Ongoing Reform of Japanese Stock Market

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1. Intermarket Competition and Reform of Japan's Stock Exchange System

It is five years since the principle of intermarket competition was accepted in Japan when the Big Bang program of financial reforms came into effect in December 1998.

"Intermarket competition" refers to the fact that stock exchanges and other markets such as the proprietary trading systems (or alternative trading systems) run by securities companies compete with one another to attract orders. In Japan the widespread view that stock exchanges and other such markets are public institutions rather than private business meant that calls to encourage competition among securities markets fell on deaf ears for many years.

Following Big Bang, however, the Securities and Exchange Law underwent extensive revision, and the rule that listed shares could only be traded on stock exchanges (the so-called "market concentration rule") was abolished. At the same time, securities companies were allowed to operate proprietary trading systems, which it had been feared would be considered "quasi-exchanges" (prohibited by the Securities and Exchange Law before 1998). In addition, the JASDAQ market, which until then had been regarded as an extension of the stock exchange markets, was upgraded to an "OTC tradable securities market" on an equal footing with the stock exchanges, while rules were created to allow stock exchanges to merge and be liquidated, thereby making them easier to restructure.

In May 2000 the Securities and Exchange Law underwent further revision, allowing mutually owned, membership stock exchanges to demutualize. As competition among the world's stock exchanges increases, an increasing number are seeking to demutualize and obtain a stock exchange listing in the belief that this will give them a competitive edge. Even in Japan, where it is accepted that the business of establishing and operating a stock exchange involves a major public responsibility, a legal framework was established to allow exchanges to be operated efficiently and for a profit.

As a result of these reforms, intermarket competition is becoming a reality in Japan. The lifting in December 1998 of the restrictions on off-exchange trading has meant that cross trades no longer have to be done on regional stock exchanges and led to the merger of the Hiroshima and Niigata stock exchanges with the Tokyo Stock Exchange and of the Kyoto Stock Exchange with the Osaka Securities Exchange. The Nasdaq Japan concept floated by the National Association of Securities Dealers (NASD) and Softbank in June 1999 was only the first of three concepts to create new markets that would compete to attract venture businesses, while since April 2001 the Osaka, Tokyo and Nagoya exchanges have demutualized and the Osaka and Tokyo exchanges have announced their intention to become listed companies.

2. Failure of Off-Exchange Trading to Expand

This is not to deny that reform has left a number of issues unresolved. One such example is proprietary trading systems. While several such systems have been developed for bond trading and appear to be gradually gaining acceptance, there have hardly been any such examples in the case of equity trading. Not only that: several of the equity trading systems that did come into operation failed to attract business and soon had either to cease operation or be sold off to other operators (see Figure 1).

Notwithstanding this, the percentage of trading in listed shares conducted on the Tokyo Stock Exchange has remained at a consistently high level (80%-plus) during this period. All that has happened is that off-exchange trading (i.e., trading on proprietary trading systems, and block and basket trades where securities companies trading on their own account act as counterparty) has taken away business that used to go to the Nagoya Stock Exchange and other regional exchanges (see Figure 2).

This is a very different state of affairs from that which exists in the United States, where, following their introduction in 1997, electronic communications networks (ECNs) have cornered a large share of the trading on the NASDAQ, and trading on the NASDAQ InterMarket in some of the stocks listed on the New York Stock Exchange (using NASDAQ's proprietary system) can account for 50% or more of the total trading in those stocks.[1]

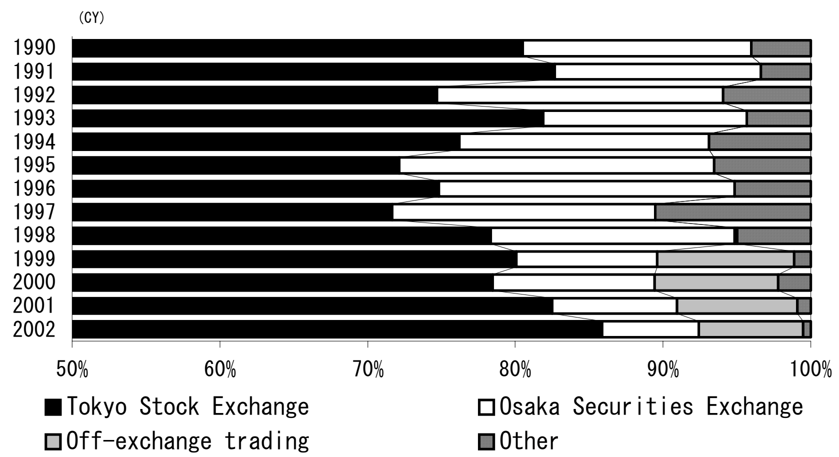
1 Trading details in NASDAQ Intermarket are available at http://www.intermarket.nasdaqtrader.com.

Figure 1 Existing Proprietary Trading Systems

Date of approval	Securities company	Securities traded	Pricing mechanism	Remarks
2000				
30-Jun	Japan Bond Trading Company	Equities	Negotiation between customers	Ceased business in July 2002.
	E-Bond Securities	Bonds	Negotiation between customers	Trades low-liquidity corporate and municipal bonds. Ceased trading and went into liquidation in April 2001.
2001				
19-Jan	MTS Japan	Government bonds	Price indication method	Crossing of government bonds between professional dealers.
	Garban Totan Securities	Government bonds	Order-matching method	Crossing of bonds between professional dealers.
26-Jan	Monex Securities	Equities	Market prices	Crossing of equities at closing price.
	Instinet Securities	Equities	Order-matching method	Crossing of equities between professional dealers.
19-Feb	Japan Bond Trading Company	Bonds	Order-matching method	Broking of bonds between professional dealers.
	Cantor Fitzgerald Securities	Bonds	Order-matching method	Best-indication execution by broking of bonds between professional dealers.
12-Nov	Japan Cross Securities	Equities	Market prices	Crossing of equities at same-day volume-weighted average price. Business transferred to Instinet Securities in October 2003.
2002				
29-Mar	Yensai.com Securities	Government bonds	Price indication method	Multi-dealer system with nine participating securities companies.
26-Jun	Bloomberg Securities	Bonds, equities	Price indication method, negotiation between customers, order-matching method	First 24-hour trading system for bonds. Equities are traded at volume-weighted average market price.
18-Oct	J Bond Securities	Government bonds	Price indication method, negotiation between customers	Trading possible using QUICK terminals.
2003				
27-Jun	Japan Securities Agents	Equities	Order-matching method	Broking of stocks traded on the Green Sheet market between professional dealers.

Source: NRI, from Financial Services Agency data.

Figure 2 Each Market's Share of Trading Value of Listed Equities



Note: Off-floor trading included in figures for each market.
Source: NRI, from Tokyo Stock Exchange, "Shoken Tokei Nenpo" [Annual Compendium of Securities Statistics] and Japan Securities Dealers Association, "Torihikijogai Torihiki: Getsuji Sobahyo" [Monthly Off-Exchange Trading Tables].

It would, of course, be wrong to conclude that, just because the Tokyo Stock Exchange accounts for the lion's share of trading in Japan, intermarket competition in that country is not working properly. Since floor trading was abolished there at the end of April 1999, the Tokyo Stock Exchange, which could rightly be called the world's largest electronic communications network, has maintained a high level of liquidity and a pricing mechanism that is both fair and efficient. It is this record and these features that are undoubtedly the main reasons why the exchange accounts for such a high proportion of trading. It is a perfectly natural result of intermarket competition that a market with a strong competitive edge should account for a large share.

However, it is also true that Japan's exchange-based stock market system gives a competitive advantage to exchanges such as the Tokyo Stock Exchange at the expense of off-exchange trading, including that conducted on proprietary trading systems. It would be wrong to ignore this fact and to attribute the Tokyo Stock Exchange's high market share purely to a strong competitive edge.

As the author has explained elsewhere, there are still many rules that serve to restrict the growth of off-exchange trading.[2] For example, any off-exchange transaction that takes place while trading is going on on a stock exchange must be in line with the prices and quotations of that exchange, while any securities company wishing to execute an order to buy or sell listed shares off the exchange must obtain the express permission of the investor concerned in advance (Article 37 of the Securities and Exchange Law). Similarly, the fact that stock exchanges are subject to severe restrictions on their activities and shareholder composition while it is virtually impossible for proprietary trading systems, which are legally securities companies and subject to restrictions on their pricing mechanisms, to become stock exchanges means that stock exchanges may have a competitive advantage.[3]

3. Review of Current System by Working Group

The Financial Services Agency is, of course, fully aware of these shortcomings. A December 2002 report by a sub-committee of the Financial System Council states that, if Japan's securities markets are to maintain a competitive edge in the global arena, more will have to be done to encourage competition among the country's securities markets and thereby achieve greater efficiency and a better quality of service.

[2] See Sadakazu Osaki, "Shoken Shijokan Kyoso o Meguru Hoseijo no Kadai" [Legal Issues Involved in Intermarket Competition], Jurist, No. 1227, 15 July 2002, pp. 110-116. Also, Sadakazu Osaki, "Kin'yu Kozo Kaikaku no Gosan" [Mistakes in Reforming Japan's Financial System], Toyo Keizai Shimposha, 2003, Ch. 5.

[3] See Sadakazu Osaki, “Japanese ATS Regulation: Its Development and Remaining Issues," Zeitschrift fuer Japanisches Recht, Nr. 12 (2001).

Moreover, the report says that all aspects of the existing system, including those affecting the OTC market and off-exchange trading, will have to be harmonized and that a fresh look will need to be taken at the status of proprietary trading systems as well as at issues such as the "best execution rule."[4]

When the Stock Exchange Working Group of the First Sub-Committee of the Financial System Council met again in October 2003, it discussed some of the issues mentioned in the above report. As was mentioned above, the author has given his views on the status of proprietary trading systems elsewhere, so the rest of this report presents his personal views on two of the issues discussed by the Working Group: the "best execution rule" and who should be allowed to operate stock markets.

4. The "Best Execution Rule"

First, let us consider the "best execution rule." The reason the "market concentration rule," which prohibited securities companies from executing orders to buy and sell exchange-listed shares on markets other than stock exchanges, used to be accepted was that it was believed—with a certain degree of justification—that concentrating the demand and supply of tradable securities in the stock exchanges helped to ensure fair and efficient pricing. However, one of the rule's disadvantages was that it ruled out any trading method (pricing mechanism) that was not used on a stock exchange, thereby restricting investor choice. Furthermore, to claim that the "market concentration rule" was being observed simply because a transaction was, at least formally, conducted on a stock exchange, even though the trading volume and liquidity on Japan's regional stock exchanges were both low, ignores the fact that such a price could hardly be considered fair and proper.

The "market concentration rule" was therefore abolished under Big Bang, but there is still the risk that the same shares could trade simultaneously at different prices if they are traded on different markets using different methods rather than just on the stock exchange where they are listed. If this were to occur on a wide scale, there could be a risk of market fragmentation, where the pricing process itself could come into disrepute.

This is not, of course, to deny the possibility that the same shares could be traded at different prices, anyway, depending on the participants' attitude to factors such as transaction size and speed of execution (e.g., whether or not they wanted to do the

[4] See Financial System Council, First Subcommittee report "Shoken Shijo no Kaikaku Sokushin" [Expediting Reform of Japan's Securities Markets], pp. 6-7. The original report can be viewed on the Financial Services Agency's Web site at http://www.fsa.go.jp/singi/singi_kinyu/siryou/kinyu/dai1/f-20021216_sir/01b.pdf.

deal immediately). However, it is difficult to judge whether individual price differences are reasonable or not, and it is a well-known fact that in Japan the prices of securities often used to be manipulated (e.g. by means of *tobashi* transactions[6]). One can therefore see why, when the "market concentration rule" was abolished, it was felt there was a need for a rule to ensure that off-exchange transaction prices were in line with stock exchange prices.

However, any rigid attempt to limit price movements risks interfering with normal pricing mechanisms and reducing either market efficiency or trading volume.

It was to solve this problem that the "best execution rule" was introduced in Europe and, in particular, the United States. The aim of this rule is to ensure that, if an order to buy or sell a security can be executed on more than one market using more than one method, the broker (securities company) is obliged to do his best to ensure that the order is executed on the best terms for the customer.[7] This principle is now fully accepted.

However, there is no clear definition of what constitutes "best execution"—either in the rules of the Securities and Exchange Commission or in those of the National Association of Securities Dealers. In practice, unless a customer is either very unhappy with or very suspicious of the way in which an order of his has been executed, it is usually assumed that a securities company will have done its best to have an order executed on the best terms for its customer. And there is no doubt that the existence of this principle has helped to prevent arbitrary order execution.

One of the reasons no major problems have occurred in the United States in spite of the rule's imprecision is the highly transparent nature of price information in that country. Since all listed shares and all the major issues on the NASDAQ are entered in the National Market System, dealers are required to report the details of all quotations

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6 These are defined as any circumstances in which the directors or employees of a securities firm assist customers in arranging transactions to temporarily transfer securities with losses to another party and one of the parties to the transaction may subsequently seek reimbursement of losses from the securities firm.

7 For more on the concept of "best execution" in the United States, seeJonathan R. Macey and Maureen O'Hara, "The Law and Economics of Best Execution", Journal of Financial Intermediation 6, 188-223 (1997).

and trades immediately. This means that, if an order is executed on terms that violate the best execution principle, it will be easy to detect the abuse—at least after the event.

In Japan much of the discussion about the National Market System would appear to focus on the need for an IT system and order-routing system (consolidated quotation system, consolidated tape system and intermarket trading system) to enable the concept to be put into practice. Indeed, the absence of such a computer system in Japan sometimes even leads advocates of a national market system to express doubts whether it would be possible to achieve fair and efficient pricing on the basis of the best execution principle alone.

Nor is there any denying the importance of a consolidated quotation system and a consolidated tape system. Just as consolidated quotation information shows where and how orders can be executed at the most favorable prices, consolidated transaction information enables checks to be made afterwards to see whether an order was executed at the best possible price. In contrast, the fact that the intermarket trading system, which is supposed to enable orders to be routed to the stock exchange with the most favorable quotation, can only be used to route orders among specialists means that it is only used in a small percentage of trades. In fact, in the United States securities companies are able to execute orders on the most favorable terms for their customers by using quotation information and transaction information to find the best market and transaction method without the need for a sophisticated order-routing system.

This suggests that, if Japan is to abolish the rule that any off-exchange transaction that takes place while trading is going on on a stock exchange must be in line with the prices and quotations of that exchange, it must ensure the transparency of quotation information and transaction information. However, this does not necessarily require sophisticated systems or major investment. It should be possible to achieve a certain degree of transparency using existing information vendor networks and the Internet and without having to construct a large new system.

Also, the fact that the securities companies that conduct off-exchange trading and operate proprietary trading systems are members of a self-regulating organization, the

Japan Securities Dealers Association, means that it should be perfectly possible to ensure that the system provides enough transparency by ensuring that all members fulfill their obligations to report quotation and transaction information to the Association.

Given that most Japanese private investors buying or selling listed shares expect their orders to be executed on a stock exchange and that in the United States and the European Union off-exchange trading is seen as the preserve of professionals, one possibility would be to retain most of the existing rules for orders from private investors but to allow them to be relaxed for institutions and other professional investors with the exception of the "best execution rule."

5. How Should Stock Markets Be Operated?

Next, let us consider who should be allowed to operate stock markets. The reason for raising this issue is that, although the Securities and Exchange Law states the principle that only stock exchanges should be allowed to operate securities markets, there is, in fact, an OTC market operated by the Japan Securities Dealers Association—the JASDAQ market. Furthermore, not only is the relative status of these two types of market unclear, but doubts have also been expressed about whether an association whose job it is to regulate securities companies should itself be allowed to operate a stock market.

In fact, similar doubts were at one time expressed in the United States, on whose legislation Japan's own securities laws are based, about the desirability of a self-regulating organization responsible for the securities industry as a whole operating its own stock market. As the author has expressed his views on this subject elsewhere,[11] only the conclusions are repeated here: given all the problems posed by a stock market operated by a self-regulating organization (especially the fact that it entails proprietary trading systems—or, in the United States, alternative trading systems—being regulated by a direct rival and the fact that securities companies that are not market participants have to bear, albeit indirectly, some of the cost of operating that market), the functions of a self-regulating organization and a stock market operator should be kept separate.

The organizational structure about which doubts were expressed in the United States corresponded more or less exactly to that of Japan's JASDAQ market. What is

[11] See "Kabushiki Shijokan Senso" [Intermarket Wars], Footnote 1 above, pp. 50-53, and "Kin'yu Kozo Kaikaku no Gosan" [Mistakes in Reforming Japan's Financial System], Footnote 2 above, pp. 228-230.

more, in addition to its responsibilities as the self-regulating organization of all Japan's securities companies and the operator of the JASDAQ market, the Japan Securities Dealers Association is responsible for collating all the securities industry's requests for reforming the taxation system (see Figure 3). Not only is it highly debatable whether a self-regulating organization, which should be neutral and impartial, should also represent the private interests of an industry, the organizational structure of the Japan Securities Dealers Association is even more debatable than that of its US counterpart, the National Association of Securities Dealers. While the Association is itself considering these issues, there have been suggestions, for example, that the Association of Tokyo Stock Exchange Regular Members should play a greater role representing the securities industry. In any case, further discussion and reform will be needed.

Figure 3 Comparison of Functions of Securities Dealers Associations in Japan and the United States

	Self-regulating organization	Operation of OTC market in equities	Industry association
US	National Association of Securities Dealers (NASD)	Nasdaq Stock Market (NASD has a 55.5% stakeholding. Shareholding to be reduced to zero by 2006. Application for registration as stock exchange in 2001.)	Securities Industry Association (SIA), the Bond Market Association (TBMA), etc.
Japan	Japan Securities Dealers Association (JSDA)	JSDA and JASDAQ (JSDA has a 72% stakeholding.)	JSDA (absorbed Bond Underwriters Association of Japan in 1998)

Source: NRI.

There have also been calls for the "OTC tradable securities market" (i.e., the JASDAQ market) operated by the Association to be converted to a stock exchange in order to allow it to (1) trade futures and options, (2) offer an off-floor distribution system [12] and (3) engage in standardized margin transactions. [13] Although these shortcomings are not the same as the more fundamental issue whether a self-regulating organization should be allowed to operate a stock market, the fact that it has been suggested that these shortcomings could be solved by converting the JASDAQ to a stock exchange and removing the Association's control is interesting.

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12 A system that was introduced on the Tokyo Stock Exchange in 1967 to allow members which receive sell orders in excess of the Exchange's normal order volume to execute those orders. When a member has informed the Exchange of its intention to execute an order in this way, the terms are announced after the close of trading, and investors are invited to place purchase orders for the shares between 8.20 and 8.45 the following morning. The trade is then consummated at a fixed price based on the previous day's closing price.

13 There are two types of margin transaction in Japan: standardized and negotiable. In the case of a standardized transaction, 1) the lending fee and period of settlement are regulated by stock exchange rules, 2) securities companies may borrow shares and cash needed from a securities finance corporation ("loan transactions"), and 3) eligible stocks are designated by the exchange in accordance with its rules. In the case of a negotiable transaction, 1) the lending fee and period of settlement are negotiable, 2) loan transactions may not be used, and 3) all listed stocks are eligible.

If the JASDAQ market was converted to a stock exchange, it is questionable whether there would be any need for an "OTC tradable securities market" in its present form. Given that the system whereby the Japan Securities Dealers Association operates a stock market is perceived to be a direct importation of a US system with its own history, it could be argued that there is little need for such a system now that stock exchanges and proprietary trading systems in Japan are allowed to operate in their own right.

However, one should be careful not to make the mistake of jumping to the conclusion that the status of Japan's stock exchanges, which, like the Japan Securities Dealers Association, are also self-regulating organizations under the Securities and Exchange Law, also needs to be reconsidered simply because the issue of whether self-regulating organizations should be allowed to operate stock markets is itself debatable.

The self-regulatory powers of Japan's stock exchanges only extend to the exchanges' members. Such powers are essential if the exchanges are to maintain a high quality of service and retain the trust of investors and the companies that are listed on them. In particular, the need to monitor trading is similar to the need of a private airline to invest in the maintenance of its aircraft in order to ensure the safety of its passengers, and does not cease simply because a stock exchange may have become a for-profit company.

Nevertheless, this does not necessarily mean that the stock exchanges need all their self-regulatory powers. For example, Japan's stock exchanges are still responsible for ensuring that their members are financially sound even though settlement is now done using a clearing house system, which solves the problem of counterparty risk. It is therefore debatable whether there is any need for the exchanges to retain this responsibility. Similarly, in the United Kingdom the responsibility for ensuring that companies satisfy the London Stock Exchange's listing standards ceased to be the Exchange's in April 2000, when it became the responsibility of the Financial Services Authority. The reason for this is probably partly the risk that, as intermarket competition increased, the Exchange might be tempted to be less stringent in order to attract more business from companies seeking a listing, and also the opposite risk that proprietary trading systems and other rivals could hitch a free lift on the back of the Exchange's listing responsibilities by trading only stocks listed on the Exchange. Such examples suggest the need to take a fresh look at Japan's stock exchanges' self-regulatory powers from a variety of angles.

6. Restructuring Japan's Securities Markets

The above is a summary of the author's personal views on two of the issues touched on in the sub-committee's report. However, a variety of views have been expressed on the future of Japan's remaining securities markets in somewhat less theoretical terms than the above discussion of intermarket competition and the stock market system.

For example, it has been suggested that those regional stock exchanges that remain might merge with other markets—partly because a number of regional exchanges have disappeared in the wake of Big Bang and partly because there has been a decline in the number of companies listed only on a regional exchange. Similarly, it has been suggested that the venture capital markets, which started with the Nasdaq Japan concept and now number seven, including those established by regional exchanges, might benefit from consolidation. Indeed, it has even been reported that this restructuring might involve the Tokyo International Financial Futures Exchange (TIFFE).

It has also been suggested that all Japan's stock exchanges should be merged in one national stock exchange. A similar concept is that of a holding company, along the lines of Deutsche Börse in Germany, with all the country's stock exchanges as its subsidiaries.

This report does not aim to discuss in detail the pros and cons of the various proposals that have been made for restructuring Japan's securities markets or the likely future shape of these markets. The future shape of these markets is something that should, in any case, be decided independently by those who operate and participate in them in terms of how to deal with the increasing competition they face. By the very nature of the issue, it is not one that lends itself to objective predictions. Nor would it be appropriate for an outsider who has not been asked to do so by anyone operating or participating in these markets to discuss the issue with any claim to objectivity. At one time, when the Ministry of Finance tried to maintain tight control over Japan's securities markets, there was discussion about their future shape with an eye to policy-making. However, as the markets have come to be operated more as businesses, it would seem better at a time when intermarket competition is thriving to leave each to decide its own future as far as possible—unless some disaster or scandal threatens to engulf them all.

Nevertheless, this much perhaps needs to be said about any proposals to merge all Japan's securities markets.

There is no doubt that intermarket competition is the best way to make Japan's securities markets more efficient and rational. As the above-mentioned report correctly points out, such competition is essential if these markets are to compete successfully in the international arena. Given the big time difference between Japan and markets in the United States and Europe as well as the absence in the same time zone (i.e., Oceania and the rest of Asia) of a major rival to its equity markets, there is a serious risk that the operators of Japan's securities markets would succumb to complacency and inefficiency if such intermarket competition among themselves were eliminated. It is surely quite inappropriate to suggest that the future shape of Japan's securities markets should be modeled on Germany's Deutsche Börse, which has several major rivals and is located in a closely knit economic zone (i.e., the European Union).