

# ANDERSON MORI & TOMOTSUNE

## MEMORANDUM

July 17, 2007

### Effect of the New Regulatory Structure of the Financial Instruments and Exchange Law on Full-Line Securities Firms

This memorandum outlines in summary form certain changes in the basic regulatory structure imposed on any securities firm seeking to operate a full-line business in Japan under the new regulatory regime embodied in the Financial Instruments and Exchange Law of Japan (the “FIEL”), as well as various related obligations imposed upon any such securities firm.

The businesses engaged in by any full-line securities firm operating in Japan are broken down into four categories for Japanese regulatory purposes. We refer to these four categories in this memorandum as “main business” (*shoken gyo*), “ancillary business” (*fuzui gyomu*), “reportable business” (*todokede gyomu*) and “authorized business” (*shonin gyomu*). For practical purposes, these four categories, currently established under the provisions of the Securities and Exchange Law of Japan (the “SEL”), will continue to exist following the replacement thereof by the FIEL. However, certain categorization nomenclature will change, and in addition the constituents of the various categories will be somewhat altered, with the result that the obligations imposed on a securities firm in order to engage in various activities within such categories may also change.

#### **I. Business Categorization under the SEL**

The four categories of business mentioned above are established as follows under the SEL:

- (a) Main Business. Main business consists of a number of standard securities business activities (such as, e.g., purchase and sale of securities), which are listed in the definition of “securities business” appearing in Article 2, paragraph 8 of the SEL. Under Article 34, Paragraph 1 of the SEL, a securities firm generally gains the right to engage in the majority of this main business upon registration. Engagement in three specific businesses within this category, however, requires approval (*ninka*) from the Prime Minister (which authority is delegated to the Financial Services Agency (the “FSA”)), namely (i) primary underwriting (*moto hikiuke*) of securities, (ii) acting as an intermediary, broker or agent for over-the-counter (“OTC”) securities derivative transactions and (iii) operation of a proprietary trading system (“PTS”) (Article 29, paragraph 1 of the SEL).
- (b) Ancillary Business. Ancillary business consists of additional securities-related business activities (such as, e.g., lending or borrowing securities), in which registered securities firms are permitted to engage without additional consent pursuant to Article 34, paragraph 1 of the SEL. Such paragraph expressly lists certain such ancillary activities, and additionally permits “other business activities incidental to the securities business”.

- (c) Reportable Business. Reportable business consists of further activities listed in Article 34, paragraph 2 of the SEL (such as, e.g., certain types of investment advisory business activities<sup>1</sup>). Article 34, paragraph 3 provides that a securities company which commences any of the activities listed in Article 34 paragraph 2 must give *post-facto* notice to the Prime Minister (which authority is delegated to the FSA) without delay as prescribed by Cabinet Office regulations.
- (d) Authorized Business. Authorized business consists of any other business which a securities firm may conduct upon the authorization (*shonin*) of the Prime Minister (which authority is delegated to the FSA) pursuant to Article 34, paragraph 4 of the SEL.

For foreign securities firms (*gaikoku shoken gyosha*) engaged in the operation of full-line securities business in Japan through a branch, substantially the same categorization is provided under the Act on Foreign Securities Brokers (*gaikoku shoken gyosha ni kansuru horitsu*) (the “AFSB”) which applies the relevant provisions of the SEL *mutatis mutandis* to foreign securities firms.

## **II. Business Categorization under the FIEL**

- (a) Main Business. Under the FIEL, the current “main business” will be subdivided into two separate types of “financial instruments business” (*kinyu shohin torihiki gyo*). An entity wishing to engage in either type of financial instruments business will be required to register for such purpose with the FSA.

Type 1 financial instruments business (*daiisshu kinyu shohin torihiki gyo*) will generally consist of activities falling into the main business category described in I. above in relation to (i) “more conventional” securities (e.g. stocks, bonds, mutual fund units) (ii) market derivatives transactions relating to such more conventional securities and (iii) OTC derivatives transactions (including securities (more conventional or with lower liquidity (as further described below)) derivatives, financial derivatives, credit derivatives and weather derivatives<sup>2</sup>) (provided that under the FIEL only PTS activities will require separate FSA approval, while primary underwriting and OTC derivative activities will be permitted by virtue of registration alone (see Article 30, paragraph 1 of the FIEL)) (Article 28, paragraph 1 of the FIEL).

Type 2 financial instruments business (*dainishu kinyu shohin torihiki gyo*) will generally consist of activities in relation to (i) securities with lower liquidity, such as collective investment schemes<sup>3</sup>, including the placement of interests in such schemes

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<sup>1</sup> In addition to the report under the SEL, investment advisory business relating to securities generally requires separate registration under the Act on Regulation, etc. of Investment Advisory Business Pertaining to Securities of Japan (Article 4).

<sup>2</sup> This does not include commodities derivatives transactions.

<sup>3</sup> Arrangements with the following characteristics will generally be regarded as a collective investment schemes under the FIEL: (i) receives investment of money, etc. from other parties; (ii) engages in business

by such schemes themselves and not by an agent or intermediary (*jiko boshu* or “self-placement”) (which is currently unregulated under the SEL) and (ii) (a) market derivative transactions relating to such low-liquidity securities and (b) market financial, credit and weather derivatives transactions (Article 28, paragraph 2 of the FIEL).

As described above, the market/OTC financial futures transactions currently regulated under the Financial Futures Transaction Law (*kinyu sakimono torihiki ho*) (“FFTL”) will be incorporated into the regulatory scheme of the FIEL within “derivatives transactions”. The table below presents in summary the treatment of derivatives transactions under the FIEL<sup>4</sup>.

Type			Current	Under FIEL
securities derivatives	more conventional	OTC	SEL	Type 1 financial instruments business
		market		
	low liquidity	OTC		Type 2 financial instruments business
		market		
financial, credit and weather derivatives <sup>5</sup>	OTC	FFTL	Type 1 financial instruments business	
	market		Type 2 financial instruments business	

- (b) General Transition Provisions for Securities Firms. Any securities firm engaged in full-line securities business in Japan (including foreign securities firms<sup>6</sup>) at the time the FIEL becomes effective will be deemed automatically registered for the purpose of both Type 1 and Type 2 financial instruments business, except for primary underwriting and PTS activities<sup>7</sup> (Article 18, paragraph 1 of the Supplementary Provisions to the FIEL (“Supplementary Provisions”). If FSA approvals were issued to a securities firm prior to the effectiveness of the FIEL in respect of primary underwriting and/or PTS activity, such firm will automatically be deemed registered, and such approvals will be deemed to carry over with respect to such activities

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using such assets; and (iii) distributes proceeds, etc. from such business to investors. The specific legal structure of the arrangement is irrelevant, as is the type of business engaged in using the invested assets. Interests in Japanese Limited Partnerships (*toshi jigyo yugen sekinin kumiai*) and those in similar offshore funds will generally fall within the definition of “collective investment scheme”. (Information in this footnote is adapted from the FSA Newsletter dated August, September, 2006: <http://www.fsa.go.jp/en/newsletter/2006/09.pdf>.)

<sup>4</sup> Commodity derivatives transactions will continue to be regulated under the Commodity Exchange Act (*shohin torihikijo ho*).

<sup>5</sup> Credit and weather derivative transactions are unregulated under the current regulatory scheme.

<sup>6</sup> The AFSB will be abolished upon the effectiveness of the relevant portion of the FIEL, and the current regulatory scheme for foreign securities firms will be incorporated into the FIEL. Accordingly, discussions in this memorandum will also apply to foreign securities firms.

<sup>7</sup> Notwithstanding such deemed registration, such securities firms will be required to submit the same documents as required for initial registration within three months of the effective date of the FIEL (Article 18, Paragraph 2 of the Supplementary Provisions).

(Articles 21 and 22 of the Supplementary Provisions). Further, in the case of OTC securities derivative activities, for which separate approval will cease to be required following the effectiveness of the FIEL as described above, all existing securities firms (whether or not previously approved) will be permitted to engage in OTC derivative activities (OTC securities, financial, credit and weather) without further action<sup>8</sup>. We illustrate the treatment of approved business under the SEL in the table below.

Activity	SEL	FIEL	Automatic Registration for All Firms	Automatic Carryover of Approval	Notes
OTC derivative	approval	registration	Yes		Every securities firm may conduct OTC derivative transactions after the effective date of FIEL <sup>9</sup> .
primary underwriting			No	Yes	Current securities firm without approval for primary underwriting under SEL will be required to make additional registration to engage in primary underwriting.
PTS		registration & approval			Current securities firm without approval for PTS activities under SEL will be required to make additional registration and obtain approval to engage in such activities.

For a securities firm that engaged in securities business prior to the effectiveness of the FIEL, but did not have FSA approval to engage in primary underwriting, OTC securities derivatives activity or PTS activity, such securities firm will be (1) required to register in order to conduct primary underwriting, (2) deemed registered to conduct OTC derivative activity (securities, financial, credit or weather), and (3) required to register and be approved in order to conduct PTS activity.

<sup>8</sup> Any securities firm which does not currently engage in OTC derivative activities, however, will be required to amend and file its Business and Service Document (*gyomu houhou sho*) (Article 31, paragraph 3 of the FIEL).

<sup>9</sup> See Note 8.

- (b) Ancillary Business. As was the case under the SEL, ancillary business under the FIEL will be comprised of a list of specified activities, and will also include a general “catch-all” phrase for other securities-related businesses. Certain activities that were categorized as reportable business under the SEL will be re-categorized as ancillary business under the FIEL, and additional specified activities will be added to the ancillary business list. Some of the new additions to such list are set forth in III (d) below.
- (c) Reportable Business. Reportable businesses under the FIEL will continue to be comprised of a list of such activities. Certain activities that were categorized as authorized business under the SEL, however, will be re-categorized as reportable business under the FIEL, thereby reducing the requirements for engagement in such activities. Some of the activities added to the reportable business category are set forth in III (e) below. For securities firms which have made reports prior to the effectiveness of the FIEL, such reports will be deemed to carry over with respect to activities that remain in the reportable business category (Article 34 of the Supplemental Provisions and Article 18 of the Supplemental Provisions to the Enforcement Order of the Financial Instruments and Exchange Law (bill)).
- (d) Authorized Business. As noted, certain activities previously categorized as authorized business will be re-categorized as reportable business under the FIEL. With this exception, the definition of authorized business will remain unchanged, with no specification of the activities actually covered, and with authorization to be given from time to time as such authorization is sought. For securities firms which have received authorizations prior to the effectiveness of the FIEL, such authorizations will be deemed to carry over with respect to activities that remain in the authorized business category (Article 35 of the Supplemental Provisions).

### **III. Implications of the Above**

Various specific implications of the above changes in regime that will occur upon the effectiveness of the FIEL are worth identifying, as follows:

- (a) OTC Securities Derivative Activities. OTC securities derivative activities under the SEL fall into the main business category, but require FSA approval. The FSA has imposed a monetary threshold of JPY 1 billion in stated capital and net assets upon any securities firm seeking such approval (Article 29, item 1, Article 29-4, items 2 and 3, of the SEL; Article 15-3, item 1 of the Enforcement Order of the SEL). Under the FIEL, OTC securities, financial, credit and weather derivative transactions may be conducted upon registration, with the result that this threshold requirement will be eliminated.
- (b) Securities Custodian Activities. Under the SEL, securities custodian activities fall within the ancillary business category (Article 34, paragraph 1, item 1). Under the FIEL, such activities will be re-categorized as a Type 1 financial instruments business (Article 28, paragraph 1, item 5 and Article 2, paragraph 8, item 16), but no change in substantive requirements will arise from this change as existing securities firms will

be deemed to have registered for this business (Article 18, paragraph 1 of the Supplementary Provisions)<sup>10</sup>.

- (c) Account Management Institution (koza kanri kikan) Activities participating in JASDEC. Under the SEL, management activities for book-entry transfer of corporate bonds, etc. through participation in Japan Securities Depository Center, Inc. (JASDEC) as an account management institution (*koza kanri kikan*), as prescribed by the Law concerning Book-entry Transfer of Corporate Bonds and other Securities (*shasai tou no furikae ni kansuru horitsu*), fall within the ancillary business category (Article 34, paragraph 1, item 1). Under the FIEL, such activities will be re-categorized as a Type 1 financial instruments business (Article 28, paragraph 1, item 5 and Article 2, paragraph 8, item 17), but no change in substantive requirements will arise from this change.
- (d) Expansion of Activities Expressly Included in Ancillary Business. Under the FIEL, the list of activities specifically identified as constituting ancillary business will be expanded, with new additions including the following (all of which were previously categorized as reportable business):
- (i) Acting as custodian for assets of an investment corporation (*toshi hojin*) (Article 34, paragraph 2 item 2-2 of the SEL; Article 35, paragraph 1, item 10 of the FIEL);
  - (ii) Corporate management consulting business (Article 34, paragraph 2 item 9 of the SEL; Article 25, item 12 of the Cabinet Ordinance concerning Securities Dealers; Article 35, paragraph 1, item 12 of the FIEL);
  - (iii) Sale and purchase of foreign currencies and other derivative related assets underlying derivatives<sup>11</sup> or otherwise acting as an agent or intermediary for such sale and purchase transactions (Article 34, paragraph 2, item 6 of the SEL; Article 35, paragraph 1, item 13 of the FIEL);
  - (iv) Sale and purchase of receivables (including certificates of deposit) or otherwise acting as agent or intermediary therefor (Article 34, paragraph 2, item 9 of the SEL, Article 25, items 2 and 7 of the Cabinet Ordinance concerning Securities Dealers; Article 35, paragraph 1, item 14 of the FIEL); and
  - (v) Mergers and acquisitions advisory business (Article 34, paragraph 2 item 9 of the SEL, Article 25, item 12 of the Cabinet Ordinance concerning Securities Dealers; Article 35, paragraph 1, item 11 of the FIEL).
- (e) Expansion of List of Activities Constituting Reportable Business. Under the FIEL, the list of activities constituting reportable business will be expanded, with new additions including the following (most of which were previously categorized as authorized business):

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<sup>10</sup> Due to re-characterization of such securities custodian activities as a part of the financial instruments business, however, regulations relating to customer protection will be imposed on such custodian activities.

<sup>11</sup> Such “derivative related assets” are to be stipulated by cabinet ordinance; however, the current legislative draft of the ordinance includes no such provisions.

- (i) Real property (land and buildings) trading business (*takuchi tatemono torihiki gyo*) (Article 35, paragraph 2, item 4);
- (ii) Real estate specified joint enterprise activities (*fudosan tokutei kyodo jigyo*) (item 5 of the same paragraph);
- (iii) Investment activities in assets other than securities or derivatives as a general partner or *tokumei kumiai* operator or similar manager of funds (item 6 of the same paragraph);
- (iv) Intermediary business for execution of agreements between trust banks and their customers under which the trust bank undertakes enforcement (under court supervision) of a will as executor thereof or disposition of inherited properties (Article 71, item 12 of the Cabinet Ordinance of Financial Instruments Dealers (*kinyu shohin torihiki gyosha ni kansuru naikakufurei*));
- (v) Real property (land and buildings) administration (*kanri*) business (item 14 of the same Article);
- (vi) Advisory business relating to investment in real property (land and buildings) (item 15 of the same Article); and
- (vii) Entry into agreements for, or agency or intermediary business relating to, trading in carbon dioxide emissions credits or allowances under the Kyoto Protocol (*Kyoto Giteisho*) and engaging in derivative transactions relating thereto (items 16 and 17 of the same Article).

Please note that (iv) through (vii) above are based on the current legislative draft of the relevant Cabinet Ordinance and are therefore subject to revision.

- (f) *Investment Discretionary Contracts*. Under the SEL, acting as agent in respect of investment discretionary contracts is deemed to constitute an ancillary business, in which securities firms are accordingly permitted to engage without reporting or authorization (Article 34, paragraph 1, item 5). Under the FIEL, however, the investment advisory and management business will generally become subject to additional regulation under a separate category defined as “investment advisory and agency business” (*toshi jogen dairi gyo*) and “investment management business” (*toshi unyo gyo*) (Article 28, paragraphs 3 and 4). This category of business will be neither a Type 1 nor a Type 2 financial instruments business, and any securities firm wishing to engage in such business will be required to undertake a separate registration (Article 31, paragraph 4). Acting as agent in respect of investment discretionary contracts will also be deemed to constitute “investment advisory and agency business”, and will require separate registration. Accordingly, the regulation of this particular activity will become more stringent under the FIEL.

Please note that this memorandum is not intended to provide a comprehensive analysis of all changes in regulatory and related obligations under the FIEL, but rather to provide a general outline and to highlight certain specific issues. In the event that we can provide advice in further detail with respect to these or related matters, please do not hesitate to contact us.

Contact: Toshinori Yagi ([toshinori.yagi@amt-law.com](mailto:toshinori.yagi@amt-law.com))

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