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Japan Regulatory Update

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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[1]. 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:

"The trading of securities or listed derivatives (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 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

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[2]; 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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