About the Financial Instruments and Exchange Law

Kei Kodachi

I. About the Financial Instruments and Exchange Law

Legislation to partially amend the Securities and Exchange Law (SEL) was enacted by the Diet on 7 June 2006. The amendment, previously known as the Investment Services Bill (ISB), is now officially titled the Financial Instruments and Exchange Law (FIEL).[1]

The FIEL aims to provide apt and sufficient protection of investors to ensure that there are no breakdowns in protection for investments made in the recent environment, which has been marked by the convergence of financial instruments and financial services. To achieve this, the FIEL covers to the maximum extent possible those financial instruments and investment services deemed to have the characteristics of an investment, applies the same rules to investments with the same economic characteristics, and provides a basic framework for building a comprehensive and cross-sectoral system of rules governing industry and business conduct, ranging from sales and solicitation to asset management and investment advice. This is financial system reform that will dramatically revise the SEL and substantially alter the legal framework, shifting the orientation of laws aimed at protecting investors from vertical (separate laws for each industry sector) to horizontal (laws that cut across sectors).

Also of interest is the clear distinction drawn between professionals and amateurs and the flexible nature of the rules in response to the level of experience and financial resources of the investor. There is less need to protect institutional investors and other professional investors than to protect general (amateur) investors, and there is a risk that overregulation will actually wind up hindering the market's ability to supply products that meet diverse needs. The legislation takes a flexible approach when professional investors are on the other side of a transaction, such as by waiving rules governing business conduct or simplifying restrictions on new entry.

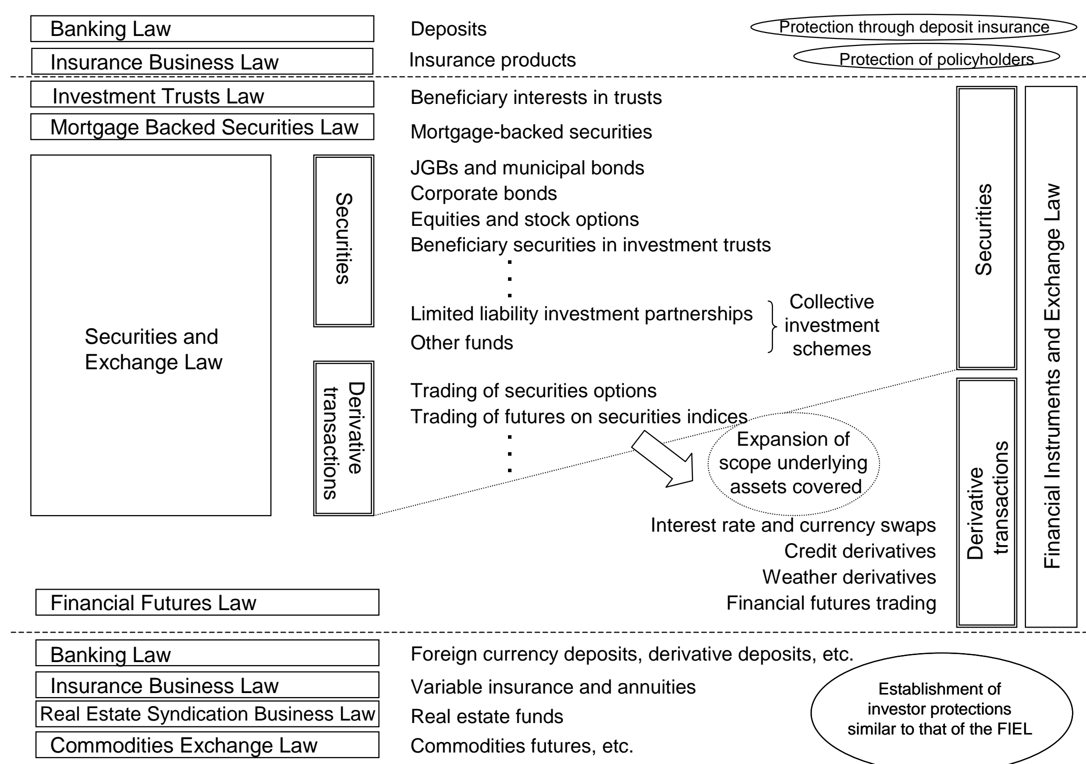
1 The report by the First Subcommittee of the Financial System Council summarizing work aimed at drawing up the Investment Services Bill, entitled "For the Investment Services Bill (tentative name)", was published in December 2005, and the legislation was produced from this report.

II. Key points of the FIEL

1. Broader applicability

To eliminate to the maximum extent possible lapses in the SEL's coverage of securities and derivative transactions, the FIEL applies to a broader range of products and services.

Figure 1 Scope of the Financial Instruments and Exchange Law



Source: Nomura Institute of Capital Markets Research

To begin with, mortgage backed securities (MBS) and beneficial interests in investment trusts are added to the definition of securities (including deemed securities), per Article 2, paragraphs 1-16 and 2-1. The beneficial interests in investment trusts treated as securities under the SEL are limited to investment trusts, loan trusts, and beneficial securities in special purpose investment trusts under the Asset Liquidation Law[2], but the FIEL also defines other beneficial interests in investment trusts as "deemed securities," thereby broadening coverage and eliminating gaps.

[2] If the proposed amendment to the Trust Law that has been submitted to the current session of the Diet is passed, beneficial securities in trusts will be added to the list of deemed securities under the SEL.

Funds based on partnerships have in recent years spread to cover a broad range of investments in different sectors, but in some cases these are excluded from the framework of investor protections. Under the SEL, investment business limited liability partnerships, similar partnerships under civil code and secret partnerships under the commercial code were treated as deemed securities, but there are other types of civil-code partnerships and secret partnerships that were not, including ramen (noodle shop) funds and idol (celebrity) funds. Under the legislation, these funds are defined as "rights to receive dividends on earnings from, or assets associated with, a business that allocates funds received as an investment or subscription from individuals who have rights based on a partnership agreement," are treated as collective investment schemes[3], and their ownership shares are broadly covered by the law as deemed securities (Article 2, paragraphs 2-5).

As for derivative transactions, under the current definition the regulations only apply to derivatives that have underlying assets that are either securities or security indices, but the law broadens the scope of underlying assets so as to encompass a wide range of derivative transactions (Article 2, paragraphs 20 to 25). This would broaden coverage to include such derivative transactions as interest rate and currency swaps, credit derivatives, and weather derivates, in addition to financial futures contracts[4] covered under the Financial Futures Trading Law, which would be abolished with the implementation of the legislation.

Depositary and insurance products are not covered by the legislation, since there is already a framework in place for protecting users through the Banking Law and the Insurance Business Law. Nevertheless, for foreign currency deposits, derivative deposits, variable insurance annuities, and other products that are deemed to have investment characteristics but that receive neither deposit insurance protection nor policyholder protection, equivalent business conduct rules will be stipulated through revisions to the Banking Law and the Insurance Business Law in order to establish a framework for investor protection at the same level as the FIEL.[5]

Regarding the coverage of financial instruments and investment services, after the FIEL is implemented debate over another comprehensive financial legislative package,

---

[3] This does not apply, however, if all investors are involved in the business that receives the investment or if no dividends are paid or property distributions made on profits in excess of the amount invested. Also exempt are that related to insurance contracts or to real estate syndication agreements. The definition of offering that applies to collective investment schemes and other deemed securities is different than that for general securities.

[4] When the Financial Instruments and Exchange Law goes into effect, the Financial Futures Law, the Investment Advisory Law, the Law on Foreign Securities Firms, and the Law on Mortgage Backed Securities will all be rescinded.

[5] To provide the same level of investor protection for real estate funds (real estate syndication business) and commodity futures trading as will be provided under the Financial Instruments and Exchange Law, the Real Estate Syndication Business Law and the Commodity Exchange Law will be revised.

a "Financial Services and Market Act," will begin, and we expect this to be broadened to encompass depositary and insurance products.[6]

2. Making industry regulation cross-sectional and more flexible

The regulation of providers of financial services has so far been covered across a wide spectrum of industry-specific laws, including the SEL (for securities companies), the Investment Trust and Investment Corporation Law (for investment trust management companies), the Investment Advisory Business Law (for investment advisors), and the Financial Futures Trading Law (for financial futures traders), but the FIEL, by creating a cross-sectoral framework for investor protection, regulates comprehensively across industry sectors. Meanwhile, the regulation of providers will in principle follow the existing regulations according to business content.

The legislation defines as "financial instruments businesses" not only securities companies but all such providers, including investment trust management companies and investment advisors, thereby standardizing entry regulations and the registration system[7] (Article 2, paragraph 8 and Article 29). It then separates these into four industry segments (1) the primary financial instruments business, (2) the secondary financial instruments business, (3) investment advisory and agency business, and (4) investment management business, and then stipulates industry rules for each (Figure 2).

Figure 2 Scope of Financial Instruments and Exchange Law

Business		Business content	<Existing businesses>
Financial instruments busines	The primary financial instruments business	(1) Trading in securities, other mediation, brokerage or agency (except deemed securities), securities-related market derivative transactions, and their mediation, brokerage or agency	Securities companies
		(2) OTC derivative transactions, mediation, brokerage or agency	
		(3) Underwriting securities	
		(4) Multilateral trading system (MTF) services	
		(5) Administration of securities	
	The secondary financial instrument business	(1) Non-discretionary investment trusts, ownership in collective investment schemes, private placement	Funds
		(2)Trading in deemed securities, their mediation, brokerage or agency, sales, enrollment	
		(3) Market derivative transactions, their mediation, brokerage or agency, sales, enrollment	
	Investment advisory and agency business	(1) Advice concerning investment assessments based on investment advisory agreements	Investment advisory businesses Investment trust management companies
		(2) Agency or mediation in the signing of investment advisory agreements or discretionary investment agreements	
	Investment management business	(1) Asset management based on discretionary investment agreements or asset management trustor agreements	
		(2) Management of assets contributed by owners of beneficial securities in investment trusts	
		(3) Management of assets contributed by owners of beneficial interests in trusts or shares of collective investment schemes	
Financial instruments introducing brokerage business		(1) Mediation of securities trading	Securities brokers
		(2) Offering securities	
		(3) Mediation of trading in market derivatives	
		(4) Mediation of entering investment advisory agreements and discretionary investment agreements	

Source: Nomura Institute of Capital Markets Research

6 The report by the First Subcommittee of the Financial System Council notes that it "will continue to consider a more comprehensive regulatory framework that covers all financial instruments by taking account of the process of promulgating and implementing the Financial Instruments and Exchange Law, the specific characteristics of each financial instrument and the nature of the financial system over the medium to long term."

7 Traditionally, both certified investment advisors and investment trust management companies have been governed by a certification system.

The primary financial instruments business and investment management business, the categories into which securities companies fall, are also subject to side business regulations (Article 35) (Figure 3). Compared with the SEL, the legislation provides for a greater degree of operational freedom. Those providers who are only in the secondary financial instruments business and/or investment advisory and agency business are not subject to additional regulation (Article 35-2).

Figure 3 Other industry regulation of primary financial instruments businesses and investment advisory businesses

Incidental services	Services of filing notifications and reports
(1) Securities lending and mediation or agency of same	(1) Trading in commodities markets
(2) Lending of money applied to margin trading	(2) Trading related to commodity price fluctuations (excluding trading in commodities markets)
(3) Lending of money collateralized with deposited securities	(3) Money lending
(4) Customer agency related to securities	(4) Trading in lots and buildings
(5) Agency for payment services of money received from the investment trusts of trustors	(5) Real estate syndication business
(6) Agency for payment of distributions of money from the invested securities of investment funds	(6) Management of assets other than rights related to securities and derivative transactions
(7) Entering into cumulative investment agreements	(7) Other businesses as stipulated by Cabinet order
(8) Offering of information and advice related to securities (excluding that based on investment advisory agreements	
(9) Agency for other services of financial instruments businesses	
(10) Custody of assets of registered funds	
(11) Consultation and mediation of M&A	
(12) Management consultation	
(13) Trading in assets related to currencies and the mediation, brokerage or agency of same	
(14) Trading in negotiable deposits and the mediation, brokerage or agency of same	
(15) Management of specified assets	

Source: Nomura Institute of Capital Markets Research

Financial instruments businesses are subject to regulations on their assets, including minimal requirements for capital and net assets or restrictions on taking deposits as security for dealing. In addition, primary financial instruments businesses, just as is the case with securities companies, are required to set aside liability reserves for trading in financial instruments and to maintain a minimum capital ratio of at least 120% (Articles 46-5 and 46-6) (Figure 4).

Figure 4 Industry regulations of financial instruments businesses

	Rules on participation	Rules on assets, etc.
The primary financial instruments businesses	Registration (only MTF services require approval)	Capital adequacy ratio Liability reserves for financial instrument trading Net asset requirements Capital requirements Joint stock company requirements
The secondary financial instruments businesses	Registration	Capital requirements (if corporation) Deposit as security for trading (if individual)
Investment advisory and agency businesses	Registration	Deposit as security for trading (if only providing investment advice and agency)
Investment management businesses	Registration	Net asset requirements Capital requirements Joint stock company requirements

Source: Nomura Institute of Capital Markets Research

In addition, the regulations currently applied to securities companies and investment trust management companies will carry over to the primary financial instruments business and investment management business, including the requirement to be incorporated as a joint stock company in order to be registered. Otherwise, other financial instrument business can be performed by either individuals or corporate entities other than joint stock companies (Article 29-4).

In principle, the legislation retains the basic framework of prohibitions on mixed banking by banks and other financial institutions. With the exception of trading in securities for investment purposes, financial institutions are prohibited from engaging in securities-related businesses (i.e., the securities business as defined in the SEL), and the services they are allowed to perform upon registration generally follow the rules stipulated in the SEL[8] (Article 33 and 33-2).

Securities brokers that trade securities or serve as an agent for trades are defined as "financial instruments introducing brokerage business" in the legislation. While it adds new services, such as intermediation for entering into investment advisory agreements, it follows the basic framework for securities brokers that is now in place, including the registration system.

The legislation also regulates collective investment schemes. Under the SEL. neither the sale nor solicitation of ownership shares in a fund nor management of a fund are subject to industry regulations. There have been some incidents in recent years where a number of general investors have been hurt when funds have managed their own offerings without going through securities companies. In the legislation, management of a collective investment scheme is considered an investment management business requiring registration as a joint stock company, while offering and private placement are considered secondary financial instruments businesses. Accordingly, sellers of collective investment schemes are required to register as financial instruments businesses, are required to submit business reports, and are subject to inspections by, and briefings with, the Financial Services Agency (FSA).

They are also subject to the same disclosure requirements as for regular securities. Those collective investment schemes that invest primarily in securities must submit securities filings during the enrollment period and are also subject to ongoing disclosure and other disclosure rules.

Nevertheless, even with collective investment schemes, when the investors are qualified institutional investors with specialized expertise in securities investments, there is relatively less need for investor protections, and the regulatory costs and other adverse effects must be taken into account. Consequently, an attempt is made to

[8] In principle, banks and other financial institutions are not only prohibited from engaging in securities-related businesses, they are also unable to engage in the business of investment management. They can, however, engage in the following securities-related businesses upon registering to do so: (1) brokerage services in writing; (2) certain securities-related businesses pursuant to Article 65, paragraph 2 of the SEL; (3) derivative transactions (except securities-related); and (4) offering or private placement of ownership in collective investment schemes, investment advice/agency, and the administration of securities.

simplify rules on entry, and when conducting the private placement of a collective investment scheme aimed primarily at qualified institutional investors, or when managing a collective investment scheme in which the primary investors are qualified institutional investors, the requirement for registration as a financial instruments business is waived, and merely providing advanced notification is sufficient (Article 63).

3. Making rules on business conduct cross-sectoral

The principle rule pertaining to financial instruments businesses under the FIEL is that a common set of business conduct rules apply, regardless of the industry segment (from Article 36 to Article 40-3). Existing rules of business conduct contained in the SEL and the Investment Advisory Law, including the suitability principle and the requirement to provide written documentation prior to and when entering into an agreement, are carried forward (Figure 5).

Figure 5 Business conduct rules for financial instruments businesses

		Financial Instruments and Exchange Law	Exisiting rules of business conduct			
			Securities and Exchange Law	Investment Trusts Law	Investment Advisory Business Law	Financial Futures Trading Law
Financial instruments businesses		(1) Duty of honesty and fairness	○			○
		(2) Duty of labeling and disclosure		○	○	○
		(3) Duty to exhibit advertising			○	○
		(4) Duty of prior disclosure of trade status	○			○
		(5) Duty to deliver documents prior to signing agreement	○		○	○
		(6) Duty to deliver documents at time of signing agreement	○		○	○
		(7) Duty to cancel in writing (cooling off system)			○	
		(8) Prohibited behavior (providing false information or conclusive judgment)	○			○
		(9) Prohibition of unwanted solicitation				○
		(10) Prohibition of compensating customers for their losses	○		○	
		(11) Suitability principle	○			○
		(12) Duty to provide best execution	○			
	Investment advisory and agency business	(1) Duty of loyalty	-	-	○	-
		(2) Duty of good faith and care	-	-		-
		(3) Prohibited conduct (transactions with conflicts of interest, lending of money or securities, accepting deposits)	-	-	○	-
	Investment management business	(1) Duty of loyalty	-	○	-	-
		(2) Duty of good faith and care	-	○	-	-
		(3) Prohibited conduct (transactions with conflicts of interest, lending of money or securities, accepting deposits)	-	○	-	-
		(4) Restrictions on commissioning investment	-	○	-	-
		(5) Duty to segregate assets	-	○	-	-
		(6) Duty to provide investment reports	-	○	-	-
	Administration of securities, etc.	(1) Duty of good faith and care			-	-
		(2) Duty to segregate assets	○		-	-
		(3) Duty to provide written agreement on provision of collateral	○		-	-

Source: Nomura Institute of Capital Markets Research

Also included in the legislation is the prohibition on unwanted solicitation included in the July 2005 revision to the Financial Futures Trading Law (Article 38). This is a business conduct rule added as a response to the multiple incidents of individual investors suffering damages related to foreign exchange margin trading, an issue that came to be viewed as a social problem over the last few years. The rule prohibits solicitation to enter into agreements, either by personal visits or over the phone, of customers who have not requested said solicitation. The Financial Futures Trading Law provides for certain exceptions to these rules,[9] and we expect the FIEL to retain these exceptions. We also expect specific cabinet ordinance to be added so as to ensure that these rules do not apply broadly to other financial transactions (Article 38).

Furthermore, the FIEL clarifies the "fiduciary duty."[10] To begin with, financial instruments businesses are obligated to provide services fairly and in good faith and to provide the best possible order execution. In addition, when providing investment advice, managing investments, or administering securities, trustees have a duty of care, a duty of loyalty, and a duty to provide segregated custody, i.e., manage assets separately (from Article 41 to Article 43-4).

The legislation also includes, in addition to business conduct rules for financial instruments businesses, measures for financial supervision. The SEL provides for supervisory remedies, including business improvement orders, business suspension orders, and the cancellation of registrations in certain cases, such as legal violations or the risk of default. In addition, the legislation provides for the issuance of a business improvement order related to the business operation or the asset status when deemed necessary to protect either the public interest or investors, and the regulations can be applied relatively more flexibly than is currently the case (Article 51).

4. Implementation of an investor classification system

The FIEL introduces an investor classification system that draws a clear distinction between professional and general investors. This system, recognizing the ability of professional investors to obtain and analyze on their own accord the information that

[9] The Financial Futures Law exempts from the prohibition on unwanted solicitation the following persons: financial futures traders with specialized expertise and experience with financial futures trading, qualified institutional investors, and joint stock companies with capital of at least jpy30 million. Also exempted are customers who do not meet the above criteria but who have maintained a continuous trading relationship by, for example, having made at least two trades in the one-year period preceding the day of solicitation, as well as corporate customers who engage in forex transactions when the solicitation is for contracts for the purpose of hedging currency risk.

[10] A fiduciary responsibility is created when receiving the trust of others and is a concept based on British and US law. This includes four central duties: the duty of care, the duty of loyalty, the duty not to delegate, and the duty to manage investments separately. The report by the First Subcommittee of the Financial System Council notes that "there is a need to spell out the fiduciary responsibility, (omitted) with the provider of investment services obligated to provide services fairly and in good faith while exercising due care, and the provider of investment management and advice obligated with (1) the duty of care, (2) the duty of loyalty, (3) the duty not to delegate, and (4) the duty to manage assets separately.

they need, exempts from business conduct rules those transactions that are with designated investors in an attempt to lower the cost of regulation. Specifically, except when stipulated by cabinet order, solicitation of professional investors for the trading of financial instruments is exempt from the suitability principal and the prohibition on unwanted solicitation, and the requirement for written documentation prior to and when concluding agreements also does not apply. When entering into investment advisory agreements and investment agency agreements, there is also an exemption from prohibitions on accepting securities for deposit by customers (Article 45) (Figure 6).

Figure 6 Exceptions to business conduct rules based on investor classifications

	Primary items
Solicitation related to financial instruments and exchange agreements	(1) Duty to exhibit advertising (2) Prohibition on unwanted solicitation (3) Suitability principle
Conclusion of financial instruments and exchange agreements	(1) Duty to provide prior disclosure of trade status (2) Duty to deliver documents prior to entering into agreement (3) Duty to deliver documents at time of entering into agreement (4) Duty to cancel in writing (cooling off system) (5) Duty to deliver in advance documents relating to best execution policy (6) Duty to provide written agreement on provision of collateral
Conclusion of investment advisory agreements	(1) Prohibition on accepting deposits of securities (2) Prohibition on lending of securities
Conclusion of discretionary investment agreements	(1) Prohibition on accepting deposits of securities (2) Prohibition on lending of securities (3) Duty to provide investment reports

Source: Nomura Institute of Capital Markets Research

This professional investor status includes two types, those with the option to be classified as a general investor and those without that option. The former includes public companies designated by cabinet ordinance and the latter, always treated as professional investors, are limited to qualified institutional investors, the government, and the Bank of Japan. There are also two types of general investor, those with an option to be classified as a professional investor and those without that option. The former includes corporations other than public companies and individual investors meeting criteria to be designated by cabinet ordinance. The latter includes individuals (except those who meet the criteria).

This distinction between professional and general investors has already been partially implemented in the Financial Products Sales Bill, which exempts the seller of financial instruments from obligations to explain when the sale is to customers with specialized expertise and experience. In fact, the designated investor system included in the FIEL is significant in that it broadens exemptions from business conduct rules to range from the solicitation of financial instruments to entering into contracts for financial transactions, while applying the rules within a cross-sectoral framework.

5. Strengthening self-regulatory organizations

The FIEL continues to recognize the status of the exchanges and other self-regulatory organizations while at the same time reinforcing their functions and systems.

To begin with, it defines exchanges broadly as financial instruments exchanges, encompassing both securities exchanges and financial futures exchanges.

The recent trends for exchanges to become joint stock corporations has created a controversy, both within and outside of Japan, over the ability to maintain the independence of the regulatory function from profit-oriented business activities. An important feature of the FIEL in this regard is that it aims to preserve the independence of the regulatory activities, including listings and delistings, of the financial instruments exchanges, while including institutional mechanisms to help prevent conflicts of interest from arising. Specifically, financial instruments exchanges and holding companies with financial instruments exchanges as subsidiaries are able to establish independent regulatory entities[11] and, upon obtaining approval, contract out the regulatory function to this new entity (Article 85) (Figure 7). Furthermore, a financial instruments exchange can form an internal regulatory committee and give this committee decision-making authority in regards to regulatory issues (Article 105-4). A majority of the directors comprising the regulatory committee must come from outside the company, thereby reinforcing the independence of the regulatory function.

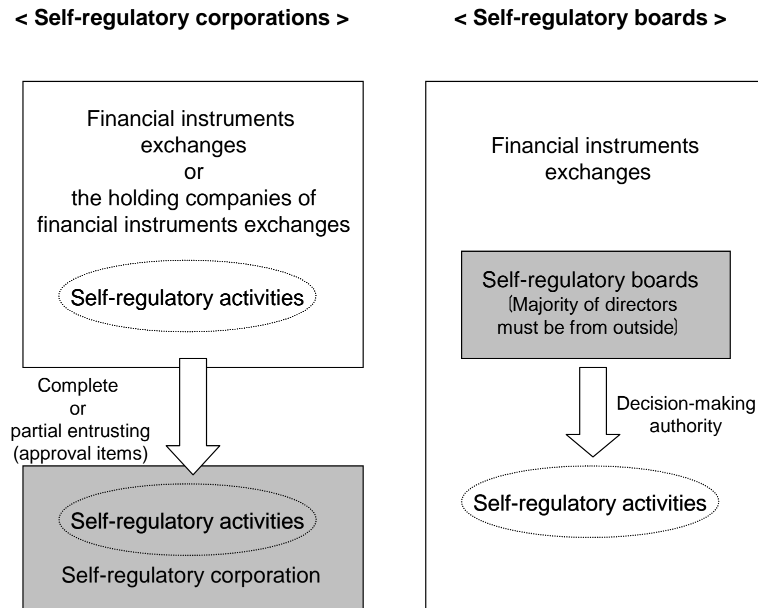
The SEL includes a major-shareholder restriction that prohibits ownership of 50% or more of the voting rights for a securities exchange. The FIEL strengthens these ownership restrictions by prohibiting regular shareholders other than the exchange or its holding company from owning 20% of more of the voting rights. Furthermore, under certain circumstance when a critical impact on financial and business decisions is envisioned, the restriction on voting rights ownership can be lowered to 15%[12] (Article 103-2).

---

[11] A majority of the board of directors of self-regulatory corporations must come from outside the financial instruments exchange entrusted with the regulatory function, and the chairman of the board, elected through internal vote, must be one of these outside directors in order to maintain the board's independence.

[12] Nevertheless, it is possible for municipal corporations to gain approval to surpass the 20% restriction on voting rights ownership, up to as high as 50%.

Figure 7 Self-regulatory activities of financial instruments exchanges



Source: Nomura Institute of Capital Markets Research

Regarding the financial instruments firms associations that serve as self-regulatory organizations in addition to the exchanges themselves, the FIEL provides for the establishment of three such associations to take over from the Japan Association of Securities Dealers and other existing associations: (1) a statutory financial instruments firms association (statutory association), (2) a public welfare financial instruments firms association (public welfare association), and (3) a recognized investor protection association (recognized association) (Figure 8).

Figure 8 Financial instruments firms associations

	Statutory financial instruments firms association (statutory association)	Public welfare financial instruments firms association (public welfare association)	Recognized investor protection association (recognized association)
Requirements for establishing	Corporation (financial instruments business) Must be approved	Public service corporation (Financial instruments business)	Corporation or other organization (requires recognition)
Members	Members of the association are financial instruments businesses	Members of the association are financial instruments businesses	Businesses covered include financial instruments businesses and brokers of financial instruments
Main services	Opening of market for trading OTC securities Discipline members (including fines and expulsion) Handle complaints and mediate disputes	Provide guidance and recommendations to members Discipline members (including fines and expulsion) Handle complaints and mediate disputes	Handle complaints and mediate disputes
Articles of incorporation and rules	Articles of incorporation require approval Rules for OTC securities trading market require approval	Industry rules require approval	

Source: Nomura Institute of Capital Markets Research

The statutory association, like the securities industry association authorized under the SEL, would be able to open a market for the trading of OTC securities and would be authorized by legislation to establish self-regulatory rules. The public welfare association is an institution for providing guidance and recommendations to its members through an approved process, and has a function close to that of the Investment Trusts Association, Japan under the Investment Trusts Law. The certified organization does not have the authority to take administrative action against its members, but primarily provides alternative dispute resolution (ADR), including resolution of complaints filed against, and mediation of disputes with, financial instruments businesses.

III. Implementation of the FIEL

The Legislation to Partially Amend the Securities and Exchange Law and other Laws is slated for implementation in four stages: (1) cross-sectional legislation for investor protection; (2) revisions to the systems governing tender offers and large shareholding reporting; (3) a strengthening of internal controls and a legislation of quarterly reporting requirements; and (4) stronger penalties for falsifying disclosure documents and for unfair trading practices. Of these, the cross-sectional legislation for investor protection will go into effect on the day established by administrative order, but no later than 18 months from the day that the bill was promulgated, which means no later than December 2007.