The Decision to Not Delist Nikko Cordial Shares

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I. Events leading up to the decision to maintain listing

On 12 March 2007, the Tokyo Stock Exchange (TSE) announced its decision to take Nikko Cordial Corporation's shares off of "Kanri Post" (supervised status) and maintain their listing. The major securities firm's shares were under scrutiny for possible delisting owing to past accounting irregularities. At the same time, TSE issued a warning and a demand for submission of an improvement report to Nikko pursuant to rules on timely disclosure.

On 18 December 2006, the Securities and Exchange Surveillance Commission (SESC) announced it was recommending a record-high civil fine on Nikko Cordial of ¥500 million, based on misrepresentations in that company's securities filings for the period ended March 2005. These included the failure to include in consolidated accounting the results of NPI Holdings (NPIH), a wholly owned subsidiary of Nikko Principal Investments (NPI), which in turn is a subsidiary of Nikko Cordial; as well as the erroneous inclusion, based on falsified issuance dates, of valuation gains on convertible bonds issued by NPIH and held by NPI. The Financial Services Agency (FSA) levied the fine as recommended.

In response to this, the TSE placed Nikko Cordial's shares on supervised status as it investigated whether the violations met its criteria for delisting, specifically article 2-1-11 of its share delisting standards, which refers to "fraudulent" securities filings by listed companies deemed to have a "grave" impact.

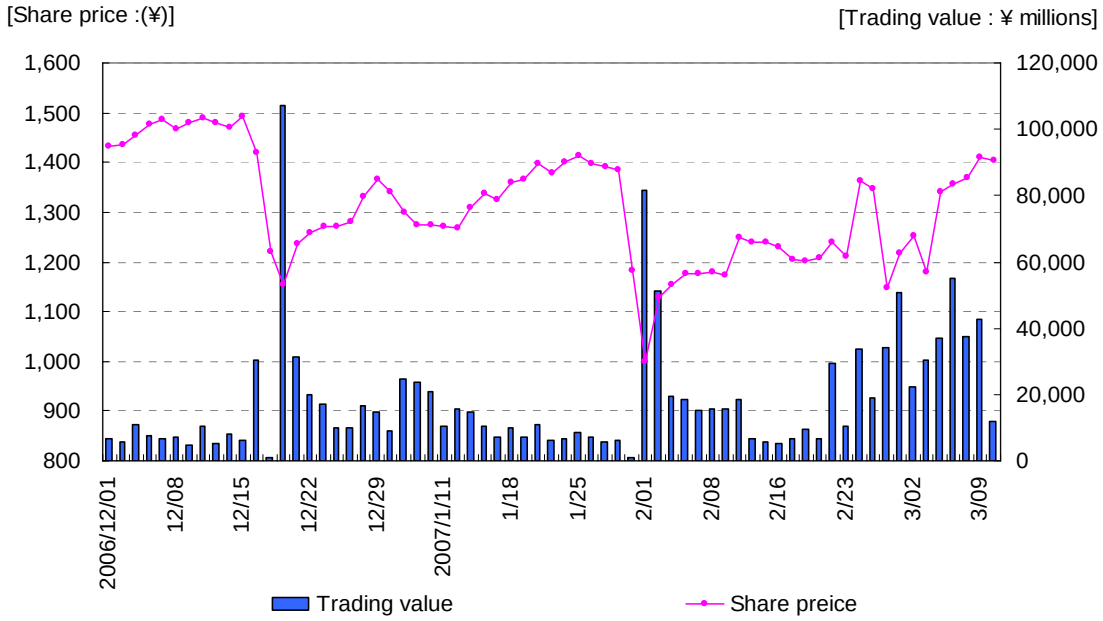
During this period, the price of Nikko Cordial's shares temporarily plunged on speculation that liquidity would dry up if the shares were delisted (Figure 1). On 6 March, the US-based financial conglomerate Citigroup, also a major shareholder in Nikko Cordial, announced that it had reached agreement on a comprehensive strategic alliance with Nikko Cordial that included broad-based business collaboration and an acquisition of Nikko Cordial's shares. This stabilized the share price, but speculation that the shares would be delisted remained strongly rooted.

This speculation can be attributed to a number of articles in leading newspapers predicting a delisting of Nikko Cordial's shares, including two front-page stories in the Nihon Keizai Shimbun (28 February and 7 March) as well as a story on page 11 of the Asahi Shimbun on 8 March.

There were also reports during this period that the Osaka Securities Exchange (OSE), where a portion of Nikko Cordial's shares are also listed, was strongly considering maintaining the listing, even if the TSE decided to delist.[1]

Based on these reports, most market participants were fairly surprised when the TSE announced its decision.

Figure 1: Share price and trading value for Nikko Cordial's shares



Source: Nomura Institute of Capital Markets Research, based on Bloomberg data.

II. Assessing the decision not to delist

1. The reasons for TSE's decision

Although the TSE's decision was contrary to what most expected, the decision itself was not necessarily inappropriate.

As noted above, the TSE debated whether Nikko Cordial's fraudulent securities filings met its criteria for delisting, specifically article 2-1-11 of its share delisting standards, which refers to "fraudulent" securities filings by listed companies deemed to have a "grave" impact.

Although the filings were in fact fraudulent, the TSE determined that the criteria for delisting were not met, and therefore maintained the listing, based on the following: (1) differences with previous delisting decisions, including that the

[1] An article by Masataka Maeda on page 1 of the *Nikkei Kin'yu Shimbun*, 9 March 2007 edition.

corrected securities filings were given unqualified opinions by the auditors, suggest the delisting is less than essential; (2) the amount by which profits were overstated was not that great; and (3) there was no evidence of a systematic effort.

Nearly all cases of delisting in the distant past were a result of acquisitions, mergers, or violations of shareholder numbers or other numerical standards, and wound up in business failure. In these cases, there was little room for any judgment calls by the TSE, and almost no question over whether delisting was appropriate.

2. Comparison with past cases

In recent years, however, there have been a number of cases in which companies that have not collapsed have had their shares delisted as a result of fraudulent filings or other violations, including Seibu Railway (delisting decision made in November 2004), Kanebo (May 2005), and Livedoor (March 2006). These cases represented a more difficult decision process for the TSE, because a decision to delist would become a proximate cause for multiple shareholders, including individual investors, to lose the opportunity to recover their invested capital.

Seibu Railways and Kanebo would probably have been delisted even if they had made accurate disclosures without any fraudulent filings, based on their not meeting standards for minority shareholder ownership percentage and on their being insolvent for two consecutive years. Livedoor had not restated its securities filings when it was delisted, making it impossible to immediately conclude fraud, but the fact that the SESC had already filed criminal charges led the TSE to determine that the impact of the fraud was severe.[2]

Nikko Cordial's situation was more favorable in several respects. Although it is true that (1) despite criminal charges having not been brought, a record-high fine of ¥500 million had been levied[3]; and (2) the violation was by a leading securities house, which should be setting a good example on corporate disclosure for listed companies, a fact that suggests the impact could be severe; on the other hand, (3) there was no reason to delist the company except for the fraudulent filing; and (4) an internal investigative committee compiled a detailed report and is considering the possibility of filing suit against the previous management team.

Also, (5) there is a possibility that the TSE's decision was also affected by the fact that if the shares were to be delisted at a time when Citigroup was planning a takeover bid, investors would have no choice but to accept the terms of the takeover offer, even if they were unsatisfactory, since other opportunities to recover their invested capital

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2 Although both Seibu Railway and Kanebo developed into criminal cases, this was not certain when the decision to delist was made.

3 Based on the laws in force when Nikko Cordial made its fraudulent filing, the maximum possible fine when guilt is established was ¥500 million (this was raised to ¥700 million with the June 2006 revision to the SEL). Taking this into account, it is possible to conclude that the sanctioning impact of the fine was sufficiently large to forego bringing a criminal case, but not to make the simple argument that the level of maliciousness was lower than in past criminal cases.

would disappear.[4] In addition, (6) there were reports that the legal opinion indicated by some well-known commercial law experts was that a decision not to delist would not be illegal (even though this opinion was not presented directly to the TSE), and there is a possibility that the TSE also took such expert opinions under consideration. When taking all of these factors under consideration, the TSE's decision to maintain Nikko Cordial's listing does not seem to be out of line.

3. The Livedoor court decision

On 16 March, the same week that the TSE decided not to delist Nikko Cordial's shares, the court handed down sentencing to former Livedoor president Takafumi Horie. The coincidental timing of these two events has led some observers to contrast the harsh treatment of Livedoor with the lenient treatment of Nikko Cordial.

With respect to the delisting decision, however, this is a mistaken view. In the case of Livedoor, the number of shares traded became unusually high because of huge stock splits, and this caused serious damage to the trading system and threw the market into turmoil. Article 2-1-19 in the delisting standards includes a blanket cause for delisting "when the delisting of said stock on this exchange is deemed appropriate to protect the public and investors," and Livedoor would have been delisted based on this clause even if there was no fraudulent filing as covered in Article 2-1-11. It is quite obvious why the decision regarding Livedoor's shares ended differently than the decision to maintain Nikko Cordial's listing.

III. An exchange should be given broad discretion

When considering the many factors working against Nikko Cordial as previously noted, if TSE had ruled the other way and decided to delist the company's share, it is doubtful that there would have been much criticism of that decision as unfair or a misuse of discretionary powers.

The conclusion of this case was affected by a qualitative judgment regarding the graveness of impact from fraudulent filing, and clearly resided in a gray area in light of similar cases in the past. It seems clear that the TSE's decision in such a case, be it to delist or not, should not have been subject to censure.

The listing of shares is based on a listing agreement reached between the issuer of the shares and the exchange, and the decision on whether to approve that listing, or later to cancel it, is one that should be made by the exchange from the perspective of whether the stock is appropriate for trading on the market. There is of course a need to

[4] Amid speculation that the TSE would delist the shares, there were reports that the OSE was considering maintaining the listing on its market alone. This was apparently based on the reasoning that if the OSE followed suit with a delisting of its own, investors would lose their only other option besides accepting the takeover bid. TSE president Taizo Nishimuro stated in an interview that Citigroup's takeover bid did not enter into the decision not to delist.

set benchmarks of appropriateness to increase predictability, but standards should not be mechanically applied, and exchanges, which have the role of underpinning market fairness, should be granted wide berth in exercising discretion.

In fact, the problematic sentence in the delisting standards is "when the impact (of the fraudulent filing) is deemed by the TSE to be grave" (emphasis is the author's).An arrangement that allows exchanges such broad discretion is not that unusual, even when compared with other countries.

For example, the New York Stock Exchange (NYSE), in its Listed Company Manual Subsection 802.01D, does not limit cause for delisting to the breaking of numerical criteria, but requires the exchange to consider and assess the appropriateness of maintaining the listing on a case-by-case basis, and to make the decision to delist when necessary, regardless of whether explicit delisting criteria have been met. In addition, it spells out other factors which may lead to a company's delisting: When the company (1) does not make timely, adequate, and accurate disclosures of information; (2) fails to observe good accounting practices in reporting earnings and financial position; (3) engages in other conduct not in keeping with sound public policy; (4) has unsatisfactory financial conditions and/or operating results; (5) receives an auditor's report that includes a qualified opinion, an adverse opinion, a disclaimer opinion, or an unqualified opinion with a "going concern" emphasis; (6) is unable to meet current debt obligations; (7) has abnormally low selling price or volume of trading; (8) makes unwarranted use of company funds for the repurchase of its shares; and (9) if there is any other event or condition which may exist or occur that makes further dealings or listing of the securities on the Exchange inadvisable or unwarranted in the opinion of the Exchange.

Also worth remembering is that when Kanebo's shares were delisted in 2005, the FSA issued an order to the TSE demanding that the exchange submit a report on whether there was a need to revise delisting criteria amid the substantial changes in the corporate environment that were going on, including a diversification of ways for turning corporations around. What is apparently behind this is the FSA's opinion that the TSE should be flexible in interpreting its delisting standards, and that it may have been best to maintain the listing of Kanebo, which was trying to wipe its slate clean and was receiving support from the Industrial Revitalization Corporation (IRC). In Japan, as well, there are now demands for more sound discretion from exchanges and a more flexible approach to delisting standards than before.

One of the reasons that the NYSE is able to exercise such broad discretion in regards to delisting is the different structure of its delisting rules. In the US, a company's shares are delisted when either the listed company itself voluntarily applies to the SEC for delisting or the exchange makes such application based on its delisting standards, and that application is approved. Accordingly, there is a possibility that the SEC will not approve the delisting if the discretion exercised by the NYSE is deemed either illegal or inappropriate.

In contrast, a 1998 revision to Japan's Securities and Exchange Law (SEL) in principle changed delisting from an action requiring approval to an action requiring notice (Article 112-1 of the SEL, and Article 126-1 of the Financial Instruments and Exchange Law (FIEL), once that law was implemented).[5] Although such a system itself appears to be fair, there is increased risk that the exchange will hesitate to make an ultimate decision on delisting, given the substantial market impact that such a decision would have.

IV. The principle of "no punishment without certainty of guilt" is inappropriate

The TSE's explanation at its press conference that it decided not to delist based on the principle of "no punishment without certainty of guilt," since it was unable to confirm Nikko Cordial's organizational involvement in the fraudulent filings, is not all that praiseworthy.

An exchange is neither an investigative body nor a court. It seems obvious that it would be impossible to establish proof of a rules violation in detail without having the authority to collect evidence. It is inappropriate, in my opinion, for an organization without public authority to follow the "no punishment without certainty of guilt" approach in the name of protecting human rights.

An exchange is a self-regulatory organization (SRO) with the responsibility to maintain market fairness. SROs are expected to adhere to ethical standards, which are on a higher plane than legal obligations. Markets are grounded in trust and expectations, and it is impossible to maintain a high level of credibility if grave violations of rules in that regard are not seen as a crime for merely having created suspicion, but are instead shrugged off under the philosophy of "no punishment without certainty of guilt."

The criteria for assessing whether the fraudulent disclosure had a grave impact should be more than just whether or not there was organizational involvement. As already noted, I think that this latest decision by the TSE can be easily justified based on an overall assessment of the pertinent facts, but I think that explaining this decision using the principle of "no punishment without certainty of guilt" is taking it too far. There would likely be some major repercussions in the future if this establishes as a precedent the principle that a listing should be maintained even when there is fraudulent disclosure as long as there is no evidence of organizational involvement; or more generally, that the exchange cannot mete out severe penalties except in cases where a blatant violation of specifically written rules is found.

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5 There is a rule (Article 113-1 of the SEL) that states that when an exchange violates its business rules when listing or delisting a company, the FSA can, after holding a hearing, order a delisting, a relisting, or other corrective measure. This process is considerably more onerous than just denying approval, however, and thus unlikely to be utilized other than for extremely serious problems.

V. Preliminary reports of delisting

Preliminary reports that Nikko Cordial's shares would be delisted had a huge impact on the market by causing panic selling by a large number of investors. Those investors who dumped their Nikko Cordial shares at a low price will probably not easily forget what happened.

Looked at from the exchange's standpoint, those reports were nothing more than wild speculation with no basis in any announcement made by the exchange. When those news stories surfaced, the exchange put up a notice on its website stating that it was still considering the possibility of delisting Nikko Cordial's at shares and that once it made a decision it would immediately make it public. The FSA had made an issue out of the way that the exchange managed information when Kanebo's shares were delisted, so it is not difficult to imagine the TSE being particularly careful in its management of information this time.[6]

So why did such mistaken information wind up being disseminated despite this extra care? To prevent the same mistakes from happening again, there is probably a need to examine the issues more closely, including how the media gathers and handles information.

VI. Future challenges

1. Ensuring the liquidity of delisted shares

There appears to be quite a bit of criticism over the lack of clarity in the delisting standards as a result of the exchange making a decision that went against the predominant expectation. I do not think this criticism is well-founded, however, given my position that exchanges should be allowed broad discretion. Assuming that the current delisting standards are ambiguous, it is probably not a good idea to try to fix that by establishing an arbitrary cutoff point for deciding when shares either are or are not delisted, such as by the percentage that profits were overstated as a result of the fraudulent filing, because this would probably create a loophole whereby seriously bad cases could escape delisting.

The Nikko Cordial case, because of the decision to not delist, did not directly bring up debate over the loss of liquidity resulting from delisting, but such a loss of liquidity is a structural problem inherent in Japan's stock market. I see an urgent need to address this problem, such as through a revision of the JSDA's Green Sheet system, and to devise a way to ensure the liquidity of delisted stocks.[7]

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6 In the interview, TSE president Nishimuro took exception to the reports claiming a delisting decision was made, saying he thought the reports were "very questionable," and "unfortunately made him want to ask where the evidence was" for the reports.

7 Current green sheet rules require that registered stocks obtain an opinion from a CPA and auditor that its recent balance sheet statement is fair. This inevitably blocks trading in stocks that have been delisted for accounting irregularities, and is actually one of the reasons why Kanebo's shares could not be traded on green sheets.

There are recent examples with the NYSE in the US of delistings caused by violations of disclosure rules, including extremely slow information disclosure, where the issuer of the shares to be delisted announces, after trading is suspended but prior to any formal decision to delist, that it will immediately make its shares available for trading on pink sheets. This means that there is no immediate loss of liquidity when the NYSE makes the decision to delist.[8]

2. Introducing effective sanctions

There is also a need to implement some effective sanctions against rules violations by listed companies prior to the stage of delisting.

Together with its decision to maintain the listing, the TSE issued a warning and a demand for improvement to Nikko Cordial based on timely disclosure rules. The TSE's "treatment of share delisting standards" states that when a company is ordered to issue improvement reports three times within a five-year period, the decision to delist shall be made based on this being "a grave violation of the listing contract" as noted in article 2-1-12 of the delisting criteria. This requirement to issue a report is actually a form of sanction, in certain respects. Nevertheless, Citigroup had already announced a takeover bid aimed at making Nikko Cordial a wholly owned subsidiary, making it likely that the company's shares would be removed from the exchange in the near future anyway, and thus the demand for an improvement report has not served as an effective sanction.

In order to increase the effectiveness of exchange rules that listed companies must follow, there is a need to provide for sanctions other than delisting or demanding an improvement report. A realistic option for this would probably be monetary fines, an approach also used in exchanges overseas. A proposal for this is included in the interim report issued on 27 March by the TSE's working group on the listing system.

Although there are many details still to be worked out, including the amount of the monetary fines, the decision-making process, and the procedures for filing appeals, these issues should be debated soon in order to ensure the integrity of markets.

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8 NYSE Group, Inc. News Release, NYSE Regulation to Suspend Trading in R&G Financial Corp. Moves to Remove from the List, February 12, 2007. For more on pink sheets, see my article *Shijou Kuubun wo Dounyuu shita Beikoku Pinku Shiito* (Pink sheets divide the US market), in the *Capital Market Quarterly*, Spring 2007 issue (in Japanese).