The NASDAQ's Exit from Japan

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On 16 August 2002 the Osaka Securities Exchange announced that it had accepted a request from Nasdaq Japan, Inc. to be allowed to revoke its agreement concerning the Nasdaq Japan market operated by the Exchange. As a result, the agreement between the two parties became null and void on 15 October. The NASDAQ's decision to exit the Japanese market was confirmed by the chairman of Nasdaq International, at a press conference on 19 August. Although the Nasdaq Japan market continues to be operated by the Osaka Securities Exchange (albeit under a new name), the company responsible for its creation (Nasdaq Japan, Inc.) has gone into liquidation.

1. Reasons for the Decision

On 15 June 1999 the National Association of Securities Dealers (NASD) and Softbank announced that they were planning to create a new venture equity market in Japan ("Nasdaq Japan"). In December of that year their joint planning venture, Nasdaq Japan Planning, Inc., joined forces with the Osaka Securities Exchange, and in June 2000 the Nasdaq Japan market was born as a new section of the OSE. Finally, in October 2000 a group of 15 Japanese and non-Japanese securities companies financed a capital increase by the new company (renamed Nasdaq Japan, Inc.) (see Figure 1).

Together with the Jasdaq (the OTC equity market) and the Tokyo Mothers market, the Nasdaq Japan market was one of the three leading markets in Japan for initial public offerings by start-ups, with more than 90 companies listed during the following two years.

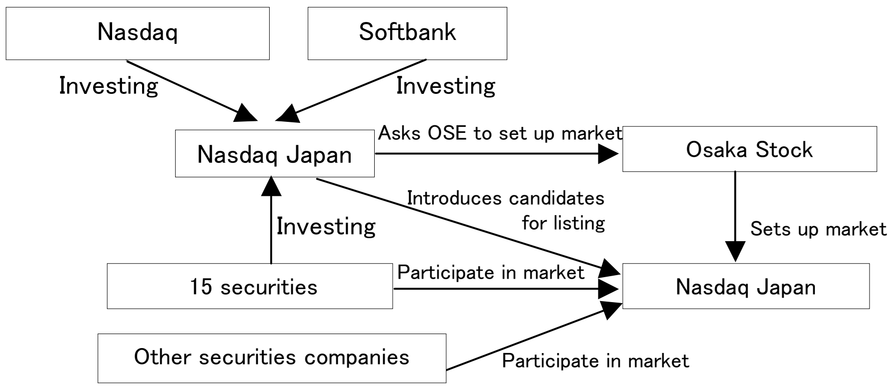
Unfortunately, however, all was not well with Nasdaq Japan, Inc. As well as trying to develop the market by scouting for potential new listings, the company was responsible for developing new trading systems for the Nasdaq Japan market. However, the fact that (1) the cost not only of recruiting a large number of new staff but also of organizing lavish parties and sponsoring golf competitions ballooned, that (2) revenues from new listing applications and fees did not meet its targets and that

(3) the development of trading systems proved extremely expensive meant that by the end of 2001 the company had accumulated a loss of more than ¥5 billion.[1]

In addition, the company found that it had misplanned its systems development. Originally it intended the system it was developing (a hybrid system incorporating elements of a market-making system in a traditional order-driven system) to be used in the Nasdaq Japan market. However, strong opposition from market participants (i.e., securities companies) (because of the fact that they would have had to invest heavily in developing connecting systems of their own and uncertainty whether they would have infringed regulations on "front running") meant that the system was never adopted.

Also, the fact that the NASDAQ was planning to become an independent stock exchange (thereby abandoning its legal status as a market operated by the NASD and becoming a listed company) meant that it was forced to dispose of its unprofitable overseas operations.[2] This was a particularly important factor at the final stage when it was decided to sever the link with the Osaka Securities Exchange. This was because the announcement by the NASDAQ on 8 August (when it released its results for the second quarter) that it had written off all its $20.1 million investment in Nasdaq Japan revealed that moves were under way to sever the link.

Figure 1 Relationship between Those Involved with the Nasdaq Japan Market



Source: NRI.

As it turned out, Nasdaq Japan, Inc. announced its decision to cease its operations and to revoke its agreement with the Osaka Securities Exchange at an extraordinary meeting of its board of directors on 16 August.

1 At the press conference following the announcement the NASDAQ was at pains to emphasize that the recession (rather than factors such as these) was the main reason for its decision.

2 At the press conference, the NASDAQ denied that the situation in the United States had influenced its decision.

2. The Post-NASDAQ Nasdaq Japan Market

1) The functioning of the market has not been affected

Although the announcement that the NASDAQ was exiting the Japanese market caused quite a stir, it did not have much of an impact on trading on the Nasdaq Japan market, which continued as usual. Nor did it have much effect on those companies that were in the process of having their shares listed on the market. Between 16 August, when the announcement was made, and the end of September there were five such listings.

One of the reasons why the NASDAQ's exit from Japan had little direct impact is the way in which the Nasdaq Japan market was organized (see Figure 1). Although there was an agreement with Nasdaq Japan, Inc., the market was established and operated on the basis of the Osaka Securities Exchange's own rules, and all the companies whose shares were traded on the market had the same listed status as those whose shares were traded on the First or Second Section of the Exchange. The company that went into liquidation (Nasdaq Japan, Inc.) was responsible mainly for public relations and advising corporate clients, and did not have any role in the market's day-to-day operations.

As soon as Nasdaq Japan, Inc. announced its decision, the Osaka Securities Exchange announced that it would continue to operate the Nasdaq Japan market and would provisionally rename it the "Japan New Market." The Exchange then invited the public to suggest a new name for the market. The name chosen from among the 452 entries and officially announced on 30 September was "Nippon New Market: Hercules." In order to choose the name, the Exchange set up a committee headed by one of its non-executive directors, which took account of the views of outside experts and tried to find a name that matched the new market's aims.

2) Psychological impact on companies significant

Although the NASDAQ's decision had no immediate impact on day-to-day trading, those companies that were already listed (or were planning to list) on the market could hardly be indifferent to the NASDAQ's exit from Japan.

Many of the companies that had opted to list on the Nasdaq Japan market (in preference to either the Jasdaq market or the Tokyo Mothers market) had been attracted by its go-ahead international image and the NASDAQ's plans for a global trading platform spanning three continents. There would seem no obvious reason why such companies should wish to remain listed on a Nippon New Market in the absence of the NASDAQ brand.

In fact, three companies (Kaga Electronics, Gigas Kansai and Don Quijote) have already applied to delist from the Nasdaq Japan market. However, all three are also listed on either the First Section of the Tokyo Stock Exchange or on the Nagoya Stock Exchange. Of those companies that are listed only on the Nasdaq Japan market, CVS Bay Area's application to list on the Tokyo Stock Exchange was granted on 2 September. However, the application was made before the NASDAQ's decision and was not directly related to it.

According to a survey of the companies listed on the Nasdaq Japan market that was carried out by the Asahi Shimbun at the beginning of September, 39 of the 91 companies that responded indicated that they would remain listed. However, six indicated that they hoped to list on another market, and 28 that they hoped to list on another market while remaining listed on the New Market. Also, although many of the companies that indicated that they hoped to list on another market said that they had been considering such a possibility anyway, some of the companies indicated that they were concerned that the NASDAQ's exit from Japan might detract from the value of a listing.[3]

3. An Assessment of the NASDAQ's Venture into Japan and the Outlook for the Market

1) A worthy but irresponsible venture

The arrival of the NASDAQ in Japan was greeted with much the same kind of shock as the arrival of Commodore Perry's fleet in 1853, and its effect on competition among Japanese venture capital markets was just as dramatic. However, only three years after the plan was announced and only two years after it was implemented, the Nasdaq Japan market was forced to shut up shop.

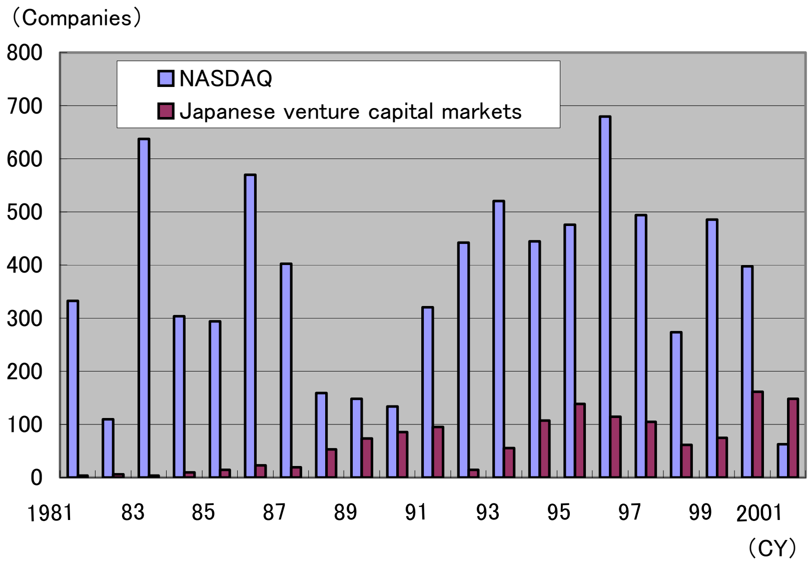
With the creation of the Tokyo Mothers market and the reform of the OTC equity market (now Jasdaq), the Japanese market for initial public offerings has undergone a major change. Although the level of activity in the venture capital market can hardly be said to be high (partly because of the recession), in 2001 the number of initial public offerings on Japan's three venture capital markets surpassed that on the NASDAQ as IPO activity in the United States declined following the bursting of the

3 Asahi Shimbun (Osaka edition) of 26 September 2002.

Internet bubble (see Figure 2). This is a historic event. Nor is it only in the United States that IPO activity is low: the same is true of Germany and other European markets. So the level of IPO activity in Japan is exceptional. This would not have happened had the NASDAQ not made its bold decision to enter the Japanese market and challenge the status quo there. There is no denying this achievement.

However, the NASDAQ's decision to exit the Japanese market after only two years was extremely regrettable and severely damaged the NASDAQ's reputation among Japanese companies, investors and securities companies. While it is true that operating a stock exchange is increasingly being regarded as a profit-seeking business and that a growing number of exchanges are becoming listed companies, the business of ensuring that investors can buy and sell securities should be seen as a long-term commitment rather than one that can be abandoned after only a couple of difficult years.

Figure 2 Initial Public Offerings in Japan and the United States



Source: NRI.

2) The shortcomings of the NASDAQ and Softbank

Much of the blame for the difficulties that led the NASDAQ to exit the Japanese market lies with the NASDAQ itself and Softbank, both of which underestimated these difficulties. For example, the key concept of a global trading platform that would span three continents was based on unrealistic assumptions and failed to take account of all the problems involved in trying to implement it.[4]

Furthermore, both companies overestimated the market's potential. For example, Softbank appears to have been over the moon when it succeeded in attracting 1,400 members to its Nasdaq Japan Club, an association for entrepreneurs interested in its plans. However, it is hardly surprising that so many owner-managers should have been interested in having their companies listed. The problem was that they assumed that all these companies would be able to list simply because they wanted to—rather than ask themselves whether these companies could live up to investors' expectations. Although the NASDAQ has claimed that it was the recession in Japan that prevented it from meeting its targets, no equity market anywhere in the world has ever grown at the rate Nasdaq Japan was projecting.[5] Even if the Japanese economy had continued to grow at a healthy rate, these projections would almost certainly have proved irresponsible.

Nor were the two companies' initial expectations the only problem: even after the market had opened, their response was woefully inadequate. For example, a global trading platform should have meant that any companies listed on the NASDAQ in the United States would also be listed on the Nasdaq Japan. This would have entailed considerable costs (e.g., in producing regulatory filings in Japanese). In spite of the fact that the number of companies listed on the Foreign Section of the Tokyo Stock Exchange has been steadily declining and that non-Japanese companies are not very interested in a Japanese listing, the NASDAQ and Softbank made little effort to encourage US companies to list on the Nasdaq Japan market. As a result, not a single US company has been listed there.

The problems surrounding the trading system were also largely the result of the NASDAQ's failure to understand the Japanese market properly. The NASDAQ insisted on trying to force Japanese securities companies to use a system designed for the US market, ignoring the latter's concerns that (1) the cost of connecting it to their own systems would be prohibitive, (2) it was not designed for the Japanese market and (3) might violate Japanese law. In fact, all the securities companies trading on the Osaka Securities Exchange refused to use the new system.

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4 This is not a matter of hindsight. The author raised doubts about the viability of the entire project when it was first announced. See Sadakazu Osaki and Hiromi Hayashi, "Nasdaq Japan - The Next Phase of Nasdaq's Global Strategy," Capital Research Journal, Autumn 1999, and Sadakazu Osaki, Kabushikishijokan Kyoso [Stockmarkets at War], Daiyamondosha, 2000.

5 For example, Nasdaq Japan apparently forecast that 850 companies would be listed on the Nasdaq Japan market by the end of 2001—18 months after the market was due to open. However, such a rapid growth in the number of companies listed on a new market would have been unprecedented—except, perhaps, for the growth in the number of initial public offerings on the NASDAQ itself during the 1990s.

3) Institutional issues and likely developments

This situation highlights the problems that can arise when a company (such as Nasdaq Japan, Inc.) that is subject to neither the approval nor the regulations of the regulatory authorities becomes involved in creating an equity market "in a planning capacity." Although Japan's Securities and Exchange Law allows stock exchanges to be joint-stock companies, the public responsibility of operating a stock exchange means that it cannot be wound up without the approval of the financial authorities (Article 135). In spite of this, however, the Japanese government was unable to intervene in the liquidation of Nasdaq Japan, Inc. Although the NASDAQ's exit from Japan did not, as we have seen, mean the liquidation of the Nasdaq Japan market, the impact of the decision (e.g., on the companies listed there) raises institutional issues that cannot be ignored.

However, the NASDAQ's exit from Japan is unlikely to have a major impact on initial public offerings by Japanese venture businesses. As we have seen, the Osaka Securities Exchange will continue to operate the market, while any companies wishing to delist should have no difficulty listing on either of the other two venture capital markets in Japan. Nor does the NASDAQ's exit mean that Japanese companies thinking of making an initial public offering for the first time will find this more difficult or that the efficiency gains achieved by intermarket competition are likely to be lost in the near future.

The NASDAQ's exit is neither a reflection of problems with Japan's venture capital markets nor a symptom of excessive intermarket competition. This cannot be emphasized too much. Nevertheless, it may well prove the starting point for a major reorganization of Japan's venture capital markets.[6] In particular, it has been rumored for some time that the Osaka Securities Exchange is looking to merge the Nasdaq Japan and Jasdaq markets. Further developments can be expected.

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6 For example, in its editorial of 20 August 2002 the Nihon Keizai Shimbun makes a case for merging the Jasdaq with the Osaka Securities Exchange in order to stimulate competition with the Tokyo Stock Exchange.