Introduction of High Frequency Trading regulation to Japan

November 2017

In brief

Amendments to the Financial Instruments and Exchange Act ("**FIEA**") passed the Diet on May 17, 2017, and will come into effect on April 1, 2018. The draft Cabinet Order, Cabinet Office Ordinance and related guidelines which provide details of the amendments were published for public comment on October 24, 2017. In this newsletter, we provide an outline of the new regulations on High Frequency Trading ("**HFT**").

In detail

1. Outline of the Regulations on High Frequency Trading

HFT regulation under the amendments to FIEA ("**Amendments**") introduces a registration system for high frequency traders, and requires each HFT investor to establish an operational control system, manage risks, and provide the regulator with certain information related to HFT. Under the HFT regulations, HFT investors will also be required to register with the Financial Services Agency Japan ("**JFSA**"). An HFT investor who already conducts HFT on April 1, 2018 may continue HFT for a six-month grace period. However, such HFT investor will be required to apply for registration during the grace period.

2. Definition of HFT

The definition of HFT under the Amendments is summarized as follows:

(1) Trading of securities or listed derivatives;

(2) Entrustment of orders for the transactions described in (1); or

(3) Any action related to the transactions described in (1) which are specified in the Cabinet Order to be equivalent to those described in (2)

that employs:

i. Decision making for execution of trading conducted automatically through a computer system; and

ii. Transmission of the trade information to the exchange, using methods to reduce latencies as designated in the Cabinet Office Ordinance.

The definition of HFT limits the regulated conduct to algorithmic trading which uses a method to reduce latency. Although the structure of this definition is similar to the one in MiFID II in that it considers HFT as one category of algorithmic trading, please be advised that HFT regulation under the Amendments does not regulate all the categories of algorithmic trading, but only covers HFT as defined above. The definition of HFT requires automated decision making and reduced latency. However, unlike the "high-frequency algorithmic trading technique" in MiFID II, it does not refer to high message intraday rates which constitute orders, quotes or cancellations.

According to the draft Cabinet Office Ordinance, the phrase "methods to minimise latencies" refers to an HFT investor's computer system being located within, close, or adjacent to the venue where the market sets its computer system to process orders, in combination with certain arrangements to prevent the transmission of the trade information by the HFT investor from competing with other transmissions by other investors (e.g. contractual arrangements with security brokers regarding exclusive possession of a virtual server). This definition clearly includes co-location. Proximity hosting may also be included in the definition considering the wording of the draft Cabinet Office Ordinance.

HFT at PTS (Proprietary Trading System, which is equivalent to ATS in the United States and MTF in Europe) is regulated in the same way.

3. Outline of the Registration System

The Amendments require HFT investors other than those who are already licensed as financial instruments firms, registered financial institutions, or remote trading participants at the market ("**Financial Instruments Firms**") to register with the Prime Minister of Japan if they conduct HFT. Practically speaking, most of the HFT investors who will be required to register will be foreign investors who have none of the licenses mentioned above.

Foreign HFT investors who apply for registration should pay attention to the following two requirements, among others.

First, a foreign HFT investor who has no representative in Japan is required to appoint an agent in Japan, who is eligible to act on behalf of the foreign HFT investor. The draft guidelines published by JFSA require an agent to have expertise in the financial regulation of HFT and the capacity to communicate effectively with JFSA. An agent is expected to accurately deliver reports from a foreign HFT investor to JFSA and to fully understand and address reporting requests by JFSA in cooperation with a foreign HFT investor.

Second, an HFT investor is required to provide JFSA with certain information on the outline of their HFT strategies, key compliance, and risk controls. As regards strategies, the draft Cabinet Office Ordinance and guidelines state that an HFT investor is required to explain the basic mechanisms of their trading strategies in plain, easy to understand language, referring to at least the following information:

- the category of each strategy (i.e. market-making, arbitrage, directional or other strategy);
- the markets where an HFT investor conducts HFT;
- the category of securities or listed derivatives covered by the investor's HFT; and
- the names of brokers whom an HFT investor retains

All documents for an application to JFSA may be written in English without the requirement of accompanying Japanese translations.

4. Compliance, Risk Controls and Reporting

An HFT investor is required to establish an operational control system as follows:

- establishing company rules related to HFT business;
- providing training or other measures for employees to ensure their compliance with company rules;
- taking appropriate measures to maintain computer systems related to HFT;
- implementing necessary and appropriate measures to prevent unfair trading through abuse of material non-public information; and
- implementing sufficient trading control to prevent intentional market manipulation.

Record-keeping and annual business reporting is also required under the Amendments. A foreign HFT investor is entitled to substitute books and records made in accordance with foreign regulations (e.g. MiFID II) for ones under FIEA. Since such substitutes must meet the requirements under the draft Cabinet Office Ordinance in addition to all applicable foreign regulations, it is necessary to check whether or not there is any discrepancy in record-keeping requirements between the requirements under the draft Cabinet Office Ordinance and those under the relevant foreign regulations. For instance, the draft Cabinet Office Ordinance require a foreign HFT investor to retain books and records for 7 or 10 years from the date of creation (depending on the type of document) which are longer periods than required under Article 29 of the ESMA RTS 6. Record-keeping and annual business reporting may be written in English provided, however, that Japanese translation of the format of such books and records is required.

5. Regulation on Financial Instruments Firms

Under the new regulations, Financial Instruments Firms are prohibited from accepting any orders for HFT from:

- any HFT investor who has no license; and/or
- licensed investors for which Financial Instruments Firms are unable to confirm that their operational control system or risk controls are appropriately implemented.

In connection with the above regulations, an HFT investor will be asked by Financial Instruments Firms to submit a written confirmation regarding operation and risk control at the beginning of trading, and written reports in the event of a trading system malfunction. Failure to submit a confirmation or report may lead to cancellation by Financial Instruments Firms of accepted orders.

6. Concluding Remarks

New regulations on HFT under FIEA are, in general, in line with international regulatory discussions on HFT. JFSA seems to accommodate foreign HFT investors in that it will accept English application documents without translation, and will not require books and records totally different from ones under other equivalent regulations in other jurisdictions. However, there remain ambiguities of certain requirements (e.g. details of information on strategies to be provided to JFSA). We must pay close attention to the developments on such issues. Assessment of discrepancies among MiFID II, FIEA and other regulations will also be necessary for an HFT investor that conducts its business globally. We are more than happy to support a foreign HFT investor who would like to address the new regulations in Japan and/or apply for registration. We can also act as the required agent on behalf of a foreign HFT investor.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

PwC Legal Japan
Kasumigaseki Bldg. 15F, 2-5, Kasumigaseki 3-chome, Chiyoda-ku, Tokyo 100-6015
Tel : 81-3-5251-2600
Email: pwcjapan.legal@jp.pwclegal.com
URL: http://www.pwc.com/jp/en/legal.html

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Makoto Hibi
Attorney at Law
81-3-5251-2746
makoto.hibi@pwc.com