

New Legislative Framework  
for Investor Protection  
- “Financial Instruments and Exchange Law”-

Financial Services Agency, Japan  
June 2006

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## . Schedule

December 22, 2005

Report of the First Subcommittee of the Financial System Council titled as “Legislation for ‘the Investment Services Law (provisional title)’”

March 10, 2006

Cabinet decision on the following two bills for legislating the “Financial Instruments and Exchange Law”

- bill for amending the Securities and Exchange Law and other financial laws
- bill for abolishing and amending the related laws to implement the above bill for amending the Securities and Exchange Law and other financial laws

March 13, 2006

Submission of the bills to the Diet (Japanese Legislature)

June 7, 2006

Passage of the bills in the Diet

June 14, 2006

Promulgation of the legislations

# . Basic Framework of the Legislations

## 1. Basic contents of the Legislations

### (1) Establishing cross-sectional framework of a wide range of financial instruments and services

- Establishing a comprehensive definition of collective investment scheme (funds) and wide-ranging definition of derivatives
- Broadening the scope of “financial instruments firms”

### (2) Enhancing disclosure requirements

- Introduction of a statutory quarterly reporting system for listed companies
- Enhancing internal control over financial reporting
- Reviewing regulations on tender offers and large shareholding reports

### (3) Increasing the maximum criminal penalties against various market frauds and expanding the scope of penalties against “misegyoku”

- Increasing the maximum criminal penalties against such frauds as false annual reports and market manipulations from 5 years in prison to 10 years

### (4) Providing organization structures for self-regulatory functions of exchanges in the form of stock corporations

- Providing organizational structures of a self-regulatory corporation or a self-regulatory committee

## 2. Laws to be amended or abolished by the Legislations

### (1) Laws to be amended (89 Laws in total)

- Securities and Exchange Law
- Law concerning Investment Trust and Investment Corporation
- Banking Law
- Shinkin Bank Law
- Trust Banking Law
- Insurance Business Law
- Norinchukin Bank Law
- Agricultural Cooperatives Law
- Commodity Exchange Law
- Real Estate Syndication Law
- Law Concerning the Regulation of Commodity Investment Business
- Law Concerning the Sale of Financial Products
- Others

### (2) Laws to be abolished (4 Laws)

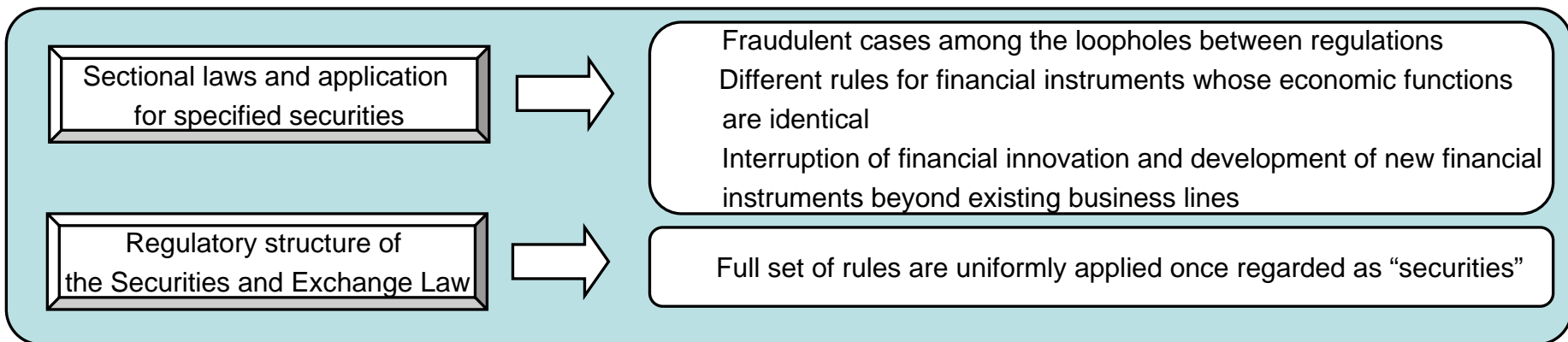
- Financial Futures Trading Law
- Law Concerning Foreign Securities Firms
- Law Concerning the Regulation of Investment Advisory Service Relating to Securities
- Law Concerning the Regulation of Mortgage Business

### 3. Effective date of the Legislations

Measures	Effective date
<ul style="list-style-type: none"> <li>● Increase in maximum criminal penalty</li> <li>● Countermeasures against trading orders with intention of canceling immediately (“misegyoku”)</li> </ul>	<ul style="list-style-type: none"> <li>● Twenty days after the promulgation of the legislations (= July 4, 2006)</li> </ul>
<ul style="list-style-type: none"> <li>● Review of regulations on tender offers and large shareholding reports</li> </ul>	<ul style="list-style-type: none"> <li>● Date to be designated by cabinet order not exceeding 6 months after the promulgation in principle</li> <li>● Date to be designed by cabinet order not exceeding 1 year after the promulgation, with regard to shortening of reporting deadline of special large shareholding reports and mandatory electronic filing of large shareholding reports</li> </ul>
<ul style="list-style-type: none"> <li>● Introduction of statutory quarterly reporting requirement</li> <li>● Enhancement of internal control over financial reporting</li> </ul>	<ul style="list-style-type: none"> <li>● Date to be designated by cabinet order not exceeding 1 year and 6 months after the promulgation</li> <li>● Applied to business year starting on and after April 1, 2008</li> </ul>
<ul style="list-style-type: none"> <li>● Establishment of cross-sectional framework of a wide range of financial instruments and services</li> <li>● Enhancement of independence of self regulatory functions of exchanges</li> <li>● Others</li> </ul>	<ul style="list-style-type: none"> <li>● Date to be designated by cabinet order not exceeding 1 year and 6 months after the promulgation</li> </ul>

# . Contents of the Legislations

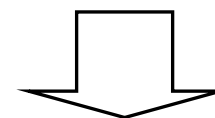
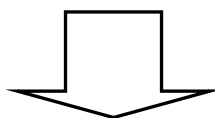
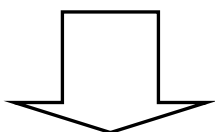
## 1. Purport and objective of “the Financial Instruments and Exchange Law”



Enhancement of user protections

Enhancement of users' convenience  
Promotion of financial innovation  
Facilitation of finance

Development of market infrastructure bearing comparison with major countries and regions



Cross-sectional protection of users

= Establishing a cross-sectional framework of a wide range of financial instruments and services

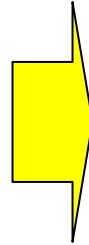
Flexible regulatory structure

= Introducing different rules depending on the characteristics of financial instruments, or knowledge and experience of the investor

## 2. Cross-sectional coverage of “the Financial instruments and Exchange Law”

### Current coverage under the Securities and Exchange Law

- Government bonds
- Local bonds
- Corporate bonds
- Stocks
- Interests in investment trusts and investment corporations
- Securities derivatives etc. (limited list)



### Coverage under the Financial Instruments and Exchange Law

- Government bonds
- Local bonds
- Corporate bonds
- Stocks
- Interests in investment trusts and investment corporations
- Interests in trusts
- Interests in collective investment scheme (fund) (basket clause)
- Derivatives etc.

### Application of the same rules of conduct

- Deposits with strong investment characteristics  
(Banking Law)  
(foreign currency denominated deposits and derivative deposits)
- Insurance with strong investment characteristics  
(Insurance Business Law)  
(foreign currency denominated insurance, and variable insurance and annuity)
- Commodity futures (Commodity Exchange Law)
- Real estate syndication business  
(Real Estate Syndication Business Law)

### 3. Collective Investment Scheme (fund) and Derivatives

#### Collective Investment Scheme (fund)

##### [Definition]

Any scheme that

- collects money or similar properties from two or more persons
- conducts business using the money, and
- distributes profits or properties to investors originated from the business

- Including any forms of funds such as partnership based on the Civil Law or secret partnership based on the Commercial Law.
- Including any business that funds conduct such as investment in any properties (securities, real estate, commodities, etc.)

(Note) The following are to be excluded in accordance with cabinet orders:

- in cases that all the investors are involved in the business,
- in cases that there are no distribution of profits or properties to investors beyond the amount of original investment

#### Derivatives

##### [Categories of derivatives transactions]

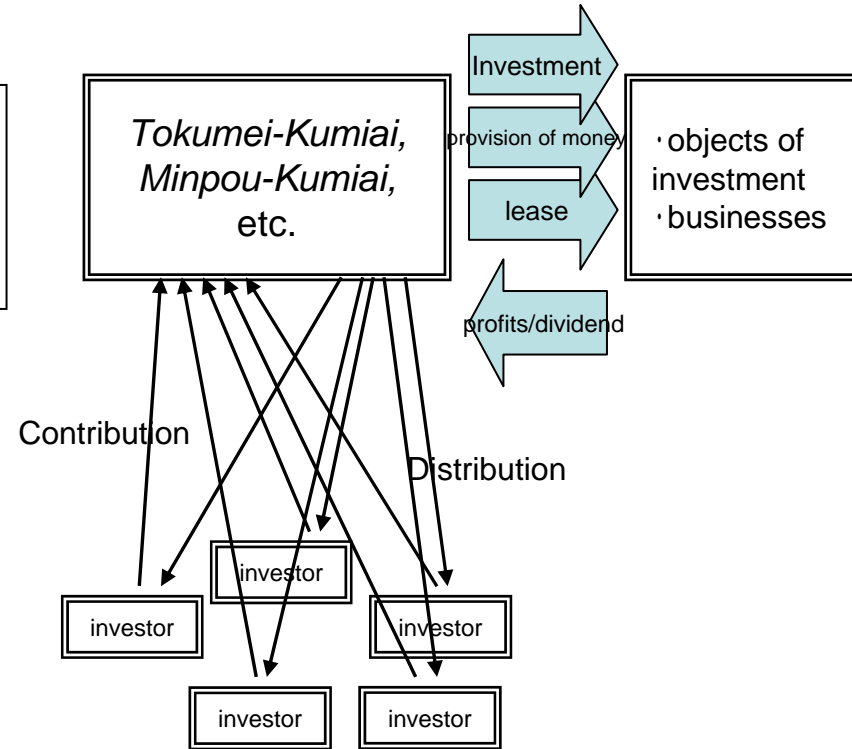
futures, forwards, options, swaps, credit derivatives, weather derivatives, and others to be designated by cabinet order

##### [Underlying assets defined as “financial instruments”]

securities, rights, currency, other assets to be designated by cabinet order, standardized contracts

##### [Indicators defined as “financial indicators”]

prices or interest rates of financial instruments, weather variables, economic statistics to be designated by cabinet order



# 4. Cross-sectional and flexible regulatory system

Current system  
(sectional regulations)

Regulatory system under the Financial  
Instruments and Exchange Law

## 【sales and solicitation】

Securities and Exchange Law	=	Securities business
Foreign Securities Firms Law	=	Securities business
Financial futures trading Law	=	Financial futures trading business
Commodity Fund Law	=	Commodity fund sales business

## 【investment management and advice】

Securities Investment Advisory Law	=	Discretionary investment business
		Investment advisory business
Investment Trusts and Investment Corporations Law	=	Investment trust management business

## 【administration of money and securities】

No regulations

## 【Introducing brokerage business】

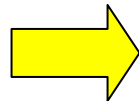
Securities and Exchange Law

(No regulations) Introducing brokerage of discretionary investment contracts and investment advisory contracts



**Financial instruments firms**

**Financial instruments introducing brokerage firms**



# 5. Regulation of “financial instruments businesses”

(Basic concept)

Coverage should be “sales and solicitation,” “investment management,” “investment advice,” and “administration of money and securities.” Expanding core businesses Cross-sectional regulatory structure  
 Regulations are tailored to types of businesses financial instruments firms conduct. Flexible regulatory structure

“financial instruments businesses”	Type of businesses	Entry regulation	Regulation of financial conditions	Regulation of other business
“the first financial instruments business”	· all financial instruments businesses dealing with all the securities and derivatives	Registration requirement	· minimum capital and net asset requirements · CAR regulation	notification or approval requirement
“investment management business”	· investment management including discretionary investment businesses		· minimum capital and net asset requirements	notification or approval requirement
“the second financial instruments business”	· sales and solicitation of securities with lower liquidity and market derivatives		· minimum capital requirement only	None
“investment advisory and agency business”	· Investment advice		· no minimum capital requirement · business security deposits requirement	None
“financial instruments introducing brokerage business”	· introducing brokerage of deals entrusted by other financial instruments firms	Registration requirement	None	None

(Note 1) Entry requirement for proprietary trading system (alternative trading system) is approval.

(Note 2) Items on which applications for registrations are to be rejected are tailored to types of businesses.

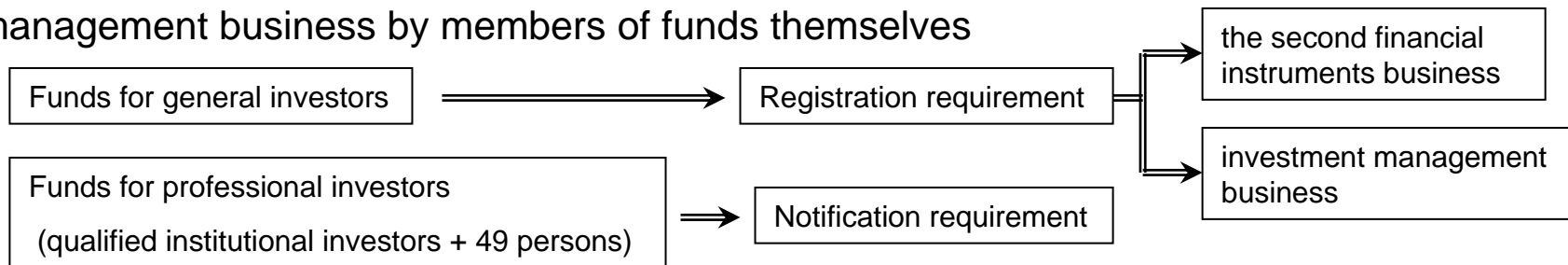
## 6. Regulatory treatment of funds business

### Current regulatory treatment of funds such as partnership or limited partnership

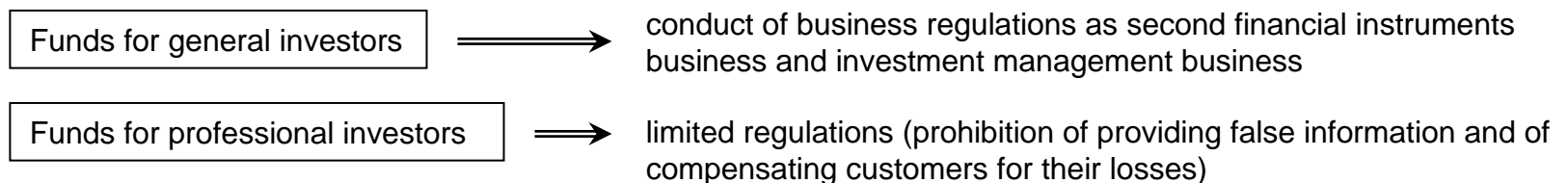
- No business regulation on sales and solicitations of interests in funds by members of funds themselves.
- No business regulation on investment management of interests in funds by members of funds themselves.

### Regulatory treatment under the Financial Instruments and Exchange Law

- Introducing business regulations on sales and solicitation business and investment management business by members of funds themselves



- Introducing conduct of business regulations on sales and solicitation business and investment management business



# 7. Regulation of conduct of “financial instruments business”

Considering current regulations in the Securities and Exchange Law and the Investment Advisor Law, conduct of business regulations should be reorganized by function and strengthening in a cross-sectional manner.

Application of regulation and its contents should be prescribed depending on types of customer in sales and solicitation or types of financial instruments (flexible regulatory structure).

## Overall framework of conduct of business regulations

### [all businesses]

- Duty of sincerity and fairness
- Obligation of notification of sign
- Prohibition of name lending
- Prohibition of becoming a trustee of a corporate bond offering
- Regulation of advertisement

### [sales and solicitation]

- Obligation of making advance indication of a trade form
- Obligation of delivering documents in advance
- Obligation of delivering documents as entering into contract
- Obligation of delivering documents as receipt of deposit money
- Cooling-offs
- Prohibition of providing false information
- Prohibition of providing conclusive judgment
- Prohibition of unsolicited promotions on specified contract
- Prohibition of call against will on specified contract

- Prohibition of promotions without confirming will of customers on specified contract
- Prohibition of compensating customers for their losses
- Requirement for suitability
- Requirement for proper treatment of customer information
- Obligation of defining best execution policy

### [investment management and investment advice]

- Fiduciary duty
- Duty of loyalty
  - Prohibited acts (transaction raising conflict of interests/advancement of money/securities lending etc.)
- Obligation of delivering investment management report

### [asset administration]

- Obligation of segregation of asset

(Note) While the regulations ( ) will be applied to all investors, the regulation ( ) will not be applied when dealing with professional investors.

## Concrete measures

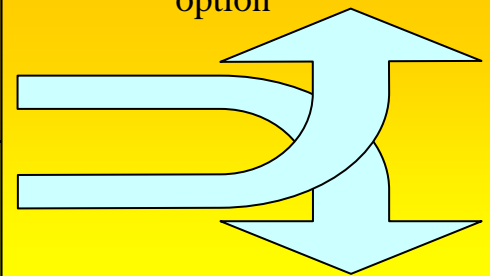
- Enhancing requirement for suitability
  - Adding “objective of making contracts” to the current requirement of “knowledge, experience, and assets”
- Introducing regulatory duty for explaining in line with the civil duty to explain under the Financial Products Sales Law
  - item to be included in documents to be delivered to customers in advance
- Introducing prohibition of unsolicited promotions, promotions without confirming will of customers, and promotions against will
  - Establishing a general framework of prohibitions for user protections
  - Actual application will be designated by cabinet order.
- Introducing obligation of disclosure of fees customers should pay and of presentation of being a financial instruments firm
  - items to be included in document to be delivered to customers in advance

## 8. Classification of customers: professional investors and general investors

**Purport:** considering contents of regulations on financial instruments firms, and setting different rules for activities such as sales and solicitation, depending on the nature of investors: professional or general investors  $\Rightarrow$  Realization of both proper protection of users and facilitation of provision of risk capital

- (e.g.) 1. For sale and solicitation to professional investors, conduct of business regulations aimed at an correction of the information disparity (obligation of delivering documents before entering into contract, obligation of delivery of documents as entering into contract, etc.) should be exempted.
2. Regulations set for the market integrity should not be exempted.

professional investors	a professional investor without an option to be classified as a general investor	qualified institutional investor Japanese government Bank of Japan	always treated as a professional investor
	a professional investor with an option to be classified as a general investor	corporation to be designated by cabinet ordinance (e.g.) • public company • a company above a certain size	option
general investors	a general investor with an option to be classified as a professional investor	corporations other than and • individual customers meeting criteria to be designated by cabinet ordinance	option
	a general investor without an option to be classified as a professional investor	individuals (except those who meet the above criteria)	always treated as a general investor



## Procedures for investors to change their status

Common procedures for professional investors to be treated as general investors and general investors to be treated as professional investors

- Customers make requests to financial instruments firms to change their status.
- Financial instruments firms shall deliver documents to customers upon consenting to the requests.
- Effective period of status change is 1 year.

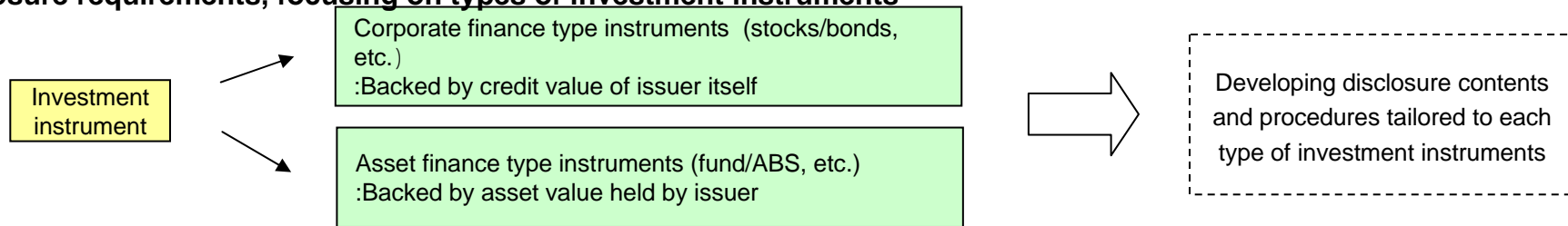
Specific procedures for general investors to be treated as professional investors

- Financial instruments firms shall get consents of customers through documents which describe contents and effects of status change.
- In case that requesting customers are individuals, financial instruments firms shall confirm whether those customers meet statutory requirements to be treated as professional investors.

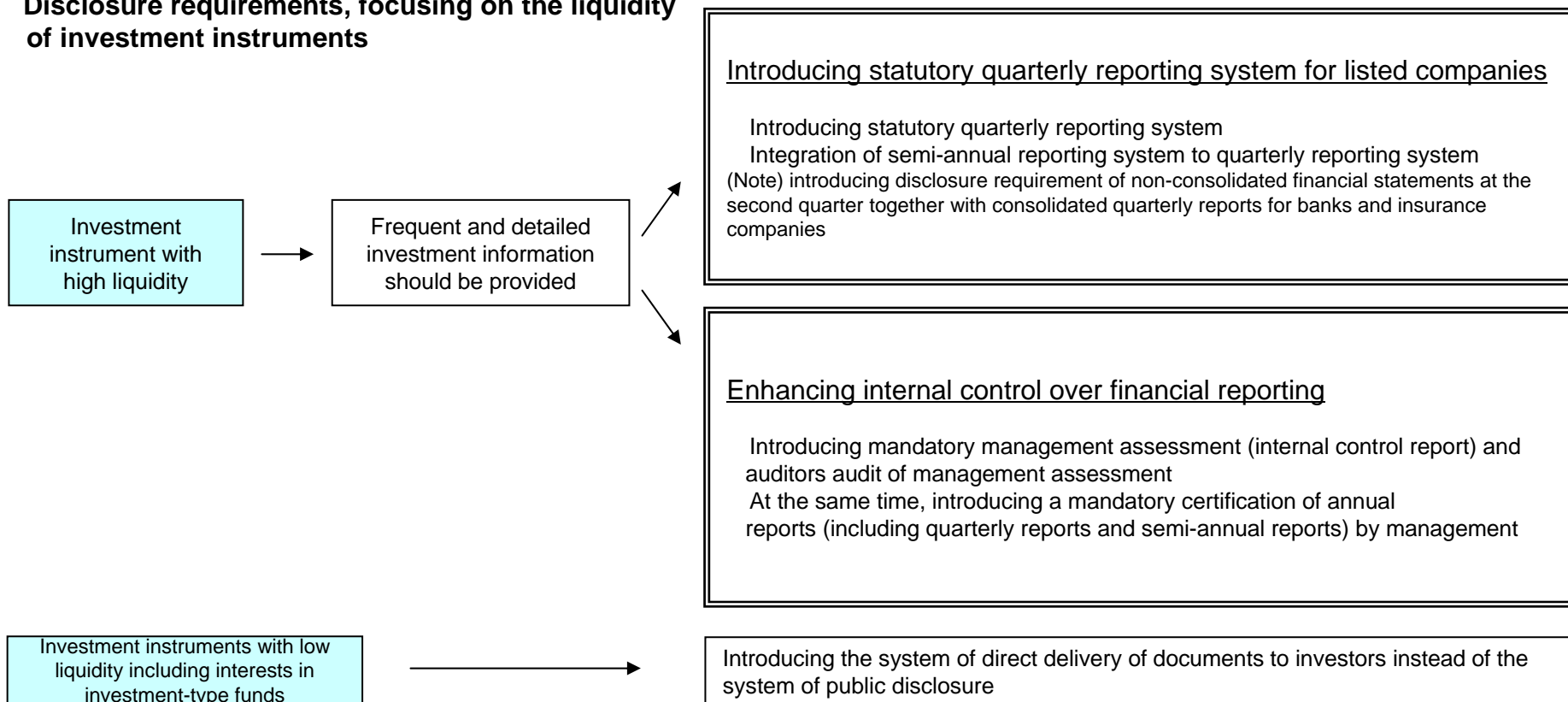
# 9. Disclosure requirements

## Disclosure requirements tailored to the nature of investment instruments

### Disclosure requirements, focusing on types of investment instruments



### Disclosure requirements, focusing on the liquidity of investment instruments



# 10. Review of Tender Offer system and large shareholdings reports

## System of Tender Offer (TOB)

### The Main framework of the Current System

- To purchase shares beyond the threshold off markets, such as more than 1/3 shareholdings, the purchaser is required to disclose the period, the amount, the price and etc. in advance and to offer shareholders an equal opportunity to sell.

### Taking measures against transactions that are evading TOB regulations:

- Clarify that it is subject to TOB regulations to rapidly increase shareholdings beyond the threshold of 1/3 by combining a purchase of the stocks off the markets and a purchase on the markets.

### Providing more information to investors:

- Require further disclosure in the “registration statement” of a TOB;
- Require the filing of a “position statement report” by a target company;
- Giving the opportunity for a target company to ask a questions to the tender offerors.

### Extending the TOB period:

- Extend upper and lower bound of the TOB period from 20 days and 60 days to 20 business days and 60 business days;
- Allow a target company to extend the TOB period to the extent of 30 business days when necessary for shareholders to take time when considering whether to sell or not.

### Expand the scope to allow withdrawal of a TOB:

- Allow withdrawal of a TOB and change in TOB conditions when the target company decides to activate takeover defenses.

### Require a bidder to make a offer to buy all stocks in a certain situation:

- Require a bidder to make an offer to buy all shares when ratio of shareholdings by the bidder becomes beyond a certain threshold of shareholding such as 2/3 to protect small shareholders from the risk of delisting of his/her shares.

### Ensure impartiality between bidders:

- Require a large shareholder (such as a one with more than 1/3 in shareholding) to make a TOB during the period of another TOB made by another bidder.

## System of Large Shareholdings Reports

### The Main framework of the Current System

- Standard reporting requires disclosure of shareholdings in excess of 5% within five business days.
- “Special Method” reporting for professional investors requires less frequent disclosure

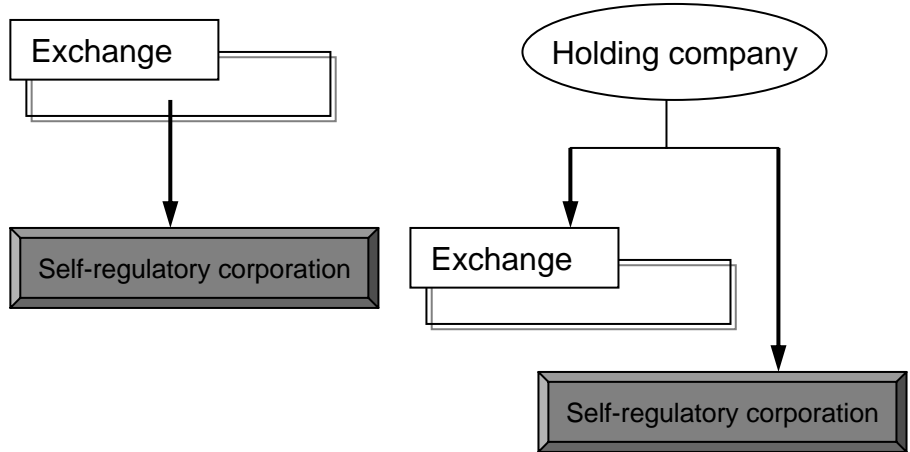
### Amend the Special reporting system for professional investors:

- Shorten the reporting cycle and deadline under the Special reporting system to the one such as twice a month or more and within five business days (currently once in three months and within 15 days).

# 11. Strengthening independence of self-regulatory functions of financial instruments exchanges

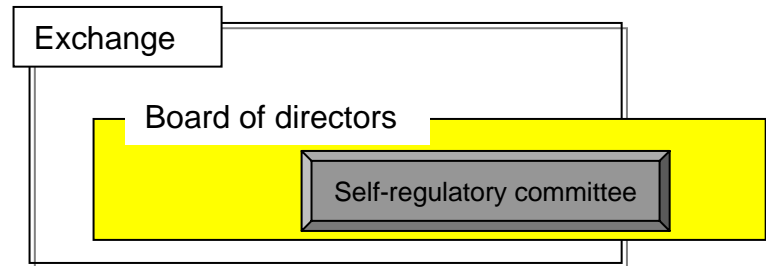
Organizational structure that financial instruments exchanges in the form of stock corporation may take  
 Approval of the FSA is necessary for shares of an exchange to be listed.

Establishment of independent corporation



- [ Authorities for deciding self-regulatory functions ]
- Listing or delisting of financial instruments
- Examination of state of trading participant's compliance with laws or regulations
- Monitoring of trading in the markets

Establishment of independent self regulatory committee within the organization

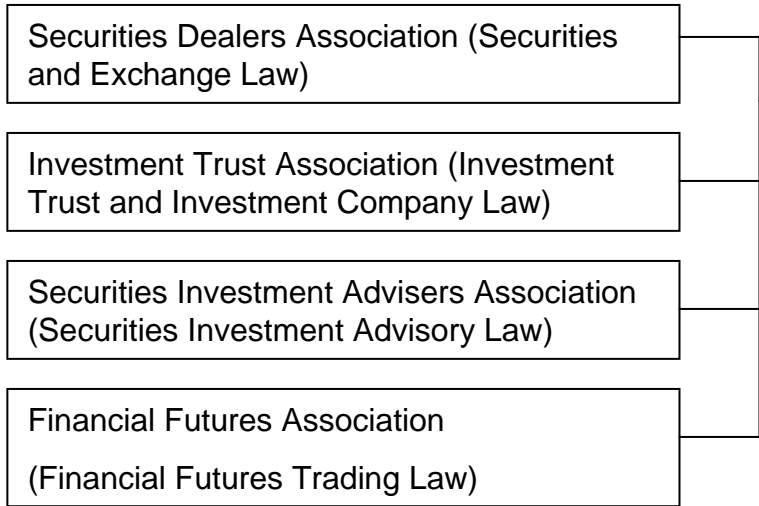


- [ Board of directors ]
  - three or more members (a majority are outside members)
- [ Independence ]
  - Approval of a majority of outside members is necessary for decision-makings
  - Approval of the FSA is necessary for an exchange to entrust self-regulatory functions to self-regulatory corporation

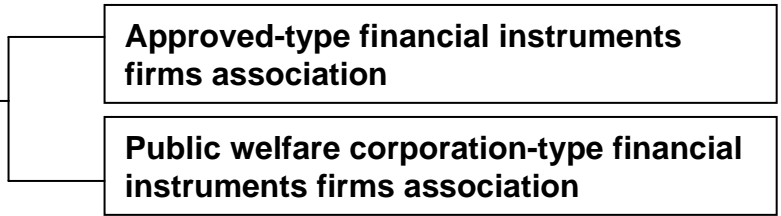
# 12. Financial instruments firms association (Self Regulatory Organizations (SROs), etc.)

Legal basis of SROs will be integrated to the Financial Instruments and Exchange Law  
 Establishing equivalent functions of all the SROs in line with the current functions of the Securities Dealers Association  
 Establishing system of recognized investor protection association which non-SRO association may apply for to deal with settlement of complaints and dispute mediation

## Current legal structure



## Legal structure under Financial Instruments and Exchange Law

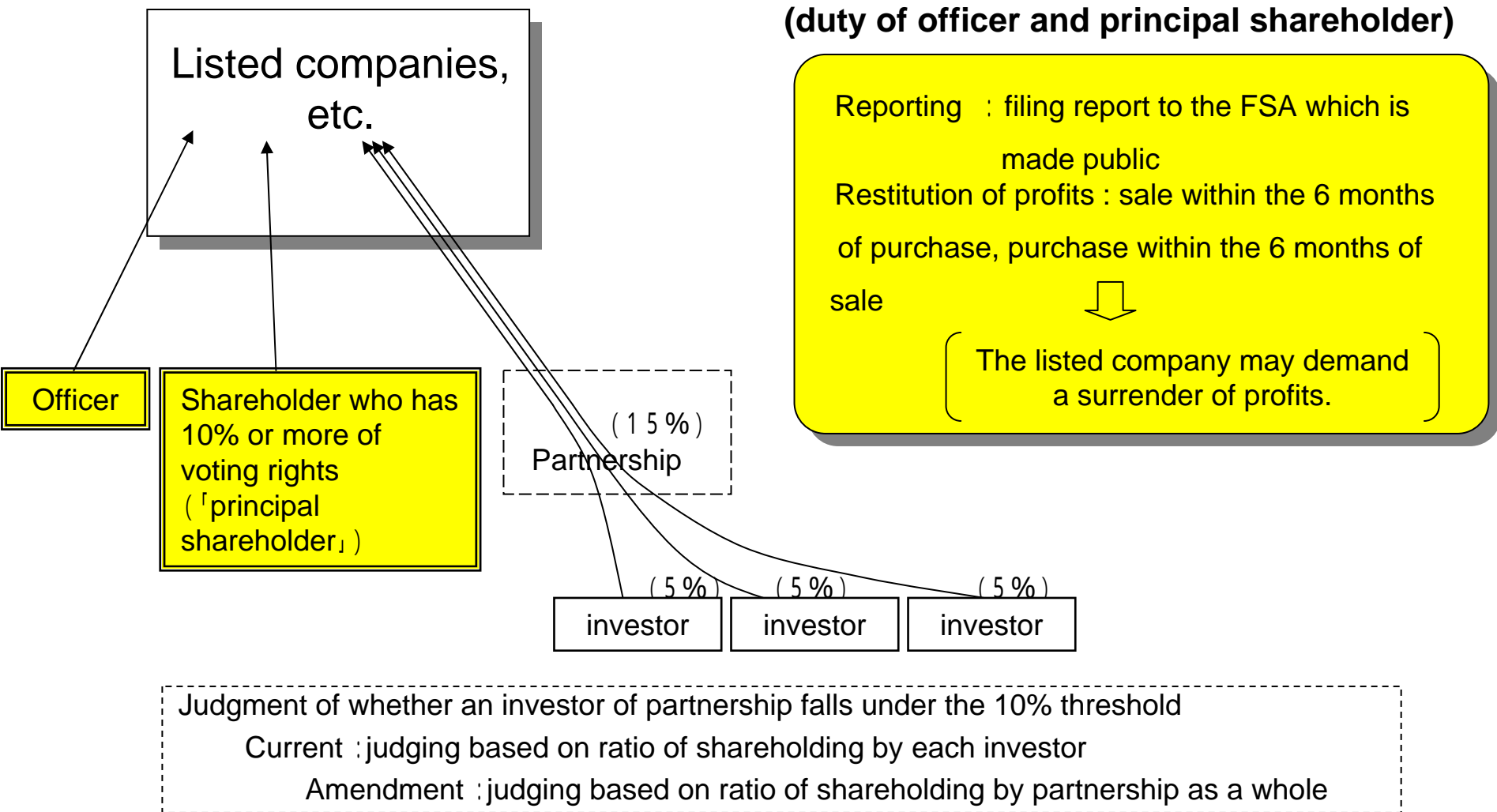


### [common functions]

- rule-making
- examination of the state of compliance with laws, regulations and rules by members
- guidance and recommendation to members
- settlement of complaints
- dispute mediation
- task of registration of financial instruments firms representatives
- spreading of knowledge, enlightening and promoting public activities on finance



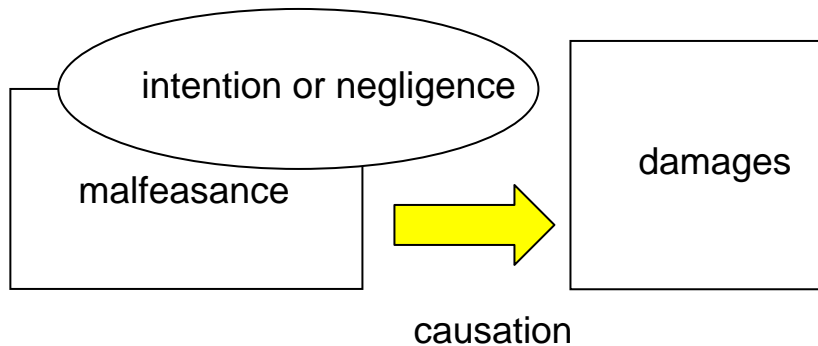
# 13. Review of the regulation on sale and purchase within 6 months by fund (partnership)



# 14. Enhancement of civil liability for sales of financial products

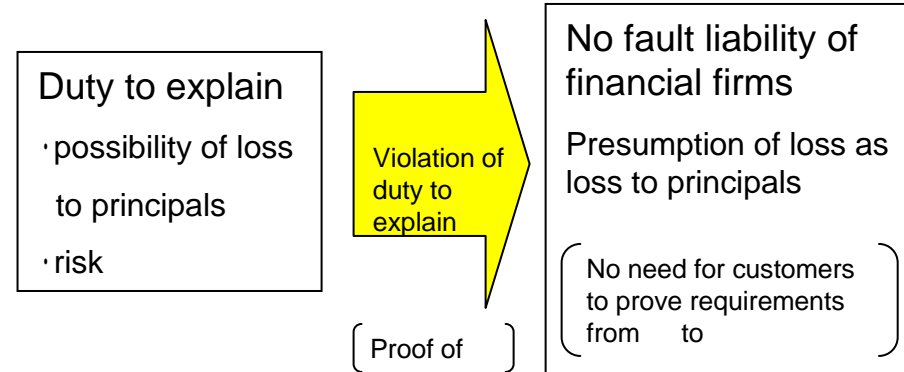
## Principles on actions for damages under civil law (section 709 of the Civil Law)

Customers (sufferers) shall prove all the requirements from intention to malfeasance to win actions for damages against financial firms.



## Financial Products Sales Law

The Law prescribes special treatment on actions for damages regarding a wide-range of financial products including deposits, insurance, securities, etc.



### Strengthening Financial Products Sales Law

Enlarging the scope of duty to explain

- Adding a possibility of losses beyond original principals and important part of schemes of financial instruments in the scope of duty to explain

Introducing prohibition of provision of conclusive judgment

- no fault liability and presumption of loss in case of the violation

## 15. Expansion of the scope of penalties against “misegyoku”

### 【“Misegyoku”】

Trading orders with intension of canceling immediately

Need for effective penalties in cases that “misegyoku” leads to market manipulation

### 【Penalties】

	criminal penalty	civil money penalty
customers		x
financial instruments firms (self-dealing)	x	x

(Note)  indicates expansion of penalties under the bills.

# 16. Increase in maximum criminal penalty

Prohibited unfair trading			
Acts of violations		Current maximum criminal penalty	To be amended
<ul style="list-style-type: none"> <li>• general unfair trading</li> <li>• spreading of rumors</li> <li>• resorting to deceptive devices</li> <li>• market manipulation</li> </ul>	Imprisonment	5 years	10 years
	Fine	[individual] ¥ 5 million [corporations] ¥ 500 million	¥ 10 million ¥ 700 million
<ul style="list-style-type: none"> <li>• insider trading</li> </ul>	Imprisonment	3 years	5 years
	Fine	[individual] ¥ 3 million [corporations] ¥ 300 million	¥ 5 million ¥ 500 million

Violation of disclosure requirements			
Acts of violations		Current maximum criminal penalty	To be amended
<ul style="list-style-type: none"> <li>• submission of false registration statement, false securities report (annual report), false tender offer statement and the others</li> </ul>	Imprisonment	5 years	10 years
	Fine	[individual] ¥ 5 million [corporations] ¥ 500 million	¥ 10 million ¥ 700 million
<ul style="list-style-type: none"> <li>• non-submission of registration statements, securities report, tender offer statement, large shareholding report, and the others</li> <li>• submission of false large shareholding report and the others</li> </ul>	Imprisonment	3 years	5 years
	Fine	[individual] ¥ 3 million [corporations] ¥ 300 million	¥ 5 million ¥ 500 million
<ul style="list-style-type: none"> <li>• submission of false quarterly report and internal control report</li> </ul>	Imprisonment	-	5 years
	Fine	[individual] - [corporations] -	¥ 5 million ¥ 500 million