

Amendments to Legislation on High Frequency Trading

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On May 17, 2017, a bill amending the Financial Instruments and Exchange Act, including regulations on high frequency trading (“Amendments”), was enacted in the Diet. The Amendments define high frequency trading, introduce a registration system for high frequency traders, and provide for the regulation and supervision of high frequency trader businesses. In addition, the Amendments introduce notification for financial instruments business operators and registered financial institutions (“Financial Instruments Business Operators, etc.”) conducting high frequency trading, prohibit Financial Instruments Business Operators, etc. from accepting orders from high frequency traders who are not registered, and enable investigations by the financial instruments exchange.

In this newsletter, we provide an outline of the Amendments concerning legislation on high frequency trading.

I. Circumstances leading to the submission of the bill

In response to an inquiry from the Minister for Financial Services on April 19, 2016, the Financial System Council established the Working Group on Financial Markets (“Market WG”) in order to review various issues concerning the Japanese financial market, taking into consideration the advances in information technology and other changes in the environment surrounding the financial markets. The “Report by the Working Group on Financial Markets under the Financial System Council -Initiatives toward Stable Asset Building and the Development of Institutional Systems related to Markets and Exchanges” (“Market WG Report”)¹ was published on December 22, 2016. It reports the results of deliberations conducted by the Market WG, including those concerning proposed legislation on high frequency trading.

¹ http://www.fsa.go.jp/en/refer/councils/singie_kinyu/20170509.html

According to the Market WG Report, advances in information technology in recent years have enabled Japanese exchanges to provide co-location services. These services allow trading participants to install their servers close to the exchange's trading system (co-location area) as a part of their efforts to accelerate trading speed. This drastically reduces latencies associated with transactions. Further, the prevalence of automatic high-speed algorithmic trading, which is typically utilized at the co-location area to place, modify and cancel orders ("High-Speed Algorithmic Trading")², has increased, along with its influence.

While it has been pointed out that such High-Speed Algorithmic Trading has provided liquidity to the market, concerns have been raised with respect to the impact of High-Speed Algorithmic Trading on market stability and efficiency, fairness between investors, price discovery functions of the markets based on medium to long-term enterprise value and system vulnerabilities. However, under the current law there is no framework to collect information directly from investors conducting High-Speed Algorithmic Trading. In addition, authorities and exchanges do not yet have a full picture of High-Speed Algorithmic Trading and strategies used therein or the status of risk management concerning the placement of orders.

The Market WG Report suggests that it would be appropriate to develop a regulatory framework in which investors conducting High-Speed Algorithmic Trading are required to be registered with authorities and to meet organizational/system requirements including risk controls. Further, the Market WG Report suggests enabling authorities to identify transactions and trading strategies of such traders.

The purpose of the Amendments concerning high frequency trading, which were based on the Market WG Report, is to introduce a registration system and establish rules in order to enable authorities to identify the status of the high frequency trading of equities.

II. Outline of the Amendments

An outline of the Amendments concerning high frequency trading is as follows:

- (1) Definition of "high frequency trading";
- (2) Introduction of a registration system for high frequency traders;
- (3) Regulations governing the business of high frequency traders;
- (4) Supervision of high frequency traders;
- (5) Notifications by Financial Instruments Business Operators, etc.³ conducting high frequency trading;
- (6) Prohibiting Financial Instruments Business Operators, etc. from accepting orders from high frequency traders who are not registered;
- (7) Investigations by the financial instruments exchange⁴; and

² Also known as HFT ("High Frequency Trading").

³ "Financial Instruments Business Operator, etc." in this context means typically securities broker-dealer.

⁴ "Financial Instruments Exchange" in this context means stock exchange (such as the Tokyo Stock

(8) Penalties.

III. Details of the Amendments

(1) Definition of high frequency trading

The Amendments define “high frequency trading” as the following:

“High frequency trading means the actions as set forth in (i) through (iii) below where the decision making concerning such actions is determined automatically through an electronic information processing system, and the information necessary for the sale/purchase of securities or the market transactions of derivatives⁵ based on such decision is communicated through information technology to the financial instruments exchange or any other person specified by the Cabinet Office Ordinance, with the methods to be used in order to shorten the time usually required for such communication to be specified in the Cabinet Office Ordinance (except those specified by the Cabinet Order as actions which are considered harmless for the purpose of protection of investors, considering the details of such actions):

- (i) Sale/purchase of securities or market transactions of derivatives;
- (ii) Entrustment of the actions described in (i); and
- (iii) In addition to (ii), actions related to those described in (i) which are specified in the Cabinet Order to be equivalent to those described in (i) and (ii).”

As described in the foregoing, details of the communication methods are delegated to the Cabinet Office Ordinance, and certain actions which are considered equivalent to those in (i) and (ii) above may be added by the Cabinet Order. Further, there are certain actions which may be excluded by the Cabinet Order. Therefore, there is still a possibility that the definition will be expanded or have aspects excluded. The finalized definition only will be determined when the Cabinet Order and the Cabinet Office Ordinance are officially published.

(2) Introduction of a registration system for high frequency traders

If a person other than Financial Instruments Business Operators, etc. and authorized transaction-at-exchange operators (limited to those conducting or those that will conduct high frequency trading as a financial instruments business, a registered financial institution business or a transaction-at-exchange operation) is to conduct high frequency trading, such person must be registered by the Prime Minister. Such registered persons shall be referred to as “high frequency traders”. Unlike other business regulations, such as those applicable to financial instruments businesses, this registration system is not limited to cases where the actions are conducted as a business.

Exchange).

⁵ “Market transactions of derivatives” means trading of listed derivatives.

In order to apply for registration, the application for registration needs to be submitted together with: (i) a document pledging that there are no grounds for refusal of registration; (ii) a document indicating the details and method of the high frequency trading related business as provided in the Cabinet Office Ordinance; (iii) articles of incorporation and certificate of registered matters, if such person is a corporation; and (iv) any other documents specified by the Cabinet Office Ordinance.

The grounds for refusal of registration are listed in the Amendments. Specifically, registration will be refused if:

- (i) the person's registration was cancelled or the person received a similar administrative disposition within the last five years;
- (ii) the person breached provisions of the Financial Instruments and Exchange Act, and either received a fine as punishment or ceased to be subject to punishment within the last five years;
- (iii) the person conducts another business which is found to be against the public interest;
- (iv) the person does not have a personnel structure sufficient to conduct business pertaining to high frequency trading in an appropriate manner;
- (v) the person does not have the infrastructure necessary to conduct business pertaining to high frequency trading in an appropriate manner;
- (vi) the person is a corporation with an officer who satisfies any of the grounds for disqualification as stipulated in the Financial Instruments and Exchange Act;
- (vii) the person is a corporation that does not have the amount of stated capital or total contribution amount required by the Cabinet Order which amount is deemed necessary and appropriate to protect investors and to be in the public interest;
- (viii) the person is a foreign corporation which has not appointed a representative or agent in Japan;
- (ix) the person is a foreign corporation and the foreign financial instruments regulatory authority of that corporation's principal place of business and other offices pertaining to high frequency trading has not provided an assurance that it will cooperate with an administrative investigation request from Japanese authorities; and
- (x) the person is a corporation with net assets less than the amount required by the Cabinet Order which is deemed necessary and appropriate to protect investors and to be in the public interest.

As described in the foregoing, a foreign corporation is not required to establish an office in Japan, but it is required to appoint a representative or agent in Japan.

(3) Regulations governing the business of high frequency traders

The major regulations governing the business of high frequency traders are as follows:

- (i) High frequency traders are required to develop an operational control system so that they can engage in high frequency trading in an appropriate manner.
- (ii) High frequency traders shall not have another person engage in high frequency trading under the name of the said high frequency trader.

(iii) High frequency traders shall carry out their business so that none of the following applies to their business operation:

- Failing to sufficiently maintain an electronic data processing system and other equipment concerning high frequency trading. Electronic data processing systems and other such equipment need to be adequately maintained to prevent any interference in the capital market by abnormal operation of the electronic data processing system.
- Other circumstances specified by the Cabinet Office Ordinance where the operations of the business are likely to be contrary to public interest or hinder the protection of investors.

(4) Supervision of high frequency traders

The major provisions concerning the supervision of high frequency traders are as follows:

- (i) Preparation and retention of books and documents;
- (ii) Preparation and submission of a business report;
- (iii) Notification of the business' commencement;
- (iv) Order for production of a report and on-site inspections; and
- (v) Order to improve business operations and other dispositions for the purpose of supervision.

(5) Notifications by Financial Instruments Business Operators, etc. conducting high frequency trading

The Amendments include provisions that require Financial Instruments Business Operators, etc. conducting high frequency trading to submit notifications to authorities.

(6) Prohibiting Financial Instruments Business Operators, etc. from accepting orders from high frequency traders who are not registered

Financial Instruments Business Operators, etc. or their officers or employees may only accept an order that involves high frequency trading relating to the sale/purchase of securities, market transactions of derivatives or any other equivalent transactions identified in the Cabinet Office Ordinance from registered high frequency traders. Those registered high frequency traders include Financial Instruments Business Operators, etc. and authorized transaction-at-exchange operators (limited to those identified in the Cabinet Order as those who conduct high frequency trading as a financial instruments business, registered financial institution business or transaction-at-exchange operation).

(7) Investigation by a financial instruments exchange

A financial instruments exchange may conduct investigations into high frequency traders' compliance with applicable laws and regulations, and make administrative dispositions. It may also take other measures necessary for ensuring the fair sale/purchase of securities and market transactions of derivatives on the financial instruments exchange markets and for the protection of investors in accordance with the Financial Instruments and Exchange Act and its articles of incorporation and other internal rules.

(8) Penalties

Major penalties concerning high frequency trading are as follows⁶:

- (i) Imprisonment for up to three years, a fine up to three million yen, or both, for a person or entity who:
 - Registered by wrongful means;
 - Conducted high frequency trading without being registered; or
 - Had another person conduct high frequency trading under the name of said person.
- (ii) Imprisonment for up to two years, a fine of up to three million yen, or both, for:
 - Violation of an order to suspend all or a part of the business.
- (iii) Imprisonment for up to a one year, a fine up to three million yen, or both, for a person who:
 - Submitted a registration application or its attachments containing false statements or information;
 - Failed to prepare and retain books and documents, or prepared false books and documents;
 - Failed to submit a business report or submitted a false business report; or
 - Violated an order for collection of a report or refused an inspection.

IV. Enforcement

The Amendments will come into effect as of the day specified by the Cabinet Order, which must be within one year from the date of the promulgation of the Amendments (May 24, 2017).

V. Transitional Measures

Those who have already been conducting high frequency trading when the Amendments come into effect (excluding Financial Instruments Business Operators, etc. and authorized transaction-at-exchange operators) may continue to conduct high frequency trading without registration for a period of six months from the effective date of the Amendments.

Financial Instruments Business Operators, etc. or authorized transaction-at-exchange operators who have already been conducting high frequency trading when the Amendments become effective shall be deemed to be high frequency traders as of the effective date of the Amendments. They may continue to conduct high frequency trading without notification for a period of six months from the effective date of the Amendments.

⁶ Dual criminal liability provisions also provide for the punishment of corporations.

VI. Concluding remarks

The Amendments are unique in that they require “high frequency traders” (as investors, and not as “business” operators such as financial instruments business operators, financial instruments intermediary service providers and credit rating agencies) to be registered under the Financial Instruments and Exchange Act. Further, as described above, because the determination of the material part of the definition of “high frequency traders” has been delegated to the Cabinet Order and the Cabinet Office Ordinance, currently, there is tremendous uncertainty as to the import of the regulation. For example, it is unclear which parties will be considered as “high frequency traders” in cross border trading (e.g., offshore funds who place their orders through SPC or custodians, PTS in Japan or so-called dark pools, or investors who conduct transactions through foreign stock exchanges which deal in Japanese stocks, etc.). It is expected that this uncertainty will be clarified through the Cabinet Order, the Cabinet Office Ordinance, the guidelines for supervision and the responses to public comments from the Financial Services Agency concerning these regulations.

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