# A new regulation on the consolidated supervision of securities companies

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**The Amended FIEA introduced a new regulation on majority shareholders of certain financial instruments firms; such majority shareholder will be required to notify to the Financial Services Agency (FSA) when their shareholding ratio of the voting securities of the subject entity becomes more than 50%, and the FSA will be empowered to issue remedial orders to majority shareholders if they are found to have exercised undue influence over the subsidiary financial instruments firms. The Amended FIEA also introduced a new legal framework for consolidated regulation of large securities companies, which consists of "downstream consolidation" and "upstream consolidation".**

Pursuant to the Act for Partial Amendment to the Financial Instruments and Exchange Act, Etc., enacted on May 12, 2010 and promulgated on May 19, 2010, the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended; the "FIEA") has been amended, introducing new regulations to strengthen the supervision of securities companies, including consolidated supervision of large securities companies (the FIEA so amended, the "Amended FIEA"). The new regulations became effective as of April 1, 2011. This article outlines some key features of the amendment.

## New regulations on majority shareholders of financial instruments firms

Prior to the Amended FIEA, a shareholder who holds 20% (or 15% in certain circumstances) or more of the voting securities of a financial instruments firm that engages in type 1 financial instruments business (e.g., securities firms) or investment management business was required to file a notification with the FSA when its shareholding ratio reaches the threshold.

Under the Amended FIEA, in addition to the foregoing notification obligation, a shareholder who holds more than 50% of the voting securities of the foregoing categories of a financial instruments firm (the "majority shareholder") is required to notify the FSA, and the FSA can order the majority shareholder to take necessary measures to improve the operation or financial status of the subsidiary financial instruments firm if the FSA deems such order is necessary for public interest and investors protection (e.g., if it is found that as a result of undue influence of its majority shareholder, a financial instruments firm has appropriated its customers' funds for the benefit of the majority shareholder or its affiliates).

In addition, if the majority shareholder violates such an order, the FSA can issue an order that makes the majority shareholder cease to be a majority shareholder of the subject financial instruments firm (e.g., disposition of the voting securities of the subject financial instruments firm).

## Consolidated supervision of large securities companies

In response to a heightened necessity to supervise and regulate overall activities of large securities companies groups, whose sudden collapse could lead to a financial disaster, the Amended FIEA also introduced a new legal framework for consolidated supervision of large securities companies, which consists of "downstream consolidation" and "upstream consolidation".

## Downstream consolidation

Under the Amended FIEA, a financial instruments firm that engages in type 1 financial instruments business (e.g., securities companies, but excluding foreign companies) that has the aggregate asset of more than ¥1 trillion (a "special financial instruments firm") is required to notify to the FSA, within two weeks after its aggregate asset crossed the threshold amount.

If a special financial instruments firm has a subsidiary, a business report concerning the special financial instruments firm and its subsidiaries must be prepared and filed with the FSA, and certain explanatory documents concerning these entities must also be prepared and made available for public inspection. In addition, capital adequacy requirements must be satisfied on a consolidated basis, and such consolidated capital adequacy ratio must be reported to the FSA and made available for public inspection on a quarterly basis.

The FSA will be able to take administrative actions, including business suspension orders, against a special financial instruments firm depending on the status of capital adequacy ratio, and if the capital adequacy ratio has not been improved and is not likely to be improved within three months after the order was

issued, a special financial instruments firm could be revoked its financial instruments firm registration.

Furthermore, the FSA will be able to compel subsidiaries of a special financial instruments firm to submit a report on such matters as the FSA requires, and the FSA will also be able to investigate such subsidiaries if such investigation is deemed necessary for the public interest and investor protection.

In addition, if a special financial instruments firm has a parent company, the special financial instruments firm is required to file with the FSA (i) certain basic information regarding the parent company; (ii) business and financial status of group companies to which the special financial instruments firm belong; (iii) if such group companies are regulated under laws other than the FIEA or laws of foreign countries, outline of such regulations; and (iv) if the parent company manages the operation of the special financial instruments firm or if the special financial instruments firm receives financial support from other group companies, outline of such financial support.

If the parent of a special financial instruments firm is also subject to the upstream consolidated supervision (discussed below), the foregoing regulations applicable to downstream consolidated supervision will not be applied.

## Upstream consolidation

If a parent company of a special financial instruments firm is found to be engaged (as its own business) in the management of the special financial instruments firm (e.g., the parent company continuously engages in business and financial administration of the subsidiary securities firm, for example, by involving itself in business strategies planning, risk management, compliance oversight, personnel matters of the subsidiary, and supervising daily operation of the subsidiary) or the parent company or its subsidiaries provide funds to the special financial instruments firm in a way that the special financial instruments firm is so dependent on such funds that stoppage of such funds would likely cause substantial hindrance on its business operation, the FSA may designate such parent company as "designated parent company" thereby making it subject to the upstream consolidated supervision.

The FSA may, however, choose not to make such designation if such parent company and its subsidiaries are appropriately supervised under laws other than

the FIEA or under foreign laws. Accordingly, if a securities firm is a subsidiary of a bank holding company or insurance business holding company that already is subject to the regulations under the Banking Act or the Insurance Business Act of Japan, or if a securities firm belongs to a group of foreign securities companies that are already subject to the regulations of foreign countries, parent companies of such security firms would not be subject to the designation and not subject to the upstream consolidated supervision. Even in such a case, however, the FSA is able to issue a remedial order to the parent company of a subsidiary securities firm (as part of the FSA's authority on the majority shareholders of financial instruments firms as discussed above) if the subsidiary securities firm is found to be inappropriately affected by the parent company.

A designated parent company (and its subsidiaries) will be subject to the following regulations: it must notify to the FSA, within one week after the designation, (i) certain basic corporate information concerning the designated parent company; (ii) if the designated parent company and its subsidiaries are regulated under laws other than the FIEA or under foreign laws, outlines of such regulations; and (iii) if the designated parent company is engaged in management of the subsidiary's business or the subsidiary receives funds for its working capital from the designated parent company or its group companies, the details of such financial support.

In addition, an "ultimate designated parent company" (i.e., the ultimate legal entity within the group companies of the designated parent company) is required to prepare a business report covering itself and its subsidiaries and file it with the FSA, and is also required to prepare certain explanatory documents concerning itself and its subsidiaries and make them publicly available. Such ultimate designated parent company will be subject to capital adequacy requirements on an entire group basis, and is required to report such consolidated capital adequacy ratio to the FSA and make them available for the public inspection on a quarterly basis. The FSA may take appropriate administrative measures against the ultimate designated parent company depending on the status of consolidated capital ratio and may also take other measures that are similar to those applicable to downstream consolidation as discussed above.

## Conclusions

Prior to the amendment, the FSA as a matter of practice often requested large securities firms to report certain information regarding their subsidiaries on a voluntary basis. Accordingly, although the Amended FIEA will provide a legal ground to such practice, the impact of the new regulations on large securities firms might not be as large as it seems. However, now that special financial instruments firms will be legally obliged to report certain matters regarding their overseas subsidiaries that could include information relating to transactions of such subsidiaries, the clients of special financial instruments firms might be reluctant to use offshore booking entities owned by such special financial instruments firms as they would be uncomfortable to have their transactions learned by the Japanese authorities. In addition, it is not clear which companies will be designated as "designated parent companies" and thus will be subject to the FSA's supervisory power, and such uncertainty might discourage direct investments in large Japanese securities companies.

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