

FINANCIAL REGULATION BULLETIN

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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. The details of the HFT regulations were published for public comment on October 24, 2017.

Under the new regulations, HFT operators will need to register with the Financial Services Agency (“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. 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 published for public comment set out such matters as the definition of HFT, the application process and standards, and the obligations of registered HFT operators. This newsletter provides an outline of these newly proposed regulations.

Mori Hamada & Matsumoto provides legal advice and support with respect to

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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. The user of the proximity service provided by the Tokyo Stock Exchange would also be likely to fall within the definition of HFT because the system is located in the neighborhood of the Tokyo Stock Exchange's primary site, but this will depend on the interpretation of "place adjacent to or in proximity of," which should become clearer in the process of public comments.

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

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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 required “compliance and other organizational structure” above would include: (i) internal rules, (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 draft guidelines, the trading system should have functions to prevent abnormal orders, including, for example, a “hard limit”, “soft limit” and “kill switch.” Staff must be trained to exercise those functions, and such functions must be tested before operation of the trading system.

“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 draft 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. Precisely what type of person would satisfy this requirement is unclear from the draft guidelines and will need to be discussed further with the FSA.

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:

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- (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 draft 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
- (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

It is still unclear as to the level of detail that would need to be provided in the business outline with respect to the “outline of trading strategy,” which would be discussed with the FSA in the course of public comment procedures and the registration process.

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. However, as a practical matter, the HFT applicant would need to prepare a summary explanation of their business (*gaiyo-sho*) in Japanese to show that the applicant meets all the requirements for HFT registration, as is the case with other types of registration under the FIEA.

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

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application of registration.

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

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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