

2009

# la**k**yara

Kyara, which means "precious" in ancient Japanese, is an aromatic resin regarded as the highest quality of all agarwood. "lakyara [la-ká'la]" aims to deliver the same quality as Kyara together with NRI's endeavour for continuous excellence and innovation to provide the most advanced and up-to-date information to our readers worldwide.

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**Japan's ATS markets have promising growth prospects**



Japanese asset management companies have only recently started to use alternative trading systems (ATS), but ATS usage is likely to grow in the future. While some asset management companies are hesitant to use ATS due to certain issues, such issues can be resolved with ingenuity. The stage is being set for widespread ATS usage.

### What is an alternative trading system?

"Alternative trading system" (ATS) is a catch-all term for any trading venue other than a regulated exchange such as the Tokyo Stock Exchange (TSE) or Osaka Securities Exchange (OSE). Various types of ATS exist. By selectively routing orders to the type of ATS best suited to the order's attributes, portfolio managers can benefit from fast, low-cost executions. The most common types of ATS are (1) real-time matching systems, (2) block crossing systems, and (3) broker dark pools (Exhibit 1).

Like exchanges, real-time matching systems are so-called displayed markets, meaning that they display bid and ask quotes<sup>1)</sup>. They are also similar to exchanges in terms of how buyers and sellers trade with each other. Real-time matching is mainly used for trading highly liquid stocks. The main factors that differentiate real-time matching systems from exchanges include execution speed and minimum tick size<sup>2)</sup>.

Block crossing systems are non-displayed markets where execution prices are determined based on exchange-traded prices or by negotiation between counterparties. Market participants use block crossing mainly to execute large orders (block orders) without alerting others of their intentions.

Broker dark pools are operated by securities brokers executing stock trades on behalf of clients. They are non-displayed markets where prices are set based on exchange-traded prices. In Japan, broker dark pools are offered mainly by foreign brokerages.

### ATS usage still in its early days

In March 2009, NRI conducted its second survey<sup>3)</sup> of Japanese management companies' trading in Japanese stocks, following up on an initial survey conducted in 2007. The survey results shed light on the current state of ATS usage and identified issues of concern.

Of the asset management companies that participated in the survey, about one in four uses an ATS on a regular basis (Exhibit 2). By type, broker dark pools are the most popular, used by roughly 80% of the ATS users. Real-time matching systems, by contrast, are not used by any of the respondent companies. ATS usage is currently still in an early stage in terms of prevalence, with use of broker dark pools running ahead of use of other types of ATS.

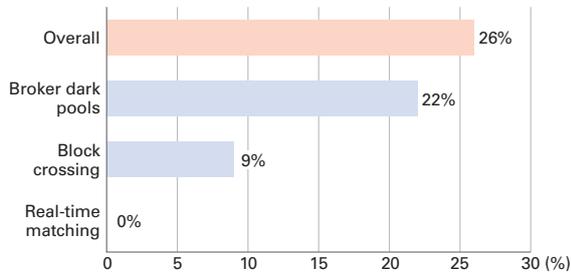
Looking ahead, more than half of the respondents intend to use block crossing systems more frequently in the future, suggesting that ATS usage will increase in prevalence (Exhibit 3).

Exhibit 1. ATS markets

Type	Displayed markets	Non-displayed markets		
	Regulated exchanges	Alternative trading systems (ATS)		
		Real-time matching	Block crossing	Broker dark pools
Examples	TSE OSE	Instinet CBX, kabu.com PTS, SBI Japannext	JapanCrossing Liquidnet BlockSec	CrossFinder (Credit Suisse), PIN(UBS), BIX(BNP Paribas)

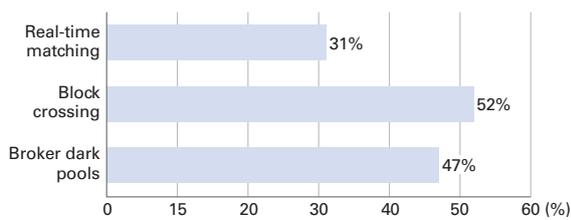
Source: NRI

Exhibit 2. Percentage of asset management companies that regularly use ATS



Source: NRI

Exhibit 3. Percentage of asset management companies that intend to increase frequency of ATS usage



Source: NRI

### ATS usage environment is taking shape

The survey also identified impediments to widespread ATS usage. Many survey respondents reported that ATS of all types pose problems in terms of (1) system compatibility and (2) compliance (Exhibit 4). The system compatibility problem is that asset management companies' computer systems were typically designed on the assumption that trades would be executed via exchanges only. In such cases, the system must be reprogrammed or otherwise upgraded to enable ATS usage, but such modifications are basically an issue of cost and time, not a serious impediment to widespread ATS usage. Major asset management companies are in fact already upgrading their systems to enable ATS usage, through in-house system development or installation of vendor products.

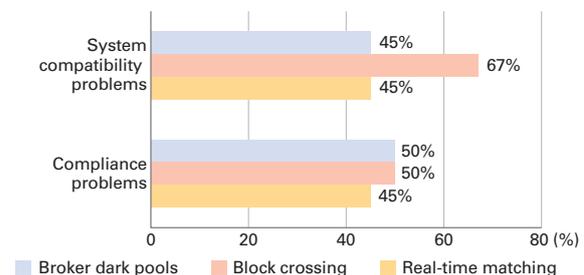
In terms of compliance, the main problem is documenting that ATS-executed trades were executed at fair prices. In Japan, exchange-traded prices tend to be strongly

accepted as fair market prices. When trading via an ATS, an asset management company acting in a fiduciary capacity must demonstrate that the execution price was fair, but there is no industry-wide consensus, even among sponsors, on how to specifically do so. Many asset management companies have refrained from using ATS for this reason.

An asset management company can resolve this problem on its own by using execution analysis, an increasingly common practice in recent years. For example, an asset manager can verify and document the fairness of the price at which an ATS executed a trade by comparing it with concurrent exchange-traded prices. In cases where block crossing is used to purchase stock at a negotiated price, the price can be negotiated beforehand based on an estimated market price adjusted to factor in market impact. Even if an asset manager decides to pay a premium to exchange-traded prices on account of liquidity or the market environment, the purchase price could be justified to clients if it was below the pre-estimated price.

Although ATS markets are often said to have a high barrier to usage, the environment is becoming conducive to their use by virtue of creative solutions such as the above examples. For asset management companies that have been hesitant to use ATS, the time has come to reaffirm the benefits of ATS usage.

Exhibit 4. Impediments to ATS usage



Source: NRI



Note

1) Bid and ask quotes consist of the price at which, and quantity that, prospective buyers and sellers are respectively willing to trade. In the market, the highest quoted bid price is called the best bid; the lowest quoted ask price is called the best ask.

2) Minimum tick size is the minimum price gradation. For example, on the TSE, stocks with a share price in the ¥50,000-300,000 range are priced in increments of ¥100.

3) The survey was sent to 57 asset management companies that meet any one of the criteria below. Of the 57, 42 returned completed surveys (74% response rate).

Companies that manage pension assets and have a minimum of ¥50bn in domestic equities under management

Companies that manage investment trust assets and have a minimum of ¥10bn in domestic equities under management

Top 10 investment trust companies and insurers by pension assets under management

Companies that use NRI's Trading  $\alpha$  execution analysis service

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