Japan's new Financial Instruments and Exchange Law

Japan's legislation on financial instruments was revised in June 2006 to consolidate, update and improve existing laws. The new law brings together elements of the old *Securities and Exchange Law*, whilst aiming to cover more industry sectors. At the same time, the notion of flexibility has been instilled when regulating financial instruments.

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In June 2006, the Japanese Diet approved a bill amending the *Securities and Exchange Law of Japan* (SEL) and other financial laws to create the *Financial Instruments and Exchange Law* (FIEL). FIEL makes overall amendments to SEL, aiming to enhance investor protection and promote the movement of individual financial assets to the securities markets by creating cross-sectoral rules for the sale and management of investment products and modernizing disclosure rules. FIEL takes effect within 18 months of the promulgation of the amendments set forth in the bill.

Regulation of financial instruments

The two core concepts of FIEL are that it be "cross-sectoral" and "flexible." The concept of being cross-sectoral requires that financial instruments that have economic functions which are equivalent be made subject to the same regulations, while the concept of flexibility requires the elimination or minimization of unnecessary regulation. These core concepts of FIEL purport to enhance investor protections and convenience, while promoting cost-efficient transactions and financial innovation.

To achieve the objective of establishing a cross-sectoral framework that regulates a wide range of financial instruments, FIEL expands the scope of regulated securities to include, for example, interests in trusts and interests in any collective investment schemes (investment funds) entitled to distributions of profits from and/or assets of the business that is the subject of investment. This includes the interests of any investment fund based on the laws of a foreign country.

The rules of conduct stipulated in FIEL are also applied by other laws and regulations to financial instruments with investment characteristics similar to the securities defined under FIEL, in order to ensure that the same rules are applied to financial instruments whose economic functions are identical. Examples are derivative and foreign currency-denominated deposits regulated under the *Banking Law*, and variable and foreign currency-denominated insurance regulated under the *Insurance Business Law*.

Financial instruments business

FIEL introduces a new term, Financial Instruments Firm, to cover companies engaging in the Financial Instrument Business, which includes:

(i) sales and solicitation of securities and derivatives (including securities-related derivatives as well as financial derivatives, credit derivatives, weather derivatives and other derivatives designated by Cabinet Order);

(ii) investment management, and

(iii) investment advice and agency business.

An entity that wishes to engage in Financial Instruments Business is required under FIEL to register as a Financial Instruments Firm, but no license is required.

The sales and solicitation of securities and derivatives are categorized into two types, First-type Financial Instruments Business and Second-type Financial Instruments Business, and include:

(i) securities business, which has been regulated under SEL and the *Foreign Securities Firms Law* (to be replaced by FIEL);

(ii) financial futures trading business, which has been regulated under the *Financial Futures Trading Law* (also to be replaced by the FIEL), and

(iii) trust beneficial interests sales business, which has been regulated under the *Trust Business Law*.

First-type Financial Instruments Business includes a substantial portion of the securities business under SEL as well as businesses related to over-the-counter derivatives. The registration requirements are therefore substantially similar to those for securities firms under SEL. The Second-type Financial Instruments Business has fewer registration requirements and relates to sales and solicitations of securities with lower liquidity (such as interests

in the investment funds discussed above) and market derivatives.

FIEL introduces regulations regarding the sale and solicitation of certain securities by the issuer (or certain parties deemed to be the issuer) of such securities. The sale and solicitation of securities by the issuer are not regulated under SEL, but FIEL includes such business within its definition of the Second-type Financial Instruments Business. Securities subject to this self-solicitation regulation include, for example, beneficiary certificates of investment trust funds and interests in investment funds, but not stocks or bonds.

The business of providing investment management (Investment Management Business) and investment advice (Investment Advisory Business) encompasses the discretionary investment management and investment advisory business regulated under the *Law Regulating Securities Investment Advisory Business* (which will be replaced by FIEL). However, since Investment Management Business and Investment Advisory Business include investment management in, and the provision of advice concerning, derivatives transactions as well as securities, the scope of such businesses is broader than that under the current laws and regulations.

Overview of regulations

In order to accomplish its objective of establishing a regulatory framework for a wide range of services, FIEL sets forth regulations applicable to all types of Financial Instruments Business and to certain types of Financial Instrument Businesses. Also, FIEL introduces the concept of Specified Investors and exempts Financial Instruments Firms from certain regulations when providing services to such professional investors. This Specified Investors classification allows for more flexibility in providing services to professional investors who, in most cases, do not need or wish to be protected by these laws and regulations. The definition details for Specified Investors will be stipulated by a Cabinet Ordinance.

New regulations related to investment fund business

FIEL introduces two new regulations for the investment fund business. The first new regulation concerns self-solicitation of investment fund interests by the investment fund or members of the investment fund. As discussed above, engaging in the business of solicitation of interests in the investment fund by investment fund members falls under the Second-type Financial Instruments Business under FIEL and requires registration as a Financial Instruments Firm. Activities constituting engagement in such business will also be subject to the rules of conduct applicable to the Second-type Financial Instruments Business.

The second new regulation concerns investment management of investment fund assets by investment fund members. Investment management of investment fund assets by the investment fund members themselves is not generally regulated under the current regime, but investment fund members who engage in the business of managing the investment fund's assets will be required to register as Financial Instruments Firms under FIEL. This is because such investment management falls under the Investment Management Business under FIEL. There are certain exemptions to the aforementioned registration requirements. For example, where the investment fund is only for qualified institutional investors and a certain limited number of non-qualified institutional investors, the investment fund member soliciting the investment or managing the investment fund's assets is not required to register, but rather needs only file a regulatory notification.

Disclosure rules

Under FIEL's disclosure rules, the scope of interests in investment funds that are subject to the disclosure obligations is expanded to include an interest in any investment fund that invests principally in securities, regardless of whatever legal form such an investment fund may take. Certain investment fund interests are already subject to certain disclosure obligations under the *Investment Trust and Investment Corporate Law*. In an effort to bring flexibility to the regulations governing investment fund interests, certain investment funds will be permitted to substitute part of the disclosure documents required under the FIEL with some of their disclosure documents required to be prepared by *Investment Trust and Investment Corporate Law* and other law.

Under SEL, mergers, share exchanges, corporate splits and other corporate reorganizations were not treated as "offerings" of securities, since no solicitation was involved in the acquisition of the relevant securities. However, under FIEL, certain corporate reorganizations, including mergers and share exchanges, require registration of the offered securities. This registration requirement applies to corporate reorganizations where the number of shareholders in the target company exceeds a threshold set by a Cabinet Order. Exemption from the registration requirement is available in cases where the shares of the target company are not subject to disclosure obligations, and where the securities being offered are already subject to disclosure obligations. Therefore, a merger where listed shares are offered to the shareholders of the target company would not be subject to a registration requirement. On the other hand, when debt securities are offered to the shareholders as a merger consideration, registration of such debt securities is most likely required because newly-issued debt securities are not normally the securities which are already subject to disclosure obligations. The new *Company Law* allows a foreign parent company to merge its Japanese subsidiary with the Japanese target company by using the foreign parent company's shares

as consideration for the merger[1]. However, if such shares of the foreign parent company are not already subject to the disclosure obligations under FIEL, then compliance with FIEL's registration and disclosure requirements will be necessary.

For high-liquidity securities such as listed shares, the disclosure rules under SEL have been made more rigorous by FIEL. FIEL introduces a quarterly reporting requirement for listed companies. Even before enactment of FIEL, Japanese stock exchanges, such as the Tokyo Stock Exchange, required listed companies to disclose quarterly results; however, this was not a statutory obligation. Moreover, pre-FIEL, stock exchange quarterly reporting requirements did not impose a requirement for review by independent auditors, and the accounting principles applicable to such quarterly financial information were not very clear. FIEL, on the other hand, imposes on listed companies a statutory quarterly report-filing obligation, and detailed accounting principles and review standards are expected to be established by FSA before April 1 2008, the fiscal year beginning on or after which FIEL's quarterly reporting requirement will apply.

FIEL also introduces requirements for managerial assessment of internal controls and for the independent audit of the effectiveness of such controls. In addition, FIEL requires mandatory certification of all statements made in annual and quarterly reports. These changes constitute the Japanese equivalent of the US Sarbanes-Oxley Act, although it is anticipated that the Japanese version may take a different approach in some respects so as not to make the requirements as onerous as those of its US counterpart. The new disclosure rules apply to the fiscal year beginning on or after April 1 2008. As a result, all Japanese listed companies must, within two years, make internal control systems ready for the required audit.

Fraud, tender offers and large-shareholding reporting

In addition to creating FIEL, the amendments increase maximum criminal penalties against certain market frauds, such as untrue statements on disclosure documents, market manipulation and

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insider trading, in an attempt to deal with recent market scandals. Criminal penalties are also expanded to apply to trading orders placed by securities companies on their own accounts with the intent of market manipulation, and civil monetary penalties are expanded to apply to trading orders placed by both securities companies and customers with such intention. These changes take effect 20 days after promulgation of the amendments.

The amendments also include changes to regulations regarding tender offers and large-shareholding reporting requirements. These changes stem from several recent cases dealing with hostile tender offers, the accumulation of listed shares without tender offers, the ambiguity surrounding certain aspects of the SEL regulations regarding tender offers and large-shareholding reporting requirements. Changes to the tender offer rules include:

(i) expanding the scope of mandatory tender offers to include the purchase of the target company's shares from the market, which results in the shareholding ratio exceeding one-third when aggregated with on- and off-market acquisitions within a certain prescribed period;

(ii) allowing the offeror to reduce the offer price if the target company activates certain takeover defences;

(iii) requiring the target company to file a statement of opinion regarding the subject tender offer;

(iv) requiring the offeror to file a statement of response to the questions set out in a statement of opinion and to extend the tender offer period if the period is shorter than the prescribed period and the target company requests for such extension on the statement of opinion, and

(v) requiring the offeror to buy all shares offered to be sold by the shareholders if the offeror comes to own shares in excess of a certain prescribed percentage.

With respect to the large-shareholding reporting requirement, which requires the filing of a report within five days after a shareholder's holding exceeds 5%, changes include making severe the statutory special treatment currently granted to financial institutions, investment advisors and investment fund manager with respect to the filing deadline. The new regulations amends such special treatment to require a large-shareholding report filing to be made within five days after the next designated date, of which there must be at least two per month. This is provided, however, that if the shareholder holds the subject shares for the purpose of making proposals to materially affect the business of the target company, such special treatment is not available.

While most of the changes to the tender offer rule and large-shareholding reporting requirements discussed above take effect within six months of the promulgation of the amendments, certain changes take effect within one year of the promulgation of the amendments.

Endnote

1 Although most of the new Company Law became effective as of May 1 2006, the portion of the new law permitting the use of the foreign parent company's shares as merger consideration will become effective one year after May 1 2006.

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