The Deregulation of Off-Exchange Trading in Japan

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In Japan, regulations against off-exchange trading of listed stocks, which had been prohibited by the articles of association of stock exchanges designed to enforce the market concentration rule, were lifted on December 1, 1998. This report will review the background of this deregulation of off-exchange trading and explain the newly introduced rules.

1. Reexamination of the Principle of Concentration of Trading on Stock Exchanges

1) Functions and Problems of the Concentration Principle

Stock exchanges in Japan, including the Tokyo Stock Exchange, had included in their articles of association and rules the so-called principle of concentrating trading in stock exchanges, under which all member securities companies were required to trade listed securities, with some exceptions, on the markets established by these stock exchanges.

This market concentration rule was justified for two reasons: (1) Concentration of buy and sell orders would enable the investor to find an appropriate party with relative ease and thus ensure liquidity of securities; and (2) Free competitive trading among large amounts of orders by many participants would help form a proper and fair market. In the times prior to the development of information and communications technologies, liquidity securities and the formation of fair prices were possible only by physically concentrating buy and sell orders by securities firms on stock exchange's trading floor. The market concentration rule contained some elements that restrained stock exchange members from providing market functions that would compete with those of their own stock exchanges, or stock exchange members from competing with each other in executing orders off the floor. These restrictions were regarded as justifiable because it was in the public interest to ensure smooth distribution of securities and the formation of fair prices, etc.

However, recent progress in computers and communications technologies has made it possible to ensure liquidity and fair prices without physically concentrating trading on the trading floor providing that information on trading regarding price and quantity is centrally released. At the same time the obligation to concentrate trading on stock exchanges began to cause some adverse effects. For instance, even when it seemed possible to execute trading at a price more advantageous to customers than quotations at the stock exchange, stock exchange members were obliged under the market concentration rule to route that order to the exchange. The principle also kept the members from meeting the wishes of large-lot customers who wanted to have their orders executed off the floor so that their orders would not cause fluctuations in market prices and have a major impact on the market.

In the United States, the concentration requirement posed a problem of hampering competition among stock exchange members or between members and non-members. In consequence, it was decided, under the Rule 19c-3 of the Securities Act of 1934 adopted in 1980, not to apply the principle of concentration on stock exchanges to shares listed on and after April 27, 1979.

2) Process of Reexamination of the Concentration Principle

A major portion of the financial system reform bill, which had been adopted at the National Diet (Japanese parliament) on June 5, 1998, was enacted on December 1, 1998. This marked the start of the Japanese version of Big Bang (the financial system reform), which aims to revive Japan's financial market as an international market comparable with that of New York or London.

At the Working Party (WP) of the Securities and Exchange Council which prepared the basic scenario for the financial Big Bang, the removal of the obligation to concentrate trading on stock exchanges was taken up as a subject for discussion. The Market WP report submitted in June 1997 made the following 5-item proposition for the abolition of the obligatory concentration (Table 1).

Table 1 Main Items Proposed by the Securities and Exchange Council's Market WP regarding Obligatory Concentration of Trading in Stock Exchanges

① The concentration requirement in the articles of association of stock exchanges should be eliminated.
② The trading price of a share for off-exchange trading during sessions should be within a certain range of the share prices made on the trading floor.
③ Securities companies should execute off-exchange trading only when investors expressly want off-exchange trading.
④ Securities companies are obliged to make an immediate report on the content of off-exchange trading to the self-regulatory organization.
⑤ Off-exchange trading should be subject to fair trade rules under the Securities and Exchange Law.

Source: Prepared on the basis of the Market WP report.

Basically, the content of the report by the Securities and Exchange Council has been adopted in compiling the Financial Systems Reform Law. However, the abolition of obligatory concentration of trading on stock exchanges required changes in the article of association by stock exchanges and the establishment of self-regulatory rules by the Japan Securities Dealers Association (JSDA), instead of amendment of the existing related laws. The JSDA and the Tokyo Stock Exchange established a study group for the preparation of the environment for the abolition of the obligatory concentration principle, and complied a report on their work in June 1998.

On the other hand, it was decided that the Financial Systems Reform Law and its related government and ministerial ordinances should include rules on the assumption that obligatory concentration will be abolished and that off-exchange trading of listed shares will be conducted.

2. Establishment of Rules Regarding Off-Exchange Trading

1) Statutory Provisions

The provisions regarding off-exchange trading of listed stocks and other securities contained in the Financial Systems Reform Law and the related government and ministerial ordinances include the following items, which were enforced as from December 1, 1998.

(1) Prohibition of off-exchange order execution in the case of unclear customer instructions

A provision has been set up to the effect that when securities companies receive orders for trading of listed stocks, etc., they should not execute that trading off the stock exchange unless customers expressly instruct an off-exchange trading (Article 37 of the Securities and Exchange Law). Listed stock, etc. under this provision are of six types: share certificates, convertible bonds, bonds with warrant, warrant certificates, subscription warrants, and subscription certificates (Article 27 of the Ministerial Order on Securities Companies).

(2) Obligatory Report on Off-Exchange Trading

When securities companies execute trading of listed stocks etc. on their own account or on customers' account, they are required to report to the Japan Securities Dealers Association, with regard to the kind and name of securities, trading price and volume (Article 79, Clause 2-4 of the Securities and Exchange Law).

(3) Disclosure of Information Regarding Off-Exchange Trading

The JSDA should inform and disclose the turnover, high, low and closing prices and other items of the reported off-exchange trading to its members, and report to the Minister of Finance regarding daily market prices and other items (Article 79-3 and Article 79-4 of the Securities and Exchange Law).

2) Amendment of the Articles of Association of the Tokyo Stock Exchange

The concentration of trading on stock exchanges was stipulated in the articles of association of the Tokyo Stock Exchange and made obligatory for members. Article 23 stipulated that the TSE's regular members should not execute trading of listed securities unless otherwise provided. The exemptions from the prohibition included trading by members of other stock exchanges on their exchanges, take-over bids and trading of listed bonds.

The Tokyo Stock Exchange amended its articles of association on November 27, 1998 and deleted Article 23 and the related Article 24. With this step, the TSE members have been allowed to execute off-exchange trading freely unless it is unlawful.

3) Establishment of the JSDA Rules

The Japan Securities Dealers Association established "rules regarding off-exchange trading of listed share certificates, etc." (Fair Practice Rules No.5). The rules have the following provisions.

(1) Applicable Objects of the Rules

The rules are applied to share certificates (including subscription warrants and foreign share certificates), subscription certificates, convertible bonds, bonds with warrant, subscription warrants, country funds and securities investment trust beneficiary certificates (Article 2).

Under the Securities and Exchange Law, the last-listed two are not included in "listed stocks, etc.", whose off-exchange trading is prohibited when customers' instructions are not clear. The reason for this provision seems to be that it is easy to calculate fair prices of country funds and investment trust beneficiary certificates from net assets, etc. and that execution of their off-exchange trading regardless of investors' intentions does not pose any serious problem from the standpoint of investor protection. Why they are subject to the JSDA regulations may be that country funds are listed on the Osaka Stock Exchange and investment trusts linked to the Nikkei 300 index are listed on the Tokyo Stock Exchange.

(2) Restrictions on Prices

The Market WP report of the Securities and Exchange Council notes that in order for price formation in off-exchange trading to be made fairly in response to its own demand and supply situation, securities companies should be obliged to constantly show quotations, link the quotations at all securities companies and all stock exchanges through systems, and execute customers' orders at the best prices, and that it would involve major cost and time to prepare the infrastructure for this purpose. This view seems to take into consideration the American concept of the National Market System (NMS), and its embodiment in such forms as the Comprehensive Quotations System (CQS), the Comprehensive Trading System (CTS), and the Intermarket Trading System (ITS).

Thus, it was considered to be appropriate to restrict prices for off-exchange trading in order to prevent possible disruption of fair price formation due to "market fragmentation" that might be caused when the ban on the off-exchange trading is removed without having adequate infrastructure such as information networks. As a result, the JSDA regulations made it obligatory to execute orders at prices within a certain range or band for off-exchange trading within normal trading sessions, on the basis of the best quotations or the latest trading prices in stock exchanges (Articles 2, 4 and 5, and Table 2).

Table 2 Price Restrictions for Off-Exchange Trading under the JSDA Regulations

Small-lot orders: (trading value: under ¥10 million)
Price within the range of the latest best bid and offer (or special quotation) on a stock exchange which releases standard prices.
Quasi-large-lot orders: (trading value: between ¥10 million and ¥50 million)
Price within 3% on both sides of the latest trading price at a stock exchange that releases the standard price.
Large-lot orders: (Trading value: over ¥50 million)
Price within 7% on both sides of the latest trading price at a stock exchange that releases the standard price.
Basket orders: (Over 15 issues and over ¥100 million of total trading value)
Price within 5% of the value calculated on the basis of the latest trading price.

Note: The provision for "under ¥10 million for small-lot orders" is applicable until complete liberalization of commissions, which is expected by the end of year 1999 (Supplementary Rule 2).
Source: The JSDA Regulations.

(3) The Reporting and Publication of Trading

Securities companies are required to report on items, such as price and quantity of off-exchange trading, to the JSDA within five minutes in principle after the trading is executed (Article 10). Upon receipt of the report, the JSDA should promptly inform trading information including price and volume to member securities companies and make it available to the general public (Article 13).

However, reports and announcements of large-lot orders worth over ¥5 billion in trading value can be postponed to 16:00 of the day following the transaction date, except for the trading for which sell orders and buy orders are matched within a securities firm (Article 7 of the Bylaws). This step seems to be based on the consideration that if information on large-lot orders for which securities companies handle customer orders on their own account is promptly announced, the risk to be taken by securities companies in holding their positions may become too great. This rule may be adequate judging from the fact that there are many cases of cross trading on companies' own account.

In the case of off-exchange trading executed through the proprietary trading systems (PTS) which has been approved under the financial reform law, reports on trading should be made by the operator of the PTS, rather than securities companies which have been involved in that trading (Article 11 of the Rules).

(4) Explanation to Customers

As is required when they solicit trading in futures and options (Article 40 of the Securities and Exchange Law), securities companies are required, to provide a written statements on off-exchange trading to customers, excluding securities companies, banks and financial institutions, and provide them with a full explanation on points that require attention (Article 14 of the Rules).

3. Conclusion

Since the deregulation of off-exchange trading on December 1, 1998, the average daily off-exchange trading has amounted to about ¥10 billion to ¥20 billion a day, which accounts for about 3 to 5% of the trading value in the First Section of the Tokyo Stock Exchange. In the United States, the market concentration rule has long been removed, and off-exchange trading systems have been developed by market makers through the PTS and the third markets. The percentage of off-exchange trading of listed shares in the New York Stock Exchange is estimated at around 8%.

In Japan, the fixed commission system is still maintained for stock trading whose value is under ¥50 million. However, the fixed commission rates are applicable only to the market operated by the stock exchanges and not to off-exchange trading. It seems that negotiations on commissions for off-exchange trading are held between securities companies and customers regardless of the size of trading value.