The Investment Services Bill

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On 7 July 2005 the First Subcommittee of the Financial System Council published its latest interim report on the Investment Services Bill. This was in response to the Subcommittee's report of 24 December 2003 ("Towards a Market-Oriented Financial System"), which identified the need to consider how to amend the Securities and Exchange Law so as best to safeguard the interests of investors with regard to both existing investment services lacking such safeguards and new investment services. The earlier report also identified the need in the medium term to establish a broader framework for safeguarding the interests of investors and the possibility of amending the Securities and Exchange Law to cover all investment services.

In 2003, in response to the launch of a number of publicly offered venture capital funds, some of which amounted to fraud, and proposals by the Ministry of Economy, Trade and Industry that the scope of such funds be extended to cover listed companies and monetary claims as well as unlisted companies, the Subcommittee recommended that such funds be covered by the Securities and Exchange Law. As a result, the Law was amended on 2 June 2004 (with effect from 1 December 2004), and such funds are now treated as securities.

However, since 2003, as many different types of investment partnerships besides venture capital funds have been targeted at the retail market and as more investment products appear that are not covered by the Securities and Exchange Law, the need for further measures, including the possibility of amending the Securities and Exchange Law to produce an Investment Services Law, has been recognized.

In 2004, as a growing number of investors fell victim to OTC currency futures trading, the issue of how to regulate this trading became one of the Subcommittee's priorities. This led to the prompt amendment of the Financial Futures Law and the inclusion of OTC currency futures trading in the Law's scope. The damage from currency futures trading occurred at a time when it had still to be decided which government department should regulate this trading and when there was still no legislation for this purpose on the statute book. This lesson only made the need for an Investment Services Law covering a wide range of investment products that much more apparent. The Subcommittee therefore met on 14 occasions to discuss this issue, starting in September 2004, and drew up its latest interim report.

Background

The need for a law covering a wide range of investment products has long been recognized in Japan. There have been several cases where the launch of new investment products has been delayed because of uncertainty about whether they were covered by the Securities and Exchange Law, which only covered those products that it specified. At the same time, a growing number of investors fell victim to get-rich-quick schemes outside the Law's scope. Although the scope of the Law has since been widened to cover many of these schemes (including OTC currency futures trading), this approach has been criticized as "shutting the stable door after the horse has bolted."

There has also been criticism that, with new financial techniques being developed all the time, different financial products may be covered by different financial regulations, with the result that there has been discrimination in cases that are economically similar.

In the United States, the definition of "securities" sometimes includes the notion of an "investment contract." As a result, many different types of get-rich-quick schemes can be regarded as securities and therefore as covered by the same regulations as these. In the United Kingdom, the Financial Services Act of 1986 extended the scope of the law to cover a wide range of financial services other than deposits and insurance products. When the Act was amended in 2000 and renamed the Financial Services and Markets Act, its scope was extended to cover even these products.

In July 1997, when there was a lull in the debate about reforming Japan's financial system in line with the aims of the Big Bang deregulation program and the lessons to be learnt from other countries, a joint study group set up at the initiative of the government departments involved in the debate ("Discussion Group on New Financial Trends") met for the first time to discuss the need for a comprehensive regulatory framework. This reflected the realization that a fresh look needed to be taken at investor protection in the light of the deregulation that was taking place in Japan's financial services industry as a result of the Big Bang program.

Building on the work of the study group, the First Subcommittee of the Financial System Council met for the first time on 8 August 1998 to discuss the drafting of a "Financial Services Law" along the lines of the United Kingdom's Financial Services Act. In its first interim report published on 6 July 1999 the Subcommittee recommended that the scope of a new regulatory framework should cover a wide range of financial products, including not only traditional ones such as bank deposits, insurance and loans but also derivatives and collective investment schemes.

The Subcommittee's aim was to continue its discussions and to submit a Financial Services Bill based on its first interim report in the spring of 2000 so that a Financial Services Law could come into effect by April 2001, the deadline for completing the Big Bang program. However, this plan was shelved as a result of disagreements with the government departments involved. At a press conference held on 8 October 1999, the Subcommittee's chairman, the late Professor Shoichi Royama, said that the

Ministry of Finance's grand vision of the bill had been an illusion.[1] As it was, all that the Subcommittee was able to propose when it published a second interim report on 21 December 1999 was the Financial Products Sales Bill and amendments to the Special-Purpose Company Law and the Securities Investment Trust Law (renamed the Law on Investment Trusts and Companies).

Although this was followed by proposals for a Financial Services Bill from various quarters, nothing specific emerged until the Subcommittee published its above-mentioned report in 2003. In the report the term "Investment Services Law" is used instead of "Financial Services Law." This reflected the aim of the government-approved policy document of the Council on Economic and Fiscal Policy ("Structural Reform of the Japanese Economy: Basic Policies for Macroeconomic Management") published in June 2001: namely, to encourage retail investors to switch some of their financial assets from bank deposits to investment products. Given this aim, it was felt that a broader regulatory framework was required.

The Scope of the Broad Definition of "Investment Products"

The Subcommittee's latest interim report points out that, whereas financial products and trading are currently governed by a number of separate laws (e.g., the Securities and Exchange Law, the Investment Advisory Law, the Investment Trust Law and the Financial Futures Law), and investment professionals have to be registered, licensed or jointly licensed under the appropriate law or laws, an Investment Services Law would cover all financial products and all investment activities, thereby doing away with the need for separate registration.

The interim report also points out that, by requiring all investment service professionals to observe a code of conduct with a common fiduciary responsibility, an Investment Services Law would reduce the need for the kind of detailed conflict of interest provisions currently required for professionals who engage in more than one activity.

However, while the report raises a number of important points on matters such as the future of the markets and enforcement, the most controversial issue is the proposal to increase the scope of an Investor Services Law.

As was mentioned above, the debate about an Investment Services Law originated from the desire to create a comprehensive regulatory framework that incorporated the arguments in favor of a Financial Services Law. The report therefore proposes that the scope of financial products should be extended to avoid a situation where (1) some products are not covered by the common regulatory framework designed to safeguard investor interests or (2) similar products are subject to different legal provisions.

In other words, the proposal is to draw up as comprehensive a list as possible and to enable the regulator to make detailed exceptions and inclusions as financial conditions change.

[1] Nihon Keizai Shimbun, 11 October 1999.

In the appendix of the report, there is a proposed list of investment products which is far more extensive than the current list of securities stipulated in the Securities and Exchange Law. This list includes products not covered by the Securities and Exchange Law: for example, bonds issued by cooperatives, educational institutions and hospitals; asset-backed loans (ABLs); syndicated loans; beneficial interests in trust other than bank loans; commodity funds; equity in partnerships other than investment partnerships; collective real estate investments; and wrap accounts.

Activities such as recommendation and sales, investment management and investment advice and custody would be considered "investment services," and the same rules that currently apply under the Securities and Exchange Law and the Investment Advisory Law (governing, for example, disclosure, business conduct, self-regulation, safety nets, markets and unfair trading) would form the basis of the new law.

Similarly, commodity funds and equity in partnerships would all be considered "collective investment schemes" and be made subject to the same rules (governing, for example, (1) registration, (2) asset management, (3) qualification requirements for fund managers, (4) fiduciary responsibility and measures to prevent conflicts of interest, and (5) investment statements).

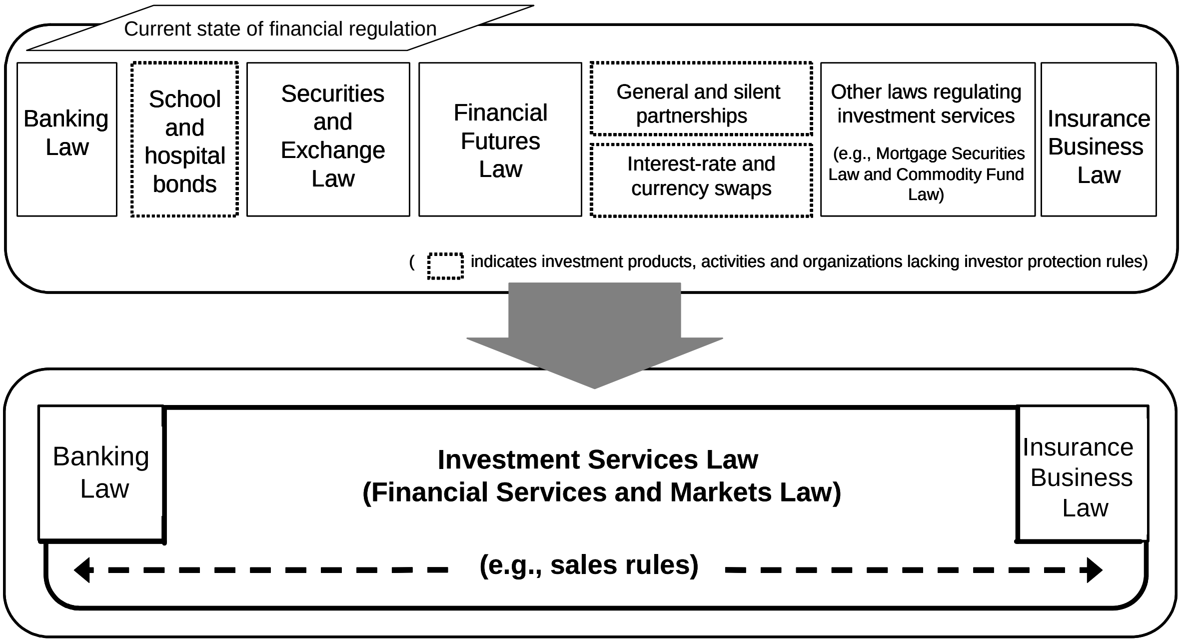
The report also recommended that further thought should be given to the treatment of bank deposits, insurance products and mutual aid schemes under the new law and to how this would affect their treatment under existing laws such as the Banking Law and the Insurance Business Law.

In particular, the new law would need to cover (1) bank accounts that were linked to the performance of the stock market or contained embedded derivatives and (2) insurance products (such as variable insurance and variable annuities) that repackaged investment trusts. In the case of many such financial products, investors would find it difficult to decide to what extent they were investment products as opposed to bank deposits or insurance products. The report therefore proposes that the rules governing recommending and selling such products should be brought into line with those in the Investment Services Law.

This would entail combining in the Investment Services Law as much general law of a similar content on selling and managing investments as possible. This would also apply to the Law on the Sale of Financial Products.

Figure 1 is a schematic diagram of the scope of the Investment Services Law. It shows how the new law would cover not only a wide range of investment products not included in current laws (such as the Securities and Exchange Law) but also the sale of bank deposits and insurance products.

Figure 1 The Direction of Financial Reform



Source: Financial Services Agency.

A Repetition of What Happened Six Years Ago Should Be Avoided

By extending in this way the scope of the products that would be covered by the Investment Services Law, the report has antagonized some of those involved with products that were either not covered by existing laws or were covered by other laws.

Products, such as commodity futures, that are listed on an exchange and whose prices change constantly as they are traded in response to orders placed by ordinary investors are simply investment products. While some may argue that the connection with real goods means that these are not "investment products," this argument does not stand up as far as trading of such products is settled in cash, when it is essentially the same as trading of financial products in that it amounts to a cash flow. The main reason for objecting to the inclusion of such trading in the Investment Services Law under discussion at the Financial Services Agency is that it is already covered by other laws (often laws that have recently been amended) that are the responsibility of other government departments.

Some may argue that there is no problem even if products that are similar to investment products are regulated by other laws that are the responsibility of other government departments so long as the same degree of protection is afforded to investors. However, if we think about the kind of financial regulation that Japan needs, we also have to think about the cost. It is surely natural to assume that, if regulations are essentially the same, they should be covered by a single law that is the responsibility of a single government department. Nor can people be expected to know which investment products are covered by which regulations that are the responsibility of which departments when they trade these products. The debate needs to conducted from the point of view of ordinary people and investors.

Similarly, bank deposits and insurance products have the same characteristics as other investment products inasmuch as they are offered for sale to the general public even though banks and insurance companies may claim that they are different from investment products. There is therefore no reason why the rules that govern them should be totally different from those that govern the sale of investment products. Bank deposits linked to derivatives and variable insurance or variable annuities linked to investment trusts have, if anything, more similarities than differences. It is therefore inappropriate for them to be subject to different rules.

Although it was expected from the outset that there would be wide-ranging opposition, the fact that such opposition has been vociferous ever since the latest interim report was published is reminiscent of what happened in 1999 and therefore a cause for concern.

As was mentioned above, when the First Subcommittee of the Financial System Council published its first interim report in July 1999, its objective was a Financial Services Law covering as wide a range of financial products as possible. After only a few months, however, this idea was abandoned in favor of a less ambitious, partial reform, which was labeled "the first stage towards a Financial Services Law in Japan."

In other words, it was clear six years ago what direction Japan should seek to go in. Nor did the Subcommittee's discussions leading up to its latest interim report contain a wealth of new insights that transcended the discussions that went on for two years from the first meeting of the Discussion Group on New Financial Trends to the publication of the Subcommittee's first interim report. Most of what there is to say about the subject was said six years ago.

If the second interim report published six years ago marked "the first stage towards a Financial Services Law in Japan," the question now is how many stages nearer we are to achieving that goal (or how big a step we still need to take). In other words, the latest round of discussions would not have been possible if six years had not passed since the first round was held. Similarly, given that it takes at least a year to put a law on the statute book in Japan, the degree of protection afforded to investors in Japan will remain vastly inferior to that afforded to investors in other industrialized nations for many years to come unless the most is made of the present opportunity to draft as comprehensive a law as possible.

If a law had been passed when the Subcommittee's first interim report appeared, some of the damage to investor protection that has since occurred (e.g., as a result of currency futures trading) could have been avoided. Let us hope that those who seek to prevent such a law reaching the statute book this time are prepared to take responsibility for similar consequences.

The Need to Ensure That There Are No Legislative "Discontinuities"

No one would disagree with the principle that similar rules should govern similar products. The problem, however, is that there are very slight differences between many products and that these differences tend to be used as ammunition by those opposed to an Investment Services Law.

One example of this is the development of syndicated loans as a product midway between bank loans and securities. As a result of this development, there now exists a seamless credit market extending from traditional loans at one end to corporate bonds at the other. Hopefully, this will encourage interest rate arbitrage between the two and make the credit market as a whole more efficient.

The latest interim report includes syndicated loans among the investment products it lists. However, syndicated loans have features in common with both securities and private-treaty loans. Indeed, it is this hybrid nature that might cause some to object to calling them investment products. At the very least, there is likely to be strong opposition to any attempt to impose on all syndicated loans the same rules (e.g., on disclosure) as apply to corporate bonds.

The possibility of applying the same rules to syndicated loans as apply to securities has also been the subject of debate in the United States, where those involved in loan syndication are seriously considering how to keep syndicated loans distinct from corporate bonds in order to prevent this happening.[2]

This reflects the fact that securities regulation is considered to be much tougher than the rules that govern traditional bank lending. Since the collapse of Enron, in particular, the rules governing securities have been tightened further, and enforcement by agencies other than the Securities and Exchange Commission (e.g., the New York State Prosecutor's office) has also increased.

In other words, the fact that the regulatory burden varies considerably, depending on whether an investment product is regarded as a security or not, has led those involved to focus on the extent to which a product is different from a security in an effort to avoid being made subject to securities regulation.

Defining syndicated loans as investment products would also make Japan's credit market and the rules governing it more seamless. More generally, the more seamlessly the degree of regulation can adjust to the extent to which a syndicated loan or some other product is an investment product, the better. Otherwise, opposition to the implementation of an Investment Services Law will continue, and unproductive efforts to avoid being made subject to the same rules as investment products will stymie efforts to innovate and to improve customer service.

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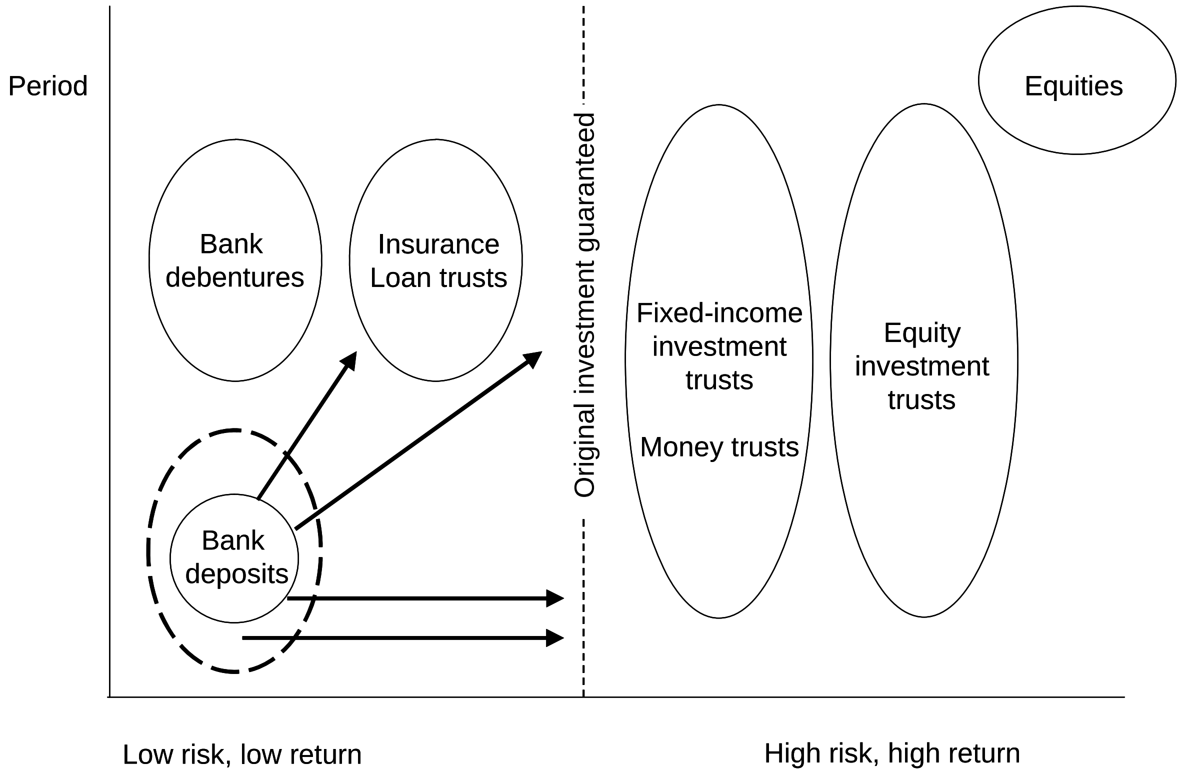
2 See Yasuyuki Fuchita, "Shinjiketo Ron Shijo no Kakudai to Shoken Kisei" [Securities Regulation and the Growth of the Syndicated Loan Market], Shihon Shijo Kuwotari [Capital Market Quarterly], Summer 2005.

This process of creating a seamless regulatory framework for not just the credit market but all financial products has been going on for some time and will, hopefully, continue. This was the approach adopted, for example, by the Discussion Group on Bank Deposits when it met in 1994-1995 at the behest of the Ministry of Finance to discuss ways of improving Japan's banking rules. Its recommendation that there should be as few discontinuities between financial products as possible and an entire spectrum of products (ranging from deposits, debentures, loan trusts and insurance to bond investment trusts, equity investment trusts and equities) to cater for the wide needs of customers raised a few eyebrows in the debate about how to regulate the different sectors of Japan's financial services industry (Figure 2).

Figure 2 Seamless System of Financial Products



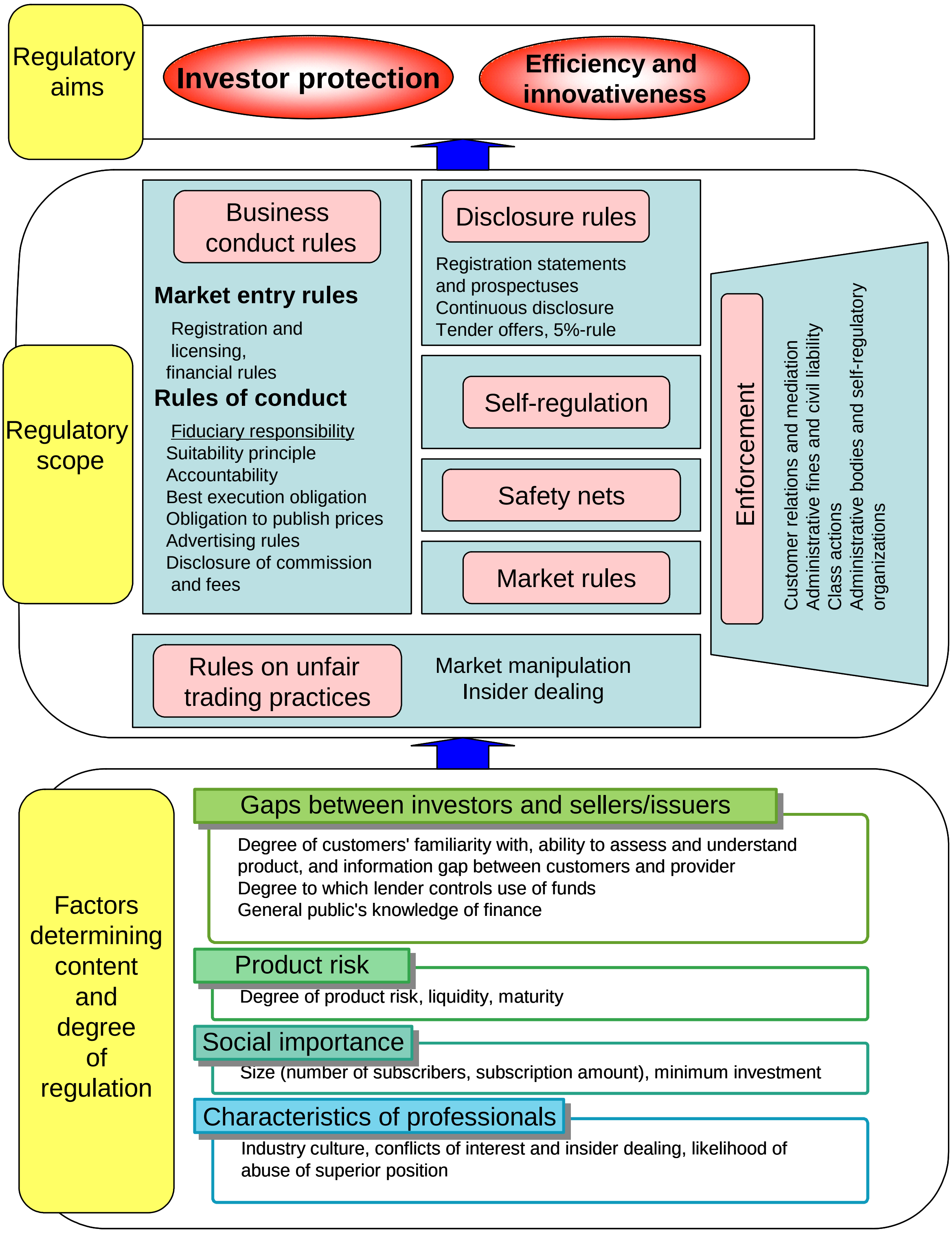
Source: Nobuyuki Kinoshita, "Yokin o Kangaeru Kondankai ni Tsuite" [Discussion Group on Bank Deposits], Fainansu [Finance], Ministry of Finance, August 1995.

The extent to which a product should be regarded as an investment product would presumably depend on a wide range of factors, including the risk of capital loss, whether or not retail investors could buy it, how liquid it was, how many investors could subscribe to it, the minimum investment amount, the total investment amount, and its maturity.

The extent to which rules governing disclosure, market entry, business conduct, markets and unfair trading practices were enforced for each investment product and each sector of the investment services industry would depend on factors such as these. The regulatory framework would shift in line with these rules and the way they were enforced. This, in turn, would cause a shift in the impact of the rules on the degree of protection afforded to investors as a whole and on the efficiency and innovativeness of the market.

Those markets that lack investor protection cannot expect to remain either efficient or innovative. However, an overemphasis on investor protection may result in a trade-off where market efficiency and innovativeness are lost. It is therefore important when choosing a regulatory framework to try to achieve the combination of these two variables (namely, investor protection and market efficiency/innovativeness) that maximizes social utility (Figure 3).

Figure 3 Regulatory aims and scope, and factors determining content and degree of regulation



Source: NICMR.

The regulatory systems of banking, insurance, commodity trading and securities trading have all developed separately. What is needed to bridge the gaps between them is an Investment (Financial) Services Law.

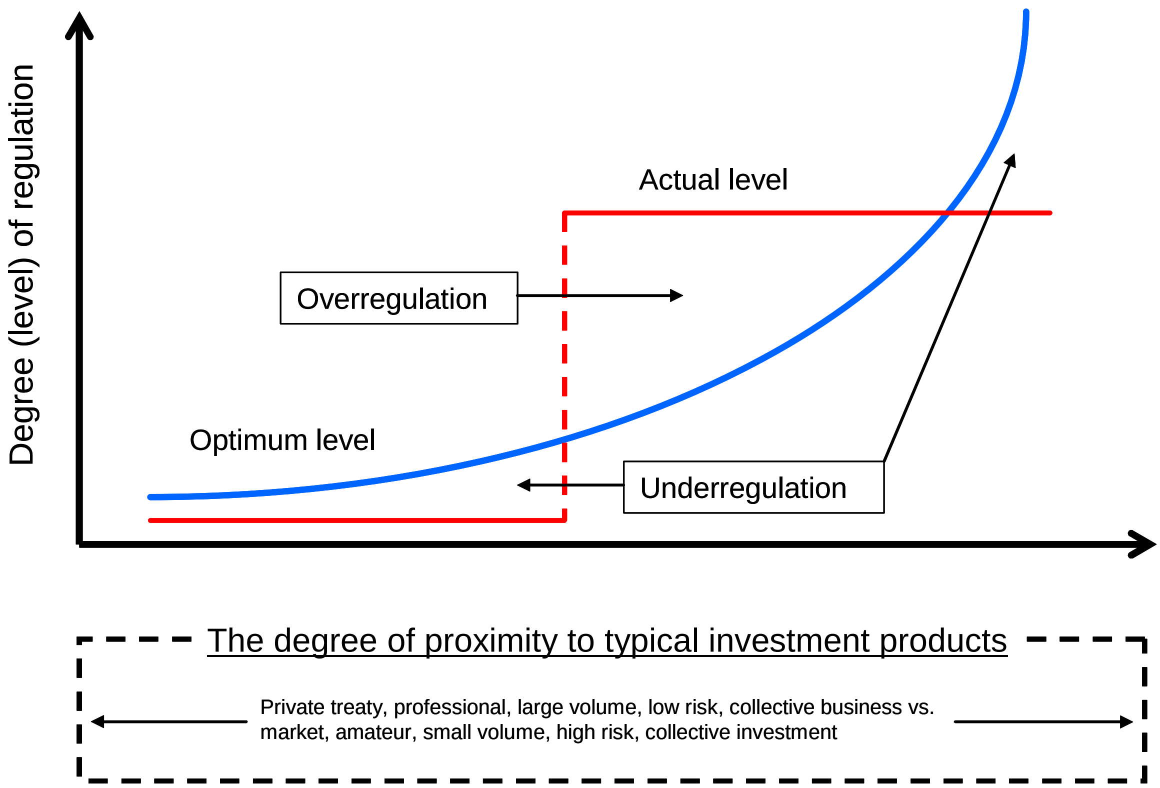
It is virtually impossible to tell in advance which combination of rules will produce the best solution for which type of trading. The only viable approach is trial and error.

All that can be said for certain is that, if one is unwilling to proceed by trial and error, discontinuities will remain, and both investor protection and efficiency/innovativeness will be lost. As the Subcommittee's first interim report showed six years ago, the only way to proceed is to establish a comprehensive regulatory framework encompassing as many products as possible and then to adjust this in order to find the best combination of rules possible.

In order to achieve this, it may be necessary to ensure that the initial regulatory burden on products that were originally outside the scope of the Securities and Exchange Law does not increase inordinately.

Nor is it necessarily the case that the degree to which products that used to be outside the scope of the Securities and Exchange Law are regulated is inadequate. If anything, the degree to which securities are regulated may be excessive and need to be reduced (Figure 4).

Figure 4 The Problem of Different Degrees (Levels) of Regulation



Source: NICMR.

From the very outset of the Subcommittee's proceedings, the chairman, Professor Hideki Kanda, emphasized the need for a flexible regulatory framework that would encompass a wide range of financial products. Such an approach would seem similar to the author's notion of a "seamless regulatory framework."

Hopefully, when the discussions on drafting an Investment Services Law begin this autumn, they will not be bedeviled by the kind of debate on the pros and cons of encompassing "a wide range of financial products" that occupied the Subcommittee six years ago and will focus instead on how to put the notion of a "seamless regulatory framework" or "flexible regulatory framework" into practice.