Washington International Law Journal

Volume 2 | Number 1

6-1-1993

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Hiroshi Naka

Akio Nakamura

Atsushi Yamashita

Scott Siegler

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Recommended Citation

Hiroshi Naka, Akio Nakamura, Atsushi Yamashita & Scott Siegler, Translation, *Introduction to the Financial System and Securities & Exchange System Reform Act in Japan*, 2 Pac. Rim L & Pol'y J. 191 (1993).
Available at: https://digitalcommons.law.uw.edu/wilj/vol2/iss1/10

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Introduction to the Financial System and Securities & Exchange System Reform Act of Japan

Kinyūseido, syōkentorihikiseido kaikakuhō no gaiyō

(No. 1293, *Syōjihōmu*, pp.2–11)

Written by Hiroshi Naka and Akio Nakamura†
Translation by Atsushi Yamashita‡ and Scott Siegler‡‡

Abstract: This translation of an original Japanese language work, by Hiroshi Naka and Akio Nakamura, both of the Japanese Ministry of Finance, details the reforms of Japan's financial and securities & exchange system made under the recently enacted System Reform Act. The major reforms under the Act include: (1) altering the "Glass Steagall" rule (the separation of securities business and banking business) in Japan so that banks and securities companies can engage in each other's business through their subsidiaries; (2) extending securities regulations to some new types of structured finance; (3) amending public offering provisions and providing new articles for private placement; and (4) amending and adding provisions to secure the soundness of banking operations, including capital requirements, and safeguards against harmful side effects (firewalls) which may arise from a bank's moving into securities business. This English language translation, along with the translators' detailed notes, provide an insightful look into these reforms.

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† Mr. Hiroshi Naka was a Deputy Manager of *Ōkurashō Ginkōkyoku Chōsaka* (the Ministry of Finance ("MOF"), Banking Bureau, Research Division) and Mr. Akio Nakamura was a Deputy Manager of *Ōkurashō Shōkenkyoku Sōmuka Chōsashitsu* (the MOF, Securities Bureau, Coordination Division, Research Office) as of July 25, 1992, when the original article was published. Both officials were involved in preparing drafts of bills involved in the Act.

In Japan, most bills are prepared by the Cabinet rather than by Diet members. (Article 72 of the Constitution implies that the Cabinet submits bills to the Diet for its approval.) Relevant ministries prepare drafts of bills on behalf of the Cabinet. In this case, the MOF, which is in charge of the financial system, was involved in preparing drafts of the bills involved in the System Reform Act. The Banking Bureau, which is in charge of the banking system, and the Securities Bureau, which is in charge of the securities & exchange system, were heavily involved in the current reform of the financial system. Explanation of an act by officials of the ministry involved in its preparation is very helpful to understand the act, including the purpose or policy behind it. In other words, such explanation is a good source of its legislative history.

‡ Atsushi Yamashita is a licensed attorney in Japan; LL.M. Candidate 1993, University of Washington Asian Comparative Law Program.

‡‡ Scott Siegler is a licensed attorney in New Jersey and awaiting admission to the New York Bar; A.B. 1988, University of Michigan, Japanese Language and Asian Studies, J.D. 1992 Fordham Univ. School of Law; LL.M. Candidate 1993, University of Washington Asian Comparative Law Program.

We wish to thank Izuru Goto, Esq. of Standard & Poors Corporation for his helpful and insightful comments.

Translators' Introductory Note: The original article provides Japanese readers with an introduction to the new financial and securities & exchange system in Japan created under The System Reform Act (defined *infra*). The System Reform Act is said to have drastically changed the Japanese post-war financial system.

The major points of the System Reform Act include: (1) reforming the "Glass Steagall" rule (separation of securities business and banking business) in Japan so that banks and securities companies can engage in each other's business through their subsidiaries; (2) extending of securities regulations to some new types of structured finance; (3) amending public offering provisions and providing new articles for private placement; and (4) amending or adding provisions to secure the soundness of banking operations, including capital requirements, and safeguards against harmful side effects (firewalls) which may arise from a bank's moving into securities business.

The System Reform Act is the fruit of more than seven years of earnest discussions by *Kinyū Seido Chōsakai* (the "Financial System Research Committee") ("FSRC") and *Shōken Torihiki Shingikai* (the "Securities And Exchange Council") ("SAEC"), both of which are councils under the Ministry of Finance ("MOF"). FSRC prepared the report titled *Atarashii kinyūseido ni tsuite* (report "Concerning The New Finance System") as of June 4, 1991 ("FSRC Report"). SAEC prepared the report titled *Shōkentorihiki ni kakaru kihontekiseido no arikatani tsuite* (report "Concerning The Basic System in respect of Securities & Exchange Transactions") as of May 24, 1991 ("SAEC Report"). The perceptions and recommendations contained in both reports became foundation of the System Reform Act. They will be occasionally referred to below.

The translators provide relevant background information and appropriate comments (historical and legislative explanations, explanations of technical terms and, to increase the clarity of the text, references omitted in the original article) in brackets in the original text and in the footnotes. Where necessary, they summarize, rather than translate directly the content of the original article (indicated in brackets as "summary"), so that American readers can easily understand the new financial system in Japan. We believe, therefore, an English translation of this article will be helpful for readers who are interested in Japan and international finance. In addition, some readers may be interested in this article because of the insights it provides into the legislative process in Japan.

I. INTRODUCTION

Kinyūseido oyobi syōkentorihikiseidono kaikakuno tameno kankeihōritsuno seibitōni kansuru hōritsu (The Act Concerning Change and Adjustment of Related Statutes For the Purpose of Change of the Financial System and Securities & Exchange System) (the "System Reform Act") was approved by the Diet on June 19, 1992 and promulgated on June 26, 1992.[1]

[1] [Translators' Note] The System Reform Act became effective on April 1, 1993. The System Reform Act loosens restrictions on the business of various cooperative financial institutions, including *Shinyōkinko* (credit unions), *Shinyō kyōdo kumiai* (credit cooperatives), and *Nōgyo kyōdo kumiai* (agricultural cooperatives). These are usually small and regional financial institutions. The authors have generally omitted translation of the original text relevant to such cooperative financial institutions because this translation is intended to provide American readers with a picture of the major points of the new system, i.e., reform of the Glass-Steagall Rule, reform of securities regulations, and establishment of firewalls between banking and securities businesses.

The System Reform Act is meant to be a comprehensive reform of our nation's financial and securities transaction systems, corresponding with developments in domestic and international social and economic affairs, such as the deregulation, internationalization and securitization of finance. The System Reform Act is intended to promote effective, proper competition in financial and capital markets and to revitalize market efficiency. It is also intended [to help] financial institutions and securities companies develop inventive operational plans and offer financial services that will meet customers' needs.[2]

Due to changes under the new act, our nation's financial system, which for the forty year period since World War II was based upon separation and specialization (*bungyōsei and senmonsei*)[3], will reach a turning point and enter a new era. In addition, it is thought that the new system, in combination with reforms under the previously enacted *Shōkentorihikitōno kōseiwo kakuhosurutameno Shōkentorihikihōtōno ichibuwo kaiseisuru hōritsu* (the Act Concerning Change in Portions of the Securities & Exchange Act to Ensure the Fairness of the Securities Transactions) will be conducive to

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[2] [Translators' Note] The FSRC Report pointed out the following three elements as considerations in the reform of our financial system: first, due to the continuing deregulation of interest rates paid on deposits, deregulation of banking business is inevitable; second, under the old system, which strictly regulated financial institutions' business, financial institutions could not provide financial services that met customers' various needs; and third, reforming the Japanese financial system is necessary to enable domestic and foreign investors to use Japanese financial markets more conveniently.

[3] [Translators' Note] A basic trait of the old financial system was that each kind of financial institution engaged in a specific business field. The old financial system was characterized principally by (i) separation of securities business and banking business, (ii) separation of long term credit and short term credit, and (iii) separation of banking business and trust business. *See* Seiichiro Saito, KINYŪ NYŪMON (INTRODUCTION TO MODERN FINANCE) (1988) 164–169 (hereinafter "INTRODUCTION TO MODERN FINANCE").

The separation of securities business and banking business was an established practice before World War II and was adopted in the Securities & Exchange Act enacted after World War II.

The separation of long term credit and short term credit (*chōtan bunri*) provides that ordinary commercial banks (such as Mitsubishi Bank, Sumitomo Bank etc.) engage in short term financing and that long term credit banks (such as the Industrial Bank of Japan, etc.) engage in a long term financing, especially for the purpose of providing industries with funds for productive facilities.

The separation of banking business and trust business provides that ordinary commercial banks are prohibited from engaging in trust business. Some kinds of trust businesses provide long term financing and, therefore, the separation of banking business and trust business is based upon the same idea as the separation of long term credit and short term credit. *See* p. 200 and *infra* note 19. Please note, however, that a company which engages in trust business in Japan is not *Shintaku gaisha* (a trust company) but *Shintaku ginkō* (a trust and banking company), a bank which mainly engages in trust business, or *Shintaku ken-ei ginkō*, an ordinary bank which engages in trust business supplementarily. *Id.* at 180–182. For example, the Sumitomo Bank is an ordinary commercial bank which engages in commercial banking business and does not engage in trust business. *See also* p. 196 and *infra* note 9 (what constitutes "Banking Business" under the Banking Act). On the other hand, the Sumitomo Trust and Banking Corporation mainly engages in trust business, rather than banking business.

preventing a repeat of the series of problems involving securities and finance, thereby restoring domestic and international trust in our country's financial and securities markets.[4]

II. OUTLINE OF THE SYSTEM REFORM ACT

The System Reform Act is omnibus legislation that revises or abolishes a total of sixteen acts, including *Ginkōhō* (Law No. 59 of 1981, as amended) (the Banking Act) and *Shōkentorihikihō* (Law No.25 of 1948, as amended) (the Securities & Exchange Act) (the "SEA"). The content of the System Reform Act will be explained in detail in later sections of this Article. Before that, we will first provide an overview of the Act.[5]

1. Entrance into New Business Field

So that financial institutions (*Kinyūkikan*)[6] and securities companies can move into various new lines of business, the System Reform Act provides that banks can establish separate securities subsidiaries and trust and banking subsidiaries, and that securities companies can establish separate banking subsidiaries and trust and banking subsidiaries . . . [one sentence discussing coöperative financial institutions is omitted.]

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4 [Translators' Note] *See* Yutaka Nakamura, Translation, *The Banking and Securities Scandals and Fundamental Theories of Commercial Jurispridence*, by Seiji Tanaka, 1 PAC. RIM L. & POL'Y J. 349 (1992).

5 [Translators' Note] The FSRC Report raised four basic goals of the new financial system: first – "customers' profit"– deregulation of the financial system promotes competition between financial institutions and the development of new financial products, enabling customers to enjoy the benefits therefrom; second–"internationalization of financial markets"–the new financial system must correspond with foreign markets; third–"maintenance of financial order"–to ensure the soundness of financial institutions and depositors' security, and to prevent harmful side effects, including conflict of interest which may occur due to financial institutions' moving to new business lines; and fourth–"to revitalize regions"–regional financial institutions must contribute to the revitalization of geographic regions in Japan.

6 [Translators' Note] There is no general conceptual definition of "financial institutions" (*kinyūkikan*) under the Japanese laws. The SEA (and the cabinet ordinance concerning execution of the SEA) provides that banks, trust companies, insurance companies, credit associations etc. are financial institutions. However, the SEA (and the relevant cabinet ordinance) does not regard securities companies as financial institutions.

2. Reform of the Securities & Exchange System

To keep pace with developments in the securitization of finance, the definition of "Securities" (*Yūkashōken*) under the SEA has been revised. The investor protection framework of the SEA, including disclosure requirements and restrictions against unfair trade practice, will apply to the newly-recognized securities. With respect to public offering and public selling (*Kōbo*), the new SEA clarifies the minimum number of offerees and provides exceptions for certain [sophisticated] investors. The new SEA also establishes new provisions related to private placement (*Shibo*), including disclosure requirements.

3. Deregulation of Operations of Cooperative Financial Institutions

[Omitted.][7]

4. To Ensure the Soundness of Financial Institutions

The System Reform Act provides necessary legal reforms for banks; it provides: (1) regulations regarding standards by which the soundness of banking operations shall be judged, (2) line of credit regulations (*Ohguchi sinyōkyōyo kisei*), and (3) controls over transactions between banks and their subsidiaries (*Heigaibōshi sochi*) [safeguards against harmful side effects known as firewalls]. In addition, the System Reform Act puts into place revised provisions concerning public inspection of documents regarding the status of bank assets and operations, and those concerning mergers and changes in corporate identity.

III. A NEW BUSINESS SUBSIDIARY (*GYŌTAIBETSU KOGAISHA*)

1. Background of the "New Business Subsidiaries System"

The FSRC [and SAEC] concluded that the most appropriate way to achieve the present reforms is, primarily, to introduce the New Business Subsidiaries System (*Gyōtaibetsu kogaisha hōshiki*) (the "NBS System") in combination with partially allowing financial institutions to engage in other

[7] [Translators' Note] *See* p. 203 and *infra* note 29.

types of business directly.[8] Under the NBS System, *Futsū ginkō* (ordinary banks), *Chōki sinyō ginkō* (long term credit banks), *Sintaku ginkō* (trust and banking corporation) and *Shōken Gaisha* (securities companies)[9] can expand their operations to other types of business through subsidiaries while maintaining their existing business lines.

Among the NBS System's merits are that (a) financial institutions can respond to their customers' various needs while, at the same time, achieving (b) superiority in preservation of the soundness of financial institutions' operations, preservation of financial order through safeguards against harmful side effects caused by conflicts of interest, and preservation of fairness of the securities market.

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[8] [Translators' Note] Banks can handle some kinds of securitized products directly. *See* p. 204. In addition, local financial institutions can move into some kinds of trust business directly. *See* p. 203 and *infra* note 29. A great deal of consideration was given to the role of the Holding Company System in the new financial & securities systems created by the Act. Under this system, a bank, a trust and banking company and a securities company are held by one holding company.

The SAEC Report recognized that such systems are effective in preventing harmful side effects (conflicts of interests). However, the NBS System, rather than the Holding Company System, was adopted under the Act; the original text does not explain the reason behind this. Article 9 of *Shitekidokusen-no kinshi oyobi kōseitorihikino kakuhoni kansuru hōritsu* (the Act Concerning Prohibition of Private Monopoly and Securing Fair Trade) (Law No. 54 of 1947, as amended) (the "Anti-Monopoly Act") prohibits establishing a holding company in Japan. Article 9 developed as a response to the several strong families (*zaibatsu*) that controlled the Japanese economy through holding companies before World War II. It is likely that the MOF adopted the NBS system, out of consideration of the above mentioned history and regulations, rather than the Holding Company System, which would require amendment of Article 9 of the Anti-Monopoly Act. *See also* p. 202 and *infra* note 27 with respect to Article 11 of the Anti-Monopoly Act.

[9] [Translators' Note] *Futsu ginko* (an ordinary bank) is a commercial bank established under the Banking Act which engages in *Ginkōgyo* ("Banking Business") i.e., taking deposits together with lending funds or discounting notes, and performing exchange transactions (Article 10. Paragraph 1 of the Banking Act). An "exchange transaction" in this context means the process of settling accounts or debts between parties residing at a distance from each other, without the intervention of money, by exchanging orders or drafts, called bills of exchange. BLACKS LAW DICTIONARY 563 (6th ed. 1990) (defining exchange - *commercial law*). An example is the Sumitomo Bank.

Chōki shinyō ginkō (a long term credit bank) is a commercial bank established under *Chōki shinyō ginkōhō* (the Long Term Credit Bank Act) (Law No. 187 of 1952, as amended) which mainly engages in long term financing to industries. An example is the Industrial Bank of Japan.

With respect to a trust and banking corporation, *see supra* note 3.

2. Legal Problems Relevant to the NBS System

[Securities Subsidiaries of Banks]

(1) Article 65 of the SEA prohibits banks from engaging in securities business (*shōkengyō*),[10] with the exception of businesses related to government securities, etc.[11] Therefore, the concern has been raised that the operation of a securities business by a bank's securities subsidiary, (which can be) regarded as the same entity as the parent, constitutes an evasion of Article 65 of the SEA.

In the current reform, we gave adequate consideration to the fundamental policies behind Article 65 of the SEA (prevention of conflicts of interests, protection against market control by banks and their influence over enterprises, and insuring the soundness of banks); the NBS System and safeguards against harmful side effects [firewalls in Japan] were adopted so that banks can expand their operations to include securities business while the sound operation of financial institutions is preserved and fairness in the securities market is maintained. Therefore, it can be said that the NBS System, as it relates to banks' securities subsidiaries, does not violate Article 65 of the SEA. We do not have the problem mentioned above [evasion of SEA Article 65] under the new system.

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[10] [Translators' Note] *Shōkengyō* ("Securities Business") of the SEA (See Article 2, Paragraph 8) mainly consists of the following businesses;

(1) "Dealing Business" i.e., purchasing and selling securities (including index, options, etc.) on its own account,

(2) "Brokerage Business" i.e., acting as *baikai* (an intermediary), *toritsugi* (a broker), or *dairi* (an agent) regarding purchasing and selling securities by its customers,

(3) "Underwriting Business" i.e., underwriting newly issued (*hikiuke*) or already issued shares (*uridashi*), and

(4) "Distributor Business" i.e., handling solicitation of an offer to buy newly issued or already issued shares on behalf of sellers or issuers. *See* Seiju Tanaka and Wataru Horiguchi, *Zentel* (Revised) Commentary, *Shōken torihiki hō* (Securities & Exchange Act) pp. 42–44 (1990).

The new SEA provides that handling private placement is included in the business of "Distributor Business" mentioned above.

Note that securities companies must obtain a license for conducting each kind of business mentioned above under Article 28, Paragraph 1 of the old and new SEA. *See* p. 198 and *infra* note 12.

[11] [Translators' Note] Article 65, Paragraph 1 of the SEA provides that financial institutions can not engage in "Securities Business" (*See supra* note 10), with some exceptions, including the purchase and sales of securities for investment purposes or pursuant to a trust agreement signed with their customers for the account of such customers. Article 65, Paragraph 2 of the SEA provides that the above mentioned restrictions do not apply to transactions concerning government securities.

The reader must note that Japanese commercial banks have been allowed to hold shares in other companies for the purpose of "investment" rather than "dealing". In the U.S.A., the Glass-Steagall Rule severely limits commercial banks' holding of shares.

(2) In accordance with these new policies, Article 65-3 of the new SEA provides that "[t]he provisions of Article 65 do not prohibit the Minister of Finance from granting a license pursuant to Article 28, Paragraph 1[12] to *Kabushiki gaisha* (a stock corporation), more than half the shares of which are held by a bank, a trust company or any other financial institutions specified in a cabinet ordinance."

(3) In addition, new provisions concerning parent companies that own NBSs are provided. For an example from the Banking Act, "Section 2-2 Subsidiaries" was added as a new section concerning business operations by subsidiaries, following a section concerning a bank's direct business. Furthermore, in the same section, the new Article 16-2, concerning holding of a NBS, provides that a bank, after receiving authorization from the Minister of Finance, can acquire or own more than half of all shares (voting stock only) in a securities company or bank engaging in trust business.

(4) [Omitted: this paragraph is relevant to cooperative financial institutions unions]

3. Details of the NBS

NBSs are regulated based on considerations of (i) the scope of their initial permissible business activities and (ii) safeguards against harmful side effects [firewalls].

[Scope of the Business Activities of NBSs]

(1) At the beginning of the enforcement of the new system, we must consider the necessity of protecting depositors and investors, preserving financial order, and promoting conditions beneficial for fair competition. It is considered that the scope of initial operations of a NBS should be limited to achieve these results.[13]

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[12] [Translators' Note] Article 28, Paragraph 1 of the SEA provides that "[n]o person other than *Kabushiki gaisha* ("stock corporation") licensed by the Minister of Finance shall engage in the securities business."

[13] [Translators' Note] The SAEC Report pointed out that major securities companies' market share in the underwriting business is still high and, on the other hand, their market share in brokerage business is decreasing. The SAEC report concluded that increases in competition by new participants is more necessary in the underwriting market than for the brokerage market. Such ideas are reflected in scope of permissible initial businesses of securities subsidiaries. According to Saito, sixty-two percent of the

Therefore, supplementary Article 19 of the SEA provides that, when the Minister of Finance grants a securities license to a bank's securities subsidiary, such license shall be subject to a condition that prohibits [the subsidiary from] engaging in stock brokerage, [with an exception] for an unspecified term.[14] The policy justification behind this is that although securities companies are charged with properly performing brokerage business, such securities companies are at the same time subsidiaries of banks which usually hold huge amounts of stock [being handled by the subsidiary].[15] Furthermore, the brokerage business is the main business of small securities companies.[16] The permissible scope of business for a bank's securities subsidiary will be further discussed based on the following considerations: promotion of competition by introduction of new participants to the capital market, effectiveness and revitalization of the market and assurance of fair competition.[17]

The scope of initial business of a trust and banking subsidiary will be preliminarily determined by the contents of the FSRC Report. The report stated that some species of *Kinsenno shintaku* [a trust in which invested

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underwriting business in Japan was handled by Big Four securities houses (*Nomura, Daiwa, Yamaichi, Nikkō*) in the 1985 fiscal year. INTRODUCTION TO MODERN FINANCE, *supra* note 3, at 242.

14 [Translators' Note] Supplementary Article 19 of the new SEA provides that securities subsidiaries can sell shares which were purchased by customers through private placement handled by the securities subsidiaries, or distributed to customers by them through public offering, and have been in their custody, on behalf of their customers.

15 [Translators' Note] As explained in note 11, Japanese banks can hold shares in other companies and, in fact, they are one of the most powerful institutional investors in Japan. Therefore, we must consider the risk that a bank's securities subsidiary might try to manipulate, through its brokerage business, the price of shares, a huge number of which are held by its parent bank (a potential conflict of interest).

16 [Translators' Note] In Japan (as in the U.S.A.), small securities companies mainly engage in the stock brokerage business rather than underwriting business. Therefore, excessive competition in the brokerage market may cause operational difficulties for small securities companies. In addition, the SAEC report concluded that the need to increase competition by newcomers in the brokerage market is not as serious as that in underwriting market. *See supra* note 13.

17 [Translators' Note] According to *Kinyūseidokaikaku jitsushi no gaiyō ni tsuite* ("Outline of enforcement of Reformation of Financial System") announced by the MOF on December 17, 1992, (i) brokerage and dealing of convertible bonds (CB) and bonds with warrants and (ii) underwriting and brokerage and dealing of stocks will also be excluded from (banks') securities subsidiaries initial permissible business. (Most of such exclusions are set forth in relevant administrative ordinances rather than in the System Reform Act. *See* p. 201 *infra and* note 21).

In addition, the MOF is considering permitting ordinary commercial banks to establish their securities subsidiaries and trust and banking subsidiaries at least one year after the implementation of the new system, although securities companies, long-term credit banks and trust and banking corporations can establish their NBS from April, 1993.

According to NIHON KEIZAI SHINBUN (Dec. 18, 1992), executives of major commercial banks complained about the narrow scope of business allowed for its securities subsidiaries and that they can not engage in new business quickly enough. *See* p. 200 and *infra* note 22.

assets are money],[18] including *kashitsuke shintaku* (loan trust)[19] and *Nenkin shintaku* (pension trust),[20] and real estate purchase and sale and rental brokerage business should be excluded from the subsidiaries' activities. The scope of permissible initial operations by trust and banking subsidiaries will be further discussed in reliance upon the FSRC report.[21] In contrast, [commercial] banking subsidiaries can engage in the full range of banking activities.[22]

[Safeguards Against Harmful Side Effects]

(2) The Banking Act provides the "Arm's Length Rule" as the main safeguard against harmful side effects caused by the new system. The Arm's Length Rule protects the parent's sound and proper banking operations from interference caused by the relationship between the parent bank and its

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[18] [Translators' Note] *Kinsen-no shintaku* (a trust in which invested assets are money) consists of (i) *Kinsen shintaku* (monetary trust), in which beneficiaries receive trust assets in the form of money when the trust is terminated, and (ii) *Kinsen shintaku igaino Kinsen-no shintaku* (*Kinsen-no shintaku* other than monetary trust), in which beneficiaries receive trust assets as they are when the trust is terminated.

[19] [Translators' Note] *Kashitsuke shintaku* (loan trust) is a monetary trust in which trusted funds are exclusively invested for long term loans. This kind of trust is said to be very unique. Loan trusts have had an important role in Japan in collecting funds from the public and providing industries with the funds needed to promote business after World War II. *See supra* note 3.

[20] [Translators' Note] *Nenkin shintaku* (pension trust) is a trust arrangement in which the employer transfers to trustees an amount sufficient to cover cost of pensions to employee beneficiaries.

[21] [Translators' Note] Under the new system, a trust in which invested assets are real estate is within the scope of permissible businesses. However, real estate purchase and sale and rental brokerage business is not a kind of trust business but a business incidental to trust business: trust and banking subsidiaries are not permitted to engage in such incidental business.

[22] [Translators' Note] Readers may be curious as to why securities companies' banking subsidiaries can engage in all areas of banking business, while banks' securities subsidiaries' scope of business is limited (e.g. the prohibition of stock brokering business by banks' securities subsidiaries are discussed in the original text).

The FSRC Report emphasized that moving into new business lines must progress gradually so that conditions for competition between financial institutions' subsidiaries and securities companies are fair, although it is desired that all the securities businesses will be open to new participants in the near future. Securities companies are usually not as strong as banks in their economic power and therefore, the scope of business of banks' securities subsidiaries is to be limited to some extent.

In addition, many readers may know that the recent depression in the Japanese economy caused the bursting of the economic bubble (sharp drop in real estate prices and stock prices). Securities companies are said to have been affected by the depression more seriously than banks. As referred to in note 17, the scope of bank's securities subsidiary's business, therefore, excludes many important activities such as underwriting of stocks. NIHON KEIZAI SHINBUN (December 18, 1992) reported that the MOF considered damages suffered by securities industries in the current depression to set such strict limit on the scope of business of (banks') securities subsidiaries.

NBS.[23] The Arm's Length Rule explicitly infuses the fundamental idea that "the transactions or actions between the parent bank and its subsidiary must be conducted as those of independent entities," into the conditions governing parent–subsidiary transactions.[24] In addition, [Article 16–3, Item 2 of] the Banking Act allows for ministerial ordinances [to be provided by MOF] to add minimum safeguards against harmful side effects of the new system. [Such additional protections can be established with respect to transactions between parent banks and their subsidiaries or between parent banks and their subsidiaries' customers.][25] The reasons for delegating [the MOF the power] to set the provisions for additional safeguards are that it is necessary [for the MOF] to respond flexibly [by way of subsequent ministerial ordinances] to changes in the economic and financial environment, and that it is impossible to cover all types of transactions or actions which may be conducted between parent banks and their subsidiaries or between parent banks and their subsidiaries' customers at the beginning of the new system.[26]

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23 [Translators' Note] The arm's length rule of the new Banking Act coincides with safeguards against the harmful side effects (firewalls) under the SEA. A purpose of firewalls in U.S.A. is to avoid banking business suffering the risks of the securities business. In Japan, under the NBS System, the purpose of firewalls is to secure the independence of securities subsidiaries, as well as avoidance of risk by securities businesses from banking businesses.

24 [Translators' Note] Article 16–3, Item 1 of the new Banking Act provides that a bank can not enter into transactions with its subsidiary on conditions unfavorable to the bank in comparison with the conditions of other ordinary transactions with third parties. The intent is to prevent harm to the parent banks' business caused by the parents' efforts to promote its subsidiary.

25 [Translators' Note] Article 16–3, Item 2 of the new Banking Act provides that a bank can not enter into transactions with customers of its subsidiary on conditions which are unfavorable for the bank in comparison with the conditions of other ordinary transactions with third parties. The purport of this provision is to prevent harm to parent banks' business caused by parents' efforts to promote its subsidiary through transactions with its subsidiary's customer.

26 [Translators' Note] In Japan, administrative acts enacted by the Diet are enforced by the Cabinet and the relevant ministries, in this case, the MOF. (The System Reform Act is typical of administrative laws.) Traditionally, the acts provide fundamental rules and delegate detailed rule making power to the Cabinet and the relevant ministry. The Cabinet and the relevant ministry make detailed rules by establishing *Seirei* (cabinet ordinances) and *Shōrei* (ministerial ordinances) [jointly referred to as "administrative ordinances"]. For example, the scope of permissible business of a securities subsidiary is limited as mentioned at *supra* note 17. The temporary prohibition of stock brokerage business is provided in the new Banking Act. However, other restrictions i.e., exclusion of (i) brokerage and dealing of convertible bonds and bonds with warrants and (ii) underwriting and dealing of stocks are provided in administrative ordinances. Changing an administrative ordinance is easier than changing acts because changing an administrative ordinance does not require legislative action. Therefore, the government will be able to flexibly abolish the above mentioned restrictions in response to changed circumstances, including the recovery of securities companies from the current depression.

This system, working together with the Cabinet and the relevant ministries preparing bills (*See supra* note †) enables the smooth execution of some administrative policies (in this case, proper and gradual deregulation of financial and capital markets) and makes possible a flexible response to changes

We will discuss safeguards against harmful side effects [firewalls] caused by the new system under the new SEA later in this article.

4. Establishment of NBS [Necessary Licenses and/or Approvals]

[Licenses and Approvals from MOF]

(1) *When a bank establishes a securities subsidiary* [emphasis added], (i) it is necessary for the [parent] bank to obtain approval to acquire or own more than half the shares of the subsidiary [under Article 16–2 of the new Banking Act]. In addition, (ii) the securities subsidiary itself is required to obtain a license to operate as a securities company [under Article 28 of the SEA].

When a bank or a securities company establishes a trust and banking subsidiary [emphasis added], (i) it is necessary for the [parent] bank or the [parent] securities company to obtain approval to acquire or own more than half of the shares of the subsidiary [under Article 16–2 of the new Banking Act or Article 43–2 of the new SEA]. (ii) The trust and banking subsidiary itself must obtain a license to *operate as a bank* [emphasis added] [under Article 4 of the Banking Act] and an approval to *engage in trust business* [emphasis added] in addition to banking business [under Article 1 of the Act Concerning Financial Institutions' Interlocking Trust Business].

[Approvals from FTC]

(2) In order to establish a NBS, it is necessary [for the parent] to secure approval of *Kōsei torihiki iinkai* (the Fair Trade Commission "'FTC") pursuant to Article 11 of *Shitekidokusen–no kinshi oyobi kōseitorihiki–no kakuhoni kansuru hōritsu* (the "Act Concerning Prohibition of Private Monopoly and Securing Fair Trade") (Law No. 54 of 1947, as amended).[27] The reason why such an approval can be granted [to the parent] is that the new system promotes competition and does not contradict anti–monopoly

of circumstances by the Cabinet and the relevant ministries. However, there is some criticism of the potentially excessive power of the Cabinet and ministries under this system.

[27] [Translators' Note] Article 11 of the Anti–Monopoly Act provides that companies engaging in financial business (banking business, trust business, insurance business and securities business) can not acquire or own shares in a domestic company in excess of five percent (or ten percent for insurance companies) of all–outstanding shares therein without obtaining approvals from Fair Trade Commission.

policy.[28] Therefore, a NBS is generally a newly established company. Exceptions to the general rule should be rare, such as when a bank acquires shares of an almost insolvent securities company.

5. Foreign Subsidiaries

[The old Banking Act required approval in order to establish a foreign banking subsidiary but did not require approval concerning the establishment of a foreign securities subsidiary.] Under the new system, a bank can hold (i) a domestic securities subsidiary and (ii) a domestic trust and banking subsidiary after [obtaining] proper approvals. Therefore, [Article 16–4 of] the new Banking Act requires a bank to obtain (i) approval in order to establish a foreign securities subsidiary in addition to (ii) approval in order to establish a foreign banking subsidiary. This reform corresponds with an international trend in which foreign securities subsidiaries are supervised by an authority from the home country. [A sentence related to special financial institutions is omitted.]

In addition, new provisions with respect to the foreign banking subsidiaries of securities companies have been established [Approvals from MOF are required for securities companies to acquire or own more than fifty percent of shares of foreign banking corporations under Article 43–2 of the new SEA].

IV. BUSINESS OPERATION OF [PARENT] BANKS AND OTHER FINANCIAL INSTITUTIONS

1. The Expansion to Trust Business by Local Financial Institutions

[Omitted.][29]

[28] [Translators' Note] A basic belief of the new system is that introduction of new participants in the financial market and securities market will promote competition in both markets.

[29] [Translators' Note] Local financial institutions, such as *Chihō ginkō* (local commercial banks), *Shinyōkinko* (credit associations) etc., are also permitted to move into some kinds of trust business under the new system. These local financial institutions are small and it is too costly for them to establish a subsidiary for trust business. Therefore, the new system allows such local financial institutions to engage in trust business directly rather than through subsidiaries.

2. *The Business Operation of Handling Securitized Products*

(1) The market for securitized products (*Shōkenka kanrenshōhin*)[30] is expected to expand in the future. The securitization of finance will develop in accordance with the demands of investors, borrowers, and financial institutions.

Under the new system, the SEA has been amended to provide investor protection. The concept of "Securities" has been broadened to cover securitized products suitable for investment and having transferability. Moreover, the SEA has been amended so that financial institutions, including banks, can deal with such products directly upon approval.

In addition, each act licensing and regulating a financial institution, including [the Banking Act in the case of] banks, has been amended to provide operational regulations with respect to handling financial products, including commercial paper, newly included in the definition of "Securities" in the new SEA.

[Summary: (2) Furthermore, some operations with respect to financial products to be included within the new definition of "Securities" of the new SEA are explicitly included as those of the banking business under the Banking Act. End of summary.]

(3) In addition to the Banking Act, each act licensing and regulating a financial institution has also been amended to provide operational regulations regarding the handling of securitized products, in a manner fundamentally identical to the above.

The new system, working hand in hand with changes in the SEA, offers a framework in which each financial institution can go forward with product development corresponding to the securitization of finance.

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30 [Translators' Note] The SAEC Report discussed some kinds of securitized products (No. 1251 *Sōjihōmu* p. 38). It focused on "securities to be secured by assets value" which are similar to "asset backed securities", a kind of structured financing, in the U.S.A.. "In a typical structured financing, a company that seeks to raise cash may sell certain of its assets to a special purpose vehicle or trust (hereinafter called the "SPV") that is organized in such a way that the likelihood of its bankruptcy is remote . . . The assets themselves are typically payment obligations, such as accounts or other amounts receivable, owing to the company from creditworthy third parties. (. . . these payment obligations are generically referred to as "receivables") . . . The SPV, and not the selling company, will issue securities to raise cash. These securities are intended to be payable from collections on the receivables purchased by the SPV. A potential buyer of the securities therefore looks to the cash flow from the purchased receivables, and not necessarily to the credit of the selling company, for repayment." Steven L. Schwarcz, *Structured Finance: The New Way to Securitize Assets*, 11 CARDOZO L. REV. 607 (1990).

3. Private Placement Activities

(1) It is necessary to foster the market for private placement in balance with the public offering market, to provide medium or small size enterprises with various financing methods and to provide investors [with investment products] that meet their needs.

Under the new system, in consideration of the plan for increasing investor protection as mentioned below,[31] the new SEA defines the handling of private placement of securities as a securities business[32] and applies restrictions against unfair trade practice to private placement. At the same time, financial institutions, including banks, can directly handle private placement upon approval from [the Minister of Finance].

Corresponding to the above, each act licensing and regulating a financial institution, including the Banking Act, has been amended to provide regulations regarding the handling of private placements.

(2) [Raising funds through] private placement activities is a kind of financing.[33] Banks have directly engaged in such business and have contributed to the steady development of the private placement market.

This business [of handling private placement] was regarded as business incidental to "banking businesses" (lending funds),[34] until the current reform. Under the new system, in consideration of the recent growth of the private placement market, the SEA provides new provisions relevant to private placement. The new Banking Act also explicitly addresses private placement. The new provision of Article 10, Paragraph 2, Item 6 refers to *Yūkashōken no shibono toriatsukai* ("handling of private placement of securities") [as one of incidental businesses to Banking Business]. In addition, Paragraph 6 provides "handling of private placement of securities under Paragraph 2, Item 6 handling of private placement (defined under Article 2, Paragraph 8, Item 6 of the SEA (definition))." (In addition to the Banking Act, each act licensing and regulating a financial institution has been amended to regulate the handling of private placements, based on the above mentioned understanding.)

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31 [Translators' Note] *See infra*, p. 213.

32 [Translators' Note] *See supra* note 10.

33 [Translators' Note] Although private placement involves securities, it is substantially equivalent to a loan because investors (lenders) are specified and investors are few in number.

34 [Translators' Note] *See supra* note 9.

V. DEREGULATION OF BUSINESS ACTIVITIES OF COOPERATIVE FINANCIAL INSTITUTIONS

[Omitted.][35]

VI. INSURING THE SOUNDNESS OF FINANCIAL INSTITUTION

The System Reform Act provides measures to insure the operational soundness of financial institutions, including provisions setting *Jikoshihon hiritsu kisei* ("Capital requirements") [Required ratio capital to assets]. Such provisions are needed to counter the risk involved in beginning new businesses under the new system. In addition, such provisions are necessary to insure the operational soundness of financial institutions and the stability of the financial system under circumstances in which management conditions have become unstable due to the progress of deregulation of deposit interest rates.[36]

1. Legal Power to Establish Standards [To Evaluate the Operational Soundness of Financial Institutions], Including Capital Requirements

A financial institution's capital is the ultimate source of its ability to pay its debts and therefore, it is the duty of each financial institution to increase adequate capital. Under the new system, based upon advice in the report of the FSRC issued in January, 1992, an act licensing and regulating each financial institution provides the appropriate authority [the Minister of

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[35] [Translators' Note] Under the new system, the scope of businesses of regional corporative financial institutions is deregulated for the purpose of meeting the demands for financial services by regional people

[36] [Translators' Note] Under a regulated system, every bank offered the same interests rates on the same kinds of deposits. Regulated interest rates were common to both the U.S. and Japan e.g., "Regulation Q" (artificial restrictions on interests rates on deposits in U.S.A., were abolished in 1980s). In Japan, strictly regulated deposit interest was based upon the idea that the stability of financial institutions' operations enabled them to provide the public with funds necessary to recover from the damage of World War II.

However, the development of securities markets (unregulated interests market) in 70s–80s had an impact on regulated deposit interest rates. Banks were afraid that funds invested in deposits (regulated interests) were shifting to the securities market ("disintermediation"). Since the first issuance of negotiable certificates of deposits in 1979, deregulation of interests rates on deposits has progressed in Japan. *See* INTRODUCTION TO MODERN FINANCE, *supra* note 3, at 130–140.

Finance] with the power to establish [standards to evaluate the operational soundness, including] capital requirements.[37]

It is expected that detailed standards to evaluate the operational soundness of banks shall be provided by an announcement by the Minister of Finance, based upon the advice of the report referred to above.

2. *Introduction of a "Consolidated Basis" Regulation [of Financial Institutions] Regarding a Single Customer's Line of Credit From a Parent Bank and a Trust and Banking Subsidiary*

(1) Under the relevant statute [Article 13, Paragraph 1 of the old Banking Act], *Oōguchi shinyōkisei* (the "Line of Credit" regulation) [a regulation regarding the maximum line of credit to a single customer] has been implemented. The regulation prohibits financial institutions, including banks, from excessive financing of individuals or individual companies. The System Reform Act provides for the line of credit regulation on a "consolidated basis". This regulates the furnishing of credit by a bank and its trust and banking subsidiary so that the Line of Credit regulation is effectively enforced. (In addition, many advanced countries have already adopted the Line of Credit regulation on a consolidated basis. Introduction of the new system follows the international trend and is prudent.)

(2) Details of the Line of Credit regulation

[Summary: Article 13, Paragraph 1 of the Banking Act provides the formula: "the total amount of capital and reserve" multiplied by "A ratio provided in a Cabinet Ordinance" constitutes the maximum amount of credit (*Shinyōkyōyo gendogaku*) for a bank to furnish to a individual or individual company for "each type of credit provided in a Cabinet Ordinance". In the

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[37] [Translators' Note] *Jikoshihon hiritsu* ("Capital ratio") means the percentage of capital (including paid-in capital, reserves, surplus etc.) compared to the risk assets (loans etc.). This percentage is used to evaluate the operational soundness of a corporation.

In December, 1987, an agreement on risk-based capital adequacy regulations was announced by the Central Banks of twelve nations, including the U.S. and Japan. Pursuant to the agreement, capital requirements for total risk assets must be at least eight percent by 1992. To meet such regulations, Japanese banks, whose percentage of capital/risk assets used to be about three percent in 1987, needed to raise their capital levels, and were discouraged from making a lot of loans. Many Japanese banks issued large amounts of subordinated bonds in the Euro market to meet the regulations by 1992 because a part of the funds raised from subordinated bonds are regarded as capital for the purpose of calculating the regulations. One commentator said that one underlying purpose of the regulations is to discourage Japanese banks' excessively aggressive business activities abroad. See INTRODUCTION TO MODERN FINANCE, *supra* note 3.

"consolidated basis" Line of Credit regulation, the same principle is applied.[38] The type of credit provided in a Cabinet Ordinance is expected to be "Loan" and "Other type of financing", both on "consolidated basis" and "non-consolidated basis". In both bases, the ratios with respect to "Loan" credit are expected to be twenty percent. End of summary.]

3. Promotion of Disclosure

[Summary: Disclosure has the effect of regulating a financial institution's operation and assets because it provides its customers and the public with an opportunity to scrutinize their operations. Therefore, disclosure is an effective method to promote a financial institution's effort to insure the soundness of its management.

Each act licensing and regulating a financial institution, including Article 21 of the Banking Act, provides special disclosure provisions, in addition to disclosures which companies must make under the Commercial Code and the SEA. The System Reform Act further extends such special disclosure requirements to cooperative financial institutions which were not required to disclose under the old system. End of summary.]

VII. AMENDMENT TO THE SEA AND THE FOREIGN SECURITIES TRADERS ACT

We will discuss the main points of the amendment to the SEA and the Foreign Securities Traders Act.

1. Change of the Definition of Yūkashōken (Securities)

(1) Change of the definition of securities

A. Need for Amendment of the Definition of Securities

The old SEA in our nation only applied to stock certificates, bonds, and [other traditional form of securities]; it did not apply to various securitized products expected to develop in accordance with the promotion of securitization of finance from this time on.[39] However, it is appropriate to

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[38] [Translators' Note] *See* Article 13, Paragraph 2 of the Banking Act.

[39] [Translators' Note] *See supra* note 30.

apply the framework of investor protection provided in the SEA, such as disclosure, protection of fair trades, and so forth, to such new financial products. The purpose for changing the act is to enable the SEA to widely regulate securitized products which are suitable for investment (*tōshisei*) and have transferability (*ryūtsūsei*).

B. Change of the Definition of Securities

[Article 2, Paragraph 1 of the new SEA]

The notion of "Securities" expressed in Article 2, Paragraph 1 of the old SEA is based on that of the Civil Code and the Commercial Code, i.e. an instrument or a certificate representing rights. (The instrument or certificate is indispensable to execute or transfer the right embodied therein.) The new SEA follows this concept.

[Summary: Under Article 2, Paragraph 1 of the new SEA, securities are divided into three categories; (1) instruments that have been traditionally considered as "securities" such as *kabuken* (stock certificates), *kokusaishōken* (government securities), and *Shasaiken* (corporate bonds), are considered "securities" under the SEA; (2) instruments such as Commercial Paper ("CP") (Sub-Paragraph 8) and CARDS[40] (Sub-Paragraph 10) are mentioned but are only considered "Securities" if designated so by a ministerial ordinance (Foreign CP shall be automatically considered Securities, if domestic CP is designated as securities.), and (3) Sub-Paragraph 11 fully delegates to the Cabinet the power to designate by Ordinance a type of financial product, other than the above mentioned securities, as a security. It also clarifies the factors relevant to such designation, i.e. transferability and other conditions. (The authors are considering designating foreign CDs as "Securities" by means of a cabinet ordinance.) End of summary.]

[Article 2, Paragraph 2 of the new SEA]

Article 2, Paragraph 2 was amended so that Securities thereunder shall also include rights not to be embodied in instruments or certificates. This notion is

40 [Translators' Note] When companies engaging in financing (including banks) sell certain of their monetary claims (arising from financing) to a special purpose trust and the trust issues documents or instruments representing beneficiary rights to the trust of such monetary claims. Such documents or instruments are called "CARDs" by the authors.

a drastic change from the prior notion which required the existence of instruments or certificates embodying the rights. Under the old SEA, rights regarded as Securities without a corresponding issuance of instruments or certificates, included *only* [emphasis added] rights to be later embodied in securities listed in each subparagraph of Article 2, Paragraph 1. However, under the new SEA, the rights regarded as Securities without a corresponding issuance of instruments or certificates *also* [emphasis added] include rights not to be embodied in instruments or certificates but designated as Securities by Cabinet Ordinance. Article 2, Paragraph 2, subparagraph 1 provides that *Jyūtakurōn saiken shintaku jyuekiken* (beneficial rights to trusts of monetary claims arising from housing loan)[41] may be designated as Securities by a Cabinet Ordinance. In addition, other kinds of monetary claims [for repayment] can be designated as Securities by means of Cabinet Ordinance upon consideration of whether they are transferable and suitable for investment.

As result of the amendment to Article 2, Paragraph 2, it is usually not clear who is the issuer of securities where such securities are rights not to be embodied in instruments or certificates. Therefore, Article 2, Paragraph 5 of the new SEA charges [the MOF] to declare, by ministerial ordinance, who issued each type of right as securities and when they were issued.[42]

The new system does not adopt the conceptual definition of Securities as used in the U.S.A. and the U.K.; (those two countries do not delegate the designation of securities to the Cabinet or the SEC). The introduction of a conceptual definition would create problems, i.e. the definition of Securities must be clear to the public because violations of disclosure and license requirements are subject to criminal penalties.[43]

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41 [Translators' Note] When companies engaging in housing loan (long term finance for acquiring or constructing house/land) sell certain of their monetary claims (arising from housing loan) to a trust and the beneficial rights to such trust are created, such beneficial rights can be designated as "Securities" under the SEA, regardless of whether instruments or documents representing such rights are issued.

42 [Translators' Note] The "issuer of securities" is responsible for various regulations, i.e., disclosure requirements, under the SEA.

43 [Translators' Note] The SAEC Report recommended that the definition of "Securities" should be conceptional just like as that of U.S.A.. (SEC v. W.J. Howey Co., 328 U.S. 293 (1946)). The SAEC Report raised some elements to define "Security" i.e. (i) investment of money (ii) in a enterprise to operate business or carry on assets (iii) with an expectation of profits (iv) from the efforts of others who operate the enterprise and (v) such rights of investors are transferable. Such definition of securities is obviously useful for investors' protection.

However, such conceptional definition was not adopted in the new SEA. In addition to the reasons described in the original text, the basic structure of SEA and administrative problems raised difficulties with a conceptional definition. Once an instrument is considered a "Security" under the SEA, only licensed securities companies (and banks, upon authorization) can handle such "Securities" under the

It is thought that if new securitized products emerge in the future and the authorities decide that application of the SEA's investor protection provisions is appropriate, the Cabinet will be encouraged to designate these products as Securities by way of Cabinet Ordinance. The decision whether to apply the investor protection provision under the SEA depends on the nature of the product, i.e. whether the product is transferable between investors and suitable for investment [income gains are expected]. The above mentioned two factors come from the underlying intention of the SEA to regulate "transferable" securities. Such intention is implied in (a) public disclosure requirements and (b) restrictions against unfair trade practice addressed to "anybody" in the SEA's regulations.

(2) Handling by Financial Institutions

Some securitized products which fall into the new definition of securities under the new SEA have been handled by financial institutions as intermediaries. Therefore, the new SEA provides that financial institutions themselves can directly handle short term (less than 1 year) financial products such as CP and securitized products involving financial institutions' assets, such as CARDs, with approval under Article 65–2 of the new SEA (Article 65, Paragraph 2 of the SEA). If financial institutions would like to deal with securitized products other than CP and CARDs, these products must be designated by a cabinet ordinance as Securities that banks can handle.

In addition, Supplementary Article 26 of the new SEA provides that a financial institution operating as an intermediary with regard to the above mentioned financial products on the effective date of the new SEA shall be deemed as having obtained the necessary approval.

2. *Amendments to the Definition of "Public Offering" and the Treatment of "Private Placement"*

(1) Amendment to the Definition of "Public Offering"

The old SEA defined [the act of] solicitation of an offer to buy the securities from "unspecified and many" persons (an administrative circular defines "unspecified and many" as about fifty persons or more) under the

SEA (*Supra* note 12) and MOF is responsible for regulating such instruments. From a practical view, it would be difficult for MOF to regulate such various kinds of instruments.

"same conditions" as a *Boshū* ("public offering") [offering newly issued securities] or *Uridashi* ("public selling") [public selling of already issued securities]. Issuers of securities in this case were required to provide investors with information necessary to make proper investment judgments (disclosure).

Article 2, Paragraph 3 of the new SEA provides the following amendments with respect to "public offerings":

[a. Minimum number of offerees in a "public offering"]

At first, the minimum number of offerees in a "public offering" shall be clarified under the law by means of a cabinet ordinance. (A cabinet ordinance will define it as "fifty persons or more".)

[b. Nature of potential investors—exception to the SEA's disclosure requirements]

The new SEA also considers the nature of potential investors. If the offerees are limited to *Tekikaku kikantōshika* ("eligible institutional investors") who have sophisticated knowledge and experience with respect to investments in securities, solicitation of such investors shall not be considered a "public offering", even if the number of the offerees exceeds the minimum number mentioned above. (a ministerial ordinance will define such "eligible institutional investors" so that the effectiveness of the disclosure system will not be harmed.) Such exception is subject to the below mentioned restriction on the resale of these securities so that the SEA's disclosure requirements are not evaded [through the resale of these securities by sophisticated investors to the public.]

[c. Distinction of a "public offering" and "private placement" under the new SEA]

Taking into consideration the above mentioned ideas of [minimum number of offerees in a public offering, consideration of the nature of investors and] restriction of resale of securities [from initial purchasers to the public], only the following cases will be considered as a "private placement" under the new SEA and relevant cabinet ordinances:

If the number of offerees is small [fifty or less], (a) in the case of offering securities other than stock, the sale of securities is subject to the condition that such securities can not be resold *unless* all the securities are resold at the same time, or (b) in the case of offering stock certificates, such stock certificates are other than listed stock certificates and those traded over–the–counter; and

If the offerees are limited to eligible institutional investors, the objects sold are securities rather than stock certificates and the offering is subject to a prohibition of reselling to persons rather than eligible institutional investors.

In addition, the new SEA abolished the "same conditions" requirement. The new SEA also sets the period during which to calculate the number of offerees at six months [for the purpose of applying the definition of "public offering"].

On the other hand, "public selling" is a kind of solicitation of offers to buy [already issued] securities and, therefore, the new Article 2, Paragraph 4 and relevant cabinet ordinances clarify only the minimum number of offerees involved in "public selling".[44] (The minimum number requirement will be the same as in a "public offering.")

(2) Handling of "Private Placement"

Taking into consideration the development of institutional investors and the increased variety of funding methods available to prudent medium and small size companies, it is thought that funding by private placement will increase in the future. Therefore, the new SEA intended to expand its investor protection framework to the targets of private placements. The new SEA defines private placement as "solicitation of an offer to buy newly issued securities through an offering which does not fall within the definition of public offering" and provides that operations with respect to private placement fall into the category of "securities business" (Article 2, Paragraph

44 [Translators' Note] In public selling, "same condition" requirements are still applicable. Otherwise, parties who sell securities are frequently required to follow strict disclosure requirements because public selling is a kind of solicitation of an offer to buy previously issued securities rather than newly issued securities.

8, Sub–Paragraph 6 of the SEA).[45] Therefore, such operations are subject to restrictions against unfair trade practice under the new SEA.

Banks have long been involved in private placement as intermediaries. In recognition of this practice, Article 65, Paragraph 2, Item 4 of the new SEA provides that financial institutions can directly handle private placements with approval [of the Minister of Finance] under Article 65–2 of the SEA.

In addition, banks engaging in private placement intermediary business on the effective date of the new SEA are eligible for automatic authorization [to continue in this business], granted under Supplemental Article 26 of the new SEA.[46] A Securities company possessing a license pursuant to Article 28, Paragraph 2, Item 4 of the *old* SEA[47] is eligible for a license [including private placement] automatically granted under Supplemental Article 21 of the *new* SEA.[48]

(3) Amendment to the disclosure system

Under the new SEA, the disclosure system was amended corresponding to changes in the concept of public offering. In addition, the following amendments were made in the disclosure system itself.

At first, *Keizoku kaiji gaisha* (regularly reporting companies), which were required to regularly submit *Yūkashoken hōkokusho* (securities reports), were issuers of listed, OTC, or publicly offered securities. Under the new SEA, a company whose securities (it is thought that a cabinet ordinance will designate stock certificates as such securities) are held by a certain number of persons (it is thought that a cabinet ordinance will provide the number as 500 persons) or more will also be subject to such disclosure requirements.

In addition, the new SEA provides new disclosure requirements according to the nature of securitized products. One such requirement

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45 [Translators' Note] *See supra* note 10.

46 [Translators' Note] Under Supplementary Article 26 of the new SEA, if banks engaging in the intermediary business on the effective date of the new SEA submit relevant notification with Minister of Finance within three months thereafter, such banks are regarded as having obtained authorization necessary for such business.

47 [Translators' Note] License pursuant to Article 28, Paragraph 2, Item 4 of the old SEA covers "distribution business;" handling of private placement is a kind of distribution businesses under the new SEA (*See supra* note 10).

48 [Translators' Note] Under Supplementary Article 21 of the new SEA, if securities companies licensed pursuant to Article 28, Paragraph 2, Item 4 of the old SEA on the effective date of the new SEA submit relevant notification to the Minister of Finance within three months thereafter, such securities companies are regarded as having obtained a license pursuant to Article 28, Paragraph 2, Item 4 of the new SEA which covers handling private placement.

concerns asset based financial products, e.g., the beneficiary rights to a trust of housing loan claims. The new SEA requires disclosure regarding the management and operation of each asset upon which a line of financial products is issued, for each calculation period.

3. Moving into New Business Lines

(1) Banks' Subsidiaries for Securities Business and Securities Companies' Subsidiaries for Banking Business

The NBS System is the best choice to promote effective and proper competition in accordance with the policy justifications behind Article 65 of the SEA (safeguards against conflicts of interest, protection against market control by banks and their influence over industry, and insuring the operational soundness of banks) and the prohibition of holding companies under the Anti–Monopoly Law.

Under the new system, the Minister of Finance can grant a securities license to a subsidiary company fifty percent or more of whose shares are held by a bank (Article 65–3 of the new SEA). A securities company may possess a subsidiary bank after receiving approval from the Minister of Finance (Article 43–2 of the new SEA). In addition, insurance companies will also be able to move into new business lines after amendments to *Hokengyōhō* (the Insurance Business Act) (Law No. 41 of 1939, as amended) and to relevant cabinet ordinances.

(2) Safeguards Against Harmful Side Effects [firewalls]

A. Basic Ideas Regarding Safeguards Against Harmful Side Effects

Safeguards against harmful side effects have a very significant role in Article 65 of the SEA.

On this point, the SAEC Report identified 11 areas for safeguards against harmful side effects. The Report recommended the creation of provisions and ordinances to enable the authorities to insure the effectiveness of such safeguards. The Report also recommended that the contents thereof must be flexible so that they can properly respond to changed circumstances in the securities market.

Authors' Note: The SAEC Report recommended the establishment of regulations on the following 11 items:

(a) A securities subsidiary is exposed to the very same risks as is its parent company.

(b) A securities subsidiary's business overly depends upon transactions with a certain entities.

(c) To [assist in] collect[ing] the monetary claim of a parent company from an enterprise in financial difficulty, its securities subsidiary underwrites and sells securities issued by the enterprise.

(d) A securities subsidiary underwrites securities issued by its parent company.

(e) To support the business of its securities subsidiary, a parent uses direct power over a company issuing securities and [potential] investors, i.e., the parent company enters transactions with such parties upon especially favorable terms [in exchange for the company's or investors utilization of the subsidiary's services.]

(f) When a parent of a securities subsidiary makes a loan, the parent extends credit to its customer upon the condition that such customer purchase securities from the subsidiary.

(g) Transactions between a parent company and its securities subsidiary made upon conditions favorable to the subsidiary.

(h) A parent company purchases securities underwritten by its securities subsidiary within a certain time after such underwriting.

(i) Passing of undisclosed information regarding issuing companies or investors by a parent company to its securities subsidiary.

(j) Interlocking directors [between a parent company and its subsidiary] or the sharing of office space by a parent company and its subsidiary.

(k) A securities subsidiary underwrites securities issued by an entity over which a parent bank can exert influence.[49]

B. The SEA's Safeguards Against Harmful Side Effects (firewalls).

The SEA provides the following safeguards against harmful side effects.

With respect to interlocking directors, Article 42 of the old SEA prohibited a director engaging in the management of executive affairs of a securities company from engaging in the management of another company.

The new SEA has added some restrictions against interlocking directors based on considerations of safeguards against harmful side effects caused by transactions involving a parent company and its subsidiary. Article 42–2, Paragraph 1 thereof prohibits all the directors or statutory auditors of a securities subsidiary from taking a position as a director or statutory auditor in its parent company or working as an employee thereof. Article 42–2, Paragraph 2 also prohibits directors, statutory auditors or employees of a parent securities company from taking a position as a director or a statutory auditor in its subsidiary. An exemption to the prohibitions on interlocking directors under article 42 of the old SEA and 42–2 of the new SEA can be obtained with the approval of the Minister of Finance. Due to the policy behind Article 65, this exemption is not available when the relevant securities company's parent is a bank or the relevant securities company's subsidiary is a bank.[50]

In addition, a securities company, its directors or statutory auditors are prohibited from taking the following actions (Article 50–2 of the new SEA):

(a) A securities company entering into a securities transaction with its parent or subsidiary company based upon conditions different from those of ordinary transactions. (Item 1)

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49 [Translators' Note] If a company whose net assets are less than 500 billion Japanese Yen (about $5 billion) issues securities and a parent financial institution (bank) acts (or acted within preceding two years) as lead trustee for issuing shares of the company, a securities subsidiary shall not assume lead managing underwriter status. This idea is announced in *Kinyūseidokaikaku jitsushino gaiyōni tsuite* (the "Outline of Enforcement of Reformation of Financial System") and adopted in relevant ordinances. *See supra* note 17. According to an official of MOF (Tadashi Iwashita, *Outline of cabinet and ministerial ordinances regarding the Financial System Reform Act*, No. 1334 KINYŪ HŌMUJIJYŌ 10), the number of companies (other than financial institutions) whose net assets are 500 billion Japanese Yen or more is said to be in the 30s.

50 [Translators' Note] *See* Article 42–3 of the new SEA.

(b) A securities company entering into a securities transaction with its customers knowing that its parent or subsidiary company provides credit to the customer on the condition that the customer transacts business with the securities company. (Item 2)
(c) Other actions by a securities company involving its parent or subsidiary company, designated by a ministerial ordinance of MOF. (Item 3)

A cabinet ordinance will provide detailed criteria to determine whether a parent–subsidiary relationship is subject to the above mentioned safeguards against harmful side effects. These criteria will focus on the capital relationship of the involved companies (including subsidiary's subsidiary) and man–power relationship, e.g., whether more than half of directors or statutory auditors of a subsidiary are provided by a parent company.

It is thought that the safeguards against harmful side effects are intended to secure the fairness of securities transactions. Therefore, *Shōkentorihikitō kanshi iinkai* (The Securities & Exchange Investigation Commission) can investigate whether securities companies comply with such regulations. In addition, this investigation can extend to a securities company's parent bank or subsidiary bank under Article 55, Paragraph 2 of the old SEA.

Furthermore, the relevant authorities [the MOF] will endeavor to cover, by a ministerial ordinance, any of the 11 items referred to in the SAEC Report which were not covered under the Act.

(3) Scope of Business of Securities Subsidiary

With respect to the scope of business of securities subsidiaries, a bank's securities subsidiary or a bank's subsidiary's subsidiary (excluding foreign banks) is prohibited from engaging in the brokering of stocks for an unspecified period (Supplemental Article 19, Paragraph 1 of the new SEA). The policy justification behind this is that such securities companies are charged with performing their brokerage business properly. At the same time, the securities company is a subsidiary of a bank which usually holds huge number of shares [being handled by the subsidiary]. Furthermore, the stock brokerage business is a main business of small securities companies.

In addition, if a bank (excluding foreign banks) purchases a pre–existing securities company directly or indirectly, the authorities [the Minister of Finance] can prohibit such subsidiary or subsidiary's subsidiary from engaging in the brokerage of stocks (Supplemental Article 19, Paragraph 2 of the new SEA).

The permissible scope of initial businesses for a bank's securities subsidiary is now being discussed, based on the following considerations: promotion of competition by introduction of new participants to the capital market, effectiveness and revitalization of the market and assurance of fair competition.

The general rule is that a securities subsidiary shall be a newly established company. [The authors think that the] cases in which a securities subsidiary purchased by a bank can engage in the brokerage of stocks are limited to situations when such subsidiaries are nearly insolvent securities companies ordered to preserve their assets and change their operations pursuant to Article 54 of the SEA.

4. Change of the Foreign Securities Dealers Act

In accordance with the change in the SEA, *Gaikokushōkengyōshani kansuru hōritsu* (the Foreign Securities Dealers Act) (Law No. 5 of 1971) ("FSDA") has been changed with respect to foreign banks entering into the securities business in Japan.

Under the old system, the "fifty percent rule" provided that a securities subsidiary of which more than fifty percent of its stocks is held by a foreign bank can not establish a branch in Japan because such a securities company is regarded as having a close relationship with an ineligible entity. Under the new system, the "fifty percent rule" has been abolished because the SEA now allows a bank to possess a securities subsidiary (Article 6 of the FSDA). In addition, Article 17 of the FSDA applies safeguards against harmful side effects similar to those of the new SEA to a foreign securities company of which more than fifty percent is held by a foreign bank (it is thought, however, that such safeguards against harmful side effects are limited to the relationship between a foreign securities subsidiary and the foreign bank's branch in Japan or with such foreign bank's trust and banking subsidiary in Japan). In addition, there are no limitations to the scope of the business of a securities subsidiary of a foreign bank under the relevant acts and ordinances.

Under the above mentioned amendment, foreign banks have three options for moving to securities business in Japan: (i) to establish a branch of a foreign securities company of which a fifty percent or less shares are held by the foreign bank (such branch would not be subject to safeguards against harmful side effects referred to above), (ii) to establish a branch of a foreign securities company in which more than a fifty percent shares are held by the foreign bank (subject to safeguards against harmful side effects referred to above), or (iii) to establish a securities subsidiary in which more than a fifty percent of its shares are held by the foreign bank (subject to safeguards against harmful side effects referred to above).

(Note: Opinions mentioned in this Article are the private opinions of the authors.)