Sales Representatives Manual

Volume 1

2024

Japan Securities Dealers Association

Foreword

Financial instruments business operators and registered financial institutions play very important roles as market intermediaries in order to ensure that the financial markets can properly exert their function to distribute funds efficiently through market mechanisms, and they are entrusted with an important social mission.

Accordingly, Sales Representatives engaged in the financial instruments business are required to have a great deal of expertise in financial instruments, as well as a high awareness and consciousness of compliance and strong professional ethics.

To meet the goals above, the Japan Securities Dealers Association (JSDA) administers the Sales Representative Qualification Examinations in accordance with its self-regulatory rules from the perspective of achieving a suitable level of quality on the part of Sales Representatives, in order to ensure that Sales Representatives who belong to Association Members (financial instruments business operators and registered financial institutions) will respond to the trust placed in them by society and carry out their activities appropriately.

The present Manuals provide explanations concerning laws and regulations that people engaged in the Type I financial instruments business need to understand, as well as the various products and operations with which they deal in their business. These Manuals are expected to serve as reference materials for such people to acquire the knowledge necessary for acting as Sales Representatives.

The 2024 edition has been edited based on the laws, regulations, rules and systems, etc. in effect or publicly available as of September 1, 2023 in principle, which may be subject to revision in the future.

It should be noted that with the enactment of the Financial Instruments and Exchange Act in 2007, the legal names of entities such as securities companies and exchanges governed by this legislation have respectively been changed to financial instruments business operators, etc. and financial instruments exchanges. However, for the purpose of convenience and ease of understanding, in this text, some explanations have been made using preexisting expressions such as “securities company” or “stock exchange”.

These Sales Representatives Manuals are tentative translations for non-Japanese readers’ reference. Please be aware that the Japanese originals are the authoritative versions. While every effort has been taken to ensure the accuracy of the translations in these Manuals, the translation is mainly based on the available information at the time of publication of Japanese versions and as such may not reflect subsequent developments. No guarantee is made with regard to its accuracy, completeness, applicability or usefulness. Under no circumstances will the JSDA be liable for any direct, indirect, incidental, special, or consequential loss or damage caused by reliance on the content of these Manuals.

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Ⅰ Structure of Securities Markets

1 Financial System and Securities Markets

1-1 Financial Markets and Securities Markets

(1) Functions of Financial Markets

Diverse economic entities acting in society, ranging from the government, companies, and non-profit organizations such as hospitals and schools, to households (individuals), procure, supply and invest funds when engaging in economic activity. This causes the trading of funds between those who supply (fund providers) and those who demand (fund recipients), and funds are transferred. The place where such transactions occur is the financial market.

Between diverse economic entities, the total amount of funds in supply equals the total amount of funds in demand, but between different sectors of the economy, an excess or shortage of funds may occur and the amount of funds in supply and demand do not necessarily correspond to each other. The shortage and surplus of funds correspond to the difference between total savings and investments in each sector of the real economy. If there is a shortage of funds in a sector, the total amount of investments is greater than that of savings, while in the case of a surplus of funds in a sector the total amount of investments is less than that of savings.

Postwar Japan experienced a long trend in which a surplus of funds (excess savings) was present in the household sector, while a shortage of funds (excess investment) was seen in the corporate and government/public sectors. Since fiscal year 2005, however, the corporate sector has been showing a tendency of excessive savings (see Chart 1-1-1).

(2) Classification of Financial Markets

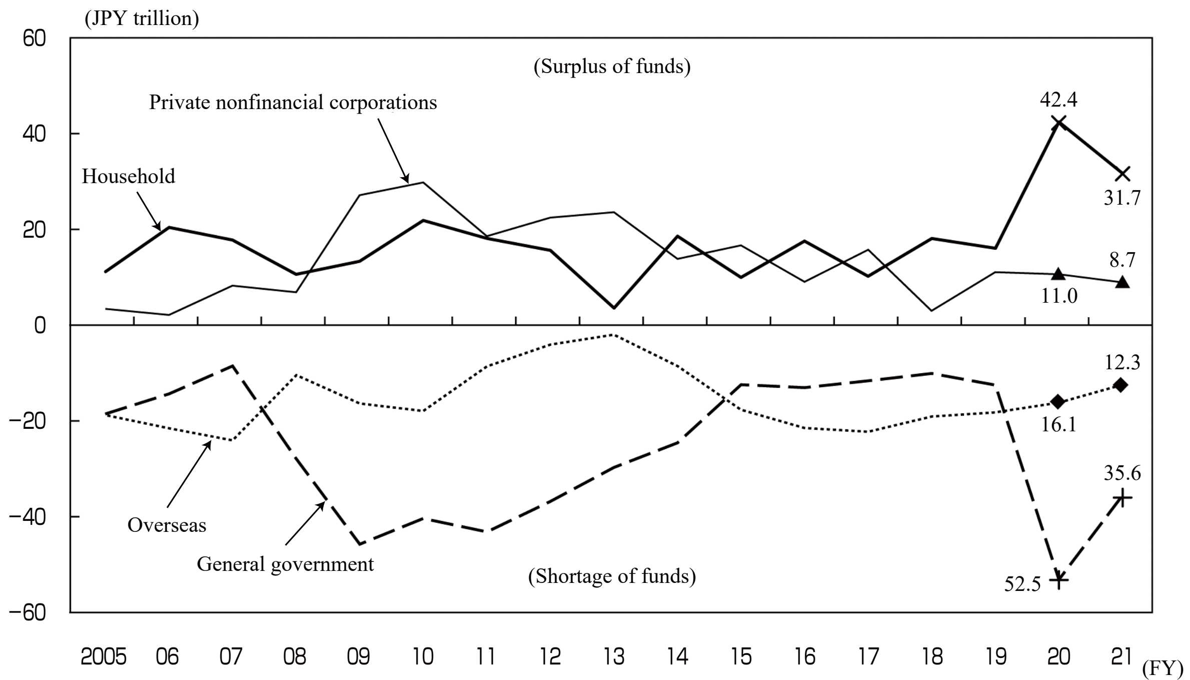
Financial markets can be classified into several types depending on the participants, contract terms, traded assets, and methods of transactions (see Chart 1-1-2).

Focusing on the participants of transactions, financial markets are largely divided into market-type transaction markets where an unspecified number of participants engage in transactions, and negotiation-based transaction markets where transaction takes place between specified participants such as depositors and banks or companies and banks. The market-type transaction markets are financial markets in a narrow sense.

Financial markets in a narrow sense are categorized according to the contract term of transaction, into short-term financial markets (one year or less) and long-term financial markets (more than one year). Short-term financial markets are further classified into interbank markets where only banks and other specified participants are eligible for transactions, and open markets where general companies may also take part in transactions. On the other hand, long-term financial markets are largely classified into bond markets, equity markets and financial derivatives markets.

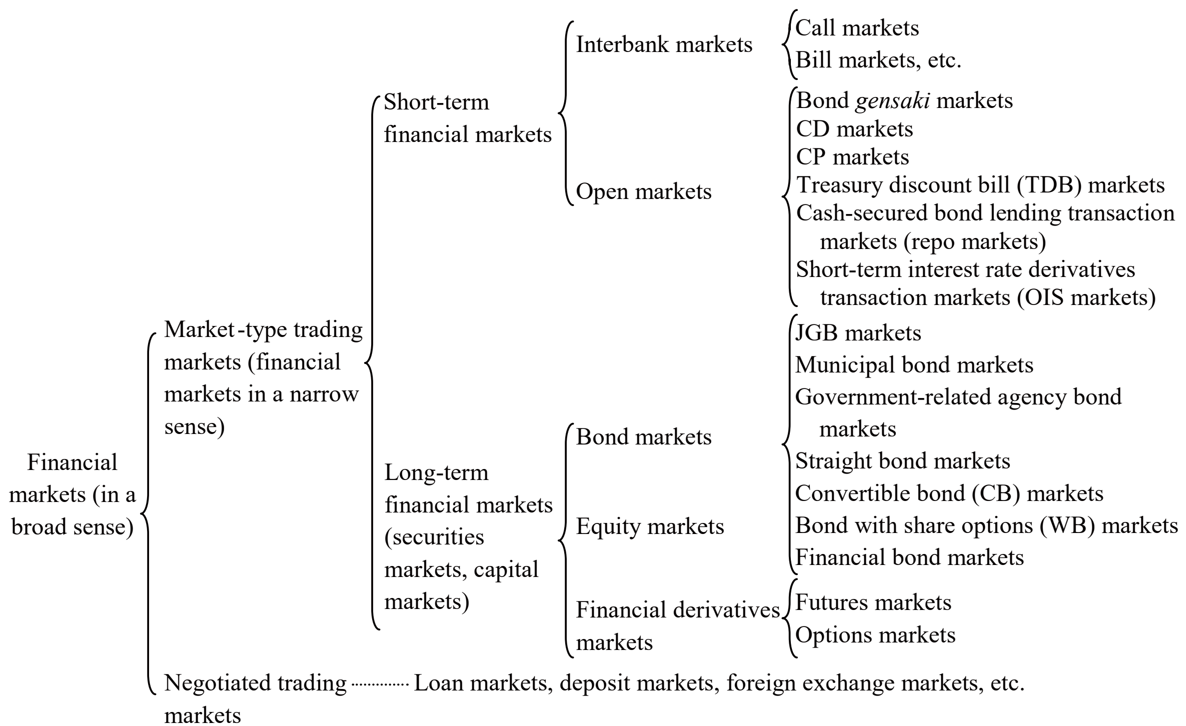
Negotiation-based transaction markets include loan markets, deposit markets and foreign exchange markets.

Chart 1-1-1 Surplus/Shortage of Funds by Sector



(Source) Bank of Japan, "Basic Figures of the Flow of Funds (Preliminary Figures, 1st Quarter 2022)"

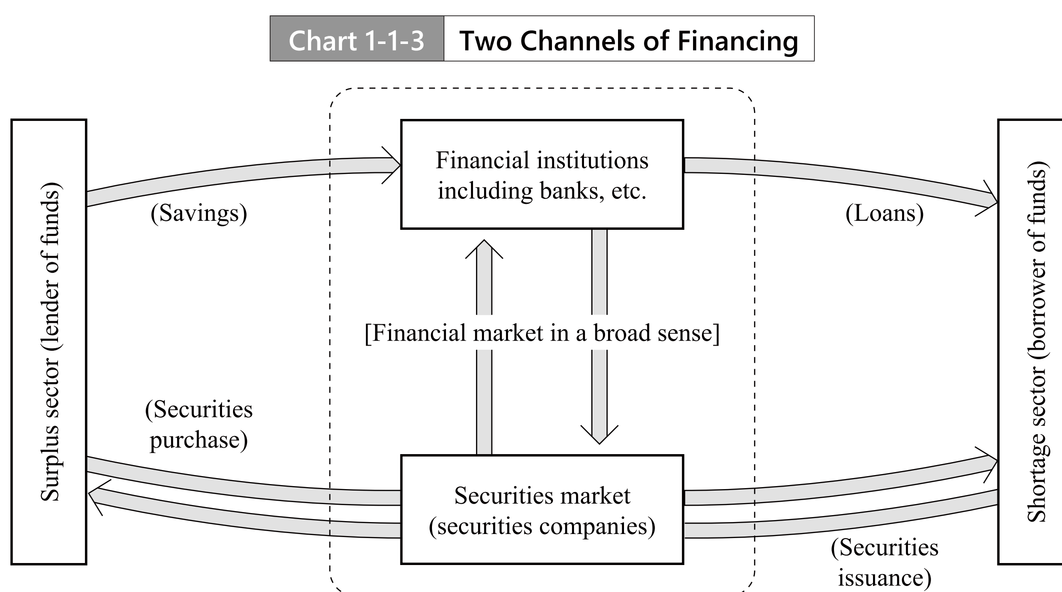
Chart 1-1-2 Classification of Financial Markets in Japan



1 2 Two Channels of Financing

The channels through which funds flow from suppliers (fund providers) to demanders (fund recipients) can be classified into (i) financial institutions, such as banks and insurance companies, and (ii) the securities markets. In channel (i), funds such as deposits and savings and insurance premiums collected from households (individuals) and other fund providers are supplied in the form of loans to fund recipients such as companies. This mechanism is called indirect financing. In channel (ii), fund recipients issue securities such as stocks and bonds and receive funds directly from fund providers. Looked at from a different angle, this is a mechanism in which investors (fund providers) supply funds to the companies they choose for investment, and this is called direct financing (see Chart 1-1-3).

Chart 1-1-3 Two Channels of Financing



With indirect financing, banks and other financial institutions that perform the financial intermediation function bear the risk of recovering the funds, while for direct financing, it is the fund providers (investors) that bear this risk.

Direct financing and indirect financing generally correspond to the flow of funds via securities markets and the flow of funds via financial institutions. However, if banks, using funds deposited by individuals (final fund providers), buy securities issued by companies, etc. (final fund recipients)in the securities markets, it may be appropriate to categorize this flow of funds as indirect financing. In this scheme, financial institutions allocate funds collected from fund providers to investment in securities traded in markets, rather than lending the funds directly to fund recipients. This can be referred to as “market-type indirect financing.”

The role of the financial markets is not only to reallocate funds from providers to recipients, but also includes various functions such as providing liquidity, the conversion of short- and long-term funds, reallocation of assets and income as well as distribution of risk. In the markets, while banks and other financial institutions play the role of collecting funds from fund providers such as households (individuals, etc.) and providing these funds to fund recipients, securities companies intermediate direct financing through which fund providers supply funds directly to fund recipients under various systems and rules in order to ensure that fund transactions are secure, fair, and efficient.

The financial mechanisms, systems and structures that include the structure of the markets and various systems and customs that were designed to realize the smooth and efficient flow of such fund transactions, and further such matters as the ratio of direct and indirect financing, are referred to in their entirety as the financial system.

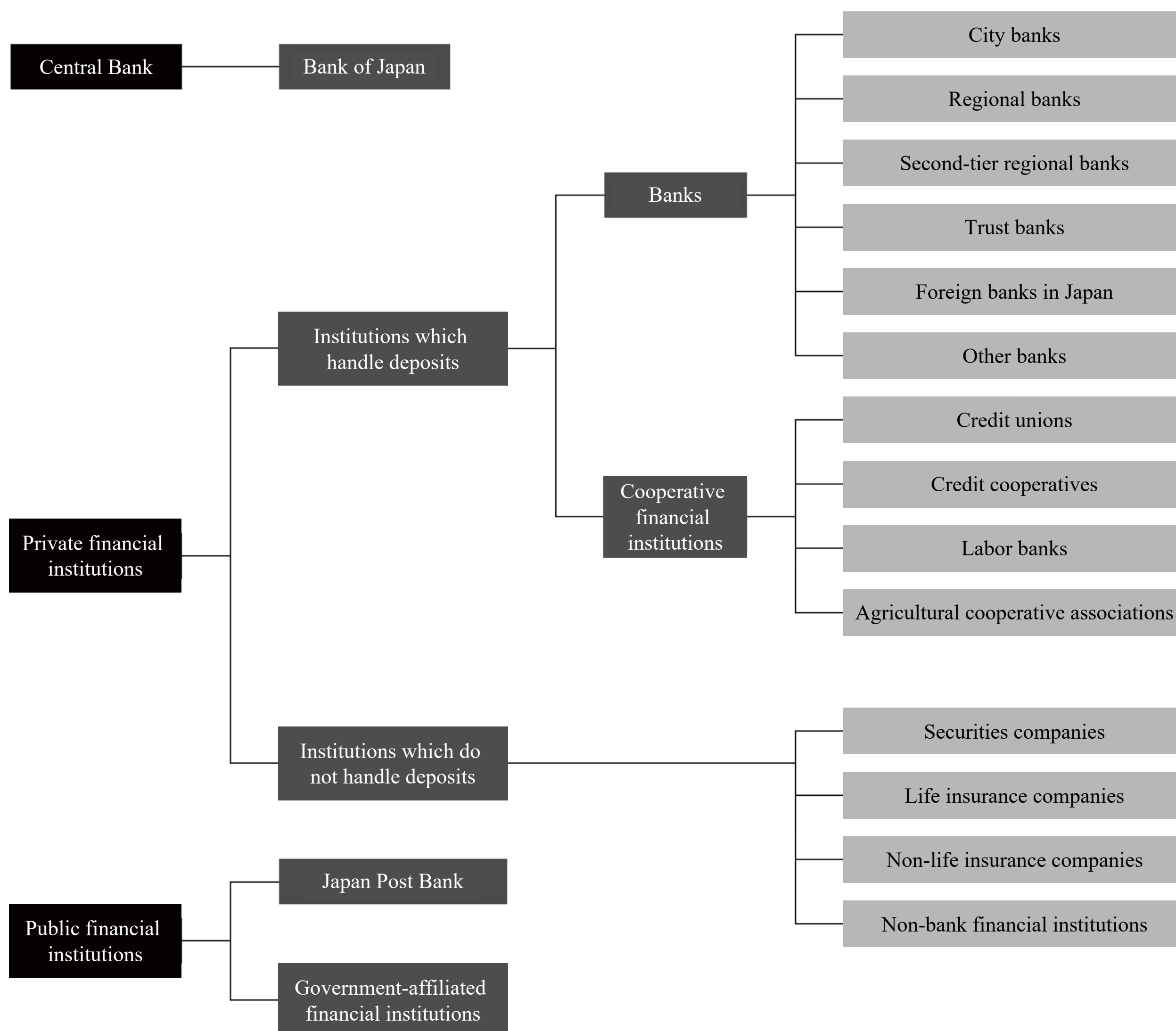
1 3 Banks and Securities Companies

Entities such as securities exchanges (referred to in law as financial instruments exchanges) and securities companies (referred to in law as financial instruments business operators) exist as the core of a securities market, and a number of laws and regulations have been established, aimed at the sound development of the national economy and investor protection. While financial institutions such as banks collect, manage, and invest funds at their own responsibility and then return the profits to the depositors, who are fund providers, in forms such as interest, securities companies provide investors, who are fund providers, with various types of information for investment and solicit them for investment, but the decision as to whether or not to acquire securities and the responsibility for that decision rest solely with the investors.

Consequently, the regulations for financial institutions, such as banks, focus on the credibility and the sound management of each institution, while the focal points of the foundation of a securities market are the disclosure system, which is designed to ensure the freedom and transparency of transactions, and the presence of “market rules” designed to ensure fair market transactions. (For details, see “2-5. Investor Protection and Depositor Protection”.)

As described above, the processes and procedures of banks and securities companies differ, but both types of entities serve as intermediaries between fund providers and fund recipients and enable the reallocation of funds. The securities market where securities companies serve as intermediaries lacks a payment settlement function, which is considered an important function of banks, and the securities markets serve as an important element of the financial system, within the context of the financial markets in the broad sense of the term (see Chart 1-1-4).

Chart 1-1-4 Japanese Financial Institutions



(Source) Masashi Nakajima and Takayoshi Shimamura, "*Kinyū Tokuhon (dai 32 han)* [Guide on Finance, 32nd edition]", Toyo Keizai, 2023.

2 Securities and Structure of Securities Markets

2-1 What Are Securities?

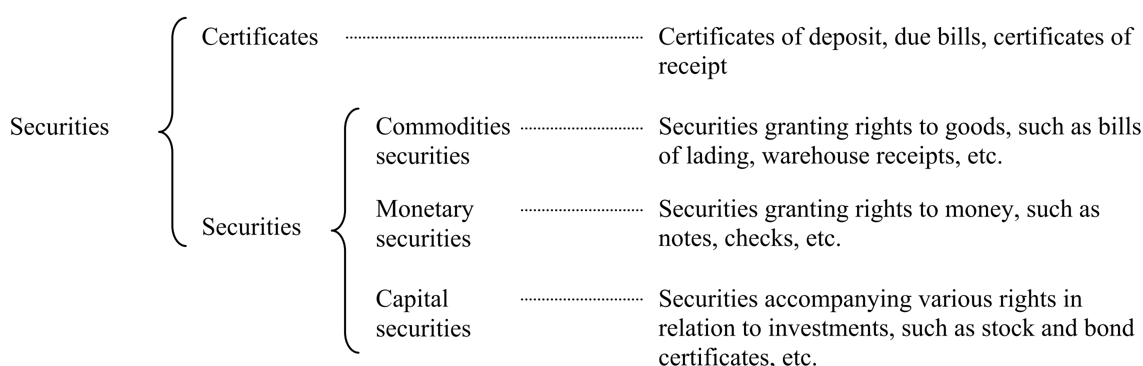
Although the terms "securities" and "negotiable securities" are used broadly, in law they can be classified as being either "securities" or "certificates." In general, the "securities" are securities that express property rights, and they need to be delivered upon the transfer (assignment) of those rights as stated on the certificate thereof. The "certificates," however, are securities that are simply proof of certain facts. In other words, while the rights are combined to (embodied in) the instrument in the case of securities, the certificates themselves can only be used as evidentiary materials to prove the existence of these rights.

Securities can be classified according to the economic contents of the property rights they represent, such as commodity securities, which embody the right to request a certain product or service; monetary securities, which embody the right to demand cash; and capital securities, which embody the rights of the provider of capital, such as the right to demand payment of income (see Chart 1-1-5).

In the narrow sense of the term, however, the term “securities” indicates capital securities that are the objects of trading in a securities market. The characteristics of these capital certificates are that, generally, they have fungibility, can be divided into specified units, and are marketable (*i.e.*, negotiable). In particular, share certificates and bonds are the objects of investment by individuals and a means to procure funds for corporations, and consequently, they play significant roles in the growth of modern economic society.

In general, when someone mentions securities, or negotiable securities, they mean these capital securities.

Chart 1-1-5 Classification of Securities



2 2 Primary and Secondary Markets

(1) Primary Market and Secondary Market

The securities market is classified into the primary market and the secondary market from a functional perspective.

The primary market is a market where investors first obtain new securities that are issued, either directly from the issuer or through a broker (underwriter = securities company, or financial institutions including banks, etc. for public bonds such as JGBs). The term “primary market” refers to the collective process by which newly issued securities are acquired by investors from issuers, and consists of the three parties of (i) issuers of securities, (ii) investors, and (iii) brokers. It is a market in the abstract sense since it does not exist as a specific marketplace such as the financial instruments exchanges that exist in the secondary market.

The secondary market, on the other hand, is a market where the securities that have already been issued and obtained by primary investors are then distributed as they are sold on to a second or third investor.

The trading methods and other features of the primary and secondary markets are very different. In the former, negotiated transactions are conducted between concerned parties, while in the latter, most of the trading is on the exchange market and is based on sophisticated trading methods.

Sometimes, secondary distribution of already-issued securities, such as a large stock sale by a large shareholder, has aspects similar to the new issuance of securities: selling pressure exists because a large volume of

securities is sold at one time and there exists an information gap between the seller side and investors, etc. Accordingly, under the Financial Instruments and Exchange Act (hereinafter referred to as the “FIEA”), secondary distributions of already-issued securities for which the solicitation is similar to that of new issuances are required to make the same statutory disclosure as the solicitation for sale (offering) of newly-issued securities.

(2) Interrelationship of Two Markets

The primary market and the secondary market are inextricably linked.

For example, if there were no active secondary market to liquidate securities held by investors, investors would not be able to invest in securities with any peace of mind. The result would be that new securities could not be issued. Since it is because of their liquidity that securities can be newly issued, the size of the primary market is affected by the level of activity in the secondary market. Moreover, the price of a security on the secondary market (market price) is a benchmark for pricing when new securities are issued, since this price is a direct indication of the investors’ evaluation of that security.

As such, a secondary market that conducts price formation fairly and continuously, and also possesses the ability to easily liquidate securities (high liquidity), is indispensable for the primary market to function. Both markets are interconnected.

2 3 Exchange Markets and Over-the-Counter Market

The secondary market is a generic name for the place where issued securities are traded (distributed) among securities companies and investors. It is classified into the financial instruments market established by the financial instruments exchanges (financial instruments exchange market) and other markets. Trading conducted on the former market is called “trading on exchange,” and trading on the latter includes the over-the-counter market, the PTS (proprietary trading system) operated by securities companies and negotiation transactions.

Trading on exchanges is highly organized in terms of systems and technics for trading. Trading on the financial instruments exchanges is conducted between securities companies with certain qualifications (the trading participant system), and securities traded on the exchanges are limited to the shares and bonds of corporations that meet certain criteria established by the exchanges (the listing system). Various rules are enacted such as the Articles of Incorporation, Business Regulations, Securities Listing Regulations and Brokerage Rules to ensure that a large volume trades will be executed without impediment and that fair prices will be formed, which includes the rule that trades are executed under the principle of competitive bidding within a certain time period. Trading is also under the strict supervision of the Financial Services Agency (FSA) and the financial instruments exchanges.

While trading on exchanges constitutes the main secondary market for stocks, exchange trades account for only a minor portion of the secondary market for bonds. This is because trading in bonds is mainly conducted as large transactions between institutional investors, and theoretically, the prices of bonds are calculated more easily than the prices of shares.

The securities traded on a financial instruments exchange are limited to those that satisfy certain listing criteria, and securities that do not satisfy such criteria or securities whose issuer does not wish for them to be listed are traded outside of a financial instruments exchange. Such transactions are conducted as negotiated transactions between securities companies or between customers and securities companies through their offices (counters).

Hence these transactions are called "over-the-counter (OTC) transactions."

While transactions at an exchange are conducted pursuant to the rules and regulations promulgated by the financial instruments exchange, over-the-counter transactions are conducted pursuant to the rules and regulations established by the Japan Securities Dealers Association (hereinafter referred to as the "JSDA").

Moreover, investment risk is higher in over-the-counter transactions (transactions in unlisted stocks, etc.) than in transactions on exchanges because over-the-counter transactions have low liquidity and it is difficult to obtain detailed information on the issuer. Therefore, the JSDA rules prohibit Association Members (financial instruments business operators, etc. which are members of the JSDA) from soliciting investment in over-the-counter securities, except in prescribed cases.

The Proprietary Trading System (PTS) is an electronic trading system operated by securities companies authorized by the FSA. As a result of the amendment to the Securities and Exchange Law (hereinafter referred to as "SEL"; the precursor to the current FIEA) in 1998, PTS trading was included in the scope of securities business.

With a view to facilitating the supply of risk money to emerging and growth companies, an equity-based crowdfunding system was introduced in May 2015 as a means of financing through the issuance of unlisted stocks. At the same time, from the viewpoint of supporting financing for locally-based companies, etc., a shareholders community system was established to promote trading of unlisted stocks and financing for unlisted companies. Both systems allow Association Members to engage in solicitation of investment, under limitations on the method and scope of solicitation. In addition, the Phoenix issues system was established, separated from the former Green Sheet issues system abolished at the end of March 2018, as a platform where the JSDA provides investors with the opportunity for cashing out the delisted shares they hold.

2 4 Financial Instruments Business

(1) Functions of Securities Companies

Securities companies play a role as an intermediary for securities transactions on primary and secondary markets. In the process of issuing securities, they serve as go-betweens for the issuer and investors and help the issuer raise funds, while selecting the issuer in consideration of risk, thus contributing to effective allocation of financial resources. On secondary markets, securities companies are expected to protect investors by handling securities trading between investors appropriately and fairly and promoting the distribution of securities.

The major functions of securities companies are as follows.

(i) Commissioned sale and purchase (Brokerage)

Securities companies accept orders from investors to sell or buy securities (*e.g.*, stocks and bonds) and place these orders to secondary markets.

(ii) Proprietary trading (Dealing)

Securities companies sell and buy securities using their own funds in the same manner as general investors.

(iii) Underwriting and secondary distribution

Underwriting consists of the following activity: when companies and the national or local governments issue new shares or bonds, securities companies buy all or part of the issued shares or bonds for the purpose of reselling them on the market, while promising to acquire those left unsold. Securities companies carry out the

same operation targeting existing securities, which is called secondary distribution.

(iv) Dealing of public offering and secondary distribution (Selling or Distribution)

Securities companies solicit investors to buy new securities that will be newly issued or securities that have already been issued. Unlike the underwriting function, securities companies are not required to acquire those left unsold.

(v) Other functions

In addition to the functions above, providing services in relation to merger and acquisition of businesses is recently becoming more important as a function of securities companies.

Originally, securities were invented and developed to be a means of financing that connects fund providers with fund recipients. There are a plethora of instruments of varying characteristics and types, from those that have features such as a right to participate in management and demand dividends as is the case with stocks, to instruments that have features such as a right to claim a fixed interest over a prescribed period as is the case with bonds, and even those that combine the features of both.

Based on the characteristics of these securities there has been a wide range of possibilities for products and services that securities companies may provide. The advances in information technology have been a notable factor in encouraging securities companies to engage in the financial services industry more actively, and there are increasing developments in securitized products, as well as products and services that resemble the products offered by banks.

(2) From Securities Business to Financial Instruments Business

As a result of the “Financial System Reform Act” of 1998, the securities business was changed from the licensing system to the registration system. Under the registration system, an entity that meets the legal requirements is registered unless it is an entity subject to one of the reasons for rejection. As a result, the businesses conducted by a securities company have become more diverse and have been deregulated, with the abolition of the duty to engage exclusively in a single type of business and with the expansion of the securities business. Moreover, the scope of concurrent businesses that a securities company can operate has also been greatly expanded, with the exception of activities that contravene the public interest or for which risk management presents an onerous burden.

In September 2007, the SEL, the law governing the securities business, was amended, and the FIEA came into force. The FIEA regulates the traditional securities business together with activities such as financial futures transactions, under the large category of “financial instruments business.” It also changed the appellation “securities company” to “type I financial instruments business operator.” The business activities of a financial instruments business operator have expanded beyond the previous scope of business of a securities company (see Chart 1-1-6).

Chart 1-1-6 Scope of Financial Instruments Business

Category		Business Description
Financial instruments business	Type I financial instruments business	• Sales and purchase of securities, and intermediary, brokerage or agency services therefor (excluding deemed securities); market transactions of derivatives or foreign market transactions of derivatives, and intermediary, brokerage or agency services therefor
		• Intermediary, brokerage or agency services for commodity-related market derivatives transactions; brokerage for clearing thereof
		• Over-the-counter derivatives transactions, intermediary, brokerage or agency services therefor; brokerage for clearing thereof
		• Wholesale underwriting of securities
		• Operation of PTS (proprietary trading system)
		• Securities, etc. management business
	Type II financial instruments business	• Handling of public offering and private placement of beneficial interests in investment trusts managed under instructions from the settlor and equity interests in collective investment schemes
		• Sales and purchase of deemed securities, and intermediary, brokerage or agency services therefor; public offering, etc. of deemed securities
		• Market transactions of derivatives or foreign market derivatives transactions, intermediary, brokerage or agency services therefor (excluding those related to securities), etc.
	Investment advisory and agency business	• Providing advice on investment decisions under investment advisory contracts
		• Agency or intermediary services for the conclusion of investment advisory contracts or discretionary investment contracts
	Investment management business	• Investment of property under discretionary investment contracts or contracts for entrustment of asset investments
		• Investment of property invested or contributed from holders of investment trust beneficiary certificates
		• Investment of property contributed from holders of beneficial interests in trusts or equity interests in collective investment schemes

2 5 Investor Protection and Depositor Protection

The principle of investor protection is the basis of public regulation of securities markets and the financial instruments business, but the characteristics and specifics of investor protection in the securities market differ from those of depositor protection at financial institutions such as banks.

For example, depositor protection is fulfilled if an individual deposits JPY1 million in a bank, and at maturity the bank pays the depositor the promised interest along with the original JPY1 million. Thus, the basis of depositor protection is to avoid the risk that a bank would not be able to return the deposit due to its insolvency. The focus is on the credibility and soundness of bank management. If circumstances under which the bank would not be able to return the deposit were to arise, deposits, in particular small accounts, will be protected through a bank merger or by the guarantee for the principal and interest under the depository insurance system.

If a securities investment is made in fixed instruments such as debt securities, and if they are held to maturity, then the principal and interest can be collected in the same manner as in the case of a bank deposit. If, however, they are sold prior to maturity, an investor would gain profits or suffer losses depending on the market price. Even in the case of fixed-income bonds, the investors may not be able to receive all or part of the principal and interest in the event of default of the issuer. On the other hand, stocks present uncertainty because there is no maturity period and dividends depend on revenues of the companies. In some cases, no dividend will be paid. Moreover, the principal is not guaranteed since the market price constantly fluctuates.

Investor protection under the FIEA does not mean a guarantee of the price of the securities in which an investment is to be made, or a promise of payment of dividends on shares. It requires that the issuer accurately disclose information on its financial status, etc. so that the investors can decide whether to invest in the company or not. Furthermore, it also includes the requirements that securities companies and the financial instruments exchanges involved in securities trading conduct their businesses appropriately, and that price formation on securities markets be conducted fairly and efficiently.

In short, investor protection, in principle, means enabling investors to obtain accurate and prompt information necessary for making decisions on securities investments, and protecting investors from unfair trading. On this basis investors make investments at their own discretion and responsibility, with any resulting gains or losses being realized by the investor. This is the so-called "principle of self-responsibility." As such, when soliciting investment, it is necessary to understand that investor protection is not a guarantee of the principal invested, unlike depositor protection. There is no advance promise or guarantee of profits or losses.

2 6 Self-Regulatory Organizations

Some organizations of firms engaged in the financial instruments business carry out activities beyond the range of so-called trade associations. These organizations have been granted broad-based authority under law, and have established detailed regulations including articles of incorporation and various rules which extend to the form and method of business. These organizations are called "Self-Regulatory Organizations" (SROs).

Major self-regulatory organizations in Japan at present are the financial instruments exchanges, the Japan Securities Dealers Association and the Investment Trust Association, etc. All of these are bestowed by the FIEA with the attributes of a self-regulatory organization. Self-regulation through these organizations is a major pillar of the regulation over the financial instruments business, together with regulation by the supervising authority (the Financial Services Agency).

2 7 Major Securities-Related Institutions

The following is a description of major securities-related institutions in Japan.

(1) Securities and Exchange Surveillance Commission

As discussed above, the schemes used in regulating the securities markets and the financial instruments

business can be categorized into public regulations and self-regulation.

Formerly, the Securities Bureau of the Ministry of Finance (now the Financial Services Agency) was the entity responsible for public regulation in Japan, and Japan's securities industry administration was centered on the protection and development of the securities business by restricting competition, and focused on preventative oversight and administration. While the securities markets and securities business flourished under this type of regulatory scheme, this system was identified as one of the causes for several so-called securities scandals—such as the summer of 1991, when a securities company was found to have compensated investor losses—leading to more vigorous market enforcement. As a result, a new regulatory body called the Securities and Exchange Surveillance Commission (SESC) was established as an external bureau attached to the Ministry of Finance under the SEL amendments in May 1992. After the reorganization of the Japanese central government that took place in January 2001, the SESC was established and currently is part of the Financial Services Agency.

The SESC is granted compulsory investigation power concerning conduct that is detrimental to fairness in the marketplace and transactions, such as insider trading, loss guarantees and loss compensation provided by securities companies, market manipulation, and false statements in securities filings, and it is authorized to recommend the Commissioner of the Financial Services Agency to issue administrative penalty payment orders to offenders and denounce them to the crime investigation authorities. The SESC is also granted on-site inspection powers to monitor compliance by securities companies and self-regulatory organizations with transaction rules, and when it uncovers violations of laws or regulations by securities companies and violations of the disposition given by a self-regulatory organization to its members, the SESC can recommend that the Commissioner of the Financial Services Agency impose an administrative action.

Furthermore, the SESC is delegated the authority to conduct investigations of the state of compliance with regulations to ensure the fairness of transactions in connection with the activities conducted by financial institutions such as banks (*e.g.*, regulations concerning firewalls between banks and their securities subsidiaries).

The SESC has become increasingly active in its operations, conducting day-to-day market monitoring, inspections of financial instruments business operators, inspections of securities reports, making accusations against offenders to the crime investigation authorities, and issuing recommendations on administrative actions. It has also increased its number of personnel.

(2) Japan Securities Depository Center

The Japan Securities Depository Center (JASDEC) is the only central securities depository in Japan which collectively conducts settlement and management of securities other than JGBs. It provides the book-entry transfer services for securities such as shares, corporate bonds and beneficial interests in investment trusts in accordance with the Act on Book-Entry Transfer of Corporate Bonds and Shares.

Since it began operations in 1991, the JASDEC has played the leading role in carrying out securities settlement system reform, and achieved the digitization of certificates for various types of securities including non-government bonds such as short-term corporate bonds (commercial papers or CP); medium- and long-term corporate bonds and municipal bonds; beneficial interests in investment trusts; and shares. The digitization of securities has made it possible to (i) reduce costs for the issuance, deposit and delivery of certificates, (ii) speed up the settlement process, (iii) perform straight-through-processing (STP) [Note 1] from contract to settlement, (iv) reduce settlement risk through the introduction of the delivery-versus-payment (DVP) [Note 2] method, and (v) reduce the risk of paper certificates being lost or stolen. All of these positive results have worked to facilitate the distribution of securities and enabled companies to reduce costs for issuing securities.

An outline of the book-entry transfer system is as follows:

(i) All procedures including issuance, distribution and redemption as well as various corporate actions (*e.g.*, share splits), are processed by way of entries recorded in the book-entry account registry (Note 3);
(ii) Dividend payments for shares, etc. can be received at a single deposit account with respect to all issues, or via securities companies; and
(iii) Principal and interest of general bonds are paid to investors depending on the balance of their account via the account management institution.

(Notes) 1. Straight-through-processing (STP) means electronic (computerized) processing of the series of clerical procedures on securities markets, from the contract to payment and delivery of securities transactions.
2. Delivery-versus-payment (DVP) is a method of settlement of securities whereby securities are delivered on condition of the concurrent payment of the price. This is designed to avoid the risk that the party in a securities transaction who delivered funds or securities is unable to acquire the corresponding securities or funds from the other party.
3. A book-entry account registry is a statutory registry set up by a book-entry transfer institution or account management institution to manage a customer's rights relating to shares, general bonds, etc.

(3) Investor Protection Fund

The Investor Protection Fund is a fund that carries out activities that include indemnifying customers for losses incurred on cash and securities under deposit when a securities company
fails, and thereby strives to achieve investor protection and maintains their trust in the securities industry.

With the Financial System Reform Act of 1998, the Entrusted Securities Indemnity Fund (incorporated foundation), which had previously been organized as a voluntary incorporated foundation, was reorganized under the former SEL as a corporation. Following this, in 2010, it became a corporation authorized by the Prime Minister pursuant to the provisions of the FIEA.

Claims eligible for indemnity cover customer assets on deposit (including deposits, deposit securities, guarantees, margin money and margin securities, cash and securities received in deposit as part of related businesses, etc.), excluding institutional investors or other professionals, up to a maximum limit of JPY10 million per customer.

(4) Japan Securities Finance

Japan Securities Finance Co., Ltd. is a stock company licensed by the Prime Minister pursuant to the FIEA.

The following are the major functions of Japan Securities Finance Co., Ltd.:

(i) Lending the cash or securities needed in the settlement of margin transactions by utilizing the settlement scheme of the financial instruments exchange market operated by a financial

instruments exchange or the settlement scheme of the over-the-counter securities market operated by an authorized financial instruments firms association;
(ii) Borrowing and lending securities, or intermediary or agency service therefor;
(iii) Lending money to financial instruments business operators; and
(iv) Lending money to customers of financial instruments business operators.

(5) Bank of Japan

The Bank of Japan (hereinafter referred to as the “BOJ”) is the central bank of Japan established in 1882. It plays three major roles as: (i) the issuing bank (issuing Bank of Japan notes); (ii) banks’ bank (conducting transactions with financial institutions such as taking deposits and lending money); and (iii) the government’s bank (handling treasury money, issuing JGBs, and handling foreign exchange trade as entrusted by the government). The BOJ also provides a JGB settlement system whereby it handles the transfer of JGBs via book entries.

The BOJ was established as an institution independent from the government, and its independence has been enhanced as a result of the revision to the Bank of Japan Act in 1997. The revised Act provides that the BOJ carries out activities for the purpose of (i) achieving price stability through currency and monetary control, thereby contributing to the sound development of the national economy, and (ii) ensuring the smooth and stable operation of the settlement system, thereby contributing to the stabilization of the financial system.

In order to achieve these purposes, the BOJ implements monetary policy measures including: (i) policy interest rate operation (setting the standard interest rates on loans extended to private financial institutions); (ii) open market operation (controlling the volume of funds through buying and selling bonds and bills, thereby affecting market interest rates); and (iii) reserve requirement ratio operation (causing financial institutions to increase or decrease their payment reserves and affecting their lending). Recently, open market operation is taking on more importance. The BOJ’s buying and selling of bonds and bills have an increasing influence on the bond prices and market interest rates.

3 Development of Securities Markets in Japan

3 1 Securities Markets Before World War II

(1) Birth and Development of Securities Markets in Japan

The first issuance of Japanese securities is said to have taken place in London in 1870 in the form of U.K. sterling-denominated government bonds. The government subsequently issued various public bonds such as the retirement allowance bond and the unemployment bond given to the former *samurai* class as well as the *shinkyū* (New and Old) government bonds to assume the debts of local Han, and faced the need to convert these bonds into cash and develop a fair pricing system .

In 1873, the First National Bank was established as the first stock company in Japan. Subsequently, the government enacted a new “Stock Exchange Decree” in May 1878, and the Tokyo and Osaka stock exchanges were

incorporated based on this decree. The decree provided that stock exchanges were to be organized as stock companies and two types of transactions, which are virtually futures transactions, were permitted. One was the "cash transactions" (spot trading) (*genba torihiki* in Japanese), and another was the "time transactions" that was a type of futures transaction (*teiki torihiki* in Japanese) incorporating a traditional method for trading in rice that was called "ledger entry rice trading" (*chōaimai torihiki*). Brokers (securities companies today) could trade on their own account as a dealer or as a broker on contract for others. In 1893, the Stock Exchange Act was enacted. This became the basic law regulating stock exchanges during the pre-war period.

Meanwhile, after Osaka Railroad Corporation issued the first corporate bonds in Japan in 1890, the issuance of corporate bonds became popular gradually and JGBs were issued more actively.

The stock market achieved substantial growth as a result of the development of the heavy chemical industry during World War I and into the post-war period, while the bond market developed gradually from the Taisho period (beginning in 1912) through the early part of the Showa period (beginning in 1926). Both of these markets began their development in earnest from Showa.

The Japanese securities industry began with floor traders ("*nakagainin*") on the stock exchanges that were established by the 1878 Stock Exchange Decree. Initially, their main activities were in the secondary market for stocks and bonds and they were particularly active in the stock market. Some companies expanded into the work of issuing securities during the latter half of the Meiji era, and from the middle of the Taisho era they came to be called securities companies, during a period when they showed their presence as wholesale underwriters of corporate bonds, together with banks and trust companies.

(2) Securities Markets Under the Wartime Economy

A controlled economy gradually emerged as Japan moved steadily into a wartime footing beginning with the outbreak of war between Japan and China which began in 1937. Both goods and funds were controlled and the securities market was gradually brought under the purview of these regulations.

The financial controls emphasized procuring funds to increase production capacity and allocation of funds to military industries. This in turn promoted the development of the indirect financing system where banks served as the main participants. The primary bond market had already been regulated by the Temporary Funds Adjustment Act of 1938, and the securities market turned sluggish as a result of extensive government control through restrictions on dividends, capital increases and issuances. In 1942, the Wartime Finance Corporation was established, and subsequently, the Japan Securities Exchange Act was enacted in 1943. This established the Japan Stock Exchange as a quasi-governmental entity, uniting stock exchanges nationwide into one and bringing the secondary stock market under government control.

3 2 Post-War Development of Securities Markets

(1) Post-War Securities Markets

In post-war Japan, stocks were distributed and held widely among the general population with the development of the securities democratization movement as a result of economic democratization policies such as the dissolution of the *zaibatsu* system and the enactment of antitrust regulations. In 1948, the SEL was enacted, and the following year, exchanges reopened. Additionally, the Securities Investment Trust Act was enacted in 1951, triggering a

renewal of the Japanese securities markets away from the structure that had prevailed before the war period. However, the development of the securities markets was unable to cope with the surge in Japanese economic growth and resulted in a crash in the securities markets around 1965.

With the amendments to the SEL in 1968, the Japanese securities industry once again experienced growth as various improvements took place. The amendments included the adoption of a licensing system for securities companies and institutional development such as improvements made to securities exchange trading methods. As a result, the environment of the securities markets changed drastically, including the high level of government bond issuance and progress made in financial liberalization and internationalization.

(2) Progress in Liberalization and Internationalization of Finance

A report compiled by the Japan-U.S. Yen-Dollar Committee was released in May 1984. This prompted Japan to declare the internationalization of its domestic market and the adoption of financial liberalization. This occurred against the backdrop when the Tokyo market, at that time, attracted international attention as one of the world's three major financial centers along with London and New York.

The bond futures market was established on the Tokyo Stock Exchange in October 1985, following which various derivatives markets have been created, including the stock futures market, the stock index futures market, and the stock index options market.

Triggered by the economic bubble in the latter part of the 1980s, the size of the Japanese stock market expanded to the point where at one time it surpassed even that of the New York market on the basis of the total market capitalization of listed companies to become the largest in the world. Thereafter, however, the Tokyo stock market stagnated as the Japanese economy faced an extended recession, financial institutions had been accumulating non-performing loans and their financial positions deteriorated, and the country faced frequent scandals in the financial and securities industries.

With the bursting of the bubble economy, the issue of paying compensation to investors for their losses was publicized as a securities scandal in 1991. In July of the following year, the Securities and Exchange Surveillance Commission was established. In addition, the so-called "*sōkaiya*" (hecklers at a stockholder's meeting) incident took place in 1997, in which securities companies secretly paid profits to *sōkaiya*. Amid such incidents, the face of the securities industry also underwent significant changes, with ongoing development of new financial products and services and the expansion of international activity. Concurrently, the introduction of IT systems and the automation of the securities business are making rapid progress.

Further, the Financial Structure Reform Act was enacted in June 1992, and in July 1993, three bank-affiliated securities companies were founded. This as a turning point enabled the realization of the affiliation system in which mutual market participation became possible for banks, trust banks, and securities companies through subsidiaries in different businesses.

3 3 Japanese Big Bang and Financial System Reforms

(1) Japanese Big Bang

During the regular session of parliament in the fall of 1996, then Prime Minister Ryutaro Hashimoto unveiled a plan to restore Japan by the year 2001 as a major player—along with London and New York—in the international

financial and capital markets. This is the so-called “Japanese Big Bang” plan.

The term “Big Bang” originally refers to the great explosion that is said to have been the genesis of the creation of the universe. This term was used in October 1986, in the United Kingdom, in referring to its securities market system reform. The actual details of the Big Bang in the UK were (i) the liberalization of stock trading commissions; (ii) the abolition of a system (single capacity system) which separated brokers and jobbers who are members of a stock exchange; (iii) the liberalization of capital participation to exchange members; (iv) the introduction of a computer platform, SEAQ (Securities Exchange Automatic Quotation System), and (v) establishment of a new Financial Services Act. These changes served to overhaul the entire securities trading system in England.

In response to Prime Minister Hashimoto’s plan, the Financial System Reform Act that includes amendments to 22 financial related laws including the SEL, the Securities Investment Trust Act and the Banking Act was passed the Diet in June 1998 (entering into force on December 1, 1998).

This Japanese Big Bang was designed to thoroughly deregulate the financial sector and achieve vibrant competition, thereby revitalizing the Tokyo financial and capital markets which had suffered a decline as a result of the extended recession, and to achieve a shift to a market oriented competitive system.

(2) Financial System Reforms and Subsequent Developments

The Financial System Reform Act (1998) completely deregulated stock brokerage commissions and eliminated the obligation to concentrate trades in listed stocks on an exchange. It reintroduced a registration system, marking a break from the former licensing system for supervision and regulation of the securities business, and the scope of business descriptions of securities companies was also enlarged. Concepts of competition were introduced to the markets themselves so that the formerly subordinate OTC markets were given the same status as exchange markets. Moreover, investment trusts now included a corporate-type structure (investment corporations), as well as private placement investment trusts. Thereafter, these instruments could be sold by banks themselves at their teller counters. This reform in the securities market through the Japanese Big Bang was a drastic system reform that is comparable to the financial and securities reforms put in place by the Supreme Commander for the Allied Powers after World War II and the reforms enacted in response to the securities meltdown of 1965.

The Japanese Big Bang includes three principles: (i) Free - a free market based on market principles (liberalization of such things as market entry, products and pricing); (ii) Fair - a transparent and credible market (clarity and transparency of rules, investor protection); and (iii) Global - a global market constantly anticipating the future (legal, accounting, and supervisory systems responsive to globalization). Chart 1-1-7 maps the financial system reforms since the Japanese Big Bang and the subsequent system reforms.

Since 2002, the expansion of securities sales channels became a major pillar in the system reform. This reflects the regulators’ stance to strengthen the trend of “savings to investments” using bank channels as the sales of investment trusts by banks which began in 1998 had largely increased its share afterwards.

In the UK the Big Bang was a system reform, which mainly centered on the reform of securities exchanges. However, the Japanese financial system faced various problems - such as successive failures and scandals among financial institutions including banks, an accumulation of a large volume of bad debts, delays in creating new financial techniques in response to globalization, and the tendency toward financial market hollowing-out, which made it necessary to undertake a more wide-ranging drastic overhaul while concurrently continuing to ensure stability of the financial system.

For this reason, the Japanese Big Bang plan went beyond reforming the securities system, and in contrast to

the reform implemented in the UK, has taken on a strong characteristic of being a financial reform as well.

Chart 1-1-7 Financial System Reform and Subsequent Developments (1998-2022)

	Expanding choices for investors/ asset managers	Promoting competition between intermediaries, improving service quality	Making the markets more efficient, fair, and transparent
1998	Apr.: Securities transaction taxes/ exchange taxes lowered Sep.: Direct payroll payments by comprehensive securities account became possible Dec.: Introduction of corporate type and privately placed investment trusts, launch of investment trust sales at bank counters, etc. Dec.: Ban on OTC securities derivatives lifted Dec.: Ban on PTS* lifted	Apr.: Stock brokerage commissions deregulated for transactions of listed stock for over JPY50 million, and full liberalization of OTC stocks Dec.: Shift from license system to registration system for securities companies	Dec.: Duty to concentrate all trades on the exchange abolished Dec.: Regulation regarding unfair trading practice, etc. introduced
1999	Apr.: Securities trading taxes/ exchange taxes abolished	Mar.: Ban on Financial Holding Companies lifted Oct.: Removal of regulation on the scope of business for trust subsidiary of securities companies Oct.: Full liberalization of stock trading commissions	
2000	Nov.: Ban on REITs lifted		
2001	Jun.: Introduction of exchange traded funds(ETFs) Oct.: Ban on treasury stock lifted Nov.: Revision of capital gains taxes		Apr.: Ban on entity conversion of the securities exchanges into stock companies lifted
2002		Sep.: Deregulation of offices concurrently operating banking services and securities business	
2003	Nov.: Reduction of taxes on individual's dividends or capital gains, opening of specified accounts		

	Expanding choices for investors/ asset managers	Promoting competition between intermediaries, improving service quality	Making the markets more efficient, fair, and transparent
2004		Apr.: Lowering of minimum capital requirements for securities companies, investment trust companies, and investment advisors (to JPY50 million) Apr.: Introduction of securities intermediary business (restriction on banks lifted in December)	Dec.: Conversion of JASDAQ into exchange
2005		Oct.: Sale of investment trusts by post offices deregulated	
2006		Jun.: Shift from license system to registration system for asset management business	May: Enforcement of the Companies Act; listed companies obliged to file quarterly securities report and internal control report
2007			Aug.: NEO established by JASDAQ Sep.: Enhancement of self-regulatory functions of exchanges Sep.: Overarching regulation on financial instruments that have a strong investment-driver nature introduced (FIEA put into effect)
2008	Jun.: Diversification of listed exchange traded funds (ETFs)	Jun.: Firewall regulations among securities company, banks and insurance companies reviewed Jun.: Expansion of scope of business for banks and insurance companies	Jun.: Creation of a professional market

	Expanding choices for investors/ asset managers	Promoting competition between intermediaries, improving service quality	Making the markets more efficient, fair, and transparent
2009			Jan.: Digitalization of stock certificate Jun.: Establishment of TOKYO AIM exchange by Tokyo Stock Exchange (TSE) Jun.: Ban on cross-entry between financial instruments exchange and commodity exchange lifted Jun.: Introduction of public regulation on credit rating companies Aug.: Establishment of a specified non-profit organization specialized in finance Alternative Dispute Resolution (ADR) services
2010			Apr.: Management integration between Osaka Securities Exchange (OSE) and JASDAQ
2011	Jun.: Two-year extension of measures to reduce taxes on individual’s dividends or capital gains		
2013			Jan.: Japan Exchange Group founded through management integration between the TSE and the OSE
2014	Jan.: Introduction of NISA (tax-exempt investment accounts) program		Feb.: Publication of Japan’s Stewardship Code by FSA
2015			Jun.: TSE’s introduction of Corporate Governance Code, requiring listed companies to submit corporate governance reports.
2016	Apr.: Introduction of Junior NISA (tax-exempt investment accounts for minors) program		
2018	Jan.: Introduction of Dollar-Cost Averaging NISA		
2019			Nov.: Japan Exchange Group’s acquisition of the Tokyo Commodity Exchange as its wholly owned subsidiary company

	Expanding choices for investors/ asset managers	Promoting competition between intermediaries, improving service quality	Making the markets more efficient, fair, and transparent
2022			Apr.: TSE restructured the market categories into the Prime, Standard and Growth Markets

* PTS refers to Proprietary Trading System.

3 4 Establishment of the Financial Instruments and Exchange Act

The Japanese Big Bang and subsequent revisions to the financial system and the securities markets have caused major changes in the nature of securities markets in Japan. Active entry into each of the sectors in the financial services industry has begun to occur, as has the providing of a wide variety of financial products and services.

Nevertheless, the various types of financial instruments were each covered by separate statutes, as illustrated by the SEL covering securities such as stocks and bonds, and the Financial Futures Transactions Act covering financial futures transactions; in consequence, new financial products and investment vehicles that did not fit into the traditional categories and businesses to handle these products and vehicles appeared, which led to calls for a new legal framework that would cover a wide variety of financial instruments subject to regulation in a comprehensive manner.

For this reason, the Financial Instruments and Exchange Act (FIEA) was passed by the Diet in June 2006 and came into force in September 2007 as a complete overhaul of the SEL and other laws. The FIEA sets forth disclosure rules regarding a wide variety of financial instruments as well as cross-sectoral regulations concerning businesses that handle these products, thereby seeking to contribute to sound growth in the Japanese economy as well as to the protection of investors, and was enacted to create an environment for the shift from savings to investment as advocated by the government. The main elements of the FIEA are as discussed below.

(1) An Overarching Legal Code for Protection of Investors in Financial Instruments with a Strong Investment-Driven Nature

The FIEA is an overarching and comprehensive law covering financial instruments and business operators engaged in financial services, and was enacted in the form of an amendment of the SEL. Under the FIEA, the name of the business entities to be regulated has been changed to “financial instruments business operators,” and the name of securities exchanges under the law has been changed to “financial instruments exchanges.”

The FIEA has broadened the definition of securities subject to regulations, as it deems trust beneficiary certificates and equity interests in collective investment schemes (investment funds) to be securities, in addition to securities that had been subject to regulations, such as JGBs, municipal bonds, corporate bonds, stocks and investment trusts. Moreover, not only derivatives transactions involving securities as underlying assets, but also other types of transactions such as currency and interest swaps as well as transactions in climate derivatives have been placed within the purview of regulation by the FIEA.

In addition, activities such as sale and solicitation of financial products using securities and derivatives transactions, as well as investment advice (investment consulting business), investment management (discretionary

investment business), and management of customer assets (custody business) are all considered to be areas of the financial instruments business under the registration system, and are subject to overarching regulation. In this manner, the regulation of entry into the investment management business has been liberalized from a licensing system to a registration system.

The FIEA divides the financial instruments business into the type I financial instruments business (formerly securities business), the investment management business, the type II financial instruments business (*e.g.*, sales and solicitation of securities that have low market liquidity such as investment funds) and the investment advisory and agency business. The details of the regulations on entering these respective fields differs depending on their relevant category. Moreover, detailed codes of conduct have been enacted with which business operatives must comply in connection with their respective activities of sales and solicitation, investment advice, investment management and custody of assets.

In addition, the FIEA classifies clients into specified investors (professional investors) and general investors (amateur investors). If a customer is a specified investor, conduct regulations such as the duty to deliver a document before conclusion of contract are waived.

Customer protection regulations (sales and solicitation rules) of the same level as under the FIEA now also apply to sales and solicitation activities by banks, insurance companies, and other financial service providers that are, in principle, not subject to regulations by the FIEA, if they deal with high-risk products. These high-risk financial instruments include foreign currency deposits, derivative deposits, foreign currency denominated insurance and pensions, variable insurance and pensions, designated monetary trusts (of the type that pay dividends based on actual performance), commodity futures transactions, and real estate specified joint enterprise business activities.

(2) Enhancement in Disclosure System

The FIEA has also enhanced the disclosure rules pertaining to financial and corporate information. A listed company is required to file quarterly reports, and is to be audited by a certified public accountant or an auditing corporation. Moreover, following the Sarbanes-Oxley Act enacted in the United States in July 2002 (known as the Public Company Accounting Reform and Investor Protection Act, or SOX Act), a duty was imposed on listed companies to file internal control reports for each business year, evaluating the effectiveness of their internal control procedures in connection with financial reporting, in order to promote the proper disclosure of financial and corporate information (this portion is referred to as the Japanese SOX Act).

The FIEA has revised the system of the public tender offer which was stipulated under the SEL due to the rapid growth in mergers and acquisitions on the part of Japanese companies, and an increase in the number of public tender offers for shares. Moreover, revisions were also made to the large volume holding reports, because large volume stock acquisitions by other companies and investment funds have increased with the growth in corporate mergers and acquisitions.

3 5 Stewardship Code and Corporate Governance Code

The Financial Services Agency (FSA) published the “Principles for Responsible Institutional Investors: Japan’s Stewardship Code” in February 2014. This Code emphasizes the “stewardship responsibilities” of

institutional investors—to enhance the medium- to long-term investment return for their clients and beneficiaries by improving and fostering the investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue—and defines principles to assist institutional investors in fulfilling their stewardship responsibilities. The Code was partially revised in May 2017 and March 2020.

In June 2015, the Tokyo Stock Exchange started the implementation of the principles for corporate governance called the "Japan's Corporate Governance Code." This Code was established with the aim of promoting transparent and fair decision-making by Japanese companies and increasing their corporate value over the mid- to long-term. It defines the term "corporate governance" as a "structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders as well of those of customers, employees and local communities."

Under the Corporate Governance Code, listed companies should appoint at least two independent directors irrespective of the type of their board of directors, and they are required to submit corporate governance reports. The code was thereafter partly revised in June 2018 and June 2021. The revision in 2021 requires companies listed on the Prime Market to appoint at least one-third of their directors as independent directors (and consider the appointment of the majority of their directors as independent directors, if necessary).

The Corporate Governance Code provides that listed companies should engage in constructive dialogue with shareholders even outside the general shareholder meeting in order to contribute to sustainable growth and the increase of corporate value over the mid- to long-term. In this respect, the Corporate Governance Code and Japan's Stewardship Code act as two wheels on the same axis. Dialogue between management and shareholders (especially institutional investors) based on mutual trust is expected to ensure effective corporate governance and promote mid-to-long-term growth in corporate value.

The most distinctive feature of these two Codes is that they are what is generally called soft law because they are not established based on a decision of the Diet or authorization by law and therefore are not legally binding, although they clearly indicate the norms that institutional investors and listed companies must comply with. Breach of the provisions of the Codes does not result in the imposition of criminal penalties and those who do not comply with the provisions are only required to explain the reasons for their non-compliance (comply or explain). However, by adopting a more flexible and realistic regulatory framework than that under law, these Codes are made more effective as norms.

4 Changes in Circumstances Surrounding Securities Markets

4 1 Current Status of Financial Instruments Exchanges

(1) Evolution of Financial Instruments Exchanges

In 1948, the SEL was enacted and securities exchanges (currently financial instruments exchanges) in Japan were reconstituted as membership organizations. Going with this, in May 1949, new financial instruments exchanges were opened in Tokyo, Osaka and Nagoya, in July 1949, in Kyoto, Kobe, Hiroshima, Niigata and Fukuoka and in April 1950, in Sapporo.

After World War II, when the financial instruments exchanges re-opened, the Tokyo Stock Exchange (hereinafter referred to as "TSE") had approximately a 60% share of trading, whereas the Osaka Stock Exchange (currently "Osaka Exchange"; hereinafter "OSE") comprised a mere 27%. The local securities exchanges had a combined share of 10% or more in the first half of the 1950s. However, in the first half of the 1970s, when companies increasingly moved their headquarters to Tokyo, the share of TSE began to rise sharply, and the share of the other financial instruments exchanges fell accordingly.

As a result, the Kobe Stock Exchange was closed in 1967. In March 2000, the Hiroshima Stock Exchange and Niigata Stock Exchange were merged into the TSE, and later, in March 2001, the Kyoto Stock Exchange was merged with the OSE.

The Financial System Reform Act of 1998 not only promotes competition among the securities companies that are market intermediaries, but has also introduced the idea of promoting greater competition among securities exchanges. The over-the-counter securities market (operated by the JSDA) was repositioned to be on equal footing with the securities exchange market. In addition, the reform abolished the duty of members of an exchange to concentrate trades in listed stocks on that exchange, and completely abolished floor trading, which had been the hallmark of exchanges (in December 1997 by the Osaka Stock Exchange and in April 1999 by the Tokyo Stock Exchange).

In January 2013, the TSE and OSE integrated their business operations, and Japan Exchange Group, Inc. was founded. Following this, the OSE spot markets were integrated into the TSE spot markets in July 2013, and the TSE derivatives markets were integrated into the OSE derivatives markets in March 2014, when the OSE changed its name from the Osaka Securities Exchange to the Osaka Exchange. As a result, the TSE became specialized in spot trading and the OSE in derivatives trading.

In November 2019, the Japan Exchange Group acquired the Tokyo Commodity Exchange as its wholly owned subsidiary company. In July 2020, it transferred commodity futures trading
(e.g., trading in precious metal, rubber, and agricultural products) from the Tokyo Commodity Exchange to the Osaka Exchange, thereby reorganizing the Osaka Exchange as a comprehensive exchange dealing with both securities and commodity futures.

(2) Establishment and Changes of Stock Markets for Emerging and Growth Stocks

In June 1999, triggered by NASDAQ America's announcement that it would create a NASDAQ Japan market as a part of its global strategy, financial instruments exchanges in Japan accelerated their initiatives toward the creation of markets for emerging and growing companies.

In November 1999, the TSE established the Market of the High-Growth and Emerging Stocks ("Mothers") for emerging companies. Subsequently, new markets for emerging companies were also established by other exchanges: "New Market Section" by the OSE; "Centrex" (which changed its name from "Growth Company Market") by the Nagoya Stock Exchange (hereinafter referred to as "NSE"); "Ambitious Market" by the Sapporo Securities Exchange; and "Q-Board" by the Fukuoka Stock Exchange.

In June 2000, NASDAQ partnered with the OSE to establish NASDAQ Japan as a division of OSE. However, NASDAQ Japan was only able to attract a number of initial public offerings that was far below its initial estimates, and it finally withdrew from the market in 2002. The OSE, which had partnered with NASDAQ Japan, changed the name of NASDAQ Japan to the Nippon New Market "Hercules" in December 2002 and thus integrated it into "New Market Section."

Significant changes have also been seen in the over-the-counter markets. The main stocks traded in the over-the-counter market in Japan are issues that are registered under the regulations provided by the JSDA, and over-the-counter managed issues consisting of issues whose registration has been cancelled under the JSDA's regulations (later including delisted issues) (OTC registered market).

The JSDA launched its "over-the-counter stock market automated system" in October 1991. This system is called the JASDAQ system (Japan Association of Securities Dealers Automated Quotation System), following the NASDAQ system (National Association of Securities Dealers Automated Quotation System), which was introduced in 1971 in the U.S.

In response to the expansion and the increased significance of the over-the-counter market, the SEL was amended through the Financial System Reform Act of 1998 to shift the position of the over-the-counter registered market from its traditional function of supplementing the exchange markets to one of equal footing with the exchange markets.

In response, the JSDA which was managing and operating the over-the-counter market has taken measures to improve and expand the market, including enhancement and improvement of the JASDAQ System; building robust, reliable, efficient and economical infrastructure for settlements; and introducing the system of market making since 1998. In addition, in February 2001, the majority of the operations of the management of the JASDAQ market was transferred from the JSDA to the "JASDAQ Securities Exchange, Inc."

In December 2004, the organization of the JASDAQ market was converted into a stock exchange. In August 2007, JASDAQ established the NEO market as a new market to support companies which have new technologies or a new business model which offers potential for growth.

In December of 2008, the JSDA sold the majority of the shares in its controlled entity the JASDAQ Stock Exchange to the OSE, and the JASDAQ Stock Exchange became a subsidiary of the OSE. In April 2010, the OSE and the JASDAQ Stock Exchange integrated management, and in October, Hercules, JASDAQ, and NEO were integrated into a new JASDAQ market. Furthermore, in July 2013, as a result of the merger of the OSE's spot markets into those of the TSE, JASDAQ became one of the markets under the TSE.

In April 2022, the TSE restructured the four markets which it had operated, *i.e.*, the First Section, the Second Section, Mothers and JASDAQ, into three new markets, naming them the Prime Market, Standard Market, and Growth Market. The concept of each market segment is as follows.

Prime Market: This market is oriented to companies which center their businesses on constructive dialogue with global investors.

Standard Market: This market is oriented to companies with sufficient liquidity and governance levels to be investment instruments.

Growth Market: This market is oriented to companies with high growth potential.

(3) Conversion of Exchanges into Stock Companies

One more noteworthy movement related to the financial instruments exchanges (securities exchanges) is the trend towards conversion of the exchanges themselves into stock companies. Previously, almost all financial instruments exchanges around the world had been organized as non-profit member corporations. However, as the competition between financial instruments exchanges intensified and they actively expanded their functions, financial instruments exchanges successively re-organized into for-profit stock companies and listed their own shares. In Europe, the Stockholm Securities Exchange was reorganized into a stock company in 1993, and other northern European exchanges and the Amsterdam Stock Exchange followed suit. Amidst the intensification of

global inter-market competition, both the New York Stock Exchange (NYSE) and NASDAQ have converted into stock companies.

In response to these movements, the SEL was amended in 2000 to allow a securities exchange in the form of stock company in Japan. With this, the OSE converted into a stock company in April 2001, followed by the TSE's conversion in November of 2001, and the NSE in April 2002.

What are the merits of conversion of a financial instruments exchange into a stock company? In general, the status of members and the structure of the decision-making process are different for a member organization and a stock company. A member organization employs a simple majority rule, under which members each possess one vote per person (or firm) irrespective of the amount they contribute. In contrast, a stock company adopts a majority rule based on the number of shares held by each member in proportion to their contribution.

Due to these kinds of differences, where the members are equal in substance and no serious conflicts of interest exist between them, a member organization is more efficient. However, where these assumptions break down, time is needed to balance the interests of all members, potentially causing the decision-making process to grind to a halt.

In addition to the speed of the decision-making process, another reason given for conversion into stock company is flexibility with regard to funds procurement. In a member organization, it is necessary to obtain the consent of the members each time funds needed for improvements to the trading system, etc. are procured. If obtaining this consent is difficult, then the member organization will have no choice but to rely on outside loans.

In contrast, a stock company can procure funds from external sources through a capital increase. In addition, if the shares of the exchange itself are made public and listed on an exchange market, the exchange will have to make a more thoroughgoing disclosure thereby increasing transparency. Moreover, by adopting incentive systems such as stock options, the financial instruments exchange can raise the morale of officers and employees.

The above are the advantages of the conversion of a financial instruments exchange into a stock company. In contrast, one of the demerits or fears surrounding conversion is the issue of a potential conflict of interest existing in an exchange that is organized as a stock company, between the for-profit nature of a stock company, and the self-regulatory functions for the purpose of achieving fairness and transparency on the exchange.

For this reason, the FIEA which came into force in September 2007 sought to achieve the proper operation of self-regulatory activities of a financial instruments exchange by allowing (i) the self-regulatory functions to be entrusted to a self-regulatory organization separate from the exchange, or (ii) creating a "self-regulatory committee" that would decide issues concerning self-regulatory activities within the same corporation, in addition to the traditional mechanism of having a self-regulatory division within the exchange.

Following this, the TSE was reorganized in August 2007 into Tokyo Stock Exchange Group Inc., as a stock company, with its subsidiary, Tokyo Stock Exchange Inc., handling the activities of operating securities exchanges, and its other subsidiary, Tokyo Stock Exchange Regulation Inc. (incorporated in November 2007), handling self-regulatory activities on entrustment from Tokyo Stock Exchange Inc. Following the integration between the TSE and the OSE, Tokyo Stock Exchange Regulation Inc. was renamed Japan Exchange Regulation in April 2014.

(4) Intensification of International Competition

In recent years, there have been many mergers and international alliances of exchanges as a part of inter-market competition. In Europe, in July 1998, just before the European monetary union, the London Stock Exchange and Deutsche Börse (the superior organization of the Frankfurt Stock Exchange, etc.) entered into an agreement regarding a merger between the exchanges, which brought the concept of a uniform European financial instruments exchange merging major exchanges of EU member countries. However, in September 2000, the Paris, Amsterdam

and Brussels financial instruments exchanges made independent moves to merge and form Euronext, and the agreement between the London Stock Exchange and Deutsche Börse was called off.

Meanwhile, the National Association of Securities Dealers (at the time; NASD) also entered into an alliance with OSE and established NASDAQ Japan as mentioned above, and sought an alliance with the Hong Kong Stock Exchange.

Initiatives towards the reorganization of trading systems worldwide were taken, such as the merger of NYSE and Euronext, the merger of the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT), and the merger of OMX, which has securities exchanges in Sweden and Finland, with NASDAQ. All these events took place in April 2007.

Subsequently, in December 2012, the Intercontinental Exchange (ICE), an electronic exchange of commodity futures and options based in Atlanta Georgia in the United States, took over NYSE Euronext. Further, in June 2014, with a view to concentrating its management resources in derivatives trading, the ICE spun off Euronext (mainly for spot stock trading).

In Japan, the TSE entered into a business alliance for the operation of the trading system with the NYSE in January 2007, and opened the TOKYO AIM Exchange, a market for professionals targeting the developing markets of Japan and Asia, in alliance with the London Stock Exchange in June 2009. Subsequently, as a result of the termination of the alliance between the TSE and the London Stock Exchange, TOKYO AIM Exchange became the TSE's wholly owned subsidiary in March 2012 and changed its name to TOKYO PRO Market in July of the same year.

These trends of international alliance between financial instruments exchanges aim to respond to the vitalization of competition between markets worldwide or the rise of electronic trading systems that perform the same order matching function as exchanges (called ATS or PTS), and to enhance competitiveness through merger of multiple markets, establishment of new markets, mutual listing, standardization of trading systems, formation of order routing systems and information network.

4 2 Changes in Competitive Environment Surrounding Securities Companies

(1) Downsizing of Securities Industry

After the burst of the bubble and the subsequent prolonged slump in the securities markets, the commission revenue which had been the main source of revenue for securities companies have dropped, and the number of business outlets of securities companies and the number of people employed in the securities industry have decreased. Two factors are largely responsible for these developments. First, around the time of the complete deregulation of commissions in October 1999, a number of online dealers entered the market in rapid succession, causing a rapid and steep decline in the level of commissions. The second is that large city banks that had for some time wanted to enter the securities retail business acquired second tier securities companies, and proceeded to combine/close business outlets and reduce their workforces.

The number of securities companies operating in Japan (Association Members) has been declining since it peaked at 322 at the end of 2008, and as shown in Chart 1-1-8, the number fell to 273 at the end of June 2023. Such downward trend has been especially prominent regarding the number of foreign securities companies which converted their branch offices into Japanese corporations, decreasing from 50 in 2001 to 9 at the end of June 2023.

In addition, while the number of securities companies business outlets was over 3,000 in 1991 at the peak, this number stood at 1,989 at the end of June 2023. In addition, the number of people employed in the securities industry (the number of officers and employees of securities companies) declined from a peak of more than 170,076 (at the end of June 1991) to about 87,133 by the end of June 2023.

Chart 1-1-8 Numbers of Securities Companies and Their Business Outlets

End of month/year	Number of head offices	Number of other offices	Total number of business outlets (incl. head offices)
Dec. 2013	258 (16)	1,848 (1)	2,106 (17)
Dec. 2014	253 (16)	1,854 (2)	2,107 (18)
Dec. 2015	252 (13)	1,878 (2)	2,130 (15)
Dec. 2016	260 (11)	1,882 (2)	2,142 (13)
Dec. 2017	265 (10)	1,919 (2)	2,184 (12)
Dec. 2018	266 (10)	1,881 (2)	2,147 (12)
Dec. 2019	268 (10)	1,815 (2)	2,083 (12)
Dec. 2020	269 (10)	1,807 (6)	2,076 (16)
Dec. 2021	274 (10)	1,759 (5)	2,033 (15)
Dec. 2022	274 (9)	1,727 (3)	2,000 (12)
Jun. 2023	273 (9)	1,716 (2)	1,989 (11)

(Note) The numbers in parentheses represent numbers pertaining to foreign corporations (the number of their principal offices in Japan is included in the number of head offices) and are included in the respective numbers above. The number of head offices is the same as the number of Association Members.
(Source) Japan Securities Dealers Association

(2) Deregulation of Stock Brokerage Commissions

As part of the financial system reform, stock brokerage commissions were deregulated. One of the factors that prompted the deregulation of commissions was the vociferous criticism lodged against securities companies when the scandals concerning loss compensation were uncovered together with the high profits earned by securities companies during the bubble era. Fixed commissions were singled out as a primary cause of these scandals, leading to the deregulation of the commissions on stock trades.

In April 1994, the commissions on large transactions of over JPY1 billion were deregulated. Thereafter, commissions were further deregulated for transactions of over JPY50 million in April 1998, and then finally commissions were totally deregulated in October 1999.

Looking at the trend in commission levels post-deregulation, some online securities companies charge no commissions for spot trading, although this depends on the transaction amount. This is a product of the intense price wars that developed as a result of the successive entry into the market of online securities companies targeting individual investors.

(3) New Entry into and Reorganization of the Securities Industry

In Japan, entities engaged in banking operations and those engaged in securities operations had been separated

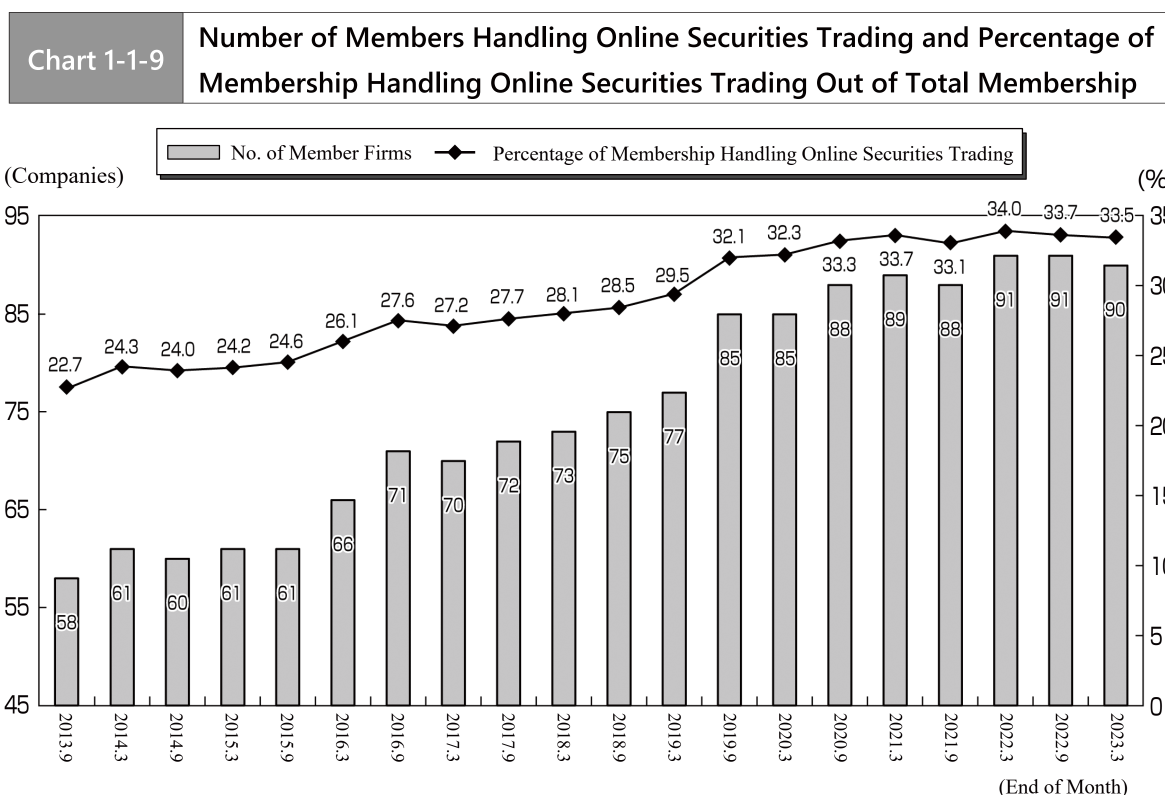
under Article 65 of the SEL. However, the Financial System Reform Act enacted in June 1992 enabled banks, trust companies, and securities companies respectively to launch businesses in the other two industries as well in July 1993 via their subsidiaries formed for the respective industrial sectors. Initially, 19 securities companies were formed as subsidiaries of banks. At the time, stock brokerage was excluded from the scope of operations that banks' securities subsidiaries may engage in, and firewalls were required to be set up between banking operations and securities operations.

The restrictions on the scope of operations of banks' securities subsidiaries were abolished in phases. These subsidiaries are now allowed to engage in stock brokerage. The firewall regulations were also eased, which led to the lifting of the ban in September 2002 on banks and securities companies from setting up joint outlets. Against such background, major banks (generally called mega banks) pursued realignment and strengthening of their securities subsidiaries by adding domestic securities companies to their corporate groups or forming alliance with foreign securities companies.

In December 1998, the Financial System Reform Act changed the regulation of the entry into the securities business from a licensing system to a registration system. This has enabled free entry into the securities industry as long as a minimum capitalization requirement of JPY100 million was satisfied. Moreover, in April 2004 the minimum capitalization was reduced to JPY50 million in order to encourage more new entrants to appear.

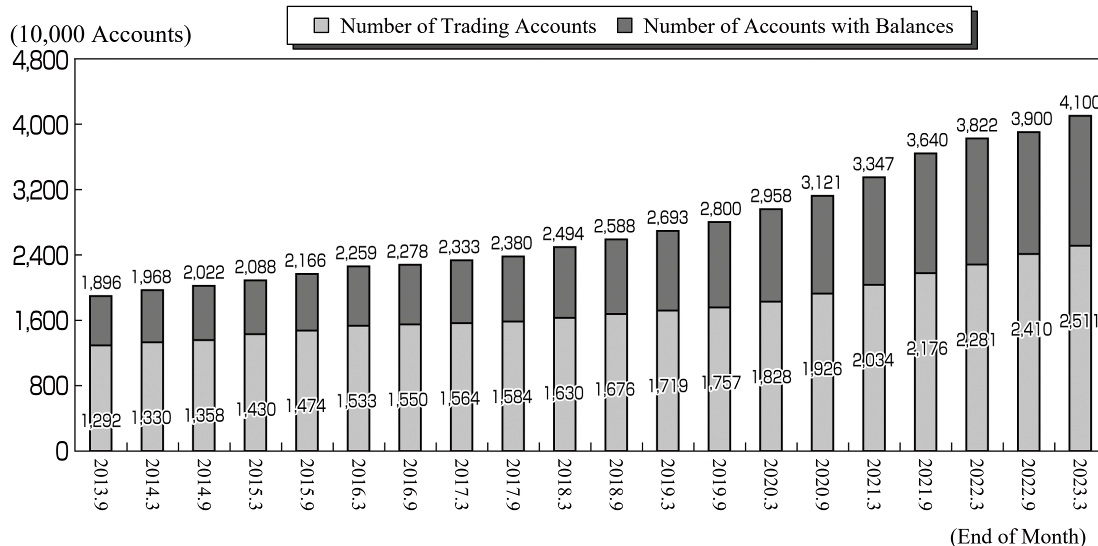
In October 1999, brokerage commissions were completely deregulated, and from around that time, online securities companies handling orders for stock trading at low prices by utilizing the Internet without opening actual outlets emerged, followed by the entry of leading securities companies who typically engaged only in "face-to-face" sales through their networks of physical outlets into the online securities trading business. The number of dealers offering online services was 90 as of the end of March 2023 (see Chart 1-1-9). In addition, the percentage of

Chart 1-1-9 Number of Members Handling Online Securities Trading and Percentage of Membership Handling Online Securities Trading Out of Total Membership



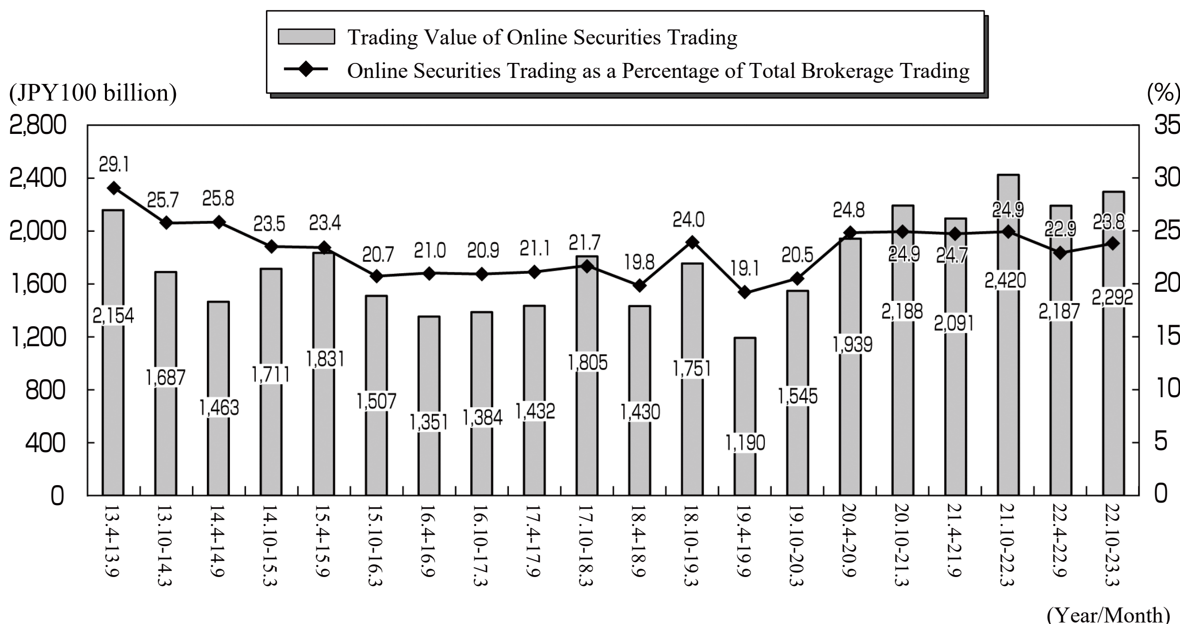
(Note) The percentage is rounded off to one decimal place.
(Source) Japan Securities Dealers Association, "Survey Report on Online Securities Trading (as of the end of March 2023)"

Chart 1-1-10 Number of Online Securities Trading Accounts



(Note 1) The percentage is rounded off to one decimal place.
(Note 2) The number of accounts is rounded off to the nearest 10,000.
(Source) Japan Securities Dealers Association, "Survey Report on Online Securities Trading (as of the end of March 2023)"

Chart 1-1-11 Trading Value of Online Securities Trading (Stock Trades) and Percentage of Online Securities Trading to Total Trading Value of Stock Brokerage Trading of All Members



(Note 1) The trading value is rounded off to the JPY100 billion.
(Note 2) The percentage is rounded off to one decimal place.
(Source) Japan Securities Dealers Association, "Survey Report on Online Securities Trading (as of the end of March 2023)"

online securities trading accounted for 23.8% of the total brokerage stock trading in the second half of fiscal 2022 (the period from October 2022 through March 2023) (see Chart 1-1-11).

As individual investors are the major customers of online securities trading, the rate of trading commissions

declined to below 0.1% of the trading price, and some securities companies declare commission-free trading. In this low-margin, high-volume industry, there were movements toward consolidation, leading some online securities companies to establish a firm position by achieving the opening of more accounts with them than with leading securities companies engaging in “face-to-face” sales.

The expansion of online securities trading also has a significant impact on the management of medium to small-sized securities companies that have relied on stock trading by individual investors, while at the same time, forcing large securities companies to review their business models.

A new system for a securities intermediary service (currently known as a “financial instruments intermediary service”) was introduced in April 2004. This service is an act that involves intermediation for the sale of securities upon entrustment from securities companies. Companies other than those in the financial sector as well as individuals may engage in this service. Since December 2004, banks may also carry out securities intermediary services (referred to as such at that time). As of the end of July 2023, there were 680 registered financial instruments intermediary service providers (excluding banks). The amendment in 2020 introduced the financial service intermediary business system which requires entities to register only once to engage in the intermediary service in banking and insurance in addition to the financial instruments intermediary service. As of June 26, 2023, seven entities were registered for the financial service intermediary business.

(4) Expansion of Investment Trusts

Individuals will continue to increase their financial assets in the future in conjunction with growth in the Japanese economy. In such environment, investment trusts have come to hold a significant position as a means of asset management by individuals.

This has led to the diversification of the types of investment trusts. As for legal systems, the “Financial System Reform Act” introduced investment corporations (corporation-type investment trusts) and private placement investment trusts in addition to the conventional contract-based publicly offered investment trusts. The amendment in May 2000 diversified investment targets and made it possible to establish real estate investment trusts (REITs). The TSE established a market for listed real estate investment trusts in March 2005 (listed in November 2005). In July 2005, stock index-linked exchange traded funds (ETFs) were listed in the TSE and OSE. In June 2023, the TSE’s securities listing regulations were revised to allow the listing of actively managed ETFs which are not linked with particular indexes, and trading in this type of ETFs started in September of the same year. As of the end of June 2023, the total net assets of domestic ETFs listed on the TSE amounted to JPY73.0 trillion and the total net assets of REIT listed on the TSE amounted to JPY11.6 trillion.

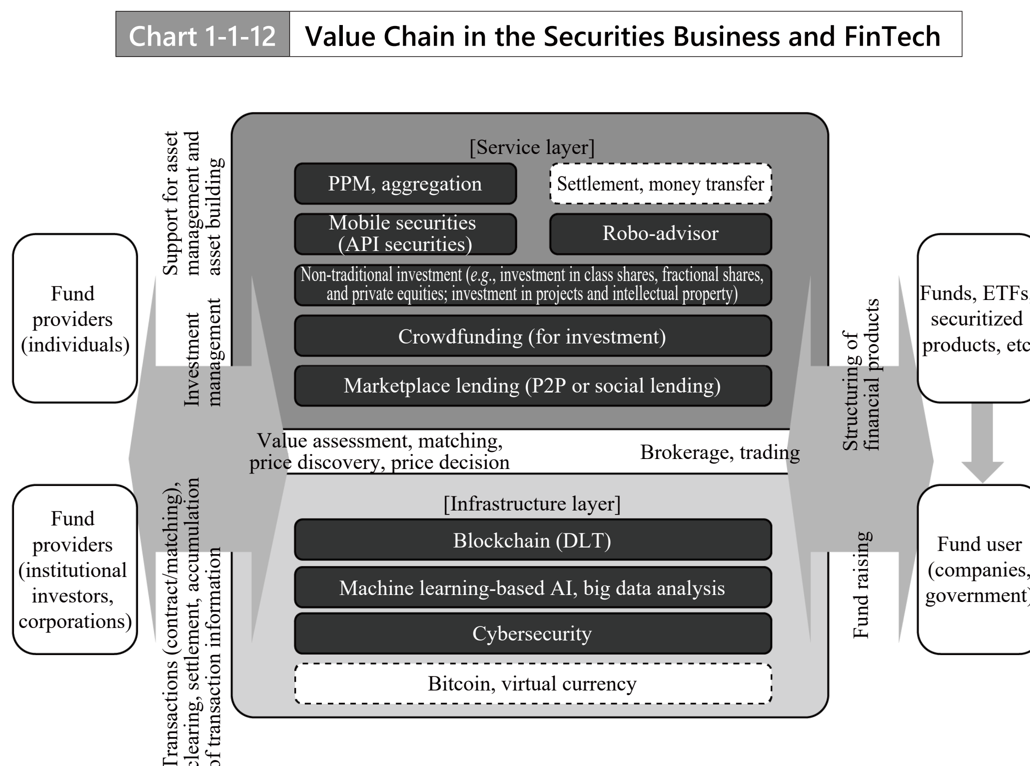
The distribution channels of investment trusts have also become diversified. Beginning in December 1997, investment trust sales by the so-called “sub-leasing” method were approved, and investment trust management companies began selling investment trusts in a corner of branches of major banks. From December 1998, the sale of investment trusts by banks themselves became allowed, and thereafter, the sale of investment trusts started at post offices since October 2005. The share of investment trust sales by banks, etc. has risen steadily, accounting to 42.5% of the total balance of publicly offered and private placement investment trusts, and 45.0% of stock investment trusts at the end of July 2023, developing into a major channel for sales of investment trusts.

The total net assets of publicly offered investment trusts amounted to JPY 51.3 trillion at the end of 1999. Since the beginning of the 2000s, stock investment trust balances continued to increase despite the influence of the fluctuations in stock prices, reaching JPY188.3 trillion as of the end of July 2023.

(5) FinTech and Securities Industry

The term “FinTech,” which is a coined word derived from “Finance” and “Technology,” refers to activities which innovate and reconstruct finance and payment services with the use of information and communications technology. FinTech has a significant impact not only on the securities industry but also on the entire financial system including banking. FinTech can be categorized into two layers: the infrastructure layer consisting of core technologies, and the service layer consisting of financial services which are supported by the infrastructure layer and used by customers (end users) (see Chart 1-1-12). The major impact of FinTech on the securities industry and markets is as follows.

Chart 1-1-12 Value Chain in the Securities Business and FinTech



(Note) The areas defined by solid lines directly relate to the securities business. The areas defined by dotted lines relate to the financial business as a whole including banking business and also indirectly affect the securities business.
(Source) Nomura Institute of Capital Markets Research

(i) PFM

PFM (Personal Financial Management) is a service that automatically keeps records of household accounts by displaying the total of the amounts of assets that an individual holds separately in different forms such as bank deposits, securities, credit cards, electronic money, and point cards, and categorizing transactions according to purposes of use. This service enables users to obtain an overview of their assets, the information of which is separated by account, and manage assets more rationally. By collaborating with PFM companies, securities companies will be able to identify each customer’s assets all-inclusively and provide consultation and planning services based on the customer’s asset situation.

(ii) Robo-Advisor

Robo-advisor is a service wherein a software program automatically calculates the risk tolerance, etc. based on the answers given by customers in response to multiple questions on a PC or smartphone, and

presents them with portfolios that are best fit for their attributes. Some robo-advisors provide discretionary investment services in which the selection of issues to invest in, execution of transactions, and rebalancing of portfolio are performed automatically. With the use of robo-advisors, investment advisory services, which have been enjoyed only by the wealthy and institutional investors, will also be made available to general investors at lower costs for small amounts of investment, enhancing the convenience for individuals in investment management.

(iii) Crowdfunding

Crowdfunding is a method whereby a fund user raises small amounts of funds from many unspecified persons via the Internet. It is categorized into four types depending on what is given to fund providers in return: (i) donation-based type (fund providers receive nothing); (ii) purchase-based type (fund providers acquire products or services from the fund user); lending-based type (fund providers acquire payment of interest and repayment of principal); and (iv) investment-based type (fund providers receive distribution of profit from the business operated by the fund user). Among these types, investment-based crowdfunding is closely related to the securities business, and it is further categorized into two types: equity-based crowdfunding (fund providers receive shares of stock) and fund-based crowdfunding (fund providers receive equity interests in the fund).

Equity-based crowdfunding is a scheme wherein investors subscribe for the shares issued by the fund user (usually an unlisted company), and the fund user raises funds from money paid in by the investors. While this scheme is similar to the conventional scheme of capital increase by public offering as both schemes solicit a number of investors to purchase shares, there is a difference in that the equity-based crowdfunding uses the Internet to raise funds from a broader range of investors.

Fund-based crowdfunding is a scheme wherein investors subscribe for equity interests in a fund in response to a solicitation by the fund user, and the fund user raises funds from contributions paid by the investors. This scheme also has aspects of purchase-based crowdfunding as it often attracts investors who appreciate or support products or services generated from the invested business.

Establishing a funding portal that supports equity-based crowdfunding constitutes the handling of public offerings or private placements of stocks and collective investment schemes, and it falls within the category of financial instruments business mentioned in 2-4. According to the amendment to the FIEA in 2014, a funding portal that only deals with the so-called “small-amount” crowdfunding campaigns that have a total issue value of less than JPY100 million each, and in which the paid-in amount per investor is not more than JPY500,000, is treated as a type I or type II small amount electronic public offering service provider and is subject to the entry conditions and regulations of concurrent business that are less strict than those imposed on general type I or type II financial instrument business operators.

(iv) Crypto-Assets (Virtual Currency)

Crypto-assets are digital proprietary assets that can be exchanged over the Internet. In Japan, they are defined as proprietary in nature in ways that satisfy the following requirements under the Payment Services Act: (i) they can be used in relation to unspecified persons for the purpose of paying consideration, etc. and can be exchanged with statutory currencies (*e.g.*, Japanese yen, US dollar); (ii) they are recorded and can be transferred by electronic means; (iii) they are not statutory currencies or assets denominated in statutory currencies (*e.g.*, prepaid cards). Such proprietary assets were initially called virtual currencies, but the amendment to the Payment Services Act changed its official name to crypto-assets. Crypto-assets exchange service providers must be registered with the FSA.

New schemes for raising funds by issuing crypto-assets have been created, such as ICO (Initial Coin Offering) and STO (Security Token Offering). In general, an ICO collectively means activities to raise funds from a broad range of investors using a digital token issued by a company or an individual. It is called STO when the tokens issued have the same legal nature as stocks or bonds.

(v) Blockchain (Distributed Ledger Technologies (DLT))

Blockchain technology is a kind of database that directly connects terminals on the information and telecommunication network and processes and keeps transaction records in a distributed manner using cryptographic technology. It is a fundamental technology used for crypto-assets. In relation to the securities business, blockchain technology can be used for book-entry transfer systems and customer identification procedures, thereby reducing transaction costs across the securities industry.

(6) Revenue Structure of Securities Companies

Chart 1-1-13 shows the revenue structure of securities companies. Operating revenue of securities companies, which corresponds to sales of non-securities companies, consists of commission received, net trading income, and financial revenue. Commission received includes commission for brokerage service, commission for underwriting and secondary distribution (underwriting new issues of securities), commission for handling of public offering and secondary distribution (selling beneficiary certificates of investment trusts), and other fees received (*e.g.*, trust fees for investment trusts, income from M&A services).

Deregulation of stock trading brokerage commissions changed the revenue structure of securities companies significantly. Before deregulation, brokerage commissions had accounted for about 40% of the total operating revenue, but recently, the proportion of this revenue source has been below 20%. The percentages of trading income and commissions for sale of investment trusts, instead of commissions for trading services, have been increasing in recent years.

However, the revenue structure greatly differs among securities companies depending on the size or nature of the companies. While large securities companies earn revenue from commissions for the sale of investment trusts in addition to brokerage commissions and trading income, the percentage of brokerage commissions in the total revenue of small and medium-sized securities companies is larger than that of larger companies.

Chart 1-1-13 Operating Revenue of Securities Companies

<Amount> (Unit: JPY billion)

Term (YY/MM or FY)	2014.3	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
Commission received	2,461	2,293	2,295	2,134	2,261	2,010	2,017	2,320	2,356	2,287
(For brokerage)	870	687	690	558	645	513	491	660	579	510
(For underwriting and secondary distribution)	170	162	176	166	138	184	150	165	181	121
(For handling of public offering and secondary distribution)	513	465	345	298	332	231	252	269	255	165
(Other fees)	905	978	1,082	1,110	1,145	1,080	1,122	1,225	1,340	1,489
Net trading income	1,097	1,237	1,088	1,113	1,004	744	868	1,066	867	861
Financial revenue	480	578	605	651	808	901	864	693	620	1,006
Operating revenue	4,088	4,156	4,038	3,956	4,133	3,727	3,785	4,112	3,860	4,192

<Composition> (Unit: %)

Term (YY/MM or FY)	2014.3	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
Commission received	60.2	55.2	56.8	53.9	54.7	53.9	53.3	56.4	61.0	54.6
(For brokerage)	21.3	16.5	17.1	14.1	15.6	13.8	13.0	16.0	15.0	12.2
(For underwriting and secondary distribution)	4.2	3.9	4.4	4.2	3.3	4.9	4.0	4.0	4.7	2.9
(For handling of public offering and secondary distribution)	12.5	11.2	8.5	7.5	8.0	6.2	6.7	6.6	6.6	4.0
(Other fees)	22.1	23.5	26.8	28.1	27.7	29.0	29.6	29.8	34.7	35.5
Net trading income	26.8	29.8	26.9	28.1	24.3	20.0	22.9	25.9	22.5	20.5
Financial revenue	11.7	13.9	15.0	16.5	19.5	24.2	22.8	16.9	16.1	24.0
Operating revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(Notes) 1. Excluding securities companies whose business was suspended at the end of March of each term.
2. The data for FY2014 and thereafter include companies whose accounts are closed during a month other than March and those that changed their accounting terms following the revision of the rules for accounting years.
3. The amounts were rounded down to JPY1 billion, and the percentages were rounded off to two decimal places.
(Source) Japan Securities Dealers Association, "Financial Overview of Regular Members"

5 Challenges in Japanese Securities Market

5-1 Globalization of Capital Markets and Japanese Securities Market

During the 20th century, Japan achieved what has been termed miraculous economic growth and has become one of the largest economies in the world. Along with this, the Japanese securities market has also achieved development.

From the beginning of the 21st century, contact and communication between the markets of the various trading zones in the EU, the U.S., and the Asia-Pacific economic zone have made further progress. This has led to vibrant global trading by the many different institutional investors that have developed, but has also intensified the competition between markets given that securities companies offer 24 hour trading and the various markets have become more homogeneous and integrated. Developments in alliance and integration between financial instruments

exchanges, international harmonization of systems and customs, increasing diversification of securities, and more sophisticated and more complicated trading methods will in all likelihood continue to progress.

Along with the economic development within Asia's newly industrialized economies (NIEs) and within the Association of Southeast Asian Nations (ASEAN), the financial and securities markets in this region have achieved remarkable growth, attracting the attention of the world. The Asian securities markets, however, as yet have only a brief history, and there are many areas in which they lack maturity. For these reasons, the governments are all putting their greatest efforts into creating a firm infrastructure, including creation of a more effective legal structure surrounding securities and improving the quality of securities companies, thereby taking initiative to foster and build their own securities markets.

In China, financial instruments exchanges opened in Shanghai, Shenzhen and Beijing, and they are thriving, backed by the high rates of economic growth. As China is a huge economic region, developments in this country have a major impact on the global economy.

It is anticipated that a huge Asian securities market will develop within the Asia-Oceania region, including Japan, in the near future. Japan's securities markets and securities companies are now being asked how they will contribute to the development of the financial and capital markets of Asia. Under such circumstances, the Tokyo Metropolitan Government and securities-related organizations have taken initiatives to make Tokyo the number-one international financial center in Asia.

5 2 Challenges of Japanese Securities Industry

The Japanese securities markets and securities industry face the following challenges for the future.

The first challenge is the response to the globalization of securities transactions. Along with this trend, the adjustment of trading and settlement systems between the markets of major countries, the standardization of regulations regarding securities and the international harmonization of financial and securities related legislations, tax systems and accounting standards have become important issues. It is desired that the Japanese government and securities associations should make accurate responses to overseas regulatory movements and participate in the formation of an international framework in collaboration with foreign governments and related organizations. This is also necessary for the process of securing Tokyo's status as an international financial center.

The second challenge is enhancement of the functionality of securities markets. On stock markets, enhancement of the equity financing function and diversification of financing methods are desirable. In particular, enhancing the function to supply risk money to startup companies is a task that is indispensable to the growth strategy of the Japanese economy. Other related issues include diversification of the types of companies issuing corporate bonds and improvement of the availability of price information and other infrastructure on bond markets.

The third challenge is the improvement of the legislative framework for securities markets. In order to ensure that active transactions will be conducted on securities markets in a transparent, fair, reliable and efficient manner, it is necessary to clearly indicate various rules and ensure sufficient customer protection, while developing conditions to make easily available investment information such as corporate information and price information. It is also desirable that securities companies have a high level of compliance consciousness as well as a sufficient system in place to monitor and detect improper transactions.

The fourth challenge is the development of environment that facilitates the participation of individual investors

in securities transactions. In 2024, the so-called Nippon Individual Savings Account (NISA; put into operation in January 2014) will be established as a permanent program and the investment limits will be raised. Efforts should be made to promote the NISA program and improve citizens' financial literacy by enhancing financial and economic education in junior high and high schools.

By addressing the foregoing challenges, the Japanese securities markets will be able to develop to an international center of finance and capital capable of responding to global inter-market competition with full transparency, fairness, reliability and efficiency.

Ⅱ Expansion of Sustainable Finance and Initiatives by the Securities Industry

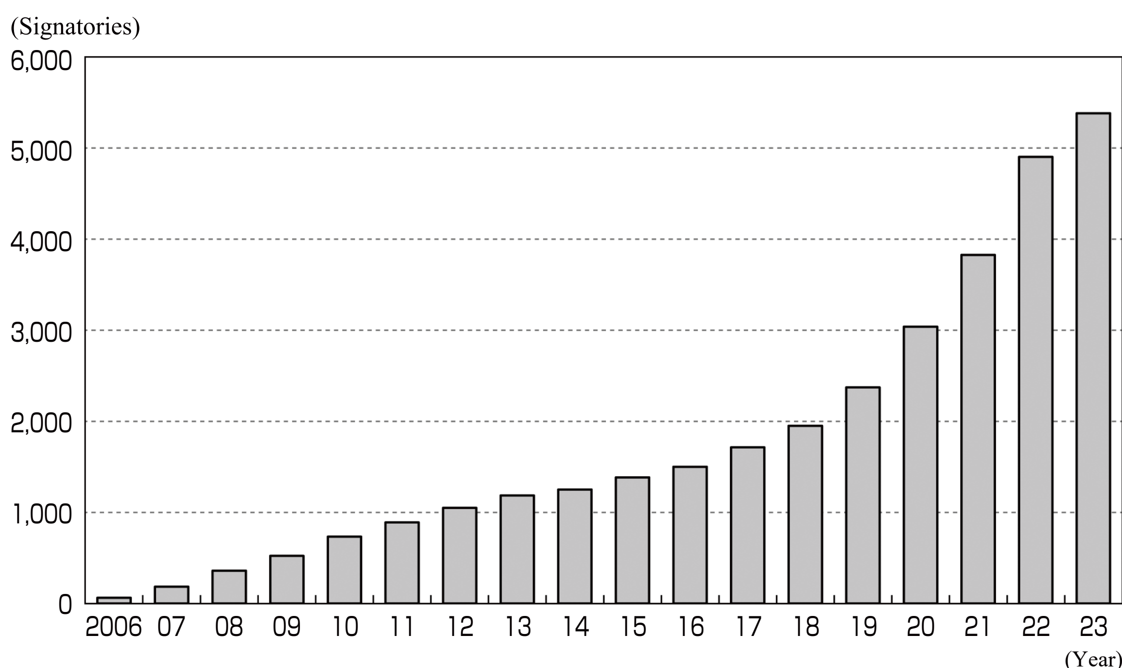
1 Expansion of Sustainable Finance

1 1 Sustainable Finance Supporting Sustainable Society in Finance

Conventionally, investment decisions have been made based on two factors: expected return and risk. On the other hand, in Europe, for instance, religious corporations followed fund management policies that they would not invest in companies that ran businesses against their doctrines (e.g., manufacturing weapons and alcohol, gambling, etc.). In the United States in the 1960s and thereafter, when there were social movements such as anti-war campaigns and anti-apartheid campaigns, pension funds adopted policies that they would not invest in companies involved in weapon manufacturing or companies running business in the Republic of South Africa (companies supporting the white government). Since the 1990s, with the global rise in interest in the global climate issues and corporate social responsibility (CSR), evaluating companies that tackle environmental issues or carry out CSR activities as the investment targets has become a trend.

In 2006, the **Principles for Responsible Investment (PRI)** were launched under the leadership of the United Nations. The PRI demands that institutional investors **make ESG investment, that is, take into account the three factors, namely, environmental, social, and governance, in investment decisions**. ESG investment founded on the PRI is based on the idea that morals or ethical values are not required to be reflected in investment decisions. ESG factors can have a significant impact on the investment return and institutional investors should not ignore them if they aim to maximize their customers' profits. The number of organizations that have endorsed and signed the PRI has been increasing year by year (Chart 1-2-1).

Chart 1-2-1 Changes in the Number of Signatories of the PRI



(Note) The data for each year is as of the end of March of the year.
(Source) Created by Daiwa Institute of Research based on the Principles for Responsible Investment

Many Japanese organizations including pension funds, insurance companies, and investment companies have endorsed and signed the PRI. In 2015, the Government Pension Investment Fund (GPIF), which is one of the world's largest pension funds, endorsed and signed the PRI, which is said to be one of the reasons behind the expansion of ESG investment in Japan.

The year 2015 was a symbolic year when the **Sustainable Development Goals (SDGs)** were adopted by the UN General Assembly, and the **Paris Agreement** was adopted at the 21st Session of the Conference of the Parties to the United Nations (UN) Framework Convention on Climate Change (COP21). As momentum toward achieving both economic growth and the resolution of environmental and social issues was growing on a global scale, awareness of the issue that finance should also change accordingly was shared widely. In 2021, the Expert Panel on Sustainable Finance, which was established by the Financial Services Agency, released a report titled "Building a Financial System that Supports a Sustainable Society," in which the expert panel points out that if we aim to realize a sustainable society, we need a financial system that is consistent with such society, and proposed the promotion of sustainable finance. **Sustainable finance** is not a term that refers to merely a particular financial instrument or investment style, but it refers to the **overall picture of the financial structure that supports a sustainable society, including financial systems, mechanisms, codes of conduct, and approaches to evaluation**.

As shown by the increase in the number of signatories of the PRI, the number of investors engaging in ESG investment has been on the rise. In recent years, **impact investment** that attempts to create beneficial environmental and social effects along with economic returns has been attracting attention. Companies that have been invested in are also accelerating their efforts toward realizing a sustainable society, which is expected to lead to an increase in the demand for funds and fundraising on securities markets. Financial instruments business operators are expected to play roles in connecting the investors with the issuing entities and in circulating funds smoothly with the aim of realizing a sustainable society, and sales representatives are expected to deepen their

understanding of sustainable finance.

1 2 Climate Change Issues, Which Are of Particular Note Among Sustainability Issues

(1) Process That Led to the Adoption of the Paris Agreement and Countries' Greenhouse Gas Emission Reduction Targets

Factors that should be taken into consideration when making an ESG investment are as follows: environmental factors are climate change, circular economy, biological diversity, and deforestation: social factors are human rights, decent work, diversity, equity, and inclusion; governance factors are board structure and political engagement (*e.g.,* political lobbying and donations by companies). (Note)

(Note) Principles for Responsible Investment (URL: https://www.unpri.org/an-introduction- to-responsible-investment/what-is-responsible-investment/4780.article) (last accessed on August 3, 2023).

Among these ESG issues, climate change attracts the most attention. It was at the United Nations Conference on the Human Environment held in 1972 that the global environment issues including climate change were first discussed by the international community. In 1992, at the United Nations Conference on Environment and Development, the United Nations Framework Convention on Climate Change (UNFCCC) was adopted and an agreement was reached to tackle the global warming issue through worldwide efforts. In 1997, the Third Conference of the Parties to the UNFCCC (COP 3) held in Kyoto adopted the Kyoto Protocol, which set the greenhouse gas emission reduction targets for developed countries. In 2015, at its 21st session held in Paris (COP 21), the Conference of the Parties to the UNFCCC adopted the **Paris Agreement**, which requests all participating countries, including developing countries, to make efforts for emission reduction, with the **goal of limiting global warming to well below 2, preferably to 1.5 degrees Celsius, compared to pre-industrial levels**. Aiming to achieve the goals set under the Paris Agreement, Japan has made goals to **reduce the greenhouse gas emission by 46% by FY2030 compared to FY2013 (and meet the lofty goal of cutting its emission by 50%), and achieve net zero by 2050** (Chart 1-2-2). "Net zero" means that the greenhouse gas emissions are completely absorbed by forests, etc.

Chart 1-2-2 Greenhouse Gas Emission Reduction Targets of Major Countries

Country/Region	2030 Emission Reduction Target	Net Zero Target Year
Japan	-46% (Continue strenuous efforts in its challenge to meet the lofty goal of cutting its emission by 50%) (from FY2013)	2050
United States	-50% to -52% (from 2005)	2050
EU	At least -55% (from 1990)	2050
United Kingdom	(1) At least -68% (from 1990) (2) -78% in 2035 (from 1990)	2050
China	(1) Strive to reach the peak of CO2 emissions by 2030 (2) Lower CO2 emissions per unit of GDP by over 65% (from 2005)	2060

(Source) Materials released by the respective countries

(2) Relationship between Climate Change and Finance

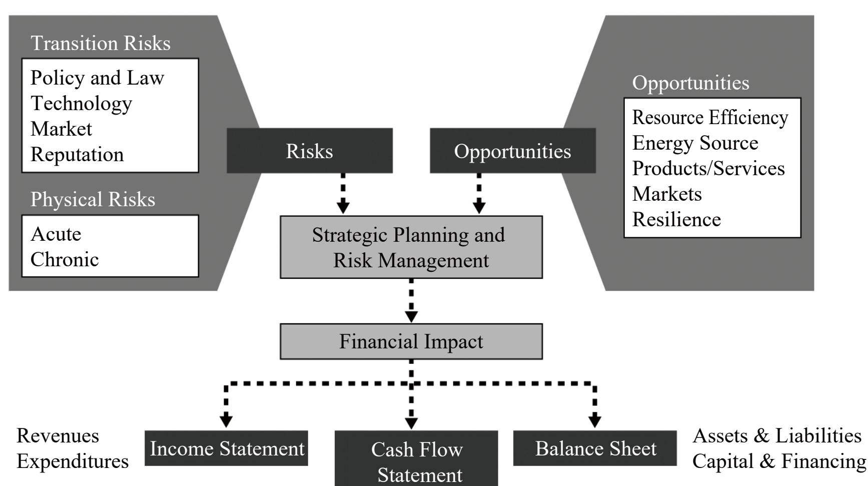
There are concerns about the impact of climate change on the financial system. In 2015, the G20 Finance Ministers and Central Bank Governors' Meeting requested the Financial Stability Board (FSB) to convene public- and private- sector participants to review how the financial sector can take account of climate-related issues. Following this, the FSB established the **Task Force on Climate-related Financial Disclosures (TCFD)**.

In its final report published in 2017, the TCFD recommended disclosure by companies of their climate change-related risks and opportunities. To date, 4,824 organizations have endorsed the TCFD's recommendations including financial institutions and companies around the world, and 1,454 organizations in Japan (as of September 25, 2023). The Corporate Governance Code revised in 2021 requested that companies to be listed on the Prime Market enhance the quality and quantity of disclosure of climate change-related information based on the TCFD or an equivalent framework.

(Note) TCFD Consortium (URL: https://tcfd-consortium.jp/about) (last accessed on October 11, 2023).

The TCFD explains the climate-related risks and opportunities that financial institutions, investors, and insurance companies (hereinafter collectively "financial institutions, etc.") should understand, as outlined in the chart below. As information disclosure by companies is promoted, financial institutions, etc. will be able to reflect climate change-related information in their decisions on investments, loans, and insurance underwriting, which is expected to lead to stabilizing the financial system.

Chart 1-2-3 Climate-Related Risks, Opportunities, and Financial Impact



(Source) Task Force on Climate-related Financial Disclosures, "Final Report Recommendations of the Task Force on Climate-related Financial Disclosures (June 2017)"

2 Typical Investment Approaches and Financial Instruments in Sustainable Finance

2-1 Seven Categories of ESG-Oriented Investment

While the term “sustainable finance” does not refer to any particular financial instrument or investment style, the Global Sustainable Investment Alliance (GSIA), which is an international organization, indicates the following as methods for taking ESG factors into consideration in asset investment: **(i) ESG integration; (ii) corporate engagement and shareholder action; (iii) norms-based screening; (iv) negative/exclusionary screening; (v) best-in-class/positive screening; (vi) sustainability themed/thematic investing; and (vii) impact investing and community investing** (Chart 1-2-4). These methods are used independently or in combination depending on investment strategies. According to the Global Sustainable Investment Review 2020 published by the GSIA in 2021, global investment by these methods reached USD35 trillion (as of the end of FY2019). For an investment approach, “ESG integration” was most frequently employed, followed by “negative/exclusionary screening” and “corporate engagement and shareholder action”.

Chart 1-2-4 ESG-oriented Investment Approaches

Investment Approach	Outline
ESG integration	The systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis.
Corporate engagement and shareholder action	Employing shareholder power to influence corporate behavior, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.
Norms-based screening	Screening of investments against minimum standards of business or issuer practice based on international norms such as those issued by the UN, ILO, OECD and NGOs (e.g., Transparency International).
Negative/exclusionary screening	The exclusion from a fund or portfolio of certain sectors, companies, countries or other issuers based on activities considered not investable. Exclusion criteria (based on norms and values) can refer, for example, to product categories (e.g., weapons, tobacco), company practices (e.g., animal testing, violation of human rights, corruption) or controversies.
Best-in-class/positive screening	Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers, and that achieve a rating above a defined threshold.
Sustainability themed/thematic investing	Investing in themes or assets specifically contributing to sustainable solutions - environmental and social - (e.g., sustainable agriculture, green buildings, lower carbon tilted portfolio, gender equality, diversity).
Impact investing and community investing	Impact investing: Investing to achieve positive, social and environmental impacts - requires measuring and reporting against these impacts, demonstrating the intentionality of the investor and the underlying asset/investee, and demonstrating the investor contribution. Community investing: Where capital is specifically directed to traditionally underserved individuals or communities, as well as financing that is provided to businesses with a clear social or environmental purpose. Some community investing is impact investing, but community investing is broader and considers other forms of investing and targeted lending activities.

(Source) Global Sustainable Investment Alliance, "GLOBAL SUSTAINABLE INVESTMENT REVIEW 2020" (edited by the author).

2 2 ESG-Related Financial Instruments

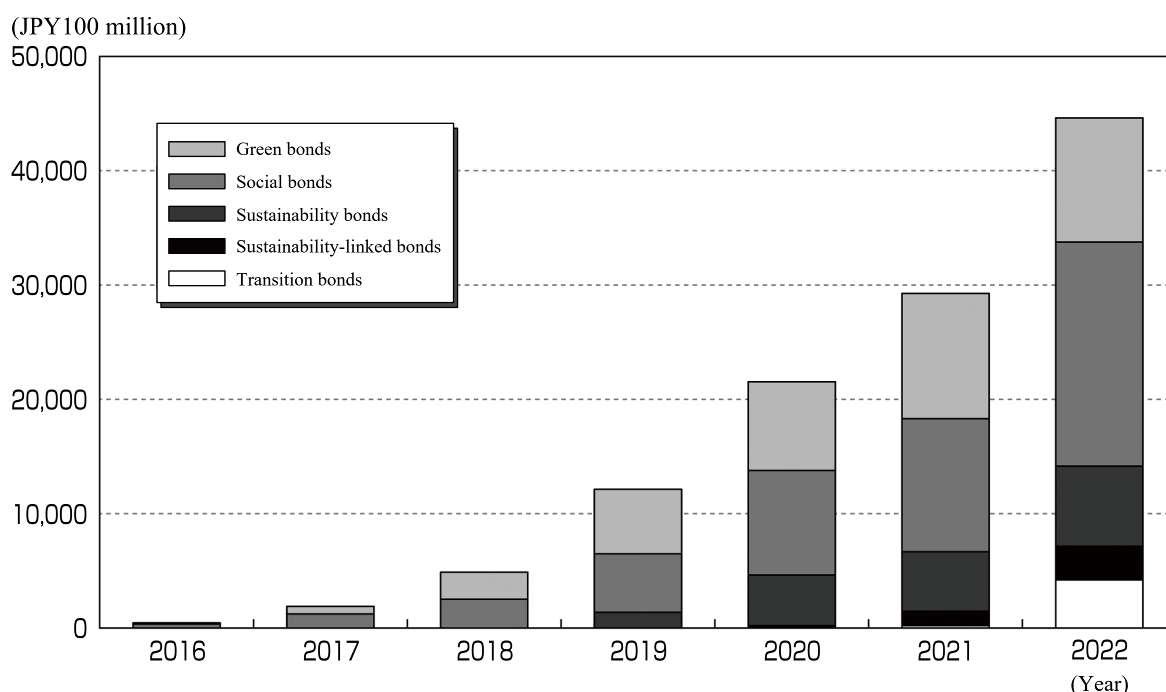
Financial instruments that contribute to the promotion of sustainable finance have been increasing, such as investment trusts that take ESG factors into account and bonds for investing funds in projects that contribute to the resolution of environmental and social issues. Typical examples include the following: "**green bonds**" issued only for using the proceeds in projects that can have a positive environmental impact; "**social bonds**" issued only for using the proceeds in projects that can have a positive social impact; and "**sustainability bonds**" issued only for using the proceeds in projects that can have a positive impact on both the environment and society. The issuance of "**sustainability-linked bonds**" and "**transition bonds**", for which the use of the proceeds is not specified, has also

been increasing.

Sustainability-linked bonds are bonds for which the issuers clearly show investors the key performance indicators (KPIs) based on their sustainability strategies, set one or more sustainability performance targets (SPTs) for each KPI, and change the conditions for interest payment or redemption depending on the status of achievement of the SPTs. On the other hand, transition bonds are expected to be used in sectors that emit a great amount of greenhouse gas and need time to achieve decarbonization (steel, chemical, electricity, gas, oil, cement, paper and pulp, etc.). Issuers of transition bonds are required to disclose to investors the medium to long-term goals they have set that align with the Paris Agreement, the plans for achieving the goals, and the governance system, thereby showing that they need to raise funds by issuing transition bonds in order to achieve decarbonization.

All these bonds, which contribute to the achievement of the SDGs, are collectively referred to as “SDG bonds” (or “ESG bonds”) in Japan. The amount of these bonds issued in 2022 was about JPY 4.5 trillion.

Chart 1-2-5 Changes in the Amount of Issuance of SDG Bonds (Publicly Offered Bonds in Japan)



(Note) Sustainability-linked bonds for which the use of the proceeds is limited (with the nature of green bonds) are counted as sustainability-linked bonds.
(Source) Japan Securities Dealers Association and Japan Exchange Group

Proceeds from these bonds are used for the following purposes: green bonds, renewable energy and improvement of energy efficiency; maintenance and management of environmentally friendly buildings; development and manufacturing of electric-powered vehicles and hydrogen-fueled vehicles, and development of infrastructure for transportation that uses clean energy; and improvement of the efficiency of logistic systems. Social bonds are issued for purposes such as the following: development of fundamental infrastructure and supply of housing that is affordable to everyone; access to medical and other services that are indispensable for people’s daily lives; creation of jobs; and supply of funds to SMEs.

With regard to the issuance of SDG bonds, the International Capital Market Association (ICMA) published the “Green Bond Principles,” the “Social Bond Principles,” the “Sustainability Bond Guidelines,” the

"Sustainability-Linked Bond Principles: Voluntary Process Guidelines," and the "Climate Transition Finance Handbook." In Japan, the Ministry of the Environment published the "Green Bond and Sustainability-Linked Bond Guidelines," the Financial Services Agency published the "Social Bond Guidelines," and the Financial Services Agency, the Ministry of Economy, Trade and Industry, and the Ministry of the Environment published the "Basic Guidelines on Climate Transition Finance." All of these principles and guidelines request the bond issuers to properly disclose to investors information concerning the purpose of use of the proceeds, the process for evaluating and selecting the projects for which the proceeds are to be used, the management of the proceeds, and the status of the projects after investment. They also recommend external reviews to be conducted by a third party other than the issuer.

3 Challenges in Sustainable Finance and Responses

3-1 Acquisition (by Investors) and Disclosure (by Issuers) of Sustainability Information

As sustainable finance grows, various challenges have been pointed out, and progress has been made in studies on how to address these challenges. Investors have mentioned inadequate disclosure of sustainability information of companies that is necessary when making decisions on investment. Investors can know companies' financial information (e.g., sales, profits, cash flow, etc.) through the annual securities reports and summaries of financial results the companies disclose based on the provisions of the FIEA and the Companies Act, as well as the rules of the exchange. However, sustainability information was disclosed only on a voluntary basis, except for information on corporate governance.

On the other hand, due to the absence of rules for disclosure of sustainability information, companies faced the problem of what information they should disclose through which documents. As mentioned above, the documents for disclosure of financial information are clearly designated, and because balance sheets, profit and loss statements, and cash flow statements can be prepared based on the accounting standards (companies listed on the TSE should choose one standard from among the Japanese accounting standards, the U.S. accounting standards, or the International Financial Reporting Standards (IFRS)). However, because of the absence of uniform standards for the disclosure of sustainability information, companies had disclosed sustainability information based on their own decisions, using standards and frameworks created voluntarily by private-sector organizations.

Under such circumstances, in Japan, the Financial Services Agency amended the "Cabinet Office Ordinance on Disclosure of Corporate Affairs" and other related regulations in January 2023. In order to promote the disclosure of sustainability information, a new section named "Policy and initiatives for sustainability" has been introduced in annual securities reports, in which matters concerning "governance" and "risk management" are required to be stated. Matters concerning "strategy" and "indicators and targets" are also required to be stated depending on their importance. Disclosure concerning human capital is also mandatory. Policies on human resource development and improvement of the internal environment, including securing diversity in human resources, and details of indicators concerning these policies, are also required to be disclosed. In addition, indicators concerning diversity have been introduced, requiring companies to state the "percentage of women in managerial positions," "percentage of men

taking childcare leave," and "gender wage gap" in annual securities reports if they publish such data under the Act on the Promotion of Women's Active Engagement in Professional Life.

International disclosure standards were published in June 2023. They were created by the **International Sustainability Standards Board** (ISSB) established by the IFRS Foundation in 2021 which is involved in the formulation of the IFRS. In June 2023, the ISSB published (i) the General Requirements for Disclosure of Sustainability-related Financial Information and (ii) Climate-related Disclosure. The Climate-related Disclosure incorporates matters for which disclosure is required by the TCFD and requires further detailed disclosure. In Japan in the future, the Sustainability Standards Board of Japan (SSBJ) (a board established by the Financial Accounting Standards Foundation (FASF) in July 2022 to study sustainability information disclosure standards in Japan) will consider the specifics of disclosure based on the ISSB standards to ensure that sustainability information disclosed in annual securities reports is consistent with information disclosed under the ISSB standards.

3 2 Challenges Related to ESG Rating Agencies and Data Providers

When institutional investors engage in ESG investment, they often refer to the evaluations and ratings provided by ESG rating agencies that evaluate companies' ESG initiatives. When companies issue SDG bonds, it is a common practice to subject them to rating by external agencies in terms of eligibility. Major ESG rating agencies include: the Arabesque Group, Bloomberg Finance L.P., CDP, FTSE Russell, MSCI., S&P Global, and Sustainalytics. (Note) Major SDG bond rating agencies include: DNV BUSINESS ASSURANCE JAPAN K.K., Japan Credit Rating Agency, Ltd. (JCR), Rating and Investment Information, Inc. (R&I), and Sustainalytics.

Based on their own rating methods, these rating agencies collect and analyze ESG information of companies and conduct ESG evaluations, using the information disclosed by the respective companies and their answers to individual questionnaire surveys. ESG ratings provided by ESG rating agencies are used by institutional investors when making investment decisions and are also used to develop the ESG indices, which serve as benchmarks for investment trusts that take ESG factors into consideration. Institutional investors also acquire ESG-related information from information vendors including ESG agencies.

(Note) JPX website, "ESG Rating Agencies" (URL: https://www.jpx.co.jp/corporate/sustainability/esgknowledgehub/esg-rating/index.html) (last accessed on August 24, 2023).

Regarding these ESG rating and data agencies, the following challenges are pointed out: (i) transparency and fairness of evaluation (although different ESG rating and data providers use different criteria or methods for evaluation and data imputation, their details or intended settings are not disclosed); (ii) governance and impartiality (when objective criteria for evaluation standards are not disclosed, there are cases of conflict of interests when, for example, a rating agency provides both external corporate or green bond evaluation and paid consulting services for the same company); (iii) appointment of suitable human resources (there is no objective guarantee of evaluation ability, the right people for the right location, and the governance structure). The Technical Committee for ESG Evaluation and Data Providers, which was established by the Expert Panel on Sustainable Finance mentioned above, discussed these challenges and compiled a report titled "Report of the Technical Committee for ESG

Evaluation and Data Providers - Towards market development through further improvement of ESG evaluation and data quality" in July 2022. Following this report, the Financial Services Agency published the "Code of Conduct for ESG Evaluation and Data Providers" (Chart 1-2-6) in December 2022. This Code of Conduct does not require action uniformly under laws and regulations, but instead serves as a voluntary code on a "comply or explain" basis in which the Financial Services Agency calls for individual ESG evaluation and data providers to express their support for the Code via public announcements. Those supporting the Code either comply with the principles and guidelines of the Code, or explain the reasons why they do not comply with a particular item.

Chart 1-2-6 Six Principles under the Code of Conduct for ESG Evaluation and Data Providers

Principle 1 (Securing Quality)	ESG evaluation and data providers should strive to ensure the quality of the ESG evaluations and data they provide. The basic procedures necessary for this purpose should be established.
Principle 2 (Human Resources Development)	ESG evaluation and data providers should secure the necessary professional human resources to ensure the quality of the evaluation and data provision services they provide, and should develop their own professional skills.
Principle 3 (Ensuring Independence and Managing Conflicts of Interest)	ESG evaluation and data providers should establish effective policies so that they can independently make decisions and appropriately address conflicts of interest that may arise from their organization and ownership, business, investment and funding, and compensation for their officers and employees, etc. With regard to conflicts of interest, providers should identify their own activities and situations that could undermine the independence, objectivity, and neutrality of their business, and avoid potential conflicts of interest or appropriately manage and reduce the risk of conflict of interest.
Principle 4 (Ensuring Transparency)	ESG evaluation and data providers should recognize that ensuring transparency is an essential and prioritized issue, and publicly clarify their basic approach in providing services, such as the purpose and basic methodology of evaluations. Methodologies and processes for formulating services should be sufficiently disclosed.
Principle 5 (Confidentiality)	ESG evaluation and data providers should establish policies and procedures to appropriately protect non-public information obtained in the course of business.
Principle 6 (Communication with Companies)	ESG evaluation and data providers should devise and improve the way they gather information from companies so that the process becomes efficient for both the ESG evaluation and data providers and the companies or so that the necessary information can be sufficiently obtained. When important or reasonable issues related to information sources are raised by companies subject to evaluation, ESG evaluation and data providers should appropriately respond to the issues.

(Source) Financial Services Agency, "Code of Conduct for ESG Evaluation and Data Providers" (December 15, 2022)

3 3 Washing Issues of ESG-Related Financial Instruments

ESG-related financial instruments have been on the rise as mentioned above. Financial instruments business operators should be careful about the washing issues such as **greenwashing** and **SDG-washing** when selling

ESG-related financial instruments. “Greenwashing” and “SDG-washing” are derived from “whitewashing” which means concealing failures or wrongdoing, and they refer to a thing that is claimed to be good for the environment or society but is not so in actuality. In the case of an investment trust, for example, if it is labeled as an “environmental fund” but its portfolio is constructed without following any clear criteria or only convenient information about the fund is disclosed to the investors (inconvenient information is not disclosed), such conduct is regarded as washing.

The “Progress Report on Enhancing Asset Management Business 2022” published by the Financial Services Agency in 2022 pointed out that asset management firms should develop effective systems for ESG investment and that appropriate information provision and disclosure should be promoted in order to enable investors to correctly understand the details of investment products without any misunderstanding and make appropriate investment decisions. Being aware of these challenges, the Financial Services Agency amended the “Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.” in March 2023 to define the scope of ESG investment trusts and clarify the information disclosure and asset management companies’ control environment required for ESG investment trusts.

Sustainable finance is said to be part of the financial infrastructure for realizing a sustainable society. As it is a relatively new and developing sector, it is necessary to expand its quantity and also improve its quality. Sales representatives are now required to be equipped with knowledge not only in finance but also in environmental and social issues.

4 Securities Industry and SDGs

The SDGs are a set of international goals consisting of 17 goals and 169 targets developed by the United Nations and are intended to be achieved by 2030, in order to realize a world where “no one is left behind.” The whole world, including developed countries, is carrying out initiatives to end poverty, fight against inequality, and take action to combat climate change. The securities industry is also promoting the SDGs under the following three themes.

4 1 Initiatives for Dissemination and Promotion of Sustainable Finance

As the SDGs cover a broad range, not only public funds but also funds from the private sector are needed in order to carry out various projects and achieve the SDGs. As mentioned above, financial institutions and institutional investors in the private sector have been proactive in expanding sustainable finance, and the Japanese securities industry has also been taking initiatives to further disseminate and promote sustainable finance, making use of the capital market’s function to supply funds.

For example, the JSDA has proposed a uniform name, “SDG bonds,” to collectively refer to financial instruments that contribute to the SDGs, including green bonds, social bonds, sustainability bonds, sustainability-linked bonds, and transition bonds. Both the number and volume of issuance have been increasing year by year, and the volume of issuance of SDG bonds publicly offered in Japan in 2022 exceeded JPY4.4 trillion. In addition, the JSDA prepared a publication titled the “Guidebook on Financial Instruments Contributing to the SDGs,” aiming to

enhance awareness and understanding of SDG bonds among officers and employees of securities companies as well as the general public. From 2022, the JSDA has published and updated the "Declaration on Promoting Sustainable Finance" with the objective of further accelerating the process of resolving social issues through the securities industry and contributing to the realization of a sustainable society.

4 2 Initiatives Related to the Work Style Reform and the Promotion of Diversity

In order for the securities industry to be a sustainable industry, it is also important to promote the work style reform measures industry-wide and enable diverse people to demonstrate their abilities, thereby increasing productivity.

Accordingly, the JSDA compiled "Practices of the Work Style Reform in the Securities Industry" and "Practices of Work-from-Home and Other Remote Working in the Securities Industry" with a view to sharing the best practices of the innovative work style reform measures and initiatives for women's empowerment and supporting discussions and efforts at companies in the securities industry. In addition, for the purpose of deepening the understanding of the current status of the work style reform and the significance of the reform, building an information sharing network in the industry, and fostering a career consciousness, the JSDA holds seminars for various categories of personnel of the member securities companies, such as human resources personnel, management personnel, and female employees, and creates video materials for training.

At these seminars, lectures are given by experts, and the member companies share their practices and exchange opinions with participants. For example, the seminars help securities companies in promoting women's empowerment initiatives in a way that female employees who participated in the seminars moved to career positions, resulting in the increase in the number of female employees in career positions.

4 3 Initiatives for the Resolution of Child Poverty

In recent years, due to the widening disparity, about one in seven children in Japan are in relative poverty (a state of being in poverty compared with the living standards of the country). The issue of child poverty affects the Japanese economy and society, and it is also likely to cause the securities market to shrink because the companies' poor business performance would lead to an income decrease, and fewer people would purchase securities for investment. As part of the measures to assist in solving this problem, the securities industry as a whole participates in the program to invite donations by used books, "Charity by the Book." By the end of July 2023, donations of about JPY4.5 million (about 162,000 books) were collected.

The JSDA operates the "Children Support Securities Network," as a platform for connecting securities companies with NPOs to make use of the goods and other resources that securities companies can provide for supporting children. To date, more than 1,200 requests of support have matched available resources, and as a result, food and beverages, including rice and instant food, and daily supplies, have been donated to NPOs. These goods are used at eating places and shelters for children that provide meals for free.

Furthermore, in order to make use of social contribution-type shareholders incentives provided by securities

companies, the JSDA has established the "Shareholders Incentives Endowment Fund for the SDGs," and has made donations through this fund to organizations carrying out activities that are considered to contribute to the achievement of the SDGs. In FY2022, the Fund collected about JPY31.39 million from 14 companies and made donations to two organizations: the World Food Programme (WFP), a UN body in charge of providing food assistance, and the Children's Future Support Fund operated by the Children and Families Agency, etc.

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Introduction

The Financial Instruments and Exchange Act (hereinafter the "FIEA") is the law coordinating the requirements to establish a capital market, and to enable such market to realize its full potential. Starting with general provisions, the FIEA contains provisions governing matters such as the disclosure system, financial instruments business operators, financial instruments firms associations, investors protection fund, financial instruments exchanges, financial instruments clearing organizations, securities finance companies, regulation on transactions, etc. of securities, and administrative monetary penalty.

The FIEA was enacted in June 2006, amending the name and content of the former Securities and Exchange Law (hereinafter the "SEL") which was enacted as Act No. 25 of 1948. Although the FIEA is an amended law of the SEL, it is in substance extensive enough to constitute an enactment of new legislation. Taking into account the changes to the domestic and foreign capital markets, etc., the FIEA has been amended every year since its enactment.

In order to enhance the competitiveness of the financial/capital market of Japan, amendments in 2008 were made to establish the so-called professional market, review the regulations on the scope of business of financial institution groups and reform the administrative monetary penalty system, etc.

The amendments in 2009 revised the disclosure system and the like related to secondary distributions of securities, and the transfer procedures for professional investors and general investors, and introduced separate management duties for securities OTC derivatives transactions as well as official regulations for credit rating agencies, established a finance Alternative Dispute Resolution (ADR) system, and introduced rules concerning cross entrance of financial instruments exchanges and commodity exchanges.

In light of the international discussions in response to the global financial crisis, and in order to respond to issues seen in the Japanese financial and capital markets, amendments in 2010 were made to require the use of clearing organizations regarding OTC derivatives transactions, etc., enhance the group regulations and supervision of financial instruments business operators and take other measures.

In 2011, the FIEA underwent further amendments for the purpose of strengthening the foundation of the capital markets and the financial industry, such as improving the disclosure system for rights offering, relaxing the regulations on the investment management business operators who exclusively deal with professionals, expanding the scope of disclosure documents that may be submitted in the English language, developing regulations for trading of unlisted shares by unregistered business operators, and prescribing additional conditions for refusing registration of investment advisory and agency business operators.

The FIEA was further amended in 2012 for the purpose of reinforcing the effort to strengthen the international competitiveness of the Japanese capital market and ensuring fairness and transparency in financial instruments transactions, by facilitating the establishment of a comprehensive exchange, obligatory use of electronic information systems for over-the-counter derivatives transaction, revision of the administrative monetary penalty system and revision of insider trading regulation.

The amendments in 2013 were intended to take measures against a financial crisis originating from market disruption and to restore the reliability and strengthen the functions of the financial and capital markets and of the financial instruments business. These amendments include: (i) strengthening the insider trading regulations in response to the recent insider trading incidents related to public offering; (ii) revising asset management regulations based on the experience of the AIJ scandal; (iii) establishing an orderly resolution regime for financial institutions; (iv) enhancing provision of capital by banks, etc.; and (v) providing diversified financing and capital policy methods

for investment corporations.

The 2014 amendments include: (i) developing a system for equity-based crowdfunding;(ii) creating a new trading system for unlisted shares; (iii) reviewing the regulations relating to the business year for financial instruments business operators; (iv) reducing the burden on newly public companies; (v) reviewing the regulations on fund distributors; (vi) introducing regulations on financial indicators; and (vii) developing a procedure for confiscation of electronic share certificates, etc.

The 2015 amendments strengthened regulations on specially permitted services for qualified institutional investors, etc., for the purpose of ensuring the sound management of funds for professional investors and facilitating the supply of growth money.

The 2017 amendments introduced various measures to adapt to the development of information and communication technology and others changes in Japanese financial and capital markets. These new measures include responding to High Speed Trading in shares, etc., enhancing flexibility in terms of the division of operations within an exchange group, and ensuring fair information disclosure by listed companies.

The 2019 amendments included crypto-and other assets in the scope of subjects regulated under the FIEA and introduced provisions to address new types of transactions and unfair acts using crypto-and other assets (the regulated subject was “crypto-assets” at the time of the 2019 amendment; as a result of the subsequent amendment to the FIEA under the Act to Partially Amend the Payment Services Act and Other Related Acts to Establish a Stable and Efficient Payment Services System (Act No. 61 of 2022), the regulated subject has been changed from “crypto-assets” to “crypto-and other assets” (effective as of June 1, 2023)).

Through the 2020 amendments, the “Act on Sales, etc. of Financial Instruments” was fully amended and established as the “Act on the Provision of Financial Services,” and accordingly, the FIEA was amended by providing for additional grounds for refusal of registration, etc. of the financial instruments business, the requirement of notification upon registration as a financial service intermediary, and the designation of the trade depository as the sole place for submission of reports on OTC derivatives transaction information, etc.

The 2022 amendments enhanced the flexibility of the requirements for changing status from general investor to professional investor, relaxed the regulations on equity-based crowdfunding, and introduced the listed company auditor register.

The outline of the FIEA is explained below, with emphasis on subjects that are highly relevant and recur frequently in the activities of sales representatives.

The abbreviations for names of laws and regulations as used in this Chapter are as follows:

“FIEA” or “Act” ···Financial Instruments and Exchange Act (Act No. 25 of 1948)
“SEL” ···············Securities and Exchange Law (Act No. 25 of 1948)
“ITA” ···············Act on Investment Trusts and Investment Corporations (Act No. 198 of 1951)
“APFS” ············Act on the Provision of Financial Services (Act No. 50 of 2020)
“CDTA” ············Commodity Derivatives Transaction Act (Act No. 239 of 1950)
“FIEAEO” ·········Order for Enforcement of the Financial Instruments and Exchange Act (Cabinet Order No. 321 of 1965)
“Definition Ordinance”
·········Cabinet Office Ordinance on Definitions under Article 2 of the Financial Instruments and Exchange Act (Ministry of Finance Ordinance No. 14 of 1993)
“Corporate Affairs Disclosure Ordinance”

………Cabinet Office Ordinance on Disclosure of Corporate Affairs (Ministry of Finance Ordinance No. 5 of 1973)

"Ordinance on Disclosure of Regulated Securities"
………Cabinet Office Ordinance on Disclosure of Information on Regulated Securities (Ministry of Finance Ordinance No. 22 of 1993)

"Securities Information Ordinance"
………Cabinet Office Ordinance on the Provision and Publication of Information on Securities (Cabinet Office Ordinance No. 78 of 2008)

"Material Information Ordinance"
………Cabinet Office Ordinance on Disclosure of Material Information under Chapter II-6 of the Financial Instruments and Exchange Act (Cabinet Office Ordinance No. 54 of 2017)

"FIBCOO" ………Cabinet Office Ordinance on Financial Instruments Business (Cabinet Office Ordinance No. 52 of 2007)

"Designated Dispute Resolution Ordinance"
………Cabinet Office Ordinance on Designated Dispute Resolution Organizations under the Provisions of Chapter V-5 of the Financial Instruments and Exchange Act (Cabinet Office Ordinance No. 77 of 2009)

"OTC Derivatives Ordinance"
………Cabinet Office Ordinance on the Regulation of Over-the-Counter Derivatives Transactions (Cabinet Office Ordinance No. 48 of 2012)

"Financial Benchmark Ordinance"
………Cabinet Office Ordinance on Specified Financial Benchmark Administrators (Cabinet Office Ordinance No. 39 of 2015)

"Securities Transaction Ordinance"
………Cabinet Office Ordinance on Restrictions on Securities Transactions (Cabinet Office Ordinance No. 59 of 2007)

"Administrative Monetary Penalty Ordinance"
………Cabinet Office Ordinance on Administrative Monetary Penalty under the Provisions of Chapter VI-2 of the Financial Instruments and Exchange Act (Cabinet Office Ordinance No. 17 of 2005)

"Financial Statements Ordinance"
………Ordinance on Terminology, Forms, and Preparation Methods of Financial Statements (Ministry of Finance Ordinance No. 59 of 1963)

"Audit Certificate Ordinance"
………Cabinet Office Ordinance on Audit Certification of Financial Statements (Ministry of Finance Ordinance No. 12 of 1957)

"Internal Control Ordinance"
………Cabinet Office Ordinance on the System for Ensuring the Adequacy of Documents on Financial Calculation and Other Information (Cabinet Office Ordinance No. 62 of 2007)

"Securitization Act"
………Act on the Securitization of Assets (Act No. 105 of 1998)

"Preferred Equity Investment Act"

………Act on Preferred Equity Investment by Cooperative Structured Financial Institution (Act No. 44 of 1993)

*Legally speaking, the Japanese government Minister having administrative jurisdiction over most of the FIEA is the Prime Minister himself; however, the Prime Minister delegates this authority to the Commissioner of the Financial Services Agency (FIEA, art. 194-7, para. 1; provided that the authorities provided in the FIEAEO are excluded), and consequently in some cases the references in this Chapter are to the Commissioner of the Financial Services Agency.

History of the Establishment of and Amendments to the Securities and Exchange Law

The SEL was drafted to integrate the patchwork pre-war regulations concerning securities trading as well as incorporating wholesale the legal system of the United States in line with the democratization of securities.

Following its enactment, the SEL was amended several times to reflect the actual condition of securities trading in Japan. Notably, the amendments in 1965 (implementation of a license system for the securities business, strengthening of the oversight provisions, and attempting to coordinate the securities sales representative system), and those in 1971 (which mainly covered rationalization of the disclosure system, and creation of registration system for the tender offer) were ground breaking in reexamining the state of securities trading at that time. In 1988, a comprehensive amendment was adopted as Act No. 75 of 1988 to coordinate the securities futures market, to reform the disclosure system and to coordinate insider trading regulations.

Several more amendments followed—amendments in 1992 after the “bursting” of Japan’s economic bubble and a spate of securities industry scandals, implemented the establishment of the Securities and Exchange Surveillance Commission, strengthened the function of self-regulatory organizations, coordinated the definition of securities, reexamined the concept of a public offering, the treatment of private placements, and mutual entry by securities and banking institutions into each other’s businesses, etc.; amendments in 1994 provided for disclosure, etc. of acquisitions of treasury shares corresponding to the liberalization of restrictions on treasury shares; and amendments in 1996 introduced market value accounting for the trading accounts of securities companies.

Subsequently, the discussion concerning the system-wide reform of the securities market in order to allow it to realize its full potential reached a fever pitch just as Japan’s Financial Big Bang was announced, and legal amendments were carried out in line with this discussion. In 1998, the SEL was completely overhauled with the enactment of the “Act on Coordination, Etc. of Laws Relating to the Reform of the Financial System (the “Financial System Reform Act”)” which orchestrated amendments to the SEL, the Securities Investment Trust Act and other relevant laws in order to expand the selection of investment products and opportunities for investors and financiers, to create a smooth running environment promoting healthy competition between securities companies, etc. and financial institutions (by once again shifting the securities business licensing system to a registration system, etc.), and to coordinate reforms to the structure of the financial and securities markets to make them more useful and reliable for domestic and foreign users.

Further, amendments were enacted in 1999 with respect to the reform of the Japanese government pursuant to the laws related to central ministries and agencies reform, etc., and again in 2000 concerning the electronic disclosure, and the conversion of the securities exchanges into stock companies. In 2002, amendments were made concerning the clearing brokerage of securities and settlement institutions, etc. In 2003, in connection with the “Program for Promoting Securities Market Reform” announced by the Financial Services Agency a year earlier, the law was amended to allow for the creation of a securities intermediary

system with a view to improve and diversify the sales channel for securities, and in 2004, an administrative monetary penalty system was introduced, the provisions for civil liability were reviewed, and the provisions relating to the prospectus were overhauled.

In 2005, amendments were made to the tender offer system for shares, to illegalize the use of off-auction floor trading in order to acquire a large block of shares in a company, in order to address the criticism that had been received as a result of the incident in which the company Livedoor had acquired a major holding in Nippon Broadcasting System by using off-auction trading, which is a vehicle for large volume transactions on the Tokyo Stock Exchange. In addition, in the same year amendments were made to the disclosure of parent company information of a listed company which had become a major issue with the Seibu Railways scandal, and a further amendment was made in connection with English language disclosure of corporate affairs by foreign companies, etc.

In 2006, criminal penalty became stricter and a fundamental review was made with regard to the tender offer system and the reporting system of possession of large volume.

The massive reform concerning the financial system began with the Financial System Reform Act in 1998, but with the globalization of the capital market, each country has progressed further reform of the financial system and Japan, too, was required to implement a comprehensive and cross-sectional reform of legal systems. In 2007, the FIEA was enacted in the form of an investment service law as an amendment of the former SEL, with objectives that included introducing an overarching legal and regulatory system with respect to matters such as selling and solicitation of investment products, as well as covering matters such as interests of collective investment schemes within the regulatory framework when they had previously been excluded from regulation, and permitting a certain degree of flexibility in the regulations for business operators (Act No. 65 and 66 of 2006).

1 Overview

1 1 Financial Instruments Markets and Securities

The financial instruments market is a market in the abstract sense that encompasses the process from the time securities are issued until they are acquired by investors, and the process by which securities circulate among investors. Financial instruments markets consist of the location where entities such as corporations and public organizations raise the funds they require through the issuance of stocks and bonds, etc. (the primary market) and a place where investors can freely convert the securities they acquired into cash (secondary market).

Only when such a secondary market exists may investors confidently participate in the primary market. The trading price and trading conditions formulated for securities in the secondary market are also a major determining factor in the scale and issue terms of new securities issues in the primary market.

In this way, the primary market and the secondary market are intimately connected, and the FIEA promotes the protection of investors by regulating the fairness and efficiency of trading activities conducted on the financial

instruments markets, centered on these two markets.

There are various types of securities, and the following are the types of securities listed in the FIEA as the subjects to regulation (FIEA, art. 2, para. 1):

(1) Japanese national government bonds;
(2) Municipal bonds;
(3) Bonds issued by a juridical person under a special act;
(4) Specified corporate bonds prescribed in the Securitization Act;
(5) Corporate bonds (including those issued by a mutual company);
(6) Investment securities issued by a juridical person under a special act (Bank of Japan investment securities, etc.);
(7) Preferred equity investment certificates prescribed in the Preferred Equity Investment Act;
(8) Preferred equity investment certificates and securities indicating preemptive rights for new preferred equity investment prescribed in the Securitization Act;
(9) Share certificates and share option certificates;
(10) Beneficiary securities of investment trusts or foreign investment trusts prescribed in the ITA);
(11) Investment securities of an investment corporation (so-called corporate-type investment trusts), investment equity subscription right certificates, investment corporation bonds or foreign investment securities;
(12) Beneficiary securities of loan trusts;
(13) Beneficiary securities of specific purpose trust prescribed in the Securitization Act;
(14) Beneficiary securities of beneficiary securities issuing trusts prescribed in the Trust Act;
(15) Promissory notes which have been issued by a juridical person in order to raise funds necessary to operate its business and are specified by Cabinet Office Ordinance (so-called CP);
(16) Mortgage securities prescribed in the Mortgage Securities Act;
(17) Securities or certificates which have been issued by a foreign state or foreign person and have the nature of securities or certificates listed in (1) through (9) above, or (12) through (16);
(18) Securities or certificates which have been issued by a foreign person, indicate a beneficial interest of a trust in which loan claims held by persons engaging in banking business or persons otherwise conducting money loan in the course of trade are entrusted, or indicate any other similar rights, and are specified by a Cabinet Office Ordinance (so-called Certificates for Amortizing Revolving Debts (CARDs), etc.);
(19) Securities and certificates which indicate the rights pertaining to transactions specified in the FIEA, Article 2, Paragraph 21, Item 3 conducted in a financial instruments market in accordance with such requirements and by using such method as prescribed by the operator of the financial instruments market, rights pertaining to the transactions conducted in a foreign financial instruments market and are similar to the ones specified in the FIEA, Article 2, Paragraph 21, Item 3 (excluding transactions related to commodities), and rights pertaining to the transactions specified in the FIEA, Article 2, Paragraph 22, Items

3 or 4 conducted in neither a financial instruments market nor foreign financial instruments market (hereinafter the rights shall be collectively referred to as the "options") (so-called covered warrants);

(20) Securities or certificates which have been issued by a person to whom securities or certificates listed in any of (1) through (19) above are deposited and in a state other than the state in which the deposited securities or certificates were issued and which indicate the rights pertaining to the deposited securities or certificates (so-called Depository Receipts (DRs)); and

(21) In addition to what is listed in the preceding items, the following are provided for in the FIEA: securities or certificates specified by a Cabinet Order as those for which it is found, when taking into consideration the liquidity thereof and other factors, necessary to secure the public interest or protection of investors (negotiable certificates of deposit issued by foreign juridical person pursuant to the provisions of the FIEAEO, art. 1 (foreign CDs) or school bonds (Definition Ordinance, art. 4)).

The rights to be indicated in the above securities and which are prescribed by Cabinet Office Ordinance (hereinafter referred to as "rights to be indicated on securities") shall, even when securities indicating these rights have not been issued, be deemed to be securities indicating these rights (FIEA, art. 2, para. 2, first sentence; registered bonds, book-entry transfer bonds, shares without share certificates, and share options without certificates fall within this rule), and among electronically recorded monetary claims, specified electronically recorded monetary claims prescribed by Cabinet Order as considered necessary to deem as corporate bonds or other securities in consideration of the status of distribution and other circumstances are deemed as securities (FIEA, art. 2, para. 2, second sentence; *provided,* however, there is no such Cabinet Order at this time).

Furthermore, the rights listed below are deemed as securities even if they are not indicated on securities or certificates (FIEA, art. 2, para. 2, third sentence):

(1) Beneficial interests in a trust;

(2) Rights against a foreign person which have the nature of beneficial interests in a trust;

(3) Membership rights of a general partnership company or limited partnership company (limited to those prescribed by Cabinet Order) or membership rights of a limited liability company;

(4) Membership rights of a foreign juridical person that has the nature of the rights set forth in the preceding item;

(5) Interests in a collective investment scheme (fund) (including those rights pursuant to a foreign law or regulation that are equivalent to the same);

Interest in a collective investment scheme shall mean rights based on a partnership agreement under the Civil Code, an anonymous partnership agreement under the Commercial Code, an investment limited partnership agreement, or a limited liability partnership agreement, membership rights in an incorporated association, or other rights for which the holder thereof can receive dividends of profits arising from the business conducted by using money invested or contributed by the equity investors (the "invested business") or distributions of assets of the invested business. Nevertheless, the following are excluded:

(i) Rights of an equity investor in cases where all of the equity investors participate in the

invested business as specified by Cabinet Order (meaning cases in which the execution of the invested business is carried out with the consent of all equity investors, and in which all equity investors are engaged on full standing basis in the invested business, or have particular specialized skills and are indispensable to the continuation of the invested business—FIEAEO, art. 1-3-2);

(ii) Rights of an equity investor where it is provided that equity investors will not receive dividend of profits or distribution of the assets of the invested business in an amount exceeding the amount invested or contributed by them;

(iii) Rights pursuant to certain insurance agreements, mutual aid agreements or real estate specified joint enterprise agreements; and

(iv) Other rights as prescribed by Cabinet Order as those for which it is found not to hinder the public interest or protection of equity investors even if these rights are not deemed to be securities (rights in connection with insurance and mutual aid agreements, rights in connection with investment, etc. in juridical persons of various types with the exception of general incorporated associations other than public interest incorporated associations as well as general incorporated foundations other than public interest incorporated foundations, rights pursuant to an agreement to divide crops or forestry yields, rights pursuant to a partnership agreement, etc. in which the invested business is a business solely by certified public accountants, attorneys-at-law, judicial scriveners, land and house investigators, administrative scrivener, certified tax accountants, certified real estate appraisers, public consultant on social and labor insurance or certified patent specialists as parties, employee stockholding associations, expanded employee stockholding associations and business affiliate stockholding associations; FIEAEO, art. 1-3-3; Definition Ordinance, art. 6 and art. 7);

In relation to (5), crypto-and other assets for which funds have been contributed by persons who are entitled to receive a distribution of profit are deemed to be money, and the provisions of the FIEA will apply to such crypto-assets (FIEA, art. 2-2);

(6) Rights specified by Cabinet Order as those for which it is found, when taking into consideration the fact that they have an economic nature similar to securities provided in the FIEA, Article 2, Paragraph 1 and rights set forth in Paragraph 2 of the said Article and other circumstances, necessary and appropriate to secure the public interest or protection of investors by deeming them as securities (certain school bonds (receivables in connection with loans to an incorporated educational institutions, etc.; provided, however, that syndicated loans for incorporated educational institutions offered by banks, etc. are excluded) are designated; FIEAEO, art. 1-3-4). Such school bonds are subject to the disclosure regulations as "rights in securities investment business, etc.") (FIEA, art. 3, item 3(a)(3).; FIEAEO, art. 2-10, para. 2).

Securities Under the FIEA

The FIEA does not seek to regulate all of the securities under private law and applies only to those that are determined to be investment instruments and investment objects that are of a nature of being suited to

formation of a securities market in a broad sense (suitability for market trading), and for which it is recognized that formation of this type of market (trading) will benefit the national economy (FIEA, art. 1). This is justified since it is necessary to identify the meaning of the content of securities from the perspective that the objective of the FIEA is to achieve fair price formation for financial instruments and by fully exerting the functions of the capital markets, thereby enabling sound development of the national economy. One precondition to enable the formation of such market transactions is that these securities under private law have a nature of being transferred freely among investors.

Under the FIEA, if securities have the potential possibility of forming a market in the future, they can be recognized as securities before they actually form a market, and even in the event that a market is closed, or in connection with subsequent windup transactions of securities that have been traded on that market, they may be treated as securities under the FIEA.

The current legal concept of securities defines instruments for which rights are embodied in certificates or receipts as being securities (but excluding securities in the FIEA, Article 2, Paragraph 2); however, the original concept of a "security" under U.S. securities law or an "investment" under U.K. securities law does not require the existence of a physical certificate. In addition, the demands for prompt processing of transactions have led to an increased need for a transfer settlement system covering the circulation of these investments. As a result, traditional securities are becoming "paperless."

1 2 Derivatives Transactions and Financial Instruments as well as Financial Indicators

In addition to securities, the scope of application of the FIEA includes certain derivatives transactions (FIEA, art. 2, para. 20).

The underlying assets that constitute the basis for derivatives transactions are financial instruments and these products include currencies, etc. in addition to securities. Moreover, investment consulting contracts or investment advisory contracts as well as asset management agreements are also considered to involve rights in connection with the securities or derivatives transactions that are made on the basis of an investment decision pursuant to an analysis of factors such as the value of the financial instruments.

It is necessary to be aware that the concepts of a financial instruments market, the financial instruments business and a financial instruments exchange do not mean business or market in financial instruments as mentioned above.

Derivatives transactions covered by the scope of the FIEA include the following:

(1) Market transactions of derivatives

Market transactions of derivatives mean those transactions that are carried out on a financial instruments market in accordance with the requirements and by using methods prescribed by the operator of the financial instruments market. This includes futures transactions in financial instruments and financial indexes, options transactions, swaps transactions, commodity-related market transactions of derivatives (market transactions of derivatives for which commodities or commodity-related financial indicators are used as

underlying assets or reference indexes), credit derivatives transactions (transactions in which the other party promises to pay cash in the event that a certain event occurs in connection with matters such as the creditworthiness of a corporation) as well as those transactions that are prescribed by Cabinet Order as being similar to the same (FIEA, art. 2, para. 21).

(2) Over-the-Counter transactions of derivatives

Over-the-Counter transactions of derivatives mean those transactions that are equivalent to market transactions of derivatives which are carried out outside a financial instruments market or on a foreign financial instruments market (FIEA, art. 2, para. 22). Provided that transactions related to commodities, etc. shall be excluded. Nevertheless, transactions in currency options that are included in savings deposits, etc., insurance and mutual aid agreements, debt guarantee agreements and loss indemnity agreements on loans are excluded from Over-the-Counter derivatives transactions (FIEAEO, art. 1-15).

(3) Foreign market derivatives transactions

Foreign market derivatives transactions mean those transactions that are carried out on a foreign financial instruments market, and which are similar to market transactions of derivatives (FIEA, art. 2, para. 23). Provided that transactions related to commodities, etc. shall be excluded.

Financial instruments mean the following (FIEA, art. 2, para. 24):

(1) Securities;
(2) Claims on a deposit agreement or other rights, as well as those securities or certificates indicating these claims or rights, and which are prescribed by Cabinet Order;
(3) Currencies;
(4) Crypto-and other assets (meaning the crypto-assets prescribed in Article 2, Paragraph 14 of the Payment Services Act or what is set forth in Paragraph 5, Item 4 of that Article and is specified by Cabinet Office Order as anything regarding which it is found to be necessary to ensure the public interest or the protection of investors);
(5) Commodities (among the commodities prescribed in Article 2, Paragraph 1 of the CDTA, meaning those specified by the Cabinet Order as a commodity for which there is no risk of harm to the appropriate price formation by the market transactions of derivatives conducted in relation to the commodity and the market transactions of derivatives conducted in relation to the commodity in the financial instruments exchange market are conducive to the national economy, by taking into account the fact that whether or not there are any measures concerning the stabilization of the price of the relevant commodity under the provisions of laws and regulations as well as other conditions of price formation and supply and demand of the relevant commodity);
(6) Assets for which there are many of the same kind, which have substantial price volatility, and which are specified by Cabinet Order as those for which it is found necessary to secure the protection of investors with regard to derivative transactions (or other similar transactions) pertaining thereto (excluding commodities under the CDTA; however, there is no such Cabinet Order at this time); and

(7) Standardized instruments (meaning those that a financial instruments exchange has prescribed for the purpose of facilitating market transactions of derivatives, in connection with those financial instruments that are prescribed by Cabinet Office Ordinance, other than currency).

Financial indicators mean the following (FIEA, art. 2, para. 25):

(1) Price or interest rate, etc. of financial instruments;
(2) Figures pertaining to the results of meteorological observations published by the Meteorological Agency or others;
(3) Among indicators which it is impossible or extremely difficult for a person to exert his/her influence on the fluctuation in and which may have serious influence on business activities of business operators or statistical figures pertaining to social or economic conditions, indicators or figures specified by a Cabinet Order as those for which it is found necessary to secure the protection of investors with regard to derivative transactions pertaining thereto (excluding commodities indices under the CDTA which are calculated based on the price of commodity under the CDTA other than the commodity).
Among the index derivatives transactions referred to indicators determined by Cabinet Order there are, specifically, derivatives transactions of reference indexes of values of measurement results of geological conditions, geological conditions, geomagnetism, geo-electricity or hydrological conditions, such as earthquake derivatives transactions, GDP derivatives transactions, derivatives transactions using as reference indexes statistics in connection with designated statistical surveys and statistical study filings, etc. under the Statistics Act, and derivatives transactions using, as reference indexes, rents, etc. for real property published or provided by the administrative organs or by organizations engaged in the real property-related business (FIEAEO, art. 1-18); and
(4) Figures calculated pursuant to these financial indicators.

1 3 Purpose of the FIEA

Article 1 of the FIEA states “The purpose of this Act is, *inter alia,* by developing systems for disclosure of corporate affairs and other related matters, providing for necessary matters relating to persons who engage in Financial Instruments Business and securing appropriate operation of Financial Instruments Exchanges, to ensure fairness in, *inter alia,* issuance of the Securities and transactions of Financial Instruments, etc. and to facilitate the smooth distribution of Securities, as well as to aim at fair price formation of Financial Instruments, etc. through the full utilization of functions of the capital market, thereby contributing to the sound development of the national economy and protection of investors.”

Article 1 of the FIEA uses language to the effect that in addition to ensuring fair and smooth transactions in and distribution of securities through full enhancement of important systems under the FIEA, including disclosure

of corporate affairs and other related matters, and regulating the financial instruments business as well as financial instruments exchanges, etc., fair formation of prices can be promoted by fully exploiting the functionalities of capital markets. Ensuring fairness of transactions and facilitating of distribution, however, are functions that are subsumed in the functions of capital markets and the broad-based objective of fair price formation. Consequently, it appears that the position has been made explicit that the objective of the FIEA is "assuring the fair price formation" through "full utilization of functions of the capital markets."

It also seems that by use of the word "thereby," "the sound development of the national economy" and "the protection of investors" is to be the result of achieving fair price formation. Thus, the greater of what has formerly been referred to as "protection of investors" has come to have a theoretical position of being a condition or assumption for achieving fair price formation by full utilization of functions of the capital markets.

"Fair price formation" is a concept that presumes a situation in which conditions for forming a market are in place, and means the forming of prices that is achieved through a competitive concentration of investment decisions by investors who identify the true value of the securities that are the target of investment. Information disclosure is a system for the purpose of enabling the identification of the true value of securities at the time of a transaction, while a financial instruments exchange is a forum in which these types of investment decisions are concentrated and prices are formed through competitions, and persons engaged in the financial instruments business are persons who fulfill the responsibility of being those who have the role of forming a market.

1 4 Organization of the FIEA

The provisions of the FIEA can be roughly divided into four types below:

(1) Information Disclosure (Disclosure) ……These provisions deal with the preparation and disclosure of the filing of the securities registration statements and prospectuses at the time of a public offering or secondary distribution of securities, as well as the preparation and disclosure of the annual securities reports and semiannual securities reports, etc. in each business year, and aim to ensure the establishment of terms for the formation of a market through providing information pertaining to the true value of the securities to the broader market in connection with issuance and distribution of securities.

In addition, there are regulations concerning tender offers under which shares are acquired in one block from an unspecified number of many persons as well as the reporting system of possession of large volume to be filed upon an acquisition of large volume of shares, etc. which relate to information disclosure.

(2) Regulation Concerning the Bearers of the Capital Markets……Detailed provisions are included with a view towards clarifying the vital roles in the capital markets played by financial instruments business operators and registered financial institutions, etc. who play major roles in various aspects of the capital markets, the financial instruments exchanges that operate markets regarding financial instruments, financial instruments clearing organizations that handle clearing of transactions, authorized financial instruments firms associations which handle the regulation of professionals in the industry, and securities finance companies who take responsibility for facilitating margin transactions and loan transactions.

(3) Regulation of Transactions……Many provisions have been stipulated concerning transactions in general in the financial instruments business as well as trading on financial instruments exchanges, in order to prohibit acts that will interfere with the functioning of capital markets, including prohibitions against unfair

transactions such as market manipulation and insider trading.

(4) Regulations Concerning Financial Regulatory Authorities……Provisions have been stipulated concerning matters such as supervision of and administrative actions against business activities by the Financial Services Agency within the regulation in connection with those who have responsible roles within the capital markets, but in addition systems exist concerning matters such as investigation of criminal cases by the Securities and Exchange Surveillance Commission as well as the system in which the Financial Services Agency orders the payment of administrative monetary penalties.

Among those mentioned above, the regulations concerning information disclosure do not apply to transactions of derivatives because the primary purpose of the regulations is to make available materials that are helpful for making decisions on investment in securities. The regulations concerning the bearers of the capital markets; those concerning transactions; and those concerning financial regulatory authorities apply to transactions of derivatives and financial instruments business operations conducting these transactions.

2 Financial Instruments Business Operators

2 1 General

○ **Financial Instruments Business Operators and Financial Instruments Business**

Financial instruments business operators are entities who have registered with the Prime Minister and engage in the financial instruments business (FIEA, art. 2, para. 9).

Financial instruments business operators play a variety of roles for the purpose of "forming fair prices in financial instruments, etc. through full utilization of functions of the capital markets," which constitutes the objective of the FIEA. More specifically, financial instruments business operators handle a large distribution market as members or transaction participants on financial instruments exchanges which constitute organized markets. They also fulfill the roll of linking the investment decisions of a broad-based stratum of investors with the financial instruments markets, through brokering on financial instruments markets the orders of investors who cannot become transaction participants.

Furthermore, it is of utmost necessity that financial instruments business operators determine the investor base that is suited to transactions in accordance with the nature of the financial instruments that are to be transacted, to achieve investment decisions that are consistent with the financial instruments market, and to prevent the interference of improper investment decisions in price formation. In order to promote the understanding of investors concerning the quality and value of securities, financial instruments business operators have a duty to provide certain explanations and advice. In the case of negotiated markets, financial instruments business operators also have a duty to engage in transactions with investors at a fair price.

Based on such roles, a financial instruments business operator can be said to be a highly sophisticated specialist who has the most central role and responsibility of assuring the functionality of the capital markets, and of giving living substance to the various rules in order for capital markets to be formed. For this reason, the FIEA imposes a variety of regulations on financial instruments business operators.

The scope of the financial instruments business has been greatly broadened with the enactment of the FIEA when compared to the former securities business. In addition to the previous securities business, the financial instruments business includes the financial futures trading business, the commodities investment sales business, the trust beneficial interest sales business, the investment advisory business, business in connection with discretionary investment contracts, the investment trust management business, the investment corporation asset management business, and the mortgage securities business, all of which had been covered under their respective business laws.

In addition to these activities, the issuer's acts of solicitation to acquire securities that the issuer will newly issue (*i.e.*, a self-managed offering), agency or intermediation in an investment advisory contract or a discretionary investment contract, forming a collective investment scheme or the like and mainly carrying out management as an investment in securities or rights in connection with derivatives transactions (*i.e.*, self-management), acts of accepting deposits of cash or securities from a customer in connection with securities transactions, as well as opening an account for the purpose of carrying out book-entry transfer of bonds, etc. and carrying out book-entry transfer of bonds have also been newly designated as financial instruments business.

In order to make a differentiation in the regulations such as conduct regulations and financial regulations depending on the type of financial instruments business that a financial instruments business operator conducts, the FIEA classifies the financial instruments business into four classes consisting of the **type I financial instruments business**, **type II financial instruments business**, **investment advisory and agency business**, and **investment management business** (FIEA, art. 28, para. 1 through para. 4), and allows flexibility in entry regulations.

In addition, banks, cooperative structured financial institutions, and other financial institutions as prescribed by Cabinet Order are generally prohibited from engaging in securities-related business or the investment management business (FIEA, art. 33, para. 1). However, this restriction is rapidly being liberalized (for details, see Section 2.12 "Financial Institutions and Financial Instruments Business").

2 2 Meaning of Financial Instruments Business

(1) Content of Financial Instruments Business

The **financial instruments business** means the following enumerated functions (FIEA, art. 2, para. 8).

(i) Sales and Purchase of Securities, Market Transactions of Derivatives (Excluding Commodity-Related Market Transactions of Derivatives), and Foreign Market Derivatives Transactions

This category covers transactions conducted on one's own account. However, commodity-related market transactions of derivatives conducted on one's own account are excluded from the scope of financial instruments business because the lawmakers considered it necessary to enable a broad range of parties who are engaged in the production and distribution of commodities and highly capable of procuring and supplying the actual commodities to participate in commodity-related market transactions of derivatives.

(ii) Intermediary, Brokerage or Agency Service for Sales and Purchase of Securities, Market Transactions of Derivatives and Foreign Market Derivatives Transactions

"Intermediary" means attempting to establish a transaction between other persons. "Brokerage" means undertaking to buy or sell, etc. securities in the securities companies' own name, but for the account of the investor. This is also referred to as "broker functions." "Agency service" means undertaking to perform

purchases or sales, etc. of securities in the name of the principal for the account of the principal (or representing one's status as the agent of the principal).

(iii) Intermediary, Brokerage or Agency Service for Entrustment of: Sales and Purchase of Securities Conducted in a Financial Instruments Exchange Market or Market Derivatives Transactions; or Sales and Purchase of Securities in a Foreign Financial Instruments Exchange Market or Foreign Market Derivatives Transactions

Intermediary, brokerage or agency service for entrustment refers to when a financial instruments business operator that does not have a qualification to conduct trades, etc. on a financial instruments exchange market consigns a customer order to another financial instruments business operator that does have this qualification.

(iv) Over-the-Counter Transactions of Derivatives or Intermediary, Brokerage (Excluding Brokerage for Clearing of Securities, Etc.) or Agency Service Therefor

Derivative financial products such as securities-related forward transactions, securities-related over-the-counter index, etc. forward transactions, securities-related over-the-counter option transactions, or securities-related over-the-counter index, etc. swap transactions (hereinafter "Securities-related Over-the-Counter Transactions of Derivatives") are products of a highly speculative nature, and traditionally only standardized derivatives transactions on exchanges have been allowed. Subsequently, in response to the various financial innovations of recent years, the 1998 revisions to the SEL completely lifted this prohibition, as a result of which Securities-related Over-the-Counter Transactions of Derivatives as well as the intermediary, brokerage and agency service thereof became permitted as a securities business. The FIEA has continued in keeping this change.

(v) Brokerage for Clearing of Securities, Etc.

This refers to the business of receiving customer orders conditional on having a financial instruments clearing organization or a foreign financial instruments clearing organization bear the debts from the subject transactions, and executing such transactions as the agent of the customer, etc. It has the nature of being a brokerage business between securities companies, which was introduced with the amendments to the SEL that were implemented in 2002 (FIEA, art. 2, para. 27).

(vi) Underwriting of Securities

Underwriting means, upon the public offering, secondary distribution or private placement or exclusive offer to sell, etc. to professional investors of securities, undertaking to sell such securities on behalf of the issuer or the offering party, or concluding a contract whereby a financial instruments business operator will acquire a share option certificate pertaining to a share option yet to be exercised and will exercise the share option or have a third party exercise it.

Professional investors mean qualified institutional investors, the national government, the Bank of Japan, investor protection funds, etc., specific purpose companies, listed companies, stock companies with a stated capital amount of JPY500 million or more, financial instruments business operators, persons who have submitted the notification of qualified institutional investors operation, persons who have submitted the notification of specially permitted services for foreign investors, foreign corporations and persons who have transferred from a general investor to a professional investor after taking certain procedures (FIEA, art. 2, para. 31; Definition Ordinance, art. 23; FIEA, art. 34-3 and art. 34-4).

Legally speaking, the underwriting of securities is the execution of an agreement to acquire for resale all

or part of such securities (firm commitment underwriting), or to acquire any unsold securities (standby underwriting) (direct underwriting from the issuer or the offering party falls within the definition of “wholesale underwriting” described in the FIEA, art. 21, para. 4 and art. 28, para. 1, item 3(a) and (b)).

Both are characterized by the incurring of a risk that some securities will remain unsold and require the ability to conduct a sophisticated underwriting examination. A financial instruments business operator must be registered with the Prime Minister as a type I financial instruments business operator in order to engage in this wholesale underwriting (FIEA, art. 28, para. 1, item 3(a) and (b) and art. 29).

Under the amendments in 2011, which introduced provisions for rights offerings (a means to raise capital by allotting share options to all shareholders free of charge), acquisition and exercise by financial instruments business operators of share options yet to be exercised are now regarded as a type of underwriting of securities (FIEA, art. 2, para. 6, item 3; FIEAEO, art. 15 and art. 17-3).

(vii) Public Offering and Private Placement of the Following Securities

(a) Beneficiary securities of investment trusts that involve beneficial interests in investment trust managed under instructions from the settlor;
(b) Beneficiary securities of foreign investment trusts;
(c) Mortgage securities;
(d) Securities or certificates which have been issued by a foreign state or a foreign person that have the nature of mortgage securities;
(e) Those rights that are to be indicated on securities set forth in (a) or (b), or those rights that are to be indicated on securities set forth in (c) or (d) above and particularly specified by Cabinet Office Ordinance, those which are deemed to be securities pursuant to the provisions of the FIEA, Article 2, Paragraph 2;
(f) Interests in collective investment schemes; and
(g) Securities as prescribed by Cabinet Order in addition to those set forth in (a) through (f).

The “public offering of securities” and the “private placement of securities” refer to the act causing investors to acquire newly issued securities or the act of solicitation thereof, but here, the “self-managed offering” by the issuer of the securities itself is considered to be the subject of the business. This reflects the characteristic of collective investment schemes where the origination of the instruments and sales are carried out as a package, and is aimed to respond to problematic cases such as fraudulent transactions prior to the enactment of the FIEA.

(viii) Secondary Distribution of Securities or Exclusive Offer to Sell, Etc. to Professional Investors

A “secondary distribution of securities” is defined as a solicitation of an application to sell or purchase already-issued securities, which in the case of Paragraph (1) Securities (securities, rights to be indicated on securities or specified electronically recorded monetary claims) shall mean those that are made to large number of persons (fifty or more persons; FIEAEO, art. 1-8) and which meet certain requirements (FIEA, art. 2, para. 4, item 1 and item 2), and in the case of Paragraph (2) Securities (deemed securities prescribed by each item under the FIEA, art. 2, para. 2) shall mean those in which a considerably large number of persons (at least 500; FIEAEO, art. 1-8-5) will render the securities in connection with the secondary distribution (FIEA, art. 2, para. 4, item 3). As in the case of public offering, with respect to Paragraph (2) Securities, securities other than those are mainly invested in securities are treated as excluded securities (FIEA, art. 3, item 3).

An “exclusive offer to sell, etc. to professional investors” is defined as the offer to sell, etc. of Paragraph (1) Securities that have already been issued to a large number of persons, which meets the requirements that [a] the solicitation is made only to professional investors, [b] the solicitation is conducted by a financial instruments business operator upon entrustment from customers or for itself (excluding where the party to which the relevant offer to sell, etc. is made is the Japanese government, the Bank of Japan, or a qualified institutional investor), and [c] the solicitation falls under cases where the securities are less likely to be transferred from the acquirer to a person other than a professional investor, etc., excluding the solicitation involving the trading on a financial instruments exchange market, etc.

(ix) Dealing in Public Offering or Secondary Distribution of Securities or Dealing in Private Placement or Exclusive Offer to Sell, Etc. to Professional Investors

A “public offering of securities” means a solicitation, from among solicitations of an application to acquire newly issued securities (including those specified by Cabinet Office Ordinance as being similar to such solicitation (acts similar to solicitation for acquisition)), depending on the type of securities: with regard to Paragraph (1) Securities, [a] a solicitation that is made to a large number (at least 50) of persons (excluding those made only to professional investors) (FIEA, art. 2, para. 3, item 1), or [b] a solicitation that does not fall under any of (A) through (C) below; *i.e.*, (A) a solicitation made only to qualified institutional investors in which the securities are less likely to be transferred from the acquirer to a person other than a qualified institutional investor (*i.e.*, a QII private placement), (B) a solicitation made only to professional investors in which the solicitation for acquisition (excluding solicitation to the Japanese government, the Bank of Japan or qualified institutional investors) is conducted by a financial instruments business operator, etc. upon entrustment from customers or for itself and the securities are less likely to be transferred to a person other than a professional investor (*i.e.*, a professional investors private placement), or (C) a solicitation to a small number of general investors in which the securities are less likely to be transferred from the acquirers to a large number of persons (*i.e.*, a limited private placement) (FIEA, art. 2, para. 3, item 1 and item 2); and with regard to Paragraph (2) Securities, a solicitation that falls under cases in which a considerably large number of persons (500 or more; FIEAEO, art. 1-7-2) will come to own the securities in connection with the solicitation (FIEA, art. 2, para. 3, item 3).

“Dealing in public offering or secondary distribution” refers to undertaking solicitation activities on behalf of another party for application to acquire the securities when the said party makes public offering or secondary distribution of such securities. This differs from underwriting in that the dealer does not assume the risk that the securities will remain unsold.

“Private placement” refers to those solicitations for application to acquire newly issued securities that do not fall within a public offering of securities since they are targeted towards qualified institutional investors, professional investors or a small number of investors (FIEA, art. 2, para. 3, second sentence). Also, “dealing in private placement” means the practice of undertaking solicitations for private placements. Financial institutions such as banks and insurance companies are also permitted to conduct the dealing in private placements (FIEA, art. 33, para. 2).

(x) Proprietary Trading System (PTS) Operations

Proprietary Trading System (PTS) operations mean sales and purchase of securities or intermediary, brokerage or agency service therefor which is conducted through an electronic information system, by using any of the following price formation method or other similar method, and in which a large number of persons participate simultaneously as the one party in the transaction or the transaction is conducted between a large

number of persons (FIEA, art. 2, para. 8, item 10):

(a) An auction method (but limited to situations where the volume of securities traded does not exceed the standards set by FIEAEO, art. 1-10);
(b) For securities that are listed on a financial instruments exchange, methods that use the trading price, on the exchange, of such securities;
(c) For over-the-counter traded securities, a method that uses the trading price of the securities announced by the authorized financial instruments business operators association that carries out the said registration;
(d) A method that uses the price established based on negotiations between customers; or
(e) In addition to the methods described in (a) through (d) above, the method provided for by Cabinet Office Ordinance (Definition Ordinance, art. 17).

Of these, the provision described in (a) above was added by amendment to the SEL in 2004. Although the traditional approach was to distinguish between an exchange and a proprietary trading system (PTS) based on the existence of a price formation function, this change meant that the distinction is now made on a basis that also takes into consideration trading volume.

However, issues for professional investors, etc. which are considered inappropriate for investor protection purpose to trade outside the financial instruments exchange market in light of the type, etc. of securities are excluded from the subject of proprietary trading system (PTS) operations (FIEAEO, art. 1-9-3).

Furthermore, if a financial instruments business operator will perform proprietary trading system (PTS) operations, it must obtain authorization from the Prime Minister (FIEA, art. 30, para. 1).

(xi) Conclusion of Investment Advisory Contract and Provision of Advice Under the Investment Advisory Contract

An investment advisory contract is a contract in which one of the parties promises to give advice to the other party by oral, written or other means in connection with investment decisions pursuant to an analysis of values, etc. of securities, or the value, etc. of financial instruments, and the other party promises to pay remuneration for the same. This, however, excludes newspapers, magazines, and others published for the purpose of sale to numerous and unspecified persons, and which may be purchased at any time by numerous and unspecified persons.

(xii) Conclusion of a Discretionary Investment Contract or a Contract on Entrustment of Assets Investments with a Registered Investment Corporation, and Investment of Money or Other Properties in Securities or Rights Pertaining to Derivatives Transactions (In Cases Relating to Commodities, Limited to Those Listed on a Financial Instruments Exchange) Conducted Base on Analysis of Value, Etc. of Financial Instruments (The former is the business activities of former discretionary investment contracts, while the latter is equivalent to the former investment corporation asset management business.)

(xiii) Agency or Intermediary Service for Conclusion of an Investment Advisory Contract or a Discretionary Investment Contract

(xiv) Investment of Money or Other Properties Contributed from a Person Who Holds Rights Such as Investment Trust Beneficiary Certificates, as an Investment in Securities or Rights Pertaining to Derivatives Transactions Conducted Based on Analysis of the Value, Etc. of

Financial Instruments (The former investment trust management business.)

(xv) **Investment of Money or Other Properties Invested or Contributed from a Person Who Holds Rights Such as Beneficiary Securities or Interests in a Collective Investment Scheme, as an Investment Mainly in Securities or Rights Pertaining to Derivatives Transactions, Based on Analysis of the Value, Etc. of Financial Instruments** (*i.e.*, self-management)

(xvi) **Acceptance of Deposits of Money, Securities or Electronically Recorded Transferable Rights (Security Tokens) from the Customers in Relation to Securities Transactions, Etc. or Derivatives Transactions** (equivalent to the former safekeeping.)

In the case of conducting the acts set forth in (ii), (iii), and (v) above with respect to commodity-related market transactions of derivatives, including the acceptance of deposit of commodity or securities or certificates issued in relation to the commodity deposited from the customers.

(xvii) **Transfer Bonds, Etc. Conducted in Response to Opening of an Account for Transfer of Bonds, Etc. as Set Forth in the "Act on Book-Entry Transfer of Corporate Bonds and Shares"**

(xviii) **Acts That Are Defined by Cabinet Order as Being Similar to Acts as Set Forth in (i) Through (xvii)**

Nevertheless, certain acts have been excluded from the financial instruments business on the grounds that in view of circumstances such as the nature of business, those acts are found not to compromise investor protection (FIEA, art. 2, para. 8, main paragraph; FIEAEO, art. 1-8-6; Definition Ordinance, art. 15 and art. 16).

(2) Classification of Financial Instruments Business

In principle, if a financial instruments business operator has registered with the Prime Minister, the financial instruments business operator is allowed to engage in any of the activities covered under the financial instruments business. Nevertheless, the extent of necessity to secure the soundness of a financial instruments business operator differs depending on the business that the financial instruments business operator will carry out.

The FIEA, therefore, in principle, requires registration as a regulation on participating in the financial instruments business, while at the same time classifying the financial instruments business into four categories consisting of the type I financial instruments business, type II financial instruments business, investment advisory and agency business, and investment management business. It further specifies differing conditions depending on the nature of the business activities with respect to matters such as attaining financial soundness, the effectiveness of compliance and the quality of management.

(i) Type I Financial Instruments Business

The **type I financial instruments business** means, among the financial instruments business, conducting any of the following acts in the course of trade (FIEA, art. 28, para. 1).

Covered under this category are the securities businesses, including the former safekeeping service, as well as the financial futures transactions business, etc.:

(a) **With respect to securities (limited to the securities and certificates set forth in each Item of the FIEA, Article 2, Paragraph 1, the rights which are deemed as such securities in accordance with FIEA, Article 2, Paragraph 2, main clause, and electronically recorded transferable rights, but not including the rights set forth in each Item of the FIEA, Article 2, Paragraph 2), (A) sales and purchase, market transactions of derivatives or foreign**

market derivatives transactions; (B) intermediary, brokerage or agency service for the transactions of (A); (C) intermediary, brokerage or agency service for entrustment of the transactions of (A); (D) brokerage for clearing of securities, etc.; (E) secondary distribution; and (F) dealing in public offering, secondary distribution and private placement;

(b) Intermediary, brokerage and agency service for the commodity-related market transactions of derivatives, or intermediary, brokerage and agency service for the entrustment of the same, and brokerage for clearing of securities, etc. therefor;

(c) Over-the-counter transactions of derivatives, and the intermediary, brokerage and agency service therefor or brokerage of clearing therefor;

(d) Underwriting of securities;

(e) Activities of operating a Proprietary Trading System (PTS); and

(f) Securities, etc. management business.

Under the FIEA, commodity-related market transactions of derivatives conducted on one's own account are excluded from the scope of Type I financial instruments business.

(ii) Type II Financial Instruments Business

The **type II financial instruments business** means, among the financial instruments business, conducting any of the following acts in the course of trade (FIEA, art. 28, para. 2).

The former commodities investment sales business and the trust beneficial interest sales business, etc. are covered under this category:

(a) Public offering or private placement of securities listed in (1) (vii) above (*i.e.*, a self-managed offering);

(b) With respect to securities (limited to the rights set forth in each Item of the FIEA, Article 2, Paragraph 2), (A) sales and purchase, market transactions of derivatives or foreign market derivatives transactions, (B) intermediary, brokerage or agency service for the transactions of (A), (C) intermediary, brokerage or agency service for entrustment of the transactions of (A), (D) brokerage for clearing of securities, etc., (E) secondary distribution, and (F) dealing in public offering, secondary distribution and private placement;

(c) (A) Market transactions of derivatives and foreign market transactions of derivatives that do not involve securities, (B)intermediary, brokerage or agency service for the transactions of (A), (C) intermediary, brokerage or agency service for entrustment of the transactions of (A), as well as (D) brokerage for clearing of securities, etc. that does not involve securities, over-the-counter transactions of derivatives and deemed securities enumerated under the FIEA, Article 2, Paragraph 2; and

(d) Acts designated by Cabinet Order as those to be included in the financial instruments business.

(iii) Investment Advisory and Agency Business

The **investment advisory and agency business** shall mean, among the financial instruments business,

conducting any of the following acts in the course of trade (FIEA, art. 28, para. 3).

The former investment advisory business, etc. is covered under this category:

(a) Entering into an investment advisory contract and carrying activities of advising in connection with values, etc. of securities or investment decisions based on analysis of values, etc. of financial instruments, pursuant to the investment advisory contract (investment advice business); or

(b) Agency or intermediary service for conclusion of an investment advisory contracts or discretionary investment contracts.

(iv) Investment Management Business

The investment management business shall mean, among the financial instruments business, conducting any of the following acts in the course of trade (FIEA, art. 28, para. 4).

This also includes the former business in connection with discretionary investment contracts, the investment corporation asset management business and the investment trust management business, and in addition business activities of forming a collective investment scheme or the like and mainly carrying out management as an investment in securities or rights in connection with derivatives transactions.

The definition of the investment management business includes the case where financial institutions such as banks conducts such acts in the course of trade but they are prohibited from conducting such acts (FIEA, art. 33, para. 1, main clause):

(a) Entering into a discretionary investment contract and engaging in investment of money or other properties in securities or rights pertaining to derivatives transactions conducted based on analysis of value, etc. of financial instruments (the former business in connection with discretionary investment contracts);

(b) Entering into a contract on entrustment of assets investments with a registered investment corporation and engaging in investment of money or other properties in securities or rights pertaining to derivatives transactions conducted based on analysis of value, etc. of financial instruments (the former investment corporation asset management business);

(c) Investment of money or other properties contributed from a person who holds rights such as investment trust beneficiary certificates, as an investment in securities or rights pertaining to derivatives transactions conducted based on analysis of value, etc. of financial instruments (the former investment trust settlor business, etc.); and

(d) Investment of money or other properties invested or contributed from a person who holds rights such as beneficiary securities or interests in a collective investment scheme, as an investment mainly in securities or rights pertaining to derivatives transactions conducted based on analysis of value, etc. of financial instruments (*i.e.*, self-management).

○ Electronic Offering Handling Business

The electronic offering handling business shall mean dealing in a public offering or secondary

distribution or dealing in a private placement of securities or exclusive offer to sell, etc. to professional investors, by means of an electronic information system or by any other means of information and communications technology specified by Cabinet Office Ordinance in the course of trade (FIEA, art. 29-2, para. 1, item 6, parenthetical statement; FIBCOO, art. 6-2).

The 2014 and 2019 FIEA amendments introduced a new scheme designed to facilitate the risk money supply for emerging and growing companies, whereby such companies in need of funds are connected to prospective fund providers via the Internet and financial instruments business operators, etc. go between them to help these companies raise a small amount of funds each from a number of fund providers by way of issuing shares and interests in funds and handling electronically recorded transferable rights. This scheme is generally referred to as equity-based crowdfunding.

The following obligations are imposed on financial instruments business operators, etc. engaged in the electronic offering handling business with regard to certain types of securities to ensure that they provide investors with the information necessary for making investment decisions and perform the minimum required checks on the issuers of securities:

(a) Submit a written application for registration stating the intention to carry out the electronic offering handling business and become registered or to have any change in relation to the business registered (FIEA, art. 29-2, para. 1, item 6, art. 31, para. 4, and art. 33-3, para. 1, item 5);
(b) Take measures to check the issuers of securities and examine their business plans (FIEA, art. 29-4, para. 1, item 1, (f), art. 33-5, para. 1, item 5, and art. 35-3; FIBCOO, art. 70-2, para. 2); and
(c) Make the information concerning the issuers of securities available for inspection by investors on the website (FIEA, art. 43-5; FIBCOO, art. 146-2).

With a view to promoting the entry in the electronic offering handling business, regulations on type I financial instruments business or type II financial instruments business, such as those relating to the capital adequacy ratio and concurrency in business, are partly relaxed in the case of financial instruments business operators engaged only in the electronic offering handling business with regard to unlisted securities, etc., which falls within the scope of type I financial instruments business or type II financial instruments business and which satisfies certain requirements (*e.g.*, the issue value of securities is small) (FIEA, art. 29-4-2 and art. 29-4-3; FIEAEO, art. 15-10-3).

These requirements as specified by Cabinet Order are as follows: (i) the amount calculated as the total issue value is less than JPY100 million; and (ii) the amount calculated as the amount to be paid by the person who is to acquire securities is not more than JPY500,000. However, as a result of the revision of the regulations relating to electronic offering handling business in 2022, the aforementioned requirement in (ii) does not apply to acquisitions by professional investors.

(3) Business Other Than Financial Instruments Business

Financial instruments business operators cannot function in their full capabilities by conducting only their main business that is the financial instruments business. Accordingly, it is understood to be desirable to allow financial instruments business operators to engage in those businesses which would be impossible to separate from their main business, or for which separation would be unreasonable, so long as such businesses will not harm the interest of the general public or be detrimental to investor protection.

Under the old licensing system, the businesses of securities firms used to be limited to the securities business and approved side businesses; however, the 1998 revisions to the SEL vastly expanded the scope of businesses

outside of the traditional securities business, and this scope has been further expanded with the enactment of the FIEA.

These businesses other than the financial instruments business are separated into incidental businesses, businesses that require notification and businesses that require approval.

(i) Incidental Businesses

A financial instruments business operator that engages in the type I financial instruments business or an investment management business may engage in the following activities as businesses incidental to the financial instruments business (FIEA, art. 35, para. 1).

It is unnecessary for the financial instruments business operator to file a separate notification or obtain the approval of the Prime Minister with respect to these businesses.

The FSA explained in its news release (dated February 21, 2014, under the title of "FSA's Responses to Public Comments") that the business of conducting commodity-related market transactions of derivatives on one's own account does not fall within any of the categories of "financial instruments business" set forth in the items of Article 2, Paragraph 8, but instead falls under the scope of "businesses incidental to the financial instruments business" (FIEA, art. 35, para. 1, main paragraph), and therefore, it is considered necessary to verify whether financial instruments business operators conducting these transactions on their own account carry out their business appropriately and maintain sound financial conditions so as to contribute to investor protection, as in the case of business operators conducting other types of market transactions of derivatives on their own account.

(a) Lending and borrowing of securities, or intermediary or agency service thereof;
(b) Money loan incidental to a margin transaction;
(c) Money loan secured by securities that are deposited for safe custody from customers (limited to those prescribed by Cabinet Office Ordinance);
(d) Agency service for a customer concerning securities;
(e) Agency service of the business pertaining to the payment of earnings, redemptions, or cancellation fees in connection with investment trusts;
(f) Agency service of the business pertaining to distribution of money, distribution of refunds or residual assets or payment of interest or redemption money with regard to investment securities, investment equity subscription right certificates, or investment corporation bond certificates or foreign investment securities;
(g) Conclusion of a contract for cumulative investment (limited to those prescribed by Cabinet Office Ordinance);

A contract for cumulative investment is an agreement under which a financial instruments business operator which carries out securities, etc. management business receives a deposit of money from a customer, and in consideration of the said money, periodically sells securities to the said customer on a date specified in advance.

(h) Providing information or advice relating to securities (other than the information or advice falling within the definition of investment advisory business);
(i) Agency service of the business of another financial instruments business operator or a registered financial institution (limited to the activities that the agent financial instruments business operator could itself conduct, and excluding those set forth in (e)

above);
(j) Retention of the assets of a registered investment corporation;
(k) Consultation to any other business operator with regard to a business assignment, merger, company split, share exchange, share transfer or share delivery, or intermediation for these matters;
(l) Consultation to any other business operator concerning management;
(m) Sales and purchase of currencies or other assets (excluding crypto-and other assets) prescribed by Cabinet Order as being related to derivatives transactions (excluding transactions of securities-related derivatives), or intermediary, brokerage or agency service thereof;
(n) Sales and purchase of negotiable deposits and other monetary claims (excluding those that fall under the category of securities), or intermediary, brokerage or agency service thereof;
(o) Investment of investment property as an investment in the following assets;
a. Specified assets as set forth in ITA, Article 2, Paragraph 1 (excluding real estate and other assets as prescribed by Cabinet Order); and
b. Other assets as prescribed by Cabinet Order in addition to a. above;
(p) Provision of customer information acquired from the customer to a third party with the consent of the customer or any other provision of information held by the financial instruments business operator to a third party, which contributes to advancement of the financial instruments business conducted by the financial instruments business operator or for enhancing the convenience of users of the financial instruments business operator (excluding an act that falls under the category of the act set forth in (h) above); and
(q) Acts to be performed by mainly utilizing human resources, information and communications technology, equipment, and any other management resources retained by the financial instruments business operator pertaining to the financial instrument business conducted by the financial instruments business operator, which is specified by the Cabinet Office Order as an act that contributes to regional revitalization, improvement of industrial productivity, or establishment of a sustainable society.

(ii) Businesses That Require Notification

A financial instruments business operator that engages in the type I financial instruments business or an investment management business may file a notification to the Prime Minister and engage in the following activities (FIEA, art. 35, para. 2 and para. 3):

(a) Business pertaining to transactions on the commodity markets, etc.;
(b) Business pertaining to transactions conducted by using fluctuations in commodity prices and other indicators, market gaps, etc. as specified by a Cabinet Office Ordinance (excluding the business set forth in (a) above);
(c) Business pertaining to money lending business or other money loans, or intermediary service of lending and borrowing of money;
(d) Business pertaining to building lots and buildings transaction business defined in Article 2,

Item 2 of the Building Lots and Buildings Transaction Business Act or lease of building lots or buildings prescribed in Item 1 of the said Article;

(e) Real estate specified joint enterprise defined in Article 2, Paragraph 4 of the Real Estate Specified Joint Enterprise Act;

(f) Business of conducting investment of money and other properties for others through commodities investment, etc. provided for in the Act Concerning Control for Business Pertaining to Commodity Investment, Article 2, Paragraph 1 (excluding the businesses set forth in (a) and (b) above);

(g) Business of conducting investment of investment property (excluding those that fall under the category of the business of conducting the act specified in (i) (o) above and those set forth in (a), (b) and (f) above) as an investment in assets other than securities or rights arising from derivative transactions; and

(h) Such other businesses as are prescribed by Cabinet Office Ordinance.

(iii) Businesses That Require Approval

A financial instruments business operator that engages in the type I financial instruments business or an investment management business may obtain approval from the Prime Minister and engage in business other than those set forth in (i) and (ii) above (FIEA, art. 35, para. 4).

In this event, the Prime Minister cannot deny this approval unless the Prime Minister finds that the proposed business is detrimental to the public interest or harmful to the protection of investors due to the difficulty of managing the risk of loss (FIEA, art. 35, para. 5).

(iv) Special Provisions for Type I Small Amount Electronic Offering Handling Business Operators

Type I small amount electronic offering handling business operators may carry out the types of business set forth in (ii) and (iii) above without making notification or obtaining approval (FIEA, art. 29-4-2, para. 3 and para. 4).

Since type I small amount electronic offering handling business operators are specialized in handling public offering, private placement of unlisted securities, etc. or electronically recorded transferable rights and are permitted to accept money deposited from customers only in the course of the electronic offering handling business, even if they fail in any other business they concurrently carry out and their management base is endangered, this could only have a relatively limited risk of harming the investors’ interests.

(v) Extent of Concurrent Business That May Be Conducted by Persons Who Only Engage in Type II Financial Instruments Business or the Investment Advisory or Agency Business

The FIEA does not stipulate any regulation, such as that set forth above, on the scope of business activities of those financial instruments business operators that only engage in the type II financial instruments business or the investment advisory or agency business (FIEA, art. 35-2).

2 3 Regulations on Major Shareholders

A major shareholder of a financial instruments business operator that engages in the type I financial instruments business or the investment management business must submit to the Prime Minister, without delay, a

notification of holdings in subject voting rights stating particulars such as the percentage of voting rights held and the purposes of holding of stock (FIEA, art. 32, para. 1; para. 3) (in principle, a major shareholder is a person that holds at least 20 percent of the voting rights of all shareholders, etc., although this also includes a person who holds at least 15 percent if certain facts exist as prescribed by Cabinet Office Ordinance as being those from which it may be presumed that the said person will have a significant influence on decisions of finance or business policy of the company).

If a major shareholder of a financial instruments business operator falls under any of the reasons for disqualification, the Prime Minister may order the major shareholder to take action, etc. so that it will no longer be a major shareholder (FIEA, art. 32-2, para. 1).

A major shareholder of a financial instruments business operator must notify the Prime Minister without delay if it ceases to be a major shareholder of the financial instruments business operator (FIEA, art. 32-3, para. 1).

In addition, if a major shareholder of a financial instruments business operator becomes a specified major shareholder (meaning a person holding voting rights in excess of 50% of the voting rights of all shareholders, etc. of the company) of the financial instruments business operator, a notification must be made to the Prime Minister without delay in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 32, para. 3 and para. 4).

This is for the authorities to timely recognize what kind of person the specified major shareholder of a financial instruments business operator is.

If the Prime Minister considers it necessary for public interest or investor protection in light of the status of business or financial standing (if the specified major shareholder is a corporation, including the financial standing of the subsidiary corporation, etc. of the specified major shareholder) of the specified major shareholder of the financial instruments business operator, it may order the specified major shareholder to take measures necessary for the improvement of the operation of business of the financial instruments business operator or the financial standing to the extent necessary (FIEA, art. 32-2, para. 2). If this order is violated, the Prime Minister may order the specified major shareholder measures to make it a non-major shareholder (*id.*, para. 3).

This provision was established in consideration of the possibility that the funding of a financial instruments business operator may become difficult due to the financial deterioration of a shareholder having a big effect on the management of the financial instruments business operator, etc. under the control of such shareholder, or the possibility that the noncompliance or conflict of interest of such shareholder may have an adverse effect on the management of the financial instruments business operator under the control of such shareholder.

In addition, if a specified major shareholder becomes a major shareholder other than a specified major shareholder of the financial instruments business operator, a notification must be made to the Prime Minister to that effect without delay pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 32-3, para. 2).

These regulations address the entry from other industries into the financial instruments business, and place ultimate priority on achieving the objectives of the FIEA by eliminating unsuitable persons from shareholders who have the ability to exercise an influence over management of a financial instruments business operator.

Similar regulations also exist over banks and insurance companies.

2 4 Registration and Authorization of Financial Instruments Business Operators

(1) Registration System for Financial Instruments Business

(i) Significance

The financial instruments business cannot be conducted by any person other than a person who has registered with the Prime Minister (FIEA, art. 29).

A “registration system” was implemented to control entrance into the securities business under the SEL as enacted in 1948; however, a downturn in the markets shortly thereafter led to questionable practices in the securities industry, and in light of several scandals that erupted, this registration system was replaced with a “license system” in accordance with the 1965 SEL revisions.

Subsequently, however, in response to calls for the promotion of free competition accompanied by the requisite deregulation in the face of changes in economic circumstances due to the globalization of finance and other factors, the 1998 SEL revisions reverted once again from a “license system” to a “registration system.” Nevertheless, this registration system differed from its previous analog, and clarifies the registration application procedures and the criteria for refusing registration, as well as implementing measures to insure that the abuses inherent in a registration system do not occur such as by making the securities companies register available for public inspection.

The enactment of the FIEA has also changed into a registration system the securities-related over-the-counter transactions of derivatives, etc., wholesale underwriting, investment trust management business, investment corporation asset management business, and business in connection with discretionary investment contracts, which were heretofore subject to an authorization system, as well as the investment products sales business which was subject to a permit system. These changes have unified the regulations on entry in connection with the financial instruments business into a registration system (FIEA, art. 29), with the exception of conduct of a proprietary trading system (PTS) (FIEA, art. 30, para. 1).

The Former “License System”

Under the former “license system,” there was a general ban on engaging in the securities business, which the Minister of Finance could lift for those persons found to satisfy certain criteria, thereby allowing them to lawfully conduct a securities business. Procedurally, a separate license was granted for the four types of functions constituting the securities business ([a] the trading of securities (dealing); [b] brokering of trades, etc. of securities (brokerage); [c] the underwriting of securities (underwriting); and [d] the dealing in public offerings and secondary distributions or private placements of securities (selling)). A single securities company would have more than one license depending on the scope of its functions (the term “general securities companies” was used to refer to securities companies that had obtained all of the available licenses).

The following minimum capitalization or deposit for operation is required as a condition for registration

or authorization depending on the type of business (FIEAEO, art. 15-7, para. 1; art. 15-11, para. 1; and art. 15-12):

- **Type I financial instruments business: JPY50 million (however, in the event of carrying out wholesale underwriting as the lead manager, this is JPY3 billion; and in other cases, is JPY500 million (or JPY300 million in the case of conducting specified over-the-counter transactions of derivatives, etc. using the electronic information system provided for the business related to over-the-counter transactions of derivatives, etc.))**
- **Investment management business: JPY50 million (however, in the case of conducting investment management business for qualified investors, JPY10 million)**
- **Type II financial instruments business: JPY10 million**
  Type II financial instruments business in the case of an individual: JPY10 million deposit for operation
- **Investment advisory or agency business: JPY5 million deposit for operation**
- **Operation of a proprietary trading system (PTS): JPY300 million**
- **Type I small amount electronic offering handling business: JPY10 million**
- **Type II small amount electronic offering handling business: JPY5 million**

If the Prime Minister authorizes the activities of operating a proprietary trading system (PTS) the Prime Minister shall enter a note stating the same in the registration of the financial instruments business operator (FIEA, art. 30, para. 2). The Prime Minister may also state conditions for authorization (FIEA, art. 30-2, para. 1); however, these conditions must be the necessary minimum for the protection of investors or the public interest (*id*., para. 2).

Specific provisions have been enacted regarding the application procedures for a registration or an authorization, as well as the criteria, etc. for authorization (FIEA, art. 29-2; art. 29-3; art. 29-4; art. 30-3; and art. 30-4).

Penalties apply to companies who engage in operations without registering or authorization (FIEA, art. 197-2, item 10-4 and item 10-5; and art. 201).

(ii) Procedures for Applying for Registration

In order to register a financial instruments business, an applicant must submit an application to the Prime Minister stating the matters prescribed in the FIEA (FIEA, art. 29-2, para. 1).

In this event, a foreign corporation that intends to engage in the type I financial instruments business must determine a representative in Japan (limited to a person who is responsible for the activities of all business offices or offices that the said foreign corporation will establish in Japan for the purpose of carrying out the type I financial instruments business, and submit a registration application.

If an application for registration has been made, the Prime Minister must register the matters set forth in the FIEA into the registry of financial instruments business operators, unless the registration rejection criteria (FIEA, art. 29-4, para. 1) are met (FIEA, art. 29-3, para. 1). The Prime Minister must make the registry of

financial instruments business operators available for public inspection (FIEA, art. 29-3, para. 2).

(iii) Registration Rejection Criteria

The Prime Minister must refuse a registration if any of the registration rejection criteria as prescribed by the FIEA have been met, or if a false entry or record is made in the registration application, the attached documentation or electronic or magnetic record, or if a material matter is not stated or entered (FIEA, art. 29-4, para. 1).

(2) Deposit for Operation

In addition to the above registration rejection criteria, a deposit for operation is required from a person who intends to engage in the type II financial instruments business (limited to an individual), or solely in the acts of investment advising or agency (FIEA, art. 31-2, para. 1).

The amount of the deposit for operation that must be deposited is to be determined by Cabinet Order in consideration of the circumstances of the business of the financial instruments business operator as well as the necessity of protecting investors (*id*., para. 2) (see (1)(i) above for details).

(3) Restrictions on Use of Trade Name, Etc.

A person who is not a financial instruments business operator must not use a trade name or firm name of a financial instruments business operator or a trade name or firm name that would be confused with a financial instruments business operator (FIEA, art. 31-3).

(4) Prohibition of Advertising and Solicitation by Unregistered Business Operators

An unregistered business operator must not (i) make an indication that the business operator conducts financial instruments business or (ii) solicit others to conclude a contract for financial instruments transactions for the purpose of conducting financial instruments business (FIEA, art. 31-3-2).

This rule was introduced under the amendments in 2011 in order to enforce early crackdown on unregistered business operators, in view of the frequent incidents in which unregistered business operators pressure elderly persons into purchasing unlisted shares.

(5) Lifting of Restrictions on Concurrent Business of Officer and Employee

Previously under the FIEA the officers of financial instruments business operators engaged in the securities-related business such as securities companies, etc. were prohibited from concurrently serving as an officer or employee of its parent bank, etc., and officers and employees of such financial instruments business operators were prohibited from concurrently serving as an officer of its subsidiary bank, etc. This is because it was believed that officers and employees of financial instruments business operators must dedicate themselves to the ensuring of capital market functions, the inherent mission of financial instruments business operators, and shall not concurrently serve as officers, etc. of banks whose inherent mission is to maintain orderly credit conditions.

However, the barriers between the banking business and the securities business are being lowered as a result of developments such as the growth in financial grouping and the progress in financial technology, which has led to the idea that the existence of the restrictions on concurrent business may constrain the positioning of officers and employees controlling the overall operations of the financial group, and that such restrictions pose an impediment from the point of view of the comprehensive risk management and compliance of the group as a whole.

Accordingly, with the amendments in 2008, the restrictions on the concurrent business by officers and

employees were abolished on the precondition having a system in place to manage conflicts of interest within a financial enterprise as well as the financial group.

The following notifications are required if officers and/or employees will hold concurrent positions.

If a director or an executive officer of a financial instruments business operator that engages in the type I financial instruments business or the investment management business is appointed as a director, accounting advisor, auditor or executive officer of another company (including cases where a director, accounting advisor, auditor or executive officer of the other company shall concurrently serve as a director or executive officer of a financial instruments business operator) or has retired from such office, he/she shall without delay notify the Prime Minister to that effect (FIEA, art. 31-4, para. 1).

Furthermore, the same applies if a director or executive officer is appointed or has retired as director, accounting advisor, auditor or executive officer of a parent bank, etc. or subsidiary bank, etc. of the said financial instruments business operator (including cases where a director, accounting advisor, auditor or executive officer of such parent bank, etc. or subsidiary bank, etc. shall concurrently serve as a director or executive officer of such financial instruments business operator) (*id*., para. 2).

(6) Organization of Conflict of Interest Management System

In accordance with the diversification of the operations within financial groups and the abolition of restrictions on concurrent business by officers and employees, the construction of a conflict of interest management system within financial groups has become even more important.

Therefore, specified financial instruments business operators (meaning persons engaged in the financial instruments business who are engaged in the securities-related business and are registered under the FIEA, art. 29 to engage in the type I financial instruments business (FIEAEO, art. 15-27)) are required in connection with the transactions conducted by the specified financial instruments business operator, etc. or its parent financial institution, etc. or subsidiary financial institution, etc. to adequately manage information concerning the financial instruments related operations (meaning operations concerning financial instruments trading acts and other operations prescribed by Cabinet Office Ordinance) by the specified financial instruments business operator, etc. or its subsidiary financial institutions, etc., prepare a system to adequately monitor the status of implementation of the financial instruments related operations and take other necessary measures to prevent unfair harm to the interest of customers concerning the financial instruments related operations conducted by the said specified financial instruments business operators, etc. or the subsidiary financial institutions, etc. (FIEA, art. 36, para. 2).

Specifically, the following measures must be implemented (FIBCOO, art. 70-4, para. 1):

(i) Putting in place a system for identifying subject transactions by an appropriate method;
(ii) Putting in place a system to properly ensure the protection of relevant customers by the following listed methods or other methods:
- **(a) A method of segregating the department that conducts the subject transaction and the department that conducts transactions with the relevant customer;**
- **(b) A method of changing the subject transaction or transaction terms and conditions with the relevant customer or the transaction method;**
- **(c) A method of suspending the subject transaction or transactions with the subject customer; and**
- **(d) A method of appropriately disclosing to the relevant customer the risk that the relevant**

customer's interests will be unduly harmed upon conducting the subject transaction;

(iii) Formulation of the policy to carry out the measures listed in (i) and (ii) above, and publication by an appropriate method of a summary of that policy;

(iv) Preservation of the following listed records (these records must be preserved for a period of five years from the day that they are created):

(a) Records relating to the identification of the subject transactions carried out under the structure set forth in (i) above; and

(b) Records of the measures for properly ensuring the protection of customers carried out under the structure set forth in (ii) above.

"Subject transaction" here means relevant transactions where, with a transaction conducted by a specified financial instruments business operator, etc. or its parent financial institution, etc. or subsidiary financial institution, etc., there is a risk of unduly harming the interests of a customer related to the financial instruments related operations that are conducted by the relevant specified financial instruments business operator, etc. or its subsidiary financial institution, etc. (FIBCOO, art. 70-4, para. 3).

A "parent financial institution, etc." means an entity holding a majority of the voting rights of the total shareholders, etc. of a specified financial instruments business operator, etc. or other persons prescribed by Cabinet Order as having a close relationship with the specified financial instruments business operator, etc. that are financial instruments business operators, banks, cooperative financial institutions or other persons engaged in the financial business as prescribed by Cabinet Order (FIEA, art. 36, para. 4).

A "subsidiary financial institution, etc." means an entity whose majority voting rights of its total shareholders, etc. are held by the specified financial instruments business operator, etc. or other persons prescribed by Cabinet Order as having a close relationship with the specified financial instruments business operator, etc. that are financial instruments business operators, banks, cooperative financial institutions or other persons engaged in the financial business as prescribed by Cabinet Order (*id*., para. 5).

(7) Registration of Change, Etc.

If a change has occurred in the matters stated in a registration application or attached documentation thereto, the financial instruments business operator must notify the Prime Minister to that effect within two weeks from the date thereof in the event of a change in the registration application, and promptly in the event of a change in the attached documentation (FIEA, art. 31, para. 1 and para. 3).

Nevertheless, authorization from the Prime Minister must be obtained in the event that financial instruments business operator which has obtained authorization from the Prime Minister in order to operate proprietary trading system (PTS) intends to make a change in the method of managing risks of loss, methods of determining sales prices, delivery and other methods of settlement or other changes in the content or methods of business as prescribed by Cabinet Office Ordinance in connection with activities for which authorization has been obtained (FIEA, art. 31, para. 6).

2 5 Financial Regulation and Risk Management

Financial instruments business operators must have a sound financial basis so their operations will not easily collapse, in order that they may fully fulfill their duties as the bearers of the capital markets, which are a public asset.

For this reason, the FIEA stipulates numerous regulations on the financial situation of financial instruments business operators that have obtained registration.

(1) Accounting (Ensuring Soundness)

It is necessary for financial instruments business operators, which lie at the core of the capital markets, to strengthen their risk management divisions and quantify their risk in order to maintain sound management at all times.

Accordingly, the following regulations have been implemented:

(i) Each business year, financial instruments business operators must prepare explanatory documents stating the matters prescribed by Cabinet Office Ordinance in connection with the status of their business and assets, and must keep such documents at each business office for a period of one year following the passage of the period fixed by Cabinet Order (four months) after the close of each business year, and maintain such documents available for public inspection at all business offices or administrative offices, or disclose them via the Internet or by other means, pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 46-4; FIEAEO, art. 16-17);

(ii) Financial instruments business operators must compute their capital adequacy ratios (the ratio of the sum of capitalization, reserves, and other amounts provided for by Cabinet Office Ordinance after deducting the sum of fixed assets and other amounts provided for by Cabinet Office Ordinance to the sum of the amount provided for by Cabinet Office Ordinance as the amount corresponding to the risks which may arise due to fluctuations in the price of securities or other reasons) and notify the Prime Minister thereof at the end of each month and in the cases prescribed by Cabinet Office Ordinance (cases where the ratio falls below 140% or recovers to 140% or more) (FIEA, art. 46-6, para. 1; FIBCOO, art. 179);

(iii) Financial instruments business operators must prepare documents stating their capital adequacy ratios on the last day of each quarter (meaning each three-month period of the business year; four times per year), and keep such documents at each business office or office and make them available for public inspection for a period of three months from the date on which one month expires from respectively the last day of March, June, September and December (FIEA, art. 46-6, para. 3); and

(iv) Financial instruments business operators must ensure that their capital adequacy ratios do not fall below 120% (FIEA, art. 46-6, para. 2).

In connection with these regulations, transitional measures have been provided; for example, if Type I financial instruments business operators that were commodity derivatives brokers under the CDTA as of the

day on which the FIBCOO (as amended upon the amendment of the FIEA in 2012) (relevant to a comprehensive exchange) came into effect (March 11, 2014) engaged only in the business pertaining to commodity-related market transactions of derivatives, they may choose not to deduct the figure representing the tangible fixed assets from the numerator in the computation formula for their capital adequacy ratios (FIBCOO, Supplementary Provisions, art. 4).

(2) Accumulating a Financial Instruments Transaction Liability Reserve

A financial instruments business operator is required to accumulate a financial instruments transaction liability reserve, to accommodate incidents in connection with a financial instruments transaction (FIEA, art. 46-5, para. 1; FIBCOO, art. 175).

If Type I financial instruments business operators that were commodity derivatives brokers under the CDTA as of the day on which the FIBCOO (as amended upon the amendment of the FIEA in 2012) (relevant to a comprehensive exchange) came into effect (March 11, 2014) engaged only in the business pertaining to commodity-related market transactions of derivatives, and the amount calculated under the Regulation for Enforcement of CDTA is smaller, they must treat this amount as the amount of financial instruments transaction liability reserve for the business year containing the day of registration as a Type I financial instruments business operator or day of registration of change (FIBCOO, Supplementary Provisions, art. 3).

Type I small amount electronic offering handling business operators are exempted from the obligation to accumulate a financial instruments transaction liability reserve, because they are specialized in handling public offering or private placement of securities and are not permitted to engage in sales and purchase, etc. of securities in the course of trade (FIEA, art. 29-4-2, para. 6).

(3) Business Year

According to the 2014 amendment, the business year of financial instruments business operators that engage in type I financial instruments business has been changed to begin on the first day of a month selected by the respective financial instruments business operators and end on the day on which one year has elapsed since the said day (FIEA, art. 46), thus allowing type I financial instruments business operators to set their business year as beginning on the first day of any month they select, instead of using the conventionally required uniform business year extending from April 1 of each year to March 31 of the following year.

Specific regulations have not been enacted concerning persons other than a type I financial instruments business operator.

(4) Duty to Submit Reports/Materials, Etc.

A financial instruments business operator must prepare a business report for each business year in the manner prescribed by Cabinet Office Ordinance, and within three months after the close of each business year must submit the same to the Prime Minister (FIEA, art. 46-3, para. 1 and art. 47-2). If a financial instruments business operator is a foreign corporation, a business report is required to be prepared within the period specified by Cabinet Order after the close of each business year (FIEA, art. 49, para. 1 and para. 3).

A type I financial instruments business operator must, in addition to submitting the business report, also file with the Prime Minister a report on the status of its business or assets, in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 46-3, para. 2).

A financial instruments business operator is further required to prepare and keep books of account concerning its business activities, in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 46-2 and art. 47).

2 6 Supervision of Business Activities

The FIEA stipulates detailed provisions concerning the nature of various acts, such as "those for which a financial instruments business operator should take initiative in performing, and behavior in which they should not engage, as bearers of the capital markets."

Regulatory authority is granted preventive and subsequent supervisory authorities over financial instruments business operators in order that financial instruments business operators will achieve the functions that are anticipated under the FIEA, including conduct regulations.

These supervisory regulations do not mean intrusive regulations on businesses, but are rather for the purpose of providing and putting into place conditions for achieving capital markets, as well as monitoring the activities and behaviors of the markets, and pursuing responsibility in connection with results.

(1) Restrictions on Withdrawal

(i) Restrictions on Withdrawal of Financial Instruments Business Operators

There may be cases in which a financial instruments business operator will halt or close its business, or will consolidate its business activities. It is, however, necessary to avoid situations in which this would be conducted in a way that would cause an impediment to the functioning of capital markets.

For this reason, the FIEA prescribes regulations on the withdrawal from business by a financial instruments business operator.

(a) Notification of suspension, etc. of business

A financial instruments business operator, etc. must notify the Prime Minister without delay if the financial instruments business operator, etc., *inter alia,* suspends or resumes its business (FIEA, art. 50).

(b) Notification of discontinuance, etc. of business

If a financial instruments business operator is to, *inter alia*, discontinue its business, the financial instruments business operator must notify the Prime Minister of that fact, in accordance with the provisions of the FIEA, within 30 days from the date of discontinuance, etc. of business (FIEA, art. 50-2, para. 1).

(ii) Restrictions on Withdrawal of Registered Financial Institutions

A registered financial institution must notify the Prime Minister without delay if it, *inter alia*, suspends or resumes its business (FIEA, art. 50).

If a registered financial institution is to, *inter alia*, discontinue its business, it must notify the Prime Minister of that fact, in accordance with the provisions of the FIEA, within 30 days from the date of discontinuance, etc. of business (FIEA, art. 50-2, para. 1).

(2) Order to Improve Conduct of Business

(i) Order to a Financial Instruments Business Operator to Improve Its Business Conduct

If in connection with the operations of business or the financial standing of a financial instruments business operator the Prime Minister finds that it is necessary and appropriate for the protection of investors or

the public interest, the Prime Minister may to the extent necessary order a financial instruments business operator to change its method of business or take other action that is necessary to improve its business operations or the financial standing (FIEA, art. 51).

(ii) Order to a Registered Financial Institution to Improve Its Business Conduct

If in connection with the operations of business of a registered financial institution the Prime Minister finds that it is necessary and appropriate for the protection of investors or the public interest, the Prime Minister may, to the extent necessary, order a registered financial institution to change its method of business or take other action that is necessary to improve the operations of business (FIEA, art. 51-2).

(3) Supervisory Actions

(i) Supervisory Actions over Financial Instruments Business Operators

Since with the exception of the PTS business the financial instruments business is subject to a registration system and the regulations on participation in the financial instruments business have been liberalized, it is necessary to thoroughly and properly carry out the supervision and dispositions after registration in order to assure the proper conduct of business on the part of financial instruments business operators. For this reason, steps are to be taken to achieve appropriate conduct of business after registration, including a revocation of registration, a revocation of authorization or an order to suspend business as well as the taking of various actions in association therewith if the amount of capital or the amount of net assets falls below the legally prescribed amounts, or if a registration has been obtained through improper means, or if a violation of a disposition by a government agency has occurred, or if another legal or regulatory event has occurred in connection with the financial instruments business.

(a) Revocation of registration or authorization or suspension of business

If a financial instruments business operator falls under the requirements set forth in the FIEA, the Prime Minister may cancel the registration or authorization of the financial instruments business operator or designate a period of not more than six (6) months and order the financial instruments business operator to suspend its business in their entirety or in part (FIEA, art. 52, para. 1).

(b) Management preservation order (prompt corrective action)

If the capital adequacy ratio of a financial instruments business operator that engages in the type I financial instruments business becomes less than 120%, and if found to be necessary and appropriate to protect investors or the public interest, the Prime Minister may to the extent necessary order a change in the method of business, the deposit of assets or other matters that are necessary for supervision (FIEA, art. 53, para. 1).

Moreover, if the capital adequacy ratio falls below 100%, the Prime Minister may designate a period of not more than three (3) months and order the financial instruments business operator to suspend its business activities in their entirety or in part (*id.*, para. 2). If the capital adequacy ratio is less than 100% even after three months, and it is found that the prospect of recovery of the position does not exist, the Prime Minister may cancel the registration of the financial instruments business operator (*id.*, para. 3).

(c) Dismissal of officers

If an officer of a financial instruments business operator (which in the event of a foreign corporation shall be limited to an officer who is stationed at a business office or office in Japan, or the representative of Japan) falls under the requirements set forth in the FIEA, the Prime Minister can order the financial instruments business operator to dismiss the officer (FIEA, art. 52, para. 2).

(ii) Supervisory Actions over Registered Financial Institutions

If a registered financial institution falls under any of the requirements set forth in the FIEA, the Prime Minister may revoke the registration of the financial institution as a registered financial institution, or designate a period of not more than six (6) months and order the registered financial institution to suspend its business activities in their entirety or in part (FIEA, art. 52-2).

2 7 Regulations Against Special Financial Instruments Business Operators

(1) Significance

Formerly, securities companies were basically regulated and supervised on a stand-alone basis as a market intermediary necessary for ensuring the appropriateness of business operations and the due management, etc. of customer assets. However, the organization of securities companies have become grouped, and in some cases the authorities have difficulty in understanding the management and risk situations of the group as a whole.

Because of this, if a securities company is conducting large-scale and complex activities as a group, and that securities company suddenly fails due to financial and operational issues, etc. caused by its parent company, subsidiary or sister company within the group, its market intermediation functions may become dysfunctional, have material effect on a wide range of investors, and eventually may have a material effect on the financial system.

Accordingly, because it is necessary to conduct strong and comprehensive risk management under due business administration with respect to a securities company conducting large-scale and complex activities which acts with its group companies as a unit, the amendments in 2010 introduced consolidated-based regulations and supervision on securities companies above a certain scale.

(2) Downstream Consolidation

Because the financial conditions of a securities company will be directly affected negatively if there is a concern regarding the financial conditions of a subsidiary, etc. of the securities company, large-scale securities companies (special financial instruments business operators) that have total assets above a certain scale shall be regulated and supervised on a consolidated-basis, covering such securities company and its subsidiaries, etc.

(3) Upstream Consolidation

If the securities company (a special financial instruments business operator) subject to downstream consolidation is conducting financial activities as a group, and that securities company suddenly fails due to financial and operational issues, etc. caused by its parent company, subsidiary or sister company within the group, its market intermediation functions may become dysfunctional, have material effect on a wide range of investors, and eventually may have a material effect on the financial system.

Accordingly, a scheme has been prepared for the authorities to designate, among the parent companies of securities companies (special financial instruments business operators) subject to downstream consolidation, (i) those which administer the management of a securities company as business or (ii) those providing financial assistance to a securities company as a group, and to regulate and supervise the entire group including the parent company on a consolidated-basis.

2 8 Sales Representative System

(1) Significance of Sales Representative System

Fair price formation of financial instruments, etc. on capital markets can be achieved through concentrating investment decisions that investors have formed based on sufficient information concerning the true value of the investment targets. However, there is no guarantee that information covered by the timely disclosure rules of the financial instruments exchanges and the periodic and occasional information disclosure systems prescribed under the FIEA will be distributed evenly among all investors.

In addition, the material that investors require to make investment decisions is not limited solely to the criteria demanded by law. Investors seek a variety of information including judgments regarding economic conditions, as well as knowledge concerning the fundamentals of the stock system. As financial instruments business operators, etc. are the persons who have the mission of linking the investment decisions of investors to the market, in this sense, financial instruments business operators, etc. have a high degree of responsibility towards capital markets in their responses within their aspect of interacting with investors.

The enacting of special provisions concerning the status and authority of a sales representative under the FIEA is not simply to prevent injury to investors, but is also for the purpose of clarifying the duties of financial instruments business operators who are responsible for building fair markets through achieving sound investment decisions.

(2) Sales Representative

A sales representative is a person who, among officers and/or employees of a financial instruments business operator, etc., engages in the following acts on behalf of the financial instruments business operator, etc., regardless of whether the person is referred to as a promoter, sales staff, canvasser, or by any other title (FIEA, art. 64, para. 1, main paragraph):

(i) Any act set forth below in connection with securities (excluding those rights under Article 2, Paragraph 2 of the FIEA that are deemed as securities pursuant to the provisions of the said Paragraph):

(a) a. Sales and purchase of securities, market transactions of derivatives, or foreign market transactions of derivatives;

b. Intermediary, brokerage or agency service for sales and purchase of securities, market transactions of derivatives, or foreign market transactions of derivatives;

c. Intermediary, brokerage or agency service for entrustment of sales and purchase of securities conducted in a financial instruments exchange market or market transactions of derivatives; and

d. Intermediary, brokerage or agency service for entrustment of sales and purchase of securities conducted in a foreign financial instruments market or foreign market derivatives transactions;

e. Brokerage for clearing of securities, etc.;

f. Secondary distribution of securities or exclusive offer to sell, etc. to professional investors;

g. Dealing in public offering or secondary distribution of securities or dealing in private placement or exclusive offer to sell, etc. to professional investors of securities;

(b) The following acts:

a. Solicitation for application for sales or purchase, or intermediary, brokerage (excluding brokerage for clearing of securities, etc.) or agency service thereof;

b. Solicitation for application for market transactions of derivatives or foreign market derivatives transactions, or intermediary, brokerage (excluding brokerage for clearing of securities, etc.) or agency service thereof; and

c. Solicitation for the entrustment of market transactions of derivatives or foreign Market derivatives transactions;

(ii) The following acts:

(a) a. Over-the-counter transactions of derivatives or intermediary, brokerage or agency service therefor;

b. Underwriting of securities; or

c. Proprietary trading system (PTS) operation activities;

(b) Solicitation for application for over-the-counter transactions of derivatives, etc.;

(iii) An act as set forth by Cabinet Order other than those prescribed in (i) or (ii) above. The acts to be prescribed by Cabinet Order shall be the following (excluding those related to the securities prescribed in the FIEA, Article 64, Paragraph 1, Item 1) (FIEAEO, art. 17-14):

a. Market transactions of derivatives or foreign market derivatives transactions, or the intermediary, brokerage or agency service thereof;

b. The intermediary, brokerage or agency service for entrustment of market transactions of derivatives or foreign market derivatives transactions;

c. The solicitation for application for market transactions of derivatives or foreign market derivatives transactions, or the intermediary, brokerage or agency service therefor; or

d. The solicitation for entrustment of market transactions of derivatives or foreign market derivatives transactions.

As mentioned above, under the FIEA, commodity-related market transactions of derivatives conducted on one’s own account are excluded from the scope of Type I financial instruments business. However, it should be noted that if officers or employees of financial instruments business operators, etc. conduct these transactions on behalf of the business operators, etc., they must be registered as sales representatives (FIEAEO, art. 17-14, item 1).

A financial instruments business operator shall not have any person other than a registered sales representative carry out the duties of a sales representative (FIEA, art. 64, para. 2).

(3) Registration of Sales Representatives

A financial instruments business operator, etc. must register the personal name, date of birth, and other requisite information of its sales representatives in the Registry of Sales Representatives kept in the location (an authorized financial instruments business operators association, or a certified financial instruments business operators association as set forth in the FIEA, art. 78, para. 2) as prescribed by Cabinet Office Ordinance (FIEA, art. 64, para. 1 and art. 64-7; FIBCOO, art. 247 through art. 256).

No person other than a registered sales representative is allowed to perform sales representative activities, and since strict conditions, as described below, are imposed on registration, not only does registration make clear the scope of authority vested in sales representatives in terms of their relationship with the financial instruments business operator, etc. to which they belong, it also in effect functions as an equivalent to a "permit" in that it lifts the general prohibition of the conduct of sales representative activities only with regard to a limited scope of such registered persons.

Fitness for registered sales representatives is enforced through the establishment of disqualification criteria and through an administrative action such as revocation of registration due to violations of the laws and regulations, etc.

Persons disqualified for registration as sales representatives are those who have been sentenced to imprisonment or heavier punishment for violating the FIEA or other laws and regulations, and for whom five years have not yet passed since the day on which the execution of the sentence was completed or these persons ceased to be subject to the execution.

The following persons are also disqualified: (i) a person who falls within the category of persons specified by Cabinet Office Ordinance as being unable to properly perform operations related to the financial instruments business due to mental or physical disorder and who has been judged in an individual examination as being unable to properly perform such operations; (ii) an adult ward or person under curatorship, or any person treated in the same manner under the laws and regulations of a foreign state; (iii) a person who has received a ruling of commencement of bankruptcy proceedings and whose rights have not been restored, or a person who is treated in the same manner under the laws and regulations of a foreign state; and (iv) a person who has been sentenced to a fine for violating the provisions of the Act on Prevention of Unjust Acts by Organized Crime Group Members or other laws, and for whom five years have not yet passed since the day on which the execution of the sentence was completed or the person ceased to be subject to the execution of the fine.

The Prime Minister must refuse a registration if the sales representative in connection with a registration application falls under any of the following or if a false statement is made or there is an omission of a material matter in the registration application or the documentation attached thereto (FIEA, art. 64-2, para. 1):

(i) A person who falls under any of the disqualification criteria (FIEA, art. 29-4, para. 1, item 2(a) through (i));

(ii) A person whose registration as a sales representative has been revoked as a supervisory disposition (FIEA, art. 64-5, para. 1 and art. 66-25; APFS, art. 77) and for whom five years have yet to expire from the date of the said revocation;

(iii) A person who is registered as a sales representative at a financial instruments business operator, etc., a financial instruments intermediary service provider or a financial service intermediary other than the registration applicant; or

(iv) A person who is registered as a financial instruments intermediary service provider (FIEA, art. 66) or a person who has obtained the registration as a financial service intermediary (limited to the registration pertaining to the category of securities, etc. intermediary business operations) (APFS, art. 77).

If a registered sales representative falls under any of the following, the Prime Minister may revoke its

registration or suspend it for a period of up to two years (FIEA, art. 64-5):

(i) If the sales representative falls under any of the disqualification criteria (FIEA, art. 29-4, para. 1, item 2(a) through (i)), or is discovered to have already been fallen under any item of the FIEA, Article 64-2, Paragraph 1, at the time of registration;
(ii) If the sales representative has committed a legal or regulatory violation in connection with the activities set forth in any item of the FIEA, Article 64, Paragraph 1 or related business in connection thereto, out of the financial instruments business (or in the event of a registered financial institution, the registered financial institution business), or is found to have committed an act that is otherwise significantly inappropriate in connection with the duties of a sales representative; or
(iii) If a sales representative whose registration has been deleted within the past five years for a reason such as resignation from employment is discovered to have committed an act that falls under item (ii) above, during the period of time in which the sales representative was representative (limited to an act during the previous five years).

In cases where a registration is revoked, etc., the registration of the sales representative will be deleted (FIEA, art. 64-6).

In addition, a financial instruments business operator must file a notification with the Prime Minister without delay if any of the following occurs with respect to one of its registered sales representatives (FIEA, art. 64-4):

(i) If there has been a change in the full name or date of birth of the sales representative, or his or her classification as an officer or employee;
(ii) If a registered sales representative falls under any of the disqualification criteria (FIEA, art. 29-4, para. 1, item 2(a) through (i); regarding item 2(a), including the case where a registered sales representative is likely to fall under the relevant criteria); and
(iii) If a representative no longer conducts the duties of a sales representative due to retirement or other reasons.

From the perspective of enhancing the function of an authorized financial instruments business operators association as a self-regulatory body, the registration tasks in connection with sales representatives of a financial instruments business operator that is a member of an authorized financial instruments business operators association, or a certified financial instruments business operators association are to be carried out by the financial instruments business operators association (FIEA, art. 64-7, para. 1).

The association that carries out the registration tasks must notify the Prime Minister without delay to that effect if the association has made a registration, changed a registration, made a disciplinary action (excluding canceling a registration) or has deleted a registration of a sales representative (*id*., para. 5).

If, in connection with a registration application, a financial instruments business operator, etc. has an objection to an inaction, refusal to register or disposition made by the financial instruments business operators association that carries out the registration work, the financial instruments business operator may make a request to the Prime Minister for a review under the Administrative Appeals Tribunal Act (FIEA, art. 64-9).

(4) Legal Status of Sales Representatives

(i) Authority of Representation (FIEA, art. 64-3, para. 1)

A sales representative is deemed to possess the authority to perform any and all extrajudicial acts in connection with the acts set forth in each item of Article 64, Paragraph 1, on behalf of the financial instruments business operator to which he/she belongs (FIEA, art. 64-3, para. 1). As a result, the actions of a sales representative are directly attributed to the financial instruments business operator, etc., and the financial instruments business operator, etc. is directly liable to satisfy the obligations borne by its sales representatives.

Through this grant of authority of representation to its sales representatives, a financial instruments business operator, etc. can broaden its business activities and allow customers to feel secure in their interaction with sales representatives, thereby promoting investor protection, and enabling greater mobility of financial instruments trading. Financial instruments business operators, etc. have responsibilities as the bearers of the capital markets, and the acts of sales representatives are an extension of these responsibilities of financial instruments business operators, etc.

Consequently, if a sales representative commits a malicious act in violation of the FIEA, the financial instruments business operator, etc. cannot avoid supervisory responsibility regarding that sales representative on the grounds that the act was outside of the scope of the authority of representation.

(ii) Recognition of the Customer (FIEA, art. 64-3, para. 2)

As mentioned above, financial instruments business operators, etc. are liable for the business activities of their sales representatives. If it can be shown, however, that the customer in the transaction had known of such scope of authority (where the customer has caused the sales representative to take actions outside the scope of authority even when the customer knows there are restrictions placed on the scope of authority of the sales representative, or where the sales representative is clearly the agent of the customer, etc.), this shall not apply (FIEA, art. 64-3, para. 2).

Therefore, unless the facts indicate that the customer had known such scope of authority, a financial instruments business operator, etc. cannot avoid liability for the acts of its sales representatives. Any finding of recognition by a customer must be premised by the fact that the sales representative fulfilled his/her responsibilities.

2 9 Conduct Regulations by Financial Instruments Business Operators

(1) General

In the past, vertically organized business laws governed the conduct regulations on financial companies engaged in transactions of financial instruments, and the regulations differed for each type of financial instrument handled. However, new financial products that are not covered by existing laws for protection of users have been developed and put on sale one after another backed by developments such as growth in financial technology and information technology. The blending of financial services has progressed, with financial institutions as well exhibiting a tendency towards handling products for which demand on the part of users could be found to exist as well as products based on business laws of another industry across sector boundaries. Moreover, products under differing laws have become similar in their content, and products that span several laws are being provided.

Given these changes in the financial environment, as well as the difference in information that exists between

business operators and users, it has been necessary to put in place a comprehensive and overarching framework of user protection in connection with a wide range of financial products and pursuant to the premise of seeking the individual responsibility of users, to expand the protection of users. The FIEA, consequently, is a law that is of a general nature in connection with the sales of financial products and investment of assets, and imposes uniform restrictions on behavior acts in financial products that have the same economic function, regardless of the industry in which they are involved.

The FIEA stipulates overarching conduct regulations of financial instruments business operators, etc. in view of their status as financial instruments business operators, etc. as bearers of the capital markets. In order to assure the functioning of the capital markets, matters are stipulated for which financial instruments business operators, etc. should take initiative in performing, and matters from which they are affirmatively prohibited. Both of these are prescribed as matters that contribute to the fair formation of prices through achieving quality and value of the object of a transaction as well as a competitive concentration of investment decisions in connection with value.

In addition to the prohibitions specifically applicable to financial instruments business operators, the general prohibitions against acts of market disruption also apply to financial instruments business operators. These are discussed subsequently (for details, see Section 12. "Regulations Imposed on Acts of Market Abuse (Regulations Against Unfair Trading)").

(2) General Obligations

(i) Duty of Good Faith and Fairness

Financial instruments business operators, etc. as well as their officers and employees are required to perform their duties in good faith and fairly towards their customers (FIEA, art. 36, para. 1).

> Under the FIEA, the regulations on financial instruments business operators, etc. are not only for the purpose of adjusting interests in the form of protecting each investor, but also for the purpose of achieving fair price formation in capital markets which is a value that extends beyond this.
>
> It can be said that the principle is that each investor enjoys the benefit to the national economy from having fair capital markets, as a citizen of the country. Capital markets that are prone to creating a bubble even if they work out to the benefit of individual investors will ultimately only be a disaster for these individual investors as well.
>
> The duty of good faith and fairness historically is derived from the "fiduciary duty" under Anglo-American common law, and there is a tendency to view this as a duty under private law. Nevertheless, it should be viewed as an expression of a duty to promote the objectives of the FIEA from the perspective of a duty to investors.

(ii) Advertising Regulations

In view of the status of financial instruments business operators, etc. as bearers of the capital markets, the FIEA requires certain representations to be made when a financial instruments business operator, etc. makes an advertisement of the contents of the financial instruments business that the financial instruments business operator, etc. carries out, and also prohibits representations that are significantly at variance with the facts, or representations that would significantly mislead people in connection with, *inter alia,* expectations of gains.

When a financial instruments business operator, etc. carries out advertising of the contents of the financial instruments business in which it engages and other acts that are prescribed by Cabinet Office Ordinance as

being similar to the same, the financial instruments business operator, etc. must, in the manner prescribed by Cabinet Office Ordinance, state the following (FIEA, art. 37, para. 1):

(a) The trade name, firm name or personal name of the financial instruments business operator, etc.;

(b) The fact that the said financial instruments business operator, etc. is a financial instruments business operator, etc., and the registration number of the said financial instruments business operator, etc.; and

(c) Those matters which involve the content of the financial instruments business that is carried out by the financial instruments business operator, etc. and which are determined by Cabinet Order as being material matters that will influence the decisions of customers.

The specific scope of acts covered as being similar to advertising are prescribed as "providing information of the same content to large number of persons" through distribution by postal mail, courier, facsimile, email, handouts or pamphlets, etc. (FIBCOO, art. 72). By way of example, sales materials would also be covered by these advertising regulations to the extent that the above requirements are met.

The matters to be stated in advertisements are prescribed as including commissions or the like, the possibility of a loss on principal or a loss in excess of principal, as well as the indexes that would constitute the cause and the reason for the same, the matters that are disadvantageous to customers in connection with material matters, and if the financial instruments business operator, etc. is a member of a financial instruments business operators association (limited to such associations in which the major association members or regular members are persons that conduct operations pertaining to the relevant financial instruments business), the name, etc. thereof (FIEAEO, art. 16; FIBCOO, art. 76). In particular, with respect to risk information, the statement must be made in letters and numbering that do not differ significantly from the largest letters and numbering that are used in the advertisement (FIBCOO, art. 73).

If a financial instruments business operator, etc. carries out an advertisement in connection with the financial instruments business in which it engages, or an act that is prescribed by Cabinet Office Ordinance as being similar to the same, the financial instruments business operator, etc. shall not make a representation that is significantly at variance with the facts or that will significantly mislead people in connection with expectations of gains from carrying out an act of financial instrument trading, or other matters as prescribed by Cabinet Office Ordinance (FIEA, art. 37, para. 2). These matters are prescribed as particulars concerning cancellation of contract, responsibility for loss, guarantee of gains, penalty for breach, etc., financial ability, creditworthiness and performance of the business operator, and commissions, etc. (FIBCOO, art. 78).

(iii) Duty to Deliver a Document, Duty to Explain and Duty to Provide Information

The duty to explain on the part of a financial instruments business operator, etc. is an important measure for the purpose of ameliorating the difference in information between the business operator and the user, and is indispensable in order to achieve fair price formation of financial instruments, etc. on capital markets.

The FIEA, consequently, treats the duty to explain of the same contents for which there is a duty to explain under the APFS as one of conduct regulations of financial instruments business operators in the form of an obligation under the FIEA, and supervisory dispositions may be executed directly against business operators in the event that they violate this obligation.

(a) Duty to Deliver a Document Prior to Conclusion of Contract

If a financial instruments business operator, etc. intends to enter into a contract for financial instruments transactions, the financial instruments business operator, etc. must, in a manner as prescribed by Cabinet Office Ordinance, deliver in advance to the customer a document setting forth the following (FIEA, art. 37-3, para. 1, main clause).

However, the preceding shall not apply to cases prescribed by Cabinet Office Ordinance as cases that do not present an impediment to the protection of investors (*id*., *proviso*):

a. The trade name, firm name or personal name and address of the financial instruments business operator, etc.;
b. The fact that the financial instruments business operator, etc. is a financial instruments business operator, etc., and the registration number of the financial instruments business operator, etc.;
c. The outline of the relevant contract for financial instruments transactions;
d. Matters that are prescribed by Cabinet Office Ordinance concerning the fee, commission or other consideration that the customer is to pay in connection with the contract for financial instruments transaction;
e. If there is a risk of loss as a result of fluctuation in interest, price of currency, prices on financial instruments markets or other indicators in connection with acts of financial instruments transactions that will be conducted by the customer, a statement to that effect;
f. If there is a risk that a loss under the preceding item will exceed the amount of a customer margin or other security deposit as prescribed by Cabinet Office Ordinance that is placed on deposit by the customer, a statement to that effect; and
g. Such other matters in connection with the content of the financial instruments business that are prescribed by Cabinet Office Ordinance as having a material impact on a customer's decisions, in addition to those set forth in each of a. through f. above.

First, a document to be delivered prior to the conclusion of contract is required to state, at the start of the document, that the document should be read thoroughly, and also state particularly important matters that will have an impact on the investment decisions of the customer, in a simplified manner using lettering and numbering of at least 12 points in size (FIBCOO, art. 79, para. 3). Next, a clear and accurate statement must be made with regard to a summary of the commissions, etc., the possibility of a loss on principal or a loss in excess of principal, the trade name, etc. of the counterparty to cover transactions in over-the-counter transactions of derivatives as well as the method of separate management and the entity with which the deposit is to be placed, matters concerning transactions covered by the electronic application-based electronic offering handling business, and the applicability of a cooling-off period. These matters must be stated within the frame borders in the document, using lettering and numbering of at least 12 points in size (*id*., para. 2). The other matters must be stated clearly and accurately using lettering and numbering of at least eight points in size (*id*., para. 1).

In addition to the statutorily required statements, common matters to be stated in the document to be delivered prior to the conclusion of contract include: a statement to the effect that the contents of the document

to be delivered prior to conclusion of contract must be read thoroughly; the amount and method of calculation of customer margins, etc. payable by the customer; the causes, indicators, etc., and reasons if the possibility exists that losses on principal or in excess of principal will occur; the outline of the taxes to be levied; the details of grounds for termination of the contract if any such grounds are stipulated; whether a cooling-off period applies; an outline, etc. of the financial instruments business operator, etc.; the method by which the customer will communicate with the financial instruments business operator, etc.; whether the financial instruments business operator has membership in any financial instruments firms association (limited to such associations in which the major association members or regular members are persons that conduct operations pertaining to the relevant financial instruments business), and the name of the association in which the business operator is a member; whether the financial instruments business operator is covered by operations of any certified investors protection organization, and the name of the organization by which it is covered; and the trade name or firm name of the designated dispute resolution organization (FIBCOO, art. 82). Other matters that should be stated depending on the financial instrument or the transaction are also prescribed (FIBCOO, art. 83 through art. 96).

The following exceptions exist to the obligation to deliver the document to be delivered prior to conclusion of contract.

The first case is where, in connection with sale and purchase, etc. (excluding derivatives transactions and margin transactions, etc.) of securities that are listed on a financial instruments exchange (excluding covered warrants, etc.), a comprehensive document (hereinafter referred to as "Explanatory Document on Listed Securities, etc.") has been delivered to the customer within one year prior to the conclusion of a contract for financial instruments transaction (FIBCOO, art. 80, para. 1, item 1).

The second exception is if, within one year prior to the conclusion of a contract for financial instruments transaction, a document to be delivered prior to conclusion of contract has been delivered to the customer in relation to another contract for financial instruments transaction that is of the same type (*id*., item 2).

The third is if a prospectus has been delivered to the customer which states all of the matters to be set forth in the document to be delivered prior to conclusion of contract (*id*., item 3).

The fourth is if a contract for financial instruments transaction is to be concluded for the purpose of partly changing another contract for financial instruments transaction already in effect, but such partial change does not result in changing the matters stated in the document to be delivered prior to conclusion of contract regrading such contract already in effect, or an explanatory document on change of contract information has been delivered to the customer (*id*., item 4).

The fifth case is where a contract for financial instruments transaction involving listed securities, etc. is to be concluded, and the matters to be recorded in the Explanatory Document on Listed Securities, etc. are made available for the customer's inspection (limited to a customer who has received an Explanatory Document on Listed Securities, etc. from the relevant financial instruments business operator, etc.) using an electronic data processing system (*id*., item 5).

The sixth case is where a contract for financial instruments transaction regarding the purchase and sale of securities set forth in Article 2, Paragraph 1, Items 1 through 3, 5, and 17 of the FIEA (*e.g.*, Japanese national government bonds, municipal bonds, and corporate bonds) is to be concluded, and the matters to be recorded in the document to be delivered prior to conclusion of contract are made available for the customer's inspection (limited to a customer who has received a document to be delivered prior to

conclusion of contract pertaining to the same type of contract for financial instruments transaction as the relevant contract for financial instruments transaction from the relevant financial instruments business operator, etc.) using an electronic data processing system (*id*., item 6).

In the fifth and sixth cases mentioned above, all of the following requirements must be satisfied:

[A] it has been explained to the customer that the relevant document will be delivered to the customer upon the customer's request;

[B] the information necessary for obtaining access to the relevant matters has been provided to the customer within one year prior to the conclusion of the contract for financial instruments transaction pertaining to the relevant transaction, by delivering a document or through any other appropriate method;

[C] measures have been taken to make sure that the relevant matters are indicated in an easily visible location on the screen of a computer used by the customer; and

[D] measures have been taken to keep the relevant matters easily available for the customer's inspection for five years following the date of the transaction, etc.

Documents such as a document to be delivered prior to conclusion of contract must be delivered to the customer if the customer requests the delivery.

The seventh case is where concise material information has been provided to the customer, and an explanation on matters set forth in the FIEA, Article 37-3, Paragraph 1, Items 3 to 7 has been given to the customer in the manner and degree necessary for the customer's understanding in light of the customer's knowledge, experience, financial standing and purpose of entering into a contract for financial instruments transaction (*id.*, item 7).

However, in the seventh case, the matters to be stated in a document to be delivered prior to conclusion of contract must be made available for the customer's inspection using an electronic data processing system, and all of the following requirements must be satisfied. The seventh exception does not apply if the customer requests the delivery of a document to be delivered prior to conclusion of contract.

[A] The matters to be stated in the document to be delivered prior to conclusion of contract are indicated in an easily visible location on the screen of a computer used by the customer by a method equivalent to the method prescribed in the FIBCOO, Article 79; and

[B] Measures have been taken to keep the matters to be stated in the document to be delivered prior to conclusion of contract easily available for the customer's inspection for five years following the last day on which the transaction referred to in those matters was conducted (if any complaint related to the information has been raised within the period before the expiration date of such period, for the period until either the expiration date of the five-year period or the day when the complaint was settled, whichever comes later).

The provisions concerning the seventh case are intended to allow a financial instruments business operator, etc. to omit the delivery of a prospectus or a document to be delivered prior to conclusion of contract in paper form if the financial instruments business operator has provided the customer with a key information sheet (material prepared to provide the customer with information on the risks, the fees, etc. of the financial instruments in a concise and plain manner so that the customer can easily compare the financial instruments), and has explained to the customer the major content of the document to be delivered prior to conclusion of contract.

The foregoing duty to deliver a document to be delivered prior to conclusion of contract may not be interpreted that simply delivering a written statement to the customer would be enough. Namely, with respect to the delivery of a document to be delivered prior to conclusion of contract, an explanation on

matters c. to g. above must be given to the customer in the manner and degree necessary for the customer's understanding in light of the customer's knowledge, experience, financial standing and purpose of entering into a contract for financial instruments transaction and enter into a contract for financial instruments transaction (FIBCOO, art. 117, para. 1, item 1), and the obligation to give explanation based on the customer's suitability must be performed.

(b) Duty to Deliver a Document to Be Delivered upon Conclusion of Contract, Etc.

A financial instruments business operator, etc. must prepare a document and deliver the same to the customer pursuant to the provisions of Cabinet Office Ordinance without delay upon the conclusion of a contract for financial instruments transaction or when otherwise specified by Cabinet Office Ordinance (FIEA, art. 37-4, para. 1, main clause).

However, this shall not apply to a case that is prescribed by Cabinet Office Ordinance as being a case in which it can be found that not delivering this document to a customer would not present an impediment to the protection of investors or the public interest, in view of the nature of the contract for financial instruments transaction or other circumstances (*id.*, *proviso*).

Moreover, if a financial instruments business operator, etc. has received a security deposit (limited to those as prescribed by Cabinet Office Ordinance, and including commodity-related market transactions of derivatives) to be placed by a customer in connection with the financial instruments business that the financial instruments business operator, etc. carries out, the financial instruments business operator, etc. shall immediately deliver to the customer a written statement to that effect, in the manner as prescribed by Cabinet Office Ordinance (FIEA, art. 37-5, para. 1).

Violations of the duty to deliver documents may be punished by an administrative action, and in addition, the violator or the corporation may be punished by penal sanction (FIEA, arts. 205 and 207).

(c) Duty to Provide Information in the Electronic Offering Handling Business

When a financial instruments business operator, etc. provides an electronic offering handling business with regard to a certain scope of securities, the financial instruments business operator, etc. must, pursuant to the provisions of Cabinet Office Ordinance, make the particulars to be stated in the document to be delivered upon conclusion of a contract which are specified by Cabinet Office Ordinance as having a material influence on decisions by the other party to the electronic offering handling business available for inspection by the said other party, by means of an electronic information system or by any other means of information and communications technology specified by Cabinet Office Ordinance, throughout the period in which it provides an electronic offering handling business with regard to such securities (FIEA, art. 43-5; FIBCOO, art. 146-2).

This duty is intended to ensure that investors are provided with sufficient information for making investment decisions.

(d) Special Provisions for Cryptoasset-Related Business

When a financial instruments business operator, etc. conducts cryptoasset-related business (meaning performing an act that constitutes a financial instruments transaction as specified by Cabinet Office Ordinance with regard to crypto-and other assets (cryptoasset-related act) on a regular basis), the financial instruments business operator, etc. must, pursuant to the provisions of Cabinet Office Ordinance, explain the nature of the crypto-and other assets (FIEA, art. 43-6, para. 1).

When executing or soliciting a customer to execute a contract for a financial instruments business operator, etc. to perform a cryptoasset-related act with the customer as the other party or on behalf of the

customer, in connection with the cryptoasset-related business it conducts, the financial instruments business operator, etc. or its officers or employees must not make representations that could cause the customer to have a misconception about the nature of the crypto-and other assets or other particulars specified by Cabinet Office Ordinance (FIEA, art. 43-6, para. 2).

The details of the cryptoasset-related business are specified by Cabinet Office Ordinance and cryptoasset-related derivatives transactions are included in the scope of cryptoasset-related business (FIBCOO, art. 146-3, para. 1).

These provisions have been introduced through the 2019 FIEA amendment from the perspective of preventing consumers' misunderstanding regarding the risks involved and ensuring the proper functioning and operations by financial instruments business operators.

(e) Written Cancellation (Cooling-Off)

In order to encourage sound investment decisions by general investors, a general clause concerning written cancellation (cooling-off) has been stipulated in the FIEA.

Except in the cases as prescribed by Cabinet Office Ordinance, a customer who has entered into a contract for financial instruments transaction (limited to those as prescribed by Cabinet Order in consideration of the substance of the said contract for financial instruments transaction and other circumstances) with a financial instruments business operator, etc. may cancel the contract for financial instruments transaction by a written statement or electronic or magnetic record during the period from and including the date on which the customer has received the written statement through the expiration of the number of days as prescribed by Cabinet Order (FIEA, art. 37-6, para. 1). Cancellation of a contract for financial instruments transaction as set forth in the preceding paragraph shall take effect if the cancellation is made by a written statement, when the written statement to the effect that the said contract for financial instruments transaction would be cancelled is issued, or, if the cancellation is made by an electronic or magnetic record, when the relevant electronic or magnetic record is sent (*id*., para. 2). Investment advisory contracts are covered by those prescribed by Cabinet Order (FIEAEO, art. 16-3, para. 1), and the number of days to be prescribed by Cabinet Order is stipulated as 10 days (*id*., para. 2).

If a contract for financial instruments transaction has been cancelled pursuant to the FIEA, Article 37-6, Paragraph 1, the financial instruments business operator, etc. cannot demand the payment of any damages or penalty, in association with the cancellation of the contract for financial instruments transaction, that exceeds the amount that is prescribed by Cabinet Office Ordinance as the amount of consideration that the customer is to pay as fees, commission or other consideration in connection with the contract of financial instruments transaction relevant to the period until cancellation of the contract for financial instruments transaction (FIEA, art. 37-6, para. 3).

Furthermore, if a contract for financial instruments transaction has been cancelled pursuant to the provisions of the FIEA, Article 37-6, Paragraph (1), and the financial instruments business operator, etc. has received prepayments of consideration in connection with the contract for financial instruments transaction, the financial instruments business operator, etc. must return the same to the customer (FIEA, art. 37-6, para. 4); provided, however, that the preceding shall not apply in connection with an amount as set forth by Cabinet Office Ordinance (FIEA, art. 37-6, para. 4, *proviso*).

Any rider which violates the provisions of each of the preceding clauses, to the detriment of the customer, shall be null and void (FIEA, art. 37-6, para. 5).

(f) Prohibition Against Uninvited Solicitation

A financial instruments business operator, etc. or an officer or employee thereof may not visit or telephone customers who have not requested soliciting and solicit entering into a contract for financial instruments transaction that has been prescribed by Cabinet Order as particularly requiring care to protect investors, in view of the contents of the contract for financial instruments transaction or other circumstances (FIEA, art. 38, item 4).

Cabinet Order provides that over-the-counter financial futures transactions and over-the-counter transactions of derivatives for individual investors are subject to the prohibition against uninvited solicitation (FIEAEO, art. 16-4, para. 1). From the perspective of preventing the evasion of this prohibition, a business operator is prohibited from soliciting a customer to enter into a contract without informing the customer in advance that the business operator intends to solicit the customer to enter into a contract for these transactions (FIBCOO, art. 117, para. 1, item 8).

Over-the-counter transactions of derivatives for individual investors shall be subject to provisions concerning the prohibition against uninvited solicitation in accordance with the 2010 amendments (FIEAEO, art. 16-4, para. 1, item 2).

(g) Obligation to Confirm Customer's Intention to Accept Solicitation and Prohibition Against Repeated Solicitation

A financial instruments business operator, etc. or an officer or employee thereof may not solicit a customer to enter into a contract for financial instruments transaction that has been prescribed by Cabinet Order as particularly requiring care to protect investors, in view of the contents of the contract for financial instruments transaction or other circumstances, without confirming with the customer prior to the solicitation whether the customer has a desire to receive such solicitation (FIEA, art. 38, item 5). Transactions prescribed by Cabinet Order include over-the-counter transactions of derivatives of interest rates, currency, etc., market derivatives transactions, and commodity-related market derivatives transactions, etc. (FIEAEO, art. 16-4, para. 2).

Moreover, a financial instruments business operator, etc. or an officer or employee thereof must not continue to solicit even though a customer who has received solicitation has indicated its intention not to enter into the contract for financial instruments transaction (including an intention to the effect that the customer does not desire to continue to be solicited) (FIEA, art. 38, item 6).

The prohibition against repeated solicitation does not permit soliciting in violation of the intention of the customer in view of the nature and substance of the product, even in connection with those for which the necessity to impose a prohibition against uninvited solicitation cannot be found to exist. The obligation to confirm the customer's intention to accept solicitation is recognized as the premise for a prohibition against repeated solicitation. Both of these prohibitions are positioned squarely of the principle of suitability and the prohibition against uninvited solicitation, and are understood as being appropriate for those instruments that present problems in view of compliance with suitability.

In order to prevent evasion of this prohibition, prohibitions exist against the act of gathering customers together and soliciting them to enter into a contract without informing them in advance that the objective (of the gathering) is to solicit customers to enter into a contract for over-the-counter transactions of derivatives (FIBCOO, art. 117, para. 1, item 8), as well as the act of soliciting the entering into of a contract even though the customer has stated in advance that the customer does not intend to enter into a contract in connection with derivatives transactions (FIBCOO, art. 117, item 9).

When conducting commodity-related market transactions of derivatives, financial instruments business operators, etc. are prohibited from visiting or making telephone calls to customers who are individuals and who are not in a business relationship with them, before soliciting them to conclude contracts or from gathering customers who are individuals without explicitly stating that they are being gathered for the purpose of solicitation (FIBCOO, art. 117, para. 1, item 8-2). This provision substantially imposes the prohibition of uninvited solicitation on financial instruments business operators, etc. in relation to customers who are individuals.

In addition, in order to give further substance to the duty to explain, a stipulation has been made which prohibits the act of entering into a contract for financial instruments transaction without providing an explanation according to the method and to the extent that is necessary for the customer to understand in view of the customer's knowledge, experience, financial conditions, and purpose for entering into a contract for financial instruments transaction, in connection with the document to be delivered prior to conclusion of contract, the written statement on listed securities, etc., or the prospectus, etc. (FIBCOO, art. 117, para. 1, item 1).

Over-the-counter transactions of derivatives for individual investors are now subject to provisions concerning the obligation to confirm customer's intention to accept solicitation and prohibition against repeated solicitation in accordance with the 2010 amendments.

(h) Duty to Explain Under the APFS

At one time, there was no special provision concerning cases in which sufficient explanation was not given to a customer in connection with financial instruments, and this was only treated as an issue of tort liability under the Civil Code.

On April 1, 2001, however, the FISA (currently the APFS) came into force, explicitly stipulating that at the time of solicitation of investment in financial instruments such as equities which present a risk of loss on principal, an explanation must be made to that effect as well as of the material matters that would cause the same, and that failure to do so would trigger a liability for damages (APFS, art. 4 Through art. 6).

> This duty to explain has substantive significance in the providing of correct information to investors concerning the quality and value of the object of a transaction, and thereby providing the investor with a correct basis to form an investment decision, with the accumulation of these investment decisions thereby generating fair price formation.
>
> To the extent of securities under the FIEA, this should not simply be interpreted as a duty pursuant to the principle of good faith under the Civil Code (Civil Code, art. 1, para. 2) but also as being a duty as a bearer of the Capital markets.

The duty to explain under the APFS is consists mainly of an explanation of risks, but it is obvious that depending on the circumstances there will be some cases in which an explanation must also be made of the structural nature of the product and the nature of the market.

First, it expanded the matters covered by the duty to explain under this law, in specifically adding "the material portions out of the structure of the transaction" to the matters covered (APFS, art. 4, para. 1, items 1 through 6(c)). In addition, the case in which "a risk exists of a loss in excess of the initial principal" was added as being covered as a separate case from a case "in which a risk exists of loss on principal" (APFS, art. 4, para. 1, item 2, item 4, and item 6(a)). It, then, enacted a standard for determining whether the duty to

explain had been satisfied, which included the concept of the principle of suitability, so that the explanation was then required to be according to the method and extent level for the customer to understand, in view of the attributes of the customer (*i.e.*, the knowledge, experience, financial standing on the part of the customer, and the customer's objective in entering into the agreement in connection with the sale of financial products) (APFS, art. 4, para. 2).

Second, a new clause was enacted to prohibit, *inter alia,* the providing of a conclusive evaluation (APFS, art. 5), and stipulating a liability for damages that would be a direct and strict liability in the event of a violation (APFS, art. 6), and a clause presuming the amount of damages (APFS, art. 7, para. 1).

The clauses concerning the duty to explain and the liability for damages under the APFS do not apply to professional investors and to cases where the customer has manifested his/her intention that the explanation on important matters is unnecessary. However, even if the customer has manifested his/her intention not to require an explanation on important matters, the financial instruments provider, etc. shall not be exempted from performing their duties to explain to the customers in the case of dealing in commodity-related market transactions of derivatives (APFS, art. 4 para. 7).

(i) Duty to Give Advance Disclosure of Transaction Modes

When a financial instruments business operator, etc. receives an order from a customer for the sale and purchase of securities or an over-the-counter transactions of derivatives, the business operator must clarify in advance to the customer whether the business operator itself will consummate the sale and purchase or the transaction as a counterparty (a transaction on dealer's basis) or whether it will undertake the intermediation, brokering or agency with respect thereto (a transaction on broker's basis) (FIEA, art. 37-2).

This is because if a financial instruments business operator, etc. that performs both broker and dealer functions does not clearly classify transactions into transactions on dealer's basis and broker's basis, there is a risk that it will injure the interests of the customer, including by selling securities that the dealer itself holds to the customer without searching for other sellers, and moreover, it goes without saying that financial instruments business operators are naturally responsible to faithfully execute the investment decisions of their customers.

(iv) Duty to Comply with the Principle of Suitability

A financial instruments business operator, etc. must engage in activities so that it does not solicit in a manner that is inappropriate in view of the knowledge, experience or financial position on the part of the customer, and objectives of entering into the contract for financial instruments transaction in connection with acts of financial instruments transactions, and so that insufficient protection of investors does not occur (FIEA, art. 40, item 1). This is generally known as the principle of suitability.

Since ensuring investment judgments that match the investor's knowledge, experience, amount of funds, and investment objectives constitutes a suitable step for the purpose of participating in price formulation in the market, this responsibility is imposed on financial instruments business operators, etc. as the bearers of the market. This principle is characterized by the fact that even if the investor wants to engage in an investment, there are cases where the financial instruments business operator, etc. must say no.

Customers who engage in high-risk transactions using funds that are saved for covering living expenses after retirement or borrow money from financial institutions at high interest rates despite the lack of assets available for repayment in order to continue margin transactions, cannot be expected to be able to make a true and reasonable investment judgment. Consequently, even if the customer wishes to do so, the financial instruments business operator, etc., as a bearer of the responsibility for securing the market functions, shall not

accept a transaction of this nature. This is positioned as the legal basis for business improvement orders, but it should be understood as a duty owed to investors.

(v) Duty of Best Execution

A financial instruments business operator, etc. is required to determine a policy and methodology for executing orders that it receives from a customer in connection with trading in securities and the like under the best transaction terms (best execution policy), in the manner prescribed by Cabinet Order (FIEA, art. 40-2, para. 1).

The financial instruments business operator, etc. must publicly disclose its best execution policy (*id*., para. 2), and orders involving securities transactions must be executed in accordance with the best execution policy (*id*., para. 3).

If a financial instruments business operator, etc. intends to accept an order from a customer in connection with trade in securities listed on a financial instruments exchange or OTC traded securities, or other transaction as prescribed by Cabinet Order, the financial instruments business operator, etc. must, in advance, deliver to the customer, in a manner as shall be prescribed by Cabinet Office Ordinance, a document stating the financial instruments business operator's best execution policy, etc., in connection with the said transaction (*id*., para. 4). If a financial instruments business operator, etc. is requested by a customer within a period of time after the execution of the order as prescribed by Cabinet Office Ordinance, additional documents must be furnished to the customer containing a statement that the order was handled in accordance with the best execution policy as required by Cabinet Office Ordinance (*id*., para. 5).

The aforementioned documents may be delivered by electronic means (*id*., para. 6).

(vi) Duty to Establish Operational Control System

A financial instruments business operator, etc. must establish an operational control system for the fair and appropriate performance of its financial instruments business or services of a registered financial institution, pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 35-3).

Cabinet Office Ordinance to be enacted will make it obligatory for financial instruments business operators, etc. in general to establish internal rules, etc. as necessary for performing their business appropriately and take measures to ensure their employees' compliance with such internal rules by providing training (FIBCOO, art. 70-2, para. 1).

Along with the 2014 amendment of the FIEA, obligations will also be introduced on financial instruments business operators, etc. engaged in the electronic offering handling business, such as taking measures to check the issuers of securities and examine their business plans (FIBCOO, art. 70-2, para. 2).

A financial instruments business operator, etc. whose parent company is a foreign company and which is designated by the Commissioner of the Financial Services Agency is required to take measures to ensure continuous implementation of business with the parent company, as prescribed by the Commissioner of the Financial Services Agency (FIBCOO, art. 70-2, para. 6).

(vii) Duty to Use Electronic Date Processing System in Over-the-Counter Transactions of Derivatives

In cases where a financial instruments business operator, etc. conducts, in the course of trade, over-the-counter transactions of derivatives which are specified by Cabinet Office Ordinance as those for which the information on the outline of the transaction should be swiftly disclosed to secure fair transactions in light of the transaction volume and other conditions of transactions (referred to as "specified over-the-counter transactions of derivatives"), the financial instruments business operator, etc. must use the electronic

information system used by financial instruments business operators, etc. or authorized operators for electronic over-the-counter transactions of derivatives, etc. for business related to over-the-counter transactions of derivatives (FIEA, art. 40-7, para. 1).

In light of the defects found in the market infrastructure for the settlement or clearing of over-the-counter transactions of derivatives such as credit default swaps (CDS) upon the financial crisis in fall 2008, each country is improving its system for the settlement and clearing of over-the-counter transactions of derivatives. In Japan, in order to improve the transparency of the actual conditions of over-the-counter transactions of derivatives, financial instruments business operators, etc. have been required to use an electronic information system for over-the-counter transactions of derivatives pursuant to the amendments in 2012.

Persons who have offered for use an electronic information system must publish the price, volume and other matters necessary to clarify the outline of the transactions pursuant to the provisions of Cabinet Office Ordinance with respect to the specified over-the-counter transactions of derivatives conducted by using the relevant electronic information system (FIEA art. 40-7, para. 2).

(viii) Duty to Comply with Brokerage Contract Rules

If a customer order is to be executed on a financial instruments exchange market, the brokerage contract rules prescribed by the financial instruments exchange of which the financial instruments business operator is a member must be followed in connection with accepting the order for the trade, etc. of securities on a financial instruments exchange market or market transactions of derivatives (FIEA, art. 133, para. 1).

Agreements in violation of these rules are not permitted, and financial instruments business operators are bound by the brokerage contract rules even if they did not know about them. The brokerage contract rules are not simply self-regulatory rules, they are public rules founded on the FIEA at the very core of the markets and are interpreted as having the same legal effect as quasi-ministerial ordinances. The effect under private law of contracts in violation of the Brokerage Rules should be judged depending on the status each provision has in the market.

The brokerage contract rules contain detailed provisions concerning the following matters: [a] conditions for accepting entrustment of sales and purchase, etc. of securities and market transactions of derivatives; [b] delivery and the manner of settlement, etc. concerning sales and purchase, etc. of securities and market transactions of derivatives; [c] matters concerning the extension of credit in relation to the acceptance of entrustment of sales and purchase of securities; and [d] in addition to [a] through [c] above, other necessary matters concerning acceptance of entrustment of sales and purchase, etc. in securities and market transactions of derivatives. It is necessary to fully understand the content of the rules when soliciting investments.

(ix) Duty of Due Care of Prudent Manager and Duty of Separate Management, Etc.

Financial instruments business operators, etc. constantly receive securities, deposits of money and other assets from customers accompanying their myriad securities transactions. In this event, a financial instruments business operator, etc. must carry out the administrative work of the securities with the care of a prudent manager on behalf of customers (FIEA, art. 43).

Financial instruments business operators, etc. are supposed to manage securities deposited from customers separately from their own property by a method specified by laws and regulations as a method for managing property in a reliable and orderly manner. However, oftentimes financial instruments business operators, etc. commingled customer margin relating to margin transactions or lending transactions, deposit for lending transactions, customer margins, etc. pertaining to a futures or options transaction, clearing margins or other customer assets with the assets of the financial instruments business operators, etc., giving rise to

problems with respect to the securing of the rights of the customer in cases where the financial instruments business operators, etc. became insolvent.

Separate management of customer assets is the duty to keep cash and securities that support the investment decisions of customers in a form that corresponds to the investment decision. It is a duty of financial instruments business operators who are to promote the substance of investment decisions that are sufficient to participate in the formation of fair prices. It should not simply be identified as a duty for the purpose of actions to be taken at the time of a failure of a financial instruments business operator, etc. If separate management is thoroughly carried out, then the problems of a failure on the part of a financial instruments business operator, etc. should not have any impact on the functioning of the capital markets.

Consequently, in order to ensure that customer assets are properly returned without incident, a financial instruments business operator, etc. must manage the securities and cash deposited from customers separately from its own assets (FIEA, art. 43-2, para. 1 and para. 2), and must also place the money to be returned to customers in trust with a trust company in cases where it discontinues the financial instruments business, etc. or other similar circumstances (*id*., para. 2). Furthermore, a financial instruments business operator must undergo periodic audits by certified public accountants or audit firms regarding the status of separate management (*id*., para. 3).

Pursuant to the amendments in 2012, financial instruments business operators, etc. have the duty to separately manage the properties deposited from customers or properties that belong to the customer's account in relation to the brokerage for commodity-related market transactions of derivatives and incidental transactions thereof (FIEA, art. 43-2-2). With regard to separate management in relation to these transactions, financial instruments business operators are not required to undergo audits by certified public accountants or audit firms.

If commodity derivatives brokers that were members of a consigner protection fund under the CDTA as of the day on which the amendment of the FIEA in 2012 (relevant to a comprehensive exchange) came into effect (March 11, 2014) have been registered as a Type I financial instruments business operator or have had a change registered in order to conduct the business pertaining to commodity-related market transactions of derivatives, and have notified the consigner protection fund of their request to include the customer assets relevant to that business in the coverage of the consigner protection fund, they may separately deposit the customer assets with the consigner protection fund or use other methods to separately manage the customer assets, in addition to entrusting the customer assets to a trust company, etc. (FIBCOO, Supplementary Provisions, art. 2).

(x) Collection of Hypothecation (Loan) Consent

Written consent from the customer must be obtained in a manner as prescribed by Cabinet Office Ordinance if a financial instruments business operator, etc. will hypothecate or lend to another person securities that the financial instruments business operator, etc. holds on behalf of a customer, or has received on deposit from a customer (FIEA, art. 43-4, para. 1; FIBCOO, art. 146).

If a financial instruments business operator, etc. will hypothecate or lend to others commodities that the financial instruments business operator, etc. possesses based on the account of a customer, or has accepted deposit from a customer, in relation to the business pertaining to the commodity market transactions of derivatives, written consent from the customer must be obtained (FIEA, art. 43-4, para. 2).

This written consent may be transmitted through electronic or magnetic means (FIEA, art. 43-4, para. 3 and art. 34-2, para. 12).

(xi) Prohibition Against Loss Compensation

A financial instruments business operator, etc. may not itself or through a third party engage in the following acts regarding trades or other transactions in securities accepted from customers:

(a) Loss Guarantee/Yield Guarantee (FIEA, art. 39, para. 1, item 1)

An act of making an offer or promise to a customer, with regard to sale and purchase or other transactions of securities, etc., to the effect that if the customer incurs any loss or shortfall in the predetermined amount of profit, property benefit will be provided to the customer in order to compensate or make up for the whole or part of such loss or shortfall.

(b) Offering/Promising Loss Compensation (FIEA, art. 39, para. 1, item 2)

An act of making an offer or promise to a customer, with regard to the sale and purchase or other transaction of securities, etc., to the effect that property benefit will be provided to the customer in order to compensate for the whole or part of a loss incurred by the customer or make an addition to the profit accrued to the customer.

(c) Implementation of Loss Compensation (FIEA, art. 39, para. 1, item 3)

An act of providing property benefit to a customer, with regard to the sale and purchase or other transaction of securities, etc., in order to compensate for the whole or part of a loss incurred by the customer or make an addition to the profit accrued to the customer.

Guarantees against loss and guarantees of a yield are prohibited since an investment that can be easily made because a guarantee has been made in advance will impair fair price formation, which is supposed to be attained by accumulating the true and independent investment decisions of investors with respect to the true value of a security.

Although post facto promises for loss compensation or ex post loss compensation do not necessarily hinder the formulation of the price itself since they are performed after the fact, these acts are also prohibited because if financial instruments business operators, etc. that are the bearers of the capital markets do not make the investor live with the results of the market, it would run contrary to their duties as bearers of the market and could cause investors to lose confidence in fair price formulation.

Also, investors being customers who demand and cause a financial instruments business operator, etc. to agree to loss compensation or provision of financial benefits to supplement profit are subject to criminal penalties (FIEA, art. 39, para. 2). It would normally be unthinkable to be adding to profits while compensating for losses after the fact, and most cases of this nature would probably be found to be the execution of a prior guarantee.

The provisions set forth in Article 39, Paragraph 1, will not apply and the acts under (a) and (c) above will be treated as simply processing an incident, and not loss compensation, in cases where the financial instruments business operator, etc. receives advance confirmation from the Prime Minister that such loss is due to an incident, and other cases prescribed by Cabinet Office Ordinance (FIEA, art. 39, para. 3). Where the

confirmation of the Prime Minister is sought, an application stating certain matters and documents necessary to prove the said facts must be submitted to the Prime Minister (FIEA, art. 39, para. 7).

In this regard, an "incident" is defined as (A) "those in which a representative, agent, employee or other worker of the financial instruments business operator, etc. causes a loss to the customer through the performance of the following enumerated acts concerning the operations of the said financial instruments business operator, etc., in connection with a sales and purchase or other transaction of securities, etc.," or (B) "those in which a loss is caused to a customer or a holder of rights as a result of the conduct of an act as set forth below, in connection with the investment advisory business or the investment management business" (FIBCOO, art. 118). However, for unfair trading that exceeds the boundaries of a simple incident, the illegality of the act will not be removed by the confirmation. In this manner, the incident confirmation of the Prime Minister is not binding on the decision of a court.

The following acts would be covered in connection with (A) above:

[i] Without confirming the content of the customer's order, making sales and purchase or other transaction of securities, etc. for the customer's account;

[ii] Making solicitation in a manner that causes the customer to make an erroneous assumption concerning the items enumerated in a. through c. below:

- **a. Characteristics of the securities, etc.;**
- **b. Conditions of transactions; and**
- **c. Rises or drops, etc. in the price of financial instruments or the amount of consideration for options;**

[iii] Making a negligent error in the clerical processing when executing the customer's order;

[iv] Making an error in executing a customer order because of abnormal functioning of an electronic information system; or

[v] Other action in violation of the laws or regulations.

Moreover, the following acts would be covered in connection with (B) above:

[i] Error in administrative processing as a result of negligence or failure in electronic information system;

[ii] Negligence in duty; or

[iii] Other legal or regulatory violation or violation of investment advisory contract or contract concerning the delegation of management authority, or other legal act.

In addition, stipulation has been made which lists cases in which confirmation of a securities incident is not required, *e.g.,* those cases where a final judgment by a court has been obtained, or if a settlement has been reached in a court, or if a settlement has been obtained through mediation by the JSDA or a certified investors protection organization, or if a settlement has been obtained through the dispute resolution proceedings of the designated dispute resolution organization (FIBCOO, art. 119 and art. 277).

As a result of the amendments in 2017, the provisions of the FIEA do not apply if the economic benefit has been provided by a Financial Instruments Business Operator, etc. to cover the whole or part of a loss caused to the principal of investment trusts specified by Cabinet Office Ordinance as those of which beneficial

interest is acquired or held for the purpose of providing it for paying or receiving money in the sales and purchase of securities or any other transactions between a customer and a Financial Instruments Business Operator, etc. (FIEA, art. 39, para. 4 and para. 6). This new provision has been introduced with the idea of money reserve funds (MRF) which are used for the management of individual investors' trading funds for the settlement of securities.

(xii) Duty to Enter into a Contract, Etc. with a Designated Dispute Resolution Organization

A financial instruments business operator, etc. must devise measures for dispute resolution such as entering into a contract, etc. with a designated dispute resolution organization (FIEA, art. 37-7). Financial instruments and services have become diverse and complicated, and in light of the gap between financial institutions and users in terms of matters such as information and knowledge and the capability to resolve problems, it is necessary to strive for effectiveness in the disposition of complaints and the resolution of disputes. Consequently, financial instruments business operators, etc. must devise the following types of measures.

First, if a designated dispute resolution organization has been established, the financial instruments business operator, etc. is obligated to use the designated dispute resolution organization. If there are multiple designated dispute resolution organizations within the business category, a financial instruments business operator, etc. must enter into a basic agreement for the execution of procedures with at least one of the designated dispute resolution organizations, and the financial instruments business operator, etc. must publicly announce the trade name and firm name of the designated dispute resolution organization that is the other party to the basic agreement for the execution of procedures (FIEA, art. 37-7, para. 2).

Second, if a designated dispute resolution organization is not established/designated, individual financial institutions are called upon to have a standardized approach for the processing of complaints and dispute resolution in order to strive to protect users against financial problems (FIEA, art. 37-7; FIBCOO, art. 115-2).

(xiii) Professional Investor System

(a) Basic Concept

The conduct regulations over dealers under the former SEL were to apply in a uniform manner under their stipulations, regardless of the attributes of the investor. Nevertheless, there are some investors for whom application of the conduct regulations is not necessary in view of, *inter alia,* their knowledge, experience and financial position, and who moreover do not wish to be covered under these conduct regulations.

The FIEA, therefore, classifies investors into professional investors and general investors, enacts differences in treatment under the conduct regulations of financial instruments business operators, etc. based on this classification, and thereby promotes regulatory flexibility.

Making this categorization enables the achievement of the necessary level of regulation without unneeded restriction of persons who are able to make their own investment decisions, from which it can, consequently, be expected that regulatory efficiency can also be achieved.

Nevertheless, the liberalization of regulations concerning professional investors should not be interpreted as meaning as "there is no need for legal intervention because professional investors do not require protection." There is a particular emphasis on the responsibility in connection with the fair formation of prices when a market is formed solely from professional investors, and this must not be understood as being a situation in which regulation is not needed.

Persons who are considered to be able to manage risks in an appropriate fashion in connection with

financial instruments transactions on the basis of their knowledge, experience and financial position are designated as "professional investors," and when a business operator engages in transactions with a professional investor, they are excluded from the conduct regulations that are designed to ameliorate the imbalance in information, including the duty to deliver a document prior to conclusion of contract. The exclusion, however, does not apply to the conduct regulations that are designed to achieve fairness in markets, including the prohibition against compensation for losses.

Even in cases that are excluded from application of the conduct regulations which are prescribed to ameliorate the imbalance in information, this exclusion is to be interpreted as at most a release from the duty to provide the explanation that is to be provided to numerous unspecified investors. It does not constitute a release from the duty to explain, which is imposed at all times on a person who brings financial instruments to the market as a financial instruments business operator. Even if the counterparty is a professional, a failure to make the necessary explanations would at least constitute an unfair transaction, or fraud. It is necessary to be careful in this regard, as it does not mean that the duty to provide direct explanations is rendered unnecessary at all times.

The FIEA lists as professional investors (i) qualified institutional investors, (ii) the government of Japan, (iii) the Bank of Japan, (iv) investors protection funds and other juridical persons as prescribed by Cabinet Office Ordinance (FIEA, art. 2, para. 31).

(b) Classification Between Professional Investors and General Investors

The FIEA has four classifications of professional investors and general investors: (A) professional investors that cannot transfer their status to that of a general investor, (B) professional investors that can choose to transfer their status to that of a general investor, (C) general investors that can choose to transfer their status to that of a professional investor, and (D) general investors that cannot transfer their status to that of a professional investor:

(A) Professional investors that cannot transfer their status to that of a general investor

Qualified institutional investors, the government of Japan and the Bank of Japan are professional investors that cannot change their status to general investors. Qualified institutional investors include, *inter alia,* banks, financial instruments business operators, insurance companies, and Shinkin banks, etc. (Definition Ordinance, art. 10).

The scope of qualified institutional investors was expanded with the enactment of the FIEA, and among the requirements for a qualified institutional investor, the requirement for a company to submit an annual securities report was eliminated, and the securities balance criteria was reduced from JPY10 billion to JPY1 billion. Moreover, new categories of qualified institutional investors were created consisting of corporations in the event of a securities balance of at least JPY1 billion, an individual that has a securities balance of at least JPY1 billion and who has had an account with a financial instruments business operator, etc. for at least one year, and a corporation or individual, etc. that is an executive partner, etc. which has obtained consent from all partners, etc., and for which the securities balance in connection with the contract is at least JPY1 billion. All of these are covered by the system of notification to the Prime Minister. The effective period of a notification in connection with a qualified institutional investor is two years.

(B) Professional investors that can choose to transfer their status to that of a general investor

Investors protection funds and other juridical persons as prescribed by Cabinet Office Ordinance among professional investors may have their status deemed as being that of a general investor if they

apply to the financial instruments business operator, etc. to be treated as a customer other than a professional investor (*i.e.*, a general investor) and taking the necessary procedures (FIEA, art. 34-2). Government affiliated institutions, investors protection funds, the Deposit Insurance Corporation of Japan, foreign corporations, listed companies, and stock companies expected to have at least JPY500 million in capitalization, etc. are prescribed as professional investors that can choose to transfer their status to that of a general investor (Definition Ordinance, art. 23).

Under the amendments in 2010, local governments have been re-categorized from “investors that can choose to transfer their status to that of a general investor” to “investors that can choose to transfer their status to that of a professional investor” (to be enforced as of April 1, 2011). Furthermore, the amendments in 2013 limited the cases where an employees’ pension fund may change its status to a professional investor, and only employees’ pension funds that have set up the necessary management systems are now able to be professional investors.

(C) General investors that can transfer their status to that of a professional investor

A juridical person other than a professional investor (FIEA, art. 34-3, para. 1), as well as an individual, etc. that meets certain requirements as being a person who is equivalent to a professional investor in view of the knowledge, experience, and financial position of that individual, etc. (FIEA, art. 34-4, para. 1) may have their status treated as that of a professional investor by applying to the financial instruments business operator, etc. to be treated as a professional investor, and taking the necessary procedures.

The following requirements exist in order for an individual to transfer his or her status to that of a professional investor. If the individual is the operator of an anonymous partnership, or is an executive partner of a civil code partnership, or is a partner in a limited liability partnership (limited to a partner that contributes to decisions on material execution of business, and who himself or herself executes the said business), [i] that the partner has obtained the consent of all partners in connection with the transfer of status to that of a professional investor, and [ii] that the total amount invested in the partnership agreement is at least JPY300 million (FIBCOO, art. 61, para. 2).

As a result of the expansion of the scope of professional investors under the amendment of the Cabinet Office Order in 2022, other individuals are now able to change their status to professional investor if they fall under any of the following four cases (FIBCOO, art. 62):

(i) The applicant satisfies all of the following requirements:
  - [A] The amount of net assets of the applicant as of the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY300 million or more;
  - [B] The total amount of the financial assets that the applicant can invest as of the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY300 million or more; and
  - [C] At least one year has passed from the day on which the applicant concluded with the business operator the first contract for financial instruments transaction that is of the type of a contract pertaining to the application.

(ii) The applicant satisfies any of the following requirements, and satisfies the requirement under (i)[C]:
  - [A] The amount of net assets of the applicant as of the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY500 million

or more;

[B] The total amount of assets of the applicant as of the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY500 million or more; or

[C] The amount of income of the applicant in the year preceding the year that includes the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY100 million or more.

(iii) The monthly average number of contracts concluded by the applicant in one year prior to the date of acceptance is not less than four, and the applicant satisfies the requirement under (i)[A] or [B], and satisfies the requirement under (i)[C].

(iv) The applicant is a person who has specific knowledge and experience, and that satisfies any of the following requirements and satisfies the requirement under (i)[C]:

[A] The amount of net assets of the applicant as of the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY100 million or more;

[B] The total amount of assets of the applicant as of the date of acceptance can be reasonably the conditions of transactions or other circumstances to be expected to be JPY100 million or more; or

[C] The amount of income of the applicant in the year preceding the year that includes the date of acceptance can be reasonably judged from the conditions of transactions or other circumstances to be expected to be JPY10 million or more.

In the case of an applicant who had previously been deemed to be a professional investor pursuant to the provisions set forth in (iii), even if the applicant no longer meets the requirements prescribed in (iii), the applicant will still be deemed to fall under the case prescribed in (iii) as long as this is appropriate in light of the applicant's knowledge and experience (FIBCOO, art. 62, para. 2).

A "person who has specific knowledge and experience" as set forth in (iv) means a person who falls under any of the following (FIBCOO, art. 62, para. 3):

[A] A person who has engaged in the financial instruments business, banking business, insurance business, trust business, or other financial business for one year or more in total;

[B] A person who has held the post of a professor, associate professor, or other teaching staff in economic science or business science at a university's faculty, special course or graduate school for one year or more in total;

[C] A person who has any of the qualifications of a certified analyst, 1st-type or 2nd-type securities sales representative, 1st-class or 2nd-class financial planner, or SME consultant, and has engaged in the respective services for one year or more in total; or

[D] Any other person who has engaged in management consulting services for one year or more and has knowledge and experience that are equal to or greater than those of the persons set forth in [A] to [C].

(D) General investors that cannot transfer their status to that of a professional investor

Individuals who do not fall under any of (A) through (C) above are classified as general investors that cannot change their status to that of a professional investor.

(c) Application of Conduct Regulations When the Counterparty Is a Professional Investor

A professional investor is a person who is believed on the basis of that person's knowledge, experience and financial position to be able to carry out proper management of risks in association with financial instruments transactions, and consequently, the conduct regulations which are for the purpose of ameliorating the imbalance of information between a dealer and a customer are excluded from application, with the exception of regulations that are for the purpose of achieving fairness in markets, such as the prohibition against compensation for losses, thereby liberalizing the regulatory system (FIEA, art. 45).

In particular, the following conduct regulations are excluded from application:

a. When a financial instruments business operator, etc. carries out solicitation to enter into a contract for financial instruments transaction, and the counterparty to the solicitation is a professional investor—the regulations on advertising (FIEA, art. 37), the prohibition against uninvited solicitation (FIEA, art. 38, item 4), duty to confirm intention to receive solicitation (FIEA, art. 38, item 5), prohibition against repeated solicitation (FIEA, art. 38, item 6), and the principle of suitability (FIEA, art. 40, item 1);

b. When a financial instruments business operator, etc. has received a request to enter into a contract or has concluded a contract for financial instruments transactions, and the counterparty to the contract is a professional investor—the duty of prior explanation of the transaction structure (FIEA, art. 37-2), the duty to deliver a document prior to conclusion of contract (FIEA, art. 37-3), the duty to deliver a document upon conclusion of contract (FIEA, art. 37-4), the duty to deliver a written statement upon receipt of deposits (FIEA, art. 37-5), written cancellation (FIEA, art. 37-6), the duty of prior delivery of a written statement on the best execution policy, etc. (FIEA, art. 40-2, para. 4), and the restrictions on acts of hypothecation, etc. of the securities of customers (FIEA, art. 43-4);

c. When a financial instruments business operator, etc. has entered into an investment advisory contract, and the counterparty is a professional investor—the prohibition against accepting deposits of cash and securities, etc. (FIEA, art. 41-4), and the prohibition against lending cash and securities, etc. (FIEA, art. 41-5); and

d. When a financial instruments business operator, etc. has entered into a discretionary investment contract, and the counterparty is a professional investor—the prohibition against accepting deposits of cash and securities, etc. (FIEA, art. 42-5), the prohibition against lending of cash or securities (FIEA, art. 42-6), and the duty to deliver investment reports (FIEA, art. 42-7).

As stated below, the exclusion from application does not apply to cases prescribed by Cabinet Office Ordinance as presenting the risk of compromise of the protection of investors or the public interest (FIEA, art. 45, *proviso*).

For example, the exemption from application of the duty to deliver a document upon conclusion of contract (FIEA, art. 37-4), and the duty to deliver investment reports (FIEA, art. 42-7) will not apply if a system is not in place so that a prompt response can be made to an inquiry from a customer concerning an individual transaction (FIEA, art. 45, *proviso*; FIBCOO, art. 156).

Moreover, although the principle of suitability (FIEA, art. 40, item 1) does not apply when soliciting professional investors for a transaction, it will apply in the event of a general customer that intends to elect to transfer its status to that of a professional investor. By way of example, a financial instruments business operator, etc. would be in violation of this principle if it encourages a customer to elect to transfer its status to that of a professional investor when the customer is not suited to be a professional investor in terms of its knowledge, experience, financial position or objectives.

In addition, the conduct regulations for the purpose of assuring the fairness of market, and the fundamental duty of a consignee, apply without change regardless of whether the counterparty to the transaction with a financial instruments business operator, etc. is a general investor or a professional investor. By way of elaboration, the following conduct regulations apply:

a. **With respect to all business activities—the duty of good faith and fairness to customers (FIEA, art. 36), the posting of signs (FIEA, art. 36-2), the prohibition against lending of name (FIEA, art. 36-3), and the prohibition against management of bonds, etc. (FIEA, art. 36-4);**

b. **With respect to sales and solicitation, etc.—the prohibition against giving false information (FIEA, art. 38, item 1), the prohibition against providing a conclusive evaluation, etc. (FIEA, art. 38, item 2), the prohibition against compensation for loss, etc. (FIEA, art. 39), the proper handling of customer information (FIEA, art. 40, item 2), the prohibition against trading, etc., without ensuring separate management (FIEA, art. 40-3), and prohibition of public offering, etc. where money has been diverted (FIEA, art. 40-3-2);**

c. **With respect to investment advisory business—the duty of loyalty to customers (FIEA, art. 41, para. 1), the duty of care as a prudent manager (FIEA, art. 41, para. 2), the prohibited acts (FIEA, art. 41-2), and the prohibition against trading of securities, etc. (FIEA, art. 41-3); and**

d. **With respect to the investment management business—the duty of loyalty to customers (FIEA, art. 42, para. 1), the duty of care as a prudent manager (FIEA, art. 42, para. 2), the prohibited acts (FIEA, art. 42-2), the delegation of management authority (FIEA, art. 42-3), and separate management (FIEA, art. 42-4).**

(d) Procedures for a Professional Investor to Receive Treatment as a General Investor

If a professional investor wishes to elect to transfer its status to that of a general investor, the professional investor must first notify the financial instruments business operator, etc. that is the counterparty to the transaction, for each type of contract that the professional investor desires to be treated as a general investor (FIEA, art. 34-2, para. 1). If a financial instruments business operator, etc. has not entered into a contract with that professional investor in the past that is of the same type as the relevant contract for financial instruments transaction, the financial instruments business operator, etc. must inform the professional investor in advance that a request of this nature can be made (FIEA, art. 34).

The types of agreements consist of four classifications (A) agreements to engage in transactions, etc. in securities, (B) agreements to engage in derivatives transactions, etc., (C) investment advisory contracts and agreements to engage in agency and intermediation in the execution thereof, and (D) discretionary

investment contracts and agreements to engage in agency and intermediation in the execution thereof (FIBCOO, art. 53).

A financial instruments business operator, etc. that has received a notification of this nature must, in principle, accept this notification before the time of either conducting solicitation for conclusion of or concluding a contract for financial instruments transaction that is of the type of the contract for which the notification has been made (FIEA, art. 34-2, para. 2). If the financial instruments business operator, etc. has accepted a notification of this nature, it must deliver to the notifying party a document stating the date of acceptance, the type of contracts, and other necessary matters (*id*., para. 3 and para. 4; FIBCOO, art. 55).

If a professional investor has transferred its status to that of a general investor, the effect of the transfer is valid until the customer gives notice of return to professional investor status. Also, if the customer returns to professional investor status, the financial instruments business operator, etc. must obtain written consent from the customer so that this can be clearly confirmed (FIEA, art. 34-2, para. 11; FIBCOO, art. 57-2). It is possible to obtain this consent by electronic or magnetic means (FIEA, art. 34-2, para. 12; FIBCOO, art. 57-3).

(e) Procedures for a General Investor to Receive Treatment as a Professional Investor

If a general investor wishes to elect to transfer its status to that of a professional investor, the general investor must first notify the financial instruments business operator, etc. that is the counterparty to the transaction, for each type of contract, that the general investor desires to be treated as a professional investor (FIEA, art. 34-3, para. 1; FIEA, art. 34-4, para. 1).

If an individual investor has given notice that he or she wishes to elect to transfer his or her status to that of a professional investor, the financial instruments business operator, etc. that has received this notice must deliver a written statement stating the content of the special exceptions in connection with applying the conduct regulations to professional investors, as well as the risks associated with the transfer (*i.e*., that there is a risk of insufficient protection if a person who is not appropriate in view of his or her knowledge, experience or financial position becomes a professional investor), and must further confirm that the notifying party satisfies the requirements for voluntary transfer of status to that of a professional investor (FIEA, art. 34-4, para. 2 and para. 3).

If a financial instruments business operator, etc. will accept a notice from a general investor, the financial instruments business operator, etc. must in advance obtain consent from the notifying party, by means of a written statement which in addition to the date of acceptance, the expiration date and the type of contracts, also confirms that the notifying party understands the content of the special exceptions in connection with applying the conduct regulations to professional investors, as well as the risks associated with the transfer (*i.e*., that there is a risk of insufficient protection if a person who is not appropriate in view of his or her knowledge, experience or financial experience becomes a professional investor) (FIEA, art. 34-3, para. 2 and art. 34-4, para. 4; FIBCOO, art. 59). Under the amendments in 2009, "the effect that the notifying party may give notification pursuant to the provisions of the FIEA, Article 34-3, Paragraph 9 at any time on or after the date of acceptance" has been added to the matters to be stated in such document (FIBCOO, art. 59, para. 2, item 5).

Although a transfer from general investor to professional investor status is valid for one year, by making a request it is possible to return to general investor status even before one year has elapsed (FIEA, art. 34-3, para. 9 and art. 34-4, para. 4). Further, while it is possible to renew professional investor status even before the validity of the transfer to professional investor expires, from the standpoint of investor

protection, the request for renewal cannot be made unless it is within a certain fixed period of time before the expiration date (no more than 1 month before the expiration date) (FIEA, art. 34-3, para. 7 and art. 34-4, para. 6; FIBCOO, art. 60 and art. 64-2).

(3) Conduct Regulations Concerning Type of Business and Condition of Business Activities

(i) Prohibition Against Lending of Name

A financial instruments business operator, etc. must not allow another person to conduct the financial instruments business under the name of the financial instruments business operator, etc. (FIEA, art. 36-3).

> The reason for prohibiting the lending of name is to prevent a person who has not obtained registration from borrowing the name of a person who has obtained registration, and conducting the financial instruments business.

(ii) Prohibition Against Becoming a Bond Administrator

A financial instruments business operator that engages in the securities-related business is not permitted to become a bond administrator, bond administrator's assistant or trustee under a secured bond trust indenture (FIEA, art. 36-4, para. 1).

> The reason for this is that these acts are for the purpose of protecting the interests of bond-holders, and are acts that are not compatible with the neutral position of a financial instruments business operator that engages in the securities business, as A bearer of the capital markets.

These financial instruments business operators, however, are allowed to serve as an underwriter (FIEA, art. 36-4, para. 2).

(iii) Prohibition Against Churning, Etc.

A financial instruments business operator, etc. must not frequently conduct the purchase and sale or any other transaction of securities or derivative transactions, etc. (excluding brokerage for clearing of securities, etc.) on the customer's account, without confirming the contents of the customer's order in advance (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 1).

Financial instruments business operators, etc. accept orders for securities trading, etc. from customers and carry them out; however, for orders placed orally or over the phone, there are instances where problems later arise between the financial instruments business operator, etc. and the customer as to whether the order was based on the intent of the customer. This is especially true in the case of churning, where several revolving trades, etc. are conducted without taking into account the intentions of the customer. This type of activity is particularly contrary to investor protection and can harm the fairness of the market. Thus, there is a prohibition on conducting frequent trades, etc., without confirming the order from the customer in advance.

(iv) Prohibition Against Excessive Underwriting Competition

A financial instruments business operator, etc. is prohibited from underwriting securities at a volume, price or other terms and conditions deemed grossly inappropriate in order to maintain its own business status or give it an advantage with respect to underwriting (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 3).

> Acts of this nature are likely to distort underwriting conditions, and as a consequence distort primary

markets, making it necessary to prohibit this type of behavior.

Conduct of this type of behavior presents the possibility that investors will buy equities at an inflated price, and then incur damage when stock prices fall drastically because of this distorted relationship between supply and demand.

(v) Preventing of Confusion with Financial Institution

If the principal office or other business office or office of a financial instruments business operator conducts activities in the same building as the principal office or other business office or office of a financial institution, the financial instruments business operator must take appropriate steps so that customers do not confuse the financial instruments business operator with the financial institution (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 22).

(vi) Prohibition Against Extending Credit by Underwriter

In cases where a financial instruments business operator sells securities that it underwrote (in the case of a financial instruments business operator who is to acquire and exercise a share option upon a commitment-based rights offering, the securities that it is to acquire by exercising the share option), it must not make a loan of the purchase price to the purchaser of such securities until six months have passed since the underwriting date (FIEA, art. 44-4).

The intent behind this prohibition is to prevent the financial instruments business operator from shifting the risks traditionally borne by it to the customer by extending credit to potential purchasers of shares acquired by the financial instruments business operator as an underwriter, thereby facilitating the acquisition of the securities.

The risk of unsold securities underwritten must be a risk that is based on the competitive principles of the capital market. If the underwriter grants credit, this can easily lead to avoiding of the underwriting risk, thereby distorting the primary market.

Consequently, this regulation has been enacted in order to assure the Integrity of the primary market.

(4) Conduct Regulations on Investment Solicitation and Acceptance of Entrustment

(i) Restrictions on Bunched Orders

A financial instruments business operator, etc. must not make an acceptance of entrustment, etc. of the purchase and sale of securities or derivative transactions from a person having been entrusted with the purchase and sale of the securities or derivative transactions through the solicitation of unspecified and many investors (excluding a person conducting acts of financial instruments transaction in compliance with the laws and regulations), knowing that such transactions are to be conducted on such investors' accounts, and without confirming such investors' intentions in advance (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 2).

There have been cases of orders received from investment advisors or an investment group which receives a delegation from numerous and unspecified investors and issues bunched orders for trading or other transactions, in which determining whether the orders actually reflected the intentions of each of the investors has become a problem at a later date. Therefore, upon accepting an order from such investment groups, financial instruments business operators, etc. are required to confirm in advance the intent of each of the investors.

(ii) Prohibition Against Solicitations by Offering a Conclusive Evaluation

Since the price of stock fluctuates in response to a variety of factors, it is impossible to accurately predict future price movements. Consequently, financial instruments business operators, etc. are prohibited from undertaking solicitations by offering a conclusive evaluation such as “buy this stock because its price is going to rise to X” or “sell this stock since it is absolutely going to fall in price” which would cause a customer to harbor strong expectations (FIEA, art. 38, item 2).

Providing conclusive evaluations concerning dividends or new share issues that have not been confirmed similarly fall within this prohibition on solicitations.

> The rationale behind the rule prohibiting these types of actions is that they cause distortions in price formulation in the markets, and customers who give credence to such statements may incur unexpected losses. Note that such solicitations do not become legal because they turn out to be correct. The issue is whether they distort the formation of the investment decision.
>
> In addition, it must be remembered that a conclusive evaluation does not have to specify a price or price range to which the security will rise or fall or pinpoint an exact date, and even opinions that do not use words like “definitely” or “for sure” can still be found to constitute a conclusive evaluation.

A business operator who gives conclusive evaluation is held to be liable under the APFS to compensate the customer for damages that the customer incurs thereby (APFS, art. 5 and art. 6). In this case as well, the amount of loss on principal is presumed to be the damage incurred by the customer, and the liability of the business operator is held to be strict liability.

(iii) Prohibition Against Acts of False Notification, Etc.

(a) Prohibition Against False Notification

It is prohibited for financial instruments business operators, etc. or an officer or employee thereof to make false notification in connection with entering into a contract for financial instruments transaction or soliciting of the same (FIEA, art. 38, item 1).

(b) Prohibition Against False Representation

Financial instruments business operators, etc. or an officer or employee thereof, in connection with the conclusion of a contract for financial instruments transactions or solicitation thereof, must not make false statements or statements that cause a misunderstanding regarding the material matters that could exert a significant influence on the investment decision of the investor (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 2).

> This applies even if no “solicitation” takes place. Statements can be made by any medium, including orally, in writing, through graphics, broadcast, or film. “Misleading statements” means not only expressions that are affirmatively misleading, but also includes omissions of necessary representation.
>
> Since this provision prohibits the statement itself, it does not distinguish between intentional or negligent statements.

(iv) Duty to Explain When Using an Unregistered Credit Rating Agency

If a credit rating was given by a person who conducts credit rating services other than a credit rating

agency, a financial instruments business operator, etc. or an officer or employee thereof must not provide the credit rating to a customer and solicit the execution of a contract for financial instruments transaction without informing the customer that the person who gave the relevant credit rating is not a person who has been registered under Article 66-27 of the FIEA and the significance of the relevant registration, as well as other matters provided by Cabinet Office Ordinance (FIEA, art. 38, item 3; FIBCOO, art. 116-3).

> Since credit ratings by unregistered businesses have not gone through a ratings process under a regulatory framework, and since no information disclosure obligation is imposed concerning the method and premises for the credit rating, there is a risk that it could distort the investor's investment decisions if this kind of credit rating is provided to an investor without making its characteristics clear.

The Cabinet Office Ordinance provides as matters to be notified [a] significance of the registration under Article 66-27 of the FIEA, [b] [i] the trade name, firm name or individual name of the party giving the credit rating, [ii] if a juridical person (including an unincorporated group with a provision on the representative or administrator), the individual name or firm name of officers (in the case of an unincorporated group with a provision on the representative or administrator, the representative or administrator), and [iii] the name of the principal office, other main business office or office and location thereof, [c] the outline of the credit rating policies and manners used by the person giving the credit rating, and [d] the premises, significance and limitations of credit ratings (FIBCOO, art. 116-3, para. 1).

Furthermore, notwithstanding the above, starting January 1, 2011, the following matters must be explained with respect to a credit rating given by an affiliate of a credit rating agency that is designated by the Commissioner of the Financial Services Agency for a fixed duration in consideration of the contents and manner of the credit rating services by such affiliate of the credit rating agency, status of disclosure of information regarding credit rating and other circumstances (hereinafter referred to as the "specified affiliate") (*id.*, para. 2):

[A] The effect that the person giving the credit rating is not registered under Article 66-27 of the FIEA;
[B] Significance of the registration under Article 66-27 of the FIEA;
[C] Trade name or firm name and registration number of the credit rating agency;
[D] Name used by the special affiliate to indicate the credit rating services;
[E] Outline of the credit rating policies and manners used by the special affiliate giving the credit rating or the method of obtaining information regarding such outline from the credit rating agency; and
[F] Premises, significance and limitations of credit ratings.

In addition, credit ratings, etc. targeting the evaluation of the credit conditions of the underlying assets of asset securitization products, etc. is provided as credit ratings which are unlikely to undermine investor protection (FIBCOO, art. 116-2).

(v) Prohibition Against Solicitation by Offering Special Profits

A financial instruments business operator, etc. or an officer or employee thereof must not solicit for contract for financial instruments transactions that promise to provide special profits to a customer or to a

person designated by a customer, or to provide special profits to a customer or a third party (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 3).

> Since the profits provided are limited to those that are special or extraordinary, this does not include services that are generally accepted as a matter of social custom. Thus, special contracts for the preferential allotment of publicly offered shares or the sale of securities at an unreasonably low price might fall under special profits.
>
> Such acts are prohibited because as investment decisions that are unrelated to the quality and value of the investment target, and which are motivated by the provision of these profits, impair fair price formulation on capital markets.

(vi) Prohibition Against Blanket Recommendations

A financial instruments business operator, etc. or an officer or employee thereof must not commit any act of soliciting unspecified many customers in relation to purchase or sale of a specified and small number of issues of securities or transactions of derivatives, or the entrustment thereof, simultaneously and in an excessively aggressive manner, continuously over a certain period, as this is likely to prejudice formation of a fair price (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 17).

> This is because encouraging customers to make concentrated purchases of a certain issue presents the risk that the price of a stock could be influenced by the sales policies of the financial instruments business operator, etc., and moreover there is a strong risk that such activities could be used to manipulate stock prices, or that customers will be subjected to high-pressure solicitations that ignore the customer's financial resources.
>
> There is a particularly strict prohibition against blanket recommendations where the solicitations are for securities presently held by such financial instruments business operator, etc.
>
> It is possible that these acts themselves could be classified as market manipulation.

(vii) Prohibition Against Accepting Orders for Insider Trading

A financial instruments business operator, etc. or an officer or employee thereof must not become the counterparty to a trade or accept the entrustment, etc. of a transaction with a customer, with knowledge that the said transaction is or may be an insider transaction (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 13).

> This provision is for the purpose of clarifying that as a bearer of the markets a financial instruments business operator, etc. may not, *inter alia,* accept entrustment of acts that are disruptive to the markets.
>
> A financial instruments business operator, etc. has a fundamental duty to contribute to the formation of investment decisions that create fair market prices on capital markets, and to prevent investment decisions that disrupt fair price formation from participating in the formation of prices.
>
> Acts such as knowingly accepting entrustment that is for the purpose of price manipulation are prohibited for the same purpose.

Administrative actions may be taken against a violation of this provision, and it is also possible that criminal liability will be sought as abetting insider trading.

(viii) Prohibition Against Soliciting by Providing Confidential Corporate Information

A financial instruments business operator, etc. or an officer or employee thereof must not carry out investment solicitation to a customer by providing confidential corporate information of an issuer of securities in connection with the trading or other transaction, etc. in the securities (FIEA, art. 38, item 9; FIBCOO, art. 1, para. 4, item 14 And art. 117, para. 1, item 14).

> Acts of this nature constitute acts of solicitation by offering special profits, and moreover, have the significance of increasing the probability of insider trading or of abetting insider trading as an act of diffusing material confidential corporate information. Consequently, this provision has been enacted in order to call for particular caution.

(ix) Prohibition Against Excessive Solicitation in Order to Gain Profits on the Part of the Business Operator Itself or Other Customers

A financial instruments business operator, etc. or an officer or employee thereof must not commit any act of soliciting many and unspecified customers to purchase or to sell securities, or to engage in market transactions of derivatives, or to consign, etc. the same, over a certain period of time and in a concentrated or excessive manner, for the purpose of profits for its own account or that of a third party other than the relevant customer by fluctuations in the prices, indexes, values or consideration based on a transaction with the relevant customer (FIEA, art. 38, item 9; and FIBCOO, art. 117, para. 1, item 18).

This includes having acts of solicitation carried out by a registered financial institution that carries out the entrustment of the financial instruments intermediary service, or a financial instruments intermediary service provider.

(x) Prohibition Against Provision of Unjustifiable Calculation Basis Data

A financial instruments business operator, etc. or an officer or employee thereof must not provide a specified financial benchmark administrator (for details, see “11. Regulations on Specified Financial Benchmark Administrators”) with calculation basis data (meaning the price, indicator, figure, or any other information provided to the specified financial benchmark administrator as the basis for calculation of specified financial indicators) that is not supported by any justifiable grounds, with a view to benefiting itself or a third party (FIEA, art. 38, item 7).

Financial indicators play an important role in financial and capital markets as they are used for the calculation of the interest rate for loans and the amount payable in derivatives transactions. Financial instruments business operators, etc. that are engaged in derivatives transactions involving such financial indicators are considered to be rather easily motivated to provide calculation basis data that is not supported by any justifiable grounds, in an attempt to manipulate figures of financial indicators and thereby earn unjust profit. To prevent such conduct, the present regulation was introduced by way of the amendment to the FIEA in 2014.

(xi) Regulations on Fund Distributers

A financial instruments business operator, etc. must not solicit customers to invest in a fund for which separate management of assets is not ensured under its rules (FIEA, art. 40-3). If separate management is not ensured, the fund management companies might misappropriate the money invested by customers, thus posing the risk of harming investors’ interests.

The 2014 amendment to the FIEA further tightened regulations, providing that financial instruments

business operators, etc. must not handle public offering of interests in a fund, knowing that the money invested in the fund is not appropriated for the intended purpose (FIEA, art. 40-3-2).

This provision assumes the case where a type II financial instruments business operator, etc. handles public offering of interests in a collective investment scheme.

(xii) Conduct Regulations Concerning Commodity-Related Market Transactions of Derivatives

A financial instrument business operator, etc. must not conduct the following acts in connection with commodity-related market transactions of derivatives.

(a) With regard to accepting entrustment, etc. from a customer to conduct a commodity-related market transaction of derivatives, recommending the customer (excluding professional investors) to make the volume and maturity of the sale or purchase in the commodity-related market transaction of derivatives or any similar transaction conducted by the customer exactly match the volume and maturity of a transaction that would offset such transaction (which means a transaction that would reduce the losses arising from such transaction) (prohibition of recommendation for cross order) (FIBCOO, art, 117, para. 1, item 35).

(b) Accepting entrustment, etc. of a transaction that would offset (that is, a transaction that would reduce the losses arising from) the sale or purchase in the commodity-related market transaction of derivatives or any similar transaction and that has a volume or maturity different from such transaction from a customer who does not understand the details of such transaction (prohibition of being entrusted, etc. with a transaction similar to cross order) (FIBCOO art. 117, para. 1, item 36).

(c) Accepting entrustment, etc. from a customer to conduct a commodity-related market transaction of derivatives and intentionally having the transaction under its own account offset with the transaction pertaining to such entrustment, etc., thereby carrying out a transaction harmful to the interest of the customer (prohibition of *mukaigyoku*) (FIBCOO, art. 117, para. 1, item 37).

(d) When seeking to accept entrustment, etc. of a commodity-related market transaction of derivatives from a customer, accepting the said entrustment, etc., without explaining the following matters to the customer in advance, despite the fact that the financial instruments business operator, etc. engages intentionally in a transaction with regard to the same commodity or commodity-related financial indicator and for the same maturity as the transaction entrusted, etc. by the customer, with a view to having a transaction on its own account offset with the customer's transaction (referred to as a "specified transaction" in a. and b. below) (duty to explain for *sagyoku-mukai*) (FIBCOO, art. 117, para. 1, item 38).

    a. the fact that the financial instruments business operator, etc. engages in the specified transaction; and

    b. when the transaction entrusted etc., by the customer and the transaction on the account of the financial instruments business operator, etc. are offset with each other via the specified transaction, the possibility that a conflict in interests could arise between the customer who has entrusted, etc. the transaction and the financial instruments business operator, etc.

These acts have a risk of causing a conflict in interests between financial instruments business operators, etc. and customers and thereby causing a huge loss to customers, and therefore they are prohibited under the FIEA in the same manner as under the CDTA.

(e) Prohibition of Bucketing

When a financial instruments business operator, etc. accepts entrustment of a commodity-related

market transaction of derivatives, etc. (meaning a commodity-related transaction of derivatives, or intermediary, brokerage, or agency service for the entrustment thereof), the financial instruments business operator, etc. shall not close a transaction by becoming the counterparty itself instead of carrying out such commodity-related transaction of derivatives, etc. pertaining to such entrustment (FIEA, art. 40-6).

This provision, which has been introduced to ensure consistency with the prohibition of bucketing provided in Article 212 of the CDTA, can be understood as a regulation specific to commodity-related market transactions of derivatives.

(xiii) Prohibition Against Accepting Orders for High Speed Trading from Unregistered Persons, Etc.

It is prohibited for a financial instruments business operator, etc. or an officer or employee thereof to engage in accepting consignment of a purchase and sale of securities or a market derivatives transaction pertaining to High Speed Trading conducted by a person other than a High Speed Trader, and engage in other acts specified by Cabinet Office Ordinance as being equivalent to them (FIEA, art. 38, item 8, and art. 60-13; FIEAEO, art. 16-4-2).

The 2017 amendments of the FIEA introduced regulations on High Speed Traders in view of the need to ensure effective regulatory control over persons engaging in High Speed Trading, who may be foreign corporations or individuals domiciling in foreign countries as well.

Under the Cabinet Office Ordinance, a High Speed Trader which has received an order for suspension of business pertaining to High Speed Trading and a High Speed Trader which cannot be confirmed to have implemented the measures for securing sufficient management of an electronic data processing system and other facilities for High Speed Trading are prohibited from accepting the entrustment of the High Speed Trading (FIBCOO, art. 116-4 and art. 230-3).

(5) Acts of Market Abuse Relating to Distortion of Market Prices

(i) Prohibition Against Front Running

When a buy (or sell) order for securities is received from a customer, the financial instruments business operator is prohibited from making, before consummating the trade, etc. related to the relevant order, etc., purchases (or sales), etc. or transactions of derivatives, for its own account of the same issue as the security ordered by the customer in order to consummate a trade at the same price or a more advantageous price than the price related to the relevant customer’s order, etc. (a price lower than the customer’s price in the case of a purchase [a price higher than the customer’s price in the case of a sale]). Such conduct constitutes the improper use of trading information and is prohibited as violating the duty of good faith and fairness towards the customer since it increases the cost of executing the trades of the customer (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 10).

Front running does constitute a violation of the duty of good faith and fairness to customers, since the customer orders will be executed at an inflated price. Nevertheless, it is difficult for a customer to prove each case of violation of the duty of good faith and fairness. For this reason, the objective facts themselves of front running have been made illegal.

It is also possible to evaluate this act as constituting a violation of the duty of a financial instruments business operator, etc. to execute customer trading orders without fail on a competitive market. A

financial instruments business operator, etc. is not permitted to execute customer orders on a market that it has distorted itself.

Moreover, it is also possible to view acts of this nature as being an act similar to insider trading, which uses large orders of customers and undermines the formation of prices on the market.

(ii) Prohibition Against Trading Without Customer's Consent

A financial instruments business operator, etc. or an officer or employee thereof may not make trades of securities on a customer account without obtaining the consent of the customer in advance (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 11).

If a financial instruments business operator, etc. makes a trade on a customer's account without an order from the customer, then even without reference to the FIEA this would be invalid as an unauthorized trade under private law, and would also be a core violation under the FIEA, as a violation in the form of providing the market with a fictitious investment judgment.

In addition, from the perspective of an ongoing transaction relationship with a customer, the conduct of trades without confirming the intention of customers presents the possibility of a subsequent dispute as to whether in fact an entrustment was made.

An act of making a purchase and subsequently obtaining the approval of the customer would constitute an act that obstructs the market unless it complies with the true intention of the investors, and there is a major risk of this encouraging mere generation of commissions.

(iii) Restrictions on Principal (or Proprietary) Transactions and Excessive Volume Transactions

By effectuating trades or other transactions as a principal, or by engaging in transactions of an excessive volume, a financial instruments business operator, etc. who performs both dealer and broker functions can magnify price fluctuations on financial instruments exchange markets or over-the-counter securities markets, presenting the risk of disrupting the order of the markets, and also encouraging financial instruments business operators to give priority to their own proprietary transactions by mixing customer transactions with their proprietary transactions.

Consequently, if a financial instruments business operator will engage in trading of securities or securities transactions pursuant to a discretionary trading agreement, etc., the financial instruments business operator must not conduct acts which are of a quantity that are found to be excessive in view of the intent of the delegation or the amount of the contract and can be found to be disruptive to the discipline of, *inter alia,* the financial instruments exchange markets (FIEA, art. 161; Securities Transaction Ordinance, art. 9, Definition Ordinance, art. 16, para. 1, item 8(a) and (b); FIBCOO, art. 123, item 13(b) through (e)).

(iv) Insufficient Management of Confidential Corporate Information

A financial instruments business operator, etc. must conduct its business so that the management of confidential corporate information that it handles (FIBCOO, art. 1, para. 4, item 14) or the management of trades or other transactions, etc. in securities by a customer does not fall into a state in which it can be found that it has not devised measures that are necessary and appropriate in order to strive to prevent unfair transactions in connection with confidential corporate information (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 5).

Confidential corporate information may incite insider trading by the financial instruments business operator, etc. itself, or incite customer trading using confidential corporate information, or may at times mean the providing of insider trading information by the customer.

Solicitation by providing confidential corporate information is separately prohibited, and this regulation covers insufficient management of confidential corporate information in and of itself.

(v) Prohibition Against Creating an Artificial Market, Etc.

Market manipulation and other harmful practices are prohibited since fair price formation is the ultimate goal of market regulation (FIEA, art. 159). In many cases, however, manipulation is difficult to prove, and consequently, the FIEA also prohibits a financial instruments business operator, etc. or its officers or employees from acts of accepting entrustment of sales and purchase or other transactions in a specific issue of stock or securities with knowledge that the completion thereof will cause the creation of an artificial market not reflective of actual market conditions irrespective of subjective purpose (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 20).

Furthermore, “with knowledge that…will cause the creation of an artificial market not reflective of the actual market conditions” is determined using an objective standard taking into account the surrounding circumstances, such as the timing of the acceptance, volume, status and identification of the person placing the order, etc.

Since the acceptance of entrustment of market manipulation itself is prohibited (FIEA, art. 159), the market manipulation provisions may also apply to such acts; however, the current provision allows an administrative action without having to wait for the court decision.

It must not be understood that “the creation of an artificial market constitutes the regulation that is the basis for administrative action and is not an act that does not constitute market manipulation.”

(vi) Prohibition Against Dual Trading in Margin Transaction

Under the current margin transaction system, financial instruments business operators executing a customer margin transaction on the market are responsible for procuring the cash or shares necessary to settle the trade. However, if the financial instruments business operator could offset the buy order of one customer with the sell order of another customer for the same issue, it could simply make up the remaining difference. It is also theoretically possible that the financial instruments business operator could become counterparty to the transaction and accomplish the same result by filing the order with its own inventory.

For example, suppose a financial instruments business operator agrees to handle a margin buy for a customer in a certain stock, and establishes the trade by offsetting it with its own margin sell. Later, when the customer directs the financial instruments business operator to sell in order to close out its position, if the financial instruments business operator offsets the sell order with its own margin buy, the financial instruments business operator will be able to settle the transaction without any cash or shares. However, in such cases, if the customer profits from a rise in prices the financial instruments business operator will suffer a loss, and if the customer suffers a loss due to a fall in prices, the financial instruments business operator will profit. Either way, the interests of the customer and the financial instruments business operator are in direct conflict.

This sort of “competing with the customer” constitutes an act that violates the duty of good faith to the

customer, the order by the financial instruments business operator cannot be said to constitute a legitimate investment decision, and is prohibited as obstructing fair price formation (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 24).

When a financial instruments business operator, etc. is entrusted with commodity-related market transactions of derivatives, etc. (meaning the commodity-related market transactions of derivatives or the intermediary, brokerage or agency service thereof), the financial instruments business operator, etc. must not effect the transaction by serving as a counter-party without carrying out the commodity-related market transaction of derivatives so entrusted (FIEA, art. 40-6).

(vii) Abuse of Position as Officer or Employee and Pursuit of Speculative Gains

Financial instruments business operators who are individuals or the officers or employees of financial instruments business operators, etc. are prohibited from engaging in the purchase and sale, etc. on the basis of trends in orders in connection with the purchase and sale, etc. in securities by customers, or other special information of which they have obtained knowledge in the course of their duties, or carry out the purchase and sale, etc., solely for the purpose of pursuing speculative gains, by taking advantage of their business position (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 12).

> Although securities trading using order information, etc. of customers does not constitute the company’s insider information, it is a transaction taking advantage of a gap in access to certain market information, and should be prohibited for the same reason as that for prohibiting insider trading.

(viii) Prohibition Against Proprietary Trading During a Stabilization Period by an Underwriting Financial Instruments Business Operator

A financial instruments business operator that may engage in stabilization activities must not during a stabilization period make purchases or request order for purchases, etc. to another financial instruments business operator for its own account in connection with equities that are issued by an issuer of securities in connection with a public offering or secondary distribution and which are listed on a financial instruments exchange, or that constitute over-the-counter securities (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 22).

> Stabilization means an artificial price maintenance that has the nature of market stabilization. These are permitted within a certain range for the purposes of procuring funds. In these circumstances if a financial instruments business operator that is engaged in stabilization activities makes a purchase for its own account, it is quite likely that this would constitute an act that would distort supply and demand in the primary market. For this reason, these provisions have been enacted in order to specifically prohibit an act of this nature.
>
> This regulation constitutes an important provision which has the nature of regulating market stabilization activities on primary markets, and also covers officers and employees of financial instruments business operators.

A financial instruments business operator that may engage in stabilization activities is also prohibited from engaging in the act of accepting entrustment of transactions in equities issued by the issuer of the relevant securities without disclosing the stabilization (FIEA, art. 38, para. 9; FIBCOO, art. 117, para. 1, item 23).

In addition to share certificates in connection with public offering or secondary distribution, the regulation also applies to share option, bonds with share option, preferred equity investment, investment securities or market-value investment equity subscription right certificates, and securities related derivatives transactions in connection with trades in the said securities. These types of transactions which have different markets are also prohibited as they may have an impact on the formation of prices on the market in connection with the stabilization.

Acts of this nature would further constitute acts that present the possibility of being considered illegal in the form of being inter-markets price manipulation, but proving this is difficult, and for this reason the acceptance of entrustment of these transactions is in itself prohibited.

(ix) Transactions Using Confidential Corporate Information

Financial instruments business operators, etc. or their officers or employees must not engage in proprietary trades or other transactions, etc. of securities based on confidential corporate information (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 16).

Confidential corporate information is obtained through the receipt of such information within the corporation. As a financial instruments business operator, etc. is usually recognized to obtain such confidential corporate information in the quality of contractor with the corporation, it falls under the recipient of information within the corporation that is subject to the insider trading regulations as a primary conductor.

Basically, a financial instruments business operator, etc. should be subject to a strict internal administration system for preventing its own insider trading. Moreover, there are cases where obtaining proof of insider trading by the business operator is not so easy. Therefore, the financial instruments business operator, etc. is prohibited from conducting securities trading by itself by using confidential corporate information.

(6) Restrictions on Transactions Between a Financial Instruments Business Operator and a Parent/Subsidiary Corporation

Financial institutions may establish subsidiaries to enter into the financial instruments markets, and financial instruments business operators may establish bank (trust bank) subsidiaries. However, in cases where transactions are conducted based on the special relationship between parent/subsidiary corporations, there is a risk of distortions in the markets that financial institutions respectively bear.

In order to prevent these harmful effects, anti-abuse provisions are included such as restrictions on transactions between the financial instruments business operator and other corporations/associations that stand in a parent/subsidiary relationship vis-à-vis the financial instruments business operator, for the purpose of ensuring the independence of each financial institution (FIEA, art. 44-3).

These provisions apply not only to newly established financial instruments business operators, but also to existing financial instruments business operators which are recognized as a “parent corporation, etc. or subsidiary corporation, etc.” in a certain capital or personnel relationship.

(7) Introduction of Margin Regulations on Securities-Related Over-the-Counter Transactions of Derivatives

In securities CFD (Contract for Difference) transactions (transactions on underlying assets such as securities or securities index conducted upon receiving the deposit of a small amount of margin and settled by net settlement), etc. in the recent years, the counterparty is sometimes an individual. In such transactions with individuals, there are issues such as (i) the possibility that the customer will incur unexpected damages, (ii) the possibility that the financial soundness of a financial instruments business operator is affected if the customer's loss exceeds the margin and (iii) the possibility of promoting excessively speculative investments.

Accordingly, in order to prevent such negative effects, the amendments in 2009 introduced margin regulations to securities-related over-the-counter transactions of derivatives with individuals.

Financial instruments business operators are prohibited from conducting securities-related over-the-counter transactions of derivatives with individuals without receiving the deposit of the margin below (against the notional amount) for each underlying asset (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, items 29 and 30, para. 17 through para. 26):

- Independent share: 20% or more (=Leverage of 5× or less)
- Share index: 10% or more (=Leverage of 10× or less)
- Bonds: 2% or more (=Leverage of 50× or less)

(8) Points of Attention Regarding Solicitation of Transactions That Use Tax Exemption for Small-Amount Investments

In January 2014, a tax exemption program for small-amount investments (hereinafter, "NISA" (Nippon Individual Savings Account)) was introduced as a scheme for supporting households in stable asset building. Starting to this, a similar tax exemption program targeting minors ("Junior NISA") was introduced in April 2016, and a new tax exemption program targeting adults who make installment investment ("*Tsumitate* (Installment-type) NISA") was also introduced in January 2018 (hereinafter the first NISA program ("General NISA"), the Junior NISA, and the *Tsumitate* (Installment-type) NISA are collectively referred to as the "NISA program").

Under the NISA program, any proceeds that investors gained from financial instruments purchased up to the annual investment limit are exempt from income tax during the prescribed tax exemption period, with a view to encouraging people to start building their assets by investing in financial instruments. In the large package of reforms to the tax system in FY2023, a policy to drastically enhance the NISA program and make it a permanent system from 2024 was proposed, which led to a major reform of the system.

First, the tax-exempt investment limit has been expanded. The annual investment limit, which was JPY400,000 under the *Tsumitate* (Installment-type) NISA and JPY1.2 million under the General NISA, has been increased to JPY3.6 million yen under the new NISA (with JPY1.2 million as the *Tsumitate* (Installment) investment quota and JPY2.4 million as the growth investment quota). The maximum amount of tax-exempt holdings is JPY18 million for the total of the installment investment quota and growth investment quota (of which the maximum amount for the growth investment quota is JPY12 million).

Second, the limit to the period of tax-exempt holding has been eliminated, enabling investment for a longer term.

Third, under the conventional NISA, the used part of the investment quota was no longer available even after selling the held assets. Under the new NISA, upon selling the held assets, the tax-exempt limit will be restored accordingly and the investor can reuse the restored portion of the quota to purchase new assets.

The General NISA, *Tsumitate* (Installment-type) NISA, and Junior NISA were abolished at the end of 2023, but assets held in the accounts under these programs will continue to be available for investment until the end of the tax exemption period (as for Junior NISA, the financial products for which the tax exemption period has expired can be transferred to the continuous management account and used for investment until the user reaches the age of 18).

When soliciting customers to engage in transactions using the NISA program, financial instruments business operators must endeavor to properly provide them with basic information on investment, such as the effects of mid to long-term investment and diversified investment, and also provide them with an accurate and simple explanation of this program if necessary in light of the principle of suitability so that customers will not have an incorrect understanding. (Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc., IV-3-1-2 (8)).

2 10 Investment Management Business

The former business of an asset management company of an investment corporation, business of an investment trust management company, as well as the business activities in connection with discretionary investment contracts under the Investment Advisory Business Act(Note) constitute the investment management business under the FIEA.

All of these investment management business activities are involved in building customer assets based on an assumption of a relationship of a high degree of trust with the customer, and share the characteristic of a strong obligation of a fiduciary duty that should be incurred, including preventing conflicts of interest.

The FIEA, therefore, implements across the board regulation of these businesses.

Under the amendments in 2011, the regulations have been relaxed with regard to investment management business exclusively dealing with professionals.

(Note) The Securities Investment Advisory Business Act has been abolished with the enactment of the FIEA. In addition, although stipulations concerning the “structure” of investment trusts and investment corporations remain extant in the ITA, they have been substantially amended, including deletion of a considerable portion of the business regulations and the conduct regulations in connection with investment trust management firms.

(1) Conduct Regulations Concerning Investment Management Business

The FIEA applies rules on sales and solicitation, including the duty to deliver a written statement before entering into a contract, in the event that a financial instruments business operator that engages in the investment management business intends to enter into a discretionary investment contract, or at the stage of carrying out sales or solicitation of interests in a collective investment scheme for which self-management is carried out. Moreover, the special provisions in relation to the investment management business apply at the stage that a financial instruments business operator, etc. carries out investment management activities.

The following are the major stipulations:

(i) Duty of Good Faith and Duty of Care as a Prudent Manager

A financial instruments business operator, etc. must carry out the investment management business faithfully on behalf of the following persons holding rights. Moreover, a financial instruments business operator, etc. must carry out the investment management business with the care of a prudent manager towards the holders of rights (FIEA, art. 42):

(a) An investment corporation by which management of the assets is entrusted (FIEA, art. 42, para. 1, item 1);
(b) The counterparty to the discretionary investment contract (FIEA, art. 42, para. 1, item 1);
(c) The beneficiaries to an investment trust (FIEA, art. 42, para. 1, item 2); and
(d) A person who has an interest, etc. in a collective investment scheme that engages in self-management (FIEA, art. 42, para. 1, item 3).

(ii) Prohibited Acts

A financial instruments business operator, etc. must not commit any of the following in connection with the investment management business (FIEA, art. 42-2).

Nevertheless, those cases that are prescribed by Cabinet Office Ordinance as being those in which investor protection is achieved or in which fairness of transactions is not hindered, or the faith in the financial instruments business is not undermined are excluded from the prohibition in connection with (a) and (b) below (FIEA, art. 42-2, *proviso*):

(a) Making an investment intended to conduct a transactions with the financial instruments business operator, etc. itself, or a director or executive officer thereof (*i.e.,* principal transactions);
(b) Making an investment intended to conduct a transactions between investment properties (*i.e.,* trading between investment properties);
(c) Making an investment intended to conduct an unjustifiable transaction regarding a particular financial instrument, financial indicator or option, for the purpose of securing the interest of the financial instruments business operator, etc. or a third party other than the right holder by using fluctuations in the price, indicator, figure or amount receivable based on the transaction (*i.e.,* scalping);
(d) Making an investment intended to conduct a transaction under terms and conditions that are different from ordinary terms and conditions and detrimental to the right holder's interest;
(e) Conducting sales and purchase or other transactions of securities, etc. based on the account of the financial instruments business operator, etc. by using the information concerning the transaction conducted as an investment;
(f) Providing property benefit to a right holder or a third party or having a third party provide it to the right holder in order to compensate in whole or in part of a loss incurred by the right holder from the transaction conducted as investment of investment property or make an addition to the profit accrued to the right holder from the transaction conducted as investment of investment property (prohibition against compensation for

losses), provided, however, that this shall exclude the cases of compensating in whole or in part of a loss incurred from a problematic conduct or a loss caused to the principal of an investment trust specified by Cabinet Office Ordinance as those of which beneficial interest is acquired or held for the purpose of providing it for paying or receiving money for the sales and purchase of securities or any other transactions between the right holder and the financial instruments business operator, etc.; or

(g) In addition to the matters set forth in items (a) through (f), commit an act that is prescribed by Cabinet Office Ordinance as being insufficient in respect of the protection of investors, or as damaging the fairness of transactions or undermining the reputation of the financial instruments business.

(iii) Delegation of Management Authority (Duty of Self-Execution)

A financial instruments business operator, etc. may entrust all or a portion of the authority to carry out the management on behalf of the right holder to another financial instruments business operator, etc. (limited to one who engages in the investment management business) or other person as prescribed by Cabinet Order, only if a stipulation is made, in the contract prescribed below or other legal act, of the matters prescribed by Cabinet Office Ordinance (FIEA, art. 42-3, para. 1):

(a) A contract on entrustment of assets investment of an investment corporation;
(b) A discretionary investment contract;
(c) An investment trust contract; or
(d) A contract, etc. in connection with a collective investment scheme that carries out self-management.

If management authority has been entrusted, the party that has received the entrustment of management authority will have a duty of good faith and duty of care of a prudent manager to the right holders, and various prohibitions shall apply (FIEA, art. 42-3, para. 3).

Finally, a financial instruments business operator, etc. which engages in the investment management business must not delegate all of the authority to manage all of its investment assets (*id*., para. 2).

(iv) Duty of Separate Management

If a financial instruments business operator, etc. engages in self-management in connection with the investment management business that it carries out, the financial instruments business operator, etc. must in accordance with Cabinet Office Ordinance segregate and manage the investment assets separately from its own proprietary assets and other investment assets (FIEA, art. 42-4).

(v) Prohibition Against Accepting Deposits of Cash or Securities, Etc.

A financial instruments business operator, etc. must not accept deposits of cash or securities from a customer, in any name whatsoever, in connection with an asset management agreement or a discretionary investment contract with an investment trust or an investment corporation, unless it does so as securities, etc. management business, or unless it does so in a case that is specified by Cabinet Order (FIEA, art. 42-5).

However, this shall not apply if this is necessary to settle a transaction due to certain actions for a customer with respect to the investment management business (*id*., *proviso*).

(vi) Prohibition Against Lending of Money or Securities, Etc.

A financial instruments business operator, etc. must not lend cash or securities to a customer, or act as an intermediary or agent in the lending of money or securities by a third party to a customer in connection with the investment management business that the financial instruments business operator, etc. carries out (FIEA, art. 42-6).

However, this shall not apply in the event of lending related to margin transactions or other cases as prescribed by Cabinet Order (*id*., *proviso*).

(vii) Duty to Deliver Investment Report

A financial instruments business operator, etc. must periodically prepare investment reports in connection with investment property, in the manner prescribed by Cabinet Office Ordinance, and deliver them to the known right holders in connection with the investment property (FIEA, art. 42-7, para. 1).

This shall not apply to cases specified by Cabinet Office Ordinance where non-delivery of investment reports to the right holders will not hinder protection of the right holders (*id*., *proviso*).

(2) Special Provisions on the Investment Management Business Operators for Qualified Investors

Under the existing law, a person who intends to conduct the investment management business needs to obtain registration from the Prime Minister (FIEA, art. 28, para. 4 and art. 29), by satisfying the strict requirements for registration established from the perspective of protecting general investors. Registration for Type I financial instruments business is also required in order to deal in public offering or private placement of Paragraph 1 Securities, such as beneficiary certificates in investment trusts. However, these business regulations have been criticized as imposing restrictions on such activities as the management of small funds operating on behalf of professionals with a certain level of ability to make proper investment decisions.

Accordingly, with a view to promoting the creation of investment funds to meet diverse needs for asset management among the public, the FIEA was amended in 2011 to (i) partially relax the requirements for registration of investment management business operators who exclusively deal with qualified investors and whose total operating assets do not exceed the prescribed amount (investment management business for qualified investors), and (ii) relax regulations relating to the solicitation for acquisition of securities.

(i) Requirements

Where a person intends to conduct investment management business for qualified investors, the following requirements must be satisfied (FIEA, art. 29-5, para. 1).

(a) The right holders of all the investment property (including creditors of an investment corporation, etc.) consist solely of qualified investors;

(b) The total amount of all the investment property does not exceed the amount specified by Cabinet Order by taking into account the actual conditions of the investment management business and the influence of the investment management business on the Japanese capital market as well as other circumstances.

"Qualified investors" means (i) professional investors or other persons specified by Cabinet Office Ordinance as those equivalent to professional investors in light of knowledge, experience and status of property, or (ii) persons specified by Cabinet Order as those having a close relationship with a financial instruments business operator (FIEA, art. 29-5, para. 3). As for the former, the Cabinet Office Ordinance prescribes individuals who are expected to hold JPY1 billion or more of financial assets such as securities or corporations, etc. with stated capital of JPY50 million or more (FIBCOO, art. 16-6; FIEAEO, art. 17-12, para.

1). However, special purpose companies whose issued share certificates, etc. are held by persons other than qualified investors are excluded (FIBCOO, art. 16-7). As for the latter, the Cabinet Order prescribes officers, employees and parent company, etc. of the relevant financial instruments business operator and persons specified by Cabinet Office Ordinance as being equivalent to these (FIEAEO, art. 15-10-7). Furthermore, collective investment schemes invested by persons other than qualified investors fall under the category of qualified investors if the relevant collective investment scheme is managed by a financial instruments business operator, etc., engaged in the investment management business (*id*., art. 15-10-8).

The upper limit for the total amount of investment assets of a financial instruments business operator engaged in investment management business for qualified investors is prescribed to be JPY20 billion (FIEAEO, art. 15-10-5).

(ii) Relaxation of the Requirements for Registration of Investment Management Business for Qualified Investors

The requirement for registration in terms of the applicant's corporate status has been relaxed to allow registration of companies with company auditors (FIEA, art. 29-5, para. 1). The minimum capital requirement has also been relaxed to JPY10 million (FIEAEO, art. 15-7, para. 1, item 7).

(iii) Relaxation of Regulations Relating to the Solicitation for Acquisition of Securities

Under the special regulations relating to the solicitation to qualified investors for acquisition of securities, if investment management business operators conduct private placement of beneficiary certificates in investment trusts managed by themselves, with professional investors being their counterparty, such private placement is deemed to be type II financial instruments business (FIEA, art. 29-5, para. 2). In this case, solicitation for acquisition must be made on condition that a contract on transfer specifying certain matters based on which the relevant securities are deemed as being less likely to be transferred to persons other than a qualified investor will be concluded (FIEAEO, art. 15-10-6; FIBCOO, art. 16-5). Moreover, a financial instruments business operator, etc. must confirm the attribute of investors of the relevant customers as measures necessary and appropriate for preventing any person other than a qualified investor from becoming its customer (FIBCOO, art. 123, para. 1, item 13-2).

2 11 Fund Regulations

The FIEA has introduced a new overarching definition of interests in collective investment schemes, and regulates various types of funds that had heretofore been outside the scope of regulation.

A "fund" here means a structure in which funds contributed by investors are pooled and managed by specialists (a collective investment scheme) but for which strict regulations envisioning participation by general investors, such as the regulations applicable to investment trusts or investment corporations.

Sales and solicitation of interests in a collective investment scheme (including a self-managed offering) constitutes a type II financial instruments business (FIEA, art. 28, para. 2, item 1 and item 2), while management to invest in securities or in derivatives transactions constitutes an investment management business (FIEA, art. 28, para. 4, item 3), and require registration of a financial instruments business.

(1) Definition of Interests in Collective Investment Schemes

The definition of interests in collective investment schemes consists of three elements; (i) the receipt of cash investments or contributions from investors, (ii) the conduct of business or investment activities using the cash that has been invested or contributed, and (iii) a right against a scheme in the form that earnings, etc. from the said activities are to be distributed to the investors.

With the exception of those cases that are excluded from application, those rights in which all of these three elements exist are subject to the FIEA as interests in collective investment schemes regardless of their form and irrespective of what type of business activities are to be conducted.

As examples of interests in collective investment schemes, the FIEA lists rights pursuant to a partnership agreement, rights pursuant to an anonymous partnership agreement, rights pursuant to an investment limited partnership agreement, rights pursuant to a limited liability partnership agreement, and membership rights in an incorporated association (FIEA, art. 2, para. 2, item 5).

In addition, not only rights pursuant to domestic law or regulation, but also rights pursuant to foreign law or regulation are treated as interests in collective investment schemes (FIEA, art. 2, para. 2, item 6).

Following the 2019 FIEA amendment, crypto-assets (as they were known at the time of the 2019 amendment; as a result of the subsequent amendment to the FIEA under the Act to Partially Amend the Payment Services Act and Other Related Acts to Establish a Stable and Efficient Payment Services System (Act No. 61 of 2022), the term “crypto-assets” has been changed to “crypto-and other assets” (effective as of June 1, 2023)) for which funds have been contributed by persons who are entitled to receive a distribution of profit are deemed to be money, and the provisions of the FIEA will apply to such crypto-and other assets (FIEA, art. 2-2).

(2) Rights Excluded from the Definition of a Collective Investment Scheme

Given that interests in collective investment schemes are defined in an overarching manner, a broad range of rights are included therein, which results in some rights being included for which there is no strong necessity for protection of investors under the scope of application of the FIEA.

For this reason, the following rights are excluded from the definition of interests in collective investment schemes, and moreover, those rights that are treated as securities under the FIEA, such as stocks, beneficiary certificates to investment trusts, membership rights in a limited liability partnership company (*gōdō kaisha*), and trust beneficial interests, etc. are treated as not constituting interests in collective investment schemes:

(i) Rights of an equity investor in cases where all of the equity investors participate in the invested business as specified by a Cabinet Order;
(ii) Rights of an equity investor where it is provided that equity investors will not receive dividend of profits or distribution of the assets of the invested business in an amount exceeding the amount invested or contributed by them (excluding rights listed in (i));
(iii) Rights covered by application of another business law that applies the FIEA *mutatis mutandis*; or
(iv) In addition to those set forth in (i) through (iii) above, the rights prescribed by Cabinet Order as being those recognized to present no impediment to the protection of investors or the public interest even if these rights are not deemed to be securities.

The cases to be prescribed by Cabinet Order as set forth in (i) above are stated as being both of the following

(FIEA, art. 2, para. 2, item 5(a); FIEAEO, art. 1-3-2):

(a) That the execution of operations in connection with the invested business will be conducted on obtaining consent from all investors (which in the case where an agreement is made that consent from all investors shall not be required, including cases in which all investors make a statement of intent concerning whether they will consent to a decision to execution of business, with execution thereby being carried out); and
(b) That all investors are constantly engaged in the invested business, or engage in the invested business exercising particularly specialized capabilities that are indispensable for the continuation of the invested business.

(3) Special Exceptions for Specially Permitted Services for Qualified Institutional Investors, Etc.

The FIEA has established an exceptional treatment for specially permitted services for qualified institutional investors, etc. in connection with those business operators that only handle funds that target professional investors, etc., thereby taking care not to obstruct financial innovation. One example of such exception is that only notification, not registration, is required to engage in these services. However, recently, equity interests in funds originally intended for professional investors have been offered to general investors contrary to the purpose of the system, causing damage to general investors. To cope with this issue, the amendment to the FIEA in 2015 strengthened regulations on specially permitted services for qualified institutional investors, etc.

(i) Scope of Specially Permitted Services for Qualified Institutional Investors, Etc.

The following requirements have been stipulated in connection with the scope of collective investment schemes that are covered by the specially permitted services for qualified institutional investors, etc. (FIEA, art. 63, para. 1):

(a) The investors in the collective investment scheme must be qualified institutional investors and those persons other than qualified institutional investors in a quantity that does not exceed the quantity prescribed by Cabinet Order; and
(b) The self-managed offering must be a private placement.

The Cabinet Order specifies, as the scope of collective investment schemes that are covered by the notification system, that the investors must include at least one qualified institutional investor, and there must be 49 or less investors other than qualified institutional investors (FIEAEO, art. 17-12, para. 1 through para. 3). The number of 49 or less investors is interpreted as not being the number of persons who are solicited to acquire an equity interest, but rather the number of persons who will come to hold an interest, having accepted a solicitation to acquire.

In addition to the limitation on the number of general investors who may invest in a fund for professional investors, the amendment in 2015 introduced the limitation by qualification, allowing only the following general investors to invest in funds for professional investors: (i) a certain scope of investors who are recognized to have ability to make investment decisions; and (ii) those who are closely related to business operators that have made notification for the specially permitted services. More specifically, investors eligible to invest in such funds include: listed companies, corporations with stated capital or net assets of JPY50

million or more, and individuals who have held an account for securities transactions for at least one year since the opening of the account and hold investment-type assets worth JPY100 million or more (in category (i)); and a parent company, etc. and subsidiary company, etc. of a business operator that has made notification for the specially permitted services and officers and employees of such business operator or its parent company, etc. or subsidiary company, etc. (in category (ii)) (FIEA, art. 63, para. 1, item 1; FIEAEO, art. 17-12, para. 1; FIBCOO, art. 233-2).

However, with regard to venture capital funds that are expected to supply growth money and drive economic growth, the scope of general investors who may invest in funds for professional investors has been expanded to include those who have a certain level of knowledge and experience in investment, by additionally designating officers of listed companies and officers and employees who have been engaged directly in corporate financial affairs etc. (FIEAEO, art. 17-2, para. 2; FIBCOO, art. 233-3). However, since the services provided in such case falls within the scope of the specially permitted services for qualified institutional investors, etc. for which protection of investors is particularly necessary, business operators engaged in the specially permitted services are required to submit to the Prime Minister a copy of a contract regarding the rights pertaining to the said services (FIEA, art. 63, para. 9 and para. 10; FIEAEO, art. 17-13-2; FIBCOO, art. 239-2). A contract must provide for particulars that include ensuring governance of the fund, disclosure of financial information, implementation of audits, and publication of the name of the public certified accountant. Also, appropriate systems for enabling these requirements must be put in place.

If investors in a collective investment scheme include a person such as an specific purpose corporation (SPC) in which many general investors acquire the asset backed securities thereof, or an operator of an anonymous partnership in which many general investors are anonymous partners, and if the collective investment scheme is treated as targeting professional investors, there is a risk that the investor protection regulations would not apply even though in substance many general investors contribute or invest in the fund.

From the perspective of protecting investors therefore, the FIEA excludes from qualified institutional investors those persons such as specific purpose corporation in which persons other than qualified institutional investors acquire the asset backed securities thereof, or the operators of anonymous partnerships in which persons other than qualified institutional investors become anonymous partners (FIEA, art. 63, para. 1, item 1(a) through (c); FIEA, art. 63, para. 1, item 2; FIBCOO, art. 234-2).

Furthermore, for the purpose of preventing investment limited partnerships that do not actually act as investors from participating in funds for professional investors, investment limited partnerships must be expected to have at least JPY500 million of outstanding assets under management (excluding borrowings) in order to act as qualified institutional investors in connection with the specially permitted services (FIBCOO, art. 234-2, para. 1, item 1).

In addition, if the amount invested by persons including those who have a close relationship with the business operator that has made a notification of a fund for professional investors accounts for more than half of the total investment, the services provided by the fund operator will not be recognized as the specially permitted services (FIBCOO, art. 234-2, para. 1, item 2 and para. 2).

(ii) Duty to Notify

A person who intends to engage in the specially permitted services for qualified institutional investors, etc. (excluding financial instruments business operators) must file in advance a notification with the Prime Minister, stating certain prescribed matters, pursuant to the provisions of Cabinet Office Ordinance(FIEA, art. 63, para. 2; FIBCOO, art. 236 and art. 238). This notification must be accompanied by documents specified by

Cabinet Office Ordinance, such as a document in which the notifying party pledges that the party does not fall within any of the categories of persons who are ineligible to engage in the specially permitted services (FIEA, art. 63, para. 3; FIBCOO, art. 238-2).

In addition, a financial instruments business operator, etc. that intends to engage in the specially permitted services for qualified institutional investors, etc. must also file a notification with the Prime Minister, stating that it will engage in such specific business activities and the type of activities (FIEA, art 63-3, para 1), except in the event that the financial instruments business operator, etc. has obtained a registration in connection with the specially permitted services for qualified institutional investors, etc. that the financial instruments business operator, etc. will carry out. The amendments in 2011 stipulate additional matters to be notified by financial instruments business operators who intend to engage in the specially permitted services for qualified institutional investors, etc. The amendment in 2015 specifies persons who are ineligible to engage in the specially permitted services for qualified institutional investors, etc. (FIEA, art. 63, para. 7).

The Prime Minister must make the matters specified by Cabinet Office Ordinance among those stated in a notification made by a person who is to engage in the specially permitted services available for public inspection (FIEA, art. 63, para. 5; FIBCOO, art. 238-4, para. 2). A notifying party of specially permitted services must, after making a notification, without delay prepare a document stating the matters specified by Cabinet Office Ordinance among those stated in the notification and keep this document at its principal business office or other office and at all of its business offices or other offices where it engages in the specially permitted services for qualified institutional investors, etc. to make the said document available for public inspection, or disclose the same via the Internet or by other means. (FIEA, art. 63, para. 6; FIBCOO, art. 238-5).

It is possible that a collective investment scheme that is formulated from the start as a fund targeting professional investors will subsequently no longer satisfy the requirements as a fund targeting professional investors, as a result of a change in the attributes of investors or contributors. It is further possible that a problem in protecting investors will occur in a case such as this if the collective investment scheme continues to be treated as targeting professionals.

For this reason, a duty is imposed on the notifying business operator that carries out investment management to file a notification with the Prime Minister if investors or contributors in the collective investment scheme no longer constitute qualified institutional investors, etc. (FIEA, art. 63, para. 13). Moreover, the Prime Minister can specify a period of not more than three months and order necessary action to be taken (FIEA, art. 63, para. 12).

(iii) Conduct Regulations

As a result of the amendment in 2015, a person who is a notifying business operator (the notifying party of specially permitted services) that carries out specially permitted services for qualified institutional investors, etc. is now also subject to the conduct regulations such as the duty to deliver a document prior to conclusion of contract, which apply to financial instruments business operators, etc. that handle funds which are offered to general investors (FIEA, art. 63, para. 1). Specifically, the notifying party of specially permitted services must comply with the following conduct regulations in addition to the prohibition of provision of false information (FIEA, art. 38, para. 1) and the prohibition of compensation for losses, etc. (FIEA, art. 39).

<General conduct regulations>

(a) Duty of good faith to customers (FIEA, art. 36, para. 1)

(b) Prohibition on name lending (FIEA, art. 36-3)

(c) Regulation of advertising, etc. (FIEA, art, 37)
(d) Delivery of document prior to the conclusion of a contract (FIEA, art. 37-3)
(e) Delivery of document upon the conclusion of a contract (FIEA, art. 37-4)
(f) Prohibition of provision of conclusive evaluation (FIEA, art. 38, item 2)
(g) Prohibition of acts specified by Cabinet Office Ordinance (FIEA, art. 38, item 9)
(h) Principle of suitability, etc. (FIEA, art. 40)
(i) Prohibition of trading, etc. without ensuring separate management (FIEA, art. 40-3)
(j) Prohibition of public offering, etc. where money has been diverted (FIEA, art. 40-3-2)

<Conduct regulations concerning investment management business>
(a) Duty of good faith and duty of care as a prudent manager (FIEA, art. 42)
(b) Prohibited acts in connection with investment (FIEA, art. 42-2)
(c) Duty of separate management (FIEA, art. 42-4)
(d) Duty to deliver investment report (FIEA, art. 42-7)

<Special provisions concerning cryptoasset-related business>
(a) Duty to explain the nature of crypto-and other assets (FIEA, art. 43-6, para. 1)
(b) Prohibition of a representation that could cause a customer to have a misconception (FIEA, art. 43-6, para. 2)

However, with a view to ensuring free transactions between professionals, transactions with professional investors are governed by the provisions concerning the duty to notify professional investors, and the procedures for the change of status from professional investors to general investors and vice versa (FIEA, art. 34 through art. 34-5).

(iv) Preparation and Preservation of Books and Documents, and Preparation and Submission of Business Reports, Etc.

A notifying party of specially permitted services must prepare and preserve books concerning its business so as to ensure the appropriateness of its business and soundness of its financial condition (FIEA, art. 63-4, para. 1; FIBCOO, art. 246-2).

In addition, in order to ensure effective audit on a notifying party of specially permitted services, it is a requirement for such party to prepare a business report for each business year and submit it to the Prime Minister within three months after the end of the business year (FIEA, art. 63-4, para. 2; FIBCOO, art. 246-3).

Furthermore, a notifying party of specially permitted services must disclose explanatory documents stating the matters deemed necessary for the protection of investors among the matters contained in a business report, such as the business status and financial conditions of the notifying party and of the fund, so that investors can ascertain the status of the fund (FIEA, art. 63-4, para. 3; FIEAEO, art. 17-13-4; FIBCOO, art. 246-5).

(v) Supervisory Actions, Etc.

As supervisory actions against notifying parties of specially permitted services, the Prime Minister may order them to improve, suspend or discontinue their business (FEIA, art. 63-5).

The Prime Minister may also order a notifying party of specially permitted services to submit reports or materials or may conduct an inspection when the Prime Minister finds this to be necessary and appropriate for the public interest or for the protection of investors (FIEA, art. 63-6).

Moreover, when the execution of operations in connection with specially permitted services for qualified institutional investors is extremely improper and is causing serious damage to the interests of investors, and

there is urgent necessity to prevent the spread of damage among investors, the court may issue orders to suspend or prohibit the sale or solicitation in relation to the fund (FIEA, art. 192, para. 1).

2 12 Financial Institutions and Financial Instruments Business

○ **Scope of Functions of Financial Instruments Business Operators and Financial Institutions**

In general, banks, financial services cooperatives, and other financial institutions prescribed by Cabinet Order cannot engage in the securities-related business or the investment management business (FIEA, art. 33, para. 1, main clause).

The rationale for this rule is (i) if financial institutions, which are under a duty to return the deposits of customers, were to concurrently engage in the securities-related business or the investment management business, for which investment risks are incurred, that conflicts of interest will arise between the lending business and the financial instruments business, including having business companies issue securities and thereby collect on loans; or that (ii) financial institutions will have an excessive influence on the manufacturing industry through substantive control of the vehicles of financing on the part of companies; as well as that (iii) as the main activity of financial institutions is to accept deposits, financial integrity will be hindered if financial institutions engage in the financial instruments business given the high risks resulting from the financial instruments business, which will contravene the protection of depositors; and that (iv) historical experience is full of examples of cases where improprieties arose as a result of financial institutions engaging in both businesses concurrently.

However, the evolution in financial securitization has spurred the expansion of the business activities on the part of banks (expansion of activities in areas such as commercial paper), and these restrictions are relaxed under certain conditions in order to lower the fences separating both businesses in the development of new financial products.

(i) Securities-Related Business and Investment Management Business of Financial Institutions

Financial institutions are allowed to conduct the following securities-related business and investment management business (FIEA, art. 33, para. 1, *proviso*; *id.*, para. 2):

(a) Conducting sale and purchase, etc. performed on a customer's account on receiving his/her written orders;

(b) Sale and purchase, etc. or intermediary, brokerage or agency service therefor, underwriting, secondary distribution or exclusive offer to sell, etc. for professional investors, dealing in public offering, secondary distribution or private placement or exclusive offer to sell, etc. for professional investors with regard to Japanese government bonds, local government bonds, government-guaranteed bonds, specified bonds, short-term bonds, etc., preferred equity investment certificates under the Securitization Act, short-term investment corporation bonds, etc., beneficiary certificates for loan trusts, and beneficiary certificates for specified purpose trusts, beneficiary certificates for trusts

issuing beneficiary certificates, commercial paper having a maturity date of less than one year, mortgage securities, certain securities that a foreign government or a foreign person issues, depository receipts of negotiable deposits that are issued by a foreign juridical person, school bonds, and deemed securities, etc. under each of the items in the FIEA, Article 2, Paragraph 2;

(c) Sales and purchase, etc. or intermediary, brokerage, or agency service therefor, dealing in public offerings or private placements of beneficiary certificates of investment trusts or foreign investment trusts, investment securities of an investment corporation, investment equity subscription right certificates, and investment corporation bonds, etc. (excluding short-term investment corporation bonds, etc.), or foreign investment certificates;

(d) Market transactions of derivatives or foreign market derivatives transactions in foreign government bond certificates, or the intermediary, brokerage agency service, intermediary, brokerage or agency service for entrustment, dealing in private placements, and the financial instruments intermediary business therefor;

(e) Dealing in private placement in securities other than those listed in (b) through (d) above and membership rights of limited liability companies, and the financial instruments intermediary service;

(f) Over-the-counter transactions of derivatives involving securities described in (b) above, and over-the-counter transactions of derivatives involving securities described in (c) through (e) above that are settled by the net cash settlement method; and

(g) Brokerage for clearing of securities, etc. with respect to the sales and purchase, etc. of securities.

(ii) Financial Instruments Intermediary Service

The restrictions on banks in the financial instruments intermediary service were fully lifted by the amendments of 2004. Originally, banks and the like were registered with the Prime Minister and permitted to handle government bonds, local government bonds, CP and securitized products of SPCs, etc., and investment trusts. This amendment, however, makes it possible for banks to handle all securities, including stocks, bonds and government bonds issued by foreign countries, within the scope of intermediation of trades and dealing in primary offerings.

Nevertheless, such transactions involving stocks must be commissioned from financial instruments business operators (FIEA, art. 33, para. 2, item 3(c) and item 4(b)). The application of firewall regulations is admitted for application to securities-related business conducted by banks in view of the concern about transactions such as those in which a bank exploits its superior position in the event that a bank handles share certificates, etc. (FIEA, art. 44-2 para. 2 and art. 44-3).

(iii) Registration of Financial Institutions

Financial institutions can conduct brokerage with written orders, some securities-related business, derivatives transactions, etc. other than transactions of securities-related derivatives, etc. (excluding those conducted for the purpose of investment pursuant to the provisions of other laws or on the account of a person that entrusts another to do so based on a trust contract, and commodity-related market transactions of derivatives on their own accounts), investment advisory and agency business, and securities, etc. management business after registering with the Prime Minister (FIEA, art. 33-2).

Procedurally, the same provisions governing the registration of financial instruments business operators are applied (FIEA, art. 33-3 through art. 33-6), and from the perspective of maintaining the functioning of capital markets, the conduct regulations of financial instruments business operators, etc. will apply to financial institutions who have been registered (hereinafter "registered financial institutions"), and also their officers or employees in order to protect investors.

(iv) Restrictions on Acts Involving a Corporation That Is a Parent or Subsidiary, Etc.

A registered financial institution or an officer or employee thereof shall not commit any of the following (FIEA, art. 44-3, para. 2), unless approval from the Prime Minister that the relevant matters are found not to pose an impediment to protection of investors or the public interest is obtained (*id., proviso*):

(a) Conducting sales and purchase or other transactions of Securities or over-the-counter transactions of derivatives with the parent juridical person, etc. or subsidiary juridical person, etc. of the financial instruments business operator, etc. under terms and conditions that are different from ordinary terms and conditions and detrimental to the fairness of transactions;

(b) Conducting acts listed in the FIEA, Article 33, Paragraph 2, Item 4(b), knowing that the parent juridical person, etc. or subsidiary juridical person, etc. of the financial instruments business operator, etc. has granted credit to the customer on the condition that a contract for financial instruments business should be concluded with the financial instruments business operator, etc.;

(c) Giving advice intended to conduct a transaction with regard to his/her investment advisory business that is unnecessary in light of the policy of the transaction, the amount of the transaction or the market conditions, or making investment intended to conduct a transaction with regard to his/her investment management business that is unnecessary in light of the policy of the investment, the amount of investment property or the market conditions, for the purpose of securing the interest of the parent juridical person, etc. or subsidiary juridical person, etc. of the financial instruments business operator, etc.; or

(d) In addition to the acts as enumerated in each of items (a) through (c) above, conduct such acts involving the parent juridical person, etc. or the subsidiary juridical person, etc. of the registered financial institution, which acts are designated by Cabinet Office Ordinance as ones that are insufficient in protection of investors or damaging the fairness of transactions, or will undermine the reputation of the registered financial institution.

(v) Prohibited Acts in Connection with Other Business Activities of a Registered Financial Institution

A registered financial institution or its officers or employees may not commit any of the following in the event of engaging in activities other than the registered financial institution activities ("other businesses of the registered financial institution") (FIEA, art. 44-2, para. 2):

(a) Act of accepting an entrustment, etc. for sales and purchase of securities on the condition of acceptance of a money loan or other credit granting should be conducted (excluding

those specified by Cabinet Office Ordinance as being less likely to result in insufficient protection of investors);

(b) Giving advice intended to conduct a transaction with regard to its investment advisory business that is unnecessary in light of the policy of the transaction, the amount of the transaction or the market conditions, or making investment intended to conduct a transaction with regard to its investment management business that is unnecessary in light of the policy of the investment, the amount of investment property or the market conditions, for the purpose of gaining profit from other businesses of the registered financial institution; and

(c) In addition to the acts as enumerated in each of (a) and (b) above, conduct such acts as designated by Cabinet Office Ordinance as ones that are either insufficient in protection for investors or damage the fairness of transactions, or will undermine the reputation of the registered financial institution business.

The Cabinet Office Ordinance stipulates the following acts (FIBCOO, art. 150):

(a) Acts of conclusion of a contract for financial instruments transaction or solicitation thereof as the condition for the carrying out of agency service for or intermediary of conclusion of an agreement of loan financing or discounting of notes or extending a credit facility;

(b) Acts of conclusion of a contract for financial instruments transaction or solicitation thereof on condition that agency service for or intermediary of conclusion of agreement of loan financing or discounting of notes or extending a credit facility will be carried out;

(c) In addition to those provided for in (a) and (b) above, acts of conclusion of a contract for financial instruments transaction or the solicitation thereof through the unfair use of its superior status in a transaction;

(d) In the cases as set forth below, intermediary of sales and purchase of securities (limited to those in which the securities shall be sold no later than the date that is six months from the date the commissioning financial instruments business operator underwriting the said securities became the underwriter) or the dealing in public offerings or secondary distributions or dealing in private placements or dealing in exclusive offer to sell, etc. for professional investors of securities without explaining the said effect to the customer:

   a. In cases in which a party owing debts under loans to the registered financial institution is issuing the said securities; and knowing that the proceeds concerning the said securities shall be allotted to the repayment of the said debts; and

   b. In cases in which a party to whom the registered financial institution is the main lender of loans is issuing the said securities (limited to cases which the fact that the registered financial institution is a lender is stated or recorded in the issuance disclosure documents provided for in the FIEA, Article 172-2, Paragraph 3 or the specified securities, etc. information provided or published pursuant to the FIEA, Article 27-31, Paragraph 2 or 4);

(e) Acts by an officer or employee engaged in the financial instruments intermediary service to receive undisclosed loan, etc. information from an officer or employee engaged in the loan business or the financial institution agency business, or to provide the same to an officer or employee engaged in the loan business or the financial institution agency business. (Certain exceptions to this prohibition, however, have been stipulated.)

Additionally, financial institutions that have a transaction qualification to carry out securities trading and market transactions of derivatives on the financial instruments exchange market are subject to the following provisions in connection with transactions involving the registered financial institutions business (FIEA, art. 112):

(a) Deposit of guarantee funds with the exchange (FIEA, art. 114);
(b) Completion of transactions upon the loss, etc. of its transaction qualification (FIEA, art. 116);
(c) Deposit of clearing margin with the exchange (FIEA, art. 119); and
(d) Provisions governing administrative actions due to violations of the laws and regulations, administrative actions, self-regulations or principle of good faith in transactions (FIEA, art. 87), etc.

2 13 Financial Instruments Intermediary Service System

(1) Definition of Financial Instruments Intermediary Service

"Financial instruments intermediary service" is a business of conducting any of the following acts on entrustment from a type I financial instruments business operator, an investment management firm or a registered financial institution, on behalf of the said financial instruments business operator, etc. (FIEA, art. 2, para. 11):

(i) Intermediary (excluding the PTS operating business as set forth in the FIEA, art. 2, para. 8, item 10) of the sales and purchase of securities;
(ii) Intermediary set forth in Article 2, Paragraph 8, Item 3 of the FIEA, (intermediary of entrustment of sales and purchase, etc. on a financial instruments exchange market, etc.; including the intermediary of entrustment of commodity-related market transactions of derivatives);
(iii) An act set forth in Article 2, Paragraph 8, Item 9 of the FIEA (dealing in public offering or secondary distribution of securities or dealing in private placement); or
(iv) Intermediary as set forth in Article 2, Paragraph 8, Item 13 of the FIEA (agency service for or intermediary of the conclusion of an investment advisory contract or a discretionary investment contract).

(2) Registration of Financial Instruments Intermediary Service

Notwithstanding the provisions of Article 29 of the FIEA, a person other than a bank, financial services cooperative, or a financial institution as prescribed by Cabinet Order (excluding officers or employees of a type I financial instruments business operator, or a registered financial institution) may obtain registration from the Prime Minister (whether such person is a juridical person or an individual) and engage in the financial instruments intermediary service (FIEA, art. 66).

To register, a person who wishes to receive the registration must file a registration application listing the following information and other necessary documents with the Prime Minister (FIEA, art. 66-2). Additionally, if an applicant does not fall under any of the reasons for rejecting registration set forth in Article 66-4 of the FIEA, the following items together with registration date and registration number will be included in the registry of financial instruments intermediaries service provider and shall be available for public inspection (FIEA, art. 66-3):

(i) Trade name, firm name or personal name;
(ii) If a juridical person, the personal names or firm names of its officers;
(iii) Name and location of business office or office in which the financial instruments intermediary service will be conducted;
(iv) Trade name or name of the financial instruments business operator (type I financial instruments business or the investment management business), or a registered financial institution (hereinafter "Entrusting Financial Instruments Business Operator, Etc.") from which entrustment will be received;
(v) Type of other business if any; and
(vi) Such other matters as determined by Cabinet Office Ordinance.

(3) Restrictions on Business

A financial instruments intermediary service provider (excluding a financial instruments business operator) shall not engage in any act (the acts listed in the FIEA, art. 2, para. 8, all items) other than the financial instruments intermediary service that the financial instruments intermediary service provider carries out on entrustment from the Entrusting Financial Instruments Business Operator, etc. for the customer of the financial instruments intermediary service (FIEA, art. 66-12).

In addition, when a financial instruments intermediary service provider intends to engage in Financial Instruments Intermediary Acts, it shall clearly state the following in advance to the customers (FIEA, art. 66-11):

(i) Trade name or firm name of the Entrusting Financial Instruments Business Operator, Etc.;
(ii) That it has no right of representation of the Entrusting Financial Instruments Business Operator, Etc.;
(iii) The meaning of the provisions of the FIEA, Article 66-13 (prohibition of cash or securities deposit); and
(iv) Other matters prescribed by the Cabinet Office Ordinance.

In addition, a financial instruments intermediary service provider shall not under any name whatsoever in connection with the financial instruments intermediary service, accept a deposit of cash or securities from a

customer, or allow a person prescribed by Cabinet Order, as a person having a close relationship with the financial instruments intermediary service provider, to accept a deposit of cash or securities of a customer (FIEA, art. 66-13). Furthermore, the FIEA provides that, with respect to the financial instruments intermediary service, a financial instruments intermediary service provider or its officers or employees may not engage in various prohibited acts, including the provision of a conclusive evaluation (FIEA, art. 66-14 and art. 66-15).

Moreover, a financial instruments intermediary service provider may not, in principle, conduct, in connection with trades in securities for professional investors, financial instruments intermediating acts concerning trades in securities for professional investors with general investors (FIEA, art. 66-14-2).

(4) Supervision, Etc. of Financial Instruments Intermediary Service Provider

If a financial instruments intermediary service provider falls under any of the following, the Prime Minister may revoke the registration of such financial instruments intermediary service provider, may order the financial instruments intermediary service provider to suspend all or part of its business for a designated period of not more than six months, may order the financial instruments intermediary service provider to change its method of business, or may order such other matters as necessary for supervision (FIEA, art. 66-20):

(i) If the financial instruments intermediary service provider becomes subject to any of the criteria set forth in the items enlisted under the FIEA, Article 66-4 (causes for rejecting registration);
(ii) If the financial instruments intermediary service provider has used improper means to obtain the registration; or
(iii) If the financial instruments intermediary service provider has violated a law, regulation or administrative action pursuant to a law or regulation in connection with a financial instruments intermediary service.

Also, the Prime Minister may order a financial instruments intermediary service provider or a person who engages in a transaction with a financial instruments intermediary service provider to submit a report or materials in connection with the financial instruments intermediary service of the said financial instruments intermediary service provider, or have the officials inspect the state of the financial instruments intermediary service if the Prime Minister recognizes that this is necessary and appropriate for the protection of investors or the public interest (FIEA, art. 66-22).

Additionally, the Entrusting Financial Instruments Business Operators, etc. of a financial instruments intermediary service provider shall, in principle, be liable to compensate a customer for any damages that the financial instruments intermediary service provider causes to the customer in connection with the financial instruments intermediary service (FIEA, art. 66-24).

The officers or employees of a financial instruments intermediary service provider who engages in acts of financial instruments intermediary service or solicitation for such acts shall be registered as a sales representative (FIEA, art. 66-25).

3 Credit Rating Agencies

Rating companies broadly provide users with reference information for investment decisions (credit risk evaluations), but since unlike investment advisory services, they do not directly involve themselves in the trading of financial instruments, thus they had not been subject to regulation.

However, particularly in the wake of the U.S. corporate accounting scandals and the sub-prime loan problems, issues were raised over matters such as (i) the possibility of conflicts of interest, (ii) the adequacy of the ratings process, and (iii) the sufficiency of information disclosure at ratings companies. Furthermore, it was also pointed out that investors may rely too heavily on ratings, and they may not sufficiently evaluate the risks of securitized products. With this kind of consciousness of the problem in the background, a movement developed internationally to introduce and strengthen public regulations of ratings companies.

In 2013, the International Organization of Securities Commissions (IOSCO) published the final report on Supervisory Colleges for Credit Rating Agencies, which recommends establishing supervisory colleges for internationally active credit rating agencies (CRAs), and provides preliminary guidelines on how to constitute and operate them.

In addition to the problems mentioned above, in view of matters such as the importance of the role and influence borne by ratings companies in the financial and capital markets and the movement towards the introduction and strengthening of international regulations, in Japan too it has come to be seen as vital that regulations and supervision should be conducted as necessary in order that, on the one hand, ratings companies appropriately exercise desired functions in the financial and capital markets, while on the other hand, the ratings given by ratings companies do not distort investors' investment decisions.

Consequently, a registration system for ratings companies was introduced and a framework for the regulation and supervision of registered ratings companies was prepared in the 2009 amendments.

3 1 Definition of Credit Rating/Credit Rating Services

Credit rating means a ranking (excluding those prescribed by Cabinet Office Ordinance as rankings to be determined mainly in consideration of factors other than a credit evaluation) for the results of an evaluation (hereinafter "credit evaluation") of the credit status of a financial instrument or corporation (including equivalents thereto; the Cabinet Office Ordinance prescribes unincorporated groups, individuals conducting business, groups of corporations or individuals and trust properties) that is indicated using symbols or numbers (including equivalents thereto; the Cabinet Office Ordinance prescribes simple sentences or letters indicating order) (FIEA, art. 2, para. 34; Definition Ordinance, art. 24).

Further, **credit rating services** are services to conduct the act of assigning credit ratings and then providing or submitting them for public inspection (excluding acts prescribed by Cabinet Office Ordinance that are found to have little risk of undermining investor protections in light of the scope of the other party to the act and other aspects of the act) in the course of business (FIEA, art. 2, para. 35; Definition Ordinance, art. 25).

The definitions of credit rating and credit rating services are important elements in demarcating the

coverage of the regulations, and international consistency is desirable. Also, these definitions are important in order to specify the coverage for which explanations are required in a financial instruments business operator's duty to explain (FIEA, art. 38, item 3).

3 2 Registration System

Corporations that conduct credit rating services (including organizations that are not corporations but which have provisions stipulating a representative or manager) may receive registration by the Prime Minister (FIEA, art. 66-27). A party that is registered is called a **credit rating agency** (FIEA, art. 2, para. 36).

Since the FIEA has created a system under which "registration is possible," and then imposes a duty to explain on financial instruments business operators, etc. when they use ratings by an unregistered business operator (FIEA, art. 38, item 3), the FIEA provides for a mechanism for ensuring the registration of ratings companies that can have a material influence on the financial and capital markets.

A party who wishes to be registered must submit to the Prime Minister a registration application form stating prescribed matters. In this case, foreign companies must designate a representative in Japan (limited to a person who will be responsible for business activities at all business offices or offices established in Japan by the relevant foreign corporation in order to conduct the credit rating services) or a person who corresponds to this as prescribed by Cabinet Office Ordinance and submit the relevant registration application form (FIEA, art. 66-28, para. 1; FIBCOO, art. 298).

Further, certain documents must be attached to the registration form (FIEA, art. 66-28, para. 2; FIBCOO, art. 299 and art. 300).

If there is an application for registration, the Prime Minister must make a registration in the credit rating agency register (FIEA, art. 66-29, para. 1) unless it falls under certain grounds for refusal of registration (FIEA, art. 66-30). The register is made available for inspection by the public (FIEA, art. 66-29, para. 2).

3 3 Duties of Credit Rating Agencies

(1) Duty to Act in Good Faith

A credit rating agency and the officers and employees thereof must perform their work independently and fairly and in good faith (FIEA, art. 66-32).

(2) Duty to Put in Place an Operation Management System

Credit rating agencies must put in place an operation management system pursuant to Cabinet Office Ordinance provisions in order to fairly and appropriately perform the credit rating services (FIEA, art. 66-33, para. 1; FIBCOO, art. 306).

This operation management system must include measures to manage the quality of work such as the posting of persons having specialist knowledge and skills, as well as measures to prevent harm to the interests of investors

by the agency or persons related to the ratings (persons designated by Cabinet Office Ordinance as having an interest in the matters that are subject to a credit rating) pursuing their own interests, and other measures in order to ensure the proper execution of work (FIEA, art. 66-33, para. 2).

This kind of provision was established because the obligation to put in place an operation management system for credit rating agencies is considered to be, together with the duty of information disclosure, fundamental to the credit company regulations.

(3) Prohibition Against Name Lending

A credit rating agency must not allow another to conduct credit rating services under the name of the credit rating agency (FIEA, art. 66-34).

(4) Prohibited Acts

A credit rating agency or the officers or employees thereof must not conduct the following listed acts in connection with its credit rating services (FIEA, art. 66-35; FIBCOO, art. 312):

(i) Where the credit rating agency or an officer or employee thereof has a close connection as prescribed by Cabinet Office Ordinance with a person related to the rating, the act of providing or making available for inspection a credit rating for matters provided by Cabinet Office Ordinance as matters with which the relevant party related to the rating has an interest;

(ii) Where advice is given to a person related to a rating concerning a matter prescribed by Cabinet Office Ordinance as a matter that should bring about a material effect on the credit rating related to the relevant party related to the rating (excluding cases of giving notice of the content of the rating policy, etc. on request by the party related to the rating, as well as such cases as are provided by Cabinet Office Ordinance as cases found to have little risk of undermining investor protection in light of the form of the advice), the act of providing or making available for inspection the relevant credit rating; and

(iii) Aside from the acts listed in (i) and (ii) above, such other acts as are prescribed by Cabinet Office Ordinance as being undermining investor protection or as causing a loss of trust in the credit rating services (specifically provided are: [a] acts of providing a fixed credit rating prior to conducting a credit evaluation as the results of such credit evaluation, or agreeing with a person related to the rating to provide the same for public inspection, and [b] acts by a person in charge of rating to receive or requesting to receive or accepting the offer to deliver, cash or goods from a person related to the rating, etc.)

These acts are prohibited from the viewpoint of ensuring the independence of credit rating agencies, the avoidance of conflicts of interest, and the ensuring of fairness in the ratings process, etc.

(5) Publication of Ratings Policy, Etc.

Credit rating agencies must stipulate and publish the policy and methods (rating policy, etc.) for applying credit ratings, and for the provision and making available for inspection of credit ratings as prescribed by Cabinet Office Ordinance, and the same applies where the rating policy, etc. is changed (FIEA, art. 66-36, para. 1; FIBCOO, art. 313, para. 1).

> This kind of disclosure duty is imposed because the policy and methods adopted when assigning credit ratings are conceivably material information when an investor uses the credit rating.

Specifically, the following requirements must be met with respect to the policies and manners concerning the assignment of a credit rating (rating policy, etc.) (FIBCOO, art. 313, para. 2):

(i) That it is rigorous and systematic;
(ii) That it comprehensively takes into account all information and materials concerning the credit conditions of the financial instrument or corporation collected (limited to those where the evaluation regarding such credit conditions are subject of credit rating);
(iii) That it states, in accordance with the categories and detailed items of matters subject of credit rating, [a] the matters that are the premises of the evaluation and the criteria used for determining the grades indicating the results of the evaluation and [b] the outline of the manner concerning the assignment of credit ratings;
(iv) That it states the policy and manner to enable persons related to the rating to confirm any factual misperceptions with respect to the principal information used by the credit rating agency upon assignment of the credit rating prior to providing the credit rating or providing the same for public inspection (including the policy and manner for securing a reasonable amount of time necessary for such person related to the credit rating to express its opinion); and
(v) That it states the policy and manner where a credit rating is giving without the request of a person related to the rating.

Further, a credit rating agency must carry out its credit rating services in accordance with the rating policy, etc. (FIEA, art. 66-36, para. 2). Specifically, it must meet the following requirements with respect to the policy and manner of providing credit ratings or providing the same for public inspection (rating provision policy, etc.) (FIBCOO, art. 313, para. 3):

(i) That the act to provide the credit rating assigned or to provide the same for public inspection shall be implemented without delay after the assignment of such credit rating;
(ii) That the act to provide the credit rating assigned or to provide the same for public inspection shall be implemented to the general public;
(iii) That the provision of the credit rating assigned or the provision of the same for public inspection shall be made by publishing prescribed matters through the use of the Internet or other methods in principle;
(iv) That the provision of information regarding the withdrawal of the credit rating assigned shall

be made without delay; and

(v) That no representation has been made which may be misunderstood as the Commissioner of the Financial Services Agency or other administrative agencies guaranteeing the reasonableness of the results of the credit evaluation.

A credit rating agency must publish its rating policy, etc. using the Internet or other manners so as to allow the easy public inspection of the same by investors and users of the credit rating at all times (FIBCOO, art. 314, para. 1).

3 4 Credit Rating Agency Accounting

A credit rating agency must prepare and preserve books of account as prescribed by the Cabinet Office Ordinance concerning its credit rating services (FIEA, art. 66-37; FIBCOO, art. 315).

Also, a credit rating agency must prepare a business report for each business year as prescribed by Cabinet Office Ordinance, and must submit this to the Prime Minister within the period set forth by Cabinet Order after each business year has elapsed (FIEA, art. 66-38; FIBCOO, art. 316).

Furthermore, a credit rating agency must for each business year prepare explanatory materials stating matters prescribed by Cabinet Office Ordinance as matters concerning the status of business, and must place this at all business offices and offices and make it available for public inspection for a period of one year from the day that a period as provided by Cabinet Order has elapsed after the elapse of each business year, as well as publish it by a method as prescribed by Cabinet Office Ordinance such as using the Internet (FIEA, art. 66-39; FIBCOO, art. 318).

As matters concerning the status of business stated in the explanatory document of the credit rating agency, the following are provided for: (i) matters concerning the overview and organization of the credit rating agency, (ii) sales figures, statistic and other information regarding the change in the credit conditions of the financial instrument or the corporation, information regarding the history of the credit rating assigned (limited to ratings which 1 year has elapsed from the date of the rating), status of related business and other business, total number of rating analysts, status of the business of the credit rating agency including the general fees structure, etc., (iii) status of preparation of the operation management system of the credit rating agency, (iv) outline of the rating policy, and (v) status of the affiliate corporations and subsidiary corporations of the credit rating agency.

3 5 Credit Rating Agency Supervision

(1) Notification, Etc. of Closure, Etc.

If a credit rating agency has closed its credit rating services, or if a corporation that is a credit rating services has been extinguished or has dissolved due to merger, a decision to commence bankruptcy procedures, or due to other reasons, a prescribed person must give notice to that effect to the Prime Minister within thirty days from that day (FIEA, art. 66-40, para. 1; FIBCOO, art. 321). If a credit rating agency falls under any one of these grounds, its registration as a credit rating agency will cease to be valid (FIEA, art. 66-40, para. 2).

If a credit rating agency applies for deletion of its registration, closes its credit rating services, merges (limited

to a merger where the relevant credit rating agency is dissolved due to the merger), dissolves for reasons other than merger and a decision to commence bankruptcy procedures, has another take over its entire business by means of a company split, or intends to assign all of its business to another, it must make a public announcement to that effect as provided by Cabinet Office Ordinance no later than thirty days before that day (FIEA, art. 66-40, para. 3; FIBCOO, art. 322).

If it has made a public announcement, the credit rating agency must immediately notify the Prime Minister to that effect (FIEA, art. 66-40, para. 4).

(2) Business Improvement Orders

If it is deemed necessary and appropriate in order to protect the public interest and investors in connection with the status of operation of a credit rating agency's business, the Prime Minister may, to the extent necessary, order the relevant credit rating agency to take necessary measures to change its method of business or take such other action as is necessary to improve its business operations (FIEA, art. 66-41).

Since it is necessary to act rapidly and appropriately to achieve sufficient investor protections against inappropriate business operations, etc. by credit rating agencies, the conditions for issuing business improvement orders, as with financial instruments business operators, etc., are not limited to violations of laws and regulations.

(3) Supervisory Actions

If a credit rating agency falls under any of the following items, the Prime Minister may revoke the relevant credit rating agency's registration, or order the suspension of all or part of its credit rating services for a period of up to six months (FIEA, art. 66-42, para. 1):

(i) The credit rating agency falls under grounds for refusal of registration as a credit rating agency;
(ii) The credit rating agency obtained registration by improper means;
(iii) The credit rating agency has violated laws or regulations concerning the credit rating services or an administrative action based on laws and regulations;
(iv) There is a fact concerning the operation of the credit rating services that harms the interests of investors; or
(v) If the credit rating agency has acted improperly or extremely unfairly in connection with its credit rating services and the circumstances are particularly serious.

If a credit rating agency falls under any one of the grounds described in (i) through (v) above, and if the relevant credit rating agency continues to conduct its credit rating services as a credit rating agency, an investor who is not aware of the circumstances cannot help but make investment decisions using credit ratings that were assigned with the understanding that the relevant credit rating agency is properly registered and is in compliance with regulations.

Consequently, in order to make possible an appropriate response by the authorities against illegal acts by credit rating agencies, provisions are established against credit rating agencies for the revocation of registration and

business suspension orders.

Also, it is provided that the Prime Minister may order the dismissal of a credit ratings agency's officer if the relevant officer falls under certain grounds (FIEA, art. 66-42, para. 2).

Moreover, if the Prime Minister is not able to verify the location of a credit rating agency's business office or office, or if the Prime Minister is not able to verify the location of an officer who represents a credit rating agency, as provided by Cabinet Office Ordinance, the Prime Minister may give public notice of that fact and if there is no notification from the relevant credit rating agency even after thirty days have elapsed since that public notice date, the Prime Minister may revoke the relevant credit rating agency's registration (FIEA, art. 66-42, para. 3).

However, upon exercise of such authority, consideration shall be made so that no involvement shall be made into the specific details of individual credit ratings or method of credit evaluations (FIBCOO, art. 325).

(4) Collection of Reports and Inspections

If the Prime Minister deems it to be necessary and appropriate for the public interest and investor protection, the Prime Minister may order a credit rating agency, a person who has transactions with the credit rating agency, a person who is entrusted business by the relevant credit rating agency (including a person who has received entrustment from such person (including entrustment at the second or higher degree of separation from the original entrustment)), or a juridical person related to the relevant credit rating agency (the relevant credit rating agency's subsidiaries, a juridical person that makes the relevant credit rating agency its subsidiary, or a subsidiary of a juridical person that makes the relevant credit rating agency its subsidiary (excluding the relevant credit rating agency)) to submit reports or materials that are of reference concerning the operations of the relevant credit rating agency, or may cause relevant staff to inspect the business conditions or materials or other articles of the relevant credit rating agency, a party that has been entrusted business by the relevant credit rating agency, or a juridical person related to the relevant rating agency (for a party that has been entrusted with business by the relevant credit rating agency or a juridical person related to the relevant credit rating agency, limited to necessary inspections concerning the operations of the relevant credit rating agency) (FIEA, art. 66-45).

However, upon exercise of such authority, consideration shall be made so that no involvement shall be made into the specific details of individual credit ratings or method of credit evaluations (FIBCOO, art. 325).

4 High Speed Traders

Along with the recent advancement of trading systems, the impact of High Speed Trading in shares, etc. has been increasing. High Speed Trading is a trading platform developed on the basis of high-specification computers and information and communication technology, whereby a large number of trading orders are made and cancelled in milliseconds with the use of algorithms pre-installed in the computers. This scheme is made possible by installing devices at a location that is physically close to the location where the market operator's trading system is placed and reducing the communication time (called "collocation"). There was a concern that this type of trading could cause various problems such as a rapid rise in the price volatility on the market, increased trading costs due to investors' mid to long-term trading needs emerging in advance, the hindrance to the price formation based on mid to long-term corporate values, and vulnerability of the trading system. However, in Japan, it was impossible for the regulatory authorities or exchanges to sufficiently understand the actual state of High Speed Trading because of the

lack of a regulatory framework that could allow them to collect trade information directly from High Speed Traders.

Accordingly, the FIEA was amended in 2017 to introduce a registration system for investors who engage in High Speed Trading and impose obligations, such as development of a risk management system and preservation of transaction records, on those High Speed Traders.

4 1 Definitions of High Speed Trading and High Speed Traders

(1) High Speed Trading

The term “High Speed Trading” means any of the following acts for which the determination on performance of the act is automatically made by an electronic information system, and the provision of information necessary for conducting the purchase and sale of securities or a market derivatives transaction based on that determination to a financial instruments exchange or any other person specified by Cabinet Office Ordinance is made by means of information and communications technology, which is specified by Cabinet Office Ordinance as a method for shortening the time normally required for the provision of information (excluding acts specified by Cabinet Order as those which, in consideration of their content and other factors, are found not to compromise the protection of investors) (FIEA, art. 2, para. 41; FIEAEO, art. 1-22; Definition Ordinance, art. 26):

(i) The purchase and sale of securities or a market transaction of derivatives;

(ii) Entrustment of the act set forth in (i); and

(iii) In addition to what is listed in (ii), an act performed in connection with the act set forth in (i), which is specified by Cabinet Order as an act equivalent to the acts set forth in (i) and (ii).

In order to ensure the flexible adaptation to the advancement of information and communication technology in the future, the details of High Speed Trading are specified by Cabinet Order and Cabinet Office Ordinance.

(2) High Speed Trader

The term “High Speed Trader” means a person registered by the Prime Minister pursuant to Article 66-50 of the FIEA (FIEA, art. 2, para, 42).

4 2 Registration System

A person other than a Financial Instruments Business Operator, etc. and authorized transaction-at-exchange operator must be registered by the Prime Minister if the person seeks to perform High Speed Trading (FIEA, art. 66-50; FIBCOO, art. 326).

When applying for registration, the applicant must submit a written application for registration to the Prime Minister in which it states: the applicant’s trade name or name; if the applicant is a corporation, the amount of capital or total contribution, the names of its officers, and the name and address of its head office (and its principal office in Japan, if any) ; if the applicant engages in other business, the business type; and other particulars specified by Cabinet Office Ordinance (FIEA, art. 66-51, para. 1; FIBCOO, art. 328).

The written application for registration must be accompanied by: a document pledging that the applicant does

not fall under any of the cases where registration should be refused; a document stating the things specified by Cabinet Office Ordinance as constituting the business outline and business methods for services pertaining to High Speed Trading; if the applicant is a corporation, the articles of incorporation and certificate of registered information; and other documents specified by Cabinet Office Ordinance (FIEA, art. 66-51, para. 2; FIBCOO, art. 329). Under this provision, the applicant notifies the regulatory authorities of the details and strategy of the High Speed Trading to be performed thereby.

If an application for registration is filed, unless its falls under any of the cases where registration should be refused (FIEA, art. 66-53; FIEAEO, art. 18-4-9 and 18-4-10), the Prime Minister must register the particulars of the applicant in the High Speed Traders register (FIEA, art. 66-52, para. 1), which is to be made available for public inspection (*id.*, para. 2).

4 3 Duties of High Speed Traders

(1) Obligation to Establish Operational Control System

A High Speed Trader must establish an operational control system for the appropriate performance of its services pertaining to High Speed Trading, pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 66-55; FIBCOO, art. 336).

According to the Cabinet Office Ordinance, the operational control system to be established must satisfy the following requirements: (i) internal rules, etc. for securing the appropriate execution of the business pertaining to the High Speed Trading are established, and training for employees and other measures are conducted to ensure compliance with the internal rules, etc.; and (ii) the measures to ensure sufficient management of the electronic data processing systems and other facilities for the High Speed Trading have been taken.

(2) Prohibition on Name Lending

A High Speed Trader must not allow another person to engage in High Speed Trading using the name of said High Speed Trader (FIEA, art. 66-56).

(3) Regulation on Business Operations

A High Speed Trader must conduct its business in such a manner that the state of its business operations does not fall under any of the following (FIEA, art. 66-57; FIBCOO, art. 337):

(i) The electronic information system or any other equipment pertaining to High Speed Trading is in such a state that its management for preventing factors such as abnormal operation of the electronic information system from compromising the full utilization of the functions of the financial instruments market is found to be insufficient; or

(ii) Beyond what is set forth in (i), the business operations are in a state specified by Cabinet Office Ordinance as one that is contrary to the public interest or that is likely to compromise the protection of investors.

(4) Preparation and Preservation of Transaction Records, and Preparation and Submission of Business Reports

A High Speed Trader must prepare and preserve books and documents for its business pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 66-58; FIBCOO, art. 338). This provision is introduced with a view to ascertaining the actual status of High Speed Traders.

Each business year, pursuant to the provisions of Cabinet Office Ordinance, a High Speed Trader must prepare a business report and submit it to the Prime Minister within three months after the end of the business year (FIEA, art. 66-59; FIBCOO, art. 339).

4 4 Supervision of High Speed Traders

(1) Notification of Business Discontinuance, Etc.

In cases such as where a High Speed Trader discontinues services pertaining to High Speed Trading, or where a High Speed Trader is a corporation and that corporation disappears or is dissolved due to a merger, an order to commence bankruptcy proceedings, or any other reasons, the person specified for each such event must notify the Prime Minister of this fact within 30 days from the day of the event (FIEA, art. 66-61, para. 1; FIBCOO, art. 344). If a High Speed Trader comes to fall under any of these cases, its registration as a High Speed Trader ceases to be effective (FIEA, art. 66-61, para. 2).

(2) Business Improvement Orders

Whenever the Prime Minister finds it to be necessary and appropriate in the public interest or for the protection of investors concerning the state of a High Speed Trader's business operations or assets, the Prime Minister, within the scope of this necessity, may order the High Speed Trader to change its business methods or may otherwise order it to take measures that are necessary for improving the state of its business operations or assets (FIEA, art. 66-62).

(3) Supervisory Measures

If a High Speed Trader falls under any of the following, the Prime Minister may revoke its registration or order the suspension of all or a part of its business activities during a fixed period of no longer than six months (FIEA, art. 66-63, para. 1):

(i) The High Speed Trader comes to fall under any of the cases where registration should be refused;
(ii) The High Speed Trader obtains the registration by wrongful means;
(iii) The High Speed Trader violates a law or regulation or a disposition by a government agency which is based on a law or regulation, in connection with services pertaining to High Speed Trading or services incidental thereto;
(iv) In light of the state of its business or assets, the High Speed Trader is likely to become insolvent; or
(v) The High Speed Trader commits a wrongful or extremely unjust act in connection with services pertaining to High Speed Trading, and the circumstances surrounding this are

particularly serious.

If an officer of a High Speed Trader falls under any of the prescribed cases, the Prime Minister may order the High Speed Trader to dismiss that officer (FIEA, art. 66-63, para. 2).

Furthermore, if the Prime Minister is unable to ascertain the location of the business offices or offices of a High Speed Trader or is unable to ascertain the whereabouts of a High Speed Trader (in the case of a corporation, the whereabouts of the officer representing the corporation), the Prime Minister, pursuant to the provisions of Cabinet Office Ordinance, may issue public notice of that fact and revoke the registration of the High Speed Trader if no filing is made by the High Speed Trader even after 30 days have elapsed since the day of the public notice (FIEA, art. 66-63, para. 3).

(4) Collection of Reports and Inspection

Whenever the Prime Minister finds it to be necessary and appropriate in the public interest or for the protection of investors, the Prime Minister may order a High Speed Trader, a person that conducts transactions with a High Speed Trader, or the person that a High Speed Trader has entrusted with its business (including a person who has received entrustment from such person (including entrustment via two or more layers)) to submit reports or materials that should serve as a reference with regard to the business of the High Speed Trader, or may have the relevant officials inspect the state of the business or assets, or the books and documents or any other articles, of the High Speed Trader or the person that the High Speed Trader has entrusted with its business (with regard to the person that the High Speed Trader has entrusted with its business, the inspection shall be limited to what is necessary to understand the business or assets of the High Speed Trader) (FIEA, art. 66-67).

5 Financial Instruments Firms Association, Etc.

The FIEA allows a financial instruments firms association to have the form of an authorized financial instruments firms association or a certified financial instruments firms association, and also provides the system of a certified investors protection organization as a vehicle for addressing disputes, etc. that have occurred between an investor and a financial instruments business operator.

5-1 Authorized Financial Instruments Firms Association

(1) Significance

An authorized financial instruments firms association is a juridical person formed under the FIEA and organized by financial instruments business operators as a self-regulatory organization whose objective is to ensure the fairness and efficiency of trading and other transactions in securities as well as derivatives transactions, etc., and to contribute to the sound development of financial instruments business operators as well as the protection of investors (FIEA, art. 67, para. 1).

An authorized financial instruments firms association engages in the general rulemaking for the financial

instruments business, and it is tasked with the implementation of the rules under the FIEA in actual practice, while at the same time it has the characteristics of an industrial organization. Self-regulation is permitted within the bounds of the law and these are not simply industry rules. Accordingly, rules such as the self-regulatory rules on the part of the Japan Securities Dealers Association, which is an authorized financial instruments firms association, have authority equivalent to laws and regulations. Based on the importance of authorized financial instruments firms associations, the FIEA includes detailed provisions governing them.

The importance of the rules must be evaluated in their relationship to the legal objective of achieving fair price formation, and thus rules by a self-regulatory institution may not be quickly judged as being of an inferior level to the stipulations in a statute. While the system of annual securities reports in which information disclosure is made once per year constitutes a system under the FIEA, timely disclosure which is a rule under financial instruments exchanges which provide information on changes in quality are far more important for the creation of a securities market, and without these a securities market cannot exist, and similarly, the authorized financial instruments firms association prescribes various important market rules which must be complied with laws and regulations as well.

(2) Establishment

The authorization of the Prime Minister is necessary to establish an authorized financial instruments firms association (FIEA, art. 2, para. 13 and art. 67-2, para. 2). For this purpose, the application for an authorization stating required items must be submitted together with the articles of association and other rules of the association to the Prime Minister and receive its examination (FIEA, art. 67-3).

The articles of association must state the following matters (FIEA, art. 67-8, art. 68, para. 2 through para. 5, and art. 68-2):

(i) Purpose;
(ii) Name;
(iii) Location of offices;
(iv) Matters related to member firms;
(v) Matters related to general meeting;
(vi) Matters related to officers;
(vii) Matters related to council and other meetings;
(viii) Matters related to execution of business operations;
(ix) Matters related to improvements in qualities of officers and employees of the member firms, and qualities of the financial instruments intermediary service providers and their officers and employees;
(x) Matters related to preparation of rules;
(xi) Matters related to resolution of complaint filed by investors concerning the operations of the member firms or financial instruments intermediary service providers and dispute;
(xii) Matters related to sales and purchase or other transactions of securities solicited by member firms or financial instruments intermediary service providers;
(xiii) Matters related to an over-the-counter securities market;
(xiv) Matters related to investigation of the status of observance of laws and regulations, dispositions given by government agencies based on laws and regulations, or the articles of incorporation or other rules, or the fair and equitable principles of transactions by member

firms and financial instruments intermediary service providers;
(xv) Matters related to membership fees;
(xvi) Matters related to accounting and assets; and
(xvii) Method of public notices.

Furthermore, any post-establishment amendments or modifications to the articles of association must be authorized by the Prime Minister (FIEA, art. 67-8, para. 2). Also, the Prime Minister possesses the authority to order amendments to the articles of association of an authorized financial instruments firms association (FIEA, art. 73). It can also order the dismissal of directors (FIEA, art. 74).

(3) Supervision of the Authorized Financial Instruments Firms Association

The Prime Minister possesses the authority to take administrative actions against violations of the laws and regulations, etc. (FIEA, art. 74), to order submission of reports and materials, and to conduct inspections of an authorized financial instruments firms association (FIEA, art. 75).

(4) Establishment, Etc. of Over-the-Counter Securities Markets

The FIEA states that an authorized financial instruments firms association is permitted to establish over-the-counter securities markets (FIEA, art. 67, para. 2).

Accordingly, regulatory measures concerning the over-the-counter securities market have been enacted, including the statement in the articles of incorporation of the authorized financial instruments firms association of matters concerning the holding of an over-the-counter securities market (FIEA, art. 67-8, para. 1, item 13), authorization by the Prime Minister of the regulations concerning the over-the-counter traded securities to be traded on the over-the-counter securities market (FIEA, art. 67-12), requisite measures taken by the Prime Minister concerning revocation of registration or re-registration, etc. (FIEA, art. 67-15), and the notification to the Prime Minister with respect to the halting of trading, or the lifting of such halt, etc. (FIEA, art. 67-16).

Additionally, provisions are included to ensure the credibility of the over-the-counter securities market. These include provisions requiring member firms to file a report with the authorized financial instruments firms association in cases where they trade securities for its own account, or engage in intermediation, brokering or agency to establish a trade (FIEA, art. 67-18), and requiring the authorized financial instruments firms association to make public announcements of certain information concerning trades of over-the-counter traded securities performed on the over-the-counter securities market (FIEA, art. 67-19).

With the amendments in 2008, an authorized association has also become allowed to open the so-called professional market (FIEA, art. 67, para. 3). The authorization by the Prime Minister is required (FIEA, art. 67-12, item 5).

(5) Measures to Ensure Member Firms' Compliance with Laws and Regulations

The authorized financial instruments firms association is required to include a provision to the effect that member firms shall endeavor to coordinate their internal rules and management systems so as to prevent violations, etc. of laws and regulations and to secure the reliance of investors (FIEA, art. 68, para. 4).

The Financial Services Agency publishes the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, Etc., placing an extremely high level of importance on establishing internal control, conducting internal auditing and checking compliance systems.

(6) Sales Representatives Registration Tasks

The authorized financial instruments firms association performs the tasks of registering the sales representatives of financial instruments business operators and financial instruments intermediary service providers under a delegation of authority from the Prime Minister (FIEA, art. 64, para. 1, art. 64-7 through art. 64-9, and art. 66-23; FIBCOO, art. 254).

(7) Dispute Resolution System

If an authorized financial instruments firms association receives a request from an investor to resolve complaints concerning operations performed by a member firm or a financial instruments intermediary service provider, the authorized financial instruments firms association must provide consultation and necessary advice to the requesting party, as well as investigate the circumstances under which such complaint arose, inform the member firm or financial instruments intermediary service provider of the content of the complaint, and seek a quick handling of the matter (FIEA, art. 77, para. 1 through para. 4).

However, if an authorized financial instruments firms association has been designated pursuant to the provisions of Article 156-39, Paragraph 1, of the FIEA, this does not apply if the request for complaint is related to a complaint concerning the classification of services for dispute resolution, etc. related to the relevant designation (FIEA, art. 77, para. 5).

Additionally, when disputes arise with respect to securities trading or other transaction, or a derivatives transaction, etc. performed by a member firm or a financial instruments intermediary service provider, a person involved in the dispute may petition the authorized financial instruments firms association for mediation to settle the dispute (FIEA, art. 77-2).

5 2 Certified Financial Instruments Firms Association

(1) Recognition

A certified financial instruments firms association is a general incorporated association that financial instruments business operators have established, and which is accepted by the Prime Minister as being recognized to be covered by the following conditions (FIEA, art. 78, para. 1):

(i) The juridical person shall aim at ensuring fair and smooth transaction of securities, including sales and purchase or other transactions of securities, and derivative transactions, etc. as well as contributing to sound development of financial instruments businesses and protection of investors;

(ii) The juridical person's articles of incorporation shall include a provision to the effect that its member firms shall be financial instruments business operators;

(iii) The juridical person shall have established the method for carrying out its operations necessary for conducting the activities of the certified financial instruments firms association appropriately and certainly; and

(iv) The juridical person shall have the knowledge, ability and financial basis necessary for conducting the activities of the certified financial instruments firms association appropriately

and certainly.

(2) Operations

A certified financial instruments firms association shall carry out the following activities (FIEA, art. 78, para. 2):

(i) To provide its member firms and financial instruments intermediary service providers with guidance and recommendation and to conduct other activities, for the purpose of having them observe the provisions of FIEA and other laws and regulations in the course of conducting financial instruments business;

(ii) To conduct investigations, to provide guidance and recommendation and to conduct other activities necessary for ensuring appropriateness in contracts and asset investment and for otherwise protecting investors with regard to financial instruments business conducted by its member firms and financial instruments intermediary service providers;

(iii) To investigate the status of observance of the FIEA, orders given thereunder, a disposition made under the FIEA or under such an order, its articles of incorporation or other rules, or the fair and equitable principles of transactions by its member firms and financial instruments intermediary service providers;

(iv) To resolve complaints filed by investors with regard to financial instruments business conducted by its member firms and financial instruments intermediary service providers;

(v) To resolve disputes with regard to financial instruments business conducted by its member firms and financial instruments intermediary service providers;

(vi) To carry out registration work with regard to sales representatives;

(vii) To establish rules or conduct other activities necessary for ensuring appropriateness in solicitation for sales and purchase or other transactions of securities conducted by its member firms and financial instruments intermediary service providers;

(viii) To conduct publicity towards investors or other activities necessary for achieving purposes of the certified financial instruments firms association; and

(ix) In addition to the items in the preceding items, operations contributing to the sound development of the financial instruments business or the protection of investors.

In addition, a certified financial instruments firms association must make efforts to promote the sound development of the financial instruments business and the protection of investors through the dissemination of knowledge, educational activities, and public relations activities in connection with finance (FIEA, art. 78-2, para. 1).

(3) Supervision of Certified Financial Instruments Firms Associations

The Prime Minister has the authority to order a certified financial instruments firms association to submit reports and information, as well as the authority to carry out onsite inspections (FIEA, art. 79-4).

5 3 Certified Investors Protection Organization

(1) Definition

The system of certified investors protection organization is a system by which a juridical person, which intends to engage in the following activities for the purpose of facilitating the trading and other transactions in securities as well as derivatives transactions, etc. and contributing to the sound development of the financial instruments business and to the protection of investors, may obtain certification from the Prime Minister (FIEA, art. 79-7):

(i) To resolve complaints filed with regard to financial instruments business conducted by a financial instruments business operator or a financial instruments intermediary service provider;
(ii) To mediate in the case of disputes arisen from financial instruments business conducted by a financial instruments business operator or a financial instruments intermediary service provider; and
(iii) In addition to what is listed in the preceding two items, activities that would contribute to the sound development of financial instruments businesses and protection of investors.

(2) Business Entities Covered

The business entities covered by the operations of a certified investors protection organization shall be the financial instruments business operators and the financial instruments intermediary service providers that are its members, as well as the financial instruments business operators and the financial instruments intermediary service providers, etc. that have consented to be covered by the certified activities (FIEA, art. 79-11).

(3) Handling of Complaints

If a request is made for resolution of a complaint by an investor in connection with the business activities conducted by a covered business entity, the certified investors protection organization shall provide consultation, and the necessary advice to the requesting party, as well as investigate the related complaint, notify the said member firm or financial instruments intermediary service provider of the content of the complaint, and seek a rapid disposition of the same (FIEA, art. 77 applied *mutatis mutandis* through FIEA, art. 79-12).

In addition, if a dispute occurs concerning a trade or other transaction in securities or a derivatives transaction, etc. conducted by a covered business entity, the parties may petition the certified investors protection organization, and seek mediation to resolve the dispute (FIEA, art. 77-2 applied *mutatis mutandis* through FIEA, art. 79-13).

(4) Preparing and Publishing Investors Protection Guidelines

A certified investors protection organization must make efforts to prepare and publish guidelines (hereinafter referred to as “investor protection guidelines”) consistent with the provisions of the FIEA, concerning contents of agreements of financial instruments trades by covered business entities, asset management by covered business entities, and other matters necessary to protect investors, for the purpose of the sound development of the financial instruments business and the protection of investors (FIEA, art. 79-17, para. 1).

A certified investors protection organization shall endeavor to provide the necessary guidance, warnings and

other measures towards the covered business entities in order to have them comply with such investor protection policies (FIEA, art. 79-17, para. 2).

In addition, a certified investors protection organization shall make efforts to promote the sound development of the financial instruments business and the protection of investors through the dissemination of knowledge, educational activities, and public relations activities in connection with finance (FIEA, art. 79-17, para. 3).

(5) Cancellation of Certification, Etc.

The Prime Minister may order a certified investors protection organization to improve the method of implementation of the operations, amend the investor protection guidelines, or implement any other measures necessary (FIEA, art. 79-18).

In addition, the Prime Minister may revoke the certification of a certified investors protection organization in the event that, *inter alia*, the certified investors protection organization is covered under any cause for disqualification, or no longer satisfies the criteria for certification, or does not comply with an order by the Prime Minister (FIEA, art. 79-19, para. 1).

6 The Investor Protection Fund

6 1 Significance

Financial instruments business operators assume heavy responsibilities as the bearers of securities market functions; however, if these financial instruments business operators themselves should fail, the link between financial instruments markets and investors' investment decisions will be cut off, leading to a serious disruption of market functions. It will also cause investors unforeseeable damages that are unrelated to the investment decisions.

While the FIEA does impose a duty on financial instruments business operators of separate management of customer assets in order to avoid a situation of this nature, it is possible that because of a reason such as the financial instruments business operator's negligence in this duty a situation of this nature may occur (*i.e.*, a disruption in market function or damage to investors) at the time of a failure. The FIEA, consequently, has enacted the system of an investor protection fund in order to provide relief to investors and to maintain the continuity of market functions in these circumstances (FIEA, art. 79-21), and Type I financial instruments business operators have an obligation to join one such fund.

There are two main type of relief provided by an investor protection fund: (i) paying general investors, and (ii) lending to financial instruments business operators (FIEA, art. 79-49, para. 1, item 1 and item 2). In (i) the fund makes payment, on behalf of the failed dealer, to general investors for the losses that they have incurred. In the case of (ii), the fund will lend to a failed dealer in order that the failed dealer itself will be able to make a prompt return of customer assets.

In contrast to banking transactions for which the basic nature is a creation of credit which requires a deposit insurance system, it is important to remember that as long as a financial instruments business operator faithfully carries out the separate management of customer assets, customers should not be harmed by the failure of the

dealer.

Pursuant to the amendments in 2012, the purpose and scope of business (scope of general investors and customers assets) of the investor protection funds were expanded to include commodity-related market transactions of derivatives and the incidental transactions thereof and, provisions were established to enable the investor protection fund to specify in its articles of incorporation that the scope of its business shall be limited to either the securities-related business or business related to commodity-related market transactions of derivatives.

6 2 Establishment of Investor Protection Fund

Membership in a fund is limited to financial instruments business operators (FIEA, art. 79-26, para. 1), and a type I financial instruments business operator must be a member of a fund. However, type I small amount electronic offering handling business operators, and type I financial instruments business operators who intend to engage only in the type I small amount electronic offering handling business, are not required to become members of a fund (FIEA, art. 79-27, para. 1; FIEAEO art. 18-7-2, para. 1).

To establish an investor protection fund, at least 20 financial instruments business operators become promoters, draft the articles of incorporation and business regulations, hold an initial general meeting, follow the requisite procedures and obtain authorization of establishment from the Prime Minister and the Minister of Finance (FIEA, art. 79-29 through art. 79-33).

6 3 Claims Eligible for Indemnification

The claims that a fund will indemnify shall be claims that general customers (meaning investors other than qualified institutional investors, national/local public bodies, the investor protection fund, the Bank of Japan, an officer of the financial instruments business operator for which the finding is made or the parent juridical person, etc. thereof, or general customers who own customer assets under a different name or a pseudonym; FIEA, art. 79-20) of a failed business operator have against the relevant financial instruments business operator). These claims include: (i) money or securities deposited with the financial instruments business operator as margins in futures trading or margins in margins transactions; (ii) money or securities belonging to the account of the general customers, or the money and securities deposited with the financial instruments business operator from general customers concerning transactions pertaining to the financial instruments business, (other than transactions pertaining to over-the-counter transactions of derivatives, etc.); or (iii) money or securities held in safekeeping (provided that there are exceptions—see FIEAEO, art. 18-7) (FIEA, art. 79-20, para. 3 and art. 79-56; FIEAEO, art. 18-11).

Further, claims for damages based on tort are not included within the definition of claims subject to reimbursement.

It should be noted that amounts that a fund will pay to general customers will be a certain amount calculated on the basis of the amount of the claim (FIEA, art. 79-56; and art. 79-57), and that there is a maximum on the amount of payment that can be made (up to JPY10 million per customer) (FIEAEO, art. 18-12).

6 4 Management of Investor Protection Fund

A fund shall be managed in accordance with the resolutions of the board of governors, etc. bound by the provisions of the articles of incorporation (FIEA, art. 79-34 through art. 79-48).

If cancellation of registration of a member financial instruments business operator or other cause has occurred, the fund shall on request by a general investor take the prescribed procedures and pay those claims in connection with customer assets for which it is found that the financial instruments business operator will have difficulty paying itself without impediment, to the maximum prescribed by Cabinet Order (JPY10 million) (FIEA, art. 79-56 through art. 79-58; FIEAEO, art. 18-12).

To expedite the refund of customer assets, a fund will provide a loan of funds necessary for such refund to a member financial instruments business operator, conditional upon a finding of necessity by the Prime Minister (FIEA, art. 79-59).

A fund possesses the authority to take any judicial or extrajudicial action against a financial instruments business operator to protect the claims of the general customer, and has a duty to carry out all such actions in a fair and faithful manner with a duty of care of a prudent manager (FIEA, art. 79-60, para. 1 through para. 3).

Member financial instruments business operators must remit as dues their share of the amounts necessary to cover the expenses of the fund’s functions in accordance with the formula provided in the fund’s business regulations (FIEA, art. 79-64 through art. 79-66).

If a financial instruments business operator ceases to engage in the securities business, dissolves or has its registration revoked, it must also withdraw from the fund in accordance with the requisite procedures (FIEA, art. 79-28).

7 Financial Instruments Exchanges

7 1 Significance

A financial instruments exchange refers to a financial instruments membership corporation or stock company that establishes a financial instruments market (meaning a market on which securities are traded or market transactions of derivatives are carried out and excluding markets which solely carry out commodity-related market transactions of derivatives; FIEA, art. 2, para. 14), having obtained a license from the Prime Minister (FIEA, art. 2, para. 16, and art. 80, para. 1).

The distribution markets for financial instruments are created on financial instruments exchanges, on which prices are formed pursuant to the principles of transparency and fairness. A financial instruments market held by a financial instruments exchange is referred to as a financial instruments exchange market (FIEA, art. 2, para. 17).

Because a financial instruments market established by a financial instruments exchange is public goods of the citizens, the establishment thereof requires a license from the Prime Minister (FIEA, art. 80, para. 1, art. 81, and art. 82). The establishment of a financial instrument market to trade in securities and conduct market transactions of

derivatives and the conduct of such transactions without a license are strictly prohibited (FIEA, art. 167-3), subject to criminal penalty (FIEA, art. 200, item 19) and the transactions so conducted are considered null and void.

Expansion of the Business of Financial Instruments Exchanges in Accordance with the FIEA Amendments

The amendments in 2008 enabled financial instruments exchanges to establish a specified financial instruments exchange market targeting only professional investors (FIEA, art. 2, para. 32; the so-called professional market).

On this professional market, general investors other than professional investors, etc. are prohibited from purchasing securities through entrustment (purchase by general investor, etc.) (FIEA, art. 117-2, para. 1), and on this premise, market rules can be designed relatively freely with respect to the manner and contents of information provision and disclosure, language, accounting standards, etc. To establish this professional market, matters such as issues related to the restriction of acceptance of entrustment of sales and purchase of securities, and the contents of the specified securities information and issuer information to be provided by or disclosed by the issuer of the specified listed securities and the manner of provision or disclosure and timing, etc. must be prescribed in the business regulations (FIEA, art. 117-2, para. 2). Therefore, amendments on business regulations require the authorization from the Prime Minister (FIEA, art. 149, para. 1). Securities listed only on a specified financial instruments exchange market are called “specified listed securities” (FIEA, art. 2, para. 33).

Furthermore, with the 2008 amendments likewise, a financial instruments exchange has become enabled to establish a market conducting emissions trading and other transactions similar to transactions in financial instruments (FIEA, art. 87-2; market for transactions similar to financial instruments trading). A financial instruments business operator that is already engaged in the type I financial instruments business or the investment management business may engage in emissions trading and intermediary service thereof (FIEA, art. 35, para. 2, item 7; FIBCOO, art. 68, item 16 and item 17), but because emissions are already the subject of on-exchange trades in Europe and the U.S., this has become admitted in Japan as well.

Moreover, with the 2009 amendments, in addition to emissions trading, a stock company financial instruments exchange may establish commodity futures markets and may carry out operations that are related to that. Pursuant to this, the cross entrance of financial instruments exchanges and commodity exchanges have become possible. A financial instruments exchange may also conduct these operations through an owned subsidiary that has been authorized by the Prime Minister (FIEA, art. 87-3, para. 1, *proviso*), and moreover, a financial instruments exchange holding company may conduct these operations through its operation and management of its subsidiary (FIEA, art. 106-23, para. 2 and art. 106-12, para. 1(a) through (d)).

To open such a market for transactions similar to financial instruments trading, the authorization of the Prime Minister is required (FIEA, art. 87-2, para. 1, *proviso*), and if such operations may damage the trust in the public nature of the operations of financial instruments exchanges or may damage the sound and adequate operations of the establishment of a financial instruments exchange market or activities pertaining thereto, the authorization shall not be given (FIEA, art. 87-2, para. 2).

Also, if it is found that by conducting such operations there is a risk of damaging trust in the public nature of the business of the relevant financial instruments exchange or a risk of damaging the sound and adequate operations of the establishment and the like of a financial instruments market, the Prime Minister may revoke the relevant authorization (FIEA, art. 152, para. 1, item 3), and the same is true if these types of risks arise

through the acts of a subsidiary (*id*., item 4).

In addition to the abovementioned amendments, under the amendments made in 2012, necessary provisions were established to facilitate a comprehensive exchange which can cross-sectionally and collectively deal with securities, financial instruments and commodities by removing the barriers among them.

Through the 2014 amendments, the business of designating numbers for identifying parties to financial instruments transactions (excluding transactions on financial instruments exchange markets) have been additionally included in the scope of business of financial instruments exchange markets (FIEA, art. 87-2, para. 1).

Furthermore, the 2017 amendments introduced a new scheme designed to enhance flexibility in terms of the division of operations within an exchange group, which enables the exchange to carry out some common and duplicate operations of the group members, such as system development (FIEA, art. 87-2, para. 1), while enabling the exchange group to continue to hold a foreign exchange, etc. as its subsidiary for a prescribed period (five years in principle) even where the foreign exchange's business operations go beyond the scope of operations allowed for its subsidiary (FIEA, art. 87-3, para. 6 to para. 8).

7 2 Forms of Organization

The FIEA, Article 1 advocates the purpose of full exploitation of the functionalities of the capital markets through the assurance of proper operation of financial instruments exchanges, and upon a financial instruments exchange establishing a financial instruments market, its articles of incorporation, business regulations and brokerage rules are examined as to whether they are sufficient to achieve fair and smooth trading of securities and market transactions of derivatives on the financial instruments market of the exchange, and to protect investors (FIEA, art. 82, para. 1), and the financial instruments exchange must implement appropriate self-regulatory activities in order to achieve such purposes (FIEA, art. 84, para. 1).

There are two legal forms of organization for a financial instruments exchange, (i) a financial instruments membership corporation (a membership-type financial instruments exchange), and (ii) a stock company (a stock company-type financial instruments exchange); however, they both are organizations for the purpose of achieving the objectives of the FIEA, Article 1, and the stock company vehicle is permitted only because it is possible to achieve the objectives in a proper fashion by using a stock company vehicle.

A financial instruments exchange is under the supervision of the Prime Minister. This includes, *inter alia*, cancellation of licenses and permits, dismissal of officers, collection and inspection of reports, various dispositions, and issuing of orders for improvement of business (FIEA, art. 148 through art. 153-5).

The Prime Minster may if necessary order changes to the articles of incorporation, business regulations or other rules, etc., or take such other supervisory measures as necessary (FIEA, art. 153), and may further order the submission of reports and documentation in connection with the business activities and financial condition, as well as have its official conduct inspections (FIEA, art. 151 and art. 188).

(1) Requirements for Establishing a Financial Instruments Market and Financial Instruments Exchanges

Normally, a license from the Prime Minister must be obtained in order to establish a financial instruments

market (FIEA, art. 80, para. 1).

Only two types of entities may become a financial instruments exchange (i) a financial instruments membership corporation, and (ii) a stock company that complies with law and regulation (FIEA, art. 83-2). A market established by an exchange is truly a financial instruments market, and a person as set forth above must obtain a license if the said person desires to establish a financial instruments exchange.

In order to obtain this license, application for a license must be made that includes submission of (i) a license application (stating, *inter alia*, the firm name, and location of principal office, as well as the names of officers and members), (ii) the articles of incorporation, and (iii) the business regulations, brokerage rules and other documentation (FIEA, art. 81, para. 1 and para. 2).

The Prime Minister shall examine the same in view of the license screening criteria (*i.e.*, criteria including that the provisions of (ii) and (iii), etc. comply with law and regulation, and are sufficient to achieve a fair and smooth functioning market and to protect investors) (FIEA, art. 82).

(2) Financial Instruments Membership Corporation

To establish a financial instruments exchange as a financial instruments membership corporation, a financial instruments business operator, etc. must become a promoter (FIEA, art. 88-2), and follow the procedures for establishment.

The main procedures follow the steps of (i) drafting of the articles of incorporation by the promoter (FIEA, art. 88-3), (ii) calling and convening the organizational general meeting, approving the articles of incorporation and deciding other matters that are necessary for establishment (FIEA, art. 88-4), (iii) preparing the general inventory and the registry of members (FIEA, art. 88-11), (iv) recording the establishment (FIEA, art. 89-2), and (v) coming into effect (FIEA, art. 89).

The articles of incorporation must state the following matters and bear the names and seals of all promoters (FIEA, art. 88-3):

(i) Purposes; (ii) Name; (iii) Location of office; (iv) Matters concerning its foundation fund and contributions; (v) Matters concerning its members, etc. (meaning Regular Members or Trading Participants; hereinafter the same shall apply in this Chapter) ; (vi) Matters concerning monitoring of the state of compliance by its members, etc. with laws, regulations, administrative actions based on laws and regulations, the articles of incorporation and other similar regulations, and the principle of fair and equitable transactions; (vii) Matters concerning guarantee funds; (viii) Matters concerning allocation of expenditures; (ix) Matters concerning officers; (x) Matters concerning meetings; (xi) Matters concerning execution of operations; (xii) Matters concerning the preparation of regulations; (xiii) Matters concerning financial instruments exchange market; (xiv) Matters concerning accounting; and (xv) Method of public notice.

A financial instruments membership corporation is explicitly prohibited from engaging in business for profit (FIEA, art. 97). A stock company-type financial instruments exchange is also an institution to achieve the objectives of the FIEA as discussed above, and thus is not a for-profit institution either (there is absolutely no contradiction between the ability to distribute surplus and the objectives involving a high degree of public interest).

(3) Stock Company-Type Financial Instruments Exchanges

If a financial instruments exchange is to be established as a stock company, the stock company established in accordance with the provisions of the Companies Act will obtain a license to operate a financial instruments market. Establishment procedures generally follow the Companies Act (Companies Act, art. 25 through art. 103).

However, under the FIEA, the following matters must be stated in the articles of incorporation of a stock company-type financial instruments exchange, in addition to those set forth in Article 27 of the Companies Act (FIEA, art. 103):

- **(i) Matters concerning examinations of the status of compliance by transaction participants with the law and regulations, and the principle of good faith in transactions;**
- **(ii) Matters concerning preparation of the regulations;**
- **(iii) Matters concerning the financial instruments exchange market; and**
- **(iv) In the event of establishing the self-regulatory committee, to that effect.**

Furthermore, minimum capital amounts (JPY1 billion) (FIEA, art. 83-2; FIEAEO, art. 19) and regulations on stock acquisition and holding (see “7-4(3) Shareholders and Trading Participants in a Stock Company-Type Financial Instruments Exchange” for details) are prescribed, stemming from the necessity of maintaining a certain financial base in order to preserve the public nature of the exchanges.

(4) Foreign Financial Instruments Exchange

A person who operates a foreign financial instruments market (meaning a market that is similar to a financial instruments exchange market, but which is located in a foreign country; FIEA, art. 2, para. 8, item 3(b)) may receive an authorization from the Prime Minister, and have financial instruments business operators and registered financial institutions engage in trades and transactions of financial instruments on foreign financial instruments markets by connecting an electronic information system and I/O units that are to be used by those persons (FIEA, art. 155 through art. 155-10 and art. 156).

A foreign financial instruments exchange shall mean a person who has obtained this authorization (FIEA, art. 2, para. 26).

(5) Organizational Conversion

A membership-type financial instruments exchange may convert to a stock company-type financial instruments exchange (FIEA, art. 101).

Conversion must follow the procedures for preparing a conversion plan and obtaining the approval of the general meeting (FIEA, art. 101-2), the authorization of the Prime Minister (FIEA, art. 101-17), resolving any creditor objections (FIEA, art. 101-4; Companies Act, art. 779), allotting shares to members (FIEA, art. 101-6), and posting capitalization in the statutory amount (FIEA, art. 101-7).

(6) Merger

Mergers between financial instruments exchanges incur restrictions which differ in their pattern depending on the form of organization of the exchange.

A membership-type financial instruments exchange can merge with another membership-type financial instruments exchange or a stock company-type financial instruments exchange. However, the surviving entity or the

entity created in the merger is subject to the following restrictions (FIEA, art. 136, para. 1 and para. 2):

(i) In the case of a merger between two membership-type financial instruments exchanges, the entity must be a membership-type financial instruments exchange; and

(ii) In the case of a merger between a membership-type financial instruments exchange and a stock company-type financial instruments exchange, the entity must be a stock company-type financial instruments exchange.

In each of these cases a merger agreement must be prepared (FIEA, art. 136, para. 1), and approval by a general meeting (FIEA, art. 139-3, para. 3, art. 139-4, para. 2, art. 139-5, para. 3, and art. 139-8, para. 1), as well as authorization from the Prime Minister must be obtained (FIEA, art. 140).

Furthermore, pursuant to the amendments in 2012, the following provisions were established with respect to the merger between a stock company-type financial instruments exchange and incorporated commodity exchange (FIEA, art. 142, para. 5 and 9).

(i) In the case where a stock company-type financial instruments exchange is to be newly incorporated as a result of the merger, the stock company-type financial instruments exchange shall succeed to the rights and obligations of the stock company-type financial instruments exchange that extinguishes by such merger on the date of completion of the merger.

(ii) The transaction, which has come into effect on the commodity market established by the incorporated commodity exchange that is to extinguish but for which the settlement has not been completed, shall be deemed to be a market transaction of derivatives that has come into effect under the same conditions on the financial instruments exchange market established by the stock company-type financial instruments exchange after the merger.

7 3 Self-Regulatory Committee and Self-Regulatory Organizations

(1) Significance of Self-Regulation

Financial instruments exchanges and financial instruments firms associations in and of themselves are referred to as self-regulatory organizations. This term is an expression of the historical nature of securities markets having been run autonomously or independently by business operators. This historical substance of self-regulation has waned given that as of the present time these organizations are under strict regulation by law from their establishment to all aspects of their operation, etc.

Since the regulation of securities markets must respond quickly to events that change constantly, it is indispensable for a self-regulatory organization to respond flexibly based on a hands-on approach. By way of example as there may be cases depending on the circumstances in which it is necessary to immediately suspend trades if a failure to make timely disclosure occurs. Delegating regulation to the exchange that knows the actual situation will better enable realistic action to be taken.

A financial instruments exchange in and of itself is a self-regulatory organization, and within the functions that it has of trading monitoring and oversight, listing examination and listing supervision have a particular need for neutrality and independence from all forces, as they are functions that truly carry the core of price formation. The FIEA refers to these latter functions particularly as self-regulation, and has created a regime for the purpose of maintaining their independence(Note).

(Note) It can be recognized that one aspect behind the direct statement in the FIEA of a regime of self-regulation of a financial instruments exchange is that the possibility exists of a conflict between the role of self-regulation that an exchange should perform and the interests of an issuer of stock in the event that an exchange that takes the form of a stock company lists its own shares on the market (FIEA, art. 124 and art. 125).

It has further been mentioned that there is a possibility that an exchange will be lenient in applying rules and listing criteria to listed companies since one source of income for a financial instruments exchange is the various fees (trading commission, listing commission) that a financial instruments exchange collects from listed companies.

(2) Self-Regulation of a Financial Instruments Exchange

The FIEA stipulates that "a financial instruments exchange must properly carry out self-regulatory operations in accordance with this law, the articles of incorporation and other rules in order to achieve the fair trading of securities and market transactions of derivatives in the financial instruments exchange market and to protect investors" (FIEA, art. 84, para. 1).

The following are included in the self-regulatory operations that a financial instruments exchange must carry out (FIEA, art. 84, para. 2):

(i) Operations regarding the listing and delisting of a financial instrument, financial index, or option;
(ii) Investigation of compliance on the part of a member, etc. with law and/or regulation, dispositions by an administrative agency pursuant to law and/or regulation, the articles of incorporation and other rules, as well as the principle of fair and equitable transactions; and
(iii) Such other operations as prescribed by Cabinet Office Ordinance as being necessary to secure fair transactions on a financial instruments exchange market.

(3) Structures for Implementing Self-Regulation

In order to nullify problems of conflicts of interest in connection with self-regulation by a financial instruments exchange, and to enable a certain level of independence and objectivity in the conduct of self-regulatory activities, the FIEA stipulates as structures for the conduct of self-regulation that (i) the self-regulatory activities are to be delegated to a self-regulatory organization (FIEA, art. 85); or (ii) carried out by a self-regulatory committee (FIEA, art. 105-4). While a self-regulatory organization is a different organization from the company that operates the market, they are both organizations for the purpose of fair price formation.

The first structure above is a form that may be taken by either a membership-type or stock company-operated exchange. The exchange must obtain authorization from the Prime Minister if the exchange will delegate self-regulatory operations to a self-regulatory organization (FIEA, art. 85, para. 1). A self-regulatory organization here means a juridical person that is incorporated for the purpose of carrying out self-regulatory operations (FIEA, art. 85, para. 1 and art. 102-2 through art. 102-7). A self-regulatory organization cannot be incorporated by any person other than a financial instruments exchange, a financial instruments exchange holding company or a parent

commodity exchange, etc. (FIEA, art. 102-3, para. 1). A self-regulatory organization must obtain authorization from the Prime Minister in order to carry out self-regulatory operations (FIEA, art. 102-14), and a self-regulatory organization may not engage in activities on a for profit basis (FIEA, art. 102-21).

The second structure is a form in which a self-regulatory committee is established within the exchange. This form may be used only by a stock company-type financial instruments exchange (specified stock company-type financial instruments exchange; FIEA, art. 105-4). A self-regulatory committee is incorporated within the stock company-type financial instruments exchange, and its authority is to determine matters in connection with the self-regulatory operations of the financial instruments exchange (FIEA, art. 105-4, para. 2). A self-regulatory committee shall have at least three members, and the majority of the membership must be outside directors (FIEA, art. 105-5, para. 1). Selection is made by resolution of the board of directors, from among the directors of the stock company-type financial instruments exchange (FIEA, art. 105-5, para. 2).

(4) Investigation of High Speed Traders

Beyond what is provided for in Article 84 of the FIEA, a financial instruments exchange is to investigate the compliance of a person engaged in high speed trading utilizing with laws and regulations and dispositions by government agencies which are based on laws and regulations and to take any other necessary measures, in accordance with the FIEA and with its articles of incorporation and other rules, in order to ensure the fair purchase and sale of securities and market derivatives transactions on the financial instruments exchange market, as well as to protect investors (FIEA, art. 85-5, para. 1). The provisions of the FIEA (excluding Article 84) apply by deeming the services pertaining to these measures as self-regulatory services (id., para. 2). These rules have been introduced because, in order to ensure the effectiveness of the regulations on high speed trading, it was considered to be appropriate to empower the exchange, which operates the trading system and observes the market from the closest position, to investigate the conduct of high speed traders.

(5) Delegation of Specified Activities

The 2008 amendments have enabled financial instruments exchanges to establish the so-called professional markets, and in accordance therewith, financial instruments exchanges have become enabled to delegate among part of its self-regulatory activities concerning the specified financial instruments exchange market activities handling matters other than matters involving the fundamentals of investor protection (specified activities) to persons other than self-regulatory organizations (FIEA, art. 85, para. 4).

It is also possible for a self-regulatory organization that has been delegated from a financial instruments exchange self-regulation to sub-delegate only the specified activities upon consent of the exchange (FIEA, art. 102-19, *proviso*). Furthermore, a specified stock company-type financial instruments exchange may similarly delegate [activities] upon determination by the self-regulatory committee (FIEA, art. 85, para. 6).

> This system was designed upon reference to the Nomad (Nominated Adviser) system of U.K.'s London Stock Exchange AIM (Alternative investment Market). In the U.K., securities companies, law firms and audit firms act as advisers nominated by the exchange.

The professional market was envisaged as a relatively free market on the premise of the information collection and analysis ability or risk management ability of professional investors, however, for this reason, a person in a position to ensure the fairness of the markets is likely to be questioned strict responsibility. Not only the exchanges

but persons being delegated of the self-regulatory activities must also conduct strict supervision for the ensuring of market fairness.

Exchanges must select an appropriate delegate to ensure the quality of self-regulation and shall be liable for the supervision thereof (FIEA, art. 85, para. 4 and para. 5; Cabinet Office Ordinance on Financial Instruments Exchanges, art. 7-3).

7 4 Members and Trading Participants

(1) Members of a Financial Instruments Membership Corporation

(i) Qualification to Become a Member

Membership in a financial instruments membership corporation is limited to financial instruments business operators, etc. (FIEA, art. 91). A member shall contribute funds as stated in the articles of incorporation, and in principle shall have liability that is limited to the extent of the said contribution (FIEA, art. 92).

(ii) Withdrawal

A member may withdraw from the financial instruments membership corporation upon the approval of the financial instruments membership corporation (FIEA, art. 94). In this event, the member may obtain approval from the financial instruments membership corporation and assign its interest (FIEA, art. 93).

A member shall also withdraw if it no longer constitutes a financial instruments business operator, etc., or dissolves or is expelled (FIEA, art. 95). If a member withdraws, the financial instruments membership corporation must refund that member’s interest in the financial instruments membership corporation (FIEA, art. 96).

(iii) Member Rights and Duties

(a) Rights

Members, etc. have the right to conduct trades or other transactions on the financial instruments exchange market (FIEA, art. 111).

(b) Duties

A member has a duty to make the equity contribution (FIEA, art. 92, para. 1). Members, etc. must deposit a guarantee fund with the financial instruments exchange (FIEA, art. 114, para. 1 and para. 2).

(2) Trading Qualification on a Membership-Type Financial Instruments Exchange

In principle only members, etc. of a financial instruments exchange that holds the financial instruments exchange market shall be permitted to conduct transactions (FIEA, art. 111).

A membership-type financial instruments exchange may, however, make a stipulation in its articles of incorporation granting trading qualifications to financial instruments business operators, authorized transaction-at-exchange operators, and registered financial institutions (FIEA, art. 112, para. 1). Pursuant to the amendments in 2012, a membership-type financial instruments exchange can now grant the qualification to trade only for commodity-related market transactions of derivatives (FIEA, art. 112, para. 2).

(3) Shareholders and Trading Participants in a Stock Company-Type Financial Instruments Exchange

(i) Shareholders of a Stock Company-Type Financial Instruments Exchange

In principle there is no particular requirement to become a shareholder of a stock company-type financial instruments exchange other than to hold stock in the exchange. Nevertheless, the following stringent restrictions exist on holding voting rights, in view of the public nature, etc. of a financial instruments exchange (FIEA, art. 103-2):

(a) No person (excluding an authorized financial instruments firms association, a financial instruments exchange, a financial instruments exchange holding company, a commodity exchange, or a commodity exchange holding company) may acquire or hold 20 percent or more of the voting rights (FIEA, art. 103-2, para. 1). This base holding ratio is reduced to 15 percent if any event occurs that is presumed to have a material influence on decisions concerning financial and operational policies of the exchange;

(b) A person who has come to hold more than five percent of the voting rights must submit to the Prime Minister a notification of holdings in subject voting rights, stating the purposes of holding and other matters (FIEA, art. 103-3). If a false statement or omission is made in the notification of holdings in subject voting rights, the Prime Minister can order the submission of a report or documentation or conduct an investigation (FIEA, art. 103-4).

In order that local governments, etc. can invest in exchanges, an exception has been enacted to the restriction on the holding of voting rights, to the effect that entities such as local governments can hold up to 50 percent of the voting rights, after obtaining authorization from the Prime Minister (FIEA, art. 106-3 through art. 106-5).

(ii) Trading Participants on a Stock Company-Type Financial Instruments Exchange

A stock company-type financial instruments exchange may, by its business regulations, grant trading qualifications to financial instruments business operators, authorized transaction-at-exchange operators and registered financial institutions (FIEA, art. 113). Persons with trading qualifications are referred to as trading participants. Pursuant to the amendments in 2012, a stock company-type financial instruments exchange can now grant the qualification to trade only for commodity-related market transactions of derivatives (FIEA, art. 113, para. 2).

A trading participant may lose its qualification according to the stipulations of the business regulations of an exchange (FIEA, art. 94 and art. 113, para. 3). Moreover, a transaction participant shall lose its qualification if it no longer constitutes a financial instruments business operator, etc., or dissolves or is expelled (FIEA, art. 95 and art. 113, para. 3).

(4) Financial Instruments Exchange Holding Company

A financial instruments exchange holding company is a stock company that has as its subsidiary a stock company-type financial instruments exchange (= holding of a majority of the voting rights of all shareholders) incorporated upon the authorization of the Prime Minister or that has been authorized by the Prime Minister (FIEA, art. 2, para. 18).

A person (stock company) who wishes to make a stock company-type financial instruments exchange into a subsidiary (= holding of a majority of the voting rights of all shareholders) shall obtain prior authorization from the Prime Minister (FIEA, art. 106-10). The examination criteria for the authorization are as follows (FIEA, art. 106-12, para. 1):

(i) That the sole purpose of the applicant or the company incorporated upon authorization (applicant, etc.) is to own the stock company-type financial instruments exchange or the stock company-type financial instruments exchange and any of the following listed companies as its subsidiary;

(a) A company that conducts operations incidental to the establishment of a financial instruments exchange market;

(b) A company that conducts operations related to the establishment of a financial instruments exchange market;

(c) A company that conducts the business of establishing commodities markets; or

(d) A company that conducts business related to the establishment of markets necessary for carrying out commodity futures transactions;

(ii) That the revenue forecasts of the applicant and the stock company-type financial instruments exchange which is to become a subsidiary of the applicant are favorable;

(iii) That the applicant has the knowledge and experience, from the perspective of its personnel composition, to perform appropriate and fair business management for the stock company-type financial instruments exchange which is to become a subsidiary; and

(iv) That the applicant has a sufficient reputation in society.

Restrictions on stock acquisition and holding similar to those for financial instruments exchanges are also provided in connection with financial instruments exchange holding companies, in view of their public nature (FIEA, art. 106-14 through art. 106-22).

Also, the regulations are essentially those imposed on financial instruments exchanges (FIEA, art. 87-2 and art. 87-3) in that the holding company cannot engage in any business other than business management of a subsidiary stock company-type financial instruments exchange, a subsidiary that conducts operations incidental to the establishment of a financial instruments exchange market, a subsidiary that conducts operations related to the establishment of a financial instruments exchange market, a subsidiary that conducts the business of establishing commodities markets, or a subsidiary that conducts business related to the establishment of markets necessary for carrying out commodity futures transactions, and related business (FIEA, art. 106-23), and that having a company as a subsidiary that engages in activities in connection with establishing financial instruments exchange markets, activities of establishing a commodity market, or activities related to the establishment of markets necessary for carrying out commodity futures transactions is possible on condition that authorization is obtained from the Prime Minister (FIEA, art. 106-24).

The Prime Minister may order the financial instruments exchange holding company or its subsidiary to submit a report or other reference materials concerning the operations or assets of such financial instruments exchange holding company or its subsidiary, or have officials conduct an inspection if the Prime Minister recognizes this to be necessary and appropriate for the protection of investors or the public interest (FIEA, art. 106-27).

In addition, the Prime Minister may, if the financial instruments exchange holding company has violated a law or regulation, or if the Prime Minister finds that in light of the circumstances of the activities of the financial instruments exchange holding company it is necessary to protect trust in the public nature and the sound and proper operations of its subsidiary stock company-type financial instruments exchange, cancel the authorization of the financial instruments exchange holding company or the authorization to have as a subsidiary a company that

conducts operations related to the establishment of a financial instruments exchange market, that conducts the business of establishing commodities markets, or that conducts business related to the establishment of markets necessary for carrying out commodity futures transactions and order it to take such other necessary supervisory actions (FIEA, art. 106-28, para. 1).

Furthermore, the Prime Minister may, if a director, accounting advisor, corporate auditor or executive officer of a financial instruments exchange holding company has violated a law or regulation or an administrative action by an administrative agency pursuant to a law or regulation, order the financial instruments exchange holding company to dismiss the director, accounting advisor, corporate auditor or executive officer (*id*., para. 2).

7 5 Listing of Securities

Securities traded on a financial instruments market must satisfy certain criteria under which the financial instruments exchange is able to take responsibility for achieving fair price formation, and for which it is possible to recognize that economic significance for the nation exists in creating a market in connection with the securities. The acceptance of these by a financial instruments exchange and making them eligible for trading on the financial instruments exchange as securities of this type is called listing.

The characteristics of listing are not simply the execution of a listing agreement between the financial instruments exchange and the issuing company, and an essential duty of the listing company is demanded from the perspective of achieving the legal objectives of demonstrating the functioning of the capital markets and fair price formation.

When an application to list securities is received, the financial instruments exchange undertakes an examination in accordance with its listing regulations. If as a result the exchange intends to list the securities, the exchange must notify the Prime Minister to such effect (FIEA, art. 121). Except in certain cases, approval from the Prime Minister is also required in the event that a financial instruments exchange intends to list securities that it issues (FIEA, art. 122, para. 1). This applies to delisting as well (FIEA, art. 126).

7 6 Trading, Etc. of Financial Instruments on the Financial Instruments Exchange Market

A financial instruments exchange market must be managed and operated to assure fair and smooth trading in securities and market transactions of derivatives, as well as to contribute to the protection of investors (FIEA, art. 110).

For this reason, the following regulations have been implemented:

(1) Persons Who May Conduct Transactions on the Financial Instruments Exchange Market

Only members, etc. of a financial instruments exchange that maintains the relevant financial instruments exchange market may engage in trading securities or market transactions of derivatives on such financial instruments exchange market (FIEA, art. 111).

(2) Restrictions on Trading and the Entrustment/Acceptance Thereof on the Financial Instruments Exchange Market

The financial instruments exchange prescribes business regulations in order to ensure that trading on a financial instruments exchange market proceeds in a fair and smooth manner (FIEA, art. 117), and must prescribe Brokerage Rules so that customer orders entrusted or accepted by the members, etc. are performed in a good faith and fair manner (FIEA, art. 133).

In the case of establishing a financial instruments market for commodity-related market transactions of derivatives, the financial instruments exchange must also prescribe, as part of its operational rules, detailed rules concerning financial instruments, etc. related to the relevant commodity-related market transactions of derivatives for each type of commodity-related market transaction of derivatives (FIEA, art. 117, para. 2).

The effect of the business regulations/brokerage rules are judged according to the meaning of the individual provisions in the market. They can be amended with the approval of the Prime Minister, and the Prime Minister has the authority to order their amendment; governors who do not comply with such orders may be removed (FIEA, art. 152), and their nature can be interpreted as almost a quasi-Cabinet Order/ministerial ordinance in accordance with the individual provisions.

(3) Notification, Announcement of Total Transaction Balances

A financial instruments exchange must promptly notify members and other relevant parties and make a public announcement regarding the daily total transaction balances, the daily high, low, and closing price for each issue, the negotiated value, and price, etc. (FIEA, art. 130).

(4) Measures to Halt Trading, Etc.

In cases where trading, etc. cannot or may not be performed fairly and smoothly, the financial instruments exchange may halt transactions, but it must notify the Prime Minister in cases where it halts trading or when it lifts a halt on trading (FIEA, art. 128). The core function of the financial instruments exchanges is market management, or monitoring the conduct of transactions on an imperfect competitive market.

If inaccurate information is spread throughout the market, a temporary halt in trading is necessary to return market conditions back to a healthy state.

(5) Deposit of the Guarantee Funds

Members, etc. must deposit the requisite guarantee funds with the financial instruments exchange in accordance with the provisions of the articles of incorporation (or the business regulations in the case of a stock company-type financial instruments exchange) of such financial instruments exchange (FIEA, art. 114, para. 1). Persons who consigned trades, etc. to members, etc. on the financial instruments exchange market have the right to receive satisfaction out of this guarantee fund ahead of other creditors (*id*., para. 4). This rule was enacted as part of the investor protection scheme.

Further, when a member, etc. causes damage to another member, etc., or the financial instruments exchange as a result of not performing its obligations based on trades or other transactions on a financial instruments exchange market, the injured member, etc., or the financial instruments exchange has the right to receive satisfaction ahead of other creditors from the guarantee funds of the member, etc. causing the injury. However, these rights are junior to the aforementioned claims of the general investor who entrusted such member, etc. with a trade or other transaction (FIEA, art. 115).

8 Financial Instruments Clearing Organizations, Etc.

8 1 Financial Instruments Clearing Organization

(1) Significance

A financial instruments clearing organization is a person who has obtained a license or approval from the Prime Minister and carries out the business activities of financial instruments obligations assumption service as well as activities related thereto (FIEA, art. 2, para. 29, art. 156-2, and art. 156-19). The counterparty to the activities of financial instruments obligations assumption service is referred to as a clearing participant (FIEA, art. 156-7, para. 2, item 3). If a financial instruments exchange will become a financial instruments clearing organization, the financial instruments exchange will only be required to obtain approval from the Prime Minister (FIEA, art. 156-19).

By the amendments in 2010, a juridical person incorporated in accordance with the laws of a foreign country that conducts the same type of business as the business activities of financial instruments obligations assumption service in a foreign country may be licensed by the Prime Minister to engage in the business activities of financial instruments obligations assumption service (FIEA, art. 156-20-2).

In addition, under the same amendments, a financial instruments clearing organization may be permitted by the Prime Minister to conduct the business activities of coordinated financial instruments obligations assumption service (to conduct as business of having a third party bear the obligations of a clearing participant regarding subject transactions other than the transactions provided for in Article 156-62, Item 1 of the FIEA, and to conduct the acts prescribed by Cabinet Office Ordinance as acts of bearing the obligations of the counterparty of the clearing participant concerning the said subject transaction) upon executing an agreement regarding the business activities of coordinated financial instruments obligations assumption service with a coordinated clearing organization, etc. (meaning other financial instruments clearing organization, foreign financial instruments clearing organization or a person incorporated in accordance with the laws of a foreign country that conducts the same type of business as the business activities of financial instruments obligations assumption service in a foreign country) (FIEA, art. 156-20-16, para. 1).

(2) Function

Since many trades and transactions are carried continuously and repeatedly with numerous counterparties on a financial instruments market, it is impossible to track the changes in each transaction, necessitating batched processing of trades.

A financial instruments clearing organization (normally referred to as a clearinghouse) stands between both parties to a transaction, and processes a large volume of clearing work in the form of assuming the respective claims and liabilities in connection with the securities and payment for the same on the part of the parties. In this manner settlement of trading parties on the entire market is centralized with one person.

By highlighting this function of a financial instruments clearing organization, this type of facility is also referred to as a “central counterparty.”

Since a financial instruments clearing organization assumes claims and liabilities, the clearing participants will

be able to carry out transactions without being particularly concerned with the credit risk of the counterparty to the trade, which will ensure that transactions in the market are conducted in an ongoing manner.

A financial instruments clearing organization carries out netting by calculating the net margins on the part of a transaction participant that engages in trades with numerous parties, and settling only the difference. This eliminates waste in transporting cash and securities back and forth, and enables efficient use thereof.

(3) Nature

The proper, accurate and sound operations of a financial instruments clearing organization, which fulfills the functions discussed above, constitutes a support for the smooth operations of the market.

The FIEA, consequently, requires that a license from the Prime Minister be obtained in order to carry out the financial instruments obligations assumption service, and stipulates that a prescribed screening be conducted (FIEA, art. 156-4 and art. 156-20-4).

Because of the nature of the role that is fulfilled by financial instruments clearing organizations, stipulations have been made in the form of a prohibition against improper discriminatory treatment of specified clearing participants (FIEA, art. 156-9 and art. 156-20-8), the duty to maintain confidentiality (FIEA, art. 156-8 and art. 156-20-7), and restrictions on business activities (FIEA, art. 156-6).

(4) Business Methods Manual

A financial instruments clearing organization must prepare a business methods manual and carry out its activities in accordance with the same (FIEA, art. 156-7, para. 1 and art. 156-20-6, para. 1). The business methods manual shall state the types of transactions that create the obligations to be addressed by the business activities of financial instruments obligations assumption service as well as the financial instruments that cover these transactions, matters relating to the requirements for clearing participants, matters concerning the bearing of and performance on obligations by the assumption, novation or other methods conducted as the business of financial instruments obligations assumption service, matters concerning the achieving of performance by clearing participants on obligations, matters concerning brokerage of securities, etc. clearing, and other matters as prescribed by Cabinet Office Ordinance (FIEA, art. 156-7, para. 2 and art. 156-20-6, para. 2).

(5) Incurring of Losses, Etc.

A financial instruments clearing organization shall set forth, in its business methods manual, that a clearing participant shall bear the entire amount of any losses that are incurred in the financial instruments obligations assumption service, and take other action to ensure faithful execution of the financial instruments obligations assumption service (FIEA, art. 156-10). The ultimate reliability of the clearing organization depends on the reliability of clearing participants.

If a financial instruments clearing organization stipulates clearing deposits in the business methods manual, and a clearing participant through failing to discharge an obligation causes loss to the financial instruments clearing organization, the financial instruments clearing organization that incurred the loss shall have a right to collect payment in preference to other creditors in connection with the clearing deposit of the clearing participant who caused the damage (FIEA, art. 156-11).

(6) Supervision

Stipulations have also been made including, *inter alia*, minimum capital regulations (FIEA, art. 156-5-2);

authorization of changes to the articles of incorporation or the business methods manual (FIEA, art. 156-12); public inspection of the total number of issued shares, etc. (FIEA, art. 156-12-2); authorization of capital reduction, etc. (FIEA, art. 156-12-3); notification of change of the business offices, etc. (FIEA, art. 156-13); order to dismiss an officer (FIEA, art. 156-14; art. 156-20-14); orders to submit reports and documentation, as well as inspections (FIEA, art. 156-15 and art. 156-20-12); orders to improve the conduct of business (FIEA, art. 156-16 and art. 156-20-13); and the canceling of a license or order to suspend business (FIEA, art. 156-17 and art. 156-20-14).

(7) Regulations Concerning Major Shareholders

If a certain major shareholder exercises undue influence on the management of a clearing organization, the clearing organization may not be able to fully perform its role as a market infrastructure. Accordingly, in order to ensure the enforcement of the foundation of a clearing organization incorporated in Japan, the amendments in 2010 has introduced regulations on major shareholders.

(i) Submission of Notification of Holdings in Subject Voting Rights

A person holding voting rights in excess of 5% of the voting rights of all shareholders of a financial instruments clearing organization shall submit to the Prime Minister without delay as prescribed by the Cabinet Office Ordinance a notification of holdings in subject voting rights stating the ratio of the subject voting rights held to the voting rights of all shareholders of the financial instruments clearing organization, the purpose of holding and other matters prescribed by Cabinet Office Ordinance regarding the subject voting rights (FIEA, art. 156-5-3, para. 1).

(ii) Authorization Concerning Major Shareholders, Etc.

A person who wishes to acquire or hold subject voting rights of 20% (if there is a fact prescribed by Cabinet Office Ordinance as a fact which enables the presumption of having a material effect on the determination of its financial and management policies, 15%; hereinafter the “holding base ratio”) or more of the voting rights of all shareholders of a financial instruments clearing organization, or a person who wishes to incorporate a company or other corporation that wishes to acquire or hold subject voting rights no less than the holding base ratio of the voting rights of all shareholders of the financial instruments clearing organization must obtain the authorization of the Prime Minister in advance (FIEA, art. 156-5-5, para. 1).

In addition, if there is no increase in the number of subject voting rights held or in other cases prescribed by Cabinet Office Ordinance, a person acquiring or holding subject voting rights no less than the holding base ratio of the voting rights of all shareholders of the financial instruments clearing organization (hereinafter referred to as the “specified holder”) shall file a notification to the Prime Minister without delay stating the effect that it has become a specified holder and other matters prescribed by Cabinet Office Ordinance (FIEA, art. 156-5-5, para. 2 and para. 3).

In such case, unless authorized by the Prime Minister, the specified holder must take measures necessary for becoming a holder of the subject voting rights less than the holding base ratio of the financial instruments clearing organization within 3 months of the date it became a specified holder (FIEA, art. 156-5-5, para. 4).

(iii) Collection of Reports and Inspections on Major Shareholders

The Prime Minister may, if considered necessary and appropriate for public interest or investor protection, order a major shareholder of a financial instruments clearing organization (meaning a holder of voting rights of no less than the holding base ratio of the financial instruments clearing organization that has been incorporated upon authorization under Article 156-5-5, paragraph 1 of the FIEA, or authorized under the said Paragraph or the *proviso* to Paragraph 4 of the said Article) to submit reports or materials that are of

reference to the business or assets of the financial instruments clearing organization, or have its officials inspect the documents or other items of the major shareholder (limited to inspections necessary on the business or assets of the financial instruments clearing organization) (FIEA, art. 156-5-8).

(iv) Supervisory Actions Against Major Shareholders

If a major shareholder of a financial instruments clearing organization is in violation of laws and regulations, or if the acts of the major shareholder are considered to harm the sound and proper operation of the business of the financial instruments clearing organization, the Prime Minister may revoke the authorization of the major shareholder and order other measures necessary for supervision to be taken (FIEA, art. 156-5-9, para. 1).

The Prime Minister must conduct a hearing upon ordering necessary measures (*id*., para. 3).

8 2 Securities Finance Companies

(1) Significance

Securities finance companies are companies licensed by the Prime Minister that are engaged in functions of extending loans of the cash or securities necessary to settle margin transactions to members, etc. of a financial instruments exchange or members of an authorized financial instruments firms association by utilizing the settlement scheme of the financial instruments exchange market operated by the financial instruments exchange (FIEA, art. 2, para. 30 and art. 156-24).

A securities finance company must be a stock company whose capital amount is at least equal to the amount determined by Cabinet Order as the amount necessary and proper in order to perform the abovementioned functions (minimum capital amount of JPY100,000,000) (FIEA, art. 156-23; FIEAEO, art. 19-5).

At present, Japan Securities Finance Co., Ltd. is the only security finance company.

(2) Functions

The four principal functions of securities finance companies are as follows:

(i) Loans for Margin Transactions ...... Loans to financial instruments business operators who are members, etc. of an exchange, of the cash or securities necessary to settle margin transactions;

(ii) Bond Financing ...... Loans collateralized by government bonds, etc. to financial instruments business operators requiring short-term funds to perform their functions as bond underwriters or dealers, and loans collateralized by bonds to customers of financial instruments business operators to allow them to purchase or hold bonds;

(iii) General Loans ...... Loans of money or securities advanced to financial instruments business operators or their customers secured by securities or cash; and

(iv) Intermediary of Bond Lending ...... Borrowing or lending bonds in order to intermediate bonds lending between financial instruments business operators and financial institutions, etc.

Securities finance companies' source of funds for loans include call money, bank loans, commercial paper proceeds and their own capital, etc.

(3) Concurrent Business

Securities finance companies can conduct the following activities as concurrent business after filing a notification with the Prime Minister, to the extent that this does not interfere with the business activities discussed above (FIEA, art. 156-27, para. 1 and para. 2):

(i) Securities lending (excluding the business activities listed in (2)(i) above) or the performance of intermediation or acting as agent with respect to a securities lending;
(ii) Loans of money to financial instruments business operators;
(iii) Loans of money to customers of financial instruments business operators; and
(iv) Other business as prescribed by Cabinet Office Ordinance.

If a securities finance company will engage other business activities in addition to this, the securities finance company must obtain approval from the Prime Minister (FIEA, art. 156-27, para. 3).

(4) Oversight

The FIEA includes provisions concerning restrictions on concurrency (FIEA, art. 156-27), approval of an amendment in the content of business, etc. (FIEA, art. 156-28), orders to amend the manner, etc. of loans (FIEA, art. 156-29), restrictions, etc. on concurrent business of directors, etc. (FIEA, art. 156-31), orders to revoke the license or halt functions (FIEA, art. 156-32), orders to improve conduct of business, etc. (FIEA, art. 156-33), orders to submit reports/materials and inspections (FIEA, art. 156-34), and preparation and submission of business reports (FIEA, art. 156-35), etc.

(5) Duty to Enter into a Contract, Etc. with a Designated Dispute Resolution Organization

A securities finance company that engages in securities lending or performs intermediation or acts as agent with respect to a loan of securities, loans cash to customers of financial instruments business operators, or performs other business as prescribed by Cabinet Office Ordinance, must take measures to enter into a basic agreement for implementation of procedures relating to designated securities finance company services with one of the designated securities finance dispute resolution organization existing, if any, or if there is no designated securities finance dispute resolution organization, must devise measures respectively to respond to complaints as well as to resolve disputes concerning designated securities finance company services (FIEA, art. 156-31-2, para. 1).

If a securities finance company has taken measures to enter into a basic agreement for implementation of procedures, the securities finance company must publish the trade name and firm name of the designated securities finance company dispute resolution organization that is the other party to the relevant basic agreement for implementation of procedures (FIEA, art. 156-31-2, para. 2).

9 Designated Dispute Resolution Organizations

9-1 Significance

With the diversification and increased complexity of financial instruments and services, there has also been an increase in disputes concerning financial instruments and services. If such disputes arise, it is possible to attempt a resolution through lawsuits based on civil rules. However, since litigation often carries a large burden for the parties, it is important to deal with disputes in a simpler and speedier form.

Accordingly in order to protect the users of financial instruments and services and to increase the trust of users, it was perceived as important to introduce into the field of finance a system of alternative dispute resolution, which is a simpler and speedier means of dispute resolution that has been used in various fields following the judicial system reforms.

With this in mind, a system of alternative dispute resolution (finance ADR) was established in the field of finance pursuant to the 2009 amendments.

9-2 Designation of Dispute Resolution Organizations

(1) Requirements for Designation

Pursuant to an application by an organization that meets the following requirements, the Prime Minister may designate the organization as being one that provides dispute resolution services (FIEA, art. 156-39, para. 1):

(i) The organization is a juridical person (including organizations that are not incorporated but that provide for a representative or manager, and excluding corporations that are established under foreign law or regulation and other foreign organizations);

(ii) The organization is not one whose designation as a designated dispute resolution organization has been revoked and five years have yet to elapse since the date of that revocation, or the organization is not one whose designation pursuant to another law as being an organization determined by Cabinet Order to be involved in services corresponding to services for dispute resolution, etc. has been revoked and five years have yet to elapse since the date of that revocation;

(iii) The organization is not one that has violated a provision of this law or the Attorneys Act or a foreign law or regulation that corresponds to these and has been sentenced to a fine (including a penalty under a law or regulation of a foreign country that is equivalent to this) where five years have not elapsed since the date of execution of such penalty, or from the date on which the said person became no longer subject to execution of the same;

(iv) An organization that, among its officers, does not have a person who falls under certain grounds for disqualification (including, in an organization that is not a corporation, a

representative or manager who is appointed as representative or manager);

(v) An organization that has the accounting and technical basis necessary to implement dispute resolution services in an appropriate manner;

(vi) An organization whose officer and employee composition will not risk bringing about an obstacle to the fair implementation of services for dispute resolution, etc.;

(vii) An organization whose regulations concerning the implementation of services for dispute resolution, etc. (business regulations) are in compliance with laws and regulations, and are sufficient for the fair and appropriate implementation of services for dispute resolution, etc. pursuant to the provisions of this law; and

(viii) An organization regarding which, as a result of the hearing of opinions, the ratio of the number of businesses operators connected with financial instruments trading who raised objections to matters concerning the cancellation of basic contracts for implementation of dispute resolution procedures and the other contents of basic contracts for implementation of dispute resolution procedures and other contents of the business regulations, to the total number of businesses operators connected with financial instruments trading comprises a ratio that is equal to or less than the ratio that is prescribed by Cabinet Order. The Cabinet Order prescribes the ratio as one-third (FIEAEO, art. 19-8).

If the Prime Minister intends to designate a dispute resolution organization, the Prime Minister must first consult with the Minister of Justice as to whether the organization falls under the conditions listed in items (v) through (vii) above (FIEA, art. 156-39, para. 3).

Also, if the Prime Minister has designated a dispute resolution organization, the designated dispute resolution organization's trade name or firm name and the location of its main business office or office, the classification of dispute resolution, etc., services related to the relevant designation, as well as the date on which the designation was made must be published in the Official Gazette (*id*., para. 5).

(2) Application for Designation

A person who intends to apply for designation must first explain the details of the business regulations to businesses connected with financial instruments trading and ask their opinions as to whether or not they have any objection to those business regulations (if there is an objection, including the reason for the objection) and prepare a document that states the results thereof as prescribed by Cabinet Office Ordinance (FIEA, art. 156-39, para. 2; Designated Dispute Resolution Ordinance, art. 3).

Also, a person who intends to obtain designation for a dispute resolution organization must submit to the Prime Minister a form applying for designation which states prescribed matters (FIEA, art. 156-40, para. 1; Designated Dispute Resolution Ordinance, art. 4).

Prescribed documents must be attached to the form applying for designation (FIEA, art. 156-40, para. 2; Designated Dispute Resolution Ordinance, art. 5).

(3) Duty of Confidentiality, Etc.

No person who is, or has been, a dispute resolution mediator or officer or employee of a designated dispute resolution organization shall divulge or use for his own interests information that the person came to know in connection with dispute resolution, etc. services (FIEA, art. 156-41, para. 1).

Moreover, for the purpose of applying the Penal Code or other penal provisions a person who engages in dispute resolution, etc. services and who is a dispute resolution mediator or officer or employee of a designated dispute resolution organization is regarded as an employee engaged in public service pursuant to the provisions of laws and regulations (*id*., para. 2).

9 3 Business of Designated Dispute Resolution Organizations

(1) Business Regulations, Etc.

A designated dispute resolution organization must conduct dispute resolution, etc. as prescribed by the FIEA and the business regulations (FIEA, art. 156-42, para. 1).

A designated dispute resolution organization (including a dispute resolution mediator) may receive compensation in connection with the dispute resolution, etc. that it carries out such as dues or fees pursuant to the provisions of a basic contract for implementation of dispute resolution procedures or another agreement that it has entered into with a party who is a member person or firm involved in financial instruments transactions (meaning the business operator related to financial instruments transactions that is the other party to the basic contract for implementation of dispute resolution procedures that was entered into) or that party's customer (including certain rights holders other than customers who are concerned with the investment management business) or with other persons (*id*., para. 2).

Also, a designated dispute resolution organization may not contract services for complaint processing procedures or dispute resolution procedures to a party other than another designated dispute resolution organization or a person who has been designated pursuant to the provisions of another law and has been prescribed by Cabinet Order as a person involved in services that correspond to dispute resolution, etc. (a contract dispute resolution organization) (FIEA, art. 156-43).

Designated dispute resolution organizations must establish business regulations concerning the following listed matters (FIEA, art. 156-44, para. 1; Designated Dispute Resolution Ordinance, art. 6):

(i) Matters concerning the content of the basic contract for implementation of dispute resolution procedures;
(ii) Matters concerning the execution of the basic contract for implementation of dispute resolution procedures;
(iii) Matters concerning implementation of the dispute resolution, etc.;
(iv) Matters concerning dues borne by a member person or firm involved in financial instruments transactions for costs necessary for the dispute resolution, etc.;
(v) Matters concerning the relevant fees if fees are collected in connection with the implementation of dispute resolution, etc. from a member person or firm involved in financial instruments transactions that is a party or a customer thereof (a party);
(vi) Matters concerning coordination with other designated dispute resolution organizations and other national government agencies, local government agencies, private businesses, and other persons who consult, process complaints, or perform dispute resolution;
(vii) Matters concerning the processing of complaints concerning dispute resolution, etc.; and

(viii) Matters prescribed by Cabinet Office Ordinance as necessary for the performance of dispute resolution, etc., in addition to the matters set forth in items (i) through (vii) above.

Under the finance ADR system detailed provisions are not made in the law for complaint processing and dispute resolution procedures, and the concrete details of these matters are to be provided in the business regulations and the basic contact for implementation of dispute resolution procedures and the like, in order to respect the independence of the designated dispute resolution organizations, and to enable the flexible reflecting of the results of practical approaches in respect to finance ADRs. Also, the approach of financial institutions to a finance ADR is regulated through the basic agreement for implementation of procedures.

The basic contract for implementation of dispute resolution procedures provides that a designated dispute resolution organization may, upon request from a customer of a party who is a member person or firm involved in financial instruments transactions, investigate the status of performance of the obligations provided for in the settlement through the dispute resolution procedures, and recommend the member person or firm involved in financial instruments transactions to perform such obligations (FIEA, art. 156-44, para. 2, item 11; Designated Dispute Resolution Ordinance, art. 7).

(2) Complaint Processing Procedures and Dispute Resolution Procedures

Designated dispute resolution organizations must endeavor to provide information and to provide advice and other support to member persons or firms involved in financial instruments transactions and other persons, in order to prevent complaints and disputes related to financial instruments service as well as to facilitate the processing of complaints and the resolution of disputes related to financial instruments service (FIEA, art. 156-45, para. 2).

Also, if there is a request for resolution of a complaint related to financial instruments service from a customer of a member person or firm involved in financial instruments transactions, the designated dispute resolution organization must consult with and provide necessary advice to the relevant customer, and together with investigating the circumstances involved with the relevant complaint related to financial instruments service, the designated dispute resolution organization must notify the relevant member person or firm involved in financial instruments transactions of the details of the relevant complaint related to financial instruments service, and must demand rapid processing of the complaint (FIEA, art. 156-49).

Parties may petition for dispute resolution procedures to a designated dispute resolution organization in order to try to settle a dispute related to financial instruments service that involves a member person or firm involved in financial instruments transactions (FIEA, art. 156-50, para. 1). If a designated dispute resolution organization receives a petition for dispute resolution procedures, it will appoint a dispute resolution mediator (*id*., para. 2) to the dispute resolution procedure, and the dispute resolution mediator will advise the parties to accept settlement proposals or present special mediation proposals (*id*., para. 6).

However, the dispute resolution mediator shall not to carry out the dispute resolution procedure if the dispute resolution mediator finds that it is not appropriate to conduct dispute resolution procedures or finds that a party petitioned for dispute resolution without good reason and for an unfair purpose (FIEA, art. 156-50, para. 4, *proviso*).

The member person or firm involved in financial instruments transactions must accept a special mediation proposal presented by the dispute resolution mediator, except where the user side does not accept, a lawsuit is filed, a lawsuit that was filed cannot be withdrawn, or otherwise where the matter is settled (FIEA, art. 156-44, para. 6).

A designated dispute resolution organization must retain the records on the implementation of procedures for

at least 10 years from the date the dispute resolution procedures it has implemented has been completed (Designated Dispute Resolution Ordinance, art. 13, para. 1).

Dispute resolution mediator shall be appointed from among persons with upright character and great judgment who fall under either of the following (FIEA, art. 156-50, para. 3):

(i) An attorney-at-law who has engaged in his/her profession for a total of at least five years;

(ii) A person who has engaged in financial instrument trading business, etc. for a total of at least ten years;

(iii) A person provided by Cabinet Office Ordinance as a person who has specialist knowledge and experience regarding matters concerning consumer affairs such as consultations involving complaints that arise between consumers and businesses concerning consumer affairs;

(iv) If the relevant petition is one that involves a dispute as provided in Article 3, Paragraph 1, Item 7 of the Judicial Scrivener Act, a judicial scrivener as provided in Paragraph 2 of that Article who has engaged for at least a total of five years in summary court legal representation service and the like as provided in the said Paragraph; or

(v) A person provided by Cabinet Office Ordinance as being commensurate to those persons listed in items (i) through (iv) above (the Cabinet Office Ordinance provides a person holding the one or multiple positions from among a judge, assistant judge, attorney-at-law, professor or associate professor majored in law for a total period of 5 years or more, a person holding one or multiple positions from among a certified public accountant, certified tax accountant, professor or assistant professor majoring in economics or commerce for a total period of 5 years or more, a person who has engaged in the business of processing complaints related to the financial instruments service, or the investigation, guidance, recommendation, formulation of rules and other activities necessary for ensuring customer protection at a corporation conducting the business of processing complaints related to the financial instruments service for a period of 10 years or more, or a person deemed by the Commissioner of the Financial Services Agency as having the same or higher level of knowledge and experience as the persons above).

However, in order to secure the impartiality and fairness of the dispute resolution procedure, at least one dispute resolution mediator must be a person as provided in either (i) or (iii) above (if it is a case that involves a dispute as provided in (iv), a person who falls under either (i), (iii), or (iv)).

Also, provisions must be made in the business regulations for the method for appointing dispute resolution mediators and the method of excluding dispute resolution mediators who have interests in the matter (FIEA, art. 156-44, para. 4, item 2).

Provisions are established for tolling the statute of limitations (FIEA, art. 156-51) and the suspension of litigation procedures (FIEA, art. 156-52) for dispute resolution procedures.

9 4 Supervision of Designated Dispute Resolution Organizations

(1) Notifications, Etc.

A designated dispute resolution organization must notify the Prime Minister if there is a change to its trade name or firm name, the name and location of its main business office or offices and other business offices or offices at which dispute resolution, etc. services are conducted, or the personal name or trade name or firm name of its officers (FIEA, art. 156-55, para. 1).

If there has been a notification of the change of a dispute resolution organization's trade name or firm name or a change in the location of its main business office or office, the Prime Minister must publish this in the Official Gazette (*id*., para. 2).

A designated dispute resolution organization must notify the Prime Minister as prescribed by Cabinet Office Ordinance (i) if it enters into a basic contract for implementation of dispute resolution procedures with a business operator related to financial instruments trading or if it ends the relevant basic contract for implementation of dispute resolution procedures, and (ii) as otherwise provided by Cabinet Office Ordinance (FIEA, art. 156-56; Designated Dispute Resolution Ordinance, art. 14). Moreover, a designated dispute resolution organization must prepare and submit to the Prime Minister a report for each business year concerning dispute resolution, etc. services relating to the relevant business year (FIEA, art. 156-57; Designated Dispute Resolution Ordinance, art. 15).

A designated dispute resolution organization must obtain the approval of the Prime Minister if it wishes to suspend or discontinue all or part of its dispute resolution, etc. services (FIEA, art. 156-60, para. 1).

(2) Order to Improve Business Operations

If the Prime Minister determines it to be necessary in order to secure the fair and appropriate performance of dispute resolution, etc., services in connection with the operation of dispute resolution, etc., and services by a designated dispute resolution organization, the Prime Minister may, to the extent necessary, order the relevant designated dispute resolution organization to take necessary measures to improve its business operations (FIEA, art. 156-59, para. 1).

In such case, the Prime Minister must first consult with the Minister of Justice (*id*., para. 2).

(3) Supervisory Action

If a designated dispute resolution organization falls under any of the following items, the Prime Minister may revoke the designation of the relevant dispute resolution organization or order a suspension of its business either in whole or in part for a period of not more than six months (FIEA, art. 156-61, para. 1):

(i) If the designated dispute resolution organization comes to fall under a ground for refusal of designation, or if it becomes clear that it fell under a ground for refusal of designation from the start;
(ii) If the designated dispute resolution organization obtained its designation by improper means; or
(iii) If the designated dispute resolution organization is in violation of a law or regulation or a disposition based on a law or regulation.

However, the Prime Minister must consult in advance with the Minister of Justice if the Prime Minister intends to issue a disposition or order (*id*., para. 2).

An organization whose designation has been revoked or that has been ordered to suspend its operations in whole or in part must give notification of the relevant action or order within two weeks of the day of the relevant action or order the parties for which complaint processing procedures or dispute resolution procedures were implemented on the day of the relevant action or order, member person or firm involved in financial instruments transactions other than the relevant parties, and other designated dispute resolution organizations (FIEA, art. 156-61, para. 3).

If the Prime Minister has revoked the designation, the Prime Minister must publish that in the Official Gazette (*id*., para. 4).

(4) Collection of Reports and Inspections

If the Prime Minister determines it to be necessary for the fair and appropriate performance of dispute resolution, etc. services, the Prime Minister may order a designated dispute resolution organization to submit reports or materials concerning its business, or the Prime Minister may have the Prime Minister's officials enter a designated dispute resolution organization's business office, office, or other facility and ask questions concerning the business circumstances of the relevant dispute resolution organization or inspect its books and papers and other property (FIEA, art. 156-58, para. 1).

Also, if the Prime Minister determines it to be necessary for the fair and appropriate performance of dispute resolution, etc. services, the Prime Minister may, to the extent necessary, order a designated dispute resolution organization's member person or firm involved in financial instruments transactions or organizations that have been contracted work by the relevant designated dispute resolution organization to submit reports or materials that should be of reference concerning the relevant designated dispute resolution organization's business, or the Prime Minister may have the Prime Minister's officials enter these parties' business offices, offices or other facilities and ask questions concerning the business circumstances of the relevant dispute resolution organization or inspect the books and papers and other property of these parties (id., para. 2).

10 Trade Repositories, Etc.

10 1 Significance

Upon the recent financial crisis, in Europe and the U.S., because financial institutions were conducting huge quantities of over-the-counter derivatives transactions as negotiated deals, and the information of risk evaluation concerning individual transactions and the retention and accumulation of such information were not conducted properly, there were concerns on the bankruptcy, etc. of individual transaction parties which increased the concerns on the counterparty risk concerning over-the-counter derivatives transactions as well as concerns regarding systemic risk of financial institutions surfaced amidst the lack of transparency in the over-the-counter derivative market. Also, the supervisory authorities were unable to fully understand the actual conditions of the transaction,

and had difficulty in taking necessary measures.

Based on these points, the amendments in 2010 introduced the system for retaining and reporting transaction information to enhance the regular monitoring of over-the-counter transactions of derivatives by the authorities as well as enabling prompt and appropriate measures upon a crisis and enhancing the transparency and predictability of the market through providing a part of the information to the market by the authorities.

10 2 Obligating the Use of Clearing Organizations Concerning Over-the-Counter Transactions of Derivatives, Etc.

A financial instruments business operator, etc. must have the person provided for in each of the following items bear the obligation of the financial instruments business operator, etc. and its counterparty upon conducting the transactions set forth below (FIEA, art. 156-62):

> The use of a clearing organization has become mandatory with respect to certain transactions which are large in transaction scale in Japan and which the reduction of settlement risk by centralized clearing is considered necessary for stabilizing the Japanese market.

(1) Among over-the-counter transactions of derivatives and other transactions, transactions which the default of the obligations under such transaction may have a significant impact on the capital markets of Japan in light of the transaction volume and other circumstances of the transaction, and which are provided by Cabinet Office Ordinance as being necessary to be cleared in Japan in consideration of its characteristics.... a financial instruments clearing organization

(2) Among over-the-counter transactions of derivatives and other transactions, transactions provided for by Cabinet Office Ordinance which the default of the obligations under such transaction may have a significant impact on the capital markets of Japan in light of the transaction volume and other circumstances of the transaction.... a financial instruments clearing organization (if the financial instruments clearing organization conducts the business activities of coordinated financial instruments obligations assumption service, including a coordinated clearing organization, etc.) or a foreign financial instruments clearing organization

The specific transactions that fall under this category are prescribed to be designated by the Commissioner of Financial Services Agency on the “Public notice on specifying the transactions to be designated by the Commissioner of the Financial Services Agency as prescribed in Article 1, Paragraphs 1 and 2 of the Cabinet Office Ordinance on Restrictions on Over-the-Counter Derivatives Transactions, Etc.” (OTC Derivatives Ordinance, art. 2, para. 1 and para. 2).

10 3 Provision of Trade Data

A financial instruments clearing organization, etc. (meaning a financial instruments clearing organization or a foreign financial instruments clearing organization) must provide data on centrally cleared trades to a trade repository or a designated foreign trade repository in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 156-63, para. 1; OTC Derivatives Ordinance, art. 3, para. 1). However, if it is impossible to provide data on centrally cleared trades due to a disaster or for any other compelling reason specified by Cabinet Office Ordinance; a financial instruments clearing organization, etc. must prepare and retain records concerning matters provided for by Cabinet Office Ordinance with respect to data on centrally cleared trades, and report the data on centrally cleared trades it retains to the Prime Minister in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 156-63, para. 2; OTC Derivatives Ordinance, art. 3-2 and art. 4, para. 1).

The term “trade data” means information regarding transactions prescribed by Cabinet Office Ordinance as those for which it is necessary to clarify the circumstances of the transactions of a financial instruments business operator, etc. for investor protection. The term “data on centrally cleared trades” means trade data that is information concerning the transactions for which the financial instruments clearing organization, etc. has assumed the obligations and that is related to transactions provided for in the items under Article 156-62 of the FIEA or other transactions prescribed by Cabinet Office Ordinance in consideration of the circumstances, etc. of transactions (FIEA, art. 156-63, para. 3; OTC Derivatives Ordinance, art. 6 and art. 6-2).

A financial instruments business operator, etc. must provide trade data other than data on centrally cleared trades to a trade repository or a designated foreign trade repository in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 156-64, para. 1; OTC Derivatives Ordinance, art. 7, para. 1). However, if it is impossible to provide trade data other than data on centrally cleared trades due to a disaster or for any other compelling reason specified by Cabinet Office Ordinance, a financial instruments business operator, etc. must prepare and retain records concerning matters provided for by Cabinet Office Ordinance with respect to trade data other than data on centrally cleared trades, and report the trade data other than data on centrally cleared trades it retains to the Prime Minister in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 156-64, para. 2; OTC Derivatives Ordinance, art. 7-2, art. 8, and art. 9).

10 4 Retention and Reporting of Trade Data by Trade Repositories

A trade repository must prepare and retain records concerning matters provided for by Cabinet Office Ordinance with regard to trade data provided thereto pursuant to the provisions of Article 156-63, Paragraph 1 and Article 156-64, Paragraph 1 of the FIEA (FIEA, art. 156-65, para. 1; OTC Derivatives Ordinance, art. 10). In addition, a trade repository must report the trade data it retains to the Prime Minister in the manner prescribed by Cabinet Office Ordinance pursuant to the provisions of Article 156-65, Paragraph 1 of the FIEA (FIEA, art. 156-65, para. 2; OTC Derivatives Ordinance, art. 11, para. 1 to para. 4). However, if a trade repository, instead of making such a report, has taken measures by which the Prime Minister makes the trade data subject to reporting under that paragraph available for inspection by a method of using an electronic data processing system and which are specified by Cabinet Office Ordinance, the trade repository is deemed to have made the report (FIEA, art. 156-65,

para. 3; OTC Derivatives Ordinance, art. 11, para. 5 and para. 6).

With respect to transactions covered by the trade data subject to reporting under Article 156-65, Paragraph 2 of the FIEA; a trade repository must publicly announce the scale and other matters prescribed by Cabinet Office Ordinance in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 156-66, para. 1; OTC Derivatives Ordinance, art. 11-2).

With respect to transactions covered by the trade data reported under Article 156-63, Paragraph 2 and Article 156-64, Paragraph 2 of the FIEA, the Prime Minister is to publicly announce the scale and other matters considered necessary to clarify the outline of such transaction (FIEA, art. 156-66, para. 2).

10 5 Designation of Persons Conducting Trade Repository Business

(1) Criteria for Designation

The Prime Minister may designate as a person conducting the trade repository business a person meeting the following criteria upon application from the said person (FIEA, art. 156-67, para. 1):

(i) That it is a juridical person (including an unincorporated group with a provision on the representative or administrator, and excluding corporations incorporated under the laws of a foreign country or other groups of a foreign country);
(ii) That it has not lost the designation as a trade repository and for whom five years have yet to expire from the date of the said revocation;
(iii) That it has not violated the provisions of the FIEA or the laws of a foreign country equivalent to the FIEA and been sentenced to penalty (or a sentence equivalent thereto under the laws of a foreign country), and for whom five years have yet to expire from the date of completion of the said sentence or the date on which the said person became no longer subject to execution of the same;
(iv) That no officer (including the representative or administrator of an unincorporated group with a provision on the representative or administrator) falls under the prescribed disqualification causes;
(v) That it possesses financial basis sufficient to soundly perform the trade repository business, and that its prospect for income and expenditure concerning the trade repository business is good; and
(vi) That it has knowledge and experience to appropriately and securely perform the trade repository business, and is considered to have sufficient social credibility in light of its personnel composition.

The Prime Minister shall publicly announce in the official gazette the trade name or firm name of the trade repository and the location of the main business office or office and the date of designation upon making a designation pursuant to the provisions of Article 156-67, Paragraph 1 of the FIEA (FIEA, art. 156-67, para. 2).

(2) Application for Designation

A person wishing to be designated as a trade repository must submit an application for designation stating certain matters to the Prime Minister (FIEA, art. 156-68, para. 1).

In addition, certain documents must be attached to the application for designation (FIEA, art. 156-68, para. 2; OTC Derivatives Ordinance, art. 12).

A trade repository must notify the Prime Minister of any changes in certain matters stated in the application for designation (FIEA, art. 156-77, para. 1).

The Prime Minister must publicly announce in the official gazette upon receiving any notice of change in the trade name or firm name, or the location of the main business office or office (*id*., para. 2).

10 6 Restriction of Concurrent Positions and Confidentiality

Unless authorized by the Prime Minister, the representative of a trade repository and officers engaged in daily business must not become the representative of a financial instruments business operator, etc. or other corporation prescribed by Cabinet Office Ordinance or engage in daily business thereof, or engage in the financial instruments business or other businesses prescribed by Cabinet Office Ordinance (FIEA, art. 156-69; OTC Derivatives Ordinance, art. 13 and 14).

An officer or an employee or a former officer or employee of a trade repository must not divulge secrets it has come to know with respect to the trade repository business, or plagiarize the same (FIEA, art. 156-70).

10 7 Businesses of Trade Repository

A trade repository shall conduct the trade repository business as prescribed by the provisions of Chapter 5-6, Section 3 of the FIEA and the business regulations (FIEA, art. 156-71).

A trade repository must prepare business regulations concerning the following matters on the trade repository business and obtain the authorization of the Prime Minister. The same applies to amendments thereof (FIEA, art. 156-74, para. 1 and par. 2; OTC Derivatives Ordinance, art. 19):

(1) Matters concerning the execution of an agreement to receive the provision of trade data (hereinafter the “contract for trade data collection”) with a financial instruments clearing organization, etc. or financial instruments business operator, etc.;
(2) Matters concerning transactions subject to the trade repository business;
(3) Matters concerning the collection and retention of trade data;
(4) Matters concerning the prevention of leakages, loss or damages to trade data and other matters concerning the safe management of trade data;
(5) Matters concerning the ensuring of the accuracy of trade data;
(6) Matters concerning the fee (the fee regarding the trade repository business must be fair and accurate in light of a fair cost under efficient management of business);

(7) If outsourcing a part of the trade repository business to another party, matters concerning measures the proper and secure performance of the business outsourced; and

(8) Other matters prescribed by Cabinet Office Ordinance as matters necessary for the implementation of the trade repository business.

If the Prime Minister considers that the business regulations he/she has approved has become inappropriate for the proper and secure implementation of the trade repository business, he/she may order the trade repository to amend its business regulations (FIEA, art. 156-74, para. 3).

In addition, a trade repository shall not treat a specific financial instruments clearing organization, etc. or financial instruments business operator, etc. in an unjustifiable discriminative manner (FIEA, art. 156-75).

10 8 Restriction of Concurrent Business

A trade repository may not conduct business other than the trade repository business and businesses associated therewith (FIEA, art. 156-72, para. 1, text). However, this shall not apply if the approval of the Prime Minister has been obtained in the manner prescribed by Cabinet Office Ordinance with respect to businesses which are unlikely to impede the proper and secure implementation of the trade repository business by the trade repository (*id.*, *proviso*, OTC Derivatives Ordinance, art. 15).

A trade repository handles trade data regarding the business secrets of financial instruments business operators, etc. and is expected to perform important roles such as the retention, reporting and public announcement of trade data for ensuring the improvement of the transparency of the market. Accordingly, it is necessary to prevent it from becoming unable to continue the trade repository business due to the management deterioration of other businesses.

A trade repository must notify the Prime Minister in the manner prescribed by Cabinet Office Ordinance when it begins the approved business above (FIEA, art. 156-78, para. 1).

10 9 Outsourcing of a Part of the Trade Repository Business

A trade repository may outsource a part of the trade repository business to another party upon obtaining approval of the Prime Minister in the manner prescribed by Cabinet Office Ordinance (FIEA, art. 156-73, para. 1, OTC Derivatives Ordinance, art. 17).

A person who has been outsourced the trade repository business may sub-outsource a part of such business to another party upon obtaining the consent of the outsourcing trade repository (FIEA, art. 156-73, para. 2).

Such person may sub-outsource a part of the trade repository to another party upon obtaining the consent of the initial outsourcer and the second outsourcer (*id.*, para. 3).

10 10 Supervision on Trade Repository

(1) Submission of Reports Regarding the Business and Assets

A trade repository must prepare and submit to the Prime Minister for each business year a report concerning the business and assets for that business year (FIEA, art. 156-79, para. 1).

The matters to be stated in the report, the due date of submission and other matters necessary with respect to the preparation and submission of the report are prescribed by Cabinet Office Ordinance (*id*., para. 2, OTC Derivatives Ordinance, art. 21).

(2) Collection of Reports and Inspections

The Prime Minister may, if he considers it necessary and appropriate for public interest or investor protection, order a trade repository, a person who has executed a contract for trade data collection with the trade repository or an outsourcee pursuant to the provisions of each Paragraph of Article 156-73 of the FIEA to submit report or materials that are of reference regarding the business or assets of the trade repository, or its officials to inspect the status of business or financial standing or books and documents or other items of the trade repository or the outsourcee under each Paragraph of the said Article (with respect to the outsourcee under each Paragraph of the said Article, limited to inspections necessary with respect to the business or assets of the trade repository) (FIEA, art. 156-80).

(3) Business Improvement Orders

If the Prime Minister considers it necessary and appropriate for public interest or investor protection with respect to the status of business or the financial standing of the trade repository business of the trade repository, the Prime Minister may order the trade repository to take measures necessary for the improvement of the management of its business or the financial standing to the extent necessary (FIEA, art. 156-81).

(4) Revocation of Designation, Etc.

If a trade repository falls under any of the following, the Prime Minister may revoke the designation or approval of the trade repository, order the suspension of all or a part of its business for a fixed term of 6 months or less, or order the dismissal of its officers (FIEA, art. 156-83, para. 1):

(i) In the event it falls under a cause for refusal of designation as a trader repository, or in the event it becomes clear that it had fallen under the cause for refusal of designation from the beginning;
(ii) In the event it has obtained the designation as a trade repository through fraudulent means; or
(iii) In the event it is in violation of laws and regulations or disciplinary action pursuant to laws and regulations.

The Prime Minister must make a public announcement in the official gazette if it has revoked the designation of a trade repository (*id*., para. 2).

(5) Order for Transfer of Trade Repository Business

If a trade repository falls under any of the following, the Prime Minister may order the trade repository to have all or a part of the trade repository business conducted by another trade repository (FIEA, art. 156-84, para. 1).

In such case, the Prime Minister must make a public announcement thereof in the official gazette (*id*., para. 2):

(i) Upon revoking the designation of a trade repository or ordering the suspension of all or a part of its business (limited to the trade repository business);
(ii) Upon authorizing the cessation or abolition of the trade repository business;
(iii) In the event there are any potential circumstances under which the repayment of debts due may be of significant hindrance to the continuance of the trade repository business or any facts may arise which shall be the cause of commencing bankruptcy proceedings; or
(iv) In the event it becomes difficult for the trade repository to implement all or a part of the trade repository business due to force majeure or other causes.

Since a financial instruments business operator using a trade repository is exempted from the obligation to retain and report trade data, the Prime Minister will become unable to obtain necessary trade data in the event a trade repository ceases or abolishes its business.

Accordingly, these measures have been set to transfer the trade repository business to another trade repository in advance.

11 Regulations on Specified Financial Benchmark Administrators

11-1 Significance

Financial indicators are generally used for calculating the basic interest rate for loans and the amount payable in derivatives transactions and also for calculating the value of securities. Thus, as the basis for financial transactions, they play an important role in financial and capital markets.

Conventionally, an act of calculating such financial indicators had not been subject to regulation. However, following the incident of manipulation of LIBOR (London Interbank Offered Rate), discussions were initiated on a global level for the introduction of public regulations on such act.

Along with this trend, the necessity to build a public regulatory framework was recognized in Japan as well with a view to strengthening the governance over financial benchmark administrators and improving the transparency of the calculation process. Accordingly, regulations on specified financial benchmark administrators were introduced via the 2014 amendment to the FIEA.

11 2 Definition of Specified Financial Indicator

The term "specified financial indicator" means a financial indicator specified by the Prime Minister as that which, in light of the mode of the derivatives transactions or transactions of securities pertaining to the said financial indicator, could have a material impact on Japan's capital market if its reliability declines (FIEA, art. 2, para. 40).

Based on this definition, not all financial indicators calculated in Japan are subject to regulations, but such a financial indicator which is widely used as the basis for financial transactions in Japan, such as a reference index for a derivatives transaction, and which could have a material impact on Japan's capital market if its reliability declines, should be designated as the subject of regulations. Specifically, TIBOR (Tokyo Interbank Offered Rate) has been designated as such a subject indicator, and Japanese Yen TIBOR and Euroyen TIBOR have been selected as specified financial indicators.

11 3 Designation of Specified Financial Benchmark Administrator

(1) Designation by the Prime Minister

When the Prime Minister finds that securing appropriate performance of specified financial indicator calculation business (meaning the business of calculating and publicizing specified financial indicators) conducted by a person engaged in specified financial indicator calculation business is necessary for the public interest or protection of investors, the Prime Minister may designate the said person as a specified financial benchmark administrator (FIEA, art. 156-85, para. 1).

When the Prime Minister makes designation under the provision of the preceding paragraph, the Prime Minister must give written notice to that effect and of the name of the specified financial indicator(s) subject to the designation to the specified financial benchmark administrator (FIEA, art. 156-85, para. 2).

However, the Prime Minister shall not make such designation when a person engaged in specified financial indicator calculation business is a person specified by Cabinet Office Ordinance as a person who is found to be under appropriate supervision with respect to its specified financial indicator calculation business by a foreign administrative organization or any other equivalent organization based on foreign laws and regulations (FIEA, art. 156-85, para. 6), in which case it is less necessary to apply regulations under the FIEA.

At present, JBA TIBOR Administration serves as a specified financial benchmark administrator.

(2) Public Notice via Official Gazette

When the Prime Minister makes a designation, the Prime Minister must give public notice of the trade name or name and the location of the head office or principal business office or office of the specified financial benchmark administrator (in the case of a foreign person who has a business office or office in Japan, including the location of its principal business office or office in Japan), and the name of the specified financial indicator(s) subject to the designation in the official gazette (FIEA, art. 156-85, para. 3). The same applies in the event of any changes in the foregoing matters.

(3) Submission of Documents

A specified financial benchmark administrator shall submit a document to the Prime Minister in which it states the following particulars, within the period specified by Cabinet Order from the day it became subject to designation (FIEA, art. 156-86, para. 1; FIEAEO, art. 19-10; Financial Benchmark Ordinance, art. 3):

(i) Its trade name or name;
(ii) The amount of capital or total contribution, if it is a corporation;
(iii) The names of its officers, if it is a corporation;
(iv) The name and location of its head office, principal business office or principal office;
(v) If it engages in other business, the business type; and
(vi) The name of its representative or administrator if it is an organization without legal personality for which a representative or administrator has been designated.

The abovementioned document must be accompanied by the articles of incorporation, the certificate of registered information, and other documents specified by Cabinet Office Ordinance (FIEA, art. 156-86, para. 2; Financial Benchmark Ordinance, art. 4). However, if the articles of incorporation have been prepared as electronic or magnetic records, such electronic or magnetic records (limited to those specified by Cabinet Office Ordinance) may accompany that document in lieu of written documents (FIEA, art. 156-86, para. 3; Financial Benchmark Ordinance, art. 5). If any of the particulars set forth in (i) to (vi) changes, the specified financial benchmark administrator must notify the Prime Minister of this, pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 156-86, para. 4; Financial Benchmark Ordinance, art. 6).

11 4 Operational Rules

A specified financial benchmark administrator must formulate operational rules concerning specified financial indicator calculation business pursuant to the provisions of Cabinet Office Ordinance and obtain authorization from the Prime Minister within the period specified by Cabinet Order from the day of receiving designation (FIEA, art. 156-87, para. 1; FIEAEO, art. 19-11). The operational rules must provide for the following matters and any other matters specified by Cabinet Office Ordinance (FIEA, art. 156-87, para. 2; Financial Benchmark Ordinance, art. 9, para. 1):

(i) Matters concerning the policy and method of calculation and publication of specified financial indicators;
(ii) Matters concerning the operational control system for the proper performance of specified financial indicator calculation business;
(iii) Rules to be observed by a person who provides calculation basis data (data provider) (the “code of conduct”);
(iv) Matters concerning the conclusion of a contract (including a contract pertaining to the code of conduct) with a data provider;
(v) Matters concerning entrustment of specified financial indicator calculation business;
(vi) Matters concerning audits pertaining to specified financial indicator calculation business;
(vii) Matters concerning public inspection of explanatory documents pertaining to specified financial indicator calculation business; and

(viii) Matters concerning suspension or discontinuation of specified financial indicator calculation business.

The primary function of the operational rules is to make it a statutory obligation for specified financial benchmark administrators to comply with the IOSCO principles. The Cabinet Office Ordinance specifies the matters to be included in specified financial benchmark administrators' operational rules in accordance with the IOSCO Principles.

The IOSCO Principles provide for the specific matters that calculation agents of financial indicators, or "financial benchmark" as referred to in the IOSCO principles, should comply with in terms of: (i) governance (primary responsibility for the benchmark determination process, and identification, disclosure, management, mitigation or avoidance of conflicts of interest); (ii) quality of the benchmark (hierarchy of data inputs, establishment and publication of guidelines regarding the exercise of expert judgment); (iii) quality of the methodology (publication of the methodology used to make benchmark determinations, development and publication of the submitter code of conduct); and (iv) accountability (appointment of an independent internal or external auditor, retention of records, submission of documents to the regulatory authority). The obligation of specified financial benchmark administrators to prepare and comply with operational rules constitutes the core of the regulations.

Authorization for operational rules is granted according to the following standards: (i) the operational rules comply with laws and regulations; and (ii) it seems to be possible to secure the proper execution of the specified financial indicator calculation business based on the operational rules in light of the system for execution of the said business (Financial Benchmark Ordinance, art. 10).

When a specified financial benchmark administrator intends to change its operational rules, it must obtain authorization from the Prime Minister (FIEA, art. 156-87, para. 3). After obtaining the authorization for its operational rules, a specified financial benchmark administrator must conduct its specified financial indicator calculation business pursuant to the provisions of the operational rules (FIEA, art. 156-87, para. 4).

11 5 Supervision over Specified Financial Indicator Calculation Agents

The FIEA provides for the following supervisory rules in order to ensure the effective regulations on specified financial benchmark administrators.

(1) Collection of Reports and Inspections

Whenever the Prime Minister finds it to be necessary and appropriate in the public interest or for the protection of investors, the Prime Minister may order a specified financial benchmark administrator or the person that the specified financial benchmark administrator has entrusted with its business (including a person who has received entrustment from such person (including entrustment via two or more layers)), to submit reports or materials that should serve as a reference in connection with the specified financial indicator calculation business, and may have the relevant officials inspect the state of the business, or the books and documents or any other articles, of the specified financial benchmark administrator or the person that the specified financial benchmark administrator has entrusted with its business (but may only have the relevant officials inspect the specified financial benchmark administrator as is necessary in connection with the specified financial indicator calculation business) (FIEA, art. 156-89, para. 1).

Whenever the Prime Minister finds it to be necessary and appropriate in the public interest or for the protection of investors, the Prime Minister, within the scope that is found to be necessary for confirming the accuracy of the calculation basis data provided to a specified financial benchmark administrator, may order the data provider to submit reports or materials that should serve as a reference in connection with the calculation basis data, and may have the relevant officials inspect the state of the business, or the books and documents or any other articles, of the data provider (FIEA, art. 156-89, para. 2).

(2) Improvement Orders, Etc.

If the Prime Minister finds that improvement is needed in connection with operations of a specified financial indicator calculation business, the Prime Minister, within the scope of this necessity, may order the specified financial benchmark administrator to take measures that are necessary for this improvement (FIEA, art. 156-90, para. 1).

If a specified financial benchmark administrator violates a law or regulation or a disposition based on a law or regulation in connection with its specified financial indicator calculation business, the Prime Minister may order the suspension of all or part of its business activities during a fixed period of no longer than six months (FIEA, art. 156-90, para. 2). Irrespective of the category of proceeding for hearing statements of opinion under Article 13, paragraph (1) of the Administrative Procedure Act, before seeking to issue such an order as mentioned above, the Prime Minister must conduct a hearing (FIEA, art. 156-90, para. 4).

If the Prime Minister orders the suspension of all or part of business activities pursuant to the provisions of the preceding paragraph, the Prime Minister shall issue public notice of this in the official gazette (FIEA, art. 156-90, para. 3).

(3) Recommendation to Transfer Business

If a specified financial benchmark administrator seeks to suspend or discontinue its specified financial indicator calculation business or in any other case specified by Cabinet Office Ordinance, the Prime Minister may recommend the specified financial benchmark administrator to have all or part of its specified financial indicator calculation business conducted by another person (FIEA, art. 156-91; Financial Benchmark Ordinance, art. 12).

It would be beneficial for a specified financial indicator to be calculated continuously as long as its reliability is secured. From this viewpoint, the abovementioned rule has been introduced to encourage a specified financial benchmark administrator that seeks to discontinue its business to transfer its business to another agent.

(4) Rescission of Designation and Notification of Suspension or Discontinuation of Business

When the Prime Minister determines that the reason for designation of a specified financial benchmark administrator no longer exists, the Prime Minister must rescind such designation and give written notice to that effect to the specified financial benchmark administrator (FIEA, art, 156-85, para. 4). When having rescinded designation, the Prime Minister must give public notice to that effect in the official gazette (FIEA, art. 156-85, para. 5).

If a specified financial benchmark administrator seeks to suspend or discontinue its specified financial indicator calculation business, it must notify the Prime Minister of this in advance, pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 156-88; Financial Benchmark Ordinance, art. 11).

11 6 Regulations on Data Providers

Regarding data providers who provide calculation basis data to specified financial benchmark administrators, the FIEA requires specified financial benchmark administrators to include in their operational rules the code of conduct that contains rules to be observed by data providers and request compliance therewith (FIEA, art. 156-87, para. 2). Thus, a framework is set in place to regulate data providers not directly but via specified financial benchmark administrators.

12 Regulations Imposed on Acts of Market Abuse (Regulations Against Unfair Trading)

The FIEA contains provisions prohibiting unfair transactions not only simply to ensure that financial instruments transactions, etc. proceed in a fair manner; their main objective is to prevent the breakdown of capital market functions that unfair transactions cause.

The British Financial Services and Markets Act of 2000 also refers to these acts using the general term of "market abuse."

12 1 General Provisions

(1) General Provision Against Unfair Trading (FIEA, art. 157, item 1)

No person shall use wrongful means, schemes or techniques with regard to sales and purchase or other transactions of securities or derivative transactions, etc. This is the general provision concerning unfair transactions, and although its requirements are quite vague, it carries heavy criminal penalties (imprisonment of not more than 10 years or a penal fine of not more than JPY10 million; in the case of juridical persons, a penal fine of not more than JPY700 million, and in the case of an individual with a profit motive, a penal fine of not more than JPY30 million, any properties gained through crimes shall be disgorged or assessed—FIEA, art. 197, para. 1, items 5 and 6 and para. 2, art. 198-2, art. 207, para. 1, item 1) (the same applies in (2) and (3) below).

This is a provision that constitutes a translation of the US Securities and Exchange Commission (SEC) Rule 10b-5. Although criticized for being ambiguous, the Japanese Supreme Court has ruled that the provision is constitutional. In the discussion below, it is necessary to keep in mind that since the utmost priority is placed on achieving the objectives of the law, for an act that severely impairs the market, the general provision is always available even if a regulation on the specific act is lacking, or even when the individual provisions are difficult to apply.

There is a portion of the comprehensive regulation on fraudulent transactions in the following paragraph, and in the event of a fraudulent transaction, the administrative monetary penalty system will apply. It is dangerous to assume that administrative monetary penalty will not be applied under this clause.

Furthermore, some sort of effort will most likely be necessary to specify to the extent possible the transactional types that fall within this provision such as by publishing guidelines, etc.

(2) **Prohibition Against False or Untrue Statements** (FIEA, art. 157, item 2)

No person may acquire money or other property, using a document or other indication which contains false indication on important matters, or lacks indication about important matters necessary for avoiding misunderstanding, with regard to sales and purchase or other transactions of securities or derivative transactions, etc.

(3) **Against Use of False Market Quotations** (FIEA, art. 157, item 3)

No one may use false quotations in order to induce sales and purchase or other transactions of securities or derivative transactions, etc. This is a form of market manipulation by using false quotations.

12 2 Spreading Rumors and Using Fraudulent Means (FIEA, art. 158)

No person shall spread rumor, use fraudulent means, or commit assault or intimidation for the purpose of carrying out a public offering, secondary distribution, sales and purchase or other transaction of securities or derivative transactions, etc. or causing a fluctuation of quotations on securities, etc. (FIEA, art. 158).

Persons who violate this prohibition will be subject to imprisonment for a term not to exceed ten years, a penal fine of not more than JPY10 million (JPY30 million in the case of a profit motive), or both (FIEA, art. 197, para. 1, item 5 and para. 2), and not more than JPY700 million in the case of a corporation (FIEA, art. 207, para. 1, item 1). Properties gained through crimes shall be subject to disgorgement or assessment (FIEA, art. 198-2).

> The 2004 amendments have also imposed an administrative monetary penalty for causing a fluctuation in the market by spreading rumors or using fraudulent means.
>
> Furthermore, through the 2008 amendments, on the idea that even if the laws and regulations do not explicitly require the causal relationship between the act of violation and the market fluctuation, such causal relationship can be presumed externally and reasonably from the effect on the market and the purpose of the act, the requirement of "market fluctuation due to the act of violation" has been amended to "effect on the market through violation," and the amount of administrative monetary penalty has been amended to be calculated not based on the "final profit/loss" but based on the "value of the positions upon the act of violation valued at the highest (lowest) price within one (1) month of the act of violation" (FIEA, art. 173) in order to increase the efficiency of the prevention of the acts of violation.

The section concerning the spreading of rumors for the purpose of causing a fluctuation of quotations is in practice a regulation against market manipulation. Recently, there have been cases exposed where the internet was used to spread rumors.

The provisions dealing with using fraudulent means in trades or other transactions of securities are general provisions, and cases have also been brought in connection with these as well. These prohibitions have functions similar to Article 157, mentioned above (art. 157 of the FIEA has its background in a similar U.S. provision; and this article has been unique to Japan since the Taisho era).

12 3 Market Manipulation (FIEA, art. 159)

Market manipulation artificially warps the price formation in markets related to securities and derivatives transactions, and consequently is strictly prohibited because of its disruption of the market.

If any person is found to have committed market manipulation, they will be subject to imprisonment for a term not exceeding 10 years, a penal fine of not more than JPY10 million, or in the case of a juridical person a penal fine of not more than JPY700 million; when such acts were conducted with a profit-motive, the penal fine for individuals jumps to not more than JPY30 million (FIEA, art. 197, para. 1, item 5 and para. 2 and art. 207, para. 1, item 1). In addition, properties gained through crimes shall be subject to disgorgement or assessment (FIEA, art. 198-2).

Persons who engage in market manipulation must pay damages to persons who incurred a loss thereby (FIEA, art. 160).

Furthermore, the levying of an administrative monetary penalty which was only applicable to market manipulation through actual transactions prior to the 2008 amendments became applicable to fictitious trades and wash trades as well as unlawful stabilization operation transactions (FIEA, art. 174 through art. 174-3).

Pursuant to the amendments in 2012, the provisions concerning market manipulation related to market transactions of derivatives under the FIEA shall also be applied to commodity-related market transactions of derivatives.

Neither damage to the interests of investors nor an objective of earning profits is required in order to establish the crime of market manipulation. Market manipulation is held to occur solely with the intent to artificially distort the fair formation of prices on a market. Although spreading rumors and acts of using false information also constitute market manipulation in the broad sense of the term, our explanation here refers to market manipulation in the narrow sense of the term.

(1) Market Manipulation

(i) Fictitious Trades and Wash Trades (FIEA, art. 159, para. 1)

A fictitious trade (or fictitious sale) is a fake transaction completed for the purpose of misleading others concerning the status of transactions in connection with a trade in listed securities, etc., a market transaction of derivatives or an over-the-counter transactions of derivatives without purpose of transfer of rights or receiving money, etc. (FIEA, art. 159, para. 1, item 1 through item 3).

A wash trade (or wash sale) is an act, committed for the same purpose as that of a fictitious trade, to sell or buy securities, etc. or make an offer for derivatives transaction based on collusion made in advance with another party in which the other party promises to purchase or sell the relevant financial instruments at the same price (or the contracted value in the case of a derivatives transaction) or to accept the offer for the relevant derivative transaction around the same time of the sales or purchase of securities, etc. or offer for derivative transactions (FIEA, art. 159, para. 1, item 4 through item 8).

Intent to distort the market can be found in the fact that, notwithstanding that the substantive investment decision is economically offset and rendered meaningless, wash trades make it appear as though trading is active. The conduct of these transactions is of course prohibited, as well as the entrustment, etc. of such transaction, or the acceptance, etc. of entrustment of such transactions for such

purposes (FIEA, art. 159, para. 1, item 9).

It is normally difficult to come up with a rational explanation for why such transactions were conducted and they are easily found to constitute market manipulation.

(ii) Market Manipulation Through Actual Transactions (FIEA, art. 159, para. 2, item 1)

For the purpose of inducing sales and purchase of securities, market transactions of derivatives or over-the-counter transactions of derivatives (referred to "sales and purchase of securities, etc."), to conduct a series of sales and purchase of securities, etc. or make an offer, entrustment, etc. or accepting an entrustment, etc. therefor that would mislead other persons into believing that sales and purchase of securities, etc. are thriving or would cause fluctuations in prices of listed financial instruments, etc. in a financial instruments exchange market or prices of over-the-counter traded securities in an over-the-counter securities market is prohibited as market manipulation.

With the 2006 amendments to the SEL, "fake positions" (the act of sending an order with no intent to contract, and then canceling the order just when it is about to be executed) in which market manipulation is performed by a securities company making an offer to trade, became prohibited as an act of market manipulation liable to criminal sanction as well as administrative monetary penalty. It has become more likely that an attempt to mount a defense on the grounds that the orders were issued by mistake would not be successful.

Since this provision involves observing a series of trades and making a finding of market manipulation, it is necessary to prove that the party who engaged in the market manipulation had the subjective intent of inducing transactions.

However, in highly liquid markets, where transactions occur frequently, the subjective intent element is inferred based on the external form of the transactions, which make use of extremely complex and intertwined trading techniques. Even in these, persons having a position of market control are able to execute market manipulation without using conspicuous techniques. There is the dilemma that the easier it is to engage in market manipulation, the harder it is to catch.

In a market where trades are concluded only sporadically, even a small movement could warp the price formulation for a security. In these types of cases, the motives surrounding the transactions (new share issue, tender offer, etc.), and other ancillary information (articles recommending the shares in a newspaper, etc.) are the focus of the investigation, and the intent to induce transactions is inferred therefrom.

(iii) Spread of Information Alleging Market Manipulation (FIEA, art. 159, para. 2, item 2)

For the purpose of inducing sales and purchase of securities, etc. to spread a rumor to the effect that prices of listed financial instruments, etc. in a financial instruments exchange market or prices of over-the-counter traded securities in an over-the-counter securities market would fluctuate by his/ her own or other party's market manipulation is also prohibited as a form of market manipulation. It is a wrongful act of market manipulation to use information that an illegal act might occur.

(iv) Market Manipulation Through False Information (FIEA, art. 159, para. 2, item 3)

To intentionally make a false indication or an indication that would mislead other parties with regard to important matters when making sales and purchase of securities, etc., for the purpose of inducing sales and purchase of securities, etc., is prohibited as market manipulation.

(2) Stabilizing Transactions (FIEA, art. 159, para. 3)

A series of sales and purchase of securities, etc. or make offer, entrustment, etc. or accepting an entrustment, etc. therefor for the purpose of pegging, fixing or stabilizing prices of listed financial instruments, etc. in a financial instruments exchange market can be said to be the very meaning of the word market manipulation since such acts artificially distort price formation in the market; however, there are instances where such acts are recognized as emergency relief measures, giving priority to the needs of companies in raising funds. This is called a stabilizing transaction.

The FIEA provides that no persons shall engage in stabilization in violation of the provisions of the Cabinet Order.

In other words, if a large volume of securities flooded the market all at once upon a public offering or secondary distribution, it could cause a break down in the balance of supply and demand, making it difficult to procure funds; therefore stabilizing transactions are permitted under certain conditions.

Only certain persons are permitted to conduct stabilization, and only during a certain period, with mandatory restrictions on price, etc. (FIEAEO, art. 20 through art. 26).

(3) Regulation of Short Selling (FIEA, art. 162)

Offering to sell securities that one does not own lacks the backdrop of the normal investment decision and generally does not constitute a transaction that should participate in price formation. Moreover, since such transactions are apt to be used in market manipulation, conducting such transactions is not acceptable. Additionally, the sale of securities borrowed from another, or the entrustment or acceptance of such sale is subject to the short sale regulations.

However, margin transactions and futures transactions that are standardized and that are established under certain regulatory formalities, and other transactions, are permitted (Securities Transaction Ordinance, art. 10 through art. 15).

As part of FSA's Emergency Market Stabilization Measures in response to the recent financial crisis, measures to prohibit short selling without having conducted borrows at the time of sale (naked short selling) (FIBCOO, art. 117, para. 1, item 24-2 through item 24-5) and to obligate holders of short positions of a certain scale or more to report to the exchange through securities companies (0.2% of the total number of issued shares) as well as causing the exchange to disclose such information (0.5% of the total number of issued shares) have been taken (Securities Transaction Ordinance, art. 15-2 through art. 15-4).

Recently, it often happened that unusual fluctuations in share prices took place around the time of announcement of a capital increase through public offering, in response to which investment funds sold the relevant shares short and made profit. In order to prevent such unfair trading practice, a new regulation has been introduced to prohibit the settlement of short sales made during the period after a public offering or secondary distribution of securities is announced and before the issue price or trading price is determined, via securities acquired through such public offering or secondary distribution (as of January 1, 2011) (FIEAEO, art. 26-6; Securities Transaction Ordinance, art. 15-5 through 15-8).

12 4 Insider Trading

If corporate insiders, such as an officer or employee of a company issuing securities, or persons who are in a position to easily obtain material information in connection with the said company from corporate insiders conduct transactions relating to the company's securities based on the information they obtain by reason of their position before such information is made public (insider trading), these corporate insiders or persons cannot be said to have made investment decisions based on an evaluation of the quality and value of the securities given that they have engaged in these transactions because they have the information that is not known to everyone, that is, by taking advantage of a disparity or a superior position in terms of information. These acts hinder fair price formation on securities markets. The FIEA makes trading of specified securities, etc. and transactions of derivatives (*e.g.,* CDS and other credit derivatives) subject to insider trading regulations, and prohibits conducting insider trading. These transactions in which corporate insiders, etc. are involved fall under the category of insider trading even if a loss is incurred.

With the amendments in 2012, regulations for insider trading occurring in relation to reorganization were set in place. As a result, acquisition of specified securities of listed companies, etc. due to merger or company split has become subject to the insider trading regulations, while certain types of acquisition of shares through a business transfer, merger or company split that are unlikely to be exploited for insider trading are excluded from these regulations.

Under the amendments in 2013, transactions of securities, etc. issued by investment corporations were included in the scope of subjects of insider trading regulations.

(1) Elements of Insider Trading

(i) Corporate Insiders

The following is the extent of corporate insiders (FIEA, art. 166, para. 1):

(a) Officers, agents, employees or other workers (officers, etc.) of the listed company, etc. (an issuer of share certificates, share option certificates, corporate bond certificates, preferred equity investment certificates, or investment securities, investment equity subscription right certificates, investment corporation bond certificates or foreign investment securities prescribed in the ITA, which are listed on a financial instruments exchange, or an issuer of over-the-counter traded securities or handled securities (FIEA, art. 163, para. 1)), including the officers, etc. of a parent company or subsidiary company;

(b) A shareholder or equity member of the listed company, etc. who has the right to inspect the books and records of the listed company, etc. (Companies Act, art. 433, para. 1 and para. 3; including the officers, etc., in case where the shareholder or equity member is a juridical person or an entity similar to a juridical person, and the agent or employees of the shareholder or equity member in the case where the shareholder or equity member is an individual or partnership, etc.);

(c) An investor of the listed company, etc. or an investor that has the right to inspect books and records of the listed company, etc. (including the officers, etc. in the case where such investor is a juridical person, and the agent or employees in the case where such investor

is a person other than a juridical person);

(d) A person who has statutory authority over the listed company, etc., such as licensing authority, authority to make on-site inspections, or authority granted by the National Diet to conduct legislative investigations, etc., or a person who has the right to request to inspect books of account, etc.;

(e) A person who has concluded, or is in negotiating to conclude, a contract with the listed company, etc., such as its main bank, certified public accountant, underwriter, attorney, etc. (including the officers, etc., in case of a juridical person, and the agent or employees of an entity, in case of an entity other than a juridical person); and

(f) An officer, etc. of a juridical person falling within (b), (c) or (e) above who came to know material facts pertaining to business or other matters of a listed company, etc. through the requisite conditions described in (b), (c) or (e) above.

A person who is not presently a corporate insider, but was previously a corporate insider, within one year after ceasing to be a corporate insider shall be subject to corporate insider regulation. In addition, persons who receive the transmission of information from the abovementioned corporate insiders (such persons are generally referred to as "initial information recipients") shall also be subject to corporate insider regulations as in the case of corporate insiders themselves (FIEA, art. 166, para. 3).

(ii) Material Facts

Material facts pertaining to business or other matters of a listed company, etc. include the following information (FIEA, art. 166, para. 2).

It is necessary to be aware that material facts include those of subsidiaries of a listed company because subsidiaries are also subject to the regulation after the consolidated financial statements system was introduced (FIEA, art. 166, para. 2, item 5 through item 8).

In the amendments in 2013, the similar provisions concerning material facts as those applicable to listed companies, etc. were set out with regard to listed investment corporations, etc. (meaning investment corporations that are listed companies, etc.) (FIEA, art. 166, para. 2, item 9 through item 14).

(a) A decision by the organ of the listed company, etc. which is responsible for making decisions on the execution of the operations of the listed company, etc. to carry out any of the following matters, or a decision by the said organ not to carry out the matter which is decided to be carried out in such a decision (limited to acts that have already been publicized):

- **Solicitation of persons who subscribe for shares issued or treasury shares disposed of by a stock company or solicitation of persons who subscribe for share options for subscription;**
- **Reduction of the amount of stated capital;**
- **Reduction of the amount of capital reserve or retained earnings reserve;**
- **Acquisition of its own shares;**
- **Allotment of share without contribution or allotment of share option without contribution;**
- **Share splits;**

- ・Distribution of surplus;
- ・Share exchange;
- ・Share transfers;
- ・Share delivery;
- ・Merger;
- ・Company split;
- ・Transfer or acquisition of transfer of whole or part of its business;
- ・Dissolution (excluding dissolution due to merger);
- ・Commercialization of a new product or technology; and
- ・Business alliances or other matters provided for by Cabinet Order as those equivalent to the above-mentioned matters;

(b) Occurrence of any of the following events:

- ・Damages caused by disaster or other damages arising in the performance of its business;
- ・Changes in major shareholders (shareholders holding voting rights of 10% or more of the voting rights of all shareholders, etc.);
- ・Facts which could cause the delisting or revocation of registration of specified securities (meaning shares, share options or bonds of a listed company, etc.; FIEA, art. 163, para. 1; FIEAEO, art. 27-3) or options on specified securities, etc.; and
- ・Facts deemed equivalent to the above-mentioned matters prescribed by Cabinet Order.

With respect to the facts described in (a) and (b) above, those fall within the standards prescribed by Cabinet Office Ordinance as those matters that are deemed to have an insignificant effect on the investment decisions (de-minimis standard) made by investors are excluded (Securities Transaction Ordinance, art. 49 and art. 50).

(c) Existence of a difference between, on one hand, the latest publicized forecasts (or publicized actual figures of the preceding business year in the case of lack of such forecasts) of net sales, current profits or net income (hereinafter referred to as “net sales, etc.”) or of the dividend or of sales, etc. of the corporate group to which the listed company, etc. belongs, and, on the other hand, new forecasts thereof newly prepared by the listed company, etc. or the results in the settlement of account for the business year of the listed company, etc., which falls under the standard prescribed by Cabinet Office Ordinance (Securities Transaction Ordinance, art. 51) as having material influence on investors’ investment decisions; or

(d) Material facts other than (a) through (c) above concerning the operation, business and assets of the listed company in question that could have a significant effect on the investment decisions made by investors.

Since this is a comprehensive provision pertaining to material facts, and due to the several recent examples of its application (Japanese Supreme Court judgment on the Nippon Shoji case), it should be noted that even if the facts at issue do not fall within a material fact spelled out in the FIEA, the insider trading restrictions may still be applied. It is more natural to assume that if the insider knowingly uses a disparity in information

to conduct transactions, there will most likely be some sort of legal violation.

(iii) Publication of Material Facts

Material facts are deemed to have been publicized when any of the following occurs (FIEA, art. 166, para. 4):

(a) If the representative director or the executive officer of the relevant listed company or its subsidiary company, or the party who was entrusted by him/her with the announcement of the material facts, has announced the material facts to more than two press institutions, such as a daily newspaper, media company or broadcast institution, and more than 12 hours has elapsed since the announcement (FIEAEO, art. 30, para. 1, item 1 and para. 2);

(b) A listed company, etc. has made a notice in accordance with the regulations of the relevant financial instruments exchanges, etc. that list the securities issued by the said company, stating material facts or facts concerning a tender offer, etc. to the relevant financial instruments exchange, etc., and such material facts, etc. have been made available for public inspection by the financial instruments exchange (FIEAEO, art. 30, para. 1, item 2). In such cases, the 12-hour rule is not applied.
Consequently, if the information has been made available for public inspection over the timely disclosure system operated and used by the financial instruments exchange (*e.g.*, the Timely Disclosure Network (TDnet) operated by the Tokyo Stock Exchange) it will be deemed to have been made available for public inspection and to have been immediately disclosed; or

(c) The material facts pertaining to business and other matters have been included in a securities registration statement or the attached documentation thereto, amended registration, shelf registration, shelf registration supplementary documents or attached documentation thereto, revisions of any of these, or an annual securities report or attached documentation thereto, or amended report thereof, confirmation statement, amended confirmation statement, internal control report or attached documentation thereto, amended report thereof, a quarterly report or an amended report thereof, semiannual report or an amended report thereof, an extraordinary report or an amended report thereof, or a report on status of parent company or an amended report thereof, and such document has been made available for public inspection in accordance with the provisions of the FIEA.

(iv) Exceptions

Even if the elements of insider trading are satisfied, conducting the following transactions would not be illegal: the acquisition of shares as a result of the exercise of the right to receive allotment of shares by the holder of the right; the acquisition of shares as a result of the exercise of share options by the holder of the share options: sale and purchase, etc. involving specified securities, etc. by exercising an option; sale and purchase, etc. based on the right to demand purchase of shares or right to demand purchase of investment equity; a purchase, etc. made upon a request that has been determined by the board of directors of the

company, etc. in order to resist a tender offer, etc.; a purchase of shares, etc. based on a resolution of a shareholders meeting; a stabilizing transaction that is conducted in accordance with a Cabinet Order; certain types of sale and purchase, etc. involving corporate bond certificates, etc.; off-exchange transactions between the parties who both have knowledge of the material facts; succession to specified securities due to a merger, etc. wherein the ratio of the relevant securities to the succeeded assets is extremely low; issuance of treasury shares as consideration for a merger, etc.; sale and purchase, etc. made as performance, etc. under a contract that was entered into prior to becoming aware of the material information; a purchase through stock cumulative investment which meets certain criteria; acquisition of unexercised share options upon exercise under the call clause based on the plan and due date decided by the issuing company prior to gaining knowledge on important facts; and the sale of acquired share options to an underwriting company (FIEA, art. 166, para. 6; Securities Transaction Ordinance, art. 59, para. 1).

In other words, the insider trading regulations prohibit "utilizing" superiority in terms of acquired information in the formation of the investment decision itself.

Given these numerous exceptions it is almost impossible to envision a case that would be punishable for the reason of meeting the formal grounds for a crime even though there was no use of priority in terms of the acquired information.

(v) Regulations Concerning Tender Offers

The need for insider trading regulations regarding related parties in a tender offer as well as an act that is equivalent to the same (meaning an act of purchasing shares, etc. of at least five percent of the total voting rights of the issuing company) is similar to the need for insider trading regulations regarding corporate insiders. However, information concerning tender offers is different from the internal information of a company issuing listed securities, etc. Therefore, separate provisions are provided for insider trading with regard to tender offers (FIEA, art. 167; FIEAEO, art. 31).

An administrative monetary penalty will be levied for violation (FIEA, art. 175, para. 2).

The elements of insider trading in tender offers are almost the same as the elements used in insider trading regarding corporate insiders.

Based on the amendments in 2013, the company subject to a tender offer, etc. and its officers and employees were included in the scope of a person concerned with a tender offer, etc. (FIEA, art. 167, para. 1). On the other hand, the amendments provide that a person who received information of a fact concerning launch of a tender offer, etc. is excluded from the insider trading regulations regarding a tender offer, etc. in cases where the person disclosed the information in a tender offer notification, etc. when making a tender offer or where six months have passed from the day on which the person received the information (FIEA, art. 167, para. 5).

(vi) Regulations for the Act of Providing Information or Recommending a Transaction

A corporate insider who has come to know a material fact shall not provide such information or recommend a transaction to other persons for the purpose of having other persons gain profits or preventing them from incurring losses by having them conduct a transaction before the material fact is publicized (FIEA, art. 167-2, para. 1). This regulation was introduced as part of the amendments in 2013 in response to the recent insider trading incidents involving the leakage of information from the underwriting securities companies upon public offering of listed companies.

The same regulation applies to a person concerned with a tender offer, etc. who received information of a fact concerning a tender offer, etc. (FIEA, art. 167-2, para. 2).

(vii) Punishment and Accomplice

Violations of the regulations prohibiting insider trading are punishable by imprisonment for a term not to exceed 5 years, a penal fine of not more than JPY5 million (not more than JPY500 million in the case of corporations), or both (FIEA, art. 197-2, item 13, and art. 207, para. 1, item 2). A person who provided information or recommended a transaction to another person in violation of the regulations for such act is subject to the same punishment if such information recipient, etc. actually engaged in a transaction (FIEA, art. 197-2, item 14 and item 15, art, 207, para. 1, item 2).

There are cases in which persons who are not directly involved in the insider trading may be punished as an accomplice with respect to their participation in the violation. Insider trading by corporate insiders are levied an administrative monetary penalty as well (FIEA, art. 175). If a person other than a financial instruments business operator, etc. engages in insider trading on an account other than its own account, an administrative monetary penalty equivalent to the amount of remuneration, etc. is levied on such person (FIEA, art. 175, para. 1, item 3 and para. 2, item 3).

As a result of the amendments in 2013, an administrative monetary penalty is to be imposed on a person who provided information or recommended a transaction to another person in violation of the regulations for such act if such information recipient, etc. actually engaged in a transaction. The amount of penalty applicable to a securities company or any other intermediary or its officer or employee is much larger than that applicable to other persons (FIEA, art. 175-2).

Furthermore, in order to prevent asset management companies from engaging in insider trading on accounts other than their own, the amount of penalty to be imposed for such insider trading has been raised significantly (FIEA, art. 175, para. 1, item 3(a) and para. 2, item 3 (a)).

As a result of the 2014 amendment of the FIEA, the procedure for confiscation of electronic share certificates, etc. has been developed and made applicable to the violation of the insider trading regulations (FIEA, art. 209-4 through art. 209-7).

(2) Duty to Report of Officers and Major Shareholders of the Company

When officers and major shareholders (the term “major shareholder” in (2) to (5) below means a shareholder that holds voting rights constituting 10 percent or more of voting rights held by all shareholders, etc., in that person’s own name or in the name of another person; FIEA, art. 163, para. 1) of a company issuing securities listed in a financial instruments exchange, including share certificates, share option certificates, corporate bond certificates or preferred equity investment certificates, or investment securities, investment equity subscription right certificates, investment corporation bond certificates or foreign investment securities prescribed in the ITA, or a company issuing over-the-counter traded securities or handled securities, buy or sell the share certificates, share option certificates, or corporate bond certificates, etc. of the listed companies, etc. (hereinafter referred to as “specified securities”), or make a purchase, etc. or sale, etc. of securities representing an option in connection with the specified securities (“related securities”; hereinafter these are collectively referred to as “specified securities, etc.”) on their own account, then except as otherwise provided by Cabinet Office Ordinance, they must file a report with the Prime Minister concerning such sale and purchase, etc. (FIEA, art. 163).

This provision is incorporated in order to ascertain insider trading.

(3) Regulations on Short-Swing Trades of Officers or Major Shareholders

When officers or major shareholders of a listed company, etc. realize a profit, for their own account, through purchase, etc. of specified securities, etc. of the listed company, etc., and sale of the same within the six months after the purchase or sales of the specified securities and purchase of the same within six months after the sale of the same, the listed company, etc. may demand that such persons return any profits earned (FIEA, art. 164).

> This provision should first be understood as a check on company officers who might pursue short-swing profits through sales of the company's own stock in dereliction of their duty of loyalty towards the company.

(4) Prohibition on Short Sales of Company Shares by Officers or Major Shareholders

The officers or major shareholders of a listed company, etc. are absolutely prohibited from short selling the company's shares or engaging in a transaction that has the same effect (a "specified transaction") (FIEA, art. 165).

> This provision should be understood as being for the purpose of securing the performance of the duty of loyalty of officers, etc. to the company, by prohibiting officers, etc., from conducting transactions that generate more profits as the price of the company's stock falls.

(5) Regulations Concerning Specified Partnerships, Etc. (Fund Regulation)

Traditionally, when making a determination of a "major shareholder" under the SEL, shares of stock held as partnership assets under a vehicle such as a Civil Code partnership, an investment LPS or a limited liability partnership that did not have juridical personality were considered to be held by each partner in accordance with the percentage of the share that each partner had in the shared interests, and not on the basis of the partnership as a whole. Consequently, these regulations did not apply even when the partnership as a whole held a share of 10 percent or more of the voting rights.

Nevertheless, it is foreseeable that the voting rights would be exercised as a block if the partners of a partnership, etc. under the Civil Code acted in a group as a partnership, when 10 percent or more of the voting rights are held as a group by the partnership.

Consequently, the FIEA imposes the regulations of (2) through (4) on a "specified partnership, etc." of this nature (FIEA, art. 165-2, para. 1, para. 3 and para. 15).

> **Regarding the Prohibition of Insider Trading and Inappropriate Management of Confidential Corporate Information**
>
> Recently, insider trading by officers and employees of listed companies and inappropriate management of confidential corporate information by securities companies have become major issues (see chart).
>
> In June 2012, an administrative monetary penalty payment order was issued against a major trust bank since its staff in charge of investments conducted the sales of shares and short-selling of borrowed shares prior to the publication of the important fact of capital increase through a public offering by a resource development company of which he/she was notified in the course of management of foreign investment trusts based on a discretionary investment contract. The officers and employees of Association Members belonging to the Japan Securities Dealers Association (hereinafter referred to as the "JSDA") should take this frequent occurrence of

insider trading seriously and engage in their business by fully recognizing that insider trading is an act strictly prohibited by the FIEA and that they are in a position to prevent the occurrence of such acts.

[Regarding the Prohibition of Insider Trading]

Then, why is insider trading prohibited? This must be understood in relation to the purpose of the FIEA.

The insider trading regulations under the current Act were introduced through the amendments to the SEL in 1988. At that time, it was explained that the basis for insider trading regulations was to ensure investor's confidence in the fairness of the securities market. These regulations were another expression of investor protection, which was the purpose of the SEL, at that time. This explanation was based on the feeling that it is unfair to allow only the specific persons who know material information to make money by using such information. Moreover, since there was insufficient understanding that insider trading is a crime, focus was placed on spreading the fact that insider trading is an illegal act and the encouragement of voluntary management.

However, because the philosophy of securities market regulations was drastically changed from the conventional investor protection to ensuring functions of the securities market through fair price formation in the securities market, the insider trading regulations could no longer be based solely on the ensuring of investors' confidence in the fairness of the securities market. Insider trading is prohibited because such trading harms fair price formation in the securities market and impairs the functions thereof. In other words, based on the fact that ensuring fairness in the market participants' appropriate and timely access to information is the condition for fair price formation, the basis of prohibition of insider trading shall be the fact that the act of forming investment decisions by using the disparity in information (advantageous position in terms of information), which cannot be considered to be a sincere investment decision with respect to the trading object, interferes with the fair price formation in markets and harms the functions of the market and thus is against the public interest. Moreover, heavier criticisms should be placed on the officer or employees of a financial instruments business operator, etc. that plays a key role in the securities market for taking part in insider trading because their involvement would cause more serious interference to the market.

In Japan, the provisions concerning insider trading regulations are established formally; they uniformly provide in detail what "important facts" are, and which case satisfies the requirements such as "organ which is responsible for making decisions" and "publication." In the past, focus was placed on the principle of no penalty without a law, and thus unless the relevant incident fell under these requirements in form, it was not considered to be an insider trading. However, the two recent judgments rendered by the Supreme Court in relation to an insider trading revoked the judgment of the High Courts that took the formal logic and pursuit for reasonable results by substantive decisions (the Nippon Shoji case concerning what important facts are and the Nippon Orimono Kako case concerning the significance of the organ which is responsible for making decisions with respect to the facts decided). As just described, the Supreme Court showed an attitude to reject legal loopholes by applying the formally established provisions of the current Act by prohibiting transactions conducted by using disparity in information or advantageous positions in terms of information through interpretation of catch all provision. This means that it is risky if we do not deal in transactions with the recognition that the numerous provisions provided in the FIEA in a formal manner are mere guidelines.

Association Members are required to deal with their customers with the abovementioned changes in the insider trading regulations in mind.

[Regarding the Management of Confidential Corporate Information]

Since insider trading must be strictly prohibited as an act of hindering the functions of securities market, a

financial instruments business operator, etc. that plays a key role in the functions of the securities market shall assume high responsibility to prevent the occurrence of insider trading and the execution of an order for insider trading in the market. Accordingly, financial instruments business operators, etc. are restricted from conducting the following acts under the FIEA.

First, a financial instruments business operator, etc. or its officers or employees are prohibited from accepting orders when they know that the sale and purchase or other transaction of securities, etc. by a customer constitutes or is likely to constitute violation of insider trading regulations (FIEA, art. 38, item, 9; FIBCOO, art. 117, para. 1, item 13). These provisions have clarified that a financial instruments business operator, etc. or its officers or employees that are responsible for the securities market must not accept acts that may harm the market, etc. If they violate this provision, they may be subject to criminal liability as an accessory to the crime of insider trading.

Secondly, a financial instruments business operator, etc. or its officers or employees are prohibited from soliciting customers by providing to them confidential corporate information of the issuer of the relevant securities with respect to the sale and purchase and other transactions of securities, etc. or the derivatives transactions related to securities or the intermediary, brokerage or agency service therefor (FIEA, art. 38, item 9; FIBCOO, art. 117, para.1, item 14). These acts may also be considered to be the act of solicitation by provision of special benefits, but, because they can increase the probability of the occurrence of insider trading or have the sense of being accessories to insider trading as an act of spreading undisclosed material information, the abovementioned provisions have been prescribed to call for special attention.

Thirdly, a financial instruments business operator, etc. or its officer or employee is prohibited from engaging in sale and purchase or other transactions of securities in relation to which they know confidential corporate information for its own account based on the said information (FIEA, art. 38, item 9; FIBCOO, art. 117, para. 1, item 16). As financial instruments business operators, etc. often receive confidential corporate information from their trading partners, etc., they are in a position to establish a rigorous internal administration system to prevent insider trading by themselves. Yet, because there are cases where it is difficult to prove the occurrence of insider trading, these provisions were established to prohibit in advance the transactions using confidential corporate information.

The confidential corporate information as mentioned here means undisclosed important information on the operation, business or properties of listed companies, etc. set forth in the FIEA, Article 163, Paragraph 1, which is found to have an impact on customers' investment decisions and undisclosed information on a decision about the launch or suspension of a tender offer as prescribed in the FIEA, Article 27-2, Paragraph 1, the buying-up equivalent thereto in regard to the share certificates, etc. and a tender offer as prescribed in the FIEA, Article 27-22-2, Paragraph 1 (FIBCOO, art. 1, para. 4, item 14). Attention should be paid that this provision states the facts which have an impact on customers' investment decisions. The scope of information which falls under the category of this information is wider than that of the material facts concerning insider trading regulations.

In order to secure the effectiveness of the abovementioned conduct control, a financial instruments business operator, etc. must take measures necessary and appropriate for the prevention of unfair transactions based on the confidential corporate information, in connection with the management of the confidential corporate information it handles or the management of the customer's sale and purchase or other transactions of securities, etc. (FIEA, art. 40, item 2; FIBCOO, art. 123, para. 1, item 5). Therefore, JSDA provided the "Rules Concerning Establishment of Confidential Corporate Information Management System by Association

Members," and has required the Association Member to provide internal rules on the management of confidential corporate information in order to prevent the occurrence of unfair transactions using such information (JSDA Confidential Corporate Information Rules, art. 4). Association Members are further required to establish procedures that are necessary to manage the confidential corporate information such that officers and employees who acquire the confidential corporate information immediately report such acquisition to the management section (JSDA Confidential Corporate Information Rules, art. 5), to manage the section which is highly likely to acquire confidential corporate information (corporate section) so that the confidential corporate information is not communicated to other sections that do not need such information for their business, by means such as physically isolating the corporate section from other sections (JSDA Confidential Corporate Information Rules, art. 6, para. 1).

As described above, Association Members are required to be aware of the fact that they are playing a key role in the securities market and the need to create a system that prevents the occurrence of insider trading.

Chart **Recent Cases of Insider Trading and Inappropriate Management of Confidential Corporate Information**

Perpetrator of the Insider Trading	Date of Judgment or Disposition	Outline of the Case
Representative of a fund	June 2011	In November 2004, a representative of a fund, who was informed of the fact that Company F will buy up the shares of Company G for 5% or more, purchased the shares of Company G until January of the following year and then sold the shares and gained a huge amount of profits. He was arrested and prosecuted by the Tokyo District Public Prosecutors Office. Although the representative of the fund filed an appeal, the Supreme Court rendered a judgment to dismiss the appeal. Thereby, the Tokyo High Court's judgment of imprisonment with work for two years, suspension of execution of sentence for three years, penalty of JPY3 million, and supplementary charges for JPY1.149 billion became final and binding.
Major shareholder of a precision equipment company	June 2012	A major shareholder of a precision equipment company was arrested and prosecuted for purchasing the shares of the company prior to the publication of the company's capital increase and then selling out the shares before their price dropped prior to the publication of the forfeiture of part of the shares. The Osaka District Court found the major shareholder guilty and sentenced him to imprisonment with work for three years, suspension of execution of the sentence for five years, penalty of JPY 4 million and supplementary charges for about 380 million yen.
Trust bank	June 2012	The FSA issued an administrative monetary penalty payment order of JPY130,000 to a trust bank for unlawfully selling the shares of Company I and Company J prior to the publication of the information of capital increase through a public offering by Company I in June 2010 and by Company J in July of the same year. The entity which provided the personnel in charge of sale and purchase in the relevant trust bank with the information on capital increase is said to be the lead manager securities company of the capital increase through the public offerings in question.
Employee of a securities company	August 2012	An employee of a securities company was arrested and prosecuted for exposing the confidential corporate information to outsiders and taking part in insider trading. It was subsequently found that the securities company had not established a management system of confidential corporate information from the report submitted to the FSA from the securities company pursuant to Article 56-2, Paragraph 1 of the FIEA, and thus the insider trading occurred. Therefore, the FSA issued a business improvement order to the securities company pursuant to Article 51 of the FIEA.
President of a fashion information company	September 2012	A president of a fashion information company gained profits by purchasing the shares of Company L, a major grocery store, prior to the publication of important facts pertaining to the tender offer of the company, after actively obtaining information on such material fact from his wife who was an external director of Seiyu. The Tokyo District Court found the defendant guilty and sentenced him to imprisonment with work for two years, suspension of execution of the sentence for three years, penalty of JPY1 million, penalty for the corporation for JPY4 million, and supplementary charges for about JPY37.25 million (jointly with the company).

Perpetrator of the Insider Trading	Date of Judgment or Disposition	Outline of the Case
Former METI senior officer	June 2013	In April 2009, a former senior officer of METI came to know of a material fact that Company M and Company N would merge into a new company, and purchased a total of 5,000 shares in Company M prior to the publication of the merger plan. He also purchased a total of 3,000 shares in Company O in May 2009 prior to the publication of the company's recovery plan under the Act on Special Measures Concerning Industrial Revitalization, and earned profit of about JPY2.3 million from this series of transactions. The Tokyo District Court sentenced him to imprisonment with work for one year and six months, with suspension of execution of the sentence for three years, and to a fine of JPY1 million with supplementary charges of about JPY10 million.
Legal advisor to a company	August 2014	A legal advisor to a major electronics retail company came to know the company's plan to increase its capital through a public offering. He sold all of the 2,000 shares in the company that he had held before the publication of this plan, and avoided a loss of about JPY210,000. After the Securities and Exchange Surveillance Commission issued the recommendation for an administrative monetary penalty, the legal advisor contract was terminated. The FSA issued an administrative monetary penalty payment order of JPY390,000 to the former legal advisor.
Overseas asset management company	December 2014	In 2010, the personnel in charge of asset management at an overseas asset management company, R, obtained information that a Japanese company, in which Company R invested funds, was planning to increase its capital through a public offering. Based on this information accessed before publication, Company R conducted short sale of the shares in that Japanese company. The FSA issued an administrative monetary penalty payment order of JPY8,040,000 to Company R.
Japanese individual	November 2015	A man in his 60s who was an office worker living in Japan came to know of the fact that a subsidiary of a mobile phone distributing company, U, was planning to make a takeover bid against an insurance company, W. Before this information was published, he provided it to his colleague, a woman in her 30s who was a company officer. Based on this information, she purchased shares in Company W before the takeover bid was announced. The FSA ordered the man and woman to pay an administrative monetary penalty of JPY250,000 and JPY510,000, respectively.
Physician	December 2015	A physician of the Medical School of University V was engaged in a clinical trial of an eye drop under a clinical trial agreement concluded between the university and a pharmaceutical company, X, but was notified by Company X of the suspension of the trial. Before this fact was published, the physician sold short 800 shares in Company X in a margin transaction, and then bought back shares in the company after the share price fell due to the announcement of the suspension of the trial. The FSA ordered the physician to pay an administrative monetary penalty of JPY600,000.
Former chairperson of a company	November 2016	B, the former chairperson of Company A, which was listed on the TSE Mothers, provided two of his relatives with the unpublished information on the forecast that the company would post an ordinary deficit for the term ending December, thereby enabling them to avoid a loss by selling off the company's shares they held. The Tokyo District Court sentenced B to imprisonment for two years with three-year suspension and a fine of JPY2 million. This is the first case in which the court applied the provision of the FIEA that prohibits a person from providing another person with unpublished information in an attempt to enable the latter to avoid a loss.
Former financial consultant	June 2017	A former financial consultant, C, was ordered by the FSA to pay an administrative monetary penalty of JPY60,000 for gaining profit based on the unpublished information acquired from a securities company's employee which was related to an electricity company's capital increase through public offering. Dissatisfied with this, C filed a suit against the State to seek revocation of the FSA's order. The Tokyo District Court upheld C's claim and revoked the order, and the Tokyo High Court supported the decision of the prior instance and dismissed the appeal filed by the State. This is the case in which the FSA's payment order was revoked by the court for the first time since the administrative monetary penalty was introduced in 2005.
Recipient of information from a company officer	June 2018	A man in his 30s living in Japan obtained information regarding the upward revision of the business results and the share split of a new electricity company, E, from the company's officer before the information was published, and, based on this information, the man purchased 13,400 shares in that company on his own account. The FSA ordered the man to pay an administrative monetary penalty of JPY11.67 million.
Recipient of information from an employee of a securities company	May 2019	A man in his 30s living in Japan obtained information regarding the plan that an office furniture company (Company I) would launch a TOB against its subsidiary (Company D), from his acquaintance who was an employee of a securities company before the information was published, and, based on this information, the man purchased 296,000 shares in Company D on his own account. The Osaka District Court sentenced the man to imprisonment with work for two years with three-year suspension and to a fine of JPY2 million with supplementary charges of about JPY68,660,000.

Perpetrator of the Insider Trading	Date of Judgment or Disposition	Outline of the Case
Former employee of a securities company	June 2020	A man in his 30s; an employee of a securities company was involved in insider trading when he provided his acquaintance with information regarding a plan of an office furniture company (Company I) to launch a TOB against its subsidiary (Company D) before such information was made public. The Osaka District Court sentenced the employee to imprisonment with work for two years with a three-year suspension and a fine of JPY2 million.
President of a mass retailer	April 2021	A man in his 50s, who was the president of Company D, a mass retailer, while in his presidency, obtained information regarding Company F's plan to strengthen the partnership with Company D, including a TOB, and advised his acquaintance to purchase Company D's shares three times before the information was published. The man's acquaintance purchased Company D's shares, sold them after the information was published, and gained a profit of about JPY69 million. The Tokyo District Court sentenced the man to imprisonment with work for two years, with a four-year suspension. This is the case in which the prohibition of "recommendation of transactions," which means recommending a third party to engage in transactions while knowing the material information, was applied for the first time.
President of a construction company	July 2022	A man in his 50s, who was the president of Company U, a construction company, obtained material information from the president of a company that is in business alliance with Company T, a medical venture company engaging in the development of a drug for COVID-19 treatment, regarding the results of the clinical trial of the drug conducted by Company T in which the symptom improvement was observed in the subject patients. The man purchased 221,747 shares in Company T in the name of Company U before the material information was made public, sold most of these shares after the material information was published, and gained a profit of about JPY 8.78 million. The Tokyo District Court sentenced the man to imprisonment with work for one year and six months with a three-year suspension and a fine of JPY 1 million, sentenced Company U to a fine of JPY 1 million, and jointly and severally imposed supplementary charges of about JPY 25 million on the man and Company U.
Employee of a leading game company	July 2023	A man in his 50s, who was an employee of a leading game company (Company S) and a game creator, obtained unpublished material information about the joint development carried out by Company A and Company B with Company S to create a smartphone game that was related to a popular role-playing game title, and purchased a total of 130,000 shares in Company A and Company B based on this information. The Tokyo District Court sentenced the man to imprisonment for two years and six months with a four-year suspension and a fine of JPY 2 million with supplementary charges of about JPY 171 million.

12 5 Other Unfair Transactions

(1) **Prohibition of Public Notice, Etc. of False Quotations** (FIEA, art. 168)

No person shall publicly notify false quotations on market prices of securities, etc., or prepare or distribute documents that contain false quotations on market prices of securities, etc. for the purpose of publicly notifying or distributing the documents. Moreover, no person shall, in response to a request of an issuer, a person engaged in secondary distribution of securities, an underwriter or financial instruments business operator, etc. prepare or distribute documents that contain fake statement on any important matters pertaining to securities issued by, apportioned to or dealt by such persons for the purpose of publicly notifying or distributing the documents.

Violators of this regulation will be subject to imprisonment for not more than a term of one year, a penal fine of not more than JPY1 million, or both (FIEA, art. 200, item 20).

(2) Restriction on Expression of Opinion in Newspaper, Etc. for Which Consideration Is Received (FIEA, art. 169)

When a person publishes in a newspaper or a magazine, or indicates by means of documents, broadcasting, motion picture or other means to the public, his/her opinion which would convey his/her decision regarding investment on securities, issuers or tender offerors in exchange for consideration received from or under a promise to receive consideration from any issuer, person engaged in secondary distribution of securities, underwriter, financial instruments business operator, etc. or tender offeror, etc., such a person shall indicate, together with the opinion, that the opinion is published or indicated in exchange for consideration received or under a promise to receive consideration.

However, that this shall not apply to cases where a person who has received or is promised to receive advertisement fees indicates such an opinion as an advertisement made in exchange for the advertisement fees.

Violators of this provision will be subject to imprisonment for not more than six months or a penal fine of not more than JPY500,000 (FIEA, art. 205, item 20).

(3) Prohibition of Indication of an Advantageous Purchase, Etc. (FIEA, art. 170)

Transactions in equities and other securities entail risks and may generate losses, which are, of course, borne by the investor.

Therefore, upon making solicitation of an application to acquire newly issued securities or solicitation of an application to sell or purchase already-issued securities to many and unspecified persons, no person shall make an indication to many and unspecified persons to the effect that the person or other person will purchase the securities acquired by members of the said many and unspecified persons at a predetermined price or higher or will make an arrangement for selling such securities at a predetermined price or higher, or shall make an indication that is likely to be understood as meaning to that effect.

The intent of this provision is to secure the fairness of the primary market, and violators of this provision will be subject to imprisonment of not more than one year or a fine of not more than JPY1 million, or both (FIEA, art. 200, item 21).

(4) Prohibition of Indication of Fixed Dividends, Etc. (FIEA, art. 171)

Upon a public offering or secondary distribution of securities, advertisements such as “annual dividends of JPYXX per share or annual dividends of YY% of profits will continue,” or that a certain amount of money will be provided are prohibited since such advertisements could distort the primary market.

Violators of this provision will be subject to imprisonment for not more than one year or a fine of not more than JPY1 million, or both (FIEA, art. 200, item 21).

(5) Prohibition Against Off-Market Netting Transactions (FIEA, art. 202)

An act for the purpose of exchanging the difference by using quotations on a financial instruments exchange market without resorting to the financial instruments exchange market constitutes an act solely of exchanging a margin without having the financial instruments or the funds enabling a transaction of the financial instruments. An act of this nature is prohibited as it is one of only taking profits without participating in the market on the basis of a true investment decision.

A person who commits this act is subject to imprisonment for a term not exceeding one year, a penal fine of not more than JPY1 million, or both.

However, certain over-the-counter transactions of derivatives in which a financial instruments business operator, etc. is one of the parties or carries out brokerage of the same are exempted from this prohibition.

(6) Creation of a Rule for Nullifying Transactions Conducted Through the Selling of Unlisted Shares, Etc. by Unregistered Business Operators

A person who is to engage in selling shares, etc. in the course of trade must be registered under the FIEA, but there was no special rule under civil law for regulating violation of this requirement of registration. Because of this, it often happened recently that unregistered business operators enticed elderly people to buy unlisted shares at high prices, by saying that these shares were going to be listed soon and guaranteeing a profit.

Investors who acquired unlisted shares and suffered loss can claim damages under tort law (Article 709 of the Civil Code) or Article 5 of the APFS, and they can also assert nullification or rescission of their transactions under the Consumer Contract Act. However, these legal provisions were criticized as failing to provide sufficient protection for investors because they imposed the burden of proof on investors. Therefore, in order to enhance relief for victims, a new rule was created through the amendments in 2011 for nullifying the sale of unlisted shares by unregistered business operators.

Specifically, where an unregistered business operator (referring to a person who, in violation of the FIEA, Article 29, engages in type I financial instruments business defined in the FIEA, Article 28, Paragraph 1 or type II financial instruments business defined in Paragraph 2 of the said Article, without obtaining registration from the Prime Minister) conducts sales, etc. of unlisted securities ("sales, etc." refers to sale or intermediary or agency services thereof, dealing in public offering or secondary distribution, or any other act specified by Cabinet Order as an act equivalent to these acts), the subject contract (referring to the contract pertaining to such sale, etc. or contract concluded through such sale, etc., under which the customer is to acquire the unlisted securities) shall be null and void (FIEA, art. 171-2, para. 1, main clause; FIEAEO, art. 33-4-4).

However, this provision shall not apply if the unregistered business operator or the seller or issuer of the unlisted securities pertaining to the subject contract (limited to those who are the parties to the contract) proves that the sale, etc. in question does not result in insufficient protection of the customer in light of the customer's knowledge, experience, status of property or purpose of concluding the subject contract or that the sale, etc. does not constitute unjust enrichment (FIEA, art. 171-2, para. 1, *proviso*). This is because such sale, etc. is not found to be against the principle of investor protection even when it is conducted by an unregistered business operator.

"Unlisted securities" mentioned here refer to corporate bond certificates, share certificates, share option certificates, and other securities specified by Cabinet Orders as securities for which it is particularly necessary to ensure proper trading, and which do not fall under any of the following (FIEA, art. 171-2, para. 2; FIEAEO, art. 33-4-5):

(i) Securities listed on financial instruments exchanges;
(ii) Over-the-counter traded securities or handled securities; or
(iii) In addition to what is set forth in (i) and (ii), securities specified by Cabinet Order as securities for which the information on the trading price or issuer thereof can easily be obtained.

12 6 Regulations on Crypto-and Other Assets Transactions, Etc.

Following the development of provisions concerning handling of crypto-and other assets under the 2019 amendment to the FIEA, new regulations on crypto-and other assets transactions, etc. have been introduced in order to address unfair acts using crypto-and other assets (the regulated subject was “crypto-assets” at the time of the 2019 amendment; as a result of the subsequent amendment to the FIEA under the Act to Partially Amend the Payment Services Act and Other Related Acts to Establish a Stable and Efficient Payment Services System (Act No. 61 of 2022), the regulated subject has been changed from “crypto-assets” to “crypto-and other assets” (effective as of June 1, 2023)).

Specifically, as discussed earlier, (i) general provisions, (ii) provisions concerning spreading rumors and using fraudulent means, and (iii) provisions concerning market manipulation have been established in relation to crypto-and other assets transactions (FIEA, art. 185-22 through art. 185-24). These provisions are also intended to address unfair trading involved in the sale and purchase of crypto-and other assets and exchange with other crypto-and other assets, as well as cryptoasset-related derivatives transactions.

However, the introduction of regulations on insider trading in crypto-and other assets was put off, because at present, it is difficult to clearly specify acts that should be prohibited by statutes, for the following reasons: (i) the issuer does not exist with regard to most crypto-and other assets, and even if the issuer does exist, it is difficult in some aspects to identify the issuer; and (ii) in the absence of an established view on factors that could cause price fluctuations of crypto-and other assets, it is difficult in some aspects to identify in advance what would be a material fact that may have a significant influence on investors’ investment decisions before its disclosure.

A person who violates the regulations is punishable by imprisonment with work for not more than ten years or a fine of not more than JPY10 million (FIEA, art. 197, para. 1, item 6). However, no administrative monetary penalty will be imposed on such a person.

13 Information Disclosure, Accounting, Auditing Systems and Internal Control

13 1 Significance

Where a large volume of securities is offered to general public and distributed, it is necessary for the issuing company to disclose certain information concerning the status of its business, financial position, management results, etc. so that investors can make an informed investment decision.

Fair price formation in the capital markets is made possible by the accumulation of different judgments with respect to the quality and value of a particular security, and without being able to know the price for the object of the transaction, it is impossible for the securities market to function. The information disclosure system exists not only to protect the general investor, but is also necessary at times in order to protect professional investors.

The content of the information to be disclosed varies depending on (i) whether the product characteristics, particularly its structure, risks and other individual information are widely known with respect to the object of

transaction (*i.e.*, securities). The structure and risks of shares of stock, for example, are widely known, and therefore only the disclosure of company information becomes an issue. For a product with a new structure, however, the disclosure of all information concerning the structure and product characteristics of a product is necessary.

Next, when (ii) the product characteristics may change, it is necessary to disclose up-to-the-minute information pertaining to such change. With respect to share certificates, continuing disclosure (secondary disclosure) is requested from this perspective.

Finally, when (iii) the transacting party (investor) is proficient in the said product, it is unnecessary to disclose information towards such persons. There is a system that does not call for information disclosure (or more precisely refer to the first paragraph of the registration statement for the public offering or secondary distribution) to sophisticated investors (qualified institutional investors or professional investors) known as QII private placement or professional investor private placement (see “13-2 Disclosure of Corporate Affairs and Other Related Matters” for details).

13 2 Disclosure of Corporate Affairs and Other Related Matters

The information disclosure system, which covers mainly shares of stock, takes the form of the disclosure of corporate affairs and other related matters in view of the general theory concerning information disclosure described above. The information disclosure system (disclosure) under the FIEA has been formalized because the targets for these “explanations” are many and unspecified persons, and it is necessary to confirm that this is an extension of the concept of providing a direct person to person explanation. Consequently, even if the disclosure regulations do not apply under the FIEA (certain interests in collective investment schemes and small number private placements, etc.) this does not mean that a direct explanation to the person in question is not required (FIEA, art. 37-3; APFS, art. 4).

The disclosure system of corporate affairs and other related matters can be classified broadly into disclosure in the primary markets and disclosure in the secondary markets. In the primary market, a registration of primary offering or secondary distribution is made to the Prime Minister by way of a securities registration statement, and it becomes possible to recruit investors or sell to investors once the registration statement becomes effective after being inspected by the government. At this time, disclosure must be made directly to the investor by means of delivering a prospectus. Moreover, in the case of the secondary market, various systems exist under the FIEA, consisting of annual securities reports that are to be filed each business year, quarterly reports that are to be filed each quarter, extraordinary reports that are to be submitted when certain material information has come into existence, and the timely disclosure which is a rule on the part of the financial instruments exchanges.

In order to secure and maintain the truthfulness, accuracy and clarity of the disclosure documents prepared for these purposes, the FIEA provides for accounting systems and the system of auditor certification by a certified public accountant or auditing firm. A system of reporting on internal control and confirmation statements has been enacted in order to assure the reliability of information disclosure on secondary markets.

The securities subject to the disclosure system of corporate affairs and other related matters are fundamentally securities pertaining to a public offering or secondary distribution in the primary market (provided, however, that the disclosure system does not apply to national bonds, municipal bonds, bank debentures, government guaranteed bonds, and certain interests in collective investment schemes which have low market liquidity (FIEA, art. 3)). Securities involved with asset securitization as well as beneficiary certificates of an investment trust and investment

securities issued by an investment corporation are covered by a special disclosure system as "regulated securities" (FIEA, art. 5, para. 1; this definition is different from that of "specified securities" in 12-4(1)(ii)(b) above), and may require a full disclosure including the product mechanism and detailed information of each asset.

Moreover, although the duty to prepare and file with the Prime Minister a securities registration statement as an offering disclosure (FIEA, art. 5, para. 2), and a duty to prepare and file annual securities reports, etc. as a continuous disclosure (FIEA, art. 24, para. 2 and art. 24-5, para. 2) are imposed on a small offering where the issue price or secondary distribution price is between JPY100 million to JPY500 million, the content of the information disclosure is simplified (it is foreseen that venture companies will fall under this regime).

Furthermore, since the company, companies of which such company owns a majority of the voting shares, and companies or groups (company groups) that meet the requirements of the Cabinet Office Ordinance as persons who have a close relationship with such company engage in activities as a corporate group, requiring each company to conduct disclosure on an individual basis would not accurately reflect the actual state of the company, and for this reason the state of accounts, etc. on a consolidated basis as a corporate group is to be presented in, *inter alia*, the securities registration statement and the annual securities report (FIEA, art. 5, para. 1, item 2, art. 24, para. 1, and art. 24-4-7).

Although consolidated information was of secondary significance prior to the 1998 SEL amendments, after the amendments, consolidated information became the primary basis for disclosure. Finally, the concept of a subsidiary company subject to consolidation applies a de facto control test (Financial Statements Ordinance, art. 8, para. 3 and para. 4). Companies to which the equity method that is a partial consolidation is applicable are referred to as affiliate companies (Financial Statements Ordinance, art. 8, para. 5 and para. 6).

Share buyback report was introduced with the liberalization in 2001 of the regulations on acquiring treasury shares (FIEA, art. 24-6). In addition, the 2005 amendments to the SEL imposed a requirement on the parent company, etc. of a listed company, etc. to submit a status report of parent company, etc. (FIEA, art. 24-7, para. 1), and permitted a foreign company that is subject to obligation to file an annual securities report to a similar type of report in English language (foreign company report) and supplemental documentation (FIEA, art. 24, para. 8).

13 3 Disclosure System in the Primary Market

(1) Significance of Public Offerings and Secondary Distributions

(i) Public Offering of Securities

A "public offering of securities" here means those solicitations for applications to acquire newly issued securities (including those solicitations that are similar to this as prescribed by Cabinet Office Ordinance (acts similar to solicitations for acquisition)) that in connection with Paragraph 1 Securities (securities, rights to be indicated on securities, specified electronically recorded monetary claims or certain types of electronically recorded transferable rights) are [a] made to a large number (50 or more; qualified institutional investors shall be excluded from this calculation) of persons (FIEA, art. 2, para. 3, item 1; provided, however, solicitations made only to professional investors are excluded), and [b] fall under none of the following: (A) a solicitation made only to qualified institutional investors and for which the securities are not likely to be transferred from the acquirer to any person other than a qualified institutional investor (*i.e.*, a QII private placement); (B) solicitation made only to professional investors and for which the solicitation for acquisition (excluding cases

where the counterparty is a national government, the Bank of Japan or qualified institutional investors) is consigned to a financial instruments business operator or conducted by the financial instruments business operator, etc. for itself, and the securities are not likely to be transferred from the acquirer to any person other than a professional investor or a non-resident (*i.e.*, a private placement to professional investors); or if a solicitation is made to a small number of general investors, and the securities are not likely to be transferred to a large number of persons (*i.e.*, a small number private placement) (FIEA, art. 2, para. 3, item 2).

With respect to the deemed securities set forth in each item of the FIEA, Article 2, Paragraph 2 (hereinafter referred to as “Paragraph 2 Securities”) a public offering of securities means that a considerable number of persons (500 or more; FIEAEO, art. 1-7-2) will own the securities in connection with the offering (FIEA, art. 2, para. 3, item 3). In principle, the disclosure regulations in connection with Paragraph 2 Securities are applied only to interests in investment-type collective investment schemes which invest in securities as their main business (FIEA, art. 3, item 3).

(ii) Private Placement of “Securities That Have Low Market Liquidity”

The information disclosure system does not apply to interests in enterprise-type collective investment schemes, which are considered to be securities that are excluded from application, as securities that have low market liquidity (FIEA, art. 3, item 3). The filing of a registration statement is not required in either the case of a QII private placement as well as a small number private placement, as long as they are private placements.

Nevertheless, this does not necessarily mean that no explanation is required. As the providing of information and an explanation is required even in the case of securities that have low market liquidity (FIEA, art. 37-3). In the case of small number private placements, a registration is unnecessary because an explanation can easily be provided to investors directly.

Moreover, even if the other party is a professional there may be cases in which an explanation must be given concerning all of the product characteristics, etc. in the case of, *inter alia*, a new product.

(iii) Secondary Distribution of Securities

A major revision of “secondary distributions of securities” was carried out pursuant to the 2009 amendments.

Formerly, a secondary distribution of securities was defined as being an offer to sell or a solicitation for offers to purchase securities that have already been issued that is made “under uniform conditions” to “large number of persons” (prescribed as at least fifty people (FIEAEO, art. 1-8)) as the other party, and a secondary distribution of securities could not be carried out unless the issuer of the relevant securities submitted a securities registration statement to the Prime Minister.

However, it was commented that in the actual practice of securities transactions, the condition that a secondary distribution be “under uniform conditions” was exerting a harmful influence. In other words, it was pointed out that pursuant to the interpretation that it is possible to avoid mandatory disclosure if it does not meet the formalistic condition that it be “uniform,” it is possible to get around the mandatory disclosure requirement by slightly changing the sales price for every forty-nine solicited persons. On the other hand, in a case such as where a securities company once settles foreign securities for its own account and then later sells them to investors, it can be viewed as simply having carried out the brokering of the securities. However, if in form the investors who are the other parties are large number (fifty or more) of persons, this activity would fall under a secondary distribution of securities and it is possible that mandatory disclosure, which properly speaking should not be necessary, would be required. It is believed that a lack of functioning of the formalistic requirement for “uniform conditions” is the cause of these problems.

Accordingly, for disclosure regulations related to "secondary distributions of securities," instead of making a decision based on the formalistic standard of "uniform conditions," it was decided to revise the definition for "secondary distribution of securities" so that it is in line with reality by requiring mandatory disclosure in what are in economic reality primary-type sales solicitations (circumstances that call for issuance disclosure in order to correct a gap in information between the seller side and investors concerning information and the like concerning the solicited securities or the issuing body, such as where a large amount of securities are disposed of all at once and sales pressure may occur), and by not requiring mandatory disclosure in the case of secondary-type sales solicitations (sales soliciting that can be considered to conform in actual practice to brokering between the secondary market and customers in connection with securities that already are in circulation in the market and for which information concerning those securities and the issuing body is widely available).

Specifically, it was revised as follows.

First, in the definition of secondary distribution of securities, "uniform conditions," which is one of the conditions for whether or not a sales solicitation for Paragraph 1 Securities constitutes a secondary distribution, has been deleted (FIEA, art. 2, para. 4, item 1). Attendant upon this, in order to decide whether or not the other condition that is "large number of persons" applies, a new provision was established to the effect that it is decided by totaling the number of solicited parties of the solicitation of sale, etc. conducted within a fixed period of time (FIEA, art. 2, para. 4, item 2 (c)).

Second, even if it is a solicitation for already issued securities, those for which it is appropriate to apply disclosure regulations as a public offering of securities instead of as a secondary distribution of securities (acts similar to solicitations for acquisition) are included in public offerings of securities (FIEA, art. 2, para. 3, main paragraph, and para. 4, main paragraph).

Third, the scope of exemption from disclosure was newly established and expanded. Mandatory disclosure is excused in the following three cases.

The first case is a solicitation or transaction that does not fall under a "secondary distribution of securities," and that includes [a] a solicitation for an application for an offer to sell securities, etc. that does not fall under a "solicitation of sale, etc." (the provision of information on such securities given as a notice under Article 67-19 of the FIEA and other provision of information to be performed as statutory obligations concerning such securities are prescribed), as well as [b] a securities transaction that does not fall under "secondary distributions of securities" (financial instruments exchange market transactions, transactions in OTC securities market, and the like are prescribed) (FIEA, art. 2, para. 4, main paragraph; FIEAEO, art. 1-7-3; Definition Ordinance, art. 13-2).

The second case is a solicitation, etc. that falls under a "secondary distribution of securities," but exempted form mandatory disclosure. Secondary distributions of foreign securities that meet certain conditions (**foreign securities distribution** (FIEA, art. 27-32-2)) (FIEA, art. 4, para. 1, item 4) fall under this case. In this case, the financial instruments business operator, etc. that conducts the foreign securities distribution which is exempted from mandatory disclosure is required to provide or publish "foreign securities information" as a simplified provision of information. However, the obligation to provide or to publish foreign security information is excused for foreign government bonds that meet certain conditions (FIEA, art. 27-32-2).

The third case is a solicitation, etc. that falls under a "**private secondary distribution**," and it provides for [a] "**qualified institutional investor private secondary distributions**" (where the offering is made

only to qualified institutional investors, and where, as prescribed by Cabinet Order, it is not likely that the relevant securities will be transferred from the acquirer to persons other than qualified institutional investors), [b] "**professional investor private secondary distributions**" (where the offering is made only to professional investors, and in which if the counterparty to the relevant offer to sale is a person other than the Government of Japan, the Bank of Japan or a qualified institutional investor, then the financial instruments business operator, etc. carries out the relevant offer to sale pursuant to a entrustment by the customer, or for itself, and where, as prescribed by Cabinet Order, it is not likely that the relevant securities will be transferred from the acquirer to persons other than professional investors), and [c] "**small number secondary distribution**" (cases other than [a] and [b] above, where it is not likely that the relevant securities will be owned by a large number of persons as prescribed by Cabinet Order) (FIEA, art. 2, para. 4, item 2).

For Paragraph 2 Securities, this means a case in which the securities related to the secondary distribution will be owned by considerable number of people (five hundred or more people; FIEAEO, art. 1-8-5) (FIEA, art. 2, para. 4, item 3). The treatment of Paragraph 2 Securities as being exempted securities other than the securities of a collective investment scheme that mainly invests in securities is the same as for a public offering (FIEA, art. 3, item 3).

Under the FIEA, the traditional treatment is to regulate public offering and secondary distribution together from the perspective of protecting investors, but it is possible to understand a secondary distribution as being a phenomenon of dispersing a "clump" of previously issued securities, which would be the opposite of a tender offer, which would be an agglomeration of dispersed securities. Accordingly, a secondary distribution differs from the traditional theoretical significance of the concept of a public offering in which new markets are formed or a market is expanded by adding new securities.

(iv) Reorganization

The FIEA has stipulated that cases of issuing securities as a result of a corporate reorganization shall be covered under the disclosure regulations, and has enacted new procedures in connection with reorganizations that issue securities (acts in connection with a merger, company split, share exchange or other company reorganization) (FIEA, art. 2-3, para. 1), referring to these as "procedures relating to securities issuance for reorganization" (FIEA, art. 2-3, para. 2). Cases in which a large number of persons are the owners of shares of a reorganized company, such as a company absorbed in an absorption-type merger, or a wholly owned subsidiary company in a share exchange ("shareholders, etc. of the reorganized company") will be included in being covered under a "public offering of securities," in the form of "specified procedures relating to securities issuance for reorganization" (FIEA, art. 4, para. 1).

In addition, in the same manner as the above, previously issued securities will be covered under a "secondary distribution of securities," in the form of "procedures relating to securities delivery for reorganization" or "specified procedures relating to securities delivery for reorganization."

In either event, if information disclosure has not been carried out for a reorganized company, the offering disclosure regulations will apply, enabling investors to make appropriate investment decisions (a registration statement will not be required if disclosure has been carried out—FIEA, art. 4, para. 1, item 2).

(v) Stock Options

A registration statement is not required if the counterparty to a public offering or secondary distribution acquires or is easily able to acquire information concerning the relevant securities (FIEA, art. 4, para. 1, item 1). This covers cases of providing stock options to officers such as directors or employees (FIEAEO, art. 2-12, items 1 and 2; Corporate Affairs Disclosure Ordinance, art. 2, para. 1 and para. 2).

(vi) Secondary Offering in the Event That Disclosure Has Been Made

Since a secondary distribution of securities, described above, involves the partitioning of securities that have already been issued, a company that files annual securities reports is not subject to the secondary distribution regulations per se (registration statement unnecessary; FIEA, art. 4, para. 1, item 3). Upon the actual solicitation, however, a prospectus must be delivered (FIEA, art. 13, para. 1). Note that it is still clear here that the absence of a registration does not necessarily mean that no disclosure is required.

(vii) Qualified Institutional Investors and Professional Investors

Qualified institutional investors include, *inter alia*, financial institutions such as financial instruments business operators, etc., and various funds and corporations and individuals that have filed a notification as holding investment securities balance of JPY1 billion or more (Definition Ordinance, art. 10, para. 1). However, although private placements are excluded from the registration and disclosure requirements for public offering and secondary distributions, since they are subject to business regulations and restrictions against unfair trading, there are instances in which non-disclosure towards qualified institutional investors may be illegal. Especially in the case of a QII private placement, which stands opposed to the concept of a public offering on the stock market, it is necessary to take special caution when selling structured products, for which a secondary market is not established, to persons who may lack a sophisticated knowledge of such products.

Meanwhile, professional investors refer to qualified institutional investors, national government, the Bank of Japan, investors protection funds, etc., specified purpose companies, listed companies, stock companies with a capital amount of JPY500 million or more, financial instruments business operators, persons that have filed a notification of specially permitted services for qualified institutional investors, persons that have filed a notification of specially permitted services for foreign investors, foreign corporations and persons who became professional investors from general investors through certain procedures (FIEA, art. 2, para. 31; Definition Ordinance, art. 23; FIEA, art. 34-3 and 34-4). For private placement to professional investors, information necessary for trading on the so-called professional market is to be provided or disclosed (FIEA, art. 27-31), however, it could be possible that business restrictions and unfair trading restrictions be applicable similarly.

Upon conducting a solicitation only for qualified institutional investors, etc., or solicitation for small number of investors, etc., or to transfer securities related thereto, the transferor must notify the counterparty that no registration statement has been filed with respect to the securities and that transfer of the securities is restricted and the contents thereof (FIEA, art. 23-13, para. 1 and para. 4), and similar notification has become required upon exclusive offer to acquire targeting professional investors, etc., and exclusive offer to sell, etc. to professional investors, as well (*id*., para. 3).

Similarly, a qualified institutional investor or a professional investor that has obtained securities in a private placement must file a registration statement with the Prime Minister if the qualified institutional investor or the professional investor intends to make an offer to sell or solicitation of offer to buy these securities to persons other than qualified institutional investors or professional investors, respectively ("general solicitation for securities acquired by a qualified institutional investor" or "general solicitation for securities acquired by a professional investor, etc.") (FIEA, art. 4, para. 2 and para. 3).

(2) Registration Statement upon Public Offering or Secondary Distribution

A public offering or secondary distribution of securities cannot be made unless the issuer files a registration statement concerning the public offering or secondary distribution with the Prime Minister (FIEA, art. 4).

Once registered, the content of the registration becomes immediately available for public inspection (FIEA,

art. 25), and soliciting of the securities for which the public offering or secondary distribution may be conducted by using the prospectus or sales materials for securities in soliciting. The registration statement must be in effect, however, before the recipient is actually allowed to acquire the securities or the sale is made (FIEA, art. 15, para. 1).

Once the Prime Minister accepts the registration filed by the issuing company, the registration generally becomes effective after 15 days elapsed since the date of acceptance (FIEA, art. 8). During this time, the Prime Minister examines the information disclosure; however, this examination is in no way a guarantee of the quality of the securities (FIEA, art. 23).

The deadline for filing a registration statement for a rights offering or an offering giving preference to existing shareholders is 25 days prior to the date of the allotment (FIEA, art. 4, para. 4). In other cases, there are no specific restrictions on timing, but since acquisitions or sales cannot take place until registration becomes effective, the procedures generally require at least 16 days before the date applications will start to be accepted.

Even in cases that are not classified as public offering/secondary distributions for which registration statement are required, a written notice should be submitted to the Prime Minister if the relevant public offering/secondary distribution falls within the category of specified public offering, etc. (securities notice; FIEA, art. 4, para. 6).

The following cases require the submission of a securities notice:

(i) A secondary distribution of securities in cases where disclosure has been made (FIEA, art. 4, para. 1, item 3) and the total secondary offering price is JPY100 million or more;
(ii) A public offering or secondary distribution where the total issue price or the secondary distribution price is less than JPY100 million but more than JPY10 million, provided that there exceptions in which this does not apply (FIEA, art. 4, para. 1, item 5); and
(iii) Those general solicitations for securities acquired by qualified institutional investors and general solicitations for securities acquired by professional investors, etc. that do not constitute a secondary distribution of securities, and for which disclosure has not been made in connection with the said securities (FIEA, art. 4, para. 5).

(3) Securities Registration Statement

The securities registration statement must be filed with the Prime Minister in order to register a public offering or secondary distribution of securities (FIEA, art. 5). The content and form of the securities registration statement is prescribed in the Corporate Affairs Disclosure Ordinance. By way of example, a domestic company will use Form 2 (Corporate Affairs Disclosure Ordinance, art. 8, para. 1).

The content of the securities registration statement is required to consist of information concerning the public offering or secondary distribution (securities information) and information concerning the issuer (company information and other information; with respect to “regulated securities,” information concerning the fund or the securitized assets or related parties). The securities information is a description of the outline of the public offering or secondary distribution and is always required (even for private placements, in some cases, such information must be stated on an extraordinary report), but company information is not required to be disclosed upon each issue if sufficient information disclosure has been made in the secondary market, and may be entrusted to the continuous disclosure of securities reports, etc. Accordingly, if certain conditions (filing of securities reports and past records of trading volume, etc.) are met, for the company information in the securities registration, it shall be sufficient to state

that the most recent securities report, etc. “shall be referred to” (FIEA, art. 5, para. 4), so disclosure of only the offering information is required.

A company to which this disclosure system is applied is a company eligible for incorporation by reference, which is an extremely important concept as the concept of a company that can rely on the secondary market functions (companies to which the shelf registration system described in (5) below applies are also companies eligible for incorporation by reference).

For the company information stated on the securities registration statement and the annual securities report, the consolidated information is considered to be of paramount importance, and the individual company information is considered to have secondary importance. The concept of a company subject to consolidation, in other words, what constitutes a parent company or subsidiary company, is based on a substantial approach (control approach).

For small amount public offerings, etc. where the total amount of offering or distribution price is less than JPY500 million, a simplified disclosure is allowed (FIEA, art. 5, para. 2).

The amendments in 2011 expanded the scope of disclosure documents that may be filed in the English language. A foreign company which is required to file a securities registration statement may, instead of filing a securities registration statement, file (i) a document stating in the Japanese language the matters concerning the public offering or secondary distribution and (ii) documents which are prepared in the English language and which are similar to a securities registration statement, etc. disclosed in a foreign country (collectively referred to as “foreign company statements”; FIEA, art. 5, para. 8), if this would not impede the public interest or investor protection (FIEA, art. 5, para. 6; Corporate Affairs Disclosure Ordinance, art. 9-6). In such case, the foreign company shall attach, to these documents, Japanese translations of the summaries of the matters necessary and appropriate for the public interest or investor protection among the matters stated in those English documents (FIEA, art. 5, para. 7; Corporate Affairs Disclosure Ordinance, art. 9-7, para. 2 through para. 4).

Furthermore, as a result of the amendments in 2013, if a public offering or secondary distribution of the specified securities has already been conducted continuously for a certain period with regard to regulated securities such as investment trust beneficiary certificates, it is not necessary to submit a securities registration statement but it is sufficient to submit a simplified document containing subscription requirements, etc. instead (FIEA, art. 5, para. 10 through para. 12).

(4) Prospectus

The prospectus is a document that states an explanation of the business of the issuer of the securities and other relevant matters at the time of a public offering or secondary distribution of securities, or a general solicitation involving securities acquired by a qualified institutional investor or a general solicitation involving securities acquired by a professional investor, etc. It must be delivered directly to the counterparty or must be delivered at the request of the counterparty (FIEA, art. 2, para. 10).

When the issuer, secondary offeror, underwriter, financial instruments business operator, etc., or financial instruments intermediary service provider will by means of a public offering or secondary distribution cause the acquisition of or sell securities for which a registration statement is required or that have already been disclosed, it must in principle deliver the prospectus to the investor in advance of, or simultaneously (FIEA, art. 15, para. 2, main text, referred to as Delivery Prospectus). No prospectus with false statements or which undermines statement of matters to be stated may be used (FIEA, art. 13, para. 4).

However, delivery of the prospectus is unnecessary in cases (i) where the acquisition or sale is with respect to a qualified institutional investor, or (ii) if the securities are to be acquired by or sold to a person who already owns

securities of the same issue as the securities in question, or if a person who lives with the said prospective acquirer or purchaser has already received the prospectus, or is expected to receive the prospectus without fail, and the prospective acquirer or purchaser consents to the waiving of delivery of the prospectus (FIEA, art. 15, para. 2, *proviso*).

Although the information stated in the prospectus should be what is stated in the securities registration statement as well as other special notes, under the amendments in 2004, it was decided that it would not be appropriate to demand the same level of detailed information in connection with securities regarding investment trusts or investment corporations, for which the disclosure of investment performance is principle, as would be required for shares of stock. The law as amended states that the matters to be stated in a prospectus may be divided into three parts consisting of (i) matters that have an extremely material effect on the investment decisions of investors, and (ii) matters that have a material effect on the investment decisions of investors (FIEA, art. 13, para. 2).

In view of this, for certain securities as prescribed by Cabinet Order (securities regarding investment trusts or investment corporations), it is adequate to provide a delivery prospectus containing matters described in (i) above, and, with respect to the matters described in (ii) above, it is sufficient to promptly deliver a prospectus upon request by an investor (FIEA, art. 15, para. 3; referred to as "Delivery of Prospectus Upon Request").

If materials other than the prospectus are to be used such as written documents, diagrams and graphics, voice recordings, etc. (including information that is displayed by means of electronic data), making any false or erroneous in such information is prohibited (FIEA, art. 13, para. 5).

Furthermore, pursuant to the 2009 amendment, the matters to be stated in a delivery prospectus for investment trust beneficiary certificates have been limited to investment information extremely significant for investment decisions and the matters to be stated have been considerably simplified as well as new provisions regarding the form of a delivery prospectus for investment trust beneficiary certificates have been established (Ordinance on Disclosure of Regulated Securities, form 25; form 25-2).

Furthermore, pursuant to the 2009 amendment, if a secondary distribution of securities with respect to which disclosure has already been made is to be carried out by a person other than the issuer, a person related to the issuer, or the underwriter, delivery of the prospectus is excused (FIEA, art. 13, para. 1, second sentence; Corporate Affairs Disclosure Ordinance, art. 11-4).

Since the issuer, persons related to the issuer, and the underwriter hold undisclosed information concerning the issuer or are in a position in which it is easy to obtain such information, in light of the issue of symmetry of information, they continue to be required to deliver a prospectus.

The amendments in 2011 introduced a flexible method for delivering a prospectus upon making a rights offering. In cases where the share options to be allotted by a rights offering are listed or are scheduled to be listed on a financial instruments exchange, and the fact that a securities registration statement, etc. concerning the share options have been filed is made public in a daily newspaper without delay after the filing, delivery of a prospectus is not required (FIEA, art. 13, para. 1, *proviso*, art. 15, para. 2, item 3; Corporate Affairs Disclosure Ordinance, art. 11-5).

Along with the expansion of the scope of disclosure documents that may be filed in the English language under the amendments in 2011, a foreign company that is required to file a securities registration statement, etc. is now allowed to disclose a prospectus in the English language if it files foreign company statements and supplementary documents (FIEA, art. 13, para. 2).

(5) Shelf Registration System

An issuer that expects to conduct a public offering or secondary distribution one or more times, and which is a company eligible for incorporation by reference, will not be required to file a registration statement at the time of the issue if the company registers a shelf registration statement stating matters such as the amount of the securities that it expects to issue during the anticipated issue period (one or two years; Corporate Affairs Disclosure Ordinance, art. 14-6). This is referred to as the shelf registration system (FIEA, art. 23-3). Pursuant to the 2009 amendments, it has become possible to use the program amount method (method whereby a "maximum issue balance" is stated in the self-registration statement, and if the issue balance decreases due to redemptions and the like, the amount that may be issued increases only by that redemption amount).

A shelf registration becomes effective on the fifteenth day after the date the shelf registration is filed (FIEA, art. 23-5 and art. 8). Persons conducting a public offering or secondary distribution under a shelf registration statement shall not begin actual sales unless the shelf registration is effective and the shelf registration supplements have been submitted to the Prime Minister for the public offering or secondary distribution (FIEA, art. 23-8).

The shelf registration supplements contain almost the same securities information as the securities registration statement and must be accompanied by a statement that the most recent reference documents should be referenced, the minutes of the board of directors resolution, etc., a document stating any material facts that occurred after the date of the most recent securities report was filed, an overview of the business, and a document providing a precise and simple explanation of developments in the management indicators (the so-called highlights) (Corporate Affairs Disclosure Ordinance, art. 14-12).

Under the shelf registration system, no registration statement is required for a public offering or secondary distribution made during the anticipated issue period; however, a shelf registration prospectus must be prepared and delivered for the purpose of solicitations (FIEA, art. 23-12, para. 2 and para. 3, art. 13, para. 1 and art. 15, para. 2).

However, under the amendments in 2011, where the issuer of securities has delivered, in advance, a document stating the matters that should be stated in a shelf registration statement and shelf registration supplements thereof (excluding the issue price) as well as stating to the effect that the issue price, etc. will be announced separately and specifying the method of announcement, and the issue price, etc. are announced by such specified method, the said document shall be deemed to be a prospectus, and the announcement of the issue price, etc. shall be deemed to be the delivery of a prospectus (FIEA, art. 23-12, para. 7). Therefore, in such case, the issuer shall be released from the obligation to deliver a shelf registration supplementary prospectus.

(6) Provision or Disclosure of Specified Securities Information, Etc.

With respect to the issuance and distribution of securities that may be traded on the so-called professional market introduced with the 2008 amendments, a special system for provision and disclosure of information was established.

Namely, as a system equivalent to offering disclosure, for the specified solicitation for acquisition such as the so-called private placement for professional investors and the specified offer to sale, etc. such as private secondary distribution for professional investors, etc. (collectively referred to as "specified solicitation, etc."), the issuer of the securities concerning the specified solicitation, etc. must provide to the counterparty of or disclose "specified securities information," the basic information to be clarified to the investor with respect to the said securities and the said issuer by the time of conducting such specified solicitation, etc. (FIEA, art. 27-31, para. 1; Securities Information Ordinance, art. 2).

As the manner of provision or disclosure of specified securities information, the issuer of the said securities

must provide the securities information by itself or upon entrustment to others, or disclose the same by using the Internet or by other methods (FIEA, art. 27-31, para. 2; Securities Information Ordinance, art. 3). Furthermore, as a system equivalent to continued disclosure, an issuer of securities for professional investors and an issuer that has provided or disclosed specified securities information must provide or disclose the issuer information to the holder of the said securities at least once every business year (FIEA, art. 27-32, para. 1; Securities Information Ordinance, art. 7).

The so-called professional market is premised on the participation of professional investors with information collection and analysis ability and risk management ability, and from the judgment that whether or not to make an investment shall be left to the self-responsibility of professional investors, no uniform regulations have been established. However, even such professional investors may not be in a position to request provision of information to the issuer or directly collect information, a minimum scheme for provision and disclosure of information concerning the issuer has been established (provision and disclosure of specified securities information and issuer information).

The content of information to be provided or disclosed and the manner and timing of provision/disclosure is to be provided for in the business regulations of financial instruments exchanges (FIEA, art.117-2), but the concrete contents thereof (form, language, accounting standards, etc.) are to be set flexibly by the rules of the exchange in accordance with the needs of corporations and investors.

As mentioned above, the so-called professional market has been granted such flexible system designs, but this should not result in the provision/disclosure of untrue information.

From this standpoint, compensation liability, administrative monetary penalty and criminal penalty apply to the provision/disclosure of untrue information (FIEA, art. 27-33, art. 27-34, art. 172-9, art. 172-10, art. 172-11, art. 197, para. 1, item 4-2, art. 197-2, item 10-2 and item 10-3, etc.).

13 4 Disclosure System in the Secondary Market

(1) Companies Subject to Secondary Market Disclosure

For financial products whose value changes daily, like share certificates, continuous information disclosure is an absolute necessity in allowing investors to form an investment decision.

To this end, the continuing information disclosure system under the FIEA, which is designed mainly for share certificates, provides for annual securities reports, which are disclosure documents filed once per year (annual reports), quarterly reports (or semiannual reports), and extraordinary reports which must be filed immediately upon the occurrence of certain prescribed matters. In addition to these reports, the financial instruments exchanges set forth rules for timely disclosure.

A securities report is an annual or almanac document which once a year compiles and preserves the timely disclosure that are made on a daily basis. The FIEA prescribes an information disclosure system for secondary markets which focuses on companies that are filers of detailed annual securities reports.

Under the FIEA, the following four types of companies are obligated to disclose information in the secondary market (FIEA, art. 24, para. 1, item 1 through item 4):

(i) Issuers of listed securities (listed companies) ...... Issuers of securities that are listed on a financial instruments exchange; provided, however, specified listed securities listed on the so-called professional

market are excluded;

(ii) Companies issuing over-the-counter trading securities ...... The text of the FIEA states that these are issuers of securities that are prescribed by Cabinet Order (FIEAEO, art. 3) as those whose status of distribution is similar to securities listed on a financial instruments exchange; provided, however, specified over-the-counter traded securities which are over-the-counter traded securities for professionals are excluded;

(iii) Persons other than those described in (i) and (ii) above that issued securities (limited to share certificates and preferred equity investment certificates; FIEAEO, art. 3-5, para. 1) that require the filing of a registration statement with the Prime Minister in a public offering/secondary distribution ...... In cases where the number of holders as of the last day of all of the preceding five business years is less than 300 (FIEAEO, art. 3-5, para. 2), or the issuer is in liquidation or has ceased its business for a substantial period of time, or the number of persons owning such securities is less than 25 persons, such issuers may apply for an exemption from the requirement to file securities reports with the Prime Minister (FIEA, art. 24, para. 1, *proviso*; FIEAEO, art. 4, para. 2; Corporate Affairs Disclosure Ordinance, art. 16, para. 2); and

(iv) Persons other than those described in (i) through (iii) above with capital of at least JPY500 million and with at least 1,000 shareholders listed on their shareholders register as of the last day of any of the most recent five business years (if the relevant securities are those directed towards professional investors, the number that is the number of professional investors calculated as prescribed by Cabinet Office Ordinance added to 1,000) (FIEAEO, art. 3-6, para. 4; this rule does not apply if the number of shareholders falls below 300; FIEAEO, art. 3-6, para. 1).

If a company meets the capital amount and number of shareholder tests stated in (iv) above, it will become subject to the FIEA; therefore, these two tests are called external criteria.

An optional method in the form of a “report substitute document” has been introduced under the FIEA with respect to regulated securities, in order to create a means for providing information that will be easy for investors to understand, and to reduce the burden on issuers. Under this vehicle, with respect to annual securities reports, semiannual reports, quarterly reports and extraordinary reports, combined filing of the statements of a portion of the matters that are to be stated in these reports (the report substitute documents) and the matters that have not been stated in the report substitute documents (FIEA, art. 24, para. 14, art. 24-4-7, para. 12 and para. 13, and art. 24-5, para. 13 through para. 16).

(2) Annual Securities Reports

Securities reports must be filed to the Prime Minister within 3 months after the close of each business year (FIEA, art. 24; the approval of the authorities is required to extend the filing deadline due to unavoidable reasons). As stated above, since a “company” issuing securities is the person obligated to file the annual securities reports, business year in this case means each company’s fiscal year (however, the information disclosure provisions are also applied *mutatis mutandis* to cases where issuer is a person other than a company; FIEA, art. 27).

The unit of calculation for the financial instruments known as share certificates is one year. On the other hand, the securities which are financial instruments generated from a so-called collective investment scheme such as an asset securitization or investment trust (hereinafter referred to as “regulated securities”) will sometimes adopt a trust structure, and in this case the unit of calculation is the unit of calculation for the trust (hereinafter referred to as the “specified period”; FIEA, art. 24, para. 5; Ordinance on Disclosure of Regulated Securities, art. 23, item 2).

The annul securities report must contain the company's trade name, the corporate group to which the company belongs, material matters concerning the status of the company's accounting and a description of its business, and the other matters prescribed by Cabinet Office Ordinance as those necessary and proper for the public interest or to protect investors (FIEA, art. 24, para. 1, main clause— corresponds to the company information under the FIEA, art. 5, para. 1, item 2). The matters to be stated on the securities report and the method of statement are prescribed in detail in the Corporate Affairs Disclosure Ordinance; domestic companies usually use Form Number 3 (Corporate Affairs Disclosure Ordinance, art. 15, item 1 (a)).

The following company information must be stated in the securities report:

(i) Company overview (developments in major management indicators, history, description of the business, status of affiliated companies, status of employees);
(ii) Overview of the business (management policy, management environment, issues to be dealt with, policy and initiatives concerning sustainability, business risks, analysis by the management of financial standing, operating results, and status of cash flow, significant management contracts, etc., and research and development activities);
(iii) Status of capital expenditures (overview of capital expenditures, etc., status of major expenditures, plans for new/removal of capital expenditures);
(iv) Status of the filing company (status of shares, etc. [total number of shares, status of share options, etc., status of exercise of share options regarding corporate bonds with moving strike options, total number of issued and outstanding shares, developments in capital formation, status by shareholder classification, status of major shareholders, status of voting rights, details of officer and employee share ownership plans, etc.], status of the acquisition of treasury stock, dividend policies, status of corporate governance, etc.);
(v) Status of accounting (consolidated financial statements, etc., financial statements, etc.);
(vi) Overview of administrative tasks pertaining to shares of the filing company; and
(vii) The filing company's reference information (information on the parent company, etc. of the filing company and other reference information).

In order to accommodate the globalization of the securities markets, and to reduce the cost of foreign companies, etc. in participating in the Japanese securities markets, the 2005 amendments allow these companies to provide disclosure in the English language.

If certain requirements are satisfied, a foreign company, etc. that must file an annual securities report may, in lieu of filing the annual securities report or quarterly reports (or semiannual reports), file a foreign company report or a foreign company quarterly report (or a semiannual report) that is stated in English, which is disclosed in the country of origin of the said foreign company, etc., and which is similar to an annual securities report or quarterly report (or a semiannual report) (FIEA, art. 24, para. 8, art. 24-4-7, para. 6, and art. 24-5, para. 7; Corporate Affairs Disclosure Ordinance, art. 17-2, art. 17-16, and art. 18-2). A supplemental document stating a summary, etc. in the Japanese language must be attached to the same.

For confirmation letters, internal control reports and parent company, etc. status reports, documents stating the matters to be stated in such reports may be submitted (FIEA, art. 24-4-2, para. 6, art. 24-4-4, para. 6, art. 24-7, para. 5; FIEAEO, art. 4-2-7, para. 3; Corporate Affairs Disclosure Ordinance, art. 17-11 and 19-7). These are referred to as "foreign company reports," etc. Initially this was applicable to foreign ETFs (tracking exchange traded

investment trusts) and was expanded to securities issued by foreign companies, foreign governments and foreign funds, etc.

(3) Semiannual Reports, Quarterly Reports

If a listed company, etc. that is required to file an annual securities report has a business year in excess of three months, the company is required to submit to the Prime Minister a quarterly report for each three month period of the said business year, within 45 days from the end of each such period, stating the state of accounts of the corporate group containing the company and other material matters (FIEA, art. 24-4-7; the approval of the authorities is required to extend the filing deadline due to unavoidable reasons).

This system has been applied to business years from April 1, 2008. The Accounting Standards Board of Japan has enacted quarterly accounting standards in connection with consolidated quarterly financial statements and segregated quarterly financial statements in order to clarify the entries to be made in quarterly reports, and the Business Accounting Council has created standards for quarterly reviews as a guaranteeing procedure for quarterly financial statements. In addition to this financial information, it is planned that an analysis of fiscal situation and management results, the condition of the company and business, etc., and the condition of shares of stock, etc. shall in principle be disclosed on a consolidated basis.

If a company other than a company that is required to file a quarterly report has a business year in excess of six months, then in accordance with the Cabinet Office Ordinance (Corporate Affairs Disclosure Ordinance, art. 18—domestic companies use Form No. 5), it must file with the Prime Minister a semiannual report for each business year, stating the material matters in connection with the six month period from the date on which the said business year commences. This semiannual report must be submitted within three months after the expiration of this six month period (FIEA, art. 24-5, para. 1; the approval of the authorities is required to extend the filing deadline due to unavoidable reasons). The matters to be stated in the semiannual reports are slightly more simplified than those in the annual securities report.

(4) Letter of Confirmation

Given cases of false disclosure such as window dressing that have occurred, the FIEA has introduced a system of internal control reporting. On the assumption that a company has an effective system of internal control, a letter of confirmation system has been introduced under which the management will confirm that the content of the statements made in the annual securities reports, semiannual reports and quarterly reports are accurate in accordance with the FIEA, thereby improving the reliability of the system of information disclosure (FIEA, art. 24-4-2, art. 24-4-8, and art. 24-5-2). This system has been applied to fiscal years on and after April 1, 2008.

The entities that will be required to file a letter of confirmation shall be listed companies, etc. for which a distribution market with high market liquidity exists, in which broad strata of investors can be expected to participate. This requirement is also imposed on foreign companies. Penalties apply to, *inter alia*, failing to file a letter of confirmation (FIEA, art. 208, item 2 and art. 209, item 3 and item 4).

(5) Extraordinary Reports

When a company that is obligated to file annual securities reports falls within certain cases prescribed by the Cabinet Office Ordinance, it must without delay file an extraordinary report with the Prime Minister stating the contents thereof (FIEA, art. 24-5, para. 4; Corporate Affairs Disclosure Ordinance, art. 19). In addition, a copy of the extraordinary report filed with the Prime Minister must without delay be submitted to the financial instruments

exchange or the financial instruments firms association (FIEA, art. 24-5, para. 6 and art. 6).

If facts occur that require the filing of an extraordinary report, those facts automatically constitute matters subject to disclosure under the timely disclosure rules of the financial instruments exchange. In such cases, it is necessary to notify the financial instruments exchange of those facts as soon as possible, and to file an extraordinary report with the Prime Minister without delay.

The events which trigger the submission of extraordinary report as prescribed by Corporate Affairs Disclosure Ordinance are the following (the matters to be described therein vary from case to case) (Corporate Affairs Disclosure Ordinance, art. 19, para. 2 and art. 19-2):

(i) Public offering/secondary distribution in a foreign country;
(ii) Private placement, etc.;
(iii) Solicitations of share options certificates that do not fall within the definition of a primary offering;
(iv) Changes in parent/specified subsidiary companies;
(v) Change in major shareholders;
(vi) Demand for sale of shares, etc. by special controlling shareholders;
(vii) Calling of a shareholders meeting intended for the acquisition of all of the class shares subject to class-wide call;
(viii) Calling of a shareholders meeting intended for the consolidation of shares;
(ix) Occurrence of major disasters;
(x) Litigation;
(xi) Share exchange;
(xii) Share transfers;
(xiii) Company split;
(xiv) Merger;
(xv) Assignment/assumption of business;
(xvi) Decision of an organ which is responsible for making decisions to acquire a subsidiary for a consideration for more than a certain percentage;
(xvii) Changes in the representative director;
(xviii) Resolution on matters up for resolution at a shareholders meeting;
(xix) Amendment or disapproval of matters up for resolution at an annual shareholders meeting, as stated in an annual securities report submitted for the annual shareholders meeting;
(xx) Change of certified public accountant/accounting firm;
(xxi) Petition for commencement of bankruptcy proceedings or petition for commencement of corporate rehabilitation proceedings;
(xxii) Occurrence of a large amount of bad receivables, etc.;
(xxiii) Occurrence of matters which severely impact the financial position/management performance of the company required to file reports (material subsequent events);
(xxiv) Occurrence of a major disaster at a consolidated subsidiary company;
(xxv) Litigation against a consolidated subsidiary;
(xxvi) Conclusion by a consolidated subsidiary of a share exchange contract having an impact

on the amount of consolidated asset or sales;

(xxvii) General meeting of shareholders in connection with a share transfer;

(xxviii) Company split of a consolidated subsidiary;

(xxix) Merger of a consolidated subsidiary;

(xxx) Assignment or acquisition of business on the part of a consolidated subsidiary;

(xxxi) Decision of an organ which is responsible for making decisions of a consolidated subsidiary to acquire the subsidiary for consideration for more than a certain percentage;

(xxxii) Petition for commencement of bankruptcy proceedings with respect to a consolidated subsidiary, etc.;

(xxxiii) Occurrence of bad receivables at a consolidated subsidiary;

(xxxiv) Occurrence of an event which severely impacts the financial position/management performance of a consolidated subsidiary (material subsequent event); and

(xxxv) Occurrence or amendment of disclosure information concerning shares for a company required to file a securities registration statement.

"Specified subsidiary company" here means those subsidiary companies (i) whose sales to the filing company represent 10% or more of the total purchases of the filing company, or whose purchases represent 10% or more of the sales of the filing company; (ii) whose net assets equal 30% or more of the net assets of the filing company; and (iii) whose capitalization or amount of equity contribution equals 10% or more of the capitalization of the filing company (Corporate Affairs Disclosure Ordinance, art. 19, para. 10). "Major shareholder" here means a shareholder who directly or indirectly holds 10% of the voting rights of all shareholders of the company (FIEA, art. 163, para. 1).

The amendments in 2011 expanded the scope of disclosure documents that may be filed in the English language. A foreign company that is required to file an annual securities report is now allowed to, instead of filing an extraordinary report, a document stating in the English language the matters that should be stated in an extraordinary report (hereinafter referred to as the "foreign company extraordinary report"), if this would not impede the public interest or investor protection (FIEA, art. 24-5, para. 15; Corporate Affairs Disclosure Ordinance, art. 19-2-2, para. 1).

(6) Status Report of Parent Company, Etc.

The parent company, etc. (excluding a company that files an annual securities report) of an issuer of securities (excluding regulated securities) listed on a financial instruments exchange, etc. (referred to in this paragraph as a "filing subsidiary") is required to submit a status report on parent company, etc. stating matters in connection with the person who owns shares in the parent company, etc. as well as other matters (FIEA, art. 24-7, para. 1).

Since the possibility exists that the parent company, etc. will have a material impact on the management of the filing subsidiary, it is necessary to have investors make investment decisions that take into consideration the information on the parent company, etc., and consequently, disclosure of information on the parent company, etc. is required. However, filing may be waived if approval is obtained on the grounds that no problem would be presented even if this report is not filed. This envisions a situation such as when the parent has suspended operation.

The status report of parent company, etc. must be filed with the Prime Minister, within three months from the end of the business year of the parent company, etc. A status report of parent company, etc. will be made available for public inspection (FIEA, art. 25).

The information to be stated consists of the status by owner of shares in the parent, the status of major shareholders, the status of officers and other accounting documents and the like. The specific details are prescribed by Cabinet Office Ordinance (Corporate Affairs Disclosure Ordinance, art. 19-5).

Penal sanctions apply in an event such as a false statement in the status report of parent company, etc. (FIEA, art. 197-2, item 6, *et al.*).

(7) Share Buyback Report

When a listed company passes a resolution of the shareholders meeting or board meeting concerning the acquisition of treasury stock, it must prepare a "share buyback report" and file the same with the Prime Minister each month (FIEA, art. 24-6), as prescribed by Cabinet Office Ordinance (Corporate Affairs Disclosure Ordinance, art. 19-3). With the removal of the prohibition on treasury stock (where the issuer acquires and holds its own shares) under the 2001 Amendments to the Commercial Code, the regulations governing treasury stock have been significantly strengthened.

If a listed company wishes to trade its treasury share certificates, certain preventative regulations must be complied with from the viewpoint of preventing market manipulation (FIEA, art. 162-2).

(8) Amendment of Registration Statements/Amendment Reports

If, after filing a securities registration statement or an annual securities report, etc., a change or the like has occurred in a material matter to be stated therein, the issuing company must file an amendment to registration statement or amendment report. There are instances in which the Prime Minister may order the submission of an amendment to registration statement or amendment report (FIEA, art. 7, art. 9, art. 10, art. 23-4, art. 23-9, art. 23-10, art. 24-2, art. 24-4-3, and art. 24-4-5, *et al.*).

(9) Timely Disclosure

In order to ensure fair price formation in the capital markets, correct information must be provided regarding the quality and price of the securities at the time of the transaction. In this sense, the financial instruments exchange rules requiring the timely disclosure of price sensitive information can truly be said to be the lifeline of the capital markets.

Once each year, the annual securities reports collect and preserve the timely disclosure made during the year as a sort of almanac or annual report, but this does not play a central role as material upon which investors base their minute-by-minute investment decisions. The argument that timely disclosure is important had been frequently made for some time, but in actual implementation, this was seen as nothing more than a rule by financial instruments exchanges in the form of self-regulatory organizations, and therefore that it was inferior to the requirements set forth in the law and regulations.

However, the financial instruments exchanges are institutions required by law in order to accomplish the legal objectives of the FIEA, and it is necessary to increase awareness by a large measure of the importance of the financial instruments exchanges since they play a pivotal role in the markets. One way to look at enactment of the laws and regulations is that originally it became necessary to ensure the substance of rules of exchanges as the base of investors broadened.

Financial instruments exchanges must adopt market monitoring measures such as ad hoc suspensions of trading activities where the timely disclosure rules are infringed, and in this sense timely disclosure should be notified to the financial instruments exchange as quickly as possible (for details, see Volume 2, Chapter 2 "Articles

of Incorporation and Various Regulations of the Exchanges").

13 5 Public Inspection

Securities registration statements, shelf registrations, shelf registration supplements, annual securities reports, semiannual reports, quarterly reports, letters of confirmation, internal control reports, extraordinary reports, status reports of parent company, etc. and share buyback reports must be kept at specified places for public inspection for a specific period with respect to each type of document (FIEA, art. 25).

However, if the Prime Minister issues an order to file amendment to registration statements or amendment reports, etc. concerning the public documents, all or part of such documents may not be provided for public inspection (FIEA, art. 25, para. 6). In such case, the Prime Minister shall notify the said effect to the filing company, etc. or the financial instruments exchanges, etc. (FIEA, art. 25, para. 7) and persons receiving such notice is relieved from the obligation to provide such documents for public inspection (FIEA, art. 25, para. 8).

13 6 Electronization of the Disclosure System for Corporate Affairs

In the 2000 amendments to the SEL, the legal conditions were put in place to enable submission and acceptance of annual securities reports and other disclosure documents, and the provisions of these for public inspection, as well as the online delivery of prospectuses, etc. Disclosure documents such as the annual securities reports, semiannual reports, quarterly securities report, securities registration statements, and tender offer registration statements, and report of possession of large volume, etc. have already been moved online. Online delivery of prospectuses has also become possible.

Under the FIEA, the "electronic information system for disclosure" means the electronic information system under which the computers (including input and output devices) used by the Cabinet Office and the input and output devices used by persons to complete disclosure procedures in accordance with the provisions of the FIEA as well as the input and output devices used by the financial instruments exchanges as well as the authorized financial instruments firms association as prescribed by Cabinet Order, are connected by telecommunications cables (this computer system is called EDINET (an abbreviation of Electronic Disclosure for Investors' NETwork)) (FIEA, art. 27-30-2).

EDINET must be used by persons who follow electronic disclosure procedures (procedures required to file the annual securities reports, semiannual reports, quarterly securities report, extraordinary reports, securities registration statements, etc.) (FIEA, art. 27-30-3, para. 1). Persons who follow voluntary electronic disclosure procedures (procedures pertaining to the submission of the securities notice) may also use EDINET (*id.*, para. 2). In these cases, when the disclosure information is stored in the file contained in the computer, the information is deemed to have reached the Cabinet Office (*id.*, para. 3).

In cases where, due to a breakdown, etc. in the telecommunications cable, electronic disclosure procedures using an electronic information system for disclosure cannot be followed, and if the Prime Minister approves, the company can make disclosure through submission of a magnetic disk (FIEA, art. 27-30-4). Even if a magnetic disk

is submitted, there are exceptional cases, such as if the Cabinet Office computer cannot read the information contained in the magnetic disk file, where submission in paper is permitted (FIEA, art. 27-30-5).

If the disclosure documents are submitted through EDINET, although a copy of the disclosure documents is supposed to be sent to the securities exchange or JSDA, it is deemed that notice was given to the financial instruments exchange, etc. at the time the file is recorded on EDINET, and it is presumed to have reached the appropriate addressee as of the expiration of the time normally required for output (FIEA, art. 27-30-6).

In cases where the disclosure documents are subject to public inspection, the documents must be made available for public inspection by displaying them on the monitor screens installed in the public inspection room at the Local Finance Bureaus, financial instruments exchanges, or the authorized financial instruments firms associations, or by displaying them on a website using web services (FIEA, art. 27-30-7, art. 27-30-8; FIEAEO, art. 14-12 and art. 14-13), however, the Prime Minister shall not provide all or part of the public documents (such portions referred to as specified portions) for public inspection, and if the Prime Minister has issued an order to amend with respect to the public documents, material reference information may be provided for public inspection in addition to the public documents (FIEA, art. 27-30-7, para. 2 and para. 5).

Portions excluding the specified portion shall be provided for public inspection at financial instruments exchanges, etc. as well (FIEA, art. 27-30-8).

EDINET can be accessed from the FSA website.

13 7 Fair Disclosure Rule

Until recently, Japan did not have rules specifying that, when issuers of securities provide securities analysts, etc. with undisclosed material information including their financial closing information, they should also provide other investors with the same information equally ("fair disclosure rules"; hereinafter referred to as the "FD rules"). In the administrative cases in which securities companies were punished for soliciting customers by providing them with insider information of the issuers of securities, it was revealed that the issuers had provided the undisclosed information concerning their business performance only to the securities analysts of these companies. Regarding this as a problem, investors, etc. called for the introduction of FD rules in Japan as in other countries.

Under such circumstances, with the objective of ensuring fair price formation through fair and timely information disclosure, the FIEA was amended in 2017 to introduce new provisions which require that, when issuers of securities provide securities analysts, etc. with undisclosed material information including their financial closing information, they should disclose that information to the public concurrently if the provision of information is intentional, or promptly after the provision of information if it is not intentional (FIEA, art. 27-36).

(1) Person Who Has the Obligation to Disclose

The obligation to disclose is imposed on issuers of corporate bond certificates, share certificates, share option certificates, investment securities, etc. which are listed on a financial instruments exchange or which fall within the category of over-the-counter securities, and any other securities specified by Cabinet Order (FIEA, art. 27-36, para. 1; FIEAEO, art. 14-15 and art. 14-16; Material Information Ordinance, art. 2). Issuers were considered to be appropriate for assuming the obligation to disclose under the FD rules because the securities issued by them are widely traded on the market and the information concerning themselves affects the price formation of the securities.

(2) Information Provider Subject to the FD Rules

The information provider subject to the FD Rules is a listed company, etc. or an asset management company of a listed company, etc. which is an investment corporation, or an officer, agent, employee, or other worker of such company who has been assigned the duty to provide information to business associates (meaning information recipients subject to the FD Rules; discussed below) (FIEA, art. 27-36, para. 1). The scope of information providers has been limited to these parties because they have the role and responsibility in providing information in the course of conducting the business of the issuer of securities. An asset management company of a listed company, etc. which is an investment corporation, and an officer, etc. thereof, are included in this scope since information on the facts related to asset management is supposed to be acquired, held and managed by an asset management company under the ITA.

(3) Material Information

The "material information," which means the information subject to the FD rules, is defined as "undisclosed material information about the operations, business, or assets of a listed company, etc. which has a material influence on investors' investment decisions" (FIEA, art. 27-36, para. 1). This definition of "material information" is intended to enable the issuers to manage information appropriately in accordance with the FD rules, while also enabling the investors to judge whether the information they receive from the issuers is subject to the FD rules.

(4) Business Associate

The "business associate," which means the information recipient subject to the FD rules, is defined as follows (FIEA, art. 27-36, item 1; Material Information Ordinance, art. 4 through art. 7):

(i) Financial instruments business operators, registered financial institutions, credit rating agencies, investment corporations, and any other persons specified by Cabinet Office Ordinance, or their officers, etc. (excluding the person specified by Cabinet Office Ordinance as a person who is not engaged in a financial instruments business in an entity that has taken the measures specified by Cabinet Office Ordinance as those necessary for appropriately managing material information); and

(ii) The persons specified by Cabinet Office Ordinance as those who receive material information concerning services pertaining to public relations aimed at investors in the listed company, etc. and who have a high probability of effecting purchase and sale, etc. of listed securities, etc. of the listed company, etc. based on investment decisions that are grounded in the material information.

The scope of information recipients subject to the FD rules has been defined as above to include those who are considered to be highly likely to be involved in the purchase and sale of securities.

(5) Cases Where Disclosure of Material Information Is Not Required

Material information provided by a listed company, etc. to a business associate is not required to be disclosed if the business associate has (i) the obligation not to provide the material information to any third party and (ii) the obligation not to engage in a purchase or sale of securities of the listed company, etc., before the disclosure of the material information (FIEA, the proviso to art. 27-36, para. 1). If the information recipient assumes these obligations against the issuer, the fair price formation on the market would not be disturbed even if such information is not disclosed.

(6) Obligation of a Listed Company, Etc. to Disclose Material Information upon Learning a Business Associate's Breach of Duty of Confidentiality, Etc.

If a listed company, etc. learns that a business associate that has received the material information has, in violation of laws, regulations, or contract, divulged to another business associate a secret concerning the material information or effected a purchase and sale, etc. of listed securities, etc. of the listed company, etc. before the disclosure of the material information, it must disclose the material information promptly (FIEA, art. 27-36, para. 3). However, disclosure is not required if material information cannot be disclosed due to a compelling reason or in any other cases specified by Cabinet Office Ordinance (*id., proviso*; Material Information Ordinance, art. 9). This provision has been introduced because the confidentiality of material information cannot be maintained when a business associate, in breach of its duty of confidentiality, provides the information to a third party that does not have such duty.

(7) Method of Disclosure

A listed company, etc. seeking to disclose material information must disclose the material information using the internet or through other means, pursuant to the provisions of Cabinet Office Ordinance (FIEA, art. 27-36, para. 4; Material Information Ordinance, art. 10). This rule has been introduced from the perspective of ensuring the prompt disclosure by issuers and providing individual investors, etc. with easy access to the information.

(8) Law Enforcement by the Regulatory Authorities

When finding that material information that is required to be disclosed has not been disclosed, the Prime Minister may instruct a person that is found to be required to disclose the material information to disclose the material information or to take any other appropriate measure (FIEA, art. 27-38, para. 1). If a person who has been thus instructed fails to take the measure pertaining to the instruction without just cause, the Prime Minister may order that person to take the measure pertaining to the instruction (*id.*, para. 2). It was considered to be appropriate to first encourage the issuer to promptly disclose the material information, and then give administrative instruction and order to the issuer in the case of its failure to take appropriate measures.

When finding it to be necessary and appropriate in the public interest or for the protection of investors, the Prime Minister may order a person that has disclosed material information, a person that is found to be required to disclose material information, or a witness, to submit reports or materials that should serve as a reference, and may have the relevant officials inspect that person's books and documents or any other of articles they possess (FIEA, art. 27-38, para. 1). When finding it necessary with regard to the order to submit reports or materials or the inspection, the Prime Minister may make inquiries to public offices or public or private organizations and request them to report necessary matters (*id.*, para. 2).

13 8 Accounting System Under the FIEA

(1) Significance of the FIEA Accounting System

Article 193 of the FIEA states that "the balance sheet, profit and loss statement and other statements of finance and accounting to be submitted under the provisions of this Act shall be prepared in conformity with the terms, forms and preparation methods which the Prime Minister prescribes in a Cabinet Office Ordinance in accordance

with the manner generally accepted fair and proper.” The “Cabinet Office Ordinance” here refers to *e.g.*, the Financial Statements Ordinance. This provision is the fundamental provision governing accounting under the FIEA (hereinafter “FIEA accounting”).

There is a growing trend to reexamine the significance of accounting which constitutes the backbone of the information disclosure system, given that the legal objective of the FIEA is understood to extend to the achievement of fair formation of prices in financial instruments, etc. by fully exploiting the functions of the capital markets, and further given that new financial instruments are developed every day.

From this perspective, the reason the FIEA contains provisions concerning accounting under the FIEA is because it is necessary to ensure the possibility of comparative evaluations with other securities, on capital markets in which various kinds of financial instruments exist on the same market, and to this end, it is necessary to use the same lens to view the assets and liabilities, etc. of issuers. The first objective of the FIEA accounting is to make it possible to apply a common measure to different financial products in the market.

The second objective is to clarify the “true value” of the object of the transaction which is the greatest value of the FIEA. “True value” here means that financial information which can lead to fair price formation (the objective of the FIEA) will be provided without fail. The “first general principle of financial accounting—the principle of truthfulness” is to the extent that it relates to the FIEA accounting precisely an expression of the legal objectives of the FIEA. In order to achieve this second objective, it is necessary to access each company’s improprieties and off-balance sheet treatment, etc.

It may appear that the objective of providing the market with a common scale of measurement and the objective of clarifying the true value could easily conflict, but these two objectives tend to converge around the overall objective of the FIEA of ensuring fair pricing and should not be understood as conflicting. Nevertheless, determining what sorts of rules should be the concrete rules is not necessarily an easy question, and therefore the FIEA avoids formulating standardized precepts for the accounting rules for the capital markets, while the Financial Statements Ordinance are to be prescribed in accordance with the manner generally accepted fair and proper.

(2) Uniform Content

Stemming from this significance of the FIEA accounting, the first characteristics of the rules that should be incorporated therein is that they must be able to constantly provide the market with changing information about the quality of the securities (company). If material information arises concerning finance in the capital markets, which have continuity, such information should be promptly provided to the capital markets; therefore, it is necessary for accounting methods to enable the same as well.

Accordingly, the first demand on the accounting system is that it can accurately record the daily transactions and be able to ascertain the daily net profit/loss position. From the objectives of the FIEA, this accounting system has its true significance not only in providing materials on the future earning capability of the relevant company that are beneficial to the investment decisions of investors, but also in enabling timely and proper disclosure of information in connection with finances.

Second, since the FIEA presumes the existence of a continuous secondary market, it is desirable to have an accounting system that guarantees the ability to compare different periods. In this sense, the principle of continuity is set forth as one of the most important principles for the FIEA accounting.

13 9 Audit System Under the FIEA

(1) Significance of the FIEA Audit System

Assuming that the significance of the FIEA accounting is to provide a common investment measure in the marketplace, to ascertain the true value of the object of the investment, and above all, to enable the timely disclosure of financial information based on a daily transactional record, then Article 193-2 of the FIEA, which requires an auditor's certification from a certified public accountant or auditing firm registered in the listed company auditor register with respect to the statements on finance and accounting that must be filed under the FIEA by the issuer of listed securities and other specified issuers, is understood as being an extension of these objectives.

In other words, the objective of the audit system is identified as being to verify that the accounting treatment and information disclosure is being made in conformity with the objectives of the FIEA accounting, and the objectives of the FIEA audit system (hereinafter "FIEA audit system") are held to be first to provide a common measure enabling the formation of a comparative investment decision in the securities markets, and second to pursue the true value of the object of the investment.

Furthermore, having persons possessing a "common" qualification verify pursuant to "common standards" from the subject of the audit that the management is processing accounts in accordance with the FIEA accounting precepts makes it possible to accomplish this first objective, while having an "independent" person with a qualification look for issues such as illegitimate practices in connection with the accounting of each of the corporations makes it possible to accomplish the second objective.

Viewed against the first objective of the FIEA audit system, an FIEA audit means an audit using a single sophisticated and public interest oriented "measure" common throughout the securities markets. This FIEA audit is addressed towards the markets and is not the same as the accounting advice given to a company. It is, thus, essential to have "independence" and "commonality" in the form of a verification using certain "common" standards by persons possessing certain "common" qualifications who do not have a special interest in the company that is subject to the audit (independent).

These persons possessing common qualifications are certified public accountants and auditing firms, and the common standards are exemplified by the audit standards. The 2007 amendments to the Certified Public Accountant Act required measures for ensuring the appropriateness of business execution and the organization of business management systems such as the formulation and implementation of policies for the management of business quality, etc. from the viewpoint of ensuring the structuring and operation of an appropriate quality management system, etc. by accounting firms (Certified Public Accountant Act, art. 34-13), which has a significance of raising the business standards of accounting firms who possess the qualification of audits under the FIEA, and ensure the standardization as a "common" qualification.

In addition, the 2003 amendments to the Certified Public Accountant Act made certain changes with the objective of enhancing the independence of certified public accountants and auditing firms. Such changes include that certified public accountants or auditing firms are prohibited from providing any audit certification services to Large Corporations (defined below) if the certified public accountant or auditing firm receives consideration on a continuous basis for the services unrelated to audit certification (as defined in Cabinet Office Ordinance) from a company subject to audits under the Commercial Code Special Exceptions Act, or a company subject to audits under the FIEA (hereinafter the "Large Corporations") (This is referred to as the "prohibition against concurrent providing of non-audit certification services."). In addition, a new system was introduced requiring a periodic

replacement of certified public accountants or auditing firms that provide audit related services to the Large Corporations (a “rotation system”).

Nevertheless, with the frequent incidents of dressing up of accounts that continued to occur thereafter, it was necessary to beef up the auditing system, and consequently explicit statement is made in the 2007 amendment that certified public accountants and auditing firms shall carry out their activities from an independent perspective (Certified Public Accountants Act, art. 1-2), and furthermore, a partner in the accounting firm who is involved in the audit certification work is restricted from assuming the office of officer, etc. of the company under audit or its consolidated companies, etc. until the completion of the following accounting term (Certified Public Accountant Act, art. 34-14-2), and if a partner assumes the office of officer of the company under audit or its consolidated companies, etc., the accounting firm may not provide audit certification work for the company under audit or its consolidated companies, etc. until the following accounting term (Certified Public Accountant Act, art. 34-11, para. 1, item 3). Moreover, steps to enhance “independence” have been taken, including rotation of the chief accountant who is responsible for an audit of a listed company at a major auditing firm (continuing audit period of five years with intervals of five years) (Certified Public Accountants Act, art. 34-11-4; Certified Public Accountants Act Enforcement Order, art. 18 through art. 20; and Certified Public Accountant Act Enforcement Regulation, art. 24). In addition, as a means of achieving reliability of quarterly reports which have been introduced with the FIEA, a system of quarterly review has been enacted. In the same manner audits are also to be conducted of internal control reports which have been introduced with the FIEA (FIEA, art. 193-2, para. 2).

Subsequently, in 2022, a registration system was introduced for the audit and attestation services for financial documents of listed companies, etc. in order to meet the growing expectations from society for the quality of audits. Under the new system, certified public accountants and auditing firms may not engage in the audit and attestation services for financial documents of listed companies, etc. unless they obtain registration in the listed company auditor register by the Japanese Institute of Certified Public Accountants. Provisions have also been developed with regard to the method of services by registered persons and the establishment of an operation control structure (Certified Public Accountant Act, art. 34-34-2 to art. 34-34-14). On the other hand, in order to develop an environment to enable certified public accountants to fulfill their capabilities, the scope of partners of an auditing firm whose engagement in the audit and attestation services of the auditing firm is restricted due to their spouse being an officer, etc. of a company, etc. is limited to partners, etc. involved in the audit and attestation services carried out by the auditing firm with regard to financial documents of the company, etc. (Certified Public Accountant Act, art. 34-11, para. 1).

(2) Audit Opinion

Stemming from this intent of the FIEA audits, the audit opinion of a certified public accountant verifies whether the financial statements, etc. have been prepared in accordance with the accounting precepts under the FIEA that are necessary to form a comparable investment judgment and to clarify the true value of the target of the transaction. The audit opinion expresses an opinion and reports that the auditing standards and procedures that are necessary for this verification have been carried out. In this sense, the audit report of a certified public accountant under the FIEA first must confirm that the person preparing the report is qualified as a certified public accountant, second must describe what audit procedures were followed, and third must declare the opinion of the auditor concerning the audit results.

The Audit Certificate Ordinance requires the certified public accountant or the accounting firm to disclose any special relationship with the audited company (Audit Certificate Ordinance, art. 4, para. 1, item 1(j)). Next, the

certified public accountant or the accounting firm must state an outline of the audit performed in the auditor's report. In addition, the certified public accountant or auditing firm must include a statement as to the scope of the audit and the fact that the audit was undertaken pursuant to generally accepted auditing standards (Audit Certificate Ordinance, art. 4, para. 1, item 1(a)(2) and para. 9).

In response to the 2002 amendments to the auditing standards, the current audit report must state (i) that the auditing standards require the certified public accountant or accounting firm who performed the audits to obtain reasonable guarantee that the financial statements, etc. include no material false statements, (ii) that the audits were conducted based on sampling, (iii) that the audits have examined the statements in the financial statements, etc. as a whole, including the accounting standards adopted by the management, the method of application thereof and the evaluation of estimates performed by the management, and (iv) that the audits have provided reasonable grounds for expressing the opinion (Audit Certificate Ordinance, art. 4, para. 4, item 2, para. 9, item 2 through item 4).

The Audit Certificate Ordinance provides that the audit report must state an opinion as to whether the financial statements, etc. "properly present" the financial position, management performance, etc. of the company subject to audit (Audit Certificate Ordinance, art. 4, para. 1, item 1(a)(2)). "Properly present" here means an opinion that the financial statements, etc. are stated in conformity with the objectives of the FIEA, in other words, that they enable a comparison between securities in the capital markets and express the true value of the individual security. Since "proper" of course includes "legal," it is not sufficient to simply conform with the standards of the "general principle of financial accounting" (this precondition is thought to contain a historically formed perception that self-regulatory rules have a higher standard than law and regulation as in Europe and North America).

Moreover, in a quarterly report, only limited procedures can be carried out in limited period of time, and consequently the statement of opinion by the auditor will express its conclusion in a negative assurance form concerning the suitability of the quarterly financial statements, etc. (the expression of a conclusion concerning whether it was not recognized in any material respect a matter that would cause the belief that a statement was not made in a proper manner), so that the statements of opinion can be divided into an "unrestricted conclusion," "a limited conclusion stating matters that are excluded," and a "negative conclusion" (Audit Certificate Ordinance art. 4, para. 17).

In addition, the Audit Certificate Ordinance does not provide a direct stipulation concerning an auditor's reserving its opinion, while Accounting Standards No. 4, (1) (iv) provides that "if the auditor is unable to obtain reasonable basis for forming the auditor's opinion because any material auditing standard could not conducted, the auditor shall not express its opinion." Stemming from the above-mentioned intent of the FIEA audit provisions, a disclaimer not only expresses mistrust towards the management, it also indicates a serious situation—since the common scale to evaluate investment options is lost, and the preconditions for forming an investment decision in the market are similarly lacking.

(3) Duty to Report at the Time of Discovering Improprieties or Illegal Activity

The 2007 amendments to the FIEA made simultaneously with the amendments to the Certified Public Accountant Act impose a duty to report on certified public accountants and auditing firms at the time they discover improprieties or illegal activity.

This duty has been imposed from the perspective of enhancing, *e.g.*, the independence of auditors and the effectiveness of audits. It requires that if a certified public accountant or an auditing firm discovers a legal or regulatory violation on the part of a specified issuer, or another event that may have an impact on the propriety of documents in connection with financial accounting (a "legal or regulatory violation, etc.") the certified public

accountant or auditing firm must notify the specified issuer of the content thereof and that the issuing company, etc. must take corrective action. Moreover, if there is a risk of an impact on the achievement of the propriety of documents in connection with financial accounts, and appropriate action is not taken, the certified public accountant or auditing firm must notify the Prime Minister (FIEA, art. 193-3).

It is hoped that this will result in the issuing company taking appropriate action prior to notification being made to the Prime Minister.

13 10 Internal Control Report System

Having a system of internal control in place within the companies that provide the financial information which is presented to the capital markets, is of utmost importance in achieving the FIEA accounting and the FIEA auditing objectives, and ensuring the fair price formation by the full functioning of the capital markets functions.

Consequently, the FIEA stipulates that listed companies, etc. that are required to file annual securities reports must for each business year file with the Prime Minister a report which assesses the regimes that are necessary to achieve the compliance of documentation and other information in connection with financial accounting involving the corporate group of which such company is involved, as well as the company itself (an “internal control report”), together with the annual securities report (FIEA, art. 24-4-4).

This internal control report must be audited by a certified public accountant or an accounting firm, in order to ensure the objectivity of the evaluation of internal control by management, and to promote the implementation of internal control procedures by listed companies, etc. (FIEA, art. 193-2, para. 2). This system was developed using the U.S. Sarbanes-Oxley Act of 2002 as a reference, and applies to business years from April 1, 2008 (this section is referred to as the “J-SOX Act”).

Although this system of reporting on internal control under the FIEA is limited to “internal control with respect to financial reports,” it is necessary to have material information provided in a timely fashion to the capital markets in order to achieve fair price formation which is the objective of the FIEA. And consequently, an internal control system must be created which will enable this to take place. From this perspective, the internal control system required by the FIEA is on a consolidated basis.

Although under the Companies Act it is the board of directors of a stock company that makes the decision to put in place an internal control system (Companies Act, art. 362, para. 4, item 6 and para. 5), a listed company, etc. which is governed by the internal control reporting system of the FIEA is required to make the decision in accordance with the internal control reporting system under the FIEA. In this sense, the internal control system that is for the purpose of achieving the objectives under the FIEA can be said to have a relationship of also contributing to governance under the Companies Act.

The Business Accounting Council has published its “On the Setting of the Standards and Practice Standards for Management Assessment and Audit concerning Internal Control Over Financial Reporting (Council Opinions),” as well as its “Practice Standards for Management Assessment and Audit Concerning Internal Control Over Financial Reporting,” for the purpose of the internal control reporting system, which are considered as generally accepted standards for evaluation of internal control concerning financial reporting and generally accepted standards for audits on internal control concerning financial reporting (Internal Control Ordinance, art. 1, para. 1, para. 4 and para. 5).

There are several characteristics of this internal control reporting system. Firstly, audits on financial instruments and audits on internal control shall be conducted as a package by the same accounting firm. Secondly, the so-called direct reporting method where the certified public accountant/accounting firm directly evaluates internal control was not adopted. Accordingly, even if a material weakness is found, if it is properly disclosed in the internal control report, it will be represented as an "unqualified opinion." Thirdly, standards concerning the defect of internal control was narrowed down to "internal control deficiency" and "material weakness to be disclosed" and if the internal control system is formulated from the perspective of preventing false statements that are created by a material weakness in internal control, and if a weakness of this nature is corrected by the end of the period, the internal control will be found to be effective. Furthermore, the standard for significance for this purpose is defined in values as approximately 5% of the consolidated profit before tax.

The contents that are to be stated in internal control reports and internal control audit report are prescribed separately by Internal Control Ordinance.

Under the 2014 amendment to the FIEA, a listed company, etc. whose amount of capital or any other scale of management does not reach the criteria specified by Cabinet Office Ordinance is exempted from the obligation to have its internal control report audited, for three years from the date of its new listing (FIEA, art. 193-2, para. 2, item 4; FIEAEO, art. 35-3; Internal Control Ordinance, art. 10-2). This is to reduce the burden on emerging and growing companies and facilitate their listing.

13 11 Disclosure of False Information and Civil Liability

(1) Civil Liability in the Primary Markets

With respect to public offerings and secondary distributions of certain securities, persons who have caused others to acquire such securities using a prospectus containing false statements of material facts or omitting material facts that must be stated or fact that is necessary to avoid misunderstanding, or using materials containing false indications or misleading indication with respect to material facts or lacks indication that is necessary to avoid misunderstanding, shall be liable for the damages incurred by such persons who have acquired the securities without knowledge of the said facts (FIEA, art. 17, main clause).

Nevertheless, a person who would normally be liable to compensate damages will not be liable if that person can prove that he/she did not know of, and was unable to know of even with reasonable care, the existence of such false statement, etc. (*id.*, *proviso*).

The liability for false statement on the part of a person who has actually used a prospectus as the means for delivery of information directly to an investor is defined as a responsibility similar to that associated with ordinary unfair trading or fraud, and the provisions relating to the responsibility of persons filing securities registration statements apply to the responsibility of issuers who have prepared a false prospectus (FIEA, art. 18, para. 2).

The registrant of a securities registration statement containing false statements or the like is liable for the damages incurred by a person who has acquired the subject securities through a public offering or secondary distribution, but this liability will not be incurred if the acquirer was aware of the said false statements, etc. (FIEA, art. 18, para. 1). The amount of such liability for damages resulting from false statements in a securities registration statement is defined under law as the amount paid by the claimant to acquire the securities minus the market value of the securities at the time of the claim or amount received upon disposition of the subject securities if such

securities have been disposed of prior to the time of the claim (FIEA, art. 19).

The right of claim for damages under the FIEA, Article 18, shall lapse if the injured party does not make a claim within a period of three years from the time that party becomes aware of the false statements or the time the claimant should have become aware of such false statements through the exercise of reasonable care. Moreover, such right of claim shall lapse after the passage of seven years from the time at which the registration of a public offering or secondary distribution became effective or the time at which the prospectus was delivered (FIEA, art. 20).

Responsibility for false statements in the securities registration statement is also assigned to the officers of the filing company, owners of the securities involved in a secondary distribution, the certified public accountants and accounting firms, and the financial instruments business operator or registered financial institution that entered into the wholesale underwriting contract (FIEA, art. 21).

(2) Civil Liability in the Secondary Markets

The officers, certified public accountants and accounting firms associated with the registrant of annual securities reports, internal control reports, semiannual securities reports, quarterly securities reports, extraordinary reports, and share buyback reports that contain false statements, etc. are liable for the damages incurred by persons who have acquired or disposed of the securities in the secondary market (FIEA, art. 24-4, art. 24-4-7, para. 4, art. 24-5, para. 5, art. 24-4-6, and art. 24-6, para. 2). If a securities registration statement contains false statements or the like, persons who have acquired or disposed of securities of the issuer who filed the securities registration statement, by means other than a public offering or secondary distribution, shall have the same right of claim for damages (FIEA, art. 22).

Under the amendments in 2004, the provisions above of the FIEA, Article 19, codifying the amount of liability for damages resulting from false statements or the like in a securities registration statement also became applicable to claims for damages against issuers resulting from false statements or the like contained in disclosures made in the secondary markets (FIEA, art. 21-2, para. 1). In addition, the law as amended established provisions for presumption of the amount of damages, in addition to the provisions of the FIEA, Article 19 (FIEA, art. 21-2, para. 3).

Under these provisions, if the fact of the false statement, etc. is publicly announced, the amount of damages resulting from the false statement may be deemed to be the average market value of the subject securities for a period of one month prior to the time of announcement (if no market prices are available for this period, the estimated disposal value) reduced by the average market value of the subject securities for a period of one month following the time of announcement.

The presumption that the amount of damages is equal to the net of the value that is thought to have been influenced by market abuse minus the value after eliminating this assumed market abuse, and setting the respective calculation dates one month prior to and after calculation, constitutes a concept of broad application, and may have practical significance against acts such as market manipulation as well. Persons who may use this vehicle of presumption of damages are limited to persons who both (i) acquired the subject securities within one year prior to the date of the announcement of the fact of false statements, and (ii) hold the securities continuously on the day of the announcement.

However, under the 2014 amendment, a company that has submitted a false disclosure document in the secondary market is exempted from the liability for damages if it successfully proves lack of negligence on its side (FIEA, art. 21-2, para. 2). As regulations to deter illegal conduct have been tightened since 2004 through the

introduction and reinforcement of the administrative monetary penalty system and the introduction of the internal control report system, it has become less important to impose absolute liability on the submitters of such false disclosure documents beyond the level of the general rules of liability for damages.

14 Tender Offer System

14 1 Significance

A tender offer (or takeover bid (TOB)) refers to “an act of soliciting offers for purchase, etc. or sales, etc. of share certificates, etc. from many and unspecified persons through public notice, and making purchase, etc. of share certificates, etc. outside of financial instruments exchange markets” (FIEA, art. 27-2, para. 6).

Tender offers are used as a unilateral strategy in a corporate buyout (including a hostile takeover). A buyout with the consent of the management of the target company is an amicable takeover, while a buyout that is opposed by management is a hostile takeover, but a hostile takeover is not necessarily an abusive one that will undermine corporate value.

The proper conduct of a tender offer requires that shareholders and investors be given sufficient information and time to consider, as well as a fair opportunity to sell. When a buy-up of shares occurs off of a market, it becomes impossible to expect the fair price formation function to operate within the market, which consequently is believed to increase the risk of adverse consequences to shareholders and investors (of course there is also the opinion with respect to this issue that a distinction should not be made between on-market and off-market).

The FIEA consequently imposes a variety of regulations on tender offers.

14 2 Tender Offers by Person Other Than Issuer

(1) Extent of Application of Regulations

In principle, a purchase, etc. of share certificates, etc., for which the issuer thereof is required to file an annual securities report or of the issuer of specified listed securities by person other than such issuer, etc., and which is covered by any of (i) through (vi) below must be made by a tender offer (FIEA, art. 27-2, para. 1).

Because the trading market for professionals was established with the 2008 amendments, share certificates, etc. of issuers of specified listed securities (FIEA, art. 2, para. 33) has become subject to tender offer. The same applies to the share certificates, etc. of issuers of OTC-traded securities for professionals (specified OTC-traded securities) (FIEAEO , art. 6, para. 2):

(i) to purchase share certificates, etc., from 11 or more persons off-market, within a 60 day period, and in which the shareholding ratio of the share certificates, etc. after the purchase will exceed five percent; (ii) to purchase share certificates, etc., from not more than 10 persons off-market, within a 60 day period, and in which the shareholding ratio of the share certificates, etc. after the purchase will exceed one-third; (iii) to purchase share

certificates, etc., by way of specified sales and purchase, etc. (such as ToSTNeT trades), and in which the shareholding ratio of the share certificates, etc. after the purchase will exceed one-third; (iv) rapid purchase that combine transactions such as purchase on and off-market (meaning acquisition of share certificates, etc. in excess of 10 percent in three months, by way of purchase or acquisition of newly issued shares, of which more than five percent will be by off-market transactions) and in which the shareholding ratio of the share certificates, etc. after the purchase will exceed one-third; (v) a purchase made within the tender offer period of another person, by a person who has a shareholding ratio of more than one-third, and in which the said person will acquire in excess of a further five percent; and (vi) such other cases as are prescribed by Cabinet Order.

The stipulation in (i) above has been imposed in order to prevent shareholders and investors from selling off their shares when they are faced with a sudden offer from the purchaser, without having been able to make a sufficient investment decision. The stipulation in (ii) above was made to provide a fair opportunity to general shareholders and investors to sell their shares of stock at the time of transfer of right of corporate control, when they would not have been provided this opportunity to sell to the acquirer without this regulation (this can also be explained as an effort to achieve a fair distribution of the premium on right of corporate control), and is referred to as the one-third rule.

Category (iii) above was introduced with the 2005 amendments. Given that a public tender offer is a transaction that is to be conducted off-market, treating an off-hours transaction of a securities exchange as being the same as a market transaction would gut the tender offer regulations since even though off-hours transactions are trades which are under the control of a securities exchange, their substantive nature is that of a negotiated transaction. The 2005 amendments, therefore, defined sales and purchase, etc. in securities by means that the Prime Minister prescribes as constituting sales and purchase, etc. in securities on the securities exchange market (which under the FIEA is a financial instruments exchange market) by means other than auction as being "specified sales and purchase, etc.," and included this specified trading, etc. under the regulation framework.

Categories (iv) and (v) were introduced with the 2006 amendments. Category (iv) was enacted because transactions occurred which appeared to evade the one-third rule by combining trades on and off market. Since the advent of category (iv) if for example a person who already holds 24 percent of the share certificates has further acquired an additional six percent off-market without making a tender offer, the acquisition of a further four percent on-market within the following three months would be illegal. Category (v) was enacted in order to assure an equal footing between purchasers, and in order to enable investors to give sufficient consideration to competitive bids.

(2) Registration System for Tender Offer

A person who makes a purchase, etc. of share certificates, etc. through a tender offer must make a public notice of the purposes of the tender offer, the purchase price, the number of share certificates, etc. to be purchased, the purchase period, and other matters (FIEA, art. 27-3, para. 1). A person who has given public notice of making a tender offer (a tender offeror) must on the date on which the said public notice is made, file a tender offer registration statement with the Prime Minister stating the purposes of the tender offer, the purchase price, the number of share certificates, etc. to be purchased, the purchase period, and other matters (*id*., para. 2).

The 2006 amendments endeavor to enhance disclosure within tender offer registration statements, and require more extensive statements concerning matters such as the management policy and the behavior policy as a shareholder.

In some cases, securities constitute the consideration for purchase in a tender offer. This type of tender offer is referred to as a swap offer. In a swap offer it is sometimes necessary to file a registration statement concerning the

public offering or secondary distribution of the relevant securities at the same time as filing the tender offer registration statement (FIEA, art. 27-4).

Immediately after the filing of a tender offer registration statement, the tender offeror must send a copy thereof to the target company, etc. of the tender offer (FIEA, art. 27-3, para. 4). Additional obligations are also imposed on the tender offeror, including that the offeror is required to deliver the tender offer circular to persons who intend to sell, etc. their share certificates, etc. (FIEA, art. 27-9), and after the completion of the tender offer period is required to file with the Prime Minister a report concerning the results of the tender offer (FIEA, art. 27-13).

The issuer of the share certificates, etc. in connection with the tender offer (the target entity) must within 10 business days from the date of announcement of the tender offer file with the Prime Minister an opinion report stating, *inter alia* its opinion in connection with the tender offer (*e.g.,* whether it approves, opposes, is neutral or reserves expressing an opinion) and the reasons for the same, whether it will take defensive action against the purchase, and other matters (FIEA, art. 27-10, para. 1).

Although the tender offeror may set a tender offer period within a range that is at least 20 but not more than 60 business days (FIEA, art. 27-2, para. 2), if a tender offer period of less than 30 business days is stipulated, the target entity may demand in its opinion report that the tender offer period be extended to 30 business days (FIEA, art. 27-10, para. 2, item 2).

Within the opinion report, the target entity may also state questions to the tender offeror (FIEA, art. 27-10, para. 2, item 1), and a tender offeror to whom questions have been asked must within five business days submit a question response report (FIEA, art. 27-10, para. 11). Through these steps it is anticipated that the areas of conflict between the offeror and the management of the target company will be clarified, thereby enabling sufficient information to be provided that will contribute to the investment decisions by investors. Documents such as tender offer registration statements, etc. are made available for public inspection from the date that they are filed with the Prime Minister until five years have elapsed from the last day of the tender offer period (FIEA, art. 27-14).

With the 2008 amendments, if the Prime Minister issues an order to file amendment to registration statement, etc. and not make the tender offer registration with false statements, etc. be available for public inspection, the financial instruments exchanges/authorized financial instruments firms association receiving such notice are relieved from the obligation to provide the copies of such documents for public inspection (FIEA, art. 27-14, para. 5 through para. 7).

Moreover, regulations have been stipulated prescribing that liability to compensate damages are to apply to a person who violates any of the regulations concerning tender offers, or who uses a tender offer circular containing a false statement, etc., or who makes a tender offer commencement notice containing a false statement, etc. (FIEA, art. 27-16 through art. 27-21). Furthermore, an administrative monetary penalty system against person not making a public notice for commencement of tender offer and a person making a public notice for commencement of public tender offer with false statements, etc. was newly established (FIEA, art. 172-5 and art. 172-6).

(3) Conduct Regulations

Since the equality of information between the offeror and the applicant in a tender offer cannot be guaranteed, and since the offeror unilaterally presents the offer price, it is difficult for the applicant to determine the fairness of the transaction.

For this reason, the FIEA does not simply relegate this function to information disclosure concerning the tender offer, but it imposes many conduct restrictions in an attempt to ensure fair transaction terms.

The terms of the price of a tender offer must be equal (FIEA, art. 27-2, para. 3). Although raising the tender

offer price during the tender offer period is permitted, in principle, the tender offer price cannot be lowered (FIEA, art. 27-6, para. 1, item 1). In exceptional circumstances, the price may be lowered (*ibid.,* parenthetical statement in the same item) if the tender offeror has stipulated as a condition in the tender offer commencement announcement or the tender offer registration statement that the price may be reduced if the target entity has made a stock split or an allocation of shares without contribution, etc. during the public tender offer term. Moreover, although the offering period may not be truncated it may be extended (FIEA, art. 27-6, para. 1 item 3 and para. 2).

In principle, an offeror who makes a tender offer is prohibited from making a separate purchase of the relevant securities through any means other than the tender offer, and thorough steps are to be taken to achieve equal treatment among investors (FIEA, art. 27-5). Furthermore, tendering shareholders who made application to sell their shares are allowed to revoke such application (FIEA, art. 27-12). Thus, if a rival suitor presents an offer price higher than the price offered by the tender offeror, the tendering shareholder can revoke its earlier application and apply to the rival suitor with the higher offer price.

This allows the tender offer to take on the role as a sort of auction market, which is hoped will lead to the formation of a quasi-secondary market price for the target securities. M&A (mergers and acquisitions) in the U.S. frequently use this kind of method. The revocation rights on the part of tendering shareholders are not simply a cooling-off system to protect investors.

Although, in principle, a tender offeror cannot revoke its tender offer (FIEA, art. 27-11), a tender offer may be revoked if the tender offeror has stipulated as a condition in the tender offer commencement announcement or the tender offer registration statement that the tender offer may be withdrawn in the event that a significant change in the business or assets of the target entity of the tender offer or its subsidiary, or other circumstance occurs that constitutes a significant impediment to achieving the objectives of the tender offer (such as the launching of defensive action against the tender offer). The tender offer may also be withdrawn in the event that a material change in the tender offeror occurs, such as bankruptcy.

If tender offer is oversubscribed, the offeror must purchase the share certificates of tendering shareholders in proportion to the number of share certificates each tendered (FIEA, art. 27-13, para. 5). This is for the purpose of treating investors equally. The 2006 amendments further require that if the shareholding ratio of the share certificates, etc. after the purchase will exceed two-thirds, the tender offeror must purchase all of the share certificates, etc. of shares offered. This requirement has been added from the perspective of protecting shareholders in the event of a case such as when de-listing will occur after the purchase (introduction of partial requirement to purchase all shares offered; FIEA, art. 27-13, para. 4).

14 3 Public Tender Offers by Issuer

Even if a listed company makes a tender offer for its own shares, it must similarly follow the aforementioned tender offer procedures. Accordingly, the procedures under the FIEA incorporate by reference a large part of the provisions concerning non-issuer public tender offers described in 14.2 above (FIEA, art. 27-22-2). However, in the case of tender offer by issuer, when taking into account (i) acquisition of control of the company, etc. is not directly relevant, and (ii) the company that possesses the material information is itself making the tender offer, the FIEA contains the following special provisions:

(1) The provisions concerning the filing of a report on statement of opinion of the target company do not

apply (FIEA, art. 27-22-2, para. 2); and

(2) When unpublished material facts exist prior to the filing of the tender offer registration statement, or when material facts arise during the tender offer period, the announcement thereof is required (FIEA, art. 27-22-3);

(3) A more explicit statement is made of the liability to pay compensation for damages in the event of a violation of the duty of public announcement as set forth in (2) (FIEA, art. 27-22-4).

15 Disclosure System of Status of Possession of Large Volume of Share Certificates, Etc. (5% Rule)

15 1 Significance

A person who holds share certificates, etc. of a listed company, etc. and whose holding ratio of share certificates, etc. exceeds 5% (a "large volume holder"), must within 5 days from the date on which such person became a large volume holder file a report with the Prime Minister stating that person's holding ratio of share certificates, etc., the funds used to acquire the share certificates, etc., the purposes of holding and such other matters as prescribed by Cabinet Office Ordinance (a "**report of possession of large volume**") (FIEA, art. 27-23, para. 1). This is known as the report system of large volume possession or simply the 5% rule.

The 5% rule itself has characteristics as a market structure regulation, requiring the disclosure of "clustered" information (occurrences, transfers, increase/decrease, and extinguishment) in an imperfect market. It is hoped that Japanese takeover techniques, by introducing this, against the sudden appearance of an undesirable cornering of shares, would come to be transactions based on tender offer which is highly transparent corporate acquisition rule premised on the transparent 5% rule.

Cornering the share certificates, etc. of an issuer to gain management control, etc. is not automatically illegal under the FIEA, unless, of course, such cornering constitutes an unfair transaction such as market manipulation, insider trading, etc. However, stock prices often fluctuate wildly on news of such cornering or substitution, etc. and general investors without sufficient market information can incur unforeseen losses. In addition, cornering a large amount of share certificates, etc. constitutes important investment information since it can signal an influence on the management of the target.

From this perspective, the FIEA contains detailed provisions on the disclosure concerning the status of possession of large volume of share certificates, etc. (FIEA, art. 27-23 through art. 27-30). Thus, by transmitting timely and proper information concerning the large volume acquisition and holding of share certificates, etc., these rules seek to increase the fairness and transparency of Japan's stock markets and protect investors.

15 2 Outline of the 5% Rule

(1) Target Securities

The securities to be covered by a report of possession of large volume would be securities issued by a corporation that is the issuer of listed share certificates, etc.

The target securities include (i) share certificates (excluding those without voting rights); (ii) share option certificates and bonds with share options (other than those which grant solely rights to acquire only shares without voting rights); (iii) certificates or securities issued by a foreign person which have the characteristics enumerated in (i) and (ii); (iv) investment securities, etc. and investment equity subscription right certificates, etc.; (v) beneficiary certificates of securities in trust of which the entrusted securities are the securities set forth in (i) to (iv); and (vi) those that are prescribed by Cabinet Order as representing rights in connection with relevant securities (FIEA, art. 27-23, para. 1; FIEAEO, art. 14-4, art. 14-4-2 and art. 14-5-2).

Since the large volume possession disclosure system seeks to regulate those who have an influence on the right of corporate control through large volume possession, non-voting share, etc. is exempted from these provisions. Treasury shares have also been exempted as a result of the 2014 amendment (FIEA, art. 27-23, para. 4).

(2) Large Volume Holders

Persons who have a duty to file reports of possession of large volume shall be those holders of the target securities (share certificates, etc.) whose ownership ratio thereof exceeds five percent (large volume holders) (FIEA, art. 27-23, para. 1). A holder here means a person who owns the share certificates, etc. in its own name or that of another person (including a person, etc. who has the right to demand delivery of share certificates, etc. pursuant to an agreement of sale, etc.), as well as persons who have the authority to exercise voting rights, etc. pursuant to a monetary trust agreement, etc. and who have an objective of controlling the business activities of the issuer, as well as a person who has the necessary authority to invest in share certificates, etc. pursuant to a discretionary investment contract (*id*., para. 3).

(3) Holding Ratio of Share Certificates, Etc.

In principle, the holding ratio of share certificates, etc. shall be the number of share certificates, etc. held by the holder plus the number of share certificates held by joint holders, divided by the total number of shares issued (FIEA, art. 27-23, para. 4). It should be noted that the number of treasury shares is included in the number used as the denominator in calculating the holding ratio of share certificates, etc.

A joint holder is any other holder of share certificates, etc. with whom a holder of share certificates, etc. agrees to cooperate in the acquisition or assignment of share certificates, etc. or in the exercise of voting rights (*id*., para. 5). Moreover, persons with whom a relationship such as spousal or parent-child exists shall be deemed as joint holders (*id*., para. 6).

(4) Report of Possession of Large Volume

A large volume holder must file a report of possession of large volume within five days (not including Sundays and other holidays as prescribed by Cabinet Order) from the date on which the said person became a large volume holder (FIEA, art. 27-23, para. 1).

The report of possession of large volume must state a summary of the large volume holder and the joint

holders, the purposes of holding, details of the share certificates, etc. held, the status of acquisition and/or disposition during the last 60 days and information concerning the acquisition funds, etc. (Cabinet Office Ordinance on Disclosure of the Status of Large-Volume Holdings in Share Certificates, Form 1). A report of possession of large volume is to be filed with the Prime Minister (or in actual practice to a person such as the Director-General of the Kanto Local Finance Bureau), and must be filed through EDINET. Moreover, a copy of the report of possession of large volume must be sent to the issuer of the share certificates, etc. (FIEA, art. 27-27). However, under the 2014 amendment, a large volume holder is not required to send a copy of the said report to the issuer of share certificates if the report has been filed through EDINET (FIEA, art. 27-30-6, para. 3).

(5) Change Report

If, *inter alia*, an increase or decrease of at least one percent has occurred in the holding ratio of share certificates, etc. of a person who is to file a report of possession of large volume, after the said person has become a large volume holder, that person must file a change report within five days (not including Sundays and other holidays as prescribed by Cabinet Order) from the date that the event occurred (FIEA, art. 27-25, para. 1).

If a change report is to be filed on account of a change in the holding ratio of share certificates, etc. caused by an assignment of a large volume of share certificates, etc. within a short period of time, entries concerning the counterparty to the assignment and the consideration for the same must be made in the change report (FIEA, art. 27-25, para. 2; FIEAEO, art. 14-8, para. 1). However, with respect to a person specified by Cabinet Order as a person to whom an insignificant number of share certificates, etc. has been assigned (*i.e.,* where the total number of share certificates, etc. that a person has acquired within the last 60 days accounts for less than 1% of all share certificates, etc.), only the matters concerning the consideration for the acquisition are required to be stated (FIEA, art. 27-25, para. 2; FIEAEO, art. 14-8, para. 2).

The amendments in 2013 made it unnecessary to submit any additional change report if a change report stating that the holding ratio of share certificates, etc. is five percent or less has already been submitted (FIEA, art. 27-25, *proviso*).

(6) Reports Subject to Special Provisions

Since entities such as securities companies, investment management companies, banks, trust banks and insurance companies engage in large volume trading of share certificates, etc. on a daily basis, they would have a very onerous clerical burden if the regulations concerning report of possession of large volume were to apply to them simply as discussed above. Consequently, the FIEA enacted a system for reporting under exceptional treatment in order to reduce the burden on this type of entity within reasonable limits, but increasing questions have been raised as to whether investment funds are abusing this exception, and consequently, the system of exceptional treatment was extensively revised with the 2006 amendments.

Essentially, the deadline for filing of the report under special provisions, which in principle had been within 15 days every three months, was shortened to within five days (not including Sundays and other holidays as prescribed by Cabinet Order) every two weeks. In addition, the situations which are ineligible for use of the reporting under the special provisions have expanded from “when the purpose of holding is to control the business activities of the company,” to “when the purpose of holding the company is to make an act as prescribed in by Cabinet Order as causing a material change or having a material effect (an ‘act of a material proposal, etc.’) on the business activities of the issuer” (FIEA, art. 27-26).

Moreover, there is no change from the prior situation in which the regulation allowing reporting under special

provisions cannot be used if the holding ratio of share certificates, etc. exceeds 10 percent.

(7) Public Inspection of Report of Possession of Large Volumes, Etc.

Reports of possession of large volume or change reports are provided for public inspection for five years (FIEA, art. 27-28, para. 1).

With the 2008 amendments, if the Prime Minister issues an order for filing of amendment reports and determines the report of possession of large volume, etc. with false statements, etc. not to be provided to public inspection, the financial instruments exchange/authorized financial instruments firms association receiving such notice shall be relieved from the obligation to provide copies of such documents for public inspection (FIEA, art. 27-28, para. 4 through para. 6).

(8) Administrative Monetary Penalty

With the 2008 amendments, the failure to file reports of possession of large volume, etc. has become subject to an administrative monetary penalty, and the amount of administrative monetary penalty has been prescribed as one-one hundred thousandth of the total market value of the issuer of share certificates, etc. concerning the report of possession of large volume, etc. to be filed (FIEA, art. 172-7).

Furthermore, the Prime Minister has the authority to hear reports from and inspect the filer, etc. of reports of possession of large volume, and as the failure to file reports of possession of large volume have become subject to the administrative monetary penalty system, not only persons who have filed the report but persons who are required to file the report have also become subject to the hearing and inspection authority (FIEA, art. 27-30).

(9) Criminal Penalties

Failure to file a report of possession of large volume or a misrepresentation on such report is punishable by imprisonment of not more than five years and/or a penal fine of not more than JPY5 million (FIEA, art. 197-2, item 5 and item 6). In addition, penal sanction applies not only to the person who committed the offense, but also to his or her company (FIEA, art. 207, para. 1, item 2).

16 Market Supervision and Oversight

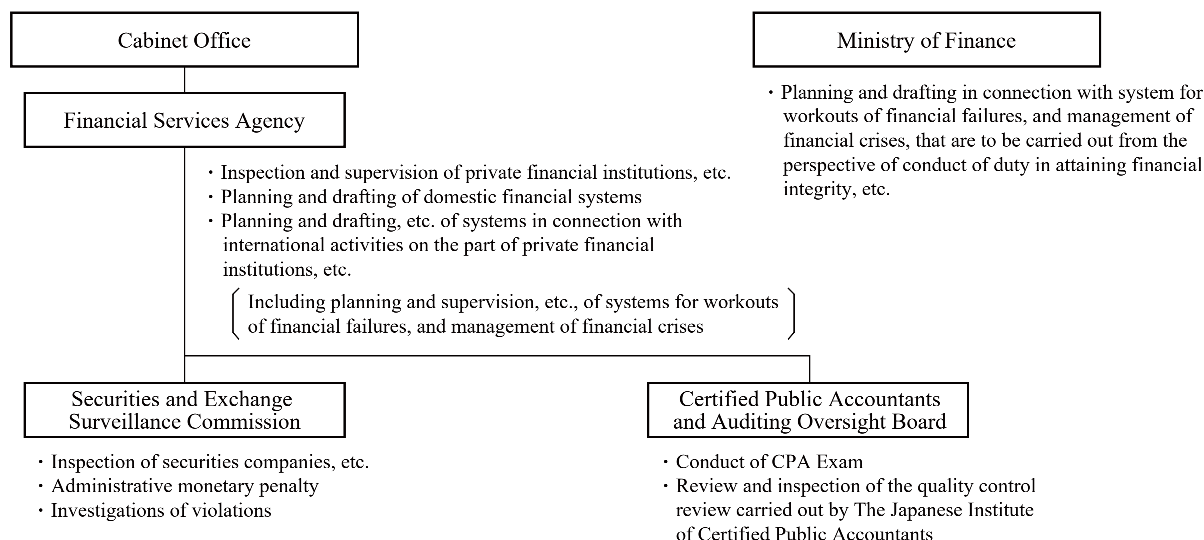
16 1 General

(1) Financial Regulatory Authorities in Japan

As of the present time regulation of financial institutions in Japan is carried out by the Financial Services Agency, which is an external agency of the Cabinet Office. Formerly, the (prior) Ministry of Finance served this role, but in 1998 the Financial Supervisory Agency and Financial Reconstruction Commission were created as agencies to inspect and supervise financial institutions and to monitor securities trading, etc. In 2000, the Financial Supervisory Agency was reorganized as the Financial Services Agency under the Financial Reconstruction Commission, and succeeded to the role of the Ministry of Finance. Thereafter in 2001, a reorganization of central

government agencies was implemented, and under the present structure, the Financial Services Agency positioned as an external agency under the Cabinet Office.

The following presents an organization chart of financial regulation in Japan as it currently stands.



(From the FSAWebsite)

(2) Delegation of Authority

The FIEA grants various legal and regulatory authorities of administrative institutions under the FIEA to the Prime Minister. Since the Prime Minister delegates these authorities to the Commissioner of the Financial Services Agency (FIEA, art. 194-7, para. 1), when reading the text, it is necessary to be careful to replace the Prime Minister with the Commissioner of the Financial Services Agency.

Moreover, the Commissioner of the Financial Services Agency further delegates some of the authorities that are delegated by the Prime Minister, to the Securities and Exchange Surveillance Commission (FIEA, art. 194-7, para. 2).

16 2 Securities and Exchange Surveillance Commission

As set forth above, the Securities and Exchange Surveillance Commission (SESC) is delegated with certain authorities by the Commissioner of the Financial Services Agency. The SESC mainly conducts daily monitoring of the markets and inspection of business operators, inspection of annual securities reports, etc., administrative monetary penalty investigations, and investigations of criminal cases.

The delegated authorities specifically include the following (FIEA, art. 194-7, para. 2):

(1) The authority to order, *inter alia*, a financial instruments business operator, etc., a financial instruments intermediary service provider, a credit rating agency, a financial instruments exchange, etc., or a counterparty to a transaction thereof, a subcontractor, related company, or foreign financial instruments business operator, etc., to submit documentation, et al., as well as to conduct inspections (FIEA, art. 56-2, para. 1, para. 3 and para. 4, art. 60-11, art. 66-22, art. 66-45, para. 1, art. 75, art. 151, and art. 155-9);

(2) Collecting reports and making onsite inspections in connection with cases in which administrative

monetary penalties may be assessed for reasons such as spreading rumors, market manipulation, or insider trading (FIEA, art. 177);

(3) Report and documentation submission orders to persons submitting public documents, etc., persons related to tender offers, persons related to reports of possession of large volume, persons providing specific information, etc., persons disclosing material information, etc., financial instruments business operators, etc., subsidiary companies, etc. of special financial instruments business operators, designated parent companies, etc., major shareholders of designated parent companies, authorized transaction-at-exchange operators, etc., persons reporting specially permitted services, etc., financial instruments intermediary service providers, etc., credit rating agencies, etc., high-speed traders, authorized associations, etc., certified associations, etc., investor protection funds, etc., persons submitting a notification of holdings in subject voting rights of an exchange, major shareholders of a stock company-type financial instruments exchange, persons submitting a notification of holdings in subject voting rights of the holding company of a stock company-type financial instruments exchange, major shareholders of a holding company of a stock company-type financial instruments exchange, the holding company of a stock company-type financial instruments exchange or its subsidiary, a financial instruments exchange, etc., a foreign financial instruments exchange, etc., persons submitting a notification of holdings in subject voting rights concerning a domestic clearing organization, major shareholders of a domestic clearing organization, financial instruments clearing organizations, etc., foreign clearing organizations, etc., a securities finance company, etc., designated dispute resolution organizations, trade repositories, etc., specified financial benchmark administrators, etc., certified public accountants or auditing firms (FIEA, art. 26, art. 27-22, art. 27-30, art. 27-35, art. 27-37, art. 56-2, para. 1 through para. 4, art. 57-10, para. 1, art. 57-23, art. 57-26, para. 2, art. 60-11, art. 63-6, art. 66-22, art. 66-45, para. 1, art. 66-67, art. 75, art. 79-4, art. 79-77, art. 103-4, art. 106-6, art. 106-16, art. 106-20, art. 106-27, art. 151, art. 155-9, art. 156-5-4, art. 156-5-8, art. 156-15, art. 156-20-12, art. 156-34, art. 156-58, art. 156-80, art. 156-89, art. 193-2, para. 6; FIEAEO, art. 38);

(4) The authorities of the Commissioner of the Financial Services Agency regarding the petition for order for prohibition or suspension by the court (FIEA, art. 192, para. 1) have also been delegated to the SESC (FIEA, art. 194-7, para. 4, item 2). In addition, by the 2010 amendments, the authority to petition for an order for prohibition or suspension by the court and the authority to take certain measures necessary for the investigation of such petition may be delegated by the SESC to the directors-general of each local finance bureau (FIEA, art. 194-7, para. 7). Furthermore, by the same amendments, from the viewpoint of ensuring the effectiveness of orders for prohibition or suspension by the court, a penalty (fine of JPY300 million or less) may be levied against juridical persons violating the prohibition or suspension order by the court (FIEA, art. 207, para. 1, item 3). Under the amendments in 2011, the court having jurisdiction over the place where the violation has been committed or will be committed is included in the scope of courts having jurisdiction over a petition for a prohibition order or order of suspension (FIEA, art. 192, para. 3). Further as a result of the amendments in 2015, the court may now issue an order for prohibition or suspension of the sale and solicitation when the execution of operations in connection with specially permitted services for qualified institutional investors is extremely improper and is actually causing serious damage to the interests of investors, and there is urgent necessity to prevent the spread of damage among investors (FIEA, art. 192, para. 1).

16 3 Administrative Monetary Penalties

Given the substantial public interest involved with the large number of transactions concentrated at a single location and the impact that the resulting price formation can have on the national economy, the legal system for capital markets must simultaneously evolve in a timely fashion in both rule making and enforcement. There are also many instances where there is a need for such provisions to be able to respond dynamically to situations such as with market oversight, management of listings and accounting rules.

Even if it is difficult to regulate what could be regarded as a living animal, the rules must be effective given their importance to the public interest. Leaving such matters in the hands of only criminal procedures and traditional administrative procedures will allow many market abuses to go unchecked and result in the distortion of fair market prices, which are important indicators for the national economy. The securities markets, with little ability to resist being caught up in a bubble, would thus become the source of a great many problems for society.

Accordingly, first, the regulatory authorities must respond immediately if it appears that a market abuse may occur. Second, if such market abuse has already occurred, it is first necessary to seize from the perpetrator the gains resulting from any prohibited conduct. Third, a system of sanctions must be in place to prevent "market abuses from occurring in the first place."

The system of administrative monetary penalties introduced by the 2004 amendments to the SEL came into being as the result of these unique concepts in market regulation. The administrative monetary penalties are imposed by the Prime Minister based on certain procedures upon the occurrence of certain types of unfair trading, and require the payment into the national treasury of an amount decided according to the particular offense involved (FIEA, art. 172). However, unlike civil penalties that impose fines which are "multiples of the amount of improper profit gained," the amount of these fines goes no further than a portion of such gains.

Originally, the application of the system of administrative monetary penalties was limited to the four prohibited types of conduct consisting of (i) violation of the duty of disclosure involving issues by making a false representation, etc. in a securities registration statement, (ii) violation of the prohibition against spreading rumors or using fraudulent means, (iii) violation of the prohibition against market manipulation, and (iv) violation of the prohibition against insider trading. With the 2005 SEL amendments, however, administrative monetary penalties have also come to apply to violation of continuous disclosure obligations such as annual securities reports, semiannual reports and extraordinary reports, etc.

In addition, with the 2007 amendments to the Certified Public Accountants Act they have also come to apply to false or inappropriate certifications by a certified public accountant or an auditing firm (Certified Public Accountants Act, art. 31-2 and art. 34-21-2), and the FSA has clarified the standards for dispositions in the "Basic Concept for Disciplinary Actions, Etc. Against Certified Public Accountants and Accounting Firms."

Tribunal proceedings have also been enacted as the procedure in order to impose administrative monetary penalty (FIEA, art. 178 through art. 185-17; Certified Public Accountants Act, art. 34-40 through art. 34-62).

The administrative monetary penalty system was reviewed with the 2008 amendments based on the past records, etc. since its introduction and to achieve a more effective prevention of acts of violation. Specifically, administrative monetary penalty standards were raised, the scope of application of administrative monetary penalties was reviewed, addition system of administrative monetary penalties and reduction system of administrative monetary penalties were introduced, statute of limitation was extended, and trial proceedings were reviewed.

These amendments have broadened the application of administrative monetary penalties to false statements in tender offer registration statements and failure to file thereof, false statements in reports of possession of large volume and failure to file thereof, fictitious trades and wash trades among market manipulation, stabilization operations among market manipulation, failure to file shelf registration documents and failure to file continuous disclosure documents.

In addition, if a person that has become subject to an administrative monetary penalty during the past five years has once again made a violation, the administrative monetary penalty has become stricter such as adding 50% to the amount of administrative monetary penalty or extending the statute of limitations from three years to five years. Furthermore, the so-called leniency system where the amount of administrative monetary penalty will be reduced by 50% if reporting of certain acts of violation (insider trading in trading of treasury shares, false statements in offering or continuous disclosure documents, failure to file reports of possession of large volume) was made prior to investigation by the authorities.

The amendments in 2011 introduced a new system for amending the facts alleged as the basis for commencement of the trial procedure for administrative monetary penalties. Under the conventional system, even when the trial examiners, in the course of examining evidence, became convinced of a fact that was inconsistent with the facts subject to the trial, it was unclear how they would rectify such inconsistency in the trial procedure, due to the absence of provisions concerning the permissibility to amend the facts subject to the trial or the method of amendment. The amendments in 2011 clarified these matters, expressly stipulating that the designated officer may amend the facts alleged as the basis for commencement of the trial procedure, the applicable laws and regulations, the amount of administrative monetary penalties, etc. as long as such amendment does not harm the interests of respondent (FIEA, art. 181, para. 4; Administrative Monetary Penalty Ordinance, art. 23-2).

Furthermore, pursuant to the amendments in 2012, in cases where an issuer, etc. submits, provides or publishes false disclosure documents, etc., a person who has conducted an act that makes such submission, etc. easier or an act that abets such submission shall be subject to an administrative monetary penalty in an amount equivalent to the amount, etc. paid as a consideration for such acts (FIEA, art. 172-12). Moreover, if a person other than a financial instruments business operator, etc. conducts unfair trading based on the account of others, such person shall be subject to an administrative monetary penalty in an amount equivalent to the amount of consideration of the remuneration therefor (FIEA, art. 173 through 175).

The amendments in 2013 authorized the Prime Minister to order the production of articles in an inspection regarding imposition of an administrative monetary penalty and to make inquiries to public offices or public or private organizations and request them to submit reports when necessary for such inspection (FIEA, art. 26, para. 2, art. 27-22, para. 3, art. 27-22-2, para. 2, art. 27-30, para. 3, art. 27-35, para. 2, art. 177, and art. 187, para. 2).

16 4 Disclosure of Names, Etc. of Persons Who Violated Laws and Regulations

When the Prime Minister finds it necessary and appropriate for the public interest or protection of investors, he/she may, pursuant to the provisions of Cabinet Office Ordinance, make public the name of a person who has violated law or regulation as well as other matters necessary for preventing the occurrence or spread of damage from such violation or for ensuring fairness in transactions (FIEA, art. 192-2).

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Introduction

The Financial Instruments and Exchange Act (hereinafter referred to as the "FIEA") is not the only law which sales representatives must take into consideration upon soliciting and selling financial instruments to customers. Laws such as the Act on the Provision of Financial Services (Note 1), the Consumer Contract Act(Note 2), the Act on the Protection of Personal Information(Note 3) and the Act on Prevention of Transfer of Criminal Proceeds(Noe 4) are closely related to the solicitation and sale of financial instruments.

Sales representatives conducting the solicitation and sale of financial instruments must fully understand and comply with these related laws.

(Note) 1. Act No. 101 of May 31, 2000; amended with the title changed from the "Act on Sales, Etc. of Financial Instruments" to the "Act on the Provision of Financial Services" as of November 1, 2021
2. Act No. 61 of May 12, 2000
3. Act No. 57 of May 30, 2003
4. Act No. 22 of March 31, 2007

1 Act on the Provision of Financial Services

The Act on the Provision of Financial Services (hereinafter referred to as the "APFS") was established as of November 1, 2021, and it amended and replaced the Act on Sales, Etc. of Financial Instruments. The APFS provides for the obligation of sales representatives to give an explanation regarding financial instruments, such as shares and investment trusts, when they solicit customers and sell these items, and also stipulates their liability for damages in case of their failure to give a proper explanation, while providing for the financial service intermediary business. Chapter II of the APFS relates to the sale, etc. of financial instruments; this chapter clarifies the obligation to make explanations and provides for the rule of presumption of damage and the shift of burden of proof, with the aim of ensuring protection for investors who are at disadvantage in terms of the access to information in comparison to financial instruments providers, etc. The financial service intermediary business is prescribed in Chapter III which provides for the registration of the financial services intermediary business that is defined as engaging in the business of any of the following: deposit, etc. intermediary business operations, insurance intermediary business operations, securities, etc. intermediary business operations, or loan intermediary business operations. This chapter also stipulates various regulations on conduct of a financial service intermediary.

1 1 Outline and Purpose

The APFS provides for the following matters (APFS, art. 1):

(i) Obligation of financial instruments providers, etc. to give explanation to customers upon selling financial instruments;

(ii) Compensation liability for damages incurred by customers arising from the breach of explanation obligations and the presumption of the amount of damages, etc.;

(iii) Other matters related to the sale, etc. of financial instruments; and

(iv) Implementing a registration system for persons engaging in financial service intermediary business and ensuring the sound and appropriate management of its business operations.

The objective of the APFS is to aim for the protection of customers of financial services and contributing to the sound development of the national economy by providing for matters mentioned above.

Customers shall purchase financial instruments under the principle of self-responsibility; however, in reality, there is a difference between the knowledge and experience of customers and financial instruments providers, and a gap in the information held (asymmetry of information). In view of such circumstances, it is important to organize the premises for customers to subjectively select risk while being aware of their self-responsibility.

Currently, other laws such as the FIEA aim to protect customers regarding trades in financial instruments, but the focus of the APFS is to expedite and lessen the burden regarding suits concerning the sale of financial instruments by the civil compensation liability and shifting burden of proof, thereby aiming to prevent disputes in advance.

The financial services intermediary business is a new business category introduced by the amendment that came into effect as of November 1, 2021. Regarding this business, the APFS provides for the registration system, and stipulates various regulations on the conduct of a financial service intermediary engaging in the business of deposit, etc. intermediary business operations, insurance intermediary business operations, securities, etc. intermediary business operations, or loan intermediary business operations, as well as measures to ensure their appropriate management of the business.

1 2 Coverage and Scope of Application

Chapter II of the APFS provides that the obligation to explain is borne by a person conducting the business of "sale, etc. of financial instruments" (financial instruments business operator, etc.) (*id.*, art. 4, para, 1). The "sale of financial instruments" refers to, for example, conclusion of a contract on acceptance of deposits etc., acts of having a person acquire securities, market and OTC derivatives transactions (each item under *id.*, art. 3, para. 1), and the "sale, etc. of financial instruments" is defined to include the sale of financial instruments, the brokering thereof or the acting as agent for or the intermediation thereof (each item under *id.*, art. 3, para. 2).

Specifically, the "sale, etc. of financial instruments" include not only the act of brokering for entrustment of trades in share certificates and the sale of investment trusts to customers, but also the act of brokering for entrustment of commodity-related market transactions of derivatives.

A person conducting the business of sale, etc. of financial instruments is considered to be a "financial

instruments provider, etc." who bears the obligation to explain under the APFS. Financial instruments business operators, etc. (including registered financial institutions) bear the responsibilities provided for in Chapter II of the APFS such as the obligation to explain important matters to customers as "financial instruments providers, etc." if they conduct the sale, etc. of such financial instruments as business.

1 3 Obligation to Explain

If a financial instruments provider, etc. conducts the sale, etc. of financial instruments as business, it must explain important matters to the customer prior to the sale of the financial instruments (APFS, art. 4, para. 1).

The explanation of important matters may be conducted by delivering a document, but it must be in the manner and extent necessary for the customer to understand in light of the customer's knowledge, experience, financial standing and purpose for entering into the contract for the sale of the financial instruments (*id.*, para. 2).

Key matters among those listed as important matters to be explained prior to the sale are as follows:

(1) If there is a possibility that the principal may be lost or a loss exceeding the initial principal may arise directly due to fluctuations in interest rates, price of currencies, market rates or other indices (market risk) (APFS, art. 4, para. 1, item 1 and item 2):
- **The effect that the principal may be lost or a loss exceeding the initial principal may occur;**
- **The said indices; and**
- **Important parts of the transaction scheme concerning the sale of the said financial instrument;**

(2) If there is a possibility that the principal may be lost or a loss exceeding the initial principal may arise directly due to the change of status of the business or assets of the provider of the said financial instrument or other persons (credit risk) (*id.*, item 3 and item 4):
- **The effect that the principal may be lost or a loss exceeding the initial principal may occur;**
- **The said person; and**
- **Important parts of the transaction scheme concerning the sale of the said financial instrument;**

(3) If there is a restriction on the period for exercising rights or the cooling-off period, the said effect (*id.*, item 7).

The obligation to explain important matters above does not apply to "specified customers" (basically the same as "professional investors" under the FIEA, (art. 2, para. 31)) prescribed by Cabinet Order as having professional knowledge and experience regarding the sale, etc. of financial instruments (APFS, art. 4, para. 7, item 1). General investors who have changed to professional investors are also treated as specified customers.

In addition, if the customer manifests its intent not to require explanation on the important matters, the financial instruments provider, etc. is exempt from the obligation to explain important matters, except where the sale of financial instruments is a commodity-related market derivatives transaction prescribed in Article 2, Paragraph 8, Item 1 of the FIEA or brokerage thereof (APFS, art. 4, para. 7, item 2). It should be noted that the financial instruments provider, etc. has an obligation to explain to the customer even if the customer has clearly

expressed that he/she does not require an explanation on important matters regarding the commodity-related market transactions of derivatives and the brokerage therefor by the financial instruments provider, etc. It should also be noted that the financial instruments provider, etc. is not exempted from the obligation to explain the details to the customer under the FIEA, regardless of whether it has been exempted from the obligation to explain to the customer under the APFS (FIEA, art. 40, item 1; Cabinet Office Ordinance Concerning Financial Instruments Business, Etc. (hereinafter "FIBCOO"), art. 117, para. 1, item 1).

1 4 Presumption of Causality and Amount of Damages (Special Provision Regarding Tort Under the Civil Code)

The APFS makes it clear that the failure of a financial instruments provider, etc. to give explanation of certain important matters or the violation of the prohibition of the provision of conclusive evaluations upon the sale, etc. of financial instruments shall be subject to compensation liability arising from tort, and as special provisions regarding tort under the Civil Code, shifted the burden of proof of the damages as well as presumes the amount of damages.

The following are the modifications made to the Civil Code as special provisions of the Civil Code:

(1) Strict Liability for Breach of Obligation to Explain

Under the Civil Code, the existence of willful intent or negligence is required to establish tortuous acts, whereas, under the APFS, if a financial instruments business operator, etc. fails to explain important matters to a customer in breach of the obligation to explain important matters, the financial instruments business operator, etc. is held liable for any damage incurred by the customer, regardless of whether it is due to willful intent or negligence, thus strict liability is prescribed (APFS, art. 6). The same applies when a financial instruments business operator, etc. provides a customer with a conclusive evaluation, etc. in breach of the obligation not to do so (*id.*, art. 5).

(2) Shifting of Burden of Proof by Presumption of Causality and Amount of Damages

Under the Civil Code, the party asserting the damages must prove the causality between the tort and the occurrence of the damages as well as the amount of damages, but under the APFS, the burden of proof with respect to causality and the amount of damages has been shifted to financial instruments providers.

Specifically, the APFS presumes the amount of damages as the "amount of loss in the principal," and the amount of loss in the principal is prescribed to be the amount calculated in accordance with the following formula (APFS, art. 7):

Amount of loss in the principal = (Total amount of the money paid by and to be paid by the customer) − (total amount of money obtained by and to be obtained by the customer + total amount of the disposition value of property other than money obtained by the customer when goods or rights are sold or otherwise disposed of by the customer, etc.)

This Article is a special provision to the Civil Code, but it is considered possible to claim compensation for damages by tort or pursue default liability under the Civil Code without using the presumption provisions, etc. above.

1 5 Obligation to Formulate and Publish Solicitation Policies

Article 9 of the APFS provides that "financial instruments providers, etc. must endeavor to ensure the appropriateness of solicitations concerning the sale, etc. of financial instruments in the course of trade." It also sets ensuring general appropriateness concerning the sale, etc. of financial instruments as a voluntary obligation as well as requiring financial instruments providers, etc. to formulate and publish solicitation policies setting for certain matters (*id*., art. 10).

Matters to be stated in the solicitation policy are as follows:

(1) Matters to be considered in light of the knowledge, experience, financial standing of the person to be solicited and the purpose of entering into a contract regarding the sale of the financial instrument;
(2) Matters to be considered with respect to the person to be solicited regarding the manner and time slot of solicitation; and
(3) In addition to (1) and (2) above, other matters concerning the ensuring of the appropriateness of solicitations.

The publication of the solicitation policy shall be (i) by posting or providing for inspection where easily seeable at the principal office or main office of the financial instruments provider, etc., (ii) by posting or providing for inspection where easily seeable at the business office or office where the sale, etc. of financial instruments is conducted, or (iii) by publishing on its website (APFS Enforcement Order, art. 14).

Financial instruments providers, etc. in breach of the obligation to formulate and publish the solicitation policy are subject to a penalty of JPY500,000 or less (*id*., art. 97).

1 6 Relation with the Suitability Rule and the Obligation to Explain under the FIEA

The FIEA also provides for the suitability rule and the obligation to explain (FIEA, art. 40, item 1; FIBCOO, art. 117, para. 1, item 1), and it seems that they overlap with the obligation to explain important matters under Article 4 of the APFS.

However, while the consequence of the violation of the suitability rule or the obligation to give substantial explanation under the FIEA is the administrative action against the financial instruments business operator, etc. in breach of such obligations, the breach of the obligation to explain important matters under Chapter II of the APFS (art. 4, para. 1) causes effects under private law (compensation liability, presumption of causality and amount of damages).

Section 2, Chapter III of the APFS provides various regulations on the conduct of a financial service intermediary. In particular, the intermediation of the purchase and sale of securities and public offering or private placement of securities conducted by a financial service intermediary are categorized as a "specified financial service contract," and therefore, these acts are subject to various regulations on conduct under the FIEA (APFS, art. 31, para. 2). With regard to these acts of a financial service intermediary, the suitability rule under the FIEA (FIEA,

art. 40, item 1, as applied *mutatis mutandis*) and the obligation to give a substantial explanation (FIEA, art. 38, item 9, as applied *mutatis mutandis*; Cabinet Office Ordinance on Financial Service Intermediaries, art. 111, para. 1, item (i)) also apply, through the necessary replacement of terms. If a financial service intermediary breaches the suitability rule or the obligation to give a substantial explanation in relation to a specified financial service contract, an administrative disposition, such as a business improvement order, a disposition to rescind its registration, or a disposition to suspend all or part of its business operations, may be imposed (APFS, art. 37 and art. 38).

1 7 Court Precedents

A court precedent acknowledging compensation liability pursuant to the APFS (the Act on Sales, etc. of Financial Instruments at the time of each case mentioned below) is the case concerning the sale of corporate bonds.

This is a precedent that upheld the compensation liability of the securities company that sold unsecured bonds to the customer that purchased the same due to the breach of obligation to explain important matters under the APFS (Tokyo District Court April 9, 2003; *Hanrei Jiho* Vol. 1876, page 76). In this case, the court found that the securities company failed to fulfill the obligation to explain because the salesperson only read aloud to the customer, on the phone, the document containing the explanation of the credit risk of domestic bonds, at a time when the salesperson was not actually soliciting the customer to conduct bonds transactions, and thus hearing the explanation given in such manner, the customer could not have understood the risk of the loss of principal. Subsequently, lower courts held securities companies liable for damages under Article 6 of the APFS (Article 5 of the Act on Sales, etc. of Financial Instruments at the time of the case) based on the finding of their breach of: the obligation to give an explanation concerning the sale of convertible bonds under the APFS; Osaka High Court, December 10, 2015; *Hanrei Jiho* Vo. 2300, page. 103); or the obligation to explain important matters upon selling structured bonds (Tokyo District Court November 30, 2010; *Hanrei Jiho* Vol. 2104, page 62; Tokyo District Court November 12, 2012; *Hanrei Jiho* Vol. 2188, page 75 etc.). However, in response to the appeal against the Tokyo District Court decision rendered on November 30, 2010 (Tokyo High Court, May 30, 2012), the high court ruled that the plaintiff was categorized as a “specified customer” and that as a result the securities company did not have the obligation to explain important matters under the APFS (the Act on Sales, etc. of Financial Instruments at the time of the case) to the plaintiff.

1 8 Customer’s Manifestation of Intent for “No Need to Explain”

A financial instruments provider, etc. is exempted from the obligation to explain important matters (APFS, art. 4) even if the customer is not a specified customer “if the customer clearly expresses that he/she does not require an explanation on important matters” (APFS, art. 4, para. 7), except when conducting commodity-related market transactions of derivatives prescribed in Article 2, Paragraph 8, Item 1 of the FIEA and the brokerage thereof, but under the FIEA, the financial instruments provider, etc. are not exempt from the substantial obligation to explain (FIBCOO, art. 117, para. 1, item 1) to customers who are not professional investors even if the customer manifests his or her intent “not to require explanation.”

However, even under the FIEA, the explanation shall be made "in light of the knowledge, experience, financial status and objective of investment" of the customer, so simplifying the explanation should be considered possible to a certain extent if the customer manifesting its intent "not to require explanation" has sufficient knowledge and experience, etc. or is purchasing additional units of financial instruments he/she has purchased before. In the Tokyo High Court ruling as of May 30, 2012 mentioned above, the court found that the plaintiff had manifested the intention not to require an explanation on the important matters.

If a customer manifests his or her intent "not to require explanation" under the APFS, it shall be documented to prevent later disputes, but if it is considered that the soliciting party has forced the customer to sign and seal such document, the manifestation of intent shall be deemed invalid and the financial instruments provider, etc. shall not be exempt from the obligation to explain, so it is important that the circumstances, etc. under which the customer requested not to receive explanation are recorded in the meeting and negotiation records, etc. with the customer.

19 Financial Service Intermediary Business

A financial service intermediary registered under the APFS may engage in the business of deposit, etc. intermediary business operations, insurance intermediary business operations, securities, etc. intermediary business operations, or loan intermediary business operations (APFS, art. 12). Notwithstanding the provisions of Article 52-61-2 of the Banking Act, a financial service intermediary registered to engage in electronic financial service intermediary business operations may engage in electronic payment services (Banking Act, art. 2, para. 21) under certain conditions (APFS, art. 18).

A financial service intermediary is subject to duties and obligations, such as the duty of good faith (APFS, art. 24), the obligation to provide information including the disclosure of fees, etc. (*id.*, art. 25), as well as common regulations applicable to the financial service intermediary business, such as the obligation to appropriately handle customer information and take other measures to ensure the sound and appropriate management of the financial service intermediary business, and the prohibition of lending one's name. A financial service intermediary is also subject to regulations through the application *mutatis mutandis* of the Banking Act, the FIEA, the Insurance Business Act, or the Money Lending Business Act, depending on the contracts handled thereby.

The securities, etc. intermediary business operations conducted by a financial service intermediary registered under Article 12 of the APFS are not deemed to fall within the category of financial instruments business prescribed in Article 2, Paragraph 8 of the FIEA (APFS, art. 17, para. 5). Although the regulations under the FIEA do not apply as they are, some provisions of the FIEA apply *mutatis mutandis* to the financial service intermediary business operations pertaining to a specified financial service contract conducted by a financial service intermediary, such as the intermediation of and sale of securities and public offering or private placement of securities.

2 Consumer Contract Act

The Consumer Contract Act, from the perspective of consumer protection, provides for the rescission and nullification of contracts concluded between business operators and consumers by way of unfair practices employed by the business operators. It applies to business operators selling financial instruments, etc. to customers who are individuals.

2 1 Outline and Purpose

The Consumer Contract Act provides for matters including the consumer's right of rescission upon acts that mislead consumers or confuse customers and the nullification of unfair contract clauses from the viewpoint of consumer protection, and a qualified consumer organization's right to demand an injunction

In view of the difference of the quality and quantity of information and strength of bargaining power between customers and business operators, the Consumer Contract Act grants the right under the private law to rescind contracts or assert the nullification of contract provisions for the protection of the consumers' interests in order to enable the restoration of the consumers' interests and contribute to the fair and smooth resolution of troubles related to consumer contracts, and to indirectly cause business operators to conduct appropriate solicitation and the use of fair contract provisions in order to contribute to preventing the occurrence of, or the spreading of, damage to consumers.

It should be noted that when selling financial instruments to consumers, the Consumer Contract Act applies in addition to the FIEA and the APFS.

The amendment which came into effect on June 3, 2017 has expanded the scope of consumers contracts that consumers are allowed to rescind (*e.g.*, a consumer contract for a transaction of an excessive volume), as well as the scope of important matters, and introduced a new provision to nullify the contractual clauses under which consumers shall waive their right of cancellation. The amendment which came into effect on June 1, 2023 further expanded the scope of consumer contracts that consumers are allowed to rescind (in cases (i) where the business operator takes the consumer to a place that is difficult for the consumer to leave and solicits the consumer to enter into the consumer contract, without informing the consumer that they are soliciting the consumer to enter into the consumer contract, (ii) where the business operator prevents the consumer from contacting someone for consultation, using intimidating words and actions, and (iii) where the business operator changes the state of the subject matter of the consumer contract before concluding the contract, thus making it extremely difficult to restore the original status of the subject matter before the change). The amendment also introduced (i) provisions on the business operator's obligation to endeavor to explain an outline of the grounds of the calculation of the penalty and (ii) provisions on the nullification of the clauses under which the business operator's exemption from liability for damage is unclear, and provisions which expanded the scope of obligations that the business operator must endeavor to comply with (*e.g.*, provide the consumer with information which is necessary in order to cancel the contract).

2 2 Coverage and Scope of Application

The Consumer Contract Act applies to "consumer contracts" (contracts entered into between consumers and business operators (Consumer Contract Act, art. 2, para. 3). For this purpose, "consumers" mean individuals other than "those who are parties to the contract as business or for business" (*id.*, art. 2, para. 1). "Business" is the same type of act conducted repeatedly and continuously with a certain purpose, and it is not necessary to be for-profit.

The definition of consumer contracts is very wide, and contracts regarding the sale of financial instruments subject to Chapter II of the APFS are included in consumer contracts so long as they are entered into between consumers and business operators.

In addition, the Consumer Contract Act applies to the act of solicitation by not only the direct party to the contract but also persons being entrusted with intermediation or granted the right of representation from the counterparty to the contract (*id.*, art. 5, para. 1 and para. 2). For example, when an Association Member sells investment trusts or variable annuity, it is not the direct counterparty of the customer, but the Consumer Contract Act applies to such case.

The Consumer Contract Act is positioned as special provisions regarding the provisions of the Civil Code regarding defects in the manifestation of intent, and applies in priority to the Civil Code and the Commercial Code, but if there are any special provisions in other laws, those provisions prevail (*id.*, art. 11). For example, the Interest Rate Restriction Act is considered as "special provisions."

2 3 Rescission of Contract Pursuant to the Consumer Contract Act

(1) Subject Contracts

A consumer may rescind a contract pursuant to the Consumer Contract Act if the business operator falls under any of the following upon solicitation of the execution of a consumer contract and the consumer manifested its intent to apply to or accept such consumer contract:

(i) Untrue Representation of Important Matters

To represent that which is not true as to an important matter to the consumer, and thereby cause the consumer to misunderstand that the contents of the representation are true (Consumer Contract Act, art. 4, para. 1, item 1).

> For this purpose, "which is not true" means that the content of the representation is objectively not true or correct, and includes cases not only by willful intent but also when the business operator was unaware that the matter was untrue. Accordingly, no proof that the business operator was aware that the contents was untrue or had the intent of deceiving the consumer is required.
>
> However, statements regarding subjective assessment which cannot be determined by the objective fact whether it was not true (such as "this is a good buy") are construed not to be an untrue representation. In any event, sales representatives shall fully understand the content of the instrument and be careful about their language and behavior upon soliciting consumers to avoid making statements about the product that can be thought of as untrue.

(ii) Provision of Conclusive Evaluations

To provide conclusive evaluations of future prices, amounts of money that a consumer shall receive in the future or such other uncertain items that change in the future with respect to goods, rights, services and other subjects of a consumer contract, and thereby cause the consumer to misunderstand that the contents of the conclusive evaluations provided is certain (Consumer Contract Act, art. 4, para. 1, item 2).

It shall be noted that the willful intent of the business operator is not required as was in the untrue representation in (i) above.

(iii) Failure to Represent Disadvantageous Facts by Intention or Gross Negligence

To represent the consumer the advantages as to important matters or matters related to the said important matters but intentionally or by gross negligence fails to represent disadvantageous facts (limited to those facts that consumers would normally consider to be non-existent by such representation), and thereby cause the consumer to misunderstand that such fact does not exist (Consumer Contract Act, art. 4, para. 2).

(iv) Business Operator's Failure to Leave

To fail to leave a place where the consumer resides or does business in defiance of the consumer's request to the business operator to leave such place, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 1).

(v) Obstruction of Leave

Not to allow a consumer to leave a place where the consumer is solicited to enter into the consumer contract by the business operator in defiance of the consumer's request to leave the place, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 2).

(vi) Taking the Consumer to a Place That Is Difficult for the Consumer to Leave and Soliciting the Consumer to Enter into the Consumer Contract, Without Informing the Consumer that They Are Being Solicited

To move to a place together with the consumer and solicit them to enter into the consumer contract in that place while knowing that it is difficult for the consumer to voluntarily leave that place, without informing the consumer that they are being solicited to enter into the consumer contract, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 3).

(vii) Preventing the Consumer from Contacting Someone for Consultation, Using Intimidating Words and Actions

In spite of the consumer expressing an intent to contact a person other than the business operator by means such as telephone or email in order to have a consultation on whether or not to enter into the contract, to prevent the consumer from making said contact while at a place where the consumer is being solicited to enter into the consumer contract, using intimidating words and actions, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 4).

(viii) Exploitation of the Consumer's Lack of Experience in Social Life

To make the consumer more anxious while knowing that the consumer, due to the lack of experience in social life, has excessive anxiety about accomplishing his or her desires regarding important matters in social life such as advancing to higher education, finding a job, getting married and making a livelihood, or other important matters concerning the consumer's looks, body shape or other physical features or conditions, and tell the consumer that the goods, rights, services or other subjects of the consumer contract are necessary for the consumer to accomplish his or her desires, despite the absence of any reasonable grounds or other

justifiable reasons that support such a statement, thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 5).

(ix) Abuse of Personal Relationships by Taking Advantage of Romantic Feelings, Etc.

To tell the consumer that his or her relationship with the person who solicits him or her to conclude the consumer contract will be broken if the consumer does not conclude the consumer contract, while knowing and taking advantage of the fact that the consumer, due to the lack of experience in social life, has a romantic feeling or other positive feeling toward the solicitor and has an illusion that the solicitor reciprocates said feelings, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 6).

(x) Exploitation of the Consumer's Reduced Ability to Judge Due to Aging, Etc.

To make the consumer more anxious while knowing that the consumer, due to the considerable reduction in his or her ability to judge due to aging or mental or physical disorders, has excessive anxiety about maintaining his or her current standard of living in terms of livelihood, health and other matters, and tell the consumer that he or she will face difficulty in this regard if he or she does not conclude the consumer contract, despite the absence of any reasonable grounds or other justifiable reasons that support such statement, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 7).

(xi) Making a Statement Based on Fortune-Telling, Etc.

To indicate to the consumer, in order to fuel their fear, that supernatural senses or other special abilities that are difficult to reasonably verify have shown that it would be impossible to avoid a serious disadvantage that could happen in the present or future to the life, person, property, or other important matter of the consumer or a relative of the consumer unless the consumer takes certain measures, or take advantage of the fact that the consumer holds such fear, and inform the consumer that entering into the consumer contract is indispensable for avoiding those serious disadvantages, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 8).

(xii) Performing the Contractual Obligation Before the Conclusion of the Contract, Thereby Making It Difficult to Restore the Status Quo

Before a consumer makes a manifestation of intention of an offer for a consumer contract or acceptance of such an offer, to (i) implement, in whole or in part, the obligations that are supposed to be fulfilled when the consumer enters into the contract, or (ii) change the state of the subject matter of the consumer contract, thus making it extremely difficult to restore the original status of the subject matter, before the implementation or change, thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 9).

(xiii) Implementing a Business Activity with the Aim of Concluding a Contract, and Subsequently Telling the Consumer That the Business Activity Has Been Implemented Specially for Him or Her and That the Business Operator Claims Compensation for Loss

In addition to the activities set forth in the preceding item, the business operator has implemented a business activity with the aim of concluding the consumer contract, such as investigation, provision of information, or procurement of goods, before the consumer manifests his or her intention to offer or accept the consumer contract, and subsequently, the business operator tells the consumer that the business activity has been implemented specially for the consumer and that the business operator claims compensation for a loss incurred from the implementation of the business activity, despite the absence of any justifiable reasons in light of socially accepted business standards, such as that the business activity has been implemented in response to the special request of the consumer, and thereby cause distress to the consumer (Consumer Contract Act, art. 4, para. 3, item 10).

(xiv) Transaction of Excessive Volume

To solicit a consumer while knowing that the volume, number of times, or period (hereinafter "volume, etc.") of goods, rights, services or other objects of the consumer contract considerably exceeds the normal volume, etc. for the consumer (meaning the volume, etc. that is normally assumed as the volume, etc. of objects of the consumer contract in light of the details and the conditions of transaction of the objects of the consumer contract, while also taking into account the living conditions of the consumer at the time of being solicited by the business operator to conclude the consumer contract and the consumer's awareness thereof), and thereby cause the consumer to manifest the intention to offer or accept the consumer contract (Consumer Contract Act, art. 4, para. 4, first sentence).

(xv) Transaction of Excessive Volume Under Contract of the Same Type

To solicit a consumer while knowing that the consumer has already concluded a consumer contract for the same type of objects as the objects under the consumer contract subject to the solicitation (hereinafter referred to as a "contract of the same type" in this paragraph), and that the sum of the volume, etc. of the objects under the contract of the same type and the volume, etc. of the objects under the contract subject to the solicitation considerably exceeds the normal volume, etc. for the consumer, and thereby cause the consumer to manifest the intention to offer or accept the consumer contract (Consumer Contract Act, art. 4, para. 4, second sentence).

(2) Manner of Exercise of Right of Rescission; Exercise Period

There are no special provisions under the Consumer Contract Act with respect to the manner of exercise of the right of rescission by consumers, and the consumer shall notify the counterparty his or her intent to rescind the manifestation of intent pursuant to Article 123 of the Civil Code. Assertion is not necessarily required to be made at the court. The manifestation of intent of rescission is limited to the consumer manifesting such intent or his or her agent or successor (Civil Code, art. 120, para. 2).

The right of rescission pursuant to the Consumer Contract Act shall lapse by prescription if it is not exercised within one year (for the rescission right set forth in Article 4, Paragraph 3, Item 8 of the Consumer Contract Act, three years) from the time that ratification becomes possible. The same applies when five years (for the rescission right set forth in the same item, ten years) have elapsed since the conclusion of a consumer contract (Consumer Contract Act, art. 7, para. 1).

(3) Effect of Rescission

If a consumer exercises the right of rescission, the contract will become null retroactively (Civil Code, art. 121). Under the Civil Code, a person that has received payment or delivery as the performance of an obligation based on an invalid act has an obligation to restore the other party to the original state (Civil Code, art. 121-2, para. 1). If a consumer received performance of an obligation under the consumer contract and did not know, at the time of receiving performance, that he/she may rescind the manifestation of intention, the consumer has an obligation to reimburse only to the extent that he/she is actually enriched as a result of the consumer contract (Consumer Contract Act, art. 6-2).

Specifically, if a consumer exercises the right of rescission with respect to an investment trust solicited by a financial instruments business operator and acquired by the customer by reason of untrue representation in the solicitation act, the entire amount delivered by the customer to the financial instruments business operator

at the time of acquisition of the investment trust will be returned to the customer, and procedures to receive the return of beneficiary rights of the investment trust from the customer (specifically, making instructions for transfer through the financial instruments business operator that is the account management organization) will be taken.

The rescission may not be asserted to a third party in good faith and without negligence (*id.*, art. 4, para. 6).

2 4 Nullification of Contract Pursuant to the Consumer Contract Act

In view of the difference in the quality and quantity of information and powers of negotiation between business operators and consumers in consumer contracts, it is not appropriate to conclude a contract including clauses that harm the interests of consumers one-sidedly. Article 10 of the Consumer Contract Act nullifies such clauses.

Contractual clauses that shall be nullified under the Consumer Contract Act are: (i) clauses that exempt the business operator from the liability to compensate for damage not attributable to the consumer or authorize the business operator to decide whether the business operator has such liability (*id.*, items of art. 8, para. 1); (ii) clauses that force the consumer to waive the right to cancel that arises from the business operator's nonperformance, or authorize the business operator to decide whether the consumer has such right to cancel (*id.*, art. 8-2); (iii) clauses that grant the business operator the right to cancel solely on the grounds that the consumer has received a ruling for commencement of guardianship, curatorship or assistance (except for clauses of a consumer contract under which a consumer provides a business operator with goods, rights, services or any other subjects of the contract) (*id.*, art. 8-3); (iv) clauses that stipulate liquidated damages to be paid by the consumer (*id.*, art. 9); and (v) clauses that unilaterally prejudice the interests of the consumer (*id.*, art. 10). In addition, the Amendment Act effective as of June 1, 2023, introduced provisions that a clause under a consumer contract is void if it partially exempts a business operator from liability for default or tort (excluding those that arise due to an intentional act or gross negligence) and does not clarify that such provision only exempts the business operator from the liability that arises due to defaults excluding those that arise due to an intentional act or gross negligence on the part of the business operator, or its representative or employees (*id.*, art. 8, para. 3).

Among these provisions of the Consumer Contract Act, Article 10 is a general provision, and the amended version thereof mentions, as an example, "clauses which deem a consumer to have manifested the intention to offer or accept a new consumer contract by reason of the consumer's inaction." However, what clause actually falls under this Article should be determined on a case-by-case basis.

Among these, with respect to provisions falling under items of Article 9, Paragraph 1 of the same Act, the entire provision does not become null but only the excessive part becomes null according to the Article.

2 5 Relation with the APFS

Both Chapter II of the APFS and the Consumer Contract Act function as special provisions to the Civil Code, but the same act is considered to be subject to both Acts redundantly.

For example, with respect to the provision of conclusive evaluations, under the Consumer Contract Act, the misunderstanding of a consumer is required, but under the APFS, the provisions regarding compensation liability and the presumption of causality and amount of damages apply to the provision of conclusive evaluations even when consumers did not misunderstand. The customer may select to assert the provision advantageous to it.

3 Act on the Protection of Personal Information

The Act on the Protection of Personal Information (hereinafter referred to as the "PPIA") provides for matters including the obligations concerning the proper handling of personal information with which business operators should comply. In light of the significantly expanding utilization of personal information as digital society evolves, the PPIA aims to protect the rights and interests of individuals, while ensuring due consideration of the value of personal information. It should be noted that even in the case of dealing with a corporate customer such as a company, the information concerning the company's employee in charge falls within the scope of personal information, and improper handling of personal information is subject to penalties under the relevant guidelines as well as under the PPIA.

3 1 Outline and Purpose

Association Members who fall under the category of business operators handling personal information must comply with the obligations of business operators handling personal information as prescribed by the PPIA, the "Guidelines for the Protection of Personal Information in the Financial Field" (hereinafter referred to as the "Guidelines for the Financial Field"), and the "Practical Guidance on Security Management Measures for the Guidelines on the Protection of Personal Information in the Financial Field" (hereinafter referred to as the "Security Management Practical Guidelines"). The Personal Information Protection Commission has published the "Guidelines for the Act on the Protection of Personal Information (Volume on General Rules)" and other sets of guidelines and Q&A materials. In practically handling personal information, it is important to make reference to these guidelines and materials.

The amended PPIA, which came into effect as of April 1, 2022, takes into consideration people's growing awareness of their own personal information, the balance between protection and utilization of personal information in light of technological innovation, and the necessity of dealing with risks arising from the increase in the cross-border flow of data, and has introduced measures including the following: clarifying the obligation to report to the

Personal Information Protection Commission and notifying the individual in the event of the leakage of the individual's personal information; adding the rules concerning pseudonymously processed information and individual-related information; enhancing the regulations concerning the cessation of utilization, deletion, and disclosure of retained personal information; and adding measures concerning the cross-border flow of data.

3 2 Coverage and Scope of Application

The PPIA covers "Personal Information," "Personal Data," "Retained Personal Data," "Special Care-Required Personal Information," "Pseudonymously Processed Information," "Anonymously Processed Information," and "Individual-Related Information" In addition, the PPIA specifies a person's fingerprints, palm prints, iris patterns, individual number (My Number), basic pension number, and the like as an individual identification code which independently allows a specific person to be identified, and includes information containing an individual identification code in the scope of personal information (PPIA, art. 2, para. 2; PPIA Enforcement Order, art. 1).

Under the PPIA, "Special Care-Required Personal Information" is defined as personal information comprising a person's race, creed, social status, medical history, criminal record, fact of having suffered damage by a crime, or other descriptions etc. prescribed by cabinet order as those of which the handling requires special care so as not to cause unfair discrimination, prejudice or other disadvantages to the person. The PPIA requires strict handling on such occasions as acquiring or using Special Care-Required Personal Information or providing it to a third party (*id.*, art. 2, para. 3, PPIA Enforcement Order, art. 2). In addition to the regulations under the PPIA, financial instruments business operators, etc. who are business operators handling personal information are placed under special regulations, such as regulations concerning "Sensitive Information."

"Pseudonymously processed information" is information relating to an individual that can be produced from processing personal information so as not to be able to identify a specific individual unless it is matched with other information, by taking measures, such as deleting part of the description, etc. contained in the personal information or replacing it with other description, or deleting all or part of the individual identification codes contained in the personal information or replacing them with other codes (*id.*, art. 2, para. 5). As pseudonymously processed information is intended only for internal utilization, the obligation concerning the change of the purpose of utilization and the obligation to notify the individual in the event of leakage are relaxed.

"Anonymously processed information" is information relating to an individual that can be produced from processing personal information in a manner prescribed for each type of personal information so as neither to be able to identify a specific individual nor to be able to restore the personal information (id., art. 2, para. 6). While anonymously processed information of an individual may be provided to a third party without the individual's consent, a personal information handling business operator engaging in producing anonymously processed information has obligations to conduct proper processing; take safety control actions; and make a public disclosure at the time of production of anonymously processed information.

"Individual-related information" is information relating to a living individual, which does not fall under any of the categories of "personal information," "pseudonymously processed information," or "anonymously processed information." Although individual-related information does not fall under the definition of personal data for the provider, if it is provided to a third party and is supposed to constitute personal data for the recipient, the provider is obliged to obtain the individual's consent (*id.*, art. 31).

3 3 Obligations Regarding "Personal Information"

"Personal Information" refers to "information relating to a living individual," (i) which contains a name, date of birth or other descriptions, etc. whereby the specific individual can be identified, or (ii) which contains an individual identification code (PPIA, art. 2, para. 1).

Information that cannot identify a specific individual but will allow easy reference to other information and will thereby enable the identification of the specific individual is also considered personal information.

"Information relating to an individual" is not limited to information whereby an individual can be identified, such as the individual's name, address, gender, date of birth, and photograph, but it covers all information that represent any fact, judgment, or evaluation regarding an individual's attributes, such as the individual's body, property, occupation, and position. It includes personal ratings, information made public by publications, and video or audio information, irrespective of whether it is kept secret by encryption. "Individual identification code" refers to any character, letter, number, symbol or other codes specified by the PPIA Enforcement Order as being sufficient to identify a specific individual (*e.g.*, codes produced by converting an individual's body features, such as genomic data, iris patterns, vocal prints, fingerprints and palm prints, as well as a passport number, basic pension number, driver's license number, and individual number (My Number)).

Obligations regarding personal information under the PPIA include the specification of the purpose of utilization (PPIA, art. 17), restriction by the purpose of utilization (*id.*, art. 18), prohibition of inappropriate use (*id.*, art. 19), proper acquisition (*id.*, art. 20) and notice of the purpose of utilization at the time of acquisition, etc. (*id.*, art. 21).

(1) Specification of the Purpose of Utilization (PPIA, art. 17)

A business operator handling personal information must specify the purpose of utilization of personal information as much as possible when handling personal information (PPIA, art. 17, para. 1). The Guidelines for the Financial Field provides that it is desirable to specify the purpose of utilization after presenting the financial instruments or services that will be provided (Guidelines for the Financial Field, art. 2, para. 1).

In addition, the purpose of utilization shall not be changed beyond the scope which is reasonably considered that the purpose of utilization after the change is related to that before the change (PPIA, art. 17, para. 2).

(2) Restriction by the Purpose of Utilization (PPIA, art. 18)

A business operator handling personal information must not handle personal information about a person, without obtaining the prior consent of the person, beyond the scope necessary for the achievement of the purpose of utilization specified (*id.*, art. 18, para. 1).

However, such restrictions do not apply to certain cases such as cases in which the handling of personal information is based on laws and regulations, or necessary for the protection of the life, body, or property of an individual, etc. and where it is difficult to obtain the consent of the individual (*id.*, art. 18, para. 3).

(3) Notification of the Purpose of Utilization at the Time of Acquisition, Etc. (PPIA, art. 21)

In order to acquire personal information stated in a contract or other document, etc. in connection with the conclusion of a contract or otherwise acquire personal information stated in a document directly from the person, the business operator handling personal information shall expressly indicate the purpose of utilization in advance

(PPIA, art. 21, para. 2). In addition, if it shall acquire personal information by other means, it shall promptly notify the person of the purpose of utilization or publicly announce the purpose of utilization except in cases which the purpose of utilization has already been publicly announced (*id.*, art. 21, para. 1).

Normally, the obligations under this Article shall be sufficiently met by publishing the purpose of utilization on the website.

3 4 Obligations Regarding "Personal Data"

"Personal Data" refers to personal information constituting a personal information database, etc. with respect to personal data, obligations regarding the assurance, etc. of accuracy of data (PPIA, art. 22), security control measures (*id.*, art. 23), supervision of employees (*id.*, art. 24), supervision of trustees (*id.*, art. 25), reporting leaks (*id.*, art. 26), and the restriction of provision to a third party (*id.*, art. 27) are provided.

(1) Security Control Measures (PPIA, art. 23), Supervision of Employees (*id.*, art. 24), Supervision of Trustees (*id.*, art. 252)

A business operator handling personal information shall take necessary and proper measures for the prevention of leakage, loss or damage, and for other security control of the personal data it handles (hereinafter referred to as "security control measures").

As security control measures, the Security Management Practical Guidelines provide the following matters in detail: institutional security control measures such as clearly prescribing the responsibilities and authorities of officers and employees concerning security control measures for personal data, developing and operating rules concerning security control, and inspecting and auditing the implementation of the rules; personnel security control measures, such as concluding confidentiality agreements with officers and employees and providing education and training for officers and employees; physical security control measures for personal data, such as controlling the areas where personal data is handled, preventing theft of equipment, electronic media, etc., preventing leakage, etc. in the case of carrying electronic media, etc., and disposing of equipment, electronic media, etc.; technological security control measures, such as controlling access to an information system that handles personal data and supervising the information system; and supervision of employees and supervision of trustees.

For example, with respect to the supervision of an entrusted party, the Security Management Practical Guidelines provide that the (i) authority of the entrusting party concerning supervision, audit and requesting of reports from the entrusted party, (ii) prevention of leakage, etc. and prohibition of utilization outside the purposes by the entrusted party, (iii) conditions for re-entrustment and (iv) liability of the trustee upon occurrence of cases of leakage, etc. in the entrustment contract (Security Management Practical Guidelines 6-3).

(2) Restriction of Provision to a Third Party (PPIA, art. 27)

A business operator handling personal information must not provide personal data to a third party without obtaining the prior consent of the Person; provided, however, such restrictions do not apply in certain cases such as cases in which the provision of personal data is based on laws and regulations, or necessary for the protection of the life, body, or property of an individual, etc. (PPIA, art. 27, para. 1).

There are other exceptions to the restrictions under this Article. In cases where a business operator handling

personal information entrusts the handling of personal data within the scope necessary for the achievement of the purpose of utilization, or cases where personal data is provided as a result of the succession of business in a merger or otherwise, a person who receives the personal data shall not be considered to be a "third party" (*id.*, art. 27, para. 5, item 1 and item 2). For example, when a business operator handling personal information entrusted an IT company with tasks such as data entry, data processing, and system maintenance, the personal data will be made accessible to the IT company. In this case, the IT company is considered not to fall within the scope of a third party because the business operator handling personal information has entrusted the IT company with the handling of the personal data in order to achieve the purpose of use of the data. However, it should be noted that, as mentioned above, the business operator handling personal information is responsible for supervising the entrusted party, and is required to follow the Security Management Practical Guidelines. In the case of using an external contractor, such as cloud service provider, to operate an information system for handling electronic data that contains personal data, whether the use of the cloud service constitutes either third party provision (PPIA, art. 27, para. 1) requiring the individual's consent, or entrustment (*id.*, art. 27, para. 5, item 1), does not depend on whether any personal data is contained in the electronic data stored in the system, but is determined depending on whether the cloud service provider is expected to handle personal data. If the cloud service provider is not expected to handle any personal data, the business operator handling personal information would not be deemed to have provided personal data to a third party, and therefore it does not need to obtain the individual's consent (see the "Q&As on the Guidelines for the Act on the Protection of Personal Information," Q7-53).

The same applies in cases where personal data is used jointly and where the items of personal data used jointly, the scope of the joint users, the purpose for which the personal data is used by the joint user and the name and address of the person responsible for the management of personal data (in the case of a corporation, the name of its representative) are notified to the Person in advance or put in a readily accessible condition for the Person (*e.g.,* published on a website) (generally referred to as the joint use system; PPIA, art. 27, para. 5, item 3). In these cases, the provision of personal data to the recipient does not constitute the provision to a third party and therefore it is allowable without the Person's prior consent. One example is where companies forming a corporate group jointly use personal data within the scope of the use intended at the time of data acquisition in order to provide comprehensive services as a group. The Guidelines for the Act on the Protection of Personal Information (Volume on General Rules) contain detailed provisions on the joint use system, and it is necessary to pay attention to these provisions when using this system.

In addition, when a business operator handling personal information agrees to cease to provide personal data identifying a Person to a third party at the request of the Person, and notifies the Person of certain matters in advance or makes such matters readily accessible to the Person in advance, the business operator may provide such personal data to a third party (PPIA, art. 27, para. 2). This is known as an "opt-out."

The PPIA does not allow an opt-out regarding: (i) special care-required personal information; (ii) personal data acquired by improper means; and (iii) personal data provided under the opt-out provisions. Furthermore, "measures to inform the Person in advance of the matters concerning the provision of his/her personal data to a third party or measures to put these matters into a state where the Person can easily know them" are to be implemented by giving the Person time necessary to demand cessation of the provision of the personal data to a third party and by employing an appropriate and reasonable method that ensures that the Person can become aware of the relevant matters (PPIA Enforcement Ordinance, art. 11). In addition, the business operator that implements the opt-out procedure must in advance notify the Personal Information Protection Commission of this fact, which then discloses the fact to the public on its website (PPIA, art. 27, para. 3 and para. 4).

Except in cases that fall under the items of Article 27, Paragraph 1 of the PPIA or the items of Paragraph 5 of the said Article, a personal information handling business operator, when providing personal data to a third party or receiving personal data provided by a third party, must prepare and preserve records concerning such provision or receipt of personal data to a third party that includes information such as the date of provision or receipt of the personal data, the name of the third party, and other matters (*id.*, art. 29, para. 1 and para. 2).

Column: Obligations to Record Matters Related to Third-Party Provision

In connection with the obligation to record matters related to the third-party provision of an individual's personal data, matters required to be recorded differ between the provider and the recipient. Furthermore, special attention should be paid to the obligation to record, because different matters are required to be recorded according to the respective types of cases shown below (PPIA, art. 29, para. 1 and para. 2).

<Matters to be recorded when providing personal data to a third party>

	Date of provision	Name, etc. of the third party	Name, etc. of the individual	Items of personal data	Individual's consent
(i) Providing personal data to a third party with the individual's consent	—	Required	Required	Required	Required
(ii) Providing personal data to a third party through the opt-out procedure	Required	Required	Required	Required	—

<Matters to be recorded when receiving personal data provided by a third party>

	Date of receipt	Name, etc. of the third party	Circumstances of acquisition	Name, etc. of the individual	Items of personal data	Disclosure by the Commission	Individual's consent
(iii) Receiving personal data provided by a third party with the individual's consent	—	Required	Required	Required	Required	—	Required
(iv) Receiving personal data provided by a third party through the opt-out procedure	Required	Required	Required	Required	Required	Required	—
(v) Receiving personal data provided by a third party that is a private person, etc. (not a personal information handling business operator)	—	Required	Required	Required	Required	—	—

In addition to the cases prescribed in the items of Article 27, Paragraph 1 or Paragraph 5 of the PPIA, keeping records of these matters is not required in cases where the individual provides his/her personal data (*e.g.*, an individual posts information on a social media website operated by a business operator, thereby making the individual's personal data automatically available to a large number of unspecified persons) or a personal information handling business operator provides an individual's personal data on his/her behalf (*e.g.*, in response to an individual's order of money transfer to another individual's account, the sending bank provides the information regarding the transfer to the receiving bank at which the recipient holds the account) (Guidelines for the Act on the Protection of Personal Information (Obligations to Confirm and Record Matters at the Time of Third-Party Provision of Personal Data), 2-2-1-1). If the individual gives consent to the provision of his/her personal data, a contract or any other document in which the relevant matters are stated may substitute for a record of these matters (PPIA Enforcement Ordinance, art. 19, para. 3 and art. 23, para. 3).

When providing an individual's personal data to a third party in a foreign country, a personal information

handling business operator is required, as prescribed in Article 28 of the PPIA, to obtain the individual's prior consent for providing the data to a third party in a foreign country, and is also required to follow the Guidelines for the Act on the Protection of Personal Information (Volume on Provision to Third Party in Foreign Country). When obtaining the individual's consent, a personal information handling business operator must provide the individual in advance with the name of the foreign country, information acquired through an appropriate and reasonable method concerning the personal information protection system in the foreign country, and information concerning measures taken by the third party for personal information protection (PPIA, art. 28, para. 2; PPIA Enforcement Ordinance, art. 17, para. 2). When providing personal data to a third party in a foreign country, a personal information handling business operator must take necessary measures to ensure that the third party continuously implements equivalent measures, and, upon the individual's request, provide the individual with certain items of information concerning those necessary measures (PPIA, art. 28, para. 3; PPIA Enforcement Ordinance, art. 18, para. 1 and para. 3).

Article 28 of the PPIA does not apply to: (i) the case where the third party is in a foreign country that has established a personal information protection system recognized to have equivalent standards to that in Japan (i.e., the EU member countries and the United Kingdom, which are specified by Public Notice of the Personal Information Protection Commission No. 1 of 2019 as being countries that satisfy all of the items of Article 15, Paragraph 1 of the PPIA Enforcement Ordinance); (ii) the case where the third party has established a system that conforms to standards prescribed by rules of the Personal Information Protection Commission as necessary for continuously taking actions equivalent to those that a personal information handling business operator must take concerning the handling of personal data; or (iii) any case falling under any of the items of Article 27, Paragraph 1 of the PPIA. For example, if a personal information handling business operator entrusts an information system company in a foreign country with the handling of personal data, this constitutes provision of personal data to a third party in a foreign country notwithstanding the exception to entrustment (*id.*, art. 27, para. 5, item 1), and the personal information handling business operator is required to obtain the individual's prior consent for providing the data to a third party in a foreign country unless the case falls under either of the exceptional cases mentioned above.

3 5 Obligations Regarding "Retained Personal Data"

"Retained Personal Data" refers to such personal data over which a business operator handling personal information has the authority to disclose, correct, add or delete the content, discontinue its utilization, erase and to discontinue the provision to a third party, excluding data which is specified by Cabinet Order as harming public interests or other interests if its presence or absence is known (PPIA, art. 16, para. 4; PPIA Enforcement Order, art. 5).

With respect to "Retained Personal Data," obligations regarding the public announcement of matters concerning retained personal data, etc. (PPIA, art. 32), disclosure at the request of the person (*id.*, art. 33), correction at the request of the Person, etc. (*id.*, art. 34), discontinuance of the utilization, etc. at the request of the Person, etc. (*id.*, art. 35), explanation of reasons at the request of the Person (*id.*, art. 36) are provided. The amended PPIA, effective as of April 1, 2022, has expanded the scope of matters that a personal information handling business operator must disclose regarding retained personal data to in principle require disclosure of security control action that it has taken for retained personal data. The amendment also includes the following: making it obligatory for a

personal information handling business operator, in principle, to disclose retained personal data at the request of the individual concerned; requiring the disclosure of records on provision to third parties at the request of the individual concerned; and introducing additional cases where the cessation of utilization or the deletion of retained personal data may be requested, and where the discontinuance of provision to a third party may be requested.

Personal information concerning anti-social forces fall under Article 5, Item 2 of the PPIA Enforcement Order (information that may enhance or invoke illegal or unfair acts if the existence or absence thereof becomes known) if they may enhance or invoke illegal or unfair acts such as unfair requests, etc. in cases where the possession thereof by the business operator becomes known, and is considered to be excluded from retained personal data. Accordingly, such personal information is not subject to the obligations under this Article, and it is considered that the name of the business operator handling such personal information, the purpose of utilization and procedures, etc. for disclosure, etc. does not need to be published, etc.

3 6 Obligations Regarding "Special Care-Required Personal Information" and "Sensitive Information"

"Special Care-Required Personal Information" refers to personal information comprising a Person's "race," "creed," "social status," "medical history," "criminal record," "fact of having suffered damage by a crime," or "other descriptions etc. prescribed by Cabinet Order as those for which the handling requires special care so as not to cause unfair discrimination, prejudicial treatment or other disadvantages to the Person" (PPIA, art. 2, para. 3).

Descriptions, etc. prescribed by Cabinet Order include the following: a fact that the Person has a certain type of physical or psychological disability; the results of health checkups; a fact that the Person has received guidance for improvement of health conditions, medical examination or prescription of drugs from physicians or other medical care professionals; a fact that the Person, as a suspect or accused person, has been subject to arrest, search, seizure, detention, public prosecution, or any other procedure in a criminal case; and a fact that the Person has been subject to investigation, probation, hearing, protective measures, or any other procedure in a juvenile protection case under the Juvenile Act (PPIA Enforcement Order, art. 2).

In principal, acquisition of Special Care-Required Personal Information requires the Person's consent, except in special cases such as where acquisition is based on laws and regulations or where acquisition is necessary to protect a human life, body or fortune, and it is difficult to obtain the Person's consent (PPIA, art. 20, para. 2). It is prohibited to provide Special Care-Required Personal Information to a third party through the opt-out procedure; the Person's consent is required for such provision to a third party except in cases prescribed in the items of Articles 27, Paragraphs 1 and 5 of the PPIA.

"Sensitive Information" is defined in Article 5, Paragraph 1 of the Guidelines for the Financial Field as including "Special Care-Required Personal Information" and information on an individual's affiliation to a labor union, family origin, registered domicile, health care record, and sexual life (excluding information on any of these matters that falls within the category of Special Care-Required Personal Information)" (excluding: information disclosed by the individual, or by a certain scope of entities such as a State organ, a local public entity, an academic research institution or equivalent, a broadcasting organization, a newspaper company, a news agency, or any other news media; and information that is obvious from the appearance of the individual and can be acquired by visual inspection or visual recording).

Association Members that fall within the category of personal information handling business operators in the

financial field are prohibited from acquiring or using sensitive information or providing it to a third party except in cases where such activities are based on laws and regulations or are necessary to protect the life, body or property of a person (Guidelines for the Financial Field, art. 5, para. 1). Attention should be paid to the fact that the Guidelines for the Financial Field do not allow them to acquire or use Sensitive Information or provide it to a third party even with the consent of the individual concerned.

3 7 Response to Leakage of Personal Data and Other Incidents

If, with regard to an individual's personal data handled by a personal information handling business operator, the leakage, loss or any other incident that is related to ensuring the security of that personal data and that is specified by the Personal Information Protection Commission Rules as having high possibility of harming the individual's rights and interests occurs, the personal information handling business operator must report the incident to the Personal Information Protection Commission pursuant to the provisions of the Personal Information Protection Commission Rules (PPIA, art. 26, para. 1).

The Guidelines for the Act on the Protection of Personal Information (Volume on General Rules), 3-5-2, provide that when a leakage of personal data or any other incident or any other case where there is possibility thereof (hereinafter referred to as "leakage, etc. or case of possibility thereof") is revealed, a personal information handling business operator must take necessary action as set forth in (1) to (5) below depending on the nature of the leakage, etc. or case of possibility thereof:

(1) Internal Reporting and Prevention of Spread of Damage

Reporting the leakage, etc. or case of possibility thereof to the responsible person immediately and taking necessary action to prevent the damage from the leakage, etc. or case of possibility thereof from spreading further compared to the time when it is first revealed.

(2) Investigation of Facts and Clarification of Cause

Taking necessary action to investigate the facts and clarify the cause of the leakage, etc. or case of possibility thereof.

(3) Identification of the Affected Area

Taking necessary action to identify the area affected by the leakage, etc. or case of possibility thereof based on the facts found in (2).

(4) Consideration and Implementation of Measures to Prevent Recurrence

Taking necessary action promptly to consider and implement measures to prevent the recurrence of the leakage, etc. or case of possibility thereof based on the results of the action mentioned in (2) above.

(5) Reporting to the Personal Information Protection Commission and Notification to the Individual

See the abovementioned guidelines, 3-5-3 (Reporting to the Personal Information Commission) and 3-5-4 (Notification to the Individual). It is desirable to promptly make public the facts of the leakage, etc. or case of possibility thereof and the measures taken to prevent recurrence from the perspective of preventing secondary damage and preventing the occurrence of similar incidents, depending on the content of the leakage, etc. or case of possibility thereof.

According to the abovementioned guidelines, 3-5-3-1, upon becoming aware of any of the incidents set forth

in (1) to (4) below (hereinafter referred to as an "incident subject to reporting"), a personal information handling business operator must report it to the Personal Information Protection Commission:

(1) A leakage, loss or damage (hereinafter referred to as "leakage, etc.") of personal data containing special care-required personal information (excluding such information for which advanced encryption or other necessary measures to protect individuals' rights and interests have been implemented; hereinafter the same in relation to Article 7 and Article 8, Paragraph 1 of the PPIA Enforcement Ordinance) has occurred, or there is possibility that it has occurred (Re: PPIA Enforcement Ordinance, art. 7, item 1);

(2) A leakage, etc. of personal data that is likely to cause property damage if utilized without authorization has occurred, or there is possibility that it has occurred (Re: *id.*, art. 7, item 2);

(3) A leakage, etc. of personal data that is likely to have been performed for wrongful purpose has occurred, or there is possibility that it has occurred (Re: *id.*, art. 7, item 3); and

(4) A leakage, etc. of personal data concerning more than 1,000 individuals has occurred, or there is possibility that it has occurred (Re: *id.*, art. 7, item 4).

Helpful information can also be found in the "Q&As on Protection of Personal Information in the Financial Field."

3 8 Corporation Information, Public Information, and Other Information

Information of corporations is not subject to the PPIA and the Guidelines for the Financial Field, but it shall be noted that information whereby the representative of the corporation or individual in charge of the transaction can be identified (*e.g.*, name, address, gender, date of birth, and photograph) is considered personal information.

In addition, the PPIA does not distinguish public and non-public information, so it must be noted that the Act does not only protect non-public information. Accordingly, public information is considered personal information so long as it falls under the definition of personal information.

Financial instruments business operators are required to ensure the proper management of information and personal data regarding individual customers (FIBCOO, art. 123, para. 1, item 6, item 6-2, and item 7). The FSA's supervisory guidelines indicate that information relating to customers (including juridical persons) constitutes the basis of financial instruments transactions and therefore it is extremely important to ensure its appropriate management, thus requiring the establishment of an appropriate control environment for the management of customer information (Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc., III-2-4). It should be noted that from the perspective of preventing insider trading and any other unfair acts, the guidelines require financial instruments business operators to establish systems to adequately manage corporation-related information (FIBCOO, art. 1, para. 4, item 14 and art. 123, para. 1, item 5), which is also included in the scope of supervisory viewpoints.

3 9 My Number Act

On January 1, 2016, the Act on the Use of Numbers to Identify a Specific Individual in the Administrative Procedure (generally called the "My Number Act") came into effect and the My Number (social security and tax number) system was put into practice. This system is designed to manage information on individuals efficiently in terms of social security, taxation, disaster control and other administrative affairs and make it possible to link pieces of information retained by multiple bodies on each individual together by means of the number assigned to the individual and thereby ascertain that these pieces of information pertain to that individual. It is expected to serve as social infrastructure to improve administrative efficiency, enhance public convenience and realize a fairer and just society.

From October 1, 2015, each individual with a resident record has been notified of a 12-digit "individual number" (*i.e.,* "My Number") and each corporation has been notified of a 13-digit "corporate number." While individual numbers are not disclosed and the acquisition, use and management thereof are subject to strict restrictions, corporate numbers are made public, with no restriction on the scope of use or user.

Business operators who are "persons in charge of affairs related to individual numbers" (Association Members normally fall within this category of persons in relation to payment of salaries to their employees) will be required to enter individual numbers of their employees in documents that they are obligated to file (initially, these documents will be limited to those concerning taxation, social security and disaster control, such as a withholding certificate and payment report to be issued for employment income). To fulfill this obligation, business operators need to be informed by the employees of individual numbers. In order to receive information on employees' individual numbers, business operators will be required to notify the employees or give public notice of the purpose of use of the individual numbers, and they will also be required to confirm the employees' identity by a prescribed procedure whenever they receive the said information (My Number Act, art. 16).

Individual numbers must be strictly managed and must not be used for purposes other than statutory purposes. The measures necessary for appropriate management of individual numbers, such as prevention of divulgation, loss, or damage of individual numbers, are required to be taken (*id.*, art. 12). "Specific personal information," which contains individual numbers, is likely to be used for name-based aggregation of information and therefore it is subject to strict protective measures as provided in PPIA. Accordingly, the My Number Act prohibits the provision of specific personal information except in the cases prescribed in the My Number Act (*id.*, art. 19), and also prohibits any person from collecting or keeping specific personal information for purposes other than statutory purposes (*id.*, art. 20).

If a person who is currently or was formerly engaged in the affairs involving individual numbers, for the purpose of acquiring a wrongful gain for him/herself or for a third party, provides or misappropriates an individual number that the person has learnt in the course of his/her duties, the person shall be punished by imprisonment with work for not more than three years or a fine of not more than JPY 1.5 million, or both. If such person, without justifiable grounds, provides a third party with a specific personal information file in which any individual's confidential matters that the person handles in his/her duties are recorded, the person shall be punished by imprisonment with work for not more than four years or a fine of not more than JPY 2 million, or both.

4 Act on Prevention of Transfer of Criminal Proceeds

The Act on Prevention of Transfer of Criminal Proceeds (hereinafter referred to as the "CPTPA") has been established for the prevention of legitimization of money obtained through criminal activities (money laundering) and financing of terrorists. In principle, when financial instruments business operators conclude contracts upon the first sale of financial instruments, etc., they should conduct identity verification upon transaction with regard to certain matters concerning customers, and if they find suspicious transactions, they should report without notifying the counterparty to the transaction and other parties concerned. The amendment to the CPTPA, which came into effect as of October 1, 2016, requires financial instruments business operators to take the following measures: clarify the method for determining suspicious transactions; implement strict identity verification upon transactions with foreign PEPs (politically exposed persons); introduce a stricter method for verifying the identity of substantial controllers of corporate customers; provide education and training for their employees; establish rules for the implementation of the procedures for verification upon conducting transactions; appoint persons responsible for supervising and managing an audit and other operations necessary for the proper implementation of such procedures.

4 1 Outline and Purpose

The CPTPA is a law which aims to prevent the transfer of criminal proceeds to preclude money laundering as well as to ensure the appropriate enforcement of international treaties, etc. concerning the prevention of terrorism financing, and, thereby, to ensure the safety and peace of national life and to contribute to the sound development of economic activities.

Accordingly, when Association Members engage in certain types of transactions, they are subject to the (i) obligation to conduct identity verification upon transaction, (ii) obligation to prepare and retain verification records, (iii) obligation to prepare and retain transaction records, etc. and (iv) obligation to notify suspicious transactions. In addition to the CPTPA, the "Foreign Exchange and Foreign Trade Act (Act No. 228 of December 1, 1949)" (hereinafter referred to as the "FEA") imposes customer identification obligations (FEA, art. 22-2).

4 2 Obligation to Conduct Identity Verification upon Transaction

An Association Member must conduct identity verification with regard to identification data of a customer when it enters into the first contract whereby the customer is to acquire securities (CPTPA, art. 4, para. 1; CPTPA Enforcement Order, art. 7, para. 1, item 1(i)). The name of this procedure was changed from "customer identification" to "identity verification upon transaction" after the amendment to the CPTPA came into force on April 1, 2013 (CPTPA, art. 4, para. 6).

Association Members must verify: (i) identification data of the customer (the name, address and date of birth in the case of an individual except for certain foreign nationals, and the name and location of the head office or main office in the case of a corporation); (ii) the purpose of conducting the transaction; (iii) occupation (in the case of an individual customer) or business description (in the case of a corporate customer); and (iv) if the customer, etc. is a corporation and there is a substantial controller thereof (a person who is in a relationship that allows such person to have substantial control of the corporation, as specified by Article 11, Paragraph 2 of CPTPA Enforcement Ordinance), the identification data of the said person. These matters should be verified by means such as receiving presentation or delivery of identification documents (CPTPA, art. 4, para. 1).

If Association Members engage in any of the following transactions, which are recognized as high-risk transactions, they should conduct strict identity verification upon transaction: (i) a transaction with a party who is suspected of pretending to be the customer, etc.; (ii) a transaction with a customer, etc. who is suspected of having given false information concerning the matters for identity verification; (iii) a transaction with a person who resides or is located in Iran or North Korea, or a transaction which involves the transfer of property to a person who resides or is located in Iran or North Korea; (iv) a transaction with the Head of a foreign state, and a person specified in Article 15 of the CPTPA Enforcement Ordinance as those entrusted with prominent public functions at a foreign government, central bank or any other similar organization or a person who previously held any of these posts; (v) a transaction with a family member (the spouse (in legal or common-law marriage; the same applies in (v)), a parent, child or sibling, or a parent or child of the spouse) of any of the persons mentioned in (iv); and (vi) a transaction with a corporation under substantial control of any of the persons mentioned in (iv) or (v) (CPTPA, art. 4, para. 2; CPTPA Enforcement Order, art. 12; CPTPA Enforcement Ordinance, art. 15). Among these, the transactions mentioned in (i) and (ii) require identity verification upon transaction by a method different from the method applied when conducting the initial verification. Furthermore, if the transaction involves the transfer of property of a value exceeding two million yen, the status of the assets and income of the customer, etc. should also be verified (CPTPA Enforcement Order, art. 11).

Identification documents include, in the case of an individual, a driver’s license, resident card, certificate of special permanent residence, individual number card, various types of health insurance card, and pension book (each item of the CPTPA Enforcement Ordinance, art. 7).

It must be noted that in principle, the identification documents must be effective as of the date of presentation of delivery for certificates with expiration dates, or prepared within six months of the date of presentation or delivery for certificates without expiration dates (CPTPA Enforcement Ordinance, art. 7, main paragraph).

Where an agent shall conduct a transaction, verification of identification data must be conducted with regard to the agent in addition to identity verification upon transaction regarding the Person. Similarly, when an accounting staff of a company opens a deposit account on behalf of the company, verification of identification data with regard to the accounting staff is also required (CPTPA, art. 4, para. 4).

If identity verification upon transaction with regard to the customer who is the prospective counterparty to a transaction has already been conducted, and verification records regarding the customer are retained, there is no need to conduct additional identity verification upon transaction if it is confirmed that the customer is the same person as the person recorded in the verification records by receiving the presentation, etc. of documents, etc. which indicate that the customer is the same person as the person recorded in the verification records, or hearing matters, etc. that could only be known by the customer (there is no need to even conduct such confirmation procedures if the business operator knows the customer in person or it is otherwise apparent that the customer is the same person as the person recorded in the verification records) (CPTPA, art. 4, para. 3; CPTPA Enforcement Order, art. 13, para. 1,

main paragraph).

However, for high-risk transactions, identity verification upon transaction must be conducted additionally even if identity verification upon transaction was already conducted.

Transactions specified in Article 4 of the CPTPA Enforcement Ordinance fall within the category of transactions for which simplified customer management is permitted and identity verification is not required upon transaction.

Under the amended CPTPA Enforcement Ordinance that came into effect as of November 30, 2018, and the amended CPTPA Enforcement Ordinance that came into effect as of April 1, 2020, the following methods for performing identity verification online are permitted: (i) a method whereby a specified business operator receives image information for identity verification transmitted by a customer, etc. using a software program provided by the specified business operator; and (ii) a method whereby a specified business operator receives image information for identity verification transmitted by a customer, etc. using a software program provided by the specified business operator, and also receives the information recorded in the semiconductor integrated circuit incorporated in the customer's identification document with a photo (CPTPA Enforcement Order, art. 6, para. 1, item 1, (e) to (j)).

4 3 Obligation to Prepare and Retain Verification Records

After conducting identity verification upon transaction, an Association Member must immediately prepare verification records and retain the same for seven years from the date of termination of the transaction under the contract or the date of termination of the transaction for which identity verification upon transaction has been completed, whichever comes later (CPTPA, art. 6; CPTPA Enforcement Ordinance, art. 21).

The verification record shall include the name of the person conducting the identity verification upon transaction, the person preparing the verification records, the date of presentation of the identification documents, etc., the type of transactions regarding which the identity verification upon transaction was conducted and the method of verification, etc. (CPTPA Enforcement Ordinance, art. 20).

4 4 Obligation to Prepare and Retain Transaction Records, Etc.

After conducting a transaction pertaining to the specified service with a customer, an Association Member must immediately prepare transaction records and retain the same for seven years from the date on which such transaction was conducted (CPTPA, art. 7).

However, there is no need to retain transaction records under certain cases such as transactions without the transfer of property, or transactions with the transfer of property for which the value thereof is JPY10,000 or less (CPTPA Enforcement Order, art. 15, para. 1).

4 5 Obligation to Report Suspicious Transactions

An Association Member must examine whether the property received from a customer is suspected to have been criminal proceeds, or whether a customer is suspected to have been disguising facts with respect to the acquisition or disposition of criminal proceeds or hiding criminal proceeds. If such suspicion is found, the Association Member must promptly submit a report of suspicious transactions to the Financial Services Agency (CPTPA, art. 8).

The matters to be reported are: (i) name and location of the reporter, (ii) date and place of the suspicious transaction, (iii) description of business, (iv) contents of the property concerning the transaction, (v) name and address of the customer or representative, etc. and (vi) reason for submitting the report (CPTPA Enforcement Order, art. 16, para. 2).

Whether a transaction falls within the category of suspicious transaction must be determined by taking into consideration the result of the identity verification upon transaction, the details and other circumstances of the transaction, and the annual report on the risk of transfer of criminal proceeds (CPTPA, art. 3, para. 3), focusing on the prescribed matters to be verified and employing the prescribed methods of verification (CPTPA Enforcement Order, art. 26 and art. 27).

For this purpose, “criminal proceeds” not only include criminal proceeds directly acquired through crimes, but also property acquired as consideration for criminal proceeds and property acquired based on the retention or disposition of criminal proceeds. For example, the interest on deposits of criminal proceeds or proceeds acquired through the sale of stolen goods is included in “criminal proceeds.”

In addition, whether a transaction is “suspicious” shall be determined by the officers or employees of the Association Member in comprehensive consideration of the form of the transaction, customer attributes and circumstances upon the transaction, etc. on the premise of general knowledge and experience in the financial industry. However, there is no need to recognize the existence of a specific crime, but only the suspicion of some crime which invokes the suspicion that the property is “proceeds from crime” is considered to be sufficient.

An Association Member shall not divulge the fact that a report on suspicious transactions will be or has been made to the customer pertaining to such suspicious transaction or persons related to the said customer (CPTPA, art. 8, para. 3).

The material published by the FSA under the title of “Reference Cases on Suspicious Transactions (Financial Instruments Business Operators)” provides many examples of the types of transactions to which financial institutions, etc. should pay special attention as transactions which are likely to fall under suspicious transactions. These types of transactions include the following:

(i) Transactions in which investments in stocks, bonds, investment trusts, etc. are made using large amounts of cash (including foreign currency; the same applies hereinafter) or checks. In particular, large-sum transactions which are disproportionate with respect to the income or assets, etc. of the customer.

(ii) Investments made in stocks, bonds, investment trusts, etc. on a frequent basis in a short period of time, where the total amount of transactions conducted using cash or checks is large.

(iii) Investments in stocks, bonds, investment trusts, etc. using an account which is suspected to be opened under a fictitious name or another person's name.

(iv) Investments in stocks, bonds, investment trusts, etc. using an account related to a customer who requests to have documents, such as transaction reports, sent to a point of contact different from the customer's address.

(v) Transactions where no rationality can be found in the facts that the IP address used at the time of login is a foreign IP address or that the browser language is a foreign language although the customer resides in Japan.

(vi) Transactions related to an account wherein investments are abruptly made in large amounts although normally, no transactions are conducted.

(vii) Transactions for which verification at the time of transaction cannot be completed due to the customer's uncooperativeness although such transactions had been conducted prior to completion of verification at the time of transaction. For example, cases where documents related to verification at the time of transaction which were to be submitted at a later date are not submitted. The same applies to cases where an agent is uncooperative.

(viii) Transactions related to an organized crime group member or person related to an organized crime group.

(ix) Based on the knowledge and experience, etc. of the employee in charge of the financial institutions, etc., transactions conducted in an unusual pattern or those related to a customer who is found to have shown an unusual attitude or movement, etc.

(x) Transactions for which inquiries or reports have been made from external parties, such as public organizations, regarding them as being likely to be related to criminal proceeds.

4 6 Obligation to Develop Necessary Systems

In order to appropriately take measures such as identity verification upon transaction, preservation of transaction records, etc. and reporting of suspicious transactions, an Association Member is required to (i) take measures to keep information up-to-date concerning the matters for identity verification upon transaction, and is also required to endeavor to: (ii) implement education and training for its employees; (iii) establish rules for the implementation of the procedures for verification upon conducting transactions; (iv) appoint a manager responsible for the necessary procedures; (v) prepare documents that are required to be prepared by specified business operators and make changes thereto if necessary; (vi) collect, organize and analyze information required for measures such as identity verification upon transaction; (vii) conduct continuous scrutiny of verification records and transaction records; (viii) require a manager's approval for conducting a high-risk transaction; (ix) collect, organize and analyze information on high-risk transactions, and prepare and preserve documents regarding the analysis results; (x) employ personnel equipped with necessary capabilities; and (xi) conduct an audit regarding identity verification upon transaction, etc. (CPTPA, art, 11; CPTPA Enforcement Ordinance, art. 32; the activities mentioned in (vi) and (vii) should be carried out by taking into account the content of the documents prepared by specified business operators).

The "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism" and the "FAQ on the

Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism" published by the FSA clarify the "required actions" and "expected actions" to be implemented by each financial institution, etc. Reference should be made to these materials when developing necessary systems.

Column: FATF Recommendations and the CPTPA

The FATF (Financial Action Task Force), an inter-governmental body established by the agreement at the Arch Summit in 1989, has published "Forty recommendations" and "Nine special recommendations," and the government of each country shall promote their anti-money laundering measures in accordance therewith. The FATF also conducts mutual evaluation on the status of compliance with these recommendations.

However, the results of the third mutual evaluation of Japan published in October 2008 presented harsh assessment on Japan's response to the FATF recommendations as being "non-compliant" on customer management mainly due to insufficiency in the legislative response. Accordingly, the Metropolitan Police Department has established a council by intellectuals to deliberate on the direction in the future and proceeded with the deliberation. On July 20, 2010, the Metropolitan Police Department issued the "Report of the Council Regarding the Manner of Customer Management by Operators as Anti-Money Laundering Measures."

This report shows the results of the deliberation that transactions with a high risk of money laundering shall be obligated under laws and regulations, and shall be responded by legislation although the manner of the provisions of such laws and regulations will require ingenuity. Following this, the law for amendment of the CPTPA was enacted, and was promulgated as of April 28, 2011, and put into effect as of April 1, 2013.

Yet, the FATF pointed out that the situation in Japan was still below the required level, although some improvements had been made. On June 12, 2013, the Council Regarding Anti-Money Laundering Measures was launched, and experts carried on discussions with an eye toward implementing system reforms to achieve the level of customer management as required by the FATF. As a result of this discussion process, the Council released a report on July 17, 2014. Following this report, the amendment to the CPTPA was promulgated on November 27, 2014, and put into effect in full on October 1, 2016.

Thus, the FATF recommendations are closely related to the amendments to the CPTPA that have been made several times thus far. Association Members should continue to pay attention to amendments to be made to the CPTPA in the future. On February 6, 2018, the FSA published the "Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism," in which it clarified the "required actions" and "expected actions" to be taken by financial institutions in order to ensure that the measures to prevent money laundering and combat the financing of terrorism through the risk-based approach will effectively function. The FSA revised the guidelines several times, aiming to reinforce the regulation. The FSA has stated that it will conduct monitoring in accordance with these Guidelines, but financial institutions should also pay attention to other regulatory documents, including the supervisory guidelines, the "Points to Note regarding the Criminal Proceeds Act" and the "List of Reference Cases of Suspicious Transactions."

Having conducted the fourth mutual evaluation of Japan in 2019, the FATF published the Mutual Evaluation Report of Japan on August 30, 2021. Following the publication of this report, Japan has established a policy council on money laundering, terrorism financing and proliferation financing, and published an action plan on measures against money laundering, terrorism financing and proliferation financing. Before this, on April 28, 2021, the FSA published "notice on the time limit for the development of internal systems for action against money laundering and terrorism financing," in which the FSA demanded that financial institutions should completely take action that is required under the "Guidelines for Anti-Money Laundering and

Combating the Financing of Terrorism" and develop an internal system as necessary by the end of March 2024, and should formulate a response plan regarding the internal system and implement it steadily under appropriate process management. Association Members should continue to take effective anti-money laundering measures.

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1 Economics

1 1 Economic Growth and the GDP

(1) History of and Challenges for Economic Growth in Japan

Looking at the global situation, many countries, irrespective of whether they are developed or emerging countries, are currently suffering from a high level of inflation. Japan is no exception, as it is currently facing high inflation for the first time since the time of the second oil shock 40 years ago, while at the same time achieving a low unemployment rate and current account surplus. However, there used to be a period when it struggled to resolve a current account deficit.

During the high growth period from around the mid-1950s to the end of the 1960s, the Japanese economy achieved tremendous advances, recording an average real economic growth rate of more than 10% per year. Nevertheless, consumer prices also rose sharply during this same period, with an average appreciation rate of over 6% per year, giving a strong impression that the economic growth was accompanied by high inflation. Economic expansion also led to many problems, including balance of trade deficits resulting from increased imports, which in turn made it difficult to pay for imports due to insufficient foreign currency reserves under the fixed exchange rate regime. This was the so-called problem of “balance of payments constraint.”

The following 1970s were said to be a period of big fluctuation. After the U.S. dollar could no longer be exchanged for gold following the “Nixon Shock” in 1971, the yen rate was switched to a floating exchange rate system in 1973, and many did not welcome the appreciation of the yen, believing it would lead to deterioration of Japan’s competitiveness in exports. It is well known that intervention in the foreign exchange markets and monetary easing by the government and the Bank of Japan (the “BOJ”) at the time led to an excess supply of currency which in turn accelerated the inflation that followed. Thus, while the spike in oil prices caused by the first oil crisis in 1973 was the immediate trigger that accelerated inflation, it can be said that the BOJ’s stance of not properly controlling the money supply paved a road to inflation.

Immediately after the first oil crisis, consumer prices soared out of control, increasing as much as 21% year-on-year during FY1974. That year, the real economic growth rate was minus 0.5%, the first negative growth rate since the end of World War II. In contrast to the high growth until the 1960s, the main problem in the Japanese economy during the 1970s was sustaining growth while controlling inflation.

The 1980s started with the second oil crisis, and Japan could not escape from the worldwide recession. In order to break free from stagflation, which refers to the simultaneous conditions of recession and inflation, the U.S. under the Reagan administration adopted a policy mix which combined a credit squeeze with fiscal expansion. This policy caused the value of the U.S. dollar to go up and the budget deficit to increase, which in turn led to a deficit in the current account, and the U.S. turned into a net debtor country.

Japan achieved economic recovery mainly by increasing exports, but its trade surplus continued to grow and other countries urged Japan to correct its external imbalance. The G7 countries (the seven of the world’s advanced economies) reached a common understanding that trade imbalances were to be corrected by adjusting exchange rates and with the Plaza Accord in 1985, the devaluation of the U.S. dollar was encouraged. Thereafter, the U.S. dollar continued to drop rapidly. In Japan, the rise in the yen and the fall in the U.S. dollar caused a substantial

deterioration in the revenues of exporting companies, and led Japan to fall into the so-called “strong-yen recession” in 1986. Nevertheless, the rising yen also enabled companies to significantly reduce their import costs for raw materials etc., such as crude oil, and as the effect of such trend, from the start of 1987 significant improvements began to be seen in corporate income. Since February of the same year, the Bank of Japan reduced the official discount rate to 2.50% and money markets eased substantially. The low U.S. dollar (strong yen), low crude oil prices, and low interest rates, at the time were called the “triple-low phenomenon” and played an important role in promoting the 51-month long economic boom that followed.

As economic expansion continued, labor was in short supply, and Japan was getting close to reaching a state of full employment. Full employment refers to a state where all people who are able and willing to work are employed, except for the case of voluntary unemployment where workers choose not to engage in work because they are not satisfied with the wage level, and the case of frictional unemployment which occurs temporarily due to people changing jobs or seeking new jobs. If companies wish to hire additional workers under the condition of full employment, they have no choice but to raise wages. Due to the increasing pressure of rising consumer prices and wages, the BOJ implemented a tight monetary policy in May 1989 as a preventive measure against inflation, and increased the official discount rate from 2.50% to 3.25%. The official discount rate continued to be increased in phases, reaching 6% in August 1990, when the Gulf crisis occurred. The Nikkei Stock Average dropped sharply immediately after peaking at the end of 1989, and its downward trend continued thereafter. The economy further slowed down in 1991, and market adjustments were necessitated. Asset prices had declined substantially since early 1990, and a successive series of counter-cyclical measures taken by the government could not easily improve the overall slump in the market. For four consecutive years starting in FY1990, corporate performance continued to decline, and the real economic growth rate for FY1993 ended up being negative. During the October-December period of 1993, it appeared that the economy had bottomed out. However, a rapid appreciation in the Japanese yen to as high as JPY80 per USD 1 for a brief period in 1995 forced the Japanese economy into a phase of short-term business adjustment. Although there was a growing shift towards correction of the overvalued yen and there have been signs of stable growth since then, the economy hit its peak in May 1997 immediately after the increase in the consumption tax rate to 5%. The economic slowdown continued throughout 1998 and the major shocks in the form of the Asian currency crisis, and the credit insecurity resulting from failures of domestic financial institutions became a significant drag on the economy.

With the recovery of the Asian economies and the global economy as a whole, exports increased. Various policies such as a special credit guarantee program took effect, and public investment was aggressively injected into the economy, so that a recovery began to occur at the start of 1999. Nevertheless, the world then experienced the collapse of the IT bubble, so that the economy again began to regress from the end of 2000.

The BOJ adopted a policy of “quantitative easing” beginning in March 2001 and maintained these accommodative financial conditions, and with the recovery of the global economy, such as in the U.S. and China, as well as the completion of inventory adjustments that began after the IT bubble had burst, the economy began to recover from the start of 2002. Since then, although the pace of recovery slowed on two occasions, under the influence of deterioration of the situation in Iraq and upon an adjustment of inventory in the IT sector, the longest period of economic expansion after the war was still recorded, exceeding that of the Izanagi boom.

Nevertheless, financial insecurity subsequently spread worldwide from around the summer of 2007 with the breakout of the subprime loan problem in the U.S., and with inflation backed by a sharp rise in the price of resources, the Japanese economy started to slow down from the end of the same year. Sparked by the subsequent collapse of Lehman Brothers in September 2008, the financial markets throughout the world were thrown into

confusion. Global demand drastically declined mainly as a result of a correction in excess consumption in the household sector sparked by a decline in housing prices in the U.S., and a contraction in international trade was also experienced, and as a result the Japanese economy began to worsen rapidly.

Affected by rapid monetary/fiscal policies by different countries, the global economy bottomed out in the beginning of 2009, and the Japanese economy went through a gradual export led recovery. In addition, a pickup of individual consumption due to domestic economic policies such as subsidies for eco-friendly cars and the eco-point system also backed the recovery of the Japanese economy.

However, the Great East Japan Earthquake, which occurred in March 2011, in combination with the worsening debt problems in Europe and the downturn in the global economy that followed, put a downward pressure on the Japanese economy which was on track to recovery. The worsening debt crisis in Europe made investors more inclined to avoid risk and prompted them to buy Japanese yen as a risk-free asset. As a result, the Japanese yen rose to a postwar record high against the dollar (USD1=JPY75.32) as of October 31, 2011. The sharp rise in the Japanese yen weakened the competitiveness of the Japanese export industry and reduced exports. Moreover, due to the suspension of operations of the nuclear power plants in Japan, imports of fossil fuels rapidly increased and thus, in 2011, a trade deficit was seen for the first time in 31 years on a calendar year basis.

After the struggle against the Japanese yen appreciation, the Japanese economy came to a turning point in the latter half of 2012. From around September of the same year, against the backdrop of a recovery in the U.S. economy and the resolution of the debt crisis in Europe, the rising trend of the yen subsided. Furthermore, a decision by the Noda Cabinet to dissolve the House of Representatives for a new election brought a sense of anticipation for the economic policy package proposed by the then President of the Liberal Democratic Party, Mr. Abe, who advocated bold monetary easing and accordingly, a rapid depreciation of the yen occurred.

The yen’s further weakening led to improvement of corporate performance and a sharp rise in share prices. These trends led to improved consumer confidence and positively impacted the asset markets, thereby boosting consumer spending. Finally, since the latter half of FY2012, the Japanese economy has been growing, driven by consumer spending. Moreover, in 2013, the economic growth led by domestic demand continued as a result of the considerable increase in public investment in addition to the increase in consumer spending.

However, the consumption tax hike to 8% as of April 2014, caused a last-minute surge in demand followed by a reactionary demand decline, resulting in a temporary significant downturn of the Japanese economy. Thereafter, the economy continued to be slow to recover due to the slowdown of economy in resource-producing countries and emerging countries in 2015. However, during the period from the latter half of FY2016 to the next fiscal year, the economy was on a recovery track. After that, business confidence deteriorated mainly in the manufacturing sector due to factors such as intensified trade friction between the U.S. and China, and the Japanese economy hit its peak in October 2018 and then started to contract thereafter. In addition, the consumption tax hike from 8% to 10% was implemented in October 2019.

Even under such circumstances, the employment and income situation continued to improve slowly, and corporate income in the non-manufacturing sector maintained an increasing trend in contrast with that in the manufacturing sector. The global demand for semiconductors entered a cyclic recovery mode, and in January 2020, the U.S. and Chinese governments signed the “phase one agreement” after their trade negotiation. However, the situation changed drastically due to the COVID-19 pandemic. Although in Japan, the U.S. and Europe, strong financial and monetary policies were implemented to support companies in raising funds and maintaining employment, the global economy fell into a severe situation in the April-June period of 2020 at a level that can be described as the worst post-war slump because strict restrictions were imposed on economic activities in order to

prevent the spread of infection.

Subsequently, progress has been made in the normalization of economic activities, although the emergence of new COVID-19 variants intermittently caused temporary worsening of the economy. In 2022, the United States and European countries almost completely abolished COVID-19-related regulations. In Japan as well, COVID-19 has been reclassified as Class 5 under the Act on the Prevention of Infectious Diseases and Medical Care for Patients with Infectious Diseases since May 8, 2023, and economic activities are becoming further normalized. In addition, the high-level wage hike achieved in the spring wage negotiations for the first time in 30 years and the further recovery of inbound tourism consumption are positive factors that will pump up the domestic economy. However, the prolonged credit crunch is causing growing financial uncertainty in Europe and the United States, and a real estate recession is becoming serious in China, all of which are increasing the risk of decline in economic conditions.

(2) Gross Domestic Product

In “(1) History of and Challenges for Economic Growth in Japan” above, the terms “economic growth” and “economic growth rate” have been used in the discussion without being properly defined. In general, economic growth is measured by Gross Domestic Product (GDP). GDP is a widely used index that represents the country’s comprehensive economic activities in three facets, *i.e.*, production (*i.e.* added value), distribution (*i.e.* income), and expenditure (*i.e.* demand). The “Principle of Equivalence of Three Aspects of National Income” applies to these three facets, since all three facets are considered to have the same numeric values.

A simple explanation of the concept of GDP from the perspective of production activities is as follows: production requires the intermediate input of raw materials and energy which are the result of production by other industrial activities; the added value, then, is the total value of production less the amount of the intermediate inputs. GDP is a flow concept, which gives the total of the added value which is generated by all the various economic activities within a country.

However, not all of the added value that remains after deducting the amount of intermediate inputs from the production amount remains as income to be gained by households or companies. This is because GDP contains consumption (depreciation) of fixed capital, which includes expenses incurred in the course of production, such as machinery and equipment that wear out after prolonged use. On the other hand, GDP does not contain income from overseas securities investments and direct investments. The value which remains after deducting depreciation of fixed capital from GDP is referred to as the Net Domestic Product (NDP). The word “Gross” in GDP indicates that the value includes the depreciation of fixed capital. The sum of NDP and net income received from abroad is referred to as Net National Product (NNP) or National Income (NI). NDP and NI are indicated at market value (including net indirect cost, calculated by deducting subsidies from indirect taxation) or at factor cost (excluding net indirect taxation). For the purpose of assessing buying power of households and companies, attention should be paid to income at factor cost.

Previously, Gross National Product (GNP) was mainly used as an indicator for measuring the Japanese economy. However, GDP is now taken as an indicator that reflects domestic economy more accurately. An indicator corresponding to GNP is Gross National Income (GNI).

GNI = GDI + Net income received from abroad

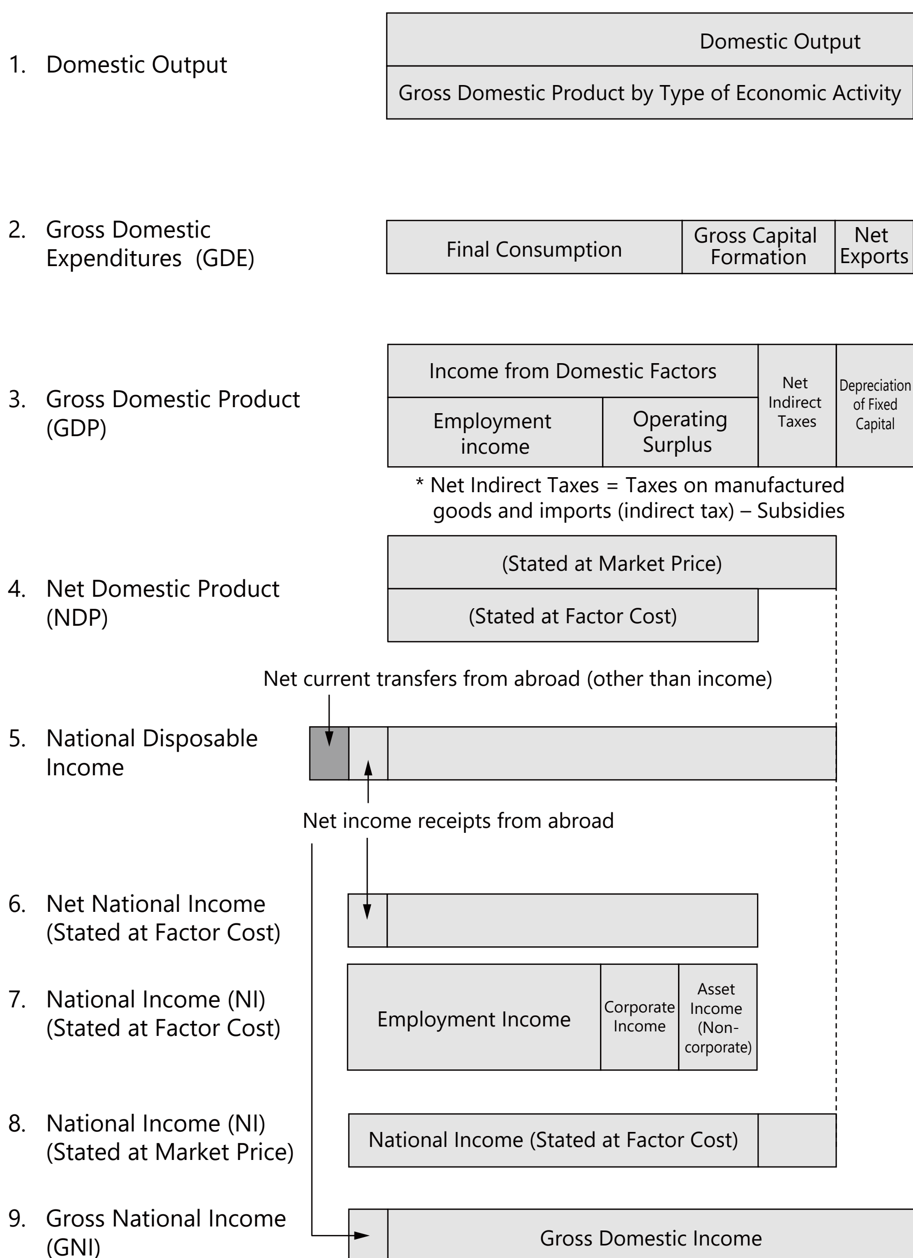
The concept of “Domestic” covers economic agents residing in the domestic territory (a country’s territory excluding the foreign diplomatic establishments and the military organizations residing in that country and adding

the country's diplomatic establishments and the military organizations residing in other countries). For example, a subsidiary of a foreign corporation in Japanese territory is included in the "Domestic" category as a producer residing in Japan since such entity conducts economic activities in the domestic territory of Japan. On the other hand, an overseas branch of a Japanese corporation would not be included within the "Domestic" category.

Furthermore, the concept of "National" means the residents of the country, and includes corporations which satisfies the requirements of being a resident as set forth in the circular "Interpretation and Application of Foreign Exchange Acts and Regulations" of the Foreign Exchange and Foreign Trade Act (FEFTA) and its subordinating orders, governments, private non-profit institutions serving households, and individuals residing in that country (anyone residing in that country for more than six months regardless of nationality; persons who are resident abroad for a period of more than two years are excluded from the category of residents).

GNI indicates the total amount of income generated by the residents of a country. GNI indicates GDP plus the

Chart 4-1 Concept of SNA Related Indexes



(Source) Cabinet Office "System of National Accounts"

net factor income received from overseas (employee income, property income such as investment income, and corporate income), and is assessed from a flow perspective.

The difference between GNI (GNP) and GDP used to be very small in Japan. However, direct overseas investments and overseas securities investments increased rapidly beginning in the late 1980s, causing net factor-income receipts to increase. As a result, the difference between GNI and GDP has been widening, and many have come to believe that GDP should be taken as a more accurate measure of the country's economic activities than the GNI, as mentioned above. Under such circumstances, the (former) Economic Planning Agency started to release national income statistics on a GDP basis from the third quarter of 1993 (see Chart 4-1).

(3) Gross Domestic Product from the Point of View of Distribution

Let us look at how added value generated in one year is distributed to the production factors such as labor and capital. According to the SNA, the following relationship is established:

GDP = Employee income + Operating surplus and Mixed income + Depreciation of fixed capital + (Indirect taxation – Subsidies)

Chart 4-2 shows the added value for 2021 from the aspects of production and distribution. According to this chart, the production in 2021 was JPY12.7 trillion from primary industries, JPY389.0 trillion from secondary industries and JPY629.9 trillion from tertiary industries, for a total of JPY1,031.6 trillion. When the intermediate inputs are deducted from these amounts to obtain the added value amounts, the respective results are JPY5.2 trillion, JPY143.0 trillion and JPY399.2 trillion, for a total of JPY547.4 trillion.

The breakdown of the distribution is as follows: JPY288.6 trillion for employee income such as wages, JPY76.6 trillion for operating surplus and mixed income which is the sum of the profits of the private corporations and the individual businesses such as farmers, rent, and interest income, JPY138.7 trillion for depreciation of fixed capital, and JPY43.5 trillion for indirect government revenue other than direct taxation ([indirect taxation] – [subsidies]), for a total of JPY547.4 trillion. Thus, the amount of GDP is the same whether seen from the perspective of production or that of distribution.

Chart 4-2 Production and Distribution Aspects of Nominal GDP (2021)

(Unit: JPY trillion)

	Primary industries	Secondary industries	Tertiary industries	Total
Intermediate inputs	7.5	246.0	230.7	484.2
GDP	5.2	143.0	399.2	547.4
Depreciation of fixed capital	1.9	38.8	98.0	138.7
Indirect taxation – Subsidies	-0.3	16.7	27.1	43.5
Employee income	2.5	79.3	206.8	288.6
Operating surplus, Mixed Income	1.1	8.2	67.2	76.6
Gross product	12.7	389.0	629.9	1,031.6

(Note) Based on the standards of 2015
(Source) Cabinet Office "System of National Accounts"

(4) Gross Domestic Expenditures

Of the three facets of production, distribution and expenditures, we have discussed production and distribution. Now, let us review national economic activities with respect to expenditures. Chart 4-3 shows the Gross Domestic Expenditures (GDE) and the composition of each final demand component.

There are two types of consumption: private consumption and government consumption. The major part of private sector final consumption (private consumption) is household consumption expenditures, whereas government final consumption consists of purchases of goods and services by the central government and municipal governments, and this includes large amounts for employment services such as salaries for civil servants, social security expenses (covered by public expenditure), education expenses, and defense spending.

Gross fixed capital formation includes investments in housing and corporate plant and equipment (construction of factories, the acquisition of machinery, research and development, etc.) by the private sector and public fixed capital formation (investments in the construction of roads, ports, airports, etc. by the government and other public sectors). Public fixed capital formation is generally called public investment.

Chart 4-3 Nominal GDE and Each Demand Type, Etc.

(Unit: JPY trillion)

Fiscal year	1995	2000	2005	2010	2015	2020	2021	2022
Nominal GDE	525.3 (100.0)	537.6 (100.0)	534.1 (100.0)	504.9 (100.0)	540.7 (100.0)	537.9 (100.0)	551.4 (100.0)	562.7 (100.0)
Final consumption expenditure in private sector	276.3 (52.6)	288.0 (53.6)	293.1 (54.9)	286.1 (56.7)	299.8 (55.4)	288.4 (53.6)	296.4 (53.7)	312.9 (55.6)
Private housing	29.1 (5.5)	25.3 (4.7)	23.9 (4.5)	17.2 (3.4)	20.4 (3.8)	19.9 (3.7)	21.3 (3.9)	21.7 (3.9)
Private investment in plant and equipment	85.9 (16.4)	88.0 (16.4)	87.0 (16.3)	72.5 (14.4)	87.0 (16.1)	86.3 (16.0)	90.6 (16.4)	97.3 (17.3)
Change in inventory of private sector	1.3 (0.2)	0.5 (0.1)	0.5 (0.1)	1.1 (0.2)	1.4 (0.3)	-1.0 (-0.2)	1.1 (0.2)	2.6 (0.5)
Final consumption expenditure in government	79.1 (15.1)	89.5 (16.6)	94.5 (17.7)	97.8 (19.4)	106.3 (19.7)	113.8 (21.2)	119.0 (21.6)	121.5 (21.6)
Public fixed capital formation	47.9 (9.1)	40.2 (7.5)	28.0 (5.2)	24.8 (4.9)	27.0 (5.0)	30.8 (5.7)	29.8 (5.4)	30.2 (5.4)
Change in inventory of public sector	0.3 (0.1)	0.0 (0.0)	0.0 (0.0)	-0.1 (0.0)	-0.1 (0.0)	-0.1 (0.0)	-0.1 (0.0)	-0.2 (0.0)
Net exports of goods and services	5.4 (1.0)	6.2 (1.2)	7.1 (1.3)	5.4 (1.1)	-1.1 -(0.2)	-0.4 -(0.1)	-6.7 -(1.2)	-23.2 -(4.1)
Exports of goods and services	46.9 (8.9)	56.5 (10.5)	76.7 (14.4)	76.1 (15.1)	92.0 (17.0)	84.4 (15.7)	103.8 (18.8)	122.8 (21.8)
Imports of goods and services (deducted)	41.5 (7.9)	50.2 (9.3)	69.6 (13.0)	70.7 (14.0)	93.1 (17.2)	84.8 (15.8)	110.5 (22.0)	146.0 (25.9)
Real GDE	462.2	485.6	515.1	512.1	539.4	527.7	541.7	549.2
GDP Deflator (Year 2015 = 100)	113.7	110.7	103.7	98.6	100.2	101.9	101.8	102.5

(Note) Percentage shares are shown in parentheses. For reasons such as statistical discrepancies, the GDE in Chart 4-3 and the GDP in Chart 4-2 do not match.
(Source) Cabinet Office "System of National Accounts"

A change in inventory is generally known as inventory investment. It consists of unsold merchandise at the end of the fiscal term, and intermediate inputs from other industries that were not consumed during the fiscal term. A change in the inventory of the public sector is a change in the government's inventory, such as a change in the government's stockpiles of petroleum, rice, etc.

Net exports of goods and services are the exports of goods and services (overseas demand for domestic products) less imports of goods and services (domestic demand for foreign products). The above consumption and investment items include the final demand for consumption goods and investment goods, regardless of whether such demand arises domestically or overseas. Imports of goods and services are deducted from such to compute the final gross value of domestic products.

The following formula shows the Gross Domestic Expenditures (GDE) (=Gross Domestic Product (GDP)) as a total of demand categories:

GDP = Private consumption + Private investment + Private inventory change + Government expenditures (government consumption + public investment) + Public inventory change + Exports – Imports

Private consumption constitutes the largest portion of demand. In FY2022, the nominal share of private consumption was 55.6%, and a comparison with previous years shows that the share of this line item is comparatively stable. Investment in plant and equipment and exports are particularly important from the perspective of fluctuations in the economy. Although investment in plant and equipment accounted for 17.3% of nominal GDP and exports accounted for 21.8% thereof in FY2022, which is relatively low when compared to private consumption, this is because the amplitude is relatively large.

The ratio of public capital formation (public investment) to nominal GDP grew substantially from the start of the 1990s and rose to the level of 9.1% in FY1995. In FY2007, as a result of the continued reduction of public works spending aimed at achieving fiscal consolidation, this ratio declined to 4.8%, the lowest level since FY1980. After the Great East Japan Earthquake, it turned upward due to the considerable increase in public works spending coupled with the large-scale supplementary budget compiled by the Abe Cabinet as a part of its economy-boosting measures. However, it has been around 5% since FY2013, and was 5.4% in FY2022.

(5) Real and Nominal

As shown in Chart 4-3, the nominal GDE (= GDP) of Japan in FY2022 was JPY562.7 trillion, whereas the real GDP for the same year was JPY549.2 trillion. The difference between "real" and "nominal" GDP values is that the nominal value GDP assesses the year's level of economic activities based on market prices, while the real value GDP assesses the same by making adjustments for the effect of price fluctuations.

An increase in nominal GDP does not mean that the level of economic activity increased by the same margin if the market price has also increased. Therefore, a change in the real GDP, which is the nominal GDP less the effect of price increases, yields a more accurate picture of the change in the level of economic activity. The real GDP is the production level in the base year evaluated at the prices as of that year. The GDP deflator is a price index calculated by dividing the nominal GDP by the real GDP. Price indexes such as the GDP deflator will be explained in more detail in Section 1.3(4).

The method of calculating the GDP deflator and the real GDP was changed at the end of 2004, from the fixed-base year method to the chain-linking method. In the calculation of the real GDP, the chain-linking method uses the preceding year as the base year, and accumulates and links the data each year. In contrast with the fixed-base year method which continues to use a specific year as the base year, the chain-linking method renews the base year each year.

As background factors for this change, one can point out the sharp decline in prices of and rapid dissemination of information technology (IT)-related goods, for which technology innovation has been ongoing at a rapid speed

and considerable improvement in quality has been seen. The fixed base-year method is unable to appropriately identify the impact of the growing demand for IT-related goods for which the relative price has declined, and the impact becomes larger as more time has passed since the base year. Using the chain-linking method enables GDP statistics to better reflect actual conditions.

(6) Assessing GDP Statistics

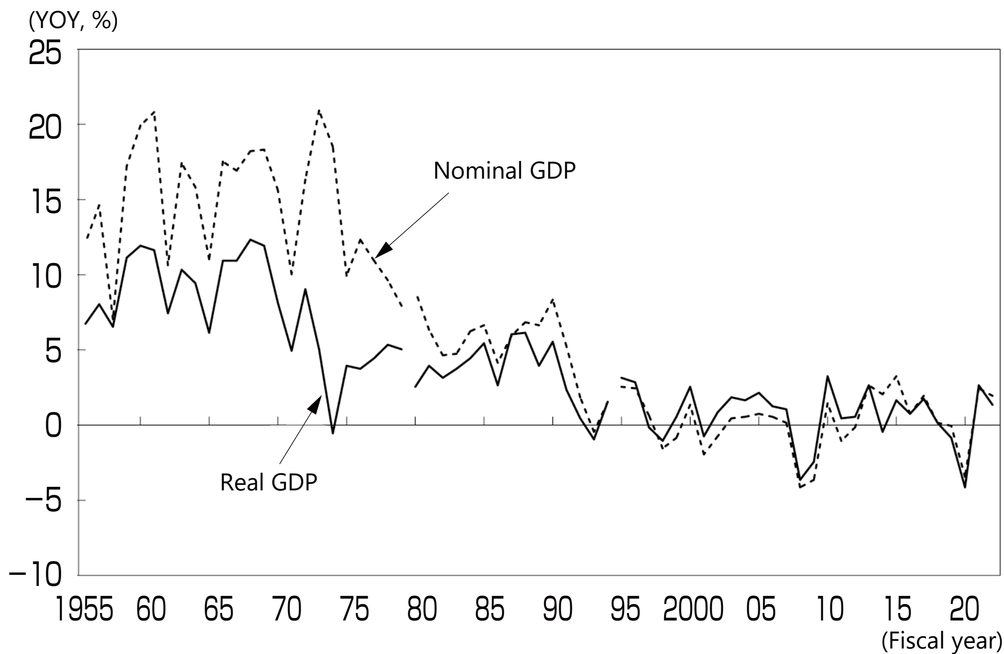
Economic growth is determined by making a comparison between the current GDP and that of the previous term (year or quarter), with economic growth consisting of the difference between the two figures. GDP is announced every quarter and is quite useful in judging the quarter's economic climate.

For expenditure-related statistics, quarterly estimates (QE) are published to provide important information for judging and evaluating economic trends. QE is calculated using various basic data. The first preliminary estimates are released about six weeks after the end of each quarter, and the second preliminary estimates are compiled using newly available basic data and released about one month after the release of the first preliminary estimates.

There are two methods of reading the QE: (a) comparing it with the previous year's QE for the same quarter, and (b) comparing it with the QE for the previous quarter of the same year at annualized rates. The former uses "serial" data that has not been processed statistically, while the latter uses data that has been "seasonally adjusted," which means it has been processed statistically.

Seasonal adjustment means statistical processing which eliminates the "regular cyclical variations during a year," such as fluctuations as a result of the climate (the harvesting of crops, etc.), systemic factors such as Christmas and bonuses, and differences in the number of days in a month. Analysis of the economic climate requires adjustments for these seasonal variation factors, and for this reason the seasonally adjusted figures are

Chart 4-4 Trends in GDP Growth Rate



(Note) The period until FY1980 is based on the year 1990, while the data for the period from FY1981 to FY1994 is based on the year 2011 using a simplified retroactive method, and the period after FY1995 is based on the year 2015.

(Source) Cabinet Office "System of National Accounts"

important information for analyzing the economic climate.

Annualized rates indicate the annual economic growth rate on the assumption that the growth for one quarter continues for a full year.

International standards for preparing GDP statistics have been established by the United Nations so as to enable accurate international comparison, and are periodically reviewed according to changes in the actual conditions of the economy. GDP statistics were completely reformed on the basis of the “1993 System of National Accounts” (abbreviated as “93SNA”) as adopted by the United Nations in 1993 for use starting in autumn 2000. This change was made in order to take into account changes in the role of the government, and changes in the social and economic environment such as an increase in the use of computers, as well as to achieve greater consistency for purposes of international comparison, and closer harmonization with other international statistics. Major changes include defining expenditures for computers and software as an investment in plant and equipment rather than as an intermediate input as had been done previously, adding the depreciation of fixed capital in the form of infrastructure to final consumption costs of the government, and separating consumption into “final consumption expenditures” that are borne as a cost of consumption, and “real final consumption costs” associated with the receipt of benefits.

At the end of 2016, GDP statistics were revised on the basis of the “2008 System of National Accounts” (abbreviated as “08SNA”), a new international standard. Changes were made to a broad range of statistical items in light of the changes in the economic situation after the adoption of 93SNA. For example, research and development (R&D), which has become more important in corporate production activities, is now treated as capital formation, instead of intermediate consumption.

1 2 Economy and the Economic Climate

(1) Economic Growth and Economic Cycles

To understand economic trends, it is important to view the fluctuations in the economy from the perspectives of “economic growth” and “economic cycles.”

When comparing the GDP of industrialized countries, most of them show sustained growth. In other words, each country seems to show a general growth trend if the economy is viewed over the long-term, although the level of growth differs by country.

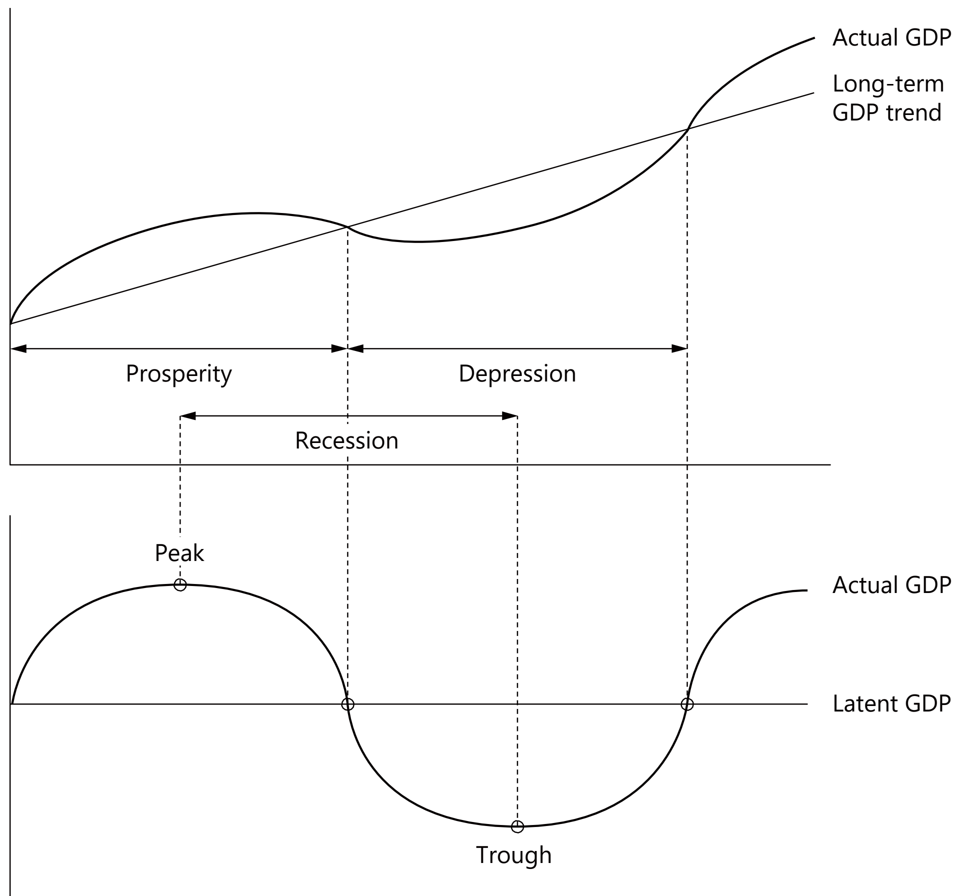
On the other hand, the economy seems to repeatedly prosper and shrink when GDP is seen over a period of three to five years, meaning that these shorter cycles revolve in a cycle around the long-term trend of economic growth. Thus, normal economic fluctuations are led by a growth trend which is accompanied by the smaller waves of fluctuation.

When assessing the economy, the focus may shift from emphasizing growth to emphasizing cycles depending on the phase of economic growth. In areas where economic growth has been very rapid, greater emphasis is placed on whether economic growth can continue in the long term, rather than on short-term economic cycles, and analysis focuses on determining the causes of economic growth.

(2) What Is Economic Growth?

The important factors leading to economic growth are supply factors. Supply factors involve matters that assist a company in obtaining the production components that are necessary to produce “goods,” such as capital

Chart 4-5 Categories of Economic Conditions in the Economic Cycle



(facilities), labor, and raw materials. Let us review this by applying the concepts to the Japanese economy during the 1960s when it sustained a high level of growth. In this example, the "supply factor" was cheap labor from rural areas, particularly agricultural communities, which supported a rapid increase in manufacturing.

When discussing economic growth, the main question often is, "What is the true level of Japan's economic capacity?" Japan's economic capacity translates to "potential growth rate" in economic terms. The potential growth rate, which is estimated and released by the Cabinet Office and the Bank of Japan on a regular basis, is the growth rate that can be achieved by utilizing available labor and capital at the average utilization ratio. The potential growth rate is used when discussing the "supply capacity" of a country's economy. In general, the factors that determine the supply capacity of a country are labor capacity, capital stock, and technological progress. The following discussions focus on these three factors:

(i) Labor Capacity

The term "labor capacity" often leads a reader to think of the number of laborers. However, the definition of labor capacity in the context of economic analysis means the "labor input volume," which is the number of laborers employed (employees) multiplied by the total work hours per laborer.

In determining the labor capacity, it is important to identify the levels of the total population, or the population of laborers of working age (actual number of people in the age group that can work; generally, the group comprising age 15 through age 64), and the ratio of people willing to work among people aged 15 or above (labor force participation rate). The decline of total population living in Japan, including persons from foreign countries, which started after reaching a peak in 2008, is having a negative influence on labor capacity. According to the birth median (death median) estimate from the "Estimated Future Population of Japan" (as of

2023) by the National Institute of Population and Social Security Research, the working age population is expected to continue declining and decrease by about 30 million people by 2070 from the 2020 level (down by about 40%).

When considering the trend of the labor force, however, the acceptance of workers of foreign nationalities must be considered, and it is also possible that there will be increases in the labor force participation rate depending on trends among women, whose participation rate is low relative to that of men, and among the population aged 65 and older. Therefore, estimates of future economic growth based on labor capacity requires consideration of legal and systemic issues, including issues related to participation of women in the workforce, pension issues, and immigration issues related to foreign workers.

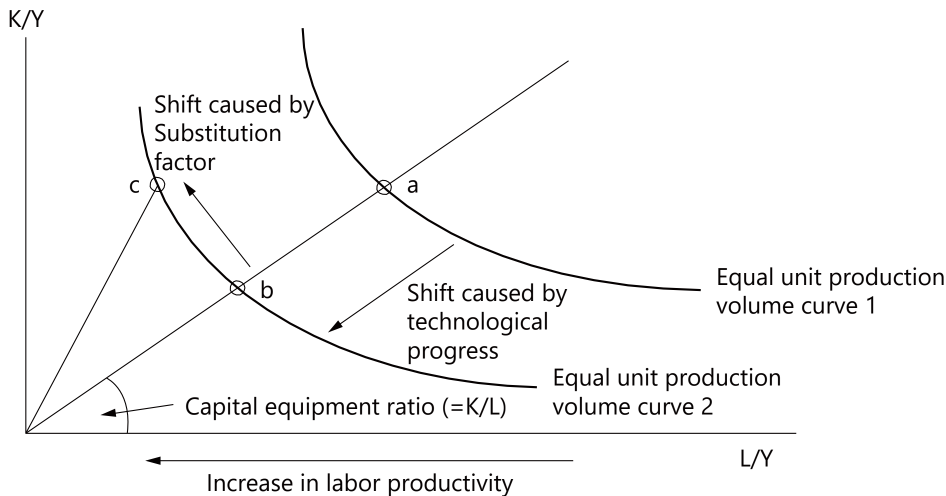
(ii) Capital Stock

"Capital stock" is the plant and equipment that are held by corporations as their production capacity. The capital stock at the end of the current term is equal to the capital stock at the end of the previous term plus the capital investment in the current term minus the depreciation of fixed capital. After a corporation decides to acquire certain machinery or to build a factory and launches production using such machinery or factory, it takes a certain amount of time for such capital investment to become productive (gestation period).

(iii) Technological Progress

Technological progress becomes clearly visible when for example the most recent equipment causes a significant increase in the efficiency of production. An increase in the capital stock as the ratio to labor (capital equipment ratio) and an increase in the rate of technological progress lead to improvements in "labor productivity." Chart 4-6 shows these relationships.

Chart 4-6 Relationship Between Technological Progress and Labor Productivity



(Note) "Equal unit production volume curve" indicates that less labor is required as one moves to the left and up along the curve which combines production facilities (K) and labor (L), the two necessary factors for production (Y is the amount of added value produced). Moving down and to the right, a production organization indicates that more labor is required to produce the same volume. This curve shows that the greater the shift to the left and downwards, the more efficient productivity becomes, and the more efficient the economy becomes.

The curve shows the combination of facility capital and labor capacity necessary to produce one unit of product.

Therefore, when there is a high level of capital equipment, the labor requirement declines. When there is a low level of production facilities, more labor is needed to produce the same amount of product.

Labor productivity (= amount of real value added produced per laborer or per laborer-hour) can be divided into a capital equipment ratio (volume of capacity per laborer or per laborer-hour) and technological progress. An increase in the capital equipment ratio means an increase in the volume of production equipment per unit of labor power. In Chart 4-6, such effect is shown by the shift of the curve (b→c).

On the other hand, an increase in the rate of technological progress is expressed as a shift of the curve to the lower left (a→b). In other words, less equipment and less labor are required to produce one unit of product, because of the technological progress.

IT and information technology investment constitutes an effort to improve labor productivity by investing in information technology such as computers. A combination of increasing the per-person capital equipment ratio and utilizing technological innovation can improve labor productivity.

The three factors mentioned are not the only determinants of economic growth. There are other factors that determine economic growth including:

- Making it easy for a company to enter and withdraw from the market (activating the activities of highly productive companies and having underproductive companies withdraw from the market);
- Advancing financial and capital markets (encouraging active investments by diversifying fund-raising methods);
- Ensuring openness of markets (introducing overseas knowledge and knowhow and strengthening competitiveness of domestic markets, in addition to expanding the market); and
- Enhancing infrastructure (social capital such as roads and harbors, technological progress, and legal systems to protect intellectual property rights to motivate innovative ideas).

(3) What Is an Economic Cycle?

An economic cycle is an evaluation method that sees the economy in cycles, alternating repetitions of prosperity and recession. In this document, an economic cycle is distinguished from economic growth, in that the economic cycle is a short-term movement that, in multiple sequences makes up a long-term trend, that is, economic growth. More technically, a long-term trend can be understood as the production level (*i.e.*, latent GDP) that can be achieved by using the average labor and capital available, and an economic cycle can be understood as the gap between the real GDP and the latent GDP (GDP gap).

There are various causes of economic cycles, including, for example, intermittent external shocks such as fluctuations in the crude oil price. The excess or deficiency in equipment and inventory can also be the cause of economic cycles. Recently, some persons have said that delays in the implementation of financial and economic strategies cause the “swing” (fluctuation) of the cycle to be amplified.

In reality, a complex combination of all of these factors causes the economic cycle, and no single factor can be

the consistent cause of economic cycles at all times. Also, once the economy reverses itself as a result of certain causes, this will tend to have a ripple effect on other factors and the level of influence becomes cumulative. It is often the case that the force changes direction only when the wave hits some barrier.

(4) Assessing Statistics on Economic Cycles

Since economic fluctuations comprise various factors, an overall assessment of the economy must be made based on a comprehensive analysis of many different aspects. However, there are almost an infinite number of indicators that represent the many aspects of the economy and covering all of these can be difficult. The Cabinet Office combines several of the most important indicators to derive indicators called the "Indexes of Business Conditions," and announces it monthly. The Indexes of Business Conditions attempt to identify trends and tipping points in economic conditions (economic peaks and troughs) by combining several economic indicators that are

Chart 4-7 Series Used in the Indexes of Business Conditions

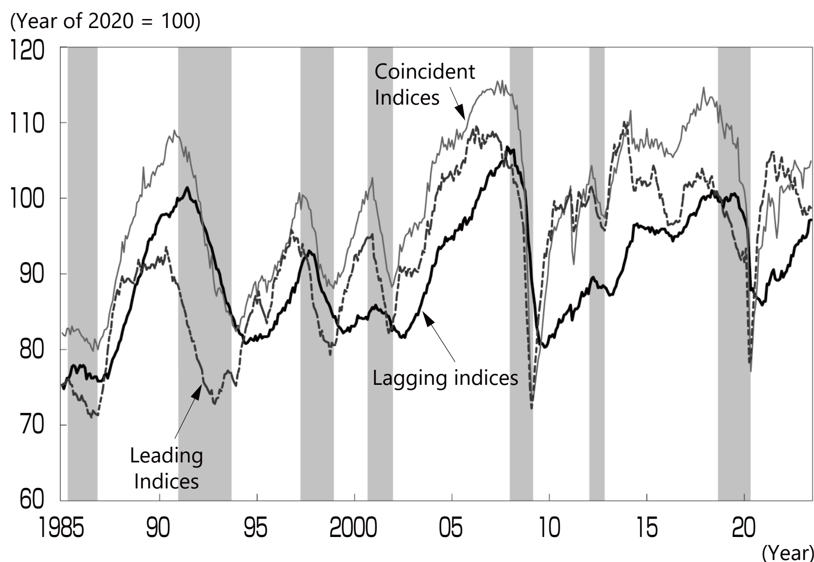
Series	No.	Indicator
Leading series	1	Index of Producer's Inventory Ratio of Finished Goods (Final Demand Goods) (Inverted)
	2	Index of Producer's Inventory Ratio of Finished Goods (Producer Goods for Mining and Manufacturing) (Inverted)
	3	New Job Offers (Excluding New School Graduates)
	4	Machinery Orders at Constant Prices (Manufacturing)
	5	Total Floor Area of New Housing Construction Started
	6	Consumer Confidence Index (households of two or more persons, seasonally adjusted series)
	7	Nikkei Commodity Price Index (42 Items)
	8	Money Stock (M2) (Change from Previous Year)
	9	Stock Prices (TOPIX)
	10	Index of Investment Climate (Manufacturing)
	11	Sales Forecast DI of Small Business
Coincident series	1	Index of Industrial Production (Mining and Manufacturing)
	2	Index of Producer's Shipments (Producer Goods for Mining and Manufacturing)
	3	Index of Producer's Shipment of Durable Consumer Goods
	4	Index of Labor Input (Industries Covered)
	5	Index of Producer's Shipment (Investment Goods Excluding Transport Equipment)
	6	Retail Sales Value (Change from Previous Year)
	7	Wholesale Sales Value (Change from Previous Year)
	8	Operating Profits (All Industries)
	9	Effective Job Offer Rate (Excluding New School Graduates)
	10	Exports Volume Index
Lagging series	1	Index of Tertiary Industry Activity (Business Services)
	2	Index of Regular Workers Employment (Change from Previous Year)
	3	Business Expenditures for New Plant and Equipment at Constant Prices (All Industries)
	4	Living Expenditure (Workers' Households) (Change from Previous Year)
	5	Corporation Tax Revenue
	6	Unemployment Rate (Inverted)
	7	Contractual Cash Earnings (Manufacturing)
	8	Consumer Price Index (All Items, Less Fresh Food) (Change from Previous Year)
	9	Index of Producer's Inventory (Final Demand Goods)

(Source) Cabinet Office "Indexes of Business Conditions"

believed to have a close relationship with the economy, including employment, production and consumption.

The series used for the Indexes of Business Conditions are categorized into the three types shown in Chart 4-7, *i.e.*, leading series, coincident series, and lagging series, and the indices calculated using these series are referred to as (i) leading indices, (ii) coincident indices, and (iii) lagging indices. All of these indices are used to assess the actual condition of the economy.

Chart 4-8 Indices of Business Conditions (Coincident, Leading and Lagging Composite Indices)



(Notes) The shaded areas indicate a phase of cyclical downturn (the most recent one is based on preliminary data).
(Source) Cabinet Office "Indexes of Business Conditions"

The leading index is created from eleven statistical series that are believed to move ahead of the economy by three to six months, and includes series for the inventory ratio and Tokyo Stock Exchange Stock Price Index. The coincident index is created from ten statistical series that are believed to move concurrently and in the same direction as economic fluctuations, such as production statistics and the ratio of job openings to job applicants. The lagging index is created from nine series that follow the economy, including the unemployment index. The Cabinet Office usually reviews the statistical series selected as composite indexes of business conditions at the time of identifying the peak or bottom of economy (including a provisional one). Through the review in March 2021, the Cabinet Office changed the statistical series adopted to create the consumer confidence index, which is a leading index, from "all households, original series" to "households of two or more persons, seasonally adjusted series," and replaced "index of non-scheduled worked hours" with "index of labor input" in the statistical series forming the coincident index.

Traditionally, public announcements in Japan focused on the Diffusion Index (DI) but from April 2008 a change was made to publication of economic indicators with more focus on the Composite Index (CI). The DI is an index which expresses the ratio of expanding series from among the series chosen, so that the economy is said to be expanding at the point where more than 50% of these series are growing. With the DI, the basic criterion is solely whether the 50% level is exceeded or not, and it is only possible to determine the trend of the economy.

The CI, on the other hand, is an index prepared as a composite of the rates of change of each series used, so

that the pace of change in the economy can also be detected in addition to the economic trend, making it more useful than the DI.

Since launching the system of publication focusing on the CI, the Cabinet Office which is the source of the public announcements, has released the "overall assessment of the economy by the CI," enabling a more precise overview of fluctuation points in the economy.

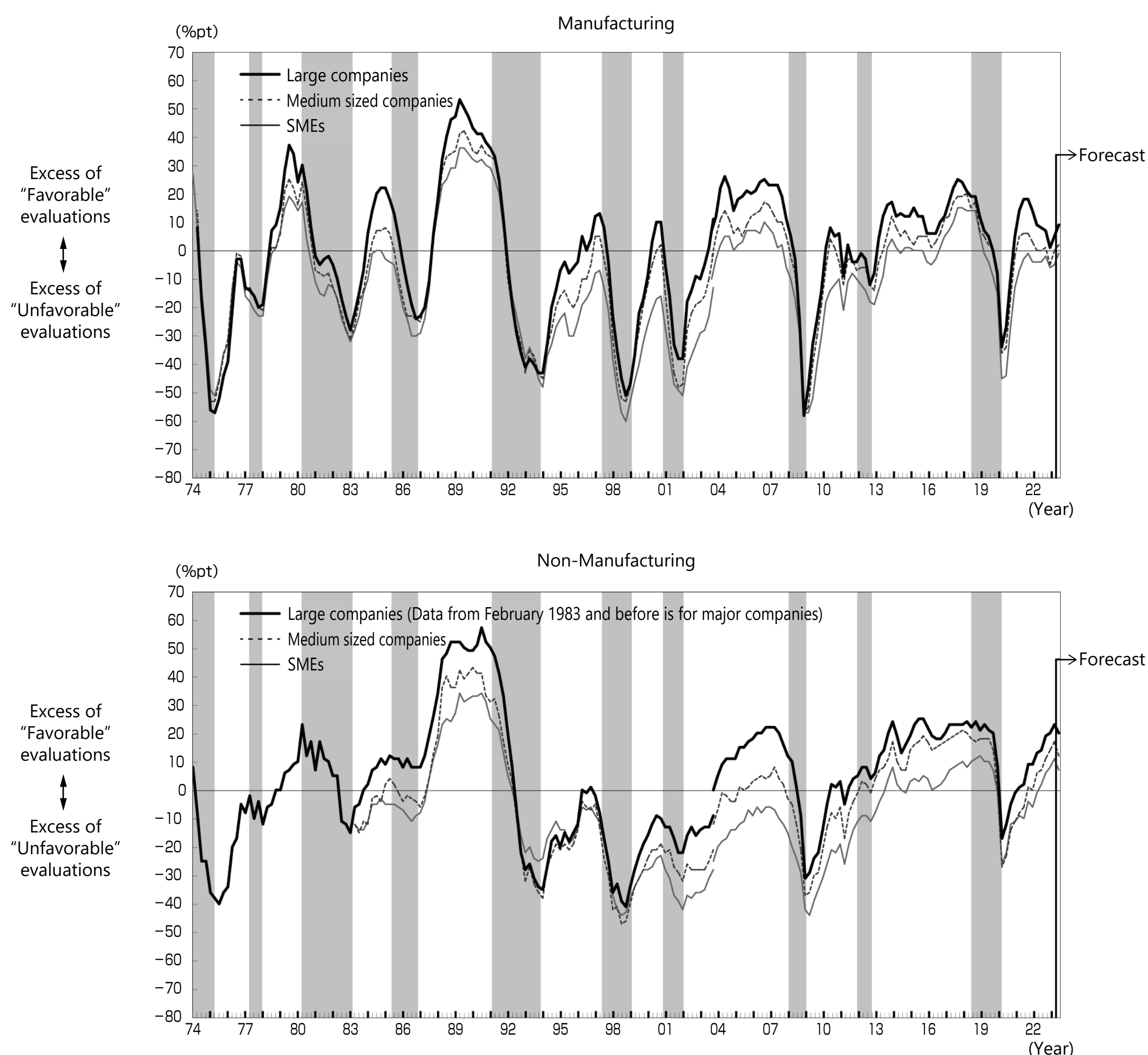
It is also possible to make a judgment of the current status of the economy from the results of various survey studies of corporations and consumers, from the perspective that it may be possible to substitute the "attitude" of corporations and consumers for the state of the economy. This is referred to as survey data.

A particularly prominent survey is the "Short-Term Economic Survey of Enterprises in Japan," known widely by its Japanese abbreviation "BOJ Tankan," which is released every three months by the BOJ. There is much interesting data for such projections, such as various DIs on industry performance, prices, facilities and equipment, employment, and cash flow etc., as well as various plans including sales, income and equipment investment plans. This survey enables us to obtain data on how companies view the economic situation and their forecasts for the future. This survey is known outside of Japan by its short name "TANKAN," and it attracts great attention from those abroad.

The beginning of an economic expansion (or end of an economic contraction) is called the economic trough and the beginning of an economic contraction (or end of an economic expansion) is called the economic peak. The economic benchmark dates in Chart 4-10 indicate the dates when economic turning points in Japan are believed to have occurred. One economic cycle consists of a trough, a period of expansion, a peak, and a period of contraction. The length of time for one cycle is called a cycle period.

Chart 4-10 confirms sixteen economic cycles in Japan since the end of World War II. Among these cycles, the average duration from the second to the 16th cycle, the full cycles of which can be confirmed, is 55 months, whereas the average duration of an expansion is 39 months and the average duration of a contraction is 16 months. As shown, the average duration of an expansion is twice as long as the average duration of a contraction. The expansion period of the third cycle is called the "Jimmu Economy" and the expansion period of the fourth cycle is called the "Iwato Economy." The expansion period of the sixth cycle is called the "Izanagi Economy." The economic expansion which started from the bottom in November 2012 (the 16th cycle) reached the peak in October 2018, marking the expansion period of 71 months, which is the second longest after the end of World War II.

Chart 4-9 **BOJ Tankan: Trends in Business Decisions**



(Notes) 1. The shaded areas indicate a phase of cyclical downturns (the most recent one is based on preliminary data).
2. From March 2004, changes were made to, *inter alia*, the companies surveyed, and consequently, the statistics are not continuous between the surveys conducted in and before December 2003, and those conducted from March 2004.
3. As a result of the recent periodic review, discontinuity occurs in the survey conducted in December 2017 and that conducted in March 2018.

(Source) BOJ "Short-Term Economic Survey of Enterprises in Japan (*Tankan*)" and Cabinet Office "Indexes of Business Conditions"

Chart 4-10 Dates of Economic Benchmarks

	Trough	Peak	Trough	Period			(Reference) Quarterly benchmark dates	
				Expansion	Recession	Full cycle	Peak	Trough
First cycle	—	Jun. 1951	Oct. 1951	—	4 mo.	—	Apr.-Jun., 1951	Oct.-Dec., 1951
Second cycle	Oct. 1951	Jan. 1954	Nov. 1954	27 mo.	10 mo.	37 mo.	Jan.-Mar., 1954	Oct.-Dec., 1954
Third cycle	Nov. 1954	Jun. 1957	Jun. 1958	31 mo.	12 mo.	43 mo.	Apr.-Jun., 1957	Apr.-Jun., 1958
Fourth cycle	Jun. 1958	Dec. 1961	Oct. 1962	42 mo.	10 mo.	52 mo.	Oct.-Dec., 1961	Oct.-Dec., 1962
Fifth cycle	Oct. 1962	Oct. 1964	Oct. 1965	24 mo.	12 mo.	36 mo.	Oct.-Dec., 1964	Oct.-Dec., 1965
Sixth cycle	Oct. 1965	Jul. 1970	Dec. 1971	57 mo.	17 mo.	74 mo.	Jul.-Sept., 1970	Oct.-Dec., 1971
Seventh cycle	Dec. 1971	Nov. 1973	Mar. 1975	23 mo.	16 mo.	39 mo.	Oct.-Dec., 1973	Jan.-Mar., 1975
Eighth cycle	Mar. 1975	Jan. 1977	Oct. 1977	22 mo.	9 mo.	31 mo.	Jan.-Mar., 1977	Oct.-Dec., 1977
Ninth cycle	Oct. 1977	Feb. 1980	Feb. 1983	28 mo.	36 mo.	64 mo.	Jan.-Mar., 1980	Jan.-Mar., 1983
Tenth cycle	Feb. 1983	Jun. 1985	Nov. 1986	28 mo.	17 mo.	45 mo.	Apr.-Jun., 1985	Oct.-Dec., 1986
Eleventh cycle	Nov. 1986	Feb. 1991	Oct. 1993	51 mo.	32 mo.	83 mo.	Jan.-Mar., 1991	Oct.-Dec., 1993
Twelfth cycle	Oct. 1993	May 1997	Jan. 1999	43 mo.	20 mo.	63 mo.	Apr.-Jun., 1997	Jan.-Mar., 1999
Thirteenth cycle	Jan. 1999	Nov. 2000	Jan. 2002	22 mo.	14 mo.	36 mo.	Oct.-Dec., 2000	Jan.-Mar., 2002
Fourteenth cycle	Jan. 2002	Feb. 2008	Mar. 2009	73 mo.	13 mo.	86 mo.	Jan.-Mar., 2008	Jan.-Mar., 2009
Fifteenth cycle	Mar. 2009	Mar. 2012	Nov. 2012	36 mo.	8 mo.	44 mo.	Jan.-Mar., 2012	Oct.-Dec., 2012
Sixteenth cycle	Nov. 2012	Oct. 2018	May 2020	71 mo.	19 mo.	90 mo.	Oct.-Dec., 2018	Apr.-Jun., 2020

(Source) Cabinet Office

(5) Inventory Cycle

If a normal economic cycle lasts for two to five years, an inventory cycle is taking place for most of that time.

Two factors determine an increase or decrease in the inventory cycle. The first factor is the gap between the anticipated demand estimated by a corporation when it plans its production strategy and the actual demand that occurs. This gap is sometimes called “unintentional” inventory changes. The second is when the corporation strategically and intentionally attempts to adjust the inventory for anticipated future price fluctuations, etc. For example, if a company expects that the price of a raw material will increase, the company may decide to make more of its products while the cost of the raw material is still cheap, in anticipation of being able to sell the products at a higher price when the price of the raw material is rising and thereby earning greater profits. Typical examples of strategic inventory adjustments can be seen when companies increase their inventories in order to take advantage of an anticipated upswing in prices for raw materials.

The inventory cycle can be identified by interpreting the cycles between such “unintentional” changes in inventory and “intentional” changes in inventory in light of the economic cycle. Based on the concept of the inventory cycle, the changes in inventory can be divided into four phases.

Chart 4-11 Graph of Inventory Cycle

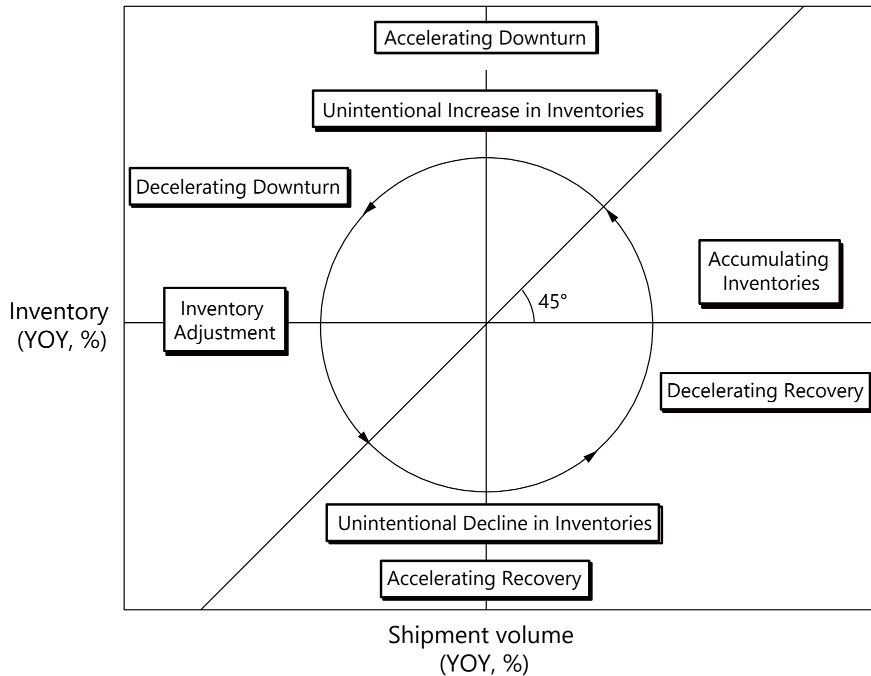
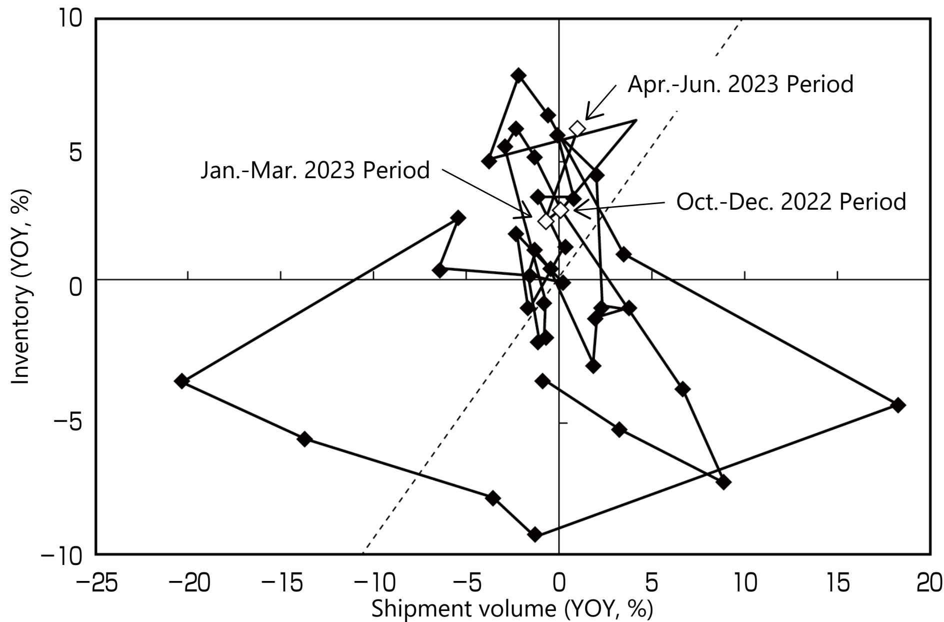


Chart 4-12 The Inventory Cycle



(Source) Ministry of Economy, Trade and Industry "Indices of Industrial Production"

When the economy bottoms out, demand approaches a recovery. However, corporate forecasts and projections reflect pessimism about anticipated demand. As a result, the inventory accumulated during a recession declines unexpectedly ("unintentional inventory decline" phase). Subsequently, when entering the economic expansion period, corporate forecasts and projections reflect optimism about anticipated demand causing them to make large-scale purchases ("inventory accumulation" phase). During such a period, tight demand for goods is more likely to lead corporations to increase inventory. However, once the economy shifts from expansion to recession, although

the corporate estimates are still bullish, demand comes to be less than had been anticipated, and corporations face "unintentional increases in inventory." Once corporations acknowledge an economic downturn, their estimates of future demand become pessimistic, and they drawdown the accumulated excess inventory. This condition is called "intentional decline in inventory." The inventory cycle moves through these processes.

When assessing the inventory cycle, the analyst must pay attention to the differences among inventory classes, such as raw materials inventory, work in process inventory, product inventory, and the inventory in the distribution sector, as goods progress through their process from manufacturers to distributors.

(6) Equipment Investment Cycle

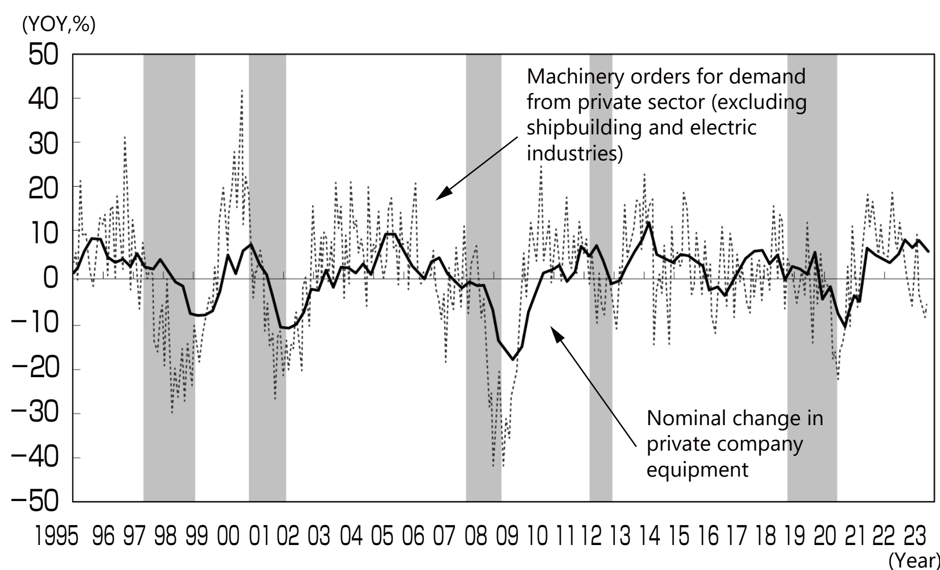
As mentioned earlier, the economic expansion that began from the bottom in November 2012 (the 16th cycle) has become nearly as long as the "Izanami Economy (the 14th cycle)," which is the largest expansion since the end of World War II. These exceptionally long periods of economic expansion contain factors that cannot be explained just by the inventory cycle.

Many of the expansions that exceed a period of five years are said to be equipment investment cycles. There are three main factors that cause demand for equipment investment.

The first is replacement investment. Over time, a company's initial equipment and machinery wears out and needs to be replaced. A cycle of equipment investment corresponds to the life span of such machinery and equipment that need to be replaced.

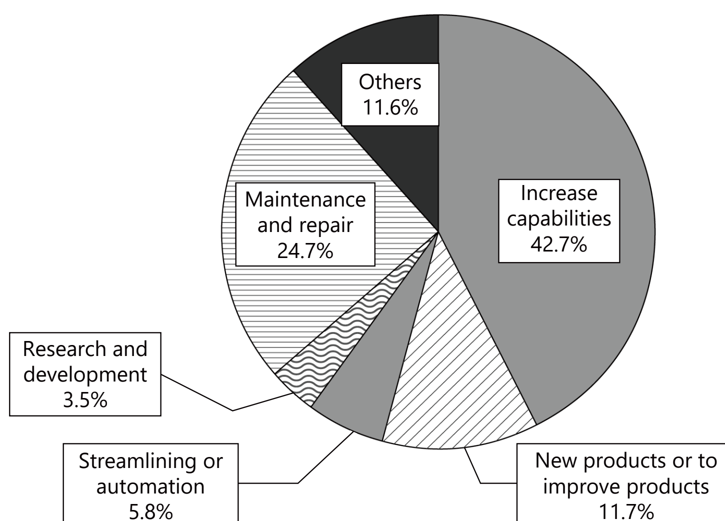
The second factor is the stock adjustment principle. When a corporation makes an investment in equipment, it first determines the desired level of capital stock, based on assessment of current and future economic conditions. This principle holds that a corporation's equipment investment is made to eliminate the gap between the existing level of capital stock and the above-mentioned desired level.

Chart 4-13 Index Pertaining to Equipment Investment



(Note) The shaded areas indicate a phase of cyclical downturns (the most recent one is based on preliminary data).
(Source) Cabinet Office "Machinery Orders," "System of National Accounts" and "Indexes of Business Conditions"

Chart 4-14 Corporate Motivations for Investment



(Note) Actual performance values for FY2022
(Source) Development Bank of Japan "Survey on Planned Capital Spending"

The third factor is autonomous investments. These investments include research and development expenses, investments in streamlining operations, and investments in automation. These investments, such as investments in product development made to maintain a corporation's competitiveness, or investments made to lower overall costs by leveraging information technology, are made from a long-term perspective, separately from investments made because of the corporation's short-term anticipation of demand.

1 3 Evaluating the Economy

(1) Assessing Consumption-Related Statistics

Fundamental perspectives of statistics, mainly on the behavior of households, will be discussed in this section.

The household plays two roles in economic activities. The first is its role as demanders through private consumption and housing investments. The second is its role in providing production inputs as labor in the labor market and supplying funds in the financial market in the form of savings. The household trends discussed here focus on the first role.

(i) Determinants of Consumer Spending

Private consumption amounts to almost 60 percent of demand in the recent Japanese economy. The factors that determine the amount of consumer spending are increases and decreases in income and changes in the propensity to consume.

There are many types of income as defined in the Cabinet Office's "System of National Accounts," such as the following: employment compensation, including wages and salaries; income from assets, including interest from savings, dividends from securities, and rental income from real estate; mixed income which is the profit of an unincorporated business; operating surplus which is basically equivalent to renting of owner-owned dwellings; social insurance benefits, such as pension payments and unemployment benefits.

Disposable income is the total of these incomes less deductions such as income tax and other items, health insurance fee, pension premium payments, and unemployment insurance fee. Disposable income is the portion of income that the household can spend freely, and is the source of funds used at the time of consuming.

Propensity to consume is the percentage of disposable income that is actually expended for consumption. There are two definitions of propensity to consume, but the one referred to in this part is what is called the average propensity to consume. On the other hand, the percentage of additional income that is expended for consumption is called the marginal propensity to consume.

Income	= Employment compensation + Income from assets + Mixed income/Operating surplus + Social insurance benefits, etc.
Disposable income	= Income – Income taxes, etc. – Social insurance premiums, etc.
Propensity to consume	$= \dfrac{\text{Consumer spending}}{\text{Disposable income}} \times 100(\%)$
Household savings	= Disposable income – Consumer spending
Household savings rate	$= \dfrac{\text{Household savings}}{\text{Disposable income}} \times 100(\%)$

Propensity to consume can be taken as equivalent to "tightness of purse strings." Consumption increases if the propensity to consume increases for some reason (the purse strings are loosened), even if disposable income stays the same.

However, disposable income and the propensity to consume are not determined independently as they are often affected by the same factors. The net of disposable income minus consumption is referred to as household savings, and the ratio of savings divided by disposable income is referred to as the household savings rate.

Households generally estimate their future income based on past experience and information about the future that is currently available. They anticipate future interest rate trends and inflation in the same manner. Then, they decide how to distribute current and future spending based on these estimates of current and future economic conditions. That portion allotted for future spending is called savings. Factors such as the employment situations of family members, the retained financial assets, as well as age, taxes and social security system are all taken into consideration when estimating future income.

With respect to private consumption and disposable income in Japan, the marginal propensity to consume declined after the first oil crisis (1973 – 1974), and as a result, the average propensity to consume declined to below 80%. With the sudden rise in oil prices, anticipated future household income declined, and job insecurity became noticeable as businesses started to review their employment practices, which caused households to become more conservative in their spending. On the other hand, a decline in the average propensity to consume was not seen following the second oil crisis (1979 – 1980). Thereafter, the average propensity to consume continued to rise and early in the 21st century, it started to exceed 95%. This is considered to have been strongly affected by the increase in the number of aged households that are consuming by breaking into their savings, with such increase being related to the increase in the number of aged households. From the spring of 2020, consumption of services was curbed following the COVID-19 pandemic, and disposable income increased due to the provision of various grants to households, resulting in a significant decline in the average propensity to consume compared to the level before

the pandemic. After that, along with the progress in normalization of economic activities, consumption expanded mainly in services such as tourism and food services, using excessive savings accumulated during the pandemic, leading to an increase in the average propensity to consume.

There are some circumstances where even if income falls sharply, the result is an increase in the propensity to consume (the ratchet effect), in contrast to the case of oil crisis mentioned above. This is because, even if the disposable income falls, a considerable amount is needed to be spent on food and other necessities, and this amount is difficult for consumers to reduce. It is necessary to be aware that in these circumstances, the propensity to consume will increase even if income falls and the consumer's mindset deteriorates. The result is that the amount of consumer spending varies less than the changes in growth of GDP.

Chart 4-15 Trends in Average Propensity to Consume

(Note) 1979 and previous years are based on the year 1990, while the period from 1980 to 1994 is based on the year 2000, and 1995 and subsequent years are based on the year 2015.

(Source) Cabinet Office, "System of National Accounts"

(ii) Types and Characteristics of Consumption-Related Statistics

There are several types of statistics that indicate the dynamics of consumer behavior, *i.e.*, Final Consumption Expenditure of Households in GDP statistics (Cabinet Office), the Family Income and Expenditure Survey (Ministry of Internal Affairs and Communications), Survey of Household Economy (Ministry of Internal Affairs and Communications), department-store sales statistics (Association of Department Stores of Japan), chain-store sales statistics (Association of Chain Stores of Japan), Current Survey of Commerce (Ministry of Economy, Trade and Industry), sales of new automobiles (Japan Automotive Dealers Association), and others.

The Family Income and Expenditure Survey compiles the figures for household income and expenditure that include the detailed items of expenditures for households nationwide other than some types of households such as those consisting of single students. These figures are published as the Family Income and Expenditure Survey Results, making it possible to analyze the consumption activities of households from a variety of perspectives, including age group, income strata, or occupation of the head of the household. The Family Income and Expenditure Survey also contains data concerning areas such as income, savings and debts. Nevertheless, since the Family Income and Expenditure Survey is conducted as a sample survey (of

approximately 8,000 households of two or more persons) it contains the problem of significant distortion associated with changes to the sample, particularly in big ticket items that are purchased infrequently. In order to resolve this issue, and also to identify consumption related to information technology, the Survey of Household Economy has been conducted since 2001 with a larger sample size (approximately 27,000 households of two or more persons). This is also used in areas such as estimating GDP. In addition, as a means to keep up with the trends in overall consumption, consumption trend indexes (CTIs) have been released since 2018. There are two types of CTIs: namely, (i) household consumption tax index (CTI micro) to estimate the trend in consumption expenditures of households which include single-person households; and (ii) total consumption trend index (CTI macro) to estimate the monthly trends in household final consumption expenditures in GDP.

It is also important to monitor consumption from a sales perspective. For example, chain store sales statistics are a particularly convenient tool for understanding the basics of consumption. Spending on less essential durable goods (appliances, automobiles, etc.), on dining-out, and discretionary (arbitrary) spending such as spending on education and leisure activities, are more sensitive to economic conditions. Sensitivity to economic conditions is more evident among the high-priced durables, such as automobiles. It is however necessary to be aware that a certain portion of consumer spending is not captured by department store, supermarket, or large-retailer sales reports, given the growing diversification of consumption by greater use of suburban-type specialty shops, convenience stores, and online sales.

The "consumer mind," meaning the psychological aspect of households regarding their own consumption, has become an important factor that affects consumption. One contributing factor towards this attention is the growing perception that uneasiness over job security, life at old age or both may have had an adverse impact on consumption. Based on this perception, this would mean that expectations for lifetime income (the amount an individual expects to earn over his or her life) have fallen, and a determination cannot be made solely on the basis of present income or employment trends. Methods used to make judgments about the consumer sentiment include studies on the trends in expenditure for durable goods and services which are not essential for daily life, and for which it is possible to select the timing for when to make purchases, and results of questionnaire surveys on consumer trends (by the Cabinet Office).

(2) Assessing Housing-Related Statistics

Along with private consumption, another role of households in the economy is the acquisition of housing. Spending on housing is included in GDP demand items as "housing investment." While private consumption is fairly stable relative to economic fluctuations, spending on housing reacts sensitively to economic fluctuations. The reasons for this sensitivity are that the significant difference in the amount of capital and interest payments on housing loans could be caused by even the slightest change in interest rates, and that changes in the employment and income situations could have an influence on an individual's ability to buy a home.

The factors influencing home investment decisions include (a) income, (b) interest rates on housing mortgages, (c) taxation, and (d) housing prices. Increases in income, decreases in interest rates, expansion of tax incentives for home purchases, and decreases in the prices of homes all contribute to an increased ability for home acquisition.

Housing-related statistics include statistics on private-home investment included in GDP statistics and the number of new housing starts in the "Building Starts Statistics" compiled by the Ministry of Land, Infrastructure, Transport and Tourism. The statistics on private home investments included in GDP statistics are "progress-based" figures, whereas the statistics on housing starts are figures based on "the commencement of new construction"

during the term. Therefore, the latter tends to move ahead of economic fluctuations, and is used as a leading economic indicator. Housing acquisition can have a significant ripple effect on the economy as a whole because it involves a broad range of industries including construction and materials industries, and the consumption of home appliances and furniture increases in most cases when people purchase housing.

(3) Assessing Employment-Related Statistics

Some areas of the employment system are associated with economic growth, while other areas of the employment system are associated with economic cycles. This part discusses the areas that most closely reflect economic cycles.

(i) Employment Adjustment Mechanism

In Japan, adjustments to labor time frequently precede adjustments to the number of workers. Over the short term, there is a tendency to make this adjustment of a gap from the ideal employment status by addressing overtime and otherwise adjusting the hours worked. Thus, restructuring by cutting the number of employees is only carried out when an employer determines that adjustments to working hours will not be sufficient as an adjustment, and that adjustments must be made over an extremely long term. Moreover, there is a strong tendency for these adjustments to first involve contingent personnel, such as part-time workers and temporary employees, rather than full-time employees. As a last resort, a company would stop hiring, and lay off full-time employees. Adjustments in work hours are often made at the same time as inventory adjustments, whereas adjustments in the number of personnel are often made at the same time as adjustments in capital investments.

As an increase in unemployment among household heads strongly impacts consumption, it is possible to track structural changes in the society through the unemployment rate for different age groups. However, consideration should be given to the fact that the environment for employment is currently undergoing change, through the spread of temporary worker dispatching business, etc., and thus the relationships between companies and employees are becoming more diversified.

(ii) Types and Characteristics of Employment Indicators

Employment indicators include overtime, the ratio of job openings to job applicants, the unemployment rate, the regular employment index etc. These statistics are announced by the Ministry of Health, Labor and Welfare, and the Ministry of Internal Affairs and Communications.

The total work hours in a month per person is called the real aggregate work hours. Real aggregate work hours are the sum of predetermined work hours (regular work hours) and overtime work hours (week-end overtime and after-hours overtime, etc.). Generally, most Japanese corporations respond to changes in the labor demand by adjusting their employees' overtime work hours. Therefore, fluctuations in overtime link in with economic fluctuations.

The "unemployment rate" is obtained by dividing the total number of completely unemployed persons by the labor force. The definition of an unemployed person is a person who is not an employed person and is looking for work during the survey period (the last week of the month) but is not yet working. The labor force is defined as the sum of employed persons and unemployed persons who are 15 years of age or older and who have a desire to work. The labor force participation rate is defined as the ratio of the labor force to the number of people who are 15 years of age or older and indicates the proportion of people who are 15 years of age or older that actually enter the labor market.

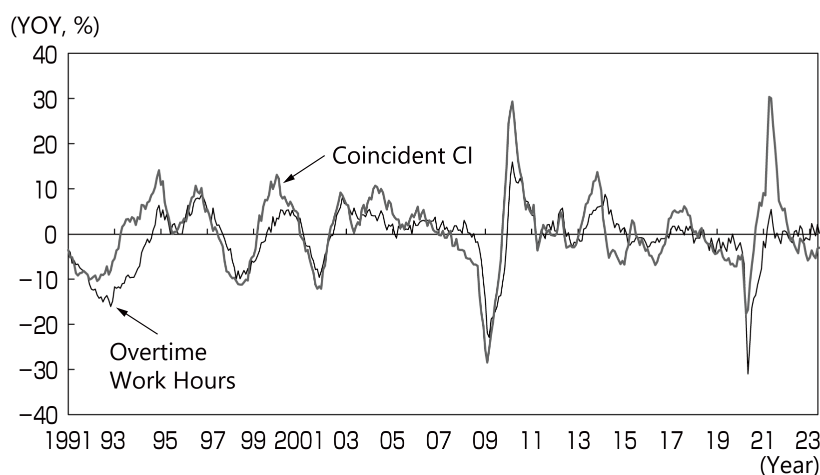
Since 2018, the labor underutilization indicator has been released on a quarterly basis. Underutilized labor

refers to persons including those who are working on a part-time basis but wish to work more or persons among the non-labor force who wish to work. By identifying room for an increase in labor supply through the analysis of the underutilized labor indicator, it may be possible to utilize underutilized labor as new sources of labor supply in the future.

As mentioned above, layoffs of employees tend to be used as a measure of the last resort. Since Japanese corporations do not readily lay off employees, the unemployment rate and regular employment index in Japan lag behind economic fluctuations. However, the competition to find a job is fierce during an economic recession, and consequently many people who have lost their jobs do not actively look for work. These people are not classified as unemployed persons and are treated as being outside of the labor market (representing a decline in the labor force participation rate). Thus, while the unemployment rate increases at a moderate speed, the actual market situation may be much worse than what is represented by the unemployment rate.

The ratio of job openings to job applicants is obtained by dividing the number of job openings by the number of job applicants. There are two types of such ratio. The ratio of new job openings to new job applicants is obtained by dividing the number of new job openings during a certain period by the number of new job applicants during the same period. The ratio of effective job openings to effective job applicants is obtained by dividing the number of effective job openings by the number of effective job applicants, using the total of the number of new job openings or new job applicants and the number of job openings or job applicants carried over from the previous month. The number of available job openings increases when the economy prospers and decreases when the economy deteriorates. Therefore, the ratio of job openings to job applicants increases during economic prosperity and decreases during an economic slump. When the ratio is greater than 1, it indicates that the number of workers sought by companies is relatively larger than the number of persons seeking jobs. When the ratio is less than 1, it indicates that the situation is opposite. While

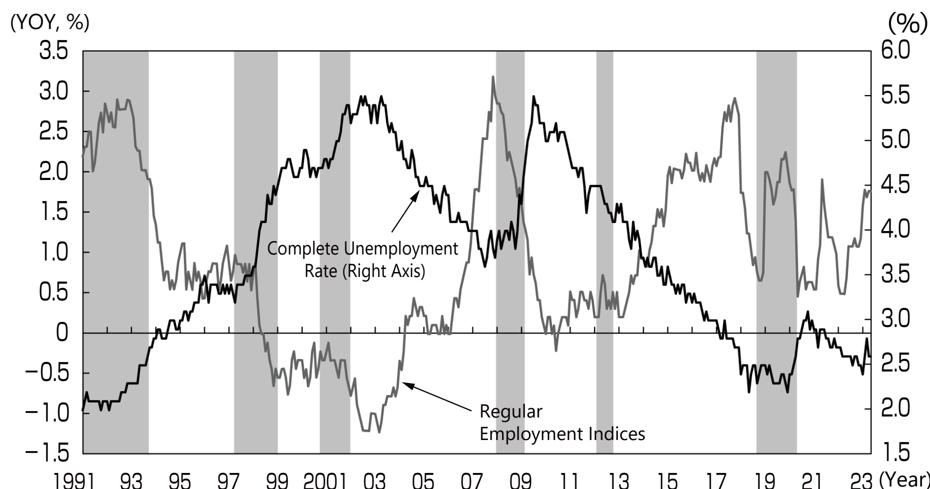
Chart 4-16 Economy (Coincident CI) and Overtime Work



(Note) The year-on-year changes in the overtime work hours during the period between January 2013 and December 2020 are based on the sampling survey data.
The data for January 2021 and thereafter is based on the main data.

(Source) Cabinet Office "Indexes of Business Conditions" and Ministry of Health, Labour and Welfare "Monthly Labour Survey"

Chart 4-17 Unemployment Rate and Regular Employment Indices



(Note 1) The shaded areas indicate cyclical downturns.
(Note 2) The year-on-year changes in the regular employment indices for the period between January 2013 and December 2020 are based on the sampling survey data.
The data for January 2021 and thereafter is based on the main data.
(Source) Ministry of Internal Affairs and Communications "Labour Force Survey," Ministry of Health, Labour and Welfare "Monthly Labour Survey," and Cabinet Office "Indexes of Business Conditions"

fluctuations in the ratio of job openings to job applicants coincide with fluctuations in the economy, the ratio includes only workers and positions registered with the Public Employment Security Offices (this is called "Hello Work"), and does not include workers who seek employment through means such as the help-wanted advertisements on newspapers and magazines.

Recently, there are situations where even though the ratio of job openings to job applicants rises, reflecting economic improvement; the unemployment rate does not fall. This appears to be a result of a mismatch in employment, in which the skills and conditions of work sought by companies do not match those of the people seeking work, or even if they do match, companies are not able to find the workers they wish to hire and workers are not able to find the companies that want them.

(iii) Labor Productivity and Unit Labor Cost

Labor productivity is the production volume per one unit of labor input. It is obtained by dividing production volume by the multiplication product of the number of employed persons and their work hours (man-hour basis). Consequently, increasing labor productivity indicates that the production volume generated by a unit of labor input (per labor unit, for example) is rising, which is a positive factor for economic growth.

Unit labor cost is the labor cost incurred for one unit of production volume. It is obtained by dividing aggregate labor costs (hourly nominal wage × number of employed persons × total work hours) by the production volume. Unit labor costs can also be derived by dividing the hourly nominal wage by labor productivity.

$$\text{Unemployment rate} = \frac{\text{Unemployed persons}}{\text{Labor force}} \times 100\ (\%)$$

$$\text{Labor force} = \text{Number of employed persons} + \text{Number of unemployed persons}$$

$$\text{Labor force participation rate (labor force rate)} = \frac{\text{Labor forces}}{\text{Population of people 15 years of age or older}} \times 100\ (\%)$$

$$\text{Ratio of job openings to job applicants} = \frac{\text{Number of job openings}}{\text{Number of job applicants}}\ (\text{times})$$

$$\text{Labor productivity} = \frac{\text{Production volume}}{\text{Volume of labor input (Number of employed persons} \times \text{Aggregate annual labor hours)}}$$

$$\text{Unit labor cost} = \frac{\text{Hourly nominal wage} \times \text{Number of employed persons} \times \text{Aggregate annual work hours}}{\text{Production volume}} = \frac{\text{Hourly nominal wage}}{\text{Labor productivity}}$$

The above concepts are useful in considering the relationship between wage increases and prices of goods. When the unit labor cost increases due to an appreciation in wages that surpasses the appreciation in labor productivity, corporate earnings are negatively influenced. Corporations in turn must cover losses by increasing the prices of their products, which may trigger inflation.

(4) Assessing Price Statistics

Price indicators include the Corporate Goods Price Index (CGPI), Consumer Price Index (CPI), Services Producer Price Index (SPPI), the GDP deflator, and others. These are weighted averages of the prices of various properties and services in terms of a base year (=100). However, if the weighting is left fixed then as time passes a significant discrepancy will occur between the base year and the actual reality. The further removed in time the year in question becomes from the base year, the further the discrepancy grows. Consequently, people started using the "Chain Linked Method" which reduces this divergence by changing the base year each year.

(i) Price-Influencing Factors and Their Effect on Wages

Prices are based on the cost of providing products or services and the profit margin applied by corporations (this is called the mark-up). Costs are determined by the price of raw materials, wages, and taxes. Mark-up rates, on the other hand, are determined by corporations depending on the degree of consumer demand for their particular goods or services. The markup rate can be higher if goods and services are popular among consumers.

Although wages are determined by companies, such decisions are strongly influenced by the labor market. When there is strong demand and corporations need to produce more, the corporations hire new workers and workers are forced to work overtime. At the same time, wages paid by the corporations tend to rise. A wage increase means an increase in production costs, and therefore, the corporation tends to cover such an increase by raising the prices of its goods. A need to expand production means that the services or products provided by the corporation are popular, and consequently the company is in a position in which it can fairly easily shift its costs to its prices. When the national economy overheats, however, demand for labor increases across the board in all industries. Under such conditions, workers prefer to be employed by a corporation that pays higher wages. As a result, the more the economy overheats the larger the increases in wages.

Price is an important indicator of economic prosperity. It is also closely related to people's lives. For

example, it is generally believed that in situations where price increases are accelerating, supply and demand are tight in the economy overall, and economic activities are showing strong performance. When the rate of increase in prices exceeds the rate of increase in wages, *i.e*., when real wages fall, the quality of life declines.

(ii) Price Index #1: Corporate Goods Price Index (CGPI)

The Corporate Goods Price Index (CGPI) is an index which represents the level of the prices of goods traded among corporations. It is released by the BOJ and consists of the domestic corporate goods price index, the import goods price index and the export goods price index, which are the three basic indices, as well as a reference index which recombines and makes adjustments to the basic indices.

Among these indices, the domestic corporate goods price index is referred to as “Producer Price Index” (PPI). The PPI is a Laspeyres-formula index computed by fixing the weight of each component according to the benchmark year. The PPI fluctuates in accordance with the supply and demand for each product, and is sensitive to economic conditions.

The PPI is influenced by price factors overseas even when there is no influence from domestic inflation (*e.g.,* a decline in the value of the yen or an increase in crude oil prices can be influential). For example, during the second oil crisis, in 1979-80, the inflationary pressure arising from domestic factors was controlled by a tightening of credit. However, the crude oil price increase caused a ripple effect in the domestic economy, in the form of a chain reaction in which “higher import prices led to higher prices for domestic corporate goods which in turn led to higher prices for consumers.” Moreover, there was a sharp spike in the international commodities markets that took place from the middle of the 2000s through the summer of 2008, beginning with crude oil and wheat, which led to upward pressure on domestic prices. Recently, commodity prices surged as a result of the progress in normalization of economic activities since the second half of 2020, supply restrictions that became a serious problem from the end of 2020, and the Russian invasion of Ukraine that occurred in February 2022.

(iii) Price Index #2: Consumer Price Index (CPI)

The CPI is an index obtained by calculating the weighted averages of the prices of about 600 items purchased by households on the basis of the average amount of consumption for each item. As with the PPI, the CPI is a Laspeyres-formula index. The CPI is released by the Ministry of Internal Affairs and Communications. The CPI, which captures the retail price trends, lags behind the PPI, which reflects the price trends of goods traded between business entities (*e.g.*, wholesale price trends).

Critics have pointed out a discontinuity between fluctuations in the CPI and the actual quality of life. Possible reasons for this discontinuity include:

a) The CPI assumes the averaged consumption basket of households that may differ from the actual household consumption basket;
b) There is a wide fluctuation in prices of perishable foods, which consumers purchase more frequently, thereby leading consumers to pay more attention to these prices when they form perceptions of overall price changes;
c) The CPI does not cover non-consumption expenditures such as direct taxes, social security payments etc., nor does it cover the prices of land, housing, etc.; and
d) Effect of the selection of the items and measurement of change in quality of goods.

Generally, the overall consumer price index excluding perishable foods (Core CPI), the overall consumer

price index excluding food (other than liquors) and energy (Core Core CPI), or the overall consumer price index excluding perishables and energy (New Core Core CPI) is often used in determining the trend of prices. This is because the prices of perishable foods and energy, such as gasoline, widely fluctuate and thereby cause a major impact on prices.

(iv) Price Index #3: Services Producer Price Index (SPPI)

The SPPI was introduced by the BOJ in 1991 to measure the prices of services offered by corporations to other corporations. A major reason for creating this new index was that such services had become an important part of corporate operations. As with the PPI and CPI, the SPPI is computed as a Laspeyres-formula index using fixed weights of components according to a benchmark point in time. Fluctuations in the SPPI are influenced by labor costs and macroeconomic factors, such as supply and demand in the service industry, foreign exchange rates, interest rates, real-estate market prices, relaxation of regulations, and technological advancements, etc. The SPPI is considered as a leading indicator of the CPI.

(v) Price Index #4: GDP Deflator

The GDP deflator can be obtained by dividing the nominal GDP by the real GDP:

$$\text{GDP deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

The nominal GDP is the total volume of goods and services produced, multiplied by the market prices of such goods and services that year. The real GDP indicates the total amount of goods and services produced.

Therefore, the GDP deflator is an index representing the prices of goods and services included in GDP. Unlike the CGPI and CPI that apply the Laspeyres-formula, which fixes the distribution ratio of products and services at a benchmark point in time, the GDP deflator is calculated in accordance with the distribution ratio of products and services at the time of the comparison, making it a Paasche-formula index.

As mentioned above, however, since the end of 2004, as shown as (a) in the text box below, the GDP deflator has been calculated by use of a Paasche-formula index method, in which the base point in time for prices is updated every year according to the chain-linking technique, in place of the previously used fixed-base year Paasche-formula method in which the base point in time for prices is fixed in a certain year.

$$\text{Laspeyres index} = \frac{\Sigma P_t^i Q_o^i}{\Sigma P_o^i Q_o^i} \times 100$$

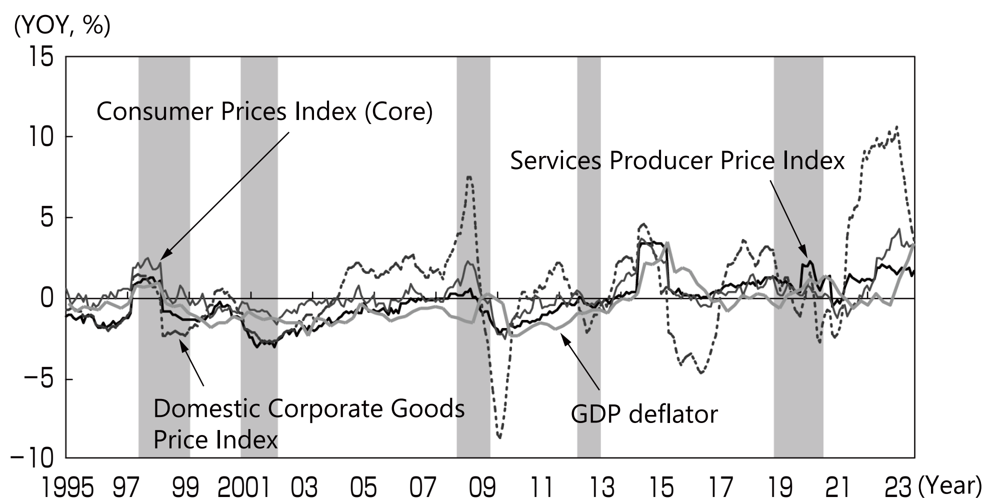
$$\text{Paasche index} = \frac{\Sigma P_t^i Q_t^i}{\Sigma P_o^i Q_t^i} \times 100$$

P_o^i Price of i goods at benchmark point in time Q_o^i Volume of i goods at benchmark point in time

P_t^i Price of i goods at the time of comparison Q_t^i Volume of i goods at the time of comparison

The GDP deflator may be a more comprehensive price index than the CPI, given that all goods and services are included in GDP. However, the GDP deflator only considers domestic goods, while the CPI includes imported goods.

Chart 4-18 Price Fluctuations



(Note) The shaded areas indicate a phase of cyclical downturns.
(Source) Ministry of Internal Affairs and Communications, "Consumer Price Index," Cabinet Office "System of National Accounts" and "Indexes of Business Conditions" and BOJ "Corporate Goods Price Index"

1 4 International Balance of Payments

(1) International Balance of Payments Statistics

International balance of payments statistics (IMF method) systematically record all of the external transactions of a given country during a specific time period. These transactions between residents and non-residents are classified as being transactions in goods, services or income; as transactions that change external assets and liabilities; and as transactions for transfers. International balance of payments statistics are organized as comprising three categories, which are the current account, the financial account, and the capital account.

The statistics on international balance of payments of Japan are compiled based on the sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6) published by the IMF in 2008.

(i) The Current Account

The current account represents the sum of three items: 1) goods and services, 2) primary income, 3) secondary income. It represents the country's balance of economic transactions with foreign countries:

Current account = Goods and services + Primary income + Secondary income

In the goods and services balance, the balance of goods is goods exported less goods imported. The balance of services comprises shipping, tourism, and other services. For example, the purchases of goods and services by foreign nationals visiting Japan are the export of goods and services, leading to improvement in the goods and services balance. The primary income consists of receipts and payments for compensation of employees, investment income (direct investments, portfolio investments, and other investments), and other primary income. If a Japanese company receives dividends from shares in a foreign company, it gains primary income. The secondary income balance consists of receipts and payments for goods and services provided

without any consideration offered in return, including grant aids of consumer-goods such as food and medical products, grants to international institutions and workers' remittances.

(ii) The Financial Account

The financial account, which represents the flow of capital between Japan and overseas entities, is the sum of direct investment, portfolio investment, financial derivatives, other investment, and reserve assets.

The financial account shows changes in assets and liabilities overseas. The change in external assets (inflow and outflow of Japanese capital to and from overseas entities) and the change in external liabilities (inflow and outflow of overseas capital to and from Japan) are shown separately. Examples of outflows of Japanese capital overseas would include direct overseas investments made by Japanese corporations and investments in foreign stocks and bonds, while examples of inflow of foreign capital to Japan would be direct investments made by foreign corporations, or investment in Japanese stocks or bonds by foreign entities.

Chart 4-19 Japan's International Balance of Payments

(Unit: JPY trillion)

Calendar Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Current account	4.8	4.5	3.9	16.5	21.4	22.8	19.5	19.3	16.0	21.5	11.5
Goods and services	-8.1	-12.3	-13.5	-2.8	4.4	4.2	0.1	-0.9	-0.9	-2.5	-21.2
Goods	-4.3	-8.8	-10.5	-0.9	5.5	4.9	1.1	0.2	2.8	1.8	-15.7
Export	62.0	67.8	74.1	75.3	69.1	77.3	81.2	75.8	67.3	82.4	98.8
Import	66.2	76.6	84.5	76.2	63.6	72.3	80.1	75.6	64.5	80.6	114.5
Services	-3.8	-3.5	-3.0	-1.9	-1.1	-0.7	-1.0	-1.1	-3.7	-4.2	-5.4
Primary income	14.0	17.7	19.4	21.3	19.1	20.7	21.4	21.6	19.4	26.4	35.2
Secondary income	-1.1	-1.0	-2.0	-2.0	-2.1	-2.1	-2.0	-1.4	-2.6	-2.4	-2.5
Capital account	-0.1	-0.7	-0.2	-0.3	-0.7	-0.3	-0.2	-0.4	-0.2	-0.4	-0.1
Financial account	4.2	-0.4	6.3	21.9	28.6	18.8	20.1	24.9	14.1	16.8	6.5
Direct investment	9.4	14.2	12.6	16.1	14.9	17.4	14.9	23.9	9.4	19.2	17.0
Portfolio investment	2.4	-26.6	-4.8	16.0	29.6	-5.7	10.1	9.4	4.4	-21.9	-19.3
Financial derivatives	0.6	5.6	3.8	2.1	-1.7	3.5	0.1	0.4	0.8	2.2	5.1
Other investment	-5.1	2.5	-6.1	-13.1	-13.7	0.9	-7.6	-11.5	-1.7	10.5	10.7
Reserve assets	-3.1	3.9	0.9	0.6	-0.6	2.7	2.7	2.8	1.2	6.9	-7.1
Errors and omissions	-0.5	-4.1	2.6	5.6	8.0	-3.7	0.8	6.0	-1.7	-4.3	-4.9

(Note) The calculation method for part of primary income (reinvested earnings) has been changed since September 2020.
(Source) Ministry of Finance and BOJ "Balance of Payments"

In addition to the current account and financial account described above, the balance of payments includes the capital account and a section for errors and omissions. Their relation is expressed by the following formula.

Current account + Capital account - Financial account + Errors and omissions = 0

(2) Overview of Japan's International Balance of Payment

Japan's current account surplus started to expand in 1982 after the second oil crisis, and reached a peak in 1987 with a surplus of USD87 billion. In line with this, Japanese foreign net assets continued to grow. In contrast, the U.S. showed an opposite trend. Starting in 1982, the U.S. started to post deficits, until 1991 when a surplus was

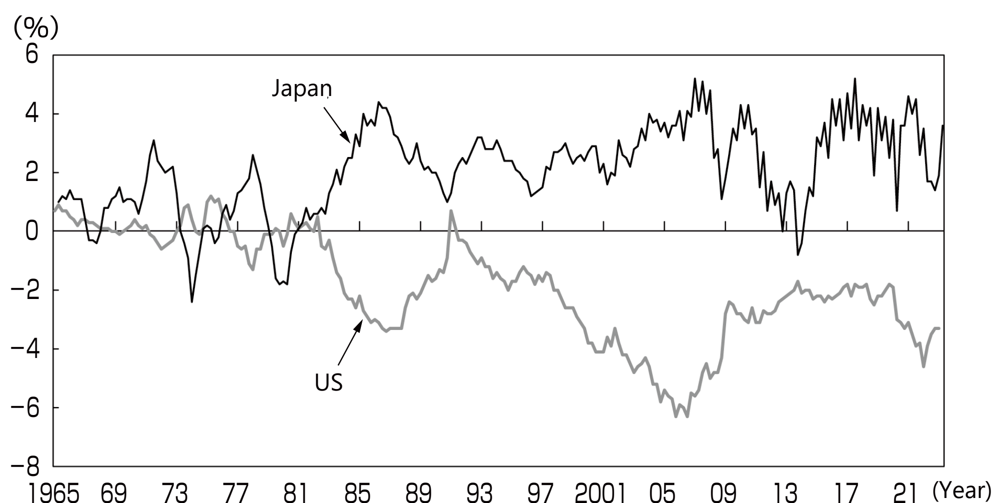
recorded temporarily, but after that once again deficits continued to increase. The U.S. incurred increasingly larger debts to foreign countries. In 1986, its foreign debit balance exceeded its foreign credit balance, thereby making it a net debtor country.

As shown in Chart 4-20, the growth of the Japanese current account balance surplus started to accelerate following the Plaza Accord of 1985, which directly led to an increase in the value of the Japanese yen, through 1987. Then, from 1987 to 1990, the surplus shrank. The significant fall in oil prices is frequently stated as a contributing factor in the continued expansion of the current account balance surplus from 1985 through 1987 despite the rapid rise of the yen.

The purpose of the Plaza Accord, which was signed in September of 1985 by the G5 (five developed countries) meeting of the finance ministers and heads of central banks from and had a significant impact on exchange rates, was to resolve a foreign exchange rate imbalance by collaborating and adjusting rates. At the time, the value of the dollar was increasing due to high interest rates in the U.S. The regulatory authorities in charge of the currencies intervened to correct the high dollar, and the value of the dollar fell quickly. However, there was no change in the fundamentals of the U.S. economy (*i.e.*, the current account deficit and the budget deficit), even in 1986, and because Japan's surplus continued to expand, the value of the dollar continued to fall.

In February of 1987, the "Louvre Accord" was enacted by the currency regulators of several countries to stabilize the foreign exchange market, as they were concerned that the value of the dollar had fallen to an excessively low level. However, the New York Stock Exchange crash on October 19, 1987 (this is called "Black Monday") led to further declines in the value of the dollar. In early 1988, the value of the dollar fell to as low as JPY120.45 per USD1, setting a record low. Following this decline, the overall Japanese economy began to expand, led by domestic consumption. Japan's current account surplus began to shrink, and in 1990, declined to USD35.8 billion, although this decline was aided by an increase in the price of crude oil following the Persian Gulf Crisis.

Chart 4-20 Ratios of Current Account Relative to Nominal GDP, United States and Japan



(Note) Data is the ratio relative to nominal GDP
Japan's GDP was based on the 1990 standard until 1979; on the 2011 standard from 1980 to 1994; and on the 2015 standard from 1995 and thereafter

(Source) Ministry of Finance and BOJ "Balance of Payments," Cabinet Office "System of National Accounts," and U.S. Department of Commerce "Gross Domestic Product" and "U.S. International Transactions"

At times, the trade imbalance has mushroomed into a political issue in the form of trade friction. The enactment of the Omnibus Trade and Competitiveness Act ("Super 301") in 1988 by the U.S. and other conditions are all demonstrations of the U.S.'s frustration stemming from Japan's persistent trade surpluses with the U.S. even after the upward valuation of the yen.

Subsequently, the yen continued to rise, falling below JPY80 per USD1 for a brief instant in 1995, touching off a rash of overseas ventures on the part of Japanese companies, particularly in the manufacturing sector. Rapid economic development in other parts of Asia also caused a major increase in imports of quality goods at low prices, which reduced Japan's current account balance surplus. From mid-1995, however, the value of the Japanese yen declined quickly, and exports, especially automobile exports, grew quickly, which in turn has caused a rapid increase in the current account balance surplus. In the latter half of the 1990s, however, in the U.S. there was a rapid rise in imports from China and Southeast Asian countries, which resulted in a smaller percentage of the U.S. current account deficit being attributable to Japan.

The current account balance surplus reached JPY15.0 trillion in 1998, and then fell to JPY10.5 trillion in 2001 as the trade surplus also declined. This period also saw the rapid development of the Chinese economy, and an increased level of concern about the hollowing out of industry, and the competitiveness of Japanese corporations. Since the start of 2002, however, the current account balance surplus has again been on the rise, while the economy has begun to recover, so that these pessimistic views are not heard much anymore. At the same time, we have seen a growing belief that the Chinese economy does not only represent a threat as a competitor, but is in fact a major market opportunity.

A review of the current account in recent years shows that the positive balance on primary income has increased. In 2019, the primary income surplus, at JPY21.0 trillion, far exceeded the trade surplus (JPY0.4 trillion). One cause for this increase in the primary income surplus is the existence of securities investment and direct investment, which have accumulated to a very high level. This is a reflection of Japan becoming the largest holder of net foreign assets, as the country's net foreign assets balance at the end of 2019 stood at JPY364.5 trillion. Meanwhile, in 2011, the trade balance fell into the red for the first time in 31 years, and has remained in the red since then. This is due to the increase in imports caused by the rise in the crude oil price in combination with the increase in the volume of imported fuel resulting from the shutdown of nuclear power plants, and the decrease in exports due to Japanese enterprises moving their production bases overseas. However, the low crude oil prices since mid-2014 significantly reduced the amount of the deficit, resulting in a trade surplus in 2016 for the first time in six years. In addition, the increase in the number of foreign nationals visiting Japan resulted in an increase in the amount received in the international travel balance, bringing about a profit of JPY2.7 trillion in the international travel balance in 2019.

From the spring of 2020, the global movement of people stopped due to the COVID-19 pandemic, and both the number of foreign nationals visiting Japan and the number of Japanese nationals going abroad decreased significantly. Due to this, the profit in the international travel balance in 2020 and 2021 declined significantly to JPY 0.6 trillion and JPY0.2 trillion, respectively. Following the substantial relaxation of the border control measures related to COVID-19 in October 2022, there was a profit of JPY0.7 trillion in the international travel balance in 2022.

(3) Foreign Exchange

The foreign exchange rate is the rate used to exchange (trade) different currencies on a foreign exchange market. For example, the exchange rate JPY100 per USD1 is a yen-denominated foreign currency exchange rate.

Foreign exchange refers to the act of exchanging one currency for another (for example exchanging Japanese yen and converting them to U.S. dollars) based on the foreign exchange rate.

The currency exchange rate, like the prices of general commodities, is determined by the supply of and demand for foreign currency. Assuming that all trade with foreign countries is conducted in U.S. dollars, the USD/JPY rate would be the exchange rate used by the two countries. Therefore, the rate would be determined by the relationship between the demand for dollars (purchases of dollars made by selling yen) and the supply of dollars (sales of dollars for buying yen).

Demand for dollars arises when Japan imports raw materials or products from overseas or purchases foreign securities. Supplies of dollars are generated when foreign countries import goods from Japan or purchase Japanese securities. Therefore, the supply of and demand for dollars can arise from either current trade or capital trade, and the relative relationship determines the foreign currency exchange rate.

However, recent changes in the foreign currency exchange rate have become largely dependent upon financial transactions rather than the actual demand for funds. Among financial transactions, the volume of foreign exchange margin transactions known as “FX” is showing a rapid increase and in Japan, FX is said to account for nearly 30% of the one-day trading volume. It is said that Japanese individual investors, who are called “Mrs. Watanabe” around the world, tend to take actions that are different from professional traders and thus the recent exchange market has begun to show incomprehensible movements.

Chart 4-21 Dollar/Yen Rate

(Source) BOJ “Foreign Exchange Rates (Tokyo Market Interbank Rates)”

15 Trends in the Global Economy

(1) The Global Economy and the Flow of Trade and Capital

While there are many countries and jurisdictions in the world, the 40 countries and jurisdictions known as the industrialized countries (the U.S., Japan, the countries in Western Europe, Canada, Oceania, and Asia NIEs) comprise approximately 60% of the global economy. Namely, the seven major countries, referred to as the G7

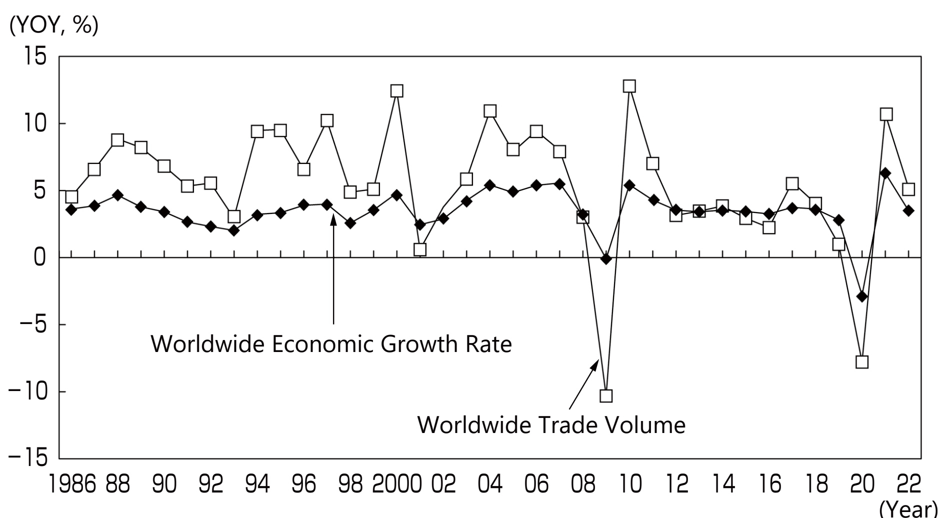
(United States, Japan, Germany, France, Italy, United Kingdom, and Canada) account for about 40% of global GDP. Consequently, the economic conditions in these countries have a significant impact on the rest of the world. The U.S. in particular has an extremely large impact on the global economy, as the country that occupies the largest share.

The link between each country and the global economy is the trade and the flow of capital. The increase in the volume of global trade exceeds global economic growth rates at almost all times, and this indicates how the connections between each country and the rest of the world have become stronger due to trade. Trade reliance is a measure that represents to what degree a country's economy is influenced by trends in global trade. Trade reliance is obtained by dividing a country's trade volume (export plus import) by nominal GDP. A high level of trade reliance means that the country's economy is readily influenced by trends in world trade.

Asia is an area of the world with one of the highest levels of trade reliance. Within Asia there are countries and jurisdictions, such as Hong Kong, Singapore, Thailand and Malaysia, with trade reliance that exceeds 100%. Next to Asia is Europe, although it does much of its trading within Europe. On the other hand, the trade reliance of countries with larger economies, such as Japan and the U.S., tends to stay relatively low.

The flow of capital moves in the opposite direction to the flow of trade. Capital flows from overseas entities into countries with current account deficits to cover the deficits (capital shortages), thereby causing financial account deficits. On the other hand, capital flows out of countries with current account surpluses in order to invest the surpluses (excess capital) overseas, thereby causing financial account surpluses.

Chart 4-22 World Economic Growth Rate and Worldwide Trade Volume



(Source) IMF "World Economic Outlook Database"

(2) Global Economy in the 1980s

The global economy of the 1980s started with the worldwide recession following the second oil crisis (1979 – 1980). In the U.S., an abrupt financial squeeze was instituted at the end of 1979 in order to break the vicious cycle of stagflation, in which the inflation rate and unemployment rate increased simultaneously. With the high interest rate policy of the U.S., countries in Central and South America, which had financed almost all of their international debt with short-term commercial loans based on Eurodollar interest rates, demanded an interest moratorium from commercial banks. Many of the major commercial banks in the U.S. had loans to these countries in excess of twice the bank's shareholder's equity. Naturally, many expressed concern about the potential for an international financial

crisis. The crisis was defused when the governments of the industrialized countries, the central banks, the governments of the developing countries, and private banks rescheduled payments. However, this severely restricted the inflow of private capital to developing countries.

The financial squeeze in the U.S. was lifted following the accumulating debt crisis, and the U.S. economy began to recover in 1983. During the initial stages of recovery, a big deflation gap existed, relieving worries about accelerated inflation despite the rapid recovery. Also, high interest rates induced foreign capital flows into the U.S., which raised the value of the dollar, and acted to control import inflation. In order to increase supply capacity, the Reagan administration implemented a large scale tax cut to strengthen savings in the hope that it would lead to an increase in investments. However, the tax cut only stimulated consumption with no increase in the private savings rate, and the enlarged budget deficit was financed with capital from countries with large amount of current account balance surpluses such as Japan and former western Germany. During the first half of the 1980s, the Japanese economy began restructuring its budget with a tight budget policy. The vivid contrast between the two countries' budget policies contributed to enlarging the imbalance in international payments.

In September of 1985, against the background of the strong dollar and expansion of the current account deficit in the U.S., the governments and central banks of five industrial countries agreed that the value of the dollar was too high (the "Plaza Accord"). Considering the fundamentals of the U.S. economy, many doubted that the value of the dollar would stay at the same level in the medium to long-term. Consequently, the value of the dollar fell rapidly after this declaration, and the exchange rate, which had been around JPY240 per USD1, fell to as low as JPY120 per USD1. The U.S. economy, on the other hand, sustained a favorable cycle of "a weak dollar, increases in exports and expansion of capital investments," starting in the latter half of 1986. The European countries also saw a boom in capital investments during the last half of the 1980s. Finally, the imbalance in international payments gradually shrank as imports and domestic demands increased in Japan and the European countries, while exports from the U.S. remained on a growth trend.

Japanese exporters lost their competitive edge in export prices due to the increase in the value of the yen that started in the fall of 1985. Japanese companies established production sites worldwide, and reallocated their production tasks to concentrate production of low value-added products that required a high volume of labor within Asian countries that had cheap labor costs, while at the same time producing high value-added products in Japan. As a result, direct overseas investment by Japanese corporations soared during the latter half of the 1980s. The growth of trade friction with the U.S., and the movement towards market unification through the European Union (EU) in 1993, accelerated the shift of production overseas.

The countries of Asia seized the opportunity of the declining price competitiveness of Japanese products, and began to increase their exports, especially to the American market. Also, the increase in direct investment by foreign countries created a favorable cycle of "the expansion of production capacity, increases in exports, increases in income, and expansion of domestic consumption."

(3) The Global Economy in the 1990s

In the latter half of 1990, the U.S. economy fell into recession when the dollar's value stopped declining and a tight fiscal policy was implemented following an increase in the inflation rate in 1989. In the latter half of the 1980s, financial institutions made excessive real estate loans. The real estate market showed no signs of recovery and many financial institutions carried bad loans. As a result, these financial institutions became more conservative than ever before in their lending.

The Federal Reserve Board (FRB) tried to relax the financial markets by repeatedly cutting interest rates.

However, banks continued to pursue a conservative lending policy leading to a credit crunch in which neither lending nor the money supply grew. The economy started to show some signs of recovery in 1992, but growth in employment and production was slower than during the initial stages of previous recoveries, as layoffs continued with ongoing corporate restructuring ("jobless recovery").

At the same time as the recovery of the financial sector, the U.S. economy entered a period of solid prosperity powered by new industries that made great use of computer networks. With the inflation rate remaining stable at low levels, labor productivity rose starting in the latter half of the 1990s, and the economy expanded for nearly ten years. Nevertheless, the economy began to slow down from 2001, as the share market had entered a correction phase from mid-2000, and there was a falloff in IT investment, which had previously driven the economy.

In the early 1990s, due to the high growth rates of countries in Asia and Latin America which were referred to as "emerging markets," capital inflow to emerging countries from industrial countries increased substantially. However, the economic crisis in Thailand and Indonesia that ignited in late 1997 ("the Asian currency crisis") and the Russian economic crisis that emerged in August of 1998 led to a virtual stoppage of capital inflow to these countries, and the rapid economic growth of the Asian economies became stagnant. After that, a gradual recovery began, propelled by increases in exports to the American market, and increases in public spending and rebuilding of the financial systems by the governments of the emerging countries.

(4) The Global Economy in the 2000s

From the start of the 2000s, we experienced even more extensive globalization which had been progressing throughout the 1990s, and we began to enter an age in which business prosperity would apply at the same time throughout the world. In the 1990s, the main players in the world economy were the U.S. and other developed countries, as well as emerging countries and regional economies, such as the NIEs and ASEAN, but from the start of the 2000s, the emerging countries and regional economies began to expand even more.

The countries referred to as BRICs (Brazil, Russia, India and China) are representatives of regions that were attracting attention as new high-growth regions. Common features of these regions are (i) that they are resource-rich countries, (ii) that they are countries with large populations, and (iii) that they are aggressively pursuing foreign investment through economic reform. Under these conditions, these regions achieved high growth as a result of investment entering the region from developed countries and by fulfilling a role as production centers within an international division of roles with the developed countries of Europe and North America being the final destinations of demand. In the year 2001, the share of newly developing countries within the global economy (in terms of nominal GDP and on a dollar basis) amounted to 21.2%, but in 2022 this had expanded to 42.5%.

In the U.S., following the collapse of the IT Bubble, the FRB greatly eased the credit supply from early 2001 onward, while the government deployed stimulus measures, including a tax cut, to support the economy through both monetary and fiscal policy, leading into a recovery starting in November of the same year. From roughly the end of 2000, the Asian region, as a world center for the production of IT equipment, experienced the strong effects of the bursting of the IT bubble in the U.S. and elsewhere, but with the subsequent recovery of the global economy, led by the U.S., the economy of this region also returned to see economic growth.

Japan also entered a period of economic expansion from February 2002 backed by the worldwide economic expansion and driven by external demand. This economic expansion (the 14th cycle) exceeded the Izanagi Boom (a 57 month period of economic expansion from November 1965 through July 1970).

This worldwide period of economic health and further anticipation of high growth on the part of newly developing countries led to a sharp spike in prices on commodities markets, including petroleum at the start of

2007. As a result, resource-rich countries such as Russia and the Middle East experienced an inflow of income, while countries that did not have natural resources experienced an outflow of income as a result of higher materials costs, leading to a slowdown in their economies.

In the summer of 2007, the slowdown in the global economy strengthened as a result of the subprime loan crisis that started in the U.S. Thereafter, the financial markets throughout the world fell into confusion, sparked by the collapse of Lehman Brothers in the fall of 2008, and the substantive economy also deteriorated at an unprecedented pace and severity (the global financial crisis). In order to overcome this global recession, cooperative easing of credit was conducted, while large-scale economic policies employing fiscal stimuli were determined.

The global economy continued to improve after hitting the bottom in the beginning of 2009, partly due to the effect of prompt monetary and fiscal policies in each country. Meanwhile, monetary easing triggered inflation worries, and the risk of monetary tightening in major countries such as China became a concern. In addition, the fiscal situation of each country deteriorated rapidly due to fiscal stimulus measures. In October 2009, window dressing was revealed in Greece.

(5) The Global Economy Since 2010

Following the revelation of the Greek window dressing, the reliability of the Euro declined and the debt crisis spread across Europe, giving rise to concerns of financial collapse in Portugal, Italy, Ireland, Greece, Spain, etc. At the same time, the situation made countries around the world face the choice between fiscal soundness and economic growth.

In the U.S. as well, the Republicans' pursuit of a rapid progress in fiscal reconstruction caused the "fiscal cliff," a situation where rapid spending cuts and tax hikes take place simultaneously. The U.S. Congress decided to make some tax reductions permanent while spending cuts were implemented compulsorily.

The debt problems in these countries have gradually subsided due to large-scale monetary easing by the FRB and the European Central Bank (ECB). However, in European countries, among others, the recovery of the growth rate has remained slow due to the ongoing relatively tight fiscal policies. Furthermore, the slowdown in the growth of Chinese economy has been putting downward pressure on the growth rates of other emerging economies, resulting in the stagnant growth of the global economy.

Despite such an environment, however, the U.S. economy continuously grew even under fiscal austerity, backed up by a recovery in the housing market and the steady increase of share prices. Beginning in September 2012, the FRB implemented the third-round of large-scale quantitative easing (QE3), but then launched a tapering of QE3 in January 2014, and ended QE3 at the end of October of the same year. Following this, due to continuing positive effects such as the improvement in the employment situation, the FRB raised the interest rate in December 2015, for the first time in nine and a half years. Interest rate hikes continued at a slow pace until December 2018.

However, as the conservatism of its trade policy became clear, the U.S. began to face fiercer trade frictions with other countries, especially China, since the mid-2018. The additional tariffs imposed repeatedly by the U.S. and China intensified the concern over the outlook of the shrinking global economy. In July 2019, the FRB cut interest rates for the first time in about ten and a half years as a preventive measure to maintain the economic expansion.

In 2020, the global economy in the April-June quarter experienced the worst decline in the post-war period. After that, although the emergence of new COVID-19 variants intermittently caused economic setbacks, the normalization of economic activities has progressed. As the risk of COVID-19 becoming more serious has been reduced thanks to vaccination, the United States and European Countries have almost completely abolished

Chart 4-23 World GDP (Nominal, Percentage Shares)

(UNIT: %)

Calendar year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Worldwide and regional totals	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Industrialized countries	61.9	60.7	60.5	60.6	61.2	60.1	60.0	59.6	60.1	58.8	57.5
Group of Seven Industrial Advanced Countries (G7)	47.0	45.7	45.6	46.4	46.9	45.6	45.4	45.5	45.8	44.4	43.7
United States	21.6	21.8	22.1	24.3	24.5	24.0	23.9	24.5	24.8	24.2	25.4
Japan	8.3	6.7	6.2	5.9	6.6	6.1	5.9	5.9	5.9	5.2	4.2
Germany	4.7	4.8	4.9	4.5	4.6	4.6	4.6	4.5	4.6	4.4	4.1
United Kingdom	3.6	3.6	3.9	3.9	3.6	3.3	3.4	3.3	3.2	3.2	3.1
France	3.6	3.6	3.6	3.3	3.2	3.2	3.2	3.1	3.1	3.1	2.8
Italy	2.8	2.8	2.7	2.5	2.5	2.4	2.4	2.3	2.2	2.2	2.0
Canada	2.4	2.4	2.3	2.1	2.0	2.0	2.0	2.0	1.9	2.1	2.1
EU	19.5	19.8	19.7	18.1	18.2	18.2	18.6	18.0	18.1	17.9	16.6
Asia NIEs	3.1	3.2	3.3	3.5	3.5	3.6	3.6	3.4	3.5	3.5	3.2
South Korea	1.7	1.8	1.9	2.0	2.0	2.0	2.0	1.9	1.9	1.9	1.7
Taiwan	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Hong Kong	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Singapore	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5
Australia	2.1	2.0	1.8	1.6	1.7	1.7	1.6	1.6	1.6	1.7	1.7
Developing Countries	38.1	39.3	39.5	39.4	38.8	39.9	40.0	40.4	39.9	41.2	42.5
Asian	17.1	18.2	19.1	21.1	21.3	22.1	23.0	23.6	24.5	25.4	25.3
China	11.4	12.4	13.2	14.8	14.7	15.1	16.1	16.4	17.5	18.4	18.1
India	2.4	2.4	2.6	2.8	3.0	3.3	3.1	3.2	3.1	3.3	3.4
ASEAN5	2.9	2.9	2.8	2.9	3.0	3.0	3.1	3.2	3.1	3.0	3.1
Indonesia	1.2	1.2	1.1	1.1	1.2	1.3	1.2	1.3	1.3	1.2	1.3
Thailand	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.5	0.5
Malaysia	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Philippines	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Central and Eastern Europe	5.7	5.8	5.3	4.4	4.2	4.5	4.4	4.4	4.3	4.5	4.7
Russia	2.9	3.0	2.6	1.8	1.7	1.9	1.9	1.9	1.8	1.9	2.2
Mideast/Central Asia	5.2	5.2	5.2	4.9	4.8	4.6	4.4	4.4	4.0	4.1	4.8
Sub-Saharan Africa	2.2	2.2	2.3	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Central and South America	8.0	7.8	7.6	6.8	6.4	6.7	6.2	6.0	5.1	5.2	5.8
Brazil	3.3	3.2	3.1	2.4	2.4	2.5	2.2	2.1	1.7	1.7	1.9
Mexico	1.6	1.6	1.7	1.6	1.4	1.4	1.4	1.5	1.3	1.3	1.4

(Note) Percentages of GDP in dollar
(Source) IMF "World Economic Outlook Database"

COVID-related regulations in 2022. In China, which shifted its policy from "zero-COVID" to "living with COVID," 'revenge consumption' mainly in the food service industry bolstered economic recovery. However, revenge consumption was already running out of steam, resulting in the slowdown of the economy in the April-June quarter.

From 2021 to 2022, due to the growing rate of wage increases combined with the sharp rise in international commodity prices, historically high inflation occurred in the United States and Europe. In response, the FRB and the ECB actively implemented a restrictive monetary policy by deciding to increase interest rates substantially, which intensified the concern over an economic recession.

2 Finance

2-1 Currency

(1) Role of Currency

There are three basic functions of currency.

First is its function as a measurement of value. The existence of currency makes it possible to show the prices of goods and services in currency. In other words, currency acts as a unit of accounting for the value of goods and services.

Second is its function as a means of exchange (a means of payment or a means of settlement). In a barter system in which goods are exchanged without currency, it is difficult for a party to find another party who owns what she/he wants. In this regard, having currency enables a person to exchange the goods that he/she owns for currency, and then exchange the currency for something that he/she wants, thereby achieving efficiency in exchange.

The third function of currency is as a means of preserving value. Owning currency means owning the value which the currency represents, and it is possible to save the value for future exchanges (payment or settlement).

As long as these functions are fulfilled, theoretically it does not matter what is used as currency. Before the current form of currency was used, various things were used as currency such as furs and grains. However, considering the practicality of exchanging and saving currency, it is more desirable that currency be uniform, durable, dividable and, moreover, not too bulky. Precious metals such as gold, silver, etc., have all of these characteristics, and therefore became widely used as currency. Yet, it is still inconvenient to use precious metals in their raw forms of gold mass or silver mass, and thus minted gold and silver coins and bank notes which guarantee exchange-ability (convertibility) with these precious metals developed.

Today, major countries in the world, under the “Controlled Currency System”, issue money without regard to gold or silver, and distribute it as currency. In Japan as well, notes (bills) and supplementary money (coins) issued by the BOJ are not exchangeable for precious metals. Therefore, the BOJ can freely issue notes without being bound by the amount of gold it owns. For this reason, it is required that a monetary authority uphold responsible monetary policies in order to maintain the credibility and security of currency.

(2) Money Stock

When we think about currency, we think of it in terms of cash currency. Cash currency consists of notes and coins, but notes account for approximately 95% of circulated currency.

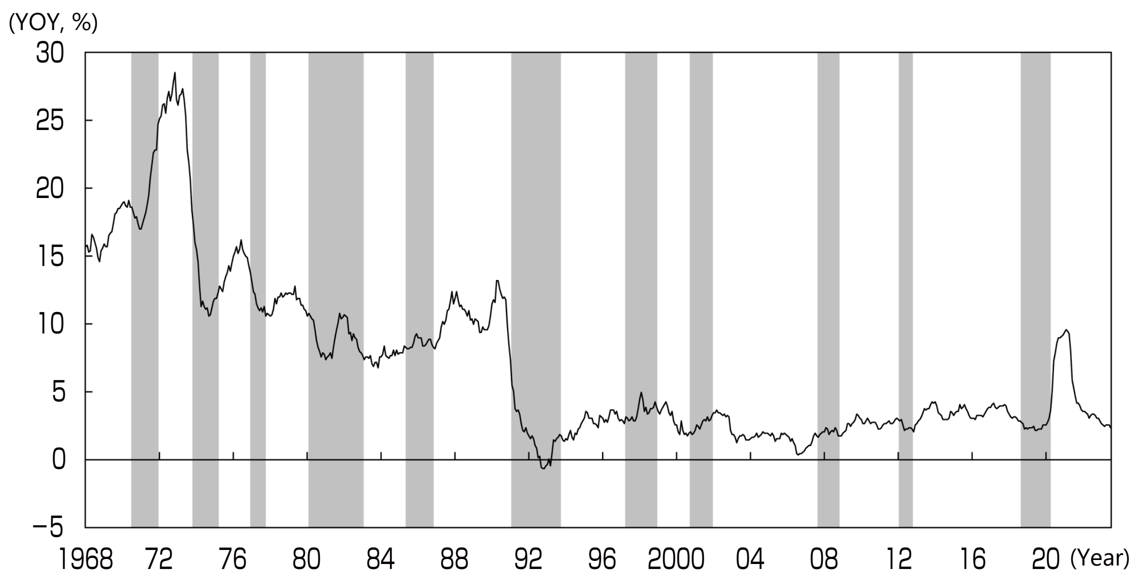
Demand deposits such as current deposits, ordinary deposits and notice deposits are called deposit currency, and are included in the term “currency”. Demand deposits can be changed into cash whenever the depositors need cash. Ordinary deposit accounts are used to make automatic transfers of payments for utilities user charges, for example, and to transfer money between bank accounts. Current deposits are used for the settlement of checks or notes. Demand deposits are widely used as a means of payment and settlement and, therefore, are considered a type of currency. Generally, both cash currency and deposit currency are combined and referred to as the “narrowly defined currency.”

Chart 4-24 Composition of Various Indicators of Money-Stock Statistic

<table>
<tr><th colspan="4"></th><th>Balance as of July 2023 (JPY trillion)</th><th>Weight (%)</th><th>Targeted Financial Products</th><th>Issuers of Currency</th></tr>
<tr><td colspan="4">M_2</td><td>1,238.2</td><td>58.4</td><td>Cash + deposit currency + quasi-currency + CDs</td><td>BOJ, domestic banks (excluding Japan Post Bank), foreign banks in Japan, credit associations (Shinkin Banks), the Shinkin Central Bank, The Norinchukin Bank, and the Shoko Chukin Bank</td></tr>
<tr><td rowspan="11">Broadly-defined Liquidity
JPY 2,121.3 trillion
100%</td><td rowspan="4">M_3
JPY 1,594.6 trillion
75.2%</td><td rowspan="2">M_1
JPY 1,071.0 trillion
50.5%</td><td>Cash currency</td><td>115.6</td><td>5.4</td><td>BOJ notes issued + currency in circulation</td><td>BOJ (Note)</td></tr>
<tr><td>Deposit currency</td><td>955.4</td><td>45.0</td><td>Demand deposits (current deposits, ordinary deposits, savings, notice, special, tax payment reserves) - checks and notes held by financial institutions covered by survey</td><td rowspan="3">Financial institutions covered by M_2, Japan Post Bank, credit cooperatives (*shinyō kumiai*), The Shin-kumi Federation Bank, labour banks (Rokin), the Federation of Labor banks (Rokinren), agricultural cooperatives, federations of agricultural credit cooperatives (*Shin Noren*), fishery cooperatives (*gyokyō*), and federations of fishery credit cooperatives (*Shingyoren*)</td></tr>
<tr><td colspan="2">Quasi-currency</td><td>491.1</td><td>23.2</td><td>Term deposits + savings with grace period + term savings + foreign currency deposits</td></tr>
<tr><td colspan="2">CDs</td><td>32.5</td><td>1.5</td><td>CDs (negotiable certificates of deposit)</td></tr>
<tr><td colspan="3">Trusts of money</td><td>369.8</td><td>17.4</td><td>Trusts of money (excluding securities investment trusts and pension trusts)</td><td>Trust accounts of domestic banks</td></tr>
<tr><td colspan="3">Investment trusts (publicly offered and privately placed)</td><td>98.2</td><td>4.6</td><td>Bond investment trusts, stock investment trusts, real estate investment trusts</td><td>Trust accounts of domestic banks, real estate investment corporations</td></tr>
<tr><td colspan="3">Bank debentures</td><td>3.0</td><td>0.1</td><td>Bank debentures</td><td>Financial institutions issuing bank debentures</td></tr>
<tr><td colspan="3">Straight bonds issued by banks</td><td>0.1</td><td>0.0</td><td>Straight bonds issued by banks</td><td>Domestic banks, and holding companies that have a domestic bank as their main subsidiary</td></tr>
<tr><td colspan="3">Commercial paper issued by financial institutions</td><td>0.0</td><td>0.0</td><td>Commercial paper issued by financial institutions</td><td>Domestic banks, foreign banks in Japan, Shinkin Banks, the Shinkin Central Bank, The Norinchukin Bank, the Shoko Chukin Bank, insurance companies, and holding companies of the above financial institutions</td></tr>
<tr><td colspan="3">JGBs</td><td>24.1</td><td>1.1</td><td>JGBs (including short-term treasury securities and FILP bonds)</td><td>Central Government</td></tr>
<tr><td colspan="3">Foreign bonds</td><td>31.5</td><td>1.5</td><td>Bonds issued by nonresidents in yen or in foreign currency</td><td>Financial institutions issuing foreign bonds</td></tr>
</table>

*1 The above covers holdings of ordinary corporations, individuals and local government entities among residents.
*2 The statistics that are used are those as of their publication in August 2023.
*3 The weight is the ratio to board liquidity, expressed as a percent.
*4 The “balance” is the average balance.
(Note) Currency, strictly speaking, is issued by the central government, but for the purposes of money stock statistics it is classified as being issued by the BOJ.
(Source) BOJ “Money Stock Statistics”

Chart 4-25 Trends in Rate of Increase of Money Stock (M_2)



(Note 1) The shaded areas indicate cyclical downturns.
(Note 2) Charts prior to March 1999 do not include foreign banks, etc., in Japan.
(Source) BOJ "Money Stock Statistics" and Cabinet Office "Indexes of Business Conditions"

Fixed deposits such as time deposits and term savings are considered the equivalent of cash currency and deposit currency and are called quasi-currency. Fixed deposits, in principle, cannot be converted to cash until maturity, and therefore cannot be used as a means of payment or settlement during a deposit period. However, if interest is waived, it is possible to cancel the account and convert it to cash. The combination of narrowly defined currency and quasi-currency is called the "broadly defined currency."

Needless to say, understanding the movement of currency is essential to analyzing financial markets, and is equally important for understanding the economy as a whole. For this purpose, it is necessary to analyze the currency supply, *i.e.*, the money stock.

Money stock means the total amount of currency supplied by the financial sector to the entire economy. In other words, it is the amount of currency owned by general corporations (excluding financial institutions), individuals, local governments, etc., excluding deposits, etc., held by national and financial institutions. This distinction between national and financial institutions, and corporations, individuals, and local governments comes from whether current deposit accounts are held with the BOJ. The national and financial institutions are subject to adjustments of their current deposits with the BOJ in organizing their receipts and disbursements of funds, whereas corporations, individuals and local governments have no direct relationship with the BOJ, and their receipts and disbursements of funds are organized through transactions with financial institutions.

There is more than one indicator of money stock, depending on such criteria as the definition of financial products and what types of financial institutions and other entities are regarded as issuers of currency. Examples include whether only cash and liquid deposits immediately payable are considered currency, or whether term deposits, etc., are included. Financial institutions and financial products are classified by terms and costs spent to transform and use money stock by means of payment. In Japan, the major money stock statistics are: M_1 (M One), which is the total of narrowly defined currency (*i.e.*, the total of cash currency and deposit currency); M_3 (M Three), which is M_1 plus quasi-currency such as term deposits and CDs (negotiable certificates of deposits); and M_2 (M Two), which is the portion of M_3 that is limited to those deposits that are deposited with domestic banks (excluding

Japan Post Bank), etc., that are domestic. There is also a category named "broadly defined liquidity," which consists of M_3 plus trusts of money, investment trusts, bank debentures, straight bonds issued by banks, commercial paper issued by financial institutions, JGBs and foreign bonds.

Of these various money stock indexes, the BOJ places importance on M_2 and broadly defined liquidity as the most commonly used indexes of money stock. In general, however, M_2 is frequently used when looking at general trends in the money stock. If a large amount of funds included in M_2 (*e.g.*, bank deposits) is shifted to other asset categories outside of M_2 (such as postal savings), the level of M_2 can fluctuate widely. Broadly-defined liquidity, however, is less sensitive to such reallocation between financial institutions. The large-scale maturation of fixed-term postal savings deposits that began in 2000 resulted in a shift of a substantial amount of funds from the Post Office to bank deposits, which created a substantial gap between the increase in broadly-defined liquidity and the increase in M_2. In this manner it is necessary to observe a variety of indicators, having differing scopes, in a comprehensive manner and with selectivity according to the purpose of the analysis at hand.

(3) Value of Currency

(i) Prices

The value of a currency is influenced by fluctuations of prices. For example, let us say there is an individual whose net annual income is JPY3 million. If his annual income does not change but prices increase, the goods or services he can buy with his JPY3 million will decrease. In other words, the value of JPY3 million in currency has decreased. Therefore, inflation devalues currency.

Inflation substantially disturbs the major functions of currency listed in "(1) Role of Currency" above. First, when the value of currency becomes unstable, the price of commercial goods as expressed in currency becomes unstable, thereby undermining the function of currency as a measurement of value. Second, when inflation is progressing, the value of currency decreases the longer it is held, and therefore, it becomes better to dispose of it as soon as possible, which damages the function of currency as a stable means of exchange. Third, in the case of owning currency in the form of cash or deposits, the loss of value of the currency due to inflation cannot be avoided, and therefore, the function of currency as a means of saving value is undermined as well. In particular, the progress of inflation proportionately increases the value of actual assets, primarily land, and therefore, in many cases, the gap between "the haves" and "the have-nots" widens. Actual assets such as land are usually owned by the wealthy classes, and therefore, this may stir feelings of unfairness among people.

Thus, because inflation in general can be a threat to the value of currency, monetary authorities are always carefully watching price trends. The representative index watched most for the trend in prices is the Consumer Price Index (CPI), which is an index of average living costs of households. Trends in the Corporate Goods Price Index (CGPI), which sensitively reflects the supply and demand of commodities, are also important. In addition, the price of crude oil, which has a substantial influence on the trend of prices, is also closely watched as an important indicator. Before the COVID-19 pandemic, along with the maturity of economies in developed countries, the low inflation rate became a problem. If the inflation rate is too low, the real interest rate discussed below would not become sufficiently low, which could reduce the motivation for economic activities such as consumption and investment. However, in recent years, the supply of commodities has not caught up with the recovery of economic activities from the pandemic and prices of a wide range of resources have increased sharply. In addition, the Russian invasion of Ukraine further intensified the rise in resource prices. As wage levels also increased at an accelerating rate, many countries including the United States and European

countries are facing historically high inflation.

(ii) Interest Rates

For example, let us suppose Individual A has JPY100 million of funds. A has no specific use for the funds. On the other hand, Company B plans to expand its business and needs JPY100 million. In this case, B could borrow JPY100 million from A. Borrowing JPY100 million means B only temporarily owns the currency of JPY100 million held by A. The interest B pays to A for the loan is the value of the opportunity cost in that A is unable to use such funds freely. If there are many people other than B who want to borrow the funds owned by A, the value of funds increases. So, if B badly needs the funds, B must pay a higher interest rate to A. On the other hand, if there are less people who need the funds, borrowing at a lower interest rate is possible. In the real economy, there is a financial institution to mediate the movement of funds and there also exists various regulations so the flow of the funds is not this simple, but, nonetheless, the interest rate plays a role in the price of funds. Therefore, in general, if the demand for funds increases when the supply of funds is relatively low, the interest rate increases, and if the demand for funds decreases when the supply of funds is high, the interest rate decreases.

When working with interest rates, it is necessary to pay close attention to their relationship to prices. For example, if funds are borrowed at an annual interest rate of 10% when the annual increase rate in prices is 8%, essentially, the loan interest rate is 2%. This is because the value of the currency will decrease by 8% after one year due to the increase in prices. The superficial interest rate of 10% in this case is called the nominal interest rate, and the interest rate of 2%, which is obtained by subtracting the rate of the price increase from the nominal interest rate, is called the real interest rate.

When prices increase significantly and people borrow funds in anticipation of such increase in prices, the nominal interest rate becomes the appropriate interest rate plus the anticipated rate of price increases. Thus, the nominal interest rate is affected by the inflation rate that people anticipate.(Note) Therefore, when inflation is progressing, high interest rates prevail, and when inflation subsides, interest rates are usually lower. However, although the close relationship between price increases and interest rates cannot be denied, these two elements do not necessarily move in unison.

The real interest rate is one of the determining factors for companies and households making decisions regarding their financial needs. In other words, even if the nominal interest rate is high, if the real interest rate is low, the demand for funds by companies and households increases. On the other hand, even if the nominal interest rate is low, if the real interest rate is high, the demand for funds stagnates.

(Note) This is called the Fisher effect and is expressed in the following formula:
Nominal interest rate = Real interest rate + Anticipated (forecast) inflation rate

(iii) Foreign Exchange Rate

The value of currency overseas is expressed using an exchange rate which is the exchange ratio between the various currencies of each country. For example, if the rate of the yen against the dollar changes from JPY200 to JPY100 per dollar, it means the value of the yen is doubled (yen appreciation). If the rate of the yen against Euro rate changes from JPY80 to JPY160 per Euro, it means the value of the yen against Euro becomes halved (yen depreciation).

The international financial market after World War II was based on the Bretton Woods System (dollar-gold standard system) under which the rates of exchange between the US dollar, the currency of the

overwhelming economic power, and the currencies of other countries, were fixed (in the case of Japan, USD1 = JPY360), and only the US dollar could be exchanged with gold at a fixed rate. However, this system collapsed as the value of dollar declined due to the U.S. current account deficit, and the major currencies of the world were appreciated based on the Smithsonian Agreement in December 1971 (in the case of Japan, the yen was appreciated by 16.88% to USD1 = JPY308). However, this so-called Smithsonian System did not last long, and in 1973 the major currencies of the world shifted to a floating exchange rate system. Therefore, today's currency exchange markets fluctuate daily, reflecting international trade balance movements and fluctuations in interest rates in each country.

The yen rate since the floating of the yen has traced a long-term trend of appreciation against the dollar until the beginning of the 2010s. In particular, after the Plaza Accord in September 1985, a rapid and wide-margin appreciation has been evident. In recent years, after hitting the post-war record high of USD1 = JPY75 in October 2011, the yen has tended to be weak against the dollar, i.e. USD1 has been equivalent to JPY120 or more until 2015. Since then, a trend of a slight appreciation in the value of yen against the dollar continued with USD1 hovering around JPY110. However, the trend of a weak yen intensified from around the fall of 2021, and the depreciation of the yen against the dollar accelerated due to the FRB's decision to raise the interest rate in March 2022. The yen weakened to reach USD1=JPY151 level at one point in October 2022. Compared with the historically high inflation in the United States, the inflation in Japan was moderate cost-push inflation, and due to the sluggish wage growth, monetary easing was maintained in Japan. On the other hand, due to the rapid depreciation of the yen, the government intervened to buy the yen for the first time in 24 years in September and October 2022. Then, the yen appreciated following the results of the Bank of Japan's Monetary Policy Meeting in December. Thus, the yen exchange rate violently fluctuated throughout 2022. In 2023, the yen started to depreciate again, staying in the higher JPY140 level in August.

The fluctuation in exchange rates has a significant influence on exports and imports and the movement of capital, as well as on prices, interest rates and on the economy as a whole. If the yen depreciates, it causes import prices to increase which leads to an increase in prices across the country, and the possibility of increases in the interest rate also increases. On the other hand, if the yen appreciates, domestic prices decline due to the decline in import prices and a decrease in interest rates can also be anticipated.

2 2 Financial Institutions

Within the economy as a whole, there exist entities such as households, which have excessive funds and are looking for a party to manage their funds, and there also exist entities such as companies which are short of funds and are looking for a party from which they can procure funds.

It is extremely difficult in reality, considering the efforts and expenses, etc., for an entity with excessive funds and an entity with a shortage of funds to try to independently seek out another party that matches its particular management/procurement criteria (the amount, the interest rate, the term, etc.). Financial institutions make the efficient distribution of funds possible by acting as an intermediary between an entity with excessive funds and an entity with a shortage of funds (this is called the "intermediation of funds by financial institutions").

There are two types of methods, the direct financing method and the indirect financing method, by which funds can be transferred from an entity with excessive funds to an entity with a shortage of funds. Direct financing is a

financing technique by which an entity with a shortage of funds issues securities, such as stocks or bonds, and an entity with excessive funds directly purchases these securities through markets and supplies the funds. In this situation, financial institutions (mainly securities companies) play a role in connecting the two parties, but, in principle, they do not supply the funds themselves. On the other hand, indirect financing is a financing technique by which financial institutions themselves (mainly banks) raise funds from an entity with excessive funds and lend the funds to an entity with a shortage of funds.

The difference between direct financing and indirect financing is the entity that bears the risk of a bad debt, etc. In the case of direct financing, such risks are borne by the entity with excessive funds that purchases securities, whereas in the case of indirect financing, such risks are borne by financial institutions.

The types of financial institutions and their operations vary from country to country and from period to period. In the case of Japan, major financial institutions are regulated by industry laws depending on the type of business, and business is conducted according to those laws.

(1) Banks

(i) BOJ

The BOJ is the central bank of Japan established under The Bank of Japan Act and has three basic functions: (a) the function of “issuing bank” that exclusively owns the right to issue bank notes; (b) the function of “bank of banks” that engages in transactions with private financial institutions; and (c) the function of “bank of the government” that handles receipts and disbursements for the government. The BOJ manages monetary policy through these functions.

(ii) Ordinary Banks (City and Regional Banks)

There are various types of banks, but the representative ones are ordinary banks such as city banks and regional banks. There are four city banks: Mizuho Bank, MUFG Bank, Sumitomo Mitsui Bank, and Resona Bank (or five banks including Saitama Resona Bank). Regional banks consist of the member banks of Regional Banks Association of Japan and the Second Association of Regional Banks. Both city banks and regional banks are licensed under the Banking Act and there is no legal distinction between them.

City banks have headquarters in big cities, develop branch networks throughout the country and deal with major corporate clients. At the end of July 2023,city banks accounted for about 50% of the total deposits and about 40% of the loan balance of domestic banks. Thus, they play a central role among commercial financial institutions in Japan.

Regional banks that are members of Regional Banks Association of Japan are headquartered in core cities in metropolises across the country, and those metropolises in which they are located are their major business bases. Therefore, their customers are mostly local residents and companies in the area. Regional banks that are members of the Second Association of Regional Banks are the same as regional banks, but were formerly mutual banks later converted to ordinary banks. Therefore, they are relatively smaller in size compared to regional banks that are members of Regional Banks Association of Japan.

Regional banks, which have concentrated their businesses in specific geographic regions, have played an important role in supplying funds to regional economies. However, some regional banks now operate their businesses beyond their geographical boundaries. Indeed, the distinction between the types of deposit-taking institutions is becoming less significant, as city banks have somewhat acquired the appearance of regional banks, while regional banks and shinkin banks have become larger through management integration. Nevertheless, regional banks do have a major impact on the local economies of their respective regions, and

improving the management soundness of both regional banks that are members of the national association and those that are members of the second association can be said to be indispensable to revitalizing the regions in which they are active. In addition, among the ordinary banks there are banks that have been converted from being long-term credit banks, and net banks specializing in transactions by use of the Internet. Moreover, foreign banks that open branches in Japan are licensed to conduct business under the Banking Act.

(iii) Trust Banks

Based on the "Act on Concurrent Operation, etc. of Trust Business by Financial Institutions," trust banks are approved to conduct trust businesses concurrently with their regular business and their primary business is trust business. They mostly deal with long-term financing based on funds collected through their trust businesses. In the past, the trust business was limited to the seven specialized banks and Daiwa Bank due to administrative guidance of the (then) Ministry of Finance which coordinated business areas, but as part of the financial deregulation, entry from other business fields into the trust business was permitted. As a result, trust banks were established by foreign banks in October 1985 and thereafter, and by banks related to securities companies in October 1993.

In addition, in 1994, two banks were added, one affiliated with the National Credit Union Association (currently the Shinkin Central Bank) and the other affiliated with Nippon Credit Bank (currently Aozora Bank). In 1995, a total of five banks were added, consisting of an affiliate bank of the Central Bank for Agriculture and Forestry, an affiliate of the Industrial Bank of Japan, and three banks related to city banks, and again, in 1998, four banks related to city banks newly entered this line of business as well. Subsequently, as a result of industry reorganization, there were 13 trust banks as of January 4, 2023.

(iv) Long-Term Credit Banks

Long-term credit banks are licensed under the Long-Term Credit Bank Act, but SBI Shinsei Bank (formerly the Long-term Credit Bank of Japan) and Aozora Bank (formerly the Nippon Credit Bank, Ltd.) have converted to being ordinary banks in FY2004 and FY2006 respectively, and thus there are no longer any long-term credit banks.

(2) Financial Institutions for Small and Medium-Sized Businesses

There are many small and medium-sized businesses in Japan and it is said that they are the source of energy behind the Japanese economy. Since it was difficult for small and mid-sized companies to utilize the capital markets and borrow from major financial institutions, there are various types of financial institutions specializing in financing for small and mid-sized businesses. However, recently there have been an increasing number of small and mid-sized businesses with outstanding capabilities, while competition among financial institutions has become more and more severe, and both city banks and regional banks are actively seeking financing opportunities with small and mid-sized businesses. Therefore, financial institutions specializing in financing for small and mid-sized businesses have been taking various measures such as improving management efficiency by merging or forming business partnerships, diversifying business and strengthening local ties.

(i) Shinkin Banks

Shinkin banks are financial institutions for small and mid-sized businesses with a cooperative structure which are licensed under the Shinkin Bank Act. Shinkin banks principally lend only to members and have a close relationship with the local region, because their business area is relatively small. At the end of May 2023, there were 254 shinkin banks nationwide.

The Shinkin Central Bank (hereinafter referred to as the "Shinkin Chukin") is the central organization for

shinkin banks throughout the country. This bank lends support to the management of shinkin banks by collecting and efficiently managing the surplus funds of each shinkin bank, by lending funds to shinkin banks with strong demand for funds, or by assisting shinkin banks whose businesses have deteriorated. In addition, since 1989, Shinkin Chukin was permitted to issue bank debentures to raise funds (at the time this bank was referred to as the "Zenshinren Bank").

(ii) Credit Cooperatives

Credit cooperatives are financial institutions that are membership organizations for small and mid-sized businesses under the Small and Medium-sized Enterprise Cooperatives Act and the Act on Financial Businesses by Cooperative. As of January 10, 2023, there were 145 credit cooperatives nationwide. Credit cooperatives have stronger characters as cooperative organizations than shinkin banks. The services of deposits and lending are, in principle, limited to their members. Compared to shinkin banks, they are smaller in size and closer with the local community. The Shinkumi Federation Bank is the central organization.

(iii) Labor Banks

Labor banks are financial institutions with cooperative organizations whose members are mainly labor unions, etc. and which engage in depositing and lending to their members. As of March 31, 2023, there were 13 labor banks throughout the country, and the Rokinren Bank is the central organization for them.

(iv) Shoko Chukin Bank

This is a special corporation (stock company pursuant to the special law) that was incorporated in accordance with the Shoko Chukin Bank Limited Act. Its main activities are to conduct the necessary business activities for facilitating lending to cooperative associations of small and medium-sized enterprises, other associations that mainly have members consisting of small and medium-sized enterprises, and their members. As one aspect of reform of monetary policy, it was converted from a government-affiliated corporation to a special corporation in October 2008, with the plan that it would later be fully privatized in five to seven years. However, due to the global financial crisis in 2008 and the occurrence of the Great East Japan Earthquake in 2011, this plan was postponed twice. In 2015, the amended Shoko Chukin Bank Limited Act was passed, under which the government would continue holding shares of Shoko Chukin Bank as necessary to enable the bank to perform the crisis response business properly for the time being, while maintaining the policy of targeting its full-scale privatization but not specifically setting the deadline.

Later, in the autumn of 2016, an illegal loan incident came to light and new discussions on full-scale privatization were made by the expert council that examined the drastic reforms of Shoko Chukin Bank. Following the evaluation by the expert council regarding the management and crisis response business of Shoko Chukin Bank, the amendment to the Shoko Chukin Bank Limited Act was enacted in June 2023. Under the amended Act, all of the government-owned shares in Shoko Chukin Bank will be disposed of within two years, and the scope of its business will be expanded, with the upper limit for its investment in companies to be raised from 10% to 100%. However, the bank will maintain its public roles, such as providing funds as crisis response loans to SMEs at low interest rates at the time of disasters.

(3) Financial Institutions Related to Agriculture and Forestry

Financing for the agricultural, forestry and fishery sectors is handled at the top by the central organization, The Norinchukin Bank, and conducted mainly by chain financing, which consists of three financing chains for the agricultural, fishery and forestry sectors. However, the fishery chain is small in size and the forestry chain only conducts lending and does not accept deposits. Therefore, the cooperative financing of the agricultural sector is

central to this chain financing.

The agricultural financing system is based on 555 (as of April 1, 2023) agricultural cooperatives (hereinafter referred to as the "Nokyo") throughout the country that engage in financial activities. Nokyo are different from other financial institutions in that they engage in a diverse range of businesses such as purchases of materials related to agriculture, sales of agricultural products and the mutual aid business. Nokyo accept deposits from association members and lend funds required for the businesses of the members, although, in general, the loan amount is substantially below the deposit amount. Nokyo deposit surplus funds at the Federation of Agricultural Cooperative Associations (hereinafter referred to as the "Shinnoren") of the respective prefectures in which they reside. A Shinnoren can manage the deposited funds by itself, but they deposit most of the funds to be managed at the Norinchukin Bank. The Norinchukin Bank manages the funds collected through such systems by lending or investing in securities, and it is the largest institutional investor in the private sector.

However, there is a possibility that the government reform of Nokyo will change the structure of the Nokyo-based agricultural financing system throughout the country. On November 11, 2016, the Regulatory Reform Promotion Council published the "Opinions on the Reform of Agricultural Cooperatives." In the opinions, the Council stated that the number of regional Nokyo which are authorized to operate credit businesses under their names should be decreased by half within three years so as to enable these Nokyo to concentrate their management resources on activities for agricultural promotion. Furthermore, in April 2017, the Norinchukin Bank required regional Nokyo to show their policies for separating and restructuring their financial business by May 2019. In August 2019, the Norinchukin Bank published the summary of the results of each general Nokyo's deliberations, the majority of which aimed at strengthening the management base while maintaining the existing business structure. The "Regulatory Reform Implementation Plan" approved by the Cabinet in June 2021 advocates "steadily pushing ahead with agricultural cooperative reforms" and clearly states that the government will continue to encourage agricultural cooperatives' self-reforms.

(4) Insurance Companies

Insurance companies are divided into life insurance companies and non-life insurance companies and both are licensed under the "Insurance Business Act." In the past, engaging in both the life insurance business and the non-life insurance business concurrently was not allowed. However, as a result of the financial deregulation that has taken place, the Insurance Business Act was amended so that insurance companies may engage in both the life insurance business and non-life insurance businesses concurrently through their subsidiaries, and mutual entry into the two businesses was permitted in April 1996. Across the country, there were 42 life insurance companies as of June 26, 2023, and 55 non-life insurance companies as of April 13, 2023.

There is no difference between life insurance companies and non-life insurance companies in that they both manage funds received in the form of insurance premiums by lending or investing in securities, etc. However, life insurance agreements cover long term periods and insurance benefits are paid steadily, whereas with non-life insurance agreements, the insurance payments are sporadic since they cover disasters, which are unpredictable in nature. Therefore, funds from life insurance are mostly invested for the long term, whereas in the case of non-life insurance, investments are mainly short-term and focus on liquidity.

(5) Financial Instrument Business Operators (Securities Companies, Etc.)

Financial instrument business operators (securities companies, etc.) are the major players in direct financing, and are registered and conduct business based on the Financial Instruments and Exchange Act. As of July 31, 2023,

there were 1,958 financial instruments business operators nationwide.

(6) Other Private Financial Institutions

(i) Securities Finance Companies

Securities finance companies are licensed under the Financial Instruments and Exchange Act and conduct various securities financing businesses, mainly money and securities lending transactions where the securities finance companies lend money and securities necessary for the settlement of margin transactions. Securities finance companies were reorganized following the abolition and consolidation of securities exchanges. After Chubu Securities Financing closed down voluntarily in 2017, Japan Securities Finance exists as the only securities finance company in Japan.

(ii) Call Loan Dealers

Call loan dealers broker money transactions between financial institutions on short-term financial markets such as call markets and bond markets, etc. Call loan dealers play an extremely important role in terms of the execution of the monetary policy of the BOJ. As of August 1, 2023, there were three call loan dealers: Tokyo Tanshi Co., Ltd., Ueda Yagi Tanshi Co., Ltd. and Central Tanshi Co., Ltd.

(iii) Non-Banks

There is no precise definition for non-banks, but in general, they are “companies which engage in the credit business without taking deposits.” Specifically, there are consumer financing companies, credit card companies, credit sales company, business financing companies, leasing companies, etc. Since these non-banks do not accept deposits, the majority of their funds are procured by external funding. Traditionally, external funding has come from loans from banks, but now non-banks are able to issue bonds to procure funding to engage in the loan business, under the Act on Issuance, etc. of Bonds for Financial Corporations’ Loan Business (the Non-Bank Corporate Bond Act) which came into effect in May 1999.

(7) Government-Affiliated Financial Institutions

The balance of postal savings accounts held by individuals at Japan Post Bank is JPY189.3 trillion (individual savings, etc. as of the end of March 2023) and accounts for approximately 20% of household savings. Through FY2000, money such as postal savings and postal life insurance received by the Postal Bureau was made available to government-affiliated financial institutions under the government’s Fiscal Investment and Loan Program (FILP) Plan, as was also the case with employee pensions and national pension funds. From FY2001, however, the postal savings funds collected through the post offices have gradually been redirected towards autonomous management. This is because the postal business has become a service which can no longer be solely provided by the national government, and also because of calls that had come to be made to provide funds to the private sector and make effective use of such funds from the perspective of stimulating the national economy. As a result, in October 2005 the Japan Post Privatization Act passed, and progress commenced towards privatizing areas such as postal savings and postal life insurance. On October 1, 2007, a 100% government-owned holding company (Japan Post Holdings Co., Ltd.) and its four operating companies began operations. On October 1, 2012, Japan Post Service Company, Limited and Japan Post Network Co., Ltd. were integrated and today, Japan Post Holdings, Co., Ltd. has become a holding company with three subsidiaries, *i.e.* Japan Post, Co., Ltd., Japan Post Bank, Co., Ltd. and Japan Post Insurance, Co., Ltd. The three companies in the Japan Post Group were listed on the first section of the Tokyo Stock Exchange in November 2015, and they are currently listed on the Prime Market.

Other institutions have been reorganized or will be reorganized as follows.

The Housing Loan Corporation was abolished, and its business was taken over by the Japan Housing Finance Agency which was newly created in FY2007. From October 1, 2008, the Development Bank of Japan and the aforementioned Shoko Chukin Bank were converted into special corporations and scheduled to be completely privatized in stages. While maintaining the complete privatization policy, the government continues to hold shares in the Development Bank of Japan in order to promote intensive investment in growth funds (i.e., funds supporting risks associated with innovations) conducive to regional revitalization, and shares in the Shoko Chukin Bank in order to ensure responsiveness to crises such as natural disasters. Also, on the same date, the National Life Finance Corporation, the Agriculture, Forestry and Fisheries Finance Corporation, the Japan Finance Corporation for Small and Medium Enterprise, and the Japan Bank for International Cooperation have been dismantled and were then combined into the Japan Finance Corporation, after their activities were limited and reduced. On April 1, 2012, Japan Bank for International Cooperation became a limited corporation after being separated from and made independent of Japan Finance Corporation.

(8) The Reorganization of Financial Institutions

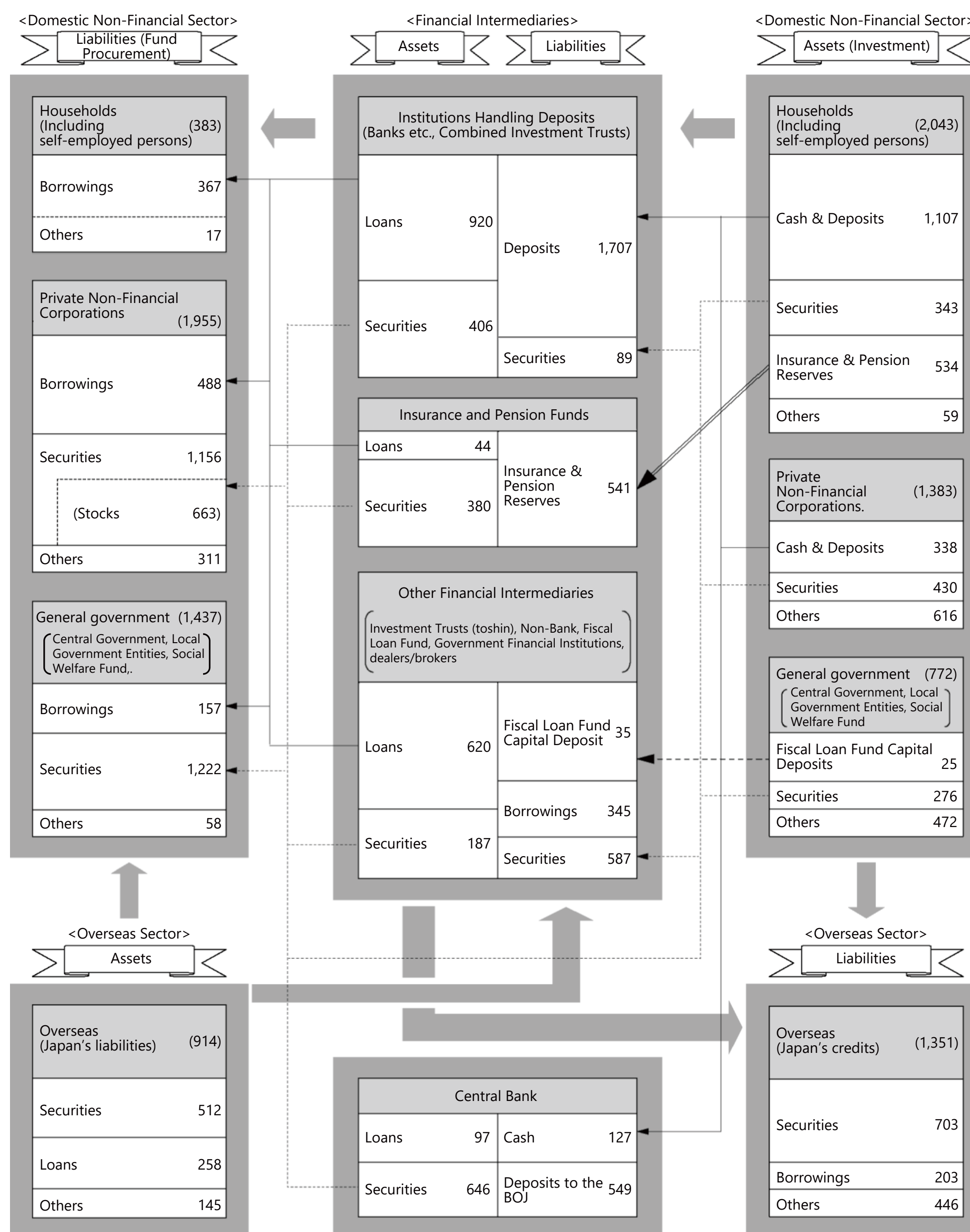
Until recently, financial institutions in Japan were considered to be entirely separated into categories according to their business objectives or lines, and whether they were engaged in short-term or long-term financial activities. In the course of progress of liberalization, however, overlapping arose in terms of the financial products and targets that they handle, and members of one category became capable of engaging the business lines of another through newly established subsidiaries, so the former distinctions among financial institutions is becoming meaningless.

Since 1997, there has been a rush of mergers and business alliances between banks after several financial institutions failed. After it became possible to have financial holding companies, the above-mentioned classification of city banks, long-term credit banks, and trust banks is becoming less distinct, and large financial groups which have a bank at the center and include life insurance and non-life insurance companies, as well as securities companies and other types of businesses, have been formed. It is possible that further reorganization will take place, which may include financial institutions whose group affiliation is not evident. Additionally, progress is also being made toward the reorganization and privatization of government-affiliated financial institutions. Moreover, new techniques such as the technique of securitization started being used, and rather than the industrial category of the entity, a functional aspect, meaning what type of financial activities are conducted and what type of risks are taken, has become more important.

As mentioned above, the greatest role played by financial institutions is that of making an efficient distribution of funds. A closer examination reveals their functional aspects in the “financial system,” that can be broken down into the following categories: (i) clearing, (ii) pooling and small lot distribution of funds, (iii) transfer of economic resources, (iv) risk management, (v) dissemination of price information, and (vi) addressing information gaps.

(i) Clearing refers to the settlement and payment of economic transactions, and lies at the core of the financial system; (ii) pooling and small lot distribution of funds refers to the amalgamation of funds to conduct large scale business operations while small-lot distribution of funds includes deposit and lending business; (iii) transfer of economic resources refers to the transfer of funds among locations, times and industries; (iv) risk management refers to the management of risks such as dealing with uncertainties and provides the means to manage such risks; (v) dissemination of price information refers to the calculation of prices used for decision-making and the provision of information of such prices, including information related to interest rates and securities prices; and (vi) addressing information gaps refers to the provision of information as a means to assist in the finalization of transactions in cases where information exists that is not known to one of the parties to the transaction.

Chart 4-26 Balance of Financial Assets and Liabilities by Sector as of End of March 2023 (in trillions of yen)



(Note 1) Charts shown for each sector reflect only the major categories and major items in order to show the cyclical flows of funds.
(Note 2) Loans (borrowings) include "BOJ lending," "call loans and bills," "loans by private financial institutions," "lending by public financial institutions," "lending by the non-financial sector," "installment receivables," and "gensaki and bond loan (borrowing and lending) transactions."
(Note 3) Securities include "stocks and beneficiary certificates of investment trusts" and "debt securities" ("government bonds and FILP bonds," "bank debentures," "corporate bonds," "beneficiary interests in trust," etc.) (securities among Japan's receivables are "overseas securities investments").
(Note 4) "Others" refers to the difference between the total amount and amounts of other stated items.
(Source) BOJ "Flow of Funds"

2 3 Financial Markets

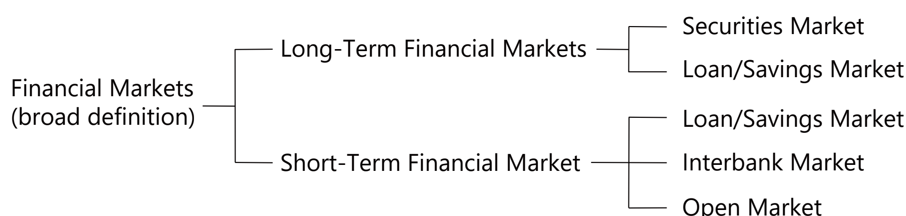
Financial markets refer to the place where transactions of funds are conducted. In general, these markets can be separated into short-term financial markets (a maturity of less than one year) and long-term financial markets (a maturity of one year or more), depending on the period until maturity of the financial assets.

Among the short-term financial markets, the savings and loans markets engage in negotiated transactions and therefore differ somewhat from the general definition of a market. In this regard short-term financial markets (money market), in their narrow definition, refer to markets excluding loan/savings markets.

Short-term financial markets (money markets) in their narrow definition can be divided, depending on the participants, into the interbank market and the open market. The participants in the interbank market are limited to financial institutions, and this marketplace is used to invest and raise funds among financial institutions. On the other hand, the open market is open to non-financial institutions such as general business corporations.

Short-term financial markets in Japan have developed around the interbank market but, lately, the open market has progressively expanded and it has surpassed the interbank market in size.

Chart 4-27 Schematic Outline of Financial Markets



(1) Interbank Market

As a result of daily business activities, financial institutions experience a difference between the amount of funds received through savings, etc., and the cost of funds paid out for loans and securities investments, etc. The interbank market serves the function of coordinating financial institutions with surplus funds as lenders and financial institutions with a shortage of funds as borrowers. The interbank market consists of the call market and the bill market.

The call market dates to before World War II and is the oldest money market in Japan. For a long time, there was only a market for secured calls in which funds were borrowed based on collateral such as government bonds and bills, but in 1985 a market was created to enable call transactions without collateral. For both secured and unsecured call markets, call loan dealers play an important role as an intermediary of funds.

The secured call market is the marketplace for ultra short-term fund transactions and deals with next day funds (overnight transactions) and term funds. Most of the transactions on this market are next day funds (overnight transactions). Although the unsecured call market has a shorter history than the secured call market, in the early 1990s, it outgrew the secured call market in scale. However, the zero interest rate policy that appeared in 1999 and the sweeping financial deregulation that hit in 2001 was followed by a rapid decline of balances to the point where the balance of the unsecured call market dropped beneath that of the secured call market. Both the secured call market and unsecured call market deal in next-day funds and various term funds (20 types from two to six-day call, one to three-week call, one to 11-month call and up to one-year call), but next-day funds account for the largest share of transactions. Following the introduction of the negative interest rate policy by the BOJ in February 2016,

the unsecured overnight call rate turned negative and the balance of the call market sharply dropped.

The biggest suppliers of call loans are the trust banks (including investment trusts, etc.). The biggest borrowers were city banks, but since the introduction of the negative interest rate policy, the amount of their loans has sharply dropped and other borrowers, namely, regional banks, securities companies, and securities finance companies, have increased their presence.

The bill market was established in 1971 by transferring longer-term funds from the conventional call market. Bills traded on the bill market are bills drawn by prime companies (original bills) and bills drawn by banks (cover bills) based on public corporation bonds such as government bonds and government guaranteed bonds and foreign currency bonds as collateral. The duration for bill transactions is, in principle, unregulated.

(2) Open Market

The short-term financial market in Japan developed around the interbank market, which was represented by the call market. The open market did not exist except for the *gensaki* market. However, starting with the establishment of the Certificate of Deposit market ("CD market") in 1979, the Treasury Bill market ("TB market"), the Financing Bill market ("FB market") and the Commercial Paper market ("CP market") were created, and thus the open market expanded.

(i) Repo Market (*Gensaki*, Bond Repo)

Gensaki transactions are transactions to purchase (or sell) instruments on the condition that they will be resold (or repurchased) at a certain price after a certain period. When referred to simply as "*gensaki*," it refers to bond *gensakis* which are repo transactions of bonds. The *gensaki* market is the oldest open market in Japan. It came about naturally after World War II as a means of financing the bond inventories owned by securities companies.

From April 1996, bond loan (borrowing and lending) transaction secured by cash began and the scale of the transaction has expanded. These are referred to as "cash collateralized bond loan transactions" (hereinafter referred to as "repo transactions" or "bond repos"). Since these bond repo transactions were in the form of a borrowing and lending that differs from international standards, and the security was reverse, from 2001 transactions referred to as "new *gensaki* transactions" were introduced, which were consistent with international standards. The size of this market has been increasing because these transactions offer improved convenience in risk management and handling.

The Repo Market includes three types of transactions with differing contractual forms, and at the present time this market is growing into a core market that epitomizes the open market.

(ii) CD Market

CDs ([Negotiable] Certificates of Deposit) are negotiable deposit certificates and were introduced as the first deposit product with a deregulated interest rate in Japan in 1979. The terms for these CDs range from two weeks to five years, but by far most CDs are issued with one month to three-month maturities. CDs with a term of six months or more are extremely rare.

Legally, CDs are deposits and, therefore, the issuance can be only by financial institutions such as banks and other deposit-taking institutions. About 50% of outstanding amount of issued CDs is accounted by city banks. Most of the holders of CDs are dealers in CDs on the secondary market (financial institutions and their affiliates, securities companies, call loan companies, etc.). In the secondary CD market, dealers engage in interest rate arbitration in the interbank market and business corporations, among others, are also buyers of CD *gensaki* in the secondary market of CDs.

(iii) Short-Term Treasury Securities (T-Bill) Market

From February 2009, the former Treasury Bills (TBs, which are discount short-term treasury securities) and Financing Bills (FBs, which are short-term government securities) have been combined into Treasury Discount Bills (short-term treasury securities). Treasury Discount Bills are discount bills (short-term government bonds) with a maturity date of less than one year. They exist in four types: two-month, three-month, six-month and one-year maturities.

The previous TBs are short-term discount government bonds that were issued for the first time in 1986 for the purpose of facilitating the smooth redemption and refunding of large amounts of maturing government bonds. There are six-month TBs and one-year TBs. On the other hand, the previous FBs are government short-term securities normally redeemable in three months (13 weeks). They were issued to compensate for the temporary shortage of funds for various accounts in the government, or to obtain funds for intervention in the foreign exchange market. In the past, almost all of the bills issued were underwritten by the BOJ, but this has been amended so that from April 1999 they have been sold generally in the market through public auction whereby the issue conditions and amounts for bids are solicited publicly.

Treasury Discount Bills are traded on the secondary market at interest rates that reflect market rates. They are also used by the BOJ for open market operations, and secondary market trading has been gradually increasing. Overseas investors use these bills as instruments for managing yen-denominated assets.

(iv) CP Market

CP is an abbreviation for commercial paper and its legal nature is that of a promissory note. In Japan, the market was established in 1987 as part of the deregulation of short-term financial markets. CPs are issued at a discount and most are for three-month terms.

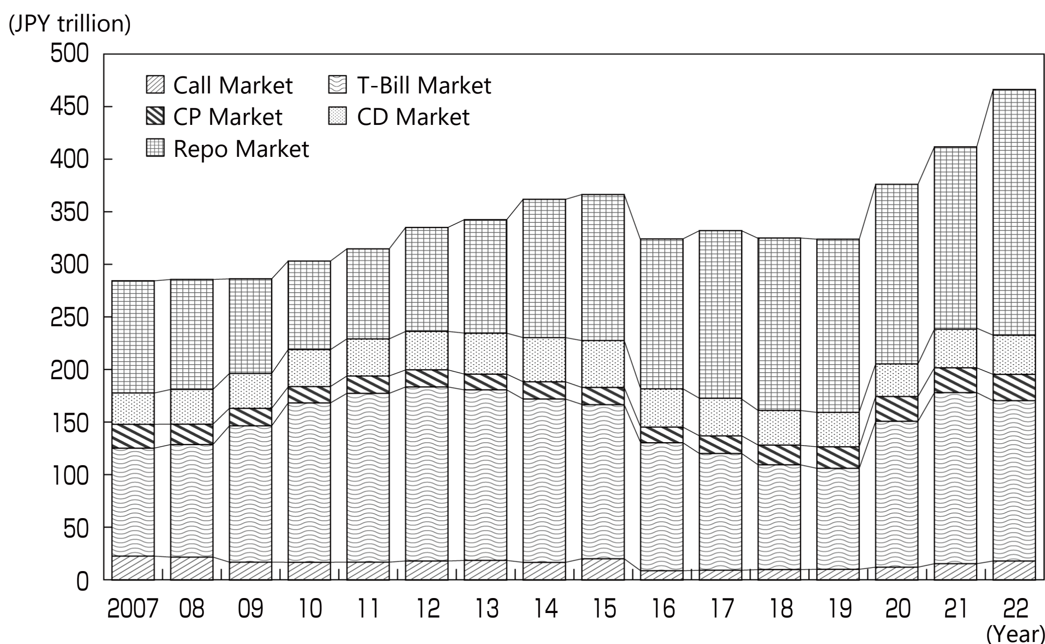
CP is issued by corporations through securities companies and banks and is sold to institutional investors, etc., through an intermediary of banks, securities companies and call loan dealers. Trading, in the majority of cases, is in the form of short-term *gensaki*. From June 1998 institutions such as banks have also been permitted to issue CP.

Furthermore, in January 2003 the Act on Book-Entry Transfer of Corporate Bonds, etc. (at the time) came into effect, and transactions in paperless electronic CPs began in March 2003.

(v) Short-Term Interest Rate Derivatives (OIS) Market

OIS (Overnight Index Swap) transactions are transactions involving a swap of the unsecured overnight call rate for a certain period of time against a fixed rate of interest. In Japan, this is the first true derivatives transaction on the overnight rate of interest, and has made it possible to observe the stance of the market towards future trends in monetary policy. After the lifting of the BOJ's quantitative easing policy in 2006, there was a time when OIS transactions became active as a means of responding to increases in and fluctuations of interest rates. However, these transactions have become sluggish again since the global financial crisis in 2008.

Chart 4-28 Size of Short Term Financial Market



(Source) BOJ "Amounts Outstanding in Short-term Money Market" and "Financial and Economic Statistics Monthly," Japan Securities Dealers Association "Issuing, Redemption and Outstanding Amounts of Bonds," "Government Bond Trading Volume by Category of Investors" and "Bond Margin Loans," and Japan Securities Depository Center, Inc. "Book-Entry Transfer System for Short-Term Corporate Bonds (CP) Outstanding Amounts of CP by Issuer's category"

(3) Bank Loans

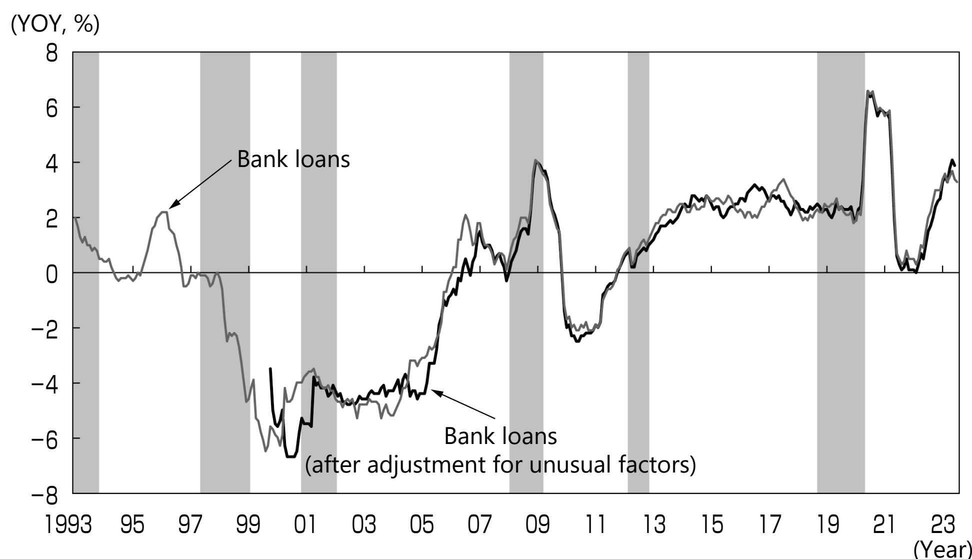
Largely due to the issue of corporate bonds and commercial paper by large corporations, dependency on bank loans has weakened and the outstanding balance of bank loans is showing a declining trend. Bank loans trend is determined by an interaction of the willingness of institutions to lend and the demand for their funds from non-financial sector, but this background is not immediately evident merely from change in the outstanding balance. In any event, Japanese corporations and households are dependent on a large number of bank loans, and there has been no change in the position of banks, acting as both deposit-takers and lenders of funds, as the major intermediaries in the supply of credit by their function of connecting suppliers of funds with those who require funds.

What is important is that loans create deposits. When a bank makes a loan, the borrower does not hold the loan as cash, but even when using funds to make a payment of one form or another, returns most of the borrowed funds to the banking sector as deposits.

The effect of bank loans that originate in an increase in deposits is called credit creation. Creation of credit is an essential part of increase in money stock, and in this sense it is useful to compare bank loans and GDP, which is an indicator of the level of economic activity.

In addition, changes in the level of deposits and of loans have an influence on the need for banks to procure funds and the demand for other asset types. For example, if there is robust demand for capital in the non-financial sector, this becomes a factor contributing toward higher interest rates.

Chart 4-29 **Bank Loans Trends (Average Balances)**



(Note 1) The shaded areas indicate economic downturns.
(Note 2) After adjustment for unusual factors: Factors such as the factoring of loan receivables and the writing down of bad debts have been taken into consideration.
(Source) BOJ "Principal Figures of Financial Institutions" and Cabinet Office "Indexes of Business Conditions"

(4) Supply and Demand of Funds

Interest rates in financial markets fluctuate reflecting movements in the supply and demand of funds.

It is necessary to understand the "deposit reserve system" of banks when looking into the supply and demand of funds.

Private financial institutions are obligated by law to deposit a certain percentage of deposits, etc., to the BOJ as current deposits without interest. This deposit is called a reserve deposit, and the ratio imposed on deposits, etc., is called a deposit reserve rate (or payment reserve rate). Financial institutions reserve an amount obtained by multiplying the deposit reserve rate by the average balance of deposits per month (required reserve amount), and deposit the amount with the BOJ during the one month, from the 16th of the relevant month, to the 15th of the next month. Building of reserves is done in current accounts of financial institutions at the BOJ; these accounts include funds for settlement of transactions and cash reserves in addition to deposit reserves. Financial institutions other than banks have current accounts at the BOJ, for use in settling government bond trades and other purposes.

Reserve deposits to the BOJ by private financial institutions are not made in equal amounts every day; the amounts increase or decrease daily depending on the following factors.

The first factor is the inflow and outflow of cash (the majority of which is BOJ notes). Financial institutions hold only a minimum amount of cash on hand, and the cash brought in is deposited with the BOJ immediately after the business day is concluded. For this reason, if the cash flows into financial institutions from companies and households, the reserve deposit increases. (From the viewpoint of the BOJ, the BOJ notes are being returned.) On the other hand, if companies and households withdraw cash from financial institutions, they are withdrawing cash from the BOJ and accordingly, the reserve deposit decreases. (From the viewpoint of the BOJ, it is an addition to the BOJ notes.)

The second factor is the outflow and inflow of fiscal funds. The payment of fiscal funds by the government to

the private sector causes a decrease in government deposits with the BOJ and an increase in current deposits by private financial institutions with the BOJ. On the other hand, the receipt of funds by the government from the private sector such as the income from tax collections results in increases in government deposits with the BOJ and decreases in deposits by private financial institutions with the BOJ.

Therefore, the return of BOJ notes and payment of fiscal funds in excess of receipts (also known as "excessive payment") will cause an increase in reserve deposits (in other words, a surplus in funds) while the additional issue of BOJ notes and a net receipt of fiscal funds will cause a decrease in reserve deposits (in other words, a shortage of funds). When the funds are short, the demand for funds in the interbank market increases and the rate in the interbank market increases. In contrast, when funds are in surplus, the amount of funds managed on the interbank market increases and the interest rates in the market decline. Since interest arbitration (the concept of raising funds on the market where the interest rates are lower and managing funds on the market where the interest rates are higher) takes place between the interbank market and the open market, in the end, rate fluctuations in the interbank market are reflected in the rates on the open market.

It is one of the important functions of the BOJ to respond to the surplus or shortage of funds and to adjust the supply and demand in financial markets. The BOJ conducts open market operations to adjust for fluctuations in the supply and demand for funds in the market (financial adjustment). When funds are short, the BOJ supplies funds by purchasing securities from private financial institutions, and when there is a surplus the BOJ absorbs funds by selling the securities that it owns. Financial adjustment is carried out in accordance with the fundamental guidelines for financial management as determined at the financial policy meeting, *i.e.*, the guideline for market operations.

To better explain how this functions, a specific look shall be taken at the "Sources of Changes in Current

Chart 4-30 **Sources of Changes in Current Account Balances at the BOJ and Market Operations (July 2023)**

(Unit: JPY100 million)

	Current Year	Previous Year
BOJ Note Sources	1,084	-1,611
Fiscal Sources	-129,824	-89,730
General Fiscal	-25,689	-20,902
Government Bonds	-121,445	-106,683
Government Short-Term Securities	19,232	17,967
Foreign Exchange	423	-365
Other	-2,345	20,253
Surplus or Shortage of Funds	-128,740	-91,341
Market Operations	112,384	-24,699
Outright Purchase of JGB	98,203	53,981
Outright Purchase of Short-Term Government Notes	3,005	3,001
Purchase of Government Bonds under Repurchase Agreement	0	0
Funds-supplying Operations Against Pooled Collateral (Head Office)	0	0
Funds-supplying Operations Against Pooled Collateral (All Offices)	60	-2,149
Purchase of CP under Repurchase Agreements	0	0
Other	11,116	-79,532
Current Deposits	-16,356	-116,040
Reference: Current Account Balance	5,428,092	5,407,009

(Source) BOJ "Sources of Changes in Current Account Balances at the BOJ and Market Operations"

Account Balances at the Bank of Japan and Market Operations" of July 2023. BOJ additionally issued notes of JPY108.4 billion, while fiscal funds resulted in net receipt of JPY12.9824 trillion, so that the "surplus or shortage of funds" in that month amounted to a shortage of JPY12.8740 trillion. The BOJ supplied funds of JPY11.2384 trillion by purchasing JGBs. As a result, the BOJ current account decreased by JPY1.6356 trillion, which brought the balance of this account to JPY542.8092 trillion by the end of the month. The BOJ performed this market operation in line with the guideline for market operations involving the purchase of required amount of long-term JGBs without setting an upper limit in order to maintain the interest rate for 10-year JGBs at around zero percent. Consequently, the outstanding amount of the monetary base at the end of July 2023 reached JPY668.8501 trillion.

2 4 Interest Rate

(1) Interest Rates in the Financial Market

The interest rates in the financial market are determined by the supply and demand of funds in the market. However, the interest rate is not necessarily determined independently in each market. Since interest rate arbitration takes place between markets, the interest rate of each market is linked with that of each other, and if the interest rate of a certain market is extremely high (low), the supply (demand) of funds in that market increases, and as a result the interest rates generally converge at a certain level.

Accordingly, the interest rates in individual markets are determined on the basis of the representative interest rate index. One such index for the short-term interest rate (with maturity of less than one year) is the Tokyo InterBank Offered Rate (TIBOR) set by the Japanese Bankers Association (JBA), which reflects the actual rates on the unsecured call market. By contrast, the 10-year JGB yield that is regarded as a risk-free rate is widely used for the long-term interest rate (with a maturity of one year or more).

(2) Deposit Interest Rate

Interest rates applied to ordinary deposits and time deposits at banks are deregulated interest rates. A deregulated interest rate means that interest rates are freely determined without restriction. In Japan, there had been a long period of regulated interest rates when deposit interest rates had been linked with the official discount rates. From the 1970s, the deregulation of interest rates progressed, and large time deposits, foreign currency deposits and negotiable certificates of deposit (CDs) became the representative deregulated interest rate deposits. Subsequently, the minimum deposit unit for deregulated interest rate time deposits has been gradually reduced, and the interest rate for all time deposits other than fixed date-time deposits was deregulated in June 1993. In addition, in association with the deregulation of the interest rate on floating deposits, the interest rate on deposits has essentially been deregulated since October 17, 1994.

In principle, the interest rate for deregulated interest rate deposits is determined by individual negotiations between a financial institution and a depositor, taking into consideration interest rates, etc., on the short-term financial market.

(3) Interest Rate on Loans

The interest rates on loans from private financial institutions are divided into rates for short-term loans with less than one year to maturity and rates for long-term loans with more than one year to maturity.

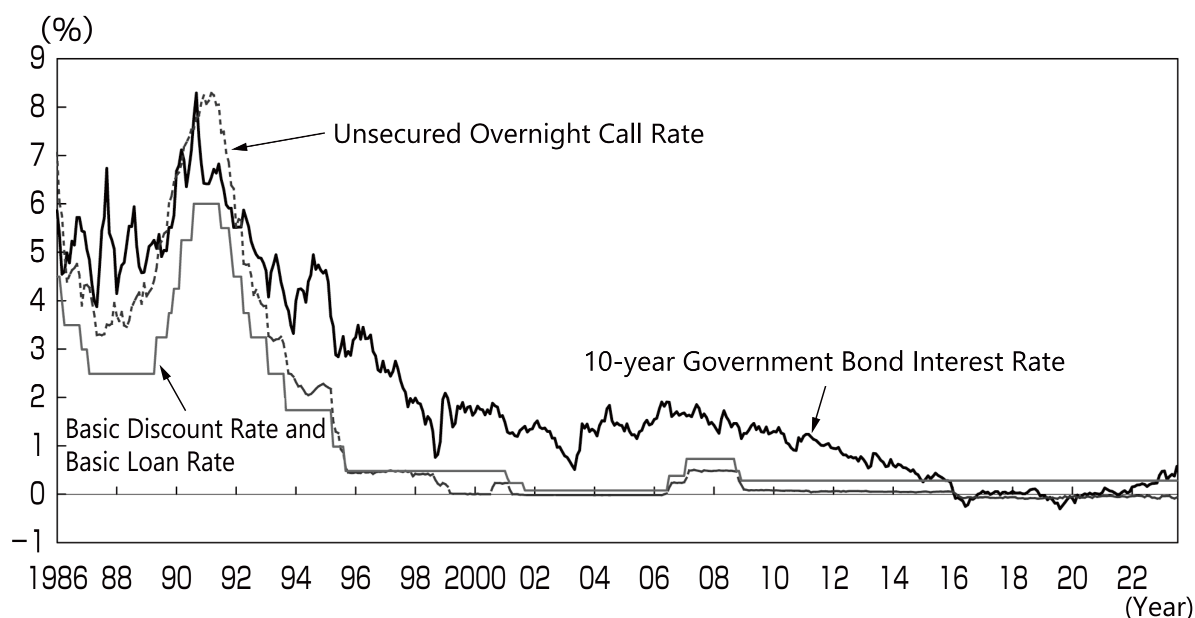
The standard interest rate for short-term loans is the short-term prime rate which is the most preferential rate applied to loans to companies with the best credit. In the past, the short-term prime rate was supposed to fluctuate with the official discount rate. However, since January 1989, the method chosen by each financial institution, considering the funds procurement costs of the bank, fund supply and demand, market rate trends, etc. (new short-term prime rate) has been adopted. As a result, the new-short prime rate reflects the fluctuation of the market interest rate more precisely, and revisions of the interest rate are carried out more frequently.

The representative long-term interest rate for loans is the long-term prime rate. Formerly, the long-term prime rate functioned as the preferential interest rate for long-term loans, but recently it has played a smaller role as the standard interest rate because of, *e.g.*, combinations of short-term and long-term loans. The long-term prime rate used to be determined as being the nominal interest rate of five-year bank debentures of long-term credit banks with the coupon plus 0.9%, and the expected dividend rate of five-year loan trusts of trust banks plus 0.88%, but at the present time is determined by adding a certain margin of profit with reference to the bank procurement cost on the market, such as the issuing rate of interest on five-year ordinary straight bonds issued by a bank. While city banks and regional banks extended long-term loans based on the long-term prime rate in the past, in April 1991 they introduced the long-term floating standard interest rate, linked to the short-term prime rate (new long-term prime rate, floating long-term prime rate), and this has led to the switch to the use of the new long-term prime rate for long-term loans.

The new long-term prime rate varies among borrowers and banks but is typically set by adding a certain interest rate to the new short-term prime rate that is used as a base.

The market is now moving in the direction of banks independently assessing the credit risk of borrowers and adding on an interest rate commensurate with the borrowers' risk, to the interest rate at which the banks procure funds.

Chart 4-31 Trends in Major Interest Rates



(Source) BOJ "Financial and Economic Statistics Monthly" and Japan Bond Trading Co., Ltd., "Historical Date, JGB Rates"

(4) The Basic Discount Rate and Basic Loan Rate (Previously Indicated as "Official Discount Rate")

The Basic Discount Rate and Basic Loan Rate are the standard interest rates applied to loans to private financial institutions by the BOJ and are generally represented by the discount rate of commercial bills. They are the rates in the supplementary credit system (so-called Lombard-type lending) that was decided to be introduced in February 2001, and are the maximum rates paid for short-term loans to financial institutions.

Change in the basic discount rate and basic loan rate exerts an influence on the cost of capital to private financial institutions, but it is thought that the psychological impact of such change is greater than that.

They had been called the Official Discount Rates, but as they had lost their functionality as policy rates, the nomenclature used for statistics was changed effective August 2006.

2 5 Monetary Policy

(1) Objective of Monetary Policy

The two objectives that the BOJ tries to achieve through various monetary policies are "contributing to the sound development of the national economy through the pursuit of price stability," and "achieving smooth and stable operations of the settlement system and thereby contributing to the stability of the financial system."

The BOJ uses various policy tools to conduct money market operations in order to accomplish these objectives. "Stability of prices," that is, stability of the value of the currency, is given particularly high importance as it has direct impact on the lives and livelihood of the country's people. That is why the BOJ is called "the watchdog of the currency." The second objective, the "stability of the financial system," is of similar great importance because if there were to be an interruption in taking deposits or making the payouts for withdrawals by banks, it would practically cause economic activities to come to a halt. The BOJ pays close attention to the exchanges of funds between banks and to the management of the banks, and in the event that a financial institution is unable to meet its obligations, the BOJ makes emergency loans as a "lender of last resort."

The BOJ is not necessarily capable of accomplishing both of these objectives at the same time. Therefore, it is necessary to give priority to either objective. The BOJ therefore manages its policies by giving priority to stable prices on the basis of the awareness that price stability is related to the long-term growth of the economy, while at the same time dealing with the maintenance of the financial system.

(2) Means of Implementing Monetary Policy

As a means for monetary policy, the BOJ implements two tools: (i) open market operations and (ii) reserve ratio control. Both of these tools are used for transactions between the BOJ and private financial institutions, and the primary tool used is open market operations.

In its open market operations (hereinafter referred to as the "operations"), the BOJ makes loans by bidding the loan rate or buys and sells JGBs in the market, causes the level of reserves it holds in current accounts for private financial institutions to rise or fall, and through those measures influences the level of short-term interest rates. When the BOJ buys bonds or other instruments and supplies credit, it is engaged in "buying operations," and when it sells instruments and withdraws funds from the market, conversely, it is a matter of "selling operations."

When the BOJ revised the level of short-term interest rates, it ordinarily causes interest rate arbitrage so that effects of the operations spread and influence the cost of funds to private financial institutions that adjust their

activities accordingly. If, for example, interest rates fall during a phase of economic downturn, the cost of funds to financial institutions declines and the rate they charge for loans also declines. As a result, the investments by businesses and demand in the household sector are stimulated due to the lower cost of funds and expectations of economic recovery arise. On the other hand, when prices are rising and market interest rates in general also rise, the interest rate at which businesses borrow from financial institutions or procure funds in the capital market rises, which in turn restrains the construction of plants and purchase of equipment. When interest rates rise, individuals experience increases in the cost of a mortgage or a consumer loan, and their investment or spending on a home and goods becomes restrained. This would promote a general slowing of the national economy and invite a decline in prices.

The reserve ratio control is a policy that affects the financial market by adjusting the amount of statutory reserves of financial institutions. This is done by changing the reserve ratio. If the BOJ raises the reserve ratio, market rates will rise due to the tightening in funds caused by the obligation imposed on private institutions to increase their deposits at the BOJ. On the other hand, if the BOJ lowers the ratio, interest rates will go down due to the easing of funds caused by the freeing up of funds held by financial institutions. However, in reality, it is the announcement effect which reflects the attitude of the BOJ, rather than the direct effect on the required reserve amount, that has a more substantial influence.

These are the monetary policy tools of the BOJ, but the reserve ratio has not been changed since October of 1991. Therefore, daily monetary adjustments are conducted by operations carried out in accordance with the guideline for market operations that is determined by the Policy Board of the BOJ in its monetary policy meetings. By buying or selling JGBs in transactions with private financial institutions, the level of funds in the market is controlled, and more concretely, the level of funds the private financial institutions have in their current account at the BOJ is caused to rise or fall.

Effects of monetary policies implemented by the BOJ and the achievement of price stability or other final objectives cannot be seen for a long time. Therefore, it is difficult to determine its effect in the short term. For this reason, the BOJ checks on the status of the effects of its monetary policies by checking the money stock, increases in loans and interest rates on loans, etc., which are integrally related to the final objective, these being medium-term objectives of monetary policy.

However, although the medium-term objective is closely connected with the final objective, it is difficult for the BOJ to control. Therefore, the BOJ establishes objectives which are easier to manipulate. Interbank market interest is a representative of such objective, and the key vehicle used was the unsecured overnight call rate.

In the past, when changes in the Official Discount Rate influenced market interest rates, adjusting the Official Discount Rate played an important role in influencing economic activities. When, however, the era of regulated interest rates ended and rates came to be determined by the market, the Official Discount Rate declined in significance as a policy rate. When, from 1995 onward, the unsecured overnight call rate was brought below the Official Discount Rates, it was the unsecured overnight call rate that became the policy rate.

From that time on, the Official Discount Rate was still recognized as an indicator of the BOJ's basic stance on monetary policy, and its change had an announcement effect, but since its nomenclature was changed in 2006 (to become the Basic Discount Rate and Basic Loan Rate) that effect has also been experiencing a steady decline in its importance.

(3) Trends in Monetary Policy Since 2000

The Japanese economy experienced deterioration from the end of 2000. As a result of this, in March 2001, the

operation target for adjustment of the money market that had been defined in terms of the unsecured overnight call rate was changed to the balance in current accounts at the BOJ (account deposit balance targeting). Because a shift from the interest rate to the amount or stock of funds was adopted, the targeting operation is called a quantitative easing. Consequently, change in short-term financial market rates including the unsecured overnight call rate came to be determined by the market, with the upper limit being the interest rate for funds supplied by the BOJ, including funds supplied through the supplementary system (at the official discount rate), and stayed close to zero.

The BOJ ended its quantitative easing policy in March 2006, and returned to using interest rates (the unsecured overnight call rate) for targeting operations. This was because the trend of consumer prices (excluding fresh foods) came to be above the levels of the previous year. Further, in July that year the target for interest rate operations was raised, marking the end of the zero-interest-rate regime.

Nevertheless, from the summer of 2007, the financial markets became unstable against the backdrop of the subprime mortgage crisis, and mushroomed into a global financial crisis with the bankruptcy of Lehman Brothers in September 2008. In order to address this disruption in the financial markets, the BOJ cut the policy rate twice, on October 31 and December 19 of 2008, in the form of cooperation with central banks in other countries (the BOJ reductions were respectively from 0.5% to 0.3%, and then from 0.3% to 0.1%). Moreover, the BOJ has worked to stabilize the financial markets and to support lending to businesses by taking initiative in providing liquidity to the market through means such as increasing its operations of purchases of Japanese government securities (JGSs) under repurchase agreements, increasing purchases of long term JGBs, and purchasing commercial paper.

Subsequently, the BOJ has taken measures for overcoming the deflationary economy or returning to a sustainable growth path through fixed interest operations promoting a longer reduction of interest rates or the new introduction of a loan system for enhancing the growth base. Moreover, on October 5, 2010, it introduced the "Comprehensive Monetary Easing Policy." In addition to cutting the policy rate from 0.1% to 0~0.1%, the BOJ set up a fund for fund purchases, etc. and decided to purchase a variety of financial assets including ETF and J-REIT which have slightly higher risks than national government bonds.

On January 22, 2013, the BOJ decided to introduce the "Price Stability Target" and implement powerful monetary easing so as to achieve a 2% increase in the year-on-year rate of change in the consumer price index at the earliest possible time. The BOJ's previous goal of price stability was shown in the form of "Price Stability Goal in the Medium to Long Term." This time, since the policy goal became clearer, the degree of transparency of financial policy can be considered to have increased.

On April 4, 2013, the BOJ introduced a new monetary policy framework of "Quantitative and Qualitative Monetary Easing." Specifically, it decided to change the main operating target for money market operations from unsecured overnight call rate to monetary base, and conduct money market operations so that monetary base will increase at an annual pace of about JPY60 to 70 trillion. Subsequently, on October 31, 2014, it decided to implement additional monetary easing and conduct monetary policy operations so that the monetary base will increase at an annual pace of about JPY80 trillion.

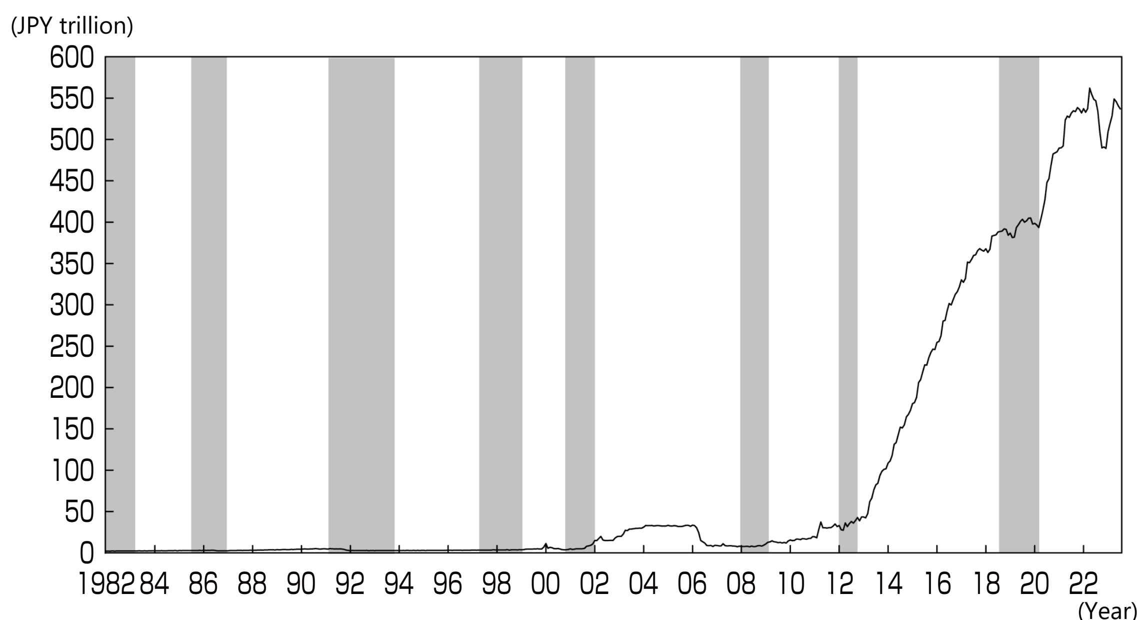
On January 29, 2016, the BOJ decided to introduce "Quantitative and Qualitative Monetary Easing (QQE) with a Negative Interest Rate" in order to achieve the price stability target of 2% at the earliest possible time, and pursue monetary easing in terms of three dimensions; quantity, quality, and interest rate. As a result of the application of a negative interest rate of minus 0.1% to part of the current accounts held by financial institutions at the BOJ, the unsecured overnight call rate and the 10-year JGB yield turned to negative.

On September 21, 2016, the BOJ decided to introduce the "Quantitative and Qualitative Monetary Easing with Yield Curve Control" as a new framework for strengthening monetary easing which consists of the yield curve

control and inflation-overshooting commitment. Under the yield curve control policy, the BOJ will determine and publish the yield curve level at each Monetary Policy Meeting, using the short-term policy interest rate and the 10-year JGB yield as the control targets. Under the inflation-overshooting commitment policy, the BOJ commits itself to expanding the monetary base until the year-on-year rate of increase in the observed consumer price index (CPI) exceeds the price stability target of 2 percent and stays above the target in a stable manner. The BOJ has thus shown its readiness to promote monetary easing toward achieving the price stability target.

On July 31, 2018, the BOJ introduced a guidance note (“forward guidance”) for the policy interest rates whereby monetary policies that are to be implemented will be disclosed well in advance of its implementation and announced that it “intends to maintain the current extremely low levels of short- and long-term interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices including the effects of the consumption tax hike.” In addition, it made policies more flexible by announcing that it would “conduct more flexible purchase” in regard to the purchase amount of long-term national bonds while admitting that long-term interest rates might “fluctuate to a certain degree.”

Chart 4-32 BOJ Current Account Deposits (Average Balance)



(Note) The shaded areas indicate cyclical downturns.
(Source) BOJ “Monetary Base” and Cabinet Office “Indexes of Business Conditions”

On March 16, 2020, in consideration of the impact of the outbreak of COVID-19, the BOJ decided to enhance monetary easing through: the further ample supply of funds by conducting various operations including purchases of Japanese government bonds (JGBs) and the U.S. dollar funds-supplying operations; measures to facilitate corporate financing including the introduction of a new operation; and active purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs). The measures to facilitate corporate financing include: the increase in purchases of CP and corporate bonds; and the introduction of the Special Funds-Supplying Operations to Facilitate Corporate Financing regarding the Novel Coronavirus (COVID-19) to provide loans at the interest rate of 0 percent with maturity up to one year. On April 27, 2020, in addition to the increase in the maximum amount of additional purchases of CP and corporate bonds, the BOJ strengthened the Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus (COVID-19) (the abovementioned operation was

renamed) and took measures such as applying a positive interest rate of 0.1 percent to the outstanding balances of current accounts held by financial institutions at the BOJ that correspond to the amounts outstanding of loans provided through this operation. The increase in the maximum amount of additional purchases of CP and corporate bonds and the implementation of the abovementioned operations targeting large companies were terminated at the end of March 2022. On March 19, 2021, the BOJ reviewed its financial policies for the purpose of implementing sustainable monetary easing in preparation for the prolonged impact of COVID-19 on the economy. The Interest Scheme to Promote Lending, which has been introduced based on the review results, is designed to encourage financial institutions to lend money by giving them incentives depending on the lending outstanding and the short-term policy interest rate, while mitigating the decline in income of financial institutions that may be caused due to the low interest rates. In addition, the BOJ introduced the "fixed-rate purchase operations for consecutive day's system," which has enabled it to carry out the "fixed-rate purchase operations," in which the BOJ continuously purchases JGBs at a fixed interest rate without limitation over a certain period of time, and as a result of that, the framework for fund supply has been further reinforced. On December 20, 2022, in order to improve market functioning while maintaining accommodative financial conditions, the BOJ decided to expand the range of the long-term interest rate from between around plus and minus 0.25 percentage points to between around plus and minus 0.5 percentage points. On July 28, 2023, the BOJ decided to conduct the yield curve control with greater flexibility, allowing the long-term interest rate to rise between 0.5% and 1%, while maintaining the existing framework of monetary easing.

2 6 Changes in Financial Markets

(1) Financial Deregulation and the History of Internationalization in Japan

Financial deregulation and internationalization developed rapidly in the 1980s, with a progressive accumulation of individual financial assets and development of a mutually dependent relationship with overseas counterparts.

First, deregulation of interest rates evolved and many deregulated interest-rate products were introduced. Originally, the deregulated interest-rate products were limited to large funds, but the size was gradually reduced to smaller items and the percentage of deregulated interest-rate products as a means of funds procurement for financial institutions increased. This has resulted in an effort on the part of financial institutions to link their interest rates on loans to the fluctuations in their funding cost.

Second, restrictions on areas in which financial institutions could do business were eased and the businesses handled by financial institutions progressively diversified. The financial system in Japan is based on divisions in the work system and the area of business of financial institutions is separated by the type of business. However, city banks, whose major business in the past was short-term loans to big companies, are increasing loans intended for smaller enterprises and long-term loans, whereas the percentage of long-term loans out of total loans of long-term credit banks is decreasing, and thus the division of roles among banks by type of business is dissolving. Also, the difference between banks and securities companies has become smaller due to the commencement of sales of public bonds and investment trusts at bank teller windows, dealing by banks, and the entry of both banks and securities companies into the CP business. The trend in recent years has been for a further easing of the restrictions of business areas of financial institutions.

Third, deregulation of capital transactions both domestically and overseas has been promoted with the amendment of the Foreign Exchange Act in 1980 and the publication of the Japan-U.S. Yen-Dollar Committee Report in 1984. As a result, Japanese companies actively began procuring funds from overseas and investing in foreign securities to manage funds. In addition, in December 1986, the Tokyo Offshore Market(Note) was established and international financial transactions in Tokyo became active.

Fourth, in 1985, as the securities markets and financial markets in Japan began to expand and internationalize, bond futures transactions began, and after that, so-called derivative product markets such as stock index futures/ options transactions and bond futures options transactions expanded. In April 1989, the Tokyo International Financial Futures Exchange was established and Euro-Yen interest futures transactions, yen and dollar currency transactions and other types of futures transactions began.

Unification of the world financial markets was promoted and the influence of financial markets in Japan on overseas markets, and the influence of overseas markets on the Japanese financial markets have become greater than in the past.

(Note) Offshore markets are international financial markets isolated from domestic financial markets; interest rates are not regulated, deposit reserves are not required, and withholding taxes are not assessed there. In the Tokyo Offshore Market, banks approved by the Commissioner of the Financial Supervisory Agency can open offshore accounts to conduct business.

(2) Development of the Euro Market

The currency traded outside of the country where it is issued is called euro money, and the market on which it is trade is called the Euro Market. Its center is in London.

The Euro Market consists of the Euro Currency Market for short-term funds between banks, the Euro Credit Market for medium and long-term loans and the Euro Bond Market for the issuing and trading of bonds. The Euro Market is a core international financial market because it is not limited by restrictions on the domestic financial markets of each country and the procedures for transactions are simple.

The Euro Market is actively utilized as a place to procure funds by governments, governmental institutions, international institutions and private companies. Syndicated loans and Euro bonds play an important role as the means by which such funds are procured. Syndicated loans are conducted by a number of banks organizing a syndicate for a large amount of medium and long-term loans. This used to be the typical means of raising funds on the Euro Market. However, when accumulated debt became a serious issue in 1982, syndicated loans slowed down and the Euro Bond Market expanded. In addition, instead of borrowing short and medium-term funds from banks, issuance of short and medium-term paper, such as notes and CP issued under the framework of NIF (Note Issuance Facilities), MTN (Medium-Term Notes), Euro-CP, etc., as the need arises and within a certain limit is now widely used.

(3) Introduction of the BIS Regulation

Globalization of financial markets is also influencing financial regulations. One such example is the regulations on the part of the Bank for International Settlements (“BIS”).

BIS was established using capital invested by the central banks of major countries around the world, and it conducts settlements between central banks and deliberates and investigates problems related to international

finance. In July 1988, BIS implemented a rule regarding the international standardization of equity capital ratio requirements for banks called the Basel Agreement, and the banks of major countries that engage in international business agreed that they had to reach an 8% capitalization ratio by the end of FY1992 (“Basel I”). Underlying the Basel Agreement was the understanding that efforts needed to be made by the regulatory authorities of each country in order to integrate financial regulations on an international basis and to maintain financial discipline across borders, in order to address the increasing risks surrounding the management of banks in association with the progress of globalization, and to maintain equal international competitive conditions among the banks of each country. In compliance with the Basel Agreement, in December of the same year in Japan, the BIS regulation was implemented by order of the director of the Banking Bureau of the Ministry of Finance.

Nevertheless, some discrepancies between the BIS system and the practical reality of bank operations, etc. appeared afterward. To address changes in the banking business and greater sophistication of risk management techniques, the Basel Committee on Banking Supervision started work on a revision of the system in 1998, and published the revised framework in June 2004 (“Basel II”). There were three key areas for reform: greater thoroughness in risk measurement, policies for strategic deployment of equity capital by the banks themselves, and greater disclosure. Here, the authorities of the various countries have established a system of domestic controls that was implemented in stages between the end of 2006 and the end of 2007.

Furthermore, in response to the global financial turmoil caused by the Lehman shock, in September 2010, an agreement to introduce a strict definition of “capital,” liquidity regulations and the leverage ratio was reached (“Basel III”). Japanese banks, mainly those adopting international standards, started to apply Basel III in the fiscal term ending March 2013 in phases. In December 2017, the reform of the approaches for measurement of risks (credit/market/operational risks) was finalized. The new measurement approaches were scheduled to be introduced in phases from 2022 and the introduction was expected to be completed by 2027. However, in March 2020, it was announced that the implementation date of Basel III standards has been deferred due to the COVID-19 pandemic. Subsequently, it was decided that Basel III standards will start to apply to domestically active banks adopting the internal model-based approach and internationally active banks from the end of March 2024, and to domestically active banks not adopting the internal model-approach from the end of March 2025. Regarding financial institutions seeking early application, the standards started to apply from the end of March 2023 upon their notification to the Financial Services Agency.

(4) The Japanese Big Bang

In Japan, in order to prepare for a society that is rapidly aging with fewer children and to maintain the economic growth of the future, it is necessary to supply funds smoothly to the growing industries that will support the next generation. There is a heightened understanding now that the financial markets of Japan should be regenerated and it should become an international financial market on equal footing with London and New York so that the financial market will be able to play the role it is supposed to play in allocating the economic resources of the country appropriately.

Based on this philosophy, on November 11, 1996, it was determined that the utmost efforts should be made to thoroughly reform the financial system. The reform was named as the “Japanese Big Bang” after the securities market reform in United Kingdom in the 1980s. The amended Foreign Exchange Act substantively started the reform with its enforcement in April 1998, and among other things, liberalized the foreign exchange business and the money changing business, and enabled the opening of accounts by Japanese nationals at foreign banks. Moreover, competition among financial institutions was increased by the liberalization of stock trading brokerage

commissions and the authorization of banks to sell investment trusts and insurance products over the counter to retail customers; both of which lowered the barriers of entry into banking, securities and insurance business.

Users have acquired greater access to financial instruments through such means as the Internet, and now have a wider range of choice of instruments from various institutions. At the same time, however, as they have acquired greater convenience, wider choices and more chances, they now must also bear by themselves the risk accompanying their choices.

(5) Lifting of Restriction Against Pay-Offs

The pay-off system (deposit insurance) is a system of deposit insurance underwritten by the government-funded Deposit Insurance Corporation whereby depositors are able to receive funds held on deposit by a financial institution that has become insolvent up to a total limit per person of JPY10 million in principal plus the interest earned on that principal. The system is funded by premiums paid by financial institutions according to the amount of funds held on deposit. The system began in 1971, and the amount of deposits covered under the system was raised steadily.

A number of insolvencies among financial institutions beginning in 1994 caused a rise in concern among depositors. In June 1995, the Minister of Finance announced that the full amount of deposits was to be protected by a freeze on pay-offs. Moreover, in June 1996 the Deposit Insurance Act was amended as a special measure to maintain the freeze on pay-offs until the end of March 2001.

The freeze on pay-offs was justified on the grounds that because of the delays in the disclosure of information on financial institutions, including information concerning their financial condition, depositors were not in a position to judge which financial institutions were safe. However, even the freezing of pay-offs was not enough to provide for a solid financial system sufficient to eliminate financial unease, and at the end of 1999, the lifting of the freeze on pay-offs was postponed for a year (this is when the protection afforded to the full amounts of the special deposits (*i.e.*, settlement deposits consisting of ordinary deposits, quick deposits and others) was also extended by a year and expanded to include amounts of interest in the relevant coverage).

Subsequently, progress was made in establishing the guidelines for handling insolvent financial institutions. In April 2002, time deposits excluding certain special deposits (checkable deposits such as ordinary deposits and current accounts) were no longer to be protected for the full amount, and the freeze on pay-offs was partially lifted. In April 2005, the freeze on pay-offs was lifted for deposits other than those used for settlement such as current account deposits and the like (*i.e.*, deposits satisfying the three requirements of being non-interest bearing, subject to mandatory payments and able to provide settlement services). Settlement deposits, however, are still protected in full even after April 2005, from the perspective of having measures in place to assure stable and reliable settlement.

Pay-offs were not actually exercised in Japan for a long period of time, but in September 2010 the Incubator Bank of Japan, Limited became bankrupt, invoking the pay-off system against that Bank for the first time.

(6) Securitization of Assets

"Securitization" of assets refers to the parceling out of the assets of a company such as loans, lease receivables, and the like held by a financial institution or similar party and remodeling the cash flow generated from the assets thus parceled out in this manner into a financial instrument used to repay investors.

The following is the basic structure:

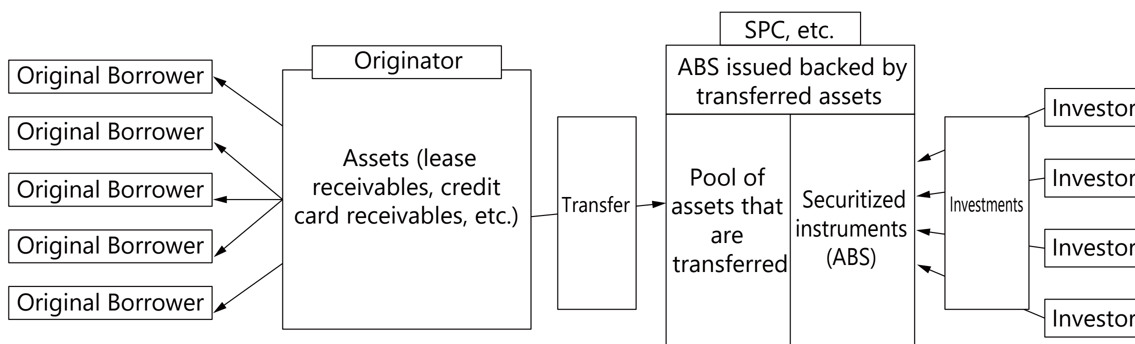
First, a special paper company is established which is called a Special Purpose Company (SPC). Next, the banks and similar parties (the "originator") holding assets in the form of loans and other receivables transfer these

assets to the SPC. The SPC then generates funds through the issuance to investors of securities based on these assets, and these funds are used as the consideration for the assets transferred from the originator. Then, the securities pay dividends to the investors from the cash flow derived from the assets held by the SPC that are in the form of loans and other receivables. Special companies such as SPCs sometimes exist as trusts rather than in company form and given the legal separation that is in place, they serve the purpose of providing insulation against insolvency at the originator.

Any asset can be transferred so long as a cash flow can be nearly assured to be generated and housing loans, lease receivables, credit card loans, auto loans and the like are often securitized. There is even one instance of securitization created on the right to sell the CDs of an entertainer.

A feature of securitized instruments is that they are underpinned by the creditworthiness of the assets generating the cash flow rather than the creditworthiness of the company issuing the security. When raising money through the issuance of corporate bonds, etc., the price is determined by the creditworthiness of the company issuing the bonds. It is on this point where a distinction exists between such securitized instruments and traditional financial instruments. Given that the underlying asset generates a cash flow, securities products in the broad meaning of the term are referred to as asset-backed securities ("ABS").

Chart 4-33 Basic Structure of Securitized Instrument (Concept)



(Note) In the case of a transfer method.

3 Fiscal Policy

The economic activity of the government is called fiscal policy, and fiscal policy is closely related to people's lives. The difference between fiscal policy and the private economy is that each acts according to a different principle.

The private economy works based on a voluntary exchange economy. Producers and consumers act to maximize profit or their personal utility (satisfaction) and, as a result, markets are formed. However, fiscal policy consists of public services supplied unilaterally by the government and public institutions, with taxes unilaterally collected by the government to cover those expenses. A major characteristic of fiscal policy is that transactions are by unilateral fiat and are not based on a voluntary exchange. Consequently, fiscal policy is a public economic activity undertaken by the government, which aims to realize maximum benefit for the society as a whole.

In recent years, the amount of public expenditures have grown, which has brought about a concurrent increase in the national government debts. In addition, Japan is already a full-scale super-aging society, which is expected to

further progress. Under such circumstances, there are many issues, including the review of the social security system to ensure its sustainability.

In FY1990, when the economy expanded due to the asset bubble, Japan was temporarily able to break away from its chronic dependence on deficit bonds. However, after that, Japan has always been suffering fiscal deficits even though it achieved relatively prolonged economic expansions, and thus, the road to financial restructuring has become increasingly severe. On the other hand, the scale of the over-the-counter trading in government bonds reached JPY37.478 quadrillion in FY2022, occupying a very significant share in the securities market.

In this way, the economic activities of the government, the national economy, and financial and securities markets are closely connected, and therefore it is very important to learn the structure of fiscal policy.

3 1 The Public Sector of Japan

Since the economic activities of government are all prescribed by laws, it is important to understand the institutional and legal underpinnings in order to understand fiscal policy.

(1) Structure of the Budget

(i) Compilation of the Budget

Preparation and submission to the Diet of the budget is the work of the Cabinet (Cabinet's prerogative for budget submission), and the actual compilation of a budget proposal is done by the Minister of Finance.

After the Democratic Party of Japan became the leading ruling party in 2009, the method of compiling the budget on and after FY2010 was changed from the previous method. For the budget for FY2010, the conventional system was changed to a politician-led budget compilation system under which the requests for the draft budget will be made in accordance with the manifesto prepared by the ruling party. From the budget for FY2011, the Cabinet decided to adopt a reorganized version of the budgetary request guidelines, and indicated guidelines for budget allocation beyond the framework of ministries and agencies for the purpose of allocating the budget predominantly to areas that contribute to economic recovery and development. However, following the inauguration of the administration led by the Liberal Democratic Party in the central position of power at the end of 2012, the budget for the fiscal year of 2014 and subsequent budgets have once again been compiled according to the budgetary request guidelines, under which each ministry and agency prepare their estimates for the budget (budgetary requests) for the following fiscal year to be submitted to the Finance Minister within the ceiling of the budgetary requests prescribed by each ministry and agency (budgetary request guidelines).

The requests for the draft budget submitted by each ministry and agency in accordance with the budgetary request guidelines are subject to the traditional assessment by the Ministry of Finance as well as the close examination by the Administrative Reform Promotion Council. Through the "screening," the Administrative Reform Promotion Council reviews the contents of operations and proposes to review or abolish operations which are considered to be low-priority. Then, the "Basic Principles of Budget Formulation" are approved by the Cabinet in early December every year and the "Economic Outlook and Basic Stance for Economic and Fiscal Management" is approved and the government's budget proposal is approved by the Cabinet in late December.

The final budget proposal prepared by the Government is submitted to the Diet around the end of January every year. The Prime Minister submits the draft budget on behalf of the Cabinet to the Diet. Deliberation of the budget starts with the House of Representatives (according to “the right of first deliberation of the House of Representatives”).

In the Budget Committee, the national policy as a whole is discussed because the budget is related to all of the country’s activities. After the budget draft is approved by the House of Representatives through deliberation in the committee, it is sent to the House of Councilors, and the budget is adopted if it is also approved by the House of Councilors. If the House of Councilors does not vote within 30 days after the receipt of the draft budget from the House of Representatives, the budget is automatically adopted.

If the House of Councilors rejects the draft budget approved by the House of Representatives, deliberative committees are organized by both houses, and if an agreement is not reached in them, the resolution of the House of Representatives becomes the resolution of the Diet and the budget is adopted.

Chart 4-34 Budget Making Process for FY2023

2022	
July 29	“Basic Policy for Budgetary Requests for FY2023” approved by the Cabinet
December 2	“Basic Principles of Budget Formulation for FY2023” approved by the Cabinet
December 22	“Fiscal 2023 Economic Outlook and Basic Stance for Economic and Fiscal Management” approved by the Cabinet
December 23	Budget proposal for FY2023 approved by the Cabinet
2023	
January 23	“Fiscal 2023 Economic Outlook and Basic Stance for Economic and Fiscal Management” approved by the Cabinet
March 28	Budget bill for FY2023 passed by the Diet

(Source) Ministry of Finance, Cabinet Office

(ii) General Account Budget

The national budget consists of the General Account Budget and the Special Account Budget. The most basic budget is the General Account Budget and reference to the term “budget” generally means General Account Budget.

The General Account Budget is the budget that covers necessary expenses for conducting fundamental financial activities such as public works, social security and education. The basic budget initially compiled as a budget for a certain fiscal year is called the Regular Budget (initial budget). However, even if the budget is not approved before the new fiscal year starts on April 1, the government cannot stop administrative activities. For this reason, the government needs to compile the budget for necessary expenses only until the budget is approved, which is the Provisional Budget. When the Regular Budget is approved, the Provisional Budget loses its efficacy, even if the period for the Provisional Budget or the balance for expenditures still remains. The expenditures or debt based on the Provisional Budget are considered to be included in the Regular Budget.

Even if the budget is approved, there are cases where there is a shortage in the amount available to meet necessary expenses or the contents need to be modified, for example, when a natural disaster occurs during the fiscal year and expenses for recovery are incurred. In such cases, new expenses are added to the budget or the contents are modified and this is called the Supplementary Budget. The Supplementary Budget is prepared,

deliberated and resolved at the Diet separately from the Regular Budget. However, after it is approved, it is executed as if it were a part of the Regular Budget.

In fact, for FY2020, two supplementary budgets were compiled in less than three months after the initial budget had been passed by the Diet, in order to cope with COVID-19 and the deterioration in economic conditions due to the measures to prevent the spread of infection. Furthermore, the government indicated the policy of formulating the third supplementary budget with a view to accelerating infection control measures and initiatives for economic recovery. As a result, the total budget amount for FY2020 reached more than 1.7 times the amount of the initial budget, being revised from JPY102.7 trillion to JPY175.7 trillion. The total budget amount for FY2021 increased from JPY106.6 trillion (initial budget) to JPY142.6 trillion. A large-scale supplementary budget was formulated for FY20222, increasing the total budget from JPY107.6 trillion (initial budget) to JPY139.2 trillion.

Chart 4-35 Summary of General Account Budget

(Unit: JPY100 million)

	FY2022 Budget (Initial)	FY2022 Budget (After the 2nd supplementary budget)	FY2023 Budget (Initial)	Remarks
(Revenues)				○ Dependence on government bonds for FY2023: 31.1% (FY2022: initially 34.3%; 44.9% after the 2nd supplementary budget)
Tax revenue	652,350	683,590	694,400	
Other revenue	54,354	83,817	93,182	
Government bonds issued	369,260	624,789	356,230	
Government bonds under Article 4 (Construction bonds)	62,510	87,270	65,580	
Special government bonds (Deficit bonds)	306,750	537,519	290,650	
Total	1,075,964	1,392,196	1,143,812	
(Expenditures)				
National debt service	243,393	240,717	252,503	
General expenditure	673,746	976,345	727,317	
Social security related expenditures	362,735	409,391	368,889	
Other expenditures	311,011	566,954	358,428	
Local allocation tax grants, etc.	158,825	175,134	163,992	
Total	1,075,964	1,392,196	1,143,812	

(Note) Each figure has been rounded off, and thus differences may occur between the fractions of each figure and those of the total figures.
(Source) Ministry of Finance

(iii) Special Account Budget

The country is originally managed by one account, and it is best if all revenues and expenditures are accounted for by a uniform system of accounts (uniform accounting system). However, in Japan, under Article 13 of the Public Finance Act, a special account is established when (a) the country undertakes a specific project, (b) specific funds are held and managed by the country, and/or (c) it is necessary to separate the accounting for general revenue and the general expenditures and to appropriate a specific revenue to a specific

expenditure.

The number and the contents of special accounts vary from year to year. The number of special accounts for FY2023 is 13, including the special account for grants of allocation tax and transferred tax, and the special account for earthquake reinsurance.

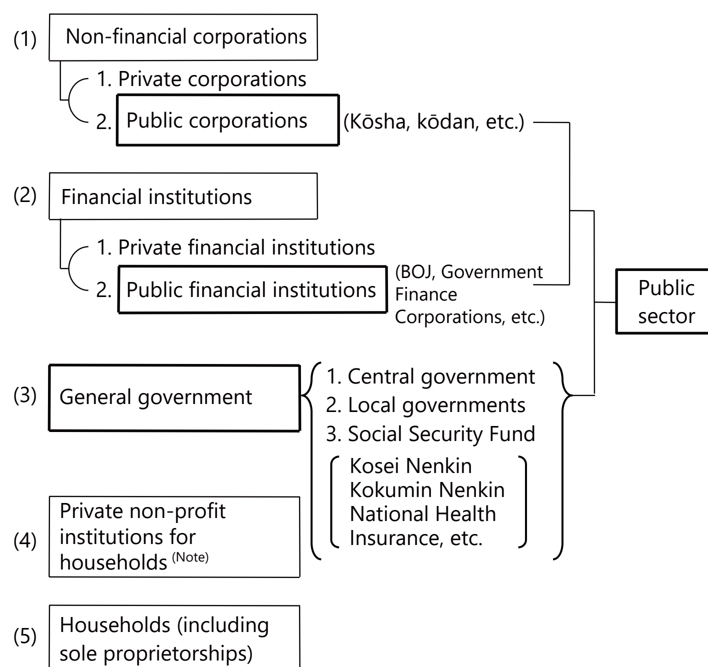
(iv) Budget of Government Sponsored Entities

Government sponsored entities are, in form, special corporations that have a different legal personality from the government, but they are established and 100% maintained by capital investments from the government. The budget for government sponsored entities must also be submitted to the Diet for deliberation and approval. These institutions consist of four organizations, the Okinawa Development Finance Corporation, the Japan Finance Corporation, Japan Bank for International Cooperation (JBIC) and the ODA loans division of the Japan International Cooperation Agency (JICA). These institutions serve the purpose of supplementing private financial activities with their funds which are acquired from expenditures out of the General Account and loans from the Fiscal Loan Fund.

(2) Scope and Magnitude of Fiscal Policy

It is beneficial to understand the concept of the general government in order to see the position of the public sector with respect to the national economy as a whole. The general government refers to the combination of the central government (the country), local governments (prefectures, municipalities, etc.) and the social security fund (public pensions, etc.) in which the overlapping portions are adjusted. The general government plus public corporations (government corporations, government related financial institutions, etc.) constitute the public sector.

Chart 4-36 Classification of Transacting Entities in the SNA



(Note) "Private non-profit institutions for households" include every non-profit institution that is a resident of Japan that provides non-marketable goods and services to households, except for those controlled by or supplied with funds from the government. Specifically, they include private schools, political parties, labor unions, political parties and religious organizations.

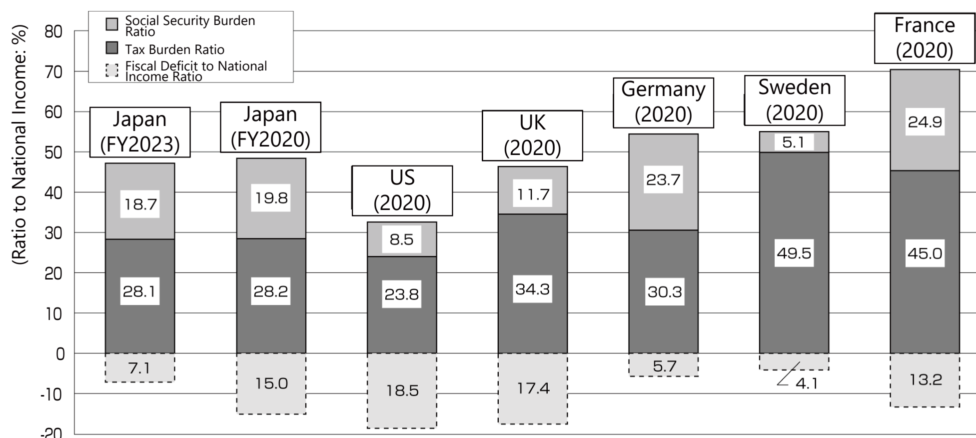
(Source) Prepared based on the materials published by the Cabinet Office

On the other hand, fiscal expenditures in the System of National Accounts (SNA) can be divided into two broad categories, government expenditures and other transfer expenditures in the broad sense of the term. The outlays that make up government expenditures can be further divided into government final consumption expenditures which are current expenditures including education, police, health, and defense; those that amount to total public fixed capital formation; and changes in public inventory (the total of these is called public demand). Transfer expenditures, in its broad definition, includes social security transfers, current subsidies, and transfers overseas by the government. In FY2022, the ratio of public demand versus domestic demand (=private demand + public demand) was 25.8% in nominal terms.

Also, it is useful to look at the scale of public finance using the national burden ratio. This is the ratio of taxes and social security to the national income. According to the data published by the Ministry of Finance in April 2023, the national burden ratio for FY2023 based on the initial budget was expected to be 46.8% (of which taxes account for 28.1%). The national burden in Japan at present appears to be equivalent to or lower than that in the industrialized countries of the Western Hemisphere, but this does not take into account the large fiscal deficit. Since the aging of society is expected to proceed further in Japan, there is a strong possibility that the national burden ratio will outpace the rate of growth in the long term. The national burden ratio, if it also takes into consideration the fiscal deficit, is normally referred to as the potential national burden ratio, and according to the abovementioned

Chart 4-37 Comparison of National Burden Ratios Among Countries

[National Burden Ratio = Tax Burden Ratio + Social Security Burden Ratio]
[Potential National Burden Ratio = National Burden Ratio + Fiscal Deficit to National Income Ratio]



	Japan (FY2023)	Japan (FY2020)	US (2020)	UK (2020)	Germany (2020)	Sweden (2020)	France (2020)
National Burden Ratio	46.8 (34.5)	47.9 (33.5)	32.3 (26.1)	46.0 (34.7)	54.0 (40.7)	54.5 (36.7)	69.9 (47.7)
Potential National Burden Ratio	53.9 (39.7)	62.9 (43.9)	50.8 (41.1)	63.4 (47.8)	59.7 (45.1)	58.6 (39.5)	83.0 (56.7)

(Data source) Japan: Cabinet Office, "National Accounts of Japan"; other countries: OECD, "National Accounts," "Revenue Statistics," and "Economic Outlook 112 (November 22, 2022)

(Notes)
1. The figures for Japan are projections for FY2023 and actual results for FY2020. The figures for the other countries are the provisional values for 2020 based on estimates.
2. The fiscal balance is based on the Government General Account (the total of the central government, local governments, and social security funds); however, the social security funds are excluded for Japan and OASDI Trust Funds are excluded for the United States.

(Source) Ministry of Finance, "Japanese Public Finance Fact Sheet (April 2023)"

data provided by the Ministry of Finance, this ratio for FY2023 was expected to rise to 53.9%.

3 2 Government Expenditures

The government conducts its expenditure activities based on the budget. Only government expenditures of the central government are considered here, and local public finance is explained in a separate subsection. The General Account budget for FY2023 based on the initial budget totaled JPY114.3812 trillion, a 6.3% increase over the previous year. In the following sections, unless otherwise specified, the budget for FY2023 and the amounts (and percentages) of budget items contained therein will be mentioned in reference to the amount of the initial budget.

(1) Primary Balance Expenses

Primary balance expenses are obtained by subtracting part of the national debt from the general account expenditure. As the cost of servicing the national debt is difficult to modify politically, other expenditures are to be considered as being the bulk of expenses for the purpose of national policy. The primary balance expenses for FY2023, at JPY89.5195 trillion, account for approximately 78.3% of the General Account expenditures.

(i) Social Security

This is the largest expense among primary balance expenses as well as among the general account (accounting for 41.2% of the primary balance expenses). Social security expenses can be divided into four categories: pension, medical treatment, nursing care and welfare, etc. The burden of social security expenses is expected to increase in keeping with the on-going trends of low reproduction rates and the swift aging of the population.

(ii) Local Allocation Tax Grants

Local allocation tax grants, etc. (which, in terms of amount, follow those for social security among primary balance expenses) are taxes which have been collected as national taxes and which will be distributed to local governments for their general fiscal resources. These funds are distributed according to the financial power of local governments. Local public finance is operated based on revenue from local taxes, local allocation tax grants, expenditures from the national treasury (subsidies for a specified purpose from the country), local government bonds, local transfer taxes, etc.

(iii) Education and Science Promotion

Expenses for the promotion of education and science account for 6.0% of the primary balance expenses. These include subsidies for the block-grant system for compulsory education, science technology promotion expenses, management expense grants for national university corporations and subsidies for private schools.

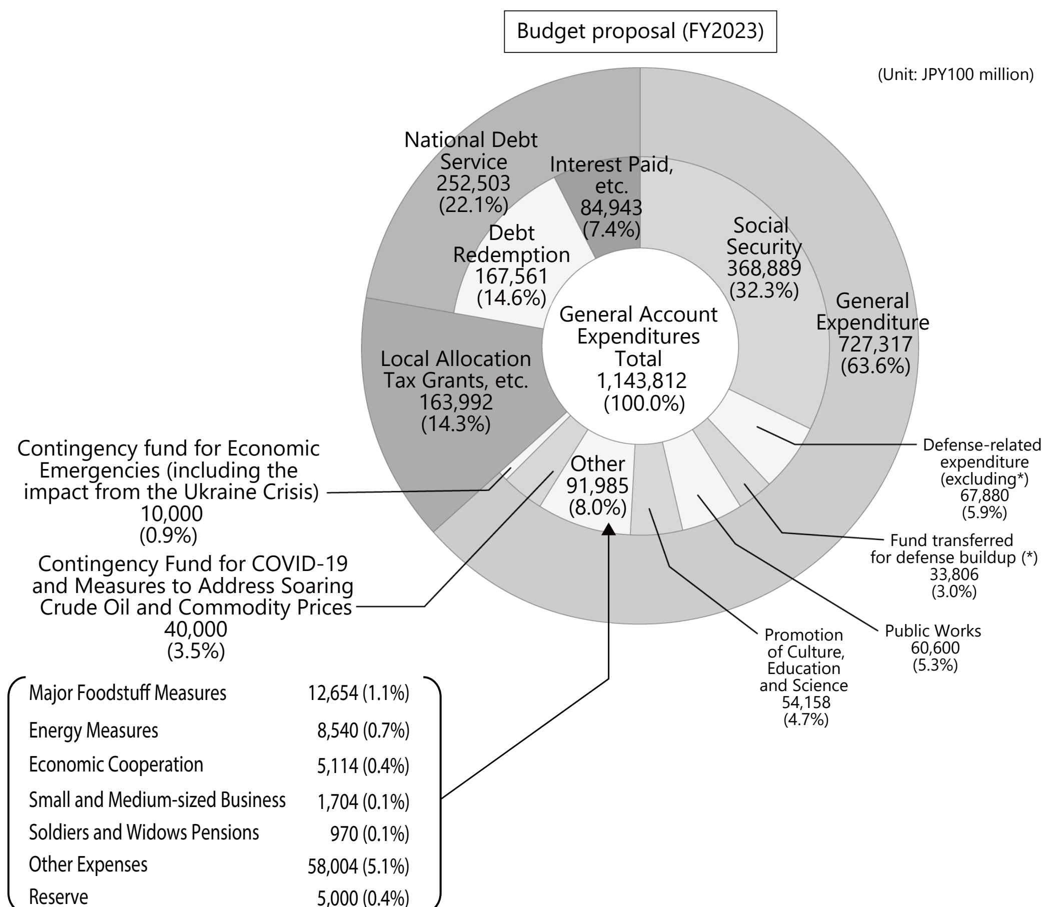
(iv) Public Works

These expenses are for managing the social capital which contributes to the stability of people's lives and the promotion of industries. These include expenses for soil and water conservation, road improvement, improvement of harbors, airports and railways, improvement of housing and urban area environment, improvement of facilities for parks, waterworks, waste disposal, etc., and comprehensive improvement of social infrastructure.

(v) National Defense

National defense is typically considered a true public good, which is impossible to fund from private

Chart 4-38 Composition of FY2023 General Account Expenditures



*General Expenditure is defined as Total Expenditure minus National Debt Service and Local Allocation Tax Grants, etc.

*Primary Expense (= expenditures excluding a portion of National Debt Service from the Total Expenditure. An indicator of policy expenses for the current fiscal year.) is 895,195 (78.3%).

(Notes) 1. Figures may not add up to the total due to rounding.
2. Social security related expenditures account for 50.7% of the general expenditure.
(Source) Ministry of Finance "Japanese Public Finance Fact Sheet (April 2023)"

sources. Opinion is divided on the level of defense expenses, but it is extremely difficult to economically determine the appropriate amount that should be paid. In Japan, since the 1976 fiscal year budget, the National Defense expenditure has been managed based on the restriction that it must remain under 1% of GNP. From the budget for FY1987, the policy to restrict it within the framework of 1% of GNP was abolished but a method to explicitly show the total amount was adopted as a new financial brake. Until now, the level of National Defense expenditure has been changing but remains at approximately 1% of GNI. However, in light of the changes in the world situation, including the Russian invasion of Ukraine, Japan decided to fundamentally reinforce its defense capabilities within five years and take budgetary measures so that the total defense expenditure and other related expenditures will reach 2% of the GDP level of FY2022 by FY2027.

(vi) Contingency Fund for COVID-19 and Measures to Address Soaring Crude Oil and Commodity Prices, and Contingency Fund for Economic Emergencies (Including the Impact from the Ukraine Crisis)

In order to take the policy measures depending on the conditions of the infection, the contingency fund for COVID-19 has been secured, starting from the first supplementary budget for FY2020. This fund was used for purposes such as securing the medical service system and providing vaccinations. In the initial budget for

FY2023, the contingency fund for COVID-19 and measures to address soaring crude oil and commodity prices was secured, accounting for 4.5% of the primary expense. In the second supplementary budget for FY2022, the contingency fund for economic emergencies (including the impact from the Ukraine Crisis) was created.

(vii) Others

In addition to the above six areas, there are expenditures for expenses relating to stable supplies of foodstuff, energy programs, economic cooperation, small and medium-sized enterprise business programs, and pensions.

(2) National Debt Service

National debt service, the second largest expenditure item following social security expenses in the General Account, is for repaying the principal and interest on outstanding government bonds. Interest payments occur every year and it is necessary to repay them regardless of the policy. At the same time, it is necessary to prepare for future repayments of principal. For this reason, 1/60 of the balance of outstanding government bonds at the beginning of the preceding fiscal year is saved and transferred to a Special Account for Government Bond Liquidation. In addition, a certain amount is listed in the budget and appropriated as the need arises.

The amount of national debt service rose sharply in the 1980s when governmental bonds were issued on a full-scale basis, and remained at a high level in the initial budget for FY2023, at 22.1% of the annual General Account budget. When debt service rises in this way it has the effect of restraining budget allocations for other purposes.

3 3 Taxes and Public Bonds

A major source of revenue for the country is the collection of taxes. Payment of taxes is prescribed as an obligation of the people in the Constitution, and taxes as provided for by various laws are imposed on the people. In FY1965, construction government bonds were issued for the first time since World War II, and in FY1975, special deficit financing government bonds (deficit bonds) were issued to cover current expenses. Issuance of the special deficit financing government bonds was conducted as an extraordinary, temporary measure to fill the shortage in tax revenue due to the first oil crisis, but thereafter special deficit financing government bonds continued to be issued every year except in FY1990-1993.

(1) Taxes

Desirable conditions for a tax system are fairness, neutrality, simplicity and low collection costs. Fairness means taxes should become proportionately higher for higher income (vertical fairness), and if the income is the same, the tax to be paid should also be the same (horizontal fairness). A neutral tax system is a system that minimizes the distortion in the allocation of resources (overall degree of satisfaction of the people in society) incurred by the imposition of the tax. A simple tax system is one which is easy for taxpayers to understand and is necessary to deter tax evasion as much as possible. Of course, the lower the tax collection cost, the better.

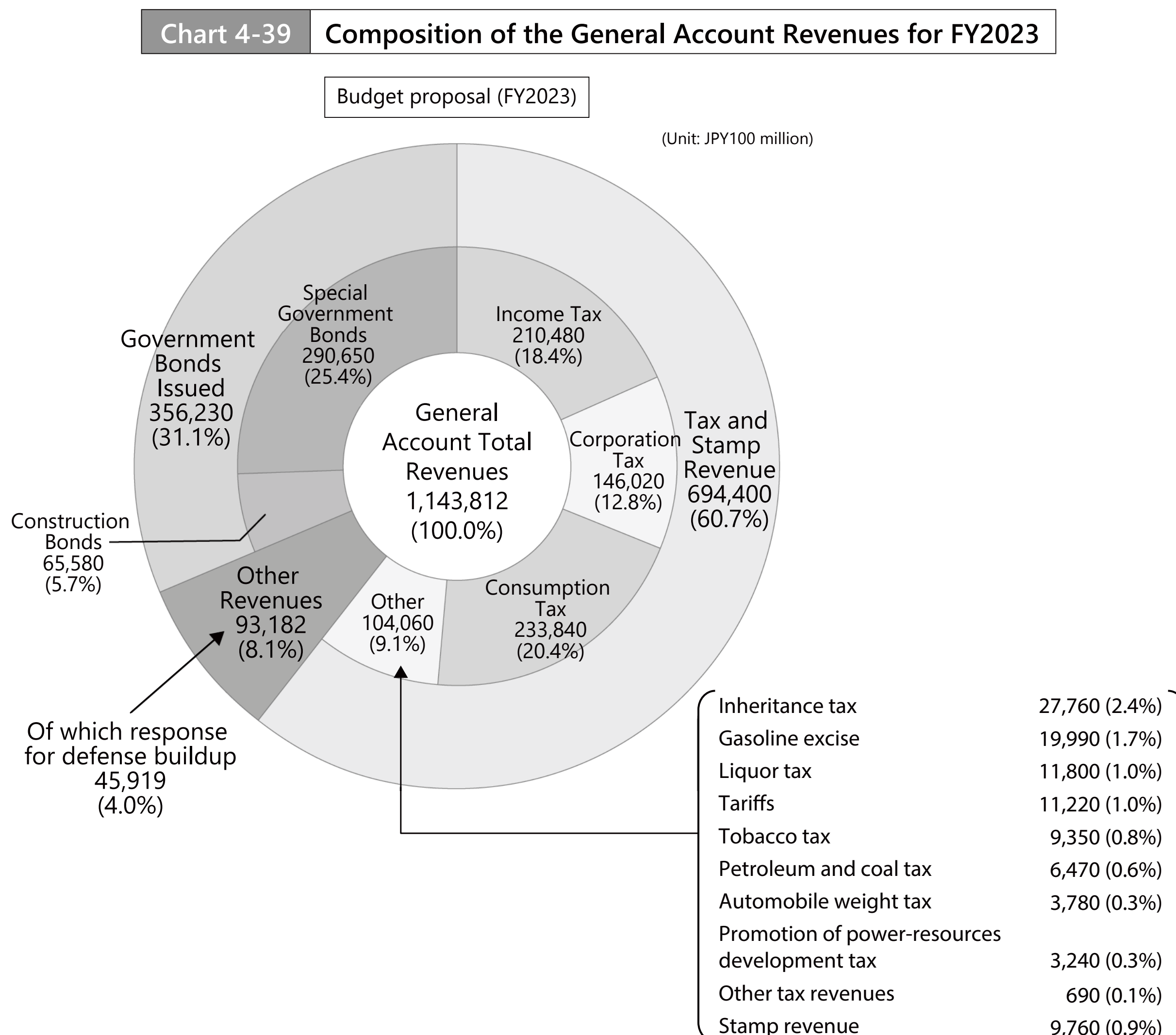
Taxes can be divided in various ways, such as into direct and indirect taxes, national tax and local taxes, or income, consumption and property taxes. Direct tax is paid by the taxpayers directly to the tax authority (including withholding tax), while indirect tax is where the entities to be taxed and the entities to pay the taxes are different.

Government tax is paid to the government and local tax is paid to local governments. Taxes can also be divided according to the basis for taxation.

The tax system after World War II was, in principle, based on the “Shoup Recommendations” made in 1949. The Shoup Recommendations had two features: a tax filing system and a comprehensive income tax. Subsequently, various incentive measures were taken in Japan and as a result the comprehensive income tax became an income tax based on salary income. Furthermore, indirect tax, which supplements the income tax, was collected mainly as taxes on certain specific products until the consumption tax was introduced in April 1989.

The tax and stamp revenues for FY2023 (General Account initial budget) is estimated at JPY69.4400 trillion.

Chart 4-39 Composition of the General Account Revenues for FY2023



(Source) Ministry of Finance “Japanese Public Finance Fact Sheet (April 2023)”

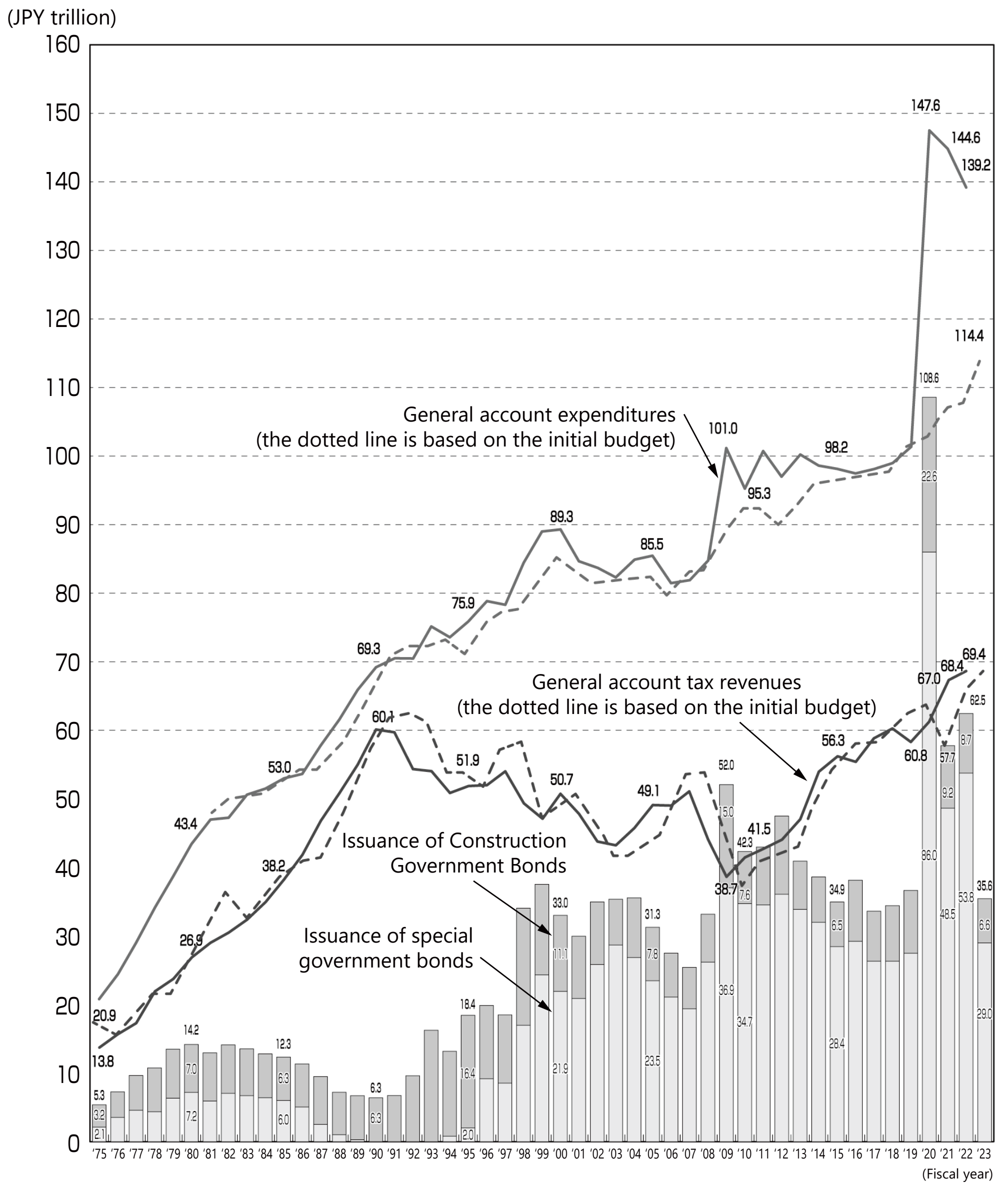
(2) Government Bonds

According to Article 4, Paragraph 1 of the Public Finance Act, in principle the expenditures of the country must have a revenue source other than government bonds and loans (government bond non-issuance policy). However, the *proviso* to Paragraph 1 of the same Article permits the procuring of revenue for expenses related to public work projects, capital investments and loans from the issuance of government bonds and loans within the limit of the required funds (construction bonds). This is based on the idea that because the burden of repayment of interest and principal of government bonds is to be borne by future generations, it is desirable to appropriate income from the issuance of government bonds to the expenditures from which future generations can benefit.

However, since FY1975, special government bonds (deficit bonds) have been issued under special legislation, enacted each year to secure a source of income for current expenses other than those mentioned above.

The increase in tax collections enabled the government to cease issuing special deficit financing government bonds from FY1990 to FY1993. However, the collapse of the bubble in the economy and substantial appreciation of the yen, among other factors, caused the economy to weaken. The government adopted certain economic policies,

Chart 4-40	Trends in Tax Revenues and Expenditures in the General Account, and Issuance of Government Bonds



(Notes) 1. Until FY2021: settlement; FY2022: second supplementary budget; FY2023: budget. The dotted lines are based on the initial budget until FY2022 and the budget for FY2023.

2. The issuance of special government bonds excludes the following bonds: Ad-hoc Special Deficit-Financing Bonds issued in FY1990 as a source of funds to support peace and reconstruction activities in the Persian Gulf Region, Tax Reduction-related Special Deficit-Financing Bonds issued in FY1994–1996 to make up for a decline in tax revenues due to a series of income tax cuts preceding the consumption tax hike from 3% to 5%, Reconstruction Bonds issued in FY2011 as a source of funds to implement measures for the reconstruction in response to the Great East Japan Earthquake, and Pension-related Special Deficit-Financing Bonds issued in FY2012 and FY2013 as a source of funds to achieve the targeted national contribution to one-half of the basic pension.

3. The expenditure for FY2023 includes funds transferred for defense buildup to be used as the financial sources to cover expenses for the Defense Buildup Program for FY2024 and thereafter.

(Source) Ministry of Finance "Japanese Public Finance Fact Sheet (April 2023)"

and starting in FY1994, it restarted issuing special deficit financing government bonds. Pursuant to the Act on Special Measures for Issuance of Government Bonds for Securing Financial Resources Necessary for Financial Management passed in March 2021, special deficit financing government bonds can be issued without undergoing Diet deliberations until FY2025.

In the future, in view of the certainty that the household savings rate will decline and the working population will decrease due to the low birth rate and aging of the population, it is expected that tax collections will decline and social security expenditures will increase. If budgetary deficits cause an annual increase in the cumulative debt of the country, the rise in interest payments will cause the national debt to snowball. If, in addition, the issuance of government bonds drains private sector funds, the decrease in availability of funds will cause interest rates to rise, depressing private fixed investment (this is called the “crowding-out effect”). If the economic growth rate declines because of shrinkage of the working population and falling off of private fixed investment, the economy will fall into a vicious circle where the national debt balloons. This means that without structural reform of the country’s finances, the Japanese economy will be plunged into dire straits in the future, and this is by no means a problem that can be immediately solved.

In connection with this, because of the heightened awareness of the necessity for structural reform of Japan’s fiscal policy, in FY1997 the Financial Structural Reform Act was enacted, applying a brake to the issuance of government bonds. Nevertheless, after heightened anxiety over the soundness of the financial system arose during the latter half of the fiscal year accompanied by weakening of economic performance, this law was repealed and the government changed to a policy of stimulating the economy by increasing public spending from FY1998 onward. Recently, refinancing of government bonds having reached a formidable scale, there has been an increase in the issuance of refinancing bonds in addition to new cash bonds. This too has been a factor behind the increase in the outstanding balance of government bonds.

There are some problems associated with the issuance of government bonds: (a) it puts pressure on private funds and causes a crowding-out effect as well as inflation due to an excessive supply of money, (b) it harms the fairness of income transfers between generations, (c) it makes financial policy rigid as a result of issuing a large volume of government bonds causing a huge amount of repayment of interest and principal on government bonds, and (d) in contrast to tax increases, government bonds can be easily used as a source of income (the sense of burden felt by citizens is lower) causing inflation and loosening of finance.

It is estimated that the amount of ordinary government bonds outstanding at the end of FY2023 will be approximately JPY1,068 trillion.

3 4 Fiscal Investment and Loan Program

The Fiscal Investment and Loan Program (FILP) is investing and financing activities (lending of funds or investment) that enable the provision of funds at long-term, fixed, low interest rates or the implementation of large-scale and super-long-term projects that are necessary from policy perspectives but that are difficult for the private sector to carry out. The FILP Plan is deliberated together with the budget and submitted to the Diet for approval. The FILP Plan is intended to control the flow of funds through the public sector and is a part of public finance. Public finance is the intermediary financing conducted by the public sector, and by the government intermediating between the final users of the funds (for example, private corporations or public entities) and the

savers (for example, households), new assets (for example, loans) and debts (for example, deposits) are created, thereby helping to connect the saved funds with actual investments.

The flow of funds in the FILP is as follows. Funds that must be repaid are borrowed for the FILP Special Account and re-lent to or invested in what are called the FILP institutions, namely government-related financial institutions, public corporations and the like. Funds obtained through the activities of the FILP institutions are paid to the Fiscal Finance Special Account and the Fiscal Finance Special Account repays its obligations by using these funds. Investments by public corporations are mainly conducted based on this plan, and investments by local governments are greatly influenced by the FILP Plan. In this regard, FILP, together with the public works related budget of the General Account, is a central factor that determines the total amount and distribution of public investment and has been considered an important means for implementing economic programs and growth policies.

FILP, together with the budget of the General Account, is politically utilized for policies because FILP loans are made at rates lower than the market interest rates, and funds can be directed toward a specific area. However, with the deregulation of interest rates, some say FILP puts pressure on the private banks beyond the framework of the supplementing of the private sector by the public sector because FILP institutions procure funds at lower rates than the rate paid by private entities. Furthermore, there is less room to lend money at an interest rate that is lower than the market interest rate without depending on subsidies.

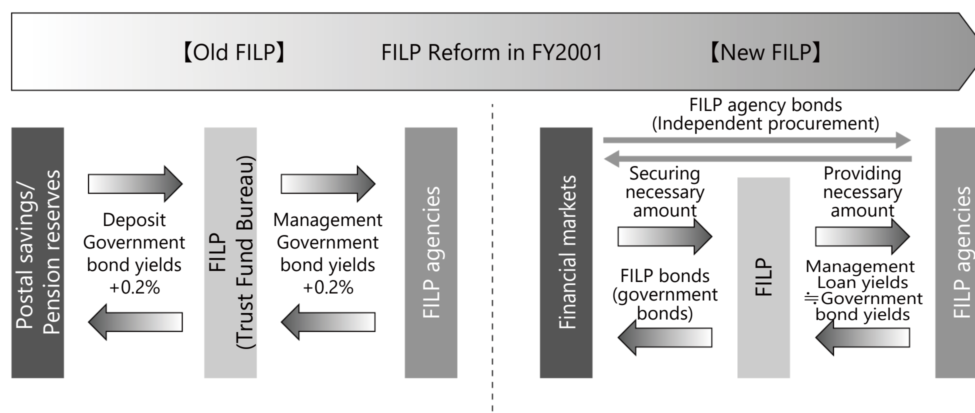
Up until March 2001, the full amount of funds collected as postal savings, national welfare pension contributions and employees' pension contributions was required to be entrusted to the Trust Fund Bureau Special Account (this is the former designation of the Fiscal Finance Funds Special Account). A large share of postal life insurance funds was also allocated for FILP. But this system for automatic transfer of funds enabled the FILP activities to continue to expand, and funds were also being provided from the general account, leading to increased costs at the FILP institutions. It thereupon became necessary to adequately evaluate the purposes and efficiencies of FILP activities.

Because of this, from FY2001, both the mandatory transfer of postal savings and public annuity contributions to the Trust Fund Bureau and the Trust Fund Bureau itself were abolished, and were replaced with the Fiscal Finance Funds system. FILP institutions were authorized to issue bonds and raise funds independently (FILP agency bonds), or issue bonds guaranteed by the government (government-guaranteed bonds), and the Fiscal Finance Funds raises funds by a lump sum to the extent of a shortfall in funding (FILP bonds). Thus, FILP is currently financially independent and operated using funds raised by issuing FLIP bonds and other means, without relying on taxation.

Regarding the investments by these bodies, they are intended to achieve enhanced certainty of efficiency by review of investment plans by quantifying the efficiency through use of policy cost analysis tools. This would enable investment that is best done by the private sector and avoid acts that would increase the national burden.

The FILP in FY2021 significantly increased to JPY40.9 trillion based on the initial budget (3.1 times more than the previous year), reflecting an increase in the amount of Japan Finance Corporation financing for the purpose of supporting the businesses of small and medium-sized enterprises, but then it was JPY18.9 trillion in 2022 and JPY16.3 trillion in 2023.

Chart 4-41 Image of the FILP Reform



(Source) Based on the "Fiscal Investment and Financing Report 2023" published by the Ministry of Finance

3 5 Local Public Finance

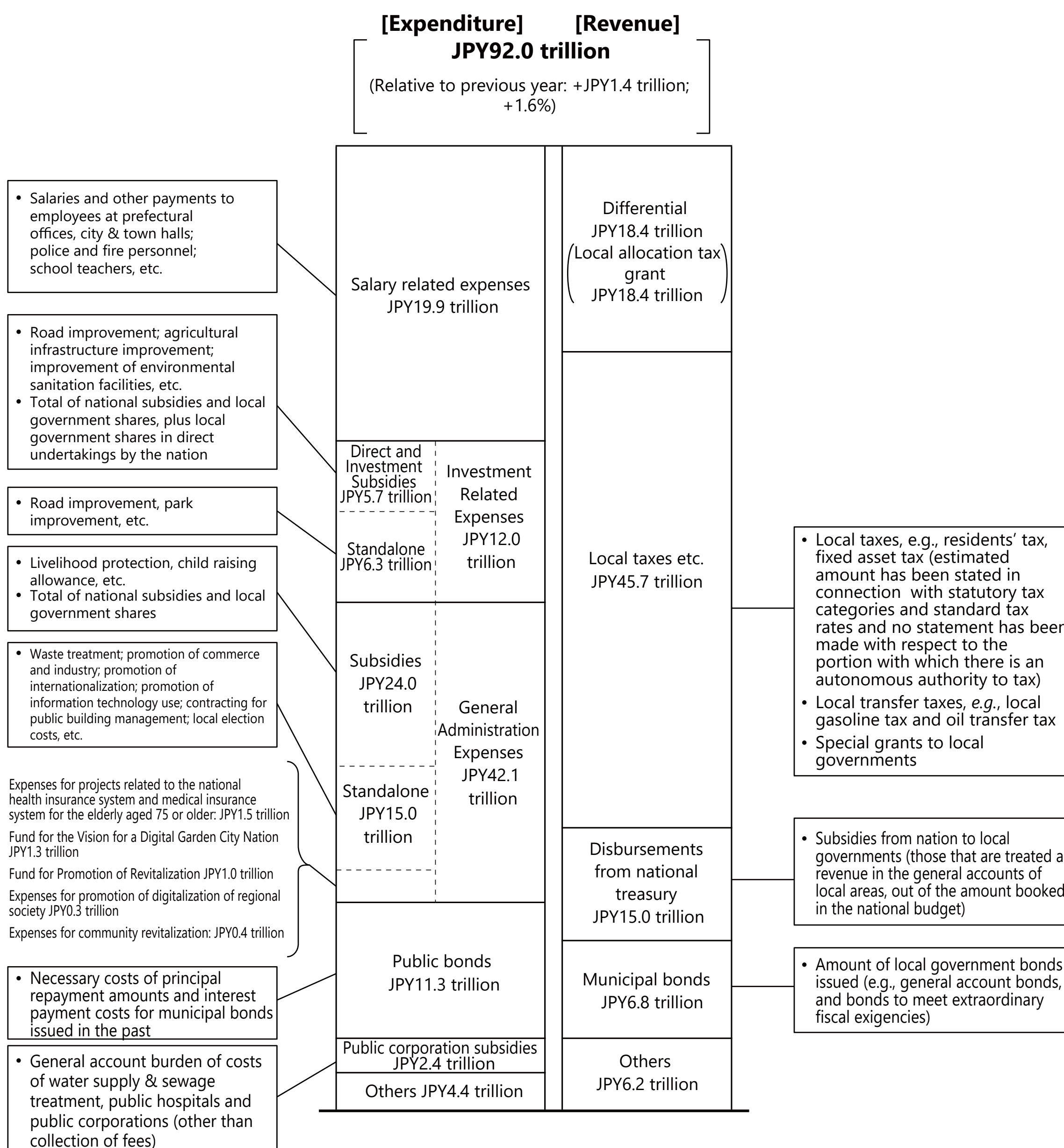
In local areas, similar to central government finance, more than 1,700 local governments represented by 47 prefectures engage in fiscal activities. The structure of local public finance is comprehensively prescribed by the Local Government Act, and is basically the same as the national government. Local governments, in each local area, provide public services closely related to people's lives such as education, environmental protection, livelihood protection, police and fire fighting, etc. The budgets for local governments are also divided into general accounts and special accounts. The special accounts are not uniform as they are divided into those for which creation is required by law or regulation, and those that each local government creates at its discretion, but they are classified into those such as publicly run corporate accounts which are operated in a manner similar to a business and the ordinary accounts that account for other administration.

Expenditures of local governments can be divided into categories including the following categories based on their purpose of use: civil administration expenses, education expenses, government bonds expenses, civil engineering works expenses, general affairs expenses, sanitation expenses, commercial and industrial expenses, agriculture, forestry and fishery industries expenses, and expenditures that are closely related to the lives of residents account for much of such expenditures. In the FY2023 budget, while the general account expenditures of the national government were JPY114.4 trillion, the local government program expenditures were JPY92.0 trillion (or a little less than those of the national government).

Revenue of local government is roughly divided into local tax, distribution of local transfer taxes, special grants to local governments, local allocation tax grants, disbursements from the national treasury, and local government bonds, of which the total of local tax revenues, etc. (local taxes, local transfer tax, and special grants to local governments) of JPY45.7 trillion is estimated for FY2023. National tax receipts amounted to JPY69.4 trillion, so that local tax revenues, etc. are less than national tax receipts. This is because in an attempt to equalize the available fiscal resources between local areas, payments are made from the national treasury to local areas in the form of subsidies that are normally earmarked for a particular use, in addition to transfers of a fixed percentage of national taxes to local areas in the form of local allocation tax grants as resources, the use of which is not specifically designated. Nevertheless, under the review of the allocation of tax resources, including national

supplemental funds, local allocation tax grants and other transfers of taxes, as a result of the "Trinity (three different parts treated as a single one) reform," the autonomy of local areas is being increased while at the same time the current gap of expenditures and tax revenues between local governments and the national government is gradually being ameliorated.

Chart 4-42 Summary of Major Items of the Local Public Finance Program (FY2023)



(Note) The total of the individual items does not match the total of the expenditure and revenue due to rounding off.

(Source) Based on the "FY2023 Outline of Local Public Finance Measures" published by the Ministry of Internal Affairs and Communications and the "Japanese Public Finance Fact Sheet (April 2023)" published by the Ministry of Finance.

3 6 Fiscal Policy and National Economy

As described above, fiscal policy (public finance) is a part of the national economy and is closely related to people's lives.

(1) Public Goods

A major role of the public sector is to provide specific goods and services called public goods. The Japanese economy essentially operates on a market mechanism whereby most of the goods and services are provided by private companies through the market. Specific goods and services such as national defense, police and justice, however, are considered to be necessary for society but are not provided through the market. These goods and services must be provided by the government appropriately. It is also desirable for the government, rather than for private companies, to provide other goods and services such as education. Relying only on the market mechanism could bring undesirable consequences to society (failure to ensure the efficient allocation of resources), which is referred to as the "failure of the market."

The definition of public goods includes the characteristics of the inability of exclusion of consumption (meaning it is difficult to exclude people who do not pay a price for consumption) and non-competitiveness of consumption (consumption by a certain person does not disturb another person's consumption). However, it is impossible to clearly classify all goods and services into purely private goods and purely public goods. Goods that are in-between are called quasi-public goods (mixed goods).

(2) Role of Fiscal Policy

There are three major roles of fiscal policy: the efficient distribution of resources, the redistribution of income and the stabilization of the economy.

(i) Efficient Distribution of Resources

As described above, if the government does not provide public goods and relies simply on the market mechanism to do so, this will result in the inefficient distribution of resources. If the private sector provides public goods, the benefit is enjoyed not only by the purchaser, but also by those who do not pay for it (this is called the "free riders phenomenon"). Since it is impossible to avoid the free-rider phenomenon, leaving the supply of public goods to the private sector will not ensure that the needed amount of goods will be provided to society. In such a case, the government is expected to provide public goods so it results in an efficient distribution of resources.

(ii) Redistribution of Income

Since the economic condition of people is based on the amount of initial holdings, there is no assurance that a socially desirable distribution of income will be achieved even if the market mechanism functions perfectly and the resources are distributed efficiently. It is very difficult to judge whether income is divided equally among individuals, but if the actual distribution of income is skewed, the government can intervene to improve society's standard of welfare (degree of satisfaction) as a whole. Fiscal policy usually imposes taxes progressively on the income of some individuals and transfers the income to other individuals, thereby adjusting the distribution of income.

(iii) Stabilization of the Economy

The economy goes through good and bad cycles, and the role of fiscal policy is to minimize the waves

caused by these cycles and to maintain full employment without inflation. These economic stabilization functions of fiscal policy can be divided into built-in stabilizers (automatic stabilizing effect) and fiscal policy (discretionary business adjustment policy).

When the economy is performing well, tax revenues from income taxes and corporate taxes naturally increase. This restrains individual and corporate demand, thereby resulting in a restraining effect on the economy. On the other hand, when the economy is performing poorly, the tax revenue decreases and financial expenditures, such as social security benefits, including unemployment benefits increase, and therefore stimulate the economy. Thus, fiscal policy has an automatic stabilizing effect on the economy. However, the real economy cannot be controlled by the built-in stabilizer alone, and therefore the government implements discretionary fiscal policies to expand or restrain the scale of public finance based on economic trends.

3 7 Budget Deficit

Budget deficit means that expenditures exceed the revenue of the government. However, the size of the deficit varies depending on how the government is defined and how revenue and expenditures of the government are presented. In general, the accounting deficit, in other words, the government bond revenue, in the General Account budget is used. However, in some cases, the deficit from the perspective of net expenditure and net borrowing (formerly the difference between savings and investment) of the public sector based on the system of national accounts (SNA) is used.

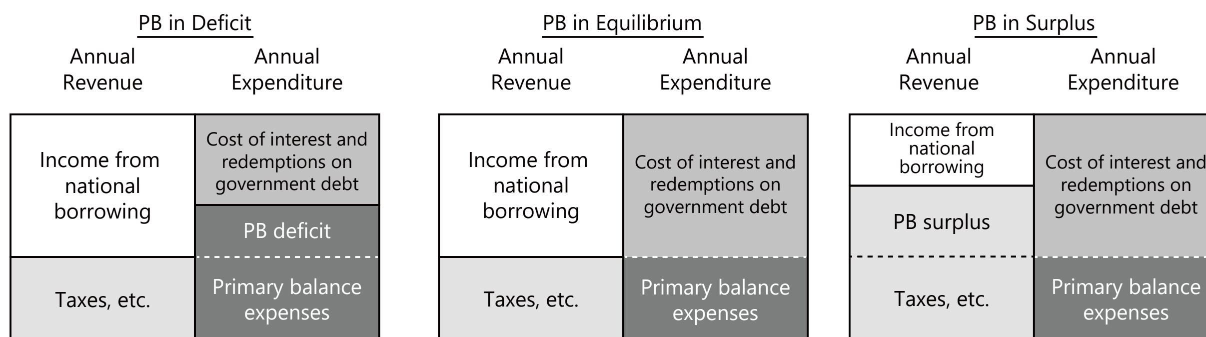
The economic effects of a budget deficit include pressures on the private economy, intergenerational inequality, rigidity of public finance, and big government. Some say that a budget deficit is justified when trying to overcome a recession. Others say that the issuance of government bonds is the same thing as a future tax increase and that this has no material influence on the economy if people expect future tax increases and act accordingly.

In addition, it is also possible to disaggregate the actual budget deficit into an economic cycle portion and a structural portion. When the economy is growing, tax revenue is positive, but it is reversed when the economy is poor. In other words, assuming there is no change in taxation or the scale of expenditure, the budget deficit shrinks when the economy is growing and expands when the economy is in a downward phase of the cycle as tax revenue then declines. Therefore, it cannot be said that fiscal restructuring is taking place smoothly just because the deficit shrinks during a good economy. In order to determine the actual situation, it is necessary to strip out the portion that is affected by changes in the economy. The portion obtained in this way is the structural deficit that remains a budget deficit even when full employment GDP is achieved. The more the structural deficit shrinks, the more strained the finance stance.

One of the indices that is closely watched by government as an indicator of the fiscal situation is the Primary Balance (PB = fundamental fiscal cash flow). The Primary Balance is the balance between revenues other than revenues generated from public borrowing (debt) and expenditures excluding the costs of interest and redemptions on government debt. If this is in balance, fiscal expenditures necessary for the life of the citizenry in any given year should be exactly matched to the tax burden on the citizenry for that year. At present, the government aims to achieve a primary surplus of the central and local governments by FY2025, but the Cabinet Office estimates that the primary deficit for FY2022 would reach JPY27.8 trillion (excluding the expenses and fiscal resources for recovery and reconstruction measures and for green transformation (GX) initiatives). If the average interest rate on debts and

the nominal rate of economic growth are the same, the balance of debt relative to GDP is maintained at a fixed level.

Chart 4-43 Meaning of the Primary Balance (PB)



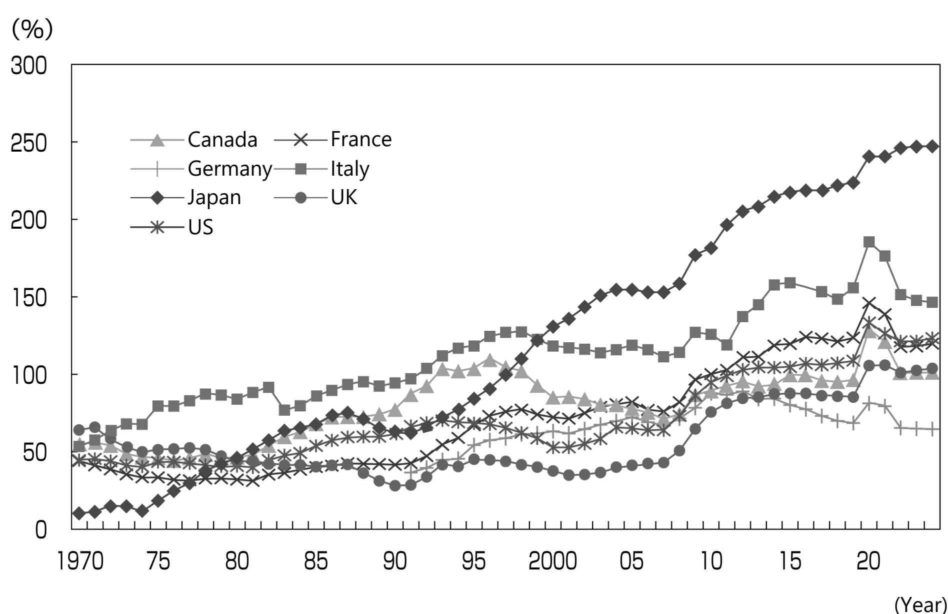
(Source) Made in reference to the materials produced by the Ministry of Finance

3 8 Fiscal Policy in the Future

Lastly, let us talk about how financial management should occur in the future. This subsection focuses on structural issues in the fiscal policy.

Pensions are directly related to issue of transfers of income between generations, and therefore it is necessary to reconsider the benefit levels and equalize the burden. Lately, there are discussions regarding reviewing the ratio of direct and indirect taxes. The taxation system and social security system in Japan is expected to be under greater pressure in the future due to the aging society, and therefore it is necessary to find a solution acceptable to the people of the country (the current generation) as soon as possible.

Chart 4-44 Balance of National Government Debt (Ratio to Nominal GDP)



(Note) The data on Japan for 2021 and thereafter and the data on other countries for 2022and thereafter are forecasts.

(Source) OECD “Economic Outlook”

In Japan, infrastructure was developed significantly during the high-growth period, but in consideration of useful life, most of the infrastructure will need to be renewed in succession from the 2020s. In order to prevent accidents and failures, it is necessary to properly make investments to renovate the aging social capital.

Nevertheless, there is anxiety over the massive scale of the government debts. The national burden in Japan appears to be equal to or lower than the ratios in other industrialized countries, but with the declining birthrate and aging of the population that lies ahead, it is expected that the national burden will rise.

Unless there is broad-based structural or institutional reform in regard to, for example, social security related expenditures, the fiscal deficits will continue to increase, causing the government debts to continue to increase. Seeing that a supplementary budget, which is considered to be relatively easily passed, is formulated every year, we cannot say that the budget as a whole is sufficiently restrained. In order to achieve a primary balance surplus by 2025, which the government is aiming for, it is required to carry out more drastic expenditures and revenue reforms.

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Introduction

Sales representatives have a major role to play as a conduit linking investors and the markets, and they must engage in sales activities with a high level of compliance awareness in order to protect investors and ensure fairness of markets.

To this end, it is important for sales representatives not only to understand and comply with laws, regulations and rules, but also to act ethically as required of them and serve customers sincerely in their day-to-day business.

This Chapter explains basic rules that sales representatives are required to observe. We hope that you understand these rules and aim to become sales representatives who will be trusted and chosen by customers.

1 The Task of a Sales Representative

1 1 Who Is a Sales Representative?

Article 64-3 of the Financial Instruments and Exchange Act (hereinafter referred to as the “FIEA”) provides as follows: “A sales representative shall be deemed to have the authority to conduct any extra-judicial acts concerning acts listed in the items of Article 64, Paragraph 1 of the FIEA (sales and purchases as well as other transactions in securities) on behalf of the financial instruments business operator, etc. to which he/she belongs.” Thus, as is evident even from the text of the law itself, the acts of a sales representative are “acts that represent the financial instruments business operator, etc.,” creating a serious social responsibility.

To carry out their important responsibilities, sales representatives are expected to have at all times an individual professional awareness of the public role of financial instruments business operators, etc., and to approach their work with a high consciousness of legal compliance, professional ethics and self-discipline. Moreover, sales representatives must constantly devote energy to self-development so that they can appropriately analyze the diverse information of the ever-changing market and give effective advice to investors. It is only through these efforts that they will be able to earn the confidence of investors.

1 2 Description of the Task

Investor expectations for returns can vary. Some expect to realize a capital gain on the value of a company as it grows, and others are more concerned with interest and dividend income over the long term. There are also differences among investors in terms of investment experience, investment planning, assets, income and the degree of risk they are able to tolerate.

For example, if the investment plan is one that places priority on the safety of the principal, a suitable recommendation would be to invest in products that provide safety, such as government bonds, and are consistent with the amount of risk the investor can tolerate. On the other hand, investors who are concerned about the

environmental problems might benefit by a recommendation to invest in a company that places value on the environmental, social, and governance (ESG) factors.

Nevertheless, given the myriad of complicated factors that impact the market, it is no easy matter for one to locate the right investment that offers the appropriate balance between acceptable risk and expected returns among a host of financial services and investment outlets.

Also, while the future is uncertain and investment activity is always accompanied by anxieties, by being diligent in one's efforts, it is possible to gain some insight about the future.

The task of the sales representative is to provide useful advice and information, within the framework of certain rules as discussed below, which assists investors in overcoming their anxieties and reaching a final investment decision. This is accomplished by repeatedly selecting appropriate investment targets aimed at an uncertain future.

In other words, a sales representative must arrive at an accurate analysis and understanding of the needs of the investor, and further, he or she must also consider other factors such as the plan and objective of the investment as well as the assets and income of the investor, and offer valuable investment advice based on a sincere appraisal of the future and backed by a full knowledge of the available investment products. By providing valuable investment advice, a sales representative is able to receive a high degree of satisfaction and trust from the customer.

This will lead to greater participation in the markets by investors, and can also be said to make a contribution to the development of a market economy and greater happiness for society in the future.

1 3 Stance for Proceeding with the Task

Having a proper stance is critical for any line of professions, and for the sales representative, the following are required to be considered:

(1) Pay Careful Attention to Basic Behavior

Failure to pay careful attention to the basic behavior required of sales representatives will make it impossible for them to carry out their duties, no matter how much knowledge or ability they have. The following are examples of issues that sales representatives should keep in mind:

- Listen carefully to the customer and learn the customer's intentions;
- Make proposals that are consistent with the customer's intentions;
- Respond to requests from customers promptly and accurately to the fullest extent possible;
- Provide prompt and accurate reports to customers; and
- Keep customer information confidential.

In addition to the above, sales representatives should also be mindful of such other issues and matters as they consider important, and pay careful attention to their basic behavior.

(2) Be Aware That a Sales Representative Is Selling Trust

It goes without saying that trust is an imperative for all sales activity, but particularly in the field of securities

what investors require is appropriate investment advice that meets the needs of the individual investor. Whether or not an investor will use this advice in making a final investment decision depends on the credibility of the financial instruments business operator, etc. and the sales representative. In this sense, it is imperative that sales representatives be aware that they “are selling trust itself.” Also, a sales representative must not act in a way that damages customer trust, such as seeking to advance his/her own interests by using his/her position as a sales representative.

(3) Continually Striving for Professional Development by Oneself

Providing advice tailored to the needs of investors is critical if one is to earn their trust. To this end, it is essential that a sales representative continually stays abreast of a great deal of the most recent information and is prepared to provide products and services that are optimally suited to the needs of the investor.

Sales representatives must always have a full awareness of their capabilities as well as the investment environment, and endeavor to identify and to refine aspects of their skill set that will contribute to their own improvement, such as their professional knowledge and technical skills. By doing this, one will become able to develop a fine-tuned sense of the changes taking place in the world, analyze large volumes of information, and provide quality services to investors.

2 Ethical Sense Required for Sales Representatives

2-1 The Necessity of Possessing a Sense of Ethics

As stated above, a sales representative is authorized to conduct, on behalf of members of the Association to which he/she belongs, any extra-judicial acts concerning trading or other transactions in securities. Therefore, sales representatives are required to perform their duties with a high sense of compliance with laws and regulations, as well as professional ethics and self-discipline, in light of their responsibility as professionals who are constantly engaged in the activities of financial instruments business operators.

For example, acts such as insider transactions or market manipulation conducted by a sales representative in his/her capacity as a professional are absolutely prohibited. This is not only simply to say that a sales representative should not act improperly or unfairly, but to say that as a professional, a sales representative is firmly expected to take the approach of actively taking action to eliminate risk or unfairness (for details, see Volume 1, Chapter 2, “12-3 Market Manipulation (FIEA, art. 159)” and “12-4 Insider Trading”).

Also, business and ethics are not opposed to one another. Only business that is in accordance with legitimate rules should be considered to be socially permissible. One can say that just as a poor quality business does not pay, a business lacking in ethics will not pay. In order to operate a good quality business, it is necessary not only to simply observe the existing rules, but also to take a position where one does not act improperly, even if there is no applicable rule.

Also, in order to foster an appropriate ethical sense, it is necessary to put yourself in the customer’s position, and always calmly consider whether what you are going to do is truly beneficial to the customer. It is also extremely

important to always bear a third party's viewpoint in mind. The act you have considered appropriate may not always be appropriate when viewed from a third party's perspective. When making a decision, it is necessary to consider it from multiple perspectives, such as whether your decision is appropriate for ensuring compliance with laws, regulations and rules, fairness of markets, and accordance with socially accepted standards.

In order to be a good businessperson and a good member of society, it is necessary to take the position of always acting on the basis of conscience.

2 2 Prohibition Against Wrongdoing and Self-Awareness as a Sales Representative

Knowing the purpose of and background to the rules, sales representatives must aim to refrain from acting wrongly or inappropriately.

The purpose of the FIEA, which prescribes the sales representative system, is "to contribute to the protection of investors and thereby to maintain and increase trust in the financial instrument exchange markets by ensuring fairness in issuance of securities and transactions of financial instruments, etc." The self-regulatory rules of the Japan Securities Dealers Association (hereinafter referred to as the "JSDA") have the same purpose.

The acts of a sales representative are acts that represent the financial instruments business operator, etc. Taking into consideration the very large number of customers to which the financial instruments business operator, etc. targets its business and the role played by the financial instruments business operator in the national economy, a sales representatives' acts involve serious social responsibility.

For example, the reason that the FIEA imposes a duty to explain and requires suitability when making solicitations is because there generally is a large information gap between financial instruments business operators, etc. and customers, and to rectify that, the customer should make investments based on the customer's own judgment only after having obtained appropriate and adequate information.

It is inexcusable for a sales representative to act wrongfully or improperly. Such an act will bring about a loss not only on the part of the person who acted in such a way, but also could greatly damage trust in the firm to which the relevant sales representative belongs and the entire industry, as well as the capital markets. It must be remembered that such an act may further damage trust in the capital markets, which may lead to harming even the essential functions of the capital markets, *i.e.,* the smooth investment and procurement of funds, and cause a serious effect even on the national economy. One must understand that the trust in the markets once damaged cannot easily be restored and that it will require a large amount of effort, time and great cost to restore. As a matter of course, this would cause considerable trouble to the customer, who is an investor, and as a result, the sales representative and his/her affiliated financial instruments business operator, etc. would have to pay immeasurable costs, such as the loss of the customer's trust in them.

Penalties for a sales representative who acts wrongfully or improperly can include revoking the sales representative's qualification, or terminating the sales representative's employment, and for a person who acts in such a way as to cause a considerable loss of trust, based on the JSDA Rules, there is also the severe penalty of denial of employment for a period of five years or permanently (*i.e.* Special Members of the JSDA must not allow the relevant person to engage in a registered financial institution business; also, Specified Business Members must not allow the relevant person to engage in the specified business).

In particular, severe criminal penalties are imposed as a result of criminal prosecution in respect of acts such as

insider trading or market manipulation. In these cases, the responsibility of the company as a whole in addition to the relevant person will be brought into question, and if administrative sanctions or the like are imposed, this could affect the company's continuity and the company will inevitably incur major economic losses (for details, see Volume 1, Chapter 2, "12-3 Market Manipulation (FIEA, art. 159)" and "12-4 Insider Trading").

Further, permitting intervention by antisocial forces in financial instruments trading or the financial instruments markets, thereby enabling persons engaged in financial instruments trading to have relationships with antisocial forces, or permitting money laundering and terrorist financing, will not only damage the health of the financial instruments markets and financial instruments-related bodies, but will also result in the loss of trust of many investors.

In recent corporate scandals, there have also been an increasing number of examples that came to light due to whistle-blowing. One must understand that if one acts in violation of laws or regulations, this will invariably be discovered and a severe penalty will be imposed.

You must not engage in illegal conduct, whether serious or minor. If you find any violation of laws or regulations, you must report it to the responsible department or organization. Concealment of wrongdoing can give rise to further wrongdoing. You must bear it in mind that you must not conceal any wrongdoing.

2 3 Points to Keep in Mind in Order to Continuously Maintain Consciousness of Ethics

The following is a summary of points to bear in mind for each individual sales representative in order to maintain rigorous professional and ethical consciousness:

(i) It must be understood that a wrongdoing will invariably be found out. Also, the concealment of wrongdoing can bring about further wrongdoing, and will cause a considerable loss of trust;

(ii) If you find any illegal conduct, whether serious or minor, you must report it promptly. The risk of something leading to an even larger incident must always be borne in mind;

(iii) As a professional, the excuse, "I didn't know the rules," cannot be tolerated;

(iv) It is necessary to make responsible individual judgments, without opting for the easy way out that "since everyone around me also does it, it probably is OK." Decisions on these occasions must not be made on the basis of an individual's assumptions, and in the event of any doubt, advice must be sought from the individual's superiors or specialist sections such as the internal control section or the legal section;

(v) Do not pretend not to see mistakes around you. You must have the courage to correct these mistakes;

(vi) It is essential to have a frame of mind where you can learn from cases of wrongdoing or inappropriate acts that occur at other companies, assuming that you could have been involved in similar cases had you made the same mistakes. You should pay attention on a daily basis and refer to the disciplinary actions taken against members or securities mediation cases, etc.;

(vii) The recent judicial trend is that courts tend to give strict judgments on corporate or professional wrongdoing. It must be kept in mind that it would take considerable time and cost to restore the social reputation once damaged; and

(viii) Strive to distance yourself from an environment that easily invites wrongdoing or temptation.

Together with maintaining health in mind and body, it is essential to act with dignity and moderation, for example, by abstaining from a lifestyle that involves taking on excessive debt.

2 4 Code of Ethics

A code of ethics consists of ethical standards that are stated systematically. Ethical standards are standards for moral behavior in the activities of corporations and individuals, and in the case of profitmaking businesses, a code of ethics has the function of restraining, within socially tolerable levels between multiple interested parties, the seeking of profit that is the basic economic activity of businesses. A code of ethics holds a position as a more fundamental (having a higher ranking) standard than laws and regulations or self-regulatory rules, and the acts, etc. that it targets are broader in scope. Even if the question of whether the act, etc. in question is right or wrong cannot be judged under laws and regulations or self-regulatory rules, it is possible to make a judgment based on ethical standards, and in this sense, a code of ethics can be regarded as functioning as a complement to laws and regulations or self-regulatory rules. As opposed to laws and regulations or self-regulatory rules, compliance with which is subject to external controls and impositions, compliance with a code of ethics is fundamentally due to self-discipline that is based on one's conscience. Therefore, it is important for each person to have a strong will to voluntarily comply with the ethical code.

The JSDA calls upon its members to possess a Code of Ethics. The background to this includes the following:

(i) A series of liberalizations in financial regulations have encouraged competition and have led to diversification in securities products and services, but at the same time, we have also seen acts on the part of certain securities companies that have the possibility of interfering with the fairness and soundness of the capital markets (*e.g.*, conflicts of interest in proprietary trading or problems related to share underwriting); and

(ii) Along with the strengthening of supervision, inspections, and monitoring, as well as the preparation and enforcement of laws and regulations by the authorities, an independent approach by the securities industry has become necessary, and the JSDA was called upon to study the preparation of standards to increase the self-discipline of securities companies.

Further, unlike laws and regulations or self-regulatory rules, ethical standards are not always universal. Therefore the effort to call for appropriate and standard ethical criteria is indispensable. Each Association Member must ensure that its officers and employees understand the meaning of holding themselves to a code of ethics and that each one of them is prepared to comply with the code of ethics voluntarily and actively, so that the code of ethics will not exist in name only.

"Rules Concerning Maintenance of and Compliance with Ethical Code by Association Members"

(i) Aim of Enactment of the Rules

In the "Working Group on Maintaining and Improving Self-regulation at Securities Companies" which was established in April 2007 under the "Securities Strategy Board and the Self-regulation Board," the JSDA acted on the understanding that it was necessary, *e.g.*, (a) to create a code of ethics (a standard model) to serve as a guideline for self-regulation by Association Members, (b) to formulate self-regulatory rules for the

possession of and compliance with a code of ethics at each Association Member, and (c) to establish an organization to study and organize the behavior and customs that are desirable for persons working in the securities industry concerning matters not directly provided in laws and regulations or rules, etc.; and conducted concrete studies, based on the “Research Report Concerning Security Companies’ Codes of Ethics” (for details, see the notice issued by the JSDA to its members dated April 17, 2007, entitled “Sending the Research Report Concerning Security Companies’ Codes of Ethics” (JSDA Notice (*ki*) 2007 No. 4), and its website).

As a result, the “Rules Concerning Maintenance of and Compliance with Ethical Code by Association Members” (hereinafter referred to as the “Ethical Rules”) were enacted in September 2007 as self-regulatory rules for the possession of and compliance with a code of ethics at each Association Member, based on the proposal for self-regulatory rules that was put together by that Working Group. These rules came into effect in December 2007.

(ii) Purpose

The purpose of these rules is to make each Association Member, as a pillar of the capital market, fully understand the importance of their duties as carrying out an intermediary function in the capital market that is entrusted by society, always maintain a sound social common sense and ethical sense for the purpose of obtaining the trust of the people, take measures that are necessary to establish the required professionalism and maintain the high sense of ethics among its officers and employees, and ensure that each Association Member endeavors to prevent any action that causes doubt or disbelief from society regarding the fair execution of business by an Association Member, thus developing trust in the capital market by maintaining and improving self-discipline in its social mission and the roles it assumes (Ethical Rules, art. 1).

(iii) Maintenance and Submission of Code of Ethics

a. Association Members are to maintain ethical standards that include the contents of the relevant model code of ethics that is separately designated by the JSDA depending on the financial instruments and transactions that the Association Members handle or rules that have the same purposes concerning the sale and purchase or other transactions of securities, etc. as prescribed in Article 3, Item 8 of the Articles of Association of the JSDA (hereinafter a “code of ethics”) (Ethical Rules, art. 2).

b. Association Members must submit the code of ethics that they possess by a method determined by the JSDA (Ethical Rules, art. 3, para. 1), and must also submit the code of ethics to the JSDA if its contents are amended (Ethical Rules, art. 3, para. 2).

(iv) Reporting and Explanation Obligations, Etc.

a. An Association Member is to voluntarily report to the JSDA regarding matters that the Association Member determines inappropriate or that may develop to be inappropriate in light of the code of ethics even though these are not directly provided by laws, regulations, and rules. (Ethical Rules, art. 4, para. 1).

b. When the JSDA is aware of the occurrence or existence of matters regarding actions or practices by an Association Member, and the JSDA determines that the matters are inappropriate or that they may develop to be inappropriate in light of the code of ethics even though this is not directly provided by laws, regulations, and rules, the JSDA may request that the Association Member concerned explain such matters (hereinafter referred to as “Material Matters”). (Ethical Rules, art. 4, para. 2).

c. When an Association Member is requested by the JSDA to explain the Material Matters pursuant to Article 4, Paragraph 2 of the Ethical Rules, the Association Member must immediately explain such matters to the extent that this is not in violation of laws, regulations, and orders, etc. made by a competent

administrative agency or other public agency (Ethical Rules, art. 4, para. 3).

d. The JSDA shall request an entity which intends to join the JSDA to submit the code of ethics maintained by the said entity before giving approval for its participation, and also receive an explanation about the details of the code of ethics and the establishment of the internal systems from a person who is to be a representative (Ethical Rules, art. 5).

(v) Establishment of Internal Systems

An Association Member shall establish internal rules that are deemed necessary for the member for the purpose of ensuring the effectiveness of the code of ethics, including the assignment of a person in charge of operation and control, providing education and training to officers and employees, and how to respond in case a violation is found (Ethical Rules, art. 6).

MODEL CODE OF ETHICS

September 18, 2007
(Amended) February 2, 2009

JAPAN SECURITIES DEALERS ASSOCIATION

As an important contributor to capital markets (which provide a principal place for raising and investment of funds for the national economy), we should fully understand our responsibilities concerning carrying out an intermediary function in the capital market, which are entrusted to us by society and pursuant to “The Principles in the Financial Services Industry” published by the Financial Services Agency, we shall make every possible effort to always maintain sound social common sense and ethical sense for the purpose of obtaining the trust of the people and to attain the required professionalism.

As good citizens we must respect each other and eliminate or prevent discriminatory utterances and any kind of harassment based on nationality, race, sex, age, faith, religion, social status or handicap.

Accordingly, we have prepared ourselves to establish the Code of Ethics set forth below as our basic attitude for conducting our business and declare our intention to comply with the Code.

1. Compliance with Social Norms and with Laws and Regulations, Etc.

We must correctly understand and strictly comply with all rules in relation to financial instruments transactions, including laws and regulations for the purpose of protecting investors and achieving fairness in transactions. We shall also maintain and implement social mores and a sense of ethics that are consistent with social norms at large, and will supplement those areas that are not foreseen in laws, regulations, rules or the like.

2. Appropriate Management of Conflicts of Interest

We must manage conflicts of interest relating to our business appropriately. Furthermore, we must not make any improper profits using our position or authority, or any information, etc. obtained through our work.

3. Compliance with Confidentiality Obligations and Information Management

We shall use the utmost care in the management of, and shall maintain confidentiality of, information of which we obtain knowledge in the course of business, with the exception of legally disclosed information and other information that we are permitted to disclose under the regulations concerning information disclosure.

4. Maintenance of Social Order and Practice of Contribution to Society

As a good corporate citizen, we shall positively participate in social activities, and shall contribute to the stability and maintenance of social order. We shall deal resolutely with forces and organizations, etc. that engage in antisocial activities, and shall not conduct any transactions with such persons.

5. Conduct Emphasizing Customers' Interests

In our work we shall ascertain and act in accordance with the customer's knowledge, experience, assets, objectives, etc. concerning investment, and shall at all times take into account the best interests of the customer.

6. Carry Out Work Honestly and Fairly from the Point of View of the Customer

As intermediaries, we shall carry out our work honestly and fairly and from the point of view of the customer, and at all times shall emphasize the needs and interests of the customer.

We will not give favorable treatment to any particular customer by using our authority or position in the company, or comparatively superior usable information. We will also endeavor to uphold the principle of self-responsibility by proper solicitation of investments and by thoroughly carrying out transactions pursuant to the discretion of the customer.

Moreover, if a fiduciary responsibility arises pursuant to a contract into which we have entered with a customer, we will at all times act faithfully for the benefit of the customer.

7. Giving Advice to Customers

When we give investment advice to customers, we should be neutral, clearly separate facts and opinions and make full use of our professional capacity.

In accordance with relevant laws and regulations, etc., we shall not give advice to customers that is based on unpublished information such as insider information which, it is anticipated, would have an effect on the value to be derived from an investment.

8. Conduct in the Capital Markets

Even where there is no provision of law or other rules, etc., the company's Code of Ethics should be consulted in making any judgment concerning conduct that is potentially doubtful having regard to commonly accepted social mores and what is expected of a market intermediary.

In accordance with relevant laws and regulations, etc., we shall appropriately manage unpublished information such as insider information which, it is anticipated, to would have a material effect on the value to be derived from an investment.

9. Consciousness of the Company's Social Mission and Maintenance and Improvement of the Integrity and Reliability of the Capital Markets

We must have a correct understanding of the fairness and integrity of the capital markets, and must do nothing to impede the sound development of the capital markets. We shall further act with the awareness of the social mission that we are carrying out through maintaining the integrity of capital markets.

We shall not participate in any inappropriate conduct that could undermine public trust in the members or damage the integrity of the capital markets by hindering proper disclosure of information, engaging in an act that may lead to the impairment of fair price formation, etc.

3 Compliance with Laws, Regulations and Rules

Financial instruments business operators, etc. have the function of market intermediaries to connect the capital markets and customers, and bear a public role. They must conduct their business activities with a full appreciation of that fact.

3-1 What Is Compliance?

In the Japanese context, the word "compliance" primarily means "compliance with laws and ordinances."

More recently, in the wake of a spate of corporate scandals, the term "compliance" has become more commonplace in general usage. The securities industry also suffered a loss of investor confidence following the demise of the bubble economy and has become stricter about compliance with the laws, regulations and rules designed to ensure investor protection with the intention of regaining investor trust.

Most products handled by financial instruments business operators, etc. are characterized by the risk of adverse price fluctuation and provide no guarantee with respect to the principal. To conduct solicitation of investment regarding such products to an unspecified but large number of investors, sales activity must be sincere, fair and thorough in terms of safeguarding the investor. Many laws, regulations and rules have been enacted in order to achieve this end, and compliance with these is required.

Consequently, sales representatives must naturally fully understand the applicable laws and regulations that govern securities together with the rationale and background leading to their enactment, and must practice lawful and appropriate sales activities.

For this reason, sales representatives are required to act in compliance with the following fundamental ethical standards:

(i) Exercise Diligence in Meeting the Trust and Expectations of the Investors

Investors regard a financial instruments business operator, etc. as a professional worthy of their confidence in matters relating to investments and expect their trades to be carried out in a fair and faithful

manner. Therefore, sales representatives must be diligent in their professional development by acquiring the requisite knowledge and technical skill as well as performing sales activity in adherence to high ethical standards in order to meet the expectations and trust of investors.

(ii) Respect the Investor as the Final Decision-Maker for the Investment

Although the sales representative must provide appropriate advice to investors, the final investment decision must at all times be made at the discretion and liability of the investor themselves. Therefore, sales representatives are required to tell the investor clearly about the principle of individual responsibility by stating like "please be aware that it is the customer who is responsible for making the final decision regarding any investment," or "please be aware that it is the investor who receives the benefit or burden of the outcome of any investment whether or not such investment is profitable."

(iii) Ensure That There Is a Correct and Reasonable Basis for Sales Activities

The principle of individual responsibility is predicated on the investor making the investment decision. However, the investment decision must be based on correct information and a sufficient understanding on the part of the investor.

When providing investment advice to an investor, the sales representative must also provide a full explanation with a rational basis. The content of such explanation and any accompanying materials must be accurate so as to avoid any misunderstanding by investors.

(iv) Consider Factors Such as the Investor's Plan and Investment Objectives When Providing Investment Advice

When providing investment advice, sales representatives must endeavor to become aware of the investment approach, investment objectives, investment experience, assets and other attributes of the customer, and must give investment advice that is consistent with the customer's intentions. However, the responsibility of a sales representative does not end with simply following the customer's wishes. If an investor is clearly engaging in investment activity that is unsuitable given the investor's investment plan and objectives, available assets and level of income, the sales representative is required to give appropriate advice to the investor in order that such investor may reconsider.

3 2 Check List for Sales Representatives

There are many points that a sales representative should take note of when actually conducting financial instruments transactions with a customer.

(1) Confirmation of a Customer Not Being an Antisocial Force

The term "antisocial force" means a person or organization that acts against the social or public interest, such as an organized crime group member, a person related to an organized crime group (*e.g.*, the spouse of an organized crime group member, a so-called corporate associate, and any other person closely related to an organized crime group), an associate corporation of an organized crime group, and a corporate racketeer (*sōkaiya*) (a person acting as a corporate racketeer or committing similar acts seeking unfair profits from companies).

The JSDA Rules provide that an Association Member must obtain an undertaking that the customer is not an

antisocial force before the customer opens an account. It is also provided that an Association Member must endeavor to examine whether a customer who wishes to open an account falls under any category of antisocial force in advance.

(2) Measures Against Money Laundering and Terrorist Financing

Money laundering is an act of concealing the source or true owner of proceeds gained through crimes, in an attempt to prevent such proceeds from being discovered or seized by the investigating authorities. Terrorist financing is the provision of funds for the purpose of supporting terrorism.

Under the Act on Prevention of Transfer of Criminal Proceeds (hereinafter referred to as the "Anti-Criminal Proceeds Act"), financial institutions, etc. have an obligation to promptly notify the Commissioner of the Financial Services Agency of suspected cases of criminal proceeds. As specified business operators under the Anti-Criminal Proceeds Act, financial institutions also have an obligation to establish a system for preventing money laundering and terrorist financing, including the procedure to confirm that the customers' funds are not derived from crimes. Along with the international trend of tightening regulations on money laundering and terrorist financing, financial institutions are required to develop and implement sufficient measures.

(3) Suitability of a Customer

(i) Are the products presented to the investor suitable in light of the investor's knowledge, investment experience, available assets, investment plan, investment purposes and nature of capital (such as type of issues, volume, frequency, etc.)? For investors interested in margin transactions, futures transactions, options transactions and so forth, does the investor pass the trade initiation standards prescribed by the relevant firm?

(ii) In relation to the principle of suitability, do you understand the points to note when soliciting customers, especially elderly customers, to make investment?

A financial instruments business operator, etc. must conduct solicitation for investments in accordance with the principle of suitability.

Generally, elderly people are said to experience a decline in memory or ability to understand or judge, in addition to waning of physical ability. Furthermore, elderly people have fewer opportunities to find a new source of income, and for many, the assets they currently hold may be the required to cover their future living costs. In some instances, customers with experience in investment and who appear to have a sufficient understanding of the investment targets at the time of solicitation may not remember the transactions they themselves executed a few days later. As a result, the customers or their families may lodge complaints, which may also result in mediation or litigation. To prevent such cases, the JSDA Rules provide that when soliciting elderly customers to purchase securities, etc., an Association Member must establish internal rules that include, among other things, a definition of "elderly customers," the scope of securities, etc. to be sold, the method of explanation, the method of taking orders, and strive to only make proper investment solicitations. Therefore, if you solicit elderly customers for investments, you should give due weight to the principle of suitability.

(iii) Do you understand the solicitation commencement standards?

The solicitation commencement standards are standards which provide for the type of customers whom financial instruments business operators can solicit by visiting or telephoning or meeting them at sales counters, in cases where such customers are individuals (excluding professional investors) who do

not request the solicitation of the relevant transaction. Under the JSDA Rules, financial instruments business operators are required to establish such solicitation commencement standards with regard to complex structured bonds similar to OTC derivatives, investment trusts, and leveraged investment trusts, and solicit only those customers who meet the standards. Therefore, when you intend to solicit a customer, you should first confirm whether the customer satisfies the standards.

The JSDA Rules also provide that financial instruments business operators shall fully understand the characteristics and risks of the securities, etc. that they intend to sell to customers, and shall not sell the securities, etc. if they cannot identify customers who are suitable for such securities, etc. (reasonable-basis suitability).

(4) Methods of Information Provision and Solicitation

(i) Was the customer provided with fair and truthful investment information that will not result in any misunderstandings?

(ii) Is the solicitation free of any conclusive statements regarding future price increases or decreases?

The FIEA prohibits the provision of conclusive statements such as “Watch it for a month. The price will definitely rise,” or “A seven percent yield is a sure thing.”

(iii) Was the solicitation carried out at a time that the customer would feel to be annoying?

(iv) Is the trade free of any collaborative transaction with the customer, any pre-trade request or promise for compensation of losses (also known as a guaranteed trade), or any post-trade request or promise for compensation of losses (including any note or statement to a customer who has incurred a loss, indicating that the loss will be compensated)? Was there any post-trade loss compensation? Is the solicitation free of any promise for special profits?

For example, any expression to the effect that “Regardless of the circumstances, we will aim at an annual return of 10%. Should anything happen, we will discuss that with you separately. We will never cause you any harm” is prohibited under the FIEA because it is deemed as promising to offer a special benefit or offering and promising a loss guarantee or compensation. Such action will be subject to administrative action, and the financial instruments business operator, etc. and the sales representative may be punished with a criminal sanction, such as a fine or imprisonment. A customer who requests and obtains a promise for a guarantee or for compensation of their losses will also be punished. Therefore, these actions must be avoided at all costs.

For engaging in such loss guarantees or compensation, the sales representative may be punished by imprisonment for up to three years or a fine of up to JPY3 million, or both. The financial instruments business operator, etc. may be fined up to JPY300 million. A customer (an individual) who requests and obtains a promise for a guarantee or compensation of losses may be punished by imprisonment for up to one year or a fine of up to JPY1 million, or both. The amount received as a guarantee or compensation for losses will be confiscated or the value thereof will be forfeit.

(5) Documents to Be Provided

(i) Was the customer provided in advance with documents (documents delivered prior to contract execution, etc.) including the following matters (there are exclusion provisions)?

- Trade name, firm name or name and address;

- A statement that the operator is a financial instruments business operator, etc. and their registration number;
- Outline of contract;
- Outline of commission, remuneration, etc.;
- If there is "a risk of loss arising" or "a risk that the amount of loss could exceed the amount of the customer's security deposit," a statement to this effect; and
- Other matters provided by law.

(ii) Was the investor provided with an explanation using the required methods, and to the degree required for the customer to understand the documents delivered prior to contract execution, etc. which were provided to the customer, in light of the customer's knowledge, investment experience, financial standing and purposes for entering into the financial instruments trading contract?

(iii) Has a prospectus been provided to the customer prior to or at the time of a primary or secondary offering of shares, etc.? In the solicitation of a primary or secondary offering of shares, etc. are materials differing in contents from the prospectus being used?

(6) Points to Note upon Receiving an Order, Etc.

(i) Is the solicitation free of any sales attempt aimed at unspecified and numerous customers relating to the purchase or sale of a small number of specified securities and continuing for a certain period, simultaneously and excessively, such as would impair the formation of a fair market price? Is an order received from the customer with the knowledge that it could lead to market manipulation or other unfair trading, *e.g.,* by using fluctuations in prices caused by such trading to make profits for oneself or for a third party other than the customer?

(ii) If the sales representative has any corporate information regarding the issuer of the securities, does the sales representative conduct a solicitation by providing such information to customers or make a recommendation regarding transactions to customers even though such information is not provided? Or is the trade conducted for the financial instruments business operator's own account based on corporate information? Has the order for a trade been accepted with knowledge that the trade falls within the category of insider trading, or of the likelihood of that the order falls within that category of trade?

An example of a trade that should be avoided at all costs would be soliciting a customer by saying: "although this is off-the-record, the company is expecting a dividend increase. If you buy now, the price will probably go up." Another example would be readily accepting an order based on a statement from a customer to the effect that "I just heard from a general manager of XX Pharmaceuticals that it will announce a new medicine next month. I think we can make some money if we buy the shares now, so buy 10,000 shares." A sales representative must always consider if, in any conversation with the customer, there is anything unnatural or suspicious in the request for the opening of an account or the trade order, etc. Therefore, knowing the employment of the customer, the motive for the investment and the reasons for selecting the particular securities are all important parts of the business.

(iii) Is the sales representative accepting an order for the trading of securities or any other transaction knowing that the customer is using a name other than his/her own name (*i.e.,* an alias or dummy name)?

(iv) Was the trade approved by the customer? Is the sales representative making any transactions for the customer's account without the consent of the customer?

(v) Has an explanation been provided to the customer of the "important matters" provided in the Act on the Provision of Financial Services (hereinafter referred to as the "APFS") by the time of sale of financial products such as securities, etc.?

The three "important matters" provided in the APFS are as follows:

<Market Risk>

If there is a risk of loss of principal caused by a fluctuation in the markets for interest rates, currencies, share prices or other indices, an explanation must be given that "loss of principal may occur," as well as of "the relevant index that would be the direct cause of this occurring" and "the mechanism by which it may occur." Furthermore, if "there is a risk that the loss incurred could exceed the amount of the initial principal," an explanation must be given of this risk, as well as of "the relevant index that would be the direct cause of loss exceeding the initial amount of the principal" and "the mechanism by which the loss could exceed the initial amount of the principal."

<Credit Risk>

If there is a risk of loss of principal caused by a change in the credit situation of the business or assets of a seller of financial products or a company that issues securities such as bonds, an explanation must be given that "a loss on principal may occur," as well as of "the relevant person who would be the direct cause of this occurring" and "the mechanism by which a loss on principal may occur." Furthermore, if "there is a risk that the loss incurred could exceed the amount of the initial principal," an explanation must be given of this risk, as well as of "the relevant person that would be the direct cause of loss exceeding the initial amount of the principal" and "the mechanism by which the loss could exceed the initial amount of the principal."

<Restrictions on Period for Exercising Rights or Cancellation>

If the product is subject to a period during which the rights can be exercised or cancellation is not permitted, an explanation to that effect must be given.

(vi) Has verification at the time of transaction been conducted at times such as commencing trading or custodial service with a customer as prescribed in the Anti-Criminal Proceeds Act?

(vii) In relation to handling an order from a person other than an account holder, do you understand the requirements that a person who acts as an agent for an account holder must satisfy?

In principle, a financial instruments trading contract must be concluded with an account holder. If it is impossible to execute a transaction with an account holder, you may execute a transaction with the account holder's agent.

If you execute a transaction with an agent of an account holder, the agent must have an authority to act as an agent for the account holder. A person has the authority to act as an agent of another: (1) if the person is granted the authority to act as an agent (voluntary representation); or (2) the authority to act as an agent is stipulated by law (statutory representation). If you engage in a transaction with a person other than an account holder, you must fully confirm that the person representing the account holder has the authority to execute the transaction on behalf of the account holder. Common ways to confirm the other person's authority to act as an agent include requesting the submission of a document that proves the authority to act an agent (or a certificate of registered matters in the case of a statutory agent), or obtaining a notification required by each Association Member.

(viii) Do you understand what you should do if you make a clerical mistake?

If you make a clerical mistake, such as inputting the wrong order data in the computer, you should first report it to, and seek instruction from, the internal administrator. Subsequently, you should deal with the customer in a sincere manner concerning this incident. You must not conceal the mistake or personally ask the customer to accept the wrong order.

(ix) Is the final investment decision made by the investor based on the investor's decisions and responsibilities?

Unless a discretionary investment management contract has been concluded, accepting an order of a trade of securities without having the investor's explicit instructions on each of the criteria of "whether to buy or sell, the type of issue, volume or price" is prohibited. For example, a sales representative can never say anything in which he/she would appear to be making the final investment decision, such as that "Regarding XX shares, I'll make sure to arrange an adequate buy price and volume. Leave it up to me" (except for accepting an order where, in accordance with the provisions of the FIEA, an adequate internal control system has been put in place).

(7) Product Characteristics and Risks

(i) Do you understand the product characteristics and risks of foreign shares?

Similar to domestic shares, foreign shares have price fluctuation risk and credit risk. Fluctuations in share prices are attributable to various factors, such as the issuing company's business results and financial conditions, and market trends. In addition, when handling foreign shares you should take into consideration exchange fluctuation risk. Fluctuations in exchange rates are attributable to factors including the currency-issuing country's financial conditions, political situations and interest policy. Exchange rates for some currencies fluctuate unexpectedly due to low liquidity or exchange intervention.

Furthermore, it is sometimes more difficult to obtain the information of the issuing companies of foreign shares than to obtain similar information for domestic shares. You should make sure to provide customers with sufficient information, such as how to obtain share price information.

(ii) Do you understand the product characteristics and risks of shares issued in emerging countries?

Similar to foreign shares generally, shares issued in emerging countries have share price fluctuation risk, credit risk and exchange fluctuation risk. In addition, low liquidity may be another risk because markets for shares issued in emerging countries have not matured sufficiently.

(iii) Do you understand the product characteristics and risks of standardized margin trading?

Margin trading is defined as the sale and purchase or other transactions in securities conducted by providing a loan or other advance of money or securities to the customer (extension of credit). If a customer is to conduct a margin transaction, the customer needs to submit a predetermined amount of money (or a certain percentage of the transaction amount) as a margin deposit (the customer may be requested to submit an additional margin (margin call)). Therefore, it is necessary to make the customer fully understand the structure of margin trading. Similar to spot trading (such as share trading), margin trading has price fluctuation risk and credit risk. A margin transaction could generate a loss that exceeds the deposited margin. Accordingly, financial instruments business operators should carefully select customers for margin transactions, and must establish standards for commencement of transactions under the JSDA Rules.

(iv) Do you understand the product characteristics and risks of complex structured bonds similar to OTC

derivatives?

Complex structured bonds similar to OTC derivatives are structured bonds with redemption or interest conditions that are determined by OTC derivatives, etc. Examples of these bonds include: (1) bonds with a redemption price that can be less than the face value; (2) bonds with interest that is not determined at the time of issuance, and for which the currency used for redemption payment and that used for purchase payment are different; and (3) bonds with interest that becomes zero or very close to zero depending on the conditions. Customers engaging in transactions of structured bonds could incur an unexpected loss due to the complexity of the structure. Therefore, the JSDA Rules require that Association Members should establish standards for commencement of solicitation when soliciting customers who do not request solicitation for sale of these bonds and confirm beforehand whether the customers satisfy the standards (see (3) Suitability of a Customer, (iii)). In April 2023, the JSDA Rules including the Rules Concerning Solicitation for Investments and Management of Customers, Etc. by Association Members were partially amended (effective as of July 2023) to introduce the following rules:

- When dealing with complex and high-risk products, the top management should be appropriately involved in verifying the reasonable basis suitability;
- Verification should be conducted by a quantitative and consistent method, such as analyzing the risks and returns of the structured bonds previously handled by the company and then verifying the reasonability of risks and returns of the structured bonds to be offered;
- The target customers should be specified (examples are given of the standards for selecting target customers). Solicitation should not be conducted with customers who obviously do not conform to the standards for target customers; and
- Addition of important matters required to be explained to customers (the fact that the product offered is complex structured bonds similar to OTC derivatives transactions, conditions for knock-in, conditions for early redemption, etc.).

In order to strengthen the obligation to explain upon solicitation and sale regarding complex structured bonds or investment trusts similar to OTC derivatives transactions, the JSDA Rules, etc. provide for the following procedures:

(a) Delivery of an Alert Document

Delivering an alert document to the customer, alerting them of the risks associated with the product to be sold and the contact information of the financial ADR organizations;

(b) Explanation of Important Matters

Providing sufficient explanation to customers and endeavoring to gain their understanding regarding the following matters, for example, in addition to the risks and fees specified in the documents delivered prior to contract execution:

a) The fact that the products to be sold are complex structured bonds similar to OTC derivatives;

b) The attributes of customers and the nature of funds that are not suitable for investment in the structured bonds;

c) The customer is considered suitable for purchasing the structured bonds in light of the following, and the reasons therefor:

- The attributes of the "target customers" for the structured bonds were verified based on the

"Concept of Article 3, Paragraph 3 of the Rules Concerning Solicitation for Investments and Management of Customers, Etc. by Association Members" (Guidelines for Reasonable Basis Suitability);
- Product characteristics such as risks, returns, and liquidity;
- The nature of the customer's funds;
- The percentage in the financial assets held by the customer (e.g., the percentage of the structured bonds in the financial assets held by the customer (or the assets deposited by the customer with the company), and the percentage of high-risk products such as complex structured bonds similar to OTC derivatives in the financial assets held by the customer (or the assets deposited by the customer with the company));

d) If the knock-in option is provided, the conditions for knock-in (if multiple reference indicators are involved, conditions for knock-in for each indicator), and the difference in terms of profit or loss from redemption and redemption method between the case where knock-in occurred and the case where it did not occur;

e) If the early redemption option is provided, a statement to that effect, the conditions for early redemption (conditions for knock-out, issuer call option, etc.), and a statement to the effect that in the case of early redemption, the customer may no longer be able to receive interest, in which case the customer may not always be able to invest under the same conditions as before;

f) The estimated amount of loss based on the assumption of the worst scenario (based on a reasonable premise such as data at the time of stress testing in the past; the same applies hereinafter) regarding the level of the financial indicators, etc. involved in the structured bonds (including the volatility level if necessary; the same applies hereinafter);

g) The possibility that the amount of loss might further increase if the situation is different from the premise assumed in f);

h) The details of the estimated amount of sales proceeds in the case of selling the bonds before maturity (the estimated amount of sales proceeds before maturity based on the assumption of the worst scenario regarding the level of the financial indicators, etc., and a statement to the effect that in the case of selling before maturity, the actual amount of sales proceeds may fall below the estimated amount of sales proceeds); and

i) Even if the customer refuses to trade the complex structured bonds similar to OTC derivatives as solicited, such refusal would not affect the customer's future financing transactions (limited to the case where financing transactions are conducted with the customer (except for individuals)); and

(c) Receipt of a Confirmation Document

Receiving a confirmation document from the customer to the effect that the important matters mentioned in (b) above have been explained to the customer and that the customer understands the content of the matters explained.

Recently, the number of complaints and requests for consultation filed by customers of securities companies, etc. with the Financial Instruments Mediation Assistance Center (FINMAC) regarding transactions in structured bonds has been increasing, and most of them are related to the solicitation at the

time of sale of bonds. Sales representatives must thoroughly comply with the principles, such as soliciting customers in accordance with the suitability rules, giving detailed explanation on important matters, and carefully confirming that the customer fully understands the content of the transactions.

In particular, when selling complex structured bonds similar to OTC derivatives, it is necessary not only to simply explain important matters to customers, but also to check whether the customer properly understands the explanation of risks and other important matters, and if concerns remain about the customer's understanding, carefully consider whether or not to continue with the solicitation, rather than merely explaining the important matters to the customer.

Be careful not to place too much emphasis on the fact that the structured bonds are high-interest, high-rating, government-guaranteed, and fixed-income bonds, place too much emphasis on the fact that knock-in is less likely to occur due to the low knock-in level in order to give a reassuring explanation, or simplify the explanation when soliciting the same customer after early redemption. Such explanation could prevent the customer from understanding the important matters properly.

(v) Do you understand the product characteristics and risks of foreign currency-denominated bonds?

As in the case of domestic currency-denominated bonds, foreign currency-denominated bonds have price fluctuation risk and credit risk. Fluctuations in prices are attributable to various factors, such as fluctuations in interest rates and the issuing company's financial conditions. In addition, when handling foreign currency-denominated bonds, you should take into consideration exchange fluctuation risk. Fluctuations in exchange rates are attributable to factors including the currency-issuing country's financial conditions, political situations and interest policy. In the case of bonds denominated in currencies of emerging countries, in particular, the spread for exchanging the Japanese yen and the foreign currency (the exchange fee) becomes large, which could reduce the amount received by customers using the Japanese yen more than they expected. Exchange rates could also show unpredicted fluctuations due to low liquidity or the currency-issuing country's exchange intervention policy. Moreover, there is also a risk that prices could fluctuate due to changes in the political, economic, or social situations in the issuer's country, leading to restrictions on trading or delivery of bonds.

While interest rates for foreign currency-denominated bonds tend to be higher than those for domestic currency-denominated bonds, there are also risks behind them. Therefore, you should properly provide customers with necessary information so that they can understand such characteristics and risks.

(vi) Do you understand the product characteristics and risks of high-yield bonds?

High-yield bonds generate a high rate of yield, as the name represents, due to the fact that they are sold at a high coupon rate corresponding to low credibility or that their unit price is declining. High yield is an attractive feature of this type of bond as an investment target. However, it also means high default risk and low liquidity. Therefore, if you solicit customers to buy these bonds, you should carefully examine the degree of their risk tolerance and ability to understand.

(vii) Do you understand that, at the time of selling an investment trust, you should explain to the customer that dividends may not be paid depending on the fund performance?

Dividends on an investment trust (fund) are paid from investment earnings, and the investment trust is managed with the aim of making a certain amount of payment for each accounting period. If there are no earnings, dividends may not be paid or the amount of dividends actually paid may be smaller than the amount anticipated.

The structure of dividends on an investment trust is difficult for ordinary investors to understand and

can be misunderstood, so you should provide an explanation to customers reflective of the level of their understanding.

(viii) Do you understand that, at the time of selling an investment trust, you should explain to the customer that when dividends are paid, the base value of the fund declines by the amount paid?

Dividends on an investment trust are paid from the investment trust assets collected from investors. Therefore, if any amount is paid as dividends to the investors, the net assets decrease and the base value declines by the amount paid. This differs from interests on bonds or deposits. This structure is difficult for ordinary investors to understand, so you should provide an explanation to customers reflective of the level of their understanding.

(ix) Do you understand the product characteristics and risks of currency-selected funds?

Currency-selected funds are investment trusts under a scheme wherein the investment results obtained from underlying assets, which are the target of investment, can be received in a different currency than that in which the underlying assets are denominated, through exchange trading. Because of this scheme, these funds have exchange fluctuation risk in addition to price fluctuation risk of the underlying assets. Furthermore, investors should understand that premiums or expenses may arise due to a difference in the interest rate between the currency in which the underlying assets are denominated and the currency chosen for exchange trading. It should be noted that exchange fluctuation risk would increase with regard to some currencies for which exchange trading is conducted as a non-deliverable forward (NDF) transaction.

(x) Do you understand the product characteristics and risks of monthly-paid funds?

A monthly-paid fund is an investment trust under a scheme wherein closing is made and a dividend is paid on a monthly basis. As mentioned above, you should provide an explanation to customers so that they will understand that dividends may not always be paid, and if any amount is paid as dividends, the base value of the fund declines by the amount paid.

There are two types of dividends, ordinary dividends and refunds of principal (special dividends), and they are subject to different taxation schemes. It should also be noted that if refunds of principal (special dividends) are paid, the individual principal decreases.

(xi) Do you understand the product characteristics and risks of funds in shares, etc. issued in emerging countries?

As in the case of the shares issued in emerging countries referred to in (ii), there are many risks such as price fluctuation risk, credit risk, exchange fluctuation risk, and low liquidity risk.

(xii) Do you understand the product characteristics and risks of complex investment trusts similar to OTC derivatives?

Complex investment trusts similar to OTC derivatives are investment trusts that will have the same product nature or effect as that of complex structured bonds similar to OTC derivatives as they are managed using structured bonds.

Similar to complex structured bonds similar to OTC derivatives, the JSDA Rules require that Association Members should establish standards for commencement of solicitation when soliciting customers who do not request solicitation for sale of complex investment trusts similar to OTC derivatives and confirm beforehand whether the customers satisfy the standards (see (3) Suitability of a Customer, (iii)). It is also necessary to specify the target customers.

Regarding the explanation upon solicitation and sale, see (iv) above. If there is an early redemption

clause or a clause under which dividends and redemption proceeds are linked with the complex structured bonds similar to OTC derivatives and fluctuate according to the reference indicators, an explanation equivalent to (iv)(b) d) and e) should be provided.

(xiii) Do you understand the product characteristics and risks of leveraged investment trusts?

Leveraged investment trusts are investment trusts managed in a manner that the change rate of net asset value per unit of the investment trust assets will match the value that is calculated by multiplying the change rate of the base indicator by a pre-defined factor (limited to two times or minus two times).

Similar to complex structured bonds or complex investment trusts similar to OTC derivatives, standards for commencement of transactions should be established with regard to leveraged investment trusts (see (3) Suitability of a Customer, (iii)).

Investors may incur a large loss by investing in leveraged investment trusts because these trusts are designed to fluctuate in price to a greater extent than the price fluctuations in the investment target assets. Furthermore, most leveraged investment trusts are created as bull/bear type funds, which are premised on the desire to earn profit by switching funds. You must note that if you solicit customers to switch funds too frequently, you might be taken as attempting to gain more fees.

(xiv) Do you understand the product characteristics and risks of ETFs and ETNs?

ETFs (exchange traded funds) and ETNs (exchange traded notes) are financial products designed so that the net asset value, etc. will be linked with the rate of rise or rate of drop of specific target indicators (stock index, bond index, and REIT index). If the index used as the basis for calculation drops in value due to the changes in economic conditions or other factors, the price of ETF or ETN will drop and may result in a loss.

With regard to ETFs and ETNs, the following points must be kept in mind. Sales representatives must have a deep understanding of the characteristic and risks of these products in advance and provide detailed explanation to customers upon solicitation.

■ Some ETFs and ETNs have characteristics that are different from those of traditional financial products. There is a risk that large fluctuations of the target indicator would cause a great loss in principal, resulting in a loss in investment. Therefore, it is necessary to examine the content of the product sufficiently:

- Leveraged type (Bull type): Products designed to fluctuate at rates that are positive multiples of the fluctuation rate of the target indicator, such as at 2x the fluctuation rate of the target indicator;
- Inverse type (Bear type): Products designed to fluctuate at rates that are negative multiples of the fluctuation rate of the target indicator, such as at -1x or -2x the fluctuation rate of the target indicator; and
- Enhanced type: Products designed to track new indicators to produce certain investment results (*e.g.*, covered-call indicator, risk control indictor, and market neutral indicator).

■ Leveraged-type and inverse-type ETFs and ETNs have the following risk characteristics, and it is necessary to be fully careful when investing in these products:

(i) The leveraged index is not suitable for long-term holding because the fluctuation rate will not be twice the fluctuation rate of the target indicator in two or more days, and so there is high possibility that the value will gradually decrease over a mid to long term period; and

(ii) Since futures transactions are conducted in order to have the leveraged-type or inverse-type ETFs or ETNs linked with the reference index or indicator, investors generally bear the cost of the futures transactions and also bear the risk upon the switching when the contract month of the futures transactions arrives.

With regard to leveraged-type and inverse-type ETFs and ETNs, the Cabinet Office Ordinance on Financial Instruments Business, etc. prescribes the following matters as matters that should be included in the advertisement and explanation in order to have the abovementioned characteristics of risk reflected therein:

(a) a statement that there will be a difference between the underlying index and the leverage index, etc., and the reason thereof;

(b) if the products are not suitable for mid to long-term investment, the statement to that effect, and the reason thereof;

(c) the characteristics of the leverage index, etc. and other matters that require customers' attention.

■ Other risks

・Early redemption risk: If the management company finds it difficult to continue investment due to a sudden change in the market trend or for other reasons, the management company may redeem (cash out) the ETFs or ETNs before maturity. It is necessary to confirm the conditions for early redemption for each product.

・Issuer credit risk: Unlike ETFs, ETNs do not hold underlying assets, and therefore, an ETN's price may decline due to bankruptcy or a deterioration of financial conditions on the part of the issuer.

* The outline and investment risks of individual products are available on the Tokyo Stock Exchange website.

In addition to the abovementioned, attention should be paid to actively managed ETFs. Actively managed ETFs are ETFs which do not track underlying indicators, unlike indicator-tracking ETFs which are linked to specific indicators such as a stock price index with the aim of achieving specific financial results. Actively managed ETFs have different characteristics in terms of price movements and expected returns than indicator-tracking ETFs. As actively managed ETFs do not track underlying indicators, management companies can manage them flexibly in response to market conditions and other factors. However, there is also a possibility that management striving for high returns may result in price movements that cannot be explained by fluctuations in the overall market or investment performances that underperform the benchmark.

(xv) Do you understand the product characteristics and risks of real estate investment corporations (real estate investment trusts; J-REITs)?

Real estate investment corporations or real estate investment trusts (J-REITs) are listed on an exchange and can be traded in the same manner as share trading. J-REITs invest principally in real estate, etc. and asset-backed securities, etc. that primarily target investments in real estate, etc., and distribute rent proceeds, etc. to investors.

Like shares, J-REITs have price fluctuation risk. In addition, as dividends are paid from earnings from the invested real estate, etc., investors might incur unexpected losses if unpredictable events occur,

such as if the management of the real estate does not go well or the real estate is subject to a natural disaster.

(xvi) Do you understand the product characteristics and risks of futures trading?

Futures trading is a contract to conduct a sale and purchase on a predetermined date in the future at a price determined today. The major financial futures currently listed on the exchanges in Japan include various share price index-related futures (*e.g.,* TOPIX, REIT, Nikkei Average), bond futures and interest-rate futures. When conducting a futures transaction, customers are required to deposit a predetermined amount (or a certain percentage of the transaction amount) as a margin.

As futures trading is conducted on the promise of future payment and futures prices fluctuate to a greater extent than spot prices, investors could incur an unexpected loss. Furthermore, investors can trade multiple issues during the same contract period. However, if the trade cannot be settled when the contract expires, the exchange or securities firm will use the margin deposit at its own discretion to pay the obligations, without giving any notice or warning and without having to follow any legal procedures. It should also be noted that a loss could occur in excess of the margin deposit.

On the other hand, futures trading can provide a wider range of investment choices because it can transfer (hedge) price fluctuation risk.

(xvii) Do you understand the product characteristics and risks of options trading?

Options trading is a transaction in which one purchases or sells the right to buy (call option) or sell (put option) a specified financial product (underlying security) at a specified price (exercise price or strike price) by a specified future date, regardless of the market price of that underlying security at the time. The major options currently listed on exchanges in Japan are share index options, securities options (options for which individual shares, individual REITs, and individual EFTs are the underlying securities), and JGB futures options. If conducting an options transaction, customers are required to deposit a predetermined amount (or a certain percentage of the transaction amount) as a margin.

As options have price fluctuation risk, a loss that exceeds the margin deposit could arise in options trading. It should also be noted that there is a time limit for the exercise of the option.

On the other hand, options trading can limit risk and create profit and loss patterns that are not found with underlying products.

(xviii) Do you understand the product characteristics and risks of OTC derivatives trading?

Unlike market derivatives trading, the conditions for OTC derivatives trading can be determined depending on the customer’s needs. Various types of assets can be the underlying assets for OTC derivatives, such as securities, interest rate, exchange rate, and commodity price index. OTC derivatives transactions can be roughly divided into three types: forward transactions, swap transactions, and options transactions. Complex derivatives transactions can be created by combining these types of transactions.

As OTC derivatives transactions are negotiated transactions, unlike market derivatives transactions, each party bears the risk of the other party falling into default (counterparty risk). Market prices of derivatives change along with the changes in the prices of the underlying assets and the passage of time. It should also be noted that investors could incur a loss depending on market liquidity.

(xix) Do you understand the product characteristics and risks of (domestic or overseas) trading in covered warrants?

Covered warrants are warrants or certificates which represent options based on individual shares or indexes. There is a time limit for the warrant holder’s exercise of the right. Furthermore, investors could

lose the whole investment amount depending on the price fluctuations of the underlying assets, and prices can fluctuate significantly. Accordingly, Association Members are required by laws and regulations as well as the JSDA Rules to collect a written confirmation from customers when commencing trading in covered warrants.

When you explain this product to customers, you should pay attention to the following points:

・Unlike bonds, covered warrants become worthless upon the arrival of the exercise date;
・While the price rise in covered warrants is larger than that in shares, the price fall is also larger than that in shares;
・If the share price falls below the exercise price and there is no prospect for a price rise in the future, the price will decline as the remaining period before maturity lessens; and
・As the remaining period lessens, covered warrants are less likely to be quoted.

(xx) Do you understand the product characteristics and risks of VWAP guarantee trading?

VWAP guarantee trading is sale and purchase of share certificates, etc. listed on an exchange at a price based on the VWAP (Volume Weighted Price Average). As the VWAP is a weighted price average, it is not always an advantageous price depending on the price movements on the relevant day.

(8) Solicitation for Switching Investment Trusts

When soliciting a transaction for switching investment trusts, has an explanation of the important matters in connection with switching been given for both the investment trust to be sold and the investment trust to be purchased?

Under the Cabinet Office Order on Financial Instruments Business, in connection with the solicitations for switching of investment trusts, if the financial instruments business operator, etc. has not provided a customer with any explanation on important matters regarding such switching, it is considered to be a circumstance where business operations are in a state that is contrary to the public interest or that is likely to compromise the protection of investors.

The FSA’s Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. points out that solicitation of frequent switches to other investment trusts may not necessarily lead to the customer’s stable and effective asset building due to such factors as increased costs arising from additional commissions on sales and, in terms of asset management, a potential decline in investment results arising from an increase in cancellations shortly after establishing a new fund that led to failure to efficiently manage the assets. It is necessary to provide detailed explanations to customers on the characteristics of investment trusts related to switching between them and the advantages and disadvantages associated with the relevant switching even when there is a rationale for switching in light of customers’ investment goals, market trends, etc., to enable customers to judge whether there is the need to switch after they have fully understood these points. Therefore, when soliciting a customer to switch investment trusts, it is required to explain matters that are necessary for the customer to know when making a judgment on whether it is reasonable to switch investment trusts, including whether the switching is consistent with the purpose of investment.

The Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. gives examples of matters that are necessary for the customer to know when making a judgment, stating as follows: in addition to the general matters for explanation regarding the sale of investment trusts, etc., those necessary matters

may include a rough estimate of profit or loss of investment trusts, etc. to be cancelled and the comparison between the characteristics and fees of the investment trust, etc. to be cancelled and those of the investment trust, etc. to be acquired; however, these could differ depending on the customer knowledge, customer experience, the state of customer assets, the purpose of investment, and the nature of the investment trust, etc. on a case-by-case basis.

(9) NISA (Tax Exemption Program for Small-Amount Investments)

Do you understand the matters that should be explained to customers regarding the NISA program (a tax exemption program for small-amount investments) when soliciting and accepting applications for the opening of NISA accounts or after opening these accounts?

The NISA is a program under which revenues from dividends and capital gains, etc., on up to JPY3,600,000 (JPY1,200,000 for the installment investment quota and JPY2,400,000 for the growth investment quota) of annual investment in listed stocks, etc., are exempt from income and inhabitant taxes. The total maximum amount of tax-exempt holdings is JPY18,000,000 (of which the maximum amount for the growth investment quota is JPY12,000,000). Accounts can be held permanently and there is no limit to the tax exemption period. The NISA program is available for investors aged 18 or older (as of January 1 of the year of use).

Upon soliciting and accepting application for the opening of NISA accounts and after opening these accounts, you should explain the following points to customers so that they have an accurate understanding:

- Each customer is allowed to open only one tax-exempt account at a single financial institution (excluding the case where the customer has changed financial institutions, etc.);
- The installment investment quota and the growth investment quota must be set up in the same account;
- Once any of the listed shares, etc. held in the tax-exempt account are sold, the customer may use the same portion of the investment quota up to the total maximum amount of tax-exempt holdings, only in the next year and thereafter;
- The annual investment quota yet to be used this year cannot be rolled over to the next year;
- Losses incurred on a tax-exempt account are disregarded for taxation purposes and therefore cannot be used to offset capital gains or dividends on other securities held in specific accounts or general accounts for tax calculation purposes;
- Refunds of principal repayments (special dividend), a form of dividends on investment trusts, are themselves tax-exempt and do not stand to benefit from the NISA program; and
- Tax exemption is granted for dividends on listed shares, etc. and similar items only if the dividends are distributed to customers via the financial institutions, etc. with which they hold NISA accounts, by the method of distribution proportional to quantity of shares.

In light of the purpose of introducing the NISA program, *i.e.*, promoting stable asset formation by households, it is necessary to refrain from soliciting customers for unreasonable short-term switching of investment trusts using the growth investment quota in the NISA account because such investment activity does not lead to the customer's stable asset formation.

(10) Others

(i) Are you aware that you must refrain from transactions that constitute a conflict of interest?

Examples of conflicts of interest in services of sales representatives include clashes between your own interests, or the interests of a related party, and the firm's interests or a customer's interests, or the holding of positions that conflict with each other in the provision of services. This includes cases that give rise to the external appearance of a clash of interests. Refraining from transactions that constitute a conflict of interest is indispensable in order to maintain trust in the fairness of transactions and services.

If there is a possibility of a conflict of interest, it is necessary to take appropriate measures to avoid the circumstances that would give rise to a conflict of interest, such as withdrawing from a position of an opposing interest or acting in accordance with the opinion of an independent third party. One example of this is the provision in the JSDA Rules that prohibits, in principle, an analyst who is in charge of a company from personally trading and owning securities in that company.

(ii) Are you aware of any influence that an act that is in violation of laws or regulations would have?

As mentioned briefly in (4) Methods of Information Provision and Solicitation, (iv) above, if there has been an act that is in violation of laws or regulations, there may be a criminal punishment or administrative action, and moreover, self-regulatory organs such as the JSDA may impose disciplinary actions, etc. (for details, see this Chapter, "2-2 Prohibition Against Wrongdoing and Self-Awareness as a Sales Representative").

The direct purpose of the administrative actions against sales representatives is to exclude unqualified persons from the scope of sales representatives, and the direct purpose of disciplinary actions, etc. by self-regulatory organs is to deter and prevent the reoccurrence of acts by the officers and employees of Association Members that are in violation of laws and regulations, and to exclude from the industry persons who have acted in a manner that causes a considerable loss of trust in the financial instruments business. Not only the relevant sales representative, but also the relevant Association Member will be subject to a disciplinary actions, etc. if it is recognized that an act by the sales representative that is in violation of laws and regulations stems from shortcomings, etc. in respect to the internal controls of the Association Member to which the relevant sales representative belongs.

The aim of administrative actions and of disciplinary actions, etc. by self-regulatory organs is to strive to achieve through these actions the protection of investors by securing the fairness of securities trading and other transactions, and to contribute to the maintenance and improvement of trust in the financial instruments business and the financial instruments trading markets.

To go even further, in recent years business scandals such as accidents involving products, false labeling, and illicit transactions have been reported by the mass media. The companies covered by such news reporting receive criticism from society, and what is more, they may suffer a negative effect such as their trading partners suspending trading with them. This reaches not only the business that caused the problem, but it also has a negative effect on other companies in the same industry and is referred to as a reputation risk or damage due to rumor. As described above, a violation of a law or regulation, etc. has a far-reaching effect, and since it can be considered to be an extremely important risk, it is necessary not to neglect to exercise care on a daily basis to avoid causing a violation of laws and regulations.

(iii) Do you understand that you should make the customers well aware of the availability of the financial ADR system?

In 2009, an alternative dispute resolution system in the financial sector (financial ADR system) was established as a new means for dispute resolution in addition to civil litigation. Under the "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.," financial

instruments business operators, etc. are required to publicize the trade name or name and contact address of the ADR body (dispute resolution organization) and make customers well aware of the financial ADR system. Financial instruments business operators, etc. are also required to explain the financial ADR system to customers on or before delivering the document to be delivered prior to conclusion of contract. With regard to disputes between Association Members and their customers concerning sale and purchase and other transactions of securities or derivatives transaction, etc., the FINMAC acts as an ADR body providing dispute resolution services.

(iv) Do you understand the duty of personal information management that financial instruments business operators, etc. must comply with?

Financial instruments business operators etc., are business operators that handle personal information and therefore must comply with the Act on the Protection of Personal Information and the Guidelines for Personal Information Protection in the Financial Field in order to protect personal information of customers.

You must acquire personal information of customers (including prospective customers) in a proper manner, and may not use the acquired information for purposes other than the predetermined purpose. If you cause any piece of the acquired information to be leaked, you will lose the customers’ trust, so you must carefully manage personal information.

In October 2015, the Act on the Use of Numbers to Identify a Specific Individual in the Administrative Procedures came into effect, and accordingly, in order to prepare statutory documents, financial institutions are required to ask customers to provide their individual numbers. Since individual numbers are special personal information subject to strict rules regarding their intended purpose for use and procedure for acquisition, special care is required for their management.

Sales representatives must conduct their sales activities with a full understanding of the matters described above.

4 IOSCO International Conduct of Business Principles

A basic approach for securities operations has been approved internationally as the code of conduct governing securities operations. In November 1990, IOSCO (the International Organization of Securities Commissions) adopted the International Conduct of Business Principles, which is described in (i) through (vii) below, in order to provide an international standard of conduct for securities business operators against a background of the rapid globalization of securities trading:

(i) Honesty and Fairness

In conducting its business activities, a firm should act honestly and fairly in the best interests of its customers and the integrity of the market.

(ii) Diligence

In conducting its business activities, a firm should act with due skill, care and diligence, in the best interests of its customers and the integrity of the market.

(iii) Capabilities

A firm should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

(iv) Information About Customers

A firm should seek from its customer information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

(v) Information for Customers

A firm should make adequate disclosure of relevant material information in its dealings with customers.

(vi) Conflicts of Interest

A firm should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its customers are fairly treated.

(vii) Compliance

A firm should comply with all regulatory requirements applicable to the conduct of its business so as to promote the best interests of its customers and the integrity of the market.

The seven principles described above are all basic rules governing the conduct of the securities business. In June 1991, the Securities and Exchange Council proposed that these business principles should be applied in Japan and that the necessary legislation should be implemented for items which are appropriate to explicitly stipulate in laws or regulations. Since then, the required legislative amendments have been implemented.

Needless to say, an awareness of and unceasing efforts for compliance with the business principles of each person involved in the activities of financial instruments business operators, etc. is indispensable to ensuring that these rules of conduct function effectively.

5 Principles in the Financial Services Industry and Principles Concerning Customer-Oriented Business Conduct

5 1 Principles in the Financial Services Industry

In April 2008 the Financial Services Agency announced "The Principles in the Financial Services Industry." The Principles are a set of key codes of conduct or general behavioral rules that underlie the basis of statutory rules such as laws and regulations, and should be respected when financial firms conduct their business as well as when the FSA takes supervisory actions. Sharing common views on the Principles among a wide range of relevant parties would bring about the following effects:

(i) Users of financial services will be able to know in advance what they can expect in terms of the behavior of financial firms as well as the quality of financial services they offer, and thus purchase financial services with a sense of security.

(ii) Financial firms that provide financial services will have a clear vision on the way they should act in cases where there are no applicable written rules or where the interpretation of existing rules may vary.

They could refer to the Principles as guidelines in their voluntary efforts to improve their services as well as develop and provide new ones, in order to respond flexibly to changing circumstances.

In this sense, the principles will indicate the direction in which the financial firms should head in their efforts to improve their services and the foundation of best practices. They may also serve as the basis for interpreting existing rules.

(iii) For its part, the FSA can (i) ensure prompt and adequate supervisory responses based on the actual conditions of the firms concerned by complying with the basic ideas as outlined in the Principles when interpreting and applying rules at the time of on-site inspections and off-site supervision. Moreover, (ii) when conducting reviews of existing rules such as laws, regulations, and the FSA's Supervisory Guidelines, efforts aimed at simplifying and clarifying rules in line with the Principles can contribute to putting in place a market and regulatory environment that does not impede innovation or free competition in the area of financial services.

Based on this, it is necessary for the relevant persons engaged in the activities of financial instruments business operators, etc. to fully take to heart the spirit of the Principles in the Financial Services Industry.

The Principles in the Financial Services Industry

Principles in the Financial Services Industry	Practical Image
Financial service providers are expected to: 1. Pursue greater customer benefits and fulfill expected roles through voluntary efforts with creativity.	(i) Ceaseless efforts aimed at providing financial services to meet customer needs; (ii) Proper relationship with diverse stakeholders; (iii) Conformity to expectations that Japan's financial services industry generate high value-added and contribute to sustainable growth of the national economy; and (iv) Responses aimed at meeting social responsibilities.
2. Participate in the markets with the resolve to improve the functioning thereof as a whole and secure fairness and transparency therein.	(i) Compliance with laws and regulations as well as self-regulations; (ii) Contribution to improving market functions, including market efficiency, through pursuit of best practices and improvement in self-regulations as needed; and (iii) Contribution to securing market transparency and fairness, by strictly confronting malicious acts that may harm transparency and fairness of the markets.
3. Pay due regard to reasonable customer expectations and conduct business with integrity and professional prudence in order to meet their needs.	(i) Due consideration of customer needs to be reflected in provision of appropriate financial services and management of contracts thereafter, including follow-ups; (ii) Maintenance of decency in transactions, including by preventing abuse of dominant positions; (iii) Thorough protection of customer information; and (iv) Fair treatment among customers and compliance with arm's-length rules.

Principles in the Financial Services Industry	Practical Image
4. Pay due regard so as to provide customers with information and advice on a timely basis and in a clear and fair manner, thus enabling them to make economically rational judgments.	(i) Disclosure of information with accuracy and clarity for customer decision-making, thereby securing substantive fairness; (ii) Conformity to the customer suitability rule; and (iii) Provision of truthful information to customers and avoidance of misleading explanations.
5. Respond to customer consultations and inquiries with integrity and provide needed information and advice, while making efforts to disseminate financial knowledge.	(i) Commitment to gaining customers' understanding and confidence to the extent possible; (ii) Accumulation and analysis of cases of consultations, inquiries and complaints, thereby improving business operations, particularly in the area of customer explanation; and (iii) Dissemination of correct financial knowledge.
6. Prevent abuse stemming from conflicts of interest between one's self, including group firms, and the customers, or among different customers.	(i) Sufficient verification as to whether conflicts of interest and other business conflicts are being handled properly; (ii) Implementation of appropriate control over conflicts of interest to avoid abuses; and (iii) Performance of duties with integrity.
7. Manage customers' assets in an appropriate manner, corresponding to the responsibilities assumed.	(i) Appropriate management of customer assets; and (ii) Fulfillment of obligations borne as asset managers. (*e.g.*, responsibilities to provide good managerial care, keep in separate custody and meet fiduciary requirements, depending on the context of contracts)
8. Establish appropriate mechanisms for corporate governance, including by way of making necessary personnel allocations, and achieve effective corporate governance, to ensure financial soundness and proper business operation.	(i) Establishment of effective and efficient corporate governance; (ii) Appropriate allocation of executives and employees; (iii) Compliance with laws, regulations and other business rules, and sound and proper conduct of business thereby; and (iv) Appointment of directors qualified as being fit and proper.
9. Conduct appropriate information disclosure, considering the significance of both setting market discipline to work and enhancing transparency of corporate management.	(i) Timely and appropriate disclosure of information to the markets; and (ii) Timely and appropriate disclosure of information to stakeholders at large.
10. Establish mechanisms so as to avoid being exploited by financial crimes, including by way of blocking antisocial parties' access.	(i) Implementation of mechanisms aimed at preventing involvement in or exploitation by financial crimes, including blocking off anti-social parties' access; and (ii) Implementation of mechanisms for customer management and collaboration with relevant organizations.
11. Maintain sound financial basis corresponding to risk profile.	(i) Proper evaluation and assessment of the structure of assets, debts and capital in the light of the risk profiles of the firms in question; and (ii) Maintenance of capital proportionate to the extent of risks.

Principles in the Financial Services Industry	Practical Image
12. Conduct appropriate risk management in accordance with the size and features of the business operation and inherent risk profile.	(i) Implementation of appropriate risk management mechanisms; (ii) Comprehensive recognition and effective control of various risks that may adversely affect assets, debts and profits and losses; and (iii) Establishment of sustainable profit structure.
13. Establish countermeasures against large-scale disasters and other contingencies in accordance with the role it fulfills in the markets.	(i) Prospects for market liquidity in times of market turmoil; and (ii) Establishment of crisis management systems and coordination among the parties involved in the event of crises.
14. Provide accurate information with integrity upon reasonable requests from the FSA, and facilitate effective communication with the FSA, including by way of interactive dialogues.	(i) Prompt provision of sufficient and accurate information meeting the FSA's needs, in response to reasonable requests; and (ii) Effective communication between the FSA and financial service providers through enhanced interactive dialogue.

(Source) Financial Services Agency

5 2 Principles Concerning Customer-Oriented Business Conduct

In March 2017, the Financial Services Agency published the "Principles Concerning Customer-Oriented Business Conduct," which represent the principles the Financial Services Agency considers to be helpful for financial service providers to achieve best practices in realizing customer-oriented business conduct. Following the establishment of the Principles, in light of the initiatives carried out by financial service providers and the changes in the environment concerning the Principles, the Working Group on Financial Markets started again in October 2019. The working group discussed updating the specific content of the Principles and promoting the visualization of the initiatives of financial service providers, and compiled a proposal of the revision to the Principles. Based on this proposal, the Principles were revised in January 2021.

In these Principles, the Financial Services Agency adopts a principles-based approach so that financial service providers can realize the customer-oriented business conduct not merely in form but in substance according to the respective situations they are in. Financial service providers are required to fully understand the purport and spirit of the Principles and make appropriate decisions regarding what they should do to put the Principles into practice.

If financial service providers decide to accept the Principles, they must develop a clear policy for realizing customer-oriented business conduct and operate their business according to the policy. Specifically, financial service providers accepting the Principles are required to develop and publish a clear policy for realizing customer-oriented business conduct, periodically disclose the implementation status of the policy, and periodically review the policy, as provided for in Principle I below. Furthermore, they should include their approach to the principles indicated in each of Principles II to VII below (including the notes attached thereto) in the policy if they accept the Principles. If they do not accept the Principles, they should explain the reasons for the non-acceptance and their alternative measures in an easily understandable manner in the policy and clearly show their initiatives that correspond to the Principles.

Principles Concerning Customer-Oriented Business Conduct

Development and Publication of Policy Concerning Customer-Oriented Business Conduct

Principle I. Financial service providers should develop and publish a clear policy for realizing customer-oriented business conduct and periodically disclose the implementation status of the policy. The policy should be periodically reviewed in order to achieve improved business conduct.

(Note) When formulating a policy for customer-oriented business conduct, financial business operators should consider their customers not only as their direct counterparty to transactions but also as the final beneficiaries in the investment chain.

Pursuit of Customers' Best Interests

Principle II. Financial service providers should maintain a high level of expertise and professional ethics, treat their customers faithfully and fairly and pursue the best interests of the customers. Financial service providers should make efforts to ensure such business conduct becomes established as a corporate culture.

(Note) When conducting transactions with customers, financial business operators should aim to secure their profits and a stable customer base by providing customer-oriented, quality services and achieving the best interest for the customers.

Appropriate Management of Conflicts of Interest

Principle III. Financial service providers should accurately identify the possibility of conflicts of interest arising in relation to transactions with customers, and appropriately manage them when there is the possibility of any conflict of interest arising. Financial service providers should develop a corresponding policy for such purposes in advance.

(Note) When judging the possibility of a conflict of interest, financial business operators should take into consideration matters such as the impact of the following circumstances on their transactions or business operations:

- the distributor, when selling or recommending a financial product to a customer, receives commissions or similar payments from the company that provides the product;
- the distributor sells or recommends a product provided by another company in the same group;
- the distributor has a corporate sales department and investment department in the same entity or group, and the investment department selects the company in which it will invest funds from among companies with which the corporate sales department has business relationships.

Clarification of Fees and Expenses

Principle IV. Financial service providers should provide information in a manner that enables customers to understand the details of all fees and expenses, regardless of name, incurred by the customers, as well as what is a service corresponding to each of such fees and expenses.

Easily Understandable Provision of Important Information

Principle V. Financial service providers should provide important information on sales or recommendations of financial products and services, in addition to the matters indicated in Principle IV. above, in a manner understandable by customers based on the presumption that there exists an information asymmetry between customers and themselves.

(Note 1) Important information should include the following:

- the basic profit (return), loss or other risks, and conditions of transactions regarding the financial product or service to be sold or recommended to customers;

- the attributes of the prospective customers of the financial business operator engaging in structuring the financial product to be sold or recommended to customers;
- the reasons for selecting the financial product or service to be sold or recommended to customers (including the reason for determining that the product or service has been selected in consideration of the customers' needs and intentions); and
- if there is a possibility of a conflict of interest with any customers in connection with the financial product or service to be sold or recommended to customers: the details of such conflict of interest (including commissions or similar payments to be received from a third party) and its impact on the transactions or business operations.

(Note 2) When selling or recommending multiple financial products or services in a package, financial business operators should indicate to customers whether the products or services can be purchased separately, and provide customers with material information on these products or services in a package or as separate items, respectively, so that customers can compare the two cases (Notes 2 to 5 also apply when financial business operators provide information on commissions).

(Note 3) Financial business operators should provide customers with information that is clear, plain, trustworthy and not misleading in content, in consideration of customers' experience and knowledge in financial trading.

(Note 4) Financial business operators should provide customers with information on financial products and services to be sold or recommended to customers in an easy-to-understand manner according to the degree of complexity of these products and services. If they sell or recommend simple and low-risk products, they are allowed to provide concise information; whereas, if they sell or recommend complex or high-risk products, they should provide information more carefully and in a manner more comprehensible to customers, using materials that enable customers to compare the recommended product with the same kind of product and that indicate the basic structure of the product such as the risk-return relationship.

(Note 5) When providing customers with information, financial business operators should categorize information by the degree of importance and attract customers' attention to more important information by emphasizing it.

Provision of Services Suited to Each Customer

Principle VI. Financial service providers should understand customers' asset status, trading experience, knowledge, trading purpose and needs, and manufacture or sell or recommend financial products and services suited to each customer.

(Note 1) In relation to sale and recommendation of financial products and services, financial business operators should pay attention to the following points:

- the financial business operator should first confirm the customer's intention, and then consider the target asset value and an appropriate ratio between risk-free assets and investment-type assets in consideration of the customer's life plan, and propose a specific financial product or service based on these factors;
- when proposing a specific financial product or service, the financial business operator should compare the content of the financial product or service it handles with similar or alternative products or services (including commissions) beyond the boundaries of business areas; and
- after selling the financial product or service, the financial business operator should provide an

appropriate follow-up service to the customer based on the customer's intention and from a long-term perspective.

(Note 2) When selling or recommending multiple financial products or services in a package, financial business operators should pay attention to whether the package as a whole is suitable to the respective customer.

(Note 3) Financial business operators engaging in structuring financial products should specify and publicize the attributes of the prospective customers of the products in light of the product characteristics and take care so that financial business operators engaging in selling the products will sell the products according to such customer attributes.

(Note 4) When financial business operators sell or recommend complex or high-risk financial products or sell or recommend products to a group of customers who are prone to suffering damage in financial trading, they should more carefully examine whether the sale or recommendation of the relevant products is appropriate according to the product characteristics or the customer attributes.

(Note 5) Financial business operators should make efforts to have their employees gain better understanding of the structures of financial products they handle and should provide customers with information actively so that they can obtain basic knowledge on financial trading according to their attributes.

Frameworks for Motivating Employees Appropriately and Other Measures

Principle VII. Financial service providers should develop frameworks for motivating employees appropriately including remuneration and performance evaluation systems and employee training designed to encourage conduct such as actions to pursue customers' best interests, fair treatment of customers, and appropriate management of conflicts of interest, and a framework for appropriately motivating employees through employee training and other means, as well as an appropriate governance system.

(Note) Financial business operators should announce the principles (including the notes attached thereto) that they implement and the alternative measures for any principles that they do not implement and raise awareness of these matters among the employees involved in the relevant principles, and should also establish a system for supporting and inspecting the business operations carried out by the respective employees.

(Source) Financial Services Agency

From the perspective of promoting "visualization" of financial service providers' initiatives to realize customer-oriented business conduct and establishing a mechanism under which financial service providers engaging in best practices will be chosen by customers, the Financial Services Agency has disclosed on its website a list of financial service providers that have adopted the Principles and disclosed their own policies for realizing customer-oriented business conduct. Since 2021, the Financial Services Agency has checked the reports from financial institutions, etc. and has included, in the list of financial service providers on the Financial Services Agency's website, such financial institutions that have clearly indicated their policies for carrying out initiatives that correspond to the contents of each of Principles II to VII. The Financial Services Agency has also published on its website the results of its analysis of reports on common KPIs for investment trusts.

6 Sales Representative's Approach to Tasks

A sales representative's tasks are not simply processing orders as requested by customers and carrying out administrative work for them. Sales representatives must know their customers, provide appropriate information and advice, offer products and services, and conduct after-sales follow-up.

6 1 Principle of Suitability and Principle of Individual Responsibility

As mentioned above, financial instruments business operators, etc. must conduct solicitation for investment in accordance with the principle of suitability. At the same time, even when financial instruments business operators, etc. provide investors with information or advice on investment, the customers themselves must make the final decision as to whether or not to invest in a specific financial product. This is called the principle of individual responsibility. In conducting financial instrument transactions, it is necessary for sales representatives to ensure that their customers fully understand this point.

In order to have the customers make appropriate investment decisions after gaining a good understanding of the principle of individual responsibility, sales representatives must identify the customers' attributes, select the products that comply with what they have in mind, and provide them with accurate information. If a sales representative is judged to have conducted solicitation for investment in a manner against the principle of suitability, it would be treated as violation of law and strict administrative sanctions (*e.g.*, suspension of business for a certain period) could be imposed.

Thus, the principle of suitability and the principle of individual responsibility are the fundamental concepts in solicitation for investment. In this respect, the "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc." provide that "financial instruments business operators must ensure that investment solicitation is conducted in an appropriate manner suited to their customer's attributes, etc., by offering transactions with terms and content that are commensurate with the customer's knowledge, experience, asset status and investment purpose as well as his/her ability to make a judgment call regarding risk management." It is very important to carry out sales activities in accordance with the principle of suitability.

6 2 Selection of Products and Services

In order to provide customers with products and services in accordance with the principle of suitability, it is important to first understand the customers' needs (objectives). After confirming the customers' intentions, it is necessary to consider the amount of assets they aim to build in light of their life plans and the appropriate balance between risk-free assets and investment assets, and propose appropriate portfolios based on these factors, thereby offering products and services that are suited to individual customers.

Needless to say, when selling products and providing services to customers, sales representatives must not conduct transactions that are inconsistent with the customers' attributes or intentions or act in the pursuit of the

interest of their affiliated operator at the risk of jeopardizing the customers' interest.

When offering products, you should correctly understand the risk and return that may arise from holding the products and explain these matters to the customers. The explanation should include the comparison between the proposed products and similar products and services, their differences in terms of advantages and disadvantages, and the fees payable by the customers. When the customers purchase products, you should confirm that they sufficiently understand the characteristics and risks of the products. Thus, sales representatives must know the products they deal with well, and to be able to do this, they must study products and investment environments on a daily basis. "Study" does not mean simply memorization, but rather training themselves to contemplate the risk and return associated with the product. Sales representatives must gather diverse information and analyze and think about such information by themselves. There is an almost limitless amount of information that can be useful for this task, such as the price movements of securities, interest rates and foreign exchange trends, analysis of information from the company's research division, articles from newspapers and magazines, stories from co-workers and superiors, and information obtained in the course of the sales activities. It is necessary to have a broad perspective and think logically by linking and connecting such diverse information.

If you understand individual customers' needs appropriately while always thinking from the customers' position and offering a broad range of products to them, you will see the best investment plans for the customers. You should not impose your own thoughts and opinions on your customers. You should maintain good communication with the customers and provide them with products and services that best match their requests.

For sales representatives; day-to-day efforts to gather information and study and have close communication with customers are important.

6 3 After-Sales Follow-Up

The business involving financial products and services is not completed when the sale (or contract) is executed. In order to provide appropriate services for customers, it is important to conduct appropriate after-sales follow-up in accordance with the customers' intentions, taking into consideration the changes in their life stages and asset status as well as changes in the market environment, while paying attention to a long-term perspective.

The customer's needs for investment may also change. Even though the customer purchased a product that suited the customer's needs at the time of the purchase, the best product for the customer can change due to changes in the economic and financial environments or the fluctuations in securities prices along with the passage of time.

Therefore, sales representatives should conduct appropriate after-sales follow-up for customers by understanding their needs and providing them with information and advice.

Conclusion

Amidst the diversification of customers' needs as well as products and services, sales representatives are required to have correct knowledge, provide clear and appropriate information, maintain an appropriate sense of ethics as professionals, and deal with customers sincerely in their position. By engaging in day-to-day tasks while keeping these matters in mind, sales representatives will be able to earn customer trust and contribute to protecting

investors and ensuring fairness of markets, and towards further achievement of sound development of markets. You should properly understand what is explained above in minute detail and then engage in your sales activities.

Outline of the Qualification Examination System for Sales Representatives

For Use by Examinees Applied Through Association Members of JSDA

[Note] The following information has been written based on the relevant systems effective as of the date of issue of these Manuals and may be subject to changes.

1. What Is the Sales Representative Qualification Examination?

Persons who wish to engage in securities operations must pass the Sales Representative Qualification Examination described below (hereinafter referred to as the "Examination") and must be registered in the Original Registry of Sales Representatives before they become engaged in the conduct of duties of a Sales Representative.

A Sales Representative must possess a certain minimum level of basic knowledge concerning Japan's laws on financial instruments, including the Financial Instruments and Exchange Act, etc., and other laws and ordinances, as well as financial products and financial instruments transactions.

The Examination administered by the Japan Securities Dealers Association (hereinafter referred to as the "JSDA") tests the extent of acquisition of this knowledge, and is part of the self-regulatory system of the securities industry.

2. Qualification to Take the Examination

With regard to the Class-1 Sales Representative Qualification Examination (hereinafter referred to as the "Class-1 Examination") and Class-2 Sales Representative Qualification Examination (hereinafter referred to as the "Class-2 Examination"), the people for whom the Association Member finds it necessary to have him/her take the Examination, and who do not fall under any of the following persons are qualified to sit for the Examination:

- Class-1 perpetrator of an inappropriate act;
- A person for whom five years have yet to elapse from the day on which such person came to be treated as a Class-2 perpetrator of an inappropriate act;
- A person who is under a waiting period to take the next Examination due to failure (for details, see "7. Required Waiting Period for Repeat Examinations"); and
- A person who is under a period during which he/she is excluded from taking the Examination due to misconduct (for details, see "8. Misconduct").

3. Examination Procedures

Each Association Member files an application with the JSDA on behalf of the persons who want to take the Examination.

The applications for officers and employees of a financial instruments intermediary service provider are handled by an Association Member with whom the financial instruments intermediary service provider has executed entrustment agreement.

Procedures for applying to take the Examination are handled exclusively by the relevant department at the Association Member. Individuals wishing to take the Examination cannot submit an application directly to the JSDA.

4. Date and Location of the Examination

(1) Examination Date

The JSDA holds, in principle, the Examinations on every business day (except Saturdays, Sundays, public holidays and during the New Year period). However, this will be different for each examination site.

(2) Examination Sites

The examination sites (test centers) are located in major cities all over Japan. Examinees should check with the examination site at their desired location for the examination date via the respective department of the Association Member in advance.

After the application, the examination site, date and time of the Examination are assigned to each applicant individually. In addition, examinees cannot sit for the Examination other than at the location and time scheduled in advance.

5. Checklist for the Day of Examination

(1) Some test centers may close unexpectedly due to inclement weather such as typhoons.

Please confirm that the test center is open via the Prometric K.K. website prior to departing for the test center.

[Prometric website]
([Top page]-[For Candidates]
URL: https://www.prometric-jp.com/en/examinee/

* If examinees have any questions, they should confirm with the responsible persons at the Association Member to which examinees belong. It should be noted that the examination administrator mentioned above and the examination sites do not accept any inquiries about whether a specific examination will be held as scheduled.

(2) Arrival at the Examination Site

Examination instructions will be announced at the test site prior to the commencement of the Examination. Therefore, all examinees should come to the examination site by the appointed time (at least 15 minutes before the fixed start of the Examination). (If examinees do not arrive at the examination site at least 15 minutes prior to the fixed examination time, they will not be permitted to take the Examination regardless of the reason.)

(3) Consent to the Rules for Taking the Examination

Examinees should carefully read and understand the " Examination Regulations" provided at the examination site before going to the reception desk.

They will be deemed to have consented to the "Rules for Taking the Examination" when they complete the reception procedure.

[Reference] Examinees can check the "Rules for Taking the Examination" in advance at the following URL:https://www.prometric-jp.com/exam_rules/

(4) Documents Necessary for Personal Identification

The identity of the examinee will be verified at the reception desk of the examination site. Examinees must bring one of the following identification documents (documents other than those listed below, such as a student's ID card, are not acceptable):

(i) Driver's license (temporary license, driver's license issued in a country outside Japan and driver's license with no indication stating "driver's license" are not allowed);
(ii) Certificate of driving history (limited to those issued on or after April 1, 2012);
(iii) Individual Number Card ("Individual Number Notice" and "Notification Card" issued to notify every resident of their Individual Number ("My Number") is not allowed);
(iv) Basic Resident Registration Card (limited to one with a photograph affixed thereto);
(v) Passport (Check your name printed in alphabetic characters);
(vi) Resident card or special permanent resident certificate; or
(vii) If an examinee does not have any of the above, the examinee must bring either (a) or (b) below:
(a) A "photo bearing employee identification card (Note)" and a "health insurance card" (substitute documents are not acceptable); or

(Note) The photo must either be split-sealed, embossed or laminated, or printed on a plastic card. The card must bear the first and last names of the examinee, the name of the Association Member and a corporate logo or the logo of the corporate group to which the Association Member belongs.

(b) An "identity verification card with photo specified by the JSDA (which must bear a company seal; a personal seal is not acceptable)" and a "health insurance card" (substitute documents are not acceptable).

(Notes)

1. Persons not in possession of a form of personal identification upon taking the Examination will not be permitted to take the Examination under any circumstances.
2. The forms of personal identification mentioned above are acceptable only if they are the originals (copies are not acceptable).
3. The forms of personal identification referred to above must be valid. Those that have become invalid by reason of expiry or other reason are not acceptable.
4. A "photo bearing employee identification card" or an "identity verification card" shall only be valid if it has been issued by an Association Member. Such cards issued by financial instruments intermediary service providers or temporary agencies are not acceptable.
5. An "identity verification card" is valid for a period of six months after the date of issuance (except when there has been a change of content).

(5) Miscellaneous

No reference material such as texts or notes may be used during the Examination. No personal belongings are allowed in the test room. Examinees must put their personal belongings except for the personal identification documents (including wristwatches, cellular devices, memo pads, etc.) in the lockers situated outside the test room at the examination site.

Examinees may use the calculator function displayed on the PC in order to solve calculation questions. If examinees need to make notes, they should use the mechanical pencil and notepad provided at the examination site.

6. Notification of Pass or Fail

Examination results will be given by a notice from the JSDA to a person-in-charge within each Association Member, in principle two business days after the Examination. The results given will be whether examinees have passed or failed, and their total score (the JSDA will not disclose any examination questions). The JSDA will not respond to inquiries from individual examinees.

7. Required Waiting Period for Repeat Examinations

A person who has taken and failed the Examination may not take any Examination for a period of 30 days from the day following the date of the original Examination.

If an examinee is later discovered to have taken the Examination within the waiting period above, the examinee's qualification will be nullified even if the examinee has passed.

8. Misconduct

(1) Acts Deemed as Misconduct and Specific Examples

Entering the examination room with notes or with information written on one's body, etc.

*** Even if such information is unrelated to the examination, this will be deemed an act of misconduct.**

(Specific examples)

- Entering the examination room with notes including information regarding the examination
- Entering the examination room with textbooks and workbooks or copies of such materials
- Entering the examination room with writing on one's palms, arms, or other areas

Bringing items other than those necessary for the examination (ID number case and personal identification documents) into the examination room

*** Even if items are unrelated to the examination, this will be deemed an act of misconduct.**

(Specific examples)

- Bringing in clocks of any kind (including watches)
- Bringing in portable devices (smartphones, tablets, wearable devices, etc.)
- Bringing in any writing tools such as pens, etc. (excluding items provided by the test center)
- Bringing in personal belongings such as notebooks, card cases, etc.

Writing information anywhere other than the dry erase board or taking information out of the examination room

*** Even if such information is unrelated to the examination, this will be deemed an act of misconduct.**

(Specific examples)

- Writing on one's body or clothes or leaving the examination room with written information
- Writing on the paper inside the ID number case or taking it out of the examination room
- Writing on one's personal identification documents and then taking them out of the examination room

Any other inappropriate behaviors inside the examination room such as the following:

(Specific examples)

- Talking inside the examination room
- Looking over at other seats
- Entering or exiting the examination room without the proctor's permission

- Not following the instructions of the proctor

(2) Monitoring Inside the Examination Venue

The examination room is monitored by the proctor walking throughout the room and by a security camera.

(3) Measures Taken in Cases of Misconduct

Those who commit acts of misconduct will not only fail that day's examination, but in addition to the misconduct being reported to the test taker's company or organization, there will be an investigation into the test taker, and he/she will be prohibited from taking any further examination for a period of up to one year (excluding renewal training). Additionally, the name of the company or organization to which the test taker belongs will be disclosed for a period of one year to all Association Members.

Even if a person's examination is halted after the person commits any act of misconduct or the person is treated as having failed the examination, the examination fee will be payable.

9. Subjects and Methods of Examination

	Class-1 Examination	Class-2 Examination
Subjects	[Laws, Regulations and Various Rules] ・Financial Instruments and Exchange Act and related laws and regulations ・Laws Relating to Solicitation and Sales of Financial Instruments ・Articles of Association and Various Rules of the Association ・Articles of Incorporation and Various Regulations of the Exchanges [Product Business] ・Equity Business ・Bond Business ・Investment Trusts and Investment Corporations Business ・Incidental Businesses ・Derivatives Transactions (Class-1 Examination Only) [Related Subjects] ・Basic Knowledge Concerning Securities Markets ・Stock Company Law in General ・Basic Knowledge of Economics, Finance and Fiscal Policy ・Financial Statements and Company Analysis ・Taxation of Securities Transactions ・Sales Operations	

<table>
<tr><th></th><th>Class-1 Examination</th><th>Class-2 Examination</th></tr>
<tr><td rowspan="2">Range of Questions</td><td>(1) Practical and professional knowledge regarding the subjects listed above
(2) Fundamental and important compliance-related topics</td><td>(1) Basic knowledge regarding the subjects listed above
(Questions regarding basic knowledge concerning items such as margin transactions and derivatives transactions, which are not included in the scope of activities a Class-2 Sales Representative may conduct, appear in the Class-2 Examination in connection with the covered subjects, such as “Equity Business” and “Bond Business.”)
(2) Same as the left</td></tr>
<tr><td colspan="2">(Note) If there is a change to the related laws, ordinances or various regulations, the questions will test the new laws, etc.</td></tr>
<tr><td>Format of Questions</td><td colspan="2">True or false questions and multiple-choice questions (to be answered by choosing the right term or making a calculation)
The questions should be answered by making entries on the computer.</td></tr>
<tr><td rowspan="2">Number of Questions</td><td>100 questions in total
(70 true or false questions, and 30 multiple-choice questions (from five choices))</td><td>70 questions in total
(50 true or false questions, and 20 multiple-choice questions (from five choices))</td></tr>
<tr><td colspan="2">For true or false questions, each correct answer corresponds to 2 points. For multiple-choice questions (from 5 choices), each correct answer corresponds to 10 points (each correct answer to multiple-choice questions (choose 2 answer choices) corresponds to 5 points).</td></tr>
<tr><td>Examination Time</td><td>2 hours and 40 minutes</td><td>2 hours</td></tr>
<tr><td>Grading</td><td>A perfect score is 440 points. A score of 70% (308 points) or higher is a passing score.</td><td>A perfect score is 300 points. A score of 70% (210 points) or higher is a passing score.</td></tr>
</table>

10. Instructions for Taking Examination

Examiners should pay attention to the following when taking the Examination:

(1) Follow the instructions of the proctors at the examination site and in their test room. Examinees who do not follow their instructions may be treated as cheating (for details, see “8. Misconduct”);

(2) Make sure they read the instructions and the questions carefully before proceeding to answer the individual questions; and

(3) Make sure they fully understand the question, and give their answer according to the directions.

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