

# The Over-the-Counter Stock Market Reaches a Crossroads

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## 1. Introduction

Since the end of 1998, the domestic over-the-counter stock market has come back impressively from an extended slump. The market index rose almost 70 percent from its low in October 1998 to March 1999, significantly outperforming other markets.

The recovery has come largely from the turnaround in small company stocks following a wide sell-off on concerns of weakening financial and business fundamentals. Other factors are specific to the OTC market, such as the emergence of companies with unique businesses and the effect of recent market reforms.

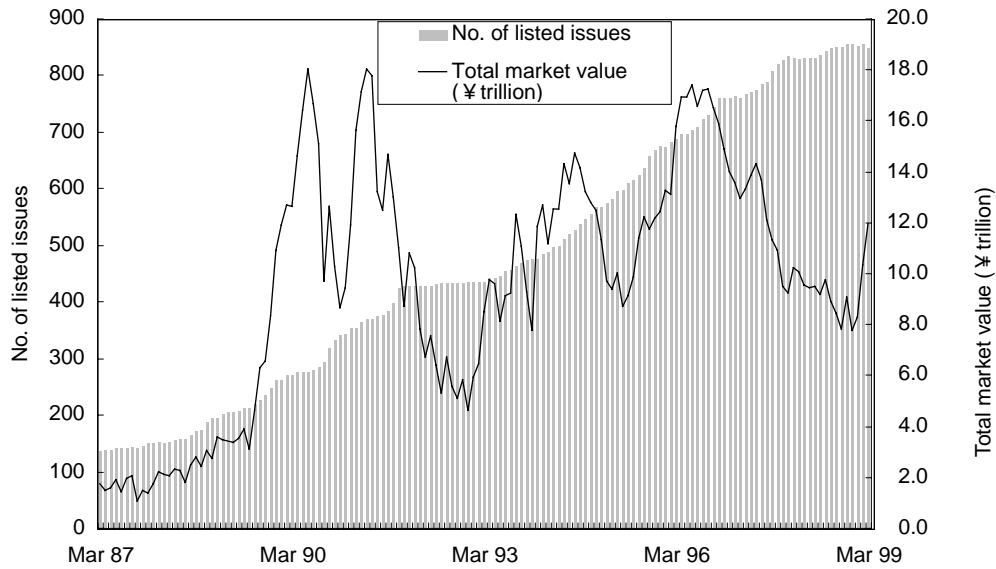
Whether the present surge amounts to a transient boom or continues to grow into NASDAQ-like proportions will have important implications for the Japanese economy. This paper looks at the present status of the OTC market primarily from the perspective of recent market reforms.

## 2. OTC Stock Market Reforms

### ( 1 ) Background of Reforms

During the 1990s, the OTC market suffered a number of severe setbacks. In addition to the recession, declining confidence in the disclosure stance of issuing companies, poor stock price performance of new issues, and the migration of stronger issues to the stock exchanges. Despite a steady increase in the number of companies going public, the size of the market contracted as stock prices fell, and greatly diminished the OTC market's presence ( Figure 1 )

**Figure 1 Number of Listed Issues and Total Market Value**



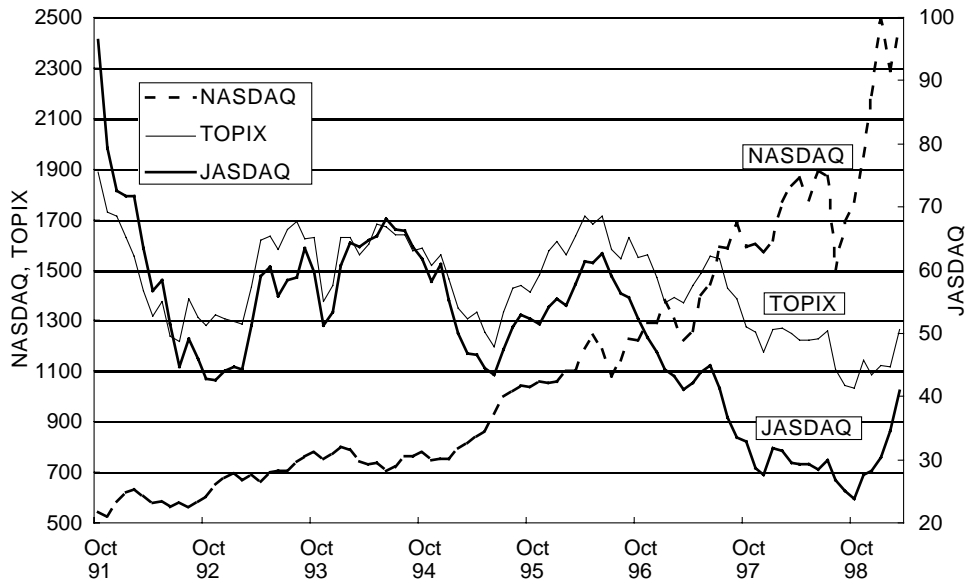
The secondary market's slump was particularly conspicuous, despite reduced commissions among some securities companies and the introduction of margin transactions. Investors fled the OTC market because liquidity could not be assured, jeopardizing the OTC market's original purpose of providing access to financing for growth companies.

Meanwhile in the U.S., the OTC market known as NASDAQ has become home to leading companies such as Microsoft, Intel, and Cisco, making it one of the largest of the U.S. stock markets. The phenomenal growth of NASDAQ, putting it in the top tier of the world's stock markets alongside the New York Stock Exchange, further accentuates the contrast with Japan's OTC market, known as JASDAQ ( Figure 2, Table 1 )

**Table 1 Size Comparison of Stock Markets**

	OTC	TSE 1st	NASDAQ	NYSE
No. of listed companies	856	1,340	5,068	3,114
Total market value ( ¥ trillion)	7.7	268	298	1,251
Monthly transaction vol. (mil. shares)	149	7,898	19,494	15,241
Monthly transaction value ( ¥ billion)	162	6,522	70,278	73,458

Figure 2 Comparison of Market Performance



Alarmed by this situation, market participants began looking into ways to bolster Japan's OTC market. The result was the revised Securities & Exchange Law in December 1998, in which the OTC market was deemed as a securities market equivalent to other exchanges. This liberated the OTC market from the designation given in the 1984 report of the Securities Transaction Council—that the OTC market was a supplement to stock exchanges, and that registered OTC companies should pursue listings on other markets—and moved it one step closer to becoming recognized as an independent exchange.

Meanwhile, in November 1998, the Japan Securities Industry Association, which administers the OTC market, compiled a report containing groundbreaking reforms (*Toward Reform of the OTC Stock Market*). The report pointed out the need for wide ranging and radical reforms, some of which have already been implemented.

## (2) Evaluation of Major Reforms

Broadly speaking, the reforms contained in the report address two areas: the secondary market, and new listings (Table 2). Below we describe reforms already underway in the secondary market, and examine their current status.

**Table 2 Timeline for Implementation of Major Reforms**

Secondary market		
	Market maker system	Dec 98
	Stricter delisting criteria	Jan 99
	Formation of new section	Undecided
New listing		
	Introduction of alternative listing criteria	Jan 99
	Review of listing criteria	Jan 99
	Deregulation of capital increases before IPO	Undecided

### *1. Market Maker System*

Almost all transactions in the OTC stock market have occurred through JASDAQ Service (formerly Japan OTC Securities) in an auction format identical to that of the exchanges. However, one problem was that for issues with small trading volumes, the scarcity of market orders meant that transactions often could not be completed.

With the introduction of a market maker system, securities companies that act as market makers for each issue are required to constantly quoting offer and bid prices, and to execute orders of a certain scale. Because it ensures a certain amount of liquidity, the market maker system is especially well suited for OTC stocks which have low trading volumes. In fact, NASDAQ is able to boast a high liquidity because it has adopted a market maker system.

As of March 1999, 14 securities firms are making markets for 28 securities. Nomura Securities is the most active market maker with 26 markets, while Avex is the top stock issue with seven market makers. By comparison, on the NASDAQ, which requires a minimum of three market makers for a stock to be listed, each stock issue has an average of 10.8 market makers (Table 3)

**Table 3 Comparison of Market Maker Systems in Japan and the U.S.**

	Japan	NASDAQ
Issues covered	28 issues	All issues
No. of market makers	14 cos.	479 cos.
Average market makers per issue	3.3 cos.	10.8 cos.

Note: As of March 1999 for Japan, and December 1998 for NASDAQ.

Of the 28 participating issues, we took the 22 issues that had previous transaction data, and compared daily trading volumes 30 trading days before and after the market maker system was begun, using day one of market making as a benchmark. The liquidity of these issues, already quite high as measured by an average quotation rate of 92%, increased to 99% after the change. Moreover, 18 of the 22 issues showed higher trading volumes. These results confirm that the market making system increased liquidity.

On the other hand, from the start of market making to the end of March, superior returns ( compared to the Nikkei OTC index ) were posted by only 12 of the 28 issues, indicating that the market maker system does not always work directly to push stock prices upward.

But the system is not without problems; large spreads still exist between buy and sell quotes, and transactions lack smoothness. However, with commissions about to be fully liberalized, securities firms are hoping to find new profit opportunities in market making, which generates profit from the spread between buy and sell quotes. Thus competition should lead to efficiency improvements in the future.

*2. Review of Desisting Criteria*

Among the growing number of listed companies, there have been issues with practically no transaction volume and whose purpose in going public was unclear. In response to criticism that these stocks obscured the characteristics of the OTC market's structure, delisting criteria were strengthened ( Table 4 )

**Table 4 Comparison of Delisting Criteria**

	Old	New
No. of stockholders	100	150
Sales	2000 shares/month	10,000 shares/month
Quotation rate	None	20 % /month

Note: Trading volume and quotation rate are six-month averages.

For the trading volume and quotation rate criteria, the number of issues that fail to meet the new criteria increases significantly compared to the old.

In addition, in comparing the three-month periods before and after adoption of the new criteria ( the three-month period to December 1998, and the three-month period to March 1999 ) we find that the number of issues that fail to meet the new criteria decreases significantly. This may indicate that issuing companies and securities firms responded to the stronger criteria by

taking measures to increase liquidity ( Table 5 )

**Table 5 Number of Issues Failing to Meet Delisting Criteria**

		to Dec 1998	to Mar 1999
Old	Transaction vol. ( below 2,000 shares )	4 ( 0.5 % )	3 ( 0.4% )
	Transaction vol. (below 10,000 shares )	97 (11.8%)	50 ( 6.0% )
	Quotation rate (below 20% )	99 ( 12.1% )	52 ( 6.2% )
New	and ( do not satisfy new criteria )	78 ( 9.5% )	36 ( 4.3% )

Source: Figures in parentheses are as proportion of all listed issues.

Due to a probationary period, the new criteria will not be enforced until 2000. However, they have definitely put companies on notice to perk up if they want to remain listed. In addition to direct measures in the secondary market, companies will need to woo investors aggressively by beefing up investor relations and other activities.

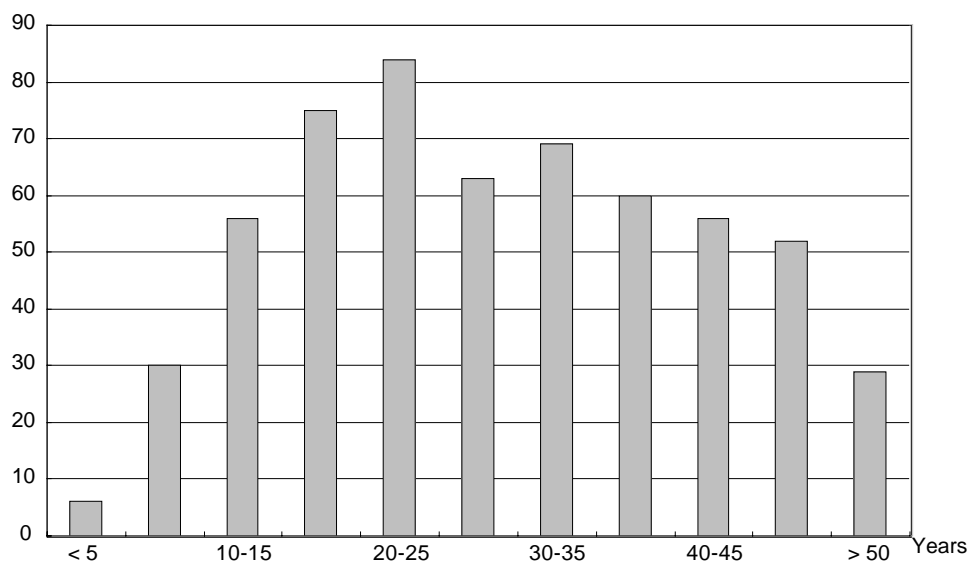
### 3. Status of the OTC Market

#### ( 1 ) OTC Listing as a Step Toward Exchange Listing

The number of newly listed companies was only 65 in fiscal 1998. Meanwhile, during the year 41 companies acquired an exchange listing, and after subtracting the nine companies desisted due to mergers and bankruptcies, there were 849 listed companies at the end of fiscal 1998 ( up 16 from the year earlier ) Listed companies are thus growing at a slower rate than before.

In addition, while some two-year-old companies have become public, the average time between establishment and listing is quite long at 23.3 years ( FY 1998 )– not exactly a sign of rampant venture activity ( Figure 3 )

**Figure 3 Time Needed to Obtain OTC Listing**



Note: Includes only companies that obtained an OTC listing after April 1993.

On the other hand, the average time between obtaining an OTC listing and an exchange listing is short at 4.3 years (FY 1998). Considering the long time companies take to acquire an OTC listing, the OTC market appears to be functioning in its role of expediting exchange listings (Table 6)

**Table 6 Exchange Listings Obtained with and without OTC Listing**

FY	New IPO		Migrated from OTC to exchange			No. of public cos. at yearend
	No. of companies	Years (est. to IPO)	No. of companies	Years (IPO to exchange listing)	Years (est. to IPO)	
1993	68	28.9	14	5.9	30.6	489
1994	113	32.1	16	3.8	24.1	584
1995	127	33.2	13	3.3	30.8	690
1996	109	27.7	32	3.8	31.6	762
1997	98	25.3	25	4.5	20.4	833
1998	65	23.3	41	4.3	27.4	849

In contrast, the major issues on NASDAQ not only went public shortly after being established, but chose to remain listed on NASDAQ even after qualifying for exchange listing. This can be attributed to their overall assessment of NASDAQ, including not only lower listing maintenance costs, but the strong growth company image that NASDAQ conveys, and the high liquidity attained by the trading system infrastructure.

## ( 2 ) Characteristics of Listed Companies

Companies listed on the OTC market are extremely diverse. In the past, many OTC companies came from industries that were not particularly well regarded, including nonbanks and pachinko machine makers. However, many of these companies went on to obtain exchange listings, and were replaced by new companies in emerging industries such as data communications services and specialized merchandise retail, gradually changing the industry composition of the OTC market ( Table 7 )

**Table 7 Industry Composition of the OTC Market ( by TSE's 33-Industry Classification )**

Mar 1994	Weight (of total market val.)	Weight (of all listings)	Mar 1999	Weight (of total market val.)	Weight (of all listings)
Other financial inst.	18.5%	1.6%	Service	25.2%	18.9%
Wholesale	16.5%	15.2%	Retail	14.8%	17.5%
Machinery	10.2%	8.6%	Wholesale	12.3%	10.3%
Retail	10.1%	11.3%	Machinery	9.1%	5.1%
Services	10.0%	12.9%	Electric machinery	6.9%	8.4%

As of March 1999, the top ten companies in market capitalization are leaders in industries not represented by companies listed on exchanges. Their characteristics include being listed relatively recently in most cases, and stratospheric stock prices that shun individual investors ( Table 8 )

**Table 8 Top 10 Companies in Market Capitalization ( March 1999 )**

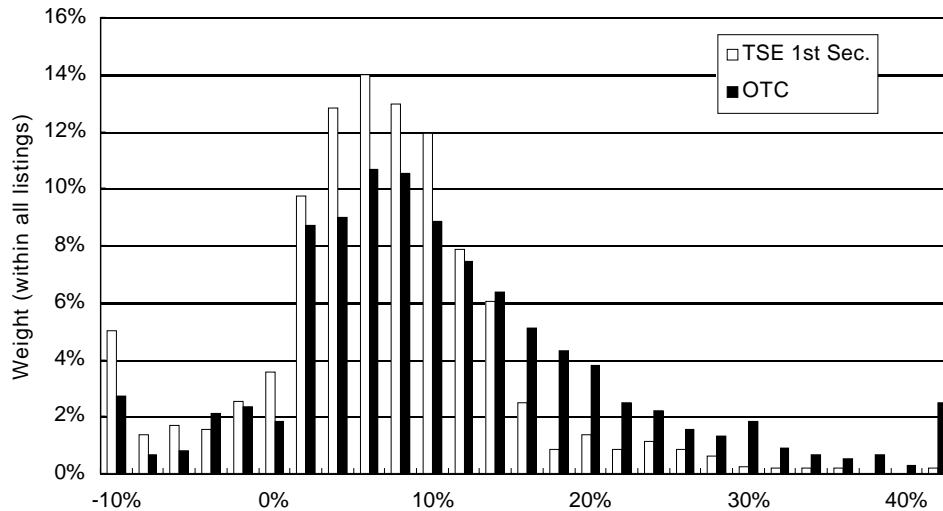
Rank	Code	Company	Business	IPO date	Stock price ( ¥ )	Minimum transact. ( ¥ million )	Market cap. ( ¥ billion )
1	4716	Oracle Japan	Database management software	99/2	12,800	6.40	908
2	9435	Hikari Tsushin	Cellular phone sales	96/2	20,900	2.09	617
3	6425	Aruze Corp.	Pachinko machine manufacturing	98/9	5,250	5.25	446
4	4689	Yahoo Japan	Internet portal	97/11	24 mil.	24.00	312
5	4704	Trend Micro Japan	Computer virus protection software	98/8	13,600	6.80	285
6	8595	JAFCO Co.	Venture capital	87/6	5,520	5.52	265
7	6481	T H K	Linear motion systems	89/11	1,760	0.17	203
8	4921	Fancl	Non-additive cosmetics	98/11	13,500	13.50	195
9	9821	Amway Japan	Multi-level marketing of home products	91/4	1,070	0.11	154
10	8186	Otsuka Kagu	Furniture retail	80/6	13,000	1.30	140

Note: Minimum trade value = 1 lot ( 1, 100, 500, or 1,000 shares ) x stock price at end of March.



Corporate earnings also tend to be high for the OTC market as a whole. When TSE first section companies and OTC companies are compared in terms of predicted ROE, the OTC distribution has longer tails, and 15% of OTC companies have a predicted ROE of at least 20% ( Figure 4 )

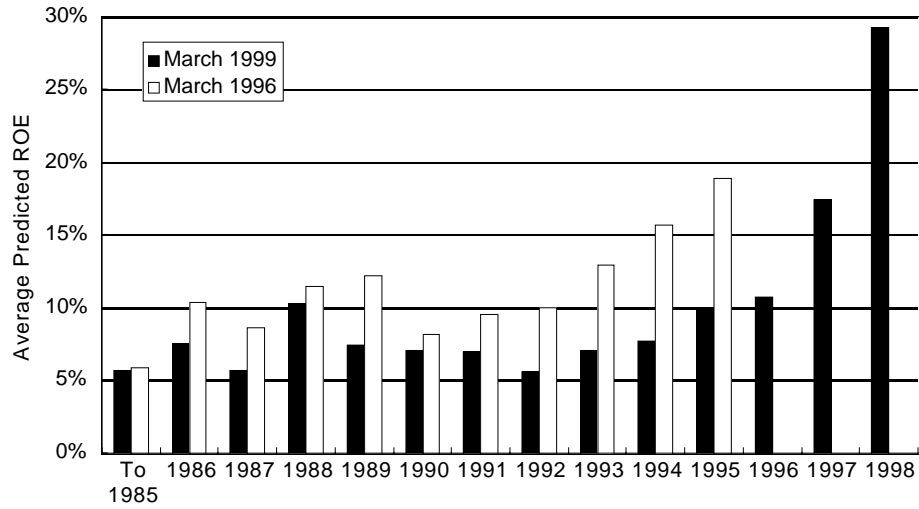
**Figure 4 Distribution of Companies by Predicted ROE**



Note: Covers companies with capitalization of at least ¥ 1 billion, excluding banks, securities and insurance companies, and other financial companies.

Next we calculated the average predicted ROE of OTC companies by year of listing ( Figure 5 ) The March 1999 data show that companies going public in fiscal 1997 and 1998 have very high ROEs. However, when the March 1996 data are also considered, they both confirm a declining tendency for high ROEs as the number of years from listing increases. This occurs because even if companies perform well at the time of listing, many will encounter difficulties later on.

**Figure 5 Average Predicted ROE by Year of Listing**

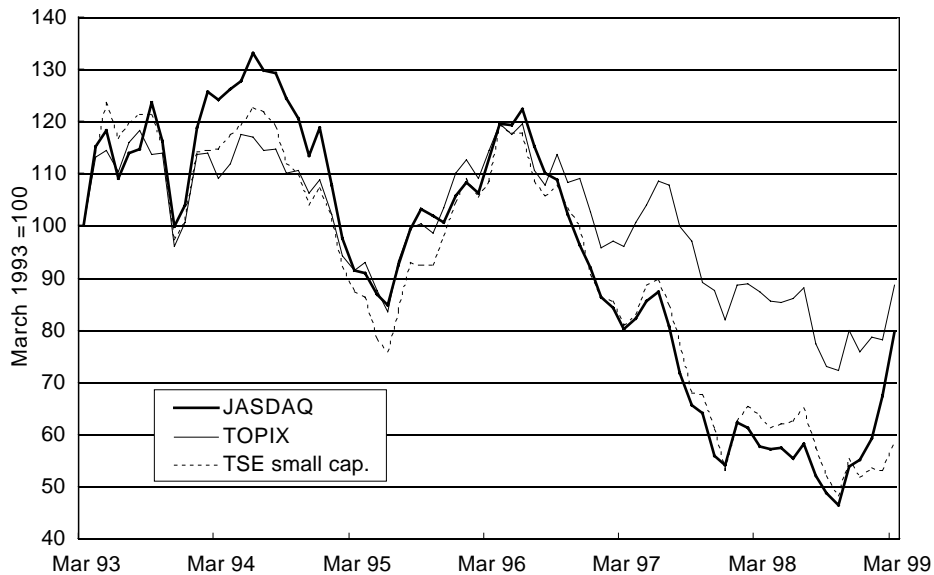


Note: Covers companies with capitalization of at least ¥ 1 billion, excluding banks, securities and insurance companies, and other financial companies.

( 3 ) Performance and Liquidity

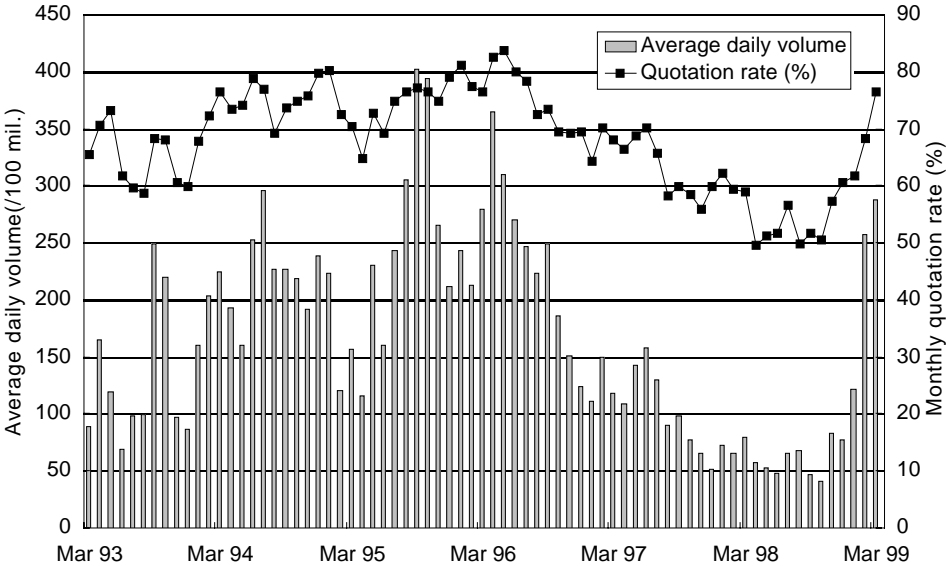
Against the backdrop of market reform, the OTC market has performed amazingly from the second half of last year led by the newly listed issues of high-growth companies ( Figure 6 )

**Figure 6 Performance Comparison of Stock Markets**



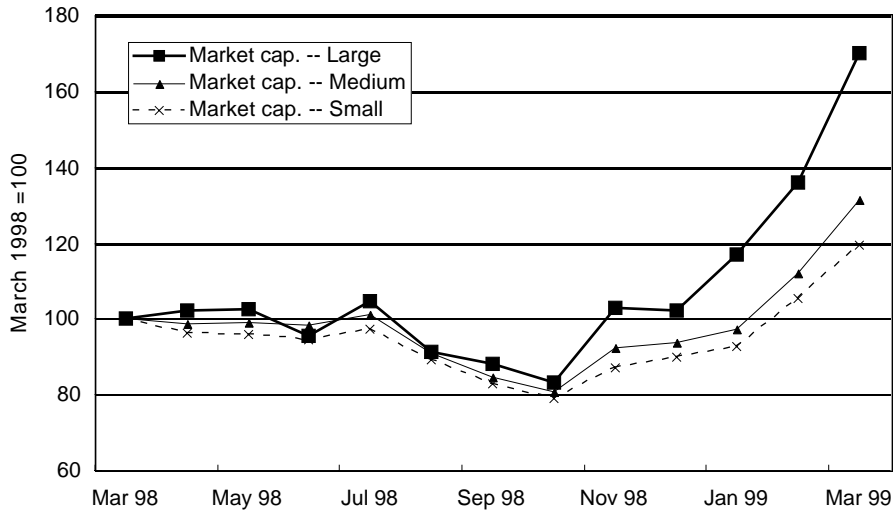
In particular, market participants are most pleased by the growth in trade volume because market reforms have strongly emphasized greater liquidity, and volume growth benefits all market participants (issuing companies, investors, and securities firms; Figure 7)

**Figure 7 Liquidity Index**



Next we ranked OTC issues by market capitalization at the end of each month, arranged them into three groups that are equal in total market capitalization, and measured each group's performance (average value weighted by market capitalization within the group). Since stock prices began rising in October 1998, the large market capitalization group have performed significantly better than the other groups (Figure 8)

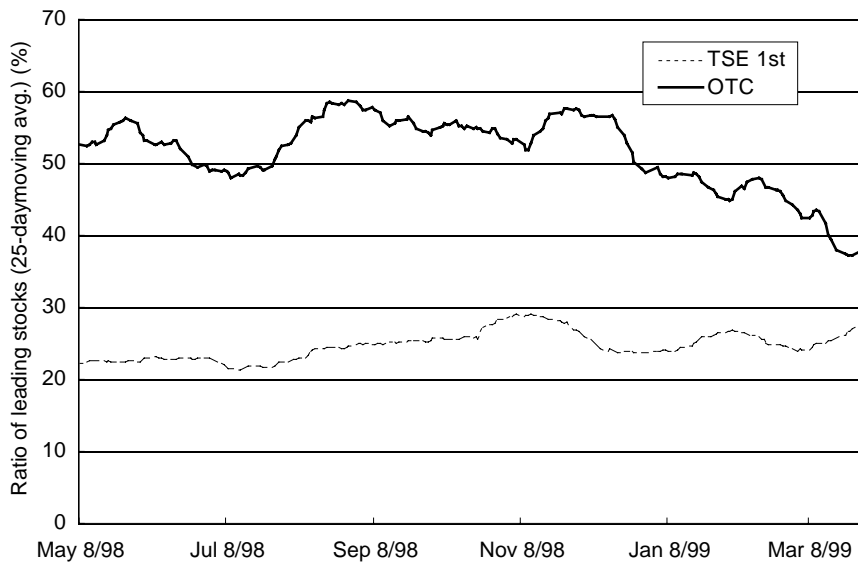
**Figure 8 Performance Comparison by Market Capitalization**



Note: The three groups were chosen so that the total market capitalizations were equal at the end of each month.

On the other hand, the 25-day moving average of the leading stock ratio ( ratio of the transaction value of the ten most active stocks to that of the overall market ) which had been fluctuating between 50-60%, fell to below 40% in March 1999. While still high compared to the TSE first section, this drop indicates that the disproportion of newly listed issues and other issues is causing the breadth of trading to gradually increase ( Figure 9 )

**Figure 9 Leading Stock Ratio ( 25-Day Moving Average )**



#### 4. Toward a More Attractive Market

The OTC market boasts many attractive companies that are maintaining high ROEs amid the recession, or developing new business areas amid the changing industrial structure. Moreover, the start of the market maker system has produced already noticeable improvement in liquidity. Yet major investors still seem to be unaware of the range of investment opportunities offered by the OTC market.

##### ( 1 ) Reform in Awareness of Listed Companies

The main reasons the OTC market is not seriously considered by investors are the lack of liquidity and information. The role listed companies can play in both these respects is large. In many cases, since a large portion of stock is held by the founder or parent company, there is an inevitable tendency to regard the interest of investors as identical to that of management ( Table 10 )

However, it goes without saying that investors are not interested only in performance measures such as ROE. In particular, companies need to aggressively facilitate the investment environment and improve the liquidity of their stock by reducing lot sizes or splitting stock to reduce the stock price.

In addition, OTC companies tend to be financially weaker and lacking in investment information compared to companies listed on exchanges, and must find ways to provide fuller disclosure, including more diversity in financial settlement release dates, introduction of quarterly reporting, and so forth. However, what emerges from the March 1998 financial statements is an inadequate stance on disclosure ( particularly from the concentration of settlement release dates; Figure 9 )

**Table 9 Concentration of Financial Settlement Release Dates**

Release date	TSE 1st	OTC
1998.5.21	15.1%	11.0%
1998.5.22	19.6%	32.3%
1998.5.25	7.5%	10.8%

Note: For companies with fiscal year ending in March 1998.

## ( 2 ) Reform of Market's Image

To be taken seriously by investors, the OTC market needs to create a more seductive image of itself.

A report issued by the Japan Securities Industry Association in November 1998 contained a bold proposal to reform the market's structure by establishing a new section for the most prominent and active issues.

This measure was originally planned for implementation this April, but has been postponed due to strong resistance from companies, as well as to the unexpectedly good progress of other reforms.

Issuing companies have the right to choose the market with the best environment, and investors also appreciate this. However, the fact that companies move on to the exchanges once they outgrow the OTC hurts the OTC market's image, because it loses its greatest asset when these top companies migrate.

To reform its image, the OTC market needs to establish the new section soon and create an environment that entices the best companies to stay; that is, offer companies the viable choice of being associated with other great growth companies.

It is well known that the prominent S&P 500 index contains some 40 NASDAQ companies. In the same way, if Japan's OTC market can nurture and retain the best growth companies, investors will quickly take notice.

## 5. Conclusion

This autumn, when trading commissions are completely liberalized on the exchanges, the terms of transaction will be identical for stocks listed on the exchanges and on the OTC market. The stock exchanges will also engage in reforms including relaxation of listing requirements and possible formation of a new market for venture companies. In addition, foreign investment is becoming more accessible due to the rapid growth of borderless internet-related businesses, revision of the Foreign Exchange Law, and advances in information and communications technology. In other words, the OTC market's rivals are not limited to the domestic exchanges.

**Table 10 Breakdown of Stockholders**

	Mean		Weighted mean (by market cap.)	
	OTC	TSE 1st	OTC	TSE 1st
Executives	18.8%	2.4%	19.0%	1.6%
10 largest stockholders	61.4%	44.4%	61.0%	43.2%
Financial institutions	14.2%	35.9%	16.0%	41.0%
Individuals	48.5%	27.6%	41.8%	18.6%
Foreigners	4.0%	7.7%	15.5%	14.5%

Japan's stock markets have an undesirable propensity of delaying vital reforms. For the OTC market, whose future is at stake, reforms are urgently needed now, especially since investors have begun concentrating their attention on the OTC market.

Fortunately, interest in OTC listings shows no sign of abating, including McDonald's Japan's stated intention to go public in 2002. The OTC market now needs to generate momentum by widely disseminating information on stock issues of greatest interest to investors, and work on expanding interest in the overall market.

To compete successfully with the exchanges, the OTC market faces an important decision on its future course: whether to provide added value through the market maker system and other means, and become a unique trading market; or to nurture venture companies and become more of a miniature exchange that specializes in small and mid-sized companies.