
Major Changes in the Stock Market and the Response of Asset Management Firms

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As a result of the complete deregulation of brokerage commissions to be scheduled, the advance towards the adoption of electronic stock trading and an increased awareness of fiduciary duties, Japan's asset management firms will enter into a more committed engagement in its efforts to reduce transaction costs.

1. Historic changes are taking place in stock trading in Japan

1) Off exchange trading has started

In 1999, Japan will completely remove all restrictions on brokerage commissions. However, ahead of this, from December 1998, the ban on off exchange trading was lifted. In this area of off exchange trading, stock exchange brokerage commission regulations do not apply and the cost of trades is fixed through free negotiations between the institutional investors and the securities firms.*¹ Look at the situation since the start of off exchange trading, as will be mentioned later on, principal trading or basket trading have become the general practices. In December 1998, the percentage of trade executed in off exchange trading in the area of listed stocks accounts for 3.2% of total trading (First Section of TSE). There is a visible trend for some institutional investors to focus more on off exchange trading.

The ban on PTS (Propriety Trading Systems), that is to say electronic securities trading systems, was lifted in December 1998 at the same times as that on off exchange trading. At the present time, no systems have yet been authorized. However, this year it is expected that a new initiative will be launched.

There have also been major changes in the OTC market. A full-scale market making system was introduced on November 2, 1998. Based on the applications made by securities firms, the issues subject to market making have begun to emerge. Up to now, almost all orders were matched by an order-driven system using the JASDAQ system. However, regarding the securities subjected to market making, this matching system is not used.

2) The importance of attaining best execution

Thus, the stock trading environment in Japan is undergoing historic changes. Under these circumstances, serious efforts are being made by the securities firms, asset management firms and pension funds, etc. to achieve appropriate trade execution prices, trade execution costs and trade

*1 For details, see "Lifting of the ban on off exchange trading in Japan" by Sadakazu Osaki, *Capital Research Journal*, Spring 1999

execution methods. The age of the conventional system of using the stock exchanges such as TSE or the OTC markets and placing orders with fixed commission rates has passed. It has become essential to aim for the best execution by comparing various execution points.

The increased interest in the nature of order execution is not only being caused by changes in systems such as the deregulation of brokerage commissions and the lifting of the ban of off exchange trading. Another important background factor is the rapid increase in awareness of fiduciary duty in the area of pension funds and pension management institutions.

In June 1996, the Ministry of Health and Welfare published a report entitled "Toward the establishment of fiduciary duty in Japan". Starting from this point, in March 1997, "Guidelines on fiduciary duty relating to asset management of welfare pension funds" and in April 1997 "Guidelines relating to the role and responsibility of persons engaged in asset management welfare pension funds" were issued. Reflecting this movement, the Welfare Pension Fund Association issued a "Fiduciary duty handbook (For Pension Fund Director)" in March 1998. It is intended to continue to discuss the formulation of guidelines on the fiduciary duty of management institutions.

In addition, it is stated in the report "Fund management in the age of deregulation" issued by the Asset Management Committee of the Welfare Pension Fund Association in November 1998 that "the achievement of total execution cost management and best execution are becoming important objectives in line with the increasing complexity and diversification of execution points channels and trading methods compared with the situation up to now."

2. The actual nature of the changes

The changes in Japan we have looked at so far such as brokerage commission deregulation, the lifting of the ban on off exchange trading and the increased awareness of fiduciary responsibility represent the same kind of situation as that faced by the US asset management sector about 25 year ago. However, the actual situation in Japan is that the changes have just started and in many aspects the situation may be different to that in the US. It is expected that Japan will go through a period of trial and error. Followings are current situations of changing Japanese market structures and investment management industry.

1) Off exchange trading

In the area of basket trading, the use of stock exchange could involve higher trading cost since the fixed commission system is not totally abolished. Thus, off exchange trading tends to be given preference. Besides, in basket trading, conventionally, it has been the general practice for securities firms to make a rate bid. Basically, the position and status of the stock exchange as a facility has been relatively low. Some firms have even started off exchange trading of individual stocks, Nevertheless, in many cases this is still a subject for future studies by asset management firms.

When market making is undertaken off exchange, the factors which contribute to lower costs include the fact that the fee payable to the stock exchange is eliminated and there is no overt commission involved and there is no consumption tax on commission. However, there are various factors which make people hesitate to engage in off exchange trading including insufficient liquidity, and at the moment a side by side comparison of securities firms' indications cannot be made and both buy side and sell side do not have adequate systems in place for processing trades executed off

exchange.

Even so, there are some securities firms and asset management firms that are making progress in creating compatible systems, and so these problems are likely to recede with the passage of time. From January 1999 more securities firms and asset management firms are engaging in off exchange trading. Some of the asset management firms engaging in off exchange trading show signs of intensifying their operations in this area. Thus, off exchange trading is expected to continue to show an increase trend for some time to come.

However, when brokerage commission are completely deregulated by the end of 1999, relatively speaking there will be a decrease in the attractiveness of off exchange trading such as freely fixable commissions and unrestricted spread fixing. Processing of trades at stock exchanges is fairly standardized and efficient. Besides, there is a full-scale movement towards improving the competitiveness of stock exchange markets as seen in the introduction of an electronic trading market called J-NET on January 25 1999 at Osaka Stock Exchange. Thus, unless the securities firms create markets which are very easy to use and are adequately satisfactory in terms of liquidity, there is a possibility that there will be a partial return to trading on stock exchanges. Regarding liquidity, one problem area is that Japan Securities Finance Company cannot be utilized for off exchange trading. In order to improve this situation, it is necessary to develop the stock lending market.

In addition, it is being pointed out that it may be difficult for securities firms to continue to take positions on their own account and display prices competitive to the stock exchange trading in the medium-term, and the credit risk and settlement risk of securities companies are also pointed out. As we will discuss in the next section, there is an increasing interest in best execution. These are discussions on the subject of what response is most appropriate in terms of best execution in the event of the opportunity presenting itself of either trading on the stock exchange or off exchange trading with multiple securities firms. It is very difficult to determine to what extent off exchange trading will expand and develop.

2) Best Execution

(1) The deregulation of brokerage commissions and the issue of fiduciary duty

As previously mentioned, in terms of the changes in the environment surrounding institutional investors in the US the deregulation of brokerage commissions is a major factor. In Japan, brokerage commissions were liberalized for transactions of 50 million-yen or over in April 1998. In addition, off exchange trading also started and it is reported that by October 1999 brokerage commissions will be completely deregulated. As is the case in the US, in addition to explicit brokerage commissions, there is also a rapid increase in awareness of the problem of how to reduce other implicit costs. It has been decided to abolish transaction tax on securities. Thus, the significance of explicit costs will decrease still further.

As was the case in the US, due to the heightened awareness of the responsibilities of fiduciaries, this change will become even more marked. In recent years there has finally been intensification in the trend for Japan's pension fund sponsors to demand detailed reporting regarding management costs and management systems from the asset management firms employed. The detailed information in the reports is examined and analyzed, and based on this they select the firms they wish to employ and effect strict cost control.

In view of this, the asset management firms are exercising strict controls on the commissions they pay out to securities firms. This is based on the ability of the securities firms to provide researches, execute trades and other services. At the same time, they are becoming even more selective in the way they choose the securities firms they deal with. Some institutional investors have reduced the number of securities firms they deal with by half over the past five years.

In order to forecast future developments, attention is being fixed on discussions contained in the report issued by the Asset Management Study Group of the Welfare Pension Fund Association entitled "Fund Asset Management in the Age of deregulation" issued in November 1998. In this report, the following important issues are addressed.

"The need to effect total cost control including implicit costs to respond to the complexity and diversification occurring in trading methods and execution points."

"The generation of awareness that the achievement of best execution is a part of the fiduciary responsibility and the necessity of demonstrating to the management institutions that the funds themselves are monitoring the execution costs."

"Naturally, the management institutions must also implement strict and thorough cost control. In order to measure phenomena such as timing costs and opportunity costs, it is necessary to establish a system to shorten the time a trader needs to place an order with a securities firm based on the investment decision of the fund manager."

(2) An approach to best execution

Although interest has built up in execution cost control including implicit costs, we are faced with the problem of how to measure and evaluate this cost. In discussions in the US, execution costs are considered not only to be a factor in commissions, trade size and the liquidity of the issue, but are also seen as major factors in management style and the reputation of asset management firms. In view of this, it is thought that it would be ideal to establish some kind of benchmark for evaluation purposes. In the US, some consulting firms collect the data on executions of each asset management firm and a side by side comparison is made of funds with common management styles. In Japan also, some securities firms and information vendors have started to provide services involving the measurement of execution costs. However, they do not yet provide services comparable to those available in the US.

Recently, among Japan's asset management firms, it is becoming common practice to implement separation of portfolio managers and traders with the object of confirming a commitment to reducing execution costs. In the US, against the backdrop of the advances made in the separation of portfolio managers and traders, it is considered important that the portfolio managers not only spend time on dealing with securities firms and observation of the daily changes in stock prices, but also devote time to considering the state of the overall portfolio. It has also been demonstrated that the method of execution has a major influence on the trading costs.

In reality, with this system it will take some time before the desired effects are achieved. However by separating these two functions, it is said that there is intensification in the will to make a clear distinction between the two jobs. This is also expected to lead to a reduction in execution costs and interest in electronic trading.

At this moment, even if efforts are made to separate these two roles, there may be confusion as

there is not yet a system in place to effectively evaluate the execution cost. For example, if large execution costs were involved in a certain transaction, this may be due to several different factors. This may be due to a low level of ability on the part of the trader or just that the fund manager pushed too hard for an order execution for an issue with a very low level of liquidity.

It is expected that several full-scale changes will take place including the deregulation of brokerage commissions, the use of off exchange trading and the introduction of PTS. These changes are a movement towards fulfilling the need to reduce execution costs. At the same time, they will bring about an increase in market making and a diversification in where executions are implemented. Thus, they will make the evaluation of execution much more complex than is now the case. The movement towards a reduction in execution costs will make the measurement of costs more difficult, and we are going to have to face this dilemma.

(3) The present state of thinking

Thus, a strong awareness of the importance of reducing execution costs has evolved. However, there are no easy answers to questions such as how costs should be cut or how to measure the effectiveness of the reductions made. In this regard, the position is that various discussions are in progress and attempts are being made even in the US. The appearance of services in which a side by side comparison is made of execution data of various asset management firms has only occurred in recent years. Moreover, not all asset management firms utilize these services. Recent research shows that even if sophisticated methods are used such as employing benchmarks calculated based on various elements such as investment style etc., due to unmeasured elements such as the object of the trade, the execution costs vary greatly. Thus, even if the best execution is aimed for, it is difficult to achieve.^{*2}

In Japan, there is some talk of trying to aim for the best execution for each trade and demanding that executions should be made at the minimum commission rate and the optimal price. If this line of discussion is pursued, it will lead to abolishing the conventional way of execution which was to distribute commission budget to the securities firms employed to carry out execution commensurate with their services and to keep score of research and execution abilities and other factors of securities firms. Instead, selecting the securities firm which offers the lowest commission rates and the best prices at any particular time would become mandate.

In the US, the SEC issued a release on the definition of best execution. In this release, it stated that when choosing a brokerage, it is not just a matter of selecting the lowest possible commissions. The client should take into account all the services offered by securities firms and the level of these services such as trade execution abilities, the value of the researches offered, the commission rate, the financial responsibility, and the speed at which a reaction is made to the requirements of the investment managers. In this respect, Japan should not go extreme and consider various factors including a properness of the soft dollar system.

As far as a consensus has been reached that total execution costs including implicit costs, the important points are that each firm should continue to engage in cost reductions in its own way and they should not underestimate execution costs because they are not a concrete concept. As there is no single clear and complete answer, each asset management firm should take into account their

^{*2} Keim, D. & A. Madhavan "The Cost of Institutional Equity Trades", *Financial Analyst Journal*, July/August 1998

own management philosophies and the nature of each fund, and they should explain to the sponsor their thinking on what is the best choice under this environment in terms of firms or funds. The process of seeking better responses from securities firms and vendors is considered very important. If the efforts made to achieve best execution are appropriate, in the final analysis, this will be reflected in an improvement in the management performance of the asset management firm.

In the US, the SEC has established a rule under which the investment advisory firm must disclose on form ADV the factors taken into consideration when deciding on the best execution. When making a contract, it must be based on the details disclosed in this form. In Japan, it is desirable to create disclosure rules or guidelines on best execution in an appropriate form, and this should include the guideline on soft dollar concept.

3) PTS and Optimark

In the revised Securities and Exchange Law enforced in December 1998, it became possible to introduce PTS (Proprietary Trading System, or now called ATS: Alternative Trading System in the US) in Japan. However, as of now, no cases of authorization being granted have emerged.

Asset management firms are adopting a cautious approach to the introduction of PTS. The reasons for this are that they have not yet switched over to electronic operations, they have not yet become accustomed to sophisticated trading system environment and, in many cases, in large scale transactions the securities firms provide the liquidity to enable the transaction. Thus, with PTS it is not certain as to what degree of liquidity will be available. In addition, there are credit risk and settlement risks as in the case of off exchange trading.

In the existing stock exchanges various efforts are being made to achieve reforms to meet needs that could be covered by PTS as can be seen in the J-NET installed at Osaka Stock Exchange and TosTNet installed at TSE. Many institutional investors are maintaining a flexible stance because, if PTS is easy to use and has liquidity, it would be acceptable to use it.

Regarding Optimark, the most advanced system being tried in the US, Osaka Stock Exchange has announced that it will introduce it in the spring of 2000. In April 1999, Japan Optimark Systems Inc. is scheduled to be established with the main investors being Nihon Keizai Shimbun and QUICK and the firms that will operate the system. Some asset management firms are displaying interest in this. And some are getting ready to invest in it. This system has just started to be used in the Pacific Stock Exchange, and depending on its performance there, there is a possibility that a movement towards consideration of investment in and utilization of the system may get underway.

4) IT strategies in Japanese stock exchanges

In the case of Japanese asset management firms, the movement to separate the fund managers and traders has just begun. However, the use of electronic system to handle screen based order tickets is minimal. Several vendors provide a service for the placement of orders from buy-side traders to securities firms. However, this is not yet utilized on a full-scale basis. Moreover, currently each vendor offers the use of its own terminal with different specifications. Thus, the securities firms are in the process of having to install all these differing terminals if they want to do business with the buy-side vendors. The switch to electronic system in the middle office and back office has not yet progressed very far and so the average asset management firm is a long way away

from installing STP (Straight Through Processing).

However, there are also changes taking place in the stock market environment, as we have seen in this report. Thus, recently, active discussions have begun to emerge on the subject of introducing STP and FIX. In the case of FIX a working committee was established on December 15 1998. Prior to this, some participants of the FIX committee such as the Osaka Stock Exchange and Daiwa Securities, etc. have been installing FIX compatible system on an independent basis. In addition, other vendors such as QUICK and NRI are preparing to install FIX compatible systems. Fujitsu and Hitachi have already produced commercial models of the FIX engine.

Regarding the Japanese version of FIX, in March 1999 the FIX Japan version FIX ver.4.1-J will be released, and in April it is expected to be approved. This is a faster pace than was originally expected. FIX is a movement towards standardization with the emphasis on front office operations. On the other hand, ISITC is a system mainly seeking to standardize back office operations. For this, ISITC Japan was established on December 24, 1998.

The backdrop to this increase in interest in the utilization of systems includes the reasons we have mentioned so far such as reducing execution costs and the necessity for evaluation of best execution. In addition, in order to cope with the Y2K problem it will be necessary to review systems anyway. At that time, it will also be necessary to think about systems that will become necessary in the future to cope with future changes. Moreover, it is intended to introduce market price accounting systems, and so it will become necessary to obtain a fast understanding of the market price of funds.

However, there are still numerous asset management firms that are lacking in enthusiasm for the switch to electronic systems. One reason for this is as follows. They think that even if FIX is installed and systems are created centering on the front office, there will still be a large amount of delivery of actual securities, and so the advantages of setting up systems will not be felt. If there is an increase in deposits to the securities depository organization to expedite the use of electronic systems in settlements and delivery, under the current commission system of this organization, some people think that costs would rise considerably if electronic systems were used.

Regarding this, it is desirable that a clear commitment to the introduction of the T+1 settlement system should be made by those concerned including the regulatory authorities as one aspect of an overall reform of the settlement system, and it is desirable to aim for a thoroughgoing improvement in cost efficiency.

5) Tie-ups with European and US asset management firms and global management systems

The European and US asset management firms are engaged in global management systems. They are seeking to achieve a situation in which the STP levels in each country are able to transcend regions and work together such as links to trading desks in each country. There are only a limited number of Japanese asset management firms which are able to operate global management systems on their own. However, as a result of the recent movement for tie-ups with European and US asset management firms, many Japanese asset management firms are now find themselves being a part of such global management systems.

In cases where the overseas management of funds being managed by Japanese asset management firms are handled by the European and US asset management firms they have tie-ups with, and the Japanese portion of funds being managed by European and US asset management firms are handled

by the Japanese asset management firms, if there is no global STP linkage system in existence, it is difficult to undertake appropriate portfolio management and trading and the confidence of the client cannot be obtained. The implementation of STP in Japan has not yet taken root, and so the establishment of global systems such as these by the Japanese asset management firms is a very challenging task.

Conclusion

Thus, the Japanese asset management firms are about to take same road as that taken by the US asset management firms. As Japan is confronted by the example of the extremely advanced system in the US it knows that it faces rapid changes. However, in reality Japan is not yet able to catch up with the US.

In the area of best execution, Japan is still at the trial and error stage. There are also major delays in the modernization of settlement systems. Under these circumstances, even if a firm makes great efforts in IT, it may not result in significant increase in its efficiency.

However, seen in reverse, this is a good time to gain a clear vision of the future. The asset management firms should not concentrate too much on superficial commission levels. They should work towards an reduction of total trade costs and implement a systematic approach involving electronic systems. Eventually, major differences in performance will emerge between asset management firms that actively engage in this movement and the firms with a low awareness of the necessity for this.