A Reexamination of Japan's Securities Exchange Regulations

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The Financial System Reform Act, which was enacted on June 5, 1998 at a session of the Japanese Diet (Parliament), fundamentally revises Japanese securities and financial market regulations. Here, the provisions of the Act aim to reevaluate the securities exchanges and the over-the-counter markets, approve the establishment of a proprietary trading system (PTS) and mergers among securities exchanges will be examined.

1. Background of the Reexamination of the Securities Exchange Regulations

The British "Big Bang" after which Japan's financial reforms are modeled called for reforms through elimination of the fixed commission system in the stock market, discontinuance of the "single capacity system" that separated jobbers from brokers, and shift from floor trading to electronic trading. The Japanese version of the Big Bang, which is far more extensive than its predecessor, focuses on the reform of securities exchanges as one of its important elements.

Conventional Securities Exchange Regulations

Under the Japanese Securities and Exchange Law, the establishment of the "securities market" for securities trading has been exclusively assigned to licensed securities exchanges. Other organizations have not been permitted to establish facilities similar to the securities markets with criminal sanctions.[1]

Under the regional monopolization system, eight exchanges in Japan have had their own assigned territory. In listing its securities, a company is required to do so on the exchange whose territory covers the place of the company's head office, though simultaneous listing on other exchanges is allowed.

Moreover, the exchanges have been exempted from the application of Anti-monopoly Law.[2] They have heavily regulated their member traders' behavior by imposing restrictive obligations

1 Article 87-2 of the former Securities and Exchange Law. Penalties are specified in Articles 198-13 and 200-15 of the former Law.

2 Securities exchanges and Securities Dealers Associations, which have been established under the Securities and Exchange Law, are exempted from the provisions of the Anti-Monopoly Law under Article 2-2 (f) of the Law Regarding Exemption From the Anti-Monopoly Law.

such as market concentration rule and the fixed commission system.[2]

These systems were based on the traditional thinking to realize fair prices and protect investors by concentrating supply and demand for securities in exchanges which were jointly established by securities dealers in respective regions. However, the rapid development of computer technologies and telecommunications in recent years have dramatically changed the environment presupposed by these systems.

Changes in the Environment Presupposed by Traditional Regulations

There are at least three major changes. First, the emergence of electronic trading systems has made it possible to participate in trading even if one is off the trading floor of the exchange. This has weakened the necessity to give regional monopoly to exchanges, and created a situation in which exchanges in different regions compete with each other in taking orders. More significantly, the currently developing "border-less economy" is helping expand such competition on a global basis.

Second, the cost of providing the functions characteristic of exchanges is decreasing. As a result, competition has emerged between the traditional exchanges on one hand, and a well-organized OTC market like NASDAQ Market, and so-called PTSs (proprietary trading system outside the securities exchanges) which are operated by securities broker-dealers such as Instinet and POSIT.[3]

Third, the development of telecommunications infrastructures and information systems has made it technically possible to provide real-time information on quotations and transaction reporting. This development has lessened general concerns that competition among markets and trading outside exchanges might lead to market fragmentation and hamper the formation of fair prices.

With the awareness of these changes in the business environment, a report presented by the Market WP of the Securities and Exchange Council in June 1997 explicitly indicated the direction of reforms for making Japan's entire securities market more competitive by introducing the system based on a new attitude of promoting competition among markets and allowing competition between institutionalized markets and outside-market trading for opportunities of execution.

2. Outline of the Reexamination of Exchange Regulations in the "Financial System Reform Act"

1) Shift to a System Presupposing Competition among Markets

(1) Revaluation of the Position of the OTC Market

Japan's Securities and Exchange Law limited the definition of regulated "securities markets" to those established by exchanges, and imposed regulations different from those for general securities transactions. However, for stock trading, there is the OTC stock market operated by the Japan

3 In the U.S. recently this is often called Alternative Trading System (ATS) rather than PTS.

Securities Dealers Association (JASD) as a trading place which is organized as efficiently as a stock exchange. This market, which is called JASDAQ market, has been treated as complementary to exchanges according to the report of the Securities and Exchange Council published in 1983.

Under the new system introduced by the Reform Act, the traditional securities market established by the exchange is now called "the exchange securities market"(Paragraph 12, Article 2 of the amended Securities and Exchange Law; hereafter the provisions of the amended law will be shown by their numbers only). At the same time, the amended law has an additional provision that allows the Securities Dealers Association to operate "an OTC trading securities market" (Paragraph 2, Article 67). Now it is expressly shown that the exchange market and the OTC market are intended for fair competition on equal terms.

The provisions of the Securities and Exchange Law regarding the Securities Dealers Association are based on the existence of several associations.[4] It is possible, therefore, for a new securities dealers association set up by securities firms to establish an OTC trading securities market outside the present OTC market. However, the OTC trading securities market is intended for distribution of securities that are not listed on the exchange, and thus is not permitted to trade listed securities (Paragraph 2, Article 67).

It is also prohibited to establish a market similar to the exchange securities market or the OTC trading securities market, and to deal in securities on such a market (Article 167-2).[5] This point will be further discussed in the section for the PTS.

(2) Reexamination of Regulations Regarding the Establishment of Securities Exchanges

With the exception of two cases, the Sapporo Stock Exchange which was established in December 1949 and the Kobe Stock Exchange which was closed in October 1967, there has been no establishment or dissolution of exchanges in Japan over more than 50 years since World War II. However, with competition becoming keener among markets, there is the possibility of new exchanges being established or the existing exchanges going bankrupt. Smooth entry or exit of competing players is the prerequisite for ensuring competition. It is from this viewpoint that in amending the law, the regulations regarding the establishment of exchanges have been reexamined and the provisions for mergers have been provided.

Reexamination of the Regulations Regarding the Establishment of Exchanges

In the past it was stipulated that exchanges be established by "securities companies". Under the amended law, the "securities companies or foreign securities companies defined by the Cabinet order" (Paragraph 1, Article 81) are allowed to establish exchanges. This step has paved the way for branch offices of foreign securities companies, which were established pursuant to the Foreign Securities Broker-dealers Act, to establish exchanges. Regulations regarding the establishment procedures have also been improved in order to facilitate actual establishment by specifying that the promoter should hold the foundation general meeting and that prospective members should pay

4 In fact, prior to the establishment of the present Japan Securities Dealers Association through integration of regional associations in July 1973, there were several securities dealers associations established with official approval pursuant to Paragraph 2, Article 68 of the Securities and Exchange Law.

5 Penalties are stipulated by Article 198-16 and Article 200-15, and their contents remain unchanged.

their contributions by the day of the general meeting (Article 81-2).

The amended financial system law has eased regulations regarding the new entry procedure by changing from licensing to registration. The establishment of exchanges still requires licensing from the Minister of Finance and the Prime Minister (Paragraph 2, Article 81). However, the amended law eliminated the so-called "economic provision" (former law, Paragraph 2-3, Article 82) regarding licensing standards which called for consideration of the number of securities companies, the situation of securities transactions and the number of listed companies in the area where the establishment of exchanges is planned. This means undoubted removal of the regionally monopolistic position of exchanges.

Specification of the Rules Regarding Mergers among Exchanges

Rules regarding the exit of exchanges were limited to the stipulation that their dissolution should be based on resolution by the members or cancellation of the license. The amended law has added a rule regarding mergers among exchanges.

The procedure for a merger requires the preparation of a written merger agreement containing prescribed items, sanction to the merger at the general meeting and approval from the Finance Minister and the Prime Minister (delegated to the head of the Financial Supervisory Authority) (Article 135-2). It is stipulated that the Minister of Finance and the Prime Minister should confirm that the articles of association, working rules and contract provisions of the exchange to be established fully comply with the laws, that trading by the liquidated exchanges through mergers would be effected smoothly on the market, and then "should approve the merger" unless unqualified members are found among directors or unless false statements are found in the application (Article 135-3).

It is also stipulated that the merged exchange should take over the right and duties of the dissolved exchange, including those held pursuant to licensing and permission by the administrative agencies (Article 135-5).

2) Reexamination of Market Concentration Rule and Approval of Proprietary Trading Systems

(1) Reexamination of Market Concentration Rule

Members of securities exchanges in Japan were required to observe market concentration rule which prohibited trading of listed securities, excluding bonds, outside exchanges pursuant to the articles of association of the exchanges (Article 23 for the Tokyo Stock Exchange, for instance). Because of this stipulation, these members had to route orders to the exchanges even if trading could be executed at a price more favorable to their customers than quotations at the exchange, and they were unable to meet the needs of large-lot investors who wanted to have their orders executed outside the exchanges simply to keep their large orders from affecting market prices in what is called market impact.

Imposing the market concentration rule on the members according to articles of association is an act to hamper competition among members or between members and non-members. In the

United States, the Supreme Court decision in the case of Silver v. NYSE in 1963 triggered discussions over the relationship between prohibition of off-floor trading and the anti-monopoly law.[6]

Then under Rule 19c-3 of the SEC's 1934 Rules adopted in 1980, application of the prohibition of off-floor trading has been removed for the stocks listed after April 27, 1979.

As was explained earlier, no legal problems have arisen in Japan because exchanges were given privileges under the Japanese Anti-Monopoly law. Non-exchange members were subject to strict application of compulsory on-floor only trading.[7] To remove this market concentration obligation, the Market WP Report of the Securities Exchange Council has made the following five suggestions.

(1) To remove the market concentration obligation in the exchanges' articles of association.
(2) To limit the prices of stocks traded outside the exchanges during market hours to a certain range of exchange prices.
(3) To allow securities companies to execute trading outside the exchange only when investors explicitly want the execution outside the exchange.
(4) To oblige securities companies to immediately report to the self-regulating organization on the contents of trading done outside the exchange.
(5) To apply fair trade rules to trading taken place outside the exchange.

In response to these suggestions, the Financial System Reform Act changes the regulations regarding off-exchange trading. As a step to realize suggestion (3) above, the amended law had added a provision (Article 37) that when securities companies receive orders regarding trading of listed stocks, they "should not execute trading outside the exchange's securities market unless the customers expressly instruct trading to be executed outside the exchange's securities market." The range of securities that fall under this regulation is determined by the Prime Minister's Office Ordinance and the Finance Ministry Ordinance.

As a step to realize suggestion (4) above, securities companies are required to report to the Securities Dealers Association, to which they belong, on trading of listed stocks done by their own account or by customers' account according to the above rules, as to the type and name of the listed stocks, as well as trading price and volume (Article 79-2 No.4). The Association is required to notify its members of this trading and make an announcement about the trading volume, high, low and final prices and other items of the reported trading and report to the Finance Minister about daily market prices and other items (Article 79-3 and 79-4).

Suggestions (1) and (2) above will be studied by the Tokyo and other Stock Exchanges regarding their realization.

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6 Mr. Silver, a non-member of the NYSE, set up a securities firm for trading municipal bonds and corporate bonds and installed direct phone lines within NYSE members' offices to receive their orders. In protest, the NYSE removed these lines. The Supreme Court decided that NYSE's action was tantamount to group boycott which is prohibited by the Sherman Act and that such act cannot be construed to be eligible for exemption from the application of the anti-monopoly law unless it is within the minimum range necessary to achieve the purpose of the Securities Exchange Act. See Joel Seligman, The Transformation of Wall Street, Northeastern University Press, 1995, pp.384-386.

7 Article 66-2 of the former Securities and Exchange Law stipulates that the exchange's articles of association should be considered in supervising the exchange's non-members. Primarily based on this provision, business instructions for non-member companies required explicit recording of member companies which have placed orders for listed stocks.

(2) Approval of Proprietary Trading Systems

In the United States, the electronic trading system called the PTS, which allows the execution of trading of listed stocks outside the exchange, is being widely used especially by institutional investors.

In Japan, by contrast, PTS activity has been slow in getting on track because trading of listed stocks has been concentrated on the exchange by securities companies, including non-member companies, and because the formation of such framework has been feared to infringe the Securities and Exchange Law's provisions against facilities similar to exchanges. However, if compulsory market concentration rule is removed, there will likely arise a move in Japan to provide the functions similar to those of the PTSs. The Financial System Reform Act represents legal preparedness to cope with possible emergence of the PTS.

The PTS is basically considered as a trading system operated by securities broker-dealers in the U.S. The amended law treats the PTS as part of securities business in Japan as well. It is now defined as "the system that allows those who are simultaneously engaged in securities transactions using electronic data processing systems with many other parties, or who act as an intermediary, agent or agency for that trading (Paragraph 8-7, Article 2). The trading price in such trading or action should be determined by any of the following methods.

(1) The price for listed securities will be determined using the exchange's trading price.
(2) The price of securities registered at the OTC market established by the Japan Securities Dealers Association will be determined using the trading price announced by the Association.
(3) The price based on negotiations among customers will be used.
(4) The price will be determined by using the method specified by the Prime Minister's Office Ordinance and the Finance Ministry Ordinance.

Methods (1) and (2) are regarded as what is called the crossing system, in which the closing price or the weighted average price in the exchange market is made the trading price and it is crossed with the same number of buying or selling orders. In the U.S. this role is played by institutions such as Instinet and POSIT. Method (3) seems to have been modeled after the function of negotiations installed in the Instinet. Instinet provides the function for the institutional investors in trading to express their intention to trade in the form not yet final, and then negotiate with other participants, who have seen this information, on quantity and price.

Some American PTSs employ a price setting method different from any of (1) to (3) above. For instance, the Arizona Securities Exchange (AZX) adopts the so-called call auction system, in which a participant in trading inputs his/her desired price and volume, and execute trading when demand coincides with supply within the prescribed time.[8]

In ordinary trading through Instinet and on Bloomberg's Trade Book, a transaction can be settled when the price and volume in selling orders are crossed and coincided with buying orders. It is not clear whether such a scheme is contained in method (4), and if price-forming function is to be judged to be as efficient as that of exchange, such a scheme would not be allowed to operate under the provision.

8 Legally the AZX is given a special position as an exchange exempted from registration requirement, but actually it is on the same level as the PTSs which are registered as broker-dealers.

The Financial System Reform Act requires a shift from the traditional licensing system to the registration system for new entries into the securities business. However, this PTS business for underwriting of securities and OTC derivatives trading of securities, as well as their intermediary, agents or agency cannot be undertaken without authorization by the Prime Minister (the power is delegated to the head of the Financial Supervisory Authority) (Paragraph 1, Article 29). The reason may be that the PTS business plays a market role close to that of exchanges and thus has a more public nature than an ordinary securities business entity. In addition to registering as an ordinary securities broker-dealer, it is customary in the U.S. for the PTS to apply to the SEC for the issue of no-action letter to the effect that it be exempted from the duty of registration as a securities exchange.

Authorization of PTS business is preceded by examination of the method for deciding selling and buying prices, methods of delivery and whether the contents of the business and methods are necessary and adequate for the protection of public interest and investors. The undertaking of PTS business will also require making a report on the participants in trading, as well as trading price and volume. The proposed rule recently announced by the SEC of the U.S. (Regulation ATS) obligates ATSs, which are operated by broker-dealers and the Securities Dealers Association, to report on the contents of a system or its changes, ensure transparency in terms of price and trading volume and disclose the information on quotations.[9]

3) Reexamination of Regulations for the Management of Securities Exchanges

If market competition is realized among exchanges, the OTC market and PTS, exchanges will have to transform themselves from the traditional monopolistic public organizations into business enterprises that provide market infrastructure. In fact, European and US exchanges, which have been exposed to market competition earlier than their Japanese counterparts, are becoming more like business entities and endeavoring to reinforce system capabilities, identify prospective companies for listing, and expand information promotion.[10]

This situation has invited some criticism that strict regulation of exchanges is deterring efforts to strengthen competitiveness. The Financial System Reform Act aims to introduce the idea of competition among markets, and enhance the market's discretion by relaxing regulations regarding the management of the exchanges.

Reforms to Ensure Greater Discretion of Securities Exchange Management

In the past exchanges were prohibited from engaging in business other than that directly necessary to achieve the purposes of their establishment (former law, Paragraph 2, Article 86). It is not unusual for European and US exchanges to rent their surplus office space or sell the software they have developed, whereas Japanese exchanges are strictly bound to perform specialized business.

The amended law has removed this restriction as well as the provision "Securities markets shall

9 SEC, Release No.34-39884, Regulation of Exchange and Alternative Trading Systems, April 18, 1998.

10 For such changes in exchanges, see "Japan's Securities Markets: The Real "Hollowing Out" Problem", by Yasuyuki Fuchita and Sadakazu Osaki, *NRI Quarterly*, Winter 1994.

not open more than one securities markets" (former law, Article 87). When the securities exchange's second section was established, discussions emerged over whether the section might infringe on this provision. The provision was construed to hamper even the opening of a new market intended for venture business in the place other than the location of the exchange.

However, the amended law does not go so far as to allow the exchange to change into a pure business enterprise that aims to earn profits. The provision prohibiting exchanges from engaging in profit-making business has been retained (Article 86). In prewar days in Japan, exchanges formed as business corporations tried to increase its trading through encouraging speculative transactions of its own shares. This history may have caused strong resistance to commercial business operations by exchanges.

Reexamination of the Listing Approval System

The system to designate the qualification certificate substitutable for membership confidence money and the system for its collateral value (the former law, Paragraphs 2 and 3 of Article 97) as well as the approval system for listing and delisting of securities (the former law, Paragraph 1 of Article 110 and Article 112) have been removed. Under the amended law, membership confidence money will be determined by the articles of association of the exchange (Paragraph 2, Article 97), and a report to the Finance Minister will suffice for listing and delisting (Paragraph 1, Article 110 and Paragraph 1, Article 112).

However, listing and delisting of futures and options still require the Finance Minister's approval (Paragraph 2, Article 110 and Paragraph 2, Article 112). This step seems to reflect the high risk of futures and options. The system for the Finance Minister's order regarding the listing of shares unlisted on the exchange, whose certificates are issued by the issuers such as the exchange, has been retained (Article 111).

Liberalization of Brokerage Commissions

Stock trading commissions, which have posed a problem in the U.S. from the viewpoint of the anti-trust law, will be fully liberalized in Japan under the Financial System Reform Act. In other words, the rule that exchanges should stipulate the commission rate and the collection method in their rules on contracts (the former law, Paragraph 2-4, Article 130) and the rule that the members should collect brokerage commissions from the customers in the amount determined by the exchange (the former law, Article 131 have been deleted. Restrictions on margin requirements for futures trading have also been deleted (the former law, Article 132).

Although major portion of the Financial System Reform Act will be enforced as from December 1, 1998, the provisions concerning the liberalization of brokerage commissions will take effect on a day between December 1, 1998 and December 31, 1999 as will be specified by a Cabinet Ordinance.

3. Significance and Challenges of the Latest Reforms

The latest amendment of exchange regulations represents full introduction of the idea of competition among markets, which has received little attention in Japan's securities market in the past. It paves the way for possible competition in Japan among the exchange market, the OTC market, and PTSs (or ATSs) as the providers of services (supply of market functions). The law has major significance and is comparable to the 1975 amendment of the Securities Exchange Act of the U.S. which introduced the concept of a National Market System (NMS) and approved competition among markets.

The 1975 amendment of the U.S. act was intended to cope with changing realities such as growing competition among markets, expanding trading outside exchanges, and the emergence of PTSs. However, the situation is different in Japan. The markets are undoubtedly involved in ongoing international competition, but competition among markets within Japan is still an ideal rather than a reality, which is to be materialized someday in the future. Therefore, in response to the changing circumstances, the recently amended regulations and rules may require constant reexamination.

For instance, the amended law is based on the understanding that the PTS is a system which uses the price-forming function of an exchange but whose price-forming function is not so efficient as that of the exchange.[11] This understanding comes from the thinking that a system with the price-forming function as efficient as that of the exchange should be subject to regulation as an exchange.

This attitude itself may be adequate[12] , but it poses problems in view of the provisions that the exchange is a membership organization composed of its founding securities companies as its members and that a profit-making business is prohibited. In other words, while a securities company is naturally permitted to individually engage in profit-making business operations, the PTS is not permitted to pursue profit when its price-forming function becomes as efficient as the exchange, and is forced to change into a membership organization composed of more than one securities firm.[13] Some constraints will likely arise due to such regulations and pose a new problem in the course of actual establishment of PTSs in the future.

11 *Securities and Exchange Council WP Report*, p.6

12 There is a view in the U.S. that application of the exactly same restriction as that on the exchange may restrict new entry of PTSs. Basically the SEC seems to have adopted this position.

13 A securities exchange is required to dissolve itself when the number of its members drops below five (Article 134-3).