
Japan's New Regulations Governing Proprietary Trading Systems

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On 26 October, 2000, the Financial Services Agency published its "Guidelines for the Setting Up of Proprietary Trading Systems" ("the Guidelines") and proposed a new set of criteria for approving applications by stockbroking companies to operate such systems. The Guidelines then became official policy on 16 November after being amended following a process of public consultation. The Prime Minister's Office Order and the revised Operational Guidelines published as part of the Guidelines then came into effect on 1 December along with the revised enforcement orders that accompanied the revised Securities and Exchange Law allowing stock exchanges to demutualize. The new Guidelines now form the basis for approving applications.

1. Reasons for Revising the Regulations Governing Proprietary Trading Systems

1) Proprietary trading systems

Proprietary trading systems are a means of matching orders from multiple market participants (including institutional investors and stockbroking companies) to buy or sell securities such as equities and bonds using a computer network operated by a stockbroking company. In recent years they have often been called "alternative trading systems" to include the securities markets that are replacing traditional stock exchanges.

The first example of a proprietary (or alternative) trading system was Instinet, which began life in 1969 in the United States and is now a force to be reckoned with, having seen volume increase since the 1980s as electronic trading has caught on. In this connection, the electronic communications networks that emerged in response to the SEC's 1997 Order Handling Rules and now process 30%-40% of the NASDAQ's turnover have attracted particular attention.¹

In the United States, ever since Instinet was set up, proprietary trading systems (or alternative trading systems) have, as a rule, been subject to the regulations that govern

¹ See S. Osaki, *Kabushiki Shijokan Senso [Stockmarkets at War]*, Chapters 3-4, Daiyamondosha, 2000.

broker-dealers (i.e., stockbrokers). In Japan, on the other hand, the fact that only stock exchanges were allowed (under Article 87.2 of the Securities and Exchange Law before it was revised in 1998) to set up markets to deal in securities meant that it was believed that proprietary trading systems would not be permitted.

Following Japan's Big Bang program of financial reform (under the banner of "free, fair and global"), however, this restriction was lifted in order to promote competition among securities markets and thereby improve both efficiency and quality. As a result, applications to operate a proprietary trading system are now subject to the same approval procedure as any other aspect of stockbroking, and such systems are no longer subject to the regulation banning the setting up of alternative trading systems (Article 2.8.7 of the Securities and Exchange Law and Article 167.2.3 before the Law was revised in 2000). In June 2000 the first two approvals for proprietary trading systems under the new Law were granted (Table 1).

Table 1 Outline of Approved Proprietary Trading Systems

Name	BB Super Trade	E*Bond
Operating stockbroker	Japan Bond Trading Company (Stockbroker whose main business is broking bonds for professionals)	E*Bond Securities (a joint venture between Softbank Finance and Lehman Brothers Japan)
Start of business	4 September, 2000	31 January 2001
Instruments traded	The 200 most heavily traded exchange-quoted and OTC-quoted stocks in Japan	Relatively illiquid bonds such as government-guaranteed bonds, public corporation bonds, municipal bonds, bank debentures, corporate bonds and samurai bonds.
Participants	Mainly stockbrokers, but terminals are also used by institutional investors	Stockbrokers and institutional investors
Trading method	Customers negotiate the details of a trade (e.g., price and size) with one another using an electronic trading system, and the Japan Bond Trading Company acts as counterparty if the trade is consummated	The system is highly transparent and allows customers to trade anonymously with E*Bond Securities as their counterparty
Trading hours	7:50~8:50 11:10~12:20 15:10~17:00 17:10~19:00	
Objectives	To enable customers to trade exchange-quoted and OTC-quoted stocks outside an exchange's normal trading hours and to meet the demand for off-floor trades where a stockbroker is the counterparty and for automated trades using systems such as the TSE's ToSTNet outside an exchange's normal trading hours	To provide liquidity, transparency and efficiency by linking buyers and sellers via the Internet

Source: NRI.

2) Problems remaining even after Big Bang

The lifting of this restriction on proprietary trading systems has allowed stockbrokers to offer their customers an order-matching service that was previously, to all intents and purposes, monopolized by the stock exchanges. This is an epoch-making development in that it allows more scope for markets to compete against each other. Nevertheless, proprietary trading systems were still subject to major restrictions, and it was thought unlikely that the Japanese authorities would permit electronic communications networks similar to those in the United States. At the same time, there was an imbalance in that computerized order-matching systems (such as the one operated by the Japan Bond Trading Company for bond dealers) were not required to comply with these regulations.

The main reason problems of this nature arose was the severe restrictions Japanese law places on the pricing mechanisms proprietary trading systems may use. Under the Securities and Exchange Law (Article 2.8.7), only three such mechanisms were allowed: (1) (in the case of listed securities) using the same price as that quoted on a stock exchange; (2) (in the case of securities listed on the OTC market operated by the Japan Securities Dealers Association) using the same price as that published by the Association; and (3) using a price based on that negotiated between customers. In addition, proprietary trading systems were allowed "to use pricing mechanisms permitted by Prime Minister's Office and Ministry of Finance orders." However, no such orders were ever enacted.

As a result, the two proprietary trading systems granted licenses by the Financial Supervisory Agency (as it was then) were both required to use prices based on those negotiated between customers. In order to maintain the appearance that prices were negotiated, however, they had to resort to the absurd device of not allowing orders to be matched automatically even if the price or quantity was the same as that stipulated by the customers.

The reason for this restriction was the view that proprietary trading systems should not be allowed to have the same degree of pricing power as the securities markets defined in the Securities and Exchange Law (i.e., existing stock exchanges and the Japan Securities Dealers Association's OTC market).

It was felt that, of the three pricing mechanisms defined in law, (1) and (2) did not allow any degree of pricing power and simply enabled orders to be crossed, while (3) allowed only a very limited degree of pricing power by virtue of the fact that those involved had to negotiate a price with each other individually. The Financial Services Agency's Operational Guidelines also state that "no proprietary trading system should be allowed to have the same degree of pricing power as a stock exchange" and that the

granting of a license to operate such a system "should be conditional on its pricing mechanism not having the same degree of pricing power as that of a stock exchange" (3-1-3 of the Operational Guidelines).

Furthermore, the May 2000 revision to the Securities and Exchange Law, which permitted stock exchanges to demutualize, also contains a clause further restricting the pricing mechanisms available to proprietary trading systems.²

As a result of this revision, the system for licensing stock exchanges was replaced by a system for licensing securities markets. Furthermore, stockbrokers operating a legally approved proprietary trading system were no longer required "to have a license from the Financial Reconstruction Commission in order to establish a securities market" (Article 80.2.2). At the same time, however, the article states that this exemption will not apply in cases where pricing is by auction or other mechanism stipulated by a Prime Minister's Office order." The effect of this was to prevent proprietary trading systems from using any pricing mechanism that could be considered an auction. Depending on how "auction" is defined, proprietary trading systems therefore faced the risk of being severely restricted.

2. The New Guidelines

As well as allowing proprietary trading systems to use pricing mechanisms other than those stipulated in the Securities and Exchange Law, the Guidelines and the Prime Minister's Office Orders and the Operational Guidelines based on them endeavor to make the regulations governing their supervision more precise. At the same time, the revisions to the various orders needed to enforce the May 2000 revision to the Law were promulgated.

A number of stockbrokers have already applied for licenses to operate a proprietary trading system under the new regulations, and two of them (MTS Japan Securities, the Japanese arm of MTS, which operates a bond trading system in Europe, and Garban Totan Securities, which has operated as a bond broker for some time) were granted approval on 19 January. Both brokers will trade government bonds on the proprietary trading systems, but can be expected to introduce systems for trading equities at some time in the future.

² The revised Law came into force on 1 December, 2000. See S. Osaki, "Legal Revisions Allow Exchanges to be Formed as Joint-Stock Companies", *Capital Research Journal*, Autumn 2000, vol.3, no.3

1) Newly permitted pricing mechanisms

The Guidelines permit the following new pricing mechanisms (Article 8.2 of the Prime Minister's Office Order on Definitions of the Wordings in the Securities and Exchange Law).

(1) Order-matching method

This is defined as "the mechanism whereby a customer's price limits are used where they match those of another customer appearing as the counterparty." In other words, customer orders are matched with those of other customers. Although this might appear similar to the *itayose* (call auction) and *zaraba* (continuous auction) methods used on Japanese stock exchanges (i.e., the "auction" method defined in Article 80.2.2 of the Securities and Exchange Law), it is actually very different in that market orders are not allowed.

Allowing this pricing mechanism did away with the absurd need to immobilize automatic order-matching in order to maintain the appearance that prices were negotiated among customers and made it possible for proprietary trading systems to be significantly more efficient.

(2) Price indication method

This is defined as "the mechanism whereby prices are based on stockbrokers' bid and offer price indications ("quotes"), which may be either their own or those of other stockbrokers, for the same security. (This excludes cases where a number of stockbrokers are obliged to give bid and offer indications on a continuous basis and where prices are based on these.)"

In other words, this is the case when a number of stockbrokers use a proprietary trading system to make a market and act as counterparty when executing customer orders. However, mechanisms similar to the market-making function on the OTC market in Japanese equities (where specific stockbrokers continuously make prices in accordance with a clearly defined set of rules and are obliged to execute orders in specific lot sizes) are excluded as it was felt that such a highly organized function had comparable pricing power to the auction method used on securities markets (Article 1 of the Government Order on Stock Exchanges).

Allowing this mechanism allows stockbrokers to set up proprietary trading systems using quote-driven pricing as well as the order-driven pricing mechanism.

The new Guidelines therefore allow proprietary trading systems to use a wider range of pricing mechanisms than before. However, the fact that the Securities and Exchange Law (Article 200.1) includes penalties for stockbrokers that operate an unapproved proprietary trading system means that any stockbroker operating a computer system as part of its securities business needs to know exactly when such approval is not required. Otherwise, it is likely to run into trouble. For example, a stockbroker displaying several quotes on its system is considered to be using the price indication method, but a stockbroker that is the only market maker in a security and executes a customer order at the same time as it is displaying a single quote for that security on its computer system may find itself in trouble.

One possibility would be to issue a no-action letter confirming that a particular system did not require approval. However, in this case, the authorities decided that the best way to clarify the situation was to include the following clauses in the revised Operational Guidelines (3-1-3 (1) of the Operational Guidelines):

"(1) Systems that transmit orders for securities traded on stock exchanges or OTC markets, or that transmit orders to another stockbroker shall not be considered to be proprietary trading systems, stock exchanges or OTC markets.

(2) Systems where prices are based on quotes and which pool the supply and demand of securities by means of multiple orders may be considered to be proprietary trading systems, stock exchanges or OTC markets even if the stockbroker concerned adjusts his own price indications to his customers' orders."

(1) refers to a mechanism for collecting orders by means of a computer system in the same way as a stockbroker's online trading system for private investors. "... that transmit orders to another stockbroker ..." probably refers to a mechanism for transmitting orders from a stockbroker that is not a member of an exchange to one that is or to a stockbroker that is acting as a market maker away from the floor of the exchange. This is because a system that transmitted orders to more than one other stockbroker could be considered to be a proprietary trading system using the price indication method.

(2), on the other hand, probably refers to a rather special situation where a stockbroker makes a market on its own. Normally, a stockbroker that makes a market would be expected to adjust its quotes to the flow of orders from its customers and its own position. However, if a stockbroker waits until its customer orders balance out before making a quote (based on the prices customers are prepared to pay), it is, to all intents and purposes, simply matching customer orders. This provision in the Operational Guidelines is designed to ensure that a stockbroker doing this seeks to have it approved as a proprietary trading system. These regulations also mean that a

stockbroker making a market on its own in the normal way (and therefore not matching customer orders) is not required to have its computer system approved as a proprietary trading system.

The above can be summarized in the following table:

Table 2 Pricing Mechanisms and Regulatory Status

	Order-driven methods	Quote-driven methods	Other
Securities market	Call (<i>itayose</i>) and continuous (<i>zaraba</i>) auctions on a stock exchange that permit limit and market orders (auction method)	A number of market makers make continuous prices on the OTC equity market	—
Proprietary trading system	<ul style="list-style-type: none"> • Order matching using limit orders only (order-matching method) • Customers negotiate their own prices with other customers (customer-negotiated prices) 	<ul style="list-style-type: none"> A number of market makers make prices (price indication method) A single market maker collects customer orders on its trading system and makes prices accordingly 	Trades are crossed using prices from a stock exchange or the OTC equity market (market-price trading)
Normal stockbroker activities	<ul style="list-style-type: none"> • Stockbrokers trading on their own account act as counterparty in response to customers' limit orders • Stockbrokers forward orders to a securities market or another stockbroker 	A single market maker makes prices	—

Source: NRI.

One activity that is often compared to operating a proprietary trading system is the posting of price indications by an information vendor on its computer screens. Although such a service is similar in some ways to stockbroking (and, by extension, to operating a proprietary trading system), there is a major difference in that it is not part of actual trading.

Here the Guidelines have tried to make the position clearer by responding to some of the comments made during the process of public consultation: "In our view, in cases where quotes from more than one stockbroker are visible (i.e., where there are competing quotes) and where the means necessary to reach agreement on the terms of a transaction (e.g., special information terminals and links for placing orders and negotiating) are provided, the activity should be considered to be "intermediation" as defined in the Securities and Exchange Law and approval should be sought to operate

a proprietary trading system." Such mechanisms should be considered to be proprietary trading systems (that use the price indication method to determine prices) rather than simply financial information systems.

2) Changes to the way proprietary trading systems are supervised and regulated

(1) Obligations and conditions attached to operating a proprietary trading system

In addition to the conditions attached to pricing mechanisms, the previous Operational Guidelines attached the following conditions to granting approval to proprietary trading systems: (1) the person in charge of the system had to have at least five years' experience in the stockbroking industry, and there had to be a proper organizational structure and sufficient staff to operate the system; (2) there had to be a procedure for checking customer identities; and (3) there had to be a way of preventing unfair practices such as insider dealing.

In addition to these conditions on the internal arrangements stockbrokers are supposed to make for operating a proprietary trading system, the new Guidelines lay down precise conditions for (1) explaining to customers matters such as how prices are determined, how settlement defaults will be dealt with, and the likelihood of a transaction being concluded at the price indicated; (2) ensuring that systems are secure and provide the necessary capacity (e.g., by backing up and testing systems); and (3) taking preventive action to ensure that transaction data remain confidential by establishing firewalls between staff operating a proprietary trading system and other staff (3-1-3 (2) (ii) and the following clauses of the Operational Guidelines). Also, the Prime Minister's Office Order now requires stockbrokers to publish monthly reports on the volume of trade conducted on their proprietary trading systems as well as keep a record of all transactions (Articles 33.2.2 and 60.1.14 of the Prime Minister's Office Order on Stockbroking Companies).

Furthermore, whereas there used to be no special requirement that stockbrokers publish prices and other details of transactions concluded on their proprietary trading systems, they are now subject to a number of obligations to ensure that trading is conducted in a fair manner. For example, the new Guidelines require stockbrokers to "make their best quotes and actual transaction prices readily accessible in real time to outsiders in such a way that they can be compared with those of other proprietary trading systems."

This requirement appears to have been modeled on the US National Market System. However, for technical reasons, it is not yet possible in Japan to consolidate quotes for the same security as happens in the United States with the Consolidated Quotation

System and the NASDAQ System. The Operational Guidelines therefore only require that "data be readily accessible to outsiders until such time as they can be made available in a form that enables them to be compared with those of other proprietary trading systems." This means that, for the time being, it will be sufficient for stockbrokers operating a proprietary trading system to display the necessary data on their Websites or on screens provided by information vendors, even if they cannot be compared with those of other proprietary trading systems.

Furthermore, this requirement that stockbrokers operating a proprietary trading system make available quotation and price data applies only to systems used for trading equities and convertible bonds—not to systems used for trading government and corporate bonds. This exemption was probably granted in view of (1) the sheer number of such bond issues and the technical difficulty of making available quotation and price data on all of them and (2) the nature of bond trading (i.e., the fact that it is relatively easy to judge what is a reasonable price for a bond from the market interest rate and the issuer's credit rating).

(2) Adoption of volume criteria

Unlike the securities markets operated by the stock exchanges and the Japan Securities Dealers Association and in spite of the fact that they perform the market function of matching orders, proprietary trading systems are not subject to self-regulation in the form of market monitoring and the supervision of market participants. However, they could come to be regarded as being of the same public nature as stock exchanges if trading on them becomes more active and if either the number of market participants increases or volume expands significantly.

In the United States, Regulation ATS reflects this possibility by imposing stricter requirements than on normal alternative trading systems in the case of systems that handle at least 20% of the total trading volume of any one issue. This is to ensure that alternative trading systems grant equal opportunities to all participants and offer the same capacity and security as the NASDAQ. Similarly, there is a regulation requiring alternative trading systems that handle more than a certain percentage (e.g., at least 50%) of the total trading volume of any one issue to register as stock exchanges (SEC Rule 3a-1, clause (b)).

The Operational Guidelines based on the new Guidelines therefore now require proprietary trading systems that handle more than a certain amount of trading in an exchange-quoted or OTC-quoted stock to comply with the same requirements as a securities market (e.g., to obtain a license to set up a securities market, to monitor trading, and to set aside reserves for penalties or losses).

More specifically, the Operational Guidelines require a proprietary trading system that handles 10% or more of trading in a particular stock in relation to the combined average daily volume on the Tokyo, Osaka and Nagoya Stock Exchanges and the OTC market over the past six months or 5% of total volume on these markets to step up its monitoring and screening, and to set aside reserves for penalties or losses. Similarly, the Operational Guidelines require a stockbroker operating a proprietary trading system that handles 20% or more of trading in a particular stock or 5% of total volume on the above markets to obtain a license to set up a securities market.

As with the requirements to make available quotation and price data, these volume criteria apply only to proprietary trading systems that trade equities and convertible bonds—not to those that trade government and convertible bonds. Given that the bulk of bond trading is done on the OTC market (even in the case of exchange-quoted bonds), it would have been inappropriate to take volume on an exchange as the criterion for deciding the level of regulation.

3. Assessment of the New Regulations and the Issues That Remain

1) Significance of the new regulations

The new regulations are a significant achievement in that they enable stockbrokers to set up proprietary trading systems using a variety of pricing mechanisms and clearly define the extent to which stockbrokers can use computer systems without having to seek their approval as proprietary trading systems—not to mention the fact that they encourage competition between markets. Although some commentators appear to feel that, by requiring stockbrokers operating proprietary trading systems to make available transaction and quotation data and (if volume increases) to comply with regulations similar to those that apply to securities markets, the authorities have overdone things, the regulations would appear to be essential if markets are to offer participants equal opportunities and safeguard investors' interests. In fact, in this respect, they should be seen as rectifying some of the shortcomings of the previous regulations.

The new regulations are also a significant achievement in that they make separate provision for trading bonds and equities/convertible bonds.

Partly because proprietary trading systems in Europe and the United States have developed around equity trading, there have been strong objections in Japan (especially from those involved in bond trading) to uniform regulations for all proprietary trading systems. However, it is clear both from the wording of the

Securities and Exchange Law and the fact that E*Bond Securities, which is aiming to trade bonds, has already been granted approval to set up a proprietary trading system that the regulations also affect bond trading. The approach adopted by the new Guidelines is therefore to avoid excessive regulation by assuming that the regulations apply to all securities trading and to adapt the volume criteria and the regulations that require stockbrokers to make price and quotation data available to outsiders to the realities of bond trading.

2) Remaining issues

Therefore although this new approach to regulating proprietary trading systems is, by and large, a significant achievement, many issues remain. However, this is the result of how securities markets in Japan are regulated in general (e.g., by the Securities and Exchange Law) rather than the contents of the new Guidelines.

The first of these issues is the problematic nature of treating one type of pricing mechanism as intrinsically superior to another and of using this as a basis to apply different regulations to securities markets and proprietary trading systems. As has already been pointed out elsewhere, if the aim is to safeguard investors' interests by applying stricter regulations to markets of a more public nature, the degree of strictness should take into account factors such as trading volume and the number and composition of market participants rather than be determined by the particular pricing mechanisms they use.³

However, the authorities would appear to be fully aware of this. In its response to public comment on the new Guidelines that any attempt to apply different regulations to stock exchanges and proprietary trading systems simply because they use different pricing mechanisms was fraught with difficulty, the Financial Services Agency stated: "The new Guidelines have attempted, as far as the law and its application allow, to reflect the nature of the securities traded and the realities of trading in its efforts to safeguard investors' interests." This can be seen as a remarkably frank comment indicating that the authorities may even be considering revising the Securities and Exchange Law.

The second of these remaining issues is the need to consolidate trading data and quotation data in order to avoid the kind of "market split" that could occur if competition among markets increases (e.g., if the same security is traded on more than one proprietary trading system). In the United States, a "National Market System" has been proposed to deal with this problem, and a number of systems, including the

3 See S. Osaki, S. Osaki, "Legal Revisions Allow Exchanges to be Formed as Joint-Stock Companies", *Capital Research Journal*, Autumn 2000, vol.3, no.3.

Consolidated Quotation System (mentioned above), are already in operation. Although the new Guidelines allow stockbrokers operating proprietary trading systems to post data on their Websites as an interim solution until such data can be consolidated, there is no doubt that such a system is required in the medium to long term. However, the Financial Services Agency's comments would appear to indicate that it is fully aware of this need. Hopefully, this will produce some concrete results.

The third of these remaining issues is the need to safeguard investors' interests when orders can be executed on more than one stock exchange or trading system. This can be done by ensuring that stockbrokers fulfil certain minimum obligations when executing customer orders (especially when the customer is a private investor). In the United States, stockbrokers are subject to a "best execution obligation." If orders can be executed efficiently on more than one stock exchange or trading system, stockbrokers are obliged to execute them in their customers' best interests.⁴

In Japan, on the other hand, the view that stockbrokers should execute orders in their customers' best interests is by no means established. Although the Securities and Exchange Law attempted to safeguard investors' interests by forbidding "bucketing" (i.e., acting as principal and agent for a customer at the same time) and other illegal trading activities, these regulations assume that customer orders will be executed on a stock exchange and are therefore inappropriate where proprietary trading systems exist. The authorities' next task (and one where they should take account of US regulations such as the best execution obligation) is to devise rules governing how customer orders should be handled and how stockbrokers should fulfil their obligation to customers to explain the details of a trade.

4 However, there is some confusion in the United States about the exact meaning of the best execution obligation. See S. Osaki, "What Exactly Does the "Best Execution Obligation" Mean?", Shihon Shijo Kuwotari, Spring, 1998.