

# The New Law of Asset Securitization in Japan\*

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## I. INTRODUCTION

The importance of the international financial services market in balancing U.S. trade is significant, although often overlooked in discussions of trade issues. In 1992, the United States enjoyed a \$61 billion trade surplus in financial services, compared to a \$96 million merchandise deficit.<sup>1</sup> As the financial markets of the Pacific Rim continue to grow, they are becoming an increasingly important source of business for American financial institutions.<sup>2</sup> Likewise, the influence of the American financial industry in the Asia-Pacific region should not be limited to the expansion of market share. The more interesting and significant contribution will be the introduction of new financial products and services to this growing market.

This Article discusses one financial product developed in the United States and expected to develop in Japan as a result of recent legislation adopted there. The Article examines the high degree of regulation of this new financial product under that legislation and concludes that such regulation, while common in Japan, will delay the full development of the market in Japan. This Article begins with a description of an important financial tool first developed in the United States, the securitization of financial assets. The Article next examines several aspects of the new Japanese legislation and reviews the provi-

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1. *U.S. Launches Drive To Open Financial Sector*, ASIAN WALL ST. J., Jan. 19, 1994.

2. The potential importance of these financial markets particularly to U.S. interests may be seen by the recent Asian-Pacific Economic Cooperation conference held in Honolulu, Hawaii, among finance ministers from the APEC countries, including Japan and the United States. *Id.*

sions of that legislation. The Article concludes with brief comments from the Author.<sup>3</sup>

## II. SECURITIZATION—BACKGROUND

### A. *Origins of Asset Securitization*

The securitization of financial assets, which first arose in the United States in the 1970s,<sup>4</sup> originated as a financing method developed in connection with home loans by the quasi-governmental Federal National Mortgage Association (FNMA) and, more recently, the Government National Mortgage Association (GNMA or Ginnie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC).<sup>5</sup> These quasi-government agencies buy qualifying home mortgages from lenders, package them into new securities backed by a pool of mortgages, provide certain guaranties, and then resell the securities on the open market.<sup>6</sup> The resulting instruments are often referred to as mortgage-backed securities. The active secondary market for these securities provides an important continuing source of home mortgage funds in the United States and remains the largest market for securitized financial assets in the United States.<sup>7</sup>

In recent years, the numbers and types of assets that have been securitized through similar, but increasingly sophisticated and complex structures have grown dramatically. Among the more prominent examples of the types of assets that are now regularly securitized are automobile, computer, and other equipment loan and lease receivables, credit card receivables, and trade receivables.<sup>8</sup> These securities are generally referred to as asset-backed securities.

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3. This Article is intended only as a brief introduction to new legislation in Japan regarding the securitization of financial assets. For a more general discussion of securitization issues in Japan see *Nihon no Kinyu Shisan Shokenka no Shuho* [Japanese Methods of Securitizing Financial Assets] (The Long-Term Credit Bank of Japan, Ltd. ed., 1993); *Shokenka no Riron to Jitsumu* [Theory and Practice of Securitization] (Corporation Finance Research Institute Japan ed., 1992).

4. See J. DOWNS & J. GOODMAN, *BARRON'S FINANCE AND INVESTMENT HANDBOOK* (1986).

5. *Id.*

6. *Id.*

7. *Id.*

8. P. RIVETT & P. SPEAK, *THE FINANCIAL JUNGLE - A GUIDE TO FINANCIAL INSTRUMENTS* 157 (1991).

*B. Benefits of Asset Securitization and Market Growth*

Securitization transactions tend to be relatively complicated and require consideration of a number of regulatory, business, accounting, rating, and legal issues—the latter including securities, bankruptcy, commercial, and tax issues—and the interplay among all of these.<sup>9</sup> Nevertheless, this method of financing often provides significant benefits to companies that generate receivables.<sup>10</sup> These companies are often referred to in U.S. securitization structures as “originators.” Properly structured, the originator is able to remove the securitized financial assets and associated financing from its balance sheets, making the company financially stronger from an accounting viewpoint, and, therefore, able to acquire more funds at a lower cost for other business activities.<sup>11</sup>

Despite the relatively high transaction costs of securitizing receivables, the originator is often able to obtain funds at a cost that is lower than traditional bank lending.<sup>12</sup> Therefore, although transaction costs may be higher, the company is able to obtain a lower “all-in” cost of funds. In part, this lower cost often results because the company is able to separate stronger assets from weaker assets, creating a pool of higher quality assets upon which financing can be obtained. The company also gains access to a source of financing other than traditional equity markets or third-party lenders.<sup>13</sup> Finally, the originator is better able to match its assets and liabilities, providing for greater management of its financial resources.<sup>14</sup>

Of course, the originator enjoys other potential economic benefits including, in the case of banks and other regulated financial institutions, an improved ability to meet capital adequacy requirements.<sup>15</sup>

Because of the significant potential benefits provided by securitization transactions, the demand for securitization of financial assets has grown at a remarkable pace in the United States. Currently, over half of all debt securities issued in the

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9. For an excellent and comprehensive discussion of legal, business, accounting, and regulatory issues affecting securitization transactions in the U.S. see J.H.P. KRAVITT, *SECURITIZATION OF FINANCIAL ASSETS*.

10. *Id.* § 3.01, at 3-5.

11. *Id.*

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

United States are issued through one form or another of such securitization transactions.<sup>16</sup> One report estimates that the total value of U.S. securitized assets as of the end of 1992 exceeded \$1 trillion.<sup>17</sup> Since the market began in the mid-1980s, \$90 billion to \$200 billion in new assets have been securitized annually.<sup>18</sup>

The success of the U.S. market was in part the result of economic, regulatory, and historical factors that may have been unique to a certain period in the United States.<sup>19</sup> This success, together with other global economic factors such as increased direct access to capital markets and reduced liquidity of traditional bank lenders, has generated interest in securitization outside the United States.<sup>20</sup> The European market for asset-backed securities is not yet as large as the U.S. market.<sup>21</sup> This differentiation can be attributed to the relative lack of experience with such transactions, the complicated nature of the transactions, and the differing regulatory environments.<sup>22</sup> However, active securitization markets do exist in the United Kingdom and elsewhere in Europe, including France, Spain, and some Scandinavian countries.<sup>23</sup>

### III. SECURITIZATION IN JAPAN

Certain types of securitized financial products existed in Japan prior to the adoption of the new legislation described in this Article. Among such products are commercial paper, securitized commercial real estate mortgages, somewhat less popular securitized residential real estate mortgages, residential mortgage trusts, and bank loan securitizations.<sup>24</sup> Transactions that allow divided ownership of real property through legal entities known as *kumiai* have also been completed.<sup>25</sup> The

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16. A. Dobson, *The Future of European Securitization*, SECURITIZATION, Sept. 1992.

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. Hideki Kanda & Michael Kawachi, *Securitization in Japan*, JCR FIN. DIG., Nov. 1993, at 1.

25. Article 667(1) of the Japanese Civil Code (*nin'i kumiai*) and Article 535 of the Japanese Commercial Code (*tokumei kumiai*). Broadly speaking, a *kumiai* is a combination of individuals or legal entities by contract. In the case of a *tokumei kumiai*, an anonymous party invests in the other party's business which is operated by one party alone.

market for these products is generally less developed than similar markets in the United States.<sup>26</sup> The lack of market development may be attributed to a number of factors, not least of which is the relatively rigid regulatory control exercised over the markets by governmental bureaucracies in Japan.<sup>27</sup>

#### IV. SUMMARY OF THE SPECIFIED CLAIMS LAW

##### A. Background

Since 1988, Japanese government-sponsored research committees have studied the field of asset securitization.<sup>28</sup> These studies have focused on the practices of U.S. regulatory agencies and market participants, such as investment banks, lawyers, accountants, and investors.<sup>29</sup> In 1990, the Securities and Exchange Council, sponsored by the powerful Ministry of Finance (MOF), published its first report on the legal and institutional improvements necessary to cope with asset securitization.<sup>30</sup> Paralleling the efforts of the MOF, a group of scholars, businessmen, and government officials referred to as the Asset Securitization Research Committee, sponsored by the Ministry of International Trade and Industry (MITI), completed its study of U.S. securitization.<sup>31</sup> That Committee published the results of its efforts on March 12, 1992.<sup>32</sup> Later that year, on June 5, 1992, the Japanese Diet passed the "Law Regarding Regulation of the Business Concerning Specified Claims."<sup>33</sup> The Law went into effect one year later in June 1993.

##### B. Chapter 1: General Provisions

Chapter 1, Section 1, sets forth the Law's general purposes, which assure the proper operation of the businesses that take assignment of receivables and businesses that sell instruments backed by such receivables, ensure that such businesses are

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26. Kanda & Kawachi, *supra* note 24.

27. *Id.*

28. Y. Kawamura, *Securitization of Finance, in JAPAN'S FINANCIAL MARKETS* (Foundation for Advanced Information and Research, Tokyo, Japan 1991); *see* Shisan Ryudo-ka no Kongo no Ari Kata ni Tsuite [Concerning How Future Asset Securitization Should Be] (Asset Securitization Research Committee 1992) [hereinafter *How Asset Securitization Should Be*].

29. *Id.*

30. Kawamura, *supra* note 28, at 344.

31. *How Asset Securitization Should Be*, *supra* note 28.

32. *Id.*

33. *Tokutei Saiken Nado ni Kakaru Jigyo ni Kansuru Horitsu* (Law No. 77 of 1992) [hereinafter *Specified Claims Law*].

operated fairly, and confirm that there is sufficient investor protection.<sup>34</sup>

Chapter 1, Section 2, includes definitions of the principal terms used in the Law. Of particular importance is the term "Specified Claims" (*Tokutei Saiken*). Specified Claims, generally speaking, refer to the kinds of receivables that may be securitized under the Law. These receivables include (1) equipment lease receivables that arise from leases of machinery or other goods with lease terms of at least one year and are not terminable by either party following the commencement of the lease term; (2) receivables that arise from purchase by presentation of a voucher where payment of the purchase price is to be made over at least three installments over a period of at least two months; (3) receivables that arise under agreement other than by voucher where, as a condition of purchase, the purchaser agrees to make payments in at least three installments over a period of at least two months; and (4) receivables that arise from the purchase of goods by voucher, where the purchaser agrees to pay and the seller agrees to receive payment of an amount calculated on the basis of a prearranged formula.

The term "voucher" is somewhat misleading, and appears to refer to a credit card, while the reference to a prearranged payment formula is generally interpreted as referring to revolving credit arrangements.<sup>35</sup> The emphasis on minimum repayment periods may be intended to reduce volatility in the market during the initial stages of market development.

Subparagraph (5) of this Article is a catch all provision that provides for the addition of other receivables as determined by Cabinet Order.<sup>36</sup>

Under Article 2, Paragraph 6, the instrument that an investor ultimately purchases under the Law is referred to as a "Small-lot Claim" (*Koguchika Saiken*). Such instruments are narrowly defined in a manner that requires the securitization to be completed by one of the methods defined in the Law as discussed below. In addition, such instruments cannot include "securities" within the meaning of the Securities and Exchange

34. *Id.* art. 1.

35. See *Japanese Unveil New Securitization Legislation*, STANDARD & POOR'S CREDITWEEK, Sept. 6, 1993; *Legislative Developments and Asset Securitization in Japan*, MOODY'S GLOBAL STRUCTURED FINANCE, June 1992.

36. Specified Claims Law, *supra* note 33, art. 2(5).

Law of Japan (SEL).<sup>37</sup> This last restriction may have negative consequences for the development of this market in Japan.

### C. Chapter 2: Assignment of Specified Claims

Chapter 2 of the Law details the methods by which the Specified Claims are assigned by the "Specified Business Person," the originator, in U.S. parlance. This assignment is the normal first step in a securitization transaction. Under Article 3, both the Specified Business Person and the "Specified Claims Assignee" are required to file notice of the plan of assignment with the MITI according to ministerial ordinance.

Chapter 2, Article 2.4 defines the term "Specified Claims Assignment-Taking Business" (*Tokutei Saiken nado no Joto Gyo*). Here, the Law sets forth the business arrangements under which Specified Claims may be securitized. The statutory definitions are rather vague and must be read in conjunction with other informal information provided by the ministries, such as the report mentioned above. Therefore, there are three permitted structures, with the option of including a trust bank in place of the Assignee. Two of these structures are described in Article 2.4 (A) and (B) to include the following: a structure in which a party that owns Specified Claims contributes them to another party, who collects the Specified Claims and distributes profits; and a structure in which a legal entity acquires Specified Claims and entrusts their management and collection to a third party who distributes earnings from the Specified Claims to the investors. Despite the potential for broad interpretation

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37. The fundamental law governing securities in Japan is *Shoken Torihiki Ho* [Securities and Exchange Law] (Law No. 25 of 1948, as amended). The SEL's Article 2, Section 1 provides specific enumeration of nine rights and instruments that are defined as "securities" in Japan. Only these enumerated instruments are considered securities and subject to the investor protection requirements, such as disclosure requirements, antifraud provisions, and prohibitions against insider trading. The SEL defines a security as one of the following items: (1) government debt security; (2) municipal debt security; (3) debt security issued under a special statute by a corporation; (4) secured or unsecured debt security issued by a business corporation; (5) stock issued by a corporation organized under a special statute; (6) stock and warrant issued by a business corporation; (7) beneficial certificate under a securities investment trust or loan trust; (8) a promissory note issued by a corporation for funding for its business, as designated by MOF regulation; (9) security or certificate issued by a foreign government or foreign corporation that has the characteristics of the security or certificate listed in (1)-(7) above; (10) a security or certificate issued by a foreign corporation that represents a beneficiary trust interest or similar interest in loans by a bank or any other lending institution, as designated by MOF regulation; and (11) any other security or certificate designated by cabinet order as necessary to ensure the public interest or investor protection, with consideration given to its transferability and other conditions.

of these descriptions, it is unlikely that great freedom of interpretation was intended or will be allowed by the MITI.<sup>38</sup>

The Law imposes a sixty-day waiting period following notification of the plan before either the originator or the Assignee may assign the receivables. The Law enumerates the conditions upon which the noticed plan may be changed within this period, and also includes measures deemed necessary for investor protection and provisions for adequate security of collections.<sup>39</sup>

In accordance with the Civil Code, Article 5 requires the originator to promptly notify the original obligee of the assignment to perfect the assignment against third parties. Section 178 of the Civil Code requires possession to perfect a security interest in movables, and Section 467 of the Civil Code requires notice to or consent from the obligee with respect to obligations of a named obligee. These requirements were, for example, a major impediment to the securitization of large numbers of credit card receivables in Japan. The Law seeks to address the difficulty posed by these requirements in Article 7, discussed below.

Under Article 6, the Specified Business Person must periodically (but not less than annually) submit a plan to the MITI and obtain confirmation that the plan conforms to three general areas of concern, including (1) the total number of claims assigned in relation to the needs of the originator's business; (2) the total number of claims assigned in relation to the quality of the originator's other assets; and (3) the collection history of the originator's claims.

Pursuant to Article 7, public notice of the assignment of the receivables is permitted if the assignment is made in accordance with a plan confirmed by the MITI under Article 6. The critical language of Article 7, Section 2 provides that public notice "shall be deemed . . . notice by the documents having a fixed date provided in the provisions of Article 467 of the Civil Code." In other words, this procedure permits a party who has properly filed notice with the MITI to avoid the cumbersome perfection requirements of the Civil Code discussed above.

Article 8 requires the Specified Business Person to provide additional information to the MITI in the event that public notice is to be made. This information is to be made available to

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38. See Kanda & Kawachi, *supra* note 24.

39. See Specified Claims Law, *supra* note 33, art. 4.2.



certain persons, including debtors under the Specified Claims, assignees of the Specified Claims, and creditors of the Specified Business Person. Requests for inspection of this information must be submitted in writing to the MITI, and may be refused by the MITI if requested for improper purposes.

Under Article 9, if the requirement for notice to obligees under the receivables is satisfied through public notice, neither the Specified Business Person nor the Assignee may cancel an agreement entrusting collection of these receivables without good cause. Section 2 provides certain limitations of an Assignee's rights in the event of an agreement's cancellation.

Article 10 provides that the MITI may require the Specified Business Person to furnish information concerning the implementation of plans confirmed under Article 3 and Article 6. The plan may be cancelled if it does not conform with the three requirements of Article 6, although public notice of the plan remains in effect.

Under Article 11, the provisions of Section 1 of Chapter 2 (that is, Articles 3 through 11, inclusive) apply *mutatis mutandis* to a trust bank. The provisions recognize structures in which the trust banks act as Specified Claims Assignees.

Section 2 of Chapter 2 deals with a new entity referred to as the "Designated Research Institute," a designation made by the MITI upon application. The research covered is that addressed under Article 3 and subparagraphs (1) and (2) of Article 6. Its purpose is to monitor performance of the confirmed plans. Article 13 concerns restrictions on those who may be designated as research institutes and expressly excludes persons violating various finance and securities laws, persons whose designation is cancelled pursuant to Article 25, and persons whose officers fall under either of the first two categories or who have been discharged less than two years previously pursuant to MITI order for violation of the Law. Under Article 14, the qualifications necessary to perform this research include knowledge, experience, and consistency with ministry ordinance; accounting and technical ability to perform the necessary work; no conflict with other work; and no hindrance of exact and smooth implementation of research work. The Designated Research Institute is required to implement operating rules in accordance with ministry ordinance. The MITI is permitted to order the Institute to change its rules.

*D. Chapter 3: The Business of Taking Assignments of Specified Claims*

Chapter 3 of the Law addresses the Specified Claims Assignment-Taking Business. Chapter 3 sets forth the terms by which a person may engage in the business of acquiring Specified Claims. In the United States, these entities would typically be the "special purpose vehicles" that are established to acquire the receivables from the originators.

Article 30 requires a license from a Competent Ministry to engage in Specified Claims Assignment-Taking Business over certain amounts to be specified by ministerial order. Standards for these licenses are set by the Competent Ministry. Informational requirements for the license application are set forth in Article 32. The standards for granting these licenses are detailed and set forth in Article 33. Sections (1) and (2) of Article 33 contain certain broad financial requirements for the Assignment-Taking Business, including minimum capital requirements and minimum debt-equity ratios. Sections (3) through (5) prohibit licensing of prior licensees whose licenses were cancelled within the previous three years, who were subject to various sanctions, and whose officers or employees fail to comply with various prohibitions against criminal and other proscribed activities.

The term of the license is three years, as specified under Article 34. Under Article 35, these licenses may be renewed, subject to the same requirements as set forth in Article 33. The expiration of the license is tolled for the period of the application. Pursuant to Article 36, decreases in capital or the qualifications of officers and employees must be approved by the Competent Ministry. Certain administrative changes, such as company name or address, or increases in capital, require notification to the Competent Ministry within two weeks following such action. Under Article 38, transfers of the licensed business in whole or part, or mergers of the entity, are not effective without approval from the Competent Ministry. The transferee or surviving entity succeeds to the position of the licensee. Discontinuance of the business requires notice to the Competent Ministry by certain named entities under Article 40.

Article 41 requires approval from the Competent Minister to carry on businesses other than the Specified Claims Assignment-Taking Business. The Competent Minister is prohibited from granting such approval unless there is no possibility that

such other business would hinder investor protection. A licensee must pay registration fees under Article 42. The amount of such fees is to be set by ministerial order.

Section 2 of Chapter 3 details the business operations of the Specified Claims Assignment-Taking Business. Under Article 43, an Assignee may not make any person carry on the business of assignment taking in the Assignee's name. Article 44 restricts the use of the business' surplus money except for (1) government bonds or other instruments designated by the Competent Ministry, (2) deposits to banks and to other financial institutions, (3) a money trust where the principal is guaranteed, and (4) other investments authorized by the Competent Ministry. Under Article 45, any Assignment-Taking Business must maintain records regarding its business and properties and make this information available for inspection by a person holding Small-lot Claims.

"Profits Distribution" refers to the profits an investor makes as a capital contribution to a third party, and which the third party uses to acquire Specified Claims. The investor receives the profit from the Specified Claims together with a return of its contribution. The investor assumes the risk of loss of its investment. Under the Earnings Distribution agreement, two or more parties jointly contribute and enter into a management agreement with a third party. The third party uses the contributed amount to acquire Specified Claims and later distributes the return and refunds the residual assets to the investors.<sup>40</sup>

Chapter 3, Section 3 concerns supervising the Assignee's business. Under Article 46, the Assignee must maintain books and records in accordance with the Competent Ministry's ordinances. Article 47 requires business reports to be filed within three months of the conclusion of each business year. Article 48 permits the Competent Ministry Authority to order the submission of books and records, or to conduct spot inspections of the books and records of the Assignment-Taking Business when necessary for investor protection. The Competent Ministry is further permitted to order the Assignee to change its business methods, to deposit its assets with others, or take other measures necessary for investor protection.

Article 50 governs the cancellation of a license or suspension of all or part of the Assignee's business for up to six

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40. See *id.* art. 2, para. 7(2).

months. Suspension or cancellation can occur if the entity violates any of subparagraphs (1) through (5) of Article 33 concerning licensing, if the entity obtained the license by "illegal means" or by violation of the Law, or if serious consequences result from an unjust or particularly undue act. Article 51 provides for public notice of such cancellation.

*E. Chapter 4: The Business of Distributing Small-lot Claims*

Chapter 4 creates a new business called the "Small-lot Claims Distribution Business." Section 1 sets forth the necessary requirements to engage in such business. Under Article 52, a legal entity must be licensed by the Competent Minister to engage in such business. Article 53 requires notice to the Competent Minister by specified individuals if the business merges out of existence, dissolves because of bankruptcy or for any other reason, or discontinues the Small-lot Claims Distribution Business. In each of the above scenarios, the license is invalidated.

The provisions of Article 31 (conditions imposed on the license necessary for the public interest and investor protection), Article 32 (contents of the written application), Article 33 (standards for licensee, except for debt-equity ratio requirements), Articles 34 through Article 37 (three-year term of license, conditions for renewal of license, approval for changes in kind and method of business or decrease in amount of capital, and notification of change in name, address, place of business, change of officers, addition of new businesses or other matters covered by ordinance of the Competent Minister) and Article 42 (payment of registration license fees and taxes) all apply the concept of *mutatis mutandis* to the Small-lot Claims Distribution Business.

Chapter 4, Section 2 describes the character of the Small-lot Claims Distribution Business. Notice of the business must be posted under Article 55. Article 56 prohibits the business from making any materially inaccurate advertising statements and from making persons materially misunderstand its financial condition or the certainty of payment of the Small-lot Claims and other matters defined by the Competent Ministerial Ordinance.

Chapter 4 presumes that the business of the Small-lot Claims Distributor is either one of selling Small-lot Claims or acting as an intermediary in the sale of such claims. Article 57

provides two types of agreements in which the Small-lot Claims Distributor may take part in concluding. The Small-lot Claims Distribution Agreement concerns the distribution of Small-lot Claims, apparently either directly (meaning that the Small-lot Claims Distributor would also be licensed as an Assignee) or as an intermediary.<sup>41</sup>

Additionally, the Small-lot Claims Distributor may act as an intermediary or agent for concluding a Specified Claims Association Agreement. The Specified Claims Association Agreement refers to an agreement under which the Specified Claims Assignment-Taking Business is permitted to receive either the Profit Distribution or the Earnings Distribution described above.

Under Article 57, before concluding either a Small-lot Claims Distribution Agreement or a Specified Claims Association Agreement, the Distributor is required to provide documents to the investor that describe the contents of the Small-lot Claims and the Specified Claims and the performance thereof, as provided for under ordinances of the Competent Ministry.

Under Article 58, following the entering into of one of the above-referenced agreements, the Distributor must provide the customer with documents containing the following information: (1) the contents of the Small-lot Claims; (2) the contents of the Specified Claims; (3) a description of the Specified Claims Assignee; (4) the confirmation of the existence of measures to secure payment of Small-lot Claims and a description of such measures, if any; (5) the terms of cancellation; (6) a description of damages, including penalties; and (7) other terms provided by ordinances of the Competent Ministry.

Article 59 permits a first-time purchaser of Small-lot Claims to cancel the purchase agreement within eight days of receipt of the documents provided for under Article 58. The cancellation is effective upon the "dispatch" of a written notice of cancellation.<sup>42</sup> The Distributor may not make any claim for damages or penalties for cancellation pursuant to Article 59,<sup>43</sup> and any agreement contrary to the foregoing is null.<sup>44</sup>

Under Article 60, a Distributor may not lend money or securities or act as an intermediary for the lending of money or

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41. See *id.* art. 2, para. 7(1).

42. See *id.* art. 59, para. 2.

43. *Id.* art. 59, para. 3.

44. *Id.* art. 59, para. 4.

securities to its customers. Article 61 prohibits a Distributor from omitting facts or making untrue statements in connection with the solicitation of investments of either the Small-lot Claims Distribution Agreement or the Specified Claims Association Agreement. The Distributor cannot omit such facts or make untrue statements to induce a customer not to cancel such an agreement. Similarly, under Article 62, a Distributor is prohibited from making threats to induce conclusion of an agreement or prevent cancellation, from refusing or delaying performance under any agreement, or committing other prohibitory acts set forth by ordinance of the Competent Ministry.

Under Article 63, Article 43 (prohibition of lending name), or Article 45 (permission to investors to review relevant documents) are applied *mutatis mutandis* to the business of the Distributor.

If an Assignee concludes a Specified Claims Association Agreement, it is deemed to be a Small-lot Claims Distributor. There is no specific provision requiring this Assignee to be licensed as a Small-lot Claims Distributor. Article 58, paragraph 5 (requiring the delivery of information concerning cancellation of the agreement) and Article 59, paragraph 1 (permitting cancellation within eight days of delivery of disclosure documents), paragraph 2 (making cancellation effective upon dispatch of notice), and paragraph 3 (prohibiting claims for damages for proper cancellation) apply *mutatis mutandis* to agreements concluded by the Assignee.

Chapter 4, Section 3 addresses Distributor supervision. Under Article 65, the provisions of Section 3 of the Specified Claims Assignment-Taking Business apply *mutatis mutandis* to the supervision of the Distributor's business. These provisions include Article 46 (keeping of books and records in accordance with competent ministry ordinance), Article 47 (submission of annual business reports within three months of end of each business year), Article 48 (order for reports from the Assignee, or third party dealing with Assignee, or spot inspections by Competent Ministry), Article 49 (Competent Ministry allowed to order changes of business methods to protect investors), Article 50 (cancellation or suspension of license), and Article 51 (public notice of cancellation or suspension of license).

*F. Chapter 5: Miscellaneous Provisions*

Chapter 5 of the Law sets forth miscellaneous provisions. Under Article 66, the Assignee is liable for debts under the Small-lot Claims during the winding down period following cancellation of an Assignee's or Distributor's business. Article 67 requires a Cabinet Order to determine the application of the provisions of the Law to an Assignee or a Distributor who is a foreign entity.

Under Article 68, the provisions of Article 3 (requirement of notification to MITI of a plan of assignment of Specified Claims by Specified Business Person to Specified Claims Assignee), Article 4 (sixty-day mandatory waiting period following receipt of notice of plan by the MITI prior to actual assignment of Specified Claims), and Article 5 (requirement of perfection of assignment pursuant to Civil Code 178 (possession of movables) and Civil Code 467 (notice or consent of named instruments)) are waived, if solicitations are made only to corporations with over a certain amount of capital (500 million yen), and it is unlikely that the Small-lot Claims will be assigned to other than Specified Investors.

Pursuant to Article 69, the provisions of Article 59 (cancellation of agreement within eight days of delivery of documents) and Article 60 (prohibition of lending money to customers) are waived in the case of a customer who acquires the Small-lot Claims with the intent of engaging in business. Additionally, in the case of a Specified Investor, the provisions of Article 57 (requirement of delivery of preexecution materials to customer), Article 58 (delivery of materials at time of execution), Article 61 (failure to state material fact or statement of untrue fact), and Article 62 (prohibition of threatening words and deeds, of refusal or unusual delay in performance, or of other acts specified by ordinance of the competent ministry) are waived.

The Assignee may not use information concerning the solvency of debtors other than research concerning payment under Article 70. The provisions of Chapter 3 (Specified Claims Assignment-Taking Business) and Chapter 4 (Small-lot Claims Distribution Business) do not apply to banks or those entities governed under other laws that would otherwise secure investor protection.

Article 72 defines the "Competent Ministry" as either the MOF or the MITI. Article 73 permits the Competent Ministry to issue ordinances concerning the enforcement of the Law.

Article 74 provides for transitional measures, including transitional penal provisions.

### *G. Chapter 6: Penal Provisions*

Chapter 6 enumerates penal provisions. Article 75 provides for either imprisonment with forced labor for not more than three years, or a fine of not more than three million yen, or both, for the following violations: (1) conducting Assignment-Taking Business or Distribution Business without a license; (2) obtaining a license under Article 30 or Article 52 by illegal means; (3) forcing another party to carry on the Assignment-Taking Business or Distribution Business in contravention of Article 43.

Article 75 provides for either imprisonment with forced labor of not more than one year or a fine of not more than one million yen, or both, for the following violations: (1) failure to notify of plans or filing false notifications; (2) failure to observe the sixty-day mandatory waiting period; (3) violation of any order under paragraph 2 of Article 4 to change the plan; (4) breach of conditions of license under Article 31; (5) failure to obtain approval under Article 36 prior to change of business under subparagraph (5) of Article 32, or the decrease of capital; (6) carrying on a business other than the licensed business without approval; (7) lending money or securities or acting as an agent in contravention of Article 60; (8) wilful failure to state facts or the making of untrue statements in contravention of Article 61; and (9) making false statements in contravention of paragraph 2 of Article 61.

Article 77 provides that an officer of a Designated Research Institute who violates Article 22 by disclosing information other than for research purposes shall be sentenced to imprisonment with forced labor for not more than one year or a fine of not more than one million yen.

Under Article 78, imprisonment with forced labor for a period of not more than one year or a fine of not more than one million yen maybe imposed for (1) violating a suspension order under Article 25 (which may be issued for any violation of Section 2 of Chapter 2 regarding Designated Research Institutes, any violation of enumerated laws dealing primarily with financial institutions under Article 13, or any violation of such laws by a person or to a person discharged for violation of the Law under Article 21); (2) failing to observe an order under Article



17 to a Designated Research Institute to change its operations or under Article 21 to discharge an officer for violation of the Law; or (3) obtaining a license by illegal means.

Article 79 imposes imprisonment with forced labor for not more than six months or a fine of not more than 500,000 yen, or both for (1) making false statements in an application, (2) making materially inaccurate statements or making persons materially misunderstand in violation of Article 56, (3) failing to deliver documents in contravention of Article 57 or 58, or (4) delivering documents without the required information or including false statements.

Under Article 80, a fine of not more than 300,000 yen is prescribed for (1) violating Article 5 (perfection under Civil Code); (2) obtaining confirmation of the plan under Article 6 by illegal means; (3) making false public notice of confirmation under Article 7; (4) failing to submit documents under Article 8 (in connection with perfection by public notice) or submitting false documents; (5) failing to make reports upon demand by MITI under Article 10; (6) failing to make notifications under Article 37 (changes in name, address, location, officers, or amount of capital); (7) failing to properly make documents available for review under Article 45; (8) failing to prepare books and records under Article 46; (9) failing to submit business reports under Article 47; (10) failing to submit reports as required under Article 48; (11) refusing, preventing, or avoiding inspections under Article 48; (12) violating orders under Article 49; (13) failing to post signs under Article 55; or (14) posting of signs in contravention of Article 55.

Under Article 81, an officer of a Designated Research Institute may be fined not more than 300,000 yen if he or she discontinued work without obtaining approval under Article 18, failed to make reports under Article 23, made false reports or refused to permit inspections, or failed to keep books or kept false books under Article 26.

Under Article 82, a person acting on behalf of a legal entity or the legal entity itself is required to pay fines for violations of Articles 75, 76, 79, or 80. Under Article 83, a person shall pay a nonpenal fine for (1) failing to file notice or filing false notice under Article 40 (discontinuance of the Specified Claims Assignment-Taking Business) or under Article 53 (discontinuance of Small-lot Claims Distributor Business); or (2) using sur-

plus money produced from business in contravention of Article 44.

Supplemental Provisions are included in the Law, primarily to provide transitional measures for companies engaged in one of the regulated businesses prior to the effective date of the Law.

## V. OTHER POINTS CONCERNING THE SPECIFIED CLAIMS LAW

### A. *Extensive Regulatory Supervision*

The most obvious characteristic of the Law is the broad regulatory supervision by the MITI or the MOF over the securitization market and its key participants. The principal elements of each securitization proposal require approval by the MITI.<sup>45</sup> The statute requires that receivables may not be transferred or accepted for a period of sixty days from receipt of such notice, although this period may be shortened in some cases.<sup>46</sup> When there is a risk that the specified claims might not be fully repaid, when security for the repayment of the divided claims is insufficient, or if there is a risk to the investor, modifications to the proposal may be ordered by the MITI.<sup>47</sup>

Other provisions of the Law require licensing with the relevant ministry by any company that will accept the specified claims (the special purpose vehicle in U.S. transactions), and any company that intends to sell the divided claims to investors.<sup>48</sup> Periodic reporting to the MITI is required by the originator, including a report of any change in the amount of specified claims transferred, and express provisions are made for inspecting the books and records by the Competent Ministry.<sup>49</sup>

The Law limits to four general categories the types of Specified Claims that are permitted to be securitized under the Law, including certain types of machinery and other lease receivables, credit receivables, and installment sale receivables.<sup>50</sup> These assets are further restricted by certain prescribed term and repayment cycles. The Law generally permits three or four types of structures that may be used in a securitization transaction, including structures under which an originator is permit-

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45. *Id.* art. 3.

46. *Id.* art. 4.

47. *Id.*

48. *Id.* arts. 30, 52.

49. *See id.* art. 46.

50. *Id.* art. 2.

ted to transfer a pool of specified claims to any type of special purpose company, one of the two types of partnerships (*kumiai*) provided for under the Commercial Code and the Civil Code and, additionally, the law permits the substitution of a trust bank in place of the licensed receivables assignee.<sup>51</sup> Violations of such laws are punishable by imprisonment and fine.<sup>52</sup>

Certain types of securitized financial products, defined broadly, existed in Japan prior to the adoption of the Specified Claims Law.<sup>53</sup> The development of the markets for these products has been limited by a number of factors, not the least of which is the relatively rigid regulatory control exercised over the markets by the ministries in Japan in a manner similar to that provided for under the Specified Claims Law.<sup>54</sup> Among such products are commercial paper, securitized commercial real estate mortgages, the somewhat less popular securitized residential real estate mortgages and residential mortgage trusts, and bank loan securitizations. Structures have also been developed that allow divided ownership of real property through legal entities known as *kumiai* under either the Civil or Commercial Code. The market for these products is generally less developed than similar markets in the United States.<sup>55</sup> It remains to be seen, however, whether the rigorous regulatory controls imposed by the Law on the securitization market will have a similar effect.

### B. *Jurisdictional Disputes Between the MOF and the MITI*

While the Law illustrates the high degree of regulatory control over financial markets in Japan, the history of the Law's development also demonstrates the competition between ministries for such control.<sup>56</sup> Professor Kanda states that such "turf battles" over jurisdiction between the MOF and the MITI are the key element of the regulatory landscape in Japan.<sup>57</sup> The power of the key bureaucracies in Japan is divided by industry

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51. *Id.* arts. 4(2), 11.

52. *Id.* ch. 6 (arts. 75-83).

53. See Kanda & Kawachi, *supra* note 24.

54. See generally *id.*

55. See generally *id.*

56. These effects can be seen in the amendments to the SEL in which, with the deletion of broad asset-backed instruments from the definition of securities, express regulation by the MOF of securitized products issued by nonbanks is avoided.

57. Hidecki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, U. PA. J. INT'L BUS. L., 569, 580 (1991).

along well-defined lines. Financial institutions, including banks, securities companies, and insurance companies, are regulated by the MOF. Other companies, such as manufacturers and retailers, are regulated by the MITI. The result of such jurisdictional division in Japan is that both the regulated industry and its regulators form an "insider-outsider" mentality where both resist regulation from "outside" ministries.<sup>58</sup>

The structure of the Law indicates the aforementioned struggle. Securitization plans must be confirmed by the MITI under Article 3. However, investments sold under the securitization transactions may not be securities, and thus avoid supervision by the MOF of companies within the MITI's jurisdiction. On the other hand, under Article 72, banks and securities companies that are governed by the MOF are exempt from the licensing requirements of Chapters 3 and 4 of the Law. Another undesirable aspect of ministries' tug of war is that investors may be adversely affected by the lack of investor protections that would otherwise be available to investors in securities under the SEL. This problem may explain the extensive investor protection rules under the Law, although the enforcement of such provisions remains unclear.<sup>59</sup> In addition, treating certain investments as nonsecurities will likely have an adverse affect on a secondary market for such investments.

Recent amendments to the SEL add some instruments not previously included as securities under the SEL. These amendments do not specifically refer to the securitization of financial assets, but may be a harbinger of a more relaxed, open attitude to the development of new instruments. Accordingly, added to the list of nine explicit security categories are commercial paper and instruments issued by foreign corporations representing beneficial interests in certain loans. Another amendment is the revision of an earlier catch all provision that permits new securities to be added by cabinet order as required for investor protection. This recently amended version is slightly more narrowly drafted than the earlier version, but, the amendment itself is taken by some to reflect a more serious intent by the MOF to designate new securities under this catch all provision. No new securities were designated under the earlier, broader version.

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58. *Id.*

59. See Specified Claims Law, *supra* note 33.

The SEL also categorizes certain rights as "deemed" securities. Amendments to the provisions of Article 2, Section 2 expanded the definition of deemed securities to include rights in trusts consisting of long-term housing loans issued by domestic or foreign financial institutions. These rights are included as deemed securities even if they are not expected to be certificated. The earlier version of this provision covered only rights that were expected to be certificated. Section 2 has also been amended to include a provision similar to the catch all provision under Section 1, described above, which gives the cabinet broad discretion to designate other rights as deemed securities where necessary for investor protection. Additionally, the open-ended provision for further additions to the list of investments may be cause for optimism, although resolution of the jurisdictional issues is a necessary prerequisite to the exercise of such options.<sup>60</sup>

### C. *No-Rule-Means-Prohibition*

Despite the adoption of the Law and its extensive regulatory nature, other factors may also inhibit the future development of the Japanese market for securitized financial products. One factor is the business custom referred to by Tokyo University's Professor Kanda as the "no-rule-means-prohibition" custom.<sup>61</sup> This designation refers to the custom in the Japanese financial industry of awaiting the enactment of an explicit rule from the relevant governmental ministry or specific legislation before creating or marketing a new financial instrument.

For example, although the Specified Claims Law expressly provides only vague guidelines concerning the types of securitization structures that may be used, it is unlikely that a company would seek or obtain approval for structures not substantially in conformity with those set forth informally by the MITI prior to passage of the Law. There are other industry customs that will also impact further regulatory and legislative developments. For example, because of both social and business customs, once enacted, new rules and legislation rarely face judicial challenge in Japan.

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60. *Id.* arts. 2(5), 6(5).

61. Kanda, *supra* note 57, at 583.

#### *D. Rulemaking by Consensus*

The distinctly different approach of the Japanese market as compared with that of the United States is balanced to some extent by the rulemaking and legislative process in Japan, in which all relevant parties actively participate. The aim of the legislative process is to reach consensus among the parties involved rather than to prevail in an adversarial system. Until such consensus is reached and the long process of rulemaking and legislation completed, no financial institution will create or market a new financial instrument. Of course, the process of reaching consensus inevitably entails compromise. For example, the original amendments to the SEL contained broad categories of asset-backed instruments, which were deleted from the final amendment as a result of strong objections from another influential bureaucracy, the MITI. On the other hand, the MITI-sponsored law was originally proposed with a much broader scope, but was significantly narrowed as a result of compromise with the MOF.<sup>62</sup>

#### *E. Technical Aspects of the Law*

One of the Law's particular benefits is that it provides a modified method to perfect title to the assigned claim.<sup>63</sup> Under the Japanese Civil Code, to achieve perfection, either specific consent from each debtor must be obtained or a dated notice must be provided to each debtor.<sup>64</sup> For securitization transactions in which large numbers of obligations are assigned, these perfection requirements would prove prohibitive. The Law permits the publication of notice in newspapers of general circulation in lieu of individual notification to debtors. Of course, this method of perfection is permitted only to securitization structures approved under the Law.

### VI. CONCLUSION

By reviewing the Specified Claims Law, the role of the governmental ministries in the development of new financial products in Japan can be more easily grasped. The new legislation points out some important characteristics of Japan's regulatory system. These characteristics include a formalistic system

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62. Kanda & Kawachi, *supra* note 24.

63. Specified Claims Law, *supra* note 33, art. 7.

64. See Articles 167 and 478 of the Japanese Civil Code.

dependent to a large degree on regulatory approval for new financial products and a system in which regulatory authority is often divided between ministries with unfavorable consequences. In the case of securitization, the result is divided regulation over what should ideally be a unified market.

The degree of and method of regulatory control exercised in Japan is unusual by American standards.<sup>65</sup> Whether such a high degree of bureaucratic intervention is generally beneficial is subject to increasing reconsideration even within Japan.<sup>66</sup> In any event, both the high degree of market regulation and divisions between the regulators may be expected to cause continued instability in the market, resulting in further delays in the development of the market. Furthermore, such deeply entrenched customs and regulatory schemes are not likely to be removed in a short time or without resistance.

Therefore, despite the passage of the Specified Claims Law, the near-term future of securitization in Japan is unclear. Unlike the market in the United States in which the energy of private interests drives the development of the market, in Japan the powerful bureaucracies of the MOF and the MITI are engaged in jurisdictional wrangling that must be resolved for the market to reach its full potential.

While such issues should not be viewed only, or even perhaps primarily, as trade issues, the liberalization of the financial markets would open the way for increased participation of U.S. interests in these markets. In addition, more efficient regulation and operation of financial markets would provide needed liquidity for the domestic Japanese economy as well as other benefits discussed above. These benefits are potentially as significant to Japanese industry as they have been to industry in the United States. One can only hope that future events will show that the recent legislation was, in fact, a positive preliminary step toward the liberalization of the financial markets generally and the securitization market specifically in Japan.

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65. A higher degree of regulatory control appears in other jurisdictions, including in Europe. See generally Dobson, *supra* note 16.

66. See Kanda & Kawachi, *supra* note 24.