

Agenda for financial markets and exchanges in Japan

Financial Markets Division
Financial Services Agency

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Overview

- Since the late 1990s, significant efforts toward diversifying trading platforms and financial products, enhancing trading systems/technologies, and unifying exchanges in Japanese markets have been made so as to improve the function of our financial markets and enhance its competitiveness.
- Now, new policy measures should be considered in order to deal with the current challenges faced by our financial markets and exchanges:
 - A significant increase in high-speed algorithmic trading, whose effects on the financial markets are widely discussed in many jurisdictions,
 - Under the recent financial conditions, portfolio diversification and sophistication of asset management activities are becoming even more important than ever, and
 - The development of FinTech such as block-chain technology is now rapidly emerging and internationally becoming an important topic for securities' markets.



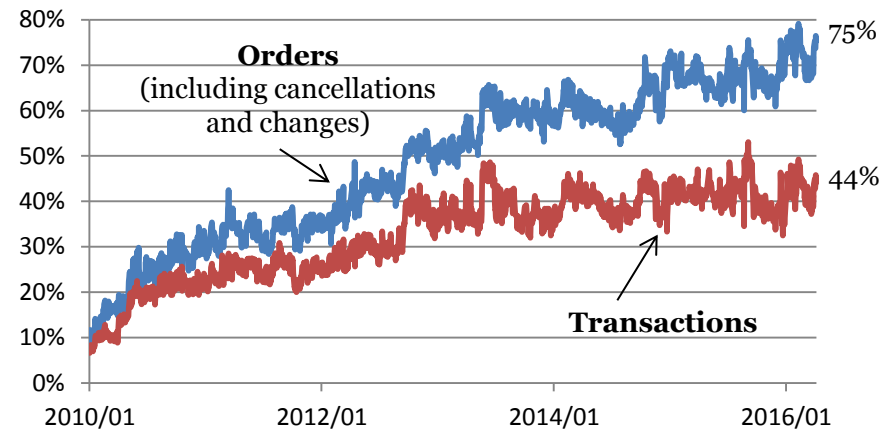
Taking account of the current market developments, including IT innovation, JFSA believes that various issues in our financial markets and exchanges need to be addressed from a broader perspective.

1: High-Speed Trading

Background

- ◆ In January 2010, Tokyo Stock Exchange (TSE) launched its new trading system, where orders can be executed within 1 millisecond. In September 2015, TSE upgraded its system to the global-standard.
- ◆ Since TSE launched its co-location service in January 2010, the share of algorithmic orders has been increased, accounting for nearly 70% of total orders in January 2016.

Shares of orders and transactions from TSE's co-location site (mainly used by trades with high-speed, algorithmic techniques)



Under MiFID II, high-frequency algorithmic traders must be authorized as an investment firm and take measures including effective systems and risk control, and have an obligation to notify and provide information to the competent authority.

Risks and challenges may be posed by high-speed algorithmic trading, including HFT

Stability and resiliency of markets

The fast and automated operation of algorithms by HFT firms may increase transitory volatility and abrupt movement in the markets.

Efficiency of markets

Excessive competition for speed may require much investment and reduce the efficiency of the markets as the increased costs could be translated to end-users.

System risks posed by HFT

Algorithms that malfunction and operate in an unexpected way may trigger a chain reaction and pose serious risks to the markets.

Integrity of markets

Abusive practices may benefit from the use of algorithmic technology, and algorithmic traders may be manipulated by other algorithmic traders.

Fairness of markets

Technological advantages may offer HFT firms the possibility of obtaining excessive profits at the expense of retail investors, which may distort the fairness of the markets.

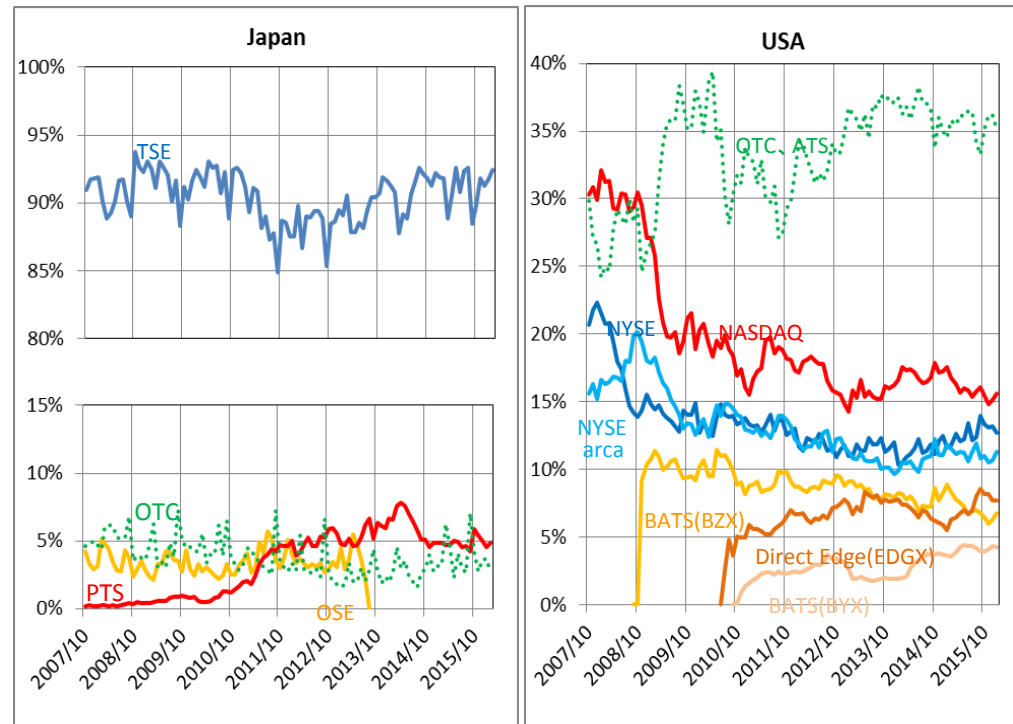
Price discovery functions of markets

Algorithmic trading used by the majority of traders in the markets may impair the price discovery functions focusing on the long-term performance of the company.

2: Alternative Trading Platforms

Background

- ◆ The establishment of Japan's alternative trading platforms, known as proprietary trading systems (PTSs), was permitted in 1998 and contributed to the development of trading systems in Japan. The market share of PTSs, however, has stalled at about 5 percent.
- ◆ While a series of US securities regulations has promoted competition among trading venues, it might also foster a fragmented market where more than 50 trading venues are competing with each other. The Nasdaq's share of trading in its listed stocks has dropped to nearly 15%, while the combined share of those alternative trading venues has increased to nearly 35%.



Trading volume of listed securities. All data are based on publicly available information.

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Competition among trading venues and PTS

The flow to promote competition among trading venues and consider the future of PTSs under the situation where most existing exchanges have been consolidated.

Market fragmentation

What to learn from other jurisdictions, where a large number of trading venues are excessively competing against each other.

Level playing field between exchanges and PTS

How to treat PTSs equally with existing exchanges while margin trading at PTS venues is prohibited.

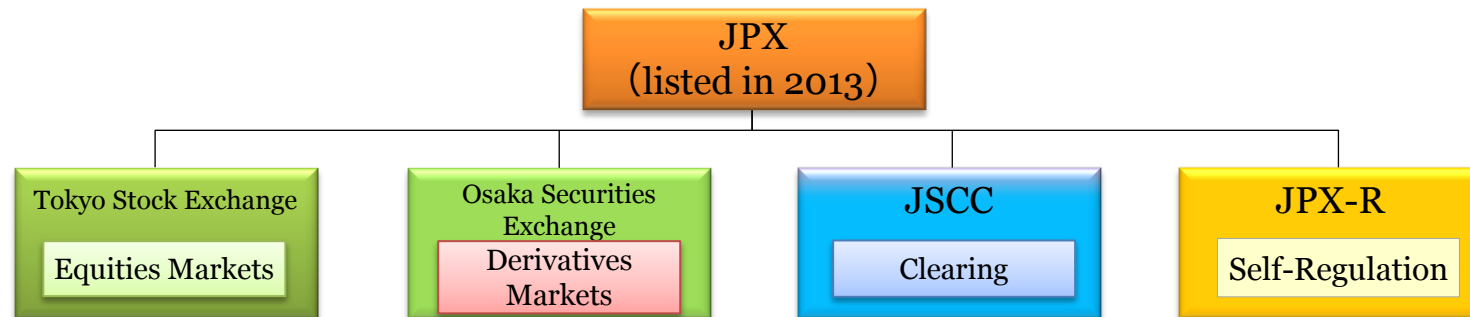
Self-regulatory framework and dark-pool

How to best form the self-regulatory framework under the Japanese legal framework while PTS operation is considered to be part of securities firms' business and thus PTS is not defined as a trading venue, and also the regulatory regime for dark pools.

3: Exchanges' Business and Self-Regulatory Function

Background and current situation

- ◆ Japan Exchange Group (JPX) was formed by the merger of Tokyo Stock Exchange Group (TSE) and Osaka Securities Exchange (OSE) in 2013. At present, JPX has over 90% of market share in Japanese equity trading (over 99% in exchange traded base).
- ◆ JPX has been listed on its own market from 2013.
- ◆ In JPX's Medium-Term Management Plan, JPX will diversify its business by expansion of overseas business and entry into new business fields. Also, it becomes crucial for the exchange to cope with recent IT innovations, including FinTech.
- ◆ Based on these changes, on the other hand, self-regulatory functions of exchanges need to be reviewed.



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Scope of exchanges' business

Consider the scope of service of exchanges based on the recent IT development and business globalization.

Response to technological innovation

Consider the development of FinTech in the mid/long-term.

Review exchanges' self-regulation

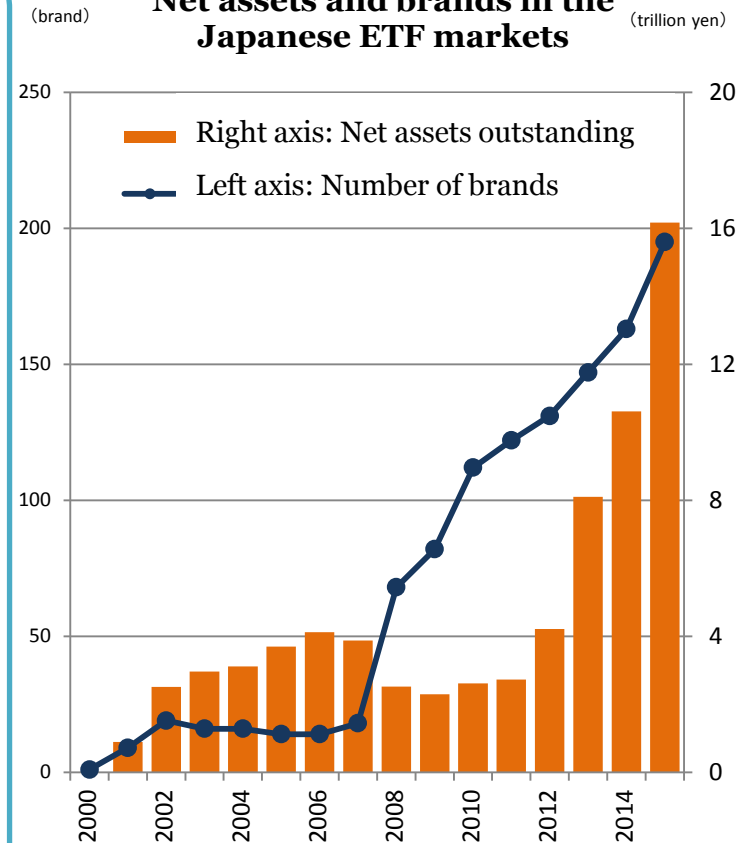
Consider the proper role of self-regulatory functions of exchanges with the recent business environmental changes in mind.

4: Exchange-Traded Fund (ETF)

Trends in the Japanese ETF market

- ◆ The Japanese ETF market has seen its assets more than triple and its brands more than quadruple over a five-year period, in response to the need for a greater variety of investment products.
- ◆ However, there is still a much potential for growth in the market. For instance, some ETFs are less liquid. It is also pointed out that some ETFs may increase volatility, since they attempt to track an index like Nikkei 225 using the index derivatives.
- ◆ Some funds in some advanced markets are now using new strategies such as smart beta, which aims for better return. In Japan, ETFs that use the same kind of investment strategies including JPX400 are also made available, although there may still be a room for a wider product range.
- ◆ Distribution channels also should be made more available in order to attract more investors.
- ◆ While some investment companies offer a public investment trust and ETF that have a similar structure, these companies should have a proper sales policy when offering those products.

Net assets and brands in the Japanese ETF markets



Source: JPX, Investment Trusts Association of Japan

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How to enhance the function of the ETF markets to attract a wide range of participants. Due consideration should be given to product design, distribution channels and liquidity of ETF.

5. Fiduciary Duty

Background

- ◆ Current developments of rules and policies on fiduciary duty:

【US】

- Employee Retirement Income Security Act (1974): All who are involved in the management of pension plans have fiduciary duties.
- The DOL's proposed fiduciary rule (2016): Broker dealers who render investment advice as a business shall also have fiduciary duties.

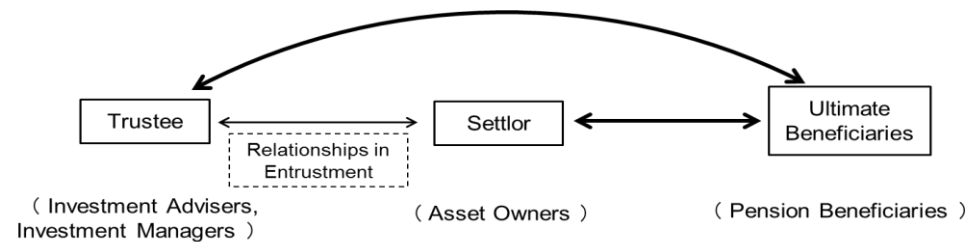
【UK】

- The Kay Review (2012): The review recommends that fiduciary duties should apply to all related parties which involve advice on investment decisions.
- ◆ The principle that all participants involved in the investment chain need to carefully consider the best interest of their customers is now even more important than ever.

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JFSA's Strategic Directions and Priorities state that the JFSA will review whether financial intermediaries that produce/distribute/manage financial products such as investment trusts and savings-based insurance products put customers' interests first. The JFSA will also support self-efforts by the industries for enhancing their practices that meet fiduciary standards. It needs to consider what measures should be taken to ensure that these principles are well-practiced in the financial markets.

The concept of fiduciary duty in ERISA



OECD: G20 High-Level Principles on Financial Consumer Protection (2011), Update Report on the Work to Support the Implementation of the Principles (2013)

- ◆ Financial services providers, brokers and advisors, etc. have to work in the best interest of their customers.
- ◆ The effective approaches provided therein are of interest across all financial services sectors – including banking and credit, investment, securities, insurance and pensions.

G20/OECD: Principles of Corporate Governance (2015)

- ◆ The corporate governance framework should provide sound incentives throughout the investment chain.
(Note: The investment chain is often long and complex, with numerous intermediaries that stand between the ultimate beneficiary and the company.)