

Easing of Firewall Regulations under the Financial Instruments and Exchange Act of Japan

1. Introduction

This Newsletter outlines the recent amendments (the “**Amendments**”) to the subsidiary legislations under the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the “**FIEA**”). The primary objective of the Amendments, which came into effect on April 1 2014, is to relax the FIEA firewall regulations (the “**Firewall Regulations**”) prohibiting securities firms¹ from sharing Non-public Information² regarding the issuers of relevant securities or the client of the securities firm (collectively, the “**Issuers**”) with their Parent Juridical Persons, etc.³ and/or Subsidiary Juridical Persons, etc.⁴ (collectively, the “**Parent and Subsidiary Companies**”).

The Amendments were effectuated through amendments to the following:

- (i) the Cabinet Office Ordinance on Financial Instruments Business, etc.; and
- (ii) the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. of the FIEA (the “Supervision of FIBO Guidelines”).

2. Background to the Firewall Regulations

(1) Purpose of the Firewall Regulations

Prior to the Amendments, securities firms were prohibited by the Firewall Regulations from exchanging Non-public Information relating to Issuers with their Parent and Subsidiary Companies.

The Firewall Regulations were intended to achieve the following in order to prevent the distortion of market functions resulting from transactions entered into by securities firms or their Parent and Subsidiary Companies based on information obtained through the misuse of the parent-subsidiary relationship:

¹ References to a “securities firm” in this Newsletter are to a Type I Financial Instruments Business Operator engaged in the Securities-Related Business (as defined in the FIEA).

² Non-public Information means (i) undisclosed and important information regarding an Issuer’s management, operations or properties which affects the investment decisions of a securities firm’s client, and (ii) information regarding certain other matters such as the sale and other transactional trends in the securities-related orders of a securities firm’s clients, where such information is obtained by officers or employees of a securities firm or its Parent and Subsidiary Companies in the performance of their duties.

³ Including (but not limited to) a parental company of a securities firm, and the subsidiaries or affiliates of such parental company.

⁴ Including the securities firm’s subsidiaries and affiliates.

- (i) independence and sound management of securities firms;
- (ii) avoidance of conflict of interests between Issuers and Parent and Subsidiary Companies of securities firms; and
- (iii) fair competition between market intermediaries.

(2) Exceptions to the Firewall Regulations

Notwithstanding the above, the Firewall Regulations did not apply in certain situations, including but not limited to the following:

- (i) where the relevant Issuer allows, by means of a prior written consent (“**Issuer’s Written Consent**”), a securities firm and its Parent and Subsidiary Companies to share Non-public Information;
- (ii) where the sharing of Non-public Information is necessary in order for a securities firm and their Specific Affiliates⁵ to coordinate their “internal control functions” (the “**Internal Control Exception**”); and
- (iii) where an Issuer (which is a juridical person) is given written notice stating, among others, that a securities firm and its Parent and Subsidiary Companies will share Non-public Information relating to the Issuer (“**Information Sharing Notice**”), pursuant to which the Issuer will, unless it expressly indicates otherwise, be deemed to permit such information sharing (the “**Opt-out**”).

The Internal Control Exception and Opt-out are discussed in further detail below.

3. Summary of the Amendments

(1) Relaxation of the written consent requirement

One argument against the Firewall Regulations is the difficulty, in practice, of obtaining an Issuer’s Written Consent where such Issuer is a foreign juridical person located in a country without regulations similar to the Firewall Regulations. As a result of the Amendments, an Issuer’s Written Consent will be deemed to have been obtained if the following conditions are met:

- (i) the Issuer is a foreign juridical person (including an association which does not have a juridical personality but has appointed representatives or managers);
- (ii) there exists no rule or regulation, in the country in which the relevant Issuer is

⁵ Specific Affiliates include (i) the holding company of a securities firm, (ii) the parent companies of the securities firm which perform the internal control functions of the securities firm and (iii) the securities firm’s Parent and Subsidiary Companies which are financial institutions (such as banks or securities firms).

located, that restricts a securities firm and its Parent and Subsidiary Companies from sharing Non-public Information regarding an Issuer; and

- (iii) (a) the relevant Issuer issues a declaration of its intention to allow a securities firm and its Parent and Subsidiary Companies to share information relating to the Issuer and/or its transactions by means of electronic records or, where no such express declaration of intent has been issued, (b) a declaration by the relevant Issuer, to allow a securities firm and its Parent and Subsidiary Companies to share Non-public Information can reasonably be construed from (x) the provisions of any agreement entered into by the Issuer and (y) the business practices of the country in which the Issuer is located.

(2) Expansion of the Internal Control Exception to Internal Control and Administrative Functions Exception

Prior to the Amendments, a securities firm and its Parent and Subsidiary Companies were permitted to share Non-disclosed Information regarding an Issuer without consent from the Issuer, if such information sharing falls within the Internal Control Exception. Before the Amendments came into effect, this exception encompassed the following:

- (i) compliance-control functions;
- (ii) functions to manage risks of loss;
- (iii) internal audit and review functions;
- (iv) finance functions;
- (v) accounting functions; and
- (vi) taxation functions.

Pursuant to the Amendments, the Internal Control Exception has been expanded to the Internal Control *and Administrative* Functions Exception, which encompasses, in addition to the functions set out in section 3 (2) above, (i) and (ii) below:

- (i) management and control functions of a securities firm's Subsidiary Juridical Persons, etc.

This function generally includes the functions of personnel reshuffling (as part of the business functions of parent companies), general supervision of business divisions and personnel, and the establishment of guidelines for sales and finance-related businesses (such as the development of comprehensive management strategies, and the maintenance of frameworks relating to risk and compliance).

It should be noted, however, that these functions will only fall within the Internal Control and Administrative Functions Exception where a securities firm receives

Non-public Information from its Subsidiary Juridical Person, etc. (while the receipt of Non-public Information from a Parent Juridical Person, etc. by a securities firm is still prohibited) or where a securities firm provides Non-public Information to its Parent Juridical Person, etc. (while the provision of Non-public Information to a Subsidiary Juridical Person, etc. by a securities firm is still prohibited).

- (ii) clearing functions in relation to the sale and purchase of securities, derivative (including, but not limited to, financial derivative) transactions and other transactions, and other functions in relation to the clearing functions.

These functions include functions relating to the closing of transactions by means of cash or securities deliveries, and other functions relating to the foregoing. Collateral management functions, client account management functions, and bookkeeping functions required by law are also included among these functions.

(3) Changes to the Opt-out⁶

Background to the Opt-out

By way of background, the Firewall Regulations provide that an Issuer which is a juridical person and is given an Information Sharing Notice will be deemed to have provided a written consent to allow a securities firm and its Parent and Subsidiary Companies to share Non-public Information relating to the Issuer, until such time the Issuer indicates its wish for such information sharing to cease. The Supervision of FIBO Guidelines require a securities firm to give an Information Sharing Notice to an Issuer on an annual basis in order to justify the continued validity of the Issuer's deemed consent to information sharing between the securities firm and its Parent and Subsidiary Companies (the "**Annual Notice Requirement**").

It should be noted, however, that the Supervision of FIBO Guidelines require Information Sharing Notices to make clear that the Issuer has the right to opt out from the sharing of Non-public Information ("**Opt-out Right**"). In this regard, the Supervision of FIBO Guidelines also sets out the methods by which securities firms can inform Issuers of their Opt-out Right, including but not limited to the following:

- (i) providing Issuers (which are juridical persons) with an Information Sharing Notice (which, as stated above, will include information on Issuers' Opt-out Right) in such manner as to make Issuers clearly aware of their Opt-out Right (for example, by providing Issuers with an Information Sharing Notice at the time they enter into an agreement with a securities firm); and
- (ii) informing Issuers (which are juridical persons) on a clear and continuing basis of

⁶ The conditions to the applicability of the Opt-out are set out in the Supervision of FIBO Guidelines. An English translation of the Supervision of FIBO Guidelines (provided by the Financial Services Agency of Japan but which may not be up-to-date) can be viewed at the following website: <http://www.fsa.go.jp/en/refer/guide/instruments.pdf>

the fact that they can exercise their Opt-out Right at any time, through the posting of information on Issuers' Opt-out Right on storefronts and/or websites and other means such as (a) the setting up of online applications on the website of a securities firm that enables an Issuer to opt out, or (b) providing information containing the address of a securities Firm's internal control division to which opt-out applications should be sent.

Amendments to the Opt-out Exception

The Annual Notice Requirement, which proved cumbersome and unpopular among securities firms and has been identified as one of the causes for the unwillingness of securities firms to utilize the Opt-out Exception, has been abolished under the Amendments.

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Contact Information:

Should you wish to receive further information or advice regarding the foregoing, please do not hesitate to contact the author Takaharu Totsuka.

Takaharu Totsuka
Partner
Email: takaharu.totsuka@amt-law.com
Telephone: +81-3-6888-1156

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