

Chapter 4.19

Laws and Regulations on Proprietary Trading System (PTS) in Japan: Japanese Alternative Trading System (ATS)

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ABSTRACT

In order to improve convenience for investors through competition among stock exchanges, operation of Proprietary Trading Systems (PTS) was authorized as a form of securities business under the Securities and Exchange Act. The Japanese PTS is equivalent to ATS (Alternative Trading System), ECN (Electronic Communications Network) in the United States and MTF (Multilateral Trading Facilities) under MiFID in the EU. In 1998, ATS and ECN had already started in the United States and Japan's PTS followed the U.S. model. Telecommunication and information technologies and computer technologies made PTS possible, and PTS makes the border between the market and brokers ambiguous. Traditional regulations on broker-dealers and stock exchanges will inevitably be reviewed and regulations on securities markets will have to be reformed.

INTRODUCTION

Under the Financial System Reform of 1998, the no off-exchange trade rule which had been imposed on the sales of securities listed on such stock exchanges as the Tokyo Stock Exchange and the Osaka Securities Exchange was abolished. As a result, it became possible for securities companies which are the members of stock exchanges to trade the listed stocks through off-exchange trades. In connection with this, in order to improve the convenience of investors through competition among stock exchanges, operation of Proprietary Trading System (PTS) was authorized as one of the securities businesses under the Securities and Exchange Act. The Japanese PTS is equal to Alternative Trading System (ATS) and Electronic Communications Network (ECN) of the United States and MTF (Multilateral Trading Facilities)¹ of MiFID of the EU (Shimizu, 1997; Shimizu,

2000; Osaki, 1999; Konishi, 2000; Yanaga, 2006²). In 1998, ATS or ECN had already begun operating in the United States and PTS of Japan followed the U.S. model (Kawashima, 2001)³.

In June 2006, the Securities and Exchange Act was revised and in 2007, the Securities and Exchange Act will be revised to the Financial Instruments and Exchange Act and regulatory framework will be modified to that of financial service law or investment service law.⁴ The securities business will be modified to the “financial instruments business” and the same definition of the PTS will be provided in the Financial Instruments and Exchange Act as one of the financial instruments businesses (Art. 2(8) (X)).

Current regulations on the PTS will generally be succeeded after being transferred to the Financial Instruments and Exchange Act.

BACKGROUND OF INTRODUCING PTS

Abolition of No Off-Exchange Trade Rule

The Financial System Reform Act (Act No. 107 of 1998) shaped the concepts and recommendations of the final report of the Securities and Exchange Council, “Comprehensive Reform of Securities Market—Towards the Realization of a Prosperous and Diverse 21st Century” (June 13, 1997)⁵, etc, and so forth. The final report recommended abolition of the no off-exchange trade rule and authorization of the off-exchange trading of listed securities from the viewpoint of meeting diversified needs of investors.

Conventionally in Japan, trading of securities listed on stock exchanges was required to be executed on the market for exchange-listed securities established by the stock exchange not only for trades by securities companies, the members of the stock exchange, but also for trades by non-member securities companies.

That is, securities companies, the members of the stock exchange were prohibited from trading of securities listed on the stock exchange off the market for exchange-listed securities by the articles of association of the stock exchange.⁶ Non-member securities companies of the stock exchange were supposed to execute trading of listed securities on the market for exchange-listed securities through consignment to member securities companies pursuant to the regulations of business and services by the minister of finance. Therefore, with respect to the listed securities of the stock exchange, there was no room for execution of trading off the market for exchange-listed securities (Kanzaki, 2000).

Abolition of the no off-exchange trade rule and introduction of the PTS are generally stated as follows in “Framework for Reliable and Efficient Transaction” (May 16, 1997)⁷, the report of Market Working Party, which was established under the Securities and Exchange Council.

The roles of securities markets are to “efficiently and fairly” perform management of financial assets and distribution of funds to capital needs and securities market reform must ensure that securities markets can play such roles sufficiently and appropriately. In order for asset management and funding to be made “efficiently,” it is essential to introduce the principle of competition and it is also necessary to review how the regulated market should be in connection with this. The prime reason for abolition of the no off-exchange trade rule was (1) the promotion of competition among stock exchanges, and secondarily, there were the following reasons: (2) response to diversified needs of investors,⁸ (3) development of information and telecommunications technologies,⁹ (4) response to globalization of stock exchanges.¹⁰

The no off-exchange trade rule has been established to give volume to the regulated market as well as to contribute to fair price discovery. Stock exchanges are granted a special position in securities market, to which the antitrust law was not applied and as a Self Regulatory Organization (SRO)

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