Financial System Council Capital Market Working Group

Final Report by the Expert Study Group on the Structure of Capital Markets in Japan

—A New Equity Market Structure Serving for Companies and Investors in the New Era of *Reiwa*—

December 27, 2019

Table of Contents

Members of the Expert Study Group on the Structure of Capital Markets

As of December 27, 2019

Chair: Hideki Kanda, Professor, Law School, Gakushuin University

George Iguchi, Chief Corporate Governance Officer, Nissay Asset Management Corporation

Kazuhito Ikeo, Professor, Faculty of Economics, Rissho University

Yuri Okina, Chairperson of the Institute, The Japan Research Institute, Limited

Yoshimitsu Kobayashi, Chairperson, Director of the Board, Mitsubishi Chemical Holdings Corporation Hiroki Sampei, Head of Engagement, Fidelity International, Japan

Hajime Takata, Vice-chairman of the Institute Executive Economist, Mizuho Research Institute Ltd.

Akihiro Matsuyama (Member of the Board, Mitsubishi Electric Corporation), Chair, Sub-Committee on Capital Market, Keidanren(Japan Business Federation)

Observers

Japan Exchange Group, Inc.

Sapporo Securities Exchange

Nagoya Stock Exchange, Inc.

Fukuoka Stock Exchange

Ministry of Economy, Trade and Industry

Bank of Japan

Japan Securities Dealers Association

(Honorifics omitted, in *Gojuon* (Japanese alphabet) order)

* Additionally, the following experts were invited to provide insights and participated in the discussion.

○Second Session (May 31, 2019)

Akiyoshi Oba (Chairman, Japan Investment Advisers Association)

Kazushige Okuno
(Chief Investment Officer, Norinchukin Value Investments Co., Ltd.)

Masakazu Hosomizu (Partner, RMB Capital Management LLC)

○Third Session (October 2, 2019)

Katsuhisa Kinoshita (Representative Director & President, Kitanotatsujin Corporation)

Takahito Kudo (Chief Financial Officer, Ecomott Inc.)

Yoshimasa Yamamoto
(Chairman, HARD OFF CORPORATION Co, Ltd.)

Atsushi Muto (Director, Senior Managing Executive Officer, Takihyo Co., Ltd.)

Kei Nagasawa (Chief Financial Officer, Mercari, Inc.)

Yo Nagami (CFO and member of Board of Directors, RAKSUL INC.)

○Fourth Session (October 23, 2019)

Hidetaka Kawakita
(Distinguished Professor, Research Department, Graduate School of Management, Kyoto University)

Etsuro Kuronuma
(Professor, Faculty of Law, Waseda University)

Kazuhiro Takei (Partner (Lawyer), Nishimura & Asahi)

(Honorifics omitted)

Introduction

Tokyo Stock Exchange has been maintaining the basic market structure which was established prior to the integration of Tokyo Stock Exchange and the Osaka Securities Exchange in 2013, and has kept the market segments generally unchanged. Five years have passed since said integration, and several issues have been identified. In response, Tokyo Stock Exchange established an Advisory Group and started its discussions since November 2018, publishing a summary of the current issues in March 2019.

Since the discussions regarding the market structure of Tokyo Stock Exchange as well as other Japanese stock exchanges would have direct impact on the overall structure of the Japanese equity market as a whole, it was decided that the subsequent debates should take place at the Financial System Council to further deepen the discussions with experts' perspectives on a continual basis. For this reason, the Expert Study Group on the Structure of Capital Markets was established under the Financial System Council Capital Market Working Group, with an aim to obtain recommendations on future market structure from experts in various fields. Since May 2019, the Expert Study Group has held six sessions, interviewing and discussing with a wide range of market participants and stakeholders, including investors and companies.

This report summarizes the results of the Expert Study Group's discussions.

1. Purpose of Reform on the Equity Market Structure

In 1961, Tokyo Stock Exchange, Osaka Securities Exchange, and Nagoya Stock Exchange, at the time, established the First and Second sections at the respective exchanges. Since then, the equity market in Japan has developed under a structure where there are multiple market sections within a single exchange. This structure has also shaped the behavior of corporations and investors.

In addition, TOPIX (Tokyo Stock Price Index), which is composed of all issues listed on the First Section of Tokyo Stock Exchange, has been referenced as the main index for the Japanese stock market since the start of its calculation in 1969. At the same time, TOPIX has been widely used as a benchmark for domestic pension funds and as an investment index for passive funds such as mutual funds and ETFs.

That being said, the following issues have been identified regarding the current equity market structure:

(i) Tokyo Stock Exchange has five market sections (First Section, Second Section, MOTHERS, JASDAQ Standard, and JASDAQ Growth), but the concept of each market section is ambiguous and may not be sufficiently convenient for many investors. In particular, the concept of the Second Section, MOTHERS, and JASDAQ are overlapping with each other and are confusing.

(ii) The listing criteria for transferring (stepping-up) to the First Section from other market sections are not strict enough. In addition, compared to the listing criteria, the criteria for transferring from the First Section to the Second Section as well as the delisting criteria are lax and thus, listed companies are not sufficiently incentivized to strive to sustain its growth and corporate value creation.

(iii) Because TOPIX is composed of all the issues listed on the First Section, though TOPIX has been the chosen benchmark of many institutional investors, it is not functioning well as an investable index. Due to the recent rise of passive investment linked to TOPIX, there is a concern that price formation of issues with relatively small market capitalization or low liquidity may be affected. By contrast, there are few institutional investors that use other indices such as JPX-Nikkei 400 or TOPIX 500 as investable benchmarks. There is no index that is functioning properly as an investable benchmark, at the same time representing wide investment opportunities.

This reform on equity market structure intends to resolve these issues while also recognizing the history of the equity market which has developed over the course of more than half a century.

By clarifying the concept of each market section and revising the stock prices indices methodology, the reform aims to incentivize sustainable growth and corporate value creation of listed companies and start-ups, thereby creating a market that is attractive to both domestic and foreign investors. Furthermore, it is expected that these improvements to market functions will bear fruits of increased corporate value and profits to Japan as a whole, including household finances.

2. Market Sections

In order to provide various companies with listing opportunities and to incentivize sustained growth of corporate value after listing, one possibility is to restructure the existing market sections, and to redesign the equity market with multiple market sections based on the characteristics of the listed issues. Specifically, it seems appropriate to reorganize the market into three sections: "Prime Market," "Standard Market," and "Growth Market" (all names are tentative; the same applies hereinafter) so as to redesign the structure based on clear market concepts.

In addition, it would be considered appropriate for currently listed companies to be able to proactively choose the market section most suitable for its listing based on the concept of each new market section, by considering the company’s corporate philosophy, quality of corporate governance, and commitment to engagement with shareholders.

(1) Prime Market

(i) Concept

The concept of the Prime Market may be defined as "a market for companies whose market capitalization and liquidity are large enough to attract investments from many institutional investors, that also have a high quality of corporate governance, as well as commitment to sustained growth and medium-to-long term improvement of corporate value with a focus on constructive dialogue with investors, thus, being a market for institutional and individual investors investing in those companies."

(ii) Listing Criteria, etc.

While market capitalization is important as listing criteria on the Prime Market, it is also important to consider other criteria such as liquidity and corporate governance.

(Market Capitalization Criteria (Market Capitalization of Tradeable Shares))

Currently, there are some issues on the First Section which have large market capitalizations but only a small number of shares actually traded. Focusing more on market liquidity, it is considered appropriate to take into account the "market capitalization of tradeable shares[1]" criteria for companies that will be newly listed on the Prime Market, in addition to the simple “market capitalization of all the shares.” Additionally, review of the current definition of

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[1] "Market Capitalization of Tradeable Shares" is calculated by "Number of shares in circulation multiplied by stock price (per one share)."

tradeable shares may also be considered.[2]

The market capitalization criteria should therefore indicate "market capitalization of tradeable shares" with a new definition,[3] based on the current market capitalization criteria for listing directly on the First Section. The current market capitalization criteria for listing on the First Section via other market sections, such as MOTHERS, have a lower standard than those for listing directly on the First Section, and it is considered appropriate to integrate these different criteria into unified and standardized new criteria.[4]

At present, the market capitalization criteria when transferring from the First Section to the Second Section are less than 2 billion yen. It has been pointed out that these criteria are unbalanced compared to the criteria for listing, preventing proper market dynamic of company's exit from and entry into the First Section. For companies that will be listed on the Prime Market under the new criteria, in order to incentivize these companies to increase their corporate value after listing, one possible design would be to set the market capitalization (market capitalization of tradeable shares) criteria for exit from the Prime Market at the same level as those for listing on the Prime Market, with a certain grace period.

In the event of insolvency, when the liabilities of a listed company on the First Section exceed its assets at the end of a fiscal year, currently the company would be transferred from the First Section to the Second Section, and if this state remains unchanged for another fiscal year, it would be delisted.[5] Revision of the criteria could be considered so as to recognize any expectation of prompt improvement of the financial condition of the company where its assets might exceed its liabilities, thereby avoiding such company to be automatically transferred or delisted.

(Liquidity (Tradeable Share Ratio) Criteria)

When the core focus of the Prime Market's market concept is on increasing corporate value through constructive dialogue with investors, an appropriate shareholder structure would be to have a high ratio of tradeable shares, which is more likely to facilitate governance of the management and strengthen constructive dialogue, compared to having most of the shares being

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[2] Currently, shares excluded from tradeable shares are those of large shareholders with shareholdings of 10% or more. In the future, the definition of tradeable shares could be redefined, to grasp the actual situation of trading more accurately, taking into account the turnover of trades and shareholders' intention for holding. It may also be necessary to consider counting shares such as those held by PE funds (including revitalization funds) as tradeable shares.

[3] Currently, the market capitalization criteria for listing directly on the First Section are 25 billion yen. In addition, the criteria for ratio of tradeable shares at the time of listing are 35% or more. With these in mind, 10 billion yen may be considered one standard for the criteria for market capitalization of tradeable shares under the new definition.

[4] Some listed companies, such as those listed on MOTHERS, could already be preparing for listing/transferring to the First Section with the current listing criteria in mind. Amongst those companies, companies that file applications prior to the amendment of the relevant rules (the step-up criteria may be revised prior to amending other rules) could be allowed to be listed on the First Section pursuant to the current rules (under the current market capitalization standard).

[5] Under the current criteria, the Second Section, MOTHERS, and JASDAQ listed companies are delisted if its liability exceeds its assets for two consecutive fiscal years, and therefore a similar revision could be made for these markets.

held by so-called “stable shareholders”. Currently, the listing criteria for the First Section stipulate the ratio of tradeable shares to be at least 35% of the listed shares, etc. However, there are some listed companies whose tradeable share ratio has dropped significantly since listing.[6] It is considered appropriate for listed companies to maintain their tradeable share ratio at a level where so-called “stable shareholders” hold less than two-thirds of shares (the threshold necessary to pass a special resolution under the Companies Act).

As for liquidity, it may be worth considering the necessity of new criteria regarding trading volume and trading value.

(Corporate Governance)

For companies listed on the Prime Market, it is necessary to require a corporate governance standard appropriate for such market, where investors could expect to find good investment opportunities in Japan.

In order for listed companies to achieve sustained corporate growth and medium-to-long term increase of corporate value, it will be necessary to continue pursuing a higher standard of governance compared to other market sections, each time the Corporate Governance Code is revised in the future.[7] Furthermore, it is strongly expected that companies listed on the Prime Market will duly comply with the relevant principles and sufficiently explain where needed, in a manner appropriate for the Prime Market, based on the selection of their own market section.

Additionally, it is also considered important to recognize the possible changes on business brought by the rapid progress of digitalization, which corporate governance might need to accommodate accordingly.

(Revenue Criteria)

Currently, the listing criteria for the First Section require a “stable revenue base." Although there are few exceptions, it has been pointed out that it is difficult for companies which run deficit in their most recent fiscal year to be listed on the First Section.

In recent years, some companies running e-commerce businesses have invested heavily on advertisement, recruiting and research and development in their early stages, and have sought to achieve significantly higher growth in the longer term. Since their investments do not appear

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[6] Under the current rules, a listed company will be delisted if the ratio of tradeable shares falls below 5% of the listed shares, etc.

[7] There were some comments that the minimum requirements for corporate governance appropriate to the Prime Market should be stipulated in the listing standards so as to clarify the differences between the Prime Market and the Standard Market. By contrast, other comments indicated that issues regarding corporate governance had been addressed on a principle basis for the past years and that much caution would be required in considering whether to introduce listing standards that compel or force compliance.

as assets under these business models, in contrast to traditional type of industries making capital investments, these companies tend to run deficit, appearing as money-losing companies.

For such cases, it is considered appropriate to revise the criteria so that listing on the Prime Market can be approved even when there is a deficit in the most recent financial results. Additionally enhancing requirements on market capitalization, revenue, disclosure and such would be appropriate.

(iii) Transitional Measures (Grandfathering)

At the hearings, etc., it was confirmed that companies listed on the First Section provide their stakeholders with tremendous values, tangible and intangible, in various forms, deriving from its listing on the First Section. These companies have established their brand images as major companies in the country/region, which have become a source of trust and security in employment and transactions, by complying with the listing criteria and being monitored from Tokyo Stock Exchange, for instance. This seems to be reflected in their corporate value even for current shareholders in these companies listed on the First Section.

For companies with small market capitalization, it might be difficult to increase their market capitalization through corporate efforts within a limited period of time. Nevertheless, in light of the concept of the Prime Market, it is still important that they strengthen their corporate governance in order to increase their corporate value.

With that in mind, even when companies listed on the First Section do not necessarily meet the new market capitalization (market capitalization of tradeable shares) criteria for listing and delisting, it is considered appropriate, in general, to allow them to be listed or to be kept listed on the Prime Market for the time being, as long as they choose the Prime Market and are committed to enhancing their corporate governance towards the higher standard.[8]

By contrast, it is relatively likely that the ratio of tradeable shares can be improved through corporate efforts such as eliminating cross-holdings of shares and issuing new shares. Accordingly, when companies listed on the First Section do not necessarily meet the tradeable share ratio criteria, it may be considered to allow them to be listed or to be kept listed on the Prime Market for the time being, as long as they choose the Prime Market and are committed to developing and disclosing initiatives and plans to improve the ratio of tradable share.

(2) Standard Market

[8] It may be considered that the criteria for companies listed on the First Section, subject to transitional measures, to transfer from the Prime Market to the Standard Market, should be set in accordance with the current criteria for transferring from the First Section to the Second Section (market capitalization of 2 billion yen).

(i) Concept

The concept for the Standard Market may be defined as “a market for companies which have a base-line, standard level of market capitalization and liquidity representing appropriate investment opportunity as a public company, basic corporate governance standards as a listed company, and which are committed to sustainable growth and medium-to-long term enhancement of corporate value, thus, being a market for investors investing in those companies."

The Standard Market could be considered as primarily consisting of companies that are currently listed on the Second Section and the JASDAQ Standard. However, it is assumed that companies currently listed on the First Section may choose the Standard Market as well.

(ii) Listing Criteria, etc.

Companies listed on the Standard Market are not necessarily required to meet the listing criteria that institutional investors expect from companies listed on the Prime Market, such as the level of market capitalization and liquidity, and higher corporate governance standards. In light of the above concept, however, it is appropriate to require companies to be committed to having a base-line, standard level market capitalization and liquidity, achieving basic corporate governance standards, and striving for sustained growth and increase of medium-to-long term corporate value in a way that is appropriate for each company.

Regarding the market capitalization criteria for companies wishing to be listed on the Standard Market, adopting the concept of market capitalization of tradeable shares in line with the Prime Market may be considered. In setting the criteria, the current criteria for listing on the Second Section[9] can be considered as a reference.

With regards to the governance criteria, companies listed on the Second Section are currently subject to all the Principles of the Corporate Governance Code, whereas companies listed on JASDAQ Standard are only subject to the basic Principles of the Corporate Governance Code. For companies transferring to the Standard Market, it is not appropriate to lower the level of corporate governance which has been required so far, and therefore, going forward, it would be appropriate to apply all the Principles of the Corporate Governance Code to the entire Standard Market. For companies currently listed on JASDAQ Standard, it is necessary to pay due attention to the possible additional burden on these companies in the course of transition.

(3) Growth Market

[9] The current market capitalization criteria for companies to be listed on the Second Section are 2 billion yen.

(i) Concept

The concept for the Growth Market may be defined as "a market for companies which have a business plan to realize their high growth potential, which disclose timely and appropriately its progress, and have obtained a certain level of market value, but at the same time, have a relatively higher risk from the viewpoint of business performance, thus, being a market for institutional and general investors investing in those companies."

It is assumed that the current MOTHERS and JASDAQ Growth listed companies will, in principle, transfer to the Growth Market.

Based on this clear concept, it is expected that this market will further contribute to the fostering of start-up companies.

(ii) Listing Criteria, etc.

Currently, it is possible for companies to be listed on the MOTHERS with a market capitalization of a billion yen. On one hand, it has been pointed out that some companies got listed with small market capitalization with no further growth observed after listing (so-called listing goal). On the other hand, it has also been pointed out that providing listing opportunities at an early stage enables a model of quick- re-investment-cycle of the acquired capital, into upcoming start-ups.

Given these two sides of the analysis, it is appropriate, in principle, to maintain the current listing criteria including those for market capitalization, so that this market continues to remain as the world's most accessible market for start-ups to obtain risk capital.

Regarding the corporate governance criteria, applying only the General Principles of the Corporate Governance Code would be appropriate, even after the Corporate Governance Code is revised.

Furthermore, fostering a market practice, where start-ups choose the appropriate timing of their listing in line with their corporate growth, would be appropriate. This practice will promote certain start-up companies in a pool of start-ups in Japan, to grow and achieve the size of so-called “unicorns,” aiming to list after having grown to a certain size.

(iii) Promoting Participation of Institutional Investors

The current MOTHERS is a market where individual investors are the main players. In order to promote institutional investors’ participation in the market, a number of measures may be considered from a broader perspective. The measures may include, for instance, publishing good disclosure practices of MOTHERS-listed companies that are attracting investments from institutional investors, revising the criteria for the number of shareholders when listing, and reviewing the appropriate distribution of shares to investors when a company is listed.

3. Index (TOPIX)

Currently, the composition of listed companies on the First Section and the composition of TOPIX are identical. Market section provides companies with a place to raise capital according to their size, etc. and it also provides investors with a place to trade the shares. In comparison, TOPIX plays its role not only as an indication of stock price trends, but also as an investment index and benchmark, which has become an even more important role especially following the recent rise in passive investment.

Since the required roles of market section and TOPIX are becoming different, it is considered appropriate to delink the composition of TOPIX from the market sections accordingly.

(1) Selection Criteria, etc.

It is necessary to aim for an index which the institutional investors (asset owners and asset managers) find convenient and which also comprising companies find reasonable. Therefore, it is considered appropriate to select companies in a way that places more emphasis on their liquidity, while also ensuring the continuity of TOPIX, considering that TOPIX has already been widely used in pension management and mutual funds. Specifically, after revising the definition of the free float currently used in calculating TOPIX,[10] it may be considered to set the criteria based on "market capitalization of tradeable shares (free float market capitalization)" which is calculated using the new definition of free float.

Based on the above points, the criteria may be set by referring to the "market capitalization of tradeable shares" criteria for listing on the new Prime Market.[11]

There were some comments on capping the number of constituents and changing the composition of TOPIX on a regular basis, or taking into account qualitative factors such as sustainability from the perspective of those including, but not limited to corporate governance and environment when selecting these companies. These issues may need to be discussed further.

In changing the methodology of TOPIX, while it is assumed that constituents will be mainly selected from companies listed on the Prime Market, it could be considered allowing other companies listed on other market sections such as the Standard Market to be selected.[12]

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[10] Currently, shares held by the 10 largest shareholders are excluded from the free float. In the future, reviewing the definition of free float may be considered to grasp the actual situation of trading more accurately, taking into account its turnover of trades and shareholders' intention for holding. Counting holdings of PE funds (including revitalization funds), etc. as free float needs to be discussed.

[11] Based on the footnote 3 on page 5, in selecting constituents, an estimate of 10 billion yen may be considered as the criteria for market capitalization of tradeable shares (free float market capital) under the new definition.

[12] There were some comments that if TOPIX constituents were to be selected from the Growth Market, it would be necessary to impose additional requirements on corporate governance as only General Principles of the Corporate Governance Code is

In addition to delinking TOPIX composition from the market sections, it is considered appropriate to explore measures that ensure independence and fairness of the process for calculating the index, so as to eliminate concerns[13] on conflicts of interest in Tokyo Stock Exchange.[14]

(2) Transitional Measures, etc.

In changing the methodology of TOPIX and publishing the calculation results, it is necessary to pay the utmost attention to ensuring TOPIX's continuity so as not to unduly affect the market, as well as to give advance notice to the public with a sufficient transition period based on a clear policy.

The past experience when TOPIX was moved to a free-float-based index may be followed as an example. With regard to issues that will not be selected under the revised methodology, it may be appropriate that the transition take place with due care and over a course of a few years. This can be achieved by reducing the weight of these issues in the TOPIX composition, gradually from the time the market sections and index methodology are changed, instead of automatically removing all these issues at a certain time.

At present, TOPIX has been used as an investment index and as a benchmark for a wide range of financial products such as pension funds and mutual funds. While it is expected that the revised TOPIX will be used when the TOPIX methodology changes, calculating the current TOPIX as a transitional measure for the time being is considered appropriate.

Additionally, in reviewing the TOPIX methodology, other related matters such as the effect on futures markets may also be reviewed as needed.

to be applied there.

[13] There were some comments that a conflict of interest might occur within the exchange if there is a department which selects index constituents mainly from the perspective of maximizing investor profits, and also a department which can earn profits by maintaining and increasing the number of listed companies.

[14] Appropriate measures must be taken by the relevant supervisory authority, in addition to consideration by Tokyo Stock Exchange, which is calculating the index.

4. Others

(1) Delisting Criteria and Secondary Trading Venue for Delisted Stocks

Currently, the market capitalization criteria for delisting from the Second Section are a billion yen and those for delisting from MOTHERS are 0.5 billion yen. A tightening in the delisting criteria may be considered to incentivize companies to increase their corporate value after being listed. By contrast, once the strict delisting criteria are applied, securing opportunity for investors to sell their shares to be delisted is necessary. Therefore, when considering tightening the delisting criteria, it is also necessary to consider developing secondary markets which seamlessly function as alternative, secondary venues of trading for these investors.

(2) Appropriate Effective Date

It is desirable that this reform on market structure be implemented in a prompt manner, following the amendment of the relevant rules of the Tokyo Stock Exchange and the sufficient period of time for companies and market participants to be informed of and respond to. Specifically, it is expected that changes to the market sections and TOPIX will occur in the first half of 2022, considering that each company will choose a market section it considers suitable to be listed after the Corporate Governance Code has been revised as planned.

Conclusion

The above recommendations are the results of the discussions by the Expert Study Group.

There are remaining issues that were not fully discussed, including those related to exit from the market and those related to the development of an alternative, secondary trading venue for delisted stocks. It is expected that these remaining issues will be further discussed in order for the equity market to sufficiently fulfill its role, revising the formal and procedural criteria to more substantial ones, about which the overall discussions could be handled with Tokyo Stock Exchange taking the lead.

Going forward, it is expected that Tokyo Stock Exchange and other stakeholders will take appropriate measures to implement the various recommendations made in this report. We hope that this implementation will increase attractiveness of the market to domestic and foreign investors, ensure fairness and vitality of the market and promote sustained growth of the companies and the economy, thereby contributing to the further development of the Japanese economy.

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