December 22, 2005
Financial Services Agency

"Legislation for 'the Investment Services Law (provisional title)'"

(Summary of the Report of the First Subcommittee of the Financial System Council)
(December 22, 2005)

Ⅰ. Purport and objective of "the Investment Services Law (provisional title)"

1. Thorough implementation of user protection rules and enhancement of users' convenience
   - Establishing a framework of comprehensive and cross-sectional protection of users of a wide range of financial instruments, the "loopholes" in the current framework of user protection rules should be closed, and the current sectional laws for investment securities businesses should be reviewed to apply a single set of rules to financial instruments whose economic functions are identical.
   - Financial innovation and user protection should be achieved together by establishing a flexible regulatory structure such as deregulating rules, which are supposed to be prescribed to protect general investors, in case of provision of services to professional investors.

2. Ensuring market functions toward the policy goal of "encouraging funds from savings to investment"
   - Moving toward the policy goal of "encouraging funds from savings to investment," in order to ensure the market functions with fair and efficient price-making mechanism, it is indispensable to make continuous efforts to review overall rules of financial and capital markets and ensure their effective enforcement.

3. Responding to globalization of financial and capital markets
   - As globalization of financial and capital markets have progressed further, it is urgent to develop market infrastructure to further enhance the attractiveness of Japan's markets as a major international market.

4. Need to enact "the Investment Services Law (provisional title)"
   - In order to establish fair, efficient, transparent and vitalized financial markets, the Securities and Exchange Law should be changed to the Investment Services

Law (provisional title), where market functions can work to the fullest possible extent, with fair and efficient price-making mechanism, through the proper protection of users and the prevention of unfair transactions in the markets.

5. Basic framework of "the Investment Services Law (provisional title)"

- It is necessary to review current sectoral business laws and establish a framework which will cover a wide range of financial instruments.
- The Investment Services Law should be characterized as a general law regarding sales of financial instruments and investment management, and the same regulations should be applied to financial instruments whose economic functions are identical regardless of types of services providers.
- "Foreign Securities Firm Law," "Investment Advisor Law," "Financial Futures Trading Law," and other laws with similar characteristics should be integrated into the Investment Services Law to the fullest possible extent.
- It is preferable to revise the "Financial Instruments Sales Law" and integrate it into the Investment Services Law.

Ⅱ. Coverage of "the Investment Services Law (provisional title)"

1. Basic concept

- "The Interim Report" of the First Subcommittee of the Financial System Council (July 7, 2005) states that financial instruments to be covered by Investment Services Law (hereinafter "investment instruments") should include a wide range of financial instruments to the fullest possible extent and sets the following criteria:
  - (i) Contribution of money and possible return of money,
  - (ii) in connection with assets or index
  - (iii) taking risks with an expectation of higher returns (economic utility).
- "Risk" in (iii) above should be mainly regarded as either "market risk" or "credit risk," and "return" should be mainly regarded as "expectation of monetary profits".

2. Prospect toward "the Financial Services and Markets Law"

- Since recent problematic cases are difficult to deal with under the current laws, a comprehensive and cross-sectional regulatory framework which covers, as broadly agreed, "financial instruments with investment characteristics" should be legislated as early as possible.

- The First Subcommittee will continue studying more comprehensive regulatory framework which would cover all the financial instruments, considering the legislation and implementation of the Investment Services Law, characteristics of each kind of financial instruments, and preferable medium and long-term financial system.

Ⅲ. Regulation of "investment services businesses (provisional name)"

1. Coverage of "the investment services business"

(1) Coverage of "the investment services business"

- Coverage of "the investment services business (provisional name)" should be "sales and solicitation," "investment management and providing advice," and "administration of assets."

(2) Solicitation by issuer and investment management

- Taking it into account that in a recent problematic case sales of interest in the collective investment scheme were made by an issuer of the fund, it is at least necessary to regulate sales and solicitation of interest in *Kumiai* by the issuer.
- Investment management of the collective investment scheme (fund), which invests in investment instruments, should also be regulated as "investment management business."
- For both issuer solicitation and investment management, necessary considerations should be provided not to interrupt financial innovation promoted by funds, sold for professionals or small number of investors, which conduct sound activities.

2. Flexible regulatory structure of investment businesses

- With cross-sectional coverage of "the investment services business," flexibility by type of business should be introduced for business regulation, establishing three levels of regulation as follows:

(1) "The first business (provisional title)"

- All businesses dealing with all investment instruments

(2) "The second business (provisional title)"

- Sales of investment instruments with lower liquidity
- Investment management of investment instruments
- Investment advice of investment instruments

(3) "Brokerage business (provisional title)"

- Brokerage of deals entrusted by another investment service company

Ⅳ. Regulation of conduct of "investment services business (provisional name)"

1. Overall framework of conduct of business regulations
   - Based on regulations in the Securities and Exchange Law and the Investment Advisor Law, conduct of business regulations should be reorganized by function in a cross-sectional manner to ensure rules such as fiduciary duties, taking into consideration the regulations of existing laws which cover the investment instruments.

2. Requirement for suitability
   - Requirement for suitability should be considered as a norm of conduct similar to the Securities and Exchange Law, surpassing a duty to structure internal systems.

3. Introduce regulatory duty for explaining based on the civil duty to explain under the Financial Instruments Sales Law as a duty in the business regulation
   - The same duty as the explanation duty in the Financial Instruments Sales Law in civil law should be introduced as a regulation of conduct of business.

4. Restriction of unsolicited promotions
   - As to restriction of unsolicited promotions, application of the rule should be limited to the instrument for which the rules has already introduced (i.e., financial futures transaction) for the time being, establishing a general framework to be able to expand the scope of application promptly in terms of user protection.
   - Restriction of call against will should be introduced as a new regulation, and be applied to instruments, such as financial futures transactions through the market.

Ⅴ. Classification of customers: professional investors and general investors

1. Classification of customers (definition of professional investors and general investors)
   - The classification of professional investors and general investors has four categories as indicated below:
     ① A professional investor without an option to be classified as a general

investor

- Application of the same concept as the qualified institutional investors for the disclosure requirement

② A professional investor with an option to be classified as a general investor

- i.e. publicly-held company, a company above a certain size

③ A general investor with an option to be classified as a professional investor

- i.e. entities other than classified in ②. Considering the existence of wealthy individual investors, it is proper to enable such an individual customer to be classified as a professional investor on his/her will, provided that it meets certain conditions.

④ A general investor without an option to be classified as a professional investor

- An individual other than has elected on his/her will to be treated as a professional investor who meets certain conditions under ③.

2. Exemption of conduct of business regulations with regards to investment services for professional investors

- It is proper that conduct of business regulations aimed at an omission of the information disparity such as an obligation of delivery documents should be exempted for professional investors whereas the regulation set for the market integrity such as prohibition of providing false statements and compensating customers for their losses should not be exempted.

Ⅵ. Collective Investment Scheme (Fund)

1. Need for developing effective regulations and specific treatments of funds for professional investors

- After considering the reporting of the investor damage caused by fund conducting business which used *Tokumei-Kumiai (TK)* as its vehicle, which were sold to a number of general customers, the effective and cross-sectional regulations of funds should be established. As for funds which are sold to professional investors, it should be noted that simpler regulations be adopted in order not to block financial innovation with excessive regulations.

2. Regulations of funds

- It is proper that the entire picture of funds regulations is mainly considered so that the authority may take prompt and direct administrative measures for violators (i.e. sales and solicitation including by an issuer and investment management).

Ⅶ. Disclosure requirements

1. Disclosure requirements tailored to the nature of investment instruments

(1) Disclosure requirements, focusing on types of investment instruments

- It is proper to develop disclosure requirements by classifying investment instruments into corporate finance type instruments and asset finance type instruments.

(2) Disclosure requirements, focusing on the liquidity of investment instruments

① Disclosure requirements for investment instruments with high liquidity

- Based on the Report of the Disclosure Working Group of the 'First Subcommittee' titled as "For the Future Disclosure System" (June 28, 2005) and the Report of the Business Accounting Council titled as "For the Standards for Management Assessment and Auditors Audit of Internal Control over Financial Reporting" (December 8, 2005), it is proper to introduce a statutory quarterly reporting system and to further develop the system of internal control over financial reporting. It is also proper to introduce a mandatory system for certification of annual reports by management.

② Disclosure requirements for investment instruments with low liquidity

- It is proper to develop disclosure requirements based on the system of direct investment instruments whose holders can be identified to some extent due to restrictions on negotiability as direct delivery of documents instead of the system of public disclosure.

(3) Expansion of the scope of qualified institutional investors

- It is proper to consider an expansion of scope of business corporations that some non-corporate and individual investors can become qualified institutional investors as well as a business corporation.
- It is proper to consider that restrictions on numbers of qualified intuitional investors (upper limit: 250) be relaxed or abolished for a small amount of a private placement.

2. Take Over Bid and large shareholding reports

- It is proper to review the systems of Take Over Bid and large shareholding reports, based on the Report of the Take Over Bid Working Group titled as "For

Take Over Bid and other systems".

Ⅷ. Stock exchange

1. Organizational structure of stock exchange in the form of stock corporation
   - It is required that the self regulatory functions of a stock exchange in the form of a stock corporation should be conducted independently of the other functions.
   - Since the environment and the concept of markets may vary by market operators (stock exchanges), operators should be given an option with regard to their organization structure of the self regulatory functions.

2. Listing of shares of stock exchange as stock corporation
   - It is proper that listed stock exchanges are required to take appropriate measures to ensure organizational independence of their self-regulatory functions. It is also proper to review the regulation of major shareholdings of stock exchanges and take appropriate measures, if necessary, considering the recent revision of the company laws.

Ⅸ. Self Regulatory Organizations (SROs)

1. Functions that should be given to the SROs and the issue on obligatory membership
   - It is proper that each SROs prescribed in the Investments Services Law should be given several functions to ensure the same functions as the Japan Securities Dealers Association, which has the strongest characteristics as a SRO.
   - To ensure regulatory effectiveness without imposing legal obligations to be a member of SROs, it is intended to develop a framework that requires non-members to establish their compliance rules which should reflect SROs rules.

2. Cross-sectional efforts for resolution of complaints and mediation of disputes on investments instruments
   - It is proper to develop a framework that the activities of resolution of complaints from users and mediation of disputes on investments instruments by private organizations other than SROs prescribed in the Investment Services Law will be accredited by the authority in order to enhance reliability of their resolution of complaints and mediation of disputes, etc., and thus promote their activities.

Ⅹ. Civil liability clause, enforcement and financial services education

1. Civil liability clause
   - It is proper to consider revising the Financial Instruments Sales Law to include schemes of financial instruments in the scope of duty to explain.

2. Enforcement
   - It is proper to take necessary measures to strengthen enforcement such as countermeasures against trading orders with intention of canceling immediately (misegyoku), as recommended by the Securities and Exchange Surveillance Commission (November 29, 2005).

3. Responding to globalization
   - It is necessary to make efforts for the early resolution on the issue of the framework for information sharing with foreign securities regulators. ("Securities MOU")

4. Financial and economic education
   - It is urgent to enhance financial and economic education and necessary for public and private sectors alike to promote financial and economic education on a full scale.
   - The Financial Services Agency should review the efforts so far, and actively continue its efforts to enhance financial and economic education.