
Outline of Financial System Reform Act

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1. A description of the Financial System Reform Act

On June 5, 1998 the Japanese Diet (Parliament) passed a Financial System Reform Bill presented by the government. It was promulgated on Jun 15, 1998, effective from December 1, 1998. The Act is a comprehensive law which will amend 22 laws and relates to major reforms of the securities market systems and the financial systems in general. This can be considered as the core of the financial “Big Bang”, a concept which was launched in November 1996 under the direction of the then Prime Minister Ryutaro Hashimoto.

The original bill presented the Diet comprised a document of over 1,000 pages, and involves major reforms, especially in terms of the Securities and Exchange Law and the Securities Investment Trust Law, and most of the articles in these two laws will be changed. The Act will result in the implementation of the report of the three financial sector councils, as published in June 1997, more or less as scheduled. Many of these reforms are scheduled to be implemented on December 1st, 1998. However, regarding several important reforms, such as the total liberalization of stock trading brokerage commissions, the mutual cross-sectoral entries of the banking sector and insurance sector, and the abolition of regulations on the scope of operations of the securities subsidiaries of banks, the enactment will be delayed. However, the structure of the financial sector "Big Bang" will come into force as law in December.

2. Important Items in the Financial System Reform Act

1) Reform of the Securities and Exchange Law

The Securities and Exchange Law is the law most extensively subjected to amendments in the Act. The following outlines the main reform points.

- (1) The definition of negotiable securities will be reviewed, and investment securities issued by corporate- type investment trusts (investment companies), covered warrants, depositary receipts (DRs) will be positioned as negotiable securities under the Securities and Exchange Law.
- (2) The ban of dealing in OTC derivatives will be lifted.
- (3) Proprietary trading systems (PTS) which operate off the floor of stock exchanges will be recognized as one form of securities businesses.
- (4) The disclosure system under the Securities and Exchange Law will be extended to apply to

securities investment trust beneficiary certificates and will be a method of protecting investors in place of recognition of trust deed provisions.

- (5) The current disclosure regulations imposed on the offering or sale of negotiable securities to the public with a total value of over 500 million yen will be applied in the case of a total value of over 100 million yen.
- (6) Disclosure of financial reports will be enforced on a consolidated basis.
- (7) The system of regulating the entry of securities firms will be changed from a licensing system to a registration system.
- (8) The obligation imposed on securities firms to specialize only in securities business will be abolished.
- (9) The obligation imposed on securities firms to keep the assets of customers in separate custody will be tightened up.
- (10) The systems governing the winding up or dissolution of securities firms will be changed from an authorization system to a registration system.
- (11) The scope of securities operations carried out by the bank subsidiaries will be broadened, and the banks themselves will be able to engage in sales operations of investment trusts.
- (12) The OTC stock market will be positioned as a negotiable securities market on the same footing as the stock exchange markets.
- (13) The regulations governing off-floor trading will be reorganized.
- (14) A system will be introduced to allow the Securities Dealers Association to undertake mediation in the case of dealing with disagreements in the area of securities trading.
- (15) An investors protection fund system will be introduced to compensate investors for losses incurred when securities firms go bankrupt or cease operation.
- (16) The regulations governing the stock exchange will be reviewed, and the establishment conditions will be relaxed. At the same time, regulations will be introduced to govern mergers between stock exchanges.
- (17) As of December 1999, the rate of stock trading brokerage commissions will be completely deregulated.

2) Reform of the Securities Investment Trust Law

The main points in the reform of the Securities Investment Trust Law are as follows. (1) The introduction of a private offering investment trust system, (2) the introduction of a corporate-type investment trust (investment corporations) system, (3) a review of regulations on the entry of investment trust management firms and regulations on the scope of operations of these firms.

In particular, the introduction of a corporate-type investment trust system means major changes in the system of the Securities Investment Trust Law, and the name of the law will be changed to the Act Governing Securities Investment Trusts and Securities Investment Corporations. The number of articles will be increased from 38 to 253.

Due to these reforms and reforms of the Investment Advisory Act, it will become possible for the investment trust management sector and the investment advisory sector, as related to investment discretionary contracts, to enter each others sectors.

3) Reform of the Banking Law, etc.

The commercial laws governing the financial institutions such as the Banking Law and the Long-term Credit Bank Law will be amended. The main items in these reforms are as follows: (1) There will be a review of the regulations on the scope of operations of the financial institutions and they will be allowed to engage in operations such as OTC negotiable securities derivative trading, etc. (2) There will be a review of the scope of operations of the subsidiaries of financial institutions, and it will become possible for financial institutions to hold the same kind of direct subsidiaries as is permitted for financial holding companies to hold as subsidiaries in their groups. *¹

In addition, a downstream holding company system will be allowed in which banks hold bank holding companies as subsidiaries. Through these reforms, banks will be able to hold insurance firms as subsidiaries. However, this regulation will only be applicable in the case of holding bankrupt insurance firms as subsidiaries until at date which the government must set by government ordinance by the end of March 2001.

(3) The Financial System Reform Law, which was enacted in 1992, will be amended in terms of setting out the rules for mutual cross-sectoral entries using subsidiaries. This will mean that by the end of March 2000 the regulations limiting the operational scope of the securities subsidiaries of banks will be abolished.

4) Reform of the Insurance Business Law, etc.

The main reform points in the reform the insurance sector are as follows: (1) A review of the scope of subsidiaries of insurance companies in line with the cross-sectoral entries on a mutual basis between the banking sector and the insurance sector, (2) the establishment of a fund to protect insurance policy holders, (3) abolition of the obligation to use the insurance premium rate of the Premium Rating Association in the area of non-life insurance.

5) Other legal revisions

(1) Financial Futures Transactions Law

OTC financial futures transactions will be introduced. At the same time, for financial futures

transactions firms, it will be obligatory to maintain separation between the deposit funds entrusted by customers and the firm's own assets.

(2) *Trust Business Law*

Establishing regulations allowing the prevention of securities held as trust assets from going to third parties even if official notice is not given. In the Trust Business Law, the requisite regarding protection of entrusted assets from third parties is the official notice system. However, regarding securities held as entrusted assets such as securities investment trusts, there are no public notice measures.^{*2} Consequently, it has been pointed out that if a trust bank were to go bankrupt, there is the possibility that the securities held in securities investment trusts, etc. could be seized by the general public creditors of the trust bank. This present revision is to avoid such a situation.

(3) *Tax Laws*

Measures will be taken to avoid double taxation in the case of securities investment corporations which are corporate-type investment trusts, a newly formed entity. This will be avoided by revising the Special Taxation Measures Law and the Local Tax Law. In addition, a tax system for private offering investment trusts will be established.

1 Regarding the Financial Holding Company System, please refer to "Lifting of Ban in Establishment of Holding Companies and Financial Holding Companies" by Sadakazu Ohsaki in "*Capital Research Journal*" Spring 1998. The Financial Holding Company Law and the Special Treatment Law on the establishment of Bank Holding Companies were both enforced on March 11, 1998.

2 Regarding the registered bonds such as Government bonds and corporate bonds, if registration is carried out as trust assets under the Trust Business Law, Article 3, Item 1, they are protected from third parties.

Table. Laws to be Revised Details of Revisions Explanation

| Laws to be Revised | Details of Revisions | Explanation |
|-----------------------------|---|--|
| Securities and Exchange Law | 1) A review of the definition of negotiable securities | Investment securities issued by securities investment corporations which are corporate-type investment trusts will now be permitted. In addition, foreign investment securities issued by foreign securities investment corporations which are foreign corporate type investment trusts, covered warrants, and depositary receipts (DRs) will be positioned as negotiable securities under the Securities and Exchange Law. |
| | 2) The lifting of the ban on OTC derivative trading | Sales operations relating to OTC derivative trading will be considered as securities operations. |
| | 3) The lifting of the ban on PTS | Brokerage in the trading of securities or securities trading per se using electronic systems (such as US Proprietary Trading Systems (PTS) which operate off the floor of the stock exchange) undertaken as sales operations will be recognized as one form of securities sector operations. In the determining of PTS prices, the following will be allowed. (1) the use of the stock exchange and OTC market prices, (2) prices formed through negotiations between customers, (3) other methods as laid down in government ordinances. |
| | 4) Applying the disclosure system to securities investment trust beneficiary securities | The system of recognition of trust deed provisions in the area of securities investment trusts will be abolished and in place of this, as a measure to protect investors, the disclosure system under the Securities and Exchange Law will be applied to securities investment trust beneficiary securities. With the exception of private offering investment trusts which attract less than 50 investors, regulations will be imposed including the need for a Prospectus and a securities issue registration statement filed to the Ministry of Finance. |
| | 5) Establishment of a disclosure system for small amount offerings | The obligation to register will be imposed on the offering or sales of negotiable securities in the case of a total value of over 100 million yen in terms of issue price and sales price. (Up to now this was 500 million yen or over.) This regulation will be enforced from April 1, 1999. |
| | 6) A shift to disclosure on a consolidated basis | It will become obligatory to include a report on the securities registration statement and securities financial reports including financial information on the corporate group made up of companies and entities with a close relationship with the companies. This regulation will be enforced from April 1, 1999. |
| | 7) A shift to a registration system for securities firms | The licensing system for the securities sector will be revised to a registration system. Regulations will be established including registration application procedures and conditions for the refusal of registration. However, regarding the underwriting of securities, operations relating to securities OTC derivative trading and PTS operations, this will be a system where the permission of the Prime Minister (Delegated to the Director-General, Financial Supervisory Authority) is required. In the case of securities firms which currently have licenses, they will be considered to be already registered. |

| Laws to be Revised | Details of Revisions | Explanation |
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| Securities and Exchange Law | 8) A review of the obligatory specialization of securities firms | Securities firms are free to engage in operations relating to securities operations such as the holding in custody of securities, and assets and liability operations relating to securities. In addition, they are allowed to engage in discretionary investment operations, investment trust management operations and financial futures trading operations. If they engage in these activities, they are required only to register the fact after the event. Regarding operations other than these, they can undertake such operations with the authorization of the Director-General of the Financial Supervisory Authority, and with the exception of certain specified cases, application for the authorization cannot be refused. |
| | 9) Separate custody of customer assets | Securities firms will be obliged to keep under separate custody (separate from their own assets) cash and deposited securities entrusted by customers. Regarding the separately held assets of customers, these must be entrusted to a trust company, etc. The securities firms will be legally compelled to maintain the regulated rate of equity capital adequacy, and this must be clearly shown. In addition, there will be an obligation to allow public access to documents explaining operations and assets. |
| | 10) Review of the regulations regarding the winding up of securities firms | The systems governing the termination of securities operations or the winding up or dissolution of securities firms will be changed from the current authorization system to a registration system. |
| | 11) A review of the securities operations of financial institutions | The securities operations open to financial institutions such as banks will be broadened to include the handling of offerings of securities investment trust beneficiary securities and OTC derivative operation within certain limits. The securities operations of financial institutions will be subject to registration requirement with the exception of underwriting operations (of government bonds etc.) and OTC derivative operations. |
| | 12) A review of the positioning of the OTC stock market | Up to now, the securities market has been defined as being a market in which a stock exchange is established under the Securities and Exchange Law. This will be changed, and the OTC markets established by the Securities Dealers Association will be defined as markets in which OTC trading of securities can be undertaken. They will be positioned as markets on the same level as the securities markets of the stock exchange. |
| | 13) The establishment of regulations governing off-floor trading | Up to now, the trading of securities off the floor of the stock exchange has not been permitted under stock exchange rules. This will now become possible, and for this, regulations will be set up such as the obligation to make public the market prices. |
| | 14) There will be a review of the system for dealing with disagreements in securities trading | Regarding the handling of disagreements in securities trading, the Securities Dealers Association will undertake mediation. As a result, the current system of mediation by the Minister of Finance will be abolished. |

| Laws to be Revised | Details of Revisions | Explanation |
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| Securities and Exchange Law | 15) The establishment of a fund system to protect investors | <p>A fund system to protect investors will be introduced in place of the current Deposited Securities Compensation Fund operated by the Japan Securities Dealers Association. The securities firms will be obliged to participate in the fund system. In the case of this fund, if the participating securities firms have their registration withdrawn, go bankrupt, start reorganization proceedings, withdraw from securities business, or have their operations suspended, in the case of it being difficult for the securities firm involved to effect repayment of debts relating to the customer's assets, the fund will make payment to the customers with a set limit on the amount (expected to be set at 10 million yen by a government ordinance). The cost of the fund will be met by the amount of money paid in by the member securities firms. However, it will also be possible to borrow funds from financial institutions.</p> <p>As a special exceptional measure, up to the end of March 2001, this fund will be able to borrow from the Bank of Japan in certain circumstances. The government can financially back the borrowings of the fund by giving guarantee to the borrowing.</p> |
| | 16) A review of the regulations governing stock exchanges | <p>The regulations governing the establishment of stock exchanges will be revised and some conditions required for obtaining a license will be abolished such as the financial conditions which cover the number of securities firms and the state of trading in the location proposed for establishment. In addition, new regulations will be established regarding the merger of stock exchanges.</p> <p>Regarding the operations of stock exchanges, the regulation forbidding the establishment of two or more securities markets by a stock exchange will be abolished, and the regulation forbidding all other operations than those directly necessary for fulfilling the purpose of the stock exchange will also be abolished. The regulating forbidding operations for profit will remain.</p> <p>The system for the listing or delisting of securities on the stock exchanges will be changed from a authorization by the Minister of Finance to a reporting system.</p> <p>The regulation forbidding the establishment of facilities similar to a stock exchange will continue to be in force. However, for securities firms which have received permission to engage in PTS operations, this rule will not apply.</p> |
| | 17) Deregulation of the rate of stock trading brokerage commissions | <p>The following regulations will be abolished and stock trading brokerage commissions will be completely deregulated. The standing rule in the model contract for securities brokerage that the stock exchange must determine stock trading brokerage commissions and the rule that member firms are obliged to charge a brokerage commission as fixed by the stock exchange will be abolished. This regulation will be enforced from the day decided by ordinance set by the end of December 1999.</p> |

| Laws to be Revised | Details of Revisions | Explanation |
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| Foreign Securities Firms Law | Review of the entry regulations and the method of regulation | In line with the reform of the Securities & Exchange Law, a review will be made of the regulations governing foreign securities firms and the entry regulations will be shifted from a license system to a registration system. In the system up to now, a license was needed for each branch, but this will be revised, and if the main office has been registered, it will be possible to carry out securities operations at other branches throughout Japan. |
| Financial System Reform Law | Review of the regulations governing the securities subsidiaries of banks | The regulation that the securities subsidiaries of banks etc. must not engage in stock trading operations will be abolished, and the limitations on the scope of operations will be removed. This regulation will be enforced from the day decided by ordinance to be set between October 1999 and the end of March 2000. |
| Securities Investment Trust Law | Introduction of private placement investment trust system | The regulations defining investment trusts which is that trust beneficiary rights are split up to allow an indeterminate number of people to obtain benefits will be revised, and this will make it possible to effect private placements for specific people or small numbers of people. |
| | Introduction of corporate-type investment trusts | <p>In this, a new securities investment corporation system will be created, and a corporate-type investment trust (investment company) system will be introduced. In line with this, the name of the Investment Trust Act will be changed to the Act Governing Securities Investment Trusts and Securities Investment Corporations.</p> <p>Securities investment corporations undertake asset management in compliance with the targets and policies for asset management as set out in the articles drawn up by the entity who established and planned the corporate entity. Acts other than asset management cannot be conducted for the purpose of earning profits.</p> <p>The entity establishing and planning the securities investment corporation is limited to those who are qualified to engage in investment trust management and investment advisory companies that have been authorized to have discretionary accounts.</p> <p>Securities investment corporation will only be able to conduct asset management if they have been registered with the Prime Minister (Authorization of Director-General of Financial Supervisory Authority).</p> <p>The management of assets by securities investment corporations will have to be delegated to management companies such as securities investment trust management firms or investment advisory firms authorized to have discretionary accounts. The custody of assets will have to be delegated to an asset custody firm such as a trust bank, etc.</p> <hr/> <p>Securities investment corporations will have to have organizations such as investors' general meetings similar to the shareholders' general meeting of a joint stock company (kabushiki kaisha) and a board of executives made up of supervisory executives and executive officers. The resolutions of the investors' general meeting will create a deemed approval system and facilitate resolutions.</p> <p>Regarding foreign securities investment corporations, registration before offering will be necessary.</p> |

| Laws to be Revised | Details of Revisions | Explanation |
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| Securities Investment Trust Law | Review of the regulations governing entry and regulations limiting the scope of operations of investment trust management companies | The system for entry into the securities investment trust management business will be changed from a license system to an authorization system. By registering, securities investment trust management firms can also engage in operations relating to the asset management of securities investment corporations, investment advisory operations and operations relating to investment discretionary contracts. If a firm is authorized, it can also engage in securities operations. |
| Securities Investment Advisory Law | A lifting of the ban on reassignment of investment discretionary contracts and a review of regulations on combining more than one operational area | The discretionary investment decision based on investment discretionary contracts can be reassigned in part or in whole to an entity as designated in ordinances. The regulations governing the engagement in more than one field, that is securities operations and security investment trust management operations, will be reviewed. |
| Banking Law | A review of the operational scope of banks | Securities OTC derivative trading etc. will be added to the ancillary operations permitted to banks. |
| | The obligation to provide information to depositors | At the time of accepting deposits, it will become obligatory for banks to provide information to depositors on the acceptance of deposits by these banks and reference information. Regarding other operations, it will become obligatory for banks to explain important points to customers. |
| | A review of the operational scope of bank subsidiaries | The range of operations of bank subsidiaries will be broadened. It will become possible for banks to have subsidiaries such as banks, long-term credit banks, securities firms specializing in securities operations, insurance companies, subordinate operations companies, companies engaging in financial related operations, firms engaged in the development of new sectors as laid down by ordinances of the Prime Minister's Office and ordinances of the Ministry of Finance, and holding companies which exclusively hold only these companies as subsidiaries (that is downstream holding companies). However, regarding insurance companies, they will be limited to companies coming within the definition of bankrupt insurance companies as laid down in the Insurance Business Law up to the day set by government ordinances to be decided by the end of March 2001. |
| Long-term Credit Bank Law, etc. | Preparation of regulations of subsidiaries and regulations of the scope of operations, etc. | The following laws will be revised: the Long-term Credit Bank Law, the Credit Union Law, Labor Credit Association Law, Small and Medium Enterprise Association Law, Law on Financial Operations by Cooperative Associations, Agricultural Cooperative Associations Law, Fishing Cooperative Associations Law, and the Central Cooperative Bank for Agriculture and Forestry Law. Regulations regarding subsidiaries and regulations regarding the positioning of OTC securities derivative operations and the obligation to provide information to customers will also all be reviewed based on the Banking Law. The Foreign Exchange Bank Law will be abolished. The Central Bank for Commercial and Industrial Cooperatives Law will be revised and OTC securities derivative trading will be positioned as a form of operations. |

| Laws to be Revised | Details of Revisions | Explanation |
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| Insurance Business Law | A review of the operational scope of insurance companies | Financial futures trading not undertaken for the management of assets, and OTC securities derivatives trading etc. will be added to the ancillary operations of insurance companies |
| | Obligation to explain important points to customers | Insurance companies will be obliged to explain important points to customers regarding operations and also be obliged to adopt measures to ensure sound and appropriate operations. |
| | A review of the scope of the subsidiaries of insurance companies | The scope of subsidiaries of insurance companies will be broadened. It will become possible for insurance companies to have subsidiaries such as life insurance, non-life insurance companies, banking subsidiaries such as banking, long-term credit banks, securities firms specializing in securities operations, subordinate operations companies, companies engaging in financial related operations, firms engaged in the development of new sectors as laid down by ordinances of the Prime Minister's Office and ordinances of the Ministry of Finance, and holding companies which exclusively hold only these companies as subsidiaries (that is downstream holding companies). However, regarding banks and long-term credit banks, these will be limited to companies coming within the definition of bankrupt financial companies as laid down in the Deposit Insurance Law up to the day decided by government ordinances to be decided by the end of March 2000. |
| | Introduction of the market price method to the trading of insurance companies | The market price method will be introduced to the trading account of insurance companies in the same way and banks and securities firms to ensure soundness. |
| | Operational reports etc. are open for inspection | It will become obligatory for insurance companies to make their explanatory documents open for public viewing |
| | Establishment of a protection system for insurance policy holders | <p>A protection system for insurance policy holders will be established as a mechanism to provide funding support for the transfer of insurance policies from a bankrupt insurance company. The system itself will be able to accept the insurance policies held by the bankrupt insurance company and so protect the policy holders.</p> <p>The insurance companies will be obliged to participate in a certain form of system depending on the type of license they have.</p> <p>The system will set up a fund to protect policy holders allowing the system to provide funding support and it will collect contributions from member companies.</p> <p>If an insurance company goes bankrupt, the fund will provide funding support for designated types of insurance. Regarding the liability reserve on a fixed amount of insurance, the system will provide support for a certain percentage of this after subtracting from the bankrupt company's assets (market value evaluation) and the cost of the bankruptcy winding up operations.</p> <p>As a special measure, up to the end of March 2001, the fund will be able to borrow a certain amount of funds from the Bank of Japan and the Government can financially guarantee the debt incurred by the borrowing of the fund. Special measures will be provided for the fund in terms of insurance policies which are within the scope of the fund support and the amount of the liability reserves.</p> |

| Laws to be Revised | Details of Revisions | Explanation |
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| Non-life Insurance Rating Association | A review of the Insurance Rating Association | The obligation to use the insurance rates as calculated by the Nonlife Insurance Rating Association will be abolished, and this will be revised to a system in which the nonlife insurance companies can, at their own discretion, use the rates of the Association as guidance. In addition, the exception of the rating system of the Association to the antimonopoly law will be abolished. This regulation will be enforced from July 1st, 1998. |
| Financial Futures Transaction Law | Introduction of OTC financial futures transactions and the introduction of the obligation to hold the assets of customers in separate custody | The regulations regarding OTC financial futures transactions will be revised to allow this form of trading. It will become obligatory for financial futures companies to keep the deposits entrusted by customers in separate custody from the firm's own funds. |
| Trust Business Law | Review of measure to protect assets held in trust from creditors | Establishing regulations allowing the prevention of securities held as trust assets from going to third parties even if official notice is not given. Through this, if a trust bank were to go bankrupt, it will be possible to avoid assets held in trust such as securities investment trust assets of customers being seized by the general public creditors of the trust bank due to their being confused with the assets of the trust bank. This regulation will be enforced from July 1st, 1998. |
| Special Taxation Measures Law/Local Tax Law | Revisions to the tax laws regarding securities investment corporation and private offering investment trusts | Regarding securities investment corporations, a new form of corporate-type investment trusts to be set up, income tax withholding at source will not be effected regarding interest earned and dividends, and the inclusion in expenses of dividends paid out will be allowed. Thus, profits from operations will be paid out as dividends to investors as they are without tax deductions and so this will have the nature of a pipeline for funds to pass through. Regarding the dividend income from the division of profits in private placement investment trusts, separate withholding taxation will not be applied. |