

# **HARNESSING THE POWER OF MARKET SURVEILLANCE:**

## **A PERSPECTIVE FROM THE SESC JAPAN**

Speech by Takashi Hashimoto,

Commissioner of the Securities and Exchange Surveillance Commission, Japan  
at Nasdaq Surveillance Conference 2023 on September 13, 2023

### **1. Introduction**

Good morning, ladies and gentlemen, distinguished guests. First of all, allow me to express my gratitude to Nasdaq for choosing Tokyo as the venue for the first in-person meeting post COVID. Speaking of myself, I attended the IOSCO Annual Meeting in Bangkok in June this year, and took part in active discussions on digital, sustainability cross-border cooperation and other topics. Living in a rapidly changing world like today, I believe in the value of people to meet and discuss emerging and complex issues and share new ideas. So, it is my pleasure to have the opportunity to speak in front of you, who are taking the lead in market surveillance around the world.

To begin my speech, let me briefly introduce the SESC Japan. The SESC was established in 1992 with the mission of ensuring the fairness and transparency of capital markets and protecting investors. In 2022, the SESC marked the 30th anniversary and enter its 11th three-year term. I was appointed commissioner of the SESC in December last year.

The SESC has inspection and investigation authority delegated by Japan FSA (JFSA), over a very broad scope of capital market matters. Specifically we engage in:

- inspection for violations of laws and regulations related to securities business by financial institutions,
- inspection for violations of disclosure requirements by listed companies,
- administrative investigation for market misconduct such as insider trading and market manipulation, and
- criminal investigation for serious and malicious market misconducts and disclosure violations.

Based on the results of its investigations or inspections, the SESC may issue recommendations for administrative actions or administrative monetary penalty payment orders or filing criminal charges against violators. The SESC may also make policy proposal to the JFSA.

In January 2023, the SESC published the Strategy & Policy for the years 2023-2025, which shows our policy for its 11<sup>th</sup> three-year term. It set out three pillars "1. information gathering and analysis for comprehensive market oversight," "2. effective and efficient investigations and inspections," and "3. effective initiatives to enhance market discipline." These pillars are intended to create a virtuous cycle towards better market surveillance that can contribute to deterring illegal and fraudulent activities. We also note development of skills and better use of technologies are key drivers to achieve the three pillars.

From now on, I would like to focus on the first pillar "information gathering and analysis for comprehensive market oversight", which is related to today's theme, and speak about the SESC's latest initiatives.

## **2. Market surveillance by the SESC**

I believe that many of the securities regulators, Self-Regulatory Organizations (SROs), and financial institutions that are here today are involved in day to day monitoring of markets and transactions responding to changing market and increasingly complex transactions.

We strongly recognize the importance of market surveillance as the entry point for all inspections and investigations into violations of securities regulations.

The SESC carries out market surveillance from various angles in order to gather useful information for its administrative and criminal investigation into market misconduct and disclosure violation as well as inspection of securities business operators.

Let me explain our initiatives of market surveillance by listing three functions, specifically, "information gathering," "market analysis," and "transaction screening."

First, with regard to "information gathering," we have set up a contact point for information reporting where we receive 6,000 to 7,000 pieces of tips and other information every year from many people including retail investors. In addition, we also search media articles and magazines as well as websites, posts and SNSs on the Internet. We also collect a wide range of information on the market in cooperation with self-regulatory organizations.

Secondly, with regard to "market analysis," we grasp trends in the primary and secondary market, as well as the business performance of individual companies, and carry out research on new financial products, transaction patterns, and structural changes in the markets.

To give an example of changes in the market, the Tokyo Stock Exchange (TSE) reviewed its market segments and launched three new segments in April 2022: the Prime Market, Standard Market, and Growth Market. At the moment, 450 companies have not satisfied the new listing standards and have been subject to transitional arrangements. We will keep an eye on the risks of disclosure rule violations and misconduct that could happen to keep up with the new listing standards.

Another example of a change in the market is the rise of High Frequency Trading (HFT). At present, there is not necessarily a wealth of analysis for the Japanese market regarding the impact of HFTs on market making and their individual profits and losses. Since this is one of the new themes of our surveillance, the SESC has set up a dedicated team in 2018 to analyze HFTs. I will come back to their research progress later.

Lastly, I would like to explain "transaction screening" process to detect transactions suspected of market misconduct in a timely and appropriate manner. In examining transactions, the SESC select issues subject to transaction analysis among the issues that caught the attention of media and online reports, issues referred in information provided by the public, issues with unnatural price movements, and issues on which

"material facts" have been released and so on.

For the selected issues, we make requests with broker-dealers to report details on the transactions and other related information. As the next step, based on the report, the SESC carries out in-depth reviews of transactions that are suspected of market manipulation, insider trading, and any other fraudulent activities such as fictitious capital increases. As a result of the screening, transactions which are likely to violate the law and regulations are handed over to related divisions for more detailed investigation and inspection.

As a result, in the Fiscal Year 2022, the SESC reviewed 1,065 cases, including 1,024 cases of insider trading, 29 cases of market manipulation, and 12 cases of other violations, such as use of fraudulent means and spreading of rumors.

The SESC's market surveillance entails all-round and integrated activities in which we gather and analyze information that covers market misconduct, violations of disclosure regulations, and monitoring of securities firms in one place.

At the same time, the environment surrounding us has become more challenging than ever. The number of listed companies in Japan continues to increase. As of March 2023, about 3,900 companies were listed. The number has more than doubled since 31 years ago, when the SESC was established. We have more than 8,200 financial institutions subject to our monitoring at the end of March 2023. The number is 7.5 times more than when the commission was established, because more and more financial services, such as high-frequency trading (HFT) and crypto-asset derivatives, have come under regulations. In this way, the scope of market surveillance continues to expand. It is also important to note that investigation on cross-border cases could increase due to the globalization of securities transactions.

In order to respond to the changing environment, the SESC will continue to improve its capabilities of market monitoring. This is an overview of market surveillance by the SESC.

### **3. Cooperation with market participants: effective use of trade surveillance outcomes in measures against suspected misconduct**

From now on, I would like to highlight two topics from our latest initiatives. The first topic is cooperation with market participants.

The SESC regularly exchanges opinions with SROs, such as Japan Exchange Regulation (JPX-R) and Japan Securities Dealers Association (JSDA), and staff in charge of trade surveillance in broker-dealers. At these meetings, we share its views as to the recent cases and other findings from day-to-day market surveillance.

Broker-dealers conduct trade surveillance in accordance with the SRO's rules. In case of detecting transactions suspected of insider trading and market manipulation, they are supposed to take appropriate measures such as alerting customers and suspending new transactions.

Recently, it came to our attention during an investigation that there were significant differences among broker-dealers in their handling of a person who was subject to an administrative monetary penalty. Based on the outcome of transaction surveillance, some companies promptly suspended new transactions, while others did not come to suspend new transactions even after they gave a number of warnings to the customer.

As a consequence, in January 2023 we requested through the JSDA that broker-dealers conduct self-inspections of their trade surveillance systems, including policy and procedure to suspend new transactions, in order to ensure that they effectively lead trade surveillance outcomes to measures against suspected misconduct.

The SESC places high expectations on broker-dealers, as a gatekeeper of the securities market, to conduct appropriate trade surveillance. For market surveillance to be truly effective, what it is essential is the ecosystem that regulators, SROs, and their member firms work together to monitor the market. I believe each of us has an important role to play.

#### **4. Analysis of HFTs using big data**

Secondly, I would like to talk about a project that analyzes transaction trends of HFTs using big data.

HFTs have a major impact on the market as a whole. As of June 2023, there were 50 HFT companies registered with JFSA. According to JFSA, the value of transactions executed by the HFTs accounts for about 30% of all orders placed on the TSE and the number of orders placed by the HFTs accounts for about 70% of total orders.

Japan started registration of HFT companies in April 2018 under the Financial Instruments and Exchange Act, which has vested the SESC with inspection power into the HFTs and enabled it to obtain registered HFT's trading data from the exchanges.

Our HFT team kicked off analysis, based on earlier research by the UK Financial Conduct Authority (FCA). The team analyzed the transaction data of registered HFTs in the stock market of approximately 4,000 companies listed on the TSE. Just like the FCA's analysis for the UK market, we also observed a "speed race" among the HFTs, where multiple participants place orders for the same issue at the same price, and compete for trading speed toward deal closure. Our estimates show that the trading volume of this race accounted for 22.8% of the total trading volume on the TSE. One particular observation is that the amount per transaction was larger in the ETF market than in other markets. This suggests that large-scale races were developed likely due to an arbitrage strategy between equities and futures and it may have contributed to promoting price correlation between the markets.

Next, our HFT team conducted a detailed analysis of the placed and executed orders of the HFTs participating in the market-making scheme in the TSE ETF market. In this scheme, designated market makers are obliged to continuously present quotations based on the TSE rules, and certain incentives are provided with market makers that fulfill this obligation. Our team looked at the fulfillment of the continuous quote obligation by the HFTs as designated market makers and the execution ratio of their make orders. By comparing the two, the team analyzed the extent to which HFTs have contributed to the

liquidity of ETFs.

The last piece of research is an early-stage analysis to figure out HFT's profit-and-loss status and trading strategies. Our HFT team analyzed detailed trading data of TSE from June 2019 to March 2023 and estimated the P/L of registered HFTs. The team also compared it with other market participants' categories, namely large brokers, small and medium-sized ones, and online brokers. Based on the daily P/L and position bias, we are developing indicators that can gauge the extent to which the regulators see the picture of HFT's trading strategies and indicators that can estimate the changes of HFT's trading strategies.

I believe that these examples of research form the first step to probe the sources of profits of HFTs and explore their entire strategies from the regulator side. It will be extremely valuable to future rule-making and supervision of HFTs and the enforcement of the rules.

## **5. Conclusion**

Let me conclude my speech with a few words.

For the future development of capital markets, we need to work on promoting market integrity and transparency, and protecting investors today. Toward this common goal, it is crucial that market surveillance by market participants, SROs, and regulators are all in action tirelessly. However, as the people carrying out the surveillance, we should not be satisfied just to be quiet and hard-working professionals. We will be able to contribute meaningfully to the enhancement of market discipline by converting surveillance knowledge into the correct messages, which are sometimes common messages, to the market. In order to build a close relationship in which market participants, SROs and regulators can cooperate, we would like to continue to share useful information and have a candid talk with our counterparts.

As securities transactions are increasingly going global, we continue to enhance international cooperation in market surveillance. With regard to cross-border cases, we actively exchange information with foreign regulators based on the IOSCO MMoU. During

the year to March 2023, we received information on 20 cases upon our request and foreign regulators voluntarily sent us information on 56 cases based on the IOSCO MMoU. To name several, we have received information from Australia, Canada, China, Hong Kong, Singapore, South Korea, Thailand, the United Kingdom, the United States and many other MMoU signatories. I would like to take this opportunity to thank those who cooperated with us.

Finally, I hope we can explore more on what market surveillance can do for a better market through further collaboration among market participants, SROs and regulators in Japan and around the world.

Let me stop here. Thank you so much for your kind attention.