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Debate about extension of equity trading hours

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Introduction

The Tokyo Stock Exchange (TSE) is mulling whether to extend its trading hours. On July 25, it published a discussion paper[1)] that proposed specific approaches to extending trading hours and highlighted anticipated points of contention. The TSE solicited public comments on the discussion paper through September 10. It plans to announce its intended course of action by year-end. Following is a discussion of the background of the debate about extending of trading hours, interspersed with my personal opinions regarding certain key points.

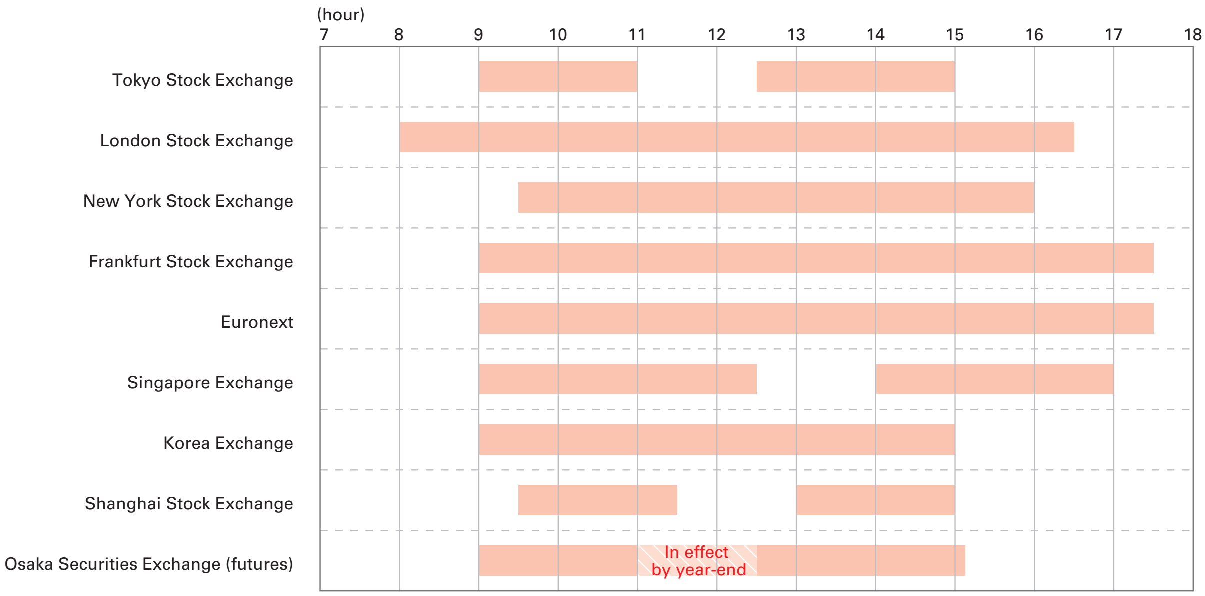
Short trading sessions in comparison to the US and Europe

The TSE stock market is open for a total of four and a half hours per trading day. Its daily trading hours comprise a morning session from 9:00 to 11:00 and afternoon session from 12:30 to 15:00. In contrast, the New York Stock Exchange and London Stock Exchange are respectively open for six and a half hours (9:30–16:00) and eight and a half hours (8:00–16:30) daily. The TSE has shorter trading hours than almost all major overseas markets (Exhibit 1).

In addition to the brevity of the TSE's trading hours, another issue drawing scrutiny is that the TSE, unlike European and US markets, closes for a midday recess[2)]. In the aforementioned discussion paper, the TSE sought public comments on specific issues pertaining to four approaches to extending trading hours: (1) shortening or eliminating the midday recess, (2) initiating evening trading sessions for cash-market equities, (3) extending existing evening trading hours for the derivatives market, and (4) rescheduling the morning trading session's open to an earlier time.

The rationale behind the TSE's prospective extension of trading hours is to enhance investor convenience and revitalize trading activity. In particular, some have noted that extending trading hours into the evening or midday recess would be conducive to greater market participation by businessmen hitherto unable to actively trade stocks because they work during trading hours. In surveys

Exhibit 1. Major exchanges' trading hours



Note: The OSE has an evening session from 16:30 to 23:30 also.
Source: JB Press article dated August 12, 2010 (http://jbpress.ismedia.jp/articles/-/4175)

conducted by some securities brokerage firms, 60–80% of retail investor respondents were in fact in favor of extending trading hours[3].

Will extended trading hours really revitalize the market?

Many of these survey respondents in favor of extending trading hours presumably believe that doing so would help revitalize the equity market by stimulating trading activity, based on the assumption that the status quo would be maintained in terms of liquidity and the efficiency and fairness of price formation. In reality, however, things are not so simple.

Equity trading on the Tokyo market is done by auction. Specifically, stocks' opening and closing prices are determined by a procedure known as a clearing-house auction, whereby a single clearing price is determined based on the rule of price priority. During trading hours between the opening and closing clearing-house auctions, prices are determined by continuous double auction (CDA) based on the rule of price priority and time priority (same-priced orders are prioritized by their time of receipt, from earliest to latest). During CDA hours, buy and sell orders that coincide in terms of price and quantity are executed against each other.

However, the probability of immediate execution of a buy or sell order during CDA hours is not very high, except in the case of certain stocks (e.g., well-known major companies) with a continuously heavy order flow. Market participants who want to be assured of order execution tend to concentrate their order submissions at clearing-house auction times, particularly morning and afternoon session openings and afternoon session closings, when prices are set for determining funds' NAVs. If the TSE were to eliminate the midday recess, in which case CDA trading would be in effect from the morning open to the afternoon close, two of the existing clearing-house auctions (i.e., the morning session's close and afternoon session's open) would also be eliminated. Such a reduction in clearing-house auctions' frequency could severely detract from market liquidity.

Incidentally, the tendency for clearing-house auctions to have more liquidity than the rest of the trading day is not unique to the Tokyo market. In the New York market, for example, some trading firms reportedly trade exclusively at the open and close, when liquidity is most abundant[4]. They do so because 58% of trading volume in the New York market is concentrated at the open and close combined. In the interim between open and close, these firms' traders apparently leave the office to play golf or work out at the gym[5].

Additionally, a sizable portion of trading volume executed by the TSE's ToSTNeT electronic trading system, which is heavily used by institutional investors seeking to mitigate the market impact of their large orders, occurs during the midday recess. It is not uncommon for companies to publicly disclose market-moving, material information during the midday recess. The midday recess is not literally a break in market action. The view that the midday recess should be eliminated because it is wasted time is at odds with market reality.

Moreover, the rationale of retail investors who say they want to trade during the midday recess or in the evening is a bit baffling. Even now, retail investors widely place buy and sell orders with their brokers by phone or online during the midday recess and in the evening. Even full-service brokers still accept customer orders during the midday recess if not in the evening. I have never heard of any Japanese brokerage taking a midday recess during business hours. Orders received during the TSE's midday recess are normally executed at the open of the afternoon session. It is hard to see how this arrangement materially inconveniences retail investors.

Evening trading has been considered before

This is not the first time that the TSE has considered extending trading hours. In July 2000, the TSE established a working group to study the advisability of extending trading hours into the evening. At the time, major trading companies had started looking into establishing proprietary trading systems (PTSs) for evening trading. The TSE decided to study the issue at the suggestion of brokerages, mainly online brokers, hoping to better meet the needs of customers who work during the day.

In the evening, however, when domestic corporate activity virtually shuts down, TSE-listed companies hardly ever release new information significant enough to influence investors' opinion of' their share prices. Moreover, domestically based institutional investors are unlikely to actively trade in the evening. Liquidity is consequently likely to be severely diminished during evening trading hours. Evening trading could therefore give rise to distorted price formation or become a breeding ground for manipulative trading.

To reiterate, the absence of evening trading does not directly inconvenience retail investors. Many securities brokerages accept equity trading orders via call centers and/or their websites even after normal business hours. Orders received at night are submitted to the market for execution at the open on the following trading day. It is difficult to see how retail investors are disadvantaged by having to wait until the next morning for order execution. Even if evening trading were available, investors would ordinarily not be able to immediately convert their shareholdings to cash. Evening trading therefore would not enhance investor convenience.

Back in 2000, I raised doubts about the need to introduce evening trading in the Tokyo market. In doing so, I cited the example of the US, where after-hours trading in certain equity markets had been marked by a dearth of liquidity and pronounced price swings[6)]. The TSE ultimately decided against introducing evening trading, but some securities brokerages began to offer evening trading services via PTSs.

I consider evening trading mediated by a PTS to be very different from evening trading on the TSE in terms of significance. PTS-mediated evening trading is by no means objectionable in my opinion. Financial instrument markets established by licensed exchanges are public utilities to a large extent. Such exchanges should therefore be subject to much higher standards than PTSs in terms of efficiency and fairness. Of course, PTSs also must have adequate investor protections and strive to prevent unfair trading and improve price-formation efficiency, but banning voluntary trading via PTSs by sophisticated investors aware of the pitfalls of after-hours trading would constitute overprotection.

May cool heads prevail

Another interpretation of the TSE's previous decision not to institute evening trading is that it stemmed from a conflict of interest between online brokerages in favor of extending trading hours to better meet investors' needs and traditional full-service brokerages concerned about increased costs, particularly personnel costs.

In light of such, some media outlets tend to frame the current debate about extension of trading hours as a dispute between online and full-service brokerages. This tendency regrettably appears to have influenced retail investors' opinions to some extent, as seen on the Internet. However, this issue should unequivocally not be seen as an intra-industry conflict of interest. If extension of trading hours would indeed contribute directly to revitalizing the equity market, even traditional full-service brokerages should be enthusiastically in favor of it. Given the risk of an ill-advised extension of trading hours detracting from market quality as discussed above, this issue should be considered carefully and dispassionately.

At four and a half hours per trading day, the TSE's current trading hours are indeed short in comparison to overseas markets. There is no reason that existing trading hours must be maintained. Completely eliminating the midday recess or adding after-hours trading is not the only way to extend trading hours. Other conceivable approaches include shortening the midday recess somewhat or establishing an evening trading session coordinated with European or US markets' opening times. In any event, the TSE should staunchly resist shortsighted institutional reforms that uncritically defer to investor opinion expressed in the aforementioned surveys.

Note

1) "Discussion Paper regarding the Extension of Trading Hours", http://www.tse.or.jp/english/news/20/100726_a.html

2) The midday recess is not unique to Japan. Certain other markets (e.g., Hong Kong, China, Singapore) also have midday recesses.

3) *Nikkei Shimbun*, September 4 and September 10, 2010.

4) "The Traders Who Skip Most of the Day", WSJ.com, September 10, 2010.

5) The NYSE has designated market makers (DMM) that continuously display bid and offer quotes for their assigned stocks. As a result, the NYSE presumably has better liquidity than the TSE, which does not have the equivalent of DMMs. It is interesting that even in the New York market, some traders target the abundant liquidity available during clearing-house auction times.

6) See "After-hours Equity Trading in the US: Current Status and Problems" by Sadakazu Osaki and Nasuka Hiramatsu in the fall 2000 issue of Capital Markets Quarterly (in Japanese). Derivatives markets tend to be more conducive to extended trading hours for rational reasons. One reason is that derivatives markets generally trade in few listed instruments. Another reason is that index futures and other derivatives' price formation tends to be governed more by macro factors than micro factors. The notion that cash market operators and participants are more conservative than their derivative market counterparts is a misconception.

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