## (2) Japan

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### Prof. Kozuka:

Having heard the updated reports by other speakers on the recent developments in neighboring countries, I would like to give you an overview of the legal system in Japan relating to financial transactions. In doing so, I would like to focus on how these regulations and rules are related to the risks assumed by investors because risks are at the very core or the very essence of financial transactions.

From this view point, we can identify four types of legal rules. The first set of rules is to determine when and under what conditions risks are transferred to investors. These are the rules of the game as they relate to the essence of the transaction itself. The second set of rules to be complied with is related to financial intermediaries when engaged in transactions with investors. They do not directly decide the results of transactions or the risk of transfer, but rather they tell financial institutions about dos and don'ts—what they are allowed to do and what they are not allowed to do. The third set of rules is to prohibit some types of transactions outright because of the harm these transactions may have on the credibility of the financial market. Lastly, the fourth type of rules is to ensure soundness of financial institutions. These rules take away from the investors trading risks of such financial institutions to the extent necessary to maintain sound financial markets, so they can just focus on risks that are intrinsic to a given transaction.

Let me look further into the first type of rules, rules on risk transfer. What we have to bear in mind is that they do not eliminate risks altogether in financial transactions, but they set conditions in advance on the transfer of risks in order to let investors make a sound decision. Typical of them is a provision to entitle investors to revoke his or her commitment under certain conditions. For example, if the investor qualifies as "a consumer" under the Consumer Contract Act of Japan and the sale of a financial product is found to have been made with misrepresentations of material facts or omissions to state such facts, the investor can revoke his or her commitment and require restitution.

Even stronger protection is given to the investor under certain statutes such as the Act on Investment Advisors by a provision of cooling off. The cooling-off provision in the Investment Advisors Act entitles investors to revoke their commitments without any conditions during the initial seven-day period. Transfer of risks is also reverted ex post facto if the exposed investor can claim damages afterwards, as, in financial transactions, pecuniary or monetary damages are equivalent to restitution.

There have been legal precedents in Japan that have established the rule that the seller of a financial product must give a sufficient explanation to the investor about the risks and the structure of a product. According to courts, breach of this duty by a financial institution can result in tort liability of the financial institution under the Civil Code. Many purchasers of variable insurance policies or warrant bonds, both being rather complicated products and not particularly suitable for investors with limited experience, have successfully recovered their investments based on rulings of the court.

There are still other types of rules governing the transfer of risks, i.e. those on the authority given to the servants and agents of the financial intermediaries. In principle, the scope of an authority of a servant or an agent is a matter to be decided by agreement between the servant or the agent and its master. However, some of the statutes, such as the Securities and Exchange Act and the Commodities Exchange Act, have a provision for constructive authority that provides that licensed agents under these acts are deemed to have been authorized for transactions without conditions. Thus investors are relieved from risks caused by the lack or limitations of the authority of the agents they are dealing with, and the investors do not have to be concerned about the possibility of these servants and agents not having been authorized properly.

Now rules on behavior of financial intermediaries—those on dos and don’ts—are abundant in statutes regarding the financial industry. Some of them prohibit misrepresentations and fraudulent methods of dealing such as decisive statements or coercive inducements. Others require delivery of documents stating the terms and conditions of the agreement before or upon conclusion of the agreement. Still others obligate the intermediaries to advise or report in writing the deal that they have mediated. These provisions are directed at financial intermediaries and these provisions are enforced by the government agency. Even penal sanctions can be resorted to in a case of severe breaches and violations.

It is to be noted however that these rules are sometimes relied on by investors in litigation, civil litigation that is, alleging that the intermediary has behaved badly. If this argument is accepted by the court, investors will be able to recover his or her investments, probably in the form of damages. They will perhaps be able to prove the violation of the intermediary under the tort rules under the Civil Code. So if this argument is accepted by the court, the investor will be able to recover his investment, probably in the form of damages. In this sense, these rules of dos and don'ts can indirectly serve as rules on risk transfer between the investor and the financial intermediary.

Turning to the third type of regulation or outright prohibition of certain types of transactions, they are rather limited in number, but they are very important. An example may be found in the prohibition of taking deposits by non-banks under the Act on Regulation of Investments and Taking of Deposits. The regulation is intended to prevent people from entrusting their money to a dubious business believing and anticipating that money is assured of repayment. As a similar regulation, the prohibition of black markets can be named. In a more general sense, some kinds of financial transactions, for example banking and insurance businesses are licensed businesses and some kinds of financial transactions are subjected to license so that an enterprise without a license is prohibited from providing the relevant services.

The last but not least important type or the fourth type of regulation is the prudential regulation of financial institutions, particularly prudential regulations for banks. The meaning of the regulation is quite obvious. It eliminates risks arising from the soundness of financial institutions so that the investors assume only such risks as are inherent in the transaction. The extreme form of this type of regulation is the deposit insurance which is currently provided up to 10 million yen for each depositor in Japan. This is to give depositors complete protection. Also important are the rules in case of bank failure that prevent unnecessary bank loans and limit the loss to be a burden to depositors to the minimum extent.

Next, allow me to add briefly the historical aspects. Until the beginning of the 1980s, the financial market of Japan was heavily regulated. The government made every effort to prevent banks and insurance companies from failing. Back in those days, even securities brokers and dealers seldom failed thanks to those regulations. There existed many rules on dos and don'ts in those days, but the rules on risk transfer were limited to

very rudimentary, basic ones. For example, disclosure rules did exist under the Securities and Exchange Act, however, those rules were very basic. In those days, many of the court decisions concerned commodities trading, which were the least regulated among financial transactions in a broad sense.

In the mid-1980s, liberalization of financial regulations started and continued all the way through until the end of the 1990s. This has brought about various types of financial products while inevitably entailing failures of financial institutions. The former resulted in a number of litigations at the beginning of the 1990s caused by unsound sales of new financial products during the bubble economy at the end of the 1980s. Bank failures did become national issues in the latter half of the 1990s. In response to these developments, rules on risk transfer have been elaborated. First, cases on the duty to explain emerged, followed by the enactment of the Consumer Contract Act and the Act on Sales of Financial Products in 2000. The prudential regulation on the financial institutions or banks as well as on their failure has also been arranged so as to satisfy the international standards. These standards in Japan are now comparable to international standards. The proposed Investment Services Act shall be regarded as the last step in these lines of development.

With that I conclude and give the floor to Dr. Sugiura to cover the details of this proposed law.

**Dr. Sugiura:**

Thank you very much, Prof. Kozuka. The development so far of consumer protection and other regulations related to the financial laws have been explained, so I would like to specifically introduce to you the latest movement, the Investment Services Act. The work is underway under the name of the Investment Services Act Bill, which is hopefully to be submitted to the Diet shortly, and we are briefing the ruling party and others on this bill. So I will just highlight the major points of the act. I have a limited capability. Some of you present today are members of the Financial Systems Council, so you know more than I about the details of the law. Moreover, as I listened to the Korean presentation this morning, I was struck by the similarity between our act and the Korean law. So maybe I could be even briefer in my explanation. And since I am a researcher and have worked for the UK financial institutions before, perhaps I could tell you the difficulty involved in coming up with a cross-sectional law like the bill. Perhaps I could

share with you my personal impression as well to conclude the last presentation today for the country report.

Now let me speak a little about the Investment Services Act. Its purports and intentions are to provide for the thorough protection of users, improved convenience for the users and promotion of financial reforms. Preparation for the internationalization of the financial and capital markets is also one of the purposes of the new law.

The major point here is that as a wide range of financial products are being offered, we have to come up with more comprehensive and cross-sectional protection measures. There are various transaction types and characteristics of the financial products, and the knowledge and the experience of the investors vary. It is a challenge to devise rules that take into account such differences.

What is the coverage of the new investment service law? There is one criterion. The law relates to transactions or products involving a capital contribution and possibilities of redemption, related to certain assets or indices, or accompanying assumption of risks in pursuit of higher returns. For example, there are government bonds, corporate bonds, equities and derivatives. The new law therefore is not something to be drawn up by revising broadly the banking law, but should be based on the Securities and Exchange Law.

At the current stage, the bill is tentatively named the Toshi (Investment) Services law, but Japanese laws tend to avoid Japanized English words (in this case Services) so officially it may be named as the Financial Instruments Transaction. When we explained the bill to the ruling party members the other day, it was called "a bill to revise part of the Securities and Exchange Law." No formal name has been chosen yet for the new law.

Now let's take a look at rules of conduct that the new law will have. The most important is the overall structure of the rules of conduct, and they should include thorough enforcement of the suitability principle. The Financial Instrument Sales Law has already been enacted incorporating the duty to explain at the time of selling financial products. The obligation in the current law will be strengthened in the new law. The new law will further include tighter prohibition of unsolicited sales.

There will also be disclosure about the fees. Already in the United States, etc., banks are obliged to show on the screen of the ATM the fees if the user use the machine. A similar situation will be seen in Japan, too, in the near future. An investment service provider will also need to indicate so to the public in a clear-cut manner. Also there will be restrictions on advertisement, too.

What is most important here is, as I mentioned at the very outset, that we have to make a distinction between the specified or professional and the general or amateur investors. This distinction is essential for proper investor protection and smooth supply of risk capital. At present, the plan is to classify investors into four categories—two for professionals and two for general investors.

The United States, as I remember, has a system of accredited investors, with net assets exceeding $1 million. In the European Union, eligible investors are those individuals having 500,000 euro or more of financial assets and engaging in large-scale transactions frequently. We do not have such a clear-cut distinction between the amateur and professional investors, but we will be discussing the distinction going forward.

There are other things being considered, like what to do with the collective investment schemes and the disclosure requirements. As Commissioner Gomi mentioned at the very outset today, we need to take measures to improve the stock exchanges. And the self-regulatory bodies are discussing measures closely related to business practices to realize environment in which financial products are sold and serviced within the framework of self-regulatory discipline. One of the key issues repeatedly addressed is the issue of enforcement. Financial and economic educations in the context of globalization is also addressed.

With regard the financial and economic educations, I discussed a lot with European and U.S. regulators when I visited them. Surprisingly, the best customers there for consumer loan providers are school teachers. Whether it is appropriate for good customers of consumer loans to teach the financial and economic educations will be addressed from now on.

Back to the Investment Services Law, what is its meaning within the overall financial regulatory system in Japan. I would say it is a new challenge. For one thing, we have had sectoral laws, but it will be reorganized into the transactional law and the

institutional law including entry requirements. The transactional law will be cross-sectional, and I do wonder whether this new framework would work properly. Working at the FSA, I probably should not, but it is indeed a great challenge.

The reason for my doubt is that in the United Kingdom, they have a universal banking system where various financial products are being sold at on place, people working for financial institutions are accustomed to selling various products, and would-be buyers are accustomed to buying different financial instruments at one place. I have no doubt that in such environment, the system will work. On the other hand, maybe the United States wanted to adopt the UK-like system. Even after the Graham-Leach-Bliley Act was passed, the United States has not been Britainized. JP Morgan Chase, and Citi have various operations but they still operate along the product line: securities sections dealing in securities, banking sections doing banking businesses, etc. Investors are not considering these entities as a unified financial institution.

Distinguishing professional and general investors is not easy, either. In Japan, we have day traders who are using the internet to trade stocks. Not all of them are large asset holders but as we witnessed in the Livedoor scandal recently, they were very active in trading related shares. Are they amateurs? They should probably be regarded as professionals judging from their behavior.

In terms of administration, the regulatory agencies are also set up according to the line of business, like the Securities Section and the Banking Section. If the law is integrated, then the administration must also be reorganized to overcome the sectionalism and to oversee the financial matters in an integrated manner. This is far beyond improving financial usability for the users and educating them. It is a big challenge for the administration to step itself up to oversee the financial issues in a uniform manner. As Prof. Kanda talked earlier about the social cost, we need to be aware of the initial cost. Definitely the initial cost will be incurred. Hopefully after 10 years, we will be able to say that the cost for the transition was cheap.

Will Japan's challenge succeed? We at the FSA must work very hard for the success. But Korea is following the similar path, and I would say it is a very big issue to pay attention to if various countries can follow the path that the United Kingdom has taken. With this, let me conclude my presentation. Thank you for your attention.

**Question:**

Thank you for your presentation. I have three questions. At first as Dr. Sugiura said, that Japanese Investment Services Law and the Korean announced Consolidated Capital Markets Law have many similar characteristics. What I think in several essential aspects, there are differences in the Korean and Japanese models. First, the coverage of the Investment Services Law on your slide number 14, I think there could be banking products, deposits, or insurance products which meet the criteria listed in your slide number 14. I would like to know if the Investment Services Law will apply to those deposits and insurance products as well.

The second question is according to your presentation, I think the primary difference between Korean and Japanese models is that the Japanese system is a dual system composed of transaction law and institutional law. Under the recently announced Korean Consolidated Capital Markets Law, there will be no remaining institutional law. There will only be one law on capital markets. So I would like to know, is there any background or reasons to adopt this dual system in Japan.

My last question is about market responses to the Investment Services Law, especially in the banking sector and the insurance sector.

**Dr. Sugiura:**

First let me answer your first question about the deposits and others. With deposits, etc., there are products with strong investment characteristics, like the variable insurance and annuity products and derivatives deposits. These will be included under the new law. Commodity futures and specified real estate joint-enterprises aimed at an unspecified number of general investors will also be under the new law. But I do not think normal deposit products should be included as there are issues like the deposit insurance.

Going on to your second question, maybe it has to do with our legal way of thinking. It is no more than a formal way to build up the system whether everything is consolidated into a single law or separated into two laws. The current Japanese approach is by means of a partial revision to the Securities and Exchange Law, and transactional clauses in the Law are consolidated into a law, and other laws are consolidated separately. The Korean

system seems more like the United Kingdom system to consolidate everything into one. That is also an ideal way to go.

But currently, many operators and institutions believe it easier for them to understand the section-by-section entry. Perhaps the Japanese approach is an option providing for continuity in the administration of financial matters in Japan.

What was your third question? Sorry, I forgot it.

**Question:**
Market response.

**Dr. Sugiura:**
I could try to respond to your question from what I know and with my own responsibility. With regard the breadth and scope of the instruments to be included, there have been lots of discussions and not everything is decided at the moment. As such, many operators cannot be sure if they are for or against the new bill. Dr. Takahashi and Dr. Hara may or may not object, but basically in terms of the overall user protection, I think it is at least an advance of a step or two. Overall it is a big challenge, but I think the law is generally considered as a new form of the financial regulatory system in Japan.

**Prof. Kozuka:**
About user protection, maybe I can make supplementary marks. To start with, the Japanese Securities and Exchange Law has already incorporated relatively strong investor protection. And I find it a great step forward that a cross-sectional law with broad coverage, applicable to areas where in the past the user protection was missing, is contemplated. However, it must also be borne in mind that the user protection regime in the current Securities and Exchange Law, which is the base for the new law, may not be adequate for the final goal of the user protection.

As for the deposits and insurances, there are reasonable regulations provided in the Banking Law and Insurance Law over ordinary deposits and insurances, respectively.

With regard to sales practices of products with higher risks, no specific rules are included in these laws. Now the new law will cover deposits or insurance products with high risks, such as variable insurances and deposits. I would say that there is a consistency in the logic of regulations here. Thank you.

**Moderator:**

Thank you for your supplementary response. Perhaps just to facilitate discussion, going back to Dr. Jung's question on the difference between the Korean approach and the Japanese approach, it is very interesting to hear that—perhaps, but—one sense I have is there is a bit of difference in environment. In the case of Korea, the Korean system encountered financial crisis in a much more serious way and since then, I think the Korean system has gone through reforms in a much bigger way. Whereas in the case of Japan, they were less open to that shock, in a way, so maybe a more prudent and continuity is still there. So that is one comment I have just to facilitate discussion.

**Question:**

Within the Investment Services Law, there is a section on the responses to the globalization trend. What are the specifics you are thinking about? How are you to respond to the tide of globalization and internationalization?

**Dr. Sugiura:**

We have a deputy commissioner in charge of international issues, and I wonder if I could ask him to answer.

**Mr. Nobuyoshi Chihara, Deputy Commissioner for International Affairs, FSA:**

Well, within the Investment Services Law, I do now know how it is addressing this issue concretely, but with the foreign authorities, we do have a channel for having information exchange. And we hope it can be promoted further so that Memorandum of Understanding (MOUs) can be concluded and we hope that the conclusion of MOUs for exchanging information can be promoted so that further responses can be made to the tide of globalization. Thank you.