

## Alerts

### Financial Reform in Japan Update #2: Crackdown on Unlicensed Securities Distribution Activities and Additional Qualifications for Investment Advisory and Agency Business

June 2011

Christopher P. Wells, Koichiro Ohashi, Thomas LaMacchia, Tomoko Fuminaga

This Client Alert is the second in a series of alerts concerning amendments (the "Amendments") to the Financial Instruments and Exchange Law ("FIEL") of Japan promulgated on May 25, 2011.

This alert concerns provisions of the Amendments that more strictly regulate the distribution of securities by persons or entities other than financial instruments business firms ("FIB Firms") holding appropriate business registrations with the Kanto Local Finance Bureau ("KFB") (a part of the Ministry of Finance under authority delegated by the Financial Services Agency of Japan ("FSA")).

Among other things, the provisions render certain transactions improperly marketed to Japan resident investors by unregistered persons or entities void. They also prohibit certain advertisements and solicitations by unregistered entities and they impose more severe penalties on unregistered persons or entities for engaging in securities distributions.

This alert also briefly discusses the parts of the Amendments concerning the more stringent operating requirements on registered FIB Firms engaging in investment advisory and agency business ("IAA Business").

#### I. Tighter Regulation on Securities Distributions by Unregistered Persons or Entities

Under the FIEL, the marketing (solicitation for the sale) of securities is a regulated activity that can only be undertaken by a registered securities sales representative working for an registered broker-dealer holding a Type 1 or Type 2 financial instruments business registration. Japanese regulators have become increasingly aware of cases where unregistered persons or entities solicit investors to purchase privately placed securities with inappropriate promotions, promises and other aggressive sales techniques to sell such securities to investors (in particular, older investors) at unfairly high prices. In practice, the private nature of such transactions has resulted in the creation of an "underground" business involving the handling of such transactions through introducers (both individuals and small firms) that use a variety of theories to justify taking a commission on these securities transactions.

Countering these improper solicitations has become a priority for regulators because these solicitations allow unregistered introducers to profit improperly from securities transactions and undermine the regulatory scheme intended to ensure that investors make investment decisions with sufficient disclosure and on the basis of a suitability evaluation by a registered FIB Firm. In the Amendments, several measures are introduced to prevent unregistered persons and entities from engaging in such solicitations.

##### 1. Voidance of Transactions made through Unregistered Persons or Entities

Under the Amendments, any subscription agreements or purchase agreement of privately placed securities (e.g., corporate bonds, stocks, share acquisition rights) executed between investors and an issuer/seller through offering, intermediary, agency or brokerage by such unregistered person or entity will be void unless the unregistered person or entity, issuer or seller proves that:

- (i) such sale or offering of securities did not undermine the protection of the client in light of the client's knowledge, experience and status of assets and purpose of the selling or offering; or
- (ii) such sale or offering of securities did not involve an improper profit for the unregistered entity.

Because of the uncertainty as to whether the parties can meet these standards properly, we believe there will be a strong disincentive to involve unregistered persons or entities in the private placement of securities. It is unclear whether fund

interests are included in the above privately placed securities and the detailed regulations to come will clarify this point.

This part of the Amendments becomes effective not later than six months from the date of their promulgation (May 25, 2011), that is, on or prior to November 25, 2011.

## 2. Prohibition of Advertisement and Solicitation Conducted by Unregistered Persons or Entities

The second element of the Amendments prohibits advertising and solicitation activity by unregistered entities and persons. Although under current law no unregistered persons or entities may conduct any activities comprising a financial instruments business (including solicitation and advertising), the Amendments specifically prohibit unregistered persons and entities from suggesting that they are conducting a financial instruments business, and from undertaking any solicitation to enter into an agreement in connection with a financial instruments business. The Amendments further criminalize such activities by providing that a person or entity that breaches such prohibitions will be penalized by up to one year penal servitude or up to one million yen penal fine or both.

This part of the Amendments also becomes effective on or prior to November 25, 2011.

## 3. Imposition of Additional Penalties on Securities Distribution by Unregistered Persons or Entities

The Amendments will also increase the penalty for violations by unregistered persons or entities. The existing penalty of up to three years penal servitude or up to a three million yen penal fine or both will be increased to up to five years penal servitude or up to a five million yen penal fine or both. If unregistered activities are conducted by a legal entity, such entity will be subject to a penal fine up to 500 million yen (approximately US\$6,250,000). This part of the Amendments became effective on June 14, 2011.

## II. Additional Requirements for IAA Business Registration

Historically, IAA Business registration applications have been relatively less onerous and the compliance expectations less detailed than for Type 1, Type 2 or investment management business registrations. The regulators' supervision and monitoring of FIB Firms engaging in the IAA Business has also been less intrusive than for FIB Firms engaging in the Type 1, Type 2 or investment management business. Recently, however, there have been increasingly serious breaches of laws and regulations resulting in significant actual harm to investors. During 2009 and 2010 the SESC imposed a number of sanctions on (mostly domestic) FIB Firms engaging in IAA Business and in doing so came to recognize the weak professionalism of the IAA industry generally. In addition, another priority for the FSA has been to eliminate organized criminal groups from the financial industry.

As a result, the FSA sought and obtained the inclusion in the Amendments of a requirement that FIB Firms engaging in IAA Business be required to maintain sufficient and appropriate human resources to conduct an IAA Business (the same standard applicable to FIB Firms holding Type 1, Type 2 and investment management business registrations) and to confirm the existence of such resources in advance when an applicant applies to be registered as a FIB Firm engaging in IAA Business.

Under the Amendments, a FIB Firm engaging in IAA Business will be required to have officers and employees that will ensure that the IAA Business is conducted appropriately and sufficiently. In addition, due to this new requirement, it is anticipated that the background check (with respect to any connection with organized criminal groups) for officers or employees of such firms will be far more detailed and rigorous. The actual qualification requirements for officers and employees are delegated to the subordinated regulations to come later.

This portion of the Amendments become effective not later than one year from the date of their promulgation (May 25, 2011), that is, on or prior to May 25, 2012.

---

*This Client Alert is provided for your convenience and does not constitute legal advice. It is prepared for the general information of our clients and other interested persons. This Alert should not be acted upon in any specific situation without appropriate legal advice, and it may include links to websites other than the White & Case website. White & Case LLP has no responsibility for any websites other than its own, and does not endorse the information, content, presentation or accuracy, or make any warranty, express or implied, regarding any other website.*

*This Client Alert is protected by copyright. Material appearing herein may be reproduced or translated with appropriate credit.*