The Enactment of the Amended Securities and Exchange Law

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I. Background

The latest amendments to the Securities and Exchange Law ("the Law") were enacted on 2 June 2004. This is the third in a series of amendments, starting in 2000 with measures such as the demutualization of stock exchanges and continuing in 2003 with measures such as the introduction of a securities intermediary system, since the Financial System Reform Law introducing Japan's Big Bang program of financial reforms was enacted in 1998.[1]

The biggest challenge facing Japan's financial policymakers (and embodied in the words "Don't save, invest!") is how to correct the economy's overdependence on the banking system ("intermediation") and encourage greater use of the securities markets. The latest amendments are intended to achieve this and were based on recommendations contained in the report "Towards a Market-Oriented Financial System" published by the First Subcommittee of the Financial System Council (FSC) in December 2003 ("the FSC Report").

According to the "Outline" of the amendment bill produced by the Financial Services Agency, the amendments correspond to three policy objectives set out in the August 2002 "Program for Expediting Reform of Japan's Securities Markets."

The first of these objectives was to "make Japan's financial markets more investor-friendly." This corresponds to a number of amendments, including those which allow banks and other financial institutions to act as intermediaries for securities companies ("securities intermediaries").

1 For further details of the first two sets of amendments, see Sadakazu Osaki, "Legal Revisions Allow Exchanges to Be Formed as Joint-Stock Companies," Capital Research Journal, Autumn 2000, and "The Latest Amendments to Japan's Securities and Exchange Law," Capital Research Journal, Summer 2003.

The second objective was to "make Japan's financial markets more trustworthy." This corresponds to a number of amendments, including those which aim to improve market surveillance (e.g., by introducing a system of administrative fines), those which streamline disclosure requirements, and those which extend the coverage of investor protection to include investment partnerships.

The third objective was to "make Japan's financial markets more efficient and competitive." This corresponds to a number of amendments, including those which require securities companies to execute customer orders on the best terms possible.

The rest of this report looks at these amendments in more detail.

II. The Amendments in Outline

1. Allowing banks and other financial institutions to act as securities intermediaries

1) The previous system

The securities intermediary system, which allows a registered entity acting on behalf of a securities company to act as an intermediary for that securities company in a securities transaction and make initial and secondary offerings of securities on its behalf, was introduced as a result of the amendments to the Law (Article 2, Paragraph 11) made in 2003. (In the rest of this report only the numbers of the relevant sections of the Law will be given. Where the wording of the Law prior to the amendments is used, this will be indicated by "Old Law.") Although securities intermediaries carry out de facto actions (such as soliciting business from customers) on behalf of one or more particular securities companies, they do not have the right to represent those companies as legal agents. Similarly, they are not allowed to accept any cash or securities from the customers of those companies, and responsibility for managing customer accounts lies with the securities companies themselves (Article 66-12).

Unlike securities companies, which have to satisfy a capital adequacy requirement and be incorporated, any entity (be it an individual or a company) can register as a securities intermediary with the Financial Services Agency (Articles 66-2 and 66-3).

One of the models for this securities intermediary system was the system of independent contractors and introducing brokers in the United States. It was therefore tacitly assumed during the discussions on introducing a securities intermediary system in Japan that entities such as tax consultants, accountants, financial planners and insurance brokers would act as securities intermediaries serving the needs mainly of retail customers.[2]

However, financial institutions defined by government ordinance (e.g., banks, cooperative financial institutions and trust companies) were not allowed to act as securities intermediaries (Article 66-2).

The reason for this was probably the existence of Article 65 of the Law, which forbids banks and other financial institutions from engaging in the activities of a securities company as part of their normal business. However, if we assume that the aim of Article 65 is, as is often suggested, to avoid conflicts of interest and unacceptable risks, it is difficult to see why it was necessary to go as far as forbidding such institutions from simply acting as intermediaries for securities companies.

In contrast, the FSC Report recommended that banks be allowed to do this for the following reasons: (1) customers were likely to enjoy a better service; (2) the banks' own customers, who tended to have little investment experience, would be encouraged to gain such experience; and (3) access to the services of securities companies would be increased in areas where they had relatively few branches.[3]

2) The amendments and their distinctive features

As a result, Article 65, Paragraph 2 of the Law was amended this time, allowing banks and other financial institutions to act as securities intermediaries.

However, it should be noted that, instead of amending Article 66-2, which forbids banks and other financial institutions from acting as securities intermediaries, the Financial Services Agency chose to amend Article 65, Paragraph 2, which, in fact, is an exception to the rule forbidding banks and other financial institutions from engaging in the activities of a securities company.

The reason for this is presumably that the Agency felt that, because a securities intermediary mainly acts as an intermediary for a securities company in a securities transaction, there was no need to allow banks and other financial institutions to act as intermediaries and brokers in transactions involving particular financial products

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2 As of 24 May 2004, five companies (including a real estate investment advisory company and an insurance broker) have registered as securities intermediaries. Four of the companies are acting as intermediaries for Nikko Cordial Securities, and one as an intermediary for LPL Japan Securities.

3 See the FSC Report, pp. 31-31.

when acting as securities intermediaries if the Law already allows them to do this when acting in their normal capacity.

It is certainly possible to argue that, inasmuch as the Law allows banks and other financial institutions to act as intermediaries in transactions involving certain types of securities (e.g., a bank may help a securities company to fulfill a customer order to buy or sell government bonds), there was no need to amend the Law for this purpose.

Be that as it may, the fact that the Law was amended means that how banks and other financial institutions act as intermediaries and brokers in securities transactions depends on the type of financial product involved: if it is an investment trust or bonds issued by a government, local authority or government-backed agency, the bank can act as an intermediary or broker even if it is not acting on behalf of a particular securities company; however, if it is any other type of financial product (e.g., equities or corporate bonds), it can only act as an intermediary or broker if it is acting on behalf of a particular securities company. At the moment, it is difficult to predict with any certainty how this will (or will not) affect the banks (e.g., the layout of their branches) as this will depend partly on what is later decided about firewalls.

2. Improving market surveillance

1) Introducing a system of administrative fines

The latest amendments to the Law include a new chapter (Chapter VI-2), which governs a new system of administrative fines. The new system is modeled partly on the system of civil fines which the U.S. Securities and Exchange Commission (SEC) can impose on any person who violates federal securities laws and partly on the administrative fines which the Japanese Fair Trade Commission can impose on businesses that have colluded to form cartels.

Under the Law as amended, administrative fines can be imposed on (1) any company or director of a company that files disclosure documents containing false information on important matters (Article 172), (2) anyone who spreads rumors or uses fraudulent means in connection with a securities transaction (Article 173), (3) anyone who has engaged in market manipulation (Article 174), and (4) anyone who has engaged in illegal insider trading (Article 175).

The Law as amended also specifies how the administrative fines for each offense should be calculated. For example, any issuer who sells equities on the basis of disclosure documents containing false information on important matters will have to pay a fine equivalent to 2% of the value of the equities issued (1% in the case of other types of securities) (Article 172, Paragraph 1, Item 1). Similarly, anyone who acquires equities as a result of insider trading will have to pay an administrative fine equivalent to the difference between the two prices (i.e., the price of those equities after the release of the price-sensitive information concerned and the price at which he acquired them) multiplied by the number of shares acquired (Article 175, Paragraph 1, Item 2).

The types of offenses that are now subject to administrative fines as a result of the amendments were already subject to criminal penalties. For example, anyone who filed disclosure documents containing false information on important matters could be sentenced to a maximum of five years' imprisonment, fined a maximum of ¥5 million or both (Article 197). Similarly, anyone who engaged in insider trading could be sentenced to a maximum of three years' imprisonment, fined a maximum of ¥3 million or both (Article 198). These rules remain in force despite the introduction of the new system of administrative fines, and anyone who commits one of the above offenses may be subject to the above criminal penalties as well as a fine.

In addition to the above criminal penalties, anyone who has engaged in market manipulation or insider trading is liable to have the assets acquired as a result of that action confiscated or to pay an additional fine equivalent to the value of those assets (Article 198-2). Also, if someone is sentenced to have the assets acquired as a result of an offense confiscated or to pay an additional fine for that offense, the value of the confiscated assets or the additional fine must be deducted from any administrative fine imposed under the new system if no appeal is possible due to the expiry of the period for filing an appeal (Article 185-7, Paragraph 2). Also, if someone who has been ordered to pay an administrative fine under the new system is later sentenced to have the assets acquired as a result of that offense confiscated or to pay an additional fine for that offense, the amount of the fine must be adjusted by the value of the confiscated assets or the additional fine if no appeal is possible due to the expiry of the period for filing an appeal (Article 185-8, Paragraph 5).[4]

In the United States civil fines and criminal penalties can also be imposed concurrently for the same offense. Although it is possible to take the view that this violates the rules on double jeopardy of both the US Constitution (Fifth Amendment) and the Japanese Constitution (Article 39), precedent holds that the SEC's civil fines

4 Although this adjustment of civil fines to take account of criminal fines is independent of the system of fines used to enforce the Antimonopoly Act, it was proposed in a set of draft amendments to the Act published by the Fair Trade Commission in April 2004. The Commission proposed that half of the amount of the criminal fine should be deducted from the civil fine. See Tetsu Negishi, "Dokusenkinshiho no Kaisei to Giron no Keii" [Reforming the Antimonopoly Act], Jurist, No. 1270, 15 June 2004.

are not criminal penalties and therefore do not risk placing anyone in double jeopardy.[5]

The procedure for imposing administrative fines is similar to that of a court.[6] Cases are normally heard by a panel of three administrative law judges. However, straightforward cases may be heard by a single judge (Article 180). Respondents have the right to be represented by counsel, and cases are held in public (Articles 181 and 182). As authority over the proceedings resides with the prime minister, who delegates his authority to the director of the Financial Services Agency (Article 194-6), the judges' status is, in theory, that of Agency employees. In practice, however, they are likely to have formerly served on the bench.

If a respondent wishes to petition against an administrative fine, he must do so within 30 days (Article 185-18).

2) Significance of the new system

Japan's system of market surveillance has often been criticized for not having the same authority and manpower as its counterpart in the United States and accused of being incapable of winning public confidence in the integrity of the country's securities markets.[7] One of the main arguments of such critics has been that Japan's regulators do not have the same quasi-legal powers to impose civil fines as the SEC in the United States. The introduction of just such a system in Japan should therefore make it easier for the regulators to carry out enforcement actions and, in turn, to win public confidence in the integrity of the country's securities markets.

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5 Compare "The Advantages of a Dual System: Parallel Streams of Civil and Criminal Enforcement of the U.S. Securities Laws," Remarks by Thomas C. Newkirk, Associate Director, Division of Enforcement, September 19, 1998. Although the system of civil penalties used to enforce the Antimonopoly Act has certain elements of an administrative sanction, it is not considered to violate Article 39 of the Japanese Constitution. See Michio Matsushita, "Keizaiho Gaisetsu" [Outline of Economic Law], University of Tokyo Press, 2002, pp. 263-264. Furthermore, in its draft amendments to the Act the Commission indicated that it did not consider that adjusting civil fines to take account of criminal fines and deducting a certain amount from civil fines would be an unreasonably harsh way of ensuring compliance with the Act or violate the Constitution. See the above article by Tetsu Negishi, Footnote 4.

6 The Law as amended (Article 177 and Article 194-6, Paragraph 2, Item 7) gives the Securities and Exchange Surveillance Commission the powers (e.g., to request information and carry out inspections) it needs to investigate cases where a civil fine may be imposed. For further details of the procedure, see Article 178 ff.

7 See, for example, Japan Federation of Economic Organizations, "Shoken Shijo no Kasseika o Motomete — Nihonban SEC (Shoken Torihiki Iinkai) no Setsuritsu o —" [Revitalizing Japan's Securities Markets: Establishing a Japanese Securities and Exchange Commission (SEC)], 21 May 2002, and Yasuhisa Shiozaki, "Toshika Hogo no Kihon ni Tachikaero" [Investor Protection: Back to Basics], Shukan Toyo Keizai [Toyo Keizai Weekly], 3 August 2002.

In the United States the SEC has the authority to impose civil fines for a wide variety of violations of securities regulations.[8] Normally, however, it has to bring civil actions and is only able to bring administrative actions (similar to the proceedings allowed under Japan's amended Securities and Exchange Law) when those charged are registered securities professionals such as broker-dealers and investment advisors.[9] In the case of many civil actions, the defendant settles with the SEC out of court and agrees to pay a civil fine.

In Japan, on the other hand, the regulators can only impose fines for certain types of action: namely, irregular trading activities, with which they have complete authority to deal. However, market abuse, an offense that applies only to investment professionals such as securities companies, is excluded. This is rather odd given that one of the arguments adduced in favor of the new system of fines was that existing, purely administrative sanctions against securities companies (such as a suspension of business) were ineffective and penalized customers as well as the companies themselves.[10]

As it is, the latest amendments to the Securities and Exchange Law only provide for the introduction of a system of fines. In the United States, however, the SEC makes extensive use not only of civil fines but also of injunctions (issued by a federal court under civil proceedings) and cease-and-desist orders (that can be issued against anyone under administrative proceedings) in order to deter violations and their recurrence.[11] Although Japan's Securities and Exchange Law also allows emergency injunctions to be issued by the court (Article 192), this power has never been used. Hopefully, more consideration will be given to this option, including the introduction

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8 The system of civil fines in the United States was introduced pursuant to the Insider Trading Sanctions Act of 1984 solely to combat insider trading but was extended pursuant to the Securities Enforcement Remedies Act of 1990 to cover all types of securities fraud.

9 This authority is relatively new, having been vested in the Commission pursuant to the Securities Enforcement Remedies Act of 1990. Compare Louis Loss and Joel Seligman, "Fundamentals of Securities Regulation," Fourth Edition, 2001, Aspen Law & Business, pp. 1420-1422. In the United Kingdom, the Financial Services Authority, pursuant to the Financial Services and Markets Act 2000, has the power to use administrative proceedings to impose financial penalties on a wide range of violators as well as registered securities professionals in cases of market abuse.

10 Indeed, the FSC Report envisaged that the system of civil fines would be applied to "misconduct by securities companies and other securities professionals" (FSC Report, p. 16). The fact that violations of the rules of conduct for securities companies set out in Article 42 of the Law are not subject to criminal penalties may have made the regulators reluctant to impose a new system of fines similar in nature to criminal penalties. However, the fact that the fines are an administrative penalty means that there should not be any problem in imposing them for conduct that is not subject to criminal penalties. This is a matter that will need to be examined further.

11 The system of cease-and-desist orders that can be issued under administrative proceedings was also introduced pursuant to the Securities Enforcement Remedies Act of 1990.

of cease-and-desist orders that can be issued without a court order, and every effort made to ensure that the new system of fines is accepted.[12]

3) Amendments to rules on civil liability

The latest amendments include one to the rules on the civil liability of those responsible for filing securities registration statements, "securities reports" (the Japanese equivalent of US annual reports on Form 10-K) and other disclosure documents that must be made available for public inspection. Such persons are civilly liable if these documents contain any incorrect information about important matters or if any important information (or any information needed to avoid any misunderstandings) is missing.

The Law has long contained numerous rules on damages for losses resulting from incorrect information contained in disclosure documents (e.g., Articles 17, 22 and 24-4). However, the only rules on how to determine the size of a loss were those concerning securities registration certificates and prospectuses contained in Article 19 (namely, that the loss should be calculated by subtracting the value of the securities at the time the claim for damages is made from their value at the time of purchase). In all other cases, the view was that it would be difficult for the plaintiff to prove the size of any loss.

The latest amendments therefore included a rule for calculating the size of any loss suffered as a result of purchasing securities (other than in an initial or secondary offering) issued by the person responsible for filing disclosure documents during the time that those disclosure documents were available for public inspection.

According to this rule, the size of the loss suffered by anyone who purchased securities during the 12 months preceding the date on which it was announced that the disclosure documents contained incorrect information can be calculated by subtracting the average market value of those securities during the four weeks following the date of the announcement from their average market value during the four weeks preceding the announcement (Article 21-2, Paragraph 2). As a result, individual investors who purchased securities in the secondary market (e.g., when the company's securities report contained incorrect information) and suffered a loss can now claim realistic damages even if they are unable to prove exactly how much they lost.

12 A similar observation is made in the FSC Report (p. 16).

3. Streamlining disclosure

1) Overhauling the prospectus system

(1) Introduction of three-part system

Since December 2000, when investment trusts have had to comply fully with disclosure requirements, a large number of shortcomings with regard to prospectuses have come to public attention. This is because it is even more important to have an efficient system for disclosing information on open-ended investment trusts, which invite subscriptions on an on-going basis, than it is for equities or bonds, for which prospectuses have long been available.

The Law as amended therefore includes rules for a new three-part system, under which the information in prospectuses will be divided into two different categories and only information in the more important category will now be required to be sent to investors. In other words, the prospectus that will have to be sent to investors will only contain information of vital importance. All other information that prospectuses were previously required to contain will now be sent to investors on request (Article 13, Paragraph 1). Any information that is not required to be contained in a prospectus will be disclosed indirectly by means of the securities registration statement, which is available for public inspection.

Finally, although it is not clear from the actual amendments, the FSC Report recommended that this three-part structure should apply only to prospectuses published by investment trusts as all the information currently contained in the prospectuses for other types of securities was of equal importance to investors.[13] This distinction should become clearer when the Cabinet Office implementation ordinances are eventually enacted.

(2) Need for more efficient ways of sending prospectuses

Under the Law as amended, investors who either (1) own the same securities as those referred to in the prospectus or (2) are a cohabitant of someone who has already received or is certain to receive the prospectus do not even have to be sent prospectuses containing information of vital importance if they agree to this in advance (Article 15, Paragraph 2). This not only simplifies the on-going process of inviting subscriptions to one and the same type of investment trust but also avoids the unnecessary duplication of effort entailed in sending multiple copies of the same prospectus to one and the same household.

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[13] See the FSC Report, p. 10.

Nor is unnecessary duplication of effort confined to investment trusts. In initial public offerings of equities, for example, the issuer first has to produce a preliminary prospectus and then has to produce a final prospectus containing exactly the same information except for details such as the issue price when the final terms have been decided. The amendments simplify this process by allowing issuers to state in their prospectuses how final terms such as the issue price will be announced and to publish prospectuses that do not contain these terms (the proviso to Article 13, Paragraph 2 and Article 15, Paragraph 5).

(3) Easing restrictions on sales material

Under the Law as amended, the definition of "prospectus" has also been reworded to make the meaning clearer (Article 2, Paragraph 10).

It was also interesting to see the amendment to the rule forbidding the use, for an initial or secondary offering of securities, of information (or of a prospectus containing information) other than that which should properly be contained in a prospectus (Article 13, Paragraph 5 of the Old Law).

This rule has been understood to mean that the use, for an initial or secondary offering of securities, of information containing "misrepresentations, contradictions or omissions" is forbidden.[14] As a result, inflexible application of the rule (e.g., forbidding the use of information about a security, even if such information was essential to an investment decision) has been a problem. In order to avoid this, the Law as amended contains a new rule (Article 13, Paragraph 5) forbidding the use, in written, visual, or audio form, of materials other than a prospectus that contain false or misleading information. This rule is generally understood to regulate the use of sales material other than prospectuses.

In itself this rule does not appear to make an explicit connection between the contents of a prospectus and those of any other sales material. However, the FSC Report calls for clearer rules that would allow the use, as sales material for which the author would not be civilly liable provided it did not contradict or misrepresent the contents of a prospectus, of price-sensitive information that was useful to investors even if it was not contained in a prospectus. This approach emphasizes the need to ensure that the information does not contradict the information in a prospectus.[15]

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[14] See Investment Trusts Association, Japan, "Toshi Shintaku Nado ni Kakaru Mokuromisho Igai no Toshi Kan'yu Shiryo Nado no Shishin" [Policy on Investment Trust Sales Material Other Than Prospectuses].

[15] See the FSC Report, p. 10.

One type of sales material other than a prospectus that an issuer of securities is allowed to use is a provisional prospectus summarizing the contents of the prospectus proper (Article 13, Paragraph 3 of the Old Law). In the United States the SEC has taken the view that this document alone does not give issuers enough flexibility to provide investors with the information they need to make decisions. As a result, since 2002, the SEC has been pursuing a legislative program to allow issuers of securities to publish documents containing information other than that contained in the legal prospectus.[16] The latest amendments to Japan's Securities and Exchange Law are similar in purpose.[17]

However, even in the United States, the regulators are very cautious about approving sales material containing information that is not in an issuer's prospectus, and, so far, only mutual funds, which are subject to the Investment Company Act of 1940, have been allowed to use such material. When it comes to the Securities Act of 1933, however, the regulators' basic stance is still to encourage issuers to put as much information as investors need in their prospectuses and to discourage them as much as possible from using other information. The reason why an exception has been made for mutual funds is probably simply that the regulators recognized their particular needs (e.g., the need to invite subscriptions on an on-going basis).

In contrast, the Securities and Exchange Law as amended fully recognizes the legal principle that issuers may use materials other than prospectuses. There is, of course, nothing to say that Japanese rules and regulations cannot be more liberal than those in the United States. Nor is it impossible to try to maintain some sort of link between sales material and the contents of a legal prospectus by, for example, understanding the rule in Article 13, Paragraph 5 forbidding the use of material that contains misleading information to refer to material that contradicts the contents of a prospectus.

Nevertheless, the issue of when sales material that differs from the contents of a prospectus is acceptable and when it is not is uncharted territory—even in the United States. Let us hope that sensible business practices will be established that will ensure that this bold piece of legislation benefits both investment professionals and investors.

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16 See Keiichi Ohara and Akiko Nomura-Kobori, "Beikoku ni Okeru Toshi Shintaku no Kokoku Kisei no Kaisei ni Tsuite" [Reform of Mutual Fund Advertising in the United States], Shihon Shijo Kuwotari [Capital Market Quarterly], Winter 2004.

17 The fact that the rules governing provisional prospectuses (Article 13, Paragraph 3) and tombstone advertisements (Article 13, Paragraph 6) have been deleted as a result of the latest amendments probably also reflects this.

2) Overhauling the tender offer system

The tender offer system was established to ensure transparency and fair treatment for existing shareholders when a company is the target of a bid. However, it has been argued that forcing companies to go through the tender offer procedure even when there is an agreement between a bidder and the targeted company has sometimes prevented them from restructuring as quickly as would otherwise have been possible.[18]

The Law has therefore been amended to exclude from the tender offer system companies that have been required to file a securities report simply because they have issued bonds and to allow investment companies that issue investment securities to be included (Article 27-2, Paragraph 1).

4. Rules governing investment partnerships

Under the Law as amended, the rules defining what "securities" are covered by the Law have been amended, and interests in limited partnerships for venture capital investment and similar interests in partnerships and silent partnerships are now regarded as securities under the Law (Article 2, Paragraph 2, Item 3).[19] The aim of these amendments is to ensure that the investor protection rules of the Law are applied to venture capital funds and other investment partnerships that invest in new venture businesses.

When venture capital funds first appeared in Japan in the 1980s, they took the form of general partnerships as governed by the Civil Code. Recently, however, it is common for such funds to take the form of either silent partnerships as governed by the Commercial Code or limited partnerships as governed by the Limited Partnership Act for Venture Capital Investment ("the Act"), which came into effect in November 1998. Venture capital funds are risky. Therefore, in the past, they tended to be packaged in a form that was unsuitable for normal investors lacking specialist knowledge. For example, they often required a large minimum investment (typically ¥100 million). Recently, however, it is not uncommon for venture capital funds to be, in effect, offered for sale to the general public, and, in some cases, this has led to fraud.[20]

The amendments to the Law are closely linked to the amendments to the Act, which came into effect on 30 April of this year. As a result of the amendments to the

18 See the FSC Report, p. 11.

19 These interests are regarded as securities pursuant to the body of Article 2, Paragraph 2 even if they are different from the interests normally specified on investment securities and certificates.

20 See the FSC Report, p. 21.

Act, its coverage, which used to be limited to small unlisted companies, has been extended to companies of any size, including large listed companies. In addition, investments can now be in the form of bonds or monetary claims as well as shares and other equity interests.[21] It was because the regulators felt that the availability of partnerships of this type offering a wider range of investment products would make venture capital funds appeal to a wider range of investors that they also considered it appropriate to make them subject to the investor protection rules of the Law.[22]

While appreciating the need for the Law's investor protection rules to apply to the kind of funds that are likely to enjoy a wide appeal among normal investors, some venture capitalists are worried that the latest amendments may unduly restrict their freedom to originate and sell funds. Hopefully, these fears will be allayed when the details of the investor protection rules are incorporated in government and Cabinet Office implementation ordinances.

5. Overhauling market rules

1) Introduction of a best-execution rule

The amendments to the Law have also entailed a major overhaul of the country's stock market rules in an effort to make them more competitive.

For example, the rule which required any securities company that wished to execute an order for listed shares off the exchange to obtain the express permission of the investor concerned in advance (Article 37 of the Old Law) and the rule which forbade securities companies from executing customer orders by acting as counterparty in a negotiated transaction rather than by having them executed on an exchange (so-called "bucketing") (Article 39 of the Old Law) have both been abolished. Also, a rule has been adopted to allow accredited institutional investors to agree to be exempted from the requirement that customers be informed in advance by a securities company with which they have placed an order whether that securities company will execute the order by acting as counterparty in a negotiated transaction or by having the order executed on a stock exchange (Article 38). Similarly, the rule that forbade securities companies from settling an order without executing it on an exchange has also been abolished (Article 129 of the Old Law).

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21 See Hiroaki Okahashi, "Toshijigyo Yugensekininkumiaiho (Fandoho) no Bappon Kaisei" [The Need for a Radical Overhaul of the Limited Partnership Act for Venture Capital Investment], Junkan Kin'yu Homu Jijo [Financial and Legal Affairs], No. 1708, 5 June 2004.

22 Until the amendments to the Securities and Exchange Law come into force, the Limited Partnership Act for Venture Capital Investment will provisionally regulate who can invest in such partnerships and what the partnerships can invest in.

The author has expressed his view elsewhere that these rules risked hindering the development of proprietary trading systems and made it difficult for securities companies to deal off exchange on their own account.[23] Their abolition is welcome, although the issue of what to do about nonstatutory rules (such as the Japan Securities Dealers Association's SRO rule restricting the pricing mechanisms that may be used for off-exchange transactions during stock exchange hours) remains unresolved.

Another rule that was adopted as part of the amendments was one on the obligation of securities companies to execute customer orders on the best possible terms (Article 43-2). This was to address the concern that such orders would inevitably be executed to customers' disadvantage once deregulation of off-exchange trading made it possible for them to be executed both on and off exchange (e.g., using proprietary trading systems) and in several different locations.[24]

What this means is that securities companies will have to draw up their own best execution guidelines (Article 43-2, Paragraph 1). They will then have to publish these and ensure that they are adhered to (Article 43-2, Paragraphs 2 and 3). Furthermore, when a customer places an order, he will have to be given a document explaining the guidelines, and he will be able to request a document explaining that his order has been executed in accordance with those guidelines once his order has been executed (Article 43-2, Paragraphs 4 and 5).

In drawing up the legislation, the regulators are likely to have referred to similar legislation in the United States (e.g., the SEC's rules). However, we need to remember that the situation in the United States, where there are highly sophisticated electronic communications networks and competition among markets is intense, is very different from that in Japan, where off-exchange trading is only now beginning to take off. Furthermore, in the United States best execution has been largely an equity market issue, whereas in Japan under the Law as amended these rules seem to apply to all types of securities.

How much practical significance these rules will have will therefore depend all the more on how they are fleshed out in the implementation ordinances. When the

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23 See Sadakazu Osaki, "Shokenshijokankyoso o Meguru Hoseijo no Kadai" [The Legal Challenges Posed by Intermarket Competition], Jurist, No. 1227, 15 July 2002, and "Kin'yu Kozo Kaikaku no Gosan" [Mistakes in Reforming the Financial System], Toyo Keizai Shinposha, 2003, pp. 184-185.

24 Even in the United States, where solid progress in promoting intermarket competition has been made, there is disagreement about how best execution should be implemented. For further details, see Sadakazu Osaki, "Regyureshon NMS Teian ni Tsuite — Beikoku ni Okeru Kabushikishijo Kisei Minaoshi no Ugoki" [Regulation NMS Proposal: Moves Towards Overhauling Stock Market Regulations in the United States], Shihon Shijo Kuwotari [Capital Market Quarterly], Spring 2004.

regulators come to do this, hopefully they will bear in mind that the main aim of a best-execution rule is not to impose more compliance requirements on securities companies but to encourage intermarket competition.

2) Overhauling the rules on proprietary trading systems

Proprietary trading systems are electronic trading systems with a function similar to that of the order-matching systems used by stock exchanges. With the enactment of the amendments to the Securities and Exchange Law that followed the enactment of the Financial System Reform Law ("Big Bang") in 1998, operating such systems became one of the activities in which securities companies were allowed to engage (Article 29, Paragraph 1, Item 3).

As proprietary trading systems were considered inferior to the stock markets operated by the stock exchanges, they were originally allowed to use only two pricing mechanisms: (1) applying the same price as that at which orders were executed on a stock exchange or the (then) OTC market or (2) letting customers negotiate a price between themselves (Article 2, Paragraph 8, Item 7). Since November 2000, however, following amendments to an implementation ordinance, they have been allowed to use two more: order matching and price indication.[25] However, only stock markets have been allowed to use the auction method used by the stock exchanges and the market-making method used on the JASDAQ (Article 80, Paragraph 2, Item 2 of the Old Law and Article 1 of the Cabinet Office Implementation Order on Stock Exchanges and Stock Exchange Holding Companies).

The latest amendments therefore added "auction" to the pricing mechanisms that proprietary trading systems may use and deleted the rule that required them to have a stock exchange license in order to be allowed to "use auctions and any other pricing mechanisms stipulated by Cabinet Office implementation ordinance" (Article 2, Paragraph 8, Item 7(i) and Article 80, Paragraph 2).

III. Conclusion

In addition to the points mentioned above, the latest amendments also produced the rules needed to allow more responsibility for inspecting securities companies to be delegated to the Securities and Exchange Surveillance Commission (SESC) (Article 194-6).

[25] See Sadakazu Osaki, "Wagakuni no Atarashii PTS (Shisetsu Torihiki Shisutemu) Kisei" [Japan's New Regulations Governing Proprietary Trading Systems], Shihon Shijo Kuwotari [Capital Market Quarterly], Winter 2001.

The amendments concerning the treatment of investment partnerships as securities, the overhaul of the prospectus system, civil liability, and securities intermediaries will come into effect on 1 December 2004; those allowing more responsibility for inspecting securities companies to be delegated to the SESC will come into effect on 1 July 2005; and the others will come into effect on 1 April 2005. In addition, the amendments provide for a review of the changes five years later with the possibility of further measures if needed (Article 23 of the Law as amended).

The latest amendments are comprehensive and far-reaching. As was suggested above, however, their impact on the market will depend largely on how they are fleshed out in government and Cabinet Office implementation ordinances. Given the importance of the underlying policy objective (i.e., to make Japan's financial system more market-oriented), it is to be hoped that these ordinances will be drafted successfully.