The Implications of a Recent Attempt to Acquire Shares in Osaka Securities Exchange

Sadakazu Osaki

I. Developments to Date

Since January 2005, Yoshiaki Murakami, an ex-official of the former Ministry of International Trade and Industry and president of M&A Consulting Inc. (popularly knows as "the Murakami Fund"), has been in the limelight for his acquisition of a large stake in Osaka Securities Exchange. Mr. Murakami has called on the company to return a larger share of its earned surplus of some ¥20 billion to shareholders in the form of a significantly higher dividend. He has stepped up these calls since the end of March, when he acquired 10% of the company's outstanding shares. In August, he filed an application with the Financial Services Agency, as required under the Securities and Exchange Law, to increase his stake to 20%.

A well known shareholder activist, Mr. Murakami even announces his vociferous and direct attempts to persuade companies to increase their shareholder value on his company's website. He made a name for himself in 2002 when he became the de facto top shareholder in clothing manufacturer Tokyo Style and proposed that the company return surplus cash to its shareholders in the form of a significantly higher dividend and share buybacks. Since then, Mr. Murakami has continued to be active, submitting proposals to Tokyo Style's shareholders every year and offering to acquire Seibu Railway, which was delisted from the Tokyo Stock Exchange after it was discovered to have falsified its filings to the Financial Services Agency. More recently, since February 2005, he has been in the limelight in the struggle for control of Nippon Broadcasting System, in which he was a major shareholder, and, in October, when he acquired a big stake in Hanshin Electric Railway and proposed that the Hanshin Tigers baseball team should be listed.

The response of Osaka Securities Exchange was to argue that it needed to keep a certain amount in cash and deposits to ensure that it would always be able to settle derivative trades. However, Mr. Murakami was apparently not very impressed with this argument.[1] Since then, he is reported to have proposed that he should be made a

1 Regional section (Hyogo Prefecture) of Nihon Keizai Shimbun, 8 April 2005.

non-executive director of the company and to have been involved in various verbal exchanges with senior managers.

II. The Issues Involved in Returning the Exchange's Surplus Cash to Shareholders

1. The lessons to be learnt from the collapse of Barings

The company's argument that it needs to keep a large amount in cash and deposits to ensure that it will always be able to settle derivative trades is by no means specious.

Nikkei 225 stock index futures are the company's main trading product. They were used in the illicit trades that brought about the downfall of Barings Bank in 1995. The huge positions in Nikkei 225 and TOPIX futures that Barings' head futures trader in Singapore, Nick Leeson, had built up were left unsettled when the bank collapsed.

It was decided that other members of the exchange would settle on behalf of Barings in order to liquidate Leeson's positions, and that Barings' margin deposit would be used to cover the resulting losses. When Barings collapsed, it was estimated that the losses on its Nikkei 225 futures positions (i.e., those traded in Osaka) would amount to some ¥30 billion. Although this was roughly the same amount as Barings' margin deposit, it was agreed that, if this was not enough to cover the loss, the "default compensation reserve" (i.e., the clearing reserve to which members contribute ex ante) would be used to cover the rest of the loss.[2]

In fact, the exchange was able to liquidate Leeson's positions, which had a nominal value of no less than ¥300 billion, quite easily, and the losses were less than had been first feared. Barings was acquired by the big Dutch financial group, ING. At the time, however, it was an anxious and exhausting experience for the officials of the two exchanges and the supervisory authorities. Indeed, one newspaper described the period, which began on 25 February with the first reports of the collapse of Barings and ended on 5 March with the news that the company had been acquired by ING, as "Ten Days That Shook the World" (after the eyewitness account of the Russian Revolution by the US journalist John Reed).[3]

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[2] Nihon Keizai Shimbun, 28 February 2005, p. 1.
[3] Nihon Keizai Shimbun, 7 March 2005, p. 9.

2. The need to ensure that adequate settlement funds are available

1) The current default compensation reserve scheme

If, heaven forbid, there should be another such incident, it is perfectly possible, depending on market circumstances, that the losses incurred in liquidating the positions of the defaulting member could exceed its margin deposit. In that case, Osaka Securities Exchange would have to draw on its members' security deposits and the funds that used to form its default compensation reserve.

However, now that the exchange is a public company governed by the Securities and Exchange Law as amended in 2000, it is obliged to record the funds in the default compensation reserve as a capital surplus on its balance sheet. Similarly, it has to post a corresponding amount under "assets" for all the cash, deposits and securities in the form of which it holds these funds. In other words, at least some of the cash and deposits that Mr. Murakami called on the company to return to its shareholders was settlement funds that it might have to draw on in the event of a default by one of its members.

2) Recommendations for central counterparties

This is not to say, of course, that Mr. Murakami has been demanding that the exchange return all of the cash and deposits it holds to shareholders. He is presumably well aware that it needs to retain enough liquid reserves to be able to cover any settlement risk and is simply claiming that the current level of those reserves is unnecessarily high.

A document drawn up jointly by two committees of the International Organization of Securities Commissions (IOSCO), namely the Committee on Payment and Settlement Systems and the Technical Committee, in November 2004 ("Recommendations for Central Counterparties") contains some pointers on how to judge the merits of Mr. Murakami's arguments.[4]

The document contains 15 recommendations on how central counterparties (CCPs) can manage some of the various risks they face.

Recommendation 5 states that "a CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the

[4] Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, "Recommendations for Central Counterparties," November 2004.

largest exposure in extreme but plausible market conditions" and explains in detail the various options that are available (e.g., the alternatives to keeping financial resources in the form of cash and the use of regular stress tests to check whether financial resources are sufficient).

Although Recommendation 5 sets "sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure" as the minimum required level, it is clear from the commentary that IOSCO does not consider this an adequate level. In other words, the document makes it clear that central counterparties need to have contingency plans in case, for example, a major default later destabilizes the market or several clearing members default within a short space of time.

Osaka Securities Exchange's holdings of cash and deposits as of the end of September 2004 amounted to ¥25.8 billion (or 16.8% of its total assets). Although this is certainly a sizeable amount (both in absolute terms and as a percentage of total assets), it is not out of line with the practice of overseas futures exchanges. The Chicago Mercantile Exchange, for example, held $357.56 million (or 12.% of its total assets) in the form of cash or cash equivalents as of the end of December 2004. We should also remember that, when Barings collapsed (an example of "extreme but plausible market conditions"), it was initially thought that the loss from liquidating the bank's positions would be around ¥30 billion.

Osaka Securities Exchange's shareholders are, of course, at liberty to express their views on how the exchange should hold its assets. Nevertheless, the above facts suggest that it would be wrong to draw the simplistic conclusion that the company holds too much cash and is therefore badly managed. Rather, they should consider the matter carefully, taking into account, for example, IOSCO's recommendations.[5]

3. The rules governing how central counterparties cover default losses

These considerations about the need for a central counterparty to have rapid access to funds in the event that a settlement risk materializes raise a number of doubts about Mr. Murakami's proposals for dealing with Osaka Securities Exchange's cash and deposits. In contrast, most of the company's arguments appear to be reasonable. Nevertheless, there appear to be a number of other problems—quite separate from

5 In July 2005 Osaka Securities Exchange set up a panel (chaired by Professor Shigeru Morimoto, Dean, Graduate School of Law, Kyoto University) to advise it on how a listed stock exchange that was also a clearing house could best manage its cash. Although the author was a member of the panel, the views in this report represent purely his personal opinions and not the deliberations or views of the panel.

those identified by Mr. Murakami—about the company's procedures for dealing with losses arising from settlement failures.

Under the existing system, the company can make an assignment on participants (clearing members) to cover a loss if the default compensation reserve is insufficient. This is the so-called "contribution scheme." It owes its origins to the fact that, for many years, stock exchanges in Japan have operated as private bourses and depended on the mutual support of their members.

However, this system has been questioned since the debate on whether to demutualize Japan's stock exchanges began. Exchange members (i.e., the securities companies) have argued that it would be unfair to expect them to bear sole and unlimited liability for losses arising from market risks but not to expect the shareholders to accept any liability at all. Not only would making an assignment on members in this way arouse strong opposition: it could even put many of them out of business.

In contrast, many overseas central counterparties that, like Osaka Securities Exchange, settle futures trades try to avoid making further assignments on their members, preferring to draw on their own capital reserves before touching the security deposits that members have already been required to contribute (Figure 1).

Figure 1 Principal Overseas Central Counterparties' Rules for Covering Members' Default Losses

	LCH	Eurex	CME	OCC	SGX
	London Clearing House, UK central counterparty for cash shares and derivatives. Currently merging with Clearnet. Will continue after merger as subsidiary of new holding company.	Europe's largest derivatives exchange. Has its own clearing house subsidiary.	Chicago Mercantile Exchange	Options Clearing Corporation, clearing house for all option transactions in the United States	Shingapore Exchange
Members' security deposits	(2) ¥63.6bn	(2) ¥74.2bn	(2) ¥92.4bn	(1) ¥168bn	(2)
Insurance	(3) ¥41.0bn	(1) ¥530mn	(1) ¥9.0bn		
Capital and capital surpluses	(1) ¥2.05bn (4) surplus funds				(1) (total for (1) and (2) of ¥21bn)
Other					
Further assignments on members			(3)	(2)	(3)
Upper limit on possible assignments on members	No obligation to contribute more than security deposit (varies according to transaction type; minimum of ¥ 20.50mn) to default fund.	No specific obligation to contribute more than security deposit (minimum of ¥700mn for general clearing members, and of ¥ 140mn for direct clearing members) to default fund.	Members obliged to contribute amount equal to their share (minimum of ¥ 52.5mn) of the security deposit pool or an amount equal to 275% of the aggregate security deposit requirement across all clearing members and allocated pro rata.	Members obliged to contribute amount equal to their share of the security deposit pool or an amount equal to the balance of the losses allocated pro rata. (Each member may withdraw membership if it is assessed an additional amount equal to the amount of its initial deposit; otherwise, it will be liable for further assessments until the balance of the losses is covered.)	Upper limit on further assignments: ¥520mn (only if letters of credit are deposited)

Notes: (1) The figure of ¥530mn for Eurex's capital and capital surplus is the amount posted in its clearing reserve to cover default losses.
(2) The following exchange rates were used to convert the foreign currency amounts to yen: US$1 = ¥105; €1 = ¥140; and £1 = ¥205.
(3) Numbers in parentheses indicate the order in which resources are allocated to cover a defaulting member's losses if the member's margin deposit, security deposit, etc. are inadequate to cover the losses.

Source: Osaka Securities Exchange.

However, the whole point of having a central counterparty for futures and cash transactions is to enable members to trade without having to worry about the credit risk of their counterparties. If there is going to be a risk, however small, of an ex post assignment being made on members in the event of a default, it means that the system itself, which is intended to eliminate counterparty risk, is not working properly. That is why overseas central counterparties have rules that try to reduce to a minimum the need to make assignments on their members.

Given the global competition among securities markets, confidence in central counterparties is a key element in maintaining a competitive lead. In view of this, more consideration should perhaps be given to minimizing the risks to a market's members in order to increase its appeal.

III. Mr. Murakami's Application and Its Rejection

1. The application and the events leading up to it

On 13 August a hearing was held to give both Mr. Murakami and the Financial Services Agency, to which he had applied to increase his stake in Osaka Securities Exchange to at least 20%, an opportunity to voice their views. The Agency indicated that it was going to reject the application and later announced this officially.[6] Although Mr. Murakami accused the Agency of "abuse of its discretionary powers," he has not sought to have the decision overturned in the courts.

The reason for the application and the hearing is that, under the Securities and Exchange Law, direct stakes in listed stock exchanges of more than 50% are not, as a rule, allowed, while proposals to became a major shareholder with a stake of 20% or more have to be approved by the Financial Services Agency in advance (Securities and Exchange Law, Article 103 and Article 106-3). However, stock exchanges, stock exchange holding companies, and securities dealers associations can become major shareholders without obtaining this approval and acquire more than 50% of an exchange's shares with the Agency's approval (Securities and Exchange Law, Article 103(1) proviso and Article 106-3(1) proviso).[7]

Mr. Murakami has continued to voice his opinions about how Osaka Securities Exchange should be run. Not only, as we have seen, has he called on the company to return to shareholders in the form of a much increased dividend its considerable retained earnings (now entered in its books as a capital surplus), he has also criticized it severely for suspending listings on its Hercules market because of a computer system failure. The reason he decided in August to apply to increase his stake in the company was apparently that he wanted to reduce the large proportion of the company's shares held by securities companies, call for the appointment of suitable non-executive directors, and strengthen the company's corporate governance.

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6 The hearings were held in public and the arguments of both sides reported in detail in the Nihon Keizai Shimbun, 18 August 2005, p. 3.

7 Until the Securities and Exchange Law was amended in 2003, the rule was even more restrictive, prohibiting anyone from owning 5% or more of a listed stock exchange's shares.

2. The rejection and the arguments of both sides

The Financial Services Agency announced at the hearing that the reason it had decided to reject Mr. Murakami's application was that he did not meet one of the three requirements for granting such an application: namely, the requirement that there should be no risk that an applicant might use its voting rights to interfere with the proper functioning of a demutualized stock exchange (Securities and Exchange Law, Article 106-4(1)).

The Agency gave as its reason for this view the fact that Mr. Murakami had a large stake in the investment fund he managed and that this fund invested in companies that were (or might be) listed on Osaka Securities Exchange. There was therefore, in the Agency's opinion, a risk of a conflict of interest between the fund's investment activities and the company's self-regulatory responsibilities (e.g., vetting listing applications, enforcing timely disclosure requirements, and monitoring trading).

Under the Securities and Exchange Law the Agency may only grant an application from a shareholder to increase its stake in a demutualized stock exchange to 20% or more if the applicant has satisfied all three requirements stipulated in Article 106-4(1).[8]

This is more demanding than the rule governing the eligibility to register as a securities company, which says that an application to register will be rejected if the applicant is liable for disqualification, even though both rules form part of the same Securities and Exchange Law. If the rule was that the Financial Services Agency would reject an application if there was a risk that the applicant might interfere with the proper functioning of a stock exchange, it would not be right for the Agency to reject an application just because of the risk of a conflict of interest unless the likelihood of such a risk materializing was extremely high.

However, that is not what the current rule says. Leaving aside the risk of a conflict of interest referred to by the Agency, Mr. Murakami's past comments (namely, that the risk of something going wrong with the settlement of a futures transaction is one that should be covered by a special loan from the Bank of Japan and not one that should be borne by a stock exchange's shareholders) would suggest to anyone that, even if his shareholder activism is acceptable, it would be a brave man who could say with complete confidence that there was absolutely no risk that he would not interfere with the proper functioning of a demutualized stock exchange. The Agency's decision

8 In addition to the requirements mentioned so far, an applicant is required to have an adequate understanding of the public nature of the work of a stock exchange and to have sufficient social standing.

cannot therefore be said to have been arbitrary and unjust, and Mr. Murakami's description of it as "abuse of its discretionary powers" is surely wide of the mark.

3. The widespread existence of rules restricting shareholdings in demutualized stock exchanges

There is nothing unreasonable about a company, such as a stock exchange, whose business has a significant impact on public welfare being subject to different rules from ordinary companies about who can become a shareholder. If there were no restrictions on who could become a shareholder in such a company, an unsuitable shareholder with a controlling interest could use the company to further its own financial interests and possibly even use that position to circumvent the normal requirement for a license or approval to engage in that business. Indeed, many countries require stock exchanges to comply with such rules.

In France and Germany, for example, anyone seeking to acquire a certain stake in a stock exchange is required to report that intention, and the regulator has the right to refuse to grant permission or to impose restrictions on the applicant's voting rights if, in its view, there is a risk that the applicant might use its voting rights to interfere with the proper functioning of the exchange. In Singapore and Hong Kong, anyone seeking to acquire a stake in a stock exchange of 5% or more and, in Australia, a stake of more than 15% is required to apply in advance, as in Japan. In Australia, the requirements for granting such an application ("If the Minister is satisfied that it is in the national interest …," Corporations Act, Section 851B(1)) are even more ambiguous than in Japan.

In the two countries with the most developed capital markets, the United States and the United Kingdom, however, there are no particular legal restrictions on shareholdings in stock exchanges. Nevertheless, in the United States some stock exchanges do prohibit direct holdings of 20% or more of their voting rights, while one of the rules proposed by the Securities and Exchange Commission in November 2004 prohibits clearing members from directly owning more than 20% of an exchange's voting rights.[9] It would seem fair to say that imposing certain restrictions on shareholdings in stock exchanges (in addition to requirements that their rules be approved by the industry regulator) is now the norm in most countries.

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[9] See Sadakazu Osaki, "Beikoku Shoken Shijo ni Okeru Jishu Kisei Minaoshi no Ugoki" [Moves to Revise the Self-Regulating Rules Governing US Stock Exchanges], Shihon Shijo Kuwotari [Capital Market Quarterly], Winter 2005, p. 43 ff. and p. 47.

4. Problems arising from restrictions on shareholdings

However, restricting shareholdings in stock exchanges also gives rise to certain problems. The threat of a hostile takeover is generally considered to keep the managers of listed companies on their toes and to improve the way the companies perform. Imposing restrictions on ownership, however, could reduce that effect and impair performance. There is also a risk that preventing a stock exchange from being taken over could be discounted (negatively) in the share price.[10]

The impact of similar restrictions on ownership will also vary depending on whether they are ex post interventionist-type restrictions, as in the above-mentioned case of France and Germany, or ex ante approval-type restrictions, as in the case of Japan, Hong Kong, Singapore and Australia. Moreover, even the same type of ex ante restrictions can be more or less severe, depending on what exactly applicants are required to do. The case in question highlights just how restrictive Japanese law is in this regard.

At the hearing Mr. Murakami is reported to have said that, if the Financial Services Agency's case was upheld, nobody's application would ever be approved, showing that the law as it stood was a bad law. Leaving aside the issue whether the law as it stands is a bad law, there is no doubt that, if an applicant has to prove that there is no risk that it might interfere with the proper functioning of a stock exchange, its application will have little chance of being approved unless it has already operated a properly functioning stock exchange.

The Agency appears to interpret the requirements for an application to be approved to be that there should be no risk of a conflict of interest with an exchange's self-regulatory responsibilities. If that is the case, it would mean that not only funds like Mr. Murakami's but also listed companies, securities companies and companies that might list at some point in the future should also have their applications to become major shareholders rejected. If this understanding is correct, it would mean that the only entities that could become major shareholders of stock exchanges would be other stock exchanges or securities dealers associations. Moreover, as Japanese stock exchanges and securities dealers associations do not need to meet the requirements of Article 106-3(1) proviso of the Securities and Exchange Law in order to obtain approval to become major shareholders of stock exchanges, the only interpretation possible is that the requirements are meant to apply only to non-Japanese stock exchanges and securities dealers associations.

10 However, this does not constitute an argument against listing the shares of stock exchanges, since the principal reason for listing shares is not to enable controlling interests in companies to be transferred.

It is, of course, possible to take the view that there is nothing wrong with this interpretation, especially if one is responsible for preventing such conflicts of interest. Similarly, it is possible to take the view that, even if there is a risk of a conflict of interest, it is more than offset by the benefits to intermarket competition from allowing a wide range of entities to be involved in the management of stock exchanges and that less, rather than more, regulation is required.

As it happens, the self-regulatory responsibilities of stock exchanges are once again in the limelight—partly because of the plans to list the Tokyo Stock Exchange.[11] The crux of the issue is how the demutualized exchange could avoid a conflict of interest between its market operating division, which would inevitably want to make a profit for the exchange's shareholders, and its self-regulatory division, which embodies the public interest. If, as the Financial Services Agency clearly believes, restricting ownership of a stock exchange can help to reduce the risk of such conflicts of interest, the risk of management succumbing to a conflict of interest as a result of trying to please its shareholders should be considerably reduced.

Mr. Murakami's actions can be said to have contributed to the debate on how stock exchanges that are supposed to incorporate a self-regulatory function that serves the public interest can best be governed.

[11] In July 2005 the Tokyo Stock Exchange set up an ad hoc committee on the subject of self-regulatory business (chaired by Professor Kenjiro Egashira, Faculty of Law and Graduate Schools for Law and Politics, Tokyo University). The committee was due to report in mid-October. Although the author was a member of the committee, the views in this report represent purely his personal opinions and not the deliberations or views of the committee.