

Outline of the Financial Instruments and Exchange Law

1. Introduction

In order to increase investor protection and achieve greater consistency in financial product regulation, in June 2006 the Japanese Diet passed two bills that will have a significant impact on the laws relating to finance and financial instruments in Japan.¹ These bills were promulgated on June 14, 2006. The new rules to be implemented under these bills are described collectively as the “Financial Instruments and Exchange Law” (“FIEL”).

This new legislation covers four basic concepts:

- More comprehensive regulation of investment services: The FIEL consolidates regulation of various securities and other “financial instruments businesses”, expands the range of regulated instruments by explicitly covering interests in trusts, partnerships and other “collective investment schemes” (*i.e.*, funds) and by broadening of the scope of the term “derivatives”. The FIEL also expands and more comprehensively regulates the types of “business” that financial firms may provide, such as by including regulating certain self-offerings of shares, self-management of properties and asset administration activities, and extends uniform rules of conduct to sales and solicitation of financial instruments, while differentiating between professional investors and general investors.
- Improved disclosure system for public companies: The FIEL introduces a statutory quarterly reporting system, enhanced internal control over financial reporting, greater disclosure of tender offers and more frequent reports of substantial shareholding.
- Enhanced performance of self-regulatory functions of exchanges: The FIEL introduces regulations which enhance the self-regulatory functions of exchanges.
- Tougher sanctions: The FIEL significantly raises maximum criminal penalties for various activities and creates civil and criminal fines and penalties for market manipulation achieved through so-called “*misegyoku*” dummy orders.

The FIEL abolishes 4 laws and amends 89 laws, chiefly those noted below:

¹ The new bills were the “Bill for Partially Amending the Securities and Exchange Law and Other Financial Laws”, Law No. 65 of 2006, and the “Bill for Abolishing and Amending the Related Laws to Implement the Bill for Partially Amending the Securities and Exchange Law and Other Financial Laws”, Law No. 66 of 2006.

Laws to be abolished and consolidated into the FIEL:

- Law Concerning Foreign Securities Firms
- Law Concerning the Regulation of Investment Advisory Service Relating to Securities
- Financial Futures Trading Law
- Law Concerning the Regulation of Mortgage Business

Laws to be amended, portions of which will be consolidated into the FIEL:

- Securities and Exchange Law (“SEL”)
- Law Concerning Investment Trusts and Investment Corporations
- Commodity Exchange Law
- Banking Law
- Real Estate Syndication Law
- Insurance Business Law
- Trust Banking Law
- Law Concerning the Regulation of the Commodity Investment Business
- Law Concerning the Sale of Financial Products
- Agricultural and Forestry Central Banking Law
- Agricultural Cooperatives Law
- Smaller Business Cooperatives Law
- *Shinkin* Bank Law

2. More Comprehensive Regulation of Investment Services**2.1 Consolidated Regulation of Securities and Other “Financial Instruments Businesses”**

The FIEL consolidates regulation of the following businesses and terms them as “financial instruments businesses”:

- Securities business (under the SEL and the Foreign Securities Firms Law);
- Investment trust management business and investment corporation asset management business (under the Investment Trusts and Investment Corporations Law);
- Investment advisory business and discretionary investment business (under the Securities Investment Advisory Law);
- Financial futures trading business (under the Financial Futures Trading Law);
- Trust beneficiary rights sales business (under the Trust Banking Law);
- Mortgage instrument trading business (under the Mortgage Business Law); and
- Commodity fund sales business (under the Commodity Fund Law).

Under the FIEL, firms engaged in these businesses will be referred to as “financial instruments firms” rather than as “securities firms” or the like (though as noted below firms engaged in certain lines of business may continue to call themselves “securities firms”) and “exchanges” will be termed “financial instruments exchanges”. The SEL will be renamed as the “Financial Instruments and Exchange Law” (“FIEL”).

2.2 Expanded Range of Regulated Financial Instruments

The FIEL expands the definition of “securities” to include interests in trusts in general and interests in a newly defined category of “collective investment schemes” that, regardless of legal structure, function to (1) collect capital or contribution in monetary or other similar form from two or more persons, (2) conduct business or undertake investments using such money, and (3) distribute profits or properties to investors from the business/investments. This will, among others, cover partnership interests in various commodity funds, real estate funds and business funds.

The FIEL also expands the regulated scope of derivative transactions from simply securities derivatives and futures transactions under the SEL, to include “derivative transactions”, “market derivative transactions”, “over-the-counter derivative transactions” and “foreign market derivative transactions”. This will cover transactions on a wide range of assets and indices, such as interest rate swaps, credit derivative transactions and weather derivative transactions. To facilitate further expansion of the range of covered derivative transaction types, the FIEL also provides a mechanism for amendment of the definition of “derivative transactions” by legislative decree.

2.3 More Comprehensive Regulation of the Types of Business that Financial Instruments Firms May Conduct

The FIEL broadens the range of businesses that are regulated while providing for greater cross-sectoral consistency.

2.3.1 Expanded “Financial Instruments Business”

The FIEL provides that the financial instruments business includes the “sales and solicitation” of securities and derivative transactions, “investment advisory” services, “investment management” services and “customer asset administration” services.

The new definition of “financial instruments business” expands the previous framework by extending regulation to:

- the self-offering of interests in investment trusts, overseas investment trusts, mortgage securities and other types of collective investment schemes;
- the self-management of properties in collective investment schemes; and
- the incidental custody and administration of customer assets (e.g., securities and cash).

In addition, the FIEL defines and regulates the “financial instruments introducing brokerage business”, which covers introducing brokerage broadly, including the introducing brokerage of investment contracts and investment advisory contracts.

2.3.2 More Flexible Rules for Financial Instruments Businesses; Registration

The FIEL provides that firms must be registered in order to engage in any financial instruments business activities. Registration requirements vary depending on the category of business, which are divided into:

- the “first financial instruments business”, covering all financial instruments businesses dealing with all the securities and derivatives;
- the “second financial instruments business”, covering sales and solicitation of securities with lower liquidity and market derivatives;
- the “investment advisory and agency business”, and
- the “investment management business”.

The FIEL establishes different requirements - such as minimum capital, net asset requirements and need for approvals to enter new businesses - depending upon the category. Only firms engaged in the “first financial instruments business” may use the words “securities firm” in their firm name.

Existing securities firms and foreign securities firms will be deemed have obtained entry approval under the FIEL on the day that the FIEL comes into

force after further specified by Cabinet Order (as noted in item 6 below), provided that they submit an Entry Request Form and the necessary accompanying documents to the Prime Minister within three months of the FIEL coming into force. The Prime Minister will register the details in a Financial Instruments Firm Register.

The FIEL also requires registration for “financial instruments introducing brokerage firms” to engage in the “financial instruments introducing brokerage business”.

2.3.3 Cross-Sectoral Application of Business Conduct Regulations

The FIEL provides for consistent rules of conduct for each type of business activity, and establishes specific investor protection rules for sales and solicitation of all financial instruments, regardless of the business type. Specific rules include the following, among others:

- Regulation on advertisements;
- Obligation to deliver written documents before making a contract;
- Obligation to deliver written documents at the time of entering into a contract;
- Cancellation in writing (cooling-off);
- Various prohibited conduct (ban on the delivery of false information, solicitation by providing decisive judgments on uncertain matters, unwanted solicitation or re-solicitation);
- Prohibition of loss compensation; and
- Principle of appropriateness.

With the object that financial instruments with similar economic functions are subject to similar regulations, the FIEL also mandates that similar rules of conduct be established for other regulated firms that market financial instruments which have strong investment characteristics (certain bank deposits, insurance, trusts, commodity futures and real estate syndications).

2.4 Flexible Regulation Based on Type of Customer

Unlike the business conduct regulations under the SEL, which apply regardless of the type of customer involved, the FIEL introduces flexibility to financial instruments firms by allowing for less restrictive rules when dealing with “professional investors” as opposed to “general investors”. For general investors, investor protection remains a predominant concern, but for transactions with professional investors concerns about

investor protection are more relaxed, while regulations aimed at market integrity remain applicable.

The FIEL defines “professional investors” to include qualified institutional investors, the Japanese government, the Bank of Japan and corporations defined by the Investor Protection Fund and cabinet ordinance. All other investors are categorized as “general investors,” with the following exceptions:

- General corporate investors may be treated as professional investors upon request, and corporations designated by cabinet ordinance may be treated as general investors upon request.
- All individual investors are treated as general investors, although they may change their status to that of a professional investor upon request if they can meet certain stringent criteria stipulated by cabinet ordinance.

3. Improved Disclosure System for Public Companies

3.1 Quarterly Disclosure Requirement

The FIEL requires companies that are listed on any Japanese stock exchange to file quarterly reports in order to secure the timely disclosure of their financial and corporate information. Such quarterly reports must be reviewed by a certified public accountant or an auditing firm and submitted within 45 days after the end of each fiscal quarter. Listed companies are relieved from the obligation to submit a semiannual securities report (*hanki hokokusho*), but must continue to file an annual securities report (*yuuka shoken hokokusho*).

The quarterly reporting requirement does not apply to companies that are subject to continuing disclosure requirements but are not listed in Japan (such as issuers of POWLS - securities which are publicly offered without listing). These firms must still file both the annual securities report and a semi-annual securities report.

3.2 Internal Control Reporting Requirement

With the aim of better ensuring adequate disclosure of financial and corporate information, the FIEL borrows from Section 404 of the U.S. Sarbanes-Oxley Act by requiring public companies to file an internal control report for each fiscal year, stating the results of an assessment of the effectiveness of internal controls over financial reporting. The report must be audited by a certified public accountant or an auditing firm. Detailed requirements for the content and form of the internal control report will be determined by the regulation under the FIEL.

3.3 Certification by Management

Together with their annual securities reports and quarterly reports (or semiannual reports, as the case may be), public companies will be obligated to file a confirmation from

management (*kakunin-sho*) that certifies that the contents of the relevant report are adequate under the laws or ordinances of the FIEL. The scope of signer of the confirmation will be specified by regulation under the FIEL.

3.4 Disclosure of Corporate Reorganizations

The FIEL establishes a new disclosure requirement for issuances and/or delivery of securities in the case of corporate reorganization events such as mergers, spin-offs and share exchanges. The FSA's guidelines in relation to disclosure had excluded such issuances and/or delivery of securities from the concept of "public offering", but the FIEL expressly includes the issuance and/or delivery of securities in connection with reorganization events within the concept of public offering.

As a result, a securities registration statement (*yuuka shoken todokedesho*) must be filed in connection with reorganization events involving share transfers if both (i) the target company is a public company subject to continuing disclosure requirements (annual securities report, etc.), and (ii) the company whose securities will be issued or delivered in connection with the corporate reorganization is a private company not subject to continuing disclosure obligations, provided that the FIEL creates an exception to the securities registration statement requirement if the number of shareholders of the target company (who will be offered shares of the initiating company) is less than a threshold number to be prescribed by regulation under the FIEL (similar to the private placement exception). The securities registration statement should in principle be filed two weeks before the shareholders meeting to approve such corporate reorganization.

Please note that even if the registration statement requirement applies to the corporate reorganization, there is no requirement that a prospectus be delivered to the security-holders of the target company (unlike typical public equity offerings).

3.5 Review of Tender Offer System

The FIEL makes several changes to the tender offer bid ("TOB") regulations.

To close a previous loophole, the FIEL requires a shareholder to commence a registered TOB if it has rapidly increased its shareholdings through certain combinations of off-market and on-market share purchases. The TOB requirements will now also be triggered if a shareholder exceeds the one-third threshold as a result of the acquisition, within a timeframe of three-months or less, of more than 10% of the target company's voting shares, including off-market purchases of more than 5% of its voting shares.

In addition, to secure impartiality between bidders, if a substantial shareholder holding more than one-third of the voting shares in the target company plans to increase its shareholding during the period of a TOB made by another bidder, the substantial shareholder is required to commence a TOB.

The information that the tender offeror must disclose in the TOB Registration Statement (*kokai kaitsuke todokede-sho*) in order to launch a TOB has been expanded to include

(i) more substantive and specific information about the offeror's purpose in acquiring shares via a TOB, and (ii) the rationale and process for determining the purchase price, among other matters.

The FIEL requires the company that is a tender offer target to file a position statement report (*iken hyomei houkoku-sho*) that will be available for public inspection. Additionally, the target company may pose questions to the tender offeror, which questions the tender offeror must respond to by submitting a publicly available report.

The TOB period, which must be a minimum of 20 days and a maximum of 60 days, is now counted based on business days, not on calendar days as under the previous rules. If the TOB period is less than 30 days, the target company may, by making a request in the position statement report, require that the period of the TOB be extended to 30 days.

In the context of takeover defense measures, a Government Ordinance has been issued under the FIEL which provides that the tender offeror may reduce the TOB price if the stock price is diluted due, for example, to a stock split or a *gratis* issue of shares by the target company, since a dilution of this nature may cause an unexpected financial loss to the tender offeror.

A Government Ordinance has also been issued under the FIEL which expands the scope for withdrawing a TOB beyond conventional causes permitted under the previous rules, such as merger or bankruptcy of the target company, to include actions typically taken by a target company in order to defend itself from a takeover, such as a stock split, *gratis* issue of shares, or sale of treasury stock, among others.

Finally, a Government Ordinance issued under the FIEL requires a tender offeror to make an offer to buy all shares when its shareholding ratio exceeds two-thirds, thus protecting small shareholders from the risk of the delisting of their shares.

3.6 Review of the Substantial Shareholding Reporting System

The FIEL contains significant amendments to enhance transparency for investors. The FIEL will require that substantial shareholdings reports be filed through the EDINET electronic disclosure system, and makes the reporting requirement applicable to public investment securities issued by an investment corporation, such as REIT (*i.e.*, real estate investment trust).

The FIEL tightens the less stringent reporting system for certain financial institutions and professional investors in several ways. First, the reporting cycle and deadline for reporting for such investors has been shortened from once in three months to at least two times per month and from within 15 days to within five business days after a shareholder's holding exceeds 5%. Second, the reporting cycle and deadline required for a shareholding increase or decrease has been tightened to apply to changes of 1% or more measured twice monthly, instead of the previous threshold of 2.5% or more measured at the end of each quarter. Third, under the new amendments, if there have been any changes in material matters or there is a change in the shareholding from more

than 10% to less than 10%, the special reporting system is not applied and a filing within five business days is required. Finally, the FIEL makes the professional investor reporting system unavailable if a purpose of the shareholding is to make “important shareholder proposals” such as a business transfer, merger or acquisition, or a change of representative director or other officers (expanding the existing disqualifying purpose of “business control”).

4. Enhanced Performance of the Self-Regulatory Functions of Exchanges

The FIEL requires financial instruments exchanges to adequately conduct “self-regulatory functions” (operations concerning listing or delisting, and examination on the compliance of market participants) in order to enhance the fairness and transparency of services offered by such exchanges. To ensure that their self-regulatory functions are adequately managed, the FIEL authorizes financial instruments exchanges to delegate any or all of their self-regulatory functions to a “self-regulatory corporation”, upon approval of the prime minister. A majority of the board members of such a self-regulatory corporation must be outside members. Corporate financial instruments exchanges may establish a “self regulatory committee” that makes decisions on self-regulatory functions; a majority of the members of the self-regulatory committee must be independent directors.

The FIEL provides that a financial instruments exchange may not list its shares, in its own market or other markets, without the approval of the prime minister.

5. Tougher Penalties

The FIEL significantly raises maximum criminal penalties for various activities and creates civil and criminal fines and penalties for market manipulation achieved through so-called “*misegyoku*” dummy orders. In the case of market manipulation through “*misegyoku*” orders, the FIEL extends to securities firms acting for their own account the criminal sanctions now applicable only to customers, and creates civil penalties applicable to both customers and securities firms.

The relevant maximum criminal penalty for a material misstatement of a securities registration statement, annual securities report, tender offer statement etc., illicit acts, fraudulent means, acts of violence or threats, manipulation and the other acts has been increased from imprisonment of 5 years or a fine of JPY 5 million for individuals and a fine of JPY 500 million for corporations to imprisonment of 10 years or a fine of JPY 10 million for individuals and a fine of JPY 700 million for corporations.

The relevant maximum criminal penalty for the non-submission of a securities registration statement, annual securities report, tender offer statement, substantial shareholdings report etc., material misstatement of an internal control report, quarterly report, substantial shareholdings report etc., or insider trading, has been increased from imprisonment of 3 years or a fine of JPY 3 million for individuals and a fine of JPY 300 million for corporations to imprisonment of 5 years or a fine of JPY 5 million for individuals and a fine of JPY 500 million for corporations.

6. Effective Date

The amendments specified under the FIEL will come into effect gradually depending on the type of provisions involved. Most of the provisions under the FIEL are expected to come into force as prescribed by Cabinet Order which shall be within the period not exceeding one and half years from promulgation of the FIEL which was on June 14, 2006. Overall, there are expected to be five separate dates upon which different provisions of the FIEL will come into effect, subject to prescription by Cabinet Order.

The first set of amendments, relating to countermeasures against market manipulation and increased penalties, came into effect on July 4, 2006.

The second set of amendments, relating to regulations concerning the tender offer system and the change from the “business control purpose” to “important proposal, etc.” in relation to the substantial shareholding reports, came into effect on December 13, 2006.

The third set of amendments, relating to the filing frequency, shorter filing deadline and the mandatory electronic filing of the substantial shareholding reports, came into effect on January 1, 2007.

The fourth set of amendments, covering most of the other provisions of the FIEL including the provision whereby the SEL will be renamed the “Financial Instruments and Exchange Law”, is specified to come into force on a date to be designated by cabinet order not later than one and a half years from the promulgation of the FIEL, which is expected to be in the summer (July to September) of 2007. However, the provisions relating to the introduction of the statutory quarterly reporting requirement, internal control system over financial reporting and management confirmation system will become effective for the fiscal year commencing April 1, 2008.

The fifth set of amendments is specified to come into force within the period not exceeding two and a half years from the promulgation of the FIEL (*i.e.*, by December 14, 2008). The provisions to take effect at this time relate to the operation of various independent business associations, such as the Japan Securities Dealers Association (“JSDA”).

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Please do not hesitate to contact us if you have any questions in relation to the FIEL and its implementation in Japan.

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