

Investment Services Law (provisional title)

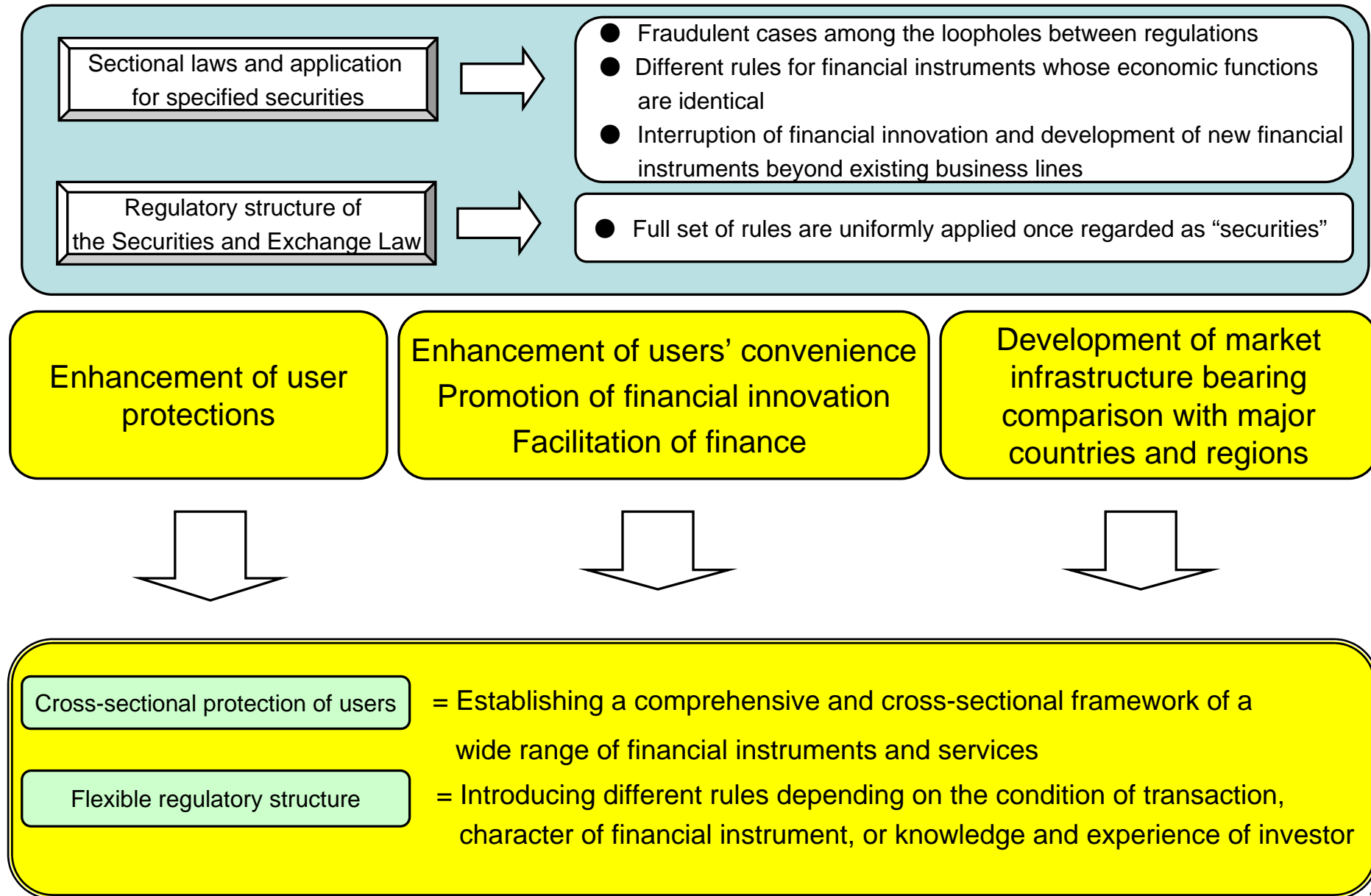
– The Report of the First Subcommittee of the Financial System Council titled as “Legislation for ‘the Investment Services Law (provisional title)’” (December 22, 2005) –

Financial Services Agency, Japan
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1. Purport and objective of “the Investment Services Law (provisional title)”



2. Coverage of “the Investment Services Law (provisional title)”

Based on the concept that financial instruments to be covered should include a wide range of financial instruments to the fullest possible extent, establishing a cross-sectional framework in line with 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.

- Specifying financial instruments to be covered widely to the fullest possible extent, including derivatives and collective investment scheme (fund), in order not to let loopholes between regulations stay open.
- Establishing a framework by which a close exemption or designation of financial instruments would be possible responding to the actual circumstances and change of financial environment.

【Concrete coverage of investment instruments】

- Government bonds and Local bonds
- Corporate Bonds
- Stocks
- Interests in Investment trusts
- Interests in trusts
- Interests in Collective Investment Scheme (fund) (basket clause)
- Derivatives
- Deposit and Insurance, with strong investment characteristics etc.

Concept of risk and return as investment instruments

- risk: market risk
credit risk
- return: monetary profits

Coordination is necessary for the investment instruments which are regulated under the other business laws

- commodity fund
- cooperative business funds of real estate
- commodity futures transaction, foreign futures contract

- First, regulatory framework which would cover financial instruments with investment characteristics should be legislated as early as possible.
- Besides, the First Subcommittee will continue studying more comprehensive regulatory framework which would cover all the financial instruments, prospecting toward “the Financial Services and Markets Law.”

3. Regulation of “investment services businesses (provisional title)”

[Basic concept]

- Coverage should be “sales and solicitation,” “investment management and providing advice,” and “administration of assets.” ⇒ Expanding primary businesses
- Necessary considerations should be provided to ensure clarity and transparency of regulated activities.

“Investment services players (provisional title)”	Type of businesses	Entry regulation	Regulation of financial conditions
“the first business (provisional title)”	all investment services businesses dealing with all the investment instruments	registration requirement in principle	same level of CAR regulation, etc. as current securities companies
“the second business (provisional title)”	<ul style="list-style-type: none"> ▪ dealing of investment instruments with lower liquidity ▪ investment management and investment advice (no restriction on conducting other businesses except investment management players)	registration requirement	minimum capital requirement etc. (no CAR regulation)
“brokerage business (provisional title)”	brokerage of deals entrusted by another investment services players (no restriction to conduct other businesses)	registration requirement	no regulation of financial conditions

- It is necessary to regulate solicitation of interests in fund by issuer.
 - It is necessary to regulate investment management of a fund as investment management business.
- Necessary considerations should be provided not to interrupt financial innovation, for example, by adopting simpler regulations for funds sold for professional investors.

4. Regulation of conduct of “investment services business (provisional title)”

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.

Application of regulation and its contents should be prescribed depending on types of customer in sales and solicitation or types of financial instruments. (flexible regulatory structure)

Overall framework of conduct of business regulations

【all businesses】

- Obligation of notification of sign
- Regulation of advertisement
- Obligation of presentation of being a investment services player

【sales and solicitation】

- Duty of Honesty and fairness
- Obligation of delivering documents such as contents of contract in advance
- Obligation of delivering documents as entering into contract
- Obligation of delivering transaction report after entering into contract
- Requirement for suitability
- Restriction of unsolicited promotions
- Restriction of call against will
- Prohibition of compensating customers for their losses
- Prohibited activities (providing false information/conclusive judgment etc.)
- Cooling-off system
- Obligation of best execution

【investment management and providing advice】

- Fiduciary duty
- Duty of loyalty
- Prohibited activities (transaction raising conflict of interests/advancement of money/securities lending etc.)
- Duty of self-execution
- Obligation of delivering investment management report

【asset administration】

- Obligation of segregation of asset

Concrete issues

○ Relationship with disclosure requirements

○ Requirement for suitability

- The current Securities and Exchange Law takes account of “knowledge, experience, and assets”
- Adding “objective (or intention) of investment”
- Treatment of “understanding of customers” or “suitability letter”

○ Introducing regulatory duty for explaining based on the civil duty to explain under the Financial Instruments Sales Law as a duty in the business regulation

○ Restriction of unsolicited promotions, etc.

- Establishing a general framework in terms of user protections
- Application of the rule should be the same as the current coverage (i.e., financial futures transaction) for the time being
- Introducing restriction of call against will

○ Handling fee disclosure

○ Obligation of presentation of being a investment services player

○ Other issues (Restriction of advertisement, etc.)

5. Classification of customers: professional investors and general investors

Purport: considering contents of regulation of investment services players, setting different rules for activities such as sales and solicitation, depending on the nature of investors: professional or general investors ⇒ Realization of both proper protection of users and facilitation of provision of risk capital

(e.g.) 1. For sale and solicitation to professional investors, conduct of business regulations aimed at an correction of the information disparity (obligation of explanation and delivery of documents before entering into contract/obligation of delivery of documents as entering into contract, etc.) should be exempted.

2. Regulations set for the market integrity should not be exempted.

professional investors	① a professional investor without an option to be classified as a general investor	(e.g.) utilize the same concept as “the qualified institutional investors”	always treated as a professional investor
	② a professional investor with an option to be classified as a general investor	(e.g.) <ul style="list-style-type: none"> ▪ public company ▪ a company above a certain size ▪ local governments ▪ government related institutions 	<div style="text-align: center;"> <p>option</p> <p>option</p> </div>
general investors	③ a general investor with an option to be classified as a professional investor	(e.g.) <ul style="list-style-type: none"> ▪ entities other than ① and ② ▪ individual customers meeting certain criteria (wealthy individuals, etc.) 	
	④ a general investor without an option to be classified as a professional investor	(e.g.) individuals (except wealthy individuals, etc.)	always treated as a general investor

6. Collective Investment Scheme (fund)

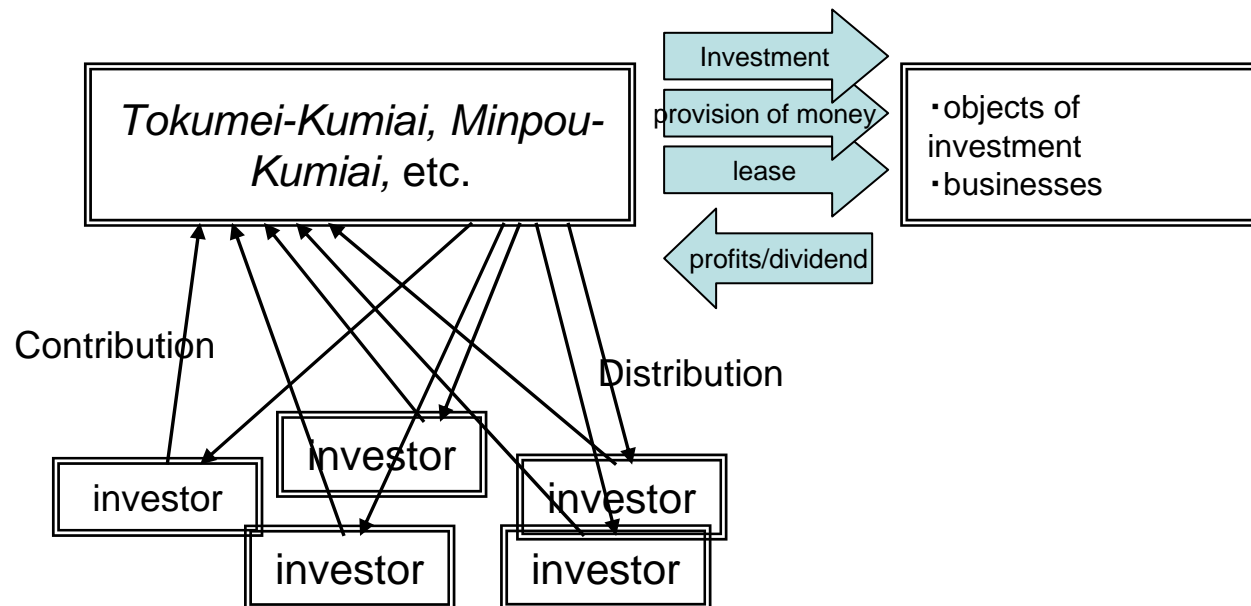
It is necessary to develop effective and cross-sectional regulations in terms of through implementation of user protection rules

- Simpler regulations for funds sold for professional investors in order not to interrupt financial innovation
- Comprehensive and cross-sectional regulation for funds sold for general investors in terms of user protections
 - ⇒ Consider overall framework of regulations for funds, mainly business regulation, referring rules of major countries and regions

Collective Investment Scheme

Any scheme, including *Tokumei-Kumiai*, that

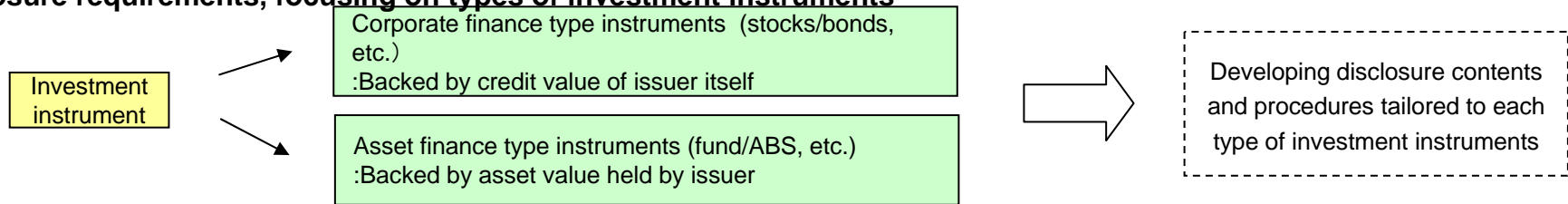
- collect money or other properties from two or more persons,
- conduct business using the money, and
- distributing profits to investors originated from the business



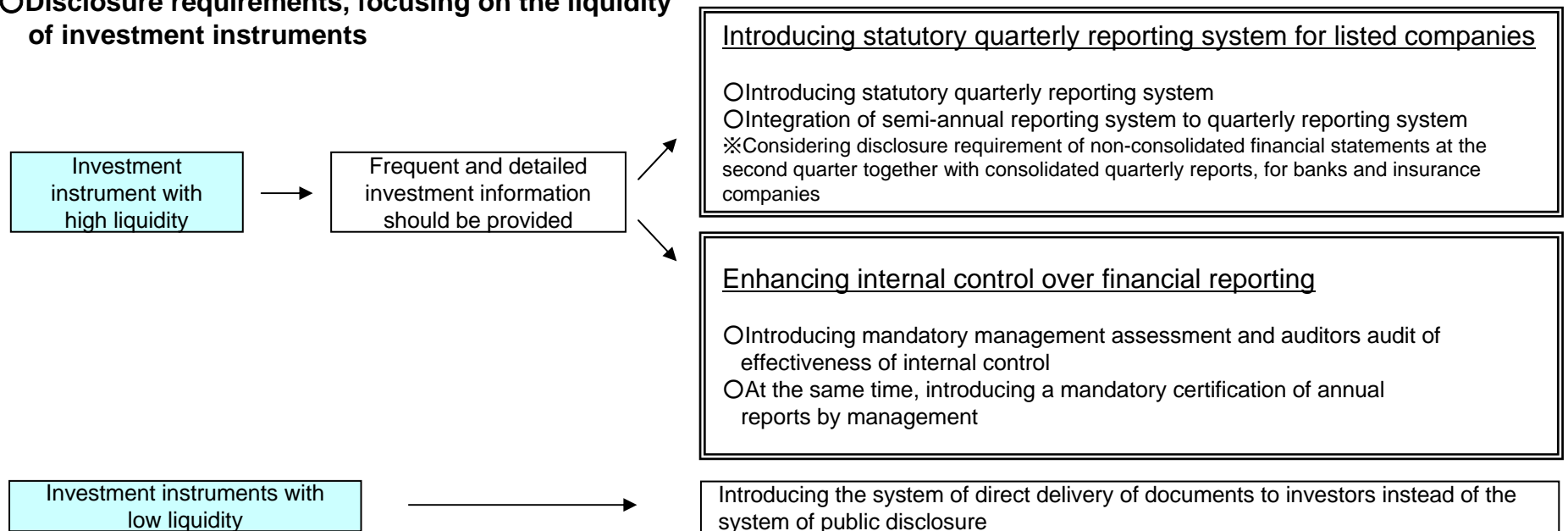
7. Disclosure requirements

I Disclosure requirements tailored to the nature of investment instruments

○ Disclosure requirements, focusing on types of investment instruments



○ Disclosure requirements, focusing on the liquidity of investment instruments



○ Expansion of scope of “qualified institutional investors” (professional investors exempted from disclosure requirements)

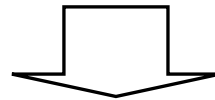
- Expanding scope for business corporations
- Expanding scope for non-corporate and individual investors, which meets certain conditions, other than business corporations

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8. Stock exchange

- Demutualization of stock exchange has been allowed since revision of Securities and Exchange Law in 2000. [Presently, Tokyo, Osaka, Nagoya, Jasdax: stock corporation, Sapporo, Hukuoka: membership organization]
- In the report by the Financial System Council in December 2003, proposed three desirable organizational forms for stock exchange proposed as follows, in order to fulfill public role required for stock exchange with business for profits as stock corporation, and stated that “options should be prepared if legal measures are necessary.”
 - Separate company with no capital relationship
 - Parent-subsidiary/Brother-sister company
 - Separate organization within a single company

- As there is a possibility of conflict of interests between commercial characteristics and self-regulatory functions as for stock exchange in a form of stock corporation, self-regulatory functions of a stock exchange should be conducted independently of the other functions.
- On the other hand, an aspect of quality management of market scene should be noted, as it becomes possible to respond closely to actual circumstances of markets when self-regulatory functions are close to the market scene.



- Statutory framework should be developed to provide concrete forms of self-regulatory functions, such as separating functions to other independent entity or separating functions within a single entity with enhanced independence, and then market operators (stock exchanges) should be given an option to choose their organizational structure of the self regulatory functions.

- Expanding the coverage of transaction admitted in stock exchange, as expanding the coverage of the Investment Services Law
- Introducing cross-sectional notification system of new listings including the abolition of the approval requirement for listing of securities derivatives.

9. Self Regulatory Organizations (SROs)

- Self Regulatory Organizations, organized by players, should establish independent system for self regulatory affairs, set proper code of conduct, and require compliance of the code for members so as to enhance users' reliability toward markets and investment services players.

- Functions that should be given to the SROs:

⇒ in order to ensure the same functions as the Japan Securities Dealers Association,, it is proper to give the following functions:

- setting rules
- examination of compliance of laws and self regulatory rules by members
- sanction against members for violation of laws and self regulatory rules
- activities of resolution of complaints from users
- mediation of disputes on investment instruments transactions
- affairs of "representatives"

Concrete measures

- To ensure regulatory effectiveness without imposing legal obligations to be a member of SROs, a framework regarding non-members should be established.
- Developing a framework that the activities of resolution of complaints from users and mediation of disputes on investment instruments by private organization other than SROs will be accredited by the authority in order to enhance reliability of their activities, etc.

10. Other Issues

Civil liability clause

Revising the Financial Instruments Sales Law (regulating compensation liability for business players) to develop the civil liability clause by including schemes of transaction in the scope of duty to explain, and making it a more useful system for customers

Enforcement (realization of law)

Taking 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)

Responding to globalization

Ensuring consistency of rules with international rules, and early resolution on the issue of the framework for information sharing with foreign securities regulators

Financial and economic education

- It is urgent to enhance financial and economic education.
- It is necessary for public and private sectors alike to promote financial and economic education on a full scale.
- ※ Concrete measures by the FSA so far: ①holding “Financial and Economic Education Discussion Group”, ②dissemination of teaching materials for students, ③holding symposiums sponsored by the FSA.

11. Review of Tender Offer Bid system and large shareholdings reports

System of Tender Offer Bid (TOB)

The Main framework of the Current System

- To purchase shares beyond the threshold off markets, such as more than 1/3 shareholdings, the purchaser is required to disclose the period, the amount, the price and etc. in advance and to offer shareholders an equal opportunity to sell.

Taking measures against transactions that are evading TOB regulations:

- Clarify that it is subject to TOB regulations to increase shareholdings beyond the threshold of 1/3 by combining a purchase of the stocks off the markets and a succeeding purchase on the markets.

Providing more information to investors:

- Require further disclosure in the “registration statement” of a TOB;
- Require the filing of a “position statement report” by a target company;
- Giving the opportunity for a target company to ask a questions to the tender offer bidder.

Extending the TOB period:

- Extend upper and lower bound of the TOB period from 20 days and 60 days to 20 business days and 60 business days;
- Allow a target company to extend the TOB period to the extent of 30 business days when necessary for shareholders to take time on considering whether to sell or not.

Expand the scope to allow withdrawal of a TOB:

- Allow withdrawal of a TOB and change in TOB conditions when the target company decides to activate takeover defenses.

Require a bidder to make a offer to buy all stocks in a certain situation:

- Require a bidder to make an offer to buy all shares when ratio of shareholdings by the bidder becomes beyond a certain threshold of shareholding such as 2/3 to protect small shareholders from the risk of delisting of his/her shares.

Ensure impartiality between bidders:

- Require a large shareholder (such as a one with more than 1/3 in shareholding) to make a TOB during the period of another TOB made by another bidder.

System of Large Shareholdings Reports

The Main framework of the Current System

- Standard reporting requires disclosure of shareholdings in excess of 5% within five business days.
- “Special Method” reporting for professional investors requires less frequent disclosure

Amend the Special reporting system for professional investors:

- Shorten the reporting cycle and deadline under the Special reporting system to the one such as once in two weeks and within five business days (currently once in three months and within 15 days).