

Personal view  
“Computerized Markets and  
Their Regulatory Issues”  
α version (ver.0.5)

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(Note) It is provisional translation by the organizer.  
Opinions expressed in this report are personal views of the author.

# Change of TOB regulation

## Overview of a revision draft of the Order for Enforcement of the Financial Instruments and Exchange Act

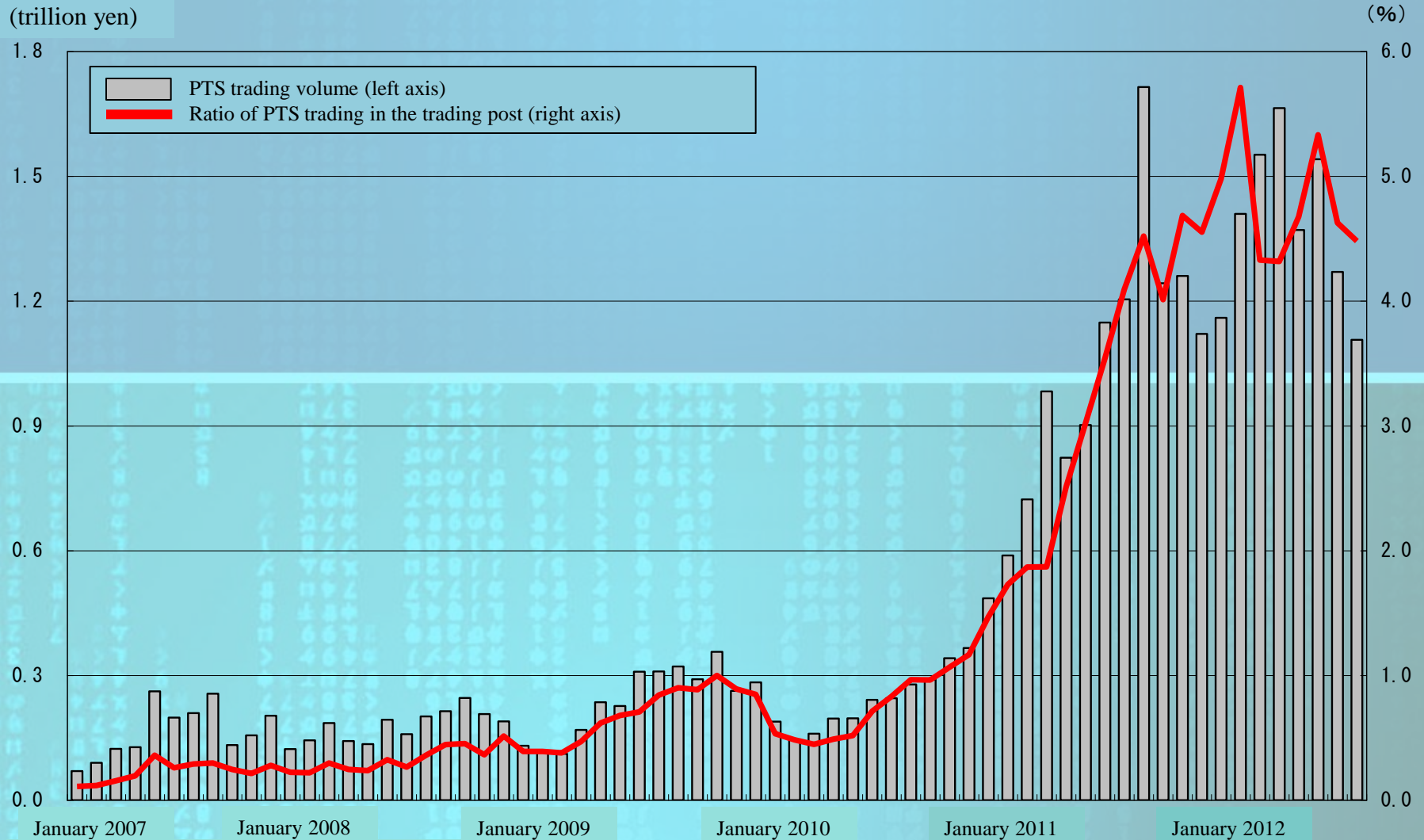
		The 5% rule of TOB regulation	The one-third rule of TOB regulation
In the market	On-floor	Not applicable	Not applicable
	Off-floor	Not applicable	Applicable
Out of the market	P T S	Applicable → Not applicable to a certain PTS Applicable	Applicable
	Others	Applicable	Applicable

(Note) There are a 5% rule and a one-third rule in the regulation of TOB.

i) If the ownership percentage exceeds 5% after PTS bids made by a large number of persons (over 10 persons in 60 days), TOB must be undertaken (the 5% rule).

ii) If the ownership percentage exceeds one-third after PTS bids made by an extremely small number of persons (10 persons or less in 60 days), TOB must be undertaken (the one-third rule).

# Present situation of PTS market in Japan



# Control over PTS (Financial Instruments and Exchange Act)

## Financial Instruments and Exchange Act Article 2 paragraph 8 item 10

Sales and purchase of Securities or intermediary, brokerage or agency services therefor which are conducted through an electronic data processing system, by using any of the following price formation methods or another similar method, and in which a large number of persons participate simultaneously as the one party in the transaction or the transaction is conducted between a large number of persons (excluding those specified by a Cabinet Order as transactions which may be considered inappropriate to be conducted in either a Financial Instruments Exchange Market or Over-the-Counter Securities Market (meaning the Over-the-Counter Securities Market prescribed in Article 67, paragraph (2)), in light of the protection of investors considering the class of Securities dealt in and other factors);

- (a) a method of auction (limited to cases where the trading volume of Securities does not exceed the criteria specified by a Cabinet Order);
- (b) with regard to Securities listed in a Financial Instruments Exchange, a method using the trading price of the Securities in the Financial Instruments Exchange Market operated by the Financial Instruments Exchange;
- (c) with regard to Securities registered under Article 67-11(1) (hereinafter referred to as "Over-the-Counter Traded Securities"), a method using the trading price of the Securities published by the Authorized Financial Instruments Firms Association to which the Securities are registered;
- (d) a method using the price decided by negotiation between customers; and
- (e) in addition to those listed in (a) to (d) above, other methods specified by a Cabinet Office Ordinance.

# Control over PTS (Financial Instruments instruments and Exchange Act)

- Financial Instruments and Exchange Act
  - Article 30, Article 32

## Article 30

(1) When a Financial Instruments Business Operator intends to conduct acts listed in Article 2(8)(x) in the course of trade, it shall obtain authorization from the Prime Minister.

(2) When the Prime Minister has granted authorization set forth in the preceding paragraph to a Financial Instruments Business Operator, he/she shall note to that effect in registration of said Financial Instruments Business Operator.

## Article 30-4

When the Prime Minister intends to grant authorization set forth in Article 30(1), he/she shall examine whether the application for approval conforms to the following criteria:

- appropriate system and regulations are developed with regard to management of risks of loss;
- the amount of the stated capital exceeds the amount of money specified by a Cabinet Order as necessary and appropriate for the public interest or protection of investors (NOTE: 300 million JPY);
- the amount of Net Assets exceeds the amount of money prescribed in the preceding item;
- the provision of Article 46-6(2) (NOTE: Regulation concerning Capital-to-Risk Ratio) is not violated; and
- the applicant's price formation method, methods of transfer and other settlements, and other contents and methods of business specified by a Cabinet Office Ordinance are necessary and appropriate for the public interest or protection of investors.

# Control over PTS (Guidelines for Supervision)

**To disclose the best quotations/trading prices, etc., of the PTS in such a form which allows comparison with other PTSs and in such a form which allows free access from the outside in real time.**

**However, information shall be disclosed in such a way which allows free access from the outside until a disclosure format which allows comparison with other PTSs is established.**

# Control over PTS (Guidelines for Supervision)

a. In the case of a PTS that handles share certificates and bonds with share options and determines prices by a method other than auctions (limited to those listed in financial instruments exchanges or those registered pursuant to Article 67-11(1) of the FIEA):

1. In the cases where the ratio of average payments of daily transactions of share certificates or bonds with share options traded on financial instruments exchanges or OTC markets (limited to those listed in financial instruments exchanges and those registered pursuant to Article 67-11 (1) of the FIEA) exceeds 10% of the sum of transaction payments of any security and exceeds 5% of the entire share certificates and bonds with share options of the previous six months, the following measures shall be taken:

A. To expand and develop a system (organization/personnel) for administering trade and inspection in order to ensure trade fairness.

B. To establish a system equivalent to the accumulated reserve for breach of contract losses in the financial instruments exchanges in order to ensure settlement.

C. To establish a periodic monitoring system to ensure the safety and certainty of system capacity, etc.

2. If the said ratio exceeds 20% of any security and 10% of the total share certificates and bonds with share options of the previous six months, a license to establish a financial instruments exchange market shall be obtained.

3. In addition to the above, new criteria shall be introduced within the boundaries of PTSs that trade other debit securities, if, with the expansion in trading volume, etc., the need arises from the viewpoint of public welfare or investor protection.

# Possible points in reviewing how to deal with PTS

Market Fragmentation

Best Execution


Commission Sharing Agreement

Technological development



# Market Fragmentation (U.S. approach)

- 2005 Regulation NMS
  - Order Protection Rule
  - Access Rule
  - Sub-Penny Rule
  - Market Data Rule
- 2009 Flash Order Regulation
- 2009 Dark Pool Regulation

 Efforts to establish places of many concurrent transactions virtually as if they were one market?

# Market Fragmentation (European approach)

- 2004 Mifid (Markets in financial instruments directive) adopted
- 2007 Mifid enforced
  - Abolition of duty to concentrate on market
  - Multilateral Trading Facility (MTF)
  - Duty of Best Execution
- 2011 Mifid reviewed
  - Organized Trading Facilities (OTF)
  - Cross-sectional regulation for regulated market, MTF, OTF



Coexistence of the existing exchange (local market) and MTF (pan European market), and safeguarding of fair competition?

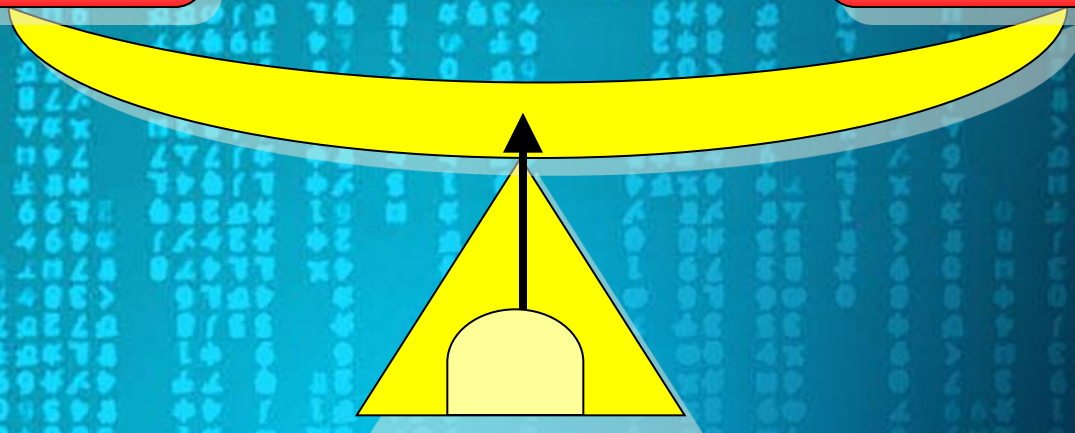
# Format to exercise market function

Infrastructure cost  
Administration cost

Innovation by  
inter-market  
competition

Lack of pressure  
from inter-market  
competition

Efficient price  
formation



# Duty of Best Execution in Japan

## Financial Instruments and Exchange Act, Article 40-2

- (1) A Financial Instruments Business Operator, etc., shall, pursuant to the provisions of a Cabinet Order, establish a policy and method for executing orders from customers for sales and purchase of Securities and Derivative Transactions (except those specified by a Cabinet Order; hereinafter referred to as "Transactions of Securities, etc." in this Article) under the best terms and conditions (hereinafter referred to as the "Best Execution Policy, etc." in this Article).**
- (2) A Financial Instruments Business Operator, etc., shall, pursuant to the provisions of a Cabinet Office Ordinance, announce its Best Execution Policy, etc.**
- (3) A Financial Instruments Business Operator, etc., shall execute orders for Transactions of Securities, etc., in accordance with its Best Execution Policy, etc.**

# Duty of Best Execution in Japan (2)

Financial System Council, the First Subcommittee Report (December 2003)

“Toward a financial system with a market functioning at the core”

As for the details of the duty of best execution, in light of the situation that trading at the exchange is beneficial to most investors, the duty shall be an execution by giving comprehensive consideration not only to price but also to various factors such as cost, speed and enforceability, and specific execution shall be determined by securities firms themselves and presented to their customers. It is also suggested that a report and announcement system be further bolstered to verify whether it is executed as determined.

Being such a duty, if, for example, it was found later not to be the best execution by focusing on a price only, it should not be taken by the authorities as a violation of the duty.

# Format to exercise market function

Duty to execute at best price

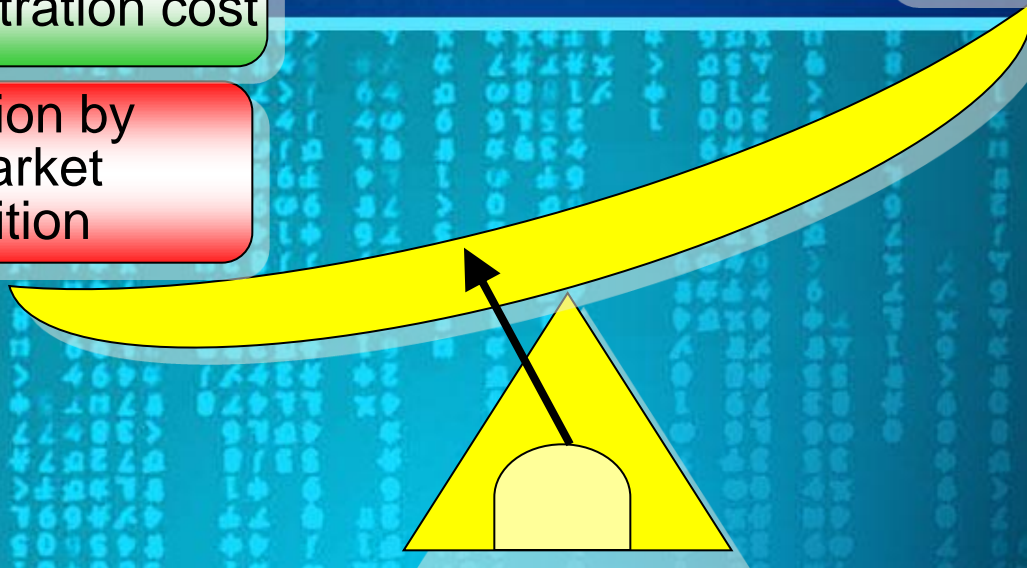


Infrastructure cost  
Administration cost

Innovation by  
inter-market  
competition

Non-competitive  
environment

Efficient price  
formation



# Format to exercise market function

Duty to execute at best price



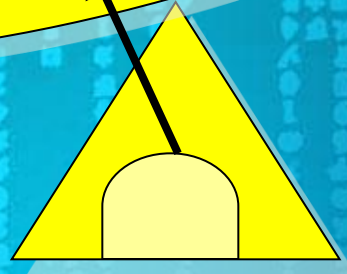
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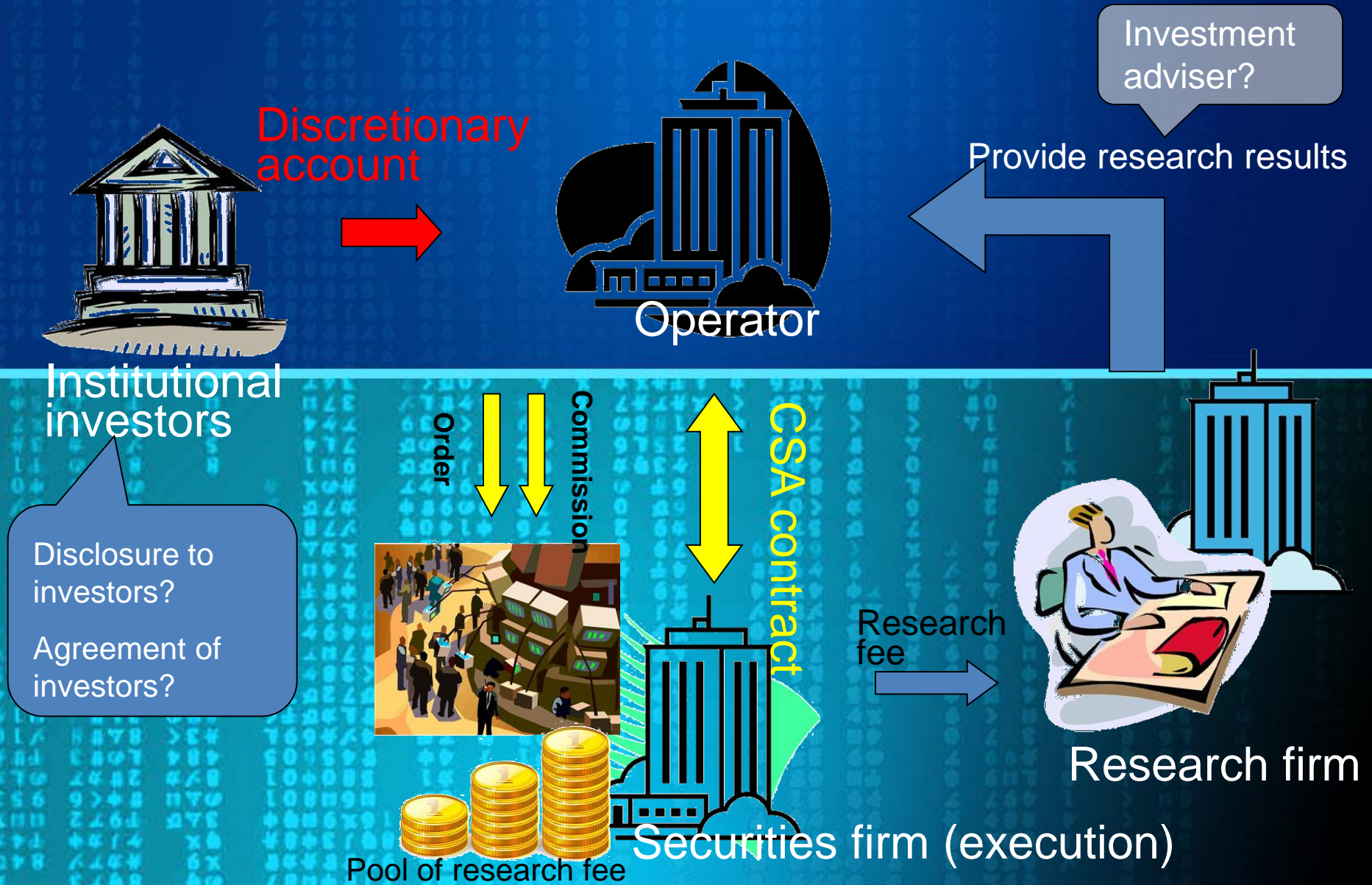
Non-competitive  
environment

Efficient price  
formation

Response capability  
of management firm  
and securities firm



# Unbundling?





# US SEC: Concept Release on Equity Market Structure on 2010

## ***Market Quality Metrics***

- What are the best metrics for assessing market quality for long-term investors and have these metrics improved or worsened in recent years?

## ***Fairness of Market Structure***

- Is the current highly automated, high-speed market structure fundamentally fair for investors?

## ***High Frequency Trading***

- What types of strategies are used by the proprietary trading firms loosely referred to as high frequency traders, and are these strategies beneficial or harmful for other investors?
- Is the overall use of any harmful strategies by proprietary firms sufficiently widespread that the Commission should consider a regulatory initiative in this area?

# US SEC: Concept Release on Equity Market Structure on 2010

## ***Co-Location***

- Ⓢ Do co-location services give proprietary trading firms an unfair advantage?
- Ⓢ If so, should the proprietary firms that use these services be subject to any specific trading obligations?

## ***Dark Liquidity***

- Ⓢ Has the trading volume of undisplayed trading centers (such as dark pools) reached a sufficiently significant level that it has detracted from the quality of public price discovery?
- Ⓢ If more individual investor orders were routed to public markets, would it promote quote competition in the public markets, lead to narrower spreads, and ultimately improve order execution quality for individual investors beyond current levels?
- Ⓢ Are a significant number of individual investor orders executed in dark pools and, if so, what is the execution quality for these orders?

## *IOSCO: Regulatory Issues Raised by the Impact of Technological Change on Market Integrity and Efficiency*

**Recommendation 1:** Regulators should require that trading venue operators provide fair, transparent and non-discriminatory access to their markets and to associated products and services.

**Recommendation 2:** Regulators should seek to ensure that trading venues have in place suitable trading control mechanisms (such as trading halts, volatility interruptions, limit-up-limit-down controls, etc.) to deal with volatile market conditions. Trading systems and algorithms should be robust and flexible such that they are capable of dealing with, and adjusting to, evolving market conditions. In the case of trading systems, this should include the ability to adjust to changes (including sudden increases) in message traffic.

**Recommendation 3:** All order flow of trading participants, irrespective of whether they are direct venue members or otherwise, must be subject to appropriate controls, including automated pre-trade controls. These controls should be subject to the regulatory requirements of a suitable market authority or authorities. In addition, regulators should identify any risks arising from currently unregulated direct members/participants of trading venues and, where any are identified, take concrete steps to address them.

## **IOSCO: Regulatory Issues Raised by the Impact of Technological Change on Market Integrity and Efficiency**

**Recommendation 4:** Regulators should continue to assess the impact on market integrity and efficiency of technological developments and market structure changes, including algorithmic and high frequency trading. Based on this, regulators should seek to ensure that suitable measures are taken to mitigate any related risks to market integrity and efficiency, including any risks to price formation or to the resiliency and stability of markets, to which such developments give rise.

**Recommendation 5:** Market authorities should monitor for novel forms or variations of market abuse that may arise as a result of technological developments and take action as necessary. They should also review their arrangements (including cross-border information sharing arrangements) and capabilities for the continuous monitoring of trading (including transactions, orders entered or orders cancelled) to help ensure that they remain effective.

# Impact of technological development on the market

Inter-operator and inter-market service competition of an order execution method only ?

Risk and cost on the system

A paradigm shift of securities business?

Radical changes in market function such as price discovery function and provision of liquidity?

Big data  
Cloud  
Obsolescence of programming language



Drastic restructuring of regulatory and supervisory system?

# For whom technology evolves?

## Financial Instruments and Exchange Act (Purpose)

The purpose of this Act is, inter alia, by developing systems for disclosure of corporate affairs and other related matters, providing for necessary matters relating to persons who engage in a Financial Instruments Business and securing appropriate operation of Financial Instruments Exchanges, to ensure fairness in, inter alia, issuance of the Securities and transactions of Financial Instruments, etc., and to facilitate the smooth distribution of Securities, as well as to aim at fair price formation of Financial Instruments, etc., through the full utilization of functions of the capital market, thereby contributing to the sound development of the national economy and protection of investors.

# The Action Plan for the New Growth Strategy (Outline)

## Action plan for invigorating financial capital markets and the financial industry

~ Toward the realization of the new growth strategy ~

### Roles of Financial Sector

- **Back up and Support the Real Economy and Enterprises**
  - Provide suitable investment opportunities and diverse fundraising methods
- **Lead the Economy as a Growing Industry itself**
  - Utilize opportunities for growth combining fundamental strengths with the nation's individual financial assets (¥1400 trillion), and positioning other parts of Asia and regions inside Japan as growth frontiers.

### 3 Pillars of the Action Plan

- I . **Supply of Funds to Companies Commensurate with Borrowers' Size and Stage of Development**
- II . **Financial Sector Serving as a Bridge between Asian and Japanese Economies**
  - Establishing Japan's Status as a Main Financial Market in Asia
  - Support to Expansion Japanese Financial Institutions' Activities in Asia
- III . **Provision of Asset Management Capabilities to Utilize Japanese National Assets Safely and Effectively**

# The Principles in the Financial Services Industry

Principles	Practical image
Financial service providers are expected to: 1. Pursue greater customer benefits and fulfill expected roles through voluntary efforts with creativity.	(1) Ceaseless efforts aimed at providing financial services to meet customer needs. (2) Proper relationship with diverse stakeholders. (3) Conformity to expectations that Japan's financial services industry generate high value-added and contribute to sustainable growth of the national economy. (4) Responses aimed at meeting social responsibilities.
2. Participate in the markets with the resolve to improve the functioning thereof as a whole and secure fairness and transparency therein.	(1) Compliance with laws and regulations as well as self-regulations. (2) Contribution to improving market functions, including market efficiency, through pursuit of best practices and improvement in self-regulations as needed. (3) Contribution to securing market transparency and fairness, by strictly confronting malicious acts that may harm transparency and fairness of the markets.
3. Pay due regard to reasonable customer expectations and conduct business with integrity and professional prudence in order to meet their needs.	(1) Due consideration of customer needs to be reflected in provision of appropriate financial services and management of contracts thereafter, including follow-ups. (2) Maintenance of decency in transactions, including by preventing abuse of dominant positions. (3) Thorough protection of customer information. (4) Fair treatment among customers and compliance with arm's-length rules.
4. Pay due regard so as to provide customers with information and advice on a timely basis and in a clear and fair manner, thus enabling them to make economically rational judgments.	(1) Disclosure of information with accuracy and clarity for customer decision-making, thereby securing substantive fairness. (2) Conformity to the customer suitability rule. (3) Provision of truthful information to customers and avoidance of misleading explanations.
5. Respond to customer consultations and inquiries with integrity and provide needed information and advice, while making efforts to disseminate financial knowledge.	(1) Commitment to gaining customers' understanding and confidence to the extent possible. (2) Accumulation and analysis of cases of consultations, inquiries and complaints, thereby improving business operations, particularly in the area of customer explanation. (3) Dissemination of correct financial knowledge.
6. Prevent abuse stemming from conflicts of interest between one's self, including group firms, and the customers, or among different customers.	(1) Sufficient verification as to whether conflicts of interest and other business conflicts are being handled properly. (2) Implementation of appropriate control over conflicts of interest to avoid abuses. (3) Performance of duties with integrity.
7. Manage customers' assets in an appropriate manner, corresponding to the responsibilities assumed.	(1) Appropriate management of customer assets. (2) Fulfillment of obligations borne as asset managers (e.g., responsibilities to provide good managerial care, keep in separate custody and meet fiduciary requirements, depending on the context of contracts).
8. Establish appropriate mechanisms for corporate governance, including by way of making necessary personnel allocations, and achieve effective corporate governance, to ensure financial soundness and proper business operation.	(1) Establishment of effective and efficient corporate governance. (2) Appropriate allocation of executives and employees. (3) Compliance with laws, regulations and other business rules, and sound and proper conduct of business thereby. (4) Appointment of directors qualified as being fit and proper.
9. Conduct appropriate information disclosure, considering the significance of both setting market discipline to work and enhancing transparency of corporate management.	(1) Timely and appropriate disclosure of information to the markets. (2) Timely and appropriate disclosure of information to stakeholders at large.
10. Establish mechanisms so as to avoid being exploited by financial crimes, including by way of blocking anti-social parties' access.	(1) Implementation of mechanisms aimed at preventing involvement in or exploitation by financial crimes, including blocking off anti-social parties' access. (2) Implementation of mechanisms for customer management and collaboration with relevant organizations.
11. Maintain sound financial basis corresponding to risk profile.	(1) Proper evaluation and assessment of the structure of assets, debts and capital in the light of the risk profiles of the firms in question. (2) Maintenance of capital proportionate to the extent of risks.
12. Conduct appropriate risk management in accordance with the size and features of the business operation and inherent risk profile.	(1) Implementation of appropriate risk management mechanisms. (2) Comprehensive recognition and effective control of various risks that may adversely affect assets, debts and profits and losses. (3) Establishment of sustainable profit structure.
13. Establish countermeasures against large-scale disasters and other contingencies in accordance with the role it fulfils in the markets.	(1) Prospects for market liquidity in times of market turmoil. (2) Establishment of crisis management systems and coordination among the parties involved in the event of crises.
14. Provide accurate information with integrity upon reasonable requests from the FSA, and facilitate effective communication with the FSA, including by way of interactive dialogues.	(1) Prompt provision of sufficient and accurate information meeting the FSA's needs, in response to reasonable requests. (2) Effective communication between the FSA and financial service providers through enhanced interactive dialogue.



# Respective roles for exercising proper market function

“Place” to execute orders

People who execute orders for investment

People who are entrusted with money and invest

People who put up money

# Thank you



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