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# Nasdaq Japan

## - The Next Phase of Nasdaq's Global Strategy -

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*The U.S. Nasdaq Stock Market, the world's largest venture-firm stock market, has announced plans to set up a branch in Japan. NASD (the National Association of Securities Dealers), the parent body of Nasdaq, and the major Japanese software distribution company Softbank, announced on June 15<sup>th</sup> 1999 that they were to set up a joint venture company as a preliminary step to establishing a new "Nasdaq Japan" securities market. They will also set up a new association of securities dealers to run the new market, and plans are for trading to start by the end of 2000.*

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## 1. The Nasdaq Japan Project

### 1) Overview

On June 15<sup>th</sup> 1999 NASD (the National Association of Securities Dealers), the parent body of Nasdaq Stock Market in the US, and Softbank, announced that they were to set up a joint venture called "Nasdaq Japan Planning Company, Ltd" as a preliminary step to establishing a new "Nasdaq Japan" securities market. They are planning for trading on the new market to commence by the end of 2000.

Initial capital investment in the joint venture will be split equally between NASD and Softbank (Exhibit 1). Once the new company has been set up and trading is set to start, the company's name will drop the "Planning" part and become simply "Nasdaq Japan, Ltd." Further capital will also be sought via share placements with other securities companies at this juncture, but these will be minority holdings and NASD and Softbank will continue to be the chief stake-holders.

**Table 1 Nasdaq market operating company details**

Name:	Nasdaq Japan Planning Company, Ltd.		
Capital:	¥600 million		
Ownership:	NASD	50%	
	Softbank Ltd.	50%	
President:	Masayoshi Son (Softbank Japan Ltd., President)		
Inauguration:	June 1999		
Activities:	Planning the establishment of the "Nasdaq Japan" new securities market in Japan		

Source: Softbank press release

Once set up, the new company will flesh out the details via discussions with the Japanese Ministry of Finance and those securities companies who will comprise the main membership of the Nasdaq Japan market.

According to the Japanese Securities Exchange Law, the only entities entitled to set up markets for the trading of securities are Stock Exchanges and associations of securities companies (Articles 2-12, 67-2). Other entities may not set up such or similar markets for securities trading, and trading on markets not set up by such entities is prohibited (Article 167-2). Therefore Nasdaq Japan Planning cannot directly set up the new market. Instead NASD and Softbank envisage that a new association of securities companies will fulfill the function of setting up the new market.

The Securities and Exchange Law stipulates that “only securities companies may set up [an association of securities companies]” (Article 68-1), and that any new association will have to recruit securities companies as members. According to the plan presented by NASD and Softbank, membership of the new association will be limited to securities companies who are conversant with the Securities and Exchange Commission (SEC) of the US’ rules, and who are also able to provide adequate system functionality, as a first step. In fact, initial membership will probably come from members of both NASD and the Japan Securities Dealers Association (JSDA). After which, if the system runs smoothly for 2 ~ 3 years, then membership will be gradually widened to include other securities companies.

First of all only stocks already listed on the US Nasdaq market will be traded on Nasdaq Japan, then from 6 months to a year after trading has begun Japanese domestic venture start-ups will start listing on the new market (Exhibit 2).

**Table 2 Nasdaq Japan Overview**

<ul style="list-style-type: none"> <li>● <b>Trading of Nasdaq listed securities (available from initial establishment of the new market)</b> <ol style="list-style-type: none"> <li>(1) Japan-based investors will be able to trade directly in the 5,000 listed Nasdaq stocks during Nasdaq trading hours (A Zone Time, 22:30 ~ 05:00 the following morning, JST).</li> <li>(2) Outside Nasdaq trading hours (B Zone Time, 05:00 to 22:30 JST), Japan-based investors will be able to trade real-time in the major 50 ~ 100 Nasdaq stocks, such as Microsoft and Intel, only.</li> </ol> </li> <li>● <b>Listing of Japanese domestic venture businesses (to commence 6 months to 1 year from start of operations).</b> <p>Listing requirements will be more relaxed, adopting the same requirements as for the Nasdaq market, while any newly established companies with growth potential will be able to gain a listing. A listing on Nasdaq Japan may be a springboard to a listing on the US Nasdaq.</p> </li> <li>● <b>Use of Internet technology</b> <p>Market participants will be directly connected to the exchange via an Internet link using Softbank technology. The use of dedicated lines to link the major securities companies is being considered, but the final aim is for the whole market to be based on connection via the open internet only.</p> </li> <li>● <b>Other characteristics</b> <p>Trading currency will be Japanese Yen, disclosure to be in the Japanese language.</p> </li> </ul>
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Source: Compiled by Nomura Research Institute from presentation materials and press release information

## **2) Aims of the Nasdaq Japan project**

According to the published plan, the aims of NASD and Softbank in setting up the new Nasdaq Japan market are as follows:

### ***(1) To provide the opportunity to invest in US high-growth stocks listed on the US Nasdaq market***

Currently, when Japanese investors wish to invest in either Nasdaq market stocks or US stocks, they generally have to go through the troublesome process of dealing with a securities company by fax or telephone etc., and are also unable to deal in real-time. Brokerage commission charges are also high. Through the Nasdaq Japan computer system however they will be able to link directly to the exchange, greatly simplifying the trading process.

Companies contemplating a future IPO (Initial Public Offering of shares) on the US Nasdaq market will expect Japanese and foreign brokers making up the new association of securities dealers to cultivate a Japanese investor base for their stock, who will in turn be able to invest funds in US companies with high-growth potential.

### ***(2) To provide an efficient means of fund raising for Japanese growth companies and an active market in their stock issues***

Currently Japanese companies are generally required to have a company history of some 20 years before being able to obtain an OTC market listing. In contrast the new market will base its listing requirements on those used by Nasdaq, and by encouraging the listing of even young companies who meet the requirements, will create a fast and efficient method of funds procurement for these Japanese businesses. The current system does not function well as generally venture capital funds invest in unlisted companies for a period of 7 years. The aim is for this average 20-year time to market to be reduced to the 4 ~ 5 years of the Nasdaq market (1 ~ 2 years for IT stocks).

### ***(3) Establishment of a transparent and stable market***

Currently the fact that company information is available only in English acts to prevent Japanese investors investing in Nasdaq listed companies. Therefore the new market intends to offer information translated into Japanese. It is anticipated that translation and other fees will be paid by the issuers themselves, and that large companies and popular issuers will make all their information available in Japanese. Possibly smaller companies will only disclose the most important information in Japanese, with other more detailed materials available in English. However, this more detailed English-language information will be obtainable by regular investors at any time.

Furthermore, as trading will be carried out in Japanese Yen there will be a problem of exchange-rate risk, though the use of hedging companies is expected to reduce this risk.

## **2. Background to the Nasdaq Japan project**

### **1) Global competition and NASD's strategy**

The plan by a foreign securities market to set up a new market in Japan was greeted with great surprise from every quarter. However, setting aside questions of details, the actual idea of Nasdaq expanding abroad is, considered against the current climate of intensifying global competition amongst securities exchanges and NASD's own management strategy, not at all that surprising.

Recently there has been mounting competition between securities exchanges, OTC markets and PTS (Proprietary Trading Systems) and suchlike entities in the provision of markets on which to trade securities, fuelled by advances in communications and computer technology. As business and securities investment activity is increasingly taking place cross-border, the competition between exchanges extends beyond domestic markets and onto a global stage.

As part of its competitive strategy, NASD has been emphasizing the great success of its market-maker based venture-firm stock market and pushed for the listing of foreign firms on Nasdaq as well as been actively involved in lending its expertise to other markets adopting the market-maker trading system. Besides investing capital in the pan-European venture stock market EASDAQ, established in May 1995, it has also supported the development of its trading rules, listing requirements and its trading system.

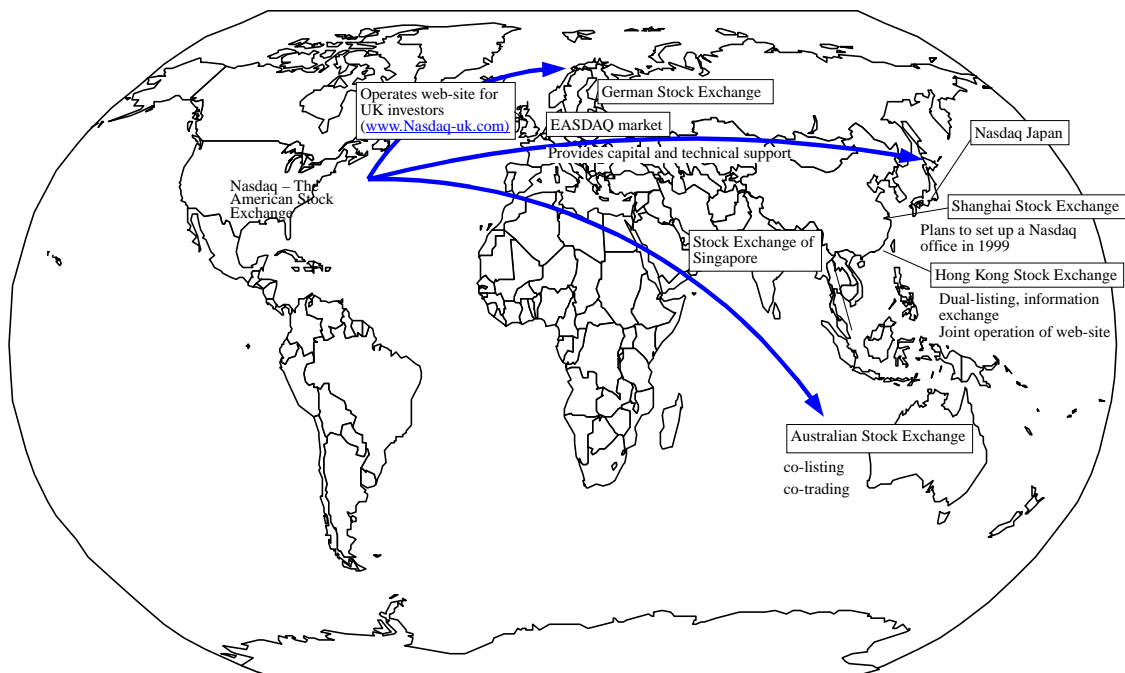
NASD's more aggressive stance has become clearer with the accession to the top seat of Mr. Frank Zarb in February 1997, who had previously served under President Ford as Administrator of the Federal Energy Administration and later worked as Chairman and CEO of the securities house Smith Barney. Mr. Zarb lifted NASD out of the club-like atmosphere it had been imbued with under the 10-year plus leadership of Mr. Hardiman, and was an energetic proponent of a more aggressive pursuit of market provision business. The personal leadership of Mr. Zarb is very much a part of the reason why the Nasdaq market has pursued a strategy of alliances with other domestic and foreign markets, and the close and trusting relationship between the President of Softbank, Mr. Masayoshi Son, and Mr. Zarb, also had an important role to play in the Nasdaq Japan venture.

Under Chairman Zarb, NASD surprised the world by announcing a merger with the American Stock Exchange ("Amex"), the number two securities exchange in the U.S. after the NYSE, in April 1998. The deal was finalized the following November, with a holding company "Nasdaq Amex Market Group" under the NASD umbrella controlling two companies who operated the two markets. With this move NASD, with its market maker based trading system, took control over the very different American Stock Exchange with its order matching type trading system and specialists.

In June 1998 the Philadelphia Stock Exchange was also set to participate in this merger, but this plan was later scrapped.

On the other hand, on the overseas front, NASD secured an agreement with the German Stock Exchange, Deutsche Boerse, to set up a working group to investigate the possibility of joint operations in June 1998, and since then has gone on to investigate many alliances with overseas exchanges (Exhibit 1).

**Figure 1 NASD expands overseas**



Source: Nomura Research Institute

Following this Nasdaq formed an alliance with the Stock Exchange of Hong Kong (SEHK) in December 1998, in which they agreed to promote dual-listings and to share information. They have also set up a joint web-site (<http://porttracker.Nasdaq-sehk.com>), where both Nasdaq and SEHK stock price information is available in either US\$ or HK\$. They are also planning to run a “pilot scheme” for a completely new service allowing the trading of Nasdaq’s top 10 stocks on the SEHK and vice versa. Its working group set up in conjunction with the German Stock Exchange is also currently in talks to develop their alliance along the same lines, and is holding similar discussions with the Singapore and Shanghai stock exchanges (Diagram 1).

Following the announcement of plans for a Nasdaq Japan in June 1999, it also announced an alliance with the Australian Stock Exchange (ASX) for the “co-listing and co-trading” of securities. More than just the listing on both exchanges of issues currently trading on just one, this envisages the harmonization of listing regulations for simultaneous listings, and adoption of the same trading technology platform.

It has also set up a web-site (<http://Nasdaq-uk.com>), targeting institutional investors in the UK in providing Nasdaq market data, share price data on London Stock Exchange listed securities and US stocks and screening tools etc.

## 2) The need for a stronger Japanese presence

As part of Nasdaq’s overall expansion strategy, its plans for a stronger presence in Japan stem from NASD’s desire to attract a larger amount of investment from the world’s second largest economy, and to increase its number of Japanese company listings.

**Table 3 Non-US Companies listed on Nasdaq (by country, as at December 1998)**

Canada	189	Belgium	3
Israel	77	Switzerland	3
UK	50	Argentina	2
Bermuda	23	Denmark	2
Holland	19	Italy	2
Australia	17	New Zealand	2
Japan	16	Singapore	2
Hong Kong	15	Taiwan	2
Sweden	13	Virgin Islands	2
S. Africa	12	Bahamas	1
Ireland	11	Belize	1
France	9	Brazil	1
Cayman Islands	6	Chile	1
Mexico	6	Finland	1
Germany	4	Indonesia	1
Greece	4	New Guinea	1
Liberia	4	Norway	1
Luxembourg	4	TOTAL	507

Source: NASD 1998 Annual report

NASD's primary aim in allying itself with foreign exchanges is to increase the number of foreign firms listed on Nasdaq through the harmonization of trading systems and mutual listings, and thus to increase Nasdaq's overall trading volume. Currently however the small number of Japanese company listings (only 16) on Nasdaq (all of them in ADR form), represents only some 3.1% of the total of 507 firms listed on the exchange.

Most of the Japanese firms listed on Nasdaq issued ADRs in the 1970s, while the one new listing to come from Japan in the 1990s has been a first-time listing of Sawako Corporation (c.f. Table 4). Most recently, IIJ, a Internet service provider listed their stocks directly on Nasdaq, without having been listed on Japanese stock markets.

NASD was no doubt scared into action on seeing its biggest rival, the NYSE, set up a Japanese office in order to attract more Japanese company listings.

Since 1994 two large Japanese companies have listed on the NYSE (NTT and Orix), while in May 1999 Toyota Motor Corp. announced its intention to move from Nasdaq to a NYSE listing within the year. NASD therefore felt it needed to strengthen its Japanese presence in order to reverse this flow.

**Table 4 Japanese Companies listed on Nasdaq and NYSE exchanges  
(as at June 1999)**

**Nasdaq listed Japanese companies**

Company	Listing Date	Funds raised
Cannon	1/12/70	No
Fuji Photo Film	1/12/70	No
JAL	1/12/70	No
Mitsui Bussan	1/12/70	Yes
NEC	1/12/70	Yes
Nissan Motors	1/12/70	No
Tokyo Marine & Fire	1/12/70	Yes
Toyota Motors	1/12/70	No
Kirin Beer	5/2/73	No
Daiei	13/11/74	No
Makita	25/1/77	Yes
Sanyo Electric	1/4/77	No
Ito-Yokado	30/8/77	No
CSK	30/8/83	No
Wacoal	6/6/84	Yes
Sawako Corporation	21/5/96	Yes

**NYSE listed Japanese companies**

Company	Listing Date	Funds raised
Sony	10/9/70	Yes
Matsushita Electric	13/12/71	No
Kubota	9/11/76	Yes
Pioneer	13/12/76	Yes
Honda Motor	11/2/77	Yes
Kyocera	23/5/80	Yes
Hitachi	14/4/82	Yes
TDK	15/6/82	Yes
Bank of Tokyo Mitsubishi	19/9/89	No
Amway Japan	29/6/94	No
NTT	29/9/94	No
Orix	16/9/98	No

Source: Nomura Research Institute

The fact that NASD has chosen the more direct path of a joint venture with a private company to access the Japanese market, rather than its more usual route of an alliance with the local exchange, indicates how importantly it regards the Japanese market. We can also perhaps surmise that exploratory discussions for an alliance with the Tokyo Stock Exchange (TSE) and other exchanges were not satisfactory.

### 3) The new threat posed by ECNs

The Nasdaq market has relied up to now on its own trading system whereby securities companies acting as “market-makers” are obliged to quote continuous two-way quotes. In recent years however there has been an expansion in the use of electronic trading systems who handle directly trades within the bid-offer spread quoted by Nasdaq market-makers. Currently there are 9 such systems, referred to as ECNs (Electronic Communications Networks), approved by the SEC as systems through which market-makers can forward trades (Exhibit 5). At present there is no reliable data on trading volumes going through ECNs, but we estimate it to be around 30% of total Nasdaq volume.

**Table 5 ECNs operating on the Nasdaq exchange**

<b>Start Date</b>	<b>System</b>	<b>Operating Company</b>
Jan.'97	Instinet	Instinet Corporation
	Island	Joshua Levine and Jeffrey Citron, Smith Wall Associates
	Archipelago	Terra Nova Trading, LLC
	Bloomberg Tradebook	Bloomberg
Oct.'97	REDI System	Spear, Leeds & Kellogg
Feb.'98	ATTAIN	All-Tech Investment Group
Apr.'98	BRUT	The Brass Utility, LLC
Nov.'98	Strike System	Strike Technologies LLC
	NexTrade	PIM Global Equities

Source: Compiled by NRI from data provided by the SEC

In so far as these ECNs are run by NASD member firms they do not constitute rival and opposing systems to the Nasdaq market run by NASD. However new SEC regulations effective from April 1999 have opened up the option for such Alternative Trading Systems (ATS), that includes ECNs, to not be regulated or supervised by NASD. In response to which the influential ECN "Island", which has a strong connection with the internet securities company Datek, has initiated proceedings to register itself as an exchange.

If these ECNs register as exchanges then trades that go through them will not count towards Nasdaq trading volume, and as off-exchange trades the brokerage commission will no longer be collected by NASD. If all the ECN's were to opt for complete "independence" from NASD, then the size of trading on Nasdaq would be severely reduced.

Even if the ECNs do not choose to separate themselves from NASD as self-run exchanges, they would still represent a threat to the position of the market-makers who are the pillars of the Nasdaq market.

There are already indications that increasing ECN trading is reducing the number of market-makers on Nasdaq. There were 479 market-makers at the end of 1998, a sharp fall from the 530 operating at the end of the previous year. Market-makers are also tending to concentrate on trading a limited number of more profitable stocks. For example, in September 1997, the largest securities house, Merrill Lynch, stopped making markets in 350 mainly smaller issues, and Bear Stearns also cut its market-maker stocks by 40% to 400 issues. In this way the growth in ECNs is causing changes in the very market structure by which Nasdaq achieved its previous growth.

NASD's adventures abroad, starting with the Nasdaq Japan project, will not have any direct effect on the ECNs. However, while formally coming under the umbrella of NASD, the ECNs are in reality now competitors in market provision, and were undoubtedly an important factor in NASD's decision to "move up the scale" in the provision of market services.

#### 4) Challenge to the existing Japanese OTC stock market

Nasdaq Japan also aims to be a rival to the OTC market run by the Japan Securities Dealers Association.

Since regulatory reforms in 1983 the OTC Stock market has played an important role as a place for venture businesses in Japan to list their shares and raise capital. However, since the latter half of the 1990s there has been growing criticism of the market as offering very few actual high-growth shares and insufficient market liquidity. In response to these criticisms, the JSDA set up the OTC Market Special Section (the 2<sup>nd</sup> OTC market) in July 1995, and introduced several reforms such as the “book-building method” in IPO procedure. In December 1998 it also introduced several reforms in keeping with the Financial System Reform Law, such as revisions to the OTC listing and de-listing requirements, and the introduction of a proper market-maker trading system.<sup>1</sup>

While these reforms have certainly gone some way to improving the OTC markets in Japan, there were still some critics who argued that a new venture-business stock exchange was necessary to create some competition with the existing market. Nasdaq Japan therefore hopes to establish a new and competitive market to enable the public trading of Japanese venture-firms under the name of the archetypal OTC market, Nasdaq.

### 3. Nasdaq Japan: Implications and Issues

Bringing the world’s largest venture-firm trading market, Nasdaq, to Japan to set up a market for the unified trading of shares in Japanese emerging companies has been loudly touted from many quarters as the perfect plan for the “Big Bang” era. Certainly there has been a high degree of interest from Japanese entrepreneurs aiming at a future public offering, and an explanatory briefing held by Softbank for the top executives of venture firms attracted some 1,400 attendees.

Even the JSDA and TSE have recognized the importance of such a development, saying that “for Japanese investors the globalization of the markets is something to be welcomed” (Mr. Seki, Vice Chairman of the Japan Securities Dealers Association), despite the fact that they would be the main rivals to such a market.

In fact, in a report entitled “The Future of the TSE,” published by the Securities Policy Committee, the TSE reported that as part of a policy for the “promotion of market-listing of venture firms,” it was considering setting up a new market with looser listing requirements in the first half of 2000. The JSDA is also likely to step up its own OTC market reforms to strengthen its competitiveness. It published a concrete plan for reforms in August 1999.

The effect of a Nasdaq Japan on the Japanese securities markets is therefore not insignificant. However, as far as is currently known about the particulars of the plan, there are undeniably several points on which it is unclear how the market is going to be implemented and also whether the resultant benefits are going to be worth the cost.

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1 Sadakazu Osaki, “Restructuring Japanese OTC Stock Market”, *Capital Research Journal*, Summer 1999, Vol.2, No.2.

***(1) Is a new market necessary in order to promote trading of Nasdaq stocks?***

Currently Japanese investors are able, via the retail branch of a domestic or foreign securities firm, to freely trade in the shares of Nasdaq listed companies. Though true that the trading costs are not cheap, and that it is not possible to trade real-time even during Nasdaq trading hours, whether the creation of a new market with its attendant huge investment in trading systems will lower the costs of trading, or how much actual demand there is for real-time trading of Nasdaq stocks, are both questionable. If it were just about the ability to trade real-time, all that is required is for a securities firm (or several, if necessary) to set up an order-broking computer system to handle the trades, rather than setting up a new “market.”

***(2) Procedures required for setting up a new association of securities dealers***

According to NASD and Softbank, the new market is to be operated by a newly established association of securities dealers, separate from the existing JSDA. As mentioned previously, according to the Securities and Exchange Law only securities companies can set up a Securities Dealers Association. In order to set up a new association it would also need to secure the involvement of at least 6 securities companies, as the laws stipulate the dissolution of any association of securities dealers with “5 or fewer members” (Securities Exchange Law, Article 79-18). However, it is still unclear which securities firm will actually apply for establishment of a new association.

***(3) Legal status of securities traded on the new exchange, and cost burden of disclosure***

Nasdaq Japan aims to facilitate the “direct trading” of Nasdaq market stocks by Japanese investors. The meaning here of “direct” is not entirely clear, but in order to realize this there seem to be two options available: either, a) direct links between member firms for the more efficient exchange of stock orders, or , b) listing of Nasdaq stocks on the new market itself. Assuming the latter option, then the Securities Exchange Law would require the continuous disclosure of annual reports and prospectuses in accordance with Japanese regulations in order for the issuer to obtain a listing on the new exchange.

In recent years there has been a continuing trend for foreign companies to de-list from the foreign section of the Tokyo Stock Exchange, resulting in the number of TSE-listed foreign firms falling from 125 in early 1992 to 48 at end March 1999. The major reason for this is that the benefits from share trading and increase in Japanese investors has not been sufficient to justify the costs of disclosure (including costs for translation of documentation into Japanese). Needless to say, considering this trend it is doubtful whether Nasdaq listed companies will be happy to pay the entire costs of listing on a new market.

***(4) Attraction to Japanese companies of an IPO on the new exchange***

Another aim of Nasdaq Japan is to encourage the IPOs of Japanese venture firms. However, it is not necessarily clear that all the difficulties experienced by Japanese firms in listing on the existing OTC market were due to the deficiencies of that market. Even the listing requirements that NASD and Softbank have singled out for criticism have been rapidly modified over recent years so that at present they are at least as relaxed as the Nasdaq market itself (Exhibit 6).

**Table 6 Comparison of Japanese and U.S. listing requirements**

Units: \$ million, unless otherwise stated

	Nasdaq Market				OTC Stock Market			
	NMS			Small Cap	Requirement for regular companies		Requirement for venture businesses	
	Listing Standard 1	Listing Standard 2	Listing Standard 3					
Net tangible assets	6	18	-	*1 4	*4 1.66		-	
Minimum bid price (share price, US\$)	5	5	5	4	-		-	
Market Capitalization	-	-	*3 75	*1 50	-	*4 4.16		
Public Float (million shares)	1.1	1.1	1.1	1.0	*5 0.5	*5 0.5		
Market Value of Public Float	-	-	-	5	-		-	
Shareholders (people)	400	400	400	300	*6 300	*6 300		
Operating History (years)	-	2	-	*2 1	-		-	
Net Income	1	-	-	*1 0.75	Declared Profits		-	
Market Makers (No. of)	3	3	4	3	-		-	

Note: \*1 Only one of these requirements needs to be met.

\*2 Or Market Capitalization of \$50 million.

\*3 Or \$75 million in total assets and \$75 million in gross revenues.

\*4 Assumes \$1 = ¥120

\*5 Or 30% or over of public offering is public float

\*6 If total issuance is less than 10 million shares. If 10 million or above then the number of shareholders required is 400 and 500 respectively.

Source: Compiled from information supplied by Nasdaq and the Japan Securities Dealers Association

It has been emphasized that, as a foothold in a new market, Japanese companies could list themselves on the US Nasdaq market, but this is unlikely to be achieved by simple changes in the structure of the market. In order for Japanese firms to raise capital on the Nasdaq market through share issuance, as well as having to meet US standards of disclosure, they would in the first place have to enjoy wide acceptance among US investors. They would have to, for example, be offering products or services extensively across the US, or be targets of investment by US capital venture firms etc.

Furthermore, it is also unclear whether Japanese firms listing on Nasdaq would actually enjoy high liquidity. Nasdaq trading volume in Sawako Corporation for example, was only 19,700 shares in the 4 months between January and April 1999, a mere 0.2% of its trading volume on the Japanese OTC market for the same period. The Nasdaq market is able to provide liquidity through its market-maker based trading system in theory, but without real investor appetite, a stock will not be traded in reality.