These articles in Business Lawyers have been re-edited and translated.

Part 5 Financial Regulation Law

- The world called regulation

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Series Overview – 5 in total

- Part 1: What is Finance Law?
- Part 2: What is Corporate Finance?
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* This series is a digest of my book "**Finance Law - Fundamentals of Finance Law and Essentials of Advanced Financial Transactions**" (Shoji-Homu, 2016). In the text, "the Book" refers to this book.

1. Financial Regulation Law

1-1. Significance of Financial Regulation

While finance law is composed of **Financial Transaction Laws**, **Financial Regulation Law**, and certain related topics in **financial economics** (see: "**Part 1 What is Finance Law? - Collaboration between Finance and Law**"), the fifth article in this series will deal with Financial Regulation Law. Financial Regulation Law focuses on laws that regulate Financial Institutions and the financial system. Laws and regulations based on Financial Regulation Law are referred to as **financial regulations**.

The types of financial regulations include disclosure regulations, business regulations, and unfair transaction regulations (see below).

1-2. Necessity (Purpose) of Financial Regulation Law

The purpose and need for financial regulations are often divided into Direct and Indirect Finance from a perspective based on **(traditional) financial theory**.

(1) Indirect Finance

In **Indirect Finance** (see: "**Part 1 What is Finance Law? - Collaboration between Finance and Law**"), depositors and other final fund providers are the direct counterparties to transactions with Financial Institutions and bear the credit risk of the Financial Institutions.

The primary objective of financial regulations in Indirect Finance is the **protection of final fund providers** such as depositors. Since risks such as **adverse selection and moral hazards** exist between Financial Institutions and final fund providers due to **information asymmetry**, it is often impossible or difficult for final fund providers to monitor the management of Financial Institutions themselves, and there is a need for regulators to monitor this on behalf of final fund providers to protect final fund providers.

The second objective of financial regulations in Indirect Finance is the **maintenance of credit order**. When one Financial Institution fails, failures of other Financial Institutions that are linked to the failed one expand sequentially, and this is called **systemic risk**. It is necessary to prevent systemic and maintain credit order, especially in Indirect Finance.

The **Banking Act** and the **Insurance Business Act** are representative examples of Financial Regulation Law in Indirect Finance.

(2) Direct Finance

On the other hand, in **Direct Finance** (see: "**Part 2 What is Corporate Finance? - Taking into account the distinction between debt and equity**"), the main focus is on the **protection of investors** and **ensuring the soundness of the market**.

In Direct Finance, investors invest in securities issued by the issuer based on their own judgment and responsibility (principle of self-responsibility). However, as there is an information gap (information asymmetry) and a gap in bargaining power between investors and the issuer or Financial Institutions such as securities companies that serve as intermediaries, an investor protection system is necessary.

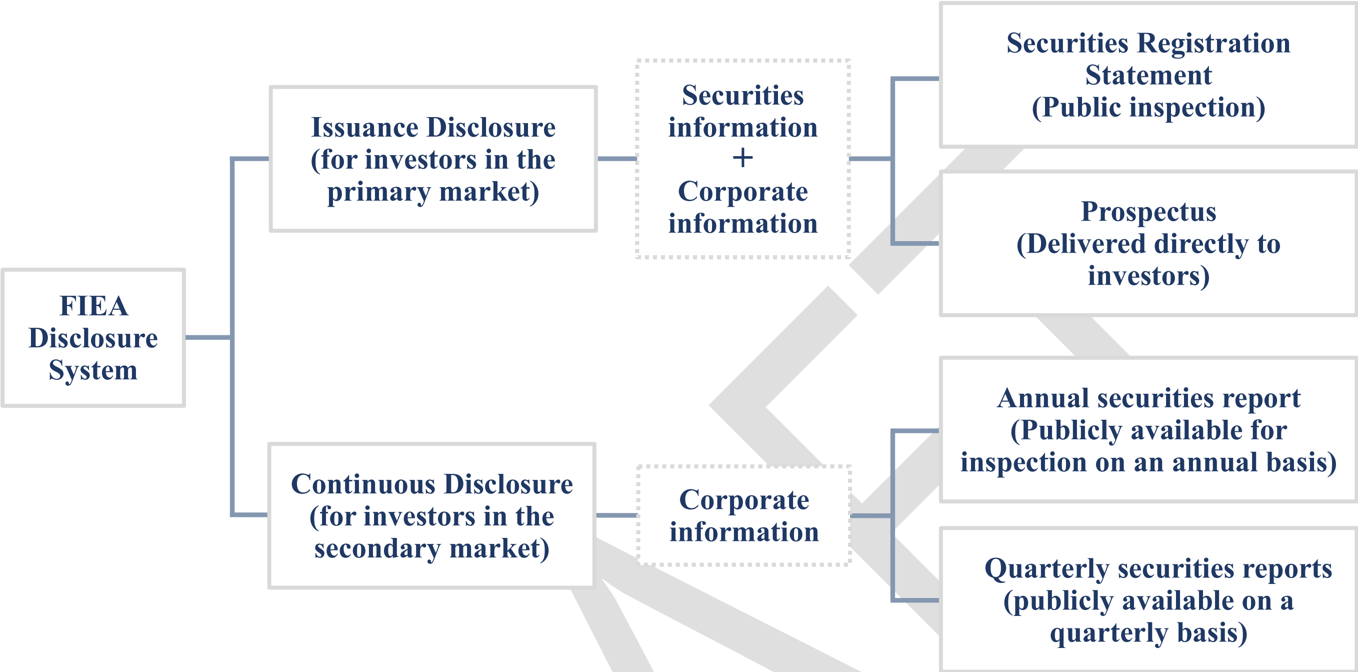
In addition, since the real market is an **imperfect market** where available information is not fully reflected in market prices, there is a need to ensure investor confidence in the market by ensuring its soundness in order for fair and smooth price formation to take place in the market.

A typical example of Financial Regulation Law in Direct Finance is the **Financial Instruments and Exchange Act (FIEA)**.

1-3. Disclosure regulations

In order to protect investors and ensure the soundness of the market in Direct Finance, **disclosure regulations** are those that subject issuers as **fund raisers to regulation** and impose on them the obligation to properly disclose information about the securities they issue (**securities information**) and issuer information (**corporate information**) for the benefit of investors. Disclosure regulations for the protection of investors are mainly implemented under the FIEA, and the disclosure system under the FIEA is referred to as the **FIEA disclosure system**. There are two types under the FIEA: (1) the **issuance disclosure system** which is used when securities are issued, and (2) the **continuous disclosure system** which is used by listed companies and others. **【Figure 5-1】** shows the overall structure of the FIEA disclosure system, including both the issuance disclosure system and the continuous disclosure system.

【Figure 5-1: FIEA Disclosure System and Issuance / Continuous Disclosure】



(Source: Created by the author based on figures in *Mitsuo Kondo et al. "Learning Financial Instruments and Exchange Law from the Basics [3rd Edition]" (Koubundo, 2015)*

1-4. Business restrictions

To realize the objectives of protecting depositors and investors, maintaining credit order in the case of Indirect Finance, and ensuring market integrity in the case of Direct Finance, **Financial Institutions engaged in the financial business are subject to regulation**. **Regulations on the financial industry (Business regulations)** (i) require licenses as part of entry regulations for conducting the financial business, (ii) impose regulations on the various acts carried out by Financial Institutions (**restrictions on the conduct of Financial Institutions**), and (iii) impose various regulations (**prudential regulation**) on banks and insurance companies in particular involved in Indirect Finance to ensure their business and financial soundness. A typical example of prudential regulation is the rules regarding solicitation and sales of financial products under the Financial Instruments and Exchange Law (FIEL). As business restrictions are applied to each type of financial service, providers of **fee businesses** that offer financial services and receive fees for doing so are often subject to prudential regulation.

1-5. Regulation of Unfair Transactions

(Unfair) transaction regulations refer to restrictions against unfair acts by market participants, such as artificially manipulating market prices or spreading unfounded rumors. Typical examples include (i) **prohibition of insider trading**, (ii) **prohibition of stock price manipulation** to artificially manipulate market prices, and (iii) **prohibition of spreading rumors**, etc., under the FIEA.

1-6. Special Laws regarding SPVs/Funds

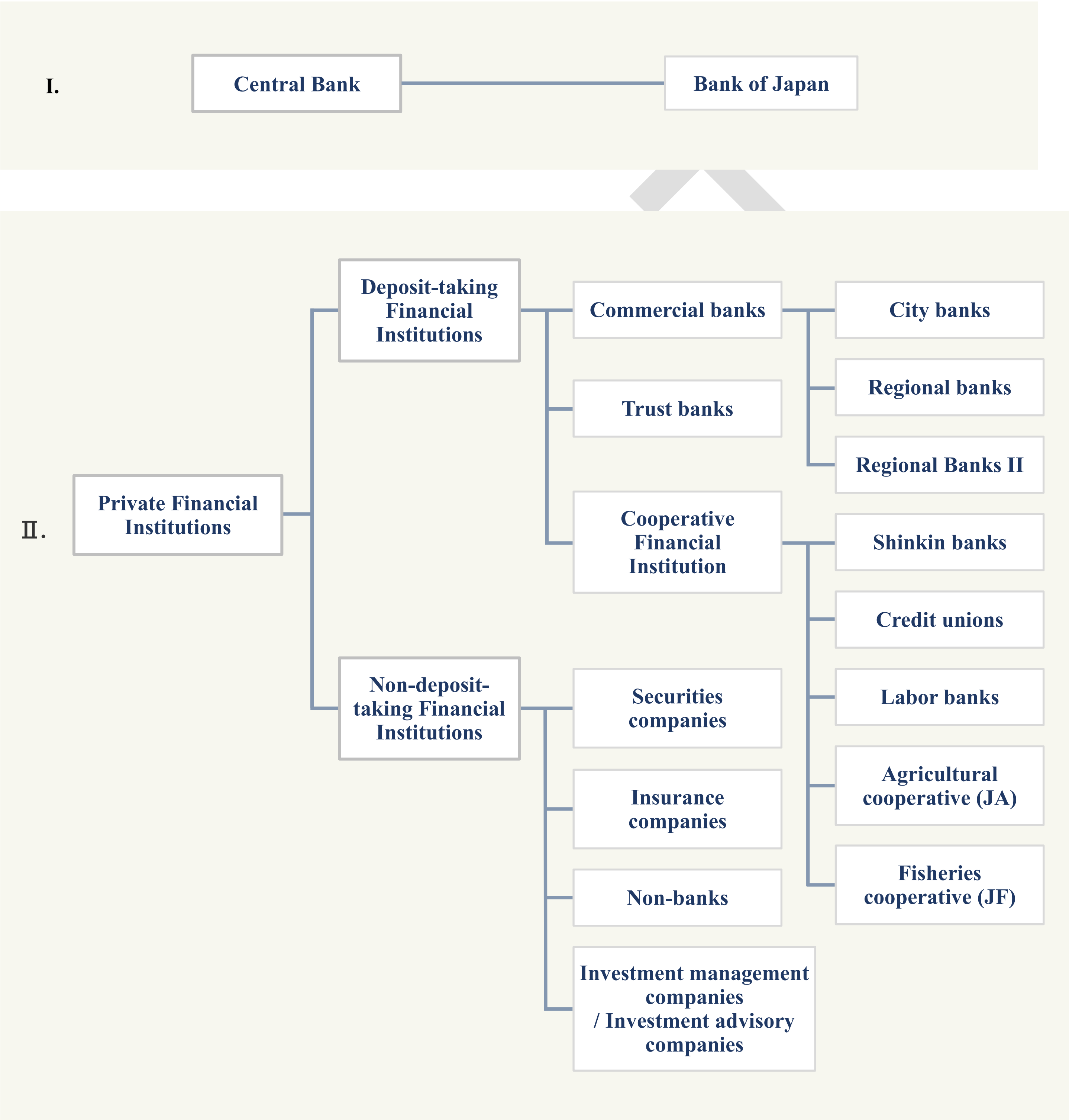
Some Financial Regulation Laws provide special financial regulations on SPVs and funds (see "Part 4 What is Asset Management? - The world of Asset Management and Investment").

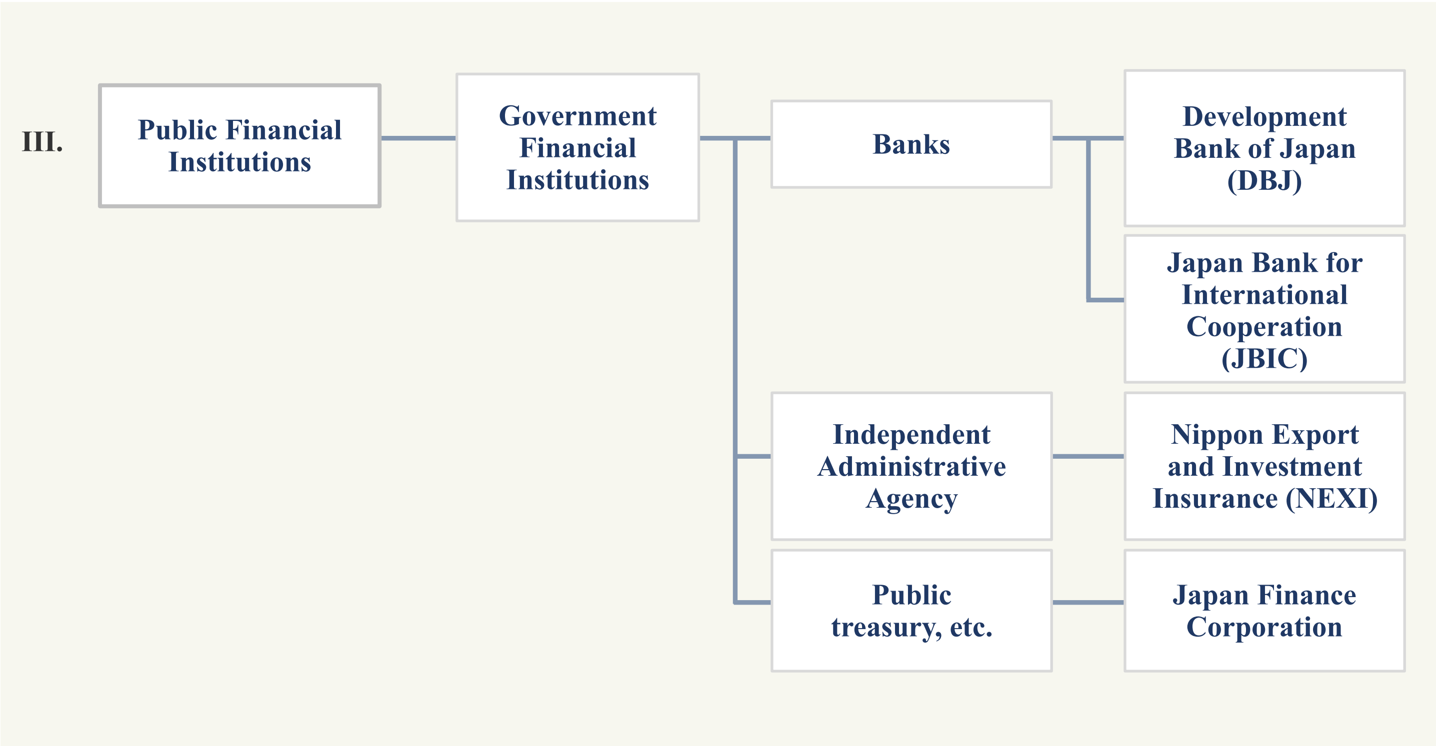
2. Financial Institutions and Financial Industry

2-1. What is a Financial Institution?

For the purposes of this document, a **Financial Institution** is defined as a corporation or other organization engaged in various types of financial business. In financial economics, Financial Institutions are described as major components or entities of the financial system. **【Figure 5-2】** illustrates Japanese Financial Institutions from the perspective of financial economics.

【Figure 5-2: Financial institutions in Japan】





(Source: Created by the author based on figures in *Kikuo Iwata "Learning Financial Structures from the Basics" (Sayusha, 2010)* and Y*oshiaki Shikano "Japan's Financial System (3rd Edition)" (Toyo Keizai Inc., 2013).*

Representative examples of financial businesses and Financial Institutions under the Financial Regulation Law include the following among private Financial Institutions (II): (i) (ordinary) banks engaged in the banking business, (ii) Type I Financial Instruments Business Operators (securities companies) engaged in the Type I Financial Instruments Business (securities business), (iii) insurance companies engaged in the insurance business, (iv) investment management companies, etc., engaged in the investment management business, (v) Investment advisory firms, etc., engaged in the investment advisory (and agency) business, and (vi) trust banks and trust companies engaged in the trust business (see below). The above (ii), (iv), and (v) are collectively referred to as **Financial Instruments Business Operators** because they are Financial Institutions that engage in the Financial Instruments Business under the FIEA. In addition, Financial Institutions that perform financial intermediary functions are referred to as **financial intermediaries**. The following sections will provide an explanation of the contents of each financial industry and an overview of business regulations for major Financial Institutions.

2-2. Banks and Banking Industry

A **bank** is a Financial Institution that engages in the banking business under a **license** under the Banking Act and subject to financial regulations under it. **Banking business** means the business of either (i) accepting deposits or term deposits together with lending funds (loans or loans) or discount bills, or (ii) engaging in foreign exchange transactions. The three businesses of accepting deposits or term deposits, lending funds or discount bills, and conducting foreign exchange transactions are referred to as a bank's **core business** or the three major businesses.

In addition to its core business, a bank may engage in what is called (a) **attached business**, (b) **securities business permitted as ancillary business**, and (c) **ancillary business** (for details, see Chapter 13, Section 2 of the Book), but it is prohibited from engaging in any other business (**prohibition of other business**). In addition, under the FIEA and the Banking Act, banks are prohibited in principle from engaging in securities-related businesses (**regulation to segregate banking and securities business**).

2-3. Type I / Type II Financial Instruments Business Operators and Securities-Related Business

A Type-I Financial Instruments Business Operator is a Financial Institution that engages in the **Type-I Financial Instruments Business** (financial business focusing on securities-related business related to Paragraph (1) Securities) based on **registration** under the FIEA and subject to financial regulations under it. **Paragraph (1) Securities** (e.g., stocks and corporate bonds) means (i) securities prescribed in Article 2 (1) of the FIEA, and (ii) rights to display securities and (iii) specified electronically recorded claims as prescribed in the first sentence of Article 2 (2) of the FIEA (for details, see Chapter 8, Section 2 of the Book).

A Type-II Financial Instruments Business Operator is a Financial Institution that engages in the **Type-II Financial Instruments Business** (financial business focusing on securities-related business related to paragraph (2) securities) based on registration under the FIEA and subject to financial regulations under it. Paragraph (2) Securities (e.g. **beneficial interests** and **interests in collective investment schemes** in the narrow sense (see: "**Part 4 What is Asset Management? - The world of Asset Management and Investment**") are defined in each item of Article 2, paragraph (2) of the FIEA (see Chapter 8, Section 2 of the Book for details).

There are various types of Type-I / Type-II Financial Instruments Businesses, the core of which is the **securities-related business (securities business)**. The main types of securities-related business include

(i) **self-trading/dealing**, (ii) **agency transactions/brokerage business**, (iii) **underwriting business** and (iv) **public offering/private placement of securities** (for details, see Chapter 13, Section 2 of this document). Type-I / Type-II Financial Instruments Business centered on these operations is collectively referred to as the **core business** of Type-I / Type-II Financial Instruments Business Operators.

In addition to their core business, Type-I Financial Instruments Business Operators (securities companies) may also engage in (a) **attached business**, (b) **notification business**, and (c) **approval business** (for details, see Chapter 13, Section 2 of the Book). Type-II Financial Instruments Business Operators are not subject to such business scope restrictions (**concurrent business restrictions**).

2-4. Insurance Companies and Insurance Business

An insurance company is a Financial Institution that engages in the insurance business based on a license under the Insurance Business Act and subject to financial regulations under it.

Insurance business refers to the business of underwriting insurance (conclusion of insurance contracts in the capacity of insurer), including life insurance, non-life insurance and other insurance. Insurance business includes **life insurance business** which is insurance business related to life insurance, and **non-life insurance business** which is insurance business related to non-life insurance. Underwriting insurance (insurance business) and investment of money and other assets received as premiums are collectively referred to as (an insurance company's) **core business**.

In addition to the insurance business, insurance companies may also engage in other businesses, which are called **attached business** or **other statutory business**. Insurance companies are prohibited from engaging in businesses other than their core business, attached business and other statutory business (**prohibition of other businesses**) in order to prevent their business or financial condition from deteriorating due to business activities outside of their expertise. The concurrent operation of life and non-life insurance businesses is prohibited (**regulation prohibiting the concurrent operation of life and non-life insurance business**).

2-5. Investment Management Companies and Investment Management Business / Investment Advisory Companies and Investment Advisory Business

An investment management company is a Financial Institution that engages in the investment management business based on **registration** under the FIEA and subject to financial regulations under it. **Investment management business** refers to financial business, etc., which concludes contracts with investors in which they are entrusted with the management of assets (**discretionary investment contracts**) and manages money and other assets on behalf of investors as an investment in rights to securities.

An investment advisory company is a Financial Institution that engages in the investment advisory business based on **registration** under the FIEA and subject to financial regulations under it. **Investment advisory business** refers to financial business that concludes agreements with investors to provide advice on the management of assets (**investment advisory agreements**) and provides advice to the investor based on said investment advisory agreement.

Under the FIEA, investment management companies are subject to the same scope of business regulations as Type-I Financial Instruments Business Operators. Investment advisory companies are not regulated as such.

2-6. Trust Companies / Trust Banks and Trust Business

A trust company is a Financial Institution that engages in the trust business under a **license** under the Trust Business Act and subject to financial regulations under it. **Trust business** refers to the "underwriting of trusts". Banks and other Financial Institutions are permitted to engage in the trust business concurrently under the Act on Engagement in Trust Business Activities by Financial Institutions (**ETBAFI Act**). Banks that concurrently operate trust business are called **trust banks**.

Under the Trust Business Act, trust companies may engage in (a) **statutory business** and (b) approved **concurrent business** in addition to trust business. On the other hand, under ETBAFI Act, trust banks may engage in (a) statutory business and (c) certain approved concurrent business in addition to trust business. Trust companies are prohibited from engaging in businesses other than trust business, other statutory businesses, and approved concurrent business (**prohibition of other businesses**).

2-7. Financial Regulations for Financial Groups

In addition to financial regulations that apply to individual Financial Institutions, there are other financial regulations that apply to financial groups, such as the following:

(1) Firewall Regulations

Firewalls refer to measures to prevent harmful effects between individual Financial Institutions belonging to a financial group. Firewall regulations include **restrictions on concurrent positions** for financial group companies and **restrictions on the transfer of non-public information**.

(2) Arms-Length Rule

When Financial Institutions conduct transactions with parties with whom they have special relationships (e.g., group companies), there is a risk of harm to the interests of interested parties if the transactions are conducted on unfair terms. To prevent such harm, financial regulations that impose an obligation to conduct transactions on normal terms are referred to as the **arms-length rule**.

(3) Obligation to establish a conflict of interest management system

3. Conclusion

The above is an explanation of Financial Regulation Law. This concludes the five-part series on “Fundamentals of Finance Law”. If the opportunity arises in the future, I plan to write about various topics (derivatives, cross-border finance, etc.) and individual finance transactions (securitization, project finance, etc.) that I omitted due to space limitations.