The Latest Report on the Investment Services Bill

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On 22 December 2005 the First Subcommittee of the Financial System Council published its latest report on the Investment Services Bill. The bill, which aims to improve investor protection and make Japan's financial markets more dynamic by overhauling the current, compartmentalized approach to financial regulation and covering a wide range of financial products, is now set to become law in the spring.

I. Why an Investment Services Law?

1. Background

The need for a comprehensive set of rules covering a wide range of financial products was recognized by the June 1997 reports of the Securities and Exchange Council and the Financial System Research Committee on implementing the Big Bang program of financial reform. However, the publication of the latest report brings this goal a step nearer realization.[1]

The original idea was to have a comprehensive Financial Services Law that would also cover bank deposits and insurance. However, since September 2004 the discussion has focused on drafting a comprehensive Investment Services Bill that would cover only investment products.

There were two reasons why its was decided to narrow the scope from all financial products to just investment products. One was the absence of applicable law in some cases or the fact that a variety of problems involving investment products have occurred because of legal discrepancies. The other was the campaign to encourage people to save less and invest more. As this entailed the possibility of a shift from traditional assets such as bank deposits and insurance to investment products, it was felt that legislation was a matter of urgency.

[1] For an account of earlier discussions about the Investment Services Bill, see Yasuyuki Fuchita, "The Investment Services Bill," Nomura Capital Market Review, Autumn 2005.

2. The bill's coverage

According to the Subcommittee's report, the bill will cover all products with an element of "investment risk." The report defines these as products (1) with a financial commitment and the possibility of a financial or other return (2) which are linked to assets or benchmarks and (3) involve greater risk (namely, the possibility of a capital loss because of market or credit risk) in the hope of gaining a higher return. The bill will apparently also take into account (4) whether the business or other operation funded by the investment is run by other people[2] and (5) the characteristics (e.g., knowledge, experience and risk-taking capacity) of typical product users.

The bill will therefore cover not only marketable securities covered by the Securities and Exchange Law and transactions covered by the Financial Futures Law but also products with an element of investment risk such as foreign currency deposits, yen-denominated derivative deposits,[3] variable insurance and annuities, foreign currency insurance, trusts with a relatively high degree of investment risk,[4] and beneficial interests in trust. The Subcommittee also considered it appropriate that the bill should cover a wide range of commercial derivative transactions (e.g., interest rate and currency swaps, credit derivatives and weather derivatives).

In view of (4) above, the Subcommittee decided that limited liability partnerships (LLPs) should be covered by the bill in the same way as they are currently covered by the Securities and Exchange Law, provided some of the partners are not involved in the business full-time. Similarly, it decided that it would not necessarily be appropriate for general and limited partnerships to be regarded as investment products as they assume that partners will be directly involved in the partnerships' activities.

On syndicated and asset-backed loans the Subcommittee decided that, since the majority are provided by financial institutions that specialize in lending and since the terms and the disclosure details are negotiated individually with borrowers, they should not be covered by the bill. This is consistent with criterion (5) above.

On financial products governed by other laws and regulations (namely, commodity funds, collective real estate investments, commodity futures and non-Japanese futures

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2 The view is that those who not only invest in a business but also make decisions that affect it are business partners rather than investors in need of protection and should therefore not be covered by the bill.

3 The Subcommittee considered it appropriate to regard as investment products those where a capital loss could occur as a result of a cancellation penalty even if the yen-denominated principal amount was guaranteed.

4 For example, products such as principle-guaranteed trusts, charitable trusts, and assets held in trust for purely management purposes will not be covered.

contracts), the report says only that the Subcommittee considered that their relationship to the Investor Services Bill needs to be sorted out.

As far as syndicated loans are concerned, an alternative approach would have been to have the bill cover highly liquid loans with similar characteristics to corporate bonds[5] but to exclude normal syndicated loans. Similarly, it is unfortunate that the bill will not explicitly cover commodity funds and commodity futures, as these, in terms of risk and return, are simply investment products. In addition, they have been at the center of numerous cases involving investor protection. This decision would appear to be the outcome of a bureaucratic turf war rather than a move to increase investor protection. It is unfortunate that departmental interests should have been allowed to take precedence over the national interest in such a brazen way.

Nevertheless, the Investment Services Bill as proposed by the report does include some of the products (e.g., variable annuities sold by banks and schemes involving sleeping partnerships) about which the National Consumer Affairs Center of Japan (NCAC) has received numerous complaints from consumers. If the bill that becomes law is in line with the report's proposals, this situation should improve. The bill should also (see below) lead to greater deregulation.

II. The Significance of the Bill in Terms of Investor Protection

The significance of the Investment Services Bill is that it will extend the kind of protection provided by the Securities and Exchange Law to new areas, including sales and sales promotion, asset management, investment advice, collective investment schemes, and the rules governing different financial services.

1. The protection offered investors by the rules governing different financial services

Anyone involved with investment products in a professional capacity has to be registered with or approved by the appropriate regulator, which may take action if its rules are violated. Although the Financial Products Sales Law covers a wide range of financial products, it can only be used in civil proceedings and is not designed to allow regulators to take action in order to protect investors' rights. As a result, there have been cases where victims have claimed damages from investment professionals only to find that the latter have been unable to pay.

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5 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.

The adoption of rules for different financial service providers requiring them to meet certain minimum financial standards (e.g., minimum capital requirements, net worth requirements, and capital adequacy requirements) in order to be registered or approved will reduce this problem. Also, the Investment Services Bill may contain restrictions on who may be a principal shareholder of a company in order to prevent undesirable persons from exercising a bad influence on financial service providers. In addition, the Subcommittee's report indicates that the bill may extend the requirement for financial professionals to be registered to representatives of financial service providers other than securities companies and financial futures traders, and give regulators powers to regulate subcontractors.

2. The protection offered investors in the area of sales and sales promotion

The Investment Services Bill will include the following provisions designed to improve investor protection against misselling and misleading sales promotion. First, sales representatives will be required to be accountable for their actions[6] and to act fairly and in good faith. The regulator will be able to take action against failure to comply with the accountability requirement, which currently (i.e., under the Financial Products Sales Law) has only the force of civil law. Second, the existing requirements under the suitability principle (namely, that an investor have the necessary knowledge, experience and capital) will be extended to include the reason for and objective of the investment.[7] Third, in cases (such as currency futures trading) where it would be unrealistic to expect service providers to observe the suitability principle, they will not be allowed to make unsolicited solicitations.[8] Fourth, service providers will have to inform clients of their commission.

3. The protection offered investors in the area of asset management and custodian services

In order to improve investor protection in the area of asset management and investment advisory services, the Investment Services Bill will require service providers to provide clients with performance statements and to fulfill their fiduciary responsibilities (e.g., by not engaging in transactions that involve a conflict of interest or lending cash/securities, by exercising duty of care and duty of loyalty, and by

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6 The Subcommittee considered it appropriate, for example, to exempt salesmen from the requirement in the code of conduct to provide clients with a written explanation in advance in cases where giving clients a copy of the prospectus ensured that the necessary information was provided.

7 Some members of the Subcommittee took the view that, under the suitability principle, consideration should be given to granting civil authority (e.g., to estimate the amount of any loss).

8 Although some members of the Subcommittee who attached particular importance to safeguarding consumers' interests felt strongly that extensive use should be made of a provision against unsolicited solicitations, the Subcommittee as a whole took the view that it should only be applied to those products currently covered (i.e., currency futures trading and similar products).

managing and controlling fiduciary properties by themselves based on each trust agreement with beneficiaries). In order to improve investor protection in the area of custodian services, the bill will require service providers to ringfence assets under management.

4. The protection offered investors in the area of collective investment schemes (funds)

When the Securities and Exchange Law was amended in 2004, investment partnerships were classified as quasi-securities and required to comply with the Law's disclosure requirements. Business partnerships, however, were excluded as investors in such partnerships tend to be business partners rather than investors. In its report the Subcommittee recommends that such schemes should also be covered by the Investment Services Bill as they are increasingly being offered for sale to retail investors as a normal investment product, sometimes with unfortunate consequences, and that they should be subject to disclosure requirements, the rules and codes of conduct governing the selling and promotion of financial services (in the case of direct public offerings, codes of conduct), and codes of conduct governing asset management, as well as registration (including the possibility of ex-post registration), ringfencing, fiduciary responsibility, measures to prevent conflicts of interest, regular client reporting, reporting to the regulator when requested, and unannounced inspections.

5. Other measures to protect investors

The report also recommends that the Investment Services Bill should ensure that self-regulating organizations have the same powers as the most archetypal such organization in Japan—namely, the Japan Securities Dealers Association—and that arrangements should be made to enable advice and mediation to be provided regardless of which investment products are involved.

The report also makes a number of other recommendations, including (1) that the accountability requirements of the Financial Products Sales Law be extended to include an explanation of trading procedures and that, in calculating compensation, consideration be given to using case law to implement the Law,[9] (2) that enforcement

[9] Some members of the Subcommittee took the view that methods of enforcement needed to be considered in order to make good any losses suffered.

be improved (e.g., in order to prevent fake orders), and (3) that more courses on finance and economics be run for the benefit of investors.[10]

III. Putting Deregulation into Practice

Because, as we have seen, one of the aims of the Investment Services Bill is to improve investor protection, one sometimes hears the view that this will lead to more regulation of financial services. The main point, however, is that the bill should remedy some of the shortcomings of Japan's existing, compartmentalized financial regulations, which have tended to be lacking in efficiency and innovation. Moreover, the bill aims to establish a flexible system where rules are only adopted if necessary—not for their own sake. In fact, in many areas the effect should be deregulation.

1. The deregulation of different financial services

Traditionally, financial services in Japan have been defined in terms of investment products. What the Investment Services Bill aims to do is to regulate the selling, sales promotion, asset management and advice, and custodian services for a wide range of financial products traditionally defined as financial services and investment products.

For example, under the current law, anyone wishing to operate as both a securities broker/dealer and a discretionary asset manager needs (1) to be registered as a securities broker/dealer, (2) to report that he is also operating as an investment adviser and discretionary asset manager, (3) to be registered as an investment adviser, (4) to be approved as a discretionary asset manager, and (5) to be permitted to operate as a securities broker/dealer, as well. Not only that: the Securities and Exchange Law and the Investment Advisory Law each have their own rules for avoiding the kinds of conflicts of interest that may arise when someone provides several different financial services. It has often been said that such legal compartmentalization has made it unnecessarily difficult for financial service providers in Japan to provide more than one type of financial service.

The Investment Services Bill will divide financial services into three categories: Category 1, Category 2 and intermediary services. Anyone registered as a Category 1 provider will be able to provide all the different types of financial service and all the different types of investment product. A Category 1 provider will have to satisfy the

[10] While some members of the Subcommittee took the view that the Investment Services Bill should incorporate rules stipulating the responsibility of the state and the Financial Services Agency for organizing courses on finance and economics, other members took the view that, although such courses were important, there was no sense in legislating on this.

same requirements as securities companies and financial futures traders currently have to satisfy (i.e., on minimum capitalization, net worth and capital adequacy).[11] On the other hand, a Category 2 provider (i.e., a company dealing in illiquid products or providing asset management and investment advice) will not have to satisfy requirements on capital adequacy or net worth, while intermediaries (i.e., companies acting as go-betweens on behalf of other financial service providers) will not have to satisfy net worth requirements.

The bill will also enable financial service providers to offer a wider range of services. Category 1 providers, for example, will be able to do this while retaining the right to provide ancillary services and services that need to be either reported to or approved by the Financial Services Agency. Category 2 providers of asset management/advice services and investment trust management companies, who, under the current system, have to obtain the approval of the Financial Services Agency in order to provide other financial services, will, when the Investment Services Bill becomes law, be able to provide ancillary services and services that need to be either reported to or approved by the Agency. This is in accordance with the aim of deregulating financial services. Category 2 providers (other than asset management companies) and intermediaries will not be subject to any restrictions on the services they may diversify into.

2. The deregulation of sales and sales promotion

In addition to accredited institutional investors the bill will allow other legal persons as well as individuals who satisfy certain conditions to opt to be treated as professionals when being sold or offered advice on investment products.[12] This will reduce the accountability of sellers and those offering investment advice.

3. The deregulation of disclosure

Under the current rules on disclosure, financial institutions are regarded as accredited institutional investors, while nonfinancial companies can register to be treated in the same way provided they satisfy certain conditions. In its report, however, the Subcommittee recommends that the criteria for institutional investors should be revised to take account of factors such as actual trading volume to allow more investors to register as institutional investors. For example, the report recommends that, in addition to nonfinancial companies, consideration should be given to regarding legal persons and individuals that satisfy certain conditions as institutional investors. Moreover, it recommends that the ceiling on the number of institutional

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11 Only Category 1 providers will be permitted to engage in OTC derivative trading and lead underwriting, offer custodian services, and operate proprietary trading systems.

12 Many of the Subcommittee's members took the view that there should be strict conditions on allowing individuals to be treated as professional investors.

investors that can be targeted by a small number private placement (currently 250) should be either raised significantly or abolished.

The bill will also divide investment products into two types with different disclosure requirements: "corporate-type financial products," whose value, like that of traditional securities, will depend on the creditworthiness of the issuer, and "asset-type financial products," whose value, like that of funds and asset-backed securities, will depend on the assets owned by the issuer. In other words, in the case of asset-type financial products, the information that will need to be disclosed will be about the asset manager and the assets underlying the product. Similarly, a flexible approach will need to be adopted to the documents that are required rather than simply copying the procedures used for traditional securities.

Furthermore, when the bill becomes law, disclosure will have to reflect differences in the liquidity of investment products. For example, if the number of investors holding a security that has been issued by public offering subsequently declines and the security becomes illiquid, it is proposed that the scope for exemption from the requirement for continuous disclosure be extended. Similarly, it is proposed that any investment products that suffer from a loss of liquidity as a result of selling restrictions should be exempted from the requirement that their disclosure details be made available for public inspection.

Finally, the report proposes that investment products which prospective investors are already informed about (or whose issuers prospective investors are already informed about) or could easily obtain information about should be exempted from disclosure requirements provided they satisfy certain conditions.[13]

4. Regulatory exemptions for collective investment schemes and derivative transactions

As we have already seen, collective investment schemes will be subject to new regulations to prevent the kind of abuses that many retail investors have fallen victim to in recent years. However, the rules governing funds aimed at professional or only a limited number of investors will be simplified. Similarly, simpler rules will apply to derivative transactions aimed at professional investors.

[13] When all the shares a company is issuing (e.g., as part of a stock option plan for officers and employees or when the company has just been established) are underwritten by its founder(s), there have been restrictions (e.g., in government ordinances and in guidelines) on the disclosure requirements for shares issued to employee stock ownership plans that meet certain conditions. One of the aims of the bill is to make these conditions explicit.

IV. Changes Affecting Stock Exchanges

Japan's stock exchanges have found themselves at the center of a debate not only about whether they should increase their range of products but also about their self-regulating function and the rules governing their principal shareholders. This followed controversy last year over how stock exchanges should apply their delisting rules and, in the case of demutualized stock exchanges, controversy over some of the demands of some of their shareholders.

1. Stock exchange products

As the Investment Services Bill will allow a wide range of financial products to be covered by a comprehensive set of rules, the Subcommittee considered it appropriate that stock exchanges should be allowed to extend their products in line with the new legislation.

2. Stock exchanges' self-regulating function and the way they are organized

Because of the risk of a conflict of interest between the profit-seeking goal and self-regulating function of demutualized stock exchanges, there have been calls for such stock exchanges to hive off their self-regulating function from their other activities and to operate it independently. However, the Subcommittee considered that the best solution might be for the those who establish a market to choose whether to hive off the exchange's self-regulating function or to make it more independent within the same organization.

3. The rules governing a stock exchange's principal shareholders

Under the current Securities and Exchange Law, no one except a stock exchange's holding company is normally allowed to own more than 50% of a stock exchange's voting rights, and the permission of the regulator must be obtained in advance in order to hold between 20% and 50% of the voting rights.

In the United States, it has been proposed that steps should be taken to prevent a minority of shareholders from obtaining most of the voting rights in the New York Stock Exchange's holding company when this is listed. Similarly, in Japan, the Subcommittee has proposed that appropriate action be taken, if necessary. While some members of the Subcommittee considered that the matter should be regulated by law rather than an exchange's articles of incorporation, others considered that it would be inappropriate to amend the Securities and Exchange Law again so soon after it was amended in 2003 to allow a single shareholder to acquire and own more than 5% of a stock exchange's voting rights—the previous limit.

V. Other Important Points

When the Investment Services Bill is passed in the spring, the following important reforms, which, until now, have been debated in the context of the Securities and Exchange Law, will be included in either the new law or the cabinet orders that will accompany it:

(1) In accordance with the June 2005 recommendations of the Financial System Council's Working Group on Disclosure, listed companies will be required to report on a quarterly basis.[14]

(2) In accordance with the December 2005 recommendations of the Business Accounting Council Subcommittee on Internal Controls, listed companies will be required to have the effectiveness of their internal controls on financial reporting assessed by their management and audited by a certified public accountant. At the same time, management will be required to check that the contents of their annual securities filing are correct.

(3) In accordance with the December 2005 recommendations of the Financial System Council Working Group on Takeover Bid Procedures, the 5%-rule reporting system and the procedures for takeover bids will be revised.

VI. The Outlook

Since the bill is intended to be an all-encompassing piece of legislation, it is unfortunate, as we have seen, that it proved impossible to incorporate clear provisions for commodity funds and commodity futures trading.

For that reason alone the bill when it becomes law this spring will simply consist of the reforms that the Financial System Council was able to reach agreement on this time round rather than all the reforms that should have been included. Hopefully, these will be included in later legislation.

If so, this will, hopefully, lead to a financial services and markets law covering not only those products that will not be included in the Investment Services Bill in spite of their strong investment character but also banking and insurance products. This is because greater investor protection will require more than dealing with the market and credit risk of the investment products covered by the bill. There has recently been a spate of cases where life insurance companies have been discovered to have failed to pay out even on normal policies, and reports of policyholders being persuaded to

[14] The report recommends that banks, insurance companies and any other financial service providers that are subject to semi-annual nonconsolidated capital adequacy requirements also consider publishing nonconsolidated financial statements every second quarter.

switch to less favorable policies are common. Such cases are not unrelated to those involving the marketing of deposits and other products where capital is guaranteed and where salesmen have been found to have put profit before product suitability.

Therefore, although some of the requirements that are due to be incorporated in the Investment Services Bill (e.g., accountability, the suitability principle, and the requirement that salesmen act fairly and in good faith) could have been incorporated separately in existing laws (e.g., the Banking Law and the Insurance Business Law), the approach that has been adopted (namely, of applying all-encompassing rules to a whole range of financial products where an asymmetry of information exists between provider and purchaser) is probably the right one in that it seeks to apply basic principles comprehensively and consistently.

Another important task (namely, that of setting up a system of enforcing the Investment Services Law) raises the question whether Japan needs its own Securities and Exchange Commission or a similar organization. If one takes the view that Japan's national interest would be better served by an organization dedicated to safeguarding the rights of investors than by an organization, such as the Financial Services Agency, that has to pursue other important objectives, such as prudential regulation and the prevention of systemic risk, as well as market regulation and the protection of those who use financial services, a Japanese Securities and Exchange Commission could be seen as one effective option. Furthermore, assuming the need for a new regulator might break the impasse (created by constant rivalry between different government departments) over whether products such as commodity futures should be covered. This is an issue the Financial System Council has not confronted head on and which some would say should be decided by the politicians rather than the Council.

Many issues remain unresolved.[15] Nevertheless, the passing of the Investment Services Bill this spring will mark the most important reform of Japan's financial services industry since the Financial System Reform Law of 1998. Several government and ministerial ordinances will be needed before the Law can come into

[15] For example, the following issues, identified as "unresolved issues" in the Subcommittee's July 2005 interim report, were left out of the December 2005 report: (1) whether the role of financial gatekeepers such as rating agencies and securities analysts should be regarded as a financial service in its own right in the Investment Services Bill; (2) whether anyone offering the kind of general asset management advice provided by financial planners should be required to be registered; (3) where to draw the line between sales promotion and investment advice; (4) how the asset management provisions of the Investment Services Bill should be applied to insurance companies, trust companies and those who are beneficial shareholders under the Trust Business Law; and (5) how the Investment Services Bill's rules on custodian services should be applied to trust companies and banks.

effect, probably in 2007. Hopefully, Japan's financial service providers will use the time between now and then to adapt to the new regulatory environment.