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The Financial Instruments and Exchange Law, future financial services, and investor protection

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Enactment of the Financial Instruments and Exchange Law has lent a major impetus to the creation of a legal framework to support the shift from savings to investment. From the perspective of investor protection, what do financial institutions need to do under the revised law, and how should they deal with customers? In everything from sales management to preventing problems the answer lies in *people*.

Objectives of Financial Instruments and Exchange Law

In June 2006 the Securities and Exchange Law was revised to become the Financial Instruments and Exchange Law (FIEL),[1)] which will take effect as early as next summer. Its goals are threefold: (1) to establish extensive rules for investor protection and to enhance convenience; (2) to ensure that market functions are secured to support the shift from savings to investment; and (3) to meet the challenges presented by the globalization of financial and capital markets. While the revised law is seen by many as a Japanese-style Sarbanes-Oxley Act (SOX), we think the attempt to transform the highly compartmentalized Securities and Exchange Law into a set of common rules for the protection of investors is very significant from the standpoint of investor protection.[2)] Financial institutions have already begun preparations to comply with the new law while keeping a close watch on directives issued by the Cabinet Office. This report looks at the revised law from the standpoint of investor protection.

Why is investor protection necessary?

Stepping back for a moment, Japan's first law for the protection of consumers was the Consumer Protection Fundamental Act, enacted in 1968. Problems related to consumer transactions have been dealt with largely through laws regulating products and industries based on the Civil Code and through autonomous industry efforts. But these alone are no longer sufficient to resolve deal with consumer problems. In modern capitalist societies, products are increasingly complex and sophisticated and are produced by large, powerful corporations. The Civil Code, however, is based on classical principles of civil law such as freedom of contract. There now exists an undeniable disparity of information-in terms of both quantity and quality-and negotiating power between consumers and producers.[3)] One condition for promoting economic development through free and fair competition driven by deregulation is the development of new contract rules that enable consumers to engage in transactions with peace of mind and ultimately ensure consumer welfare.

We also see an endless string of troubles with contracts, exemplified by the encyclopedia-sized contracts for insurance policies. Under the Civil Code, a contract is not considered to have been concluded unless the two parties have demonstrated an intent to enter into it, with one making an offer and the other accepting it. The legal binding force of contract clauses has long been a mystery—namely, why are contracts whose individual clauses are not understood by one of the parties considered valid? Today there is prior disclosure, and there seems to be a general agreement that a *fiction of intent* will be acknowledged between the two parties as long as the content of individual clauses is *reasonable*.[4)] But given the information and bargaining disparity noted above, more is needed in the way of legal regulation, including mandatory prior disclosure and explanation of contract terms and conditions, government screening of individual contract terms, and legal interpretations that favor the consumer.

The new investment regulations certainly do not place an excessive or lopsided burden on financial institutions. The FIEL takes into account the possibility of further regulation[5)] and has already set Japan on the course of establishing true investor protection rules.[6)] Financial institutions will not be allowed to continue forever their practice of agreeing with the generalities while disagreeing with the particulars. The year 2000 saw the enactment of the Consumer Contracts Law and the Law on Sales of Financial Products,[7)] which were driven by the wave

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of deregulation and the movement towards consumer independence and accountability that began in the 1990s. This led to a major change in the government's approach towards consumer regulation, with a shift in focus from *consumer protection* to *consumer rights*. In other words, consumers have become the leading players and are responsible for preventing and resolving problems on their own.

Response by financial service providers

Some financial institutions are probably taking a wait-and-see approach to the FIEL in light of past experience. However, we think there are many things financial institutions could do to improve customer satisfaction and foster the healthy development of Japan's capital markets.

Given the broader scope of the new regulations, financial institutions need to ensure that products that were unaffected in the past do not "fall through the cracks." Responsibility for individual products at these institutions tends to be spread unevenly across a number of departments. The revised law therefore represents a good opportunity for institutions to shift from a product-driven approach to a market- or customer-driven approach.

One example is a review of sales methods. Banks have a minimal obligation to explain products to customers, but this alone is insufficient. We question whether customers understand the complex technical terms involved in contracts, and how many executives and employees actually purchase products sold by their employers. Executives and employees themselves need to do more to experience what ordinary investors goes through. While few salespersons still believe that the customer's signature on a contract resolves them of all responsibility, it is critical to ensure that investors understand and accept the products they buy. Independent investment behavior is possible only when investors make their own judgments and choose their own products, and financial institutions need to do everything in their power to make this possible.

Instead of selling products and walking away or leaving all responsibility with the sales staff, institutions also need to establish support systems for sales staff. The revised Law on Sales of Financial Products requires sellers to take the customer's knowledge and experience into consideration when explaining products and does not allow perfunctory responses that sound as though they were being read from a manual. Explanatory templates would probably be useful for the critical clauses that customers need to understand and accept.[8] On the subject of basic investment education, sellers also need to make continued efforts—using seminars and so on—to improve customer understanding of their products. Another option would be to employ data mining techniques on records of past troubles and customer complaints to develop sales methods tailored to the company's own circumstances. Further, companies might establish a policy of refusing to sell products that fall above a certain risk threshold to customers above a certain age.

Regardless of such preparations, there are bound to be some problems. But cultivating relationships with customers on a daily basis is necessary to prevent critical mistakes. This is why companies need to discontinue the old practice of personnel rotation, which results in frequent changes in customer representatives. A chain of communication that stretches from the customer to people inside and outside the company is essential. Short-term performance evaluations are another source of problems. The key issue here is how to balance incentives and compliance given increasing external pressure to boost earnings. One solution might be something similar to the balanced scorecard (BSC) approach.

Direction of future financial services

The general trend away from savings and towards investment is unlikely to reverse, and financial institutions play a key role in this new environment. It is no longer enough for customer representatives to have a wide range of product knowledge. They must also master the basics of customer service and develop the ability to pinpoint the real needs of individual customers. The representatives working on the front lines are more than just salespersons,

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and the talented ones deserve to be compensated well. It would be no exaggeration to say that everything depends on *people*.

In light of the above, one option for banks without sufficient in-house resources would be to strategically outsource sales activities. Another possibility might be to use third-party marketers,[9] a common practice in the US. And with the growing separation between the production and sale of financial products, there might be room for the emergence of a financial player specializing in customer-focused sales. Now more than ever, financial institutions need to develop “win-win” relationships with meaningful benefits for both customers and product providers.

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Note

1) The Law on Sales of Financial Products and related legislation were revised at the same time.

2) For example, forex margin transactions, which resulted in significant losses for many individual investors, became an issue of public concern in 2002 and 2003.

3) Article 1 of the Consumer Protection Fundamental Act.

4) The leading case is the Supreme Court Judgment of 24 December 1915.

5) Supplementary Article 220 calls for a review within five years. For reference, see other supplementary resolutions.

6) Work in progress at the Financial System Council makes it clear that the law will be revised in line with the UK's Financial Services and Markets Act.

7) These were enacted on 1 April 2001.

8) Investor rights and responsibilities in particular.

9) These are companies that provide either fully or in part the resources needed to sell financial institutions' investment products. Given the heavy burden entailed by sales of these products, some providers should probably consider leaving this area to specialists.

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