The International Capital Markets Review

Sixth Edition

Editor
Jeffrey Golden

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EDITOR'S PREFACE TO THE SIXTH EDITION

There is a lesson from the international capital markets that took me, as a young ICM lawyer, a measure of time to both comprehend and appreciate. It was namely this: in matters legal, market participants have a marked preference for certainty above almost anything else. Even sometimes ahead of justice!

Market participants need to know where they stand.

You see, you can trade or structure around a position that you know to be certain, however undesirable that position may be, and whether or not you believe it to be fair. What is abhorred is not knowing what your position is. Eventually being told by a court after months or years of litigation, for example, that you were correct in your earlier view does not give a lot of comfort if, waiting on that answer, you stood 'naked' to a market that has moved on and significantly against you while you remained uncertain whether, when and to what extent to hedge your exposure or otherwise move in reliance on the position you had previously assumed.

Let me give you an extreme example of this preference for certainty over justice as it is reflected in the terms widely used by the derivatives markets when structuring a trade under my favourite contract form, the ISDA Master Agreement. There, a library of product-specific definitional booklets provide various terms tied to particular product markets, including details of pricing sources, relevant market conventions, and fallbacks and adjustments for when a given source may not be available and for other market disruptions. Relevant booklets can be incorporated into the parties' trade confirmations and thus added to the parties' contract on an 'as and when needed' basis.

Many of these booklets include a provision that is widely embraced for trades that base their prices on published and displayed screen rates. It provides, for example, that where a relevant rate for a pricing date is based on information from certain sources such as a Reuters screen page the rate is, as you might expect, subject to corrections made by that source – but only if the correction is made within one hour of the time when the

relevant rate is first displayed.[1] After that, even if the displayed rate has an extra zero in it, and even if it is later corrected, the rate as it stood one hour out becomes the irrevocable basis for the relevant pricing of the transaction. That is the potentially harsh but, in order to ensure certainty, market-preferred position.

This desire for timely and reliable answers can also be seen by the considerable contractual privilege and discretion afforded, for example, to a non-defaulting party by allowing it to self-determine a close-out amount following its counterparty's default. That determination is subject to good faith and reasonableness. However, a conscious decision was taken that the number of issues subject to referral to court for determination, and the evidentiary basis on which those issues should be decided, would, in each case, be narrow. It was intended that it should be of no consequence if, perhaps with the benefit of hindsight, a better answer could be determined by the court. It was thought more important by the markets that an answer honestly derived by a party could be relied upon as final so that the party could move on.

Whether it is the measure of their claims following a default, the scope of their exposure to market risk, or the strength of their collateral credit support, market participants hate surprises. They need to know where they stand. They seek authoritative answers that can be relied upon. And they trust in the rule of law.

My former law partner, Philip Wood CBE, QC (Hon) recently published a fascinating book.[2] In it, Philip argues that the challenge set for our planet is survival, that the rule of law has supplanted religion in providing the basis for a morality that will be necessary to ensure that survival, and that it falls to lawyers to form a 'priesthood' capable of providing relevant answers, as well as preserving the certainty and order, that can contribute to that quest for survival.

And yet we look out at a marketplace with more than a little uncertainty at the moment (Brexit, a worrying US presidential election looming, equally worrying ongoing world political tensions and even conflict, a systemically relevant global financial institution facing crippling fines and a crisis of confidence, cyber insecurity, etc.). Perhaps not surprisingly then, the press reports that the value of initial public offerings has fallen by about a third this year when compared with last year in this period of market volatility and political uncertainty.

That is where this book comes in (with a new jurisdiction, Hong Kong, having been added). Our legal experts who have contributed have been tasked with promoting legal certainty through guidance about where matters relevant to the international capital markets stand in their home jurisdictions. They are our priests!

Join them, and take up Philip Wood's challenge. If you are reading this book, it is almost certainly because someone is looking to you for answers – looking to you to provide the legal certainty the capital markets seek.

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1 See, e.g., 2006 ISDA Definitions, Section 7.6.

2 Philip R Wood, *The Fall of the Priests and the Rise of the Lawyers*, (Hart Publishing Ltd, 2016).

My admiration for our contributing experts continues, and of course I shall be glad if their collective effort proves helpful to our readers when facing the important challenge of framing the correct answers.[3]

Jeffrey Golden
P.R.I.M.E. Finance Foundation
The Hague
November 2016

3 Did I finally make it through a preface without mentioning the Global Financial Crisis?

Chapter 13

JAPAN

Akihiro Wani and Reiko Omachi[1]

I INTRODUCTION

i Structure of financial laws and regulations in Japan

The Financial Instruments and Exchange Act (FIEA)[2] and the Cabinet Order and Cabinet Office Ordinances thereunder are the most basic and important direct regulations on capital markets in Japan. The FIEA regulates the financial instruments business and financial transactions, including securities offerings and distributions, for the purpose of maintaining the fairness of capital markets, protecting investors and developing the economy. In Japan, there are no overarching laws that regulate all financial institutions, which means that each type of institution is regulated separately. For example, banks are regulated by the Banking Act,[3] securities firms are regulated by the FIEA and insurance companies are regulated by the Insurance Business Act.[4] The FIEA is still important, however, even for financial institutions that are regulated by other laws, because such laws may refer to provisions of the FIEA that are then applied to such institutions *mutatis mutandis*. As a result, such institutions are in effect also regulated by the principles of the FIEA in many respects, for example when conducting securities and derivatives transactions.

Additionally, there are several other laws and regulations that specifically govern certain types of financial transactions including derivatives transactions, securitisations, structured products, investment funds, trusts and partnerships, such as the Commodity

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1 Akihiro Wani is a senior counsellor at Morrison & Foerster LLP / Ito & Mitomi. Reiko Omachi is an of counsel at Morrison & Foerster LLP / Ito & Mitomi and currently seconded to Morrison & Foerster (UK) LLP. The authors express sincere thanks to Markus Christoph Glodek for his assistance editing the chapter.

2 Act No. 25 of 1948, as amended.

3 Act No. 59 of 1981, as amended.

4 Act No. 105 of 1995, as amended.

Derivatives Act (CDA),[5] the Act on Investment Trusts and Investment Corporations,[6] the Limited Partnership Act for Investment,[7] the Act on Securitisation of Assets,[8] the Trust Act[9] and the Companies Act.[10]

ii Roles of regulatory and supervisory agencies and of the central bank in the Japanese capital markets

The Financial Services Agency (FSA) is responsible for, *inter alia*, ensuring the stability of the Japanese financial system, protecting investors and carrying out surveillance over securities transactions. The FSA delegates powers relating to securities registration to local finance bureaus (LFBs), and powers relating to daily market surveillance, inspections of financial instruments firms, inspections of disclosure documents and related activities to the Securities and Exchange Surveillance Commission (SESC).

The commodity derivatives business is regulated by either the Ministry of Economy, Trade and Industry (METI) or the Ministry of Agriculture, Forestry and Fisheries, or by both, depending on the type of underlying commodity.

The Bank of Japan (BOJ), which is Japan's central bank, is independent of the government, including the FSA, similar to many other central banks in other jurisdictions. Its mission mainly focuses on the implementation of monetary policy, treasury and government securities-related operations.

Additionally, there are several self-regulatory organisations (SROs) whose membership consists of financial institutions. Among them, the Japan Securities Dealers Association (JSDA) is the most representative and important organisation in the Japanese capital markets. The JSDA promotes sound business development, and protects investors by ensuring that securities transactions by its members are conducted fairly and smoothly.

There is also an electronic system called 'Compliance WAN', which can be accessed by the SESC, LFBs, securities companies, SROs (including the JSDA) and stock exchanges. This system enables the SESC and LFBs to utilise transaction data sent, for example, from securities companies for the purpose of market surveillance.

iii Financial dispute resolution in Japan

Several options exist for resolving financial disputes in Japan: judiciary proceedings in court, arbitration procedures at an arbitral tribunal and alternative dispute resolution (financial ADR) procedures.

Usually, a party to a financial transaction is able to sue the counterparty in court, and once a court procedure is chosen, the parties will be entitled to a decision by a district court and two instances of appeal to the High Court and the Supreme Court.

Alternatively, a party may elect arbitral institutions including the Japan Commercial Arbitration Association or the International Chamber of Commerce for arbitral awards that

5 Act No. 239 of 1950, as amended.
6 Act No. 198 of 1951, as amended.
7 Act No. 90 of 1998, as amended.
8 Act No. 105 of 1998, as amended.
9 Act No. 108 of 2006, as amended.
10 Act No. 86 of 2005, as amended.

are deemed to be final and binding by the courts. Japan is a member of both the ICSID Convention and the New York Convention, and Japan's Arbitration Act[11] is based on the UNCITRAL Model Law.

In addition to court and arbitral procedures, an investor may seek settlement of a financial dispute by choosing the financial ADR procedures, a simplified and expeditious resolution system.

iv Scope of jurisdiction

In general, it is believed that Japanese laws and regulations do not apply to activities by foreign companies outside Japan, as the scope of jurisdiction should be limited to Japanese territory. With respect to cross-border cases, however, there is no provision that specifies the extent of the application of financial laws and regulations, and the scope of the powers of regulatory authorities is still open to interpretation. Even so, it is almost certain that Japanese laws and regulations apply when a foreign company solicits an investor who resides in Japan, even from outside Japan (see Section II.v, *infra*).

In practice, the FSA maintains close contact with the regulators of foreign countries on a daily basis. Financial institutions should pay careful attention to the relevant overseas regulations and to Japanese regulations as well.

II THE YEAR IN REVIEW

i Developments affecting debt and equity offerings

Framework for legislation or regulation on debt and equity offerings

To conduct a debt or equity offering (whether primary or secondary), a securities registration statement (SRS), mainly consisting of information about the securities being offered and about the issuer, must be filed with the director general of the LFB, unless such offering constitutes a 'private placement' that is exempt from disclosure obligations (private placement exemption). Two major private placement exemptions are the small-number exemption (which may be available when solicitations are made to no more than 49 investors in Japan) and the professional investors exemption (which may be available when solicitations are made only to qualified institutional investors (QIIs) or specified investors defined in the FIEA). Detailed conditions for each exemption differ depending on the type of security being offered.

Once a company has filed the SRS with the LFB as described above, it becomes subject to ongoing disclosure obligations, and must file annual securities reports, semi-annual or quarterly reports and extraordinary reports with the LFB, as all listed companies in Japan must do.

Recent developments in regulations

Equity crowdfunding

Although there are several ways to provide money to new growth companies, an offer and sale of securities will invariably be subject to the FIEA, regardless of whether such offer or sale is conducted through the internet and regardless of the total amount raised. However,

11 Act No. 138 of 2003, as amended.

to encourage the growth of equity crowdfunding, amendments to the FIEA that took effect in May 2015 significantly relaxed the licensing and documentation requirements for public offerings, secondary distributions and private placements of unlisted and certain other securities through investment crowdfunding. In addition, it has been permissible since June 2016 to settle crowdfunding transactions through credit cards, provided that the amount of credit accommodation is not more than ¥100,000, even though credit card settlement is otherwise not generally allowed in securities transactions.

See Section II.v, *infra*, with respect to the government's policy regarding the development of fintech.

Disclosure documents

The corporate disclosure system was recently reviewed by several relevant institutions, including the METI and the Tokyo Stock Exchange Inc (TSE), for the purpose of promoting 'constructive dialogue' between companies and their investors.

In April 2016, the Working Group on Corporate Disclosure of the Financial System Council, established by the FSA, published a document entitled 'Report – Promoting Constructive Dialogue', which proposes a review of the current disclosure system requiring mandatory disclosure of earnings releases, business reports and annual securities reports. The report recommends that the stock exchange rule relating to earnings releases, which are filings made by listed companies at the time of announcement of their financial statements, be revised to reduce the number of required disclosure items to enable companies to conduct flexible disclosure depending on each company's individual situation. The report also proposes that the currently duplicative disclosure requirements be eliminated by unifying the requirement under the Companies Act to disclose business reports with the requirement under the FIEA to disclose annual securities reports. On the other hand, the report recommends enhanced disclosure of non-financial information such as business policies, strategies, and management's discussion and analysis of financial condition. The FSA plans to reform the mandatory and voluntary disclosure system based on this report.

Price transparency in bond market

With respect to price information for over-the-counter (OTC) corporate bond transactions, the JSDA for a long time published reference prices that were not real trading prices but merely mid-price quotations reported by major JSDA members. Because there was no system to disseminate real trading prices for OTC corporate bond transactions in Japan, it was difficult for anyone other than the parties involved in actual transactions to know real trading prices.

In November 2015, however, the JSDA launched a new system to disseminate real trading prices for OTC corporate bond transactions. As a result, the JSDA now publishes the trading prices and transactional data for corporate bond transactions exceeding ¥100 million on a daily basis. To ensure the accuracy of JPY bond reference prices, the JSDA has also made revisions to its calculation procedures. This new system has improved efficiencies and contributed to the further development and transparency of the Japanese bond market.

High-frequency trading

The Working Group on Financial Markets of the Financial System Council established by the FSA is currently discussing possible restrictions on high-frequency trading (i.e., stock trading

carried out by computers at high speeds), which has been criticised as a cause of sudden market fluctuations. It is possible that regulatory measures similar to those proposed in the EU and the US will be introduced in Japan within the next few years.

Curtailing settlement risks

At present, the JSDA is actively advancing efforts for shortening settlement cycles for government bonds and stock trades to facilitate and strengthen the functioning of the capital markets.

Financial benchmarks

In May 2015, an amendment to the FIEA became effective, introducing a new regulatory framework for organisations that set financial benchmarks such as the Tokyo Interbank Offered Rate (TIBOR) (financial benchmark administrators). Under the amended FIEA, the FSA may designate entities as financial benchmark administrators that are then required to establish and observe operational rules consistent with the principles for financial benchmarks of the International Organization of Securities Commissions (IOSCO) regarding their systems of governance, the quality of their benchmarks, the quality of their methodology and accountability. Financial benchmark administrators are subject to supervision by the FSA (not the SESC), including on-site inspections. Each reference bank or financial institution that submits rate data is subject to and monitored for compliance with the code of conduct agreed upon with the financial benchmark administrator. Manipulative activities by financial instruments business operators (FIOs) or registered financial institutions (RFIs) are sanctioned. The FSA has designated the JBA TIBOR Administration (JBATA) as a financial benchmark administrator. JBATA engages in the calculation, publication and administration of JBA TIBOR, which is a 'virtual' rate rather than 'actual' rate due to the difficulty of obtaining data for actual transactions with some tenors. JBATA is currently considering the introduction of new financial indices (TIBOR+) that are expected to be based on 'actual' transactions in view of the principles of the IOSCO. JBATA is currently planning its third public consultation with market participants, which has so far been delayed due to the introduction of the BOJ's negative interest rate policy.

ii Developments affecting derivatives, securitisations and other structured products

The FIEA is the most basic and fundamental instrument of regulation applicable across the spectrum of derivatives, securitisations and other structured products. In addition, there are other laws governing derivatives, securitisations and other structured products such as the Act on Investment Trusts and Investment Corporations, the Limited Partnership Act for Investment, the Act on Securitisation of Assets, the Trust Act and the Companies Act. Other related laws and regulations may apply depending on the type of the product.

In 2006, the FIEA underwent radical amendment (it was formerly the Securities and Exchange Act), as did the CDA in 2011 (formerly the Commodity Exchange Act). The main purpose of these amendments was to provide more complete protection for investors, and to improve and enhance the convenience of participating in the Japanese market. While these amendments introduced strict and rigid regulations for investor protection, there are exceptions for rules and regulations that are applicable to financial instruments businesses targeting only professional investors, QIIs or commodity derivatives professionals. In other words, the rules and regulations applicable to the financial instruments business can differ depending on the type of investor. The FSA has also promoted a considerable number of

further amendments to the FIEA in recent years to implement agreements reached at the G20 summits, which aim to strengthen the global financial system by fortifying prudential oversight, improving risk management, promoting transparency and continuously reinforcing international cooperation.

Derivatives

In light of the statements made by leaders at the G20 summits calling for improvements in OTC derivatives markets, there have been several legislative and regulatory developments intended to implement new policies regarding central clearing, trade reporting, margin requirements and trading platforms since 2012. With respect to central clearing and trade reporting, see Section II.iv, *infra*.

On 1 September 2015, a Japanese version of an electronic trading platform was introduced. FIOs and RFIs are required to use electronic trading platforms when engaging in OTC interest rate swap transactions denominated in Japanese yen to enhance the immediate disclosure of information about the derivatives trade. More details regarding the scope of transactions subject to regulation are prescribed in the FSA's public notice under the Cabinet Office Ordinance of the FIEA. The regulation also provides for a licensing system, minimum capital requirements, recordkeeping and other rules for electronic trading platform operators.

On 1 September 2016, non-cleared margin rules under the Cabinet Office Ordinance of the FIEA became effective that implement the Basel Committee on Banking Supervision (BCBS)–IOSCO margin requirements for non-centrally cleared derivatives. These rules require that FIOs engaged in Type I financial instruments business (Type I FIOs) and RFIs post[12] and collect initial margin (IM) and variation margin (VM) to and from the counterparty on a bilateral basis, with some exceptions. For both IM and VM, there will be phase-in periods during which margin obligations will apply to a given entity only if certain *de minimis* thresholds are met by the average over the preceding three months of the month-end aggregate notional amounts of the entity's non-cleared OTC derivatives, OTC commodity derivatives, and physically settled FX forwards and swaps (determined on a consolidated group basis). Specifically, IM obligations will be phased in from 1 September 2016 to 1 September 2020, with an initial *de minimis* threshold of ¥420 trillion which will gradually be lowered until it reaches ¥1.1 trillion for the last portion of the phase-in period from 1 September 2019 to 1 September 2020. VM obligations will be phased in from 1 September 2016 to 1 March 2017 with a *de minimis* threshold of ¥420 trillion for the entire duration of the phase-in period. After the IM phase-in period ends on 1 September 2020, IM will be required if:

a the average over the preceding year of the month-end aggregate notional amounts of the entity's OTC derivatives (on an unconsolidated basis) is ¥300 billion or more; or

b the average over the preceding year of the month-end aggregate notional amounts of the entity's non-cleared OTC derivatives, OTC commodity derivatives, and physically settled FX forwards and swaps (determined on a consolidated group basis) is ¥1.1 trillion or more.

12 Until the EU introduces its margin regulations, Type I FIOs and RFIs are allowed to use a trust account or a custodian account as an interim method to ensure that the posted IM is segregated from the property of the counterparty.

Likewise, after the VM phase-in period ends on 1 March 2017, VM will be required if the average over the preceding year of the month-end aggregate notional amounts of the entity's OTC derivatives (on an unconsolidated basis) is ¥300 billion or more. Parties may agree bilaterally to introduce a minimum transfer amount as long as it does not exceed ¥70 million for the sum of IM and VM. Eligible types of collateral are:

a cash;
b government or local government debt securities;
c high-quality debt securities with specific ratings by eligible rating agencies;
d equities included in a major index;
e convertible bonds with specific ratings by eligible rating agencies; and
f investment trusts meeting certain conditions.

IM must be segregated in a trust account or through a similar method so that the IM will be returned to the posting party in the event of a counterparty default. Re-hypothecation and reuse of IM are not permitted unless the IM consists of cash, and such re-hypothecation and reuse are conducted in a safe manner that bears a relation to the management of the IM. Inter-affiliate trades are exempt from the margin requirements.

Even if Type I FIOs and RFIs are below the *de minimis* threshold for VM, they are still required by the FSA's comprehensive guidelines to establish internal systems reasonably designed for the appropriate posting and collection of VM in line with BCBS–IOSCO's final report.

With respect to cross-border trades, Type I FIOs and RFIs are required to post and collect margins to or from the counterparties that conduct OTC derivatives transactions in the course of trade and are estimated to have a notional outstanding amount of OTC derivatives of ¥300 billion or more (to be calculated in the same way as the ¥300 billion *de minimis* threshold applicable to FIOs). Trades with counterparties that conduct OTC derivatives transactions in the course of trade in non-netting jurisdictions or trade with counterparties that are foreign sovereigns are fully exempt from both the VM and IM requirements, although such trades are still subject to appropriate risk management standards under the FSA comprehensive guidelines. The FSA has issued a public notice approving compliance with non-cleared OTC derivative margin regulations of US Commodity Futures Trading Commission and the Office of the Superintendent of Financial Institutions in Canada as substituted compliance, which allows Type I FIOs and RFIs to post or receive IM and VM in accordance with such foreign regulations in any domestic, cross-border or offshore transactions. The US Commodity Futures Trading Commission has made a comparability determination that permits substituted compliance with the FIEA's margin requirements for uncleared swaps in lieu of compliance with the uncleared swap margin provisions of US law.

Apart from the foregoing, the FSA's comprehensive guidelines will be amended to require the inclusion of stay provisions in derivatives agreements governed by non-Japanese law as of 1 April 2017 (with respect to Japanese stay regulations, see Section II, iii, *infra*).

Investment funds

A recent amendment to the FIEA addresses concerns of the FSA about general partners who were not registered as Type II FIOs and relied on the 'QII business exemption' under Article 63 of the FIEA. Under previous regulations, if a general partner relied on the QII business exemption, up to 49 non-QII investors were allowed to invest in the partnership under the relaxed rules so long as at least one QII joined the partnership as a limited partner. Because

general partners sometimes used this exemption to solicit non-QIIs without providing adequate information, the FIEA was amended in June 2016 to require business operators relying on the QII business exemption to submit a notification providing information about their principal business office, the names of the QII, the names of auditors and accountants, the non-QIIs to be solicited, and the details of their investment plan. These requirements are intended to enable the regulatory authorities to easily understand the QII's business. Parts of this notification will be made publicly available at LFBs or on a website. The FIEA was also amended to limit the category of non-QIIs allowed to invest in the partnership to investors that are corporations having assets or capital of more than ¥50 million, governments, local authorities, subsidiaries of fund managers, and directors, officers or employees working for parent companies or subsidiaries of fund managers; provided, however, that in the case of venture capital funds, the category also includes directors or ex-directors of listed companies, attorneys, accountants and tax accountants, and individuals who have experience in starting up a new business. Furthermore, a general partner will not be able to rely on the QII business exemption when a limited partnership having assets of less than ¥500 million plans to become the only QII with respect to the new fund, or when more than half of the new fund's assets are to be contributed by persons who made or relate to the notification. When a general partner is not able to rely on the QII business exemption under the amended FIEA, Type II registration is required to solicit limited partners.

Additionally, the FSA has the power to conduct inspections, give orders or impose administrative sanctions, and the amended FIEA disqualifies a general partner who has received an order to discontinue its business or who has been subject to criminal sanctions in the past, as well as a general partner who is a foreign individual or corporation not having any representative in Japan. The regulations applicable to solicitation of non-QIIs has also been strengthened by introducing new rules regarding suitability, explanatory documents to be delivered prior to the conclusion of a contract, fiduciary duties, restrictions on advertisement, segregation of investors' funds and delivery of investment reports.

Fund passport

Japan, Australia, Korea and New Zealand are signatories to the Asia Region Funds Passport's Memorandum of Co-operation, which came into effect on 30 June 2016. The Asia Region Funds Passport is an international initiative that aims to facilitate cross-border offerings of eligible collective investment schemes with sufficient investor protections in signatory countries.

iii Relevant tax and insolvency law

Tax law

In general, all corporations in Japan are subject to treatment as taxable entities. Foreign corporations are liable to pay certain types of corporate tax and income tax on domestic-sourced income, which varies depending on whether the foreign corporation has a permanent establishment in Japan. Non-corporate forms that are sometimes used as a vehicle for financial transactions, such as general partnerships, limited liability partnerships or trusts, are, in principle, fiscally transparent for Japanese tax purposes. However, in a tax dispute over whether a limited partnership established under the laws of the state of Delaware (Delaware LP) is a corporation for Japanese taxation purposes, the Supreme Court ruled on 17 July 2015 that a Delaware LP constitutes a corporation under Japanese tax law. This ruling stated that whether a foreign limited partnership is regarded as a corporation under Japanese

tax law shall be determined on a case-by-case basis and it did not refer to any other foreign limited partnership. This ruling is expected to have an effect on tax return practice and the use of foreign limited partnerships, because it had been fairly common to file tax returns assuming that a foreign limited partnership did not fall within the category of corporations for Japanese taxation purposes.

Apart from the above, the following reforms on domestic taxation that may affect investors have recently been implemented.

First, the combined national and local effective corporate tax rate will be reduced to 29.97 per cent from the current 32.11 per cent for taxable years beginning on or after 1 April 2016. A further rate cut is planned for 2018, which would result in a combined effective tax rate of 29.74 per cent. The reduction in the corporate tax rate is intended to strengthen Japan's attractiveness as a location and enhance the competitiveness of Japanese companies.

Second, since 1 January 2016, capital gains arising from the sale of listed shares and certain designated bonds have been classified as falling within the same income category, which means that under the current tax law, capital losses arising from the sale of listed shares and such designated bonds can be set off against dividends from other listed shares or interest on other designated bonds. Likewise, capital gains arising from the sale of non-listed shares and non-designated bonds are classified together as belonging to a different income category. Capital gains or losses arising from the sale of listed shares can no longer be used to offset capital losses or gains arising from the sale of non-listed shares. For payments received after 1 January 2016, redemption gains on discount bonds have been treated as capital gains, which means both capital gains on listed shares and redemption gains on discount bonds are equally subject to a rate of 20.315 per cent for Japanese resident individuals, and 15.315 per cent for Japanese corporations and non-Japanese residents. The FSA further intends to permit that income or losses from derivatives transactions be set off against income or losses from the sale of shares or bonds to improve the Japanese capital markets and prevent tax avoidance activities.

Third, with a view to international harmonisation, the 2015 tax reforms created a new tax exemption with respect to margin interests in OTC derivatives transactions.

Fourth, a Japanese version of an individual saving account (ISA) system, called 'NISA', was introduced in 2014, which makes investments of up to ¥1 million per year tax free if the investment was made through an ISA. An investor can hold an ISA as a tax-exempt account for a maximum of five years falling within the period from 2014 to 2023. The government continues to proactively promote the use of the NISA because NISA steadily increases participation in the stock market by individuals and has attracted the interest of retail investors.

Fifth, in view of the recommendations of the final report issued by the project of the OECD/G20 to tackle and prevent base erosion and profit shifting (i.e., tax-avoidance strategies exploiting gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations), Japanese-based multinational companies are now required to provide tax authorities with a their country-by-country report, their master file (i.e., a report providing a business overview of group companies) and their local file (which describes information to be used for computing arm's-length prices for foreign-related transactions).

With respect to the consumption tax, please see Section II, v, *infra*.

Insolvency laws
There have been no material amendments to the insolvency laws[13] or the Companies Act.

On 6 March 2014, an orderly resolution regime covering banks, securities companies, insurance companies, financial holding companies and similar entities that are experiencing financial difficulties was implemented through the Deposit Insurance Act[14] in line with the international agreement reached at the Financial Stability Board and G20 Cannes Summit. This regime gives the Prime Minister the authority to suspend the application of any termination provisions of certain financial agreements and to close out netting provisions for a period that the Prime Minster designates. The Prime Minster thus in effect has the ability to implement a kind of temporary stay for a designated period to enable a troubled financial institution to transfer its assets to an acquiring financial institution or a bridge financial institution. Related to this, from 1 April 2017, financial institutions will be required by the FSA's amended comprehensive guidelines to include stay provisions in the non-Japanese law governed agreement covering the OTC derivatives transactions or securities lending transactions, etc., by way of adopting the ISDA 2015 Universal Resolution Stay Protocol or other appropriate methods.

iv Role of exchanges, central counterparties (CCPs) and rating agencies

In principle, the FIEA regulates financial instruments exchanges, financial instruments clearing organisations (CCPs) and rating agencies. The CDA regulates the commodity exchanges.

JPX is the largest company operating financial instruments exchange markets to provide market users with venues for cash equity trading through its subsidiary, TSE, and for derivatives trading through Osaka Exchange, Inc (OSE). TSE also offers companies an alternative listing framework to meet the needs of professional and other investors, which consists of Mothers, JASDAQ, TOKYO PRO Market and the TOKYO PRO-BOND Market. In addition to providing market infrastructure, JPX also provides clearing and settlement services through a CCP, Japan Securities Clearing Corporation (JSCC) and conducts trading oversight to maintain the integrity of the markets. To date, JPX has not yet commenced commodity trading operations, because the Tokyo Commodity Exchange Inc (TOCOM) has decided not to become a subsidiary of JPX, and is still considering alternative survival strategies amid Japan's shrinking commodities market.

Exchanges
On 30 April 2015, TSE established a new market for funds that invest in infrastructure and related facilities, including energy-based power generation facilities (e.g., solar plants), public infrastructure and other infrastructure (e.g., airports, roads and ports). Rules on the infrastructure fund market are based on the framework provided for the real estate

13 The insolvency laws include the Bankruptcy Act (Act No. 75 of 2004, as amended), the Civil Rehabilitation Act (Act No. 225 of 1999, as amended), the Corporate Reorganisation Act (Act No. 154 of 2002, as amended), and the Act Concerning the Special Provisions for the Reorganisation of Financial Institutions (Act No. 95 of 1996, as amended).

14 Act No. 34 of 1971, as amended.

investment trust market. In June 2016, the first investment corporation investing in solar power plants was listed on the new infrastructure fund market. Infrastructure investment funds are expected to pull in capital from private investors to finance building infrastructure.

CCPs

Since November 2012, FIOs and RFIs have been required to clear certain types of OTC derivatives transactions via the mandatory use of central clearing under the FIEA.

Under the current FIEA, the types of OTC derivatives transactions that are subject to mandatory clearing are credit default swaps (CDS) on Markit iTraxx Japan referencing the credit of no more than 50 Japanese corporations, and 'plain vanilla' yen-denominated interest rate swaps (IRS) referencing three-month or six-month JPY LIBOR or Euro JPY TIBOR, which are eligible for clearing services provided by a Japanese CCP (i.e., JSCC). Certain transactions, however, such as transactions with a party that is not an FIO or RFI, transactions that are booked in a trust account or transactions between affiliates, may be exempt from the mandatory use of the CCP.

With respect to client clearing, CDS or IRS transactions with a party that is not a clearing participant of the CCP may be exempt from mandatory clearing. However, IRS transactions are subject to mandatory clearing (through client-clearing services) when one or both parties are FIOs or RFIs that are registered with the FSA. Such registration is required when the monthly average outstanding notional amount of OTC derivatives is ¥300 billion or more; or, starting on 1 December 2016, when the monthly average outstanding notional amount of property booked in a trust account of FIOs or RFIs is ¥300 billion or more.

JSCC and its parent company, JPX, expect that many other market participants will become members of the clearing framework at JSCC in the near future, and JSCC has expressed its intention to expand its range of services. For example, JSCC provides clearing services for listed derivatives and FX transactions traded on the OSE in addition to the clearing services offered for equities transactions traded on the TSE. With a view towards enhancing the convenience of the market, JSCC has extended its clearing services to IRS transactions denominated in US dollars, Australian dollars and euros. Furthermore, a new clearing window starting from 17:30 to 19:00 has been set up since April 2016 to enable prompt clearing. With respect to clearing regulations in the US, Europe and Australia, JSCC has been authorised as an Exempt DCO, TC-CCP, or Prescribed-CCP, which means that these countries regard JSCC as a third-country clearing organisation subject to comprehensive supervision in Japan that is comparable to their own respective supervisory regimes.

With respect to commodity derivatives transactions, Japan Commodity Clearing House Co, Ltd, which provides clearing services for transactions conducted at the TOCOM or the Osaka Dojima Commodity Exchange, extended its clearing services to OTC commodity derivatives transactions on 16 May 2014.

Transaction information and trade repositories

Since November 2012, certain financial institutions, CCPs and trade repositories have been required to report OTC derivatives transaction information to the FSA under the FIEA. More specifically:

a FIOs and RFIs are required to store transaction information, and to report this information to the FSA on or before the third business day of the following week,

unless the transaction was cleared by a Japanese or foreign CCP (registered in Japan) or the information has been provided to the 'trade repositories' within three business days.

b Japanese and foreign CCPs (registered in Japan) must record transaction information and report this information to the FSA within three business days.

c Trade repositories must record transaction information provided by FIOs or RFIs and report this information to the FSA within one business day.

The FSA uses such data to publish information on the number of transactions and total amounts. The Depository Trust & Clearing Corporation Data Repository Japan has provided trade depository services in Japan as a 'Foreign Trade Repository' under the FIEA since March 2013.

v Other strategic considerations

The FIEA, which imposes restrictions on the solicitation of certain securities transactions (including offerings, purchases and sales of securities, but excluding securities lending and repo transactions) directed at residents in Japan, applies regardless of whether the solicitation is domestic or from overseas. This means that direct solicitation for securities transactions is permitted without satisfying licensing requirements only when it is directed at QIIs such as banks, FIOs and insurance companies. All other direct solicitation for securities transactions directed at residents in Japan is strictly prohibited by the FIEA, and requires agency or intermediary services by a licensed FIO. Similar, but different, standards apply to the solicitation of derivatives transactions from overseas (which are also controlled by the FIEA). In any event, careful legal due diligence is highly recommended before entering into securities transactions with residents in Japan.

Money-lending activities from overseas to residents in Japan are restricted mainly under the Money Lending Business Act[15] and the Usury Act.[16] Briefly stated, direct lending from overseas to residents in Japan is prohibited except if a foreign bank uses a branch in Japan that is licensed as the foreign bank's branch under the Banking Act. This restriction does not apply when the borrowing is made in the form of a bond issuance.

It is noteworthy that the FSA is promoting the development of fintech. To date, the FSA has made amendments to the Banking Act, the FIEA and the Payment Services Act[17] (regulating bitcoin) to facilitate fintech-related business in each of these sectors (e.g., the ownership of a fintech company by a bank is now allowed by an amendment of the Banking Act). The need for multiple amendments reflects that institutions in each of these sectors are subject to separate regulatory regimes (see Section I.i, *supra*). To accommodate financial services that transcend conventional boundaries through technological development, the Working Group on the Financial System of the Financial System Council established by the FSA in July 2016 is currently discussing potential improvements to the financial business environment that would allow IT financial services affected by multiple regulations to be provided more easily. The current financial regulations and administrative system, which provide for separate supervisory regimes depending on the sector to which the entity being

15 Act No. 32 of 1983, as amended.

16 Act No. 195 of 1954, as amended.

17 Act No. 59 of 2009, as amended.

regulated belongs, may move towards regulations that apply across different sectors to reflect that, through the use of technology, financial institutions are expected to operate diverse businesses that defy conventional classification on a sector-by-sector basis.

It is also noteworthy that the FSA's '2015–2016 Strategic Directions and Priorities' encourage financial institutions that produce, sell or manage financial products to observe 'fiduciary duties.' In the same vein, the FSA states that financial institutions should put customers' interests first. While there appears to be a global trend towards the more frequent use of the notion of 'fiduciary duties', there is no specific legal definition or established precedent regarding 'fiduciary duties' under current Japanese law. Given the vagueness of the concept of 'fiduciary duties', it may be expected that the FSA will exercise broad discretion in interpreting the concept.

Meanwhile, the BOJ introduced a negative interest policy in early February 2016. The FSA has overall adopted a passive attitude towards this policy, but monitors any potentially negative impact on the business performance of banks, especially small and medium-sized regional banks. The introduction of negative interest requires many changes to the traditional legal understanding of 'loan', 'deposit' and similar concepts under Japanese law.

Furthermore, several basic laws (especially the Civil Code) are being reviewed for future amendment, and such amendments are likely to affect the capital markets in Japan. Incidentally, consumption tax increased to 8 per cent in April 2014, and is scheduled to further increase to 10 per cent in April 2017. While consumption tax is not directly applicable to financial transactions, the increase in consumption tax from 8 to 10 per cent that will be implemented in April 2017 may have broader implications for the Japanese economy, including the financial markets.

III OUTLOOK AND CONCLUSIONS

The FSA, under the leadership of Commissioner Nobuchika Mori, is currently pursuing a market regulation model that is different from the models used by other countries such as the US and the EU. The FSA currently follows a Plan-Do-Check-Act (PDCA) cycle in designing and implementing financial regulations. In accordance with this policy, the FSA published the '2015–2016 Strategic Directions and Priorities' as the outcome of the 'Plan' stage of the PDCA cycle in October 2015, and the 'Financial Report for Fiscal Year 2015' as the review required by the 'Check' stage of the PDCA cycle in September 2016. The FSA took into account the outcome of this review and it released its new strategic directions and priorities in late October 2016.

In the '2015–2016 Strategic Directions and Priorities', fintech and cybersecurity are mentioned as being among the FSA's strategic priorities. The FSA supports the promotion of fintech to improve productivity and reduce costs with a view to developing the Japanese economy (see Section II.v, *supra*). The FSA also supports the enhancement of cybersecurity to secure financial stability. Supervision of financial institutions is a strategic priority as well. As part of such supervision, the FSA plans to review the relationship between financial institutions and their customers, financial institutions' corporate governance practices, and the level of preparedness of these institutions for stresses in the markets and the economy.

In his recent address entitled 'From static regulation to dynamic supervision', Commissioner Mori stressed that in adopting the PDCA cycle, the FSA is further shifting its policy from rule-based towards principle-based regulation. He suggests that the entire framework of regulatory and supervisory policy should be assessed from five perspectives,

namely whether the framework is 'aggregate', 'behavioural', 'cross-sectoral', 'dynamic', 'ecosystem', 'feedback-loop' and 'general equilibrium' (perspectives A to G). Mori recommends that the FSA enter into a closer dialogue with individual banks based on perspectives A to G, and that close supervision should be complemented by these perspectives with a view to achieving financial stability and growth.[18] The FSA is not adopting a policy of deregulation but a shift towards greater reliance on self-regulatory initiatives by financial institutions in the Japanese financial markets. The FSA's approach places importance on the vitalisation and streamlining of the markets rather than the imposition of tight restrictions on financial institutions, and is, as such, considered to be 'market friendly.' These efforts by the FSA may embody the first large-scale reforms that Japan is experiencing since the Japanese Big Bang in 1996, which focused on the creation of 'free', 'fair' and 'global' markets.

18 www.fsa.go.jp/common/conference/danwa/20160413/01.pdf.

Appendix 1

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Akihiro Wani has almost 30 years' experience in the capital markets arena and is widely renowned as an expert in the banking sector. He has acted for major financial institutions on financial regulations and cutting-edge derivatives transactions, advised on the establishment of head and branch offices of financial institutions, and acted on various matters involving cross-border financial trading, securities, insurance and general corporate transactions. Mr Wani is a professor at Sophia University Law School, a counsel for the International Swaps and Derivatives Association in Japan, and a financial expert at the P.R.I.M.E. Finance Foundation. He is also a financial policies monitor of the Financial Services Agency of Japan.

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