

Interim Note on Rules for Professional Investors
— Focusing on the Financial Instruments and Exchange Act —¹

I. Overview of Rules for Professional Investors

The Financial Instruments and Exchange Act (the "FIEA") sets forth a regulatory system for qualified institutional investors (*tekikaku kikan tousehika*) (the "Qualified Institutional Investor System") as well as a regulatory system for professional investors (*tokutei tousehika*) (the "Professional Investor System") as structures that apply differing regulations in content and extent depending on the attributes of the investors. Such regulations can be considered, in the broader sense, as the rules for professional investors.

Qualified institutional investors are defined in the FIEA as those having expert knowledge of and experience with investment in securities. Qualified institutional investors consist of two types: (i) those that automatically constitute qualified institutional investors (such as certain financial instruments business operators as well as banks), and (ii) those that may become qualified institutional investors as a result of filing the necessary notification with the Commissioner of the Financial Services Agency (the "FSA") (e.g., corporations that manage at least 1 billion yen in total value of securities). The disclosure regulations prescribe a special exception for an offering of securities to qualified institutional investors based on the perception that protection by way of detailed disclosure is not necessary for these investors. In particular, a person who makes a sales solicitation of securities is exempted from the obligation to submit a securities registration statement or to prepare and deliver a prospectus if certain requirements are satisfied, where such requirements include that the solicitation is to be made only to qualified institutional investors and that restrictions are imposed on assigning the securities to any person other than a qualified institutional investor.

¹ Note to English version:

The Japanese version of this paper was published on December 25, 2010, and this English version is a concise summary of such Japanese version.

For the purpose of seeking more flexibility of applying the relevant regulations, the Professional Investor System classifies investors as either professional investors or general investors (amateur investors), with differing application of rules of conduct depending on such classification. Such classification occurs as a result of (a) the classification into four categories as described immediately below, and (b) a change of status requested by the investor (if any). The four categories into which the investors are divided are: (i) professional investors that are not allowed to change their status to that of a general investor (i.e., qualified institutional investors, the government of Japan and the Bank of Japan); (ii) professional investors that are allowed to change their status to that of a general investor (i.e., corporations that meet certain requirements (e.g., listed companies; corporations with capital of more than 500 million yen; or foreign corporations)); (iii) general investors that are allowed to change their status to that of a professional investor (i.e., corporations other than those set forth in (i) and (ii) above, as well as individuals who satisfy certain other requirements); and (iv) general investors that are not allowed to change their status to that of a professional investor (i.e., individuals other than those set forth in (i) or (iii) above). A change of status from that of a professional investor to a general investor or vice versa is carried out within the relationship with a financial instruments business operator, etc. by the investor making a request to such financial instruments business operator, etc.

When a counterparty of a financial business operator, etc. is a professional investor, certain rules of conduct that would otherwise be applicable are not imposed on the financial instruments business operator, etc. The main purpose of imposing the different rules of conduct is to narrow the information gap between a financial instruments business operator, etc. and an investor. Examples of the rules of conduct which are not imposed on a financial instruments business operator, etc. when a counterparty is a professional investor are (i) the obligation to deliver the explanatory document prior to conclusion of contract, (ii) regulations regarding advertising, (iii) the principle of suitability, and (iv) the duty of substantive explanation.

II. Practical Issues in Connection With the Rules for Professional Investors

There are several key practical issues that arise in relation to the regulatory system

regarding qualified institutional investors. The first issue is whether it is truly appropriate to apply the same set of rules to persons who become qualified institutional investors through notification, regardless of the actual expert knowledge or experience of such persons, given that these rules have been created on the presumption that a qualified institutional investor has professional investment experience. The second issue is whether the structural protections are sufficient to ensure that the disadvantages of becoming a qualified institutional investor are understood prior to the investor providing the notification to that effect. Furthermore, it might be questionable whether the imposition of personal responsibility on an individual investor that decides to become a qualified institutional investor is premised on reasonable considerations. A third issue is with regard to the ease of use of the notification system. In particular, it may be argued that the notification system must be improved by increasing the opportunities to file notifications, providing greater flexibility in the effective period, and permitting withdrawal and modification of notifications.

The practical issues in connection with the Professional Investors System include, *inter alia*, the appropriateness of uniform treatment as a general (amateur) investor, the application of the principle of suitability to the procedures to become a professional investor, and the duty to explain to the professional investor.

The uniform treatment as an amateur investor means that a financial instruments business operator, etc. treats all investors, or all investors other than those who have specifically requested to be treated as professional investors, as general investors for the purpose of avoiding complexity in administrative processing of handling the classification of investor. Despite the existence of the Professional Investor System, some financial instruments business operators, etc. nonetheless choose to apply this uniform treatment to all investors to reduce operating costs. Although this uniform treatment is not necessarily consistent with the intent of the Professional Investor System, which seeks flexibility in application of the law, it does not constitute a violation of any law. This treatment may be considered to be unavoidable from an administration perspective, as differentiating between investor classifications could be burdensome for business operators.

According to the view of the Financial Services Agency, the principle of suitability is applicable when a financial instruments business operator, etc. (i) notifies a

customer that such customer is eligible to become a professional investor, or (ii) accepts a request from a customer to become a professional investor. The financial instruments business operator, etc. must then make a determination of whether it is appropriate for the customer to become a professional investor. It would appear to be excessive and unnecessarily onerous to make a financial instruments business operator, etc. responsible (and subject to potential administrative sanction or civil liability) for the role of screening the appropriateness of an investor becoming a professional investor by the application of the principle of suitability. In that regard, the application of the principle of suitability may be considered to restrict the financial instruments business operators, etc.'s flexibility in approving requests from investors to become professional investors.

It is understood that a duty of explanation to a customer, based on the principle of good faith under the Civil Code, may be imposed on a financial instruments business operator, etc. even when the customer is a professional investor. Indeed, in a case prior to the enforcement of the FIEA, the court found that a securities firm had violated a civil duty of explanation to a customer who had extensive experience in derivatives transactions. Nevertheless, if a customer is a professional investor, the information gap with the business operator should be eliminated with the exchange of appropriate and necessary information in the course of negotiations between the parties. The approach of imposing a civil duty on a securities firm (which is a financial instruments business operator) to provide an explanation to investors in order to thereby reduce the information gap would appear to be unnecessary in at least a relationship between the professional investor and the financial instruments business operator as envisioned under the Professional Investor System.

III. Approaches and Areas of Improvement to Promote the Use of the Rules for Professional Investors

Although notifications under the Qualified Institutional Investor System are used widely, there are few cases of becoming a professional investor under the Professional Investor System. There are three key reasons for this: (a) it is difficult to become a professional investor without having knowledge and experience in various types of securities trading and other transactions; (b) there are few advantages for either the investor or the financial instruments business operator,

etc., of the investor to become a professional investor irrespective of the complexity of the system and the process involved; and (c) since the principle of suitability applies to the procedures for becoming a professional investor as discussed above, the financial instruments business operators, etc. do not in practice encourage investors to undertake this procedure.

There are four possible approaches and areas of improvement that can be envisioned in order to promote the use of the Professional Investor System. First, a more detailed segmentation of the units of changing² to a professional or general (amateur) investor, such as distinguishing based on each type of securities, should be introduced. Secondly, there should be promotion of a business category of financial instruments business operators, etc. that handle only financial products for professional investors in order to reduce the transaction costs and increase the advantages to becoming a professional investor. Thirdly, the criteria for determining the status as an amateur or professional investor must be simplified so that the investor status may be determined automatically based on simplified criteria such as assets or transaction experience, and a prohibition on solicitation by financial instruments business operators to make investors change their status to professional investors should be implemented thereby allowing such choice to remain a voluntary one for the investor. Fourthly, it is advisable to expand the base of investors that are suited to being treated as professional investors.

Given that: (i) the Qualified Institutional Investor System and the Professional Investor System have the same objectives of achieving a reduction in excessive transaction costs as well as balancing the protection of investors and the facilitation of transactions; (ii) qualified institutional investors are included within the category of professional investors; and (iii) the concept of the professional investor is used in the disclosure regulations as well, it can be said that both of these systems are on the same continuum. Hence, it would be worthwhile to consider the possibility of merging the Qualified Institutional Investor System and the Professional Investor System into one notification system. This is particularly so in light of the factors identified above (i.e., (i) through (iii)), as well as taking into account the administrative burden for financial instruments business operators,

² Currently, an investor may choose a type of trading in which the investor changes its status within four categories of transactions: securities trading transactions; derivatives transactions; investment advisory contracts; and investment management contracts. Such categories are referred to "units".

etc. under the Professional Investor System, and from a perspective of streamlining of the regulations. Such a notification system should be based on an objective determination of professional investor status and should be supervised by the Japanese government in the same manner as the current Qualified Institutional Investor System. The merging of the Professional Investor System and the Qualified Institutional Investor System into a notification system would also mean the elimination of the application of the principle of suitability. Adopting the above measures will make the system more useful to investors and more efficient for business operators.