

# Japan Regulatory Update

Japan

DT Legal Japan

January 11, 2017

## Shift in the Supervisory and Inspection Approaches of the FSA and SESC.

### A. BACKGROUND

On October 21 and 25, 2016, both the Financial Services Agency of Japan (the “**Japan FSA**”) and the Securities and Exchange Surveillance Commission (the “**SESC**”) issued policies regarding their supervisory frameworks which included their inspection standards for Financial Instruments Business Operators (the “**FIBO**”)s) registered under the Financial Instruments and Exchange Act (the “**FIEA**”).

Interesting to note in these new policies is a clear shift in the approach of the Japan regulators with respect to the manner by which it shall supervise and inspect FIBOs. Historically, the Japan regulators appeared to adopt a more “targetted” enforcement approach whereby certain FIBOs were flagged for inspection based on specific concerns of wrongdoing or where such FIBOs was engaged in business activities that was focused on a large number of retail customers while periodic inspections of FIBOs was only undertaken in a very limited scope.

However, based on the new policies, the Japan regulators seem to be taking a more “comprehensive” enforcement approach.

This Client Alert will briefly discuss some main concepts expressed in these policies.

### B. CONCEPTS EXPRESSED IN THE FSA POLICIES

The second annual Financial Administration Policy (the “**2016 FSA Policy**”) issued by the Japan FSA with respect to the administrative year<sup>1</sup> of 2016 (the “**Year 2016**”) set forth information regarding

the general stance that the Japan FSA is taking with respect to financial administration as well as goals that the Japan FSA seeks to achieve during the Year 2016.

In the 2016 FSA Policy, the FSA indicated, among others, its plan to shift the fundamental concepts and process of its inspection and/or supervision of FIBOs:

- (i) moving away from inspections which prioritize the strict compliance by the FIBO to applicable regulations (so-called “minimum standard”) to put further emphasis on monitoring the business practices of such FIBO to ensure the provision of high-quality financial services (so-called “best practice”);
- (ii) shifting from examinations which focus on the financial soundness of the FIBO as a specific set of time to put a greater focus on examining the sustainability of the business model of the FIBO for the future; and
- (iii) moving away examinations that focus on a FIBO’s response to a specific regulations which may be applicable to it to put a greater focus on determining whether a FIBO can response to a regulatory issue that is key or central to its business.

As of this time, there are no specific details as to the means by which these concepts will be directly implemented by the Japan FSA though the SESC Monitoring Policy (see below) does provide some information on this topic.

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<sup>1</sup> The “regulatory administrative year” was changed from the original period of April to the following March period, to July to the following June period.

### C. CONCEPTS EXPRESSED IN THE SESC POLICY

The SESC is the enforcement arm of the FSA and it is generally held as the responsible government authority to monitor FIBOs and investigate possible conducts of wrong doing.

In light of its role as the enforcement authority, based on the concepts stated in the 2016 FSA Policy, the SESC issued Securities Monitoring Basic Policy (the “**SESC Monitoring Policy**”) for the Year 2016. The SESC Monitoring Policy provides more concrete procedures for the implementation of the new concepts expressed in the 2016 FSA Policy.

Based on the information set forth in the SESC Monitoring Policy, in line with the 2016 FSA Policy, the SESC will also shift its inspection approach of FIBOs from allocating resources to focus on certain selected FIBOs through on-site inspection to undertaking a more comprehensive approach by monitoring all FIBOs through both on-site and offshore monitoring. Like the 2016 FSA Policy, the shift in this approach would permit the SESC to provide some level of oversight to all FIBOs and then engaging in further in-depth investigations as required.

The SESC Policy notes that this new approach is a means to adapt to the evolving financial industry of Japan. With a significant increase in the number of registered FIBOs in Japan (approximately 8,000) and the increasing diversity of products and services being offered, this new approach is deemed as the most effective and efficient means by which the SESC can properly regulate FIBOs and the financial industry of Japan.

Specifically, the SESC generally will first engage in “off-site monitoring” of FIBOs (e.g., through questionnaires and reporting requirements). Then, based on the information acquired through such off-site monitoring activities, the SESC will analyze the business model, effectiveness of operations/governance, and appropriateness of the risk management of such FIBOs (i.e. a “risk-based” assessment). Based on such results, the SESC will select certain FIBOs which it will conduct on-site monitoring.

In addition from its discussion on enforcement, the SESC provided the focus points for its inspection for each type of FIBO in recognition of the different scope of services being provided. For example,

with respect to investment managers, the focus of the SESC will be the governance structure of such investment manager. With respect to Type II Financial Instruments Business Operators and Article 63 Exemption Filers,<sup>2</sup> the focus of the SESC will be to ensure that the investment activities of the limited partnership funds being solicited by the Type II Financial Instruments Business Operator or the Article 63 Exemption Filer are consistent with the fund documents/marketing material and whether the capital contributions of the limited partners are appropriately segregated from the proprietary assets of the general partner. It should be noted that the foregoing focus points are not intended to be applicable to each and every FIBO engaging in the specific regulated activity – but is intended more as a general guideline regarding key areas of focus.

### D. CONCLUSION

With this promulgation of these policies by both the Japan FSA and the SESC, it is clear that there will be a shift in the manner by which FIBOs will be regulated.

The Investment Management Group of DT Legal Japan has extensive experience in providing compliance-related advice to FIBOs and Article 63 Exemption Filers and will be monitoring developments in this area closely.

We offer compliance audit services to FIBOs which are tailored to the specific registration held by the FIBO as well as its business activities in Japan with the purpose of enhancing the overall understanding of the current compliance structure of the FIBO as well as highlighting any potential regulatory issues, if any. The undertaking and completion of periodic compliance audits is generally recommended for all FIBOs and the adoption and implementation of a well prepared compliance program can significantly reduce the unnecessary risks and confusion of a FIBO in light of a pending regulatory inspection. As a general matter, the purpose of the audit will be to ensure the maintenance and control of legally required documents (e.g., internal rules and ledgers) and will assist management personnel comprehend the types of queries which may be received through training by mock interviews, etc. Please contact us if you wish to have further information of our service.

For anyone who did not receive this Client Alert and wishes to be placed on the mailing list for

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<sup>2</sup> General partners who filed a notification for the Exemption for Special Business Activities Directed at Qualified Institutional Investors pursuant to Article 63 of the FIEA.

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## Contacts

DT Legal Japan (Tokyo)

Koji Yamamoto, Partner [koji.yamamoto@tohmatu.co.jp](mailto:koji.yamamoto@tohmatu.co.jp)

Yoshiyuki Omori, Partner [yoshiyuki.omori@tohmatu.co.jp](mailto:yoshiyuki.omori@tohmatu.co.jp)

## Issued by

DT Legal Japan

Shin-Kokusai Building 2F, 3-4-1 Marunouchi, Chiyoda-ku, Tokyo 100-0005, Japan

Tel : +81 3 6870 3300

Corporate Info.: [www.deloitte.com/jp/en/dtlegal](http://www.deloitte.com/jp/en/dtlegal)

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