

Japan Regulatory Update

Japan

DT Legal Japan

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The Financial Services Agency of Japan Releases ITS Draft “Principles of Fiduciary Duty”

On January 19, 2017, the Financial Services Agency of Japan (the “**Japan FSA**”) released its draft of the “Principles concerning the Operation of Fiduciary Duty” (*kokyaku hon-i no gyomu unei ni kansuru gensoku*, the “**Principles of Fiduciary Duty**”).¹

In this Client Alert, we will provide a brief summary of the background of this release by the Japan FSA as well as a description of the principles set forth in the Principles of Fiduciary Duty.

A. Background

On April 19, 2016, Japan’s Finance Minister requested Japan’s Financial System Council (*kinyu shingi kai*, the “**Council**”) to examine various issues relevant to Japanese financial markets and financial exchanges for the purpose of exploring ways to support the sustainable economic growth and stable financial accumulation of Japanese household assets.

On December 22, 2016, the Council’s Working Group on Financial Markets (the “**Working Group**”) published its “Measures for Financial Accumulation of Household Assets and Appropriate Rules regarding Financial Markets and Financial Exchanges” (*kokumin no anteiteki na shisankeisei ni muketa torikumi to shijou torihikisho wo meguru seidoseibi ni tsuite*, the “**Working**

Group Report”).² This Working Group Report served as the basis for the Japan FSA’s Principles of Fiduciary Duty.

B. Understanding the Principles of Fiduciary Duty

It is important to note that the Principles of Fiduciary Duty will not be implemented as a law or regulation of Japan. Instead, much like the Stewardship Code that was issued in 2014 by the Japan FSA, the Principles of Fiduciary Duty is a recommended set of basic fiduciary principles that financial business operators (the “Financial Business Operators”)³ may elect to adopt in connection with their performance of client-oriented services. In that sense, there is no explicit obligation on Financial Business Operators to either comply with, or adopt, all or any portion of the Principles of Fiduciary Duty. Instead, Financial Business Operators will have the discretion to elect whether they wish to adopt all or certain portions of the Principles of Fiduciary Duty.

Under the Principles of Fiduciary Duty, a Financial Business Operator that elects to adopt such principles will be required to establish a clear policy regarding its own fiduciary duties (“**Policy regarding Fiduciary Duties**”). In preparing such Policy regarding Fiduciary Duties, the Japan FSA’s expectation is that each Financial Business

¹ <http://www.fsa.go.jp/news/28/sonota/20170119-1.html> (Financial Services Agency(Japanese))

² http://www.fsa.go.jp/singi/singi_kinyu/tosin/20161222-1.html (Financial Services Agency(Japanese))

³ “Financial Business Operators” is not intentionally defined by the Japan FSA, but broadly includes all financial institutions, etc. that conduct or provide sales of financial instruments, investment advice, product development, asset management, investment management, etc. The Japan FSA expects that the principles will be widely adopted by Financial Business Operators that seek for customer-oriented services. However, it is important to note that the exact definition has been left vague and it is unclear which entities should be covered under the scope of this definition (e.g. offshore general partners, investment advisers, etc).

Operator will take a “principle-based approach” in formulating such policy. Specifically, under this “principle-based approach”, each Financial Business Operator may take into account various facets of its own business (e.g. target clients, complexity of products, etc.) and articulate a policy which best complements its own business activities and the best interests of its clients.⁴ However, if it does not adopt a specific principle set forth in the Principles of Fiduciary Duty, the Financial Business Operator will be required to explain sufficiently the circumstances and reasons for not adopting such principle and what, if any, alternative measures such Financial Business Operator is implementing to address such principle.

C. The Seven Principles of Fiduciary Duty

In its current form, the Principles of Fiduciary Duty sets out the following seven overarching principles:

1. Establishment and Announcement of the Policy concerning Fiduciary Duties;
2. Pursuing the Best Interest of the Clients;
3. Appropriate Management of Conflicts of Interest;
4. Clarification on Fees, etc.;
5. Provision of Important Information that is Easily Understandable to the Client;
6. Provision of Services Suitable for Each Client; and
7. Establishing the Framework for Appropriately Motivating its Personnel to Comply with Fiduciary Duties.

It should be noted that the concepts of the enumerated principles do appear to overlap numerous existing obligations that are applicable to certain types of registered financial instruments dealers under applicable Japanese laws and regulations. However, with respect to those Financial Business Operators that elect to operate under the Principles of Fiduciary Duty, the Japan FSA expects that by adopting its own Policy regarding Fiduciary Duties, such Financial Business Operators will formulate and adopt standards of fiduciary duties that go beyond their strict legal and regulatory obligations should such Financial Business Operator also be a registered financial instruments dealer in Japan.

Furthermore, of the seven above principles, we are aware that there is a fair amount of discussion in the industry regarding Principle 3, “The Appropriate Management of Conflicts of Interest”. With respect to this specific principle, the Japan FSA provided fact pattern examples that Financial Business Operators should consider to determine whether any of such fact patterns (or similar circumstances) could be applicable to their own businesses and how such situations would be managed from a conflicts of interest perspective. Whilst the fact patterns describe conduct that is not explicitly prohibited under Japanese law, the Japan FSA is of a view that such activities may have an inherent risk of raising issues of conflicts of interest.

Examples of such fact patterns include:

- When a distributor receives commissions from the provider of a financial instrument in connection with such distributor making sales or recommendations to its clients to purchase such financial instruments;
- When a distributor sells or recommends financial instruments which are sponsored or managed by an affiliated group company to its clients; and
- Where a Financial Business Operator has a corporate sales department and an investment management department within the same entity or as affiliated entities, and the investment management department selects and invests into a company which is an existing client of the corporate sales department.

Additionally, there have also been discussions in the market that the Japan FSA is concerned with potential conflicts of interest issues which may arise in relation to domestic banks and financial institutions actively offering their affiliated entities’ products.

D. Conclusion

Ultimately, as it will not be mandatory for Financial Business Operators to adopt the Principles of Fiduciary Duty, it is unclear what the real impact of the published Principles of Fiduciary Duty will have on the financial industry in Japan, as well as what types of entities would fall under the definition of a “Financial Business Operator”. However, much like the Stewardship Code, it is possible that the decision for a Financial Business Operator not to

⁴ This approach is different from the more conventional “rule-based approach” where universal standards of operations are established and applied comprehensively to all Financial Business Operators without regard to specific considerations of each Financial Business Operator.

adopt the Principles of Fiduciary Duty may negatively impact its ability to enter into certain business arrangements with certain types of investors in Japan, such as pension funds.

The Japan FSA is currently soliciting comments on the Principles of Fiduciary Duty and we would anticipate that the Japan FSA will issue the results of such public comments in the upcoming months. DT Legal is closely monitoring this situation and we anticipate that we will be issuing a separate Client Alert on such results when available.

Please do not hesitate to contact us if you did not receive this Client Alert and you would like to be placed on the mailing list for Japan regulatory updates issued by DT Legal Japan's Investment Management Group.

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