JAPANESE REGULATOR UNVEILS NEW REGULATORY FRAMEWORK ON HIGH-FREQUENCY TRADING, SEEKING PUBLIC COMMENTS

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BACKGROUND

On May 17, 2017, the Japanese Diet passed an amendment bill (the "2017 Amendment") [1] to the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948) (the "FIEA"). The 2017 Amendment includes new regulation on high-speed trading (also known as high-frequency trading). The 2017 Amendment was promulgated on May 24 and would come into effect on a date designated by an ordinance but no later than May 24, 2018.

The 2017 Amendment was prompted by concerns raised by various parties, in particular, by a group of experts under the Financial System Council in December 2016, which set forth key policy considerations in appropriately regulating algorithmic high-speed trading, and presented a proposed regulatory framework. [2]

On October 24, 2017, the Financial Services Agency of Japan (the "FSA") proposed amendments to the relevant enforcement order, cabinet office ordinances, and supervisory guidelines under the FIEA to implement the 2017 Amendment ("Proposed Rules") and requested comments thereon. [3] Comments must be submitted by November 22, 2017, 5:00 p.m. JST and in Japanese. The FSA stated in its notice that the effective date for the 2017 Amendment is expected to be April 1, 2018; however, that date is subject to change (the "Effective Date").

NEW HFT REGULATIONS UNDER THE 2017 AMENDMENT AND PROPOSED RULES

Essentially, the new regulation on high-speed trading under the 2017 Amendment requires a firm or individual, when *conducting* [4] certain "high-speed trading activities" ("HFT Activit(ies)"), to be registered with the relevant Local Finance Bureau, either as part of its registration as a "Financial Business Operator" (such as Type I Broker-Dealer ("Type I BD"), Investment Manager ("IM"), or Type II Broker-Dear ("Type II BD"), collectively, "Financial Business Operator") or "Registered Financial Institution" (such as a bank, trust bank and insurance company that is registered to engage in certain permitted activities of a Financial Business Operator), or a stand-alone registered high-speed trader ("High-Speed Trader").

1. Definition of HFT Activities

The key component of the 2017 Amendment and the Proposed Rules is the introduction of a definition of HFT Activities that defines the scope of the new regulation.

Under the 2017 Amendment and the Proposed Rules, an "HFT Activity" is defined as:

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(1) An activity that is either: [5]

(a) The purchase or sale of securities or market transactions of derivatives ("Activity (a)");

(b) Engaging (entrusting) a third party for Activity (a);

(c) Managing cash or other assets by way of Activity (a) (including giving an instruction); [6] or

(d) Carrying out a transaction or other conduct that results in its counterparty conducting in Activity (a), such as conducting market transactions of derivatives with a party conducting in Activity (a) as the counterparty; [7] and

(2) The decision to conduct as activity set forth in (1) above is made automatically by an electronic data processing system; and

(3) The transmission of information necessary to carry out, based on such decision, the corresponding purchase or sale of securities or market transactions of derivatives to a financial instrument exchange or a proprietary trading system [8] is done in a manner that utilizes information communication technology and shortens the time usually required for such communication to be transmitted and that (a) the facility in which the electronic data processing system used for decision making is located within (or adjacent or in proximity to) the location in which the respective exchange or proprietary trading system has installed its electronic data processing system to receive such transmission of the information, and (b) a mechanism has been put in place to prevent the transmission of information hereunder "from competing with" other transmissions to carry out the purchase or sale of securities or market transactions of derivatives to such exchange or proprietary trading system). [9]

The definition provided under the 2017 Amendment and Proposed Rules still presents many questions, in particular, on the third element, e.g., geographical coverage of proximity and the exact kinds of arrangements or environment provided by a broker to a high-frequency trader that would fall under the scope of the new regulation.

Notably, while the 2017 Amendment provides the FSA with authority to exempt certain "HFT Activity," [10] it appears that the FSA, because it did not refer to its exemptive authority in the Proposed Rules, does not intend to exercise such exemptive authority.

2. General Prohibition of Unauthorized HFT Activity

As stated above, under the 2017 Amendment, a firm or individual must be registered with the Japanese regulator to conduct HFT Activities. To respond to such registration requirement, the 2017 Amendment provides a general prohibition for supporting HFT Activities of a non-registrant and certain non-compliant registrants.

More specifically, under the 2017 Amendment and the Proposed Rules, any party would be prohibited from: [11]

(1) Accepting engagement (entrustment) for the purchase or sale of securities or market transactions of derivatives involving HFT Activity from those who fail to satisfy the registration requirement; [12]

(2) Accepting engagement (entrustment) for the purchase or sale of securities or market transactions of derivatives involving HFT Activity from a High-Speed Trader or a HFT Trader Financial Institution (defined below) who has received an operation suspension order regarding its HFT Activity;

(3) Accepting engagement (entrustment) for the purchase or sale of securities or market transactions of derivatives involving HFT Activity from a High-Speed Trader or a HFT Trader Financial Institution (defined below) for which it cannot be confirmed that the trader or institution has arranged appropriate measures to manage the electronic data processing system facility involving the HFT Activity or other facilities; or

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(4) Carrying out the purchase or sale of securities or market transactions of derivatives involving HFT Activity as part of managing cash or other assets by way of HFT Activity (including giving an instruction), or a transaction or other conduct that results in its counterparty conducting in the purchase or sale of securities or market transactions of derivatives, conducted by a party other than a HFT Trader Financial Institution (defined below) or High-Speed Trader, or a party which falls under either of (2) or (3) *mutatis mutandis.* [13]

This means that, for example, a broker providing support for high-frequency trading would be required to introduce an appropriate screening mechanism that satisfies the above-described general prohibition, which may not be clear in the Proposed Rules.

3. Registration Requirements for High-Speed Traders

As noted above, the 2017 Amendment would introduce a registration requirement for conducting HFT Activities. Generally, a licensed financial institution such as a Financial Business Operator or Registered Financial Institution would have to describe its operations that involve HFT Activities in its registration documents (an "HFT Trader Financial Institution"). [14] Others would have to be registered as "high-speed traders" (High-Speed Trader(s)). [15]

Application for Registration

To register as a High-Speed Trader, applicants would be required to submit a registration application (Form 29) with a relevant Local Finance Bureau. [16] As part of the application for registration, an applicant would have to, among other things, designate an agent or a representative in Japan, [17] describe its intended operations involving HFT Activities including its trading strategies, cybersecurity-related operations, [18] and certain financial documents. [19]

The application as well as attachments would be permitted to be submitted in English. [20]

Disqualification

The relevant Local Finance Bureau would refuse a registration application if the applicant falls under one or more disqualifying conditions. [21] Notable disqualifying conditions under the 2017 Amendment and Proposed Rules include: failure to satisfy, if the applicant is a corporation, the minimum capital amount requirement, which is proposed to be JPY10 million (approximately USD 90,000), [22] or, if the applicant is an individual, having a negative net worth, [23] and certain bad actor provisions, and, in the case of a non-Japanese firm or individual, failure to designate a representative or agent in Japan. [24]

Continuing Obligations and Conduct Regulations

Under the 2017 Amendment and the Proposed Rules, a High-Speed Trader would be subject to various continuing obligations, among others, to update its registration for any changes within two weeks, [25] provide various notices, [26] keep records, [27] and submit annual reports (Form 30) within three months following the end of a fiscal year. [28]

A High-Speed Trader would also be subject to certain conduct regulations such as having to implement an operational management system to appropriately conduct HFT Activities that satisfies standards set by the FSA. [29] More specifically, a High-Speed Trader would be required to have operations in place designed to avoid any failure in the system and facilities and necessary and appropriate measures in place to prevent improper transactions involving insider and corporate information or intentionally moving or fixing pricing or indices or other

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transactions that intentionally do not represent actual market value. [30] Under the Proposed Rules, a High-Speed Trader would also be required to have appropriate internal policies and procedures, provide employee trainings, and implement necessary cybersecurity-related measures. [31]

Further, High-Speed Traders would be required to cooperate with the Japanese regulator and exchanges in providing information, if requested.

4. Transition

The 2017 Amendment would provide certain transitional measures.

Under the 2017 Amendment:

(1) Type I BDs, IMs, and Registered Financial Institutions that would in fact conduct HFT Activities as of the Effective Date would be required to file and complete an amendment *notification* within six months following the Effective Date;

(2) Type II BDs (only) that would in fact conduct HFT Activities as of the Effective Date would be required to file and complete an amendment *registration* within six months following the Effective Date; and

(3) anyone (other than the foregoing) that would in fact conduct HFT Activities as of the Effective Date would be required to file and complete *registration* within 6 months following the Effective Date (and the general prohibition of unauthorized HFT Activity discussed in Section 2 above would not apply during this 6-month transition period).

Further, the annual reporting requirement would commence with respect to the registrant's fiscal year commencing on or after the Effective Date.

NEXT STEPS

The FSA is accepting comments from the public until November 22, 2017, 5 p.m. (JST). To meet the currently scheduled Effective Date of April 1, 2018, it is expected that in a few months the FSA will issue final versions of the amendments to the relevant enforcement orders, cabinet office ordinances, and supervisory guidelines under the FIEA to implement the 2017 Amendment.

While the standard processing time for registration is proposed to be two months from the date on which the relevant Local Finance Bureau *accepts* the application, [32] we expect the High-Speed Trader registration process under the 2017 Amendment to take considerably longer. Therefore, interested parties should take advantage of this opportunity to plan for the regulatory change and minimize any business disruption.

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[1] The text of the 2017 Amendment can be viewed here (available only in Japanese): http://www.fsa.go.jp/common/diet/193/02/shinkyuu.pdf.

[2] *See* The Working Group on Financial Markets under the Financial System Council, Report by *the Working Group on Financial Markets under the Financial System Council -Initiatives toward Stable Asset Building and the Development of Institutional Systems related to Markets and Exchanges* (Dec. 22, 2016), http://www.fsa.go.jp/en/refer/councils/singie_kinyu/20170509/03.pdf.

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[3] *See* The Financial Services Agency, *Notice on Release of Draft Ordinance and Cabinet Orders, etc. to Implement 2017 Financial Instruments and Exchange Act Amendment* (Oct. 24, 2017), http://www.fsa.go.jp/news/29/syouken/20171024.html (available only in Japanese).

[4] Compare with "engaged in … [as business]."

[5] §2(41) of the FIEA amended by the 2017 Amendment (the "Amended FIEA").

[6] §1-22(i) of the proposed Order for Enforcement of the FIEA (the "Proposed EO").

[7] §1-22(ii) of the Proposed EO.

[8] §26(1) of the proposed Cabinet Office Ordinance regarding Definitions under Article 2 of the FIEA (the "Proposed Definition Ordinance").

[9] §26(2) of the Proposed Definition Ordinance.

[10] §2(41) of the Amended FIEA.

[11] §38(viii) of the Amended FIEA.

[12] *Id*.

[13] §116-4(i)-(iii) of the Proposed Cabinet Office Ordinance on Financial Instruments Business, etc. (the "Proposed Business Ordinance").

[14] §66-50 of the Amended FIEA.

[15] *Id.*

[16] §66-51(1) of the Amended FIEA; §§326(1), 327 of the Proposed Business Ordinance. Please note that, once registered, a High-Speed Trader would be listed in the registry, which would be made public. §66-52 of the Amended FIEA; §331 of the Proposed Business Ordinance.

[17] §327 of the Proposed Business Ordinance.

[18] §328 of the Proposed Business Ordinance.

[19] §329 of the Proposed Business Ordinance.

[20] §326(2)(3) of the Proposed Business Ordinance.

[21] §66-53 of the Amended FIEA.

[22] §18-4-9 of the Proposed EO.

[23] §18-4-10 of the Proposed EO.

[24] §66-53 of the Amended FIEA.

[25] §66-54 of the Amended FIEA; §§334, 335 of the Proposed Business Ordinance.

[26] §342 of Proposed Business Ordinance.

[27] §66-58 of the Amended FIEA; §338 of the Proposed Business Ordinance.

[28] §66-59 of the Amended FIEA.

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[29] §§66-55, 66-56, 66-57 of the Amended FIEA.

[30] §337 of the Proposed Business Ordinance.

[31] §336 of the Proposed Business Ordinance.

[32] §350 of the Proposed Business Ordinance.

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