The Financial Products Sales Law

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On 23 May 2000 the draft "Law Concerning Sales of Financial Products" was enacted into law by the Diet to become effective from 1 April 2001. The Law sets out comprehensive regulations governing the selling of financial products and customer solicitation, and is a major component of the "Japanese Financial Services Law," new legislation to cover the financial services industry.

1. History and Background

1) The Debate Over the "Japanese Financial Services Law"

With the enactment of the Financial System Reform Act[1] in December 1998, the Japanese government went a long way to establishing the legal framework for wholesale reform of Japan's securities markets and financial system – the so-called Japanese "Big-Bang." The aim of the Big-Bang reforms was to create a "free, fair and global" financial marketplace with a much looser regulatory framework that promoted free competition across traditional market boundaries.

It was then felt necessary, for reasons of market fairness, to enact "umbrella" (horizontal) legislation to govern financial services, and thereby develop an infrastructure for financial services in accord with current movements towards liberalization and free competition. This was the concept that motivated the "Japanese Financial Services Law," modeled on the UK's horizontal legislation ("the Financial Services Act, 1986"). The fulfillment of this concept began with the establishment, in July 1997 (as the work of the three financial sector councils on the contents of the Financial System Reform Act was coming to a close) of the "Discussion Group on New Trends in the Financial Sector." Unusually for Japan, the group consisted of 13 representatives from various related government ministries and agencies, with the aim of achieving a complete overhaul of Japan's vertical sector-specific financial system legislation.

The group's discussions were summarized in a report published in June 1998, and in December the first sub-committee of the Financial System Council, an advisory panel to the Finance Ministry, took up the baton. The council discussed the two main issues raised: replacement of the vertically segregated system of legislation, which it was feared was hindering innovation in financial products, with horizontal legislation providing a single set of

1 See S. Osaki "Outline of Financial System Reform Act" (Capital Research Journal, Summer 1998) for a more detailed treatment of this legislation

rules and regulations to govern the wide range of financial products; and questions of investor protection, involving the clarification of civil liability for financial service providers.

The council examined the following: (1) changes to the current legislative framework for collective investment schemes from the current fragmentary product-specific scheme to a single comprehensive framework covering a wide range of products; (2) introduction of legislation regarding selling of financial products and solicitation of customers to protect customer rights; (3) setting up an out-of-court dispute resolution scheme offering fast-track recourse to investors who have suffered a financial loss.

Two working groups were set up to debate the first and second issues. The working group in charge of developing rules for financial product sales submitted its report entitled "Regarding the Establishment of Rules on Sales of Financial Products and Customer Solicitation" on 7 December 1999. The Financial Products Sales Law is based on the recommendations that appeared in this report.

2) The Debate on The Working Group

The first issue to be discussed by the working group looking at legislation for financial products sales was the importance of information disclosure by the seller of financial services.

The group considered that financial products should be treated differently to other purchase contracts because of the abstract nature of the products themselves: since consumers cannot physically examine the products, and in many cases the structure and function of the products are difficult to comprehend, the knowledge gap between the seller and the customer is very large. Customers have to make a decision based on trust in whatever information has been provided by the seller. In addition to that, the purchase of a financial product exposes the buyer to the risk of losing money. Therefore it was thought that sellers should have an obligation to provide adequate information about the product in order that customers understand what they are buying and to facilitate a smoother trading process.

At present, if as a result of an inadequate explanation of a financial product by the seller the customer suffers a loss and claims for damages, then the case usually proceeds on the grounds that the seller has an obligation to act "in good faith" (Civil Code, Article 2) in explaining the product to the customer, and that the neglect of this obligation is an act of tort (Civil Code, Article 709). This at least produced some cases where compensation was ruled as due to the claimant. For several reasons however, this process has been criticised: the proof requirement from the customer / plaintiff is extremely onerous and the compensation amount is adjusted according to the degree of negligence attributable to either side, generally resulting in the plaintiff receiving less than the actual amount they lost. It was also pointed out that, with financial innovation producing ever more varied and complicated financial products, legislating a seller's obligation to make an adequate explanation to an investor and the clarification of liability for damage compensation arising out of a failure to fulfil this responsibility would be greatly in the interests of both sellers and buyers. The clarification of rules regarding product explanation would simplify sales procedures since sellers would know precisely what they had to do, while customers would feel more confident buying. General confidence in financial services would be increased, leading to a more active and smoothly-functioning market for financial services. Consequently, the council drafted a bill

centred around a requirement for sellers of financial products to give a full explanation of investment risk.

Table 1 Developments Towards A Financial Services Law

Date	Event
1998 June	Discussion Group on New Trends in the Financial Sector presents final report
1999 July	First sub-committee of the Financial System Council issues initial interim report
November	Report by the working group examining collective investment schemes "Regarding the establishment of horizontal collective investment schemes"
December	Report by the working group examining selling of financial products "Regarding the Establishment of Rules on Sales / Solicitation of Financial Products" First committee of the Financial System Council issues second interim report
2000 May	"Act for Partial Revisions to the Securities Exchange Law and Financial Futures Trading Law" enacted into law by Diet "Act for Partial Revisions to the Law on Securitization of Specified Assets by Special Purpose Companies" enacted. " The Financial Products Sales Law" enacted.

Source: NRI

2. Law Contents

1) Financial Products Covered (Article 2)

While the Financial System Council intended to write comprehensive legislation that would be applicable to a wide range of financial instruments, this was found to be rather difficult. In the end they had to simply list the types of financial products that are defined in various other items of financial sector legislation, such as the Banking, Insurance Business and Securities and Exchange laws, and resolved to specify by government ordinance any new financial products as and when these appeared. The Law named the following financial instruments, covering most of the product types currently in existence and ranging from the low- to relatively high-risk: deposits and savings, trusts, insurance, marketable securities, mortgage securities, collective investment scheme related products, financial futures and options. Instruments not included were commodity futures, golf club memberships (in many cases in Japan these are a tradable investment) and lottery tickets.

2) Information Provision Requirements (Article 3)

Where a financial services provider[2] is engaged in the sale or acts as an intermediary, proxy or agent for the sale of financial products covered by the definitions in Article 2, they are required to inform the client of the risk if any of losing principal due to (1) fluctuations in interest or exchange rates, or market prices of securities, or (2) a change in the business condition or asset holdings of the services provider. Further, financial service providers are obliged to inform the client of the risk, if any, of loss of principal due to any other factors specified by government ordinance as being important for a client in order to make a judgement concerning this risk. In essence, for the sale of financial products or in the

2 A "financial services provider" is defined as an entity whose business is the sale of financial products.

solicitation of clients, the service provider must make the client fully aware of the risk of losing the principal amount of an investment, and in order to do this would have to explain the fundamental structure and features of the financial instruments they are trying to sell. Further, the provider is also required to explain to the client any time limit on rights exercise or rescission.

The council also debated the question of making a distinction in information provision requirements between market professionals and non-professionals. The eventual conclusion was that financial services providers should not be required to provide such information for clients who "are specified by government ordinance as having specialist expertise or experience in the sales of financial products" or who have expressed that they do not require the provision of such information. As to the question of who would be deemed a "professional" by government ordinance, it seems that the legislators intend to draw from the definition of "accredited institutional investors"[3] in the Securities and Exchange Law.

The council also examined the exclusion from information provision requirements of financial products whose structure and characteristics are particularly "clear or well-known," though this exclusion was not in the Law.

Guidelines as to how each product needs to be explained will most likely be produced by a self-regulatory body or industry group.

3) Liability for damages caused by violation of information provision requirements

In the event that a financial services provider neglects to provide a client with the required information and a client subsequently sustains a loss, the provider shall be liable to pay damages (The Financial Products Sales Law, Article 4).

Presumably the reason why the group decided to make the financial services provider the legal entity liable to pay damages according to laws on consumer liability (Civil Code, Article 75), was due both to their ability to pay compensation and to the difficulty of specifying the service provider / seller in certain trades (over the internet, for example). Further, the amount to be compensated is assumed to be equal to the amount of loss of principal (The Law, Article 5). This was included in order that clients would no longer have to go through the process of establishing the liable amount themselves. It is also true however that determination of the liable amount would also be subject to Civil Code provisions for contributory negligence (Civil Code, Article 722) and extinctive prescription (Article 724) (The Law, Article 6), so that even if the liable amount is initially assumed to be the amount of loss of principal this amount may subsequently be reduced.

On the other hand, in order to demonstrate liability the customer only has to show that the financial services provider failed to provide the necessary information. Previously in cases regarding the selling of financial products where the claimant pursued damages against an action in tort under Article 709 of the Civil Code, the claimant had to prove (1) that the service provider was required to provide the necessary information, (2) that the service provider neglected to provide the necessary information, (3) the occurrence of a loss and the

3 Securities and Exchange Law, Article 2-3

amount, and (4) that there existed a causal relationship between the failure to provide the necessary information and the financial loss sustained.

During the course of the council's debate the possibility of recognizing cancellation or voiding of contracts was also examined. However, inclusion in the draft bill was rejected on the grounds that a much more detailed examination was required to determine the effect such legislation would have with regard to trade security, in addition to which it was felt that the option for any customer in the case of a dispute over financial product sales to have recourse to a claim for damages and be able to receive financial compensation was sufficient as a means of redress.

4) Ensuring Appropriate Solicitation (Article 8)

The Law stipulates that financial service providers must draw up and publicize a solicitation policy so that solicitation of customers in the selling of financial products will be conducted in an appropriate manner. The solicitation policy must provide for due consideration of (1) the knowledge, investment experience and asset condition of the customer, and (2) the method and hours for solicitation activities. One example of a solicitation condition might be that "Financial product A will not be marketed to customers with under 3 years investment experience and under ¥100 million in assets." Financial service providers who do not draw up or publicize a solicitation policy would be subject to a fine of up to ¥500,000 (The Financial Products Sales Law, Article 9).

The working group also discussed the treatment of fraudulent solicitation, the framing of regulations concerning product suitability,[4] and cold-calling. Regarding fraudulent solicitation, the working group was of the opinion that if a current Consumer Contract bill before the Diet stipulating that contracts entered into due to fraud or threat of violence can be voided by the purchaser were to be passed, then this would also cover the selling of financial products. It further concluded that questions of product suitability and cold-calling should be dealt with as part of the company's solicitation policy, so that the company would be self-regulating in this regard through its internal compliance department.

3. Probable Impact Of The Financial Products Sales Law

1) Lighter Burden Of Proof For Plaintiffs

One effect of the new Law will certainly be to lessen the burden of proof of plaintiffs in dispute cases regarding the selling of financial products, which will be a significant step forward in the interests of customer protection. Under the current system, since the burden of proof was so onerous, courts took a much longer time to deal with cases which no doubt

4 Securities regulations where the securities company soliciting customers for securities trading will not encourage investment activity unless it is appropriate given the investment experience, expertise and asset condition of the customer.

resulted in many cases not even being heard. In future, faster processing by the courts is likely to result in a greater number of cases being brought.

2) Product Information Provision Guidelines

As a result of the passage of this legislation, some guidelines would have to be drawn up governing how each financial product should be explained to customers. Questions remain however: if the industry organization with the closest involvement with a particular financial product is to draw up guidelines for that product (e.g. savings and deposits would fall under the remit of *Zenginkyo*, the Bankers Association of Japan), who will draw up the guidelines for financial products that do not fall under the remit of a particular industry organization? Or whether separate rules will be necessary for similar products governed by different industry laws?

3) Formulation Of Internal Compliance Rules

The Law clearly stipulates that financial service providers will be required to draw up their own customer solicitation policy covering the marketing of financial products. In addition to providing for fair conduct in the solicitation of customers, in placing the responsibility for drawing up detailed provisions regarding solicitation with the service providers themselves, this regulation places the emphasis on self-regulation.

Financial service providers probably already have company rules that cover similar ground to this "solicitation policy," but the new legislation will force them to publicize these rules, which will have the effect of strengthening internal compliance regulations and forcing companies to comply with them. The working group's report also welcomed the fact that this might lead to competition between service providers regarding compliance regulations.

4. Future Outlook

The subcomittee of the FSC is tackling 3 major regulatory areas with the "Japanese Financial Services Law:" namely, (1) the introduction of collective investment schemes, (2) the formulation of regulations governing the sales of financial products and solicitation of customers, and (3) the creation of a system of out-of-court dispute resolution (ADR – Alternative Dispute Resolution). The first two were dealt with by the Revised Investment Trust Law[5] and the Financial Products Sales Law. Regarding the outstanding issue of an ADR system, the FSC is currently examining the construction of a new appeals system that would be able to resolve disputes more quickly and with less red-tape than the current costly and time-consuming court-based system. While some have pressed for a financial ombudsman system modeled on that of the UK, there remain many issues to resolve such as which body is to operate the system, and how it will be funded and staffed. A conclusion will have to wait until the subcommittee's final report in June 2000.

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5 For a detailed examination of this law please refer to Y. Seki "Investment Trust Law Revisions To Expand Scope Of Investments" (Capital Research Journal, Summer 2000).