

## Japan Regulatory Update

Japan

DT Legal Japan

November 16, 2017

### Japan FSA Publishes the Supplemental Guidelines with respect to HFT Operators

This Client Alert is our third Client Alert on the introduction of a regulatory regime to govern high-frequency trading (“HFT”) on Japan exchanges and proprietary trading systems (collectively, “Exchanges”).

On October 24, 2017, the Financial Services Agency of Japan (the “Japan FSA”) released its drafts of, among other regulations, the Enforcement Order, the Cabinet Order, and the Supervisory Guidelines in connection with the HFT activities (collectively, the “Supplemental Regulations”). The Supplemental Regulations provide further details and information with respect to the precise manner by which the amendments to the Financial Instruments and Exchange Act (the “FIEA”) regarding HFT activities (the “Amendments”) will be effected, as well as certain interpretative information.

It is anticipated that the effective date of the Amendments will be April 1, 2018.

In connection with the publication of the draft of the Supplemental Regulations, the Japan FSA has extended an invitation to the public for comments on the released draft of the Supplemental Guidelines.

This Client Alert provides a summary of the information set forth in the Supplemental Regulations that we believe may be particularly relevant to fund managers and traders engaging in HFT activity (collectively, “HFT Operators”). While we have sought to cover the significant portions of the Supplemental Regulations, this Client Alert should not be viewed as a comprehensive summary of the Supplemental Regulations.

#### A. Definition of High-Frequency Trading

With the release of the drafts of the Supplemental Regulations, one of the key developments is that

the full scope of High-Frequency Trading and HFT Operators has been fully defined.

“High-Frequency Trading” is defined in the Amendments as follows:

“The trading of securities or listed derivatives (including the delegation of such trading, or other similar activities as defined under the Enforcement Order) whereby the trading consists of the following features:

- (i) the decision making process is automated by a computer system in relation to the trades; and
- (ii)(a) the trade instructions are transmitted to the Exchanges through the use of communication technology; and
- (ii)(b) mechanisms, to be specified by the Cabinet Order, are utilized to reduce the time of the transmission of the trade instructions to the Exchanges.”

With the release of the draft of the Supplemental Regulations, as both the terms “similar activities” and “mechanisms” are specified, it is now possible to understand the full scope of the definition of High Frequency Trading.

(“Other Similar Activities”)

As set forth in the definition, HFT applies to “trading of securities or listed derivatives (including the delegation of such trading, or **other similar activities as defined under the Enforcement Order**)...” (**emphasis added**)

The Enforcement Order defines “other similar activities” as follows:

- (a) asset management activities that include trading of securities or listed derivatives; or

- (b) through the execution of OTC derivative transactions or other transactions, requiring a counterparty to engage in the trading of securities or listed derivatives.

("Mechanisms")

In the definition of HFT, one of the requirements is that trader utilizes "**mechanisms, to be specified by the Cabinet Order**, to reduce the time of the transmission of the trade instructions to the Exchanges." (**Emphasis added**)

The Cabinet Order defines "mechanisms" as methods that use both of the following aspects:

- (a) a system/server or similar facility which automatically generates trade orders is located in the specified co-location areas provided by the Exchanges (including areas adjacent to or close to such co-location areas); and
- (b) measures <sup>1</sup> so that the trade orders transmitted to the Exchanges will not be obstructed by other trade orders.

While there remains certain room for further clarification, the above definitions should provide some guidance as to the scope of activities which the current draft of the Supplemental Regulations seek to cover in relation to HFT.

## B. Registration Procedures and Documents

With the release of the draft of the Supplemental Regulations, further information is now available as to the registration process for HFT Operators and the application documents.

As a general matter, the application process for a HFT Operator appears to be somewhat similar to the application process for a financial instruments dealer. However, based on the draft of the Supplemental Regulations, we have listed some key points of note in relation to the registration process for HFT Operators:

- the application documents to be submitted to the Kanto Finance Bureau may be submitted in English;

- all offshore HFT Operators will be required to appoint and name a Japan representative or a Japan agent<sup>2</sup> in its application;
- in the Business Methods Manual to be submitted, among other matters, the HFT Operator will need to provide: (i) a summary of its trading strategy (e.g., market arbitrage, market making, etc.)<sup>3</sup>; (ii) a description of the trading systems being utilized; and (iii) an outline of the control mechanisms to be implemented by the HFT Operator in relation to its trading systems;
- identification and submission of the name, title, and resumes of key personnel of the HFT Operator (e.g., Compliance Officer, and HFT Business Manager); and
- certain financial information (e.g., latest balance sheet, income statement, information on its net asset).

Once registered as a HFT Operator, similar to a financial instruments dealer in Japan, each HFT Operator will be required to submit an Annual Business Report (which can be in English) to the Kanto Finance Bureau. Furthermore, all HFT Operators will have an ongoing obligation to properly maintain ledgers on trade orders – which may also be in English.

## C. Key Controls for HFT Operators

HFT Operators are required to establish a proper and compliant internal control system by implementing the necessary internal rules based on their business, size, complexity, etc. Furthermore, HFT Operators will be required to provide adequate training to its officers and employees. As part of such internal control requirements, based on the draft of the Supplemental Regulations, we have provided a brief summary of two areas which we believe will be critical for any HFT Operator application.

### 1. Internal Controls for the Proper HFT Operations

HFT Operators will be required to have implemented the following:

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<sup>1</sup> Based on the Supervisory Guidelines, such measures include entering into an agreement with a broker regarding exclusive use of virtual server, etc.

<sup>2</sup> Based on the Supervisory Guidelines, the expected qualification and role of both Japan representative and Japan agent seem to be identical; such representative or agent is required to have certain knowledge regarding the FIEA applicable to HFT. Furthermore, by having a proper understanding of HFT activities, the appointed representative or agent is expected to be able to properly respond to the requests by the Japan regulators for information/reports regarding the HFT Operator.

<sup>3</sup> The need to provide information on the trading strategies has been viewed as a particular point of interest for HFT Operators due to the sensitivity of this information. As of this time, there is no clear instructions as to the extent of the details that needs to be provided.

(i) *Measures to Avoid System Failures*

- ✓ sufficient control system through ongoing trainings, regular inspections, etc.;
- ✓ sufficient stress tests prior to the activation of its trading system;
- ✓ involvement of personnel who can judge the setting, activation and cancellation of hard-limits, soft-limits, kill-switches, etc.; and
- ✓ implementation of crisis-management measures.

(ii) *Measures to Avoid Unfair Transactions*

- ✓ systematic control of trades through the appointment of responsible personnel, trainings thereto, periodic inspections, etc.;
- ✓ measures to prevent insider trading; and
- ✓ setting objective criteria and detection systems with respect to market manipulation, etc.

**2. Proper Personnel Structure**

HFT Operators will be required to be staffed with personnel to ensure the proper operations of its HFT business. To evaluate if a HFT Operator has the proper personnel to conduct its business, the regulator will consider the staffing of the following personnel:

- ✓ capable officers having experience and knowledge of the HFT business, compliance and risks, etc. thereof;
- ✓ officers/employees having experience and knowledge of the HFT business and the types of securities being traded;
- ✓ a responsible internal control manager;
- ✓ a responsible compliance officer who has the necessary experience and knowledge of the HFT business and who is also independent from any HFT activities engaged in by the HFT Operator;
- ✓ a responsible person for the maintenance of ledgers, risk management, system management, insider information management, trade management, internal audit, etc.; and
- ✓ a Japan representative or agent who can accurately and appropriately respond to inquiries from the regulators.

**D. CONCLUSION**

We believe that for interested parties, the chance to submit comments on the proposed Supplemental Regulations will be a valuable opportunity to address any specific concerns. The official deadline for the acceptance of comments is 5:00 pm on November 22, 2017 (Tokyo time) and the Investment Management Group of DT Legal

would be pleased to assist any client wishing to submit comments to the Japan FSA.

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