

Financial Regulation Newsletter



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High-Frequency Trading: Overview of the New Japanese Regulations

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1. Introduction

On May 17, 2017, the Japanese Diet passed a bill (the “Bill”) to amend the Financial Instruments and Exchange Act (the “FIEA”) to introduce a new regulatory framework for high-frequency trading (“HFT”). The Bill introduces a new registration requirement on operators of HFT strategies, and requires those operators to maintain appropriate risk control systems as well as retain books and records concerning their HFT. The Bill is expected to come into effect within one year of its promulgation, which occurred on May 24, 2017.

The Bill imposes a registration requirement on operators of HFT strategies, but does not contemplate imposing restrictions directly on HFT. The Bill is rather intended to enable the Financial Services Agency (the “FSA”), which is the integrated financial regulator responsible for ensuring financial stability in Japan, to collect information and better understand the implications of HFT in Japanese capital markets and urge HFT traders to conduct HFT in a properly controlled manner.

The details of the regulations to be established as a result of the Bill are yet to be clarified by anticipated amendments to the Enforcement Order, Cabinet Office Ordinance and the FSA’s Supervisory Guidelines that will implement the amendments to the FIEA. However, we believe that investors engaging in HFT should acquaint themselves with the outline of the new regulations at this early stage. We hope that those investors will find this newsletter of some assistance in better understanding the incoming regulatory framework.

2. Outline of the new HFT regulations

(1) **Scope of HFT caught under the Bill**

(a) **Definition of HFT under the Bill**

The definition of HFT under the Bill can be summarized as follows:

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HFT shall mean a form of trading of securities or listed derivatives products, entrustment of orders for those products or similar conduct to be designated in the Enforcement Order that employs:

(A) automated decision making for the execution of trades by a computer system; (B) transmission of the trade information necessary for trading of securities or listed derivatives products to the exchange or another person to be designated by the Cabinet Office Ordinance by information and communication technology; and (C) method(s) to reduce the time for the transmission of the trade information in a manner to be designated by the Cabinet Office Ordinance.

Certain trade patterns that are unlikely to prejudice investor protection will be designated under the Enforcement Order to be issued and will be excluded from the definition of HFT.

The Cabinet Ordinance to designate “method(s) to reduce the time for the transmission of the trade information” is yet to be issued. In the next paragraph (b), we will discuss what method(s) will be designated in the Cabinet Office Ordinance.

(b) What method(s) will be designated by the Cabinet Office Ordinance as a component of HFT to reduce the time for the transmission of the trade information?

An exact definition of HFT was not provided in the Report of the Market Working Group of the Financial System Council issued on December 22, 2016 (the “Markets WG Report”), based on which the framework for the regulation of HFT in the Bill was designed.

While what will be designated in the Cabinet Office Ordinance as “method[s] to reduce the time for the transmission of the trade information” is unclear at this juncture, we believe that the definition of HFT in the regulations on HFT adopted by the EU may provide a hint of what might subsequently appear in the Cabinet Office Ordinance. The Market Working Group took into account the regulation of HFT adopted by the EU when they prepared the Markets WG Report.

The EU’s Markets in Financial Instruments Directive (MiFID) as amended in 2014 (“MiFID II”) introduced regulations on high-frequency algorithmic trading techniques.

According to MiFID II, a “high-frequency algorithmic trading technique” is a form of algorithmic trading where a trading system analyzes data from the market at a high speed and then sends or updates large numbers of orders within a short timeframe as a result of that analysis.

Under the MiFID II, a “high-frequency algorithmic trading technique” is characterized by:

- infrastructure intended to minimize network and other types of latencies, including at least one of the following facilities for algorithmic order entry: co-location, proximity hosting or high-speed direct electronic access;
- system-determination of order initiation, generation, routing or execution without human intervention for individual trades or orders; and
- “high message intra-day rates” which constitute orders, quotes or cancellations.

For the identification of “high message intra-day rates,” the “Final Report ESMA’s Technical Advice to the Commission on MiFID II and MiFIR” issued on 19 December 2014 by ESMA recommended the use of a threshold to determine that there is a “high message intra-day rate” if there is the submission on

average of :

- at least 4 messages per second with respect to all instruments across a venue; or
- at least 2 messages per second traded with respect to any single instrument traded on a venue.

A similar approach was adopted by the Commission Delegated Regulation (EU) of 25 April 2016.

We believe that the FSA will, in its drafting of the incoming Cabinet Office Ordinance, take into account the scope of HFT caught under the MiFID II.

(2) What would the new registration requirement mean for the operator of HFT?

(a) “Registration requirement” as opposed to “Notification Requirement”

The Bill stipulates that any person who engages in HFT as a business must be registered with the FSA unless it is otherwise registered with the FSA as a Financial Instruments Business Operator (“FIBO”) or a so-called Authorized Transaction-at-Exchange Operator, which is a remote offshore trade participant in the Japanese exchange transactions.

Since there is a registration requirement, the applicant’s qualification for registration will be subject to more strict scrutiny of the FSA than the existing requirements of notification to the FSA under Article 63 of the FIEA relying on the so-called qualified institutional investor exemption.

A FIBO that is already registered with the FSA is not required to apply for the registration, but they will probably be required to file a notification with the FSA concerning their engagement in HFT.

Please also note that a person that is engaging in HFT at the time when the Bill comes into effect will be allowed to continue to engage in HFT for six months thereafter without registration or notification. In addition, a person that applies for registration as an operator of HFT during that six month period will be allowed to engage in HFT without registration until the relevant regulatory authority decides to approve or reject the application.

(b) What information must be provided in the application?

An applicant for HFT registration must state its name and address of the principal place of its business, other business operations that it engages in, and other items designated by the Cabinet Office Ordinance.

Unlike an application for registration as a FIBO, the disclosure of the name of the Compliance Officer of the applicant is not likely to be required.

The application form must be submitted together with various appendixes, namely:

- (i) a covenant that none of its officers is a disqualified person and there is no other ground for refusal of registration with respect to the applicant;
- (ii) a document setting forth the manner in which and method by which the applicant intends to conduct HFT in the form designated by the Cabinet Office Ordinance;
- (iii) a copy of the Articles of Incorporation of the applicant and certified copy of the commercial registration of the applicant or the like under the laws governing the applicant; and

(iv) other documents as required under the Cabinet Office Ordinance.

Among these documents that must be submitted as appendixes, (ii) is one commonly known as a “Statement of Operational Procedures (*Gyomu Hohosho* in Japanese)” that an applicant for registration as a FIBO must adopt.

In the case of an application for registration as a FIBO, the applicant must submit various internal policies that are cited or referred to as an appendix in the Statement of Operational Procedures as well.

As the Markets WG Report recommended that the FSA should require a registered operator of a HFT strategy to submit a description of its algorithmic trading strategies, it seems likely that an applicant for HFT registration will be required to submit the same to the FSA.

In the application for FIBO registration, an applicant is required to establish internal policies that demonstrate that the applicant has required systems and procedures to comply with the FSA’s requirements and maintain effective internal control. We believe that an applicant for HFT registration is likely to be required to make similar efforts. For example, in order for an applicant for HFT to satisfy the requirement to maintain sufficient human resources to properly conduct HFT, the applicant may be required to prepare an organization chart specifying which group within the applicant entity engages in HFT and also adopt an internal policy for HFT that sets forth an approval requirement for certain acts or transactions and systems and procedures to maintain control over the systems and technologies employed for HFT and minimize exposure to risks of malfunction or failure of those systems.

(c) Grounds for refusal of registration/qualification requirements

Like the provisions of the current FIEA applicable to an application for FIBO registration, the Bill has a similar provision that sets forth the grounds for refusal of HFT registration.

The grounds for refusal of HFT registration represent the converse of the qualification requirements for registration. The following grounds for refusal of HFT registration stipulated under the Bill are particularly noteworthy.

(i) Legal status of an applicant

An applicant can be a legal person or an individual. An applicant does not have to be a Japanese person, either. However, please see the ground for refusal of registration discussed in (iv) below, which applies only to non-Japanese applicants for HFT registration.

However, the applicant must not be a legal person that has an officer who has been convicted of a crime or otherwise falls into one of the categories for disqualification as an officer specified under the Bill.

(ii) Ground for refusal of registration: an applicant does not have sufficient human resources required for the proper operation of HFT.

Based on our experience in applying for FIBO registration, we believe that an applicant for HFT registration will be required to have qualified human resources who have appropriate authority and responsibility to establish and maintain the systems and procedures discussed in (iii) below

required for the proper operation of HFT. More specifically, an applicant would be required to demonstrate that the applicant has, for example, an IT specialist who has sufficient skills and experience to operate and perform troubleshooting in relation to the systems and technology employed for HFT, and a Compliance specialist who has sufficient expertise and experience to understand and observe Japanese HFT regulations and implement an appropriate compliance program at the applicant to prevent a breach of the Japanese HFT regulations.

- (iii) Ground for refusal of registration: an applicant does not have appropriate systems and procedures required for the proper operation of HFT.

Under the current FIEA, an applicant for FIBO registration is required to demonstrate that it has established and will maintain appropriate systems and procedures to conduct its FIBO business properly without causing problems such as systems problems, a breach of Japanese regulations or a dispute with its customers. An applicant for HFT registration would be required to demonstrate similarly appropriate systems and procedures. To some extent, this requirement (iii) overlaps with requirement (ii) above to have sufficient human resources required for the proper operation of HFT. This requirement (iii), however, may include technical requirements to verify the stability and reliability of the systems and technology employed for HFT, such as history of stable operation of the system without the incidence of major problems, and various redundancy arrangements and in-tandem operation of the systems that provide an additional degree of comfort to the FSA concerning the stability and reliability of the HFT system.

- (iv) Additional ground for refusal of registration where an applicant is a non-Japanese person

Where an applicant is a foreign legal person, the applicant must be a person that satisfies the following two requirements:

- (A) the applicant must appoint a local representative or agent in Japan; and
- (B) the applicant must be a person whose financial regulator in its home jurisdiction has granted a guarantee to the FSA to cooperate with the FSA's investigation pursuant to Article 189, Paragraph 2 and Item 1 of the FIEA.

As for requirement (A), a foreign legal person doing business in Japan must appoint a representative in Japan under Japan's Companies Act. If the foreign legal person does not engage in business in Japan, it does not have to appoint such a representative. When applying for HFT registration, however, such foreign legal person needs to appoint a representative or agent in Japan.

Although the scope of authority and responsibility of such a representative or agent is unclear at this juncture, we believe that the representative or agent will, at a minimum, be required to maintain close communication with the applicant's headquarters and have both authority and responsibility to file a report or notification with the FSA when required, and to convey to the applicant's headquarters all inquiries and information requests from the FSA so that the headquarters can respond to those inquiries and information requests without delay.

As for requirement (B), Article 189 of the current FIEA stipulates conditions under which the FSA shall cooperate with the investigation of a foreign financial regulator at its request if and to the extent the FSA believes that there is a reason for the FSA to provide such cooperation. One of those conditions is the existence of a mutual guarantee of cooperation between the FSA and the

foreign regulator requesting the FSA's cooperation.

If an applicant's financial regulator has not provided such mutual guarantee to the FSA, it would constitute a ground for refusal of HFT registration.

Such mutual guarantee has been provided to the FSA by many major financial regulators in Asia, the U.S. and European countries that have become signatories of IOSCO's (International Organization of Securities Commission's) Multilateral Memorandum of Understanding.

(d) Regulation of a HFT operator's business activities

Like the regulations applicable to a FIBO under the current FIEA, the Bill stipulates various similar regulations concerning a HFT operator's business activities. The following regulations are particularly noteworthy.

(i) Requirement to establish an appropriate internal control program

The Bill stipulates that a registered HFT operator must maintain an appropriate internal control program as designated by the Cabinet Office Ordinance.

There is a similar regulation that applies to FIBOs. Among other things, the applicable provision of the Cabinet Office Ordinance stipulates that a FIBO must establish internal policies necessary for the proper conduct of its business operations and must conduct internal education seminars or otherwise implement actions to instill an understanding of those internal policies among its employees and officers.

(ii) Prohibition of improper operation of HFT business

The Bill prohibits a HFT operator from conducting its HFT business in any of the following improper manners:

- (A) a manner by which the HFT operator's control over its computer systems and other related facilities is insufficient for the purpose of avoiding causing an adverse impact on the Japanese markets as a result of the malfunctioning of its computer systems or other incidents; or
- (B) a manner by which the HFT operator's business operations are otherwise improper as designated under the Cabinet Office Ordinance.

Under the current FIEA, there is a similar regulation that applies to FIBOs. Among other things, the applicable Cabinet Office Ordinance stipulates that a FIBO must not operate its business without sufficient control over its computer systems..

Provision (A) above is a special rule that applies to HFT operators and specifically requires sufficient control over systems to operate HFT.

The Cabinet Office Ordinance applicable to a FIBO also stipulates that a FIBO must not have an insufficient trade surveillance program that is inadequate to prevent the artificial formation of a market through trading activities.

We believe that the incoming Cabinet Office Ordinance may include a similar provision

applicable to HFT operators.

(iii) Retention of legal ledgers

A HFT operator must maintain legal ledgers pursuant to the Cabinet Office Ordinance.

Since a FIBO is not required to maintain legal ledgers in Japanese, we believe that the Cabinet Office Ordinance is unlikely to require a HFT operator to prepare legal ledgers in Japanese. Foreign investors, however, may need to modify their systems in order to maintain all the required trade records in the manner required under the Cabinet Office Ordinance. For example, FIBOs engaging in securities business or asset management business are required to maintain order placement slips including order slips for any orders that are cancelled or subsequently amended. If foreign investors do not have a system to maintain records of those cancelled or amended orders, they are required to modify their systems.

(iv) Submission of Annual Business Report

Similar to FIBOs, a HFT operator must submit an annual business report summarizing its business activities.

(e) The FSA's supervisory power over HFT operators

The Bill stipulates that the FSA shall have the power to conduct an inspection of a HFT operator, require a report and information from a HFT operator and issue a HFT operator with an administrative order called a "Business Improvement Order" that requires remedial action to rectify irregularities and prevent re-occurrence of those irregularities.

(f) A financial instruments exchange's supervisory power

As a general rule, a financial instruments exchange has supervisory power over its trading participants, but not customers of the trading participants. The Bill, however, stipulates that a financial instruments exchange shall have the power to require a report from a HFT operator.

(g) Prohibition of a FIBO's acceptance of HFT orders from a non-registered person

The Bill prohibits a FIBO from accepting HFT orders from a person that is not registered with the FSA as a HFT operator. The Bill also prohibits a FIBO from accepting "similar" orders as designated by the Cabinet Office Ordinance.

The Markets WG Report proposed that the FSA should also prohibit a FIBO from accepting HFT orders from a HFT operator if the FIBO is unable to verify that the HFT operator has appropriate systems and procedures in place for the proper operation of HFT, including effective risk controls. It is possible that the Cabinet Office Ordinance will accommodate this proposal and prohibit HFT orders from such HFT operators. In that case, we believe it would be appropriate to clarify what verification the FIBO should conduct in order for it to be released from the obligation not to accept orders from such a HFT operator.

3. Next Steps

The Bill, in accordance with the recommendations of the Markets WG Report, anticipates the promulgation of provisions that enable the FSA to better understand the practices of HFT operators and avoid negative impacts of HFT by allowing only qualified HFT operators having proper systems and procedures to engage in HFT of Japanese securities.

We consider the legislative intent behind the Bill to be appropriate and believe that the registration requirements and other new regulations for HFT under the Bill are not materially different from the regulations in the EU and potential regulations currently being mooted in the U.S. In that sense, we do not believe that the new regulations will affect the Tokyo markets' competitive advantages over other major markets in the world.

However, it is possible that foreign HFT operators, especially hedge funds and other investors, may find the new registration requirement and ongoing requirements to comply with the requirements under the Bill burdensome if the FSA scrutinizes the sufficiency of human resources at the applicant and other requirements as closely as it does when reviewing applications for FIBO registration, or if the FSA chooses to closely monitor a HFT operator's compliance with the ongoing requirements for a HFT operator to maintain proper systems and procedures including system controls and the retention of a legal ledger.

In light of the fact that HFT is today a commonly employed trading technique for a large number of investors, we are hopeful that the FSA will strike an appropriate balance between achieving the legislative purpose of the Bill and being mindful of avoiding the potential adverse impact of regulations on the competitive advantages of Japanese markets over major markets in the world.

We intend to actively participate in the public comment process when the FSA solicits public views on the drafts of the Enforcement Order, Cabinet Office Ordinance and the FSA's Supervisory Guidelines to implement the Bill.

We respectfully invite your input so that we will be able to make comments on those drafts of regulations reflecting the needs and concerns of investors engaging in HFT in the Japanese markets.

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