Protecting Investors While Encouraging the Supply of Risk Capital

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I. Introduction

Participants at the G20 Summit held in St. Petersburg, Russia in September 2013 named strengthening growth and creating jobs the priority issues, and cited long-term investment as playing a critical role in achieving both. They also identified as important creating an environment that encourages long-term investment financing, including for infrastructure and small and medium enterprises (SMEs).

The long-term investment finance seen as important by the G20 is referred to as “supplying risk money” (i.e., risk capital) in Japan, where its promotion has likewise been seen as important in recent years.

Securities markets provide the primary channel for supplying risk capital, and one of the goals of securities regulation is to ensure that securities markets function soundly as a venue for raising that capital.

Another important goal is to protect the investors who supply it. Because furthering investor protection also raises trust in securities markets and promotes the supply of risk capital, these two goals are intertwined.

It is often the case, however, that disclosure requirements, seen as the primary tool for protecting investors, wind up placing a significant burden on entities seeking to raise risk capital. This means that there is some degree of trade-off between the two objectives of security regulation: promoting the supply of risk capital and improving investor protection.

During periods in the US when securities regulators placed more emphasis on promoting the supply of risk capital, including from the late 1970s to the early 1980s and again in the early 90s, some of the policies protecting investors were relaxed while others were strengthened as securities regulators fine-tuned the balance between the two objectives.

That is, at the same time as leaving open the possibility of issuing securities under more relaxed disclosure obligations than usual, limits were placed on the amount of issuance, the number of investors, the class of investors, and the class of corporation.

When the Jumpstart Our Business Startups (JOBS) Act was passed in 2012, attention was drawn to attempts to establish a new equilibrium point in the balance between these two objectives.

As we show below, Japan has also started putting more emphasis on promoting the supply of risk capital recently, but its approach to balancing that with investor protection, although similar in some respects, differs in some important ways.

II. Encouraging risk capital while protecting investors in Japan

When Japan passed its Securities and Exchange Act, which is modeled after the Securities Act of 1933 and the Securities Exchange Act of 1934 in the US, after World War II, it began basing investor protection on disclosure, including by requiring filings when seeking investors in securities, as in the US.

For a long time after the war, however, Japan's financial system was built around the banks supplying funding, including risk capital. Spurred in part by the securities recession of 1965, advancing securities markets from their undeveloped state was made a goal of securities regulation, and rather than navigating the policy trade-off between making securities markets function better in supplying risk capital and protecting investors, a policy package was put together that shared goals common to both.

After the collapse of Japan's economic bubble, the excessive role of banks as intermediaries of risk capital was seen as a cause of the nonperforming loan (NPL) problem, and to revitalize the economy securities market reforms were pursued with a view toward shifting from a bank-centric financial system to one underpinned by markets. This was framed as a shift from savings to investment, and securities regulation aimed at making securities markets the primary venue for supplying risk capital also incorporated investor protections as part and parcel to that objective.

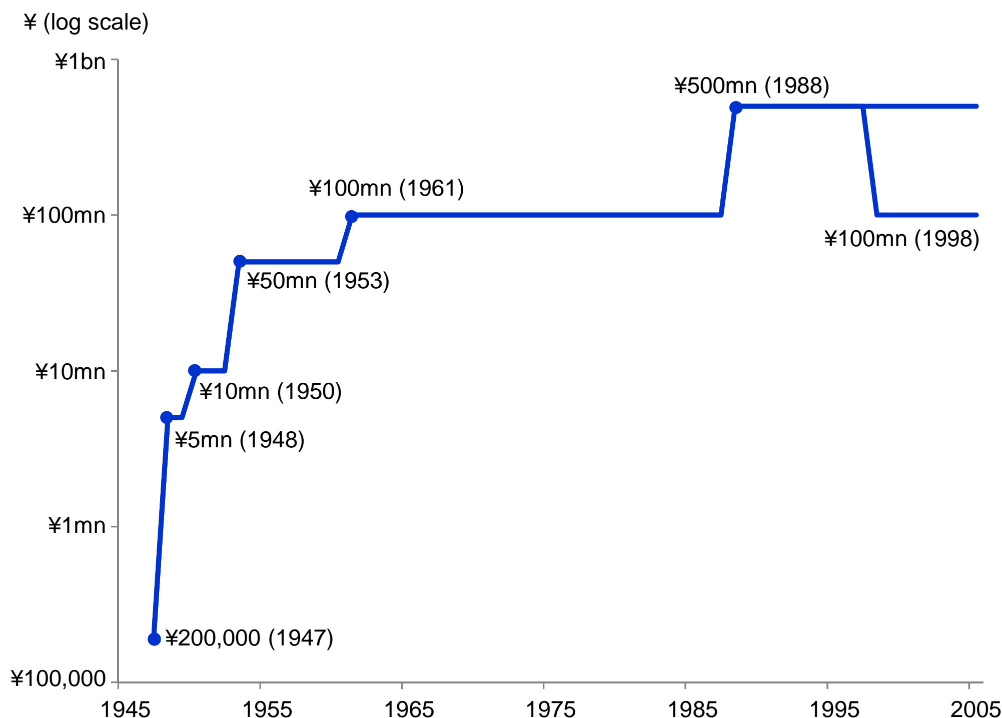
Many of the specific policies implemented during this process, as in the US, loosened disclosure requirements to make it easier for corporations to access securities markets, and this led to attempts to design other investor protections to offset this.

These included exemptions for small-cap offerings, private placements with a small number of investors, private placements to professionals, issuance in markets for professionals, collective investment schemes, specially permitted businesses for qualified institutional investors, and the Green Sheet. We look next at the specific measures taken and the events leading up to their implementation.

1. Exemption for small caps

Figure 1 shows the amounts of issuance below which the exemption from filing requirements applies. The large increase in 1953 reflects postwar inflation and the end

Figure 1: Maximum amounts exempt from filing requirements in Japan



Source: Nomura Institute of Capital Markets Research

of the US occupation of Japan, which allowed excessive securities regulations introduced during the occupation to be revised.

There appears to be another large increase in 1961, but this increase was actually accompanied by a change in the criteria from the total face value of the securities to the total issuance price, which effectively tightened the requirement. This is because issuance at market value had just begun around that time, and deals were being exempted from filing because they had a total par value issuance below ¥50 million, even though they had a total issuance price of several hundred million yen or more. A spate of accounting fraud cases around that time had caught the attention of regulators, and led to efforts to strengthen regulations with an emphasis on protecting investors, including by introducing the practice of using independent auditors and toughening the penalties for filing false information.

These rules were not relaxed until 27 years later, in 1988, in effect easing the regulations that had been tightened as a result of the oil shock having started driving prices sharply higher midway through that period. Finance was also increasingly being liberalized and globalized at the time, allowing companies to become more active in procuring funding from overseas sources, and this led to revisions aimed at invigorating domestic markets.

Under the Financial System Reform Act of 1998, new disclosure rules were introduced for small-cap offerings, and this expanded the disclosure requirement

down to small-caps with an issuance price from ¥100 million up to just below ¥500 million. The exemption for offerings of this size consisted of allowing disclosures of corporate information on a parent-only rather than a consolidated basis.

Consequently, the maximum qualifying amount for the filing exemption was reduced back to its level of 1971. This reduction was justified at the time because implementation of the Green Sheet market made it possible for brokerage firms to solicit unlisted, unregistered stock and because of concerns over offerings with an issuance price of less than ¥500 million, and thus exempt from disclosure requirements, being made over the Internet without going through a brokerage firm.

Many of the reforms at the time were various strains of deregulation that were part of Japan's Big Bang, which also emphasized investor protection. This aspect seemed to be strongly evident in the area of filing exemptions.

It has been noted that the reason the filing requirement was waived for amounts less than ¥100 million is that in the US, offerings of securities with an issuance price of $1 million or less were exempt from disclosure requirements.

The maximum amounts noted above include any offerings (sales) of the same type of security made during the one-year period preceding the date of the offering. This period was actually shortened from two years in 2004 as part of the private placement deregulation proposed by the Financial System Council in 2003.

Of the offerings less than ¥100 million exempted from securities filings, those valued at over ¥10 million are required to submit written notification to the Prime Minister by the day before the offering. These rules, implemented shortly after the war's end, are aimed at understanding the actual status of securities issuance and gaining access to data to know whether securities without a filing requirement are being offered or sold. The notice requires only limited information, including the name of the issuer, the par value of securities, the amount issued, the offering price, and the planned use of the net proceeds. Required attachments include copies of the articles of incorporation, the meeting minutes with the issuance resolution, and the prospectus (when used). This securities notice is not meant to be read by the public.

2. Private placements for a small number of investors and for professionals

A June 1991 report issued by the Securities and Exchange Council proposed revisions to the concept of public placements (offerings and sales) and the drafting of legislation on private placements. Revision of the public placement concept was seen as necessary because under the Securities and Exchange Act, flotations and offerings to the general public had to offer securities under equal terms, but the lack of legal clarity over the concept of "the general public" created a problem.

In the context of disclosure aimed at protecting investors, the report noted that a uniform application of this numerical criteria was not necessarily appropriate for those clients not requiring protection via detailed disclosures.

Another reason for the revision was to stop the practice of avoiding disclosure requirements on the grounds that the terms were not uniform by varying the selling price and other terms.

"The general public" was defined in a 1971 Notice as 50 or more individuals, and in response to the proposals in the above-noted Council's report, a 1992 revision to the Securities and Exchange Act exempted solicitations of less than 50 individuals from disclosure requirements. This number of individuals is calculated over the 6-month period ending the day the securities are issued.

Additionally, solicitations aimed only at a subset of institutional investors (qualified institutional investors) were exempted from disclosure requirements even when presented to 50 or more individuals. When soliciting investors other than qualified institutional investors, however, the total number including qualified institutional investors counts, and if that number is 50 or higher, it is considered a flotation. Meanwhile, the "uniform terms" criteria was eliminated.

The report deemed legislation on private placements necessary because, as the market became more institutionalized, (1) overseas jurisdictions were increasingly putting mechanisms in place for issuing securities through private placement, (2) Japanese corporations were issuing multiple different types of securities overseas, including through private placement, many of which were purchased by Japanese investors, and (3) second tier and smaller businesses that cannot easily use public issuance markets needed access to private placement to diversify their options for obtaining funding.

In response to this proposal, private placement was more clearly defined, restrictions were placed on reselling, and rules on unfair trading practices were applied.

This created a framework for small-scale private placements (solicitations of less than 50 individuals[1]) and professional private placements (solicitations of qualified institutional investors[2]).

Qualified institutional investors were initially designated by ministerial ordinance and limited to a positive list for each category of financial institutions, but in a Cabinet Decision made in March 1998 entitled "Three years of promoting deregulation (revised)," the definition of qualified institutional investors in the market for privately placed bonds was expanded to include "individuals with specialized knowledge and experience related to investing in securities." Making a large amount of investments in securities qualifies as having "specialized knowledge and experience related to investing." Consequently, even nonfinancial corporations with a securities portfolio worth at least ¥50 billion are deemed qualified institutional investors according to the notice from the Ministry of Finance.

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[1] This only allowed solicitation of a small number of people, and only allowed products with a small risk of being transferred to a large number of individuals.

[2] This is only allowed to be offered to qualified institutional investors and only of products with a small risk of being transferred to individuals who are not qualified institutional investors.

A December 2002 report from the Financial System Council on promoting securities market reform included a proposal to invigorate private placement markets for professionals in order to make it easier for startups and SMEs to obtain funding, and this led to an expansion of the definition of qualified institutional investor (by including venture capital firms meeting certain criteria and the Employees' Pension Fund, and by lowering the size of securities portfolio needed by a nonfinancial corporation to be considered a qualified institutional investor to ¥10 billion), the exclusion of up to 250 institutional investors from the count when determining whether a private placement was "small-scale," and the allowing of professional private placements for equity-related products.

A December 2005 Financial System Council report on financial services legislation that proposed the Financial Instruments and Exchange Act recommended opening a pathway to becoming a qualified institutional investor that included individuals and legal entities other than business corporations, and in August 2007 it became possible for both legal entities and individuals with a securities portfolio of at least ¥1 billion to become qualified institutional investors. In addition, the previous maximum of 250 qualified institutional investors that could be excluded from the count to determine whether a private placement was "small-scale" was eliminated.

3. Markets for professionals

In June 2007 under the first Abe administration, a Cabinet Decision, "Economic and Fiscal Reform 2007 (Basic Policies 2007)" argued for the need, given Japan's declining population, to restructure the economy through innovation and globalization and improve productivity, and noted that this would require supplying risk capital to growth sectors. It also asked the Financial Services Agency (FSA) to draw up a plan for making Japan's financial and capital markets more competitive.

The FSA announced its plan in December 2007, where it noted that "in numerous other countries, there has been an expansion of free markets with the professional investor in mind, including in markets based on AIM in the UK and SEC Rule 144A in the US," and went on to say "while we think that investor protection through information disclosure will become increasingly important, with a view toward invigorating and increasing the global competitiveness of financial and capital markets, it is necessary to treat professional investors differently than general investors by allowing them greater freedom in making trades on the basis of their being responsible for their actions."

In response, the Financial Instruments and Exchange Act (FIEA) was amended in 2008 to exempt securities traded on markets for professional investors from disclosure requirements.

Hence solicitations of professional investors to buy securities[3] are excluded from the definition of securities flotation, and no securities filings are required. It also allows for trading on markets for professional investors, i.e., markets in which only professional investors can directly participate in trading.

Under rules introduced in the FIEA passed in 2006, there are three different categories of professional investor: a) Japanese government, the Bank of Japan, and qualified institutional investors that cannot change their status to general investors, b) listed corporations and corporations with capital of at least ¥500 million that can change their status to general investors ; and c) operators of investment partnerships with equity of at least ¥300 million, individuals with net assets and investable assets of at least ¥300 million and at least one year of investment experience, and legal entities that were originally general investors and became professional investors.

Disclosure under the FIEA is not required for securities meant for professional investors, but because it is likely that some professional investors may not necessarily have sufficient capabilities to gather their own information, issuers are required to publish or provide to investors “professional securities information.”

Additionally, issuers of securities to professional investors must publish or provide to the holders of those securities “issuer information” at least once every business year. The law does not specifically define professional securities information or issuer information, leaving the flexibility to define the terms in the rules of the exchange and elsewhere.

The TOKYO AIM exchange, a joint venture between the Tokyo Stock Exchange (TSE) and the London Stock Exchange (LSE), was launched as a market for professionals in June 2009, but only a few companies listed their shares there, and in July 2012 the TSE, after having bought out the LSE’s stake in TOKYO AIM and integrated it into the TSE, rebranded it as the TOKYO PRO market.

That market is less stringent in what it demands of the companies it lists. It does not have quantitative criteria for listing, but rather requests an evaluation of a company’s suitability for listing by a TSE-approved service provider (J-Adviser) specializing in providing advice on corporate finance, makes corporate governance reports and quarterly disclosures optional, and accepts a certificate of audit for just the most recent year, instead of the usual two years.

[3] This applies when two conditions are met: (1) when the client is someone other than a government, the Bank of Japan, or a qualified institutional investor, the financial instruments business operator (FIBO) is trading on orders from a client or on their own account and (2) the security is designated by government order as having a low risk of being transferred by that client to an individual other than a professional investor or nonresident.

4. Collective investment schemes and specially permitted businesses for qualified institutional investors

Venture capital in Japan had primarily been in the form of voluntary partnerships under the Civil Code, but this was a problem in that it subjected the partners to unlimited liability. To deal with this, in November 1998 the Limited Partnership Act for Investment by SMEs was enacted, making it possible to distinguish between unlimited partners performing services and limited partners only providing investment capital. The scope of that Act was later expanded, prompting a change in the name of the law to the Limited Partnership Act for Investment.

The spread of the Internet in the early 2000's made it possible to offer funds that invest in various businesses, including in startup firms, to smaller investors, and also wound up activating channels through the Internet for soliciting investments from general investors. Then with passage of the FIEA in 2006, the definition of securities was extended to ownership in various types of collective investment schemes. Businesses that invest securities that amount to more than 50% of the ownership of a collective investment scheme (including rights in the securities investment business) were also made subject to disclosure requirements.

Accordingly, when selling ownership in a collective investment scheme to the general public, that issuance must be disclosed via securities filings. In packaging such a scheme, however, there are a number of different ways used to fix the details while taking into account investor demand, making it difficult to determine at what point in time the application for purchase was tendered. Consequently, rather than being based on the number of individuals solicited, the criteria are based on the number of solicited individuals who actually became investors. That number was also set at 500 or more.

Under the FIEA, when the managers of venture capital solicit investment in their own investment fund, they are required to register as a Type II financial instruments business, and when they manage the assets in their own investment fund, they are required to register as an investment management business.

There are also a considerable number of individual venture capitalists and small-scale venture capital firms on whom it is unrealistic to impose such strict registration requirements, however. They are therefore allowed to operate as specially permitted businesses for qualified institutional investors when conducting private placements of shares in collective investment schemes that primarily invest in securities or derivatives to one or more qualified institutional investors and 49 or less individuals who are not qualified institutional investors, without having to form a Type II financial instruments business or investment management business, and needing only to submit prior notification[4].

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4 This allowance for a certain number of individuals to not be qualified institutional investors takes into account that often the officers of the fund management company invest in the fund.

5. Green sheets

As a part of its deregulation efforts in response to the proposal to eliminate the ban on brokerage firms handling unlisted and unregistered stock, the Japan Security Dealers Association (JSDA) introduced Green Sheet issues in 1997. To protect investors amid this easing of regulations, the following framework was introduced.

First, brokerage firms were allowed to handle the securities (OTC securities) of companies that either provide ongoing disclosures or have financial statements certified with an unqualified general opinion by a CPA or auditing firm and that said brokerage firm provides continuous trading quotes for. These are called Green Sheet issues.

Under this system, even unlisted companies can raise cash by selling stock to investors through brokerage firms without an issuance notice if the issuance amount is small, although in this case the brokerage firm is required to provide an adequate explanation to their clients using a company report that also includes the financial statements noted above[5]. This report must be updated every business year, submitted to the JSDA, and be viewable by the public.

III. The future direction of reforms

1. Shift from savings to investment has become a global issue

In the US, where securities markets were already playing a substantial role in corporations' capital formation, it has been a trial and error process as regulators have sought to strike the proper balance between encouraging risk capital and protecting investors so as to extend the benefits of the system to startup companies.

In contrast, Japan has had the broader aim of further developing its securities markets, given that the use of securities markets is not as developed as financial intermediation through the banks. Recognizing the heavy reliance on banks for funding, more emphasis has been placed on making securities markets more functional, particularly since the mid-1990s, and that goal has necessitated measures to promote the supply of risk capital and also better systems to protect investors.

Furthermore, Japan is unique in that measures to encourage the supply of risk capital have been incorporated within comprehensive policy initiatives, including deregulation and regulatory reform as well as structural reforms and growth strategies, and thus extend beyond the realm of securities regulation into the broader national strategy dialogue.

As outlined in the working plan on financing for investment approved at the G20 Summit in September 2013, encouraging the supply of long-term investment

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[5] Information on the two preceding business years used to be required, but to ease the burden on startups, starting in 2002 only the financial statements from the immediately preceding business year have been required for the first business year that a company gets Green Sheet status.

financing requires first of all that governments make efforts to provide the proper conditions, including sustainable macroeconomic and fiscal management, tax reform, and the simplification of those administrative procedures and regulations that inhibit businesses. Japan has already demonstrated its resolve to adopt such a comprehensive approach.

Moreover, Japan has already implemented, or is currently studying, many of the proposals for financial and capital markets included in that working plan and in the OECD's High-level Principles of Long-Term Investment Financing by Institutional Investors, as well as the different arguments made in the European Commission's green paper, "Long-Term Financing of the EU Economy."

Other countries have begun to recognize the importance of the shift from savings to investment that Japan has been pursuing for over a decade, and they are now trying to catch up.

2. The need for further reforms

Nevertheless, the measures implemented by Japan thus far have yet to produce sufficient results, and given the ambitious developments taking place in other countries, including moves to create a framework for crowdfunding and debates over accounting standards and achieving tax neutrality between equity and debt, Japan needs to further strengthen its reform efforts.

Japan's launch of tax-free investor savings accounts (NISA) in January 2014 is a big step toward promoting the supply of risk capital, but the system must first be improved to ensure that it takes hold and becomes used more widely.

In addition, the Japan Revitalization Strategy approved in a Cabinet Decision in June 2013 includes a discussion of how Japan's public and quasi-public pensions should be managed as well as measures to promote investments in startups; it will be interesting to see what specific steps result.

Regarding the former, government has put together a panel of experts to consider policies that improve the investment and risk management capabilities of public and quasi-public funds. A change in ERISA's prudent man rule in 1979 that accelerated investment in venture capital by pension funds was of critical significance in the development of startup firms in the US, an indication that pension management is an important issue.

Regarding the latter, in addition to considering crowdfunding as a way to diversify funding sources, other areas under consideration are better management of the Angel tax rules aimed at promoting investment in startups by individuals, as well as measures to promote startup investments by private-sector corporations.

The implementation of crowdfunding was also proposed as a part of the deregulation plan decided by the Cabinet when it passed the Japan Revitalization Strategy. Other proposals in the regulatory reform plan aimed at encouraging new business formation funded with risk capital included the streamlining of disclosure

requirements for newly listing corporations and a revision of the rules on Green Sheet issues. To achieve these reforms, the Financial System Council has been debating these issues within a working group on supplying risk capital to EGCs.

3. Financial regulation aimed at supporting securities market access for small and emerging companies

In the US, the SEC has held its Forum on Small Business Capital Formation every year since 1982, and it established the Office of Small Business Policy within its Division of Corporation Finance to serve as the secretariat for the forum. That office handles routine inquiries regarding small business securities issuance and disclosures, and also plays a lead role in formulating policies that affect small businesses.

In 2004, it established an Advisory Committee on Smaller Public Companies to address the burden created by Sarbanes-Oxley and the sharp drop in IPOs, and in 2011 it launched its Advisory Committee on Small and Emerging Companies. It was the discussion at these forums that led to the establishment of the JOBS Act.

The SEC's website includes a new "Small Businesses and the SEC" page, where it provides a detailed explanation of how small businesses can obtain funding from securities markets.

In contrast, Japan's policy toward small business financing has typically been focused on banks and smaller financial institutions, as typified by its community-based financing initiatives and its measures aimed at facilitating lending to smaller businesses. The Ministry of Economy, Trade and Industry (METI) has taken a lead role in the area of startup financing.

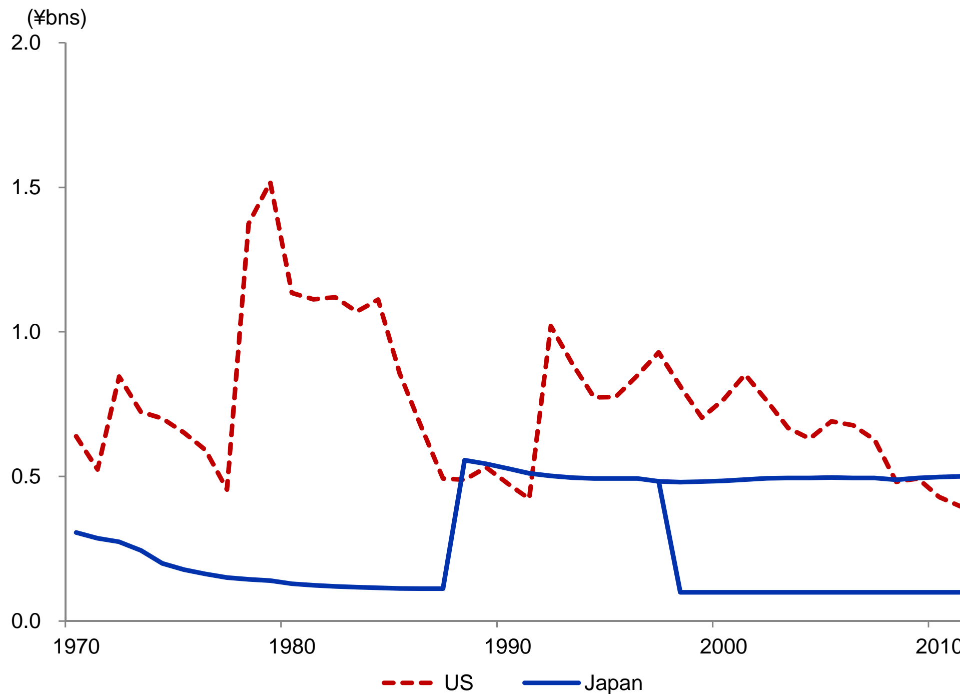
Ideally, the current discussion at the FSA will not end upon implementing immediate fixes, but rather, like at the SEC, improving small and emerging company access to securities markets will be made a priority of financial and securities regulators and become a regular topic of discussion at the level of the FSA and MOF's Finance Bureau.

IV. Exemptions for small caps and exceptions for small-cap offerings

A comparison of the framework in the US established by the JOBS Act and the current situation in Japan suggests several ways the debate should proceed, based on the understanding of the problem noted above.

Figure 2 compares the effective maximum issuance amounts that are exempt from filing requirements in Japan and the US (the amount subject to regulation A). The amounts for both Japan and the US are inflation-adjusted based on 2012 prices, and US amounts are converted to yen at the exchange rate at the end of each year.

Figure 2: Maximum (inflation adjusted) amounts exempt from filing requirements



Note: In real terms based on 2012 prices. Amounts for US are converted using the exchange rate at the end of each year.
US figures are the maximum amounts eligible for Regulation A treatment.

Source: Nomura Institute of Capital Markets Research

At first glance, Japan's maximums are now tighter than those of the US, and look very tight relative to historical levels.

When taking into account that Form 1-A under Regulation A in the US requires some disclosures and that filing with state regulators is also required, Japan's regulations are not necessarily any stricter. In fact, when Japan raised the maximum issuance amount to less than ¥500 million in 1988, it was possible to issue without any special disclosures a higher amount than that effectively allowed by the US under regulation A, and the revision of this in 1998 therefore seems to have been appropriate.

In the US, Rule 504 provides a small-cap exemption for issuance up to $1 million based on Form D, a simpler form than Form 1-A.

In Japan, however, small-cap offerings of between ¥100 million and ¥500 million came under special rules for formal issuance disclosures and like Regulation A were not exempt from filings, and thus did not have a significantly lighter disclosure burden than issues of ¥500 million and up.

In the US, the 1995 Paperwork Reduction Act required government agencies to estimate the time it takes to fill out the paperwork they require and to get their paperwork requirements approved by the Office of Management and Budget. Based on these estimates, filling out Form 1-A under Regulation A only takes about 60% of

the time it takes to fill out Form S-1, which is used for formal filings[6]. Regulation A also does not require audited financial statements.

Additionally, the JOBS Act added a Regulation A+, which has a maximum amount that is 10 times the Regulation A maximum, in order to energize the small-cap offerings sector, which is currently hardly used at all in the US. We think this makes it worthwhile to keep an eye on trends in this sector.

V. Crowds or angels?

1. Crossing the "Death Valley"

Japan's Financial System Council proposed introducing mechanisms for crowdfunding in December 2013 based on new ideas concerning how to strike a balance between easing disclosure requirements and protecting investors. In Japan, however, the introduction of crowdfunding has been discussed as a way to get past the "Death Valley."[7] We think this represents a difference in understanding with that of the US.

"Death Valley" refers to the problem of businesses being unable to take off because of an insufficient access to risk capital at the stage of turning technology and ideas into a business. Crowdfunding is apparently not seen as playing a major role at this stage in the US[8].

In the US, crowdfunding is regarded as a novel way to raise funds when starting or right after starting a company. Historically, a company at this stage had no other choice but to depend largely on family and friends[9]. In contrast, at the stage when "Death Valley" becomes a problem, more important than small amounts of funding from general investors is having a relationship with an entity that has the expertise to put together larger amounts of funding. It is at this stage that Angel investors play an important role. Venture capital also plays an important role at later stages of investment (Figure 3).

Funding using rule 506 under Regulation D, which governs professional private placements in the US, is central to raising capital from these angel investors. This is because many angel investors are accredited investors. This suggests that Japan should also focus on the role of individual investors capable of becoming angel investors as a way to help companies cross the Death Valley.

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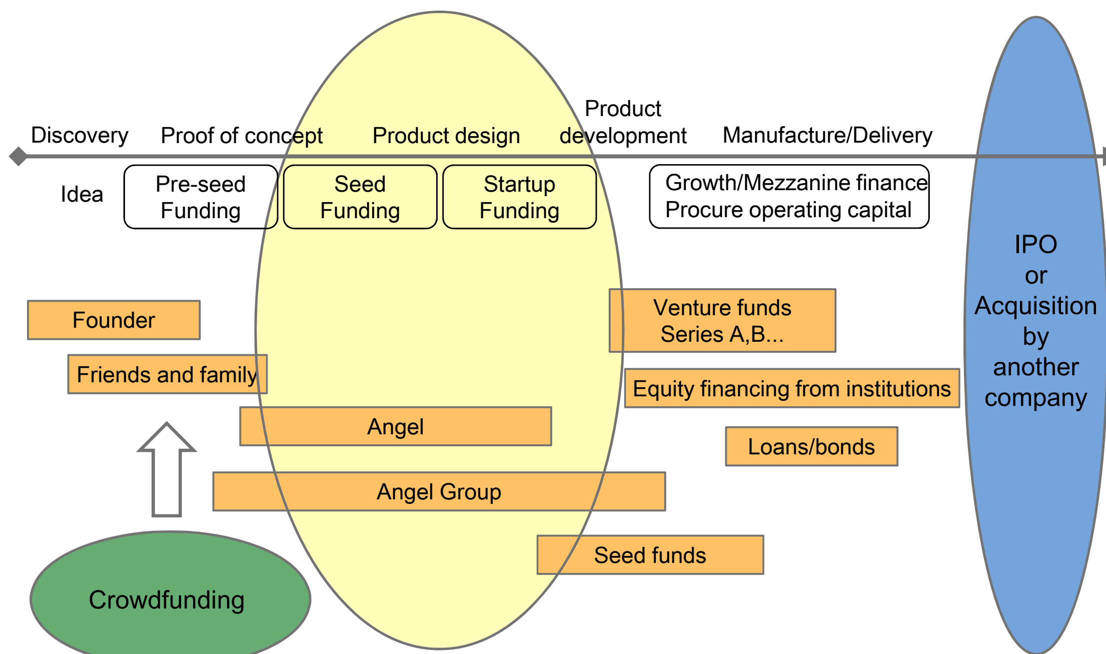
6 Form 1-A take 608 hours and Form S-1 takes 972 hours, while Form D takes only 4 hours.

7 One example of this is the documentation that accompanied Economy and Financial Services Minister Taro Aso's statement to the Industrial Competitiveness Council on 15 March 2013.

8 See page 10 of the written submission from William Hambrecht, Chairman and CEO of W.R. Hambrecht & Co., to the SEC's Advisory Committee on Small and Emerging Companies on 1 May 2013.

9 See page 9 of the handouts used by the Angel Capital Association at the SEC's Advisory Committee on Small and Emerging Companies on 1 May 2013.

Figure 3: Financing from formation to IPO



Source: Based on materials from the Angel Capital Association, with additions

2. A Japan-US comparison of angels

Although the criteria may be tightened in the future, it is estimated that over 8 million households, 7.2% of all households, now qualify as accredited investors in the US[10]. Of these, about 270,000 individuals are said to be active angel investors. The number of angel groups, which gather angels together, identify investment opportunities, and provide their capital collectively, has been increasing every year, and there are currently about 400 active angel groups. The average annual amount of angel investments totaled over ¥2 trillion in 2012, and compared with venture capital a higher percentage of this investment was made at the seed and early stage (Figure 4).

In contrast, in Japan only 33 individuals had filed with the FSA as qualified institutional investors as of 30 September 2013. The amount of investment by individuals using angel tax rules is less than ¥10 billion annually[11].

According to the Family Income and Expenditure Survey, 10.4% of all households in Japan with two or more persons have savings of at least ¥40 million, and households with savings of at least ¥30 million allocate 15.8% of their savings to

[10] United States Government Accountability Office, “Alternative Criteria for Qualifying as an Accredited Investor Should be Considered”, July 2013, p19.

[11] The amount of investment by individual investors using angel tax rules. See materials from the FSA Secretariat dated 26 June 2013.

Figure 4: Angel investors and venture capital in the US (2012)

	Angel	Venture capital
Investment amount	$22.9bn	$26.7bn
Number of deals	67,000	3,700
Of which		
Seed	24,000	280
Early stage	22,800	1,650
Growth stage	20,100	1,800
Number of investors	At least 268,000 (individuals)	522 (active firms)

Source: Angel Capital Association

securities investments[12]. This suggests that only a small number of individuals have a securities portfolio larger than ¥1 billion.

Additionally, for an individual in Japan to be deemed a qualified institutional investor, they must file with the FSA Commissioner, and the FSA must send out a public notice with the name and address of filers, and also publish that information on the FSA website. In the US, since cost and privacy are taken into account, the SEC does not manage a list of accredited investors.

Japan does have a system whereby certain investors can participate in markets for professionals, but individuals must have net investable assets of at least ¥300 million to qualify a considerably higher standard than must be met to be an accredited investor in the US. Additionally, there were only six listed companies in that market as of end-December 2013, and few actual cases of capital being raised in that way.

The role of angel investors is also considered important in Japan, and angel tax rules have already been put in place, but the system still seems to be undeveloped. It is probably worth considering lowering the criteria that must be met for individuals to become qualified institutional investors or professional investors so as to widen the base of individuals able to make angel investments[13].

Also worth considering is to broaden eligibility beyond what is currently allowed for private placements by opening a pathway for individuals who may not have the

[12] Ministry of Internal Affairs and Communications, Family Income and Expenditure Survey (Savings and Liabilities) 2012 yearly average (preliminary)

[13] Under Rule 506 in the US, up to 35 non-accredited investors can be included, provided they are sophisticated investors and the same level of information is provided as in the case of a normal offering, including audited financial statements. In the US, the Securities Act of 1933 is interpreted to mean that a determination of whether an offering is private should be based not only on the number of investors but on a comprehensive assessment that includes the capabilities of investors and their ability to access information. This is because Rule 506 provides a safe harbor under this principle. Contrast this with Japan, where any offering to less than 50 individuals is automatically treated as a small-scale private placement, with no disclosures required. Furthermore, qualified institutional investors are excluded when counting the number of investors, and the general investors numbering less than 50 are not given any more information than that given to qualified institutional investors. It is conceivable that Japan will also revise its rules for small-scale private placements.

requisite assets or securities holdings but who meet certain requirements to invest in companies exempt from formal disclosures under angel rules.

In the US, the JOBS Act allows for general solicitation and general advertising when all purchasers of a security are accredited investors[14]. Rules have already been introduced in Japan that allow investors in collective investment schemes to make decisions as purchasers rather than as subjects of solicitation, and we expect the same approach to be adopted for professional private placements.

VI. Positioning of secondary markets

1. Disclosure and listing criteria

The US framework of disclosure-based investment protection established in the 1930s is based on the idea that if a company is financially weak, as long as that weakness is accurately disclosed to investors the issuance of securities would not be blocked. This represented a major change from the previous framework of "merit regulation" at the state level, whereby only those securities deemed worthy of issuance were allowed to be issued.

For securities traded on an organized secondary market, however, the merit-based approach, which includes the listing standards applied by stock exchanges, plays an important role in protecting investors.

In Japan, because trading by brokerage firms in unlisted and nonpublic shares has also been regulated, and raising equity capital on a securities exchange still requires a listing on (registering with) the exchange, measures to promote the supply of risk capital have tended to focus more on relaxing listing standards than on easing disclosure regulations.

Conditions have changed some recently. Equity placements for professional investors are also allowed now and a broader range of investors are now considered qualified institutional investors. Nevertheless, the easing of disclosure requirements and establishment of markets for professionals and Green Sheet issues to make it easier for small and emerging companies to raise capital has been managed within the framework of organized secondary markets, and therefore also uses merit-based selection.

These markets have first-hand experience in dealing with the problem of deciding how much emphasis to put on the liquidity of small and emerging corporate equity so as to balance usability for corporations with ensuring the protection of investors.

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[14] Related regulations are at the SEC proposal stage.

Figure 5: Market capitalization versus individual investor ownership

Market cap	Individual ownership
Up to $50mn	89.1%
$51mn - 100mn	80.1%
$101mn - 250mn	68.7%
$251mn - 500mn	56.3%
$501mn - 1bn	37.6%
Over $1bn	16.5%

Note: Universe is all stocks listed on the major US stock exchanges. Individual investor ownership percentages are median figures.
Source: Materials presented by Cowen and Company CEO Jeffrey M. Solomon at the SEC's Advisory Committee on Small and Emerging Companies on 17 September 2013.

2. Markets for professionals

Markets for professionals in Japan are within the framework of an exchange-listed market, but because angel investors generally do not invest with the intent of selling at a profit over the short to medium term, they are unlikely to demand an established secondary market. As the prospects for crossing Death Valley improve, the number of people wanting to invest starts to increase, and along with it the opportunity to resell, but most commonly the stake is held until then or until the IPO. Of course, these investments are made knowing that there is a high probability of never being able to cross Death Valley and sell.

Additionally, an exchange may be the best framework for preventing resale to nonprofessionals, but if that is the goal there are other ways to achieve it.

The US has also authorized the operation of online platforms to conduct the sale and solicitation of Regulation D securities. It is conceivable that a new framework for professional investors may be implemented in Japan, given that the current market for professionals has yet to produce the results that were initially expected.

Figure 5 shows the relationship between a stock's market cap and the percentage of its shares owned by individuals for stocks listed on the major US stock exchanges. It is clear from this that the smaller a company's market capitalization, the higher the percentage of its shares owned by individuals, a percentage that approaches 90% for micro-caps.

This suggests that trying to make a market for professionals function as a forum for issuing and trading the equities of small and emerging companies will probably be difficult unless the current professional investor system is changed to allow broader participation by individuals.

3. Green Sheet issues

Green Sheet issues were introduced in Japan as a secondary market for the securities of unlisted companies, but once the exchanges created a startup (venture)

section with significantly relaxed listing criteria, many of the companies chose to list on the startup market. In addition, rules on insider trading rules and timely disclosure were introduced in 2004, raising the compliance burden on issuing companies and brokers. As a result, the number of Green Sheet issues declined from 96 at end-2004 to 36 in October 2013, and their annual trading value declined from ¥3.12 billion in 2006 to only ¥40 million in 2012.

The Green Sheet market placed a priority on offering a functioning secondary market with members providing constant quotes, but it was probably the case that companies at the stage of needing a liquid market opted for a stock exchange. Here as well, where the emphasis is not on accessing the function of a secondary market, a lighter framework that is easier for both issuers and investors to use may make more sense. This also suggests that there is probably a need to reconsider the proper mix between listing standards and the requirements placed on Green Sheet issues in terms of achieving a balance between level of regulatory burden and level of investor protection.

In this case, given that even with startups listed on an exchange there are frequent occurrences of accounting fraud and unfair financing practices that harm the trust of individual investors, if there is a reduction of the disclosure burden and easing of selection standards in the Green Sheet market meant for smaller companies, we think it is essential that some other means be used to prevent such deregulation from leading directly to a weakening of investor protections.

The report released by the Financial System Council's working group in December 2013 proposed limiting the solicitation of investment to the unlisted company's directors, employees, family members, shareholders, vendors, and other stakeholders, and creating a new trading system for unlisted stock with a lighter disclosure requirement and exemption from insider trading rules. The focus is now on the JSDA and its efforts to work out the details.

VII. Investor protection that does not constrain investors

1. The burden of disclosures

As also argued by the G20, encouraging the supply of risk capital provides major benefits for the overall economy by promoting economic growth, innovation, and employment. These benefits are not enjoyed only by the investors who provide the risk capital, but rather entail significant positive externalities.

It is therefore best to promote the supply of risk capital in a way that avoids compromising investor protection and burdening investors through restrictions on who can invest and their investment amounts, while instead providing support to the overall economy and overall market.

Assuming that disclosure places a burden on emerging companies that issue securities, rather than reduce that burden by increasing risk to investors, it should be

theoretically possible, when taking externalities into account, to craft a policy of providing some sort of public support to reduce that disclosure burden.

In addition, there is a need to examine on a regular basis whether current disclosure requirements overall are excessive, not only for startups but also for large corporations.

In the US, a new category called emerging growth company (EGC) was established under the JOBS Act that instead of requiring different levels of disclosure depending on whether a company is listed or not, reduces disclosure requirements at the IPO while also streamlining ongoing disclosures for a maximum period of five years after the company has gone public, as long as its total sales remain below a certain threshold. It also raises the threshold for the number of shareholders that triggers the ongoing disclosure requirement, including for companies not categorized as EGCs.

Article 108 of the JOBS Act requires a comprehensive review of regulation S-K, which determines the non-accounting items that must be disclosed to the SEC, to look for improvements aimed at reducing the burden on EGCs.

We expect this to provide a reference point for constructive discussions in Japan. Angel investors, in particular, tend to put more weight in their investment decisions on management's dedication, reliability, and specialized expertise and on the attractiveness of the product than on the expected ROI. In a certain sense it is natural to assume that a company in the Death Valley stage is not yet established as a going concern and that it is the success or failure of its major projects that are key, hence information on corporate governance as well as financial metrics such as current earnings and the amount of physical assets are relatively less useful. Even for a period of time after the IPO, the biggest priority is on the stable development of the core business. A disclosure framework that takes this into account should be considered.

The report released by the Financial System Council's working group in December 2013 proposed shortening the disclosures required for an IPO from the past five years of financial statements to just the past two, and eliminating the requirement for a CPA audit of corporate governance reports for the first three years after the IPO. Such a change would be a step forward if implemented.

2. Deterring unfair business practices and regulating/supervising intermediaries

Simplifying disclosures without lowering the level of investor protection would require strengthening the type of investor protection policies that do not put direct constraints on the freedom of investors. This could be achieved, for example, by strengthening regulations on and penalties for unfair business practices and by the use of mechanisms to regulate and supervise intermediaries.

Fraud associated with unlisted shares occurs frequently, and any moves to introduce crowdfunding must be accompanied by stronger measures to deal with

unfair business practices, including fraudulent and borderline fraudulent fund raising efforts[15].

Intermediaries play a critical role in matching the needs of individual investors with seekers of funding, and also make good gatekeepers, selecting investments based on the investor's experience, capabilities, and risk tolerance.

As indicated by the Kay Review, however, the more that different types of intermediaries insert themselves between investors and seekers of funding, the higher that agency costs become. When intermediaries focus on maximizing their own short-term gain, it has an adverse impact on investor protection.

Ever since Japan's Financial Big Bang, a focus on encouraging competition has precluded any strengthening of regulations affecting the participation of intermediaries and instead relied on ex post regulation, but with Japan having limited resources to devote to securities oversight compared with the US, as the number of financial service providers grows, supervision and examination become physically more difficult to accomplish.

It also becomes more difficult for general investors to distinguish among approvals, registrations, and notices, and in some cases they are under the mistaken impression that a financial provider has received a stamp of approval from regulators when all that provider has done is submit notice to the FSA. Simultaneous with increasing the freedoms of providers that operate sound businesses, it is necessary to come up with clever stratagems to keep problem providers from getting involved[16].

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[15] The 2011 revision to the FIEA renders the relevant agreements invalid in principle when unlisted securities are sold by unregistered dealer-brokers (Article 171-2).

[16] Intermediary here is broadly defined to include all entities involved in the process between the ultimate receiver of funds and the ultimate provider of funds, including exchanges, collective investment schemes, and certified public accountants. Examples of where exchanges have had problems include in January 2008, when the FSA issued a business improvement order to the Nagoya Stock Exchange for its lax screening of listings on its Centrex market for start-ups. Specially permitted businesses for qualified institutional investors come under a special rule introduced to take account of lighter weight venture capital that allows them to collect funds from individuals without registering as an investment business but by only submitting a notice. These businesses, which emphasize on their websites how easily and cheaply a business can be started up, have been running a large number of online ads offering support to business startups recently. This allows companies that provide startup assistance to be considered qualified institutional investors, and some have suggested that by establishing separately numbered funds (including a No. 2, No. 3,...) they are effectively able to skirt around the limits on the number of general investors allowed to participate. There have been frequent instances of fraudulent use of the system, including through the above means, and in February 2012 the FSA warned investors and announced some stronger measures. Nevertheless, it is probably difficult to thoroughly supervise over 3000 such providers. We think a revision of the rules is needed, including those related to small-scale private placements. There is also a gatekeeper problem whereby certified public accountants are providing low-quality audits as a refuge for problem firms.