

## FINANCIAL REGULATION BULLETIN

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### Update: Japanese HFT Regulations to Take Effect in April 2018

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#### I. Overview – Timing of registration

The Japanese government has moved to regulate High Frequency Trading (“HFT”). The relevant amendments to the Financial Instruments and Exchange Act (“FIEA”) passed the Diet on May 17, 2017, and will come into effect on April 1, 2018. After the public comment period which commenced on October 24, 2017, the details of the HFT regulations were finalized and published on December 27, 2017, together with responses of the Financial Services Agency (“FSA”) to the public comments (“FSA Responses”).

Under the new regulations, HFT operators will need to register with the FSA and will be subject to surveillance by the FSA. A person or a corporation already conducting HFT on the effective date can continue conducting HFT for a 6-month grace period, during which an “application” for registration must be made. However, as it would take a few months to make an official application after starting a pre-application consultation with the FSA, HFT operators will need to start preparation of their applications well in advance. Before April 1, 2018, the FSA will not accept official applications for registration, but will accept pre-application consultation. Completion of registration would take around 2 months after application is made. Unregistered HFT operators would be subject to a penalty of imprisonment of up to 3 years and/or a fine up to JPY 3 million.

The details of the regulations that were recently finalized set out such matters as the definition of HFT, the application process and standards, and the

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obligations of registered HFT operators. This newsletter updates our previous newsletter released in November 2017 during the public comment period and provides an outline of these regulations and the FSA's interpretation indicated in the FSA Responses. The underlined portions indicate the updates from our previous newsletter.

Mori Hamada & Matsumoto provides legal advice and support with respect to HFT regulations. Please feel free to contact any of the authors directly for assistance navigating these new regulations.

### II. Definition of HFT

HFT is defined as (i) certain trading or activity, including the trading of securities and derivatives, (ii) which is conducted automatically by an electronic data processing system (i.e., using algorithms), (iii) the orders for which (x) are submitted to a stock exchange from inside the stock exchange or a place adjacent to or in proximity to the stock exchange, and (y) are segregated from other orders. There are no specific requirements as to frequency or volume of orders.

From the definition above, it is clear that you will meet the definition of HFT if you use an exclusive virtual server provided by a securities firm located inside a stock exchange (such as a co-location service provided by the Tokyo Stock Exchange) and automatically make orders for securities trading using an algorithm through such virtual server. Also, any location provided by a third party (other than a stock exchange) could satisfy the "proximity" requirement as described in (iii) (x) above if such location is adjacent to the site in which the order matching engine is placed by the stock exchange. Although the FSA Responses do not clearly provide the answer to the question whether the proximity service provided by the Tokyo Stock Exchange or third party would fall within the definition of HFT, the FSA Responses indicate that a location in proximity to the access point does not necessarily satisfy the "proximity" requirement. The FSA Responses say only that the physical distance from the site in which the order matching engine is placed by the stock exchange matters with respect to the "proximity" requirement, and even the latency time has nothing to do with the requirement.

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### III. Registration Process

#### 1. Registration Requirements

An HFT applicant must satisfy the following requirements to be registered with the FSA:

1. Absence of disqualification reasons (no incarceration record of the applicant's directors, etc.)
2. Sufficient human resources
3. Compliance and other organizational structure
4. Minimum capital
5. (In the case of foreign applicants) appointment of attorney-in-fact in Japan

As to “sufficient human resources,” an HFT applicant must have sufficient human resources to conduct HFT appropriately, which would require (i) capable management, (ii) an operating officer knowledgeable and experienced in compliance and risk management, (iii) an operator knowledgeable and experienced in HFT and trading securities, (iv) internal control management, (v) a compliance department independent from the HFT department, and (vi) human resources to perform certain functions to produce reports, oversee trading, manage IT systems, handle material non-public information, conduct internal audits etc. The FSA Responses clarified that one person generally may serve dual functions, although the compliance functions need to be independent from the investment decision functions. The internal audit functions may be outsourced to the HFT applicant's affiliate.

The required “compliance and other organizational structure” above would include: (i) internal rules (which may be prepared in any language), (ii) a trading system capable of preventing unexpected trading, and (iii) preventive measures against market manipulation and other unfair trading (such as through procedures to monitor suspicious trading and a proper handling of material non-public information).

According to the guidelines, the trading system should have functions to prevent abnormal orders, including, for example, a “hard limit”, “soft limit” and “kill switch”. The FSA Responses indicate that those functions are not necessarily required to be taken by the HFT applicant itself, and the HFT applicant may rely on those functions provided by the securities firms through

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which the HFT applicant places its orders.

“Minimum capital” for an HFT applicant is stated capital of 10 million yen. An applicant must also have positive net assets. Such minimum capital and positive net assets must be maintained.

Further, if an HFT operator is a foreign company or person, an appropriate domestic attorney-in-fact must be appointed. The guidelines provide that the attorney-in-fact must be capable of properly responding to the request for reporting by the FSA and have some knowledge of the HFT-related regulations under the FIEA. While the FSA Responses clarified that no specific licenses (such as lawyer or accountant licenses) are required, precisely what type of person would satisfy this requirement will need to be discussed with the FSA on a case-by-case basis.

If HFT is conducted by partnership or limited partnership, a legal entity or an individual who is the general partner of the partnership must be an applicant for registration.

### 2. Filing Process

In the registration filing, the HFT applicant must submit a document explaining the outline of its business (“business outline”) to the FSA. The business outline must contain the following:

- (i) Basic rules of business operation
- (ii) Method of business operation
- (iii) Organizational structure
- (iv) Outline of trading strategy
- (v) Name and title of compliance officer
- (vi) Name and title of officer responsible for management of HFT
- (vii) Outline, place and maintenance of computer system for HFT
- (viii) Measures to control computer system for HFT

According to the regulations, the “outline of trading strategy” must contain:

- (i) Type of trading strategy (i.e., market-making strategy, arbitrage strategy, directional strategy, or other strategies)
- (ii) Outline of trading strategy

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- (iii) Name of the related stock exchange(s)
- (iv) Name of broker/dealer executing HFT orders
- (v) Type of securities or derivatives which are target of HFT

The FSA Responses do not fully clarify the required level of detail of the “outline of trading strategy” that must be provided in the application. The FSA Responses only provide that “the outline does not have to be detailed” and should be determined on a case-by-case basis.

Any subsequent change to the business outline must be reported to the FSA without delay.

Under the regulations, the application form and all attachments thereto, including the business outline, can be in English. As a practical matter, the HFT applicant would need to prepare a summary explanation of their business (*gaiyo-sho*) to show that the applicant meets all the requirements for HFT registration, as is the case with other types of registration under the FIEA. The FSA Responses do not indicate whether this summary explanation can be prepared in English. While the FSA has not accepted English summary explanations in other types of registration, it may be possible that the FSA will accept a summary explanation in English, considering that HFT applicants are allowed to prepare the formal application in English. As this point could affect the practical workload of the application process, we need to keep an eye on the application practice going forward.

Upon registration, only basic information such as name, capital amount, name of directors, addresses and name of attorney-in-fact will become public, and the business outline will not become public. The business outline would need to be submitted to the Tokyo Stock Exchange (if it is a related stock exchange) upon registration according to the exchange’s proposed amendment of rules.

### IV. Obligations of Registered HFT Operators

A registered HFT operator is required to maintain (i) appropriate business operation structures (in particular, internal rules and management of the computer system and other facilities relating to HFT), (ii) a trading system capable of preventing unexpected trading, and (iii) preventive measures against market manipulation and other unfair trading, all of which must be ready upon application of registration.

In addition, a registered HFT operator must (iv) maintain trading books and

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records and (v) prepare an annual business report. A registered HFT operator must report to the FSA certain events in relation to its business, including stoppage of business, merger or business transfer, bankruptcy, amendment of Articles of Incorporation, violation of law, litigation or arbitration. All records and reports can be in English.

Trading books and records maintained by a registered HFT operator include (i) order forms and transaction diary or (ii) investment statements and order placement forms, depending on the types of transactions. The order forms or investment statements must contain (a) a time stamp (the time when the stock exchange accepted the order) and (b) an acceptance number (the number or symbol used by the stock exchange to identify the order). In addition, a registered HFT operator is required to (x) identify the program used for each order and (y) prepare these books and records in an organized manner that can be easily searched. These books and records can be substituted with equivalent books and records prepared under foreign laws if the registered HFT operator is a foreign entity or resident. Order forms and investment statements must be maintained for 7 years, while the transaction diary and order placement forms must be maintained for 10 years.

An annual business report must be prepared and filed with the FSA within 3 months after the end of each fiscal year. The deadline for the filing can be extended with approval.

### V. FSA's Surveillance over Registered HFT Operators

Registered HFT operators will be subject to surveillance by the FSA. The FSA can request registered HFT operators and contractors entrusted by registered HFT operators to report on anything deemed appropriate by the FSA, and the FSA can conduct onsite inspections of the operators. The FSA Responses provide that such requests by the FSA and reports by HFT operators must be in Japanese.

If necessary for protecting investors, the FSA can issue business improvement orders against registered HFT operators, and in more difficult circumstances, the FSA can order suspension of business for up to 6 months or cancel the registration.

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