

# Toughening up

**Tatsu Katayama, Ayako Kuyama and Jeffrey A Eagan of Anderson Mori & Tomotsune outline enhanced regulations regarding marketing of OTC derivatives and structured products in Japan**

**O**n April 1 2011, Japan's regulations regarding marketing of over-the-counter (OTC) derivatives and structured products were significantly reinforced. The government amended the regulations under the Financial Instruments and Exchange Act (FIEA), as amended, that provide the regulatory framework with respect to the marketing of derivatives products by entities in the different types of financial services sectors (referred to below as the 2011 Amendments). Industry organisations echoed the governmental efforts and enhanced as of the same date the rules applicable to the relevant financial services sector relating to the marketing of derivatives transactions and structured products.

## Overview of Japanese regulations

Derivatives, whether traded OTC or traded on an exchange, are classified according to the type of underlying asset as: (i) securities-related derivatives (equity or bond derivatives, for example); (ii) financial derivatives (interest rate or

currency derivatives, credit derivatives, weather, earthquake or catastrophe derivatives, or property derivatives); and (iii) commodity or other derivatives.

It is interesting to note that, before April 1 2011, the property derivatives business was free from licensing or registration requirements or specific customer protection rules under Japanese law. The regulators, however, forecasting an increasing need for property derivatives as hedging instruments against fluctuations in the value of real estate, and with the goal of protecting purchasers of such property derivatives, have expanded Japan's regulatory regime under the FIEA to cover the business of property derivatives.

The main legislation that regulates OTC transactions which fall under items (i) and (ii) above (collectively the OTC securities-related and financial derivatives transactions) is the FIEA. The business of conducting these transactions is subject to registration requirements and detailed customer protection rules, including restrictions on customer solicitation, suitability rules, restrictions on advertising and requirements for the delivery of documents to customers.

Furthermore, as of January 1 2011, engagement in the commodity derivatives business became subject to regulation under the Commodity Derivatives Act, which imposes licensing requirements and detailed customer protection rules. The FIEA and/or other statutes and regulations relating to financial services also regulate the marketing of certain structured products in which derivatives components are incorporated (for example structured notes, units in investment trusts and structured bank-deposits).

The Financial Services Agency (FSA), which is the principal regulatory authority under the FIEA and other statutes and regulations relating to financial services, has also issued guidelines. Unlike the statutes or their subordinate regulations, the FSA's guidelines are not legally binding, but as a matter of practice they are very important because they provide certain interpretations by the FSA of the FIEA and

other statutes and regulations relating to financial services.

In addition to the above rules implemented through governmental regulations and guidelines, relevant industry organisations have implemented regulations and/or guidelines in order to enhance customer protections.

## Enhanced regulations

As detailed below, the 2011 Amendments strengthened the following types of marketing regulations with respect to certain OTC securities-related and financial derivatives transactions.

### Unrequested solicitation restriction

Generally, OTC derivatives transactions have negative attributes such as a lack of transparency of prices and possibly causing losses to investors that exceed the amount invested by such investor. OTC derivatives transactions require highly specialised knowledge for appropriate investment decisions. Nonetheless there are investors who engage in such transactions without having such requisite knowledge.

In light of this, the FIEA contained customer protection regulations before the 2011 Amendments. In particular, brokers and dealers were heavily regulated with respect to certain types of OTC financial derivatives transactions (such as currency contracts for difference and currency options), regardless of the type of customer involved.

For example, brokers and dealers were already prohibited from soliciting, either by a face-to-face visit or a telephone conversation, potential customers (individuals or otherwise, but excluding specified professional customers) to engage in such types of OTC financial derivatives transactions unless the customer requested such solicitation. This was known as the unrequested solicitation restriction.

With respect to the mentioned types of OTC financial derivatives transactions, the unrequested solicitation restriction will not apply to certain types of customers (customers with which prescribed ongoing relationships exist with respect to the same kind of transactions) or certain types of transactions (those entered into as exchange-rate hedging instruments for customers engaging in the business of foreign trade or foreign exchange transactions).

The FSA observed, however, that other OTC derivatives transactions, such as equity contracts for difference, also raised a serious concern with respect to the

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protection of individual customers. In response to such, and in order to ensure appropriate customer protection, the 2011 Amendments broadened the scope of the unrequested solicitation restriction to cover all OTC securities-related and financial derivatives transactions where the potential customers are individuals (excluding specified professional customers).

With respect to the newly-covered transactions, the restriction will not apply to certain types of customers (those with which prescribed ongoing relationships exist with respect to the same kind of transactions) or certain types of transactions (stock call options granted by individual customers under which such stock is provided to the option holder as collateral, for example).

### Other enhanced regulations

As with the unrequested solicitation restriction, under the 2011 Amendments the scope of other marketing regulations also expanded to cover all OTC securities-related and financial derivatives transactions with individual customers (excluding specified professional customers).

For example, under the 2011 Amendments, brokers and dealers are generally prohibited from soliciting an individual customer to engage in any OTC securities-related and financial derivatives transaction without first confirming whether the customer wishes to be solicited, or after such customer has indicated that he/she will not engage in such transaction or does not wish to be solicited. The 2011 Amendments also impose heavy requirements on brokers and dealers to deliver extensive disclosure

### Author biographies



#### Tatsu Katayama, partner

Tatsu Katayama's areas of expertise are international banking, finance and securities matters with a particular emphasis on structured finance, financial derivatives and other complex financial transactions. He has been instrumental in structuring innovative transaction schemes and regularly advises investment banks, asset managers and investment vehicles such as TMKs (special purpose companies) and J-Reits in relation to real property acquisition, development and financing. Mr Katayama has served as the Director of International Affairs of the Japan Federation of Bar Associations and is a graduate of

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#### Ayako Kuyama, associate

Ayako Kuyama works primarily in the field of financial regulatory issues, derivatives, structured finance and various issues relating to trust laws and other financial transactions. With respect to her work in derivatives, she advises on a variety of issues relating to financial products and structured finance products that incorporate derivatives. She also provides advice on regulation and other issues relating to structuring, documentation, and handling of defaults and disputes relating to such derivatives. Ms Kuyama has advised on establishing and licensing procedures of companies engaging in derivatives and

on the investor protection regulations relating to marketing derivatives. She received an LLB and an LLM from The University of Tokyo and has served as a lecturer at The University of Tokyo School of Law. She is admitted to practise law in Japan.



#### Jeffrey A Eagan, foreign legal associate

Jeffrey A Eagan works on a wide range of insurance and financial regulatory matters as well as financial transactions. His experience includes handling regulatory issues relating to derivatives and transactions that include such financial products. Mr Eagan received a JD from the George Mason University School of Law and an LLM from the Temple University Beasley School of Law. He is admitted to practise law in Virginia.

statements to individual customers with respect to all OTC securities-related and financial derivatives transactions, with some exceptions.

### Enhanced regulation of industry organisations

The 2011 Amendments did not change the regulations regarding OTC securities-related and financial derivatives transactions entered into with non-individual customers. The reasons for this distinction are that, as compared to individual customers, non-individual customers are considered to have the knowledge necessary to make appropriate investment decisions, and non-individual customers would have wide-ranging needs for OTC derivatives transactions as hedging instruments.

With respect to currency options, the FIEA already imposed quite strict requirements before the 2011 Amendments, even where customers were non-individuals. This remains the same after the implementation of the amendments because there are still many problematic issues.

In addition, the 2011 Amendments did not change the regulations regarding structured notes or units in investment trusts which are complex and similar to OTC derivatives transactions or which are highly-leveraged, or structured bank deposits that incorporate derivatives transactions, regardless of the types of customers. This is because, as compared to OTC derivatives transactions, such products do not cause losses exceeding investment amounts to investors, and there

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have been fewer problems regarding methods of solicitation.

There remained, however, some problematic practices which were not fully addressed by the 2011 Amendments with respect to OTC securities-related and financial derivatives transactions and structured products. Newly-implemented rules of industry organisations were intended to bridge this gap. Namely, in order to enhance customer protection, the relevant industry organisations – Japan Securities Dealers Association (JSDA), The Investment Trusts Association, Japan (ITA) and The Financial Futures Association of Japan (FFAJ) – implemented new regulations with respect to such transactions or products by which their respective members must abide.

Because these regulations are tailored to reflect the different practices of the relevant industry and transactions/products, there is some variation in them. In addition, the Japanese Bankers Association (JBA) has implemented new guidelines for its member banks with respect to structured bank-deposits that incorporate derivatives transactions.

The features of such self-imposed regulations and the JBA's guidelines are summarised below.

### Reasonable basis suitability rules

The JSDA has newly adopted so-called reasonable-basis suitability rules under its self-imposed regulations. This is a different concept from the consumer-specific suitability rules concepts of which are considered to be already adopted in the FIEA and other statutes and regulations relating to financial services. Under the latter rules, brokers and dealers must not solicit customers who are not suitable for the relevant transactions/products in light of their knowledge, experience, wealth and purpose of executing/purchasing such transactions/products of such customers, and must explain the salient features of such transactions/products to the customers in such manner and level that can be understood by the customers in light of their knowledge, experience, wealth and purpose of executing/purchasing such transactions/products.

By contrast, under the reasonable-basis suitability rules adopted by the JSDA, brokers and dealers must first consider whether they may solicit any of their customers with respect to new transactions/products. They are prohibited from executing with or selling to the customers of such transactions/products

## Summary of Regulations

	Individual customers	Non-individual customers
<b>OTC securities-related and financial derivatives transactions</b>	Enhanced regulations through the FIEA and the self-imposed regulations of the JSDA and/or the FFAJ including: <ul style="list-style-type: none"> <li>• unrequested solicitation restriction;</li> <li>• reasonable basis suitability rules;</li> <li>• delivery to customers of documents for forewarning purposes; and</li> <li>• confirmation by customers.</li> </ul>	Enhanced regulations through the self-imposed regulations of the JSDA and/or the FFAJ including: <ul style="list-style-type: none"> <li>• reasonable basis suitability rules;</li> <li>• delivery to customers of documents for forewarning purposes; and</li> <li>• confirmation by customers.</li> </ul>
<b>Complex structured notes, complex units and highly-leveraged units</b>	Enhanced regulations through the self-imposed regulations of the JSDA and/or the ITA including: <ul style="list-style-type: none"> <li>• reasonable basis suitability rules;</li> <li>• criteria of commencing solicitation;</li> <li>• delivery to customers of documents for forewarning purposes; and</li> <li>• confirmation by customers.</li> </ul>	Enhanced regulations through the self-imposed regulations of the JSDA and/or the ITA including: <ul style="list-style-type: none"> <li>• reasonable basis suitability rules;</li> <li>• delivery to customers of documents for forewarning purposes; and</li> <li>• confirmation by customers.</li> </ul>

unless they can reasonably assume that at least some of the potential customers would be suitable to execute/purchase such transactions/products, in light of the nature of, and risks involved in, such transactions/products.

The ITA also implemented similar reasonable basis suitability rules which are applicable to managers of investment trusts with respect to the self-solicitation of units in new investment trusts that such managers administer.

The JBA adopted similar rules in its guidelines, which are applicable to member banks with respect to their handling of new types of structured bank deposits.

### Criteria of commencing solicitation

The JSDA's self-imposed regulations provide that, in order to solicit individual customers (excluding specified professional investors) who have not requested such solicitation for certain financial products, brokers and dealers must first set forth criteria of commencing such solicitation (for example the customer's age, trading experience, asset status, purposes and policies of investment). The brokers and dealers are prohibited from commencing such solicitation unless the customers satisfy such criteria.

The financial products at issue are (i)

structured notes which are complex and similar to OTC derivatives transactions – such as so-called knock-in type notes; (ii) units in investment trusts which are complex and similar to OTC derivatives transactions (units in investment trusts which have the same economic features as complex structured notes by investing therein); and (iii) units in investment trusts which are unlisted and highly-leveraged.

The ITA also established similar regulations which are applicable to managers of investment trusts with respect to the self-solicitation of the complex units or the highly-leveraged units in investment trusts that such managers administer.

In addition, the JBA also adopted similar rules in its guidelines which are applicable to member banks with respect to their solicitation of complex structured bank-deposits.

### Delivery of documents for forewarning

Under the FIEA and/or other statutes and regulations relating to financial services, in order to enter into with customers (regardless of whether they are individuals, but excluding specified professional investors) OTC securities-related and financial derivatives transactions, or sell to such customers complex structured notes, complex units or highly-leveraged units,

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brokers and dealers are generally required to deliver documents containing prescribed information (for example information regarding such transactions/products and related risks) and to explain such information to the customers in advance.

In addition to the above requirements under the FIEA, the self-imposed regulations of the JSDA and the FFAJ generally require for forewarning purposes the delivery of other documents containing certain information and to explain such information to the relevant customers, before entering into with or selling to such customers OTC securities-related and financial derivatives transactions, complex structured notes or complex units. The information that must be provided in such documents includes (i) whether the unrequested solicitation restriction is applicable to such transactions/products; (ii) forewarning on related risks; and (iii) that a certain complaint processing and dispute resolution system provided by a specified dispute-resolution body is available.

The ITA similarly adopted regulations which are applicable to managers of investment trusts with respect to the self-distribution of the complex units in investment trusts that such managers administer. The information that must be provided in the documents delivered to the

relevant customers includes forewarning on related risks and that a certain complaint processing and dispute resolution system provided by a specified dispute-resolution body is available.

In addition, the JBA implemented similar rules in its guidelines which are applicable to member banks with respect to their acceptance of complex structured bank-deposits.

#### **Confirmation by customers**

In order to confirm that customers understand the salient features of the above-mentioned transactions/products, and enter into or purchase such transactions/products based on their own judgment and on their own responsibility, the self-imposed regulations of the JSDA require brokers and dealers to obtain confirmation letters describing prescribed matters from the relevant customers (regardless of whether they are individuals or otherwise, but excluding specified professional investors) before entering into with or selling to such customers such transactions/products. The matters that must be confirmed by the above-mentioned letters include:

(i) any expected losses that might be incurred in connection with such transactions/products;

(ii) based on any expected losses that might be incurred in connection with such transactions/products

(a) the amount of losses which are allowable for the customers to incur, and

(b) that the customer is capable to enter into/purchase such transactions/products in light of the impact by any such expected losses on the operational, financial and asset status of the customer; and

(iii) if the customer is a non-individual and such broker/dealer has provided financing to the customer, that the rejection of the solicitation of such transactions/products will not affect in any way any future financing.

The FFAJ, ITA and JBA adopted similar rules and regulations which are applicable to brokers and dealers of certain OTC financial derivatives transactions, managers of investment trusts with respect to the self-distribution of the complex units in investment trusts that such managers administer, and member banks with respect to their acceptance of complex structured

bank-deposits, respectively.

#### **Investment trusts**

With respect to complex units, the ITA's self-imposed regulations provide other regulations including:

- benchmark indices applicable to such investment trusts must be those that are available to investors from newspapers, informational terminals, websites of the relevant managers of such investment trusts and/or information provided by distributors of such units; and
- names of such investment trusts must not mislead investors into believing that there is a guarantee of principal or return of interest, or that the volatility risk of the benchmark prices of such units is low.

In addition, the ITA's self-imposed regulations introduced enhanced disclosure requirements with respect to prescribed complex units.

#### **Enhanced complexity**

In conclusion, the regulations regarding the marketing of OTC derivatives transactions and structured products in Japan have been enhanced and are now even more complex (as summarised in the summary of regulations table).

A significant portion of the new regulations were implemented by industry organisations rather than the Japanese government. It should be noted, however, that such organisations' rules were in fact encouraged by the FSA's desire to enhance customer protection. Effective as of April 1 2011, the FSA amended its guidelines applicable to these industries for the purpose of reflecting the new regulations implemented not only through the 2011 Amendments but also through the relevant self-imposed regulations and the JBA's guidelines. Through such amended guidelines, the FSA has shown its interest in enforcing the rules contained in the self-imposed regulations and the JBA's guidelines.

Given that the regulatory environment for offering OTC derivatives transactions and structured products has become more stringent, and such change would have a significant impact on market practices, practitioners and market participants must pay close attention to such regulatory developments.