■ **FINANCIAL REGULATIONS/FINANCIAL COMPLIANCE**

FinTech developments in Japan and reform of the Banking Act

I. Introduction

On June 3, 2016, the Reform Act of the Banking Act (the 'Reform Act'), which includes amendments to the Banking Act of Japan, was enacted. Scheduled to be implemented by no later than June 3, 2017, the Reform Act contains important deregulation measures that will have a significant impact on the business relationships between banks and FinTech companies. This article summarizes some of the notable changes to the existing regulatory frameworks that will impact on the FinTech environment in Japan.

II. The FinTech Movement in Japan

FinTech was featured as a strategic priority of the Financial Services Agency of Japan (the 'JFSA') in last year's Strategic Directions and Priorities Guidelines. Released on September 18, 2015, the Guidelines set out the JFSA's aims for the period from July 2015 to June 2016.

The Guidelines reiterate the JFSA's commitment to developing regulatory structures which are responsive to the future shape of financial services. To that end, the JFSA plans to analyze the potential impact of FinTech on the financial services sector and seek input from experts and industry participants worldwide. The JFSA views FinTech as something that could transform the financial services industry by injecting a range of innovative services into the market.

The Governor of the Bank of Japan (the 'BOJ') outlined similar thoughts in a speech in March 2016 when he said that:

> "*To make the innovations in payments that are taking place due to innovations in information technology truly useful for the users of financial services and the economy, it is important to develop a network and win-win relationships with a wide range of entities beyond the traditional financial industry.*"

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The number of business alliances between banks and FinTech companies has increased, particularly in personal financial management and AI (artificial intelligence) related businesses.

III. Amendments to the Banking Act

However, despite the enthusiasm for the FinTech movement, it is often remarked that the scope of business restrictions under the Banking Act are a structural impediment to investing in FinTech companies and the further development of the FinTech sector.

Under the current Banking Act, the activities that a company is permitted to engage in are strictly limited in circumstances where a bank holds more than 5% of voting rights in the case of a domestic company (15% if held by a bank holding company) or more than 20% of voting rights in the case of a foreign company (15% if a close relationship exists) (the 'Business Scope Limitation'). For example, if a domestic FinTech company operates a line of business that is not permitted under the Banking Act, there is in principle no way for a bank or bank holding company to purchase more than 5% or 15% (as the case may be) of its voting rights.

The only exception is investment via a venture capital subsidiary. However, a venture capital subsidiary is obliged to sell the shares within a certain number of years and is subject to other limitations. As such, the Business Scope Limitation is an obstacle for banks or financial services companies seeking to invest and incorporate cutting edge FinTech technologies and innovation into their products and services.

To address this concern, the Reform Act creates a new path for banks to invest in the FinTech sector. A bank may acquire more than 5% of voting rights of a company notwithstanding the Business Scope Limitation provided it obtains the JFSA's approval, the company uses IT related technologies and either:

(i) the company's business will enhance the sophistication of the banking industry; or

(ii) the company's business will provide additional convenience to the bank's customers.

The criteria for the JFSA's approval has not yet been announced. However, approval is expected to be given in a broad and flexible way to encourage the growth and innovation of the FinTech sector in Japan. The Reform Act also contains important FinTech-specific provisions relating to, among other things, the regulation of virtual currency and the deregulation of the revenue rules for IT related business subsidiaries.

IV. Future of the FinTech Sector

The deregulation to come from the Reform Act is expected to further promote and encourage the FinTech movement in Japan and increase the number of private acquisitions of FinTech enterprises. However, the full implications of the Reform Act are still unclear. The forthcoming publication of the JFSA Comprehensive Guidelines for Primary Banks will likely shed more light on the intended operation of the Reform Act.

The JFSA and the BOJ are both actively providing support to FinTech companies and are working to create circumstances favorable to the development of the FinTech sector. For example, the JFSA established the 'FinTech Support Desk' to assist FinTech companies to identify the laws and regulations that are applicable to

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their business activities. Similarly, the BOJ also established its own ‘FinTech Center’ in April 2016 for the purpose of supporting the development of FinTech innovations.

The JFSA and the BOJ are bullish on the potential advantages that FinTech innovations may bring to the financial services sector, including improved efficiency and enhanced access to financial services. At the same time they are also carefully monitoring each new development to promote consumer protection and the integrity of the entire financial system.

The FinTech movement in Japan has only just begun. However, the encouragement and support of FinTech innovation is ongoing and the development of the sector looks set to continue apace with the continued support of the JFSA and the BOJ.

■ **RESTRUCTURING/INSOLVENCY**

Japan's new standard in electing sponsors for corporate restructurings

I. <u>Restructuring Practices in Japan</u>

As with restructuring in many other jurisdictions, it is common practice in Japan to elect a sponsor to provide finance to a failing business to assist with its rehabilitation. In many insolvency cases, the election of a sponsor is essential for a successful restructuring.

If a debtor must eventually commence an in-court restructuring procedure, the fairness and appropriateness of the election of the sponsor will be examined by the court. Questions surrounding the election of a sponsor may arise in the following common scenarios when:

(i) a court or a court-appointed supervisor (in Japanese, '*kantoku-iin*') is asked to determine whether to grant a motion for approval of, or consent to, a sponsorship agreement or asset transfer agreement in civil rehabilitation proceedings;

(ii) a supervisor is asked to determine whether to advise a debtor to terminate a sponsorship agreement entered into by the debtor prior to the insolvency filing in the context of a 'pre-packaged' civil rehabilitation case; or

(iii) a court or a supervisor is asked to determine whether to approve a rehabilitation plan that entails the election of a sponsor or give consent to a proposal for such a rehabilitation plan in a creditors' meeting.

Japanese insolvency practitioners have long discussed what ought to be the appropriate criteria for electing sponsors in restructuring cases and to what extent an election should be upheld in an in-court restructuring procedure. Several criteria have been proposed to date with many involving an auction or a bidding procedure. But they have stopped short of mandating an auction or bidding procedure in all circumstances.

However, in practice, a conservative approach has been taken and an auction or a bidding procedure has been required in order to justify the election of a sponsor irrespective of the size of the debtor or the nature of the business. This approach has made it difficult for certain companies to elect a sponsor and successfully restructure a business. For example, the criteria are simply too tough on small size debtors who do not have the time nor money to complete an auction or a bidding procedure or where the nature of the debtor's business makes it difficult for the debtor to find a sponsor.

Against this backdrop, a working group comprising insolvency experts developed a new approach to apply to all companies, irrespective of their size, sector or circumstances. This new approach has been dubbed the 'twin standard approach'. The 'twin standard approach' ensures that the election of a sponsor shall be deemed appropriate and upheld by the court if it is overseen by a debtor or a trustee. However, this approach does not automatically render the procedure for the election of a sponsor invalid if this approach is not followed.

II. <u>The New 'Twin Standard Approach'</u>

The court must first determine whether an auction is required to elect a sponsor by taking into account the characteristics of the debtor in question. Following that determination, one of the following approaches will be applied to determine the appropriateness of the conducted sponsor election procedure:

(i) If an auction is unnecessary, the sponsor election procedure will be deemed appropriate, unless such election is clearly unreasonable (the ‘Reasonableness Test’, as discussed further below); or

(ii) If an auction is necessary, an auction must be conducted and the bidder who proposes the ‘highest amount of support funding’ shall be elected (the ‘Enhanced Scrutiny Test’, as discussed further below).

First Step: Is an Auction Required?

Consideration must be given as to whether it is appropriate to have potential sponsors provide competing proposals. Factors for consideration include: (a) the size of the business or debtor as an entity, (b) the nature of the business, (c) how dependent the business or debtor is on a specific person (such as the business founder) and (d) how quickly the debtor must elect a sponsor in order to avoid irreparable harm to the business and successfully restructure. Each factor is taken into consideration for the following reasons:

(i) first, if the scale of the business or debtor is small, it is assumed that the number of potential sponsors who would be prepared to participate in a bidding process will be small or it may be difficult to find a potential sponsor at all. Requiring an auction for small businesses or debtors may discourage potential sponsors and complicate the task of finding an appropriate sponsor. Conversely, larger entities may have a better chance of finding a suitable potential sponsor and a bidding process may be suitable;

(ii) second, the nature of the business itself may make finding a potential sponsor difficult. For example, investors may not have any expertise in investing in niche businesses and may baulk at participating in a bidding process. In these circumstances, it would be better not to require an auction;

(iii) third, if the business is heavily dependent on one specific person (for example, the business founder) reforming the management structure may be unrealistic. This may discourage potential sponsors from participating in a bidding process; and

(iv) fourth, if the value of the business is diminishing rapidly and the time and cost involved in conducting an auction may result in irreparable harm to the business, it may be better not to conduct a standard auction.

As yet there is no consensus over which of the above considerations should be given precedence over the others or on how strictly or flexibly this new approach should be applied. Note that if a related insolvency proceeding is filed in a foreign jurisdiction, it is likely that the standards in that jurisdiction would also be taken into account.

Second Step: Was the Election Procedure of the Sponsor Appropriate?

Pursuant to the aforementioned Reasonableness Test, an election procedure is presumed to be appropriate unless this presumption can be rebutted and the court concludes the procedure is ‘clearly unreasonable’. When determining whether an election is clearly unreasonable, the court will consider various factors including the purpose of maintaining/developing the business, the existence of synergies with the elected sponsor and whether staff will be retained.

Pursuant to the aforementioned Enhanced Scrutiny Test, generally, an election shall be deemed as appropriate if the bidder who was elected offered the ‘highest amount of support funding’ in an auction and the identity of the bidder will not create significant issues including in relation to the continuation of the business and external commercial relationships. The ‘highest amount of support funding’ means the recovery amount that the creditors can expect to receive in relation to the asset pool, but not necessarily the exact amount that appears in the proposal by each bidder.

III. Involvement of Creditors in Sponsor Election Procedures

Although creditors may vote for or against the reorganization plan or rehabilitation plan, there is only limited scope for creditors to become proactively involved in the proceedings. The purpose of a Japanese in-court restructuring procedure is to maintain the fairness of the procedure and coordination with the debtor and relevant parties through supervision by the court and the court-appointed supervisor or investigator (in Japanese, '*chosa-iin*').

Despite this, it is common practice for the court to ask the creditors (as well as the debtor) for their views only in circumstances where there is a stand-out major creditor or a major creditor 'group' that could affect the result of a vote on the reorganization plan or rehabilitation plan. Also, mediation between a debtor and creditors has only been used to negotiate and agree difficult issues between the parties.

Recently, however, a creditor opposed the sponsor elected by the debtor and submitted an alternative rehabilitation plan to a creditors' meeting in opposition to the rehabilitation plan proposed by the debtor.

Also, the number of cross border insolvency cases involving Japan has been increasing recently. This has generated debate over how information concerning cross border insolvencies should be shared between creditors involved in the Japanese end of transnational insolvencies.

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