

Backing the tortoise

Is Japan's slowly, slowly approach the best route to the *best* best execution?



As the fable of the hare and the tortoise taught us, being the fastest away from the blocks does not guarantee the best result. Most in the trading community agree that Japan has lagged behind international standards, despite the importance of its market. However, as Peter Twist of IND-X Securities reports, taking a look-and-wait approach may be Japan's path to success.



By Peter Twist, CEO, IND-X Securities

These days, it seems impossible to have a discussion about trading without someone alluding to the concept of a more formalised “best execution” mantra. Fuelled by the ever-increasing number of independent execution venues, the obsession with best execution might have become a global fad, but is it anything new? Arguably, the practise has always been at the forefront of all those within the trading community, aided by varying degrees of direct involvement from

fund managers. Yet, if this is the case, why is there suddenly so much interest? The fundamental issue surrounding the topic of best execution has to be the underlying meaning. What is best execution?

Everyone has an answer, but there is no single definition that satisfies all parties, and divergent motives allow for significant freedom of interpretation. Even within segments where one might expect a degree of consensus, there is scope for fragmentation. For instance, fund managers

who fall into the long term buy and hold category could differ markedly from shorter term momentum investors who could, in turn, be diametrically opposed to the latency play individuals. While the definition of best execution isn't, in itself, a reason for choosing one execution venue over another, the lack of unanimity only serves to support the self-serving world of best endeavours.

Japan catching up?

Historically, Japan has never been at the cutting edge of new trading landscapes. Rather it has often been slow to move beyond the primary exchanges (including some of the smaller, regional exchanges), and still offers very little in terms of alternative venues. While PTS or similar licenses are now available, and some leading brokers have applied to operate competing venues, there have been varying degrees of success.

The core issue for Japan has always been, and – at least for the foreseeable future – looks set to be, the divide between its domestic / onshore and its foreign / offshore trading models. The irony is that new best trading practices are not being forced onto the foreign broker by the local authorities, but rather the high number of foreign brokers operating in Japan are forcing change onto the markets. Given the importance Japan plays within the global economy, this is as surprising as it is expected.

Balancing foreign and domestic interests

Domestically, however, any changes that occur are happening at a much slower rate on the back of the onset of a number of retail focused, i-net based platforms. Retail investors have been a leading force in Japan for some time, and it is only natural

third of the trading population.

While Japan's domestic economic woes should not be overlooked, the country still needs to recognise the demand and the long-road to travel if it is to open up the established exchanges to greater competition. In short, it has to do more to bring down the costs of participating in its markets, and it has to do more to embrace changes currently being advocated, such as the unbundling of trading and research that has driven trading innovations in other international markets.

That said, Japan has its advantages. Widespread fragmentation, seen in other international markets, has not happened, and this has allowed the procedures of clearing and settling to remain relatively straightforward. So, while it is clear that Japan needs to keep abreast of global changes, its careful hold-back approach is not always a bad thing.

Accessing domestic capital

One of the tallest hurdles for any foreign investor in Japan has been how to approach the vast and generally conservative wall of domestic money. Domestic money is principally held via Toshin Funds (mutual funds) or Tokkin Funds (investment trusts), and the onshore nature of these products makes it both complicated and expensive for genuine advances to be made. For example, it is only within the last few years that these Toshin and Tokkin onshore funds

capacities have improved, but for as long as FIX becomes increasingly relevant, significant challenges remain if some of the possible advances are to be fully and successfully explored.

Entering the unbundled world

A key driver behind recent international changes has been the need for fund managers to be more open to their stakeholders about the services for which they are paying, and how much they are paying. Japan has yet to embrace the concept of unbundling, but its regulators have investigated the issues to the point of exhaustion, and are now prepared to consider how best this process might be implemented in Japan. The indications are that some direction on this matter will be issued from the FSA (Financial Services Agency) towards the end of this year, and the market waits expectantly.

Commission Share Agreements, (CSAs, or CCA, Client Commission Agreements in the US) are now an established part of the international trading landscape, and the universal uptick of interest in alternative research is immense – but neither has yet reached Japanese shores. These are two areas that could seriously benefit Japanese brokers. Alternative research can, by its very nature, afford to be more thought provoking and useful than its bulge bracket competitor. To that end, if a research provider is able to be rewarded for that product via a CSA (executed using cutting edge technology, with the commission credits being held in segregated accounts), research providers would probably find themselves better rewarded than they are currently: CSA's would uphold the value of research and not tarnish the quality of research at the expense of poor quality execution.

Would CSA's mean that trade flows are concentrated into a smaller number of venues? Potentially, but the deciding factor would be best execution. In the same way that independent / alternative research has to stand on its own two feet, so execution venues should need to justify their existence.

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that regulators need to balance newer ideas with both foreign and domestic interests in mind. The question is: What has this meant for Japan? The upshot is that, despite new trading landscapes with their high degree of automation, significant advances have been slow to gain traction in Japan. The efforts instigated by the bulge-bracket firms may have been implemented in their local Japan operations, but this only caters for up to a

have started to accept an average price for a trade rather than seeing a print for every line of execution [i.e. the fund couldn't buy 10,000 SONY 6758 @ an average 25.11, it would have to buy and book trades in the actual lot sizes purchased, say 1,000 shares, 10 times over].

Japan does now allow Direct Market Access (DMA), so some advances have been made, and exchange latencies and

if a fund manager is not compelled to pay directly for services via execution and can use alternative, preferred execution venues to pay for research services via a commission share, many of Japan's very able and worthwhile brokers may suffer. If the principles of best execution are not being met by a given broker, it stands to reason that there should be other ways of paying for research. Indeed, implicit within the CSA model is a requirement for

fund managers and/or traders to examine and understand their rationale for trading through a particular venue, as payments are no longer locked to any one broker.

Japan is lucky to have a variety of influential regional and smaller brokers that provide valuable insights into the depths of domestic Japan and add significant value to fund managers, but as the trading landscape moves towards global imperatives, it may happen that being a large local entity is

certainly not an asset of the brokers that hold the commission pots.

The best way forward

The modern trading environment now provides fast, direct access to market gateways at generally attractive rates, such that execution risk has now been



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not in itself sufficient to ensure continued trade flows. On the other hand, a good local service or agency only local execution broker will generally be required in all local markets in which a fund manager needs to trade. The defining issue is pure, unbundled quality.

However, some brokers have yet to embrace FIX technology which makes it difficult to trade with them, both from a best execution and counterparty risk perspective. Given all these factors, it is doubly important for regulators to think long and hard about how advances in the execution landscape could impact the local brokerage community.

Protecting commissions

Another challenge for Japan as it moves towards a CSA environment, will be the protection of the commissions generated but not yet paid out. This was an issue that took centre-stage in October 2008, since when, and rightly so, fund managers have become more demanding about what is happening to their commission dollars post trading. One issue that remains strangely blurred is whether monies awaiting payment in a commission pot remain an asset of the fund manager. Thankfully, it seems common sense has prevailed, and there is general agreement that such monies are not an asset of the research / service providers (at least until payment has been made), and

passed back to the buy side dealer. The next step for Japan is clear, but will not be easy. Establishing a best execution ideology, within the CSA concept of trading in one location and purchasing services from another, is novel and will take time to become established, especially within the domestic community.

Exciting times lie ahead for Japan and, supported by the cornerstone of the FIX Protocol, large roles await those companies, such as IND-X, that provide a complete CSA offering. Best execution relies on ease to market, and standardised, electronic order routing simplifies this process without compromising on flexibility. It offers transparency, reduces errors and, with some of the vendor products that are now available, can interact with systems from portfolio creation, order placement and execution through to downstream processing and transaction cost analysis. Japan might not be the first market to unbundle, but it has the chance to be the best.

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