



# SECURITIES REGULATION & LAW



VOL. 42, NO. 34

**REPORT**

AUGUST 23, 2010

## INTERNATIONAL DEVELOPMENTS

### Regulatory Registrations Under Japan's Financial Instruments and Exchange Law



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**T**he Japanese regulatory framework for financial instruments business operators was changed significantly from October 1, 2007 with the changes that came into effect under the Financial Instruments and

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*Terms in capital letters not otherwise defined herein are used with the meanings specified in prior articles in this series. This content of this article is necessarily summary in nature and should not be viewed as legal advice. It is prepared as background information for the international legal community and other interested persons. The explanations herein should not be acted upon in any specific situation without appropriate legal advice from a qualified Japanese lawyer.*

Exchange Law ("FIEL"). The FIEL covers the business of soliciting and dealing in financial instruments (including equity and fixed income securities and derivatives instruments) and is the centerpiece of the regulation of financial instruments and financial instruments businesses in Japan.

The following is a brief outline of the principal registrations and licenses under the FIEL covering the major categories of financial instruments businesses permitted thereunder. Entities engaged in a "financial instruments trading business" ("FIB") in Japan must be registered with the FSA or Kanto Local Finance Bureau as a financial instruments business operator.

#### **1. Type 1 Financial Instruments Business (the "Type 1 FIB")**

Under the FIEL, "securities" are broadly separated into two categories. Paragraph 1 of Article 2 of the FIEL defines the financial instruments deemed to be included in the first category of securities (the "Paragraph 1 Securities") while Paragraph 2 of Article 2 of the FIEL de-

fines the second category of securities (the “Paragraph 2 Securities”).<sup>1</sup>

Paragraph 1 Securities include financial instruments such as shares of capital stock companies, bonds, beneficiary interests of investment trusts, warrants and commercial paper. Paragraph 2 Securities include certain “illiquid” financial instruments such as interests in limited partnerships, limited liability partnerships and limited liability companies.

Subject to certain exceptions, any party engaging in the marketing and distribution of Paragraph 1 Securities is required to hold a Type 1 FIB registration or a Financial Instruments Sales Intermediary registration (the “FI Intermediary”).<sup>2</sup> Similarly, any party engaging in the marketing and distribution of Paragraph 2 Securities is required to register as a Type 2 FIB.

The Type 1 FIB registration allows registrants to engage in businesses involving Paragraph 1 Securities, including the activities of, trading, acting as an intermediary or broker, undertaking market derivative transactions, engaging in primary and secondary public offerings, brokerage of securities clearing, engaging in OTC derivative transactions, intermediation, brokerage or acting as agent in OTC derivative transactions and other businesses involving Paragraph 1 Securities.<sup>3</sup>

The FI Intermediary services include the conduct of intermediation of a variety of financial instrument transactions including securities transactions, securities index future transactions and securities option transactions on stock exchanges, as well as foreign securities transactions and foreign securities future transactions on foreign stock exchanges. Since a FI Intermediary is acting as an intermediary for its sponsoring securities broker-dealer, the FI Intermediary may market only those securities products that the sponsoring securities broker-dealer is permitted to market to investors in Japan. For instance, a FI Intermediary may not market a foreign securities product to Japanese investors if that product has not been registered by a sponsoring securities broker-dealer with the Japanese regulators for distribution in Japan.

FI Intermediary services are limited to intermediation services between an investor client and the sponsoring securities broker-dealer that the FI Intermediary is serving. Consistent with this structure, the actual securities trading contracts and other securities related contracts are to be made in the names of the sponsoring securities broker-dealer and the investor client. This means that as intermediaries, FI Intermediaries are not permitted to receive or handle cash or instruments in connection with a securities acquisition transaction with the investor. In other words, a FI Intermediary may only undertake securities marketing activities and may not undertake any back office functions, all of which must be handled by the sponsoring securities broker-dealer.

## 2. Type 2 Financial Instruments Trading Business (the “Type 2 FIB”)

Type 2 FIB registration allows registrants to engage in businesses involving Paragraph 2 Securities, including primary offerings and private placements of certain

<sup>1</sup> Article 2 of the FIEL.

<sup>2</sup> Article 2(11) of the FIEL.

<sup>3</sup> Article 28(1) of the FIEL.

types of FIEL securities, such as domestic and foreign beneficiary certificates of investment trusts and limited partnership interests, trading, engaging in domestic or foreign derivative transactions, intermediation brokerage or acting as an agent in trading and ordering, brokerage of securities clearing, primary and secondary public offerings, domestic and foreign derivative transactions and other similar businesses involving Paragraph 2 Securities.<sup>4</sup>

The Type 1 FIB, Type 2 FIB and the FI Intermediary business are the key registrations required for parties to engage in the solicitation of securities of all types. The Type 1 Business registration is a more onerous registration with higher capital and staffing requirements, while the Type 2 Business registration can typically be achieved in a shorter time frame with relatively fewer resources.

## 3. Investment Management Business

The other two major registrations under the FIEL are not related to the solicitation or offering of particular securities, but are instead involved with the management of financial assets on either a discretionary or non-discretionary basis.

The Investment Management Business is the combination of authorities to conduct business under two previous laws – (i) the investment trust management business under the pre-2007 Investment Trusts and Investment Corporations Law and (ii) the investment management business under the Investment Advisory Business Law – and the business of managing funds invested in or contributed to by holders of collective investment schemes.

The Investment Management Business registration is required for any party engaged in the discretionary investment of assets of third parties, including collective investment schemes (an “Investment Manager”).<sup>5</sup> An additional authority under this registration permits Investment Managers to sponsor, establish and manage securities investment trusts (Japanese mutual funds) through a trust agreement with a Japanese trust bank or trust company.

## 4. Investment Advisory and Agency Business

The Investment Advisory and Agency Business is the combination of the non-discretionary investment advisory business set out in the prior Investment Advisory Business Law and the newly defined business of acting as intermediary or agent for parties entering into either investment advisory agreements or investment management agreements.<sup>6</sup>

The Investment Advisory and Agency Business is defined as:

(i) the business of providing advice in connection with the value of securities, the value of securities related options or the trends in a securities index<sup>7</sup> or providing investment advice (with respect to the type, issues, quantity and/or price or whether to buy or sell securities that are the target of investment, etc.) based on

<sup>4</sup> Article 28(1) of the FIEL.

<sup>5</sup> Article 28(4) of the FIEL.

<sup>6</sup> The status of such intermediation business had been ambiguous under prior law.

<sup>7</sup> Article 2(8)(xi)(a) of the FIEL.

the analysis of the values of financial instruments pursuant to an investment advisory agreement<sup>8</sup>; and

(ii) acting as an intermediary or agent to enter into investment advisory agreements or investment management agreements.

The main distinction between the Investment Management Business and the Investment Advisory and Agency Business with respect to the provision of investment advice is the discretionary and non-discretionary characteristics, respectively. The Investment Manager registration is the more complex registration application, involving considerably higher staffing, compliance, operational and risk management resources. The degree of complexity will vary depending on the particular business model of the registrant, but the Investment Manager registration is considerably more complex than for the Investment Advisory and Agency Business registrant (the "Investment Advisor").

## 5. Capital Requirements and Form of Entity

The minimum capital requirement for a Type 1 FIB is JPY 50 million. However, because a minimum solvency margin of 120 percent must be maintained throughout the existence of such registrant entity, most firms actually invest considerably more than the minimum in capital. In general the FSA expects the minimum required capital to be invested in government securities. With respect to the required form of entity, only a Japanese public corporation (*kabushikikaisha*) or the Japan branch of a foreign corporation similar to a *kabushikikaisha*, may hold this registration.

The minimum capital requirement for a Type 2 FIB is JPY 10 million. Such capital must be maintained throughout the existence of the registrant; however, there is no solvency margin for a Type 2 FIB. Type 2 FIBs need not be in the form of *kabushikikaisha* and foreign legal entities (qualifying entities established outside Japan) may register to be Type 2 FIBs.

The minimum capital requirement for an Investment Manager is JPY 50 million. Such capital must be maintained throughout the existence of the registrant; however, there is no solvency margin for an Investment Manager. With respect to the required form of entity, only a Japanese public corporation (*kabushikikaisha*) or the Japan branch of a foreign corporation similar to a *kabushikikaisha*, may hold this registration.

There is no minimum capital requirement for an Investment Advisor. However, a security deposit of JPY 5 million is required to be made with the relevant depository office with the government at the time of registration. Investment Advisory and Agency Businesses need not be conducted through *kabushikikaishas* and foreign legal entities (qualifying entities established outside Japan) may register to conduct an Investment Advisory and Agency Businesses.

## 6. Compliance Function

Type 1 FIBs and Investment Managers are required to hire and retain a full-time compliance officer resident

<sup>8</sup> Article 2(8)(xi)(b) of the FIEL.

in the office in Japan. There are specific qualifications (set by the JSDA) required for a compliance officer of a Type 1 FIB. It is typical (and advisable) that the compliance officer for an Investment Manager have the same qualification or have equivalent experience in the past.

Type 2 FIBs and Investment Advisors are not required to have a full-time compliance officer, but the applications for these registrations must disclose an appropriate level of compliance oversight. In certain cases such oversight can be provided using a combination of offshore and outsourced resources.

## 7. Timing

Specific requirements and estimated required resources for each of the above outlined registrations can vary greatly depending on the particulars of each potential registrant. As some of these registrations can take a significant amount of time and resources, parties that are contemplating engaging in any of the above activities in Japan should be sure to discuss their regulatory requirements with knowledgeable advisors early in the planning stages.

In general, applicants should budget 6-9 months for the Type 1 FIB and Investment Manager registrations and 3-6 months for the Type 2 FIB and Investment Advisor registrations.

## 8. Periodic Registration Review and Activity Mapping

As the FIEL has been in effect since 2007, regulators in the current more vigilant regulatory framework fully expect all participants in the financial instruments business in Japan to have all necessary registrations and licenses and comply with the laws. This means that offshore legal and compliance officers should periodically review with their local staff and executives the types of activities the local enterprise is engaged in and "map" such activities on to the registration held by the local entity (as disclosed in the descriptions contained in the registrations).<sup>9</sup>

To the extent that there is the potential that activities could go beyond the scope of activity disclosed in the application, amendment or supplement of the application is advisable. In addition, in certain cases it may be prudent to obtain additional authority for the conduct of the business in the form of another registration. The reputational damage resulting from a regulatory sanction (e.g., a business improvement order or worse, a suspension) due to insufficient authority to conduct certain businesses can be severe in the Japanese marketplace.

<sup>9</sup> It should be noted that within the four main registrations certain additional activities beyond "core" activities may require additional, subordinate, authorizations. Discussion of the types of activities requiring such additional permission is beyond the scope of this article.