Legal Issues Concerning the Use of the Internet in Securities Markets: The Japanese Case[1]

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1. Introduction

In recent years, advances in information and communications technology have led to a rapid growth in online securities trading and other uses of the Internet in securities markets.

At the retail end of the securities business, individual investors have been making increasing use of the online trading services provided by brokerage firms and mutual fund companies which enable investors to place orders to buy and sell equities and mutual funds via the Internet. On the other hand, at the wholesale end, the emergence of online trading systems called "proprietary trading systems" (PTSs) or "alternative trading systems" (ATSs) has led to fierce inter-market competition.

Although the United States has led the way in the development of online securities trading, Japan is catching up—especially since the "Big Bang" program of financial reform began in November 1996. Taking this as our starting point, this paper looks at related developments—especially in the Japanese legal system—and outstanding issues.

2. Problems Related to Online Securities Trading by Retail Investors

Online securities trading is not something that has emerged overnight. The world's first proprietary trading system, Instinet, was launched in 1969, and the NASDAQ, where shares are traded on computer terminals rather than a trading floor, began life in 1971. In the late 1980s, institutional investors and securities companies began to make extensive use of online systems to route orders to stock exchanges as well as in their back offices.

[1] This paper is based on a presentation delivered by the author at the “International Symposium on Electronic Commerce and Legal Issues” organized by Kyushu University in July 2001.

However, with the exception of the rules which the US Securities and Exchange Commission (SEC) was quick to draw up for proprietary trading systems (see below), the development of such systems generally did not have much of an impact on legislation governing securities trading. This situation changed significantly in the late 1990s when growing use of the Internet led to retail investors joining the list of those who traded online.

National legislation and regulation governing securities trading is basically designed to protect retail investors. The use of online systems, such as Instinet, in trading by institutions did not raise much concern from the regulator’s point of view. However, the arrival online of retail investors brought home the need to review securities regulation in order to ensure that small investors would be reasonably protected in the new world of cyber-space.

Internet trading of securities by retail investors has created a number of problems not covered by existing legislation. These include the following.

First, there is the risk that client orders may not be processed properly because the host computer of the securities company concerned may not be working or may be overloaded because of a temporary surge in orders. Also, the fact that how messages are routed on the Internet cannot be decided in advance means that it is not clear whether it is the investor himself, his Internet service provider, the telecoms company or the securities company that is responsible if a problem occurs.

Second, there is the possibility that an incorrect order may be accepted because an investor has misunderstood something or input the wrong data. A simple mistake that would have been spotted by a live broker if an order had been received either orally at a branch of a securities company or by telephone may be assumed to be correct by a computer if received online.

Third, unlike the situation where a client decides to buy or sell securities after talking to a broker, there is a risk in online trading that a client may not have understood fully the information upon which he is acting. There is therefore a need for rules to oblige a securities company to provide information in a way that takes into account the specific nature of online trading. However, online trading does eliminate the possibility of the kind of fraudulent sales talk that has been known to occur when a client talks to a broker before buying or selling securities.

Fourth, there is a risk that the number of unregistered or unauthorized persons offering false or misleading investment advice or services could increase. It is difficult for investors to tell which online securities traders are acting within the law and which are not. There is also a risk that unscrupulous operators could use the anonymity of the Internet and the low cost of sending information to a large number of people simultaneously to spread rumors (e.g., on investor bulletin boards or by e-mail) and try to manipulate markets.

Fifth, there is the risk of impersonation (if Internet users' IDs and passwords are stolen) and electronic eavesdropping.

Some of these problems can be solved (at least in part) if securities companies improve their system security, while others (such as market manipulation) should be solved by applying the Securities and Exchange Law more rigorously. It is also often unclear (1) whose responsibility it is for implementing rules and monitoring whether they are being implemented or (2) what standards apply.

The guidelines ("Points to Beware of When Trading Securities on the Internet") issued by the Japan Securities Dealers Association (JASDA, the body responsible in Japan for self-regulation under the Securities and Exchange Law) in September 1999 are an attempt by the securities industry to regulate online trading services targeted at retail investors and to take into account some of these risks.

The guidelines set out the various issues that face securities companies offering online trading on the Internet as a result of the fact that such trading lacks any personal contact and there is no written record.

As well as pointing out a number of general points (e.g., the fact that online trading is subject to the same rules and regulations as conventional trading and that there has to be a proper compliance system with its own rules and regulations), the guidelines describe in detail the following: (1) general matters concerning the type of financial products that can be traded online and how they may be traded; (2) matters concerning compliance and transactional security; (3) matters concerning the provision of information to clients and trading procedures; and (4) matters concerning adherence to rules and regulations.

Unlike the Association's rules, the guidelines are not legally binding. However, they do deal in detail with many of the issues that are likely to arise in the course of online securities trading and should be a valuable source of advice for all those involved in the securities industry. Recently, the guidelines were reviewed by a working group of practitioners. In April 2001, a revised version of the guidelines was finally adopted.

3. Need to Review Existing Regulations

Existing regulations on securities trading presuppose that investment advice is given and investment instructions received orally (either face to face or by telephone), and confirmed in writing. With the growth of online trading, however, this presupposition no longer necessarily applies.

In particular, the very rules and regulations that were intended to protect investors (especially retail investors, who have traditionally been at a disadvantage to professionals and institutions in terms of access to information and knowledge) are actually making it more difficult for retail investors to enjoy the efficiency benefits of online trading.

It was this realization that led the Securities and Exchange Commission in the United States to carry out an extensive review of US securities rules and regulations several years ago. Twice (in October 1995 and May 1996) the SEC has published interpretative releases and revised some of the existing rules in order to encourage issuers and securities companies to use the Internet and other electronic media.[2]

The release issued in October 1995 allowed prospectuses and proxy documents to be sent to shareholders electronically. More specifically, issuers and broker-dealers were allowed to send investors electronic prospectuses provided the following three conditions were met: (1) investors had to be notified of this separately (e.g., by telephone, fax, conventional mail or e-mail); (2) electronic documents had to be just as convenient as paper documents and investors had to be able to access information; and (3) hard copies of prospectuses and other documents had to be provided if investors requested.

This has enabled (1) issuers to post prospectuses on their Web sites and invite investors to subscribe to new securities (a new method of raising capital that might well be called "Internet finance") and (2) online securities companies to aggressively market initial public offerings (IPOs).

Meanwhile, the release issued in May 1996 allowed broker-dealers and investment advisors to use electronic media to send investors the various documents they are legally required to send them (e.g., execution confirmations, statements of account, and performance reports). The conditions that had to be met are virtually the same as

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2 Use of Electronic Media for Delivery Purposes, SEC Release, No. 33-7233; 34-36345; IC-21399 (October 6, 1995), Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information, SEC, Release No. 33-7288; 34-37182; IC-21945; IA-1562 (May 9, 1996).

those that apply to sending prospectuses: (1) an electronic version of a document had to contain the same information as a hard copy; (2) investors had to be notified separately that they had been sent an electronic document and there had to be a means of checking that it had been sent properly and that investors could access it; and (3) hard copies of documents had to be provided if investors requested.

Given the confidential nature of much of the information contained in such documents, the 1996 release stressed the importance of system security and the need for informed consent by investors.

In Japan, following the complete liberalization of brokerage commissions in October 1999 and the appearance of online brokers charging very low rates, retail investors have also begun to make increasing use of online securities trading. Given that low cost is one of the main selling points of online brokers, the cost of having to send investors documents such as prospectuses and transaction reports by conventional mail is not insignificant, and the need to find a solution has increased since December 1998, when the revised Securities and Exchange Law added prospectuses for mutual funds to the list of documents that have to be sent to investors.

Since then, the May 2000 revision to the Securities and Exchange Law has allowed information contained in prospectuses to be sent as an electronic file via the Internet by adding the following: "Where a prospectus has to be sent to an investor, the information contained in the prospectus may be sent instead using an electronic communications network, provided this is stipulated in a Cabinet order, or by any other means stipulated in a Cabinet order" (Securities and Exchange Law, 27-30-9). This is regarded as equivalent to sending the prospectus itself[3].

Moreover, the enactment in November 2000 of the Law for the Provision of Laws on the Use of Information Technology to Send Documents made it possible to send execution confirmations and mutual fund performance reports in the same way from this April. In January of this year the corresponding government orders, which stipulate that clients must give their consent before this can be done, were enacted. In April 2001, the corresponding Cabinet order was enacted, but most Japanese securities firms still do not send prospectuses electronically. This is because the Cabinet order effectively provided that "delivery" of a prospectus will only be completed when a customer actually downloads an electronic file containing the information in a prospectus to his own computer. Currently, Japan's Financial Services Agency is trying to amend the Cabinet order in order to make it possible for

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[3] A detailed discussion of Japanese regulations on electronic prospectuses can be found in Sadakazu Osaki, "The Lifting of Restrictions on the Use of Electronic Media for the Delivery of Prospectuses: An Unfinished Job," Capital Research Journal, Summer 2001.

securities firms to send prospectuses electronically without taking unnecessary legal risks.

4. Cross-Border Nature of the Internet

The growth of online securities trading (especially the increasing use of the Internet) has not only produced the kind of technical amendments to rules and regulations we saw above, but also raises a more fundamental question about the Internet related to its distinctive characteristics. This is the question which country (or region) has jurisdiction over financial promotion or public offerings of securities given the Internet's stateless status that makes it possible to access the same information from anywhere in the world.

In the United States and the United Kingdom the regulators have sought to provide a partial answer by clarifying the law.

In the United States, the SEC made it clear in a March 1998 release that (1) a company offering investment advisory services on the Internet would be exempted from the registration requirement of the Investment Advisers Act provided it had taken measures reasonably designed to limit the number of its US clients to no more than 15 (e.g., by posting a disclaimer stating that it was not offering a service for US persons) and that (2) a foreign broker-dealer operating a Web site would not be required to register under the Securities Exchange Act provided it had taken measures reasonably designed to make it clear that its service was not intended for US persons or that it would not enter into any transactions with such persons.[4]

Meanwhile, in the United Kingdom in May 1998 the Financial Services Authority published a guidance release to the effect that it would not regard investment advertising on the Internet that did not appear to be targeted at UK residents as being subject to the Financial Services Act.[5] Similarly, the Financial Services and Markets Act of June 2000 (a complete revision of the 1986 Financial Services Act) states that, even if a communication originating outside the United Kingdom can be construed as financial promotion, it will be subject to regulation only if the communication is capable of having an effect in the United Kingdom (Section 21(3)), thereby clarifying the treatment of financial services offered on the Internet.

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4 Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore, SEC, Release No. 33-7516; 34-39779, IA-1710, IC-23071, International Series Release No. 1125 (March 23, 1998).

5 Treatment of material on overseas Internet World Wide Web sites accessible in the UK but not intended for investors in the UK, FSA, Guidance Release 2/98 (28 May 1998).

The approaches of the United States and the United Kingdom are basically supported by the International Organization of Securities Commissions (IOSCO). A report published by IOSCO's Technical Committee in September 1998 ("Securities Activity on the Internet") gives the following three conditions as examples of the kind of criteria for deciding whether a particular country (or region) should have jurisdiction over Internet securities trading services or public offerings of securities on the Internet: (1) the information provided is clearly targeted at residents of the regulator's area of jurisdiction; (2) the service provider or issuer has already entered into transactions with residents of the regulator's area of jurisdiction; and (3) the information provided has been targeted at residents of the regulator's area of jurisdiction using e-mail and other such methods.[6]

In Japan, an overseas-based broker-dealer is not required to register if it has simply received an unsolicited order from a Japanese resident (Law on Foreign Securities Firms, 3-2 and Cabinet Order for the Enforcement of the Law on Foreign Securities Firms, 2-2). Indeed, there appears to be a significant level of such cross-border transactions by Japanese retail investors, and there is no denying that a number of Web sites operated by overseas-based broker-dealers appear to be targeted at Japanese residents.

The response of Japan's Financial Services Agency was to issue a revised set of administrative guidelines on this issue in December 2000 in order to clarify the status of cross-border transactions entered into by Japanese residents with overseas-based broker-dealers via the Internet (Regulatory Issues Involving Foreign Securities Firms, 1-4-4). The guidelines make it clear that (as in the United States) advertisements posted on such a broker-dealer's Web site will not be regarded as targeting Japanese residents provided there is a disclaimer on the site that the service is not available to such investors and there is a mechanism to prevent any such transactions from taking place. The next issue will be what exactly the Japanese authorities should do if a Japanese investor does enter into such a transaction in apparent ignorance of these rules.

5. Rules Governing Online Securities Trading Systems

(1) Lifting of restrictions on proprietary trading systems as part of Big Bang

Another issue connected with online securities trading—but slightly different from the issues mentioned so far, which have mainly been about online securities trading targeted at retail investors—is that of how proprietary trading systems (PTSs, also known as "alternative trading systems") should be regulated.

6 Technical Committee of the International Organization of Securities Commissions, Securities Activity on the Internet, September 1998. As a Special Research Staff of the Japan Securities Dealers Association, the author took part in the discussions by the IOSCO taskforce that produced the report.

The first of these systems, which are similar to stock exchanges, was the US system Instinet, which began operation in 1969. PTSs have become a force to reckon with since the late 1980s, when trading volume began to increase by allowing broker-dealers to participate. Particularly noteworthy has been the growth of so-called "electronic communications networks" (ECNs), which appeared soon after the SEC introduced its Order Handling Rules in 1997 and now account for 30%-40% of trading in NASDAQ shares.

In the United States, PTSs have basically been subject to the regulations governing broker-dealers since Instinet began its operation. In Japan, on the other hand, PTSs were effectively banned by the Securities and Exchange Law, which (until its 1998 revision) prohibited the formation of an organized market for securities other than a stock exchange (Securities and Exchange Law, 87-2).

This situation changed completely when, as part of the Big Bang program of financial reform, the government decided to encourage competition between securities markets as a means of improving their efficiency and quality. Operating a PTS was designated as one of the licensed activities of a securities company. The Securities and Exchange Law was revised so that the rule prohibiting the formation of alternatives to stock exchanges would not be applied to anyone who had received permission to operate a PTS (Securities and Exchange Law, 2-8-7; 167-2-3 prior to the 2000 revision). In June 2000 the first approvals under the new regime were granted to Japan Bond Trading Company and E-Bond Securities.[7]

(2) Shortcomings of original rules for proprietary trading systems

The lifting of the restrictions on proprietary trading systems as part of the Big Bang reforms was epoch-making insofar as it gave broker-dealers the right to match orders to buy and sell securities, which had previously been the monopoly of the stock exchanges, and encouraged competition between markets. However, proprietary trading systems were still subject to considerable restrictions, and it was thought unlikely that the Japanese authorities would permit electronic communications networks similar to those in the United States.

This is because, under Japanese law, proprietary trading systems were severely restricted in the type of price discovery mechanism they could use. More specifically, the Securities and Exchange Law limited this to the following three types: (1) in the

7 See S. Osaki, "Legal Revisions Allow Exchanges to Be Formed as Joint-Stock Companies," Capital Research Journal, Autumn 2000. E-Bond Securities stopped its operation and was dissolved in May 2001.

case of listed securities, the same price as that at which the securities traded on a stock exchange; (2) in the case of securities quoted on the OTC market operated by the Japan Securities Dealers Association, the same price as that at which the securities traded on the OTC market; and (3) in other cases, at a price negotiated between the clients concerned (Securities and Exchange Law, 2-8-7). Although the Law also allowed "any other mechanism stipulated in a Cabinet or Ministry of Finance order," no such order was enacted.

As a result, two PTSs that were granted approval by the Financial Supervisory Agency (as it was then) were required to use prices negotiated between clients. However, in order to maintain this pretence, one of the systems was even obliged to adopt an absurd procedure that prevented it from matching orders automatically even when price and quantity did match.

(3) Financial Services Agency's revised guidelines

In December 2000 a set of Financial Services Agency guidelines on operating PTSs was enacted together with a related Cabinet order and a set of administrative guidelines, thereby enabling PTSs to use two price discovery mechanisms in addition to those that had already been statutorily approved: (1) using client limit orders to match transactions and (2) using multiple price quotations by securities companies (Prime Minister's Office Order on Definitions of the Wordings in the Securities and Exchange Law, 8-2).

In addition, in response to public comment on the administrative guidelines, it was made clear that the following should not be regarded as PTSs: (1) an arrangement whereby a securities company that makes the only market in a security enters into a transaction with a client via an online system and (2) information vendors.

Since January 2001, six additional PTSs for trading bonds and equities have been approved under the new guidelines.

(4) Unresolved issues facing proprietary trading systems

Although considerable progress on the issue of how PTSs should be regulated has therefore been achieved in a short time, a number of major issues remain unresolved.

First, it is difficult to justify why a PTS should be regarded as an inferior means of price discovery to an organized securities market operated by a stock exchange or a securities dealers’ association. While the more public status of stock exchanges and the need to protect investors may well require that they be subject to rigorous regulation, there is no good reason why particular price discovery mechanisms should be the preserve of stock exchanges or an organized OTC market operated by the Japan Securities Dealers Association.

In the United States, trading systems with a similar function to stock exchanges are regarded as alternative trading systems (ATSs), and the degree of regulation to which they are subject depends on the level of trading volume rather than the particular price discovery mechanism used. Also, even a stock exchange (with its obligation to meet certain self-regulatory standards) may be exempted from the need to register with the SEC in order to lighten its regulatory burden if trading volume is exceptionally low.

In Japan, the December 2000 revision to the Securities and Exchange Law, which permits the demutualization of stock exchanges, can also be interpreted as restricting competition. The fact that demutualized stock exchanges are subject to more restrictions than PTSs (e.g., restrictions on diversification of business and a 5% limit on shareholdings) makes it very difficult for PTSs to become stock exchanges. As a result, Japanese law makes it difficult for trading systems that use the same price discovery mechanisms as existing stock exchanges to compete and can be said to shield the latter from competition.

Second, as intermarket competition increases and more PTSs trade the same security, the need to prevent market fragmentation by consolidating trading information and quotation information will also increase. In the United States, a "National Market System" (NMS) has been proposed as a means of providing the necessary infrastructure for this, and a number of sub-systems, including a "consolidated quotation system" (CQS), are up and running. Similarly, the NASDAQ consolidates and reports quotation data from ECNs trading mainly NASDAQ shares.

In its guidelines the Financial Services Agency permits PTS operators to report trading information on their Web sites until it is possible to do this centrally. In the medium to long term, however, some system solution is required.

Third, as it becomes possible to execute orders on more than one market (stock exchange, proprietary trading system, etc.), it will become necessary to impose certain requirements on how securities companies deal with client orders (especially those from retail investors) to ensure that investors' rights are protected. In the United States, broker-dealers are, in principle, subject to a "best execution obligation," which is understood to oblige them to execute a client order on the best terms if the order can be executed on a number of markets or systems.

In Japan, on the other hand, this notion is not very well established. Until recently, the Securities and Exchange Law protected investors' rights by prohibiting activities such as "bucketing." However, these rules assumed that client orders would normally be routed to a stock exchange, and are not really suitable for a situation where several proprietary trading systems exist. Rules will therefore have to be devised for handling client orders and explaining the situation to clients (drawing, for example, on US experience of the SEC's order-handling rules).