

Waking Up to the New Japanese Liquidity Landscape | Ofir Gefen, Clare Rowsell



At the intersection of markets and technology, Insights provides ITG's global perspectives on market structure, analytics and research, and liquidity.

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Although alternative trading venues have been around for some time in Japan, in the past year volumes in both dark and lit trading venues have taken off. This means that off-exchange liquidity is now at levels no institutional investor should ignore.

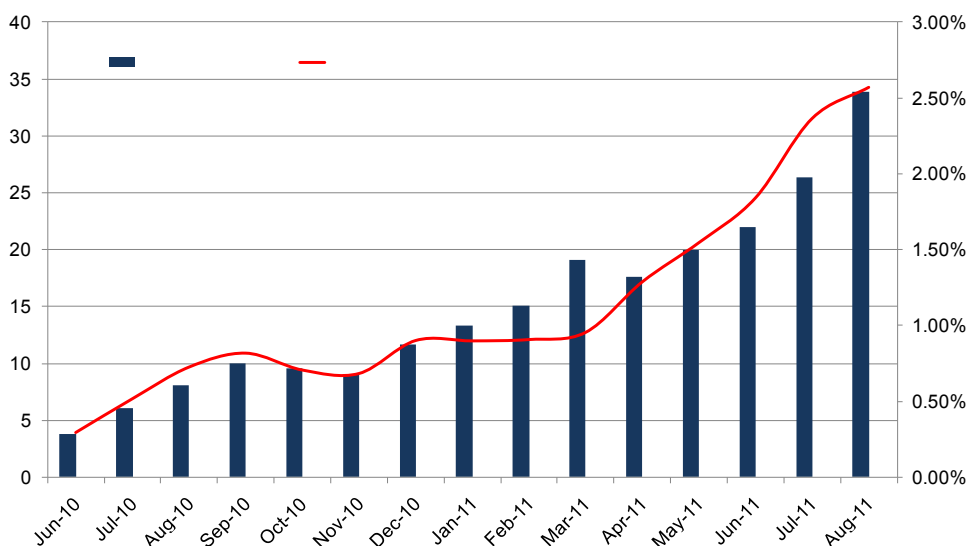
For several years Japan has looked, from the outside, like the only market in Asia Pacific to have embraced competition and allowed alternative lit venues to challenge the main exchanges. This has been in the form of Proprietary Trading Systems (PTSs), the Japanese version of ATs or ECNs, such as SBI JapanNext and Kabu.com which launched over four years ago.

For several years these PTSs consistently struggled to garner any market share and remained trading less than 1% of total Tokyo Stock Exchange (TSE) turnover. Kabu.com, a PTS aimed largely at the domestic Japanese retail market, shut down recently following years of low volumes and regulatory restrictions and amid rumours that they had failed to compete with the technology of the TSE since the latter's Arrowhead system upgrade in January 2010. Alternative liquidity in Japan has been seen as an insignificant part of the market, and institutional investors have carried on trading primarily on the TSE, maintaining the status quo.

However, the past six months have seen rapid growth in a few key venues which now look well positioned for further expansion. SBI JapanNext and Chi-X Japan, two technology-focused lit markets, have gained a combined average monthly volume of almost 6% of Tokyo Stock Exchange (TSE) turnover in recent months. Chi-X is now grabbing 2.81% market share of Nikkei 225 stocks while JapanNext has stated its ambitions of winning 10% market share by mid-2012.

This sudden shift in the availability of alternative liquidity is therefore starting to have an effect on the types of trading participants in the market, and in turn on trading costs and the tools institutional traders need to use to make the most of these changes. With a growth story like this, accessing alternative liquidity is now the hot topic for institutions trading Japanese equities.

Figure 1: Monthly Turnover Trends for SBI JapanNext and Chi-X (source: SBI JapanNext and Chi-X)

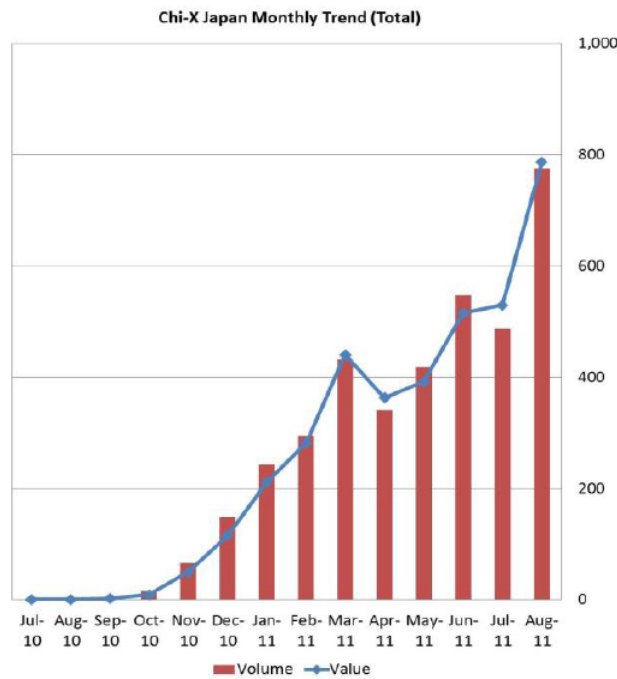


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Figure 1: Monthly Turnover Trends for SBI JapanNext and Chi-X (source: SBI JapanNext and Chi-X)



Why now?

Several key hurdles have been brought down in the past 18 months, acting as the catalyst for PTS growth. Most significantly, in July 2010 the Japan Securities Clearing Corporation (JSCC) allowed PTSs to clear through their central clearing counterparty structure for the first time, bringing clearing and settlement risk for PTS trades up to par with trades done on-exchange. A short-sell ban in force on the PTSs (for longer than the exchanges) was also lifted, allowing the PTSs to compete more effectively with traditional venues. This has encouraged the typical PTS customer – the high frequency, large volume traders and the electronic market makers – into the market and this liquidity has been bolstered by the addition of retail flow. In particular, SBI is one of Japan’s largest retail brokers and is now routing retail flow to its PTS.

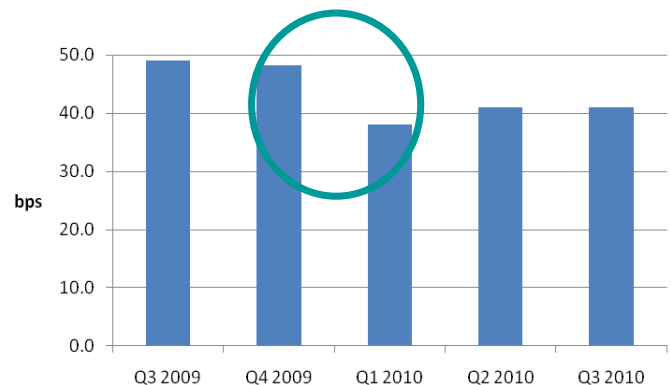
PTSs are competing for turnover based on three key factors, similar to their model in other markets. Fast technology and low latency are important, although the TSE is also focusing on these areas; a bigger differentiator is that, unlike the

TSE, current PTSs technology gives them the ability to set their tick sizes at sub 1 Yen increments for those wanting to slice the spread ever finer; and additionally, the PTSs are offering slightly lower fees and free market data to incentivize usage.

It’s worth noting that there are some constraints which are likely to limit exponential growth on the PTSs – specifically a regulation that requires PTSs to get full exchange registration if they consistently have over 10% market share; and a reporting rule that triggers a compulsory takeover bid if 5% ownership of a stock is reached not on an the “open market” (i.e. exchange) or reported on Tostnet, a specialized facility that the PTSs do not use.

Nevertheless, there is no doubt that as the structure of Japanese markets changes, so does the market constituency. The PTSs and the TSE are all gearing up for new liquidity participants including electronic market makers and high frequency firms.

Figure 2: Average Quarterly Trading Costs (source: ITG’s Peer TCA database)



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When we look at the effect of all the changes to the market on Japanese trading costs, overall there is a positive downward trend (as measured using implementation shortfall). This trend has been ongoing for some time as the market as a whole becomes more efficient—for example at the time of the TSE Arrowhead implementation, tick size reductions resulted in a direct and sustained fall in average trading costs of over 8bps in Q1 2010, (Figure 2).

However, when we drill down into recent changes, the impact of cost reductions in Japan is most noticeable in the large caps and maybe reflective of the slow but steady effect of the PTSs. The typical high frequency or electronic user of a PTS trades predominantly in large caps and over 95% of trades on the PTSs are currently in large cap stocks.

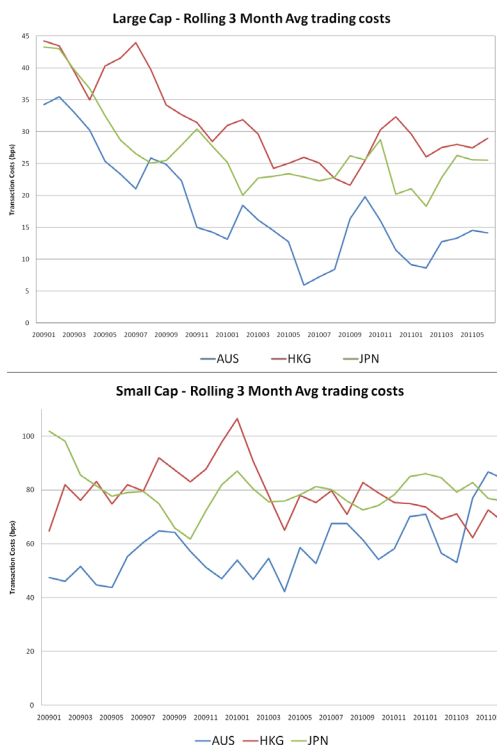
For most institutional investors, these trends have some important consequences. Although non-exchange liquidity in Japan has been considered negligible for years, traders should be aware of Japan's rapidly evolving liquidity profile and its effects on how they trade. While spreads are narrowing and transaction costs are trending down, the skew is toward large cap liquidity and indicative of electronic markets maker and HFT activity.

In response to these shifts, dark pools and dark aggregation are growing in popularity for institutions trading Japan. Dark pools can provide an effective way to minimize information leakage while still taking advantage of off-exchange liquidity pools such as internalization engines and agency pools. ITG's trading cost research for Asia Pacific shows that dark liquidity can be particularly effective in generating cost savings in the mid and small cap space where spreads are wider and displayed liquidity may be scarcer. In addition to that, buy-

side investors are looking toward smart order routers and lit and dark liquidity aggregation tools to manage Japan's increasingly fragmented market.

The speed at which PTSs are gaining market share, and dark pool aggregators are also growing in popularity, is significant. As these changes take effect, traders should be aware of how these developments are affecting liquidity, trading patterns and transaction costs to ensure they are getting the best outcome from the new Japanese market landscape

Figure 3: Small and Mid-Cap Average Trading Costs



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