



Banking Regulation

Second Edition

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CONTENTS

| | | |
|-----------------------|---|-----|
| Preface | Peter Hsu & Rashid Bahar, <i>Bär & Karrer Ltd</i> | |
| Albania | Ada Braho, <i>Frost & Fire Consulting</i> | 1 |
| Angola | Hugo Moredo Santos & Nádia da Costa Ribeiro, <i>Vieira de Almeida & Associados</i> | 11 |
| Argentina | Javier L. Magnasco & Daniel Levi, <i>Estudio Beccar Varela</i> | 18 |
| Canada | Blair W. Keefe & Eli Monas, <i>Torys LLP</i> | 24 |
| Chile | Max Spiess, Juan Pablo Baraona & Ricardo Vásquez, <i>Baraona Abogados</i> | 33 |
| China | Dongyue Chen & Xingyu Wu, <i>Zhong Lun Law Firm</i> | 45 |
| Colombia | Luis Humberto Ustáriz González, <i>Estudio Jurídico Ustáriz & Abogados</i> | 58 |
| Congo D.R. | Angeline Mangana & Gaby Kabue, <i>MBM-Conseil</i> | 65 |
| Cyprus | Elias Neocleous & George Chrysaphinis, <i>Andreas Neocleous & Co LLC</i> | 71 |
| Ecuador | Dr Boanerges Rodríguez Freire & Pedro José Izquierdo LL.M., <i>Coronel & Pérez</i> | 81 |
| Finland | Andrei Aganimov & Niina Nuottimäki, <i>Borenus Attorneys Ltd</i> | 87 |
| France | Jean L’Homme & Gaël Rousseau, <i>Fidal</i> | 96 |
| Germany | Dr. Maximilian von Rom & Sebastian Tusch, <i>Gleiss Lutz</i> | 105 |
| Greece | George Bersis & Smaragda Rigakou, <i>Potamitis Vekris</i> | 113 |
| Japan | Koichi Miyamoto, <i>Anderson Mōri & Tomotsune</i> | 122 |
| Mozambique | Orlando Vogler Guiné, João Mayer Moreira & Filipe Ravara, <i>Vieira de Almeida & Associados</i> | 132 |
| Netherlands | Joris van Horzen & Joost Achterberg, <i>Kennedy Van der Laan N.V.</i> | 140 |
| Portugal | Hugo Moredo Santos & Benedita Aires, <i>Vieira de Almeida & Associados</i> | 149 |
| Russia | Alexander Linnikov, Sergei Sadovoy & Leonid Karpov, <i>LEAD Consulting Law Firm</i> | 158 |
| Rwanda | Julien Kavaruganda & Emmanuel Muragijimana, <i>K-Solutions & Partners</i> | 174 |
| Singapore | Elaine Chan, <i>WongPartnership LLP</i> | 183 |
| Spain | Fernando Mínguez Hernández, Íñigo de Luisa Maíz & Rafael Mínguez Prieto, <i>Cuatrecasas, Gonçalves Pereira</i> | 192 |
| Switzerland | Peter Hsu & Rashid Bahar, <i>Bär & Karrer Ltd</i> | 205 |
| Togo | Martial Akakpo & Sandrine Badjili, <i>MARTIAL AKAKPO & PARTNERS, LLP</i> | 215 |
| United Kingdom | Ben Hammond, Nicola Higgs & Lorraine Johnston, <i>Ashurst LLP</i> | 224 |
| USA | Reena Agrawal Sahni & Timothy J. Byrne, <i>Shearman & Sterling LLP</i> | 235 |
| Uzbekistan | Mels Akhmedov & Irina Tsoy, <i>Business Attorney Service</i> | 245 |
| Venezuela | Gustavo J. Reyna & Carlos Omaña, <i>D’Empaire Reyna Abogados</i> | 256 |

Japan

Koichi Miyamoto
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Introduction

Until the advent of the recent global financial crisis, the Japanese government had tended toward deregulation with the aim of increasing the competitiveness of Japan's financial sector. However, in line with the worldwide movement to tighten financial regulation in response to the global financial crisis, the Japanese government also seems (notwithstanding the relaxation of certain rules) to be moving in the general direction of stricter regulations to ensure a more stable financial system.

Regulatory architecture: overview of banking regulators and key regulations

Key legislation and regulations

Banking Act

The principal legislation regulating banks in Japan, including bank-holding companies and foreign bank branches, is the Banking Act (Act No. 59 of 1981, as amended (**Banking Act**)). The Banking Act, together with the orders and ordinances issued thereunder, primarily govern the following matters in respect of banks: licensing; organisation and governance; business scope; customer protection; prohibited acts; capital adequacy; subsidiaries and shareholders; accounting; disclosure; and mergers and acquisitions. The Financial Services Agency of Japan (**FSA**) also issues various guidelines (**Guidelines**) concerning banking activities. Although the Guidelines do not have legal enforceability, banks in Japan are, in practice, required to comply with them.

Financial Instruments and Exchange Act

The financial regulatory framework in Japan is similar to that in the US, and does not adopt a universal banking system like the EU, although banks and bank-holding companies in Japan are allowed to hold subsidiaries that provide a broad range of financial services. Banks in Japan may engage in securities-related services within the prescribed scope. Securities-related services that banks in Japan are allowed to provide include brokering and dealing in securities, sale of securities, underwriting of securities and derivative transactions. The key legislation regulating banks' provision of securities-related services is the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended), the orders and ordinances issued thereunder and the Guidelines.

Regulatory body

The principal regulator that exercises oversight of banks in Japan is the FSA, whose authority to supervise banks is delegated by the Prime Minister. The FSA supervises banking activities, issues banking licences, and imposes administrative sanctions on banks for wrongdoing or lack of adequate internal control systems.

Off-site monitoring and on-site inspections of banks in Japan are also primarily performed by the FSA. On the other hand, inspections in respect of banks' securities-related services are conducted by the Securities and Exchange Surveillance Commission of Japan.

Key restrictions

Licensing

No person is allowed to engage in any Banking Businesses in Japan or with a person in Japan without

having first obtained a banking licence from the FSA. “**Banking Businesses**” refer to: (i) the (a) acceptance of deposits, and (b) lending of funds or discounting of bills or notes; or (ii) the conduct of exchange transactions.

There are two ways by which a foreign bank may engage in Banking Businesses in Japan. The first is to establish a local subsidiary or a local affiliate in the form of a joint-stock company (*kabushiki kaisha*). The second is to establish a foreign bank branch in Japan, and obtain a banking licence for such bank branch.

Banks in Japan are, in principle, required to obtain a licence from the FSA if they wish to provide securities-related services in Japan. Such licensing requirement is in addition to the banking licence that banks in Japan have to obtain for the provision of banking services.

Scope of business

Banks in Japan are only permitted to engage in Banking Businesses, businesses incidental to Banking Businesses, and such other businesses expressly permitted under the Banking Act and other legislations.

Limitations of holding voting rights of other companies

Under the Banking Act, local banks are, in principle, prohibited from holding more than 5% (or, in the case of bank-holding companies, 15%) of the voting rights of any company in Japan other than companies engaging in certain finance-related businesses or businesses ancillary to the banking business (**5 Percent Rule**).

Permitted business by banks’ subsidiaries

Under the Banking Act, businesses in which the subsidiaries of local banks are permitted to engage are limited to certain finance-related businesses or businesses ancillary to the banking business.

Large exposure limits

The large exposure rules under the Banking Act prescribe a limit to a bank’s aggregate credit exposure to a single counterparty or a group of connected counterparties. Pursuant to this regulation, a local bank cannot have aggregate credit exposure to a single person (including that person’s group companies) that exceeds, in principle, 25% of the bank’s non-consolidated regulatory capital (calculated with certain adjustments).

Proprietary transactions

Although banks are not prohibited from engaging in proprietary transactions, they need to be mindful of the following regulations.

(i) Insider trading

The FIEA prohibits the sale and purchase of the securities of an entity listed on a securities exchange in Japan by (a) persons affiliated with the listed entity, and (b) persons who have received information from those affiliated with the listed entity and who therefore know or have access to significant insider information concerning the securities of the listed entity prior to the disclosure of such information.

(ii) Short selling

Naked short selling of securities is prohibited in principle, and certain short selling that exceeds the amount prescribed under the FIEA must be reported to the relevant securities exchange.

(iii) Other wrongful acts

The following acts, which are considered wrongful, are generally prohibited:

- use of wrongful means, schemes or techniques;
- misrepresentation of important matters, or omissions of material matters the disclosure of which is necessary for the avoidance of misunderstanding;
- use of false quotations;
- spreading of rumours;
- fraudulent practices;
- commission of assault or intimidation; and
- market manipulation.

Investment in funds

Banks are not prohibited from investing in funds.

Recent regulatory themes and key regulatory developments in Japan2013 Amendments of Banking Act

In accordance with the recommendations of a report entitled “Method of Regulations on Banks which Contribute to the Stability of the Financial System, etc.” issued in January 2013 by the Financial System Council, which is a consultative body reporting to the Japanese Prime Minister, the Commissioner of the FSA and the Minister of Finance, the Banking Act and the subordinate regulations have been amended. Most of the amendments came into force on 1 April 2014. Others, such as amendments with respect to the large exposure limit, came into force on 1 December 2014.

Relaxation of the 5 Percent Rule

The time limits and the holding ratio limits in respect of the acquisition or holding of voting rights in a company in Japan (other than companies engaging in certain finance-related businesses or businesses ancillary to the banking business) by a local bank have been amended in the following ways:

- the duration for which banks are permitted to hold voting rights acquired through the conduct of a debt equity swap transaction has been extended from one year to three years (or, in the case of a small or medium-sized companies, five years), and the 50% holding ratio limit in respect of such holdings has been abolished;
- a bank is now permitted to directly acquire or hold voting rights in a company that is undergoing a business revitalisation procedure (as prescribed in the Banking Act). The duration for which a bank may directly hold voting rights in such a company is essentially three years (or, if such company is small or medium, five years);
- the duration, as stipulated in the Banking Act, for which banks may (through their investment-specialised subsidiary) hold voting rights in a company that conducts venture businesses has been extended from 10 years to 15 years;
- a bank’s investment-specialised subsidiary may hold voting rights in a special exception company (being a company that conducts business and activities that contribute to the development of local and rural areas) for up to 10 years, unless such special exception company is a subsidiary (*kohoujin tou*) of said bank;
- the duration for which a bank is permitted to hold voting rights as a limited partner under the Limited Partnership Act for Investment (Act No. 90 of 1998, as amended), which used to be 10 years, has been abolished; and
- the one-year limit on the duration for which a bank is permitted to hold voting rights as trust property in an account with a trust bank (during which the trust bank has the authority to exercise the voting rights as trustee) has been abolished. The 50% holding ratio limit in respect of such holdings has also been abolished.

Tightening of large exposure limits

To be consistent with the international standards countenanced under “The Basel Core Principles” published by the Basel Committee, and to respond to the calls for reinforcement by the IMF Financial Sector Assessment Program, the amendments aim to tighten the existing large exposure rules in the following ways:

- undrawn amounts in commitment line transactions, interbank transaction amounts (including call loan amounts) and amounts deposited with other financial institutions, publicly offered bond amounts, trading account balances in banks, and amounts equivalent to credit risk in derivative transactions are now subject to large exposure rules; and
- for purposes of determining the companies in a consolidated group of companies (as a debtor group), subsidiaries which are effectively controlled by a company and affiliated companies are now included in the consolidated group of companies (in addition to subsidiaries in which a company directly or indirectly holds more than 50% of the voting rights).

Additionally, the amendments have established safeguards that prevent any non-compliance with

- the regulations, such as through the use of multiple names or circumventive financing; and
- the aggregate exposure limit of a consolidated group of companies (as a debtor group) has been lowered from 40% to 25%.

Tightening of regulations on foreign bank branches

The amendments have also tightened regulations applicable to foreign bank branches as follows:

- in order to ensure the soundness of foreign bank branches in Japan, the FSA clarified its supervisory guidelines with respect to matters to be monitored such as the circumstances of fund transfers within the foreign bank group (including transfers to and from its head offices and branch accounts), the foreign bank branch's assets in Japan, deposit types provided by the foreign bank branch and the foreign bank branch's manner of treating deposits in Japan. The FSA also clarified that these points of consideration are applicable not only to criteria for licensing but also the daily monitoring for foreign bank branches;
- foreign bank branches in Japan are required to maintain at all times assets equal to the minimum capital amount that local banks are required to maintain (i.e., ¥2bn). During the transitional period (i.e., from 1 April 2015 to 31 March 2016), a foreign bank branch is required to maintain the larger of (a) ¥1.5bn, and (b) the earned surplus reserve on its balance sheet on 31 March 2014. If its earned surplus reserve exceeds ¥2.0bn, the amount required to be maintained will be ¥2.0bn;
- foreign bank branches are now also required to explain certain matters to customers (such as the fact that deposits in foreign bank branches are not covered under Japan's deposit insurance system); and
- the penalty for breach of an order to maintain assets in Japan, which may be issued by the FSA to a bank (including a foreign bank branch) has been augmented.

Relaxation of requirements in respect of agency and intermediary services for foreign banks

In principle, the Banking Act requires a foreign bank to be licensed when it solicits banking transactions in Japan, including deposits, loans and fund remittances. The framework of agency or intermediary services for foreign banks, which is subject to permission from the Commissioner of the FSA, is designed to provide an exception to this principle by permitting a foreign bank to make a Japanese entity, which possesses a Japanese banking licence, to function as an agent or intermediary of a foreign bank. Following the amendments, the capital ties requirement between the agent or intermediary bank in Japan and the foreign bank no longer applies.

Relaxation of regulations on the scope of permitted business for local banks' subsidiaries in respect of outbound M&A transactions

Following the amendments, local banks may now hold foreign subsidiaries which conduct businesses that are not permitted under the Banking Act for a period of 5 years so long as these subsidiaries are held pursuant to a transaction involving a merger or acquisition.

2013 Amendment of the Deposit Insurance Act

After the recent global financial crisis, the guidance under the "Key Attributes of Effective Resolution Regimes for Financial Institutions" (**Key Attributes**), developed by the Financial Stability Board (**FSB**) in October 2011, was internationally endorsed at the G20 Leaders' Summit at Cannes in November 2011. In line with each G20 member's effort to standardise measures for the orderly resolution of failed financial institutions, the Deposit Insurance Act (Act No. 34 of 1971, as amended; the **DIA**) has been amended and came into force on 6 March 2014. It should be noted that, with the amendment of the DIA, plans have been put in place in respect of the entire financial industry (including depository financial institutions, insurance companies, financial instruments business operators, financial holding companies and foreign bank branches) in respect of systemic risks. These plans are discussed in further detail below.

Confirmation

Where the Prime Minister believes that the maintenance of an orderly credit system in Japan or a region therein may be seriously hindered if measures for the orderly resolution of failed financial institution are not taken, he or she may, following deliberation by the Council for Financial Crises, confirm whether any of the following measures have to be taken.

Type I Measures

Where a financial institution (that is not in capital deficit) is at risk of failure and such failure could result in severe disruption to the financial system in Japan, the Deposit Insurance Corporation of Japan (**DICJ**) may, in order to avoid such severe disruption to the financial system and upon receipt of confirmation from the Prime Minister, supervise the subject financial institution and provide loans to or subscribe for shares in the subject financial institution.

Type II Measures

Where a financial institution (that is in capital deficit or may possibly go into capital deficit) is at risk of failure and such failure could result in severe disruption to the financial system in Japan, the DICJ may, in order to avoid such severe disruption to the financial system and upon receipt of confirmation from the Prime Minister, supervise the subject financial institution and provide financial assistance for the orderly resolution of the financial institution, such as by assistance for a business transfer or a merger of the failed financial institution to another financial institution.

Bail-in

The Prime Minister has been given the power to trigger a contractual bail-in for the implementation of Type II Measures. The contractual bail-in is a way to write off debts of an insolvent debtor or to convert these debts into equity where the relevant contract contains a clause permitting such writing off or conversion.

Bank governance and internal controls

Under the Banking Act, a local bank must have a board of directors, a board of corporate auditors and an accounting auditor. A local bank may also choose to be a “Company with Committees” under the Companies Act (Act No. 86 of 2005, as amended), being a company with three committees comprising an audit committee, remuneration committee and appointment committee. Directors and executive officers engaging in the ordinary business of a local bank must have the knowledge and experience to be able to manage and control the bank appropriately, fairly and efficiently and must have “sufficient social credibility”. For local banks with a board of corporate auditors, the representative director is required to take command of the establishment and maintenance of the internal compliance framework, make risk management a primary concern, establish a sufficient internal control framework to properly disclose the bank’s corporate information to the public, and ensure that appropriate internal audits are performed. The board of directors must proactively oversee the representative directors, establish and review business management plans in line with the bank’s business objectives, establish a clear risk management policy by taking these objectives into consideration, and ensure appropriate performance and review of internal audits.

With respect to foreign bank branches, although there is no required specific corporate governance structure applicable to them as is the case for local banks, the branch manager of foreign bank branches must also have the knowledge and experience to manage and control the branch appropriately, fairly and efficiently, and must also have sufficient social credibility. In addition, officers with sufficient knowledge and experience must be appointed to manage the branch, and the proper authority to do so must be delegated to those officers by the overseas head office.

There is no explicit provision under the Banking Act that directly restricts the amount, form and manner of remuneration paid to the management or employees of banks or their affiliates. The regulators, however, have been placing greater emphasis on ensuring appropriate remuneration in light of the need to avoid excessive risk-taking and to conform with the consensus of the FSB. More specifically, as part of general prudential regulations, banks are expected to: (i) have an independent committee or other type of organisation to sufficiently monitor the remuneration of management and employees; (ii) ensure financial sufficiency, appropriate risk control, consistency between incentive bonuses and actual performance and contribution to long-term profits in determining remuneration structures; and (iii) disclose important matters regarding remuneration.

Bank capital requirements

The framework for regulating local banks’ capital adequacy under the Banking Act has been amended in line with the implementation of Basel II. By March 2008, the regulatory framework of Basel II

had been fully introduced into Japanese banking laws through amendments of the FSA administrative notice.

Local banks with international operations are required to maintain a minimum common equity Tier I ratio of 4% and Tier I ratio of 5.5% until 31 March 2015, and a minimum common equity Tier I ratio of 4.5% and Tier I ratio of 6% on and after 31 March 2015. This is in accordance with the FSA administrative notice, which is in line with the Basel III regulatory framework.

Local banks without international operations are required to have a minimum risk-adjusted capital ratio of 4% (on both a non-consolidated and consolidated basis) and local banks employing the IRB approach must maintain a capital ratio of 8%. Similar capital adequacy requirement is also applicable to bank-holding companies. From 31 March 2014, however, the calculation formula has changed in accordance with an amendment to the FSA administrative notice. As a result of this change, the requirement for those banks have also changed and local banks without international operations are required to have a core capital ratio of 4% (on both a non-consolidated and consolidated basis) from 31 March 2014, and those banks employing the internal ratings-based approach will be required to have a core capital ratio of 4.5% from 31 March 2015.

The status of the capital adequacy of banks, including the risk-adjusted capital ratio, must be reported and disclosed on a semi-annual basis. If a bank's capital ratio falls short of the minimum mentioned above, the FSA may require the bank to prepare and implement a capital reform plan. In extreme cases, it may reduce the bank's assets, restrict the increase of its assets, prohibit the acceptance of deposits, or take any other measures it deems necessary.

The regulatory capital framework mentioned above does not apply to foreign bank branches, on the grounds that the capital adequacy of these banks must be reviewed by their principal overseas regulators.

Rules governing Banks' relationships with their customers and other third parties

Arm's-length rule

A bank is prohibited from entering into certain transactions with related persons (such as the bank's subsidiaries and affiliates) or the customers of such related persons. Specifically, a bank is prohibited from entering into:

- a transaction with a related person that is less beneficial to the bank compared to the benefits that the bank would obtain if it had entered into a transaction under the same conditions (in terms of transaction type and amount), with a person similar to the related person (but does not fall within a related person) in type, size, and creditworthiness;
- a transaction with a related person's customer that is less beneficial to the bank compared to the benefits that the bank would obtain if it had entered into a transaction under the same conditions (in terms of transaction type and amount), with a person similar to the related person's customer (but does not fall within a related person's customer) in type, size, and creditworthiness (in exchange for the execution of the contract between the related person and the related person's customer);
- a transaction with a related person under terms that are unjustly disadvantageous to the bank in light of the typical terms of similar transactions entered into by the bank; or
- a transaction or act, in whatever name, that is intended to evade the prohibitions above.

Bank confidentiality

Duty of confidentiality

There is no substantive law that imposes any duty of confidentiality on banks with respect to customer information in Japan. However, the Supreme Court of Japan has affirmed, based on commercial practice or contract, that financial institutions owe a duty of confidentiality to their customers with respect to customer information (such as information on customers' transactions and creditworthiness) that is obtained in connection with transactions with their customers.

A bank's duty of confidentiality is generally considered to be a duty that prohibits a bank from disclosing information obtained from its customers in connection with transactions with such

customers without justifiable reasons. In other words, if there are “justifiable reasons”, the bank may be exempt from the duty of confidentiality. There are no clear rules on exemptions to a bank’s duty of confidentiality. However, the general view is that a bank will be exempt from the duty of confidentiality where: (a) a customer consents to the bank’s disclosure of the customer’s information; (b) disclosure of the customer information by the bank is required under the law; and (c) disclosure of the customer information is necessary for the bank to protect its rights and interests.

From a regulatory perspective, the Banking Act requires a bank to appropriately handle customer information acquired in relation to its business. More specifically, the Guidelines require every officer and employee of a bank to be well informed about the bank’s standards in the handling of customer information, review system for the appropriate management of customer information, and reporting system when customer information has been inadvertently leaked. These regulations are based on the understanding that a bank owes a duty of confidentiality to its customers under civil law and requires banks to establish appropriate internal management systems to handle customer information from a regulatory perspective. Accordingly, it is necessary for a bank to carefully consider whether the disclosure of customer information is appropriate given its duty of confidentiality under civil law even when such disclosure is permissible under the relevant regulations.

Personal information

If customer information falls within the definition of personal information under the Act on the Protection of Personal Information (Act No. 57 of 2003, as amended) (the **PIPA**), a bank needs to comply with the rules therein on appropriate handling of personal information. The purpose of the PIPA is to establish a basic principle for the fair handling of personal information, to prescribe the basic governmental policy considerations for protecting personal information, to make clear the obligations of national and local authorities, and to impose obligations that business operators which handle personal information are required to comply with. The purpose and scope of the general duty of confidentiality referred to above, and the provisions of the PIPA are not the same, but overlap to some extent. Accordingly, a bank which complies with the provisions of the PIPA also needs to carefully consider whether it can disclose customer information given its general duty of confidentiality under civil law.

There are no restrictions under Japanese law on the international transfer of personal information.

ADR

Banks are required to enter into an agreement with the Japanese Bankers’ Association for dispute resolution with respect to Banking Businesses. This financial ADR system is intended to provide banks’ customers with an easier and faster way of resolving claims as compared to filing lawsuits against banks.

Deposit insurance system

The deposit insurance system in Japan protects depositors and other parties against the insolvency of banks in Japan. The DIA governs the deposit insurance system. The DICJ, which was established pursuant to the DIA, provides a public safety net to protect depositors. The deposit insurance system covers banks whose headquarters are located in Japan. Insured banks pay insurance premiums to the DICJ annually.

There are certain limitations to the coverage. For example, while ordinary deposits are covered under the deposit insurance system, foreign currency deposits and derivative deposits are not covered. Furthermore, while deposit accounts for settlement purposes will generally receive full coverage, other insured deposit accounts are generally covered up to ¥10mn per person and per bank.

Anti-money laundering

Verification upon transaction

The Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007, as amended (APTCP)) requires a bank to adequately perform verification of the identity of its customer upon commencement of the specified transaction (such as acceptance of deposits, lending of funds, transactions under which a customer acquires securities and derivative transactions) (**Verification upon Transaction**).

In performing Verification upon Transaction, a bank is required, at the time of the transaction, to verify the following matters with respect to its customers and the customer's personnel who are in charge of the transaction:

- name;
- domicile (or location of principal office);
- date of birth (or date of birth of the representative);
- purpose of the transaction;
- occupation (or description of business); and
- identification of every shareholder of the customer which holds more than 25% of the voting rights in the customer.

The Verification upon Transaction must be conducted through the use of prescribed official identification documents (such as a registration certificate, an insurance certificate, a driver's licence, or a resident card).

Report of suspicious transactions

The APTCP requires a bank to report suspicious transactions to the FSA if any property accepted from its customer in connection with the bank's business is suspected to be criminal proceeds, or if the customer is suspected to have committed the crime of concealment of criminal proceeds or drug-related criminal proceeds.

The matters required to be reported to the FSA include:

- information on the bank filing the report (such as name, address and telephone number);
- information regarding the suspicious customer (such as the name, address, telephone number, nationality and the date of establishment); and
- the reason for the report.

Cross-border activities

Banking Businesses

Foreign banks may not, in principle, enter into Banking Businesses in Japan or with persons in Japan without establishing a branch in Japan and obtaining a banking licence for a foreign bank branch.

Under "foreign bank agency business" framework, both overseas banks without a licensed foreign bank branch and the unlicensed branches of an overseas bank may conduct a core banking business with persons in Japan through either a local bank within the same group, or a foreign bank branch of the bank acting as an agent or intermediary. Both of these options require the local bank or foreign bank branch to obtain separate approval from the FSA.

Securities-related services

Foreign banks are, in principle, required to be registered pursuant to the FIEA to provide securities-related services (including dealing in public offerings or secondary distributions, dealing in private placements, or underwriting) in Japan or with persons in Japan.

Notwithstanding the above, foreign banks providing securities-related services in a foreign jurisdiction may provide the following services:

- securities-related services, including solicitation of securities, to a registered financial instruments business operator under the FIEA (**Financial Instruments Business Operator**) operating securities-related services;
- securities-related services from outside of Japan to financial institutions (only for their investment purpose or for account of settlor under trust agreement) and investment management companies (only for their investment management);
- sale and purchase of already-issued securities to or from banks upon order from customers of such banks for account of such bank;
- sale and purchase and intermediary, brokerage or agency services for sale and purchase of already-issued securities from outside of Japan with a person in Japan upon order from such person on condition that the offshore entity does not engage in any solicitation;
- sale and purchase of already-issued securities with a person in Japan via agency and intermediary by the relevant Financial Instruments Business Operator;

-
- negotiation with an issuer or a holder of the securities in Japan to determine the terms and conditions of a wholesale underwriting agreement with respect to public offerings, private placements or secondary distributions of such securities only when such public offering, private placement or secondary distribution is to be conducted outside Japan subject to notification to the Commissioner of the FSA as it involves a party in Japan; and
 - participation in a wholesale underwriting agreement (an underwriter syndicate) in Japan if it meets the following requirements: (a) a foreign bank has a history of underwriting of securities outside Japan for 3 years or more; (b) the foreign bank has a total capital and net assets of ¥500mn or more; (c) a wholesale underwriter (and not the foreign bank) will negotiate with an issuer or a holder of the securities in Japan; (d) marketing of securities to be issued must be made outside of Japan; and (e) the foreign bank must obtain the approval of the Commissioner of the FSA.

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- (1) “Practice of Fund Inspection – Recent trends in inspections of fund vendors”, Capital Market Monthly No.305 (January 2011); and
- (2) the Japan Chapter in “Neate and Godfrey: Bank Confidentiality 6th Edition”, Bloomsbury Professional (January 2015).

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