The Latest Changes to the Rules Governing the Green Sheet Market

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I. What Is the Green Sheet Market?

On 1 April 2005 the last of the June 2004 amendments to the Securities and Exchange Law ("the Law") finally came into force. They range from the introduction of a system of administrative fines to the abolition of Article 37 of the Law and a requirement for securities companies to publish best execution guidelines.[1] One of the amendments is to the rules governing the Green Sheet market.

The Green Sheet market was established in July 1997 (shortly before the government announced its Big Bang program of financial reform) as a market for shares in privately traded companies (i.e., companies that were neither listed on a stock exchange nor registered on the OTC market).[2] One of the models for the new market was the Pink Sheets, a quotation medium for shares in privately traded US companies. Shares on the new market, which was operated by the Japan Securities Dealers Association ("the Association" or JSDA), were divided into four categories: "regional" (small local companies); "emerging" (start-ups with good growth prospects); and "phoenix" (companies that had been delisted, e.g., because of financial difficulties).

Unlike investing in publicly traded companies, where investors are protected by disclosure requirements and rules on unfair trading activity, investing in Green Sheet companies is highly risky. Securities companies that recommend such companies are therefore required (1) to give investors a copy of their reasons for recommending them along with a summary of key company data (instead of a full company prospectus) and (2) to obtain investors' signed agreement to any transactions.

Also, unlike share trading on a stock exchange, there is no procedure for batching orders. However, in July 2003, Japan Securities Agents was authorized by the

1 See Sadakazu Osaki, "The Enactment of the Amended Securities and Exchange Law," Capital Research Journal, Autumn 2004.

2 See Sadakazu Osaki, "Ugokidasu 'Mikokaikabu' Torihiki" [The Start of Trading in Unlisted Shares], Shihon Shijo Kuwotari [Capital Market Quarterly], Autumn 1997.

Financial Services Agency to broker Green Sheet transactions between securities companies using a multilateral trading facility (i.e. electronic trading system).

II. The Latest Changes to the Rules Governing the Green Sheet Market

1. The amendments to the Securities and Exchange Law

The changes to the rules governing the Green Sheet market that have come into force along with the rest of the latest amendments to the Law are aimed at raising public awareness of and increasing public confidence in the market by means of rules such as those governing unfair trading activity.

More particularly, the amendments establish a new category of OTC shares by extending the Law's rules on unfair trading activities such as market manipulation and insider dealing to cover Green Sheet shares and requiring Green Sheet market makers to give customers a document containing the main details of any transactions involving Green Sheet shares and to report their quotations along with the details of any transactions to the Association, which must publish the details and inform other securities companies (e.g., Article 40, Paragraph 1; Articles 79-2, 79-3 and 79-4; Article 159; and Article 166 of the Law).

2. Details of the changes to the Japan Securities Dealers Association's rules

Before these amendments came into force, the Japan Securities Dealers Association amended its own rules governing Green Sheet shares. The main changes were to endeavor to put in place systems to ensure investor protection by, for example, requiring Green Sheet companies to make timely disclosure of material information (using the TDnet system operated by the Tokyo Stock Exchange) and monitoring (including, if necessary, suspending) trading in Green Sheet shares. In addition, the "regional" category was abolished while a new category ("ordinary") was introduced for companies satisfying all the requirements for the "emerging" category except good growth prospects (Figure 1). It is also envisaged that companies that have registered under the "emerging" category but fail to live up to their own projections will be relegated to the "ordinary" category.

Figure 1 The Changes to the JSDA Rules Governing the Green Sheet Market

Provision	Details
Relaxation of rules on share recommendations	• Members other than those responsible for screening a company and making a market in its securities may recommend the securities to investors. • Members may recommend "other OTC" securities to accredited institutional investors.
The adoption of a timely disclosure requirement and measures to prevent irregular trading activities	• The timely disclosure requirement will be extended to cover Green Sheet securities, and issuers will be required to use the TDnet system for this purpose. • The Association will monitor trading in Green Sheet securities. • The Association will check issuers' details and introduce systems for requesting disclosure documents and suspending trading.
Changes to registration requirements	• There will be no restrictions on the transfer of Green Sheet shares. Existing issuers will be required to amend their articles of incorporation accordingly within one year of these changes' coming into effect.
Changes to market categories	• In addition to the categories "emerging" and "phoenix" (for delisted companies), there will be a new category ("ordinary") for companies which do not meet the requirement for good growth prospects. • Companies in the "emerging" category which fail to attain at least 50% of the earnings growth projections in their summary of key company data will be relegated to the category "ordinary." • The "regional" category will be abolished and the companies in it de-registered unless they comply with the Association's timely disclosure requirement. • Only in special circumstances will members be allowed to recommend companies belonging to the "regional" category when it is abolished.
Allocation of costs	• The cost of operating the new system will be shared between issuers and market makers.

Source: NICMR, from Japan Securities Dealers Association data.

At the same time, the Association allowed its members to recommend "other OTC" shares (i.e., shares that are neither listed on an exchange nor registered as OTC or Green Sheet shares)—but only to accredited institutional investors. Previously members were not allowed to recommend such shares at all and are still not allowed to trade them with other members.

Unlike companies in the "emerging" category (start-ups with a vested interest in substantiating their claims to good growth prospects), companies in the "regional" category (mainly long-established local companies) would appear to have little incentive to disclose information actively. In spite of that, these companies will lose their status as Green Sheet shares and become "other OTC" shares unless they comply with the Association's timely disclosure requirement. Where that happens, however, members will still be allowed to recommend them to investors other than accredited institutional investors for the time being, but only "in special circumstances."

III. Doubts about the Need for the Changes

1. Does the Green Sheet market really need revitalizing?

These changes are intended to "revitalize" the Green Sheet market. However, the author has serious doubts about both the reasons for the changes and the changes themselves.

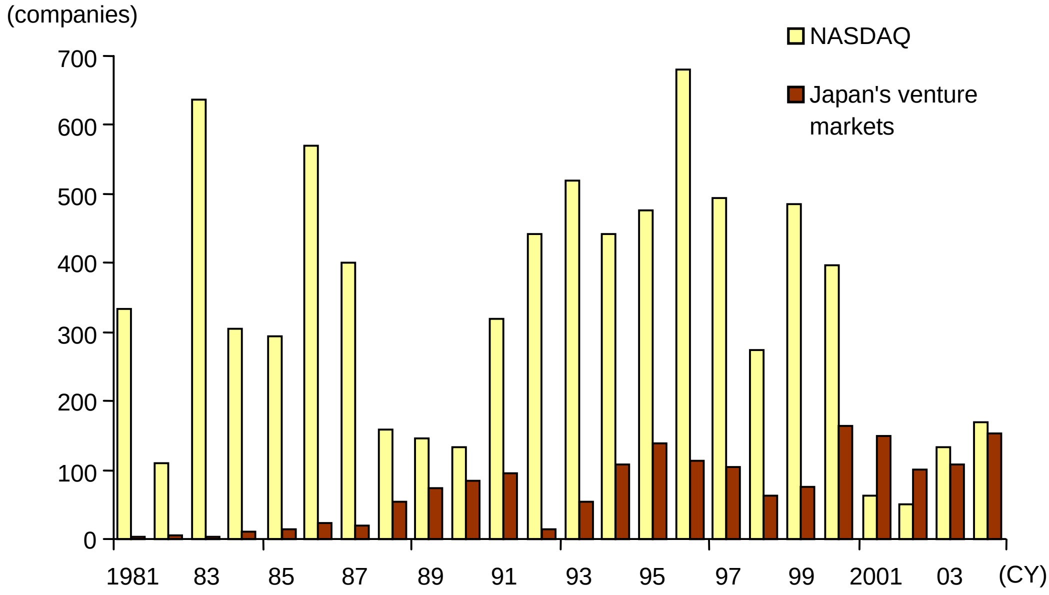
First, let us take the reasons. Does the public really need to be made more aware of the Green Sheet market?

There was a day when start-ups were shunned by Japanese equity markets. Equity financing was regarded as the prerogative of a handful of major companies. Until the OTC market was established in the 1980s, unlisted companies were not allowed to offer their shares to the general public; and, even when the OTC market was established, formidable barriers to going public remained (e.g., in addition to the official requirements, companies seeking to register on the OTC market had to satisfy unofficial requirements, such as having recorded a profit for the previous three years). It was therefore assumed that it would take a company at least 20 years after it was established before it could make an initial public offering.

However, this situation changed in 1999 when the National Association of Securities Dealers (NASD) and Softbank jointly proposed to set up a "Nasdaq Japan" market. Markets were suddenly faced with the prospect of having to compete in order to attract start-ups.

Japan's venture markets—the Jasdaq Securities Exchange (as the OTC market became in December 2004), the Tokyo Mothers market, the Osaka Hercules market and the Nagoya Centrex market—are all keen to attract start-ups with good growth prospects. Compared with the 1980s, when there were only about 20-70 initial public offerings each year, there are now about 100-150—more than in the United States after the dotcom bubble burst (Figure 2). With start-ups now able to make an initial public offering within about three years, the barriers to going public in Japan are now much lower than they used to be.

Figure 2 Number of Initial Public Offerings on Japan's Venture Markets



Note: The figures for Japan's venture markets break down as follows: for the period up to and including 1998, the OTC market; for the period since then, the total for the JASDAQ, the Tokyo Mothers market, the Osaka Hercules market (formerly Nasdaq Japan), the Nagoya Centrex market, the Sapporo Ambitious market, and the Fukuoka Q-BOARD.

Source: NICMR, from NASDAQ data and data for each of Japan's stock exchanges.

In addition, Japan's venture capitalists are now actively investing in privately traded companies, and it is no longer very difficult for such companies, provided they have good growth prospects, to raise capital by issuing shares even before they meet the requirements of these markets (e.g., when they are established). There would therefore seem to be little need to make a special effort to "revitalize" the Green Sheet market just to satisfy the government's general policy of making it easier for start-ups to raise capital.

The argument for changing the rules governing the Green Sheet market is that, since revitalization involves making the market appeal to more investors (including individuals), there is no alternative but to adopt the same disclosure requirements and rules on unfair trading activity as the stock exchanges' venture markets in order to reassure these investors. However, window dressing and insider dealing are rife on these same venture markets. To try to persuade more investors (including individuals) to invest in companies that have not met the requirements for these markets is to expose them to even greater risks of the same kind. Unlike in the days when individual investors were excluded from investing in start-ups, there are now ample opportunities for them to invest in such companies via the venture markets and therefore little justification for exposing them to additional risks.

2. Too many rules can be counter-productive

Second, these changes to the rules governing the Green Sheet market are counter-productive in that they will act as a straitjacket.

In order to comply with the timely disclosure requirement, companies will have to invest in the necessary systems at considerable cost. The problem that this raises is illustrated graphically by the fate of the companies that used to belong to the now defunct "regional" category. These companies used to be traded very sporadically even before the Green Sheet market was established in 1997, albeit with the proviso that securities companies were not allowed to recommend them. For example, there are many local railway companies with customers who would like to become shareholders in order to receive free tickets as a perquisite. Following the changes, these shares have now become "other OTC" shares, and securities companies will only be allowed to recommend them to accredited institutional investors. As a result, investors have been deprived of one of the opportunities extended to them in 1997.

It could be argued that one of the principles that underlie the Green Sheet market (namely, that securities companies should not be allowed to recommend to customers or trade amongst themselves shares in companies that have not met certain standards or requirements) amounts to a boycott by the Association's members. Normally, it would be considered the social duty of a securities company to quote a price for dealing in the shares of a company a customer wanted to invest in or to recommend shares in which he was interested, even if the companies concerned were not traded publicly.

However, the establishment of the Green Sheet market in 1997 only lowered the barriers to Japan's securities markets by correcting some of the more irrational rules that governed them, without solving the fundamental problem presented by a boycott of companies unable (or unwilling) to surmount these barriers.

The latest changes to the rules governing the Green Sheet market deserve recognition for allowing securities companies to recommend "other OTC" shares to accredited institutional investors. However, they increase the regulatory burden of companies without coming to grips with the rules' more fundamentals shortcomings.

While there is some truth in the view that "other OTC" companies could improve their disclosure, it has to be said that these companies are complying with the requirements of the Securities and Exchange Law and that any shortcomings in their disclosure are the result not of any failure to comply with the law but of a failure to disclose more than the law requires.

IV. The Situation in the United States

The equivalent of the Green Sheet market in the United States is the OTC Bulletin Board (OTCBB) run by the National Association of Securities Dealers and the Pink Sheets run by Pink Sheets LLC.

Securities and Exchange Commission Rule 15c2-11 makes it unlawful for a broker-dealer to publish any quotation for a security unless it has copies of the relevant disclosure documents (e.g., prospectus and annual report) in its records and has a reasonable basis for believing that the information they contain is accurate. These are no more than the legal disclosure requirements and entitle a broker-dealer to, for example, no more than ask an issuer to send it a copy of any such documents it files.

Similarly, NASD Rule 6530 restricts issuance of OTCBB-eligible securities to companies that comply with the continuous disclosure requirements of the Securities Exchange Act of 1934.[3]

However, these rules apply only to quotations made by broker-dealers in the process of recommending the securities concerned. In other words, broker-dealers are not required to check whether an issuer has filed disclosure documents if a quotation is simply the bid or offer price of an investor who wishes to buy or sell the security concerned.

Over the years, many Pink Sheet shares were bought and sold in this way without the companies concerned having filed any disclosure documents, and it was only in

3 This restriction did not apply prior to April 1999.

October 2004 that Pink Sheet LLC required broker-dealers initiating quotations in shares that had never been either listed or quoted on the OTCBB to check that they were complying with their legal disclosure obligations. In February 2005 this was extended to cover shares in which broker-dealers had made quotations prior to October 2004.

However, all of these moves to improve the disclosure of material information by privately traded companies in the United States have confined themselves to the legal disclosure requirements and have not sought to exceed these.

V. Conclusion

The latest changes to the rules governing the Green Sheet market have been seen as "upgrading" the market and would appear to have been welcomed by a group of securities companies eager to deal in Green Sheet shares. However, it is not the market that needs upgrading but the companies whose shares are traded on it.

Helping ambitious start-ups that will create new industries is a useful contribution to the nation's economy. It would therefore be wonderful if the companies that are currently registered with the Green Sheet market were to be successful enough to list on one of the venture markets, such as the Jasdaq Securities Exchange or the Tokyo Mothers market, or even the First Section of the Tokyo Stock Exchange one day. However, there is nothing in these changes that will contribute to achieving this. In fact, to "upgrade" a market when nothing about the companies whose shares are traded on it has changed (and some of the companies, such as those in the "regional" category, have actually been "abandoned" as a result) is to put the cart before the horse.