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Significance of Japan Exchange Group's formation and future challenges

Sadakazu Osaki

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Nomura Research Institute, Ltd.

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Sadakazu Osaki
Head of Research
Center for Strategic Management and Innovation

NOTE

1) To be precise, the TSE's holding company was merged into the OSE, which was then renamed Japan Exchange Group, and a new OSE operating subsidiary was spun out of the newly merged company.

2) More precisely, Tokyo Stock Exchange Regulation is not a subsidiary but a self-regulatory entity incorporated by the TSE and TSE Group under the Financial Instrument and Exchange Act.

3) The OSE currently clears derivative trades in-house.

1. Advent of JPX

The Tokyo Stock Exchange (TSE) and Osaka Securities Exchange (OSE) merged in January 2013 to form Japan Exchange (JPX) Group[1], setting the stage for an historic business integration of the TSE and OSE, hitherto east-west rivals for nearly 130 years.

JPX aims to be the preferred exchange in Asia by creatively providing reliable, publicly beneficial, and high-quality services under the aspirational slogan "Your Exchange of Choice." In short, JPX aims to be Asia's top exchange.

The JPX Group is a holding company that initially will control the existing TSE and OSE, together with Tokyo Stock Exchange Regulation and Japan Securities Clearing Corporation (JSCC), as operating subsidiaries[2]. The TSE and OSE will remain organizationally unchanged for time being, except that they are now under the control of a holding company. JPX plans to consolidate its cash market operations (First and Second Sections, Mothers, JASDAQ, and Tokyo Pro Market) into the TSE, self-regulatory functions into Tokyo Stock Exchange Regulation, and clearing functions into the JSCC[3] by a target date of July 2013. As a result, customers' margin deposits will be consolidated into a single balance for all JPX markets. Next, JPX will consolidate its derivatives markets (e.g., JGBs, equity indices) into the OSE, slated to be renamed the Osaka Exchange (tentative name), by a target date of March 2014. If this two-phase integration proceeds as planned, JPX will complete its reorganization into a group of single-function operating subsidiaries controlled by a holding company during fiscal 2013 (Exhibit 1).

Exhibit 1: JPX Group after reorganization of operating subsidiaries

	Holding company		
Self-regulation entity	Cash market operating company	Derivatives market operating company	Clearinghouse

Source: TSE and OSE

2. Benefits of integration

The TSE commands an overwhelmingly dominant share of domestic cash equities trading while the OSE's strength lies in derivatives trading. By integrating the two, JPX will be a well-balanced exchange group with a strong presence in both cash and derivatives markets. As JPX's scale of operations grows, its exchanges' operational stability should increase over the medium to long term.

Near term, JPX is expected to derive the most concrete benefit from integrating trading systems and clearing functions. Integration of the TSE and OSE's duplicative computer systems, including their respective trading systems, should reduce operating expenses and depreciation. The annual cost savings realizable from such system integration is estimated at around ¥7 billion[4].

4) The TSE and OSE's aggregate operating revenues totaled ¥75.5 billion in fiscal 2011.

Additionally, consolidating clearing functions into JSCC will enable customers' margin deposits to be consolidated into a single balance for all trades in similar derivatives, such as TOPIX and Nikkei 225 equity index futures. When the Chicago Mercantile Exchange (CME) and Chicago Board of Trade (CBOT) merged in 2007, consolidation of margin deposits for trades in the CME's S&P 500 futures and CBOT's DJIA futures reportedly spurred substantial growth in trading volumes. While trading volume is largely a function of the market environment, improvement in trading efficiency should help to boost volumes.

The Exchange's cultures also are likely to change. The TSE has often been criticized for being overly bureaucratic, perhaps because of its role in market-wide institution-building. However, now that it has been merged into the OSE to form JPX, a listed company, JPX executives who have spent their entire careers at the TSE will for the first time be forced to earnestly engage with shareholders, including foreign funds. Once these market operators are themselves subjected to the market's judgment, they are likely to become more progressive in terms of organizational culture and how they operate their markets.

3. Future challenges

(1) Improvement of international stature

While JPX stands to reap many benefits from integration, it also faces a number of challenges. Its most urgent challenge is to strengthen its competitiveness and upgrade its international stature as an exchange group.

As the TSE and OSE have emphasized, once the JPX Group's cash markets have been consolidated into the TSE, the TSE will in fact be ranked number-one in Asia and number-three in the world by listee companies' aggregate market capitalization. Despite such impressive rankings, JPX is by no means already Asia's top exchange, nor will it be able to easily achieve this distinction.

In the wake of economic globalization, advancements in information, communication and computer technologies, and the advent of new electronic trading systems, the world's exchanges now engage in fierce cross-border competition. Such competition has been accompanied by aggressive consolidation among exchanges. For example, NYSE Euronext, operator of the New York Stock Exchange, the world's largest equity market, sought to merge with Deutsche Boerse in 2011, but the merger was blocked by the EU on antitrust grounds.

In terms of its listee companies' aggregate market capitalization, JPX is ranked first in Asia and third in the world behind the NYSE and Nasdaq, the flagship exchanges of two of the world's top exchange groups, NYSE Euronext and Nasdaq OMX.

NYSE Euronext operates cash equities exchanges in five countries: the US, France, the Netherlands, Belgium, and Portugal. It also owns NYSE Liffe, one of Europe's leading derivatives exchanges. Nasdaq OMX operates the Nordic derivatives market and seven cash exchanges in northern Europe and the Baltics in addition to its US markets. It also provides trading systems for more than 70 other markets in 50 countries.

JPX's rivals are thus diversified exchange groups with large footprints in terms of operating both cash and derivatives markets and providing trading systems. Moreover, the recent wave of international consolidation among exchanges is by no means over, as evidenced by the recent news that IntercontinentalExchange (ICE) agreed to acquire NYSE Euronext on December 20, 2012.

When exchange groups are ranked by their own market capitalizations, the most objective measure of their true stature, JPX trails well behind not only NYSE Euronext and Nasdaq OMX but also Hong Kong Exchanges and Clearing and Singapore Exchange (Exhibit 2).

Stock prices of course vary from day to day. The possibility that JPX's stock may command a far higher valuation than the OSE's stock ever did cannot be ruled out[5].

5) The OSE's current share price already discounted the benefits of TSE-OSE integration once it became clear that the TSE's takeover bid for the OSE was successful and would lead to JPX's formation. Its share price seems unlikely to move much solely in response to the JPX transition.

Exhibit 2: World's leading exchanges by market capitalization (at January 11, 2013)

($bn)

1	Hong Kong Exchanges and Clearing	21.36
2	CME Group	17.95
3	BM&F Bovespa	13.61
4	Deutsche Boerse	12.03
5	IntercontinentalExchange	9.41
6	NYSE Euronext	7.95
7	Singapore Exchange	6.32
8	ASX Group	5.99
9	London Stock Exchange Group	5.06
10	Nasdaq OMX Group	4.38
11	JAPAN Exchange Group	3.67
12	TMX Group	2.84
13	CBOE Holdings	2.78
14	Dubai Financial	2.50
15	Bolsas y Mercados	2.45

Source: Bloomberg

Conversely, the lofty valuations of exchange operators such as Hong Kong Exchanges and Clearing and BM&F Bovespa could conceivably be temporarily inflated by expectations of synergies from recent M&A or future restructuring.

However, with exchange groups using their stock like currency to acquire other exchanges, JPX would be in serious jeopardy if unable to attain a market valuation high enough to preclude being acquired relatively easily by a rival, although it is currently protected from takeover by legal restrictions[6].

6) The Financial Instrument and Exchange Act (Article 106(14)-1) generally prohibits any single shareholder from owning more than 20% of the shares of a financial instrument exchange holding company such as JPX. As an exception to this general rule, a foreign exchange that meets certain requirements would be permitted to own up to 50% of JPX (FIEA Article 106(17)-1, FIEA Enforcement Ordinance Article 19-3(3)-2) but it could not acquire JPX as a wholly owned subsidiary.

(2) Transformation into a diversified exchange

The fact that JPX has a smaller market capitalization than rival exchanges reflects another challenge–namely, transformation into a diversified exchange that offers trading in a broad range of derivatives, including commodity derivatives.

To be sure, the OSE has built a successful derivatives trading business. However, it is undeniably dependent on a single product, the Nikkei 225 equity index.

In contrast, many overseas rivals are diversified derivative exchanges that offer trading in not only equity indices but also a wide range of other derivatives, including financial (e.g., currency, interest rate), commodity (e.g., precious metals, raw materials), credit, and even weather derivatives. Such rivals have multiple bread-and-butter products. Exchanges with strong derivatives trading businesses are regarded as highly competitive companies, as evidenced by the relatively unknown ICE's pending acquisition of the venerable NYSE Euronext.

The OSE has of course long pursued transformation into a diversified exchange, having recognized the riskiness of its overdependence on Nikkei 225 index products. However, truly diversified exchanges that offer trading in a broad range of derivatives under the oversight of a single regulator were outlawed in Japan until recently, largely due to a lack of consensus among the Financial Services Agency (FSA), which regulates securities exchanges and other financial instrument exchanges, and the Ministry of Economy, Trade and Industry and Ministry of Agriculture, Forestry and Fisheries, which regulate commodity exchanges.

Diversified exchanges may finally become a reality in Japan as a result of a September 2012 amendment of the Financial Instruments and Exchange Act (FIEA). Once the amended FIEA takes effect in January 2014, if a financial instrument exchange establishes a commodity-related market through a merger with or acquisition of a commodity exchange, the commodity exchange's market participants will be eligible to trade on the financial instrument exchange's newly established market. Additionally, regulatory supervision of such diversified exchanges will be centralized in the FSA.

If JPX decides to transform itself into a diversified exchange, realistic acquisition targets include Tokyo Commodity Exchange and Kansai Commodities Exchange (slated to be renamed Osaka Dojima Commodity Exchange in February 2013), both of which have seen their trading volumes slump in recent years. The question is whether JPX would be able to build a highly competitive diversified exchange by "rescuing" a struggling exchange. It also remains to be seen whether any domestic commodity exchange would welcome a takeover bid in the first place.

(3) Sustaining a sense of urgency

As mentioned above, there are high hopes that the TSE and OSE's organizational cultures will be transformed by virtue of JPX being a listed company. At the same time, there are concerns that JPX will be unable to achieve such a transformation and management discipline will slacken.

In any event, JPX will have monopoly status in the domestic market, with a nearly 100% share of trading in cash equities, equity index derivatives, and bond derivatives.

Consequently, the Japan Fair Trade Commission thoroughly scrutinized the TSE-OSE merger from the standpoint of antitrust law[7]. During the business integration process, JPX is required to implement measures to eliminate de facto restraints on competition. For example, decisions on revision or elimination of listing-related fees will be delegated to an advisory body made up of outsiders. The FSA decided in late October 2012 to review its takeover bid regulations, which have been criticized as an impediment to expansion of proprietary trading systems' utilization. It presumably did so in recognition of a need to expose the post-integration JPX to adequate competitive forces.

7) For more details, see http://www.jftc.go.jp/en/pressreleases/120704.pdf.

A merger between two companies naturally gives rise to various internal frictions. To avoid such frictions, executives and managers often succumb to the temptation of deferring hard decisions on issues such as consolidating duplicative functions and merging organizational units. Moreover, in the case of a company like JPX, such procrastination will not have an immediate adverse effect on earnings despite international competitive pressures. A company with de facto monopoly status in its domestic market is unlikely to immediately experience earnings deterioration even if it procrastinates in dealing with the challenges it faces.

To maximally reap the benefits of business integration, JPX's management team must exercise strong leadership in implementing management reforms without worrying about internal frictions.

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about NRI

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Inquiries to : Financial Technology and Market Research Department
Nomura Research Institute, Ltd.
Marunouchi Kitaguchi Bldg.
1-6-5 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan
E-mail : kyara@nri.co.jp

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