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Domestic PTSs' untapped potential

Although proprietary trading systems can often execute trades at better prices than those available on exchanges, this fact is not yet widely known in Japan. However, with market infrastructure being progressively upgraded to facilitate PTS access, PTSs can no longer be ignored from the standpoint of best execution.

PTSs are growing in Japan

Among alternative execution venues, proprietary trading systems (PTS) have recently seen dramatic growth in trading volume. PTSs are not exchanges but electronic markets established by securities firms.

Japan's first PTS was established in 1998. For the next 10 years, Japanese PTS trading volume grew slowly before picking up sharply from October 2008, when several PTSs initiated trading during regular market hours. This change led to an increase in domestic PTS use by foreign investors. PTSs' share of exchange-listed stocks' total trading volume increased from 0.39% in January 2009 to 1.0% in October 2009, a 2.5-fold rise in less than one year. PTSs now account for a larger share of total equity trading volume than the JASDAQ, Japan's third-ranked exchange.

Yet, with PTSs accounting for only around 1% of total equity trading volume, some domestic investors do not

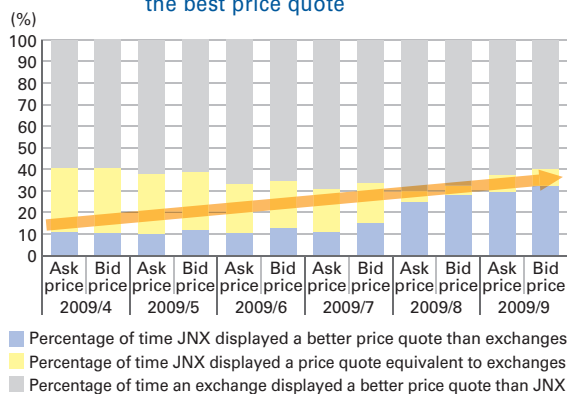
think it is worthwhile to go to the trouble of executing trades via PTSs. However, a closer look at PTSs' actual performance reveals that their potential to deliver best execution cannot be ignored.

PTSs offer substantial execution opportunities

A key role of trading venues is to provide investors opportunities to execute trades at better prices. How good are the prices currently available from PTSs?

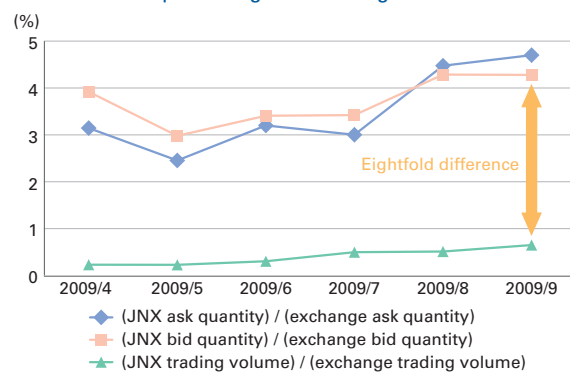
As one example, we analyzed¹⁾ the best bid and ask quotes²⁾ for Nikkei 225-constituent stocks on SBI JapanNext (JNX), Japan's largest PTS. We found that JNX has consistently offered prices as good as or better than exchanges' prices around 40% of the time (Exhibit 1). Additionally, the percentage of the time that JNX offers better prices than exchanges has recently increased sharply from 10% to 30%. JNX has thus been gaining stature in terms of offering better prices.

Exhibit 1. Percentage of time JNX is displaying the best price quote



Source: NRI, based on SBI JapanNext data

Exhibit 2. JNX's bid/ask quantities and trading volume as a percentage of exchanges'



Source: NRI, based on SBI JapanNext data

However good the prices they offer, PTSs cannot be said to adequately function as trading markets if they do not offer sufficient opportunities for execution—i.e., liquidity. We therefore analyzed JNX's best bid/ask quantities³ like we did with prices. We found that JNX's best bid/ask quantity has grown to roughly 5% of exchanges' best bid/ask quantity (Exhibit 2). Given that JNX's trading volume is equivalent to some 0.6% of exchange-traded volume, JNX offers potential best-execution opportunities disproportionately greater than its actual trading volume by a factor of more than eight.

Services that support PTSs' growth

Certain PTSs thus function very well as markets even today. Nonetheless, PTSs have collectively captured only 1% of total equity trading volume. This discrepancy reflects two main factors. First, investors are not yet fully aware of PTSs' performance record. Second, there are system compatibility and compliance issues involved in PTS usage⁴. To access a PTS, investors must invest time and money to modify their computer systems to ensure compatibility with the PTS. Additionally, when the trade is executed by a PTS instead of on an exchange, compliance rules dictate that the fairness of the execution price must be substantiated.

Currently, however, investors can resolve these problems by utilizing services offered by securities brokers or information vendors.

One such service offered by brokers is smart order routing (SOR). With SOR, orders are automatically routed to the venue—i.e., exchange, domestic PTS, or dark pool⁵—that is most advantageous to the investor⁶. SOR enables investors to easily access multiple venues, including exchanges and PTSs, by merely submitting an order to a broker. It consequently reduces the expense and trouble of achieving system compatibility. Meanwhile, information vendors that provide market data to investors offer real-time price data from multiple PTSs. Using such data feeds, investors can check best prices on multiple markets on a timely basis, enabling them to verify the fairness of PTS execution prices.

Some investors that are aware of PTSs' performance record and recognize PTSs' utility have in fact installed the requisite hardware and/or software and adapted their compliance regimes to accommodate PTS usage. Such investors are using PTSs in the belief that doing so will reliably profit their sponsors and general investors.

PTSs are becoming a force that can no longer be ignored

In 2010, PTSs will benefit from a number of tailwinds conducive to growth in their usage. First, the Tokyo Stock Exchange (TSE) commissioned its new Arrowhead trading system in January. In July, the Japan Securities Clearing Corporation (JSCC) will begin clearing trades executed via PTSs. This summer will also witness the Japanese debut of Chi-X, Europe's largest PTS.

The advent of the TSE's Arrowhead system has improved TSE's order execution speed to approximate parity with PTSs'. This improvement will enhance the performance of SOR, which aims for best-price execution through access to multiple venues, by enabling orders to be instantaneously rerouted to the venue displaying the best price. Additionally, once PTS trades become eligible for clearing by JSCC, investors that were previously reluctant to use PTSs due to settlement risk will be more likely to begin using them. Chi-X's entry into the Japanese market will not only increase PTS diversity, it should also enhance liquidity by facilitating European investors' access to the Japanese market.

With PTSs amply offering better price quotes than exchanges and becoming increasingly accessible, investors that still ignore them can be accused of being negligent in terms of best execution. If 1998 was PTSs' inaugural year in Japan, 2010 may go down in history as a key year in which PTSs gained widespread popularity. Future PTS trends will bear close watching.

Note

- 1) We compared best bid (ask) quotes between the TSE and JNX and tallied the cumulative time that each one was displaying a higher bid (lower ask) price. We conducted the analysis using data for Nikkei 225-constituent stocks (as of September 30, 2009) over the period from April through September 2009.
- 2) Of the price quotes displayed on the market, the best quoted price from the standpoint of a seller (buyer) is the highest bid price (lowest ask price).
- 3) The quantity is the number of shares bid for (offered) at the highest bid price (lowest ask price) displayed by JNX.
- 4) For more details, see lakyara No. 56, "Japan's ATS markets have promising growth prospects" (June 2009) (<http://www.nri.co.jp/english/opinion/lakyara/2009/pdf/lkr200956.pdf>).
- 5) Dark pools are non-public, proprietary electronic trading venues operated by securities brokers. Orders received by the broker are crossed internally instead of being routed to an exchange.
- 6) For more details, see lakyara No. 47, "Smart order routing takes DMA to a new level" (December 2008) (<http://www.nri.co.jp/english/opinion/lakyara/2008/pdf/lkr200847.pdf>).

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