

Christopher P. Wells
White & Case Tokyo Office

JSDA Member Compliance: An Overview of Basic Principles After Adoption of the FIEL

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Overview

- Role of Internal Control and Basic Knowledge Requirements of Compliance Staff
- Background to FIEL--what changed from prior law
- Rules Applicable to the Solicitation Process
- Investor Classes and Disclosures
- Private Placements and Public Offerings
 - Type 1 Offerings
 - Type 2 Offerings
- Maintenance of Books and Records
- Handling 5% Filings Under FIEL Article 27-23.
- Review of Recent FSA Sanctions and cases; what they can teach us about maintaining compliance going forward
- Today's session is educational in nature, it is not legal advice; speak with your regular advisors about these matters before taking action

Role of Chief Internal Control Manager (CM3)

- **Chief Internal Control Manager**
 - **Instill proper respect for compliant conduct by business lines**
 - **Establish functional internal control system**
 - **Teach and supervise subordinate sales and internal control managers**
 - **Establish and maintain proper communication and coordination with government and self-regulatory authorities**
 - **Report problems to President (or Board of Directors) and receive and implement corrective action**

Roles of Sales and Internal Control Managers (CM 3-4)

▪ Sales Manager

- Guide and supervise business activities of relevant business unit
- Is point of contract for compliance and control systems vis-a-vis clients
- Is required to be knowledgeable about FIEL sales requirements
- Has duty to report misconduct to the internal control officers

▪ Internal Control Manager

- Duty to monitor whether FIEL is being complied with presumes a knowledge of FIEL and JSDA regulations
- Duty to report problems in compliance with
 - Customer solicitation rules
 - Customer management rules
 - Functions as a “check and balance” on Sales Managers and roles cannot overlap
 - Each business unit in principle should have 1 internal control officer

Basic Responsibilities of Internal Control

- Preparation and maintenance of customer identity records
- Verification of customer identity (CM 9-13)
- Preparation and confirmation of sufficiency and accuracy of customer documentation
- Identify and prevent false name transactions in trading
- Duty to verify customer identity and perform cross-checks (CM 12)
- Promptly notify government of suspicious activities by customers/market (CM 15)
- Ensure delivery of foreign securities transaction disclosure documents (CM 18)
- Obtaining confirmation letters for relevant OTC transactions (CM 25)
- Monitoring and ensuring documentary compliance with discretionary account transactions in accordance with requirements as to issuer, price, purchase or sale and volume—substantive knowledge of instances where discretion can apply to one element and for system trading (CM 32)

Check items for Internal Control (SESC IM-11)

- **Is the business administration systems working properly**
 - Checks and balances in place?
 - Firm's management policy clear, well formulated and advanced by management
 - Risk recognition by management including importance of legal/compliance
 - Independent auditors, maintenance of proper internal (Board) records, etc.
- **Is the legal and compliance systems running properly?**
 - Is there commitment to basic principles by management teams
 - Are practices programs (by product, etc.) codes of conduct, internal rules, in place?
 - Are legal and compliance independent of management--culture of professionalism?
- **Is the internal control system functions well and continuously?**
 - Sufficient staff to carry out effective internal control?
 - Is education and training of compliance staff adequate?
 - Are the internal control functions properly "tuned" to the functions of the firm?
- **Is there an "internal audit" function in place and is it meeting expectations?**
 - Is the internal control function recognized and is there a program for periodic independent internal review
 - Are internal audit plans well organized, implemented and followed-up on? Are external resources used well?
- **Is there a well developed "crisis management" system in place for natural (and man-made) disasters which can threaten the entire enterprise and market confidence?**

Compliance Officer's Bookshelf and Reading List

- JSDA Compliance Manual
- JSDA Gaimuin Examination Volumes
- JFTI Translation of **Financial Instruments Exchange Law**
- JFTI Translation of **Enforcement Order** For FIEL (Cabinet Order No. 321, September 30, 1965) 金融商品取引法施行令（昭和四十年九月三十日施行令第三百二十一号）
- JFTI Translation of Cabinet Office Ordinance Concerning The **Definitions** Specified In Article 2 Of FIEL (Ministry of Finance Ordinance No. 14 of 1993) 金融商品取引法第二条に規定する定義に関する内閣府令（平成五年大蔵省令第十四号）
- Cabinet Office Ordinance Concerning Restrictions On **Transactions, Etc. In Securities** (Cabinet Office Ordinance No. 59 of August 8, 2007) 有価証券の取引等の規制に関する内閣府令（内閣府令第59号、平成19年8月8日）
- JFTI Translation of Cabinet Office Ordinance Concerning **Financial Instruments Trading Business, Etc.** (Cabinet Office Ordinance No. 52, August 6, 2007) 金融商品取引業等に関する内閣府令（内閣府令第五十二号、平成十九年八月六日）
- Translation of **Corporation Code**
- Translation of **Foreign Exchange** and Foreign Trade Control Law
- JFSA **Inspection Manual** for Financial Instruments Dealers, Etc.

Background to the FIEL



What has changed?

- Expansion of Definition of Securities

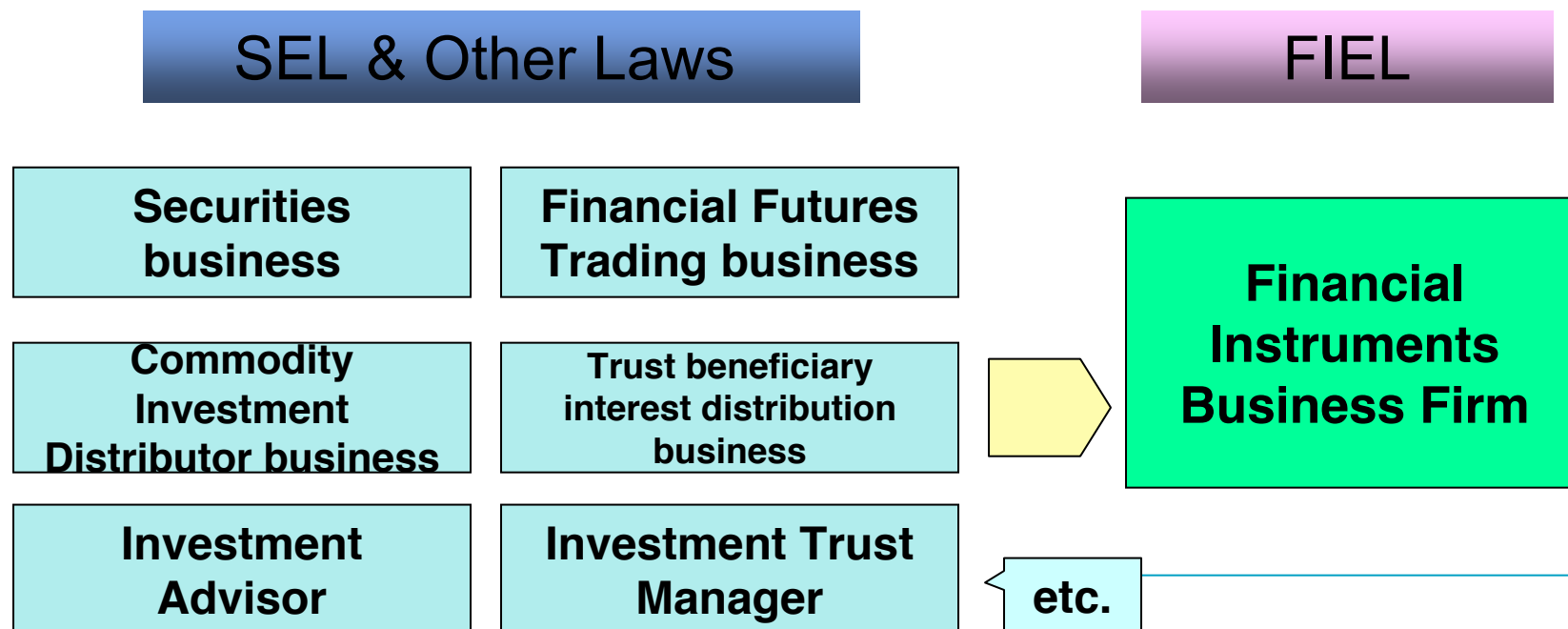
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FIEL

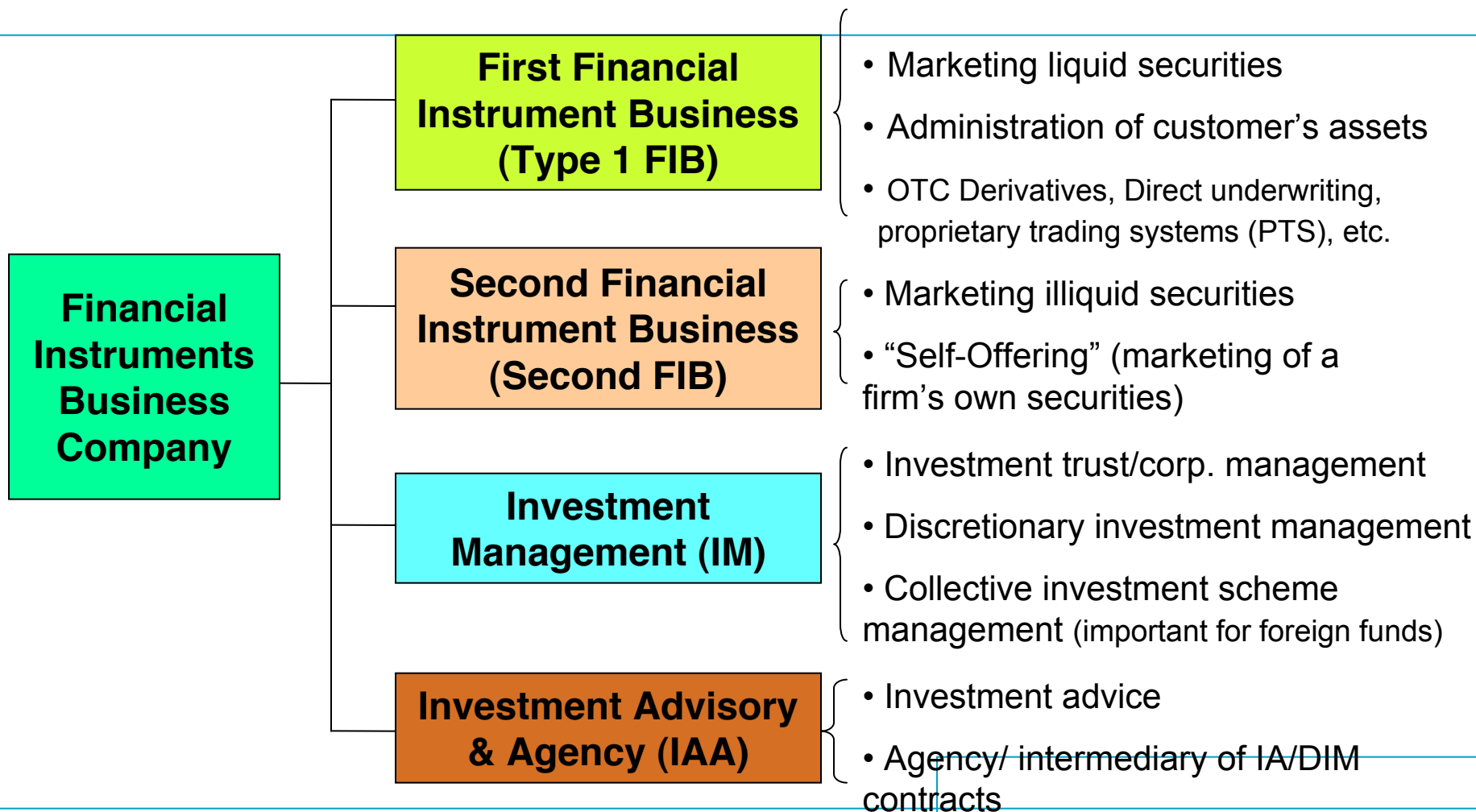
Securities	<p>¶ 1 Securities: Bonds, Stocks, Investment trust, etc.</p>		<p>Bonds, Stocks, Investment trust, etc.</p>
			<p>Mortgage securities, Beneficiary certificates of trusts</p>
Deemed Securities	<p>¶ 2 Securities: Beneficiary interests of loan trusts</p>		<p>Beneficiary interests of trusts</p>
	<p>Certain types of LP/LLP/TK/NK interests</p>		<p>Collective Investment Scheme interests</p>
	<p>GK interest, etc.</p>		<p>Gomei, Goshi, GK interests</p>
	<p>Others (depending on circulation, economic nature)</p>		<p>Others (economic nature)</p>

What has changed? - Unification of Businesses

- Several businesses (such as below) which are regulated by separate laws have been unified into “Financial Instruments Business” (excluding banking and insurance businesses).



What has changed? - Financial Instruments Business



Type 1 Financial Instruments Dealers

- **Business currently carried on by securities companies and financial futures transaction dealers**
 - **Trading in securities (excluding those constituting derivatives transactions)**
 - **Over-the-counter (“OTC”) derivatives transactions**
 - **Underwriting of securities**
 - **Operating Proprietary Trading System**
 - **Securities, etc., management business**
- **Requirements:**
 - **The total amount of capital or equity contribution is not less than 50,000,000 yen**
 - **The applicant must be a stock company**
 - **Its net assets is not less than 50,000,000 yen**
 - **Major stockholders are not disqualified persons.**
 - **Its solvency margin is not less than 120% based on solvency calculation regulations**

Type 2 Financial Instruments Dealers

- **Business previously carried on by financial futures transaction dealers, investment trusts and collective investment schemes handling:**
 - **A primary offering or a private placement of paragraph 2 securities**
 - **Trading in paragraph 2 securities**
 - **Market derivative transactions excluding securities derivative transactions**
- **Who can be a Type 2 Financial Instruments Dealer?**
 - **A Corporation the total amount of capital or equity contribution not less than JPY 10 million**
 - **Individual person who places a business security deposit (not less than JPY 10 million) into escrow with a legal affair bureau**

Emergence of Offshore Type II Securities Licenses

- Type II Securities are “collective investment scheme” securities which generally means limited partnership interests
- Registered Type II Securities firms (both domestic and offshore) acting as placement agents can approach Japanese investors with offering and subscription documentation for foreign Type II securities
- Previously an offshore placement agent who traveled to Japan to approach an investor contact about a new fund risked being found to be engaged in an unregistered securities business subject to criminal sanctions
- Holding a Type II registration permits these foreign placement agents to accompany manager representatives (coming to Japan as officers or directors of the GP entity under an Article 63 filing) to make direct offers of Type II securities to Japanese investors; alternatively, they can make the offers as agents of the offshore parties
- Investment managers could also register as Type II placement agents for the funds they manage
- Note that Type II registrants cannot distribute Type I fund securities (corp. and trust form funds and various other forms of Type 1 securities)

Types of Entities That Can Obtain Specific Licenses

Entity Type/License Type (Required Capital/Deposit)	Type 1 Securities Dealer	Type 2 Securities Dealers	Asset Management Firm	Investment Advisor
Public Corporation (kabushiki kaisha)	Yes (¥50 million)	Yes (¥10 million)	Yes (¥10 million)	Yes (¥5 million dep.)
Special Private Corporation (Tokurei Yugen Kaisha)(requires a BOD and statutory auditor)	[Possibly (¥50 million)]	Yes (¥10 million)	No	Yes (¥5 million dep.)
Limited Corporation (Godo Kaisha)	No	Yes (¥10 million)	No	Yes (¥5 million dep.)
General Partnership (Nin-I Kumiai)	No	No	No	No
Silent Partnership (Tokumei Kumiai)	No	No	No	No
Individual	No	Yes (¥10 million)	No	Yes (¥5 million dep.)

- Note that several of the registrations can be held by the same entity; however, compliance (firewalls), management, tax and other considerations should be considered before doing so--their can be advantages with having separate entities from a practical management standpoint

Fundamental Principles Of Solicitation

- All officers and employees must maintain honesty and fairness in transactions as required by FIEL Article 35
- All customer transactions must be conducted on the basis of self-responsibility
 - This means that customer investment decisions must be based on **fully informed independent judgment**
 - Requires that **customer understands** the transactions being contemplated
 - Employees need to be sensitized to difference between customer and counterparty--constantly
 - Securities company staff owes **duty of full explanation** of products to all types of customer whether professional or non-professional
 - All material matters must be disclosed
 - Must be clear that **customer understands transaction** being undertaken

Meaning of Reasonable Solicitation

- All transactions based on Principle of Reasonable Solicitation—that is, no solicitation is permitted that is not consistent with **knowledge, experience, financing condition or investment objectives** of customer
 - To comply with this principle it is essential that employees know these factors BEFORE commencing solicitation
 - JSDA Checklist titled Guidelines for Investment Solicitation has 5 primary divisions:
 - Clear explanation of transaction
 - Solicitation only in a manner that matches investment purpose, financial capacity and experience of customer
 - Confirmation that proper, full and not misleading information has been provided
 - Confirmation that customer has investment intent through independent decision making
 - The transaction is **otherwise fair and equitable** - put yourself in customer's position

Duties of Control Officers for Transactions (FIEL § § 38-39)

- Be able to identify and prevent transactions based on false statements
- Be able to identify and prevent transactions where a “**definitive judgment** concerning an uncertain matter which can leave a mistaken impression” with the customer
- Be able to identify and prevent solicitation using **false representations** which can give a mistaken impression of a material matter
- Be able to identify and prevent solicitation using **special economic benefits**
- Be able to identify and prevent **excessive solicitation**
- Be able to identify and prevent the use of guarantees of **compensation for losses** in solicitation
- Be able to identify and prevent the use of transaction offering future benefits to compensate for losses
- Prevent solicitations contrary to disclosure and time restrictions

Factors In Classifying Offerings - 1

- **Rules applicable to offers made to customers (solicitations) are distinguished using various factors including:**
 - **Timing: newly issued and already issued securities**
 - **Number of offerees: public offers and private placements**
 - **Type of securities offered: type (paragraph) 1 securities or type 2 (paragraph) securities**
 - **Type of investor: QII, Professional and Non-Professional**

Factors In Classifying Offerings - 2

- **Solicitations by offers of newly issued securities are called “Primary Offerings” and Offers of already issued securities are called “Secondary Offerings”**
- **“Public offerings” refer to solicitations where offers are made to 50 or more persons within a 6 month period, and “private placements” refer to solicitations where offers are made to 49 or fewer persons FIEL § 2.3**
- **Type 1 Securities are securities typically represented in transferable certificates including shares, bonds and tradable derivatives while Type 2 Securities are securities representing rights to collective investment schemes that have low market liquidity**
- **Legal entities are “professional investors” unless they elect otherwise and individuals are “non-professional” investors unless they have relevant experience and elect otherwise; QIIs are always professional investors**
- **Most combinations of the four factors exist in the market but some are less common than others: “Primary public offering of Type 1 Securities” and “Secondary private placement of Type 2 Securities”**

Professional Investor System

- All investors must be classified into “Professional Investors” and “Non-Professional Investors”
- All Qualified Institutional Investors are “Professional Investors”
- Individual investors who want to be “Professional” must:
 - Have net assets of more than JPY 300 million
 - Have maintained a securities account for 1 year or more
 - Renewed annually
- Legal entities are professional unless they elect to be treated as non-professional
- Regulations not applicable to Professionals:
 - FIEL Article 37 relating to advertising
 - Certain financial futures solicitation activities
 - Requirement to confirm suitability of transactions
 - Duty to deliver documents prior to contract execution
 - Prior delivery of documents describing best execution policies
 - Certain provisions applicable to investment advisory and asset management agreements

Importance of Categorization of Offerings - 1

- **First Step: What is the “Theory of Distribution” for the offering:**
 - Type of securities?
 - Newly issued or existing securities?—primary offerings need not be on “uniform conditions”
 - Intended offerees: QII only, professionals or non-professionals
 - Limitations on the number of offerees; over 50 in 6 months?
- **Second Step: Decide the Level of Disclosure To Apply to the Offering?**
 - Will non-professional customer disclosure of capacity, suitability, knowledge apply?
 - Will a FSA or KFB filing be required in connection with your distribution?
 - Is a resale restriction applicable to your offering (applies to many private placements)?
 - Is there a disclosure requirement about non-registration (applies in principle to non-QII offerings)?

Importance of Categorization of Offerings - 2

- Apply the Rules of Your Offering Category To Your Term Sheet so that Deal Teams and Sales Persons know what to tell clients.
- Delivery of prospectuses (basic disclosure material) is required at or before time of offer for all Primary and Secondary offerings; however:
 - No obligation to deliver prospectus to a QII unless requested
 - If consent to non-delivery has been obtained for same security by investor or same household, but delivery must be made if requested.
 - Preliminary prospectus is used during 15 day “waiting period” before final issue; final prospectus need not be delivered (but this is best practice) if preliminary prospectus advises investor of public announcement of details (2 newspapers rule)
 - Care needs to be taken with so-called “Other materials”;
 - Includes material in any advertisement, publication, etc.
 - These should refer to prospectus and provide information on how to obtain one
 - These must be consistent with prospectus and not false or misleading
- Check your firm’s legend requirements for particular offers, but always remember that:
 - QII private placements require a restriction on resale to non-QIIs
 - Hybrid private placements require restriction on subdivision of interests

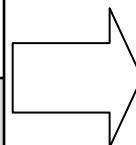
Private Placement of Funds -- Distribution License and Product Registration Requirements

<i>Type of Product</i>	<i>Distribution License</i>		<i>Product Registration</i>
	<i>Required or not</i>	<i>Target investors</i>	
Foreign Investment Trust	Yes (Type 1)	QIIs (Unlimited)	Yes (ITL Filing with FSA)
	Yes (Type 1)	Non QIIs (Up to 49)	
Foreign Investment Corporation	Yes (Type 1)	QIIs (Unlimited)	Yes (ITL Filing with FSA)
	Yes (Type 1)	Non QIIs (Up to 49)	
Foreign LLC (similar to Godo Kaisha)	Yes (Type 2)	QIIs (Unlimited)	No
	Yes (Type 2)	Non QIIs (Up to 499)	
Foreign L.P.	No (but §63 Notification required)	QIIs (and up to 49 non-QIIs)	No
	Yes (Type 2)	Non QIIs (Up to 499)	

Reforms to Disclosure Requirements for Fund Securities

< Former SEL >

		SEL Filing	ITL Filing	JSDA Filing
Public Offering		Securities Registration Statement ("SRS")	Notification of Foreign Investment Trust/Corp with FSA	Notification of Distribution by JSDA member
Private Placement	Small Number P.P.	Securities Notification		None
	Hybrid P.P.	Securities Notification		
	QII P.P.	None		



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SEL Filing	ITL Filing	JSDA Filing
SRS	Notification of Foreign Investment Trust/Corp	Notification of Distribution
None		None

ITL Filings – Required Documents

- **Foreign Investment Trust Notification (in Japanese)**
- **Attachments:**
 - **Trust Deed;**
 - **Investment Management Agreement;**
 - **Power of Attorney;**
 - **Certificate of Incumbency;**
 - **Legal Opinion from Legal Counsel in Home Jurisdiction; and**
 - **Offering Memorandum (if to be distributed)**
 - **All the attachments can now be submitted in English**

Contents of Pre-Contractual Disclosures

- A Pre-contractual document refers to a customer disclosure documents that generally covers disclosures of a securities firms status under the FIEL and Financial Instrument Sales Law; disclosure **MUST** be given prior to contracting; you should continuously improve your materials
- Pre-contractual documents require certain specific disclosures:
 - Name of firm, registered nature and registration number
 - Summary of contract
 - Fee disclosures regarding commissions, etc.
 - Disclosures concerning risks of loss to returns from interest, currency and price factors
 - Risk of **loss to investment principal** irrespective of product type
 - Other specific requirements:
 - Need to read and understand document; margin and security deposits required
 - Changes to indexes or other factors that could result in loss of principal
 - Exposure to **credit risk of securities firm or counterparty** and identity of that party
 - Tax factors affecting the investment
 - Termination considerations
 - Existence and substance of a **cooling off period** for the investment if relevant to status of customer
 - Description of firm and its business and membership in investor protection organizations
 - **Method for communication** with the securities firm applicable to customer relationship

Waivers of Delivery of Pre-Contractual Disclosures

- Pre-contractual disclosure is not required from a securities firm in the following situations only (CM 71):
 - Where the customer is a “**specified investor**” (professional)
 - Where a listed securities disclosure document has been provided within the prior year
 - Where a pre-contractual disclosure has been provided for the **same type of instrument** within the prior year (does not include OTC derivatives)
 - If the same disclosure has been provided in a prospectus delivered to the customer
 - Where immaterial changes will be made to an existing agreement
 - Certain other trades such as cumulative investment agreements
- Overriding duty to explain on the part of the securities firm (CM 72)
- Requirement to report changes to form pre-contractual documents (CM 73)
- Special rule for bond sales involving 50 bps or more yield discrepancies (CM 73-4)
- Special rule for soliciting trades in foreign securities; basically these require heightened disclosure and confirmations of intent and understanding by investor

Solicitation Using Company Non-Public Information and Advance Inquiries

- Prohibition on info. use is “other side” of trading on insider information (FIEL § 166-7)
- Coverage is broader than “material non-public information” constituting “insider information” subject to criminal liability; **any information that would influence a customer decision** is included
- Basic rule is that securities firms may not use non-public information obtained from issuers to promote sales of their stock
- “Advance inquiry” regulations instituted to prevent use (short-selling) of information received through inquiries of interest to investing parties
 - Prohibited in principle in Japan except for certain 3rd party allotments
 - Requires involvement of legal/compliance function from outset
 - Requires agreement by party to which inquiry made to
 - Maintain “restricted list” status until offering is made
 - Maintain confidentiality of all information provided
 - Contractual undertaking is required for **each inquiry made**
 - Similar restrictions must apply to all foreign affiliates/third party agents/inquiries of party in Japan
 - Requires consent from issuer for which advance inquiry made
 - Violating investor (that is, customer who trades) required to be placed on “black list” (CM 83)

Other Areas of Required Monitoring

- **Monitoring for Churning (CM86):**
 - Member Securities companies are required to monitor salespersons, traders and staff for “excessive dealing” (churning of accounts) and to report the same to authorities
 - Prohibition against churning applies to both trading promotion and permitted discretionary trading
- **Monitoring Against Name Lending (CM 88):**
 - No officer or employee of a securities company can allow his/her/its name to be used to hide the true nature of the underlying investor
 - Securities firms must take precautions against being drawn into schemes where they knowingly allow a false name to be used in connection with trades or filings
- **Monitoring Against Trading without Permission:**
 - Customer consent is required prior to any trading for a customer’s account and trading without such consent must be reported even if the customer consents after the fact
 - All discretionary trading account activity must be documented specifically and permission of the regulator is required before any trading can take place; customers must consent to issue, price, quantity and limit or market order status
- **Monitoring against misleading customers in solicitation and/or mistakes in processing transactions**

Underwriting Requirements: Fairness in Allotment of Shares

- An emerging enforcement area is the perceived practice of **unfair allotment in new share issuances** as part of the underwriting process
- JSDA rules require fair allocation of shares in a primary or secondary offering for stocks, warrants, warrant bonds, preferred contribution certificates and REIT shares
 - Preferential allotment may be permitted but only if a reasonable explanation is given **in the prospectus** (e.g., maintain shareholding ratio in corporate group)
 - For new public issues, a lottery system must be used to allocate new shares with **at least 10 percent reserved for individual investors**
 - Allocations other than by lottery must avoid excessive or repeated allocations to specific customers; reference base for comparison is amount in a lottery
 - Compliance officers are required to include relevant rules and procedures in their Basic Guidelines and Internal Rules and to monitor and enforce them; attention should be paid to this
 - Allocation records must be maintained for 5 years
- For newly listed shares, **orders from certain parties are prohibited** from being handled by a securities firm making the public offering through competitive bidding including (i) parties with a special relationship with the issuer; (ii) 10 largest shareholders; (iii) employees of the listing applicant; (iii) other parties with a capital affiliation

Handling Advertising Issues

- **JSDA Members must make certain statements in any advertisement they make**
- **Advertisements include TV, radio, newspaper, internet, postal mail, e-mail, courier, facsimile, pamphlets ad flyers**
- **Items required to be disclosed include:**
 - **Name of firm, registration status and number; membership in JSDA, etc.**
 - **Any matter that has or could have a significant impact of decisions by a customer:**
 - Fee amounts, commissions, including maximum amount or summary of method of calculation
 - Any **margin deposit** requirement and the circumstances and possibility of loss
 - Where a loss could occur from changes in an index or currency, the type and manner of the relevant loss
 - Other material matters involving risks or restrictions on the customer
- **There is a general restriction on excessive advertising in terms of both repeated instances and claims included (see CM 106); advertisements and premiums given must maintain dignity of industry and constitute fair dealing**
 - **All advertising must be reviewed by internal control and advertising officer**

Use and Control of Analysts Reports

- Another emerging area of enforcement
- Analysts reports **should not become advertising** and JSDA members are required to put in place a system of internal controls that preserve independence of analyst reports including through **regular internal inspections**
- JSDA members are required to make full disclosure of any existing or potential conflicts of interest that may exist with particular analyst coverage
- Disclosure and inspections requirements extend to externally generated analyst reports as well
- Specific report restrictions and disclosure requirements exist where securities firm is also an underwriter of securities including disclosure of that status for 1 year following any underwriting
- JSDA member cannot permit analyst reports by persons who have become officers of the company for which coverage is occurring

Other Restrictions Arising From Membership in JSDA

- **General prohibition on accepting industry orders without the permission from another member of JSDA; applies to all employees, officers and directors of JSDA members**
 - JSDA requires monitoring to prevent such orders in customer identification procedures
 - Consent of other member may be obtained as an exception, but is not best practice
- **General restrictions on transactions during “financing” and “stabilization” period**
 - “Financing period” means period from issuance resolution date until payment date
 - “Stabilization period” means period from day after price setting date until date subscriptions are closed.
 - Stabilization trading may only be undertaken for primary offerings and **party undertaking them must be disclosed in prospectus;**
 - Internal control officers must scrutinize all stabilization transactions for insider trading violations and for potential attempts at market manipulation
- **Requirement for Formulation of a “Best Execution” Policy**
 - Internal control officers are required to develop systems for ensuring best execution for clients
 - Policies must ensure that customer orders are handled ahead of firm orders
 - Policy must be **disclosed to all customers** entering into transactions through the JSDA member firm including by delivery to customer of
 - (i) a copy of policy and
 - (ii) explanations regarding best execution

Maintenance of Books and Record-Keeping by JSDA Members

- **Types and detail of books required depends on nature of business; but basic types of records required (and period of retention) for Type 1 firms include (CM 154):**
 - **Five year retention requirement:**
 - Consent records for Professional and Non-Professional investors
 - Copies of “pre-contract” documents, documents delivered upon execution of agreements, “best execution policy” and related documents
 - Copies of Prospectuses, contract amendment documents, collateral documents with customers, and documents related to disclosure of material non-public information
 - **Seven year retention requirement: Order slips for transactions**
 - **Ten year retention requirement:**
 - daybook, intermediation/agency transaction records, brokerage and clearing records, primary and secondary private placement records
 - Customer account and certification code ledgers, trading instruments and gensaki trading accounts, and statements of custodial holdings
 - Results of segregated management audits and proprietary trading system operation records (5 years from date of preparation)
 - For IA registrants: IA agreements, records of advice and transaction records for agency and intermediation transactions
 - For IM registrants: legal agreements required for IM holders, copies of management reports and detailed management statements

Maintenance of Books and Record-Keeping -2

- **Storage requirements:**
 - **After 3 years records may be maintained on microfilm with required control procedures**
 - **With permission, records may be maintained using acceptable electronic means**
 - **Storage location:**
 - After 3 years have passed, storage may be centralized at head office location with permission
 - With special permission, accounts may be centralized in one location provided:
 - A system is established which ensure timely response to customer questions
 - A system is established to enable inspection of the books within a reasonable period of time
 - The system used does not create problems from an internal audit perspective
 - Internal control officers should **avoid seeing this as solely an “IT issue”**

Unfair Trading-Insider Trading

- FIEL prohibits trading by any person with material non-public information or **any person having a special relationship with an issuer** [CM168]
- FIEL requires securities firms to make all reasonable efforts to prevent such trading
- Use by employees of inside information to **promote securities sales** is also prohibited
- Employees and Firms are prohibited from acting as counterparties in trades they know may be based on insider information— I.e., **passive involvement** is also prohibited
- Employees are prohibited themselves from trading on such information
- Implied duty to report suspicious activity to SESC

Unfair Trading-Insider Trading-2

- **Covered persons (“insiders”) include:**
 - any person who has **concluded a contract**, or is in the process of concluding a contract with the listed company;
 - officers, etc. of a legal entity of the above type, who obtained material facts concerning the operations, etc. of the listed company through the exercise of his/her duties as described above; and
 - any person who was **a company affiliated person**, but who ceased to be a company affiliated person less than one year ago
 - Employees of the securities firm handling M&A transactions for a customer

Unfair Trading-Insider Trading - 3

- **“Material” facts include:**
 - ❖ Plans to issue shares, convertible corporate bonds, share divisions, etc;
 - ❖ Reductions in capital, repurchases of shares, distributions;
 - ❖ Mergers, business transfers, JVs, dissolution, delisting events
 - ❖ Commercialization of a new product or technology; and
 - ❖ Damages resulting from fires or other disasters that occurred during the course of business;
 - ❖ Changes in major shareholders and management changes
 - ❖ Changes in financial projections
- ❖ **Use common sense in evaluating materiality: would it have mattered to your decision?**
- **Information is considered “sanitized” when: (i) 12 hours have passed since the listed company announces the material facts to more than two press institutions or (ii) the material facts are disclosed in a public filing.**

Unfair Trading-Insider Trading - 4

- **Firms must make proactive efforts to prevent insider trading including tracking trades made by insiders through creation of an “insider trading card” for each of the following (related to issuer):**
 - **Officers (and ex-officers for 1 year) of listed and OTC issuers**
 - **Spouses and relatives of such officers**
 - **Major shareholders who are QIIs**
 - **Major shareholders with inspection rights**
 - **Affiliates of the issuer**
 - **Securities firm staff who are directors of issuer**

Market Manipulation-Basic Prohibition

- **Spreading of rumours for purpose of influence market is prohibited [CM 165]**
- **Undertaking fictitious or wash trades with intent to mislead others and/or market is prohibited [FIEL 159(2)]**
- **Both customers, SSRs and covered firms are prohibited from taking above actions**
- **Volume trading with purpose of misleading others as to market activity also is prohibited**
- **Any concerted activity intended to move market or interfere with fair price formation is prohibited**

Market Manipulation-Short Selling

- **Short sales are sales transaction in respect of securities that one does not own, or which are borrowed, or which cannot readily be delivered for settlement [FIEL 162(1)]**
- **JSDA members cannot undertake short sales for themselves or for customers at prices more advantageous than the most recent sale price (the “uptick” rule)**
- **Firms must identify all short sale transactions, except in connection with futures and margin transactions both internally and to exchanges**
- **Certain transactions are excluded from these restrictions including futures transactions, when issued transactions, trades during settlement period, securities under allocations rights (CM 197)**

Market Manipulation-Artificial Markets

- **JSDA members are prohibited from continuously undertaking **coordinated excessive solicitations** for certain issues in a manner which could impair fair pricing (in order to avoid “ramping”)**
- **Any activity which creates an artificial market and/or impairs proper price formation is prohibited whether conducted by Firm or by third party using Firm**
- **Excessive activity in margin, options and futures transaction can also create an artificial market and any such excessive activity is prohibited (focus on MSCB transactions)**
- **Recent SESC focus on activities in primary market**

Tender Offer Restrictions

- **Conducting tender offers for shares of listed companies involves a number of complex disclosure and compliance issues-JSDA recommends close coordination with specialist counsel**
- **Under the block shareholding reporting system, purchases over 5% require reporting within 5 days of purchase (to be discussed)**
- **Purchases at the 10% level must also be reported as large shareholdings**
- **Purchases on the exchange beyond 10% are permitted subject to reporting requirements**
- **Purchases off-exchange are subject to the so-called 5% rule such that for a holder of more than 10% purchases shares in excess of 5% will be required to wait**
- **After the one-third level, all additional purchases require the initiation of a public tender offer**

Article 63 Businesses Overview:

- The number of filings under Article 63 has skyrocketed and compliance officers need to be aware of the rules
- As of April 30, 2008 4,133 have been filed; of those, 424 were filed by foreign entities.
- Provision is structured as an exception to Financial Instruments Business registration (§ 29) requirements of FIEL to require notification for:
 - (a) Private placements of so-called “issuer-offerings” by GPs of interests Japanese or foreign collective investment schemes; and
 - (b) Self Management of collective investment schemes: that is, management of Japanese investor assets
- It is very important not to confuse exemptions under Article 63 **relevant to Managers** and scope of permitted so-called “Article 63 Distributions” **relevant to issuer-offerings**
 - Manager filing exemptions DO NOT APPLY to permitted distributions under Art. 63
 - All persons wishing to use Article 63 Distribution Exemption MUST file a notification EVEN IF they may qualify for an exemption as a Manager of Japanese investors moneys
 - So, if you are a representative of a GP (e.g., management firm) traveling to Tokyo to discuss an existing or new fund, you should be filing an Article 63 Notification before you arrive.

How Article 63 Affects Foreign Managers (Management Aspect)

- **Article 63's application to asset managers covers self-management of collective investment schemes (i.e., domestic and foreign TKs, GPs, LPs, LLPs etc, but NOT domestic investment trusts or investment corporate fund interests)**
- **NB: Article 63's application to asset managers does NOT cover (i.e., notification is not applicable/possible):**
 - **Foreign management of investment corporations (corporate form funds)**
 - **Foreign management of investment trusts (trust form funds)**
- **Manager (GP) of foreign collective schemes not exempted must file notification to JFSA prior to visiting any investors in Japan to discuss investment in any existing or new fund**
- **Securities firms have obligation to know whether or not their clients are using Article 63 and to counsel them properly**

Scope of the “Under 10 QIIs Exception”

- An **exemption** for foreign managers from registration under Article 29 (i.e. Investment manager) and from filing an Article 63 notification exists.
- The requirement is as follows (all requirements need to be met):
 - 1) All Japan resident investors holding rights specified provisions of the FIEL (so-called “Direct Investors”) are ;
 - 1) (i) QIIs, or
 - 2) (ii) have filed a notification under Article 63 or 63-3;
 - 2) All Japan resident investors in Foreign Collective Investment Schemes by means of the Japanese Collective Investment Schemes (so-called “**Indirect Investors**”) are QIIs;
 - 3) The total number of investors under (1) and (2) is less than 10 ; and
- 4) The total assets that have been invested or contributed by the Direct Investors (Not including the Indirect Investors) is **not more than 1/3 of the total amount of the assets under management**

Making Article 63 Exempted Solicitations in Japan (Distribution Aspect)

- In general, if the entity sells Type 2 securities (such as LPs, TKs, etc), such entity is required to be registered as Type 2 Financial Instruments Dealer as discussed above.
- Article 63 distributions should be viewed as an exemption from the above and a clarification of the “**self offering**” exemption.
- Allows narrow domestic and foreign solicitation and sale activities:
 - Offering must be only to at least one QII and up to 49 general investors (and must be less than 500 total investors in Japan)
 - For domestic and foreign TKs, GPs, LPs, LLPs, but NOT domestic and foreign investment trust or investment corporate fund interests
- Regulation of the Article 63 distributor is less strict than for a Type 2 Financial Instrument Dealer (provided, however, provisions and sanctions for “Prohibited Acts” under § 38 and 39 (fraud, misrepresentation, loss compensation, etc.) apply to activities conducted (§ 63(4)))
- JFSA/KFB general inspection and sanction authority applies (§ 63(8))

Expansion of Qualified Institutional Investors

- **As of March 1, 2008, the total number of Qualified Institutional Investors has risen to 339 entities (including 88 foreign entities)**
- **Prior to the January filing period the number was 100 (including 44 foreign entities) so the QII universe has expanded by 340% in 2 months:**
 - **The number of the entities whose expiration date is August 31, 2008 is 13 (including 6 foreign entities)**
 - **The number of the entities whose expiration date is February 28, 2008 is 21 (including 14 foreign entities)**
 - **The number of the entities whose expiration date is August 31, 2009 is 66 (including foreign 24 entities)**
- **QII status is important not only for purposes of Article 63 fund distributions, but also for purposes of QII private placements**
- **Recent liberalization of rules now means that QII application filings can be made by investors quarterly**

The 5% Block Holding Filing: Basics

- **Regulatory rationale of block holding reporting requirement is to ensure prevention of unfair practices and ensure proper price formation”**
- **Theory is that purchase or sale of 5% or more is “material information” that issuers need to know in order to avoid disruption of business**
- **Issuers covered: firms listed on a stock exchange in Japan**
- **Securities covered: public equities securities, ETFs and certain other securities listed on a Japanese exchange**
- **Many offshore firms request their securities firms or law firms to handle these filings for them; this can be a source of liability and requires expertise; today it is **often outsourced****

Outline of Block Holding Report Requirement

- Issues to be considered when making a block holding company filing:
 - Securities Subject to Disclosure
 - Persons with Reporting Obligations
 - Joint Holders
 - Calculation of Ownership Ratio of Shares and Filing Period
 - Fluctuation Reports
 - Reporting Timeline
 - Content of Disclosure
 - Special Reporting Rules
 - Role and Use of EDINET in reporting process

Please note that this presentation is an overview of reporting requirements, and is not intended to be a complete explanation of the laws and regulations relevant to reporting.

Securities Subject to Disclosure

“Applicable securities”

- Share certificates of listed companies (excluding shares without voting rights)
- Subscription warrants or warrant bonds of a listed company
- Listed investment securities (i.e. certificates of corporate type investment trusts)
- Covered warrants representing options in connection with trading of (1) through (3) above
- Trust beneficiary certificates where the entrusted securities are (1) through (3) above
- Depository receipts representing the rights in connection with (1) through (3) above
- Corporate bonds that grant the holder of the bonds the right to demand redemption by means of (1) through (3) above

Note: Shares in the discussion below include and refer to all of the above.

Persons With Reporting Obligations

The following persons have an obligation to file the Block Holding Report:

- (1) Persons who hold shares (in their own or another person's name, including a fictitious person)
- (2) Persons who hold the right to demand delivery of share certificates etc. pursuant to a trade or other agreement
 - Example: A person who is making a purchase through a margin transaction
- A person who has authority to exercise voting rights or the authority to give instructions concerning the exercise of voting rights etc. of an issuer pursuant to a monetary trust agreement or other agreement and who has the intention of controlling the business activities of such issuer
- A person with investment authority based on a discretionary investment management contract

Joint Holders

- “Joint Holder”; What is a “joint holder”?
 - A shareholder with whom the Block Holder agrees to cooperate in the acquisition or assignment of shares of a target company or in the exercise of voting rights of other shareholder’s rights.
 - If multiple companies have a special relationship such as capital relationship or family relationship, these parties are deemed to be Joint Holders of one another.
- If companies are deemed to be Joint Holders, the shareholding of each Joint Holder will be aggregated.

Example:

- Company X is the parent of Company Y and owns over 50% of the voting rights of Y.
 - X holds 3.2% of the shares of a target company while B holds 2.5 % of the shares of the same company.
- A and B are Joint Holders and are required to file a Block Holding Report.

Calculation of the Ownership Ratio of Shares and Filing Period

Basic Formula

Number of shares owned + Number of shares owned by Joint Holder

Total number of shares issued by the company

- Potential shares such as subscription warrants and warrant bonds are converted into the relevant number of shares and included in the number of shares owned.

Filing Period

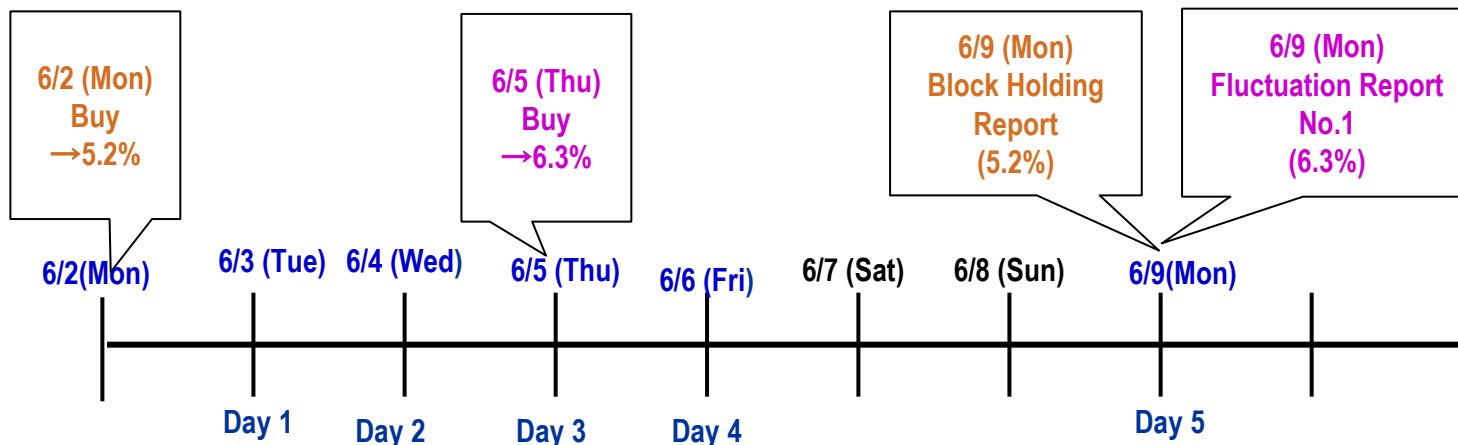
Within 5 business days from the date when a shareholder holds over 5% of the issued shares under the above formula.

Fluctuation Reports

Block Holders must submit a Fluctuation Report within 5 business days from the date of occurrence of the following:

- Where the percentage of shareholding increases or decreases by 1% or more; or
- Where a change has occurred in material matters that should be recorded in the Block Holding Report, such as:
 - company name and address
 - the holding purpose
 - transfers of the joint holders
 - guarantee contracts relating to the shares

Reporting Time Line



Note: If conditions occur requiring the submission of new Fluctuation Report on or before the day prior to submission of a Block Holding Report or a Fluctuation Report, this new report on fluctuation must be submitted to the KFB at the same time as the submission of the report which has not yet been submitted.

Content of Disclosure (Contents of Report)

- **Outline of Filer** (name, head office location, date of incorporation, name of representative, title of representative, business activities)
- **Purpose of Shareholding**
- **Actions of Material Proposals**
- **Breakdown of Shares Owned by Filer** (number of shares, percentage of shares)
- **Transaction Record** (acquisitions or disposals in connection with shares issued by issuer of shares over the past 60 days)
- **Material Agreements Including Security Agreements Related to the Shares**
- **Funds for Acquisition of Shares** (breakdown of funds for acquisition, breakdown of borrowings, name of lender)

Special Reporting Rules (Monthly Reporting)

Applicable to a shareholder:

1. That is a domestic/foreign financial instrument firm engaging in Type 1 financial instruments trading business, investment management business, banks, trust companies, insurance companies etc.;
2. That has submitted record dates to KFB on the 15th and the last day of the month;
3. Whose purpose of holding is not to commit an act of introducing a material proposal to the issuer; and
4. Whose shareholding ratio is 10% or less
 - Such shareholder can submit a Block Holding Report within 5 business days from the record date.
 - Such shareholder does not need to disclose Transaction Record and Funds for Acquisitions of Shares.

Registration and Submission of Reports Through the EDINET System

- Sending necessary documents to KFB by mail

Takes at least 5 business days

Articles of Incorporation (with full translation)
POA (signed original)

- Receive EDINET registration number from KFB by mail

If there are Joint Holders, send necessary information through the EDINET system using the representative entities' EDINET registration number

Takes at least 3 business days

No need to send Joint Holder's AOI and POA

Receive each Joint Holders EDINET registration number from KFB by mail

- Submit reports by using EDINET registration number

Need to attach PDF copy of POA(s) (including POAs of all Joint Holders)

Major Shareholder's Trading Reports

(1) Persons with obligation to report

- Officers of the issuer
- Shareholders who hold at least 10% of voting rights

(2) Content of report

Details of share purchase and sale

- Trading date, quantity, unit price, purchase price, handling costs

(3) Filing period

To KFB by the 15th day of the month following the date on which the trade or other transaction was made.

Report is of particular relevance to parties pursuing an “activist” strategy towards an issuer

Reporting Under Foreign Exchange and Foreign Trade Control Law

(1) Share Acquisition Report

- An acquisition of 10% or more of a listed company's issued shares by a foreign investor is a form of "Inward Direct Investment" (*tainai chokusetu toushi*) and requires a report to the Bank of Japan.
- Submission period: **Within fifteen (15) days of such acquisition.**

(2) Prior Notification

- If a foreign investor directs its Inward Direct Investment to certain businesses or certain businesses that make certain products, the investor must submit a prior notification to the Ministry of Finance and ministries with jurisdiction over the business in question through the Bank of Japan
- Submission period: **At least 3 months prior to the planned date of such investments.**

Reporting Under Anti Monopoly Law

(1) Persons with obligation to report

A foreign company that does not have a domestic subsidiary, and possesses a total amount of assets exceeding ten billion yen.

(2) Cases to Report

The acquiring company holds **more than 10%, 25% or 50% of the voting rights** of the target Japanese company which has a total amount of assets exceeding one billion yen.

(3) Filing Period

The report is required to be filed to the Japan Fair Trade Commission **within 30 days after the date when the ownership ratio of the voting rights exceeds 10%, 25% or 50% of the target company.**

Note: The above rules are more complex than suggested by this summary and should be checked on each reporting occasion

Recent Case Examples

- **Pictet Asset Management Case (7/2007)**
 - **Although not a securities company case, it illustrates:**
 - Rule requiring fair allocation of IPOs to customers
 - Consequences of weak internal control and lack of checks and balances
 - Absence of independent audit function
 - Resulted in 1 month trading suspension
- **Lehman Brothers litigation against Marubeni (3/2008)**
 - **Illustrates importance of customer identification**
 - **Sophistication of current fraud techniques**
 - **Weaknesses in corporate governance in face of traditional business culture in Japan**
- **Nomura Securities insider trading scandal (4/2008)**
 - **Illustrates difficulty in maintaining strict controls in complex world of M&A transactions**
 - **Need for comprehensive monitoring system for all staff in M&A division**
 - **Conflicts between requirements for personal information privacy and need to monitor against criminal violations**

THANK YOU FOR YOUR ATTENTION!