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## **FPL Japan Electronic Trading Summit 2008**

# **The impact of ongoing regulatory changes on the Buy-Side trading**

- Analysing FIEA, Financial Instruments Exchange Act, in Japan in comparison with Reg NMS and MiFID**

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## Agenda

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- Financial Instruments and Exchanges Act and Progress of Better Market Initiative
- Transactions between investment properties so-called “Inter-fund cross trades”
- Commission Sharing Arrangement



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# 1 . Financial Instruments and Exchanges Act and Progress of Better Market Initiative



## (1) FSA Policies

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### ◆ Goal of Japanese Capital Market

- Financial assets held by household sector that amount to 1,500 trillion yen should be encouraged to move towards investments (from savings to investments).

As Japan is quickly becoming an aging society, the individual financial assets are expected to be grown through the investment themselves rather than through government initiatives.

- Highly value-added financial service sector will be the center of economy.
  - The downturn of manufacturing industry due to the cheap labor force provided by Asia countries.



## (1) FSA Policies – Enactment of FIEA

### ◆ Developing the market infrastructure including regulation

- Creation of reliable and vibrant markets  
--JDR, Markets for professional investors ,ETF, Commodity Futures ETF,  
Expanding J-REIT, Attract foreign fund managers, etc.
- Regulation that promotes financial innovation – FIEA (*Kinshoho*)
- “Better Regulation”
- Tax system, securing financial experts, revitalization of financial areas in the capital

FIEA

### ◆ Role of market participants

- Exchanges : Develop newly-listed financial instruments
- Listed Companies : Strength corporate governance / internal control (J-SOX)
- Retail Investors : Improve the literacy of finance
- Institutional Investors : Execute Fiduciary duty, reform public pension funds

Initiative

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## (2) Financial Instrument and Exchanges Act

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- ◆ Creation of reliable and vibrant markets
  - Establishing cross-sectional framework of a wide range of financial instruments and services
    - Securities and Exchanges Act was consolidated with Financial Futures Trading Act and collective investment scheme (funds)
- ◆ Financial instruments business operators
  - Type 1 financial instruments business
  - Type 2 financial instruments business
  - Investment management business
  - Investment advisory and agency business
- ◆ General (Retail) investors / Professional investors
  - General (Retail) investors (Enhancement of user protection)  
Reinforcement of product explanation for the purchase of mutual funds led to improve literacy of finance
  - Professional investors  
More flexibility to attract foreign investors



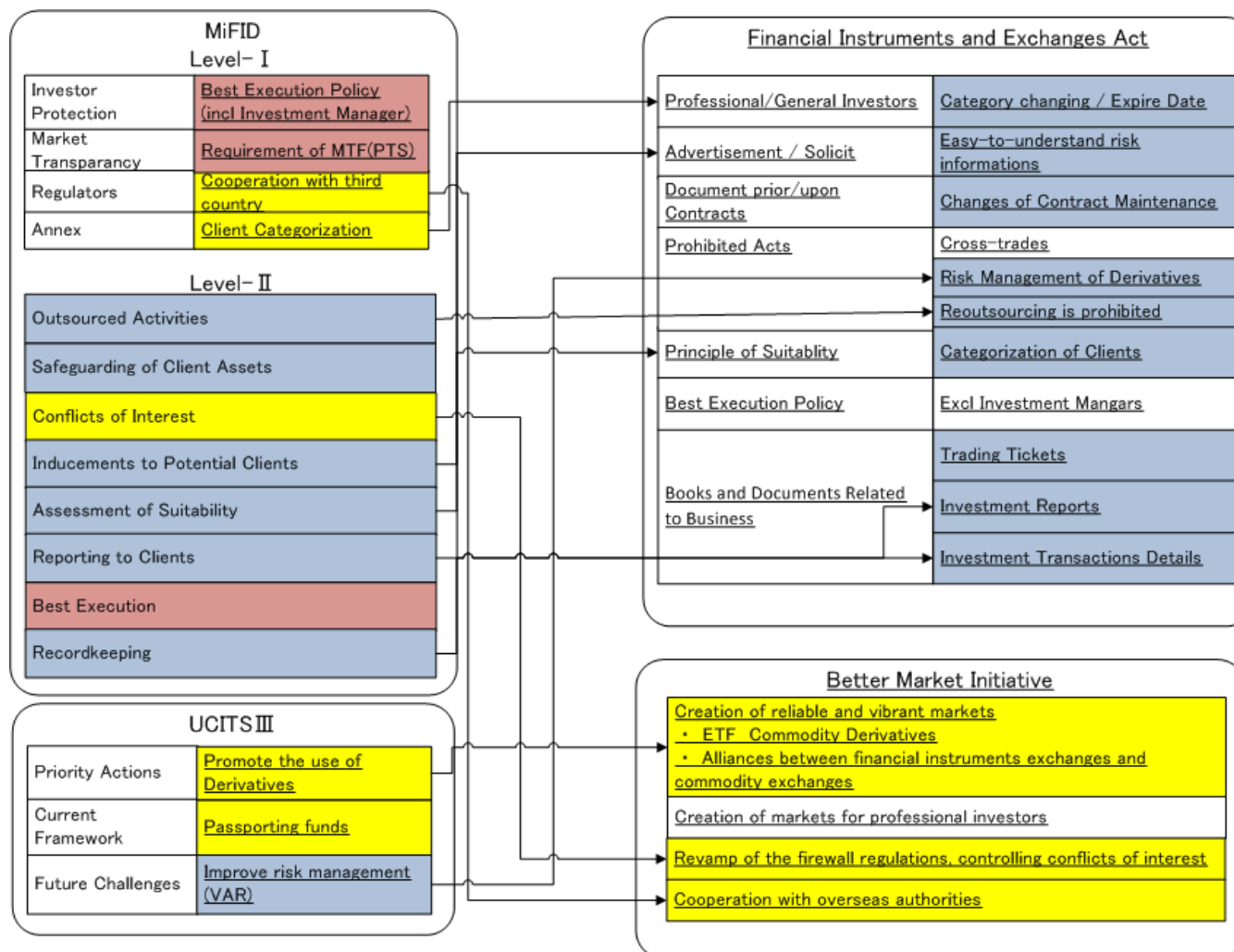
## (3) Contents of FIEA

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- ◆ J-SOX ; Article 24-4-4 ---Internal Control Report
- ◆ Suitability
- ◆ Best Execution Policy
  - excludes investment management business
- ◆ Prohibited Transaction activities
  - Transactions between investment properties - “Inter-fund cross trades”
- ◆ Books and Documents Related to Business
  - Trading Tickets etc



## (4) Comparison with MiFID







## (5) Progress of Better Market Initiatives

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- ◆ I. Creation of reliable and vibrant markets
  - Develop a framework for secondary markets of JDRs
  - Allow incorporating overseas real estates into J-REITs
  - Further diversification of ETF products
  - Introduction of ETFs investing in commodity futures
  - Creation of markets for professional investors
- ◆ II. Putting in place a business environment that vitalizes the financial services industry and promotes competition
  - Minimize the "PE risk" to attract foreign fund managers to Japan's markets
  - Broaden the scope of businesses permitted to banking and/or insurance groups
    - Spot transactions of commodities
    - Emissions trading
    - Islamic finance
- ◆ While non-traditional markets are getting introduced, Tokyo Capital Market will never become “global “ without further development of the traditional institutional asset management business.



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## **2. Transactions between investment properties**

- “Inter-fund cross trades”**



## (1) What is Inter-fund Cross Trades ?

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### ◆ Inter-fund cross trades

#### ➤ Brokered cross trade (Cross trade through brokers)

A placement of a selling order for one client with a buying order for another client for the same instrument through broker-dealers

#### ➤ Direct cross trade (Internal cross trade)

Matching internally (within a buy-side institution) a selling order for one client with a buying order for another client for the same instrument without executions by broker-dealers.

### ◆ Prohibited transaction

Equally prohibited



## (2)Exemptions

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- ◆ Article 129, Cabinet Office Ordinance regarding Financial Instrument Business
  - Transaction to terminate client portfolio
  - Transaction not to breach the restriction of maximum holding amount or weight based on client mandates or regulations
  - Transaction deemed as “necessary and reasonable” in light of investment policy, investment size and market condition.
  
- ◆ Inspection Manual for Financial Instruments Business Operators
  - Buy and Sell orders (by a single trader) for the same security placed by more than one fund managers
  - Buy and Sell Market Orders placed before the market open
  - Cross orders placed during the market continuous session with a certain length of time interval of order placements
  - Transactions for systematically-traded index funds
  - Crossing with Broker discretion orders including VWAP target



## (3)Buy-side Challenges

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- ◆ Best Execution vs. Compliance with Inter-fund cross trades rules
- ◆ Sample Cases;
  - The rest of partially filled market order (selling order) occasionally crosses with a buying order at the same execution price
  - Part of a selling order which is placed through a broker algorithm crosses with a buying order at the same price  
(Can this be considered as one of the exemptions where transaction is executed by a third party such as VWAP target etc ? )
  - Model driven accounts produce buying and selling orders for the same instruments if accounts have different cash flows when portfolios are rebalanced



## Recap

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- ◆ Best Execution Policy of FIEA is

Not clearly defined for investment managers

- ◆ Obligation of Investment managers

Article 36 Good Faith to Customers

Article 43 Duty of Due Care of Prudent Manager



## (4)US Cases – Internal Cross trade -1

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### ◆ Mutual Funds ; SEC Rule 17(a)-7, Investment Companies Act

A purchase or sale transaction between registered investment companies is exempt from section 17(a) of the Act. Provided that;

- Market quotations are readily available
- The transaction is effected at the independent current market price of the security
- The transaction is consistent with the policy of each registered investment company
- No brokerage commission, fee



## (4)US Cases – Internal Cross trade -2

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- ◆ ERISA Fund (for pension funds) - Fiduciary Self-Dealing:  
To avoid “conflicts of interest” between client accounts, cross trades would be limited to some exemption cases.
- ◆ Agency cross-trade rules; SEC Rule 206(3), Investment Advisors Act, SEC’s Interpretation
  - an adviser is not "acting as broker" within the meaning of the Section if the adviser receives no compensation
- ◆ Exemptions promulgated by the Department of Labor PTE 86-128
  - Class exemptions
    - ✓ Index Fund, Model-driven fund
    - ✓ The use of last price, No commission, Objective allocation
    - ✓ Triggering Event
  - Individual exemptions
    - ✓ Wells Fargo, State Street, Northern Trust, Fidelity
  - Exemption does not address cross trades of securities among “actively-managed” accounts.





## (5)Next steps to move for relaxing cross trades

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- ◆ Exemptions of those prohibited cross trades in Japan should be reviewed based upon more pragmatic and specific considerations of the ongoing investment management process.

### -Proposed examples of exemptions;

#### 1. Expanding Interpretation of Model driven fund

(now) systematically-managed index fund

(after) Index funds managed by computer programs - model-driven fund

#### 2.Consideration for Active Funds.

- "Trades for adjusting the total asset values of fund due to an investment cash-in and cash-out"
- "Cross-trades must take place within three (3) days of a triggering event"
- "No further cross trade is allowed for three (3) days from the date when the last cross trade took place"
- "The total amount of cross trades should be less than 5 percent of the aggregated average daily trading volume for the security for the past three months"



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## **3.Commission Sharing Agreement (CSA)**



## (1) Why CSA in Japan ?

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- ◆ CSA is highly expected to be introduced because
  - Investment Manger can achieve best execution in the background that
    - Development of execution service and the growing trend  
DMA, Algorithm, Crossing Network
    - Emergence of broker-dealers who only provide execution service  
Buy side traders are reducing the number of execution brokers for efficiency
  - Ongoing Japanese Globalization
    - Growing trading volume by overseas investors
    - Response to overseas disclosure guideline, negative impression to Japan
  - Concern over the continuity of research service as execution volume decreases
    - Opposite reaction took place in UK
- ◆ Key Differences
  - Fiduciary duty on use of soft commission and execution commission by asset managers is not so much recognised here in Japan.
  - Motivations are best execution, expanding research access, etc.



## (2)Case Study - UK & US - CSA

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### ◆ Commission Sharing Agreement (CSA) UK

- FSA Policy Statement 05/9, Effective from 1 Jan, 2006

Transitional Period until 30 June 2006.

- limit investment managers' use of dealing commission to the purchase of 'execution' and 'research' services
- require investment managers to disclose to their customers details
- incentives to secure value for execution and research
- promote competition between independent research service providers
- Rapidly adopted as MiFID was introduced in Nov 2007

### ◆ Client Commission Agreement (CCA) USA

Not as actively adopted as in the UK, however SEC continues to review the rules

- SEC Rules 28(e)

Safe harbor rules which allows money managers to purchase without breaching its fiduciary responsibility

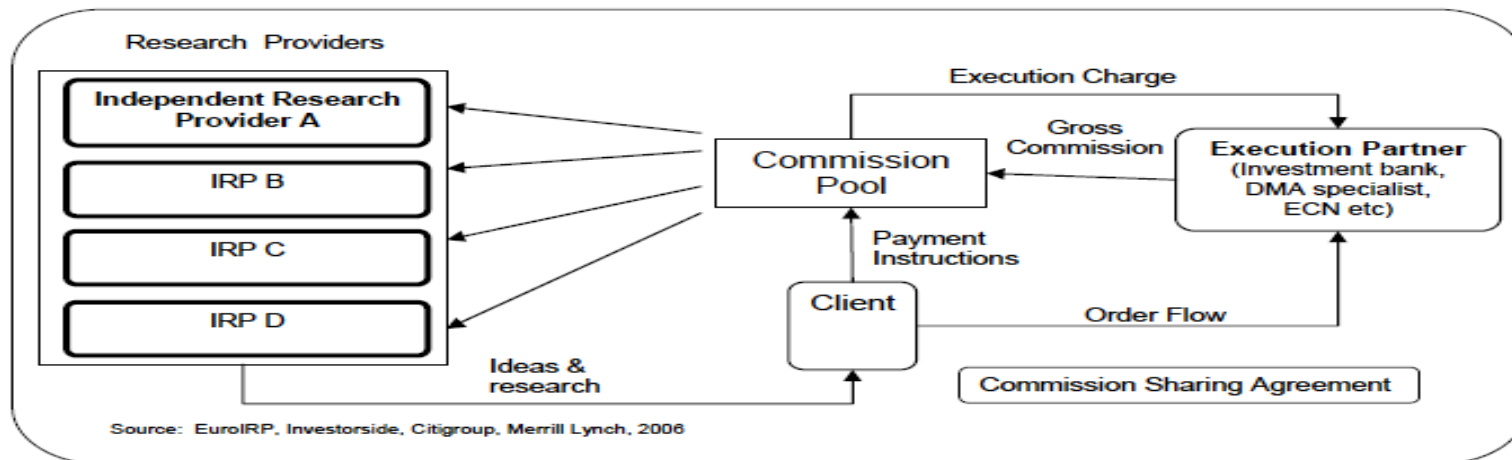
- SEC No Action Letter

Commission pools lose their character as “commissions” when they are used to compensate a research firm

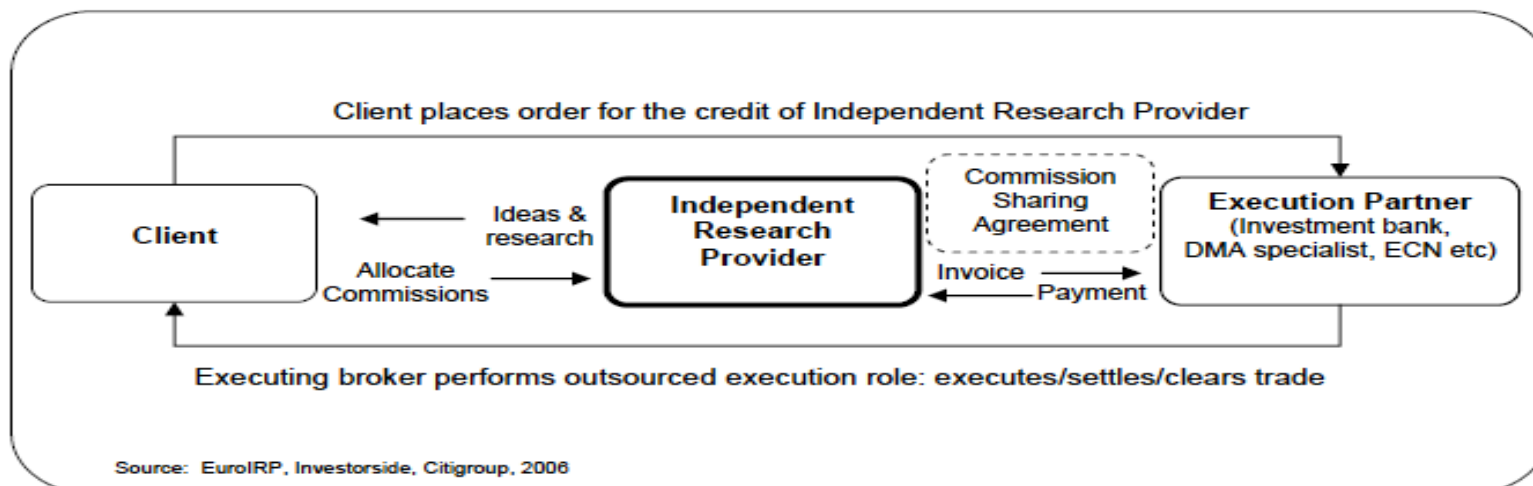


### (3) CSAs take two main forms

*"Pooled" CSA structure*



*Individual CSA structure*





## (4) IMA(UK) -Pension Fund Disclosure Code

Investment Management Association

### APPENDIX 3

#### IMA COMPARATIVE DISCLOSURE TABLE

How commissions paid have been generated and how they have been used

Report for: Client A

Asset type:

#### Analysis of Trading in period

| Counterparty | Total (£) | Of which: |                      |                |
|--------------|-----------|-----------|----------------------|----------------|
|              |           | % Net     | % with Commission    |                |
|              |           |           | At Full Service Rate | At Other Rates |
| 1            |           |           |                      |                |
| 2            |           |           |                      |                |
| 9            |           |           |                      |                |
| 10           |           |           |                      |                |
| Other        |           |           |                      |                |
| ALL          |           |           |                      |                |
|              | (a)       | (b)       | (c)                  | (d)            |

| Firm-Wide Comparators                  |      |   |   |   |
|--|------|---|---|---|
| All (Equity/Bond/Other) Trading        | 100% | % | % | % |
| Client A Trades                        | 100% | % | % | % |
| Average Firm-Wide Commission Rate (bp) |      |   |   |   |
| Client A Average Commission Rate (bp)  |      |   |   |   |

#### Sources of Commissions Paid (£)

#### Uses of Commissions Paid (£)

| At Full Service Rate (£) | At Other Rates (£) | Total Paid Out (£) | Of which:                    |                       |                              |                       |
|--------------------------|--------------------|--------------------|------------------------------|-----------------------|------------------------------|-----------------------|
|                          |                    |                    | For Execution (£)            |                       | Other <sup>1</sup> (£)       |                       |
|                          |                    |                    | Retained by Executing Broker | Paid to Third Parties | Retained by Executing Broker | Paid to Third Parties |
|                          |                    |                    |                              |                       |                              |                       |
|                          |                    |                    |                              |                       |                              |                       |
|                          |                    |                    |                              |                       |                              |                       |
| (e)                      | (f)                | (g)                | (h)                          | (i)                   | (j)                          | (k)                   |

|   |   |      |   |   |   |   |
|---|---|------|---|---|---|---|
| % | % | 100% | % | % | % | % |
| % | % | 100% | % | % | % | % |
|   |   | XXbp |   |   |   |   |
|   |   | XXbp |   |   |   |   |

<sup>1</sup> Other is research.



## (5) Japanese FSA is about to change rules, however

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- ◆ Senior Management Arrangements, Systems and Controls (SYSC), FSA Handbook
  - Chapter 10, Conflicts of Interest / Types of Conflicts
    - (5) receives or will receive from a *person other than the client* an inducement in relation to a service provided to the *client*, in the form of money, goods or services, other than the standard commission or fee for that service. -----which means “Soft commission”.
  - Conflict of Interest measures is about to be incorporated in FIEA
- ◆ The enactment of the Bill for Amendment of the Financial Instruments and Exchange Act (2008/6/6)
  - Relax the firewall regulations between securities firms, banks and insurance firms
  - Establishment of systems for managing a risk of causing conflicts of interest
    - What about soft dollars ?



## (6) Next Steps

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- ◆ Recognizing an ongoing paradigm shift
  - Top-tier brokers
    - should strengthen both execution and research service
  - Middle and low - tier brokers
    - would be encouraged to provide a distinctive research service which will differentiate themselves without a highly IT-driven execution service.
- ◆ Deregulation needs framework- Guideline to be considered
  - Industry associations need to set up the guidelines which will include ;
    - Definition of the “research”
    - Designated investments for the purpose of its use
    - Detailed condition of goods or services
      - adding value to the investment or trading decisions
      - does not merely state what is commonplace or self-evident
    - Record keeping and the method and timing of disclosure to clients
    - Broker evaluation rule
    - Require investment manager to establish adequate internal rules





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## Conclusion



## Conclusion (1)

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- ◆ Experiencing credit-crunch and sub-prime turmoil
  - Decreasing M&A, Shrinking investment bank business
  - however business of investment managers continue
  
- ◆ From “Savings to Investments”
  - Key challenges
    - Encourage the retails sector to invest more on Investment Trusts (Toshin)
    - Growing importance of pension fund and its reform for the future
    - Traditional asset management companies have to play more and more important role
  
- ◆ Can an institutional buy side market be a catalyst to revitalize the Japanese market?



## Conclusion (2)

### ◆ FIEA (*Kinshoho*)

Clearer measures of strengthening and internationalising the institutional investment management business in Japan are highly desired.

### ◆ Revitalization of the Tokyo capital markets and gaining its credibility

#### 1. Provide more liquidity through;

--- Realizing Best execution by investment managers

--- Solid trading volume by domestic institutional investors

More incoming off-shore buy-side order flows with a better access

#### 2. Develop alternative execution venues

--- Supply more liquidity by execution-specialist type of broker-dealers

--- Distinguish each broker based upon strength either by execution or research

### ◆ For further proliferation of asset management business in Japan; we should provide

1. Easy-to-access financial markets structure from overseas fund managers / investors

--- Global standard, clear and fair regulation structure

2. Tokyo to become the hub for accessing the whole Asian market ?

--- Product development and marketing of cross border Investment Trusts across Asia

--- JDR, Markets for professional investors,

Emergence of independent research provider

Best  
Execution  
Policy for IM

Cross  
Trade

CSA