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- Proposed Rules and Guidelines for a New Regulation under the Amended Banking Act -

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- 2018 Tax Reform and Amendment to the Industrial Competitiveness Enhancement Act -

■ Financial Regulations/ Financial Compliance

Regulatory Framework for Open Innovation
- Proposed Rules and Guidelines for a New Regulation under the Amended Banking Act -

I. Introduction

On March 9, 2018, the Financial Services Agency of Japan (the 'JFSA') released details on its website of a proposed new regulation regarding FinTech companies providing electronic settlement and account information services for bank account holders. The JFSA is currently accepting public comments on its draft rules and guidelines and, following further revisions as necessary, the new regulation is scheduled to come into force on June 1, 2018.

This new regulation aims to enhance collaboration between banks and FinTech companies, thereby promoting open innovation that is expected to facilitate the development of useful services for bank account holders. Another important objective is to reduce the security risk by requiring FinTech companies to register and become subject to regulatory supervision, as well as encouraging banks to permit registered FinTech companies to access their online systems through Application Programming Interfaces ('APIs'), without needing to use bank account holders' secure information (i.e., ID and password). This article provides a high level summary of the proposed regulatory framework and sheds light on the current industry-based trends promoting open APIs.

II. Background

As part of the rise of FinTech companies providing electronic services for bank account holders, such as account aggregation services in personal financial management software, it is often the case that FinTech companies obtain secure information from bank account holders to directly access banks' systems on their behalf, which gives rise to concerns about unauthorized disclosure or misuse.

To address these concerns and other relevant issues as well as to promote open innovation based on collaboration between banks and FinTech companies, a working group was set up within the Financial System Council, an advisory board to the Minister of Finance, to discuss current Japanese practice and regulations overseas, including the PSD2 (i.e., the revised EU Payment Services Directive). The working group published a report in December 2016 setting forth a blueprint for a new regulatory framework including the promotion of open APIs. Generally in line with

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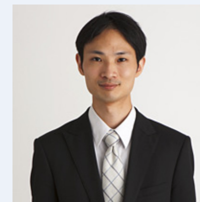
■ Financial Regulations/ Financial Compliance



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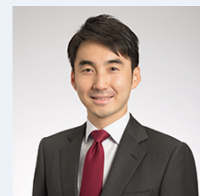
■ Mergers and Acquisitions (M&A)



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the framework as proposed by the December 2016 report, the amendment to the Banking Act of Japan was enacted on May 26, 2017.

III. Scope of Regulated Business

Under the amended Banking Act, entities who provide the service of conveying money remittance instructions to, or obtaining bank account information from, banks by way of electronic processing systems at the request of bank account holders (collectively, 'Electronic Settlement Agency Services') are required to register as an Electronic Settlement Agent with a competent Local Finance Bureau. A limited number of services are exempted from this registration requirement, including recurrent payment services to specific recipients or certain settlement services if provided without obtaining bank account holders' secure information.

IV. Distinction from Bank Agent

As the December 2016 report pointed out, there has been a concern that entities providing Electronic Settlement Agency Services may need to obtain permission to operate as a 'Bank Agent' under the Banking Act, which is required for certain agency services provided for the benefit of banks, especially when such entities receive fees from banks, and be subject to stringent regulations. The proposed guidelines address this concern and clarify that the requirement to obtain permission to operate as a Bank Agent is not triggered by engaging in Electronic Settlement Agency Services, subject to, however, the characteristics of the actual service provided and the nature of any fees received from banks (e.g., fees that banks pay in consideration for using systems prepared by such entities).

V. Registration as Electronic Settlement Agents

FinTech companies already engaged in Electronic Settlement Agency Services as of the date that the new regulation comes into force (i.e. June 1, 2018) are permitted to continue their businesses without registering as an Electronic Settlement Agent until the expiration of a six-month transitional period (upon an application for registration, the transitional period will be further extended if necessary until the completion of the registration process). However, such companies will be subject to the rules applicable to formally registered Electronic Settlement Agents even before registration, except for the regulatory obligation to execute a contract with a bank concerning certain statutory matters and publicly disclose the details of that contract.

To register as an Electronic Settlement Agent, applicants are required to meet certain statutory conditions. In making its assessment, the regulator will focus on the adequacy of an applicant's system risk controls, including development, operation and audit of computer systems, cyber security management and contingency plans. The regulator will take a risk-based approach to its assessment; for example, system risk controls for money remittance services will tend to be subject to a more strict review due to its higher probability of loss to customers in the case of a system failure.

VI. Obligations of Electronic Settlement Agents

Electronic Settlement Agents are required, among others, to comply with the following notable regulatory obligations:

(i) execution and public disclosure of a contract with each bank to agree on the allocation of each party's burden for indemnification to customers, proper treatment and security of customer information and other statutory matters;

(ii) provide an explanation to customers about claim reporting, indemnification of damages, service fees and costs, when customers' secure information will be obtained and other statutory matters; and

(iii) establish and maintain internal control systems for, among others, proper treatment and security of customer information, management and supervision of outsourcing and clarification that the services provided are not the services of the banks.

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- ***Getting the Deal Through - Insurance Litigation 2018 Japan***
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  by Kei Asatsuma, Shuichi Nishimura (co-author)
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  by Kunishige Masui
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  by Kei Ikuta (co-author)

Other than the obligation in paragraph (i) above, which will not come into effect with respect to bank account services until a date separately designated by the JFSA within two years after the effective date, these obligations shall come into force on the effective date of the new regulation (i.e. June 1, 2018).

VII. Requirements for Banks

To comply with another provision under the amended Banking Act that is already in effect, banks have published their basic policy regarding Electronic Settlement Agency Services. In such policies, many banks announced that they have either set up systems to accept API connections or will be ready to do so within a relatively short period of time.

After the effective date of the new regulation (i.e. June 1, 2018), banks are also required to publish the criteria that the Electronic Settlement Agents will need to fulfill in order to enter into the aforementioned contracts, and are prohibited from unduly discriminating against such Electronic Settlement Agents when executing these contracts. Further, the JFSA will set a date within two years of the effective date by which banks will be required to make efforts to provide Electronic Settlement Agents with access to their systems without using bank account holders' secure information, for example, through open APIs.

VIII. Industry-based Efforts to Promote Open APIs

In addition to the aforementioned regulatory framework, efforts to accommodate open innovation are gathering pace. Among others, a Review Committee on Open APIs established by the Japanese Bankers Association released a report in July 2017 to set industry standards for open APIs and principles for security and customer protection. In June 2017, the Center for Financial Industry Information Systems also released a report with a focus on system security and technical aspects of open APIs, and an API connection checklist for the purpose of reducing the banks' burden in verifying the adequacy of the system security of FinTech companies.

The credit card industry has also followed the banking industry's movement and, in a study group set up by the Ministry of Economy, Trade and Industry, credit card and FinTech companies have held discussions on the use of open APIs for credit card data. The group is currently in the process of finalizing API guidelines for the credit card industry and expect to release the guidelines soon.

IX. Future of the Japanese Financial Services Sector

With these new regulations and industry-based efforts taking hold, the financial services sector as a whole in Japan is expected to experience further change as collaboration continues with FinTech companies for convenient and safe online access for customers through a variety of interfaces.

Wider regulatory reform in the financial services sector continues to be discussed and will undoubtedly also affect the future of the Electronic Settlement Agency Services and other financial services. In November 2017, in the context of the recent rapid development of unbundling and rebundling of financial services, the Financial System Council established a Financial System Study Group to explore the possibility of a fundamental shift from the current regulatory approach based on business types (e.g., banking, securities brokerage and insurance) to a function-based approach (e.g., settlement, credit, asset management and risk transfer). In the most recent round of discussions the Financial System Study Group categorized Electronic Settlement Agents as independent intermediaries within the settlement function, and flagged various issues for further consideration, including a potential conflict of interest arising from their receipt of fees from banks and allocation of burden for indemnification to customers. While discussions are still at an early stage, the reform plan is expected to strike a balance between customers' protection and flexibility of regulations to accommodate further innovation in the financial services sector.

■ Mergers and Acquisitions (M&A)

Opening the Door to Using Stock as Consideration in Stock Acquisitions
- 2018 Tax Reform and Amendment to the Industrial Competitiveness Enhancement Act -

I. Introduction

In Japan, stock is commonly used as consideration in an acquisition, but only when the acquisition takes the form of a merger (in Japanese, '*gappei*') (including a triangular merger) or a share exchange (in Japanese, '*kabushiki koukan*') (including a triangular share exchange). Stock is rarely used as consideration in other types of acquisition, such as a tender offer or a private sale of stock of a target company. This is for mainly two reasons: (i) capital gains tax implications, and (ii) certain restrictive requirements under the Companies Act (Act No. 86 of 2005, as amended).

In February 2018, the Japanese Cabinet proposed to the National Diet a combination of a tax reform and an amendment to the Industrial Competitiveness Enhancement Act (Act No. 98 of 2013, as amended) (the 'Enhancement Act'); the combination of which is expected to clear these two hurdles for specific types of transaction that have been submitted to, and authorized by, the Ministry of Economy, Trade and Industry ('METI'). The tax reform bills passed the Diet on March 28, 2018, while the amendment to the Enhancement Act remains under deliberation at the House of Representatives. These legislative developments are expected to open the door to the use of stock as consideration in acquisitions other than mergers or share exchanges.

II. Current Regime - Impediments to the Use of Stock in a Stock Acquisition

(i) Tax Implications

In case of a merger or share exchange (i.e. a form of corporate combination defined by the Companies Act whereby one company becomes a wholly owned company of the other company), stockholders of the acquired company, who receive the acquiring company's (or its parent's) stock as consideration, will be entitled to tax deferral under Japanese tax law if such transaction satisfies the requirements of a 'tax-qualified restructuring' (in Japanese, '*tekikakuk soshiki-saihen*'). In contrast, a straightforward sale and purchase of stock (including by tender offer) is a taxable transaction and the selling stockholder will be liable to pay Japanese income tax on any gains made (without being entitled to tax deferral). This tax implication is the main reason why exchange offers are almost unprecedented in Japan. Even if a non-Japanese resident stockholder sells stock of a Japanese company, it may be subject to Japanese income taxation for the capital gains unless an exemption applies depending on the historical ownership of the stock, the number of shares of stock sold, and any relevant tax treaty.

(ii) Requirements under the Companies Act

Under the Companies Act, a company that wishes to use its stock as consideration in an acquisition usually faces two major requirements.

First, it will need a special resolution (passed by a two-thirds vote) of its stockholders if the stock to be used as consideration is issued at a preferential price. This is likely to be the case in light of the premium that the acquirer would give to the stockholders of the target company.

Second, certain statutory requirements on in-kind contributions (i.e. issuance of stock in exchange for consideration other than cash) will apply if the acquirer issues its stock in exchange for the target company's stock. This consists of (i) a mandatory investigation by a court-appointed inspector, and (ii) the potential exposure of each seller (in its capacity as a subscriber of the acquirer's stock) as well as the directors of the acquirer to a liability to indemnify the acquiring company for any substantial shortfalls in the value of the target company's stock vis-à-vis the price of the target company's stock as determined by the acquiring company upon its decision to issue its stock in exchange for such in-kind contribution.

There are certain exemptions that apply to the need for an investigation by a court-appointed inspector, such as when: (a) the number of stock to be issued is no more than 10% of the entire issued shares of stock; (b) the value of the asset to be contributed in exchange for the issued stock (the 'Contributed Asset') is no more than 5 million yen; (c) the Contributed Asset is securities traded on the market and the paid-in amount for the stock to be issued does not exceed the amount of the market price of such securities; or (d) a lawyer, certified public accountant or tax accountant verifies the value of the Contributed Asset.

However, the risk of indemnification liability (i.e. (ii) above) cannot be eliminated if the acquirer is a joint stock company (in Japanese, '*kabushiki kaisha*') formed under the Companies Act. If the acquirer is a GK (in Japanese, '*godo kaisha*'), which is an LLC type company under the Companies Act, both of the requirements discussed

under (i) and (ii) above will not apply.

III. The Proposed 2018 Tax Reform.

The tax reform bills approved by the National Diet will permit tax deferral treatment to sellers when the sale is made in exchange for stock of an acquirer pursuant to a 'special business restructuring plan' (in Japanese, '*tokubetsu jigyo-saihen keikaku*'), which has been submitted to, and authorized by, the competent minister(s) pursuant to the Enhancement Act (as amended by the proposed amendment described below). In order to be eligible for such tax treatment, the plan must be authorized on or prior to March 31, 2021.

IV. The Enhancement Act and the Proposed Amendment

The current Enhancement Act, enacted in 2014, grants an exemption to the special resolution requirement for stock issuances at a preferential price and the other requirements on in-kind contributions under the Companies Act. The exemption is also available for stock-consideration tender offers (i.e. exchange offers) that are conducted in accordance with a 'specified business restructuring plan' (in Japanese, '*tokutei jigyo-saihen keikaku*') that has been authorized by the competent minister(s), as mentioned above. Tender offers are eligible for this exemption only when the offeror purports to acquire a controlling stake in the target company (accordingly, settlement of the tender offer must be conditioned upon the tender of shares that results in no less than 40% of the target company's voting rights being held by the offeror upon settlement). Although this exemption has been available since 2011 under the Law on Special Measures for Industrial Revitalization and Innovation (the 'Revitalization Act'), which has been replaced by the Enhancement Act, not a single exchange offer has been made (with or without the use of the exemption) to our knowledge. This is mostly likely due to the onerous tax implication discussed above.

The proposed amendment to the Enhancement Act is designed to widen the scope of the plans that can be authorized, in addition to changing the definition of such plans from a 'specified business restructuring plan' to a 'special business restructuring plan'. As discussed above, tax deferral treatment granted to sellers under the proposed 2018 tax reform is linked to the latter plan.

The amendment will expand the type of transactions eligible for authorization by eliminating the specific requirements on tender offers and will encompass any acquisition of a controlling stake of another company. The amendment will further require that, in order to qualifying as a 'special business restructuring', the goal of the plan must be to achieve considerable improvement in the productivity of the acquirer's business through: (i) utilization of innovative technology or business of the acquired entity in certain priority industry sectors (namely, mobility revolution; building of new-generation supply chains; FinTech; extension of healthy life expectancy; and development of comfortable infrastructure and towns); (ii) utilization of resources of the acquired entity in new businesses that provide products or services essential to a considerable number of other business operators (e.g. platformers); or (iii) substantial strengthening of its core business by the acquisition.

Before considering taking advantage of the benefits accorded to an authorized special business restructuring plan, it is worth drawing attention to the following caveats.

(i) Foreign entities are not eligible

By definition, only a Japanese joint company is allowed to implement a 'special business restructuring'. Further, to qualify as a special business restructuring, consideration offered to the seller must be the stock of such Japanese joint company. In other words, use of stock of a foreign parent company is not allowed. The target company, however, may be a Japanese or non-Japanese entity.

(ii) A value threshold applies

The proposed amendment requires that in order to qualify as a 'special business restructuring', the value of the total consideration necessary to implement the acquisition must exceed the acquiring company's cash and cash equivalents minus normal working capital. A detailed calculation method regarding the necessary value threshold will be set forth in implementing regulation to be issued by METI.

(iii) Special stockholder approval may still be required

Although the Enhancement Act will exempt an authorized transaction from the special resolution requirement with regard to the issuance of stock at a preferential price, a special resolution of stockholders of the acquiring company is still required where the number of shares of stock to be issued by the acquiring company as consideration is more than 20% of its issued stock, or, even if such 20% threshold is not met, an objection is made by stockholders holding voting rights above a certain threshold during a two-week window following a public announcement (or individual notifications to stockholders) of the stock issuance by the acquiring

company. These requirements are designed to replicate the requirements and exemptions that apply to share exchanges under the Companies Act.

V. Further Legislative Approaches

In addition to the proposed amendments outlined above, substantial revisions to the Companies Act are being considered by the Legislative Council of the Ministry of Justice. On February 28, 2018, the Legislative Council released an interim proposal regarding such revisions and is currently soliciting public comments in that respect through until April 13, 2018. An English translation of such interim proposal has been published by the Tokyo Stock Exchange and is available at http://www.jpx.co.jp/english/news/1020/20180314-01.html. The interim proposal includes a proposal to introduce a new statutory form of a business combination called 'Share Delivery', under which an acquiring company (i.e., a joint stock company) may deliver its shares to stockholders of a target company (which also must be a joint stock company) in exchange for their target company stock in a transaction that results in the target company becoming a subsidiary of the acquiring company (other than a wholly-owned subsidiary, which could otherwise be achieved through a share exchange). Many of the procedural aspects of the proposed Share Delivery business combination are analogous to the share exchange procedures mentioned above. It is unlikely that such revisions will be finalized or enacted during 2018, however, nonetheless, the revision process warrants close monitoring.

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