The Latest Amendments to Japan's Securities and Exchange Law

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On 23 May 2003 the latest amendments to Japan's Securities and Exchange Law were approved by the Diet. The amendments introduce a system of stockbroker agents and allow stock exchanges to become holding companies.

1. Background to the Amendments

Japan's securities laws underwent a major change in December 1998, when the main parts of the Financial System Reform Law ("Big Bang") came into effect, and again in December 2000, when the amendment to the Securities and Exchange Law allowing stock exchanges to become for-profit corporations came into effect.[1] Despite this, however, progress in achieving the goals of the Financial System Reform Law (i.e., to revitalize Japan's securities markets and transform the country's financial system) has been slow. More than half of personal financial assets in Japan (estimated at about ¥1,400 trillion) are still held in the form of savings deposits, and Japanese companies are still largely dependent on bank loans for their capital.

This was the background against which, in August 2001, the Financial Services Agency published its "Program for Structural Reform of Japan's Securities Markets: Creating the Conditions for Retail Investors to Play a Key Role" and, in August 2002, its "Program for Expediting Reform of Japan's Securities Markets." These two policy documents contain a wide range of proposals (including amendments to existing legislation) aimed at revitalizing Japan's securities markets and, in particular, encouraging individuals to invest more in securities.[2]

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1 For more about the Financial System Reform Law see Sadakazu Osaki, "Outline of Financial System Reform Act," Capital Research Journal, Summer 1998. For more about the amendment to the Securities and Exchange Law allowing stock exchanges to become corporations see Sadakazu Osaki, "Legal Revisions Allow Exchanges to Be Formed as Joint-Stock Companies," Capital Research Journal, Autumn 2000.

2 Both documents can be accessed via the Financial Services Agency's Internet site ＜ http://www.fsa.go.jp/＞.

The "Program for Expediting Reform of Japan's Securities Markets" seeks (1) to make it easier for ordinary individuals to invest in securities and to ensure (2) that they can rely on the markets on which securities are traded and (3) that these markets are efficient and competitive. In order to achieve these aims it includes a wide range of proposals, including proposals to increase the number of stockbrokers' sales channels, educate the public about investment, increase the powers of the Securities and Exchange Surveillance Commission (SESC), tighten disclosure requirements, remove some of the restrictions on private placements and reform the systems governing both the country's stock exchanges and the securities settlement system. Following the publication of the proposals, the Financial System Council's First Subcommittee set up three working groups in September 2002 to consider the proposals, and the Subcommittee's first report ("Expediting Reform of Japan's Securities Markets") was published in December 2002.[3]

As the proposals being considered by the Working Group on Disclosure Requirements (e.g., the content of the Japanese equivalent of US annual reports on Form 10-K and the system governing private placements) did not require any changes in the law, its recommendations have been gradually put into effect since the end of February 2003 by amending government and Cabinet Office ordinances and official guidelines. However, the recommendations of the Working Group on Market Intermediaries and the Working Group on Stock Exchanges had to take the form of amendments to the Securities and Exchange Law.

The recommendations of these two working groups cover two main areas: (1) the securities industry (especially the introduction of a system of stockbroker agents and the extension of stockbroking without solicitation by financial institutions) and (2) the stock exchanges (especially the proposals to allow stock exchanges to become holding companies and to allow overseas stock exchanges to locate trading terminals in Japan).

2. The Amendments Concerning the Securities Industry

1) The proposed introduction of a system of stockbroker agents

The proposal to introduce a system of stockbroker agents is aimed at giving investors greater choice in where they place orders to buy and sell securities.

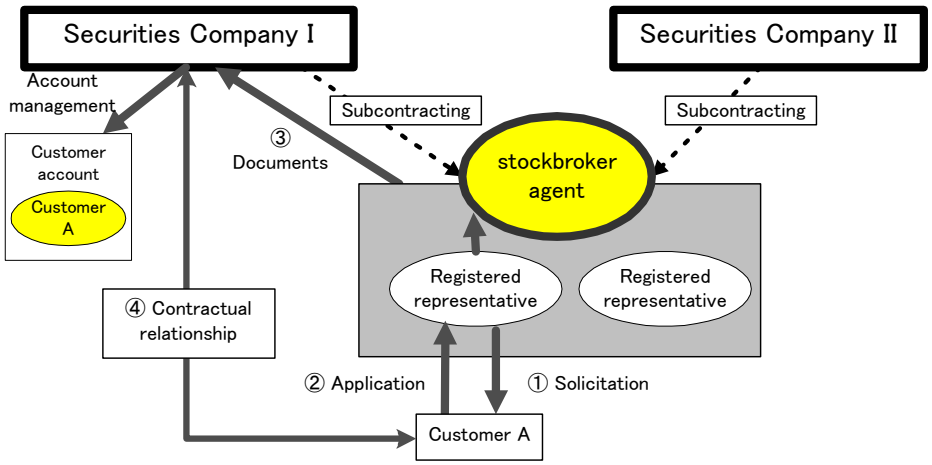
One of the factors apparently behind this proposal is the existence in the United States of independent broker-dealers (so-called "independent contractors"), who

[3] The report can be accessed via the Financial Services Agency's Internet site.

otherwise work as accountants or financial planners, as well as broker-dealer firms (so-called "introducing brokers") that outsource all their back office work.

Section 2.11 of the Securities and Exchange Law defines a "stockbroker agent" as someone who "…, acting on behalf of a securities company, channels orders to buy and sell securities (including futures and options on securities) to that securities company or solicits subscriptions to offers of securities (including private placements) on its behalf." A stockbroker agent may solicit business and take orders from customers on behalf of one or more securities companies. The contractual relationship is between the customer and the securities company (see Figure 1).

Figure 1 Role of the Multi-Tied Stockbroker Agent



Source: Financial Services Agency.

Under the proposals (Section 66.2), anyone wishing to act as a stockbroker agent will have to register with the Financial Services Agency. Unlike securities companies, which are required to be a corporation and to have a minimum capitalization, stockbroker agents may be either individuals or corporations. However, financial institutions (including banks) and securities companies as well as directors and employees of securities companies and financial institutions will not be allowed to act as stockbroker agents (Sections 66.2 and 66.5.5).

This may be because Section 65 of the Securities and Exchange Law prohibits banks and other financial institutions from normally engaging in stockbroking. However, if the point of prohibiting banks and other financial institutions from engaging in stockbroking is, as is often claimed, to prevent conflicts of interest with customers or avoid putting the institution at risk, it is difficult to see why it is necessary to prohibit an activity that only involves channeling orders to a securities company.

Whenever a stockbroker agent acts as an intermediary, he will have to tell his customer which securities company he is acting on behalf of (Section 66.10). Similarly, he will not be allowed to be entrusted with cash or securities from customers, and any entrustment will have to be done directly between a customer and the securities company concerned (Section 66.12).

Directors and employees of a stockbroker agent are prohibited from either (1) soliciting orders using undisclosed information about issuers of securities which has come into their possession in the course of other business or (2) trading in securities on their own account using information about customer orders (Section 66.13). Similarly, any loss suffered by a customer as a result of action by a stockbroker agent will normally be regarded as the responsibility of the securities company on whose behalf the agent has acted (Section 66.22).

Finally, any directors or employees of a stockbroker agent who solicit customer business will have to have passed the Japan Securities Dealers Association's examination and be registered representatives (Section 66.23).

2) The proposed greater use by banks of stockbroking without solicitation

Although the Securities and Exchange Law prohibits banks and other financial institutions from normally engaging in securities business, there are a number of exceptions such as the sale of government bonds and investment trusts. Another of these exceptions is the acceptance and execution of unsolicited orders from a customer by a written instruction (Section 65).

Under the amendments, this section and the corresponding sections of the Law Governing Agricultural Cooperative Associations and the Law Governing Shinkin Banks will be amended, and even so-called Cooperative Financial Institutions will be allowed to offer stockbroking without solicitation. However, the fact that this exemption precludes any solicitation of customer business and inevitably entails considerable administrative cost means that banks are, without exception, reluctant to offer this service. Therefore, even if cooperative financial institutions are allowed to offer such a service, it is unlikely to result in any immediate increase in securities investment by individual investors.

3) The proposed introduction of wrap accounts

In the United States it is quite common for investors to have "wrap accounts" with broker-dealers, which offer advice on asset allocation, fund management and mutual funds, execute orders and provide regular reports. Investors pay a fee based on the balance of their account. US full-service brokers are now using such accounts, nowadays usually called "separate managed accounts," as part of their strategy to acquire new customers by improving their asset management advice and fend off competition from online brokers.

The introduction of such accounts in Japan was envisaged as part of the country's Big Bang, and the legislative framework is already in place. Indeed, some Japanese companies (e.g., the Nikko Cordial Group's Global Wrap Consulting Group) are already marketing such products.

However, under the existing rules, Japanese securities companies that operate discretionary accounts are obliged to inform customers in writing of the details of any transactions they carry out on their own account. This means that, if they offer wrap accounts, an external investment adviser has to be involved. Some observers therefore believe that not many securities companies in Japan would be keen to offer such accounts.

The amendments therefore provide that, in situations where the Financial Services Agency considers that not informing customers in writing of any transactions that securities companies carry out on their own account would not be detrimental to the public good or investors' interests, securities companies should be exempted from this requirement (Section 31.2 of the Investment Advisory Law).

3. The Amendments Concerning Stock Exchanges

1) The introduction of a system of holding companies

Since December 2000, following earlier amendments to the Securities and Exchange Law , Japanese stock exchanges, which until then could only be mutually owned, have had the option of demutualizing. However, in order to ensure that Japan's stock exchanges were able to continue to perform their public role and not become dominated by special interests, it was decided that no single shareholder should be allowed to own 5% or more of the shares in any one exchange (Section 103 of the Securities and Exchange Law before the latest amendments).

In contrast, in some other countries a more flexible attitude has been taken to the way in which stock exchanges operate in order to encourage greater cooperation among them. One such example is Euronext, a holding company which operates a number of stock exchanges as subsidiaries. In Japan, however, any attempt to go down that route would inevitably lead to the merger of the exchanges involved. Also, under the law as it currently stands, no single shareholder would be able to gain a controlling interest in a stock exchange even if it was demutualized. Free of the risk of a takeover, the management might not be quite as disciplined as they might otherwise have been, and the shares issued by the stock exchanges might trade at a discount.

The latest amendments therefore replaced the current 5% limit on shareholdings in a demutualized stock exchange with a limit of 50% (Section 103 of the Securities and Exchange Law). Also, anyone acquiring more than 5% of the shares will be required to declare this, while anyone wishing to become a principal shareholder with 20% or more of the voting rights (15% or more if the share acquisition is likely to enable that shareholder to exercise a significant influence over the company's finances or how the company is run) will have to obtain permission (Sections 103.2 and 106.3). In addition, the amendments allow holding companies that own the majority of shares in a stock exchange to be set up, provided this is approved by the Financial Services Agency (Sections 106.3 and 106.10). Similarly, the Japan Securities Dealers Association, the stock exchanges, and financial futures exchanges that have been granted permission to own stock exchanges as subsidiaries will be allowed to have a majority shareholding in stock exchanges (Section 103).

Stock exchange holding companies will be subject to the same shareholder rules and the same supervision as the actual stock exchanges: shareholdings of more than 5% will have to be declared; shareholdings of 20% or more will have to be approved; and shareholdings of more than 50% will not be allowed (Sections 106.14, 106.15 and 106.17). Moreover, stock exchange holding companies will not normally be allowed either (1) to engage in any business other than managing their stock exchange subsidiaries and related activities or (2) to own any subsidiaries other than those engaged in activities related to setting up a stock exchange securities market (Sections 106.23 and 106.24). These restrictions on their activities are basically the same as those on the activities of demutualized stock exchanges (cf. Section 87.2 of the current Securities and Exchange Law).

The reason the Japan Securities Dealers Association and the stock exchanges will also be allowed to own stock exchange subsidiaries is probably that, since both are allowed under the existing Securities and Exchange Law to set up securities markets, doing this via a subsidiary was considered to be unproblematical.

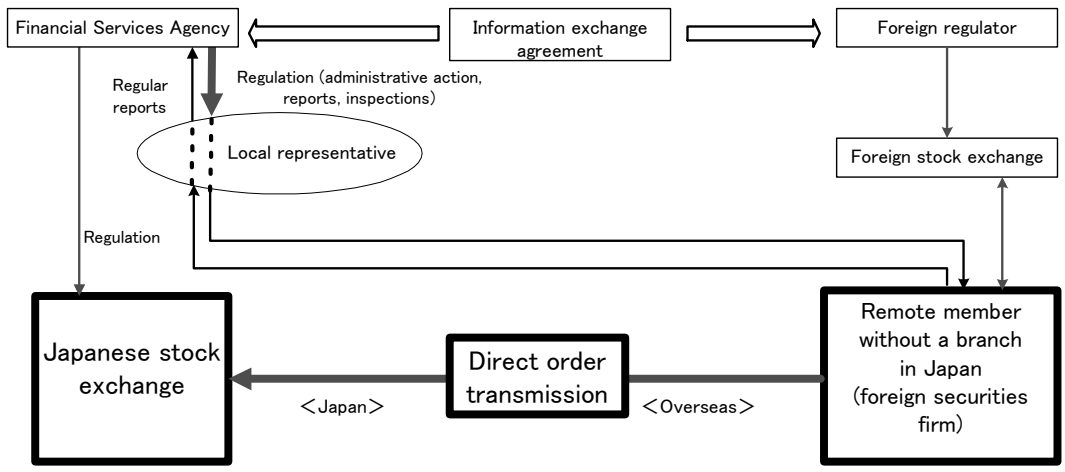
2) Foreign participation in Japanese stock exchange trading and the location by Japanese stock exchanges of terminals overseas

Advances in information and communications technology and the globalization of securities trading have led to increased competition among securities markets. Just as alternative or proprietary trading systems are increasingly able to offer the same capability as a traditional stock exchange, stock exchanges themselves are increasingly becoming demutualized. As a result, stock exchanges are increasingly cooperating on an international scale. Often this cooperation involves listing the same companies, using the same trading systems or granting mutual recognition to members or trade participants—in other words, a strengthening of links.

However, even if Japanese stock exchanges had cooperated with foreign stock exchanges and, for example, agreed to recognize their members or trade participants, under existing Japan law they would only have been able to do this if the member firms concerned had branches in Japan and were registered under the Law on Foreign Securities Firms.

The amendments therefore seek to enable foreign securities companies to engage in stockbroking in Japan (albeit restricted to exchange trading) without having to set up a branch under the Law on Foreign Securities Firms. In other words, the amendments will enable foreign securities companies to engage in exchange trading in Japan with the approval of the Financial Services Agency (Section 13.2 of the Law on Foreign Securities Firms). This will enable Japanese stock exchanges to recognize foreign securities firms that do not have a branch in Japan as "remote members" (see Figure 2). In terms of actual trading, the Japanese stock exchange concerned would probably set up its own trading terminals overseas and receive any orders direct.

Figure 2 Trading Procedure for Foreign Securities Firms Without a Branch in Japan



Source: Financial Services Agency.

However, in order to ensure that they do not act as a conduit for any unfair trading activity including insider trading and market manipulation, foreign securities firms that are allowed to do this are required to report to and undergo unannounced inspections by the Japanese regulatory authorities as well as have a representative in Japan (Sections 31, 13.4 and 13.8 of the Law on Foreign Securities Firms).

Parallel to this, foreign stock exchanges may seek to set up their own trading terminals in Japan. According to the Financial Services Agency, there are already cases where a foreign stock exchange (e.g., the Chicago Mercantile Exchange with its Globex system) has been granted permission to set up a trading terminal in a dealing room belonging to a Japanese securities firm. There have been similar cases overseas. In the European Union, as a result of the development of the single market, stock exchanges are allowed to set up trading terminals in other member countries under the Investment Services Directive (ISD) adopted in 1993. In the United States, the British exchange Tradepoint Financial Networks plc, as it was known at the time, was exempted from having to register with the Securities and Exchange Commission (under Section 5 of the Securities and Exchange Act of 1934, which grants this exemption to exchanges with a low trading volume) and allowed to set up trading terminals on condition that it reported the level of trading activity to the Commission.[4]

Under the amendments, a new rule ("Foreign Stock Exchanges") will be included in the Securities and Exchange Law to enable foreign stock exchanges to seek approval from the Financial Services Agency to set up trading terminals in Japan and to set up a securities market on which Japanese and foreign securities firms (in the case of government bond futures, also banks) will trade (Section 155 of the Securities and Exchange Law).

4. An Assessment of the Amendments

Most of the provisions in the amendments will come into force in April 2004. However, any lifting of the ban on stockbroking without solicitation by agricultural cooperative associations will come into force a month after the law is promulgated.

The amendments have a twofold aim: to make it easier for Japanese investors to buy and sell securities and to enable Japan's stock exchanges to adapt to globalization.

4 Tradepoint subsequently entered into a deal with the Swiss Stock Exchange to create virt-x, to which it later changed its own name. In February 2003 the Swiss Stock Exchange acquired nearly all the outstanding shares in virt-x and brought it under its ownership.

In order to achieve this aim, the amendments focus on three main policies: the introduction of a system of stockbroker agents; the introduction of a holding company system for stock exchanges; and allowing stock exchanges to set up trading terminals overseas.

The proposal for the introduction of a system of stockbroker agents is in response to the calls for such a system (mainly from new entrants to the Japanese market) following the success of independent contractors in the United States. Provided this poses no serious risk to investors, it would seem only sensible to respond to such calls—not least in order to make Japan's securities markets more competitive. However, as was mentioned above, it is questionable whether there is much sense in prohibiting banks from taking part in such a system. Moreover, whether or not the introduction of such a system will induce retail investors to become more active will depend on the extent to which stockbroker agents can gain their confidence.

It is questionable whether, in an attempt to reform Japan's stock exchanges, it is reasonable for the authorities to prohibit anyone in normal circumstances from acquiring a majority shareholding in either a stock exchange or a stock exchange holding company. It cannot be denied that the business in which stock exchanges are engaged (i.e., that of setting up securities markets) is of a highly public nature and therefore requires a certain degree of monitoring of their principal shareholders in order to safeguard the interests of the public. However, it should be sufficient for shareholders with an interest of 20% or more to be approved by the authorities: to go one step further and insist that anyone acquiring a majority shareholding must form a holding company would seem to be excessive regulation. In fact, this insistence could even make it more difficult for corporate groups involved in businesses other than running a stock exchange to gain a controlling interest in an exchange, impairing their management and making them less competitive on the international arena.

Finally, while the proposal to allow Japanese stock exchanges to set up trading terminals overseas and foreign stock exchanges to set up trading terminals in Japan is understandable as a response to the trend towards global competition among securities markets, the risk that setting up trading terminals overseas could encourage unfair trading activity by foreign securities firms beyond the jurisdiction of the Japanese regulatory authorities cannot be ignored. This is why the amendments require foreign securities firms that engage in such trading to have a representative in Japan. However, it remains to be seen whether this will provide sufficient regulatory control.