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# Recent Developments and Future Perspectives of the Tokyo Market

By MINORU NAGAOKA\*

## I. INTRODUCTION

In keeping with the discussions which took place during this international conference under the timely theme "Globalization of Securities Markets," this Paper will address the topic of recent developments in, and future perspectives of, the Tokyo Market.

### A. Recent Developments

There have been some major developments in the Tokyo market. A rapidly growing economy has sparked strong foreign interest in doing business in Japan, and, as a result, fifty-nine branch offices of foreign brokerage firms are now operating in Japan, as compared with thirteen branches five years ago.

Responding to this changing environment, the Tokyo Stock Exchange (TSE) opened its membership to foreign brokers, and admitted six such firms in 1985, sixteen in 1987, and three last April. As a result, foreign members now total twenty-five, twenty percent of the total memberships.

Also, recent efforts have been made to diversify the products being traded on the TSE. Diversification in this sense means the introduction of derivative products such as futures and options contracts. The TSE began trading in Japanese government bond futures in 1985, Tokyo Stock Price Index (TOPIX) futures in September 1988, and U.S. treasury bond futures in December 1989. In addition, the TSE introduced TOPIX options in October 1989 and options on Japanese government bond futures in May 1990.

### B. Future Perspectives

Given these developments, one may think that no problems remain

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in the Tokyo market. However, Japan is not satisfied with the current situation, and many issues must be resolved.

First among these is the recent decline of the Tokyo equity market. The stock prices in Tokyo dropped sharply during the first four months of 1990, after having peaked in December 1989. Though the market remained stable until mid-August 1990, it has since fallen again. In terms of the TOPIX, the market fell thirty-eight percent from its all-time high of 2884.80, recorded in December 1989, to the recent low of 1800 in September 1990. This rate of decline is much larger than that which occurred in 1987 when the market fell twenty-five percent from its peak that year to its lowest point after the October crash, and is now only just below the forty percent decline at the time of the oil crisis of the 1970s.

The market stress which occurred in the spring of 1990 can be attributed largely to rapidly rising long-term interest rates. On the other hand, the more recent sharp decline can be attributed to uncertainty about economic prospects due to the events in the Middle East. However, the real interest rate has since reached a historic high of six percent, and the value of the yen has been firming. If the Middle East crisis is settled soon, a rapid recovery of the market will be forthcoming.

We should bear in mind that a major price decline in one country is rapidly transmitted to other countries, as was seen at the time of the 1987 October crash. In that sense, it can be said that all nations are "in the same boat." Accordingly, Japanese investors kept in close contact with the New York Stock Exchange (NYSE) and traded market information during the mini-crash in October 1989. It is important that major marketplaces strengthen the ties among themselves so that they will not exacerbate crisis situations by behaving independently and inconsistently.

The second issue which must be resolved in order to secure the future strength of the TSE is related to program trading and index arbitrage, in particular.

Tokyo recently introduced futures and options on securities, having learned a great deal from what the United States experienced in this field. Fortunately enough, the occurrence of the October 1987 crash, and the discussions in its wake in the United States, coincided with Japanese discussions concerning the design of the basic structure of financial futures and options markets. Based on learning and open discussion, all securities and their derivatives in Japan are now traded on stock exchanges and are overseen by one regulatory agency, the Securities Bureau of the Ministry of Finance. On the stock exchanges, the same rules and principles apply to both the cash and derivative markets so that both can be well-

coordinated with each other. Nonetheless, index arbitrage activities have been criticized as being responsible for stock index declines in 1990.

Because index arbitrage trading accounts only for three to four percent of all stock trading in Japan, and also because such trading serves to link the cash and futures market, the stock exchange does not want to regulate it excessively. Nevertheless, as index arbitrage is, from the traditional investor's point of view, a sort of mechanical trade, quite irrelevant to the fundamentals of individual stocks, the exchange began disclosing information on index arbitrage in April 1990. These efforts to harmonize the functioning of both the cash and derivative markets, with the full recognition that they are in effect one market will continue.

Japanese efforts in this context cannot be limited to domestic markets. Derivatives on Japanese stock indexes have been, and will be, traded actively in overseas markets, especially in the United States. Thus, highly coordinated intermarket operation is necessary across borders so that overseas derivative markets will not have adverse impacts on the cash market at home. At the very least, overseas derivative trading without the consent of the underlying market should be avoided. An effort is definitely needed to establish an international set of rules which govern such coordination across borders on a worldwide basis.

As with any financial innovation, the derivative market requires social adaptation in order for the benefits it renders to be fully enjoyed. Such social adaptation is required at the international level as well.

A third effort on behalf of the future stability of the Japanese stock exchanges is the enhancement of the operational capacity, and hence, the liquidity of the cash market. This effort also relates to the social adaptation discussed above. In the United States, it is believed that insufficient operational capacity in the cash market contributed to the disconnection between the cash and futures markets at the time of the October 1987 crash. Learning from this lesson, the Tokyo market has decided to enhance the capacity of its cash market in order to deal effectively with the increasing volume of trading, including program trading. By applying modern technology to the trading floor operations, the Tokyo market will soon be able to handle five billion shares per day, instead of the present two billion share capacity.

It is widely recognized that the liquidity of a market should not limit its operational capacity. Obviously, all the stock exchanges in the world are concerned with how they can increase the liquidity of their markets. The TSE is purely an order-driven market, where buy and sell orders directly interact with each other without the assistance of the market makers. Accordingly, it is necessary for the TSE to maximize its

liquidity by disseminating market information as widely as possible. More fundamentally, it is necessary to mobilize liquidity by inviting the participation of investors, especially individual investors who have diverse investment judgment. Unfortunately, individual share ownership has fallen consistently in the past, although it rose slightly in 1989. The same is true of trading volume. If the trend continues, the market may suffer from decreasing liquidity and increasing volatility, thus leading to the deterioration of the functioning of the market. This deterioration eventually would adversely affect the primary market. Thus, it is crucial to make stock investment more attractive to individual investors. For this purpose, the TSE is encouraging listed companies to effect stock splits. The TSE is taking other measures to enable investors to buy stocks with smaller amounts of money. The TSE is also encouraging listed companies to increase dividend payouts for the benefit of investors who are more interested in income gains.

The fourth and last concern for the future of the Japanese market is the maintenance of the fairness and transparency of the market. In 1989 control over insider trading was tightened and the initial public offering system was made more transparent. In addition, with the so-called five percent rule, the Diet has amended the Securities and Exchange Law to enforce disclosure of large stock holdings. The Ministry of Finance has prepared the Cabinet and Ministerial Orders to put the amendments into effect as of December 1990. This surely will contribute to increasing the transparency of the market, thus providing for better protection of investors.

These efforts should continue in response to changing circumstances. In this light, the TSE must address the issue of preventing unfair trading on the cash and derivative markets. Although there have been no such unfair trades as yet, it is necessary to pay close attention to this issue if the TSE is to develop soundly, especially in the area of derivative markets, which have been cultivated with great effort.

Unfair trades occurring across the national borders must also be prevented. The Securities and Exchange Law has been amended with provisions which permit investigations based on requests from foreign securities regulators. As securities trading will be further internationalized, further efforts are necessary to prevent unfair cross-border trading.

Along this line, major efforts have been made by some stock exchanges:

- (1) The TSE has entered into agreements with five overseas exchanges to exchange market surveillance information;
- (2) The International Federation of Stock Exchanges (FIBV) has

decided to share regulatory information among thirty-seven member stock exchanges in thirty nations, and to improve the surveillance system in each exchange as a base for such information sharing; and

(3) The TSE has entered into an agreement with the NYSE to simultaneously halt or suspend the trading of a stock listed on both exchanges in order to effectively prevent insider trading from occurring across the Pacific Ocean.

Through these endeavors, the TSE has been trying to prevent fraudulent activities from occurring internationally and will continue to do the same in the years ahead.

## II. CONCLUDING REMARKS

This Paper has addressed recent developments and future perspectives of the Tokyo market. The TSE will further endeavor to increase investor confidence in order to improve the function of its market as one of the international capital markets.

Needless to say, a capital market is useful not only for Japan's national economy, but also for the world economy. However, effective functioning of a capital market cannot be expected without continuous efforts in that direction. We should always bear in mind that it is the most important responsibility of market regulators to endeavor to maintain a fair, efficient, and stable market.

