Competition Among Japan's New Venture-Oriented Exchanges

Sadakazu Osaki

TSE's "Mothers" market heralds a new era of inter-exchange competition

The Tokyo Stock Exchange set up the new "Mothers" ("Market of the high-growth and emerging stocks") market for start-up companies in November 1999. The purpose of the market was on the one hand to host listings for recently established or loss-making companies by adopting less stringent listing requirements than the existing first or second sections of the exchange, while also offering a higher standard of investor disclosure by requiring companies to hold regular analysts meetings and produce quarterly earnings reports.

Two companies listed their shares along with the setting up of the new Mothers market, with trading starting from 22nd December. The new market attracted substantial investor attention, so much so that the first day of trading ended with both of the stocks un-traded and priced bid-only. Subsequently the market has attracted a number of new listing applications, so that by end April 2000 Mothers was home to a total of 8 stock issues.

Up to now in Japan there has been a clear division of roles between the over-the-counter (OTC) market and the TSE. The JSDA (Japan Securities Dealers Association)-operated OTC market was for venture company IPOs to list on initially, transferring across to the TSE years later if their business expanded to a considerable size. Companies also took it for granted that, as business continued to grow, the ladder of advancement dictated that they be promoted from the second section of the TSE to the first.

The setting up of a new venture-oriented market by the TSE that has up to now dealt only with larger and more established firms is surely a sign that the traditional framework in Japan, whereby the various stock exchanges and OTC markets co-exist with clearly defined and separate roles, is starting to dissolve. However, while Japan is only in the early stages of developing a truly competitive environment, the US and Europe are already some years ahead: in the US the New York Stock Exchange and the tech-laden Nasdaq Stock Market have long been in direct competition for listings, while in Europe the development by the various national stock exchanges of venture-oriented markets in competition with the pan-European Nasdaq equivalent "Easdaq" has meant that a competitive environment has existed since the mid-1990s.

Nasdaq Japan and moves to reform the OTC market

In June 1999, prior to the establishment of the Mothers market, the US National Association of Securities Dealers (NASD) (parent of the Nasdaq market) announced plans to set up "Nasdaq Japan" together with the Japanese firm Softbank Corporation. Just as with regular businesses such as department stores and car manufacturers, it wanted to establish a presence in the Japanese market as a rival to the local competitors. Sounding alarm bells with many in Japan, whose markets had often been criticized as being unfairly "closed," this attempt at forcing open the doors to the market was likened to the "black ships" that arrived off Japan's shores in the mid-19th century demanding that Japan open its ports to trade with America after centuries of self-enforced isolation.

Nasdaq Japan subsequently changed its original plan, of setting up an entirely new stock market operated by a securities dealers association, instead choosing to enter into a broad-based alliance with the Osaka Stock Exchange.[1] In March 2000 the "Japan Nasdaq Association" was set up with Hirotaro Higuchi, honorary chairman of Asahi Breweries, at its helm, charged with setting the overall rules and policies of the new exchange. It was further announced that the market was to be divided into "Standard" and "Growth" sections, with two separate sets of listing requirements. Nasdaq Japan Planning, Inc. (a joint-venture between NASD and Softbank), that has up to now played the leading role in the preparations for the new market, will be busy drumming up new listing candidates in the run up to the market's planned end June 2000 launch.

Table 1 Comparison of the New Venture-oriented Exchanges

	OTC	Mothers	Nasdaq Japan
Market operator	Japan Securities Dealers Association	Tokyo Stock Exchange	Osaka Stock Exchange
Start date	1963	1999	2000
No. of listed (registered) companies	873	7	8 (expected as at 19 June)
Special features of listing criteria	Divided into Grades 1 (Regular) and 2 (Venture), with the latter grade open to even loss-making companies. De-listed if average monthly trading volume is under 10 trading units over a 6-month period or if issue is traded on less than 20% of the days over a 6-month period	Listing allowed for loss-making firms or those with negative net worth, as long as over 1,000 trading units and at least 300 new share-holders are created at the time of listing. De-listed if average monthly trading volume over a 1-year period is under 10 trading units, or if the stock is not traded for a 3-month period.	Divided into "Standard" and "Growth," with "Standard" criteria as stringent as US Nasdaq. De-listed (according to "Growth" criteria) if free-float falls under 500 trading units.
Trading method	Trading based on auction over the 'Jasdaq' system. Recently introduced a market-maker system which now accounts for over 90 issues.	Auction (same as for TSE 1st and 2nd sections).	To use the OSE system at first, and later plans to transfer to an auction system.
Other characteristics	Only a simplified version of the Securities Report for Listing Application Part 2 required, and shorter listing examination period. JSDA also operates the "Green Sheet" market for the trading of unlisted stocks.	Listed companies obliged to produce quarterly earnings reports and hold regular meetings to brief investors. Has made it easier for companies to list by reducing listing and examination fees, and no longer requiring Part 2 of the Securities Report for Listing Application.	Plans to create a 24-hour trading environment by linking up with the US and European Nasdaqs. Nasdaq Japan Planning (joint-venture between Softbank and NASD) is in charge of drumming up listing applications.

Note: Data correct as at 10 April 2000
Source: NRI

1 For a more detailed discussion of the alliance between NASD and the OSE, please refer to S.Osaki "New Markets Enter The Battle For Japan's Venture Businesses," (Capital Research Journal, Spring 2000).

Now under threat from these two new rival markets, the JSDA has begun to fight back: it has simplified the information that needs to be supplied in Part 2 of the Securities Report for Listing Application, reduced the time it takes to examine the applicant to approve a listing on its OTC market and introduced a market-maker system to increase the liquidity of small-cap stocks despite boasting over 870 listings already, showing itself to be going out of its way to introduce reforms that will encourage venture companies to list. In a report published on 12 April 2000 the association also moved to tighten its de-listing criteria and expand the number of stocks traded under the market-maker system.

Regional exchanges also move to cultivate venture-oriented markets

Not just the Tokyo and Osaka exchanges, but a number of Japan's regional exchanges are also hurrying to cultivate markets for venture start-ups.

In October 1999 the Nagoya Stock Exchange set up a new market for "growth" venture firms averaging over an annual 10% growth rate. With similar loose listing requirements to those of the TSE Mothers market, such as allowing the listing of loss-making firms, the new Nagoya market hopes to celebrate its first company listing in May 2000.

With regional stock exchanges currently feeling the harsh winds of competition, forcing for example the planned mergers of the Niigata and Hiroshima stock exchanges with the TSE, they are hoping that setting up new venture-oriented markets mainly targeting local firms will work to reinvigorate their ailing businesses.

In January 2000 the Sapporo Stock Exchange announced plans to set up a new market called "Ambitious" for small- to medium-sized enterprises in the Hokkaido region, the northernmost of Japan's four islands. In contrast to the TSE, according to the draft listing criteria the SSE is not planning to allow loss-makers to list on the exchange, but will instead be more lenient regarding number of shareholders and number of shares at issue, saying that these different criteria are more appropriate for businesses in Hokkaido.

The Fukuoka Stock Exchange has also announced plans to set up a market (called "Q Board") aimed at enabling entrepreneurs to gain access to venture capital. With this in mind, it intends to establish particularly loose listing criteria that would enable the listing of firms with a market capitalization of only ¥300 million for example.

The real significance of inter-market competition

Due to the dominance of bank-based indirect financing in the traditional Japanese financial structure, the direct procurement of funds through the markets via issuance of bonds and equities has played a minor role. Particularly in the case of equities, until the revision of the regulations concerning private (neither exchange-listed or registered on the OTC market) securities in 1997, it was very difficult for companies to procure funds from a diverse investor-base without either listing or registering their shares. At the same time however it was an extremely difficult and long-drawn out process to meet the stringent listing / registration requirements, perhaps taking several years.

In such circumstances it was not uncommon for a stock listing to be used primarily to enhance the "status" of the company or as a means to keep company ownership being passed down through a succession of owner-managers. Investors also felt they were being deprived of investment opportunities in growth companies as their US counterparts enjoyed with the Nasdaq market.

The advent of inter-exchange competition being brought about by the establishment of these new markets therefore promises a serious chance of changing this situation. The three major venture-oriented markets, including the existing OTC market, are all trying to attract new listings through looser listing requirements, simplified procedures and lower fees (Table 1). A look at the companies who have already listed on the Mothers market or at listing applicants shows that times have indeed changed: prominent among the new listings are young internet start-ups, a far cry from the previous situation where companies were told they would have to be at least 20 years old. However, as competition among the three markets fuels a need to find promising new start-ups, there is also a need for further reform in the accounting and corporate legislation fields to support IPOs by young companies.

While this is all of course good news for the emerging companies who want to fund future growth through an IPO, the competition between the new venture company markets will, it is hoped, also in the long-term be instrumental in changing Japan's industrial structure, as new companies are nurtured and whole new business sectors created.

Japan still far away from an "IPO explosion"

Despite recent developments, it is still jumping the gun to say that Japan will now see a huge increase in the number of IPOs. While the venture-oriented markets are all proceeding with reforms looking to the US Nasdaq market with its hundreds of IPOs every year as their model, considering the real differences that still exist between the environment in Japan and the US as regards the funding of recent start-ups, simply changing market regulations is, we believe, unlikely to bring about the level of activity that is seen in the US Nasdaq Market.

One major difference between Japan and the US is in the activities of venture-capital firms, who in the US provide risk-capital on the strength of a single business plan drawn up by a new start-up. Through the provision of seed-capital these venture-capital firms are then given the right to become deeply involved in the running of the company, being entitled to hold preference shares and to elect board members. In return, in the short-time leading up to an IPO they spur company growth by providing the benefits of their management expertise, arranging mergers or tie-ups, or in certain circumstances calling for replacement of the management. Many of the Nasdaq-listed companies have come from a background of having had the support of a major venture-capital firm, and despite the short time between starting up and an IPO will have formed surprisingly solid business foundations.

However, the backing of a high-performance venture-capital firm also serves to attract investors subsequent to the IPO itself. From the point of view of Nasdaq investors, that a reputable venture-capital firm is an investor in a start-up is one important factor in their investment decision, especially considering the lack of much other investment information in the as yet immature firm. On the other hand, large institutional investors with the capability to take large investment risks can, by investing in venture-capital funds themselves, be privy to important investment information prior to the IPO, and then switch to direct investment subsequently and so contribute to the firm's growth.

The level of venture-capital activity in Japan, however, is still tiny in comparison to the US. Existing Japanese firms have only started to seriously invest in start-ups since last year, along with the arrival of major venture-capital funds from abroad. Though the funds attracting most media attention recently are generally those who invest mainly in big-name internet and IT related companies, even these do not have such a long trading history. In the US, venture-capital fund investment is typically for a period of between 7 to 12 years, so in Japan's case it is still several years down the road before the funds that invest mainly in start-ups in the new markets or the OTC market can be expected to show serious returns.

Concerns over the current nature of inter-market competition

As we have already said, competition between several venture-oriented markets is ultimately a desirable thing. However, this sort of competition may not necessarily always produce desirable results. Depending on the nature of this competition it may also cause a certain amount of harm, and it would be wise to be aware of the dangers.

Firstly, there appears to be a certain lack of differentiation between the venture-oriented markets that 5 of the 6 national exchanges have all decided to set up. As for the 3 major venture markets, the TSE Mothers market can boast of its position as the venture-oriented arm of the country's main stock exchange, while the OTC market is holding up its market-maker-based trading method as its strong point and Nasdaq Japan is selling itself on the strength of being a global market network. However, a company is faced with the difficult task of having to consider the various characteristics of the markets and decide on which one it should list. It is also possible to see the intentions of the Nagoya, Sapporo and Fukuoka exchanges to set up venture-oriented markets as merely following in the footsteps of Tokyo and Osaka. In order to revitalize business on their exchanges, surely they need to expand their creative horizons beyond the simple expedient of setting up a venture-oriented market.

Our second concern lies with the way in which the competing markets have placed undue emphasis on how much easier they have made obtaining a listing by relaxing the listing requirements and simplifying the listing procedures. Since these are to be public venture-oriented markets participated in by ordinary investors, the operators must not debase the quality of the markets by allowing any old company to easily obtain a listing. Though of course the securities house lead-managing the issue will still be responsible for conducting due diligence, the market operators should conduct a strict examination to weed out companies without solid future prospects in order to maintain the overall quality of the market itself even while allowing more companies to apply via less stringent listing requirements. Further, while reports have appeared in the Japanese press claiming that the police have warned that the new Mothers market is at risk of being used by certain organized crime groups or affiliates in an effort to procure funds due to the less-stringent listing criteria, if such abuse were to actually occur then public trust in the markets could swiftly evaporate. If any of the new venture-oriented markets were to become mired in scandal due to their scant regard for proper examination procedures, they could go the way of the American Stock Exchange's ECM (Emerging Company Marketplace) and find themselves being closed down.[2]

2 Regarding the fortunes of ECM, please refer to a footnote in S. Osaki "New Markets Enter The Battle For Japan's Venture Businesses," (Capital Research Journal, Spring 2000).

Our third concern, related to the above, is that while management in some quarters may then treat the business of listing their stocks lightly, certain investors might also concentrate their investment in IT related stocks, consequently militating against the efficient distribution of capital that is the market's avowed purpose. There are also recent examples of funds raised by an IPO being in turn used for investment in other venture companies, or of large amounts being raised that are out of proportion to the amount that would be objectively deemed necessary in order to develop core businesses. We may see the performance of a company raising funds in the equity markets suffering in the long-term precisely because the barriers to obtaining funds have been lowered so substantially. To facilitate greater disclosure regarding the purpose to which funds raised by an IPO will be put, both regulatory revision and cooperation on behalf of listing applicants is required.

Fourthly, market operators seem to be too concerned with garnering as many listings as possible, and a worrying trend has emerged where they are fighting to attract companies already listed on other exchanges. Nasdaq Japan for example has been holding seminars with companies already listed on the OTC market, and offering "sweeteners" for companies already listed on the OSE to also list on Nasdaq Japan. Such transfers and duplicate listings however are for cosmetic purposes only, and do not make any contribution to the development of Japan's equity markets as a whole.

Towards venture-oriented equity markets

As we have seen, there are several concerns surrounding the current nature of competition between Japan's venture-oriented markets. However, at the same time it is hardly necessary to repeat that both the opening up to new classes of applicants with the significant loosening of previously stringent listing criteria, and the enthusiasm with which the TSE and OSE have embraced the idea of venture-oriented markets, are huge steps forward. These have greatly heightened the awareness of the new venture-oriented exchanges among Japan's new wave of equity investors and among companies thinking of obtaining a listing, signaling an important change in the structure of Japan's equity markets.

The managers of listed companies must however fully understand the social responsibility they hold once their shares are listed on an exchange and are being bought and sold by public and individual investors. Listing of a company's shares should not be regarded as simply one method of raising finance. Nor should the originators of start-up companies' sole ambition be to make a killing by selling their holdings at the top of the market. The management of a publicly traded firm bear the responsibility of company growth and the distribution of profits both to the firm's originators and to the numerous shareholders who are not so intimately involved with the day-to-day running of the company. As a result, management has a responsibility for information disclosure and explanation of the company's actions beyond that prescribed in law, and they should implement the necessary management-level changes and bear the attendant costs.

We very much hope that the market operators do not concentrate their efforts on cosmetics such as number of listings, but take a more long-term view and aim to create markets whose reputation is built on market quality. With markets around the world now seriously considering reconstituting themselves as profit-seeking joint-stock companies, market operators are coming to act more and more like businesses. Nevertheless, it is still true that a market in which a large number of individual investors can take part is in some ways very much a ‘public’ institution. Market operators, in our view, should not just be striving to attract more listings and boosting trading volumes, but should also work to maintain high standards of fairness and transparency in the markets they operate.

At the same time, in order that the venture-oriented markets should enjoy long-term growth, it is perhaps somewhat paradoxically true that we must not neglect the importance of the role that private equity has to play in investing in companies prior to their obtaining a listing on major stock or OTC markets.

As already mentioned, the success of the Nasdaq market in the US has been supported by the activity of private equity capital. In Japan as well, while on the one hand investment in start-up companies by venture capital is increasing substantially, institutional investors are also becoming more interested in venture funding as it can both diversify their portfolios and boost investment performance. It would seem safe to say that there are now signs of real growth in private equity capital investment.

If it is only the venture-oriented public markets that expand while Japan still lacks any significant degree of private investment (in which it is difficult for ordinary individual investors to participate), then the long-term investment risk that in the US has been traditionally borne by professional investors may be forced onto individual investors. If this happens then large losses might occur among investors and trust in the markets deteriorate, perhaps even making it hard for start-ups to raise equity financing. It is important to remember that the capital markets function best in aiding the growth of venture firms when private trading by professional investors through private placements goes hand in hand with secondary trading in public markets by ordinary investors.

As at April 2000, no doubt influenced by a correction phase in the previously bullish US Nasdaq market, all 7 issues then listed on the TSE’s Mothers market were trading under their issue price, with a resultant sharp dampening of the previous “over-enthusiasm” in the new market. This has caused several companies that have already received approval to delay their market listings. In the light of such events, one cannot necessarily be optimistic about the environment surrounding Japan’s venture-oriented equity markets. Whether the current wave of interest will turn out to be more than just a “fad” and venture-oriented markets making a valuable contribution to nurturing start-up companies really take root in Japan is soon to be decided through the coming phase of inter-market competition.