

## AKTUELLE RECHTSENTWICKLUNG RECENT LEGAL DEVELOPMENTS

### **Comprehensive Overhaul of the Securities and Exchange Law: The Draft Law on the Trading of Financial Products of 2006**

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The draft Law on the Trading of Financial Products was submitted to the Diet earlier this year. It was adopted on June 7 and is to take effect in the business year commencing in April 2008.

The draft law took the form of the “Bill for the partial amendment to the Securities and Exchange Law and other laws” designed for the protection of investors “across the board”. The law represents a comprehensive overhaul and expansion of the current Securities and Exchange Law.

The insufficiency of investor protection has long been felt in Japan. Although, as a result of the Big Bang, the financial system underwent major changes in the direction of increased freedom for financial institutions, protection of investors lagged far behind this development. Financial market regulations were highly compartmentalised. The Securities and Exchange Law covered only “securities” as defined rather narrowly in the Law. There were various other financial products which were regulated by separate laws which came under the portfolio of different government agencies. Since the Big Bang, various new products emerged, but some of them were not sufficiently regulated, due to this compartmentalised system.

Actually, the enactment of a comprehensive law on financial markets of the UK Financial Services Act type was discussed in the late 1990s and was proposed by the Financial System Council of the Ministry of Finance in 1998. However, due to the serious financial crisis and the discord between ministries, this initiative never materialised. A resolution of both Houses of Parliament, calling for an “across the board regulation” of the financial market, such as the Financial Services Act for the protection of investors, was adopted when a set of laws dealing with the restoration of the financial system was adopted in 1998, but ultimately no action was taken.

Under the compartmentalised system, in the absence of an across the board regulatory system, problems with investors emerged with products such as overseas commodities futures options and foreign currency margin transactions. Even in the area covered by the Securities and Exchange Law, products such as exchangeable bonds have caused problems.

In the meantime, in the UK, the Financial Services Act was replaced by the Financial Services and Markets Act in 2000. In Japan, the government was slow to respond to the increasing necessity of a comprehensive law. It was only in 2004 that the Financial Services Agency referred to the enactment of an “Investment Services Law” in its programme for further financial reforms, but its scope was fairly limited. On the other hand, there was growing concern that the current regulatory system was far from perfect. In 2004, the Japanese Federation of Bar Associations proposed the enactment of a comprehensive law regulating the financial market, mainly from the viewpoint of consumer protection. In 2005, the influential National Institute for Research Advancement (NIRA) published a proposal for a Japanese “Financial Services and Markets Act” along the lines of the UK Act, intended to be a law for comprehensive market regulation. In the light of some celebrated cases where ambiguities in the regulations were abused, the move for a comprehensive law gained momentum, and culminated in the present Bill.

The gist of the law is as follows:

#### *Scope of the Law*

The new law is to expand the coverage of financial products. Under the present law, the concept of securities is the key. If a financial product falls within the definition of securities, the law is applicable. The new law maintains this system, but gives a comprehensive definition of collective investment schemes. Shares in such a scheme are to be covered as “securities”.

#### *Securities Business (shōken-gyō) renamed and redefined*

Securities business as regulated in the Law is renamed as the “business of trading in financial products”. Such business now covers sale and solicitation, asset investment and advice, as well as asset management businesses. It includes trading in derivatives, such as trading in futures, index futures, options, index options, swaps and credit derivative tradings.

#### *Professional and Non-Professional Investors*

Qualified institutional investors are differentiated from general investors. If the counter party to the transaction is a qualified institutional investor, some obligations of those involved in the business of trading financial products, such as the obligation to provide documents before the transaction, do not apply.

#### *Takeover Bid*

The system is to be streamlined and potential loopholes are to be closed. If, as a result of the acquisition of shares off the market and on the market combined, one-third of shares would be held by a single entity in conjunction with affiliated persons, the remaining shares must be acquired by a takeover bid. If, in the process

of a takeover bid initiated by another person, a shareholder who holds more than one-third of shares intends to acquire shares over a certain amount, this acquisition must be effected by a takeover bid.

Furthermore, if after the takeover bid, the percentage of shares held by the bidder reaches a certain level, the bidder must bid for the remaining shares as well. This level is to be set at 60% by a cabinet order.

#### *Reporting of Large Shareholding*

The disclosure requirement for a large block shareholding, which proved to be ineffective, is going to be modified.

#### *Penalties*

Penalties are to be increased. For instance, the maximum penalty for a false entry in the securities report, the spreading of rumour, forgery, the manipulation of the market, etc. is increased from five years imprisonment and a five million yen fine to ten years imprisonment and a ten million yen fine (for juridical persons, the fine was increased from 500 million yen to seven million yen). Insider dealing will be penalised by imprisonment of five years or a five million yen fine (500 million yen for juridical persons).

#### *Internal Compliance System*

When submitting a securities report, listed companies are required to submit a report on their internal compliance system. This has to be audited by an accountant or an accounting firm. This reflects the requirements of the Sarbanes-Oxley Act.

However, despite these significant changes, the fact remains that the new law is not going to be fully comprehensive or applicable across the board. The banking and insurance industries are left to a separate piece of legislation. Commodities futures including commodities in the overseas market are not within the scope of the new law either. Although some relevant laws are to be amended in order to allow application of the provisions of the new law with modifications, it is arguable whether this is sufficient or not.