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Competition in Capital Markets – Note by Japan

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Japan

1. Introduction

1. The Japan Fair Trade Commission (JFTC) has undertaken a variety of initiatives related to competition in capital markets. This contribution paper introduces the following initiatives, organized into three categories: competition among sources of capital, exit-route competition, and business combination cases in capital markets.

1.1. Initiatives related to competition among sources of capitals

2. To understand the actual conditions of business practices of start-ups in a wide range of industries, the JFTC published the "Report on the Fact-Finding Survey on Business Practices of Start-ups" in 2020, which clarified how start-ups in Japan raise funds. Based in part on the results of this survey, the JFTC, in cooperation with the Ministry of Economy, Trade and Industry, formulated the "Guidelines on Business Partnership Contracts with Start-ups and Investments in Start-ups," which set out the JFTC's views based on the Antimonopoly Act (AMA) regarding investment contracts and other transactional relationships between start-ups and investors. In addition, to ascertain whether transactions are being conducted in line with the Guidelines, the JFTC conducted a survey of transactions and contracts between start-ups and investors.

1.2. Initiatives related to exit-route competition

3. Setting offering prices that reflect the corporate value of start-ups and demands, etc., can make it easier for them to procure necessary funds for the growth of their businesses. This leads to developing an environment promoting their growth in the markets and, consequently, to revitalizing the whole economy, which is desirable from the viewpoint of competition policy. Based on the above understanding, the JFTC conducted the "Inquiry on Initial Public Offering (IPO) Pricing Process, etc." and published the report in 2022. In light of the findings, in 2023, the JFTC issued a caution to Mizuho Securities Co., Ltd.

1.3. Business combination cases in capital markets

4. In the M&A case between Tokyo Stock Exchange Group, Inc. and Osaka Securities Exchange Co., Ltd. (FY2012), the JFTC concluded that, given the remedies that the parties presented to the JFTC, the business combination would not substantially restrain competition in services related to listing stocks on emerging markets, services related to trading stocks, and services related to trading Japanese stock index futures.

2. Initiatives related to competition among sources of capital

2.1. Fact-finding survey on investment in start-ups

5. As start-ups have the potential to greatly contribute to improving the productivity of the Japanese economy by promoting innovation, ensuring an environment in which start-ups can compete fairly and freely is crucial for future Japanese economic development. With this view, the JFTC conducted a survey to understand the actual state of business

practices of start-ups in a wide range of industries, from the perspective of promoting fair and free competition in start-ups' business activities and published the report on the "Fact-finding Survey on Business Practices of Start-ups" in 2020. The report presented cases that could potentially raise problems under the AMA, together with the JFTC's views on those cases under the AMA. It also clarified the actual conditions of start-ups' fundraising (investment) and exit, as described below.

6. It is often difficult for start-ups to obtain loans from a financial institutions because, when they start business, they have no track record of business performance, and, at the time of fundraising, they conduct business activities in a field with no or still-unclear demand, which makes their future sales are difficult to predict. Therefore, many start-ups procure the funds necessary for their business activities through direct financing, specifically, by issuing their own shares and obtaining investments from investors such as venture capital firms or operating companies. Investors that invest in start-ups mainly include operating companies, venture capital firms, corporate venture capital firms, and angel investors. At the time of the survey, investments by operating companies and venture capital firms constitute most of the total amount of investments in start-ups.

7. In addition, as the return on their investment in a start-up, investors seek capital gains, which are profits arising from an increase in the value of the shares the investors hold. Thus, when they invest in a start-up, they often require the start-up for an exit either by listing on a stock exchange or by being acquired by another company, within a period of about 10 years as an exit.

8. Initiatives related to exit-route competition are introduced in 3. below.

2.2. Guidelines on Business Partnership Contracts with Start-ups and Investments in Start-ups

9. In 2022, the JFTC, jointly with the Ministry of Economy, Trade and Industry, formulated the "Guidelines on Business Partnership Contracts with Start-ups and Investments in Start-ups" (hereinafter referred to as the "Guidelines") by revising the previous guidelines, which had addressed only business partnerships between start-ups and partner businesses. To facilitate successful innovation through business partnerships and investment succeed, the Guidelines aim to set out appropriate contract practices and approaches between start-ups and the businesses and investors that seek to partner with them. This paper presents excerpts from the Guidelines concerning investment in particular: problematic cases that may arise under investment agreements between start-ups and investors, and the views under the AMA on those cases.

2.2.1. Restrictions on trading partners

10. A start-up may be restricted by an investor from partnering or otherwise dealing with other enterprises, or from receiving investments from other investors. The views under the AMA and an example case that could be problematic, as set out in the Guidelines, are as follows.

(Views under the AMA)

> *It is not considered to be a problem under the AMA, in principle, if an investor restricts a start-up from dealing with other enterprises when it is necessary to maintain the confidentiality of the investor's know-how, etc. used in the start-up's goods or services. However, when an investor, which is an influential enterprise in the market, prohibits a start-up, for example, from dealing with other enterprises beyond a reasonable extent, and there is a risk that the prohibition may have*

foreclosure effects, such act of the investor may be problematic as trading on exclusive terms (paragraph (11) of the General Designation of Unfair Trade Practices) or trading on restrictive terms (paragraph (12) of the General Designation of Unfair Trade Practices).

(Example case that could be problematic under the AMA)

11. A company was made subject to a condition, added by an existing investor, to the effect that the terms of trade between the existing investor and the company would be changed to those that are considerably disadvantageous for the company if it received investments from a new investor. As a result, the company was effectively unable to receive investments from new investors.

2.2.2. Restrictions on research and development activities

12. A start-up may be prohibited by an investor from conducting research and development activities for new products, etc. The views under the AMA and an example case that could be problematic, as set out in the Guidelines, are as follows.

(Views under the AMA)

An investor's act to restrict a start-up's free research and development activities, such as prohibiting the start-up from conducting research and development by itself or jointly with a third party on technologies that compete with technologies held by the investor or its other investees, generally has a risk of diminishing competition in the future technology market or market of goods, etc. through its influence on competition in research and development. Accordingly, such an act is highly likely to be problematic as trading on restrictive terms (paragraph (12) of the General Designation of Unfair Trade Practices).

(Example case that could be problematic under the AMA)

13. A company intended to start developing AI system utilizing its own technology. However, its investor prohibited the development on the grounds that the AI system could compete with an AI system of another investee, and stated that it would terminate the investment agreement if the company did not comply. The company therefore had to give up the development.

2.2.3. Most favored treatment clause

14. A start-up may be subjected by an investor to a most favored treatment clause (a condition that makes the terms of the investor's transactions equal to or more favorable than those of other investors). The views under the AMA and an example case that could be problematic, as set out in the Guidelines, are as follows.

(Views under the AMA)

It is not immediately problematic under the AMA for an investor to establish a most favored treatment clause for a start-up. However, when an investor, which is an influential enterprise in the market, sets a most favored treatment clause for a start-up, and there is, for example, a risk that such a clause makes it difficult for its competitors to deal with the start-up on more favorable terms and reduces those competitors' incentives for a deal, thereby impeding competition between the investor and those competitors and resulting in having foreclosure effects, such an act of the investor may be problematic as trading on restrictive terms (paragraph (12) of the General Designation of Unfair Trade Practices).

(Example case that could be problematic under the AMA)

15. A company was made subject by an investor to a most favored treatment clause providing that, if another investor concludes an investment agreement with the company on more favorable terms in the future, the same terms will be applied to the investor. As a result, the company no longer received investment offers from other investors.

2.3. Survey on transactions involving start-ups

16. To examine whether transactions were being conducted in line with the Guidelines, the JFTC conducted written surveys covering transactions and contracts regarding start-ups including those between start-ups and investors: one targeting start-ups and another targeting partner businesses and investors. Based on the results, for cases in which abuse of superior bargaining position or other violations were suspected, the JFTC conducted hearings with 37 start-ups and on-site inspections of 13 partner businesses and investors. The JFTC compiled the results of these surveys and sent letters specifying concrete concerns to eight partner businesses and investors in which matters that could lead to problems under the AMA were found. The JFTC published the results of the survey in 2022.

3. Initiatives related to exit-route competition

3.1. Inquiry on Initial Public Offering (IPO) Pricing Process

3.1.1. Background and purpose of the inquiry

17. Setting offering prices that appropriately reflect the company values of start-ups and demand, etc., can make it easier for start-ups to raise the funds necessary for the growth of their businesses. This leads to developing an environment promoting their growth in the markets and, consequently, to revitalizing the whole economy, which is desirable from the viewpoint of competition policy. Based on the above understanding, the JFTC conducted an inquiry in 2022 into (i) the actual situation of the IPO pricing process, (ii) the actual situation of the variety of options for listing and (iii) the AMA issues regarding trade practices in IPOs for the purpose of examining possible causes of the phenomenon in which the opening price is much higher than the offering price from the perspective of competition policy and the AMA.

3.1.2. Market developments related to IPOs

18. Looking at the track records of securities companies in serving as lead underwriters for the 92 IPOs on the Tokyo Stock Exchange in 2020 (excluding those listed on the TOKYO PRO Market), the top five companies have a 90.2% aggregate share.

19. A lead underwriter is the principal securities company among those that provide start-ups with support services for listing preparations.

3.1.3. Issues under the AMA

20. Issues under the AMA identified in the report include, for example, the following.

Unreasonable interference with other securities companies' undertaking the role of a lead underwriter

(Actual situation)

> *The questionnaire and hearing inquiries did not confirm any clear practice of unreasonably interfering with other securities companies' undertaking the role of a lead underwriter. However, some securities companies stated that "other securities companies have interfered with our undertaking the role of a lead underwriter by exercising the influence of their affiliated banks and venture capital firms on start-ups."*

(Views under the AMA)

21. The report sets out the following view on unreasonable interference with other securities companies' undertaking the role of a lead underwriter:

> *If securities companies unreasonably interfere with other securities companies' undertaking the role of a lead underwriter by exercising the influence of affiliated banks and venture capital firms on start-ups, the interference can be an issue under the AMA (interference with a competitor's transactions).*

Exchange of information, etc. between securities companies

(Actual situation)

22. The hearing inquiry did not confirm any clear practice of exchange of information on the underwriting commission rate between securities companies, etc.

(Views under the AMA)

23. The report sets out the following view on exchange of information, etc. between securities companies:

> *In the future, an agreement on the rate of the underwriting commission among securities companies would be an issue under the AMA (unreasonable restraint of trade).*

Unilateral setting of offering prices, etc.

(Actual situation)

24. The questionnaire and hearing inquiries did not confirm any clear practice in which a lead underwriter with strong bargaining power unreasonably disadvantaged start-ups by, for example, unilaterally setting the offering price. However, one opinion stated that "the upper limit of the tentatively set price range was decided unilaterally. After the completion of the examination of recommendations, however, the lead underwriter could not be changed without significantly postponing the scheduled listing date, which was difficult for us to accept. We therefore could not change the lead underwriter."

25. The examination of recommendations is an examination conducted by the lead underwriter of whether a start-up is eligible for listing, so that the lead underwriter can recommend the listing to the stock exchange.

(Views under the AMA)

26. The report sets out the following view on unilateral setting of offering prices, etc.:

> *If it is recognized that a lead underwriter in a superior bargaining position unreasonably creates a disadvantage for start-ups in light of normal commercial practices by, for example, unilaterally setting an offering price in performing its duties as the lead underwriter, this can be an issue under the AMA (abuse of superior bargaining position). For example, if an estimated issue price is set low*

in the name of an IPO discount without an explanation of the reason, and not based on reasonable grounds, this can be an issue under the AMA.

3.2. "The JFTC Issued a Caution to Mizuho Securities Co., Ltd."

27. In April 2023, the JFTC issued a caution to Mizuho Securities Co., Ltd. (Mizuho Securities), on the grounds that Mizuho Securities' conduct may lead to a violation of Article 19 of the AMA (falling under Article 2, paragraph (9), item (v), (c) [abuse of superior bargaining position]).

3.2.1. Details of the case

28. An IPO takes place through the offering pricing process after the completion of the examination of recommendations. For start-ups that do not wish to postpone their scheduled listing date on a stock exchange, it is difficult to change the lead underwriter during the offering pricing process. Therefore, even if the lead underwriter makes a request that is significantly disadvantageous to the start-ups, it is considered that the start-ups will have no choice but to accept it. In light of the above, Mizuho Securities may be found to have been in a superior bargaining position to the start-ups that had difficulty changing their lead underwriter in the offering pricing process of the IPOs for which Mizuho Securities served as the lead underwriter.

29. In the offering pricing process of the 21 IPOs for which Mizuho Securities served as the lead underwriter, Mizuho Securities had set an estimated issue price or a tentatively set price range below the prices claimed by two start-ups (Company A and Company B), over which Mizuho Securities may have been found to have been in a superior bargaining position, and requested that the start-ups accept them as follows.

- Company A

30. Company A explained to Mizuho Securities the calculation method, level, etc., regarding the estimated issue price, which it had thoroughly examined based on a second opinion from another securities company. Mizuho Securities, however, did not sufficiently examine this explanation. It set an estimated issue price below the price claimed by Company A and requested Company A to accept it.

- Company B

31. When the tentative price range was set, one of the institutional investors whose opinions had been heard valued Company B's shares higher than the estimated issue price. Nevertheless, Mizuho Securities treated this investor's view as an opinion that the share price was appropriate merely because it had asked that institutional investor whether the estimated issue price was acceptable and had received a positive answer. In addition, Company B had met with institutional investors at a company information session and later presented the results of those meetings to Mizuho Securities. Without sufficiently explaining why it did not take those results into account, Mizuho Securities set a tentatively set price range below the price claimed by Company B and requested Company B to accept it.

32. As a result of complying with Mizuho Securities' requests, each of the two start-ups had an estimated issue price or a tentatively set price range set below the price it had claimed. The offering prices were then determined at levels close to or equal to these. Subsequently, the opening prices of both start-ups' IPOs were more than double the offering prices, significantly exceeding them. The start-ups could have raised more funds if they had been able to set the offering prices based on the prices that they had claimed.

3.2.2. Summary of the caution

33. Mizuho Securities had given specific explanations of the basis for setting the estimated issue price and the tentatively set price range. Taking this and other factors into account, the JFTC could not find that Mizuho Securities had gone so far as to unilaterally set prices without any rational basis. Although Mizuho Securities' conduct was not immediately found a violation of the AMA, it may lead to a lower offering price being set unilaterally by the lead underwriter with strong bargaining power and unfairly put start-ups at a disadvantage, which might result in adversely affecting fair and free competition. Accordingly, the JFTC issued a caution, as the conduct may lead to a violation of the AMA. This caution was an initiative based on the Inquiry mentioned above (the JFTC published the results of the Inquiry in 2022).

4. Business Combination cases in capital markets

34. The following introduces the acquisition by Tokyo Stock Exchange Group, Inc. of shares of Osaka Securities Exchange Co., Ltd. as a case in which the JFTC conducted a business combination review.

4.1. Outline of the case

35. In this case, Tokyo Stock Exchange Group, Inc., which has Tokyo Stock Exchange, Inc. (hereinafter "TSE") and other companies as its subsidiaries, planned to acquire shares in Osaka Securities Exchange Co., Ltd. (hereinafter “OSE”) and thereby to acquire more than half of the voting rights (hereinafter “the Business Combination”). The JFTC received the notification of the plan for the Business Combination in January 2012 and conducted a business combination review, including the secondary review. The JFTC concluded that, given the remedies proposed by the parties, the Business Combination would not substantially restrain competition. In July 2012, the JFTC notified the parties that it would not issue a cease and desist order. The outline of the review concerning services related to listing stocks on emerging markets and services related to trading stocks, which are among the fields of trade for which remedies were to be implemented, is as follows.

4.2. Services related to listing stocks on emerging markets

4.2.1. Particular field of trade

36. Services related to listing are the duties to receive each listing application and to decide whether clearance of eligibility for listing can be given to each application for actuals (share, bond, etc.), and to continuously manage and observe as to whether the eligibility of the actuals cleared to be listed is retained. With regard to the service range, there are main markets and emerging markets on which shares are listed. Given that in the case of Initial Public Offering (IPO), most companies choose emerging markets, the JFTC defined emerging markets as the service range. With regard to the geographic range, the parties argued that the geographical range of their businesses is Asian region. However, there was no confirmed tendency among Japanese companies to positively list their shares on Asian exchanges. Accordingly, the JFTC defined the geographical range as “all parts of Japan”.

4.2.2. Review concerning substantial restraint of competition

37. In the emerging markets, competition is mainly centered on winning IPOs. Based on the number of listings for the past five-year period, the combined post-merger market share of the parties would be around 95% (ranked 1st). After the Business Combination, the HHI would increase by about 3,700 to about 9,100, which did not meet the safe harbor thresholds for horizontal business combination.

Table 1. Market shares in the emerging markets based on the number of listings for the past five-year period

Rank	Company Name	Market Share
1	OSE (JASDAQ)	Around 70%
2	TSE (Mothers)	Around 30%
3	Company G	0 — 5 %
4	Company H	0 — 5 %
5	Company I	0 — 5 %
	Total	100%

38. With respect to the emerging markets, competition between the parties would be lost as a result of the Business Combination, which would create a state of quasi-monopoly. There would be no effective constraint, such as competitive pressure from users or from neighboring markets, on the market power of the parties. In addition, with respect to services related to listing stocks on the emerging markets, it was not confirmed that the parties aggressively use fees as a method for attracting new listings. However, according to the results of interviews and questionnaire surveys with users, fees related to listing stocks are not insignificant for a company that plans to list its shares on an emerging market. Given the present circumstances, if either of the parties raises fees related to listing stocks to a substantially high level, it would place the fee-raising party at a competitive disadvantage against the other party. Accordingly, it was confirmed that with respect to raising fees there was a certain degree of mutual constraint between the parties.

39. Considering the above, a situation may arise in which the parties, which would stand in a position of quasi-monopoly in services related to listing stocks on the emerging markets as a result of the Business Combination, may have some discretion to raise fees for services related to listing stocks. It was therefore considered that the Business Combination may substantially restrain competition in the field of trade for the services related to listing stocks on the emerging markets.

4.2.3. Remedies proposed by the parties and their assessment

40. The parties proposed the following remedies:

- Decisions on fees related to listing stocks on the emerging markets will require, without any time limit, the approval of an advisory committee composed of persons other than the parties.
- For ten years following the Business Combination, the parties will report the following to the JFTC: the establishment or abolishment of fees, the change of fee amounts, the change of the Advisory Committee Rules (limited to the changes concerning fees related to listing stocks on the emerging markets), the change of

the Rules on the Board of Directors (limited to the changes concerning fees related to listing stocks on the emerging markets), etc.

41. The JFTC judged that these remedies would be effective against the competitive concerns under the AMA arising from the Business Combination, considering the following points:

- The members of the advisory committees are considered able to express their opinions independently.
- Most members of each advisory committee are board members, executive officers, or employees of securities companies. These members wish to see companies newly listed, and so tend to share common interests with their clients wishing to list their shares. They may, therefore, function as a constraint on inappropriate fee increases by the parties.
- The public functions that exchanges have and an effect of supervision by the Financial Services Agency concerning the process of changing fees may restrain, to a certain extent, the parties' ability to raise fees related to listing.

4.2.4. Conclusion

42. It was considered that, given the remedies the parties proposed, the Business Combination would not substantially restrain competition in the field of trade for the services related to listing stocks on the emerging markets.

4.3. Services related to trading stocks

4.3.1. Particular field of trade

43. A service related to trading actuals, including shares, means a service that allows investors to conduct a trade in actuals by establishing a financial instruments exchange market or by operating a Proprietary Trading System (hereinafter, a “PTS”), either of which is necessary for such trading, and to execute trades between investors. The actuals include shares, government bonds, convertible bonds and ETFs, etc. The characteristics of those instruments greatly differ from one another. As a result, there was no substitutability of demand between different actuals. Accordingly, the JFTC defined each service range for each of actuals. The JFTC examined the services related to trading shares that account for a large portion of the services related to trading actuals. In addition, the services related to trading shares are conducted by exchanges and PTS operators in Japan. Accordingly, its geographical range was defined as “all parts of Japan”.

4.3.2. Review concerning substantial restraint of competition

44. The combined market share of the parties in the services related to trading shares was around 95%. Following the Business Combination, the HHI would increase by about 1,000 to around 9,300, which did not meet the safe harbor thresholds for horizontal Business Combination. In addition, PTS operators (Company J and Company K in the table below) and local exchanges existed as competitors of the parties, but the market share of each was small.

Table 2. Market shares of trading share related services in 2011

Rank	Company Name	Market Share
1	TSE	Around 90%
2	OSE	Around 5%
3	Company J	0-5%
4	Company K	0-5%
	Others	Marginal
	Total	100%

45. TSE had held an overwhelmingly strong position in the market with respect to services related to trading shares even prior to the Business Combination, and it was not recognized that OSE was exerting strong competitive pressure against TSE. However, the Business Combination would eliminate OSE, which was effectively the only competitor of TSE. Since there was no effective constraint, such as competitive pressure from users or from neighboring markets, the dominant position of TSE on the market would be maintained and reinforced.

46. On the other hand, PTS operators had been growing rapidly as competitors in recent years. Competitive pressure from PTS operators was expected to become stronger as a result of amendments to the regulations applicable only to them. However, for PTS operators to function as a source of competitive pressure, it was considered necessary to promotion of new entry and growth of PTS operators that Japan Securities Clearing Corporation (hereinafter "JSCC"), a subsidiary of Tokyo Stock Exchange Group, Inc., assume the clearing of trades executed on their systems, that is, assume the obligations relating to the delivery of the shares and the payment of the consideration once a trade has been executed. At the same time, there was a concern that, if PTS operators expanded their market shares and came to exert strong competitive pressure on the parties, JSCC might foreclose or give discriminatory treatment to them.

47. If, however, JSCC foreclosed or gave discriminatory treatment to PTS operators, this could result in a loss of competitive pressure from the PTS operators against the parties. This could also give rise to a condition in which the parties may have some discretion over determining prices, etc. Accordingly, it was considered that the Business Combination would substantially restrain competition in services related to trading shares.

4.3.3. Remedy proposed by the parties and its assessment

48. The parties proposed to the JFTC a remedy by which JSCC would continuously assume clearing operations concerning the sale and purchase of shares for competitors of the parties in the future on terms and conditions that are not substantially discriminatory and do not place competitors at a competitive disadvantage. If the remedy the parties proposed was implemented, it was considered that a condition in which PTS operators can continue to entrust JSCC with the clearing operations would be ensured and that competitive pressure from the PTS operators against the parties would not be lost.

4.3.4. Conclusion

49. It was considered that, given the remedy the parties proposed, the Business Combination would not substantially restrain competition in the field of trade for services related to trading shares.