

SECURITIZATION IN JAPAN

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I. INTRODUCTION

The Japanese securitization market remains inactive even though the motivation for and benefits from securitization are similar to those in the United States and elsewhere. Although there is little disagreement about the potential for such a Japanese securitization market,¹ there are both legal and nonlegal factors inhibiting securitization in Japan. This Article focuses on the legal obstacles to securitization.

Specifically, there are three major legal obstacles to securitization in Japan. First, compliance with the legal requirements for perfecting an asset transfer is quite costly. Perfection of transferring loans and receivables requires notarial certification of individual loans and receivables one by one.² The only exception available is under the Law for Regulating Business for Specific Claims (“MITI Law”).³ The MITI Law permits leasing and credit companies to perfect an asset transfer with a so-called special purpose entity in a registration system⁴ similar to the United States’ system under the Uniform Commercial Code.⁵

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1. See, e.g., HISASHI OGAKI, LECTURES ON STRUCTURED FINANCE (1996); THEORY AND PRACTICE OF SECURITIZATION (Corporate Finance System Research Institute ed., 1992).

2. MINPO (Civil Code), art. 467 [hereinafter Civil Code].

3. See Law No. 77 of 1992 [hereinafter MITI Law].

4. See *id.* art. 7.

The [s]pecified [b]usiness [p]erson who obtained a confirmation to a plan of assignment of the [s]pecified [c]laims under the provision of the preceding article may . . . make a public notice of that effect. If the public notice . . . was made, it shall be deemed that a notice by the documents having a fixed date provided in the provision of Article 467 of Civil [Code] was made to the debtors of the said [s]pecified [c]laims.

Id.

5. See U.C.C. § 9-102 (1995).

Second, Japanese corporate law makes it expensive to set up a special purpose entity as a vehicle for asset securitization. For example, a special purpose entity in the corporate form requires minimum capital of 10 million yen, at least three directors, and an auditor.⁶

Third, the regulatory structure of securities is complex and inflexible, reflecting a long political history in which divided ministries have had jurisdiction over divided industries.⁷ For instance, the scope of the Japanese Securities and Exchange Law ("SEL"),⁸ a counterpart to the U.S. Securities Act of 1933⁹ and Securities Exchange Act of 1934,¹⁰ is limited. On the one hand, there are financial products that are not within the SEL's definition of security.¹¹ For these products, scattered special statutes and administrative guidance protect investors,¹² and securities companies cannot market such non-security securities.¹³ On the other hand, for a product defined as a security, the SEL does not allow institutions to trade among themselves when the securities are issued under a private offering exemption. Therefore, a market like the one recognized under Rule 144A of the 1933 U.S. Securities Act¹⁴ is not permitted in Japan.

In November 1995, Prime Minister Hashimoto announced a drastic reform plan of financial regulation known as Japan's Big Bang.¹⁵ As part of this program, legal changes are planned that will affect securitization.¹⁶ In fact, the first two of the three legal obstacles

6. See, e.g., SHOHO (Commercial Code), arts. 168-4, 255, 273 [hereinafter Commercial Code].

7. In 1998, regulatory authority over banking, securities and insurance institutions will be transferred from the Ministry of Finance [hereinafter MOF] to a newly established agency called the Financial Supervision Agency [hereinafter FSA]. The Ministry of International Trade and Industry [hereinafter MITI] has authority over leasing and credit companies.

8. Law No. 25 of 1948 [hereinafter SEL].

9. 15 U.S.C. § 77a (1994) [hereinafter Securities Act].

10. 15 U.S.C. § 78a (1994) [hereinafter Securities Exchange Act].

11. See *infra* notes 80-82 and accompanying text.

12. See *infra* notes 83-85 and accompanying text.

13. See SEL, *supra* note 8, art. 43.

14. See Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A (1997).

15. For the contents of the Big Bang program in English, see *About the financial system reform* (last modified June 20, 1997) <<http://www.mof.go.jp/english/big-bang/ebb1.htm>>. For a discussion of the recent trends in financial regulation, see Hideki Kanda, *Globalization of Financial Markets and Financial Regulation in Japan*, 4 ZEITSCHRIFT FÜR JAPANISCHES RECHT 9 (1997).

16. See The Financial System Research Council, *Regarding the Reform of the Japanese Financial System, Contributing to the Vitalization of the National Economy* (last modified June 18, 1997) <<http://www.mof.go.jp/english/tosin/e1a602f5.htm>>.

discussed above are expected to be removed in 1998.¹⁷

Section II describes existing securitized products in Japan. Section III reviews the Japanese legal framework for securitization and examines (1) the Securities and Exchange Law ("SEL"), the fundamental law governing the area, (2) the MITI Law, and (3) legal changes that are expected to occur in 1998. Section IV evaluates the Japanese situation from a broader perspective including regulatory characteristics, political elements, market attributes, and recent trends. Section V concludes the article.

II. SECURITIZED FINANCIAL PRODUCTS IN JAPAN

To the extent securitization is defined as the creation of marketable securities, certain securitized financial products already exist in Japan.¹⁸ The markets for these products remain underdeveloped for a number of reasons, not least of which is that most of these products were developed and are controlled under highly regulated environments, and under administrative rules that they may only be marketed to certain types of investors.¹⁹ In addition, under the Civil Code, each assignment of a non-negotiable instrument may be perfected only with notice to the debtor and with official certification by a notary regarding the assignment of individual rights.²⁰ These Civil Code requirements effectively make instruments such as consumer receivables unsuitable for securitization unless special treatment is obtained under the MITI Law.²¹

A. Commercial Paper

The commercial paper market, which includes securitized short-term corporate debt, was introduced to Japan in November 1987.²² The market's growth has been rapid since that time,²³ yet

17. See *infra* Part III(C).

18. For example, residential mortgage trusts and bank loan securitization currently exist in Japan.

19. For example, bank loan securitization has been marketed only to institutional investors that are well informed on the financial markets by the MOF Release (*Tsutatsu*). See MOF Release, Banking, No. 800 (Apr. 30, 1992), amended by MOF Release, Banking, No. 1770 (July 31, 1997).

20. Civil Code, *supra* note 2, art. 467 (assignment of obligation right).

21. See *infra* note 99 and accompanying text.

22. Commercial paper has been defined as an unsecured promissory note issued mainly by non-financial corporations with short terms. In other words, commercial paper was introduced in Japan as a special financing tool in the form of a commercial transaction and was strictly limited to certain types of qualified corporations. See BANK OF JAPAN INSTITUTE OF

commercial paper was not a security under the SEL until 1992.²⁴

B. Mortgage Deeds

A mortgage deed, or *teito shoken*, is a negotiable instrument issued by the Land Registry Office under the 1931 Mortgage Deeds Act,²⁵ but is not a security under the SEL.²⁶ Theoretically, either residential or commercial real estate mortgages can be securitized under the *teito shoken* system,²⁷ but only commercial real estate mortgages have been securitized to date. Mortgage deed securitization did not become popular until the early 1980s.²⁸ Under the current scheme, a mortgage company issues mortgage certificates²⁹ which are neither negotiable instruments nor securities under the SEL.³⁰ These certificates are backed by mortgage deeds held by the mortgage company,³¹ and the certificates then are marketed to the general public.³²

The rapid growth of the mortgage deed securitization market in the 1980s was accompanied by widespread fraud. For example, some companies issued certificates without sufficient underlying mortgage deeds.³³ In response, the government enacted the 1987 Mortgage Deeds Business Act.³⁴ The Act regulates entry into and business within the field.³⁵ Today there are about ninety mortgage deed companies registered under the 1987 Act, including a number of bank

MONETARY AND ECONOMIC STUDIES, JAPAN'S FINANCIAL SYSTEM 175 (1995).

23. As of December 1997, the amount outstanding is ¥12 trillion (U.S. \$96 billion). See BANK OF JAPAN, PRINCIPAL FIGURES OF FINANCIAL INSTITUTIONS (Feb. 13, 1998).

24. See SEL, *supra* note 8, art. 2(1)(viii).

25. See Law No. 15 of 1931.

26. See SEL, *supra* note 8, art. 2(1).

27. The Mortgage Deeds Act places no restriction on the purpose of the mortgage. "Any person, who is entitled to a hypothec the subject of which is a land, building or superficies, may apply. . . ." Mortgage Deeds Act, *supra* note 25, art. 1.

28. After the early 1980s, deregulation of financial instruments stimulated investors to favor more profitable investment. Mortgage deeds offer a better interest rate to investors than bank deposits.

29. See YUKI FUJIWARA, PRACTICE OF MORTGAGE DEEDS 23, 31, 298 (1992).

30. See SEL, *supra* note 8, art. 2(1).

31. See FUJIWARA, *supra* note 29, at 23, 31, 298.

32. *Id.*

33. See FUJIWARA, *supra* note 29, at 36-37.

34. See Law No. 114 of 1987.

35. See *id.* art. 3. The Mortgage Deeds Business Act was enacted primarily to introduce the registration requirement of issuers to the MOF. The Act also was passed to prohibit self-custody of the mortgage deeds by sellers who market the certificates backed by the deeds. See FUJIWARA, *supra* note 29, at 38-41.

and securities firms' affiliates.³⁶

C. Residential Mortgage Certificates

A residential mortgage certificate, or *jutaku teito shosho*, is issued by a residential mortgage company and is backed by residential mortgages the company holds.³⁷ The certificate is neither a negotiable instrument nor a security under the SEL.³⁸ One possible reason these instruments have limited appeal is that transferees of residential mortgage certificates are limited to financial institutions.³⁹ This scheme was introduced in 1974,⁴⁰ but has not gained widespread popularity.⁴¹

D. Residential Mortgage Trusts

A residential mortgage trust, or *jutaku loan saiken shintaku*, involves the formation of a trust and the transfer of residential mortgages held by a financial institution to a trustee bank.⁴² The trustee issues certificates representing beneficial interests in the trust.⁴³ Such a certificate is not a negotiable instrument, and it was not a security until 1992.⁴⁴ The beneficial interest in this trust became a security under the SEL in 1992.⁴⁵ When this residential mortgage scheme was introduced in 1973, the settlor of the trust could only be a mortgage

36. See *The Current Status of Mortgage Deeds Business*, 17 MORTGAGE DEEDS BUSINESS 118 (Dec. 1997).

37. The *jutaku teito shosho* was introduced to provide new funding measures for housing loan institutions (*jusen*). See MOF Release, Banking, No. 3095 (Sept. 6, 1974).

38. See SEL, *supra* note 8, art. 2(1).

39. Examples of these financial institutions include banks, insurance companies and *Shinkin* (community financing companies). See MOF Release, Banking, No. 3095, (Sept. 6, 1974).

40. See *id.*

41. As of 1993, a residential mortgage trust is classified as a security, but a residential mortgage certificate is not. In other words, packages of residential mortgage loans are transferred as an assignment of obligation right at one time. Due to these classifications, the residential mortgage certificate, when compared to the residential mortgage trust, is not regarded as an appropriate subject of investment. See Taisuke Ito, *Analysis of Japan's Securitization from Originators' Standpoint*, 31 SECURITIES ANALYST JOURNAL 11-23 (Sept. 1993).

42. The residential mortgage trust was introduced first to provide a new route of funding for housing loan companies, and then to provide banks a means of improving capital adequacy for regulatory purposes. See MOF Release, Banking, No. 1238 (June 10, 1988); MOF Release, Banking, No. 800 (Apr. 30, 1992), *amended by* MOF Release, Banking, No. 1770 at I (July 31, 1997).

43. See MOF Release, Banking, No. 800, (Apr. 30, 1992) at I.

44. See SEL, *supra* note 8, art. 2(1).

45. See *id.* art. 2(2)(i).

company and only pension funds could be transferees of trust certificates.⁴⁶ The scheme was deregulated in 1988 when the Ministry of Finance ("MOF") permitted banks to act as settlors and institutional investors to act as transferees.⁴⁷

E. Bank Loans

The securitization of bank loans was introduced for loans to municipal bodies in 1989⁴⁸ and for other loans in 1990.⁴⁹ Bank loans are securitized by partial assignment, and the transferee in these transactions must be a financial institution.⁵⁰ An assigned portion is neither a negotiable instrument nor a security under the SEL.⁵¹ In 1997, a beneficial interest in a trust did become a security under the SEL where the trust property is any loan from a financial institution.⁵²

F. Divided Ownership Interest in Commercial Real Property

Several years ago, real estate companies created a structure by which ownership interests in certain commercial real property were divided and sold to investors.⁵³ Such divided interests are typically sold to wealthy individuals because this structure enjoys favorable tax treatment in Japan and often functions as a shelter for other taxable income.⁵⁴ In 1994, a special statute entitled the Law for Regulating Common Business of Real Property was passed under the leadership of the Ministry of Construction. The idea was to introduce a scheme like a real estate investment trust in Japan.⁵⁵ This scheme is not very popular, however, because the real estate industry insisted that investors' interests remain in real estate, thereby preserving the investors' depreciation deduction for tax purposes.⁵⁶ As a result of this tax

46. See REIJI YASUI, PRACTICE OF SECURITIZATION OF REAL ESTATE FINANCE 212, 221 (1988).

47. See MOF Release, Banking, No. 1238, (June 10, 1988).

48. See MOF Release, Banking, No. 1821 (July 17, 1989).

49. See MOF Release, Banking, No. 521 (Mar. 12, 1990).

50. See MOF Release, Banking, No. 800, (Apr. 30, 1992), at II, III.

51. See SEL, *supra* note 8, art. 2(1).

52. See SEL APPLICATION ORDINANCE art. 1-3.

53. In the early 1980s, some real estate companies (for example, Maruko) promoted this structure in to develop large projects by means of their creditworthiness, without hearing to raise substantial funds. This scheme performed as a tax shelter during the 1980s, as it did in the United States.

54. A tax benefit is gained from claiming a depreciation deduction for buildings.

55. See Law No. 77 of 1994, art. 1.

56. Income Tax Law, Law No. 33 of 1965, arts. 26, 37(1).

treatment, there is no negotiability of the securitized product under the real estate investment trust.

G. Leases and Autoloans

In recent years, leasing and credit companies created financial products securitizing lease receivables and autoloans. Some of these companies use a trust structure in which a pool of autoloans or lease receivables is transferred to a trustee and the beneficial interests in the trust are marketed.⁵⁷ Others use a special purpose company to which such pool is sold, and the claim representing the price of the sale is divided and marketed.⁵⁸ These products are neither negotiable instruments nor securities.⁵⁹ Beginning in June 1993, they were regulated by the MITI Law unless they were marketed solely to certain institutional investors.⁶⁰ In 1996, a corporate form vehicle that issues debt securities and commercial papers was introduced,⁶¹ and since then the market for securitization of leasing obligations and other credits has grown extensively.⁶²

H. Other Asset Securitization

All of the foregoing securitized products were introduced under a highly regulated environment. In recent years, however, holders of assets that did not fall within this regulatory framework, such as industrial companies, gradually began to securitize their assets—typically commercial receivables and loans—by setting up a special purpose corporation (SPC) that issues debt securities or commercial papers.⁶³ Sometimes the originators make costly notarial perfection of asset transfer to the SPC, and sometimes they do not. Due to rating concerns, they often set up an SPC outside Japan—typically in

57. See STUDY GROUP ON ASSET SECURITIZATION, FUTURE OF ASSET SECURITIZATION 5-6 (1992) (unpublished research paper on file with author).

58. See *id.*

59. See SEL, *supra* note 8, art. 2(1).

60. See MITI Law, *supra* note 3, art. 68.

61. See MITI LAW APPLICATION ORDINANCE, art. 1-2 (amended 1996).

62. See *Credit Securitization Shows Sharp Growth*, NIKKEI ENG. NEWS, Feb. 10, 1997, available in 1997 WL 4443284.

63. For example, consider Mycal Corporation's securitization structure for capital equipment. See *Mycal Adopts Unusual Securitization Structure*, NIKKEI ENG. NEWS, May 30, 1997, available in 1997 WL 10671296.

the Cayman Islands—and have the SPC ownership given to a charitable trust.⁶⁴ Such SPC sets up a branch, or subsidiary, in Japan and the assets are transferred to the branch or the subsidiary. Securities issued by the SPC are marketed either in or outside Japan. If they are issued and marketed outside Japan, the SEL does not apply.⁶⁵ If they are issued and marketed in Japan, however, the SEL applies, but they usually are marketed to institutions within the private offering exemption of the SEL.⁶⁶

III. LEGAL FRAMEWORK

A. The Securities and Exchange Law

1. *The Basic Structure.* The fundamental law governing securities in Japan is the Securities and Exchange Law.⁶⁷ The SEL was modeled on the U.S. federal securities laws, specifically the 1933 Securities Act⁶⁸ and the 1934 Securities Exchange Act.⁶⁹

2. *Amendments Before 1992.* There are several important differences between the Japanese legal framework for securities and that of the United States.⁷⁰ First, while the notion of a security is broadly defined in the United States,⁷¹ it is quite limited in Japan.

64. For tax purposes and to achieve a bankruptcy-remote structure, the SPC should be owned by an independent third party such as a “charitable trust”. If declared as a trust, this entity technically would have no stockholder. See STEVEN L. SCHWARCZ, STRUCTURED FINANCE, A GUIDE TO THE PRINCIPLES OF ASSET SECURITIZATION 21 (2d ed. 1993).

65. No case has applied the SEL extraterritorially.

66. See SEL, *supra* note 8, art. 2(3)(ii).

67. See SEL, *supra* note 8.

68. See Securities Act, *supra* note 9.

69. See Securities Exchange Act, *supra* note 10.

70. See SEL, *supra* note 8. Until 1992, the SEL art. 2(1) defined a security as one of the following items:

- (i) government debt security;
- (ii) municipal debt security;
- (iii) debt security issued under a special statute by a corporation;
- (iv) secured or unsecured debt security issued by a business corporation;
- (v) stock issued by a corporation organized under a special statute;
- (vi) stock and warrant issued by a business corporation;
- (vii) beneficial certificate under a securities investment trust or loan trust;
- (viii) security or certificate issued by a foreign government or foreign corporation that has the characteristics of the security or certificate listed in (i) - (vii) above; and
- (ix) any other security or certificate designated by cabinet order.

71. See U.S.C. § 77(b)(a)(1) (1994).

This is of particular significance to the securitization market in Japan.

Although the MOF was empowered to name new securities under Section 1, Article 2, item 9 of the SEL,⁷² the last instrument to be newly designated under this provision was in 1953.⁷³ Thus, in practice the definition of a security has been limited to the specified items. The definition of a security was changed with the SEL's 1992 amendments, which are discussed later in this section.⁷⁴

A second important difference between U.S. and Japanese securities laws is that, by employing the notion of a security, the SEL links its investor protection rules to Article 65 of the SEL (a rule similar to a provision of the U.S. Glass-Steagall Act),⁷⁵ which essentially prohibits banks and insurance companies from engaging in the securities business (with the exception of government and public securities).⁷⁶ This regulatory structure, known as the "one-set structure" in Japan, is crucial to understanding developments in the regulation of new financial instruments. If a financial product is a security as defined by the SEL, investors enjoy the protection of the SEL, but banks are prohibited from handling the product.⁷⁷ On the other hand, Article 43 of the SEL prohibits securities firms from handling a product other than a security unless they obtain special permission from the MOF.⁷⁸ If a product is not a security, banks may handle it while securities firms may not; investors therefore receive no protection under the SEL.⁷⁹

As new financial products developed, the MOF was forced to prioritize the issue of whether the banking or the securities industry would handle each new product at the expense of the investor protection issue. This was the result of a long battle between the two industries.⁸⁰ For example, the MOF adopted a policy of allowing both

72. See *supra* note 70.

73. The "beneficial certificate under loan trust" was designated as a security by the SEL Application Ordinance in 1952, and was defined as a security under SEL Article 2(1)(vii) in 1953.

74. See *infra* notes 86-96 and accompanying text.

75. 12 U.S.C. § 335 (1994).

76. See SEL, *supra* note 8, art. 65.

77. See *id.*

78. See *id.* art. 43. See also *supra* note 7.

79. See SEL, *supra* note 8, art. 65.

80. See *infra* text accompanying notes 132-134.

banks and securities firms to handle commercial paper. The securities firms received special permission to handle commercial paper under Article 43 of the SEL.⁸¹ Meanwhile, the banking industry successfully persuaded the MOF to exclude securities firms from intermediary services for residential mortgage trusts and securitized bank loans.⁸² Thus, the MOF treated these instruments as “non-securities,” which banks may handle under the SEL.

As a result, investors in non-securities are left without the disclosure and anti-fraud protections of the SEL. This has been of great concern to the MOF, especially prior to 1992. To remedy this situation, the MOF took two actions. First, it initiated special legislation to protect investors with respect to certain instruments, including *teito shoken* (mortgage deeds).⁸³ Second, by administrative guidance, the MOF prohibited banks (and securities firms with respect to commercial paper) from selling certain products with a unit value of less than one hundred million yen.⁸⁴ The purpose of this limitation was to prevent the sale of such products to the general public, who were deemed to require the protection offered by the SEL. Commercial paper and residential mortgage trusts were included in this limitation.⁸⁵

This special legislation has imposed enormous costs on the industry. For example, hundreds of new statutes must be passed and no new financial product may be sold until corresponding legislation is enacted. The “minimum unit rule” disqualified new financial products from potential sale to small investors, thereby hindering the development of secondary markets and raising initial financing costs. As a result, many non-securities in Japan await further fundamental reform of the SEL. The important amendments made to the SEL in 1992 have addressed some of these issues.

81. See SEL, *supra* note 8, art. 43. Article 43 prohibits securities companies from engaging in business other than the securities business. However, special permission to engage in such activities may be gained as long as the nature of the business is related to securities, and does not violate public policy or threaten investor protection.

82. See *infra* text accompanying notes 132-134.

83. See *supra* note 34.

84. See MOF Release, Banking, No. 610 (Apr. 1, 1993).

85. See *id.*; MOF Release, Banking, No. 800 (Apr. 30, 1992).

3. *1992 Amendments.* Amendments to the SEL and to certain banking statutes were passed by the Diet in June 1992, and came into effect in April 1993.⁸⁶ These new amendments address some of the concerns raised above. For example, the definition of “security” under the SEL was amended to include the following:

(viii) a promissory note issued by a corporation for funding for its business, as designated by MOF regulation; . . . (x) a security or certificate issued by a foreign corporation which represents a beneficiary trust interest or similar interest in loans by a bank or any other lending institution, as designated by MOF regulation.⁸⁷

Commercial paper was designated as a security under item 8 above, and securitized credit card receivables organized in the United States (known as CARDS) were designated as securities under item 10 above.⁸⁸ Of course, these could have been designated as securities prior to the 1992 amendments, but, as mentioned previously, no such designations were made under item 9 of the current SEL.⁸⁹

In addition, the catch-all provision of the current SEL, item 9, was replaced by the following: “(xi) 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.”⁹⁰

While more narrowly drafted than the old catch-all provision, this new provision is expected to be relied upon by the MOF to designate new securities.⁹¹ The new provision permits the MOF to have any other “paperized” (i.e., “certificated”) instrument designated as a security under item 11, unless the transferability of the instrument is restricted or, for instance, the instrument is governed by a different statute concerning investor protection (typically administered by a different ministry). Thus far, negotiable certificates of deposits issued outside Japan have been designated as securities.⁹²

86. Law No. 73 of 1992.

87. *See id.* art. 2. In 1993, preferred stock issued by a certain cooperative financial institution was also added to the definition of security. *See id.* art. 2(5-2).

88. *See* MOF Regulations (*shorei*) for further interpretation of the definition of a security under Article 2 of the SEL.

89. *See supra* notes 80-82 and accompanying text.

90. *See* Law No. 73 of 1992.

91. Since the MOF drafted the 1992 amendments in order to enhance investor protection, its intent to use the new provision is clear. While it could be argued that this was the case under the old SEL in 1948, the subsequent battle between the banking and securities industries prevented the designation of new securities under old Article 2(1)(ix).

92. *See* SEL APPLICATION ORDINANCE art. 1.

The definition of a "deemed" security was expanded under Article 2, Section 2 of the SEL to include not only a right which, in principle, is expected to be paperized (though it may not actually be certificated), but also a right which is not expected to be paperized, if such right falls within one of three categories.⁹³

A beneficial interest in a residential mortgage trust was designated as a security by cabinet order in 1993.⁹⁴ In 1997, this was expanded to include a beneficial interest of a trust in which the trust property is any loan from any financial institution.⁹⁵ In addition, the MOF is empowered to have any right or interest designated as a security by cabinet order if the right is a monetary claim, the designation of the right as a security is necessary to ensure the public interest or investor protection and consideration is given to the transferability of the right and other conditions.⁹⁶

Although the definition of a "security" has been expanded by the 1992 Amendments, these statutory changes have resulted in a new definition narrower in scope than originally envisioned. This result is in part due to the political battles and compromises reached between the banking and securities industries, as well as those reached among the ministries, particularly the MOF and the Ministry of International Trade and Industry ("MITI").⁹⁷

In addition, the wall between the banking and securities industries has been lowered as a result of the new legislation. For instance, a bank is now permitted to establish a subsidiary to engage in certain types of securities businesses. At the same time, "fire walls" are required between a parent bank and its securities subsidiary.⁹⁸

93. See SEL, *supra* note 8, art. 2(2). The three categories are:

- (i) Beneficial interests in a trust of loans by a bank, a trust company or a person engaged in a business of lending money on a long-term basis principally for the purposes of acquiring housing;
- (ii) Rights against a foreign juridical person having the same nature as the rights enumerated in the preceding Item; and
- (iii) In addition to those enumerated in the preceding two Items, those prescribed by Cabinet Order as those necessary and appropriate for the public welfare or the protection of investors.

Id.

94. See SEL APPLICATION ORDINANCE arts. 1-3 (as amended, 1993).

95. See SEL APPLICATION ORDINANCE arts. 1-3 (as amended, 1997).

96. See SEL, *supra* note 8, art. 2(2)(iii).

97. See *infra* text accompanying notes 132-134.

98. See, e.g., SEL, *supra* note 8, art. 42-2.

B. Law for Regulating Business of Specified Claims

As briefly noted above, special legislation on asset securitization of leasing and credit companies was passed in 1992 and went into effect in June 1993. The Law for Regulating Business of Specified Claims ("MITI Law") was passed under the leadership of MITI. The main thrust of this law is to permit an easy way of perfecting an assignment of loans and receivables by the leasing and credit companies to the special purpose entity. A registration system was introduced: simple registration with the MITI as well as public notice of the loans or receivables is now sufficient for perfection of the transfer.⁹⁹

However, scheme regulation was imposed, and leasing and credit companies now must submit to additional layers of regulatory control. For example, such companies must register the planned securitization structure with the MITI and be subject to its supervision.¹⁰⁰ There is substantive review of the securitization plan by a special organization known as the Structured Finance Institute of Japan.¹⁰¹ Exemption from this scheme regulation is available when marketing is limited to certain large business entities.¹⁰²

In addition, unless a trust is used, the special purpose vehicle must be licensed by both the MITI and the MOF.¹⁰³ Moreover, those who market the securitized products to investors must be licensed to do so by both the MITI and the MOF and are subject to rules for investor protection under the law. The joint jurisdictions of the MITI and MOF result from political battles between them in drafting the statute.¹⁰⁴

Finally, the scheme under the MITI Law is unavailable to other originators of securitizable assets, such as banks and industrial companies.¹⁰⁵

99. See MITI Law, *supra* note 3, art. 7.

100. See *id.* arts. 3, 12.

101. See *id.* art. 12. The Structured Finance Institute of Japan was established to protect investors and to promote the sound growth of the market for structured finance products by reviewing structured finance plans, collecting and dispensing information, undertaking studies and holding seminars. See STRUCTURED FINANCE INSTITUTE OF JAPAN, SPECIFIED CLAIMS LAW AND STRUCTURED FINANCE PRODUCTS (Mar. 1995).

102. See MITI Law, *supra* note 3, art. 68.

103. See *id.* art. 30.

104. See *id.* art. 72; see also *infra* text accompanying notes 132-134.

105. See MITI Law, *supra* note 3, art. 2.

C. Expected Legislative Changes in 1998

Unfavorable economic conditions pervasive since the stock market and real estate bubbles burst in 1991, coupled with the subsequent decrease in the power and competitiveness of the financial and real property sectors in Japan, drew attention to the expansion of the securitization market. While proponents of this expansion often mistakenly view securitization as the panacea for bad loan and other post bubble-bursting problems in the financial and real estate markets, the proposed legislative changes fortunately include improvements in the general structure of the relevant laws and regulations.¹⁰⁶ Among the three legal obstacles for securitization identified at the outset—unpractical method of perfection, costly corporate law and lack of a secondary market among institutions (together with complex securities regulation in general)—the first two are expected to be resolved.

First, the Ministry of Justice has prepared a bill for a special statute which would recognize a special rule for perfecting an assignment of loans, receivables and other claims.¹⁰⁷ The new scheme would permit perfection by registration at a local registry office, and this method would be available for any assignment of a monetary claim by any incorporated entity.¹⁰⁸ Thus, perfection should prove less cumbersome.

Second, the MOF has prepared a bill for a special statute that would reduce the cost of legal compliance when setting up an SPC.¹⁰⁹ This special corporation could be set up with minimum capital of three million yen, and issue debt securities (including commercial paper) and preferred stock. Dividends to the preferred stock would be exempted from double taxation under certain conditions.¹¹⁰ These securities would become securities under the SEL definition.¹¹¹ The governance structure of the corporation would exist simpler than that

106. See Financial System Research Council, *supra* note 16.

107. See Bill relating to the Law for Special Treatment of the Perfection of Assignment of Obligation Rights in the Civil Code, submitted to the Diet, Feb. 6, 1998.

108. See *id.* art. 2.

109. See Bill Relating to the Law for Securitization of Specific Assets by Specific Purpose Company, submitted to the Diet, Mar. 10, 1998.

110. See Outline of Bill Relating to the Law for Securitization of Specific Assets by Specific Purpose Company (Feb. 1998).

111. See *id.*

of an ordinary joint stock company: under the proposed law, there could be one director, but an auditor and an accountant are required.¹¹² However, the corporation would have to be registered with the FSA, and be subject to its supervision. This supervision would be mainly to ensure that the corporation could not engage in activities other than securitization. There would be no merit review, as is the case under the MITI Law.¹¹³ This scheme would be available for the securitization of any type of monetary claims (including loans and receivables) as well as real property.¹¹⁴

If all these proposed legal changes are made in 1998, some of the fundamental legal obstacles identified at the outset will be removed. Among these three fundamental legal obstacles, only the third (lack of a secondary market among institutions, such as a Rule 144A market¹¹⁵) remains a possible concern. Other matters, though perhaps minor, include the validity of a contract clause prohibiting the SPC from filing an insolvency petition.¹¹⁶ This type of clause is of particular concern to rating agencies, and is most likely to be invalid under current Japanese law.¹¹⁷ Also, accounting treatment is still uncertain in Japan, and except for the scheme that falls within the new SPC law, tax law is not favorable for a corporate form entity.¹¹⁸ However, these factors are rather small, and once all the proposed legal changes are made, the securitization market in Japan is expected to grow. The following section describes broader environments that may be relevant to securitization in Japan and discusses unique characteristics in regulation, politics and the Japanese market.

112. *See id.*

113. *See id.*

114. *See id.*

115. *See* Private Resales of Securities to Institutions, 17 C.F.R. § 230.144A (1997).

116. Rating agencies usually require the special purpose entity to insert this clause so as to be "bankruptcy-remote." *See* Petrina R. Dawson, *Rating Games with Contingent Transfer: A Structured Finance Illusion*, 8 DUKE J. COMP. & INT'L L. 379, 391 n.73 and accompanying text (1998).

117. *See* Tokyo High Court Decree, 33 KAMINSHU 1433 (Nov. 30, 1982).

118. There is no special provision in Japanese income tax law that permits a one-tier tax on corporations. Compare with U.S. Internal Revenue Code sections 860A-860G on the real estate mortgage conduit (REMIC), and sections 860H-860L on the financial asset securitization investment trusts (FASIT). *See* 26 U.S.C. §§ 860A-860L (1994).

IV. EVALUATING CHANGING REGULATORY ENVIRONMENTS

A. Regulatory Characteristics¹¹⁹

1. *No Rule Means Prohibition.* In Japan, an important customary rule exists in the financial services area. The lack of an explicit legal rule endorsing a certain activity is interpreted as a prohibition of such activity.¹²⁰ If no explicit rule exists as to whether a new instrument—such as a negotiable certificate that represents the beneficial interest in a trust (other than a loan trust or a securities investment trust)—is a security under the SEL, or if the rules are unclear, financial institutions will not invent and market such instruments. In other words, until there is a consensus about a financial instrument and then a lengthy process to establish an explicit rule or administrative guideline, virtually no institution will create or market such instrument. As Japan's Big Bang program is implemented further, however, this custom may disappear.¹²¹

2. *Lack of Litigation.* There is almost no litigation involving new financial instruments in Japan.¹²² All relevant parties participate in the administrative rulemaking and legislative processes. Once the parties reach an accord, it is unlikely that the agreement will be challenged in a court. When a dispute is resolved by introducing new legislation, it may be difficult and costly to attack such legislation judicially. Likewise, judicial challenges against administrative rulemaking are rare in Japan.¹²³ Again, however, as the Big Bang program proceeds these legal traditions may change.¹²⁴

3. *Formalism.* The MOF's rules and guidelines under the SEL consist of complex formal rules. For instance, under the current SEL the legal form of the fund determines whether units of a non-securities investment fund are treated as securities.¹²⁵ If the fund is

119. For a theoretical explanation of these regulatory characteristics, see Hideki Kanda, *Politics, Formalism, and the Elusive Goal of Investor Protection: Regulation of Structured Investment Funds in Japan*, 12 U. PA. J. INT'L BUS. L. 569 (1991).

120. *See id.* at 583.

121. *See Japan's Big Bang*, WALL ST. J., Apr. 1, 1998, at A18.

122. *See* Kanda, *supra* note 119, at 583.

123. *See id.*

124. *See Japan's Big Bang*, *supra* note 121.

125. *See* SEL, *supra* note 8, art. 2(1).

organized as a corporation, the units are securities, but if the fund is organized in trust form, the units are not securities.¹²⁶

B. Political Elements

1. *Political Power of the Banking Industry.* The banking industry in Japan formerly had substantial political influence and enjoyed a generally favorable reputation. In the past, the banking industry successfully discouraged industrial firms from going directly to the capital markets for cheaper funds.¹²⁷ Long-term credit banks issued bank debentures to the general public and transferred the proceeds to their customer firms in the form of lending.¹²⁸ Trust banks sold special products called “loan trusts” and provided the proceeds to their customer firms as traditional loans.¹²⁹ Thus, the banking industry prevented the liberalization of bond markets by imposing various customary requirements on business firms that wanted to issue bonds.¹³⁰ Whenever new financial products were invented or imported from outside Japan, the banking industry successfully persuaded the MOF to place these new products outside the SEL’s definition of a security, and prevented the securities firms from monopolizing the intermediary business for such products.¹³¹ The recent decline of the banking industry’s power and competitiveness, however, suggests that this industry may not control future regulatory reform of the Japanese securitization market.

2. *Interaction Among Ministries.* Disputes among ministries in legislative and administrative rulemaking processes also shape the regulatory landscape in Japan. A strong competitor of the MOF is the MITI. For example, in 1990 the MITI attempted to introduce a market for commodity futures funds with support from trading companies and leasing companies. The original draft prepared by the MITI faced strong opposition from the MOF, and the resulting legislation was a compromise between both ministries.¹³² In 1992, the MITI strongly opposed the MOF’s proposed extension of the SEL’s

126. *See id.*

127. For example, *tekisai-kijun* (bond eligibility standards) establishes standards for permitting certain large companies to issue bonds.

128. *See* Long-Term Credit Banking Law, Law No. 187 of 1952.

129. *See* Loan Trust Act, Law No. 195 of 1952.

130. *See supra* note 127.

131. *See* SEL, *supra* note 8, art. 2(1).

132. *See* Law for Regulating Business of Commodity Investments, Law No. 66 of 1992.

definition of security. The resulting definition¹³³ is narrower than originally contemplated by the MOF. Also in 1992, the MITI attempted to introduce legislation to enable leasing companies and finance companies to securitize their asset portfolios under the MITI's control. The MOF strongly opposed this proposed legislation. Again, the resulting legislation was a compromise permitting joint jurisdiction in the administration of the law.¹³⁴ In short, disputes among relevant ministries and their business constituencies is an important factor in the legislative process.

C. Market Characteristics

1. *Market and Industry Fragmentation.* Market fragmentation exists throughout the financial sector. Traditionally, the money generated in the Japanese capital markets was available only to major industrial companies, such as Toyota, for long-term investment purposes.¹³⁵ Short-term corporate financing needs always were met through bank loans.¹³⁶ Medium and small companies had no access to the Japanese capital markets.¹³⁷ On average, such companies were required to obtain funds at a relatively high cost. Individuals such as residential mortgage borrowers also had little access to Japanese capital markets.¹³⁸ As a result, excess funds generated in the Japanese capital markets during the recent economic expansion had no outlet in Japan other than large industrial firms. Thus, much of these funds flooded out of Japan into overseas markets.¹³⁹

This traditional characteristic of fragmentation in the Japanese financial markets is linked to bureaucratic control. Due to the division of power amongst the various ministries, certain aspects of financial regulation are divided and managed independently from one another. For example, as a result of the Ministry of Construction's

133. See SEL, *supra* note 8, art. 2(1)(2).

134. See MITI Law, *supra* note 3.

135. See *supra* note 127.

136. Commercial paper was not recognized until 1987.

137. See *supra* note 127.

138. In Japan, the residential mortgage has never been securitized. One explanation is that there is a separate scheme for subsidizing homeowners, administered by the Ministry of Construction. A public corporation, the Home Finance Corporation, extends mortgage lending with low interest to homeowners. The Corporation does not receive funds from the capital market, but rather from the government budget.

139. See STUDY GROUP II, on *Fundamental Matters, Securities and Exchange Council*, in REPORTS OF THE SECURITIES AND EXCHANGE COUNCIL 130 (1992).

support, residential mortgages have received a special subsidy through favorable tax treatment.¹⁴⁰ Similarly, the road construction industry has sometimes received favorable financing terms with the backing of the Ministry of Construction.¹⁴¹

Under these circumstances, an insider/outsider distinction has emerged. Hence, if a firm in a particular industry securitized its financial assets, it would generally have the entire securitization process, including enhancement and selling the securitized products to investors, controlled within the industry and thus the ministry to which it belongs. Such a firm is likely to resist involvement by industry outsiders. This means, for example, that a leasing company would deem it undesirable to securitize its assets under the SEL because doing so would result in the possible involvement of securities firms and the MOF.

2. *Non-existence of Asset Finance.* Another notable characteristic of the Japanese financial and capital markets is the absence of asset-based lending. Lenders disburse funds on the basis of the creditworthiness of a borrower, not the borrower's assets. This lack of asset-based lending prevented the emergence and development of asset securitization in Japan.

D. Recent Trends

Securitization is a worldwide trend unlikely to be reversed in the short term, yet it is difficult to predict its future in Japan. Until quite recently, the legal and nonlegal environment seemed to discourage the rapid development of a domestic securitization market. Regulatory conditions reflect the complex political and historical landscape of Japan. The degree of the banking industry's political power suggests that increased securitization in Japan in the future would accompany increased involvement of banks in intermediary services. Recent unfavorable economic conditions and the decline of financial institutions' power and competitiveness, however, have crystallized in a call for a drastic change of the regulatory environment for securitization.¹⁴² Coupled with the Big Bang program, the Japanese securitization market may well flourish in the near future.

Although domestic forces are likely to be the most important

140. See Special Tax Measures Law, Law No. 26 of 1957, art. 41.

141. The government has spent substantial funds on road repair and construction. See LECTURE ON PUBLIC FINANCE IN JAPAN 185 (Yoshio Tamura ed., 1997).

142. See The Financial System Research Council, *supra* note 16.

source of change, globalization of financial markets may also be relevant. As capital markets become increasingly internationalized, the traditional regulatory environment in Japan may have to change. A country with a unique regulatory environment might be placed in an unfavorable position if such regulatory differences prevent worldwide capital market activities in that country. The increased need for regulatory cooperation in the international financial services field may influence Japan to progress toward a more universal standard in administering and enforcing their policies.¹⁴³

V. CONCLUSION

The legal and nonlegal environments for securitization in Japan, like those in other countries, are complex and difficult to understand in isolation. The worldwide trend toward deregulation and increased competition among financial intermediaries has had significant impact on Japanese developments in recent years, both in regulation and practice. However, the domestic concern seems to be the major impetus for reform of financial regulation in Japan. The Japanese securitization market may flourish as a result of the drastic reform program. Nevertheless, it is difficult to predict when and how rapidly the Japanese regulatory environment will evolve to the point where Japanese elements of regulation and practice become indistinguishable from other international forms.

Perhaps it is fair to say that every capital market regulatory reform in Japan continues to be led by bureaucrats. However it is the marketplace, rather than the government, that produces demand for continuous change in the regulatory environment as new financial products emerge. Thus, recent developments viewed as a whole may be understood as an indication of a long-term trend that will result in Japanese capital markets ultimately becoming demand-driven rather than government-driven. If recent developments are viewed as centering on the market, the key issue will be the fundamental change of the government's role in Japanese capital markets. Capital markets function in an efficient way only when new instruments or securities are created, handled and sold under market-based mechanisms. They do not fit in a system of segmented government regulation. Viewed this way, a fundamental change in the regulatory environ-

143. The universal standard currently being developed consists of (1) capital adequacy of financial intermediaries; (2) increased disclosure of information; and (3) increased cooperation among regulators. See Kanda, *supra* note 15, at 14-15.

1998]

SECURITIZATION IN JAPAN

379

ment must occur if Japanese capital markets are to regain international competitiveness. Securitization may eventually serve as an impetus for such fundamental change.