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Finance for your clients: Harmonisation of Capital Markets

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National Report of Japan

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1. Briefly describe the level of integration of the capital markets at the infra-national, national and supra-national levels.

In Japan, the level of integration of the capital markets is at the national level.

Historically speaking, securities laws in Japan has been deeply influenced and affected by securities laws in US.

However, from practical view point, different from US where financing/funding through capital market[1] is major finance method for enterprises, loans from banks (or non-banks) have been traditional and major finance method for Japanese enterprises (especially small and medium sized enterprises)[2]. In addition, it is generally understood that there is so called "main bank" system in Japan[3] where "main bank" plays a major role to provide necessary funds for enterprises.

On the other hand, financing/funding through capital market has not been major finance method for Japanese enterprises (especially small and medium sized enterprises). However, after the collapse of a bubble economy in Japan in the middle of 1990's where many Japanese banks fell into financial crisis due to so many defaulted loans to enterprises, it has been discussed that finance method needs to be shifted from loans by banks to capital market (including securitization[4] and crowdfunding (as discussed below)) where investors directly take credit risk of enterprises as issuers, in order for enterprises available to use various and efficient (low-cost) financing methods depending on situations

2. Which measures have been adopted (or are foreseen) in your jurisdiction to support access to finance by small and medium sized enterprises ("SMEs")? Measures might include (i) supporting venture capital and equity financing; (ii) lowering information barriers; (iii) enhancing access to public markets; (iv) supporting equity financing; (v) facilitating infrastructure investment; and/or (vi) promoting innovative forms of corporate financing.

In Japan, we have adopted various measures to support access to finance by SMEs. However, the type of such measures is different between (i) existing and/or traditional SMEs ("**Existing SMEs**") which usually engage in a small sized business and are usually or mainly operated by family members, such as

[1] It is categorised as "direct finance" in economics.

[2] It is categorised as "indirect finance" in economics.

[3] "Main bank" is generally interpreted to mean such a bank/banks which has the most close relationship with a company not only through finance/lending but also holding certain ratio of shares of the company and sending directors to the company.

[4] It is categorised as "market-oriented indirect finance" in economics.

subcontract factories and small local stores and (ii) new and venture type of SMEs ("**Venture SMEs**") which are newly established to start new business and aiming to be listed on stock exchanges in the future. Please see the details below.

(1) Supporting venture capital and equity financing

We assume that this is applicable to Venture SMEs.

(a) Stock Exchanges

First, we have some stock exchanges for developing Venture SMEs. The first is "JASDAC", which was originally established in 1983 as over-the-counter ("**OTC**") market operated by Japan Securities Dealers Association ("**JSDA**") and later licensed as a stock exchange in 2004. The owner of JASDAC changed from JSDA to Osaka Stock Exchange ("**OSE**") in 2008, and further changed from OSE to Tokyo Stock Exchange ("**TSE**") in 2010 due to integration between TSE and OSE. After the integration, Japan Exchange Group ("**JEG**") which operates both TSE and OSE was established. It is generally discussed that JASDAC is a Japanese version of NASDAC in US. However, due to its long history, listed companies on JASDAC are not limited to Venture SMEs but include various and some developed famous enterprises.

The second is "Mothers" (Market of the high-growth and emerging stocks), which was established in 1999 and has been operated by TSE (after the above integration, by JEG). Mother is a market for Venture SMEs which aims to be listed on the second or the first section of TSE.

(b) Working Group "how to provide risk money to developing venture enterprises" by Financial System Council

Second, there was a working group "how to provide risk money to developing venture enterprises" by Financial System Council ("**FSC**"), a council managed by Financial Services Agency in Japan ("**FSA**"). The following are the items which FSC proposed in its report published in 2013.

i) Crowd Funding

FSC proposed to facilitate crowd funding for financing/funding by Venture SMEs through capital market.

In Japan, from legal and regulatory perspective, crowd funding is categorised into several types: (1) "Gift" where a contributor will receive no return; (2) "Sales" where a contributor will receive something (products or services) other than money/cash; and (3) "Investment" where a contributor will receive return by money/cash. In "Investment" type, there are further (x) crowd

funding through partnership investment, which is subject to securities regulations applicable to collective investment scheme (please see the detail below) under the Financial Instruments and Exchange Act ("**FIEA**"), and (y) crowd funding through unlisted shares issued by Venture SMEs, which is subject to securities regulations applicable to shares (please see the detail below) under the FIEA. In the case of (x), (i) distribution of such partnership interests and/or management of such fund is permitted with simple filing(s) to the FSA (more specifically, the Kanto Local Finance Bureau) if certain conditions to protect investors under the FIEA are met and (ii) disclosure requirement under the FIEA is not usually applicable (i.e. it is only applicable when such partnership interests are sold 500 or more investors). In the case of (y), (i) distribution of such shares must be handled by licences broker/dealer under the FIEA and (ii) disclosure requirement is applicable in many cases (i.e. it is applicable when such shares are "solicited" to more than 50 investors unless certain exemptions are met under the FIEA) .

To facilitate type (3)(y) of crowd funding, the FIEA was amended in 2014 to relax license requirement for brokers/dealers when it only treats certain small amount of crowd funding. Also, voluntary regulation of JSDA, which prohibits licensed brokers/dealers to sell unlisted shares, was also amended recently and certain small amount of crowd funding is exempted from the voluntary regulation.

ii) Amendment to OTC Market

Second, FSC proposed to amend OTC Market for unlisted shares of Venture SMEs.

Traditionally, we have had OTC market for unlisted shares of Venture SMEs named "Green Sheet System", which was established in 1997 and has been operated by JSDA. However, it is planned that Green Sheet System will be abolished in 2017 in exchange for introduction of new market in the future for unlisted shares acquired by crowd funding (as noted above).

iii) Facilitate IPO by Venture SMEs

Third, FSC proposed to facilitate IPO by Venture SMEs by relaxing (i) listing requirements of stock exchanges for Venture SMEs and (ii) burden of listing (especially disclosure requirements) under the FIEA

As to the listing requirement of stock exchanges, Mothers recently amended and relaxed its minimum shareholders' number

requirement for listing from 300 shareholders to 200 shareholders. As to the disclosure regulation under the FIEA, the FIEA was amended in 2014 and relaxed disclosure regulation applicable to Venture SMEs. More specifically, a newly listed enterprise, both the capital and the debt of which are not JPY 10 billion or more, shall be exempted from the obligation to audit its internal control report for three years.

(c) Facilitate investment in Venture SMEs by financial Institutions

There are special exemptions for banks/insurance companies to invest in Venture SMEs.

Under financial regulations in Japan, (i) it is prohibited for banks and insurance companies to engage in business other than permitted business under the Banking Act and the Insurance Business Act respectively (e.g. banking business in case of banks, insurance business in case of insurance companies), and such permitted business does not include non-financial business. Also, (ii) it is prohibited for banks and insurance companies to have affiliated companies engaging in businesses other than financial business (banking business, securities business, insurance business, trust business, and other related or ancillary business of such financial business), and is required to obtain permission by or to make notification to the FSA when acquiring shares of such affiliated companies engaging in financial business ("**Permitted Affiliates**"). Further, (iii) it is prohibited for banks and insurance companies in principle to hold more than certain ration of shares (5% in case of banks, 10% in case of insurance companies) issued by Japanese companies engaging in non- financial business.

Provided, however, that investment (i.e. holding shares) by banks and insurance companies in certain Japanese Venture SMEs engaging in non- financial business is exempted from the regulation listed (iii) above (subject to filing requirement as noted in (ii) above) in order to facilitate investment in Venture SMEs by banks/insurance companies.

(2) Lowering information barriers

In Japan, there are no special laws, rules or systems for Existing SMEs and Venture SMEs to lower information barriers between SMEs and investors.

However, in the case of Existing SMEs, as one of the method under the SME Finance Facilitation Act which was effective from December 2009 to March 13, a guideline named "Inspection Manual for Deposit-Taking Institutions" applicable to banks was amended, and banks was obliged to try to refinance or reschedule their loans to Existing SMEs even when such Existing SMEs are insolvent. In order to make such refinance/reschedule, banks was obliged to deeply consult with Existing SMEs and rely on not only its balance sheet but

also its cash flow in the future and its potential growth, etc. Even after the expiration of the SME Finance Facilitation Act, the FSA announces that duties of financial institutions as listed above shall not change.

(3) Enhancing access to public markets

Please see 2(1) above.

(4) Supporting equity financing

Please see 2(1) above.

(5) Facilitating infrastructure investment

There are various structures to facilitate infrastructure investment in Japan, such as project finance, whole business securitizations, revenue bonds, etc. Also, there are various laws to facilitate and regulate infrastructure investment. However, there are no special laws, rules or systems to facilitate infrastructure investment by Existing SMEs and Venture SMEs.

(6) Promoting innovative forms of corporate financing

There are various innovative forms of corporate financing, such as (i) asset based lending ("**ABL**") with full-covered security package on movables, account receivables and deposits, (ii) hybrid securities and subordinated loans, and (ii) debt-equity swap ("**DES**"), debt-debt-swap ("**DDS**") and DIP finance.

Japanese government has facilitated ABL as new finance method for Existing SMEs on behalf of traditional secured loans by mortgage in such cases that mortgage is not practically available (e.g. in case where there is no excess value of real estate when deducting outstanding amount of secured loans by other mortgages). DES, DDS and DIP finance are used for financial restructuring of Existing SMEs (including in both legal insolvency proceedings and alternative dispute resolutions) when they are insolvent.

3. Has your jurisdiction adopted (or are there any trends indicating that may do so in the future) any measures to remove barriers to cross-border investment? Measures could include (i) improving market infrastructure; (ii) fostering convergence of insolvency proceedings; (iii) removing cross-border tax barriers; (iv) strengthening supervisory convergence.

We have adopted various measures to remove barriers to cross-border investment. Please see the details below.

(1) Improving market infrastructure

(a) English-language Disclosure System under the FIEA

Under the FIEA, issuers of certain securities are obligated to submit

Registration Statements, Annual Reports, and other disclosure documents in Japanese, in principle. In terms of this language requirement, the English-language Disclosure System ("**EDS**") was introduced in 2005 when the FIEA (then known as the Securities and Exchange Act) was amended. EDS is a system which allows foreign companies to submit English documents (limited to those which were actually disclosed in a foreign country pursuant to laws and regulations, including rules of a stock exchange or an equivalent institution, in the foreign country) in place of the above-mentioned Japanese documents in cases where these English documents are deemed not to be inadequate in consideration of the public interest and investor protection in Japan. When a foreign company submits these English documents (including those which are required as supplementary documents), such company shall be deemed to have submitted Registration Statements, Annual Reports, and other disclosure documents.

Following a gradual expansion of its scope, the system currently applies to almost all documents submitted by foreign companies which have disclosure obligations under the FIEA.

(b) Tokyo Pro Market

TOKYO PRO Market (previously named as TOKYO AIM) was established in June 2009 as a market operated by TOKYO AIM, Inc., which was created as a joint venture between TSE and London Stock Exchange ("**LSE**"), based on the provisions for markets for "professional investors" which was introduced in 2008 by the amendments to the FIEA. The objectives of TOKYO AIM were to provide new opportunities for financing and advantages other markets could not offer to companies with growth potential in Japan and Asia, to offer new investment opportunities to professional investors in Japan and abroad, and to revitalize and internationalize the financial market in Japan. TOKYO AIM worked to realize agile and flexible market management by adopting the J-Adviser System based on the Nomad System of London AIM operated by LSE. In 2012, TOKYO AIM changed its name to TOKYO PRO Market, and since then TSE has operated TOKYO PRO Market based on the original market concept.

(2) Fostering convergence of insolvency proceedings

In terms of extraterritorial application of insolvency laws, previously insolvency laws in Japan (the Bankruptcy Act and the Corporate Reorganization Act) had adopted strict territoriality where the effects of insolvency proceedings commenced in Japan do not extend to assets located in foreign countries, and vice versa.

However, the Act on Recognition of and Assistance in Foreign Insolvency Proceedings, which was effective from 2001, introduces and provides the

inbound effect of foreign insolvency proceedings where Japanese court (i) may approve the foreign insolvency proceedings and (ii) may issue orders to support approved foreign insolvency proceedings. Also, by the enactment of Civil Rehabilitation Act and the amendment to previous Bankruptcy Act and Corporate Reorganization Act which were effective from 2001, it is provided that the outbound effect of insolvency proceedings commenced in Japan do extend assets located in foreign countries (practically, approval by foreign courts are also necessary). These were amendments in order to abolish rigid territoriality, as well as to introduce procedures to recognize foreign insolvency proceedings based upon the Model Law of UNCITRAL for cross-border insolvency. It is broadly expected that, with such amendments, the insolvency proceedings of Japan will be able to be handled in smooth cooperation and harmonization with foreign insolvency proceedings.

(3) Removing cross-border tax barriers

(a) Withholding Tax and Tax Treaties

Under the Income Tax Act of Japan, a 20.42% withholding tax (including Special Reconstruction Income Tax, which is imposed until December 2037) is levied on the interest paid to foreign lenders under a loan. Provided, however, that if Japan and the country where the foreign lender resides are parties to a tax treaty (such as the United States or the United Kingdom), the withholding tax rate may be lowered or the obligation to withhold tax may be relieved entirely. For example, no withholding tax is levied on interest paid to all UK lenders under the tax treaty between the UK and Japan.

(b) Change from the Entire Income Principle to the Attributable Income Principle

Recently, we had a tax reform from the Entire Income Principle (the Force of Attraction Principle) to the Attributable Income Principle.
The difference between the two principles is the scope of taxable income of a foreign company with a permanent establishment ('**PE**') in Japan. Under the Attributable Income Principle, the business income attributable to the PE of such foreign company is subject to corporate tax and the Japanese source income not attributable to the PE is taxed in the same way as Japanese source income earned by a foreign company without a PE in Japan (i.e. in principle, subject to withholding tax only, except for certain capital gains, etc.). On the other hand, under the Entire Income Principle, a foreign company with a PE in Japan is liable for corporate tax on all Japanese source income (in principle) regardless of whether such income is attributable to the PE.
The change is intended to mitigate double taxation/no taxation in either jurisdiction by adopting the Attributable Income Principle broadly accepted by many countries and to ensure consistency with tax treaties

concluded by Japan.

(4) Strengthening supervisory convergence

The FIEA, main securities act in Japan, was enacted by amending the Securities and Exchange Act and took effect from September 2007. The purpose of the amendment/enactment of the FIEA was to change Japanese securities regulation from vertically-structured regulation governed several laws to cross-sectional regulation under a single law/FIEA. It was also aimed to respond to changes in the environment surrounding the financial and capital markets and to adapt to the internationalization of the financial and capital markets.

4. Have specific measures been adopted (or are foreseen) to increase choice and competition in cross-border retail financial services and/or insurance?

Except for measures as noted in this report, there are no specific measures to increase choice and competition in cross-border retail financial services and/or insurance.

5. Capital markets harmonisation aims to facilitate companies' access to finance, particularly for SMEs by promoting more diversified funding channels that are complementary to bank financing. Is non-bank financing significant in your country? Please consider the role of private equity, venture capital, alternative finance, loan-originating funds, etc.

(1) Non-bank Financing

Non-bank financing has been important financing method for Existing SMEs, especially SMEs whose financial condition does not satisfy credit criteria by banks. Under Japanese practice, typical style of non-bank financing are such as (i) loans by registered Money Lending Business Operators under the Money Lending Business Act ("**MLBA**"), (ii) finance lease by leasing companies and (iii) factoring by factoring companies.

As to loans, commercial lending in Japan is regulated under the MLBA and no one (including, but not limited to, a loan-originating funds) may engage in a money lending business to borrowers in Japan unless registered under the MLBA except for certain exemptions provided under the MLBA. Licensed banks under the Banking Act fall under the exemption in the MLBA.

(2) Private equity/venture capital

For Venture SMEs to obtain initial funding before their IPO, private equity funds and venture capital funds play an important role. Investment managers (including general partners of partnerships) of these funds are regulated by

applicable financial regulations, including the FIEA which regulate collective investment schemes that are not regulated by the other laws.

As to IPO of these funds, please see 1 above.

(3) Alternative finance

The FIEA was amended to facilitate crowd funding. Please see 1 above.

(4) Loan-originating funds

Loan-originating funds may engage in a Money Lending Business to borrowers in Japan only when registered under the MLBA. Please see 5(1) above.

6. While loans traditionally represent the bulk of the banking assets, most financial entities also invest in capital markets. Do financial institutions in your jurisdiction invest highly in the capital markets? Are bonds and equity investments a significant proportion of the assets of financial institutions in your jurisdiction?

Financial institutions in Japan invest highly in the capital markets. Japanese government bonds (JGBs), corporate bonds and equity investments are a significant proportion of the assets of financial institutions in Japan.

As to equity investment, most of shares held by financial institutions are shares issued by financial institutions due to the following reasons. First, (a as noted in 2 above, it is prohibited for banks and insurance companies (including their Permitted Affiliates engaging in financial business, such as securities companies and trust companies) in principle to hold more than certain ration of shares (5% in case of banks, 10% in case of insurance companies) issued by companies engaging in non- financial business. On the other hand, (b) it is permitted for banks and insurance companies to invest in more than 5%/10% of shares issued by companies engaging in financial business.[5] In addition to (b), it is general practice for bank/insurance company group in Japan to hold their shares each other. As a result, as noted above, most of shares held by financial institutions are shares of other financial institutions or their Permitted Affiliates.

[5] In the case of (b), (i) when acquired shares are less than the qualification ration for Permitted Affiliates (15% in the lowest cases, though it depends on other conditions) (i.e. typically, financial institutions in other financial groups), there is no procedural requirement under the Banking Act and the Insurance Business Act; and (ii) when acquired shares are equal to or exceeds the qualification ration for Permitted Affiliates, there is procedural requirement to notify to or to obtain permission by the FSA under the Banking Act and the Insurance Business Act. Please also see 2(1)(c) above.

7. Harmonisation requires standardisation, particularly in terms of credit information. Is SME credit information easily available in your jurisdiction? Is your jurisdiction adopting any measures to boost availability and standardisation of SME credit information at the national and supra-national levels?

SME credit information is not easily available in Japan. Japan does not adopt measures to boost availability and standardisation of SME credit information at the national level.

8. Is there any recent or proposed legislation in your jurisdiction aimed to establish a framework for simple, transparent and standardised securitisation? Examples might include measures (i) to simplify prospectus requirements; (ii) to increase/decrease the information required to be provided to investors before making an investment decision; or (iii) to reduce barriers for smaller firms to access capital markets. If there have been no recent developments, please describe the current situation of securitisation in your jurisdiction.

There is no recent legislation in Japan specifically aiming to establish a framework for simple, transparent and standardised securitisation.[6]

As a rule applicable to investment trusts and investment corporations (including REIT), there is a measure (i) to simplify prospectus requirement. Under the FIEA, there are two types of prospectus for these financial instruments: summary prospectus which must be delivered without regard to request by a customer, and full prospectus which is delivered only when the customer requests to deliver it.

As general rules under the FIEA applicable to all type of financial transactions, there are some legislations relating to the above. As to (ii) decrease the information required to be provided to investors before making an investment decision, there are exemptions from obligation to deliver documents which explains applicable risk and necessary information for a customer when the customer satisfies certain conditions and falls under "professional investors" (including, but not limited to, qualified institutional investors in Japan) under the FIEA.

Also, there were some recent amendments on special laws for securitization and investment trusts/ corporations to make their structures more flexible. Due to the

[6] We assume that "securitization" does not include collective investment scheme under investment trusts and investment corporations (including REIT), though we understand that investment trusts and investment corporations can be included in "securitization" from different category method.

amendment on the Asset Liquidation Act which usually provides private (not-listed) securitization scheme, (i) a SPC called TMK (*Tokutei Mokuteki Gaisha*) may invest in assets (real estates, in many cases in practice) more flexible and (ii) funding methods by TMK becomes more flexible. Due to the amendment on the Investment Trust and Investment Corporation Act which usually provides public (listed) collective investment scheme, funding methods by REIT becomes more diversely.

9. In your experience as a banking/capital markets lawyer, have you detected in your jurisdiction any unnecessary regulatory burdens, interactions, inconsistencies and/or rules that have unintended consequences which threaten the ability of the companies to finance themselves?

It is generally discussed among practice lawyers that "borderlines" are not clear whether certain financial regulations are applicable or not.

The first example is the scope of extraterritorial application of Japanese financial regulations. In most cases, applicable financial regulations do not provide explicit provisions on this issue and, as a result, it is usually interpretation issue of such regulations. Especially, it is generally interpreted that the MLBA is theoretically applicable to both cases where (i) foreign lenders without Japanese offices lend money to person/corporations located in Japan and (ii) Japanese lenders lend money to person/corporations located outside of Japan. However, many Japanese practice lawyers criticize the above conclusions because regulating all cases without any exemptions (e.g. loans against certain professional borrowers, etc.) is too much.

The second example is that it is not clear what activities falls under the scope of "solicitation", which triggers disclosure regulations, license requirement or some other regulations under the FIEA. As to the "solicitation" in case of disclosure regulations, disclosure guideline issued by the FSA was amended in 2014 and created certain "safe harbours" cases in the guideline in order to clarify the borderlines to trigger disclosure regulations.

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