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OSE/Jasdaq merger's significance and the future of Japan's venture markets

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The Osaka Securities Exchange and Jasdaq have merged and plan to launch a new Jasdaq market in October 2010. Japan's venture equity markets have continued to languish since the Livedoor scandal of 2006, but the OSE/Jasdaq merger and pending market consolidation is likely to lead to improvement in market fairness, partly through sharing of know-how regarding market supervision and screening of IPO applicants.

OSE has swallowed up Jasdaq

In April 2010, the Osaka Securities Exchange (OSE) absorbed its former subsidiary Jasdaq Securities Exchange in a merger. In October, the OSE plans to consolidate its Hercules market into Jasdaq to form a new Jasdaq market. The new market will be Japan's premier venture market, with over 1,000 listed companies.

Together with the Tokyo Stock Exchange (TSE), the OSE is one of Japan's oldest securities exchanges, but trading in stocks of mature companies typically listed on the TSE's First Section is heavily concentrated on the TSE. The OSE has consequently had to seek opportunities in businesses other than cash-market trading of equities. It successfully launched trading in Nikkei 225 index futures in 1998 and has captured a large share of securities derivative trading.

While securities exchanges tend to be seen as public institutions, the OSE has also aggressively pursued business strategies as a commercial entity. In 2000, it established NASDAQ Japan (currently Hercules) in alliance with the US's Nasdaq Stock Market, Inc. (currently the NASDAQ OMX Group). In 2001, the OSE demutualized to become a joint stock company. In 2004, it became the first Japanese exchange to self-list its shares.

NASDAQ Japan played a key role in igniting Japan's venture market boom in the early 2000s, floating over 100 IPOs in rapid succession. NASDAQ Japan subsequently became the Hercules market when Nasdaq Stock Market exited Japan. In December 2008, the OSE launched a takeover bid for Jasdaq, the successor to Japan's old OTC market, in accord with its aim of making derivatives trading and venture equity markets the two pillars of its exchange business. The OSE succeeded in gaining control of Jasdaq as a subsidiary.

Venture market boom and bust

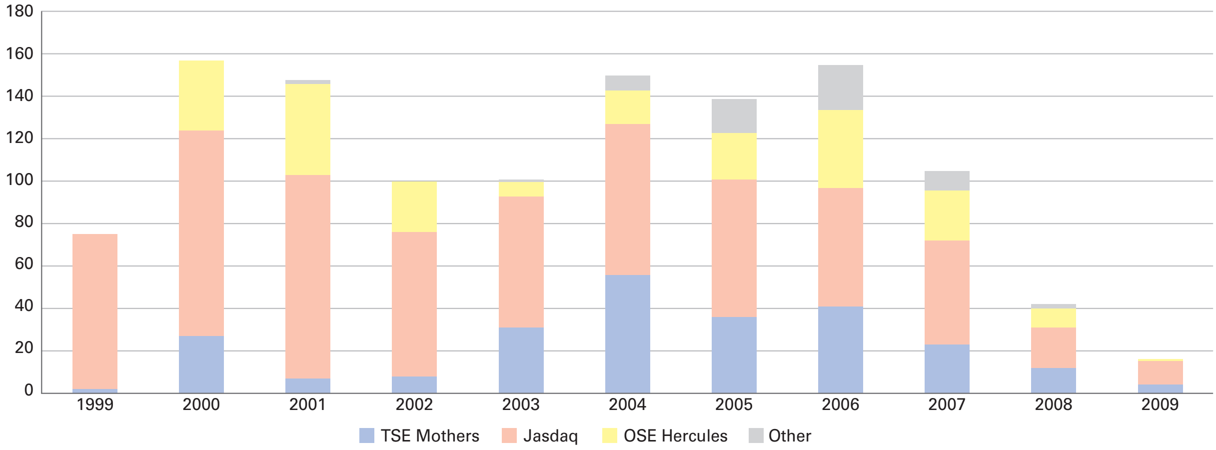
The OSE/Jasdaq merger was partly motivated by changes in the market environment in addition to the OSE's own business strategy as described above.

The June 1999 announcement of plans to establish NASDAQ Japan triggered a headlong rush among domestic securities exchanges to establish their own venture markets with lenient listing requirements in comparison to those of main equity markets such as the TSE's First and Second Sections. The new markets actively recruited and assisted IPO candidates and floated 100-150 IPOs annually from 2000 (see exhibit). By 2009, they had collectively staged a cumulative total of over 1,100 IPOs.

This venture market boom played a major role in incubating new industries and diversifying investment opportunities. At the same time, however, it led to lapses in underwriting due diligence at some investment banks and a decline in corporate executives' ethical standards, as evidenced by a spate of scandals, including accounting fraud and capital policies severely detrimental to investors' interest.

Most notably, Livedoor, the most renowned venture company in Japan, became the target of a prosecutorial investigation in January 2006. News of the investigation shook investors' confidence in venture markets in general. In response, trading volume on venture markets shrank, share prices slumped, and the number of IPOs plunged.

Exhibit . Number of IPOs on Japanese venture markets



Note: (1) OSE Hercules was originally named NASDAQ Japan. The name was changed to Hercules in December 2002.
(2) Jasdaq IPOs include NEO IPOs also.
(3) "Other" is the total for Centrex (Nagoya Stock Exchange), Ambitious (Sapporo Securities Exchange), and Q-Board (Fukuoka Stock Exchange).
Source: Securities exchange data

Against such a backdrop, concerned parties called for consolidation of fragmented markets to restore investors' trust in venture markets. The rationale behind such pressure was that competition among many markets led to deterioration in the quality of market supervision and screening of IPO applicants. While the validity of such criticism is subject to debate, expectations of market consolidation were certainly a key driving force behind the OSE/Jasdaq merger.

Hopes riding on market revival measures

Will the OSE/Jasdaq merger lead to revival of Japan's venture markets?

Reduction in the number of competing markets will certainly alleviate excessive competition among markets. Sharing of know-how about IPO applicant screening and market supervision also should contribute to ensuring fairness in markets.

However, such measures alone are unlikely to be sufficient to revive venture markets. Venture markets' slump in recent years is not entirely attributable to a loss of investor confidence in the markets. Other contributing factors include the global financial crisis and ensuing economic downturn, heightened risk aversion by investors, and a downshift in venture capital investment.

The sense of stagnation enveloping venture markets could conceivably change dramatically over a short timeframe by virtue of equity market appreciation or a high-profile IPO.

Even at the height of their previous boom, venture markets had a number of widely known structural shortcomings, including a lack of participation by institutional investors, inadequate investment information (e.g., analyst coverage), and a tendency for successful companies to migrate to the TSE's First Section. Hopefully, the post-merger OSE will earnestly endeavor to further develop its venture market based on a recognition that true market revival will not be accomplished by mere share price appreciation, growth in trading volume, or increased IPOs.

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