

Interim Report on the Concept of a “Securities Market”

1. Background

The Law Regarding the Modification of Related Laws for Reform of the Financial Systems (the “Financial Systems Reform Law”) came into force in 1998. Changes made by the Financial Systems Reform Law included liberalization of brokerage commissions on the sale of stocks, enhancement of the regulations for the organization of stock exchanges, and enhancement of regulations concerning the over-the-counter market (the Securities and Exchange Law, hereinafter “SEL”, Article 67 and thereafter). The Financial Systems Reform Law also eliminated the requirement to concentrate stock transactions in an exchange,¹ and enhanced the regulations related to outside exchange trades (the SEL Article 2(8)(vii), Article 29, and Article 80). These changes also amended the status of the over-the-counter market, giving it the same status as an “exchange,” which had been the traditional “securities market,” while the over-the-counter market had served as a supplementary market. The name of the over-the-counter market was also changed to “the market in over-the-counter traded securities.”² Further, upon the introduction of proprietary trading systems (PTS) as a new

¹ The requirement to concentrate stock transactions in an exchange market sought to achieve both a density of transactions and a fair price formation by concentrating stock trading in one place. Previous exchange charters (e.g., Chapter 23 of the Tokyo Stock Exchange Charter) contained a rule that members must trade instruments such as listed shares on the exchange even if a customer gave an instruction stating that the instrument might be traded off of the exchange. Even securities companies that were not members of an exchange were understood to be required, by regulations concerning the method of business, to trade in instruments such as listed shares executed on a securities market of an exchange, through contracting the trade to a securities company that was a member of an exchange. The reasons for reconsidering the market-concentration requirement were (1) a necessity to promote competition between markets in order thereby to improve fairness and efficiency of the securities market, (2) the diversification of investors’ requirements concerning transactions, (3) a need to improve market infrastructure commensurate with new trading systems that are likely to appear as a result of advancements in telecommunications and information technology, and (4) a need to cope with globalization of securities trading. See Katsurô Kanzaki “Abandonment of the Market Concentration Rule,” in Shôken Torihiki Hô Kenkyûkai (ed.), *Reform of the Financial System and Securities Trading Systems* (Tokyo: Japan Securities Economics Research Center, 2000), at 145ff.

See also Jun Yokoyama, “Present Conditions and Issues of Off-Exchange Trading in Japan,” *Shôken Keizai Kenkyû*, 26 (2000), at 77ff, which states “the purpose of concentrating transactions on an exchange is to ensure liquidity and discovery of a suitable price through the concentration of supply and demand. Eliminating this requirement and removing the prohibition against trading outside an exchange presents the issue of how to prevent adverse impacts from interruptions of supply and demand, and how to ensure liquidity and fair prices.”

² SEL Article 67(2) defines this as “a market for the purposes of trading (limited to members trading on their own account or where a member acts as a broker, intermediary or agent. The same shall apply hereinafter in this paragraph and to Article 75(1)) in securities (limited to securities that have been registered pursuant to Article 75(1)) for the objective of facilitating the distribution of securities (limited to those that are not listed on a securities exchange. The same

means of transaction outside of organized exchanges, venues for trading in securities have been expanded. Changes such as the reform of the regulations governing the conversion of securities exchanges into stock companies, improvement of regulations concerning over-the-counter markets, and the advent of PTS have raised the level of awareness of competition between exchanges. New trading formats such as the Tokyo Stock Exchange Trading Network System (ToSTNeT), which differ from the traditional auction market, have also been launched within securities exchanges. A variety of techniques have thus been introduced into the secondary market for securities, including the launching of several new markets for the purpose of trading in the stock of venture companies and similar businesses. Moreover, with regard to buybacks by listed companies, revision of the Commercial Code in 2001 replaced the words “exchange” and “transactions equivalent to an exchange” with the word “market”.³ This report examines the concept of a “securities market” and several topics involved.

2. “Securities Market”

The present SEL defines a “securities market” as “a market which engages in trading of securities, futures transactions of securities indexes, etc., or securities options transactions (hereinafter referred to as ‘securities trading, etc.’)” (the SEL Article 2(12))^{4,5} As to what

shall apply hereinafter in this paragraph and in Article 75(1)), to assure the fairness of trading or other transaction therein, and to contribute to the protection of investors.”

³ Prior to the revision of the Commercial Code in 2001, regulation of buybacks was under Article 210-2(10) of the Commercial Code, which provided as follows:

In the event of purchasing shares under paragraph 1, if the shares are shares with a market price, they shall be purchased in a transaction on an exchange, and if the shares are shares with a price that is similar to a market price on an exchange they shall be made through a transaction that is similar to a transaction on an exchange, provided that this shall not apply to a transaction made in which public notice is given of the purchase of shares.

After the 2001 amendment of the Commercial Code, Article 210(8) reads as follows:

A purchase of shares pursuant to a resolution of paragraph (1) must be made pursuant to a transaction on a market, or through a method of a public tender offer as prescribed in Chapter 2-2, Section 2 of the Securities and Exchange Law (Law No. 25 of 1948), provided that this shall not apply if a resolution has been made in connection with a matter set forth in paragraph (2)(ii).

⁴ Prior to the 1998 revision (Law No. 107), SEL Article 2(12) stated that a “securities market” was a “market held by a securities exchange for the purpose of securities purchase and sales transactions, etc. (Author’s note: meaning a purchase and sales transaction of securities, futures transactions of securities index, etc., and securities options transactions). Subsequent to the 1998 amendment, this clause was changed to read “under this law a ‘securities market of an exchange’ shall mean a market held on a securities exchange for the purpose of trading, etc. in securities,” and the definition of a “securities market” was deleted. Then in the 2000 amendment (Law No. 96) Article 2(12) was shifted down to Article 2(15), and was amended as “under this law ‘a securities market of an exchange’ shall mean a securities market held by a securities exchange,” while a new Article 2(12) was added and a definition of a “securities exchange” once again appeared. After the 2000 amendment, Paragraph 12 read “a securities market” under this Law shall mean a market which engages in trading of securities, futures transactions of securities index, etc., or securities options transactions (hereinafter referred to as “securities trading, etc.”).

⁵ The concept of a securities market taken up here is that of a secondary market in contrast to a primary market. A secondary offering of securities that have been previously issued (SEL Article 2(4)) is subject to the same restrictions that apply to a primary offering, since the pressure of selling will increase as a result of selling to numerous persons. Off-floor distribution conducted at an exchange (for example Article 42 and below of the Operating Rules of the Tokyo Stock Exchange), however, seems to be restricted only as a secondary market. The distinction between

constitutes a “securities market,” the SEL clearly states in its definition that a “securities market of an exchange” constitutes a securities market (Article 2(15)), and it is thus clear from the definition that a “securities market of an exchange” does constitute a securities market. Further, the SEL Article 67(2) defines a “market in over-the-counter traded securities” as “a market for the purposes of trading (limited to members trading on their own account or where a member acts as a broker, intermediary or agent. . . .) in securities (limited to securities that have been registered pursuant to Article 75(1)) for the objective of facilitating the distribution of securities (limited to those that are not listed on a securities exchange. . . .), to assure the fairness of trading or other transaction therein, and to contribute to the protection of investors.” Although a “market in over-the-counter traded securities” is restricted to trading of securities, and trading is not permitted in futures transactions of securities indexes, etc. or securities options transactions, a “market in over-the-counter traded securities” is included within the scope of a “securities market.”⁶

3. Transactions Outside a “Securities Market of an Exchange” and “Over-The-Counter Securities Market”

Advances in information technology have made possible new modes of securities transactions other than a “securities market of an exchange” or an “over-the-counter securities market.”

Starting in the 1950s, the natural-monopoly characteristic of exchanges underwent a revision in the United States, and Instinet, a means of trading securities by the use of computers, was developed in 1969. Following that, in 1975, stock trading commissions were deregulated and the Securities Exchange Act of 1934 was amended to make all exchange and non-exchange markets into competitors. Demand subsequently increased for trading outside

primary markets and secondary markets is not very clear.

Further, “securities,” as defined by the present Securities Exchange Law (Article 2(1)), includes a wide variety of instruments, but it is mainly stock certificates that are relevant in the concept of “market,” as they have a long history of regulation and are traded in high volumes. There may be some doubt about treating low-liquidity securities in the same manner as shares. Concerning this approach, see Tatsuo Uemura, “New Scheme – The Securities and Exchange Law (Part 1) – Purpose of the Law and Its Organization,” *Kigyō Kaikei*, 53:4 (2001), at 132ff.

⁶ A “securities market” is understood as essentially meaning a “securities market of an exchange,” or a “market in over-the-counter traded securities” (or an equivalent market in a foreign country). Nevertheless, there is room for interpreting a securities market as including other mediums, such as the proprietary trading system (PTS) of SEL Article 2(8)(vii). The grounds for interpreting the PTS as also constituting a “securities market” include (i) SEL Article 2(12) which defines a “securities market” as a “market which engages in trading, etc. of securities,” and is not a restrictive definition such as “a securities market of an exchange, or a market in over-the-counter traded securities”; (ii) SEL Article 167-2 which prohibits trading on a “securities exchange” opened in violation of Article 80, while a “securities market of an exchange,” and a “market in over-the-counter traded securities” are not securities markets opened in violation of Article 80. Consequently, it is not necessarily true that a securities market only includes the concepts of a “securities market of an exchange or a market in over-the-counter traded securities”; (iii) given the changes in codification stated in footnote 4 above, the concept of a “securities market” as defined in paragraph 12 after the year 2000 amendment developed separately from the concept of a “securities market” prior to the 1998 amendment. The pre-1998 concept of a “securities market” is probably closer to the “securities market of an exchange” as prescribed in paragraph 15 of the present law, while the concept of a “securities market” under paragraph 12 after the year 2000 amendment is a new concept and should be kept separate, even though it uses the same term as that used prior to the 1998 amendment.

auction markets, as a result of the institutionalization of investors. At the same time, the National Market System⁷ was introduced as an inter-market contract information transmission system in order to eliminate the discontinuity between markets, and attention was given to regulations governing trading outside of exchanges. During this time, the name of the trading system given attention shifted from PTS to Alternative Trading Systems (ATS) and then to an Electronic Communications Network (ECN), which was considered to be a type of ATS. The Securities Exchange Commission defined an ECN as “any electronic system that widely disseminates to third parties orders entered into it by an exchange market maker or over-the-counter market maker, and permits such orders to be executed in whole or in part.” This definition excludes in-house order execution systems as well as crossing systems that execute orders at a given price at a given time. According to a study released in June 2000 by the Securities and Exchange Commission on ECN and after-hours trading released,⁸ nine companies’ ECN were in use in the stock market at the time the study was made, and trading through these systems was equivalent to about 30% of trading (in number of shares) and about 40% of the value of NASDAQ stocks. As of the present day, however, the idea that these systems can be differentiated in nature or concept from an exchange has been abandoned, and at the present time the ATS can choose with consideration given to the scale of operations, whether it is to be regulated in accordance with regulations for broker-dealers as well as those for an ATS itself, or, alternately, to be registered and regulated as an exchange.⁹ Action has also taken place in the United States to introduce a unified price

⁷ The basic concept of introducing a national market system is explained as follows:

An essential concept of a national market system was ‘to make information on prices, volume, and quotes for securities in all markets available to all investors, so that buyers and sellers of securities, wherever located, can make informed investment decisions and not pay more than the lowest price at which someone is willing to sell, or not sell for less than the highest price a buyer is prepared to offer.’

(U.S. Securities and Exchange Commission, “Special Study: Electronic Communication Networks and After-Hours Trading,” June 2000).

⁸ *Id.*

⁹ Yasuyuki Fuchita, “Exchange Regulations and Regulations of Private Trading Systems,” 1155 JURIST 185ff (1999). Shimizu Yoko. “Proprietary Trading Systems in America and Inter-Market Competition” 7 SHOKEN KEIZI KENKYŪ 122ff (1997).

In December 1998, the SEC enhanced its regulatory framework in connection with ATS systems, and adopted the Regulation ATS in order to join the ATS into a nationwide market system. This offered an ATS the alternative of being regulated as a market broker, or registering as an exchange in the form of its own market. Moreover, ATS systems with considerable transaction volume are required to comply with the following supplemental regulations:

- (a) Alternative trading systems registered as broker-dealers were required to link with a registered exchange or with the NASD and publicly display their best priced orders (including institutional orders) for those exchange-listed and NASDAQ securities in which they had 5% or more of the trading volume. Alternative trading systems also had to allow members of the registered exchanges and the NASD to execute against those publicly displayed orders ...
- (b) An alternative trading system with 20% or more of trading volume also had to ensure that its automated systems met certain capacity, integrity, and security standards. This was intended to prevent the system outages ...
- (c) An alternative trading system with 20% or more of trading volume also had to refrain from unfairly denying investors access to its system. This requirement only prohibited *unfair* discrimination among persons seeking access. The systems were free to establish *fair and objective* criteria, such as creditworthiness, to differentiate among potential participants.

(U.S. Securities and Exchange Commission, “Special Study: Electronic Communication Networks and After-Hours Trading,” June 2000).

publication system and to ensure thorough performance of the best execution practices, in order to prevent market fragmentation in the competition among markets including exchanges and markets outside exchanges.

While the United States has taken these actions, Japan has also experienced legal amendments. What the Securities Exchange Law now calls “securities markets” includes three types, namely “securities markets of an exchange,” “markets in over-the-counter traded securities,” and “foreign securities markets” (the SEL Article 2(8)(iii)(b)), whereas, as stated above, prior to the Financial Systems Reform Law only “securities markets of an exchange” were defined as “securities markets.” From the viewpoint of fostering competition between markets, the principle of concentrating transactions in the market was abandoned when the SEL was revised in 1998, and securities companies were authorized to trade using a PTS as part of their securities business with authorization from the applicable regulatory authority.¹⁰ PTS trading refers to a trade, brokerage, mediation or agency that is carried out using an electronic data processing system according to a certain method in which numerous persons simultaneously become one of the parties (by use of any of four methods: that of using a market price for transactions; negotiation of a price between the buyer and seller; matching customer orders; and the method of offering a trading quotation).¹¹ It is understood that “these activities in opening electronic trading markets contribute to improvement of the convenience of investors through inter-market competition which raises the efficiency of the securities market in overall terms, and through improvement of the secondary market for securities having low trading volume.”^{12,13}

¹⁰ Even though the market-concentration rule was abandoned and off-exchange transactions, such as those by means of PTS, were authorized, “securities markets of an exchange” have continued, as is noted after the main text of this report, to be the major market for securities trading, and even the SEL provides that when an order to buy or sell securities has been received from a customer, “except when it has been clearly indicated that the order is for a transaction outside a securities market of an exchange, the purchase or sale must not be executed outside a securities market of an exchange” (Article 37). Further, bucket-shop operations remain prohibited (SEL Article 129).

¹¹ PTS operation is defined as a form of the brokerage industry in the SEL Article 2(8)(vii) and the Cabinet Office Order Concerning the Definitions Set forth in Article 2 of the SEL Article 8-2 (see reference text at the end of this document). Together with the revision of the this Cabinet Office Order (on November 16, 2000) the conditions to be satisfied for approval of a PTS were released by the Financial Services Agency, as “Guidelines for Establishing a PTS.” Additionally, at the time of applying for approval, the following regulations seemed to be applied to a PTS: (i) regulations of the Japan Securities Dealers Association, namely “Regulations Concerning Trading Etc. of Listed Stock Certificates Outside the Exchange Market” (Fair Practice Rule No. 5), Article 4 Paragraph 3 and Article 5, concerning the movement range of prices of listed securities traded outside an exchange-type market, and (ii) the Japan Securities Dealers Association’s regulations concerning the movement range of prices of listed securities traded over-the-counter, namely Regulations for Transactions Such as Trading of Over the Counter Securities (Fair Practice Rule No. 1-22), Article 20. Through these measures, for example, it is necessary in the case of listed securities to conform to price limits during the hours of business of the exchange, but not after the exchange has closed. Goldman Sachs is understood to have already begun night trading of listed securities without price limits, by using the market-making method (see the company’s homepage, at www.gs.com/japan). Monex is handling trades at night using the exchange’s closing prices (see www.monex.co.jp).

¹² Guidelines for Establishing a PTS, *supra* note 11.

¹³ Some are also of the opinion that the novelty of a PTS is in its equivocating of the distinction between exchanges (markets) and broker-dealers (principals). See Sôichirô Ozuka, “Comment on Tadakazu Ôzaki, ‘Issues in Regulation of Electronic Securities Trading,’” in *Advance of*

4. Issues Related to the Concept of “Securities Market”

Here we examine several issues (including issues related to legislation) concerning the concept of a “securities market” as discussed above. Although in the present SEL alone there are more than 50 articles and sections where “securities market,” “securities market of an exchange,” and/or “over-the-counter securities market” are mentioned, this report discusses the following topics:

- (1) A “securities market” and a PTS
- (2) Takeover bids, and a “securities market of an exchange” or a “market”
- (3) Exceptions to regulations against insider trading
- (4) A “securities market of an exchange” in regulations barring price manipulation

5. The Study

- (1) A “securities market” and a PTS
 - a. PTS and the price formation mechanism

The SEL Article 80(1) states that a license from the Prime Minister is necessary to open a securities market, but a license is not required if one of the items of paragraph (2) thereof is satisfied. Whereupon item (ii) of paragraph (2) states that in principle a license is not needed when a securities company, a foreign securities company, or a registered financial institution engages in trading, brokerage, mediation, or agency of securities transactions in accordance with the SEL or the Law Concerning Foreign Securities Firms. However, in such a case, an exception is made when the transaction “is to be carried out by auction or other method as may be prescribed by order of the Cabinet Office.” Article 1 of the Cabinet Office Order Concerning Securities Exchanges states that except in the case of use of the auction method, a license is required when transactions are carried out through a trading method in which a permanent market-maker offers price quotations in a manner similar to the over-the-counter market, or when trading, brokerage, mediation or agency of such transactions is carried out (i) with numerous persons simultaneously being one party or both parties, (ii) using an electronic information processing system, and (iii) using an operating method other than one that has been approved as a PTS.¹⁴ The argument motivating such an exceptional requirement of a license seems to be those methods which have advanced functions of price formation should be required to have licenses as “securities exchanges,” and be imposed duties as self-regulating organizations. However, the concept of “auction sales” has not been very clear, even though it is one of the standards for determining whether a license is required. A PTS is also permitted to use the customer order matching method (in which a transaction is made when a limit order made by a customer matches another limit order indicated by another customer who becomes the first party’s counterparty to the transaction), but at the time this was authorized, the Financial Services Agency commented that “while this method does have a type of price formation function in the form of matching

Information Technology, and Financial Regulation / Research Report No. 7, (Kyoto: Kyoto University Graduate School of Human and Environmental Studies, Department of Law, Juridical Practice Exchange Center, 2001). See also Shōken Torihiki Hō Kenkyūkai’s “Conversion of Exchanges into Joint Stock Companies” (*Investment*, 54:1 [2001]), at 35f (statement by Prof. Kanda), which holds that the ineligibility of an exchange to operate a PTS represents a defect in current law.

¹⁴ See reference text at the end of this report.

limit orders by customers, (a PTS) is categorized as not having as extensive a price formation function as a securities market of an exchange in the sense that market orders or the *ita-yose* method are not used.”¹⁵ Auction markets are generally referred to as “competitive” trading, and use the “*zaraba* method” in addition to the “*ita-yose* method,” on the basis of the principles of priority in time and of price. Even limit orders are made using such auction market methods¹⁶. Therefore, some element of “competitive” trading is already included in the method of matching customer orders. And if the “auction sale” in the statutory text cited above has the purport of being competitive trading, it is not certain that this concept is clearly maintained. It is also not clear whether the lack of both market orders and *ita-yose* of an auction sale are intrinsic to auction sales, or whether a lack of both market orders and *ita-yose* can be considered a definitive factor in determining that a PTS is not “auction sales.” For this reason, some are of the opinion that the price setting method would make it too difficult to define a PTS and an exchange.¹⁷

¹⁵ As in Note 11 above, “Guidelines for Establishing a PTS.” The guidelines comment on the method of trading price quotations as follows:

Although this method does have a certain price forming function in the sense that trades are performed based on the stated quotes of the market-maker itself, it should be categorized as not having as sophisticated a market forming function as in the case of a market for over-the-counter traded shares.

¹⁶ See “Domestic Stocks – Trading Rules – 5. Method of Making Sales Contracts” at the Tokyo Stock Exchange Website (www.tse.or.jp). Regarding “priority of time” and “priority of price” see Article 10 of the Tokyo Stock Exchange Operating Rules. Further, on the open issue on the meaning of “auction sales” prior to the issuance of the above-mentioned Cabinet Office Order, see Ryūtarō Sakata, “Issues Related to Clarification of Approval Criteria for PTS, and Further Improvement of the Legal Infrastructure Such As for the Settlement Environment on Behalf of Realization of a Smooth Operating Environment for PTS,” in *Kinyu Zaisei Jijō*, October 23, 2000, at 18ff.

¹⁷ At the time that public comments were made concerning the “Guidelines for Establishing a PTS” referred to in note 11, one of the comments adopted this interpretation. The Agency maintained its position that “From the viewpoint of investor protection, with special reference to the characteristics of matters such as the price formation function, in such cases as, for example, when a securities company or others make transactions by a method with a sophisticated function of forming prices, such as through an auction, this type of entity should be covered under supervisory regulations not as a “securities business” but as an “exchange,” having self-regulatory functions. The Agency further responded that the above Guidelines “maintain this position, and address this issue taking into consideration factors such as the protection of investors and the nature of the securities and transactions handled, within the extent permitted under interpretation and application of the SEL.” The Guidelines and the guidance for their application have as one part a quantitative standard for supervision of PTS. The following item is one criterion for approval:

{Quantitative Standard Based on Trading Volume}

- (1) During the past six months, if the ratio of the daily average value of trading of listed stocks and listed convertible bonds (hereafter called listed stocks, etc.) as well as over the counter stock certificates and over the counter convertible bonds (hereafter called over the counter stocks, etc.) handled by a PTS to the daily average traded on the Tokyo Stock Exchange, Osaka Stock Exchange, Nagoya Stock Exchange and in the over the counter market, is equal to 10% or greater for any issue, and is equal to 5% or more of the total of listed stocks, etc. and over the counter stocks, etc., then PTS must:
 - enhance or put in place a system (both an organization and human resources) that will manage and inspect trades in order to ensure the fairness of transactions;
 - put in place a system of the same type as the reserves for loss resulting from

b. Fragmentation of the principal and subordinate markets

Even if a PTS is accepted as stated above, such acceptance does not mean that such PTS will be permitted to be a “main” market. As a practical issue, PTS systems have only recently been introduced in Japan, and their transaction volume is not necessarily substantial. It is also clear that their position under law is one of being “subordinate.” The SEL Article 37 states that when a securities company has received a trade order from a customer for a listed security, “the securities company may not execute the trade outside a securities market unless the instructions of the customer clearly state that the trading should take place outside a securities market.” This paragraph is based on the principle that “the position has been taken that the price finding function of a securities market of an exchange should be maintained, and transactions outside a securities market of an exchange should be executed by using this function. In order for a securities market of an exchange to be efficient in performing its function of finding prices, it is desirable that as many trading orders in listed shares, etc. as possible be executed on securities markets of exchanges”¹⁸. While it is important to avoid market fragmentation and to enable discovery of fair prices in the market, these desiderata are not necessarily congruent with the intent of the above-described reforms, which have the purpose of promoting competition between “markets.” In the broad sense of competition between markets, this Article is heavily to the advantage of securities markets of an exchange. Assuming that PTS systems have both a system and internal controls that enable them to fill part of the role of the price finding function, a clause such as the SEL Article 37 should, after making a thorough statement of the duty of best-practice execution, have been essentially deleted through an act of legislation.

Explanations of price information and public disclosure of prices to customers are essential to eliminate fragmentation of trading within the market and to maintain the functions of a unified market. When a securities company has received an order to engage in a trade of a listed security outside an exchange, the securities company is obliged to provide certain explanations (the SEL Article 40; Cabinet Office Order Regarding Securities Companies Article 29; Japan Securities Dealers Association’s Rules Concerning Trading, Etc. of Listed Securities, Etc. Outside a Market of a Securities Exchange [Fair Practices Rules No. 5], Articles 14 and 15). Although these explanations are required to include certain price information such as the price on the securities exchange that publishes benchmark prices, there has been criticism that these explanations are only after-the-fact steps taken when a customer has already placed an order.¹⁹ Moreover, in order to achieve transparency and fairness in trading on the market as a whole, a securities company is also required to report

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- the breach of contracts at a securities exchange, in order to ensure the reliability of execution of settlements; and
 - periodically conduct sufficient monitoring to ensure the safety and stability of system capacity, etc.
- (2) A PTS must obtain a license to operate a securities market if, during the past six months, the ratio of the daily average value of trading of listed stocks, etc. as well as over the counter stocks, etc. handled by a PTS to the daily average traded on the Tokyo Stock Exchange, Osaka Stock Exchange, Nagoya Stock Exchange and in the over the counter market, is equal to 20% or greater for any issue, and is equal to 10% or more of the total of listed stocks, etc. and over the counter stocks, etc.
- (3) In addition, new standards will be set to the extent necessary for the public welfare or for the protection of investors in response to the increase of transaction volume.

¹⁸ Kanzaki, *supra* note 1, at 152.

¹⁹ Kanzaki, *supra* note 1, at 155.

to the Japan Securities Dealers Association (hereinafter “JSDA”) and to disclose transactions that have been conducted outside an exchange (the SEL Article 79-2 and Article 79-3). Article 10 of the JSDA’s Rules Concerning Buying, Selling, Etc. of Listed Securities Outside the Securities Exchange Market [Fair Practices Rules No. 5], requires a securities company which is a member of the Japan Securities Dealers Association to report to the JSDA certain matters related to any off-exchange transaction within five minutes of its occurrence.²⁰ Nevertheless, some are of the opinion that this requirement of Article 10 does not serve to ensure best-execution practices on behalf of customers, as discussed below, since the required report to the JSDA is not a report or a public disclosure of quotations.²¹

Since the 1970s the matter of “best execution” has been important in the United States, but under Japan’s SEL there is no clear requirement that securities companies must provide best executions. Securities companies in Japan do, however, have a duty of care as a conscientious management to customers who contract with them, on the basis of the duty of an entrustment (*inin*)(Civil Code Article 644).²² This presents the question of how a securities company who receives an order should handle a situation in which there is a conflict between this duty of care as a conscientious manager, and the obligation to place priority in trading on a securities market of an exchange (such as when it would be to the advantage of a customer to make a trade outside a securities market of an exchange, by a method such as the use of a PTS, rather than executing the trade on the exchange, even though the customer has not given an explicit instruction to make a trade outside a securities market of an exchange).²³ Whereas this is not necessarily an issue related to the SEL Article 37, there is a potential problem in the question of which market to use for executing an order when an exchange has more than one market, or when the security is listed on more than one exchange. Further study is thus needed concerning how to safeguard the interests of customers when a number of “securities markets” coexist. Some argue that Japan now needs a system that enables price comparisons, like the National Market System in the United States. In the operating guidelines for the FSA, there is a provision anticipating conditions for the authorization of this type of system, but at this time there is still no clear statement concerning best execution.²⁴ It is believed that as long as the existence of a multiple markets

²⁰ See reference text at the end of this report.

²¹ Kanzaki, *supra* note 1, at 159. As mentioned in note 24 below, publishing of price information, etc. to outsiders is a requirement for authorization of a PTS system.

²² SEL Article 42(1)(viii) prescribes the regulation of front running.

²³ Concerning this issue, see Kanzaki, *supra* note 1, at 152

²⁴ The following is one of the requirements for authorization under the Administrative Guidelines:

{Availability of Price Information to the Public }

In the event that share certificates, etc. (meaning share certificates, convertible bonds and other securities to be prescribed by order of the Cabinet Office as set forth in SEL Article 37) are covered by the business, publication should be made in a form in which the best quotes and the transaction prices, etc. of the system can be compared with other PTS systems, and through a method that enables outside parties to freely access the information in real time.

However, until such time as the format of publication can be arranged in a form that enables comparison with other PTS systems, it will be sufficient to make the information public by whatever method enables outsiders to freely access the information.

The meaning of best practice is not limited to price matters – it implies a need to select the best method for execution after considering the reliability and security of the execution process (Toku Terada et al., “Roundtable Discussion / Liberalization of Stock Trading Commissions, and the Value of Information,” *Shōken Analyst Journal*, 35:7 (1997), at 13ff).

is accepted, it is necessary to adopt a best execution rule as soon as possible.

c. Comparison to a non-auction market within an exchange

The exchanges, in keeping with the advance of diversification of investment techniques, the institutionalization of investors, and the intensification of global competition as well as other major changes in the environment, have adopted methods of processing trades that differ from those of the pre-existing auction markets. For example, the Tokyo Stock Exchange created ToSTNeT in 1998 as a new method of handling trades that would improve the efficiency and convenience of the exchange's market.²⁵ Other exchanges have also introduced trading methods other than the auction method, including the Osaka Stock Exchange's "J-NET"²⁶ as well as the Nagoya Stock Exchange's "Compenet" and "Dealers Board"²⁷. It is thought that this expansion of non-auction markets on exchanges will result in an adaptation of the existing concept that non-auction markets with sophisticated price setting functions will be treated as a "securities market of an exchange." Moreover, there is an undeniable possibility that if steps are not taken such as establishing best execution practices, these transaction methods together with PTS systems, will fragment the "market",

²⁵ See the TSE homepage, and Hirotake Kawai, "The Introduction of 'ToSTNeT,' a New Trading System," *Shôken* 35:7 (1997), at 13ff. According to this, ToSTNeT consists of two types: ToSTNeT-1 for large-scale or basket trades and ToSTNeT-2 for trades using either closing prices or value-weighted average prices (VWAP).

(1) ToSTNeT-1

In ToSTNeT-1, large-scale trades and basket trades are made at prices within a certain range based on the auction market outside of floor trading hours and in the same manner as off-auction floor market trades, and by cross trades using VWAP. In addition, ToSTNeT-1 offers a further medium for large block trades in which participants can negotiate transaction terms anonymously over a display terminal.

(2) ToSTNeT-2

ToSTNeT-2 is intended to satisfy the needs of those who wish to do trades using either closing prices or VWAP. Trades are possible from the minimum trading unit. Specifically, three times a day (8:45 a.m., 12:15 p.m., and 4:00 p.m.) off-hours buy and sell orders are accumulated and trades are executed using the closing price. In the case of such trades, orders are filled in the order of receipt, and cross-trades are filled prior to other types of trades.

(In addition to the above references, see Special Cases of Operating Rules Related to ToSTNeT Trades, at the Tokyo Stock Exchange Website.)

²⁶ J-NET is "(1) for trades (single-stock trades and basket trades) in the J-NET market operated by the Osaka Stock Exchange K.K., using (2) an electronic telecommunications network that (3) by use of a dedicated line (4) enables negotiation of the terms and conditions of trades" (information from the Osaka Stock Exchange). In December 2000 the Osaka Stock Exchange opened the Optimark market, but subsequently closed the market on June 2001 because of the low level of trading (see the Exchange's press release of June 5, 2001, at <http://www.ose.or.jp>).

²⁷ Compenet is a medium in which "institutional investors show terms such as the issues and quantities of their offers to securities companies (the 'offer') with whom they place orders and request a proposal of the execution price and commission (the 'proposal'). The investors then compare proposals by securities companies who respond to the offer, and determine the securities company with which they will contract."

The Dealers Board is understood as being a forum "on which securities companies state terms such as the sale price, the purchase price, the minimum quantity, and the maximum quantity for each price of issues that the securities company would like to trade on its own position, and institutional investors can place orders in the quantity that they desire based on the conditions offered" (information from the Nagoya Stock Exchange).

and will make it more difficult to achieve integrated and fair formation of prices. It is necessary to devote serious study to whether "exchanges" should use this form of transaction, while giving attention to its effects on the function of price formation.

(2) Takeover bids, and "a securities market of an exchange" and a "market"

The regulations concerning public tender offers by parties outside the issuer (the SEL Article 27-2, hereafter referred to as "takeover bid regulations") and the regulations of public tender offers by a company that is the issuer of shares (the SEL Article 27-22-2, hereafter referred to as "buyback regulations") are covered under "purchases, etc. outside of a securities market of an exchange" (the SEL Article 27-2 and the SEL Article 27-22-2). These regulations present the question of how transactions in a "securities market of an exchange" should be considered in relation to takeover bids and buyback activity. After-hours trades done by means of ToSTNeT, and in particular, after hours cross trades, would be the appropriate subject of inquiry (Cross trades that are within an exchange market and to which the auction transaction rule [priority of time and priority of price] applies are ordinarily no different from trades in an auction market and are omitted from consideration here, as it is believed that such trades involve few problems.²⁸ There is, however, sufficient cause to be concerned with transactions such as cross trades across markets).

a. Takeover bid regulations

Regulation of takeover bids by third parties, which are bids made by means of a purchase of shares in the market, originated with the regulatory system introduced in 1971. This regulatory system was introduced to protect investors and assure an orderly market. Subsequent to the reforms of 1990, present regulations of takeover bids require that certain purchases, etc. of securities outside a "securities market of an exchange" must be made by a public tender offer (mandatory public tender offer), but in certain instances this requirement is not applied. (the SEL Article 27-2).²⁹ The principal focus of the existing regulations is on disclosure, and on fair treatment of existing stockholders. The following points give the general reasoning behind limiting the application of this system to transactions outside a "securities market of an exchange": "(1) securities markets by their nature should be free and open, and it is unsuitable to impose special restrictions depending on the motive for trading; and (2) in order to ensure a free and open market, the SEL has added restrictions including those against market manipulation and excessive trading, which hinders the discipline of the market, while securities exchanges have prescribed, in their own self-governing rules, methods for purchase and sale transactions as well as settlement by delivery."³⁰ Although it appears that there have been instances of stock transactions or other transactions intended to achieve a transfer of control over companies by means of ToSTNeT cross trades, some professionals have expressed doubts about whether such transactions should be permitted. Such transactions have traditionally been handled cautiously because of their relation to the public tender offer regulations.³¹ There is undoubtedly room for restudying whether the

²⁸ Ichirô Kômoto, "Application or Non-Application of Takeover Bid Regulations and Cross trades in the Market," in: Ichirô Kômoto and Hiroshi Imai, *Corporate Law / Valuation and Operations* (Tokyo: Yuhikaku, 1999), at 205ff.

²⁹ Ichirô Kômoto and Tainan Otake, *Securities Transactions Law Reader, Fourth Revised Edition* (Tokyo: Yuhikaku, 2000), at 82f.

³⁰ Corporate Finance Department No 2., *Securities Bureau, Ministry of Finance (ed.), Explanation on the Revised Securities and Exchange Law* (Tokyo: Zeimu Kenkyukai Shuppankyoku, 1971), at 210.

³¹ Nishimura and Partners (ed.), *Complete M&A Law* (Tokyo: Shôji Hômu Kenkyûkai, 2001,

above requirements are suited to the purposes of the takeover bid regulations if a “securities market of an exchange” has changed in various elements from the traditional concept of an auction market. Nevertheless, the SEL openly regulates only trades outside a “securities market of an exchange.” After-hours trades, including trades made by means of ToSTNeT, are understood as being trades within a “securities market of an exchange” in accordance with the regulations of the Exchange, and thus the only possible interpretation of the current SEL is that these transactions are not subject to the takeover bid regulations. We should not carelessly make an expanded interpretation or an interpretation by analogy which transgresses the text of the law in a code such as the SEL, which regulates the nature of transactions. However, there have long been grave doubts as to whether it is suitable to include diverse trading methods such as these in the concept of a “securities market of an exchange,” and exchanges themselves should be cautious in their own studies of whether to involve themselves in this type of operation (Even though cross trades made by means of ToSTNeT-2, as discussed below in section “b,” comply in form with trades within a “securities market of an exchange” under the SEL, the recommendation discussed in “b” below, which has been provided at the Tokyo Stock Exchange, appears to come from this perspective, although further study is required concerning whether this recommendation is sufficient). Thorough study will also be required to develop future legislation related to the regulation of public tender offers. Such legislation would be concerned with issues such as the method of regulating takeover bids themselves, whether there are any adverse impacts of having these bids made through a non-auction market, and problems in the event that a large purchase of securities (such as one envisioned by a public tender offer) is made on a traditional auction market. There are two possibilities for the direction of codification. The first is that the legislation would not draw a line solely on the basis of whether the bid is made in or outside of a “market of a securities exchange,” and certain exceptions would be introduced in connection with this line. The second possibility is to revise the current regulation of public tender offers which does not regulate tender offers on a “securities market of an exchange,” and extend the general regulations concerning public tender offers to cover purchases offers that are made on the exchange market.³² The latter case would present a further issue of how to provide for exceptions to the regulations of public tender offers.

b. Buyback regulations

The same reasoning as above appears to be applicable to regulation of public tender offers in connection with buybacks. There already exist a considerable number of regulations on prior-announcement buybacks³³ using ToSTNeT-2.³⁴ Under the SEL, ToSTNeT-2

1971), at 71 states that, “although comments have been made for some time questioning whether cross trades are used to evade the public tender offer regulations, at least according to the formal language of the law, cross trades are not covered under the tender offer regulations as long as they are transactions on “a securities market of an exchange,” and that “we have strong doubts about the rationality and propriety of Japan’s mandatory public tender offer system, and indeed the system should be rectified by a straightforward amendment of the law.”

³² This is the thinking in the United States’ Securities Exchange Act of 1934 (§14(d) (1)).

³³ “Prior-announcement buybacks,” by means of ToSTNeT-2 “have been made by several listed companies to date, by first making an inquiry or request with certain sellers (who are major shareholders, etc.) as to whether they will sell, after which a prior-announcement is made of the content of the purchase offer, and the purchase is made on ToSTNeT-2. The prior-announcement of the contents of the tender offer is made to eliminate concerns about insider trading on the part of the seller who receives an inquiry, etc. concerning whether the seller will sell, on the basis of the specific content of the prior purchase offer (Tokyo Stock Exchange, “Concerning the Method

tradings are transactions that are executed in a “securities market of an exchange,” and on that basis are understood as not being subject to the public tender offer regulations. On the other hand, the Tokyo Stock Exchange has discouraged the use of ToSTNeT-2 for cross trades because the time-priority principle does not function in that medium,³⁵ and therefore cannot prevent violations of the spirit of the principle of the equality of shareholders, etc. under the Commercial Code.³⁶ There is a rational aspect to use of ToSTNeT-2 if its use is limited to trades that are not cross trades, because of the potential for influencing price formation if a company buys back large blocks of its own shares on an auction market. It is thought that there would be relatively little opposition to treating ToSTNeT-2 transactions other than cross trades as transactions in a “market” under the Commercial Code, inasmuch as the acquisition price is the closing price on the Exchange,³⁷ and moreover fairness is ensured by application of the time-priority principle.

The Commercial Code prior to the 2001 amendment required that a buyback by a company of its own shares be made by a public tender offer (the SEL Article 27-22-2 and below), by a “transaction on an exchange,” or a “similar transaction” if a “market price on an exchange” or a “similar price” existed for the shares. After the amendment, however, the law requires that the transaction be made on a market (provided that a company may purchase its own shares through a negotiated transaction and not through a public tender offer if a resolution by a general meeting of shareholders is made to that effect (amended Commercial Code Article 210(8)), or when acquiring shares from a subsidiary (amended Commercial Code Article 211-3)). This presents an issue of what is meant by the concept of a “market” and whether, with the change in the language of the statute, there has been an associated change in the concept of a “market”, or whether the term “market” should simply be read as either a “securities market of an exchange” or, alternatively, a “market in over-the-counter traded securities” (which would mean that for a listed company, the above regulations of public tender offers in connection with buybacks would apply to transactions “outside a securities market of an exchange”). If reference is made to discussions that took place at the time of the 1999 amendments to the Commercial Code concerning the method of asset valuation (Commercial Code Articles 285-4, 285-5 and 285-6), in which the term “price on

of Buying Back Corporate Shares Using the Tokyo Stock Exchange,” January 19, 1999).

³⁴ Tokyo Stock Exchange, “Table of Companies That Have Bought Back Shares by the Prior-Announcement Method Using ToSTNeT-2” (up to October 2001), at the Tokyo Stock Exchange Website.

³⁵ Tokyo Stock Exchange, “Questions and Answers Concerning Acquisition of a Company’s Own Shares by Means of the Prior-Announcement Method Using ToSTNeT-2” (December 14, 2000), at the Tokyo Stock Exchange Website.

³⁶ The Cabinet Office Order Concerning Trading, Etc. of Listed Shares, Etc. by a Company that is the Issuer of Listed Share Certificates, Etc. (Cabinet Office Order No. 72 of 2001), which was enacted to prevent a listed company (or a company registered for over-the-counter trading) from manipulating the market price of its own shares, imposes certain limits on price and the method of purchase, etc. However, accompanying a major liberalization under the Commercial Code’s 2001 amendment of restrictions on a securities company acquiring its own shares, such limits on price and the method of purchase have been relaxed by permitting a listed company to acquire its own shares “pursuant to a method that ensures equitable treatment among shareholders,” as one of the appropriate methods for ensuring the fairness of transactions.

³⁷ The Cabinet Office Order Concerning Trading, Etc. of Listed Share Certificates, Etc. by a Company that is the Issuer of Listed Share Certificates, Etc. states that (a purchase) by a limit order for a price that is equal to or less than the closing price of the previous day is one of the methods that is accepted as appropriate for the purpose of ensuring the fairness of transactions (Cabinet Office Order Article 7(i)(a)).

an exchange” was amended to “market price,” it must be thought that the concept of a “market” under the Commercial Code is quite broad and generally refers to markets in which there is a market price. It is not necessarily limited to a “securities market of an exchange” or a “market in over-the-counter traded securities” as prescribed in the SEL, and would include PTS systems that have a price formation function.³⁸ Conversely, since there is no requirement to apply formal concepts such as an “exchange” under the SEL to a “market” under the Commercial Code, it is doubtful whether cross trades using ToSTNeT-1 or ToSTNeT-2 are included within the concept of a “market” under the Commercial Code. Rather, a substantive judgment should be made of the price formation function.

(3) Exceptions to regulations against insider trading

In order to protect the fairness of transactions on securities markets, insider trading is prohibited (the SEL Article 166 and Article 167). Nevertheless, the SEL provides exceptions to the prohibition against insider trading when both parties are insiders who have insider information or when both parties are recipients of insider information, and where the transaction is not made on a “securities market of an exchange” or on a “market in over-the-counter traded securities.” (the SEL Article 166(6)(vii) and 167(5)(vii)). These exceptions have been granted because even if parties possessing insider information engage in transactions between themselves, there would be no imbalance between the parties in the necessary investment information, and because third parties would not be affected if the transaction is made outside of a market. It is also thought that it may not be necessary to prohibit transactions even when they are conducted on a securities market of an exchange, if they are “negotiated” transactions such as a cross trade on a non-auction market, since third parties would not be interposed, and consequently there would be no impact on the market.

However, if information on “negotiated” transactions such as cross trades is disclosed according to the rules of exchanges (the SEL Article 122 and Article 123), and if such disclosure influences price formation, the regulations prohibiting insider trading must be applied to such transactions. Further, if, in the future, trading information in securities, such as trading information on a PTS which is not a “securities market of an exchange” or a “market in OTC traded securities,” is recognized as market information, and if this information has an impact on price formation and consequently mediums such as a PTS system constitute a market in the broad sense of the term, then as a matter of legislation, these transactions should not be permitted as an exception to the prohibition against insider trading.

(4) A “securities market of an exchange” in regulations barring price manipulation

The SEL Article 159 prohibits acts intended to manipulate prices. Article 159(2)(i) prohibits making a group of trades, etc. in listed securities, or on consignment or acceptance of consignment thereof, which is made for the purpose of inciting trades, etc. in listed securities, and which causes a fluctuation in the price of listed securities, etc. on a “market of a securities exchange” (known as the prohibition against price manipulation). With regard to

³⁸ Kôji Harada, Kazuho Seki, Akiyuki Han, and Yoshitaka Ichihara, “*Questions and Answers / 2001 Revision of the Commercial Code / Stock Swaps and Market Valuation*” (Tokyo: Shôji Hômu Kenkyûkai, 1999), at 134. Kôji Harada, Keita Taida and Daisuke Kôtani suggest that a “market price” is a broader concept than an “exchange price” in “Explanation of the Revised Commercial Code with Reference to Revision of Buyback Regulations [Part 2],” *Shôji Hômu*, 1608 (2001), at 96, though this opinion is shown as an interpretation of the treatment of fractional shares under the Revised Commercial Code 220-1.

price manipulation, the Financial Systems Reform Law goes beyond trading of listed securities in a securities market and, under the category of inciting acts, regardless of whether the transaction is performed on or off-market, covers trading of securities, futures transactions of securities indexes, etc., securities options transactions, and securities OTC derivative transactions in connection with OTC indexes in listed transactions.³⁹ Further, with the abandonment of the market-concentration requirement, off-market transactions become subject to these regulations and the terminology has been changed, by replacing the expression “trading transactions” (*baibai torihiki*), having the sense of a transaction under the regulations of an exchange, with the general word trading (*baibai*). The SEL Article 160 states that persons who engage in market manipulation, etc. have a certain liability to compensate damages, but as a matter of legislation it would seem that it is not necessary to limit this liability to transactions on a “securities market of an exchange” or a “market in OTC traded securities.”

Moreover, acts of price manipulation are taken as a group of trades, etc. of listed securities with the purpose of changing the price of listed securities on a “securities market of an exchange” (this also applies to an “over the counter securities market” [the SEL Article 159(4)]). The Financial Systems Reform Law added the expression “on a securities market of an exchange” to regulation as described in the previous sentence, but this addition is understood as having no meaning or purpose other than for the organization of the article’s text. It is within the realm of possibility that in the future a “market price” will be formed in a “securities market” that is neither a “securities market of an exchange” nor a “market in over-the-counter traded securities.”⁴⁰ Also, concerning the regulations on excessive transactions (the SEL Article 161), transactions outside an exchange are understood to have been added to the scope of the regulations’ application to acts of this type, through the amendment’s substitution of the term “trading transaction” (*baibai torihiki*) with trading (*baibai*).⁴¹

³⁹ Eiji Chatani, “Explanation of the Law Regarding the Modification of Related Laws for Reform of Financial Systems,” *Shôji Hômu*, 1503 (1998), at 23.

⁴⁰ Shôken Hôsei Kenkyûkai (ed.), Section by Section Explanation / Securities and Exchange Law” (Tokyo: *Shôji Hômu Kenkyûkai*, 1995), at 722 gives the following commentary on the “market price” in Article 159 of the SEL prior to its revision by the Financial Systems Reform Law:

The “market price” indicates a price under which the supply and demand of numerous investors are integrated, and is generally understood to objectively reflect trends in supply and demand.

As to over-the-counter transactions as well:

- (i) the characteristics of a “market price” are met if trading prices, etc. of the same type as in a transaction on a securities exchange are published in a uniform fashion by an entity that has a certain degree of credibility (although the trading price of a negotiated transaction that is completely secret would not be recognized as a “market price”); and
- (ii) if an announcement is made to numerous investors concerning a “quoted value,” and if such investors understand that because a trade can be executed at the announced quotation, it would be possible to regard this quotation as a “market price.”

Consequently, in addition to securities listed on an exchange, it would appear that the prices announced by the JSDA would meet the requirements of a “market price,” since the JSDA publishes the trading prices, etc. of instruments such as both over-the-counter registered stock and convertible bonds registered over the counter in a uniform fashion.

⁴¹ Shigeru Morimoto, “Modification of Regulations Governing Unfair Transactions,” in: *Shôken Torihiki Kenkyûkai* (ed.), Reform of the Financial System and Securities Transaction System

(5) Conclusion

Several issues relating to the concept of “securities market” have been discussed above. It appears that it is necessary to study whether the above interpretations and applications, which are based on an understanding of a “securities market” as a concept that has been modified through amendment, are sufficient to achieve the essential purposes of the law. Such study should include a further review of the purposes of several specific statutory provisions, and should settle these issues through means including legislation, where desirable.

-- End

(Tokyo: Japan Securities Research Institute, 2000), at 190.

Reference Text

Securities and Exchange Law Article 2

8. “[S]ecurities business” under this law shall mean the business of engaging in any of the acts listed in the following by persons other than banks, trust companies, and such other financial institutions as shall be described by Cabinet Order:

[Items i. through vi. omitted]

- vii. trading in securities, brokerage, mediation or agency of the same that is performed using an electronic data processing system and through a method of determining the price that is as set forth below, with numerous persons at the same time, either as the party on one side or as both parties:
 - a. a method that uses the trading price for the securities on a securities market held by a securities exchange in connection with securities listed on said securities exchange;
 - b. a method that uses the trading price for securities that is published by the securities dealers association that registers the securities in connection with securities registered pursuant to the provisions of Article 75(1);
 - c. a method that uses a price that is based on negotiation with customers; or
 - d. a method designated by order of the Cabinet Office, in addition to the methods set forth in a. through c. above.

Cabinet Office Order Concerning the Definitions Set forth in Article 2 of the Securities and Exchange Law Article 8-2 (Method of Determining Trading Prices of a Business of Operating a Proprietary Trading System)

The method to be prescribed by order of the Cabinet Office as set forth in the SEL Article 2(8)(vii)(d) shall be the following method:

- i. a method which uses the price stated by a customer if the price stated by that customer conforms to a price stated by another customer who would be the counterparty to the transaction; or
- ii. a method in which a securities company (including a foreign securities company. The same shall apply hereunder in this Article) states a quotation for plural sell offers or buy offers of itself, of another securities company or of a registered financial institution as set forth in the SEL Article 65-2(3) (hereinafter in this Article “securities company, etc.”) for the same issue, and uses a price that is based on the quotation of said multiple sell offers or buy offers (excluding cases in which multiple securities companies constantly state quotations of sell offers and buy offers, and have a duty to make trades pursuant to the quotation of said sell offer or buy offer).

Securities and Exchange Law Article 80

1. A securities market must not be held by any person other than a person licensed by the Prime Minister.

2. The provisions of the preceding paragraph shall not apply in the event of the following:

- i. if a securities dealers association will hold an OTC traded securities market; and
- ii. if, pursuant to the prescriptions of this Law or Law Concerning Foreign Securities Firms, a securities company, a foreign securities company or a registered financial institution will carry out a trade in securities, a futures transaction of securities index, etc., or a securities options transaction (excluding those made outside a securities market of an exchange in the case of a securities futures transaction, futures transaction of a securities index, etc., or a securities options transaction) or will broker, mediate, or act as an agent in a transaction of one of these types (unless this is to be carried out by auction or another method as may be prescribed by order of the Cabinet Office).

Cabinet Office Order Concerning Securities Exchanges Article 1

Method to be Determined by Order of the Cabinet Office as Set Forth in SEL Article 80(2)(ii)

Article 1. The method to be set forth by order of the Cabinet Office pursuant to the Securities and Exchange Law (Law No. 25 of 1948. Hereinafter “SEL”) shall mean a method as set forth below in the event of specifying said method and holding a securities market:

- i. an auction method;
- ii. a method in which more than one securities company or foreign securities company as prescribed in the Law Concerning Foreign Securities Firms (Law No. 5 of 1971) Article 2(ii) (hereinafter referred to as “foreign securities company” in this Article and in Article 8(iii)) or a registered financial institution as prescribed in the SEL Article 65-2(3) continuously state quotations of sell offers or buy offers and have a duty to make trades pursuant to the quotation of said sell offer or buy offer; or
- iii. a method in which trading, brokerage, mediation, or agency thereof is conducted with numerous persons simultaneously being one party or both parties, using an electronic information processing system (excluding the method of business conducted by a securities company or a foreign securities company which has obtained authorization pursuant to the SEL Article 29(1)(iii) or the Law Concerning Foreign Securities Firms Article 7(1)(iii)).

Japan Securities Dealers Association “Rules Concerning Trading, Etc. of Listed Securities, Etc. Outside a Market of a Securities Exchange” [Fair Practices Rules No. 5]

If a trade is executed off of an exchange, a member shall report to the Japan Securities Dealers Association each of the following items within five minutes after the trade is executed, according to the method set forth in the Detailed Rules, provided that the report may be made later if the report is delayed as a result of reasonable cause or in other circumstances as set forth in the Detailed Rules:

- i. name of issue;
- ii. trading price (meaning the trading price set forth in the Detailed Rules);

- iii. quantity of trade;
- iv. the date and time on which the trade was executed;
- v. whether the trade was a buy or sell;
- vi. whether the trade was a proprietary trade or on consignment (i.e., whether the member made the trade on its own account, or whether the trade was made as a broker, intermediary or agent);
- vii. the name of the securities exchange publishing the benchmark price and the price thereof (or the best quotation in the event of a small lot order);
- viii. the counterparty to the trade (the name of the member if the counterparty to the trade is a member, and the fact that the counterparty is a customer if that is the case); and
- ix. such other particulars as the Japan Securities Dealers Association determines to be necessary.