



**Response to Request for Public Comments regarding the “Working Group on Financial Markets”**

**Provided to**

**Financial System Council, Financial Services Agency**

**by**

**FIA Japan Proprietary Trading Study Group**

**October 18<sup>th</sup> 2016**

## Introduction

Futures Industry Association Japan ('**FIA Japan**') is the only organization in Japan with a membership drawn from the entire cross-section of the futures industry. Members include futures and securities exchanges, FCMs, securities firms, banks and other users of the markets, as well as legal, technology and other professionals that provide services to the industry. FIA Japan provides a forum for discussion of industry issues as well as education and promotion of the Japanese Derivative Markets.

FIA Japan Proprietary Trading Study Group ('**FIA Japan PTSG**'), a sub-group under FIA Japan, consists of firms that trade their own capital in equities, futures & options, and other asset classes in Japan. Members of this group engage in manual, automated, and hybrid methods of trading and are active in a wide variety of asset classes such as equities, fixed income, foreign exchange, and commodities.

The guiding principles of FIA Japan PTSG are:

- **Integrity:** All market participants should operate with integrity and communicate with regulators in an open and honest way.
- **Regulation:** A well regulated market provides stability and creates efficiencies. For this reason, market participants and trading platforms should be appropriately regulated.
- **Transparency:** Markets should strive for real transparency for investors and market participants.
- **Stability:** Stable, reliable and well-functioning markets increase security & safety and provide the foundations that encourage investor confidence.
- **Equal access:** Access to markets should be open to all in a non-discriminatory way.
- **Equality of information:** All market participants should have access to the same trading information in order to provide a level playing field.
- **Risk Management:** Having risk controls in place to ensure orderly, safe and secure markets.
- **Competition:** Fostering competition between market participants, trading platforms, clearing platforms and co-location facilities to encourage innovation and promoting market efficiencies.

We have reviewed explanatory documents available on the website of Financial Services Agency of the following meetings:

- Joint Session of the 37th General Meeting of Financial System Council and the 25th Meeting of Sectional Committee on Financial System held on April 19, 2016.
- First Meeting of Working Group on Financial Markets held on May 13, 2016.

FIA Japan PTSG commends the efforts currently being undertaken by the Financial System Council of the Financial Services Agency to contribute to a detailed understanding of Algorithmic and High Frequency Trading.

To support these efforts, we provide the following comments regarding topics raised and questions posed by the Secretariat of the Working Group on Financial Markets.

## **Support for Prudent Regulation**

As key market participants, FIA Japan PTSG members fully support the continued development and growth of Japan's markets, and regulation that promotes fairness, efficiency, transparency and competitiveness in these markets designed to enhance capital formation.

Like the FSA, we believe the key to enhanced market integrity is clear and well-designed rules and regulations, well-run technology and reliable risk management systems. We believe that rules and regulations to protect the market from abuse and to mitigate the risks from technology failures are essential for a sound market structure.

FIA Japan PTSG members support enhanced transparency and risk requirements focused on market operators, intermediaries and end users. In particular, we would support a regime that includes: a simplified registration process that identifies the underlying market participant; the tagging of automated orders; and an appropriate set of risk controls (including pre-execution and post-trade controls) at the market operator, clearing firm and end user level. These controls should be implemented with uniformity and transparency. The key is that all activity is covered by risk controls, so that there are consistent safeguards in place to prevent market disruptions, no matter where they arise.

## **Algorithmic Trading**

During the last decade, technology, innovation and regulatory reform have come together to prompt an evolution of the financial market place. One of the manifestations of this evolution is the advent of algorithmic trading and a subset of algorithmic trading called high frequency trading (HFT). Algorithmic Trading encompasses trading systems that are reliant on mathematical formulas and computer programs to determine trading strategies. HFT fully involves human intervention from the inception of a trading idea, to analysis of market data and design, testing, deployment, monitoring, and execution of trading strategies. HFT trading strategies include market making, momentum, and statistical arbitrage.

Due to the advent of HFT, investors today, both large and small, enjoy a deeper pool of potential buyers and sellers, a wider variety of ways to execute trades, tighter spreads and lower execution fees/transaction costs than ever before. HFT brings broader market access, enhanced transparency and greater competition. HFT enhances market quality and efficiency for all participants by intermediating between the buyers and sellers, increasing liquidity, facilitating price discovery, narrowing spreads, and lowering the volatility of the prices for financial assets.

The advent of HFT has also resulted in changes to the nature of the operational risks and regulatory concerns most relevant to financial markets. In the view of FIA Japan PTSG members, these changes require an adjustment of regulatory strategy and focus, and there are broadly three regulatory principles that should be pursued for the preservation of efficient, robust financial markets. First, market participants should be required to implement and maintain appropriate risk controls. Secondly, a market regulator must have access to comprehensive order and trade data to oversee the operation of the market. Thirdly, where appropriate, principles for identifying the trading firm (or client) responsible for those orders which have originated from an automated trading system should be clear.

## **Risk Controls**

All FIA Japan PTSG members are active participants on electronic markets globally and operate in those markets with well-designed risk controls. Indeed, our businesses are highly dependent on effective risk management and controls. We believe that risk controls are fundamental to preserving safe and orderly markets and should be mandatory for all market participants, including brokers, clearers, and exchanges. Ensuring that there are appropriate pre and post-trade risk controls should be one of the main objectives of any regulatory framework for automated trading. Multiple and independent lines of defence provide the best environment for these controls to be effective. In EU and US markets, PTSG affiliates have been operating under the “ESMA Automated Trading Guidelines” since February 2012 and the SEC’s “Risk Management Controls for Brokers or Dealers with Market Access” rule since 2010, both of which are good examples of sensibly designed rules to improve market safety.

A further, critical consideration in formulating regulation imposing risk controls is allowing for an appropriate level of flexibility in how those risk controls are implemented. An absence of flexibility may result in controls that are unnecessary for a particular trading strategy or type of participant, and may hinder the future development of more efficient and innovative ways to mitigate the risks. Against this, it is also important to ensure that participants facing similar risks are required to implement functionally equivalent controls.

## **Transparency**

To function efficiently, and for the benefit of all market participants, financial markets require effective surveillance by a suitably informed regulator. FIA Japan PTSG members strongly support increased transaction transparency for exchanges, PTSGs, and particularly regulators. We support flagging of automated orders in a well-designed and flexible regime. Sensible design of such rules would allow the regulator to have clear sight of where and how orders are originated.

Properly designed regulation should promote comprehensive order and transaction data for regulatory monitoring, surveillance and analysis, including the identification of all orders and trades, together with the client and ultimate beneficial owner for all brokerage accounts authorised to place orders on an exchange. We believe that such information will further improve the ability of Japan’s regulatory bodies to oversee Japan’s financial markets, and allow those bodies to identify and investigate inappropriate market behaviour efficiently and effectively.

## **Recognition**

To accomplish the objective of appropriate market transparency, FIA Japan PTSG members would support a simplified registration regime whereby automated trading firms identify themselves to relevant regulatory authorities. Under this regime, it would be appropriate for identifying details of the firms originating the orders to be available to those supervising the markets.

## **Moving Forward**

We are pleased to assist the FSA with its review of the local regulatory environment but caution against importing certain requirements from regulatory regimes that may have been designed to solve different problems that aren't present in Japan, and to be wary of solutions that impose substantial costs and complexity which ultimately could undermine local markets. In this vein, we would also encourage a rule set that is simple in design and implementation and that promotes harmony and a level playing field on the Japan markets.