



Japan Regulatory Update

Japan

DT Legal Japan

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The Council of Financial Services begins its discussion on HFT

On May 13, 2016, the Working Group on Financial Markets (the “**Working Group**”) of the Financial System Council¹ (*kinyu shingi kai*, the “**Council**”) held its first meeting to discuss and evaluate the issues regarding Japanese markets and exchanges, with a specific focus on “high frequency trading” (“**HFT**”).

On the same day, the Financial Services Agency of Japan (the “**FSA**”), as the secretariat of the Working Group, announced an invitation to the public for comments on the issues to be discussed at the Working Group (the “**Public Comments**”)².

In this Client Alert, we will provide a brief summary of the background information with respect to these discussions.

A. BACKGROUND

On April 19, 2016, for the purpose of supporting the sustainable growth of the Japanese economy, the Finance Minister of Japan requested that the Council examine various issues relevant to Japanese markets and exchanges taking into account the recent developments surrounding the

Japanese markets and exchanges such as information technology³. For this purpose, the Council set up the Working Group.

As part of this initiative, it appears that for the first time, the FSA provided two definitions as to the types of trading activities which they deem to be HFT. While these definitions are only intended to be used as a reference⁴, this is notable in that it provides a glimpse as to the scope of activities which the FSA is seeking to regulate.

The first definition of HFT sets forth the broader concept of “high-speed and high-frequency trading” with the second definition focusing on specific elements of “high-speed and high-frequency trading as a passive market-making strategy”⁵. While it is not certain, we believe that discussion of the Working Group will focus on definition of HFT in the broader sense.

B. ISSUES TO BE DISCUSSED

According to the explanatory document dated April 19, 2016 issued by the FSA, the material concerns of the regulators seem to be based on the changes in the markets (e.g., increasing speed of trade orders,

material No. 2 in the meeting).

⁵ A strategy to earn profit from bid-ask spreads by placing both bid and ask orders and matching them with other investors’ orders (this strategy will likely to have huge number of orders and cancels).

1 The Council is an extra-ministerial bureau of the Cabinet Office and the FSA, established in 1998.

2 The FSA release on May 13, 2016.

3 The FSA release on April 19, 2016.

4 Explanatory document dated May 13, 2016 (handout

growing share of HFT activities on exchanges) as well as the various developments in the US and Europe (e.g., IOSCO report, MiFID II and invitation of public comments on Regulation Automated Trading by CFTC after so-called “Flush Crash”).

Given such concerns, it is anticipated that the Working Group will discuss the following issues and it should be noted that these issues will be the focus on the Public Comments:

- (1) High-speed trading (including HFT);
- (2) Alternative trading platforms (including PTS);
- (3) Business and self-regulatory function of exchanges;
- (4) Exchange-traded funds (ETFs); and
- (5) Fiduciary duties.

More specifically, the Working Group will examine the following issues with respect to (1) above:

- Stability and resiliency of Japan markets (e.g., whether HFT is causing or has influence on rapid market movements or volatility increase);
- Integrity of markets (e.g., possibility of HFT to be used for fraudulent trading such as market manipulation);
- Efficiency of markets (e.g., whether investing significant amounts of time and costs in high-speed trading is reducing the market efficiency by transferring the cost to end-users);
- Fairness of markets (e.g., whether HFT is benefitting such HFT traders at the expense of retail investors);
- System risks posed by HFT (e.g., impact of system errors and risk of chain reaction); and
- Price discovery functions of markets (e.g., whether HFT is disturbing the price discovery function based on the mid- to long-term performance of a company).

C. CONCLUSION

Please note that comments received from the public will be used only for the purpose of discussion of the Working Group and therefore, no specific responses will be provided to each comment. The FSA responded to our no-name basis inquiry noting that they will have discretion in choosing which comments are presented to the Working Group and how such comments will be presented (including whether to disclose the name of person who submitted the comments).

As further information will be available going forward as discussion progresses, please feel free to contact us if you have interests in any of the specific topics. The Investment Management Group of DT Legal Japan is happy to assist preparing and sending of comments if you wish.

For anyone who did not receive this Client Alert and wishes to be placed on the mailing list for Japan regulatory updates issued by the Investment Management Group of DT Legal Japan, please do not hesitate to contact us.

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