Restructuring Japanese OTC Stock Market

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On November 2, 1998, the Japan Securities Dealers Association released a report "Reforming the Over-the-Counter Stock Market". The report, compiled in response to an earlier report "Direction of Reforms of the Over-the-Counter Stock Market" issued in July, explains how to utilize the market making functions and reexamine the registration standards in concrete terms. The main part of the proposal has been implemented with the amendment of the JSDA regulations that took place in step with the Financial Systems Reform Law which was enforced on December 1, 1998.

1. Review of the OTC Market Reforms so far

In response to the interim report of the Securities and Exchange Council which was presented in June 1983, reform measures were taken such as relaxing registration standards and the lifting of the ban on public offerings to expand OTC stock market. Since then Japan's OTC stock market has developed as the place for small and medium-sized companies to raise funds. In recent years, however, the growth rates of the number of registered companies and their fund raising have been declining, and this has combined with sluggish stock prices to stagnate trading on the secondary market (Table 1). Under these circumstances, there is strong demand for the reform of the OTC market system in both secondary markets.

Table 1 Changes on the OTC Stock Market

	Number of Registered Companies		Paid-in Capital Increase by Registered Companies		IPO		Trading Value (¥m)
		New Registration	Number	Amount Raised (¥100m)	Number	Amount Raised (¥100m)	
1982	108	6	N.A.	N.A.	—	—	25,092
83	111	4	7	123	N.A.	N.A.	52,526
84	116	10	21	465	N.A.	N.A.	169,550
85	127	15	10	192	13	81	186,721
86	140	22	16	231	15	97	440,472
87	151	19	16	384	16	84	376,152
88	196	53	14	507	49	464	683,035
89	263	73	25	1,280	70	2,221	2,045,300
90	342	86	18	2,100	85	3,535	6,040,841
91	430	95	9	664	94	3,277	5,009,137
92	436	15	7	110	14	248	1,082,521
93	477	55	6	80	54	2,127	2,863,274
94	568	107	20	707	105	2,974	5,371,517
95	678	137	17	1,312	137	2,243	5,884,229
96	762	114	76	326	112	2,531	5,599,601
97	834	105	22	61	103	1,537	2,657,458
98.1～9	851	42	21	820	39	499	1,142,847

Source: Compiled on the basis of the Japan Securities Dealers Association, "Shoken Gyoho" (securities industry report).

It has been pointed out in recent years that the OTC stock market faces the following problems.

(1) There have been only few IPOs by venture businesses with high growth potential.

(2) The liquidity of the market is low, reflecting a low demand for OTC stocks among investors after IPOs are completed.

(3) Price formation at the time of the IPO often lacks transparency and does not fully reflect market forces.

Table 2 Recent Move toward OTC Stock Market Reforms

Year	Remarks
Dec. 94	# The Ministry of Finance, eight stock exchanges in Japan and the Japan Securities Dealers Association officially release a report "Lifting of restrictions on the number of IPO companies", which proposes the removal of the limitation of the number of IPOs to 3-5 companies a week and the creation of a more relaxed registration standard.
Jun. 95	# The JSDA's "council on the OTC registration standard study" released a report, proposing the establishment of a new registration standard for R&D-oriented companies. # The Ministry of Finance issued a notice to the chairman of the JSDA to confirm the non-existence of so-called "substantial standards" for OTC public offering.
Jul. 95	# The OTC market special section (Second OTC market) was established.
Sep. 95	# The Securities and Exchange Council presents a report "On the desirable state of the public offering of stocks at the OTC special market ", proposing a relaxation of the regulations on the movement of stocks before public offering and the introduction of the book building method for deciding on the public offering price.
Oct. 95	# Interim measures were taken to allow the auditor's report necessary for registration of specified stocks at the specified OTC market, to cover only the preceding year.
Feb. 96	# MITI's "OTC registration system reform working group" released an interim report which proposed the adoption of the book building method and the expansion of the market maker system.
Jun. 96	# The JSDA's " OTC stock market working group" prepared the "Measures to improve the OTC stock secondary market", which proposes the introduction of the margin trading system the "when issued" (WI) system and the stock lending system.
Dec. 96	# ATL Systems was the first to publicly offer its stocks on the OTC special market.
Apr. 97	# The JSDA decided on main points for solicitation of unlisted and unregistered stocks (relevant rules were implemented in July 97).
Jun. 97	# The Securities and Exchange Council presented a report, proposing the reexamination of the positioning of the OTC as a complementary market, utilization of the market making functions and the lifting of the ban on dealing in unlisted and unregistered stocks.
Sep. 97	# The IPO price was decided for the first time by the book building method for OTC regular issues.
Dec. 97	# D-Brain Securities, which started off as a securities company specialized in non-publicly offered stocks, started to engage in the trading of OTC securities.
Mar. 98	# MITI's OTC market study group released an urgent proposal " A desirable form for the OTC market", suggesting obligatory market making for regular issues, and the creation of a new OTC market by a new management entity.
Jul. 98	# The JSDA announced "Direction of the stock OTC market reform".
Nov. 98	# The JSDA released a report "Reforming the stock OTC market".
Dec. 98	#The JSDA implements relevant rules for OTC stock market reform.

Source: Nomura Research Institute

In order to solve these problems, various reform plans have been considered and studied, especially by the JSDA since the mid-1990s and then progressively implemented. (Table 2)

In reaction to criticism (1) against inactive public offering by venture businesses, the OTC registration standard was amended in July 1995, and the OTC special market has been opened, paving the way to public offering by R&D-oriented enterprises, including even companies not making any profits. The Ministry of Finance issued a notice denying the existence of so-called "substantial standard" in reaction to the criticism that the uniform "substantial standard" prevents even the companies, which formally satisfy the registration standard, from actual registration. In July 1997, securities firms were permitted to handle unlisted and unregistered stocks with the establishment of the OTC-handling securities system, which made it possible to raise funds through public offering even without going through the procedure of OTC public offering.

With regard to criticism (2) about liquidity, a request was made from many quarters for the introduction of a market maker system in view of the continued boom in the U.S. NASDAQ. For instance in June 1996, the JSDA's business committee compiled a report, the "Measures to improve the OTC stock secondary market", proposing that “securities companies should endeavor to familiarize themselves with the market making business, which is the OTC market's basic mechanism."

The Securities Exchange Council's Market Working Party (WP) presented a report in June 1997, which said that, compared with the basically "order-driven" exchange markets, the OTC market is required to clarify its aim to be a market characterized by its market making function (the function of providing liquidity through dealing) and stressed the necessity to firmly establish the market making system.

With regard to criticism (3) about price formation, the bidding method adopted in April 1989 was modified to employ the book building method, in which securities companies decide on the public offering price on the basis of the demand estimated through hearings with institutional investors as to specified issues, and then as to regular issues after September 1997.

The Financial Systems Reform Law enacted in June 1998 is designed to materialize the Japanese version of Big Bang. By reexamining the former characterization of the OTC market as complementary to the stock exchange markets, the amended Securities and Exchange Law clearly defined the OTC market as an “OTC trading securities market”. In line with the enforcement of the law, the JSDA decided to reform the OTC stock market, and its business committee (currently the market management committee) began to study how to realize the reform.

The results of the study were compiled into a report in July 1998 "Direction of the reform of the stock OTC market", and specific reform measures were discussed by respective working groups for secondary market, clearing and settlement, IPO underwriting and credit risk analysis. The recent report "Reforming the OTC stock market" is a compilation of the results of the studies conducted by these working groups, and its main points were implemented with the amendment of the relevant regulations on December 1, 1998.

2. Outline of the Current Reform

1) Secondary Market

The results of the study by the secondary market working party led to:
(1) a conclusion of discussions about the market maker system that were continued from the introduction of the registered dealer system adopted through the 1983 reforms, (2) a proposal for the crossing trading system using the trading system of JASDAQ Services Co. and for

off-hour trading, and (3) a proposal for reexamination of the issues classification and the registration cancellation standard.

(1) Introduction of the Market Maker System

The registered dealer system, which was introduced in 1983 simply calls for the indication of buy and sell quotations more than twice a week, and in reality has hardly functioned since. On the other hand, market making has been conducted continuously for the OTC special market stocks. The report proposed an extension of this system to cover all registered issues, and presented a specific plan for this purpose. This proposal was adopted and implemented with the amendment, on November 27, 1998, of "the regulation regarding OTC stock market trading and other trading over the counter" (Fair Practice Rules No.1).

The new market making system has the following five features (Table 3).

(1) This new system is designed for issues defined as market make issues reported by more than two securities companies for their market making. The idea of obliging the lead manager for public offering to make a market for all issues was not adopted.

(2) The market maker is required to continuously present sell and buy quotations, but no limit is set for the spread between sell quotations and buy quotations. The so-called 5% rule (keeping the spread under 5% of buy quotations) that was conventionally applied to OTC special market no longer applies.

(3) Members other than market makers are required to trade market make issues within the best bid and offer. Market makers are obliged to respond to this trading with best quotations presented by themselves (which do not always coincide with the market's best bid and offer).

(4) More than 90% of trades on the stock OTC market were handled by the order-driven method for which JASDAQ Services Co. functioned as a virtual stock exchange. By the recent reform, it has been decided not to trade market issues through JASDAQ Service and to avoid combined use of the order-driven method and the quote-driven method.

(5) When securities underwriters simultaneously work as market makers, there is a possibility for them to manipulate quotations and thus influence the issued price. The U.S. NASDAQ market has a "passive market maker" system to prevent such unfair trading. Japan's new regulations include a system to force underwriting firms to refrain from releasing two-way quotations.

Table 3 Comparison of Japan's Market Making System in the OTC Stock Market with the American NASDAQ Market

Items	Present Situation of NASDAQ Market	Japan's Stock OTC Market
Issues for market making	One of the registration maintenance standards is the existence of more than two market makers. All issues are covered.	Only the issues reported by market makers are covered.
Market maker qualifications	No reinstatement is permitted for 20 business days after the suspension of quotation indication	Continued indication is obligatory for a month after retirement is registered. No reinstatement is permitted within three months after withdrawal.
Obligatory release of quotations	Obligatory continuous release during trading hours	Obligatory continuous release during trading hours
Obligatory trading through quotations	Obligatory response to trading at best quotations presented by market makers up to the presented number of stocks. Obligatory response to trading for small-lot orders through the SOES (automatic execution system) * 1	Market makers are required to respond to trading at best quotations presented by themselves up to the number of stocks indicated on the terminals. Members other than market makers are obliged to execute trading with customers at prices within best quotations as long as market makers present quotations.
Finance underwriters' handling of market making	Lead managers should act as "passive market makers" who are subject to constrains such as prohibition of the indication of best quotations	Underwriting contractors refrain from releasing quotations. There should be temporary market makers.
Restrictions on indicated quotations and spread	When there is a coincidence, or reverse, between a market maker's sell quotation and other company's buy quotation, and between a company's buy quotation and other company's sell quotation, there should be no indication of these quotations. There is no restriction on spread. However, in the case of NMS issues, market makers, whose average monthly spread exceeds 150% of the average spread of all market makers, are ordered to withdraw. * 2	When there is a coincidence, or reverse, between a market maker's sell quotation and other company's buy quotation, and between a market maker's buy quotation and other company's sell quotation, there should be no indication of these quotations. No range of figures is set for the spread between sell and buy quotations. No restriction on price range is applied to market make issues.*3
Obligatory report	Report is required within 90 seconds after trading is executed.	Report is required promptly after trading is executed. "Promptly" means the time needed to ensure fairness in practical handling.
How to handle the customer's limit order	When a customer's limit order is more favorable than the market maker's best quotation, the market maker should choose between adapting his quotation to the limit price and transferring the order to ECN such as Instinet.	There are no definite rules on how to handle limit orders. No order-driven trading through JASDAQ Service is effected for market make issues.

Note: * 1 NASDAQ does not have any rules on execution price for members other than market makers. However, all securities companies including market makers are required to perform best execution as a more general obligation.

* 2 In addition, the guideline prohibits a mark-up of the acquired price by over 5% in selling registered issues to customers.

* 3 The resolution made at the directors' meeting "Regarding trading in the secondary (distribution) stock market", which regarded "the latest contract price or the similar price between best quotations" as an adequate price, does not apply to market make issues.

Source: Nomura Research Institute

As of May 6, 1999, 17 securities firms are acting as market makers for 32 stocks out of 851 registered OTC stocks. Although the market maker system has been contributing to enhance liquidity of the market, there are some criticisms against bid-offer spread and lack of protection for customer limit orders. JSDA is trying to develop an electronic system for market making by March 2000, so that market makers will be able to narrow bid-offer spread under more efficient market environment.

(2) Introduction of Crossing Trading and Off - Hour Trading

The report proposes that crossing trading (using the closing prices for normal trading hour) should be introduced for OTC stock market and OTC convertible bonds market, and that trading in the early morning (16:00 - 09:00 the following day) and hours between sessions (11:00 - 12:30) should be considered. These types of trading will be conducted by JASDAQ Services Co. as a broker.

JASDAQ Services Co. also receives orders for crossing trading through facsimile (F-NET) between 15:15 and 16:00 after the trading closes at 15:00, and executes trading by the contract time of 16:00. The content of the contract is reported to the JSDA by 17:30 and announced at 18:00. The use of the existing JASDAQ trading system in receiving orders and reporting to the JSDA is being studied.

The report suggests that early morning trading and inter-session trading should be studied taking into consideration recently implemented off-exchange trading rules. It is also suggested that rules on cross trading that does not go through JASDAQ Services Co. for issues other than market make issues should be studied.

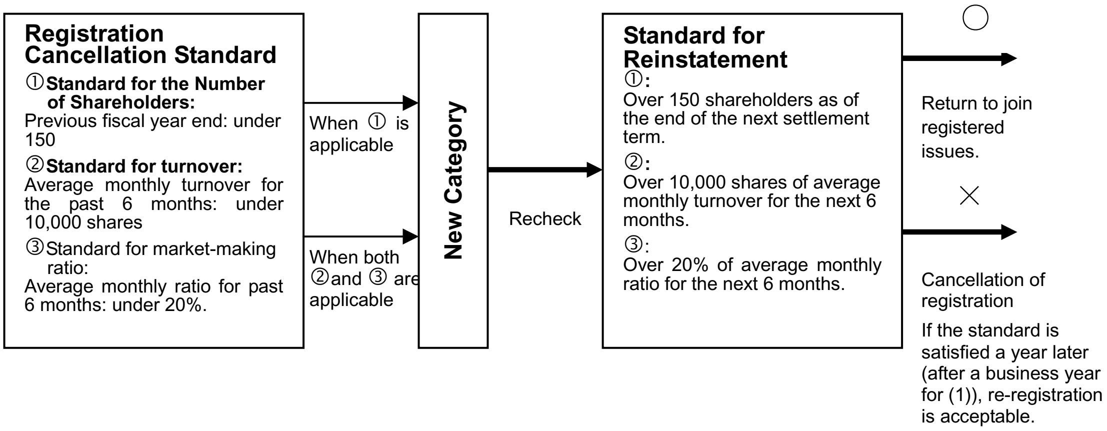
(3) Reexamination of the Classification of Registered Issues and Standards for Registration Cancellation

The report points out that the number of registered issues has reached 850 including some issues that are rarely traded. It also proposes the establishment of some groups with high liquidity that attracts institutional investors for their index trading, as well as a raising of the cancellation standard for issues of extremely low liquidity, in order for market participants to understand the market structure more easily.

Concerning the standard for registration cancellation, the report suggests that a new category for issues that have reached the cancellation standard should be set up. The issues in this category should be subjected to renewed examination after a certain period of time to see whether they have really satisfied the standard. If they have, they should be immediately returned to the category for general registered issues. If the issues, for which registration was once canceled because they failed to clear the standard, pass the standard a year later and apply for reinstatement, they can be re-registered without detailed screening.

Most issues in the category of "OTC controlled issues" which is originally designed for temporary trading of the issues which have been delisted or cancelled registration, tend to stay there as control issues for a long period of time. Considering this fact, the report suggests that the current six-month stay should not be extended and that registration of the control issues that have remained in this state for over six months should be canceled after a certain period of grace.

Figure 1　Regarding Reexamination of the Registration Cancellation Standard



Note:　The market-making ratio is set at 10% only for one year from the start of calculation.
Source:　Nomura Research Institute

2) Clearing and Settlement

The report makes the following five proposals with regard to clearing and settlement:

(1) the establishment of a compensation fund to secure settlement of OTC stock trading.

(2) implementation of the delivery versus payment (DVP) in the future;

(3) a study of specific effects of non-issuing of share certificates;

(4) insisting that the parties concerned make overall use of the Japan Securities Depository Center (JASDEC) and the upgrading of the JASDEC system; and

(5) examination of integration of the clearing and settlement business and how outsourcing should be implemented. These proposals have been left for further study because it was considered difficult to make immediate decisions.

3) Underwriting for IPOs

The report's proposal regarding registration with the OTC stock market was to replace the present two standards for regular and special issues with two new standards for general companies and venture business. The proposal was implemented with the amendment on November 27, 1998 of "Regulations on registration and the announcement of prices of OTC trading securities"(Fair Practice Rules No.2) (Table 4).

Table 4 Details of the Review of Registration Standards

	Former Registration Standard		New Registration Standard	
	Regular Rule	**Special Rule**	**Standard 1 for Ordinary Companies**	**Standard 2 for Venture Business**
Companies to be Covered	No restriction in principle.	(1) Profit or net asset should not meet the regular standard. (2) The main business should contain aspects deemed by the applying member company to be innovative and promising. (3) Cost for commercialization of the new business should exceed 39% of sales.	No restriction in principle.	A company which has been operating (or engaged in main line) for less than 10 years, or a company whose cost for new business (or main business) exceeds 3% of sales.
Number of Issued Shares	Over 2 million as of the day of registration, or average 1 million in the previous term.	No standard.	Smooth distribution should be ensured.	
Number of Shareholders	Over 200 when the number of issued shares is under 20 million on the day of registration, or over 400 in other cases.	Over 50 shareholders	Over 300 when the number of issued shares is under 10 million on the day of registration, over 400 when the number of issued shares is between 10 and 20 million, and over 500 when the number of shares is over 20 million.	
Number of Shares for Public Offering	Number of issued shares at the time of application x 12.5% + 25,000 - 500,000 shares.	Over 500,000 shares.	The floating share ratio at the time of public offering should be over 30%, or the minimum number for public offering should be over 500,000.	
Profit	Over ¥10 per share in before-tax profit for the previous term.	No standard	Black-figure net profit for the term, both consolidated and non-consolidated.	No standard
Net Assets	Over ¥200 million at the end of the previous term.	Over ¥200 million at the time of registration.	Over ¥200 million for the previous term, both consolidated and non-consolidated.	Market capitalization of over ¥500 million (at the time of public offering.
	Present Standard for Cancellation of Registration		The Report's Proposed Standards for Cancellation of Registration	
	Regular Rule	Special Rule	Common standard	
Number of Issued Shares	When the number drops below 2 million.	No standard	When the number drops below 2 million.	
Number of Shareholders	When the number drops below 100 and fails to exceed 100 within the following year.	When the number drops below 25 and fails to exceed 25 within the following year.	When the number of shareholders drops below 150 at the end of the previous fiscal year.	
State of Operations	When the company posted a deficit at the end of each of the last three business years.	When the company posted a deficit at the end of each of the last five business years.	When the company posted a deficit at the end of each of the last three business years.	
Liquidity of Shares	When the average monthly turnover for the previous year drops below 20 million shares.	No standard	When the average monthly turnover for the last six months drops below 10,000 shares.	
Others	Merger, bankruptcy, suspension of transaction with banks, violation of laws.	Merger, bankruptcy, suspension of transaction with banks, violation of laws.	When the average monthly market making ratio for the last six months drops below 20% by the newly established monthly market making ratio standard.	

Source: Nomura Research Institute

In reexamining the standard for IPOs, importance of the liquidity of shares is much emphasized by making it possible to register without offering or selling if the ratio of floating shares is over 30%, and raising the minimum number of shareholders required.

4) Credit Risk Analysis in the Underwriting Procedure

The report proposes that a study should begin aiming to change the present content of due diligence obligation imposed on securities firms concerning the underwriting of IPO issues. The following three are mentioned as specific items for study.

(1) Reexamination of examination of the report from securities companies to the Association.

(2) Reexamination of the report prepared by the issuing company for registration application.

(3) Elimination of duplicated examination by certified public accountants and securities companies, and clarification of the scope of their responsibilities.