[Topics] Issues in Japan's Stock Market Structure

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Summary

Japan's stock market has long been described as concentrated on the Tokyo Stock Exchange (TSE). This is now changing, mainly because of the rise of PTSs (proprietary trading systems). In addition, the largest PTS has exceeded the trading volume cap set out in the Financial Services Agency's (FSA's) supervisory guidelines, and the FSA has announced that it will review "the future shape of Japan's stock market structure." Looking at the rules for each type of trading venue in Japan, exchanges are still required to maintain a high degree of public character and neutrality, even though they have become private companies. This creates an imbalance with PTSs, which now have market functions comparable to those of exchanges. For dark pools, the biggest problem is that they are not regulated as trading venues. Overall, when Japan reviews its market structure rules, it should focus on two ideas: "transparency and responsibility in proportion to size" and "disclosure and explanation of internalized trading."

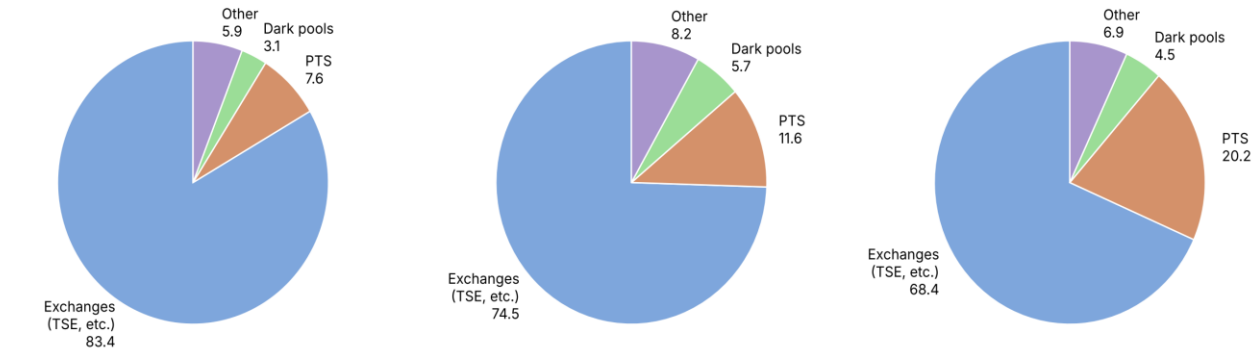
Introduction

Japan's stock market has long been described as concentrated on the TSE. This structure is now changing. From last year into this year, trading on PTSs has grown rapidly, and Japan began to see the same trend as other countries: exchanges are losing trading share (so-called "market fragmentation"). Also, this spring Japannext, the largest PTS, exceeded the PTS trading volume cap in the supervisory guideline. In response, the FSA announced that it would begin a review of the future shape of Japan's stock market structure during fiscal year 2026 (Cabinet Secretariat, "Financial Strategy," July 2026). In this article, I explain which parts of Japan's stock market rules need to be reviewed, and I give my own view of the current situation.

The growth of PTS trading and the trading volume cap

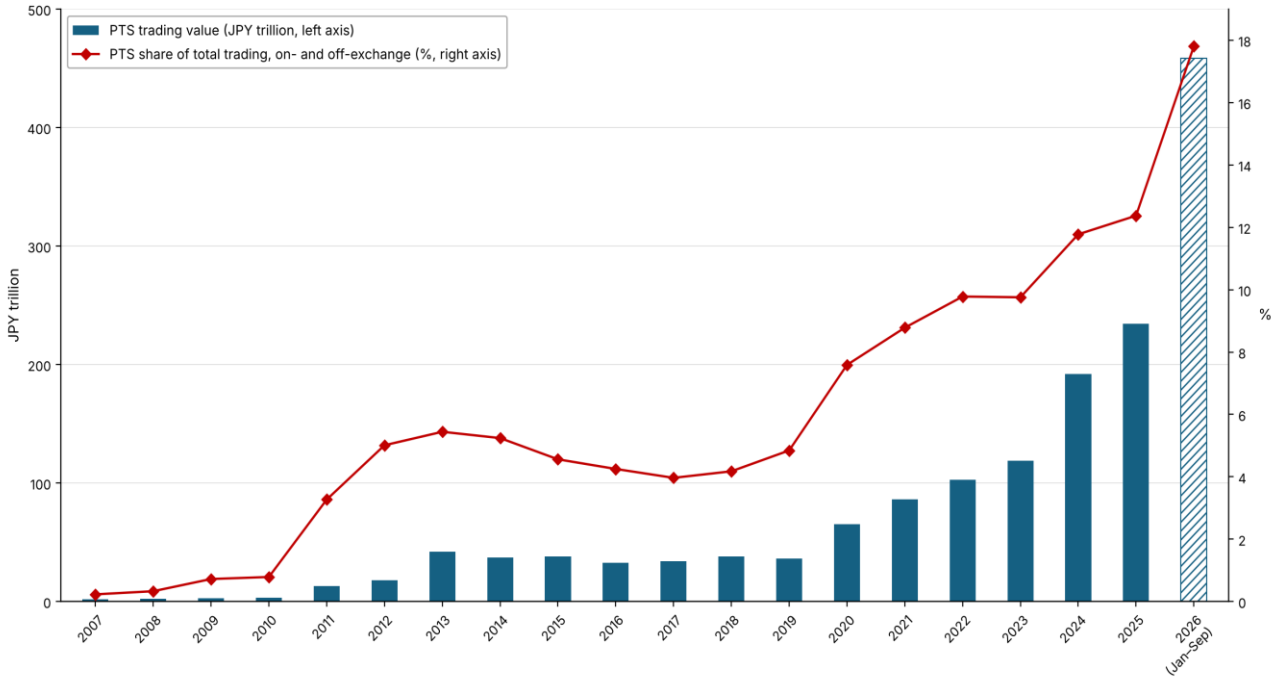
The PTS system was introduced in 1998, when the "Financial Big Bang" abolished the rule that all trades had to be sent to an exchange (the "exchange concentration requirement"). However, PTS trading stayed small for many years (a share of a few percent or less). After margin transaction was allowed on PTSs in 2019, PTS trading started to grow, and its share exceeded 10% in 2024. It then grew rapidly from last year to this year and has now reached about 20% (see Figures 1 and 2).

Figure 1: Market shares of exchanges, PTSs and others (%)



Source: Japan Securities Research Institute, based on data from the Japan Securities Dealers Association and JPX.

Figure 2: PTS trading value and share



The two main PTSs, Japannext and JAX, were set up by the SBI Group and Rakuten Securities respectively. They are the preferred places where these online brokers execute their orders. JAX began full operation last year. At the same time, stock trading by individual investors through online brokers increased, partly because of the AI boom. These two factors are seen as the main reasons for the sudden increase in PTS trading.

Under the FSA's supervisory guideline, there is a cap on PTS trading volume. If a PTS's share of total stock trading exceeds 20% in any single stock and 10% for all stocks

combined, the PTS must obtain an exchange license. Japannext is said to have exceeded this cap this spring. This was the direct trigger for the FSA's review of stock market structure.

How to approach the review of market structure

What would happen if a PTS now in operation tried to get an exchange license, as the supervisory guideline require? The first problem is that a PTS has no companies listed on its own market. Under the current rules, it would therefore have no stocks to trade. One proposed solution is to adopt a U.S. system called "unlisted trading privileges" (UTP). Under UTP, each exchange can also trade stocks that are listed on other exchanges. Others argue that the supervisory guideline should simply be relaxed. These two options have been discussed for some time.[1]

Japan's rules for exchanges and PTSs were designed on the assumption that trading is concentrated on the TSE. They do not take into account the recent move toward market fragmentation. The FSA is already aware of this. A 2022 report of the Financial System Council[2] said: "As the share of PTSs may continue to grow, further study is needed on the roles of exchanges and PTSs, and on the systems and controls that PTSs need as trading platforms."

For this reason, before choosing between the two options above, we first need to take a fresh look at the rules for exchanges, PTSs, and dark pools. The following sections discuss each of these from that point of view.

Changes in the exchange system: from public body to private company

The biggest change in the exchange system in recent years has been "demutualization" — exchanges becoming stock companies (and later listing their own shares). In the past, exchanges were non-profit membership organizations and a kind of public body. However, exchanges needed more ways to raise funds and faster decision-making. So a 2000 amendment to the Securities and Exchange Act allowed exchanges to take the form of stock companies.

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[1] At the JPX Study Group on the Financial Instruments and Exchange Act (April 23, 2021), Mr. Otawara, then Director of the FSA's Market Division, said on this issue that "there are two options: allowing PTSs to expand their share, and allowing unlisted trading privileges." He added that "unlisted trading privileges are somewhat more difficult … there is no listing review … is it enough to just pay a cost? … how would that be calculated? … and what about the relationship with regional exchanges?"

[2] Market System Working Group, Second Interim Summary (December 21, 2022).

At the same time, to keep exchanges highly public in nature, the Act added several rules: limits on shareholders (for example, limits on holding 20% or more), limits on the scope of business, and clearer rules on self-regulatory functions.

Later, exchange holding companies (2003) and self-regulatory organizations as separate legal entities (2006) were introduced, giving exchange groups more freedom in how they are run. In this way, since 2000 there has been a move "from public body to private company." On the other hand, Japan (compared with other countries) still treats exchange business as "business of a highly public nature" (Financial System Council Market Working Group Report, 2016), and many rules strongly require exchanges to be public-minded and neutral.[3]

Self-regulation by exchanges

A typical example of the highly public work of exchanges is self-regulation. Around the world, as exchanges have become private companies, their self-regulatory role is said to be getting smaller.[4]

In the United States, as exchanges demutualized and listed their shares, there was a push to separate market operation from self-regulation. As a result, in 2007 the member regulation units of the NYSE and the NASD (National Association of Securities Dealers) were merged to form FINRA (Financial Industry Regulatory Authority). This transferred much of the responsibility for regulating securities firms from the exchanges to FINRA. Then, from 2011, the NYSE and other exchanges began to outsource their market regulation work to FINRA. Today, much of the self-regulatory work of U.S. exchanges is in practice done by FINRA. (This is said to have made it possible for FINRA to monitor trading across markets.)

In the United Kingdom, to avoid conflicts of interest after the exchange became a private company, the power to review listings was moved from the exchange to the financial regulator (the then UK Financial Services Authority). This power has since passed to the FCA (Financial Conduct Authority). In the UK there is generally said to be a shift "from self-regulation to public regulation." (The UK never had formal self-regulation of securities firms in the first place.)

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[3] Under the business scope rules, side businesses and related businesses each need individual approval by FSA. When deciding whether to approve a related business, consideration is given to, among other things, "whether there are no other suitable providers and the exchange group is needed to provide it for the benefit of the market as a whole" (Financial System Council Market Working Group Report, December 2016).

[4] See World Bank, "Self-Regulation in Securities Markets" (2011).

In Japan, as noted above, exchanges are moving toward being private companies, but their self-regulatory role is not clearly shrinking. If anything, Japan seems to be trying to make sure that exchanges fully carry out their self-regulatory role, for example by placing it in a separate self-regulatory entity.

There is also a practical reason. In Japan, financial regulation is carried out directly by the FSA, which is a central government agency. Japan does not have strong financial regulators like the SEC and FINRA in the U.S. or the FCA in the UK. As a result, Japan has no choice but to rely heavily on self-regulation by exchanges. (The same is true for the self-regulation of securities firms.)

In the U.S., outsourcing self-regulation is very common, and this makes it easier for new exchanges to enter the market. Some therefore argue that Japan should also make more use of this system. However, we should note that in the U.S., self-regulation is basically outsourced to FINRA, not from one exchange to another (as is possible under Japan's rules). (Creating a FINRA-like body in Japan would need careful study, given the problems that come with a single, all-purpose self-regulatory organization.[5])

Rules for PTSs: keeping them different from exchanges

The PTS system started in 1998, when the "Financial Big Bang" abolished the exchange concentration requirement. At that time, the Securities and Exchange Act set out in detail, and limited, the trading methods a PTS could use (such as negotiation between customers). In this way, PTSs were kept different from exchanges. The idea was that a PTS is a market that "does not have price formation functions as advanced as an exchange," and the line between the two was drawn by trading method. In the end, however, this approach failed. At first the trading methods were too limited, so PTSs could not work as markets. The rules were later widened to include the method of matching customer orders (now the main PTS method), and then, in 2004, auction trading (within certain limits). As a result, there was little real difference left between PTSs and exchanges.

The trading volume cap on PTSs was then used instead to keep them different from exchanges. Its content is explained above. But the Act defines a PTS by its trading method, while the supervisory guideline says that a PTS needs an exchange license

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[5] I have visited FINRA twice, and I came away with the impression that "FINRA is an organization with many dilemmas." FINRA is an organization dedicated to regulation that works closely with the SEC. Because FINRA sits in an unclear position between the government and the private sector, it faces considerable criticism from various quarters. Also, because it has unusually strong powers for a private body, it has even been challenged in court on constitutional grounds.

once it exceeds the cap. It is hard to avoid the impression that this was something of a stop-gap measure.

As for other PTS rules, the FSA has steadily relaxed them to encourage competition between markets. Certain purchases on PTSs were exempted from the 5% threshold under Japan's tender offer rule (2012), margin transaction was allowed (2019), and most recently the limits on auction trading were eased (2024). As a result, PTSs can now perform market functions almost equal to those of exchanges. On the other hand, because PTSs are private trading systems, they are not subject to the strict rules placed on exchanges (such as shareholder limits and business scope limits, which come from the need for public-mindedness and neutrality). This creates an imbalance.

Dark pools: treated as ordinary business of securities firms

The definition of and rules for dark pools are set out in the supervisory guideline (written in 2010). The guideline says that "a system that passes buy and sell orders at the same time to ToSTNeT is not a PTS or an exchange." This is a rather contrived way to set the rules, both in form and in substance. (It does, however, have one benefit: because the trades are publicly disseminated by the exchange as ToSTNeT trades, there is post-trade transparency.)

Dark pool business is not treated as a PTS. A securities firm can run a dark pool as part of its normal business. No separate registration or notification is required for operating a dark pool, so the exact number of firms doing the business is unknown (the number is thought to be about 20).

In recent years, concerns have been raised about the role of dark pools in market structure. In a 2011 report, IOSCO noted that dark pools do not give enough information about how orders are executed or about trades, and that if their share becomes large, the market's price discovery function may weaken. These issues were also discussed by the Financial System Council's Market Working Group in 2016. The question was raised whether the current rules were "enough from the point of view of regulating trading facilities." However, the group decided not to change the rules, saying that "at present, the need is not necessarily strong."

The biggest problem with dark pools today is that they are not regulated as trading venues. As a result, there are no rules on matters such as disclosure of how dark pools execute orders or ensuring that their trading systems are reliable. In addition, linking a dark pool to ToSTNeT so that its trades become exchange trades is anomalous, even as a form of competition between markets.

What matters for market structure (1): transparency and responsibility in proportion to size

So far, I have discussed the problems in Japan's rules for trading venues. Next, I give my view on what we should focus on to improve market structure as a whole.

In the U.S. and Europe, where market fragmentation has gone further, exchanges, PTS-type venues (called ATSs in the U.S. and MTFs in Europe), and dark pools are all regulated under one common framework. Exchanges have listing systems and self-regulatory functions, while ATSs and MTFs do not. But there is no trading volume threshold that separates the two. Instead, there are volume thresholds within ATSs and MTFs: venues below a certain level are exempt from the duty to publish quotes and can operate as dark pools. In other words, the market share of dark pools is limited so that the market's price discovery function does not weaken. Also, in the U.S., ATSs with a large market share must meet duties close to those of exchanges, such as fair access and no unfair discrimination.

Looking at these examples, I believe that in Japan too, instead of having venue-specific rules for each type of trading venue, it is important to apply transparency and responsibility across all venues in proportion to their size.

What matters for market structure (2): multiple markets and internalized trading

In recent years, the "internalization" of stock order execution has been growing around the world. In the U.S., retail brokers increasingly route their customers' orders to wholesalers with which they have close business relationships (in practice, HFT firms) for execution. In 2025, wholesalers' market share reached 38%, and the exchanges' share fell below 50% for the first time. The incentive is that when a retail broker sends orders to a wholesaler, it receives a rebate called PFOF (payment for order flow).

In Europe, too, execution through SIs (systematic internalisers), which are similar to wholesalers, is increasing. In Europe, however, PFOF is in principle banned.

In Japan, major online brokers send their customers' orders first to PTSs and dark pools in their own groups. This can be seen as a kind of internalization.[6] These PTSs and dark pools are mainly funded by fees collected only from market makers (in

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[6] For example, Japannext's X Market is mainly a place where a small number of HFT firms trade against retail orders from online brokers in the same group. This is similar to execution by wholesalers in the U.S.

practice, HFT firms). This is what allows the brokers to offer “zero commission” trading to retail customers.

Internalized trading generally raises concerns about conflicts of interest and best execution. For this reason, U.S. retail brokers must disclose PFOF and explain it to customers. Since the situation in Japan is in some ways similar to PFOF, I think that making public the income that group trading venues receive from HFT firms could help ensure fair order execution and fair competition between markets.

Conclusion

Finally, I return to the two options for dealing with a PTS that has exceeded the cap. First, from the point of view of “transparency and responsibility in proportion to size,” the PTS cap in the supervisory guideline should be abolished. If PTSs have any limits on their market functions compared with exchanges, those limits should also be removed. At the same time, PTSs above a certain size should be required to have stronger market surveillance and neutrality than they do now (including cooperation with the TSE). As for exchanges, Japan will continue to rely on their self-regulatory functions, but their rules should be relaxed further, in light of their growing convergence with PTSs and to ensure a level playing field.

Trading venues above a certain size should be required to provide fair (or broad) access. In Japan, however, prices on different PTSs are hardly compared at all. For competition between markets and best execution to work better, we need a best execution duty and trading practices under which customer orders are actually executed at the best quote available across all trading venues that meet a specified size threshold.

As for UTP, it is worth considering if it would actually promote competition between markets. In Japan, the TSE carries heavy responsibilities, such as listing management (including corporate governance reform) and self-regulation. So this issue should be examined in light of what kind of trading venue would compete with the TSE — a fully equipped venue like the TSE, or a more lightly equipped PTS-type venue.

(End)