(Referential translation)

Consultation Paper "Review of TSE Cash Equity Market Structure"

December 21, 2018

Tokyo Stock Exchange, Inc.

Introduction - Background

Japan Exchange Group (JPX) was established in January 2013 via the business combination between then Tokyo Stock Exchange Group, Inc. (now Tokyo Stock Exchange, Inc.; TSE) and then Osaka Securities Exchange Co., Ltd. (now Osaka Exchange, Inc.; OSE). Each exchange's cash equity markets were integrated in July 2013, generating a synergy that would raise competitiveness internationally.

The market structure in general was kept unchanged when integrating the TSE and OSE markets, in order to minimize any unnecessary burden on potential or existing listed companies and avoid confusion for investors, which may have occurred if the listing rules had been revised. Thus, currently, there are four market divisions catering to retail and professional investors (1st Section, 2nd Section, Mothers and JASDAQ), each with its own set of listing criteria.

Five years have passed since the said integration, and it has become more evident that the integrated market structure needs improvements. To explore this matter, TSE established the Advisory Group to Review TSE Cash Equity Market Structure (herein after referred to as the "Advisory Group") in October 2018, which serves as a venue for expert discussion of the optimal market structure for the cash equity market.

Purpose of Review

The current market structure provides companies of various types (i.e. business characteristics, sizes and industries) with the opportunity to list. TSE's current structure of market divisions divide listed companies' according to their type, aiding investors in their investment decisions, and thus creating an accessible market environment.

In practice, majority of companies have aspired to be listed on the 1st Section after their initial listing on the 2nd Section, Mothers and JASDAQ. The hierarchical design of the current market structure has played an important function in motivating listed companies to improve their total value as a corporation in the medium and long term, and to enhance their internal management structure.

Taking into account the role the market structure plays, <u>it is important that TSE reviews the market structure in order to further incentivize listed companies to proactively improve their overall</u>

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value as corporation, in addition to further attracting diverse global and domestic investors by providing attractive investment opportunities. Conducting a review of the market structure, with the aim of supporting these roles, will further contribute to the development of a sustainable capital market and, by extension, the wider Japanese economy.

This consultation paper was prepared by TSE, taking into consideration the discussions at the Advisory Group meetings, and summarizes the main discussion points for consultation of the optimal market structure. TSE invites comments from a wide range of stake holders and market participants, regarding the discussion points outlined in this consultation paper.

(Referential translation)

I. Entry-level market divisions (2nd Section, Mothers, and JASDAQ)

(1) Current Situation

The current TSE cash equity market provides various companies with listing opportunities, and TSE has divided the market segment of the entry-level markets for newly listed companies into two separate categories: one investment pool for more established companies provide, where relatively risk-averse investors can invest, and the other for the startup companies with relatively high investment risk but with high growth potential.

After the cash equity market integration, Mothers has provided listing opportunities to start-up companies[1], whereas the 2nd Section and JASDAQ (Standard) to established companies.

<Market for Startup Companies>

Mothers provides listing opportunities to companies with a high growth potential, so that these companies can grow by raising capital through listing, helping to foster innovation and develop new industries .

Approximately 50 companies list on Mothers every year. It has established itself as the go-to market for startup companies to list their stocks. However, some companies list their stocks, not with the goal of further growth, but to allow for founders and/or venture capital firms to exit their investments. Some argue that there are insufficient incentives for companies to achieve their expected positive growth following their listing. Therefore, it is necessary to develop a framework that incentives and motives startup companies to realize sustainable growth following their listing.

In addition, despite the fact that around 50 companies are newly listed each year, only a limited number of investment-intensive companies (R&D-focused), that have a high demand for capital, have been provided with listing opportunities. For example, investment-intensive companies, such as biotech companies, conduct extensive R&D prior to production, thus taking a longer time to commercialize their product than other businesses, resulting in the potential reporting of losses after listing. Additionally, the biotech industry is a highly specialized business area with unpredictable future revenue stream. Therefore, the investment risk of these companies is relatively high. In promoting and developing new industries, it is critical to create an attractive environment for these investment-intensive companies, giving them the opportunity to list their stock and broaden their ability to raise capital.

[1] No stock has been listed on JASDAQ (Growth) since the market integration.

<Market for Established Companies>

The market for established companies provides listing opportunities to companies with an established business track record, and is an investment pool for relatively risk-averse investors Every year, both the 2nd Section and JASDAQ (Standard) each attract approximately 10 new listed companies, showing a certain degree of appetite amongst companies to list their stocks.

However, there is a view that the current listing criteria for the 2nd Section and JASDAQ (Standard) do not set an appropriate minimum standard and are insufficient for relatively risk-averse investors. For example, the listing criteria for JASDAQ (Standard) does not set any minimum standard for the ratio of tradable shares (i.e. how many shares are publicly held and tradable by public investors). Therefore, companies can list their stocks with only a small number of public shareholders holding their shares, making it an unattractive investment for risk-averse investors. Currently there are two different set of listing criteria for 2nd Section and JASDAQ (Standard), however, in view of these arguments, an optimal set of listing criteria and a minimum standard for established companies needs to be reconsidered.

(2) Call for comments on:

<Market for Startup Companies>

(i) What is the ideal incentive-mechanism for startup companies to promote growth following their listing?

- What framework or criteria is needed to promote the sustainable growth of startup companies following their listing?
  - ✓ For example, are the current Mothers and JASDAQ (Growth) disclosure framework and delisting criteria[2] effective (in the current structure, are there part of the framework or delisting criteria that inhibits the growth of startup companies)? Is there a better framework?

(ii) What are the ideal listing criteria or framework for the startup companies' market?

- One of the questions would be, given the previous example of investment-intensive companies, and in view of the investment risk of these companies, what would be the ideal listing criteria or framework for these companies, so that they can be provided with appropriate listing opportunities?

[2] Obligation to hold Investors Meeting for Mothers listed companies, or delisting criteria regarding financial results at Mothers and JASDAQ (Growth), obligation to prepare Mid-term business plan for JASDAQ (Growth) listed companies and 10-year rule for Mothers listed companies (in order to establish Mothers as market for start-up companies, after 10 years from new listing, Mother's listed companies have to choose whether to stay in Mothers proving high growth potentials or transfer to 2nd Section as established company).

<Market for Established Companies>

(iii) What are the ideal listing criteria or framework for the established companies' market?

- As opposed to startup companies, established companies have an established business track record, which makes their stocks a suitable investment instrument for relatively risk-averse investors. Given this, do the current listing criteria or framework of the 2nd Market and JASDAQ need to be reviewed?

II. Ideal step-up market division (1st Section)

(1) Current Situation

The 1st Section is one of the divisions of the Main Market (1st Section and 2nd Section) and structured as the market for companies with higher liquidity than 2nd Section listed companies. However, the 1st Section is also regarded as the market for companies that represent and lead the growth of the Japanese economy. The 1st Section is positioned as the market where newly listed companies in the entry-level markets aim to "step-up" to after their initial listing.

For companies listed on other market divisions to "step-up" to the 1st Section, for example from the 2nd Section, companies need only have a market value of 4 billion JPY. Therefore, newly listed companies can "step-up" to the 1st Section without much growth in their overall value as corporation following their initial listing. Also, amongst the 1st Section listed companies, there are instances where listed companies impair their overall value as corporation. Therefore, in some instances the level of the 1st Section listed companies' corporate governance and internal management structure is not sub-optimal and may not differ significantly from companies listed on other market divisions. Additionally, some believe that the criteria for transferring companies out from the 1st Section are insufficient do not function properly.

These concerns have resulted arguments in favor of higher standards of listing criteria and higher obligations for companies to list and maintain their listing on the 1st Section. Therefore, it is necessary to review the listing criteria and framework of the 1st Section, so that listed companies are motivated to maintain and improve their overall value as corporation, and meet the Japanese and overseas investor expectations of the 1st Section.

(2) Call for comments on:

(iv) What are the ideal listing criteria and obligations that companies listed on the "step-up" market should be required to meet?

- For example, should listing criteria, in terms of corporate scale, liquidity (public share holder ratio etc.), and/or the governance structure and internal management structure be reconsidered and what could be reconsidered? If so, what could be reconsidered about the standards of those criteria?

(v) When companies listed on the “step-up” market no longer meet the required listing criteria and obligations, what should be the ideal treatment of these companies?

III. Ideal market exit (delisting)

(1) Current Situation

To maintain orderly financial markets and to provide appropriate investor protections, when listed companies are no longer suitable for investment by retail and professional investors it is necessary for the stock of such companies to be removed from the centralized public market. The delisting criteria outline the minimum standard for a company to maintain its listing, with a purpose to remove those stocks not suitable for investment by retail and professional investors. These act not only as criteria to determine which stock should be delisted, but certain delisting criteria also incentivize listed companies to take proactive action to improve governance and restructure their business to avoid delisting.

Some concerns have been raised that the current delisting criteria do not appropriately serve their purpose. For instance, the minimum market capitalization criteria could be too low, or the insolvency and financial results delisting standards do not adequately incentivizes companies to proactively restructure their businesses, nor do they act as appropriate functions to delist the stocks of companies whose business model has failed. Given these concerns, the current delisting standards need to be reviewed to ensure they are functioning as intended.

Unlike other countries, in Japan, the secondary market for non-listed companies’ stock is effectively non-functioning[3]. Therefore, when companies are delisted, existing shareholders are no longer able to sell their stock holdings. Therefore, in order to appropriately and effectively delist and remove stocks from the centralized public market, consideration needs to be given to the mechanism for allowing existing shareholders to sell a delisted stock.

(2) Call for comments on:

[3] Japan Securities Dealers Association operates the Phoenix issues system as a scheme for supporting opportunities for investors to convert stocks delisted from exchanges into money and rehabilitation of delisted companies, no stocks have been designated as Phoenix issues since the end of June, 2016.

(vi) What are the ideal delisting criteria?

- Do the delisting criteria need to be reviewed? If so, what could be reconsidered about the current delisting criteria? What would be the optimal mechanism for shareholders to sell and their stocks after delisting?

Ⅳ. Other Issues

In order to support the growth of listed companies' overall value as corporation and expand the range of attractive investment instruments, increasing opportunities for investors, is there anything else related to the cash equity market structure that you feel need to be discussed or reviewed.[4]

Call for comments on:

(vii) Are there other issues with the listing framework to be reviewed?

- In view of supporting growth of listed companies' overall value as corporation and providing attractive investment opportunities to investors, are there other listing criteria, frameworks or discussion points that require review or discussion?
- What other issues need to be considered in conducting a further review of the market structure (divisions)?

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[4] As, the ideal market structure and its framework are reviewed and discussed, one important consideration is that the actual criteria and evaluation points should not be overly prescriptive. Therefore, in reviewing the cash equity market structure and listing criteria, we will take into consideration the balance between formal criteria and substantive criteria that will suit the actual conditions of companies. Therefore, we would like to solicit comments on this issue as well.