.jpx.co.jp/regulation/listing/principle/index.html</a> (only in Japanese)</li> </ul>

<b>6. Principles of Fiduciary Duty (FSA)</b>	<ul style="list-style-type: none"> <li>Emphasizing the importance of financial institutions' fiduciary duty and putting customers' interest first, through developing a customer-oriented business model and building trust with their customers (Mar. 2017)  <a href="http://www.fsa.go.jp/news/28/20170330-1.html">http://www.fsa.go.jp/news/28/20170330-1.html</a> (only in Japanese)</li> </ul>
<b>7. Principles for Effective Management of Audit Firms (The Audit Firm Governance Code)(FSA)</b>	<ul style="list-style-type: none"> <li>Promoting audit firms to accomplish the effective management of the firm from the viewpoint of public expectations of audits and changing circumstances surrounding audits. (Mar. 2017)  <a href="http://www.fsa.go.jp/news/28/sonota/20170331-auditfirmgc/3.pdf">http://www.fsa.go.jp/news/28/sonota/20170331-auditfirmgc/3.pdf</a> (only in Japanese)</li> </ul>

## 15. “Comply or Explain” approach

This principles-based approach has already been adopted in Japan’s Stewardship Code. **The significance of this approach is found in having parties confirm and share the aim and spirit of the principles and review their activities against the aim and spirit, not against the literal wording of the principles**, even where the principles may look abstract and broad on the surface. For this reason, the terminology used in the Code is not strictly defined as is the case with laws and regulations. It is anticipated that companies that are accountable to shareholders and other stakeholders will apply appropriate interpretations of the terminology in accordance with the aim and spirit of the Code.

(Source: Japan’s Corporate Governance Code )

- Japan’s Stewardship Code and Japan’s Corporate Governance Code is not legally binding. The approach they adopt for implementation is “comply or explain” (either comply with a principle or, if not, explain the reasons why not to do so).
- Both of the Codes assume that if a company finds specific principles inappropriate to comply with in view of their individual circumstances, they need not be complied with, provided that the company explains fully the reasons why it does not comply.
- Each company is evaluated by other market participants according to its disclosure and explanation.

Thank you