

April 2018

Amendments to Cabinet Order, Cabinet Office Ordinances, etc., for Registration System for High Speed Traders¹

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On May 17, 2017, legislation to amend the Financial Instruments and Exchange Act was enacted in the Diet. Subsequently, on October 24, 2017, the Financial Services Agency announced its proposed Cabinet Order, Cabinet Office Ordinances, etc., in relation to the amendment and invited public opinion on public comment procedures (Public Comments). The results of such Public Comments were published on December 27, 2017, and the finalized Cabinet Order, Cabinet Office Ordinances, etc., were promulgated on the same day.

In this Newsletter, we provide an outline of the Cabinet Order, Cabinet Office Ordinances, etc., related to the registration system for high speed traders.

I. Circumstances leading to Enactment

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”)² published on December 22, 2016, suggested that a registration system for traders/investors engaged in high-speed algorithmic trading be introduced, the necessary structures be developed, and risk management obligations be imposed, and that it would be appropriate for the financial authorities to develop a regulatory framework to enable them to identify transactions and trading strategies, etc., for such traders. Based on this suggestion in the Market WG Report, a law to amend the Financial Instruments and Exchange Act (the “FIEA”) to introduce such a

¹ This type of trading is commonly referred to in English as “high frequency trading” (abbreviated as “HFT”); however, recently it is more often referred to in Japan as “high-speed trading (HST)” in line with the defined term in Japanese used in the FIEA (*kosoku torihiki*).

² https://www.fsa.go.jp/en/refer/councils/singie_kinyu/20170509.html

registration system for high speed traders (the “Amendment Act”) was enacted in the Diet on May 17, 2017, and promulgated on May 24, 2017.

With a view to implementing the Amendment Act, the Financial Services Agency published “Proposed Cabinet Order, Cabinet Office Ordinances, etc., in relation to the Amendments to the Financial Instruments and Exchange Act of 2017” on October 24, 2017, and invited Public Comments until November 22, 2017. The results of these Public Comments³ were published on December 27, 2017, and the finalized Cabinet Order, Cabinet Office Ordinances, etc., were also promulgated on the same day. We provide below an outline of the Cabinet Order, Cabinet Office Ordinances, etc., for the registration system for high speed traders (the “Amendments”).

II. Outline of the Amendments

(1) Definition of high speed trading

In Article 2, Paragraph 41 of the FIEA (as amended by the Amendment Act, hereinafter the same, and article numbers indicated in this Newsletter shall mean the article numbers after amendment unless indicated otherwise), “high speed trading” is defined as follows:

“High speed trading means the actions 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 market transactions of derivatives (i.e., exchange-traded derivatives) based on such decision is communicated through information technology to the financial instruments exchange or other person specified by a Cabinet Office Ordinance, with the methods to be used in order to shorten the time usually required for such communication to be specified in a Cabinet Office Ordinance⁴:

- (i) Sale/purchase of securities or market transactions of derivatives;
- (ii) Entrustment of 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).”

Based on the above definition, the Amendments define matters to be specified by a Cabinet Office Ordinance as follows:

- “Persons to whom information that constitutes high speed trading is communicated” shall be (a) financial instruments exchanges and (b) financial instruments business operators authorized for PTS (Proprietary Trading System) (the “Financial Instruments Exchange, Etc.”), which are designated by the Commissioner of the Financial Services Agency (Article 26, Paragraph 1 of the Cabinet Office Ordinance on the Definitions provided in Article 2 of the Financial Instruments and Exchange Act (Ministry of Finance Ordinance No. 14 issued in

³ <http://www.fsa.go.jp/news/29/syouken/20171227.html> (available only in Japanese)

⁴ The Amendments provide that “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” shall be excluded from the definition of high speed trading. However, there is no directly corresponding provision in such Cabinet Order.

- 1993; the “Ordinance on Definitions”). Seven persons⁵ are designated in the announcement⁶.
- An amendment to the Cabinet Office Ordinances clarifies that “a method of communicating information that constitutes high speed trading” (as provided in the FIEA) is a method which satisfies both of the following (Article 26, Paragraph 2 of the Ordinance on Definitions):
 - A facility that houses an electronic information processing system to perform automated determination of investments is located in a place where a matching engine of the Financial Instruments Exchange, Etc., is installed (including places adjacent or close thereto); and
 - A mechanism that prevents such communication from conflicting with other communications is established.

With regard to the second item above, such mechanism is considered to include a case where an arrangement for an exclusive use of one or more virtual servers, in the case of Tokyo Stock Exchange, has been made (III-3-1-2 of the Guidelines for Supervision of High Speed Traders; the “Guidelines”).

- The following two types of actions are specified in the Cabinet Order as those considered to be high speed trading (Article 1-22 of the Order of Enforcement of the Financial Instruments and Exchange Act; the “Order”):
 - Management of funds or other assets (including instructions for such management) that constitute the actions described in II.(1)(i) (i.e., a sale/purchase of securities or a market transaction of derivatives) (Item 1); or
 - Causing a person to conduct the actions described in II.(1)(i) (i.e., a sale/purchase of securities or a market transaction of derivatives) (in a Financial Instruments Exchange, Etc.) by entering into over-the-counter derivative transactions with such person or by any other method⁷ (Item 2).

Concerning application of Article 2, Paragraph 41 of the FIEA in a case where several entities (securities brokers-dealers which accept orders, foreign securities brokers-dealers, SPCs, etc.) are involved in a series of transactions, the FSA replies to Public Comments indicate that it is necessary to examine whether the requirements provided in that paragraph are satisfied for each action made by each entity (Answer 31, etc. to Public Comments). For example, when a Financial Instruments Business Operator as a participant in a transaction undertakes brokerage (without any discretion) of orders placed by registered high speed traders to a Financial Instruments Exchange, the Financial Instruments Business Operator is not considered to be engaged in high speed trading (Answer 31 - 34 to Public Comments). However, the Amendments present the understanding that when a

⁵ Designation of parties to which information that constitutes high speed trading shall be communicated (the Financial Services Agency’s announcement No. 50 of 2017)

⁶ Tokyo Stock Exchange, Inc., Osaka Exchange, Inc., and local exchanges (Nagoya Stock Exchange, Inc., Securities Membership Corporation Fukuoka Stock Exchange, Securities Membership Corporation Sapporo Stock Exchange) are designated as Financial Instruments Exchanges, while SBI Japannext Co., Ltd and Chi-X Japan Limited are designated as PTS.

⁷ The FSA response to Public Comments indicates that this includes, for example, the case where a person executes a contract for a total return swap with a securities broker and gives instructions on individual and specific stocks, and such securities broker performs hedge transactions based on such instructions falls under this item (in such case the person behind the securities broker will be regarded as a high speed trader) (Answer 22 to Public Comments).

domestic Financial Instruments Business Operator conducts high speed trading for its foreign affiliated company's proprietary account under a discretionary trading agreement, such trading is basically considered to be an action made by the domestic Financial Instruments Business Operator and not by its foreign affiliate and will be considered to be high speed trading by the former (Answer 37 to Public Comments).

(2) Introduction of registration system for high speed traders

To make an application for registration as a high speed trader under Article 66-50 of the FIEA, it is necessary to submit an application for registration and accompany it with (i) a document pledging that there are no grounds for refusal of registration, (ii) a document indicating the details and method of high speed trading as specified in Cabinet Office Ordinance, (iii) the articles of incorporation and a certificate of registered matters (or equivalent document), if such person is a corporation), and (iv) any other documents specified by Cabinet Office Ordinance (Article 66-51 of the FIEA).

In response to the above, the Amendments provide the following matters specified by Cabinet Office Ordinance⁸:

- The following are specified as matters required to be described in the statement of operation procedures (Article 328 of the Cabinet Office Ordinance on Financial Instruments Business; the "Ordinance on Financial Instruments Business")
 - Basic principles of business operation, the method of execution of business, the method of division of duties (Items 1- 3);
 - Summary of trading strategies for each transaction (Item 4);
 - Types of trading strategies, name or trade name of the Financial Instruments Exchange, Etc. to be used, categories of securities, etc. (a - c), as well as name or trade name of securities brokers who accept orders which will be used should be included (in the statement of operation procedures) (III-3-1-1(2)(ii) of the Guidelines).
 - Name and title of persons in charge of compliance and operations management pertaining to HST business (Items 5 and 6);
 - Summary, place of installment, and retention method of trading system (Item 7);
 - Details of measures to ensure sufficient management of trading system (Item 8).
- Documents that contain personal information of officers, final BS/PL and other documents are specified as documents required to be attached (Article 329 of the Ordinance on Financial Instruments Business).

The Amendments provide that, among the grounds for refusal of registration (Article 66-53 of the FIEA), the minimum capital amount (Item 5(b)) and the minimum net asset amount (Item 7) are to be concrete amounts decided by Cabinet Order, and these amounts presently are 10,000,000 yen and 0 yen (no negative net worth) respectively (Articles 18-4-9 and 18-4-10 of the Order).

⁸ The details of the application documents can be found on the website of the FSA below.
<http://www.fsa.go.jp/en/regulated/hst/index.html>

The Amendments also provide that a failure to provide a representative or agent in Japan constitutes a ground for refusal of registration for a foreign corporation, etc. (Article 66-53, Item 5 (iii) and Item 6(ii)). In this regard, in the context of organizational review of the applicant (III-3-1-3(1)(i)(g) of the Guidelines), the Guidelines provide that an "appropriate" person must be appointed as a representative or agent in Japan (for example, a person with relevant knowledge of high speed trading under the FIEA, etc., who is capable of accurately responding to a request for reporting, etc., instead of merely conveying messages between the high speed trader and the supervisory authorities).

(3) Regulations governing the business of registered high speed traders

As part of the Amendments, the Cabinet Office Ordinance specifies major regulations governing the business of registered high speed traders as follows:

- (i) A registered high speed trader must have appropriate internal rules and also take measures to manage the trading system adequately, as part of the operations management system that registered high speed traders are required to establish (Article 66-55 of the FIEA) (Article 336 of the Ordinance on Financial Instruments Business);
- (ii) A registered high speed trader must conduct its business operations so that it will not fall under a circumstance where management of transactions to prevent any actions that intentionally cause market prices to move are insufficient⁹ (Article 66-57 of the FIEA) (Article 337 of the Ordinance on Financial Instruments Business).

(4) Preparation and retention of books and documents, other accounting and supervision

The Amendments provide details of types, matters to be described, method of preparation, and retention period regarding books and documents required to be prepared and retained by registered high speed traders (Article 338 of the Ordinance on Financial Instruments Business). As a matter to be described, order tickets are required to contain a time stamp and order acceptance number notified by the Financial Instruments Exchange, Etc. (Paragraph 6), and as a method of preparation, the contents of program(s) used to create an order must be easily confirmed (Paragraph 7, Item 1). In addition, all books and documents are required to have systematic structures so that the information contained can be easily searched (Paragraph 7, Item 2).

Furthermore, the Amendments provide necessary specifications for accounting and supervision of registered high speed traders, such as details of a business report (Article 66-59 of the FIEA), notification of commencement, etc., (Article 66-60 of the FIEA) and notification of winding-up of business, etc. (Article 66-61 of the FIEA) (Articles 339 - 346 of the Ordinance on Financial Instruments Business).

(5) Whether preparation of documents for submission in English is allowed, and attachment of

⁹ The FIEA specifies circumstances (to be avoided by registered high speed traders) where the management of a trading system to prevent interference with the full functioning of the financial instruments market is regarded to be insufficient due to physical malfunctioning of the electronic information processing system or for other reasons (Article 66-57, Item 1 of the FIEA).

translation necessary or not

All statutory documents required to be submitted by applicants for registration for high speed trading as well as by registered high speed traders may be prepared in English and a Japanese translation of such documents was determined to be unnecessary (Article 2, Article 326, Paragraphs 2, 3, etc., of the Ordinance on Financial Instruments Business).

The above also applies to any document, other than statutory documents, which may be prepared and submitted during the course of application for registration as a high speed trader, in response to an informal request by the regulator¹⁰ (that is, materials prepared in English will be accepted) (Answer 113 to Public Comments).

(6) When Financial Instruments Business Operators, etc., perform high speed trading

For details of matters required to be notified (to the regulator) when Financial Instruments Business Operators, etc., perform high speed trading (Article 29-2 of the FIEA, etc.), a set of provisions similar to those for registered high speed traders was added (Article 8, Item 11 of the Ordinance on Financial Instruments Business on Matters to be Described in Statement of Operation Procedures, etc.).

(7) Prohibition of accepting orders from unregistered high speed traders

Under Article 38, Item 8 of the FIEA, acceptance of any high speed trading transactions commissioned by unregistered high speed traders and “any actions specified by the Cabinet Office Ordinance as actions that are equivalent to the foregoing” are prohibited actions for Financial Instruments Business Operators, etc.

Following from the above, the Amendments specify, as prohibited actions for Financial Instruments Business Operators, etc., any acceptance of orders for high speed trading commissioned by registered high speed traders which were ordered to suspend their high speed trading business under Article 116-4 of the Ordinance on Financial Instruments Business (Item 1), and by registered high speed traders whose adequate measures to ensure sufficient management of trading system cannot be confirmed (Item 2).

(8) Preparation and retention of books and documents, when Financial Instruments Business Operators, etc., accept orders for high speed trading

Preparation and retention of books and documents become obligatory not only when Financial Instruments Business Operators, etc., themselves conduct high speed trading but also when they accept orders for high speed trading. The matters to be described and the method of preparation of such books and documents are basically the same as those for registered high speed traders (as described in (4) above) (Article 158, Paragraph 4, etc. of Cabinet Office Ordinance on Financial Instruments Business, etc.)

¹⁰ In the case of application for registration as a Financial Instruments Business Operator pursuant to the FIEA, it is customary for the regulator to request the applicant to prepare and submit a document called a “summary of applicant (*gaiyo-sho*)” in Japanese.

III. Enforcement

The Amendments (i.e., the Cabinet Order, Cabinet Office Ordinances, etc., related to the amendments to the FIEA of 2017) have come into effect as of April 1, 2018.

IV. Transitional Measures

Transitional measures provided in relation to the Amendments include a measure providing that those who have already been conducting high speed trading when the Amendments come into effect may continue to conduct high speed trading without registration for a period of six (6) months from the effective date of the Amendments (Article 3, Paragraph 1 of Supplementary Provision of the Amendment Act). A person who conducts high speed trading under the transitional measure will be considered to be a registered high speed trader in relation to the prohibition against accepting orders from unregistered high speed traders (Article 38, Item 8 of the FIEA) (Article 3, Paragraph 2 of Supplementary Provision of the Amendment Act).

In addition to the above measure, similar transitional measures have been provided for actions required when Financial Instruments Business Operators, etc., perform high speed trading and accept orders for high speed trading, etc. (Article 2 of Supplementary Provision of Amendment to Cabinet Office Ordinance, etc.).

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