Developments on the Rules and Regulations regarding High-Frequency Trading

This Client Alert is a follow-up to our Client Alert dated June 16, 2016. In such Client Alert, we discussed the first meeting of the Working Group on Financial Markets which covered various topics, including the possibility of creating a regulatory framework for governing high-frequency trading on Japan exchanges (“HFT”). Based on the proposal issued by the Working Group, on May 17, 2017, the Japan Diet passed amendments (the “Amendments”) to the Financial Instruments and Exchange Act of Japan which established a new framework for fund managers and traders engaging in HFT (collectively, “HFT Operators”) on Japan exchanges. While historically there were no rules and regulations that specifically governed HFT Operators in Japan, under the Amendments, HFT Operators would be required to register with the Financial Services Agency of Japan (the “Japan FSA”).

The effective date of the Amendments will be within one year of the date of promulgation of the Amendments (i.e., one year from May 24, 2017) as specified by the Enforcement Order in relation to the Financial Instruments and Exchange Act (“Enforcement Order”).

It is important to note that while the language of the Amendments has been promulgated, the supplemental rules and regulations which provide the specific details and operational aspects of the Amendments have yet to be released. However, notwithstanding the foregoing, we believe that there is a great deal of interest within the financial industry as to the impact of the Amendments. This Client Alert will provide a brief summary of the Amendments.

A. Definition of High-Frequency Trading

One of the prevailing points of interest in the Amendments is the exact scope of HFT Operators which will be subject to these new regulations.

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

(i) the decision making process is automated by a computer system in relation to the trades; and

(ii)(a) the various trade instructions are transmitted to the exchanges through the use of communication technology; and

(ii)(b) mechanisms, to be specified by the Enforcement Order, are being utilized to reduce the time of the transmission of the trade instructions to the exchanges.”

On its face, there remains certain ambiguity in the scope of the above definition and further detailed guidance will surely be forthcoming from the Japan regulators in the yet to be released accompanying supplemental legislation. However, there have been numerous academic articles and publications which speculate on various facets of the above definition. For example, some articles discuss that the referenced “mechanisms” in item (ii)(b) above may be limited to those mechanisms whereby orders of the trader are made from the so-called “co-location areas” or “similar facilities” and such orders will not be aggregated with orders made by

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1 Japan Regulatory Update:June 16, 2016(DT Legal Japan)
other traders or otherwise be obstructed by orders
made by other traders.

B. Registration Requirements and
Enforcement

Under the Amendments, all HFT Operators will be
required to be registered with the Japan FSA as an
HFT Operator. With respect to those entities which
are already registered with the Japan FSA as a
financial instruments business operator, such
entities will be required to submit an amendment
notification to their existing registration to cover any
contemplated HFT activities.

At the time of this Client Alert, there is no detailed
information available as to the registration
requirements for an HFT Operator. However,
similar to other financial instruments business
operators, an applicant must satisfy, among others,
the following:

(a) neither the applicant nor any of its officers has
engaged in any conduct which would classify
them as “disqualified applicants”;

(b) the applicant has a sufficient personnel
structure to properly engage in HFT activities;

(c) the applicant has implemented internal controls
and procedures pursuant to which it can
engage in the proper operation of HFT; and

(d) in case of a foreign applicant, such foreign
applicant has appointed a local representative
in Japan.

While it will be necessary to review the
supplemental rules and regulations to confirm the
further specific details, an applicant for an HFT
Operator registration is also required to prepare
certain application documents for submission to
the Japan regulator including the document
describing the business methods of the applicant
regarding HFT activities.

Once registered, such HFT Operator will be
required to follow certain rules similar to financial
instruments business operators (e.g., maintenance
of certain ledgers, filing of various reports including
an annual business report).

Furthermore, as in many cases with respect to the
implementation of new registrations in Japan, there
will be a six (6) month grace period for HFT
Operators to properly register with the Japan FSA.

As a final point, it should be noted that the
Amendments will forbid brokers from accepting
any HFT order from any trader that is not properly
registered as an HFT Operator. Furthermore, the
exchanges will have authority to investigate HFT
Operators directly for the purpose of fair trades and
investor protection. Through this prohibition on the
brokers and the supervisory authority that will be
provided to the exchanges, the Japan FSA will
seek to control and prohibit the HFT activities of
unregistered traders.

C. Conclusion

The specific scope and impact of the Amendments
on fund managers, etc., engaging in HFT is an area
of great interest to industry participants.

The Investment Management Group of DT Legal
Japan intends to actively monitor these
developments and provide regular updates as the
supplemental rules and regulations are released.

For those interested in submitting comments
and/or queries to the Japan FSA regarding the
Amendments, DT Legal is happy to assist.

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2 There have been discussions in the market that such internal controls and procedures will include those controls which
are aimed at preventing unfair trades or trades which could cause a disruption to the markets due to the possible failures
of IT systems.
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