

Japan's new economic security
law's implications for
financial businesses

- Interview with Hideaki Umetsu
by Jun Tsutsumi -

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Executive Summary

On May 11, Japan's National Diet passed an economic security law, one of the primary aims of which is to ensure the security and reliability of core infrastructure critical to Japan's national security. The law designates 14 industries, including financial services, as societal infrastructure businesses. With many details remaining to be finalized as the law is phased into effect, NRI's Jun Tsutsumi spoke with Hideaki Umetsu, a partner at Mori Hamada & Matsumoto, about the law's implications for financial institutions.

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Hideaki Umetsu

*Partner
Mori Hamada & Matsumoto*

Licensed to practice law in Japan since 2004. Earned LLM degree from University of Chicago Law School in 2009. Admitted to New York State bar in 2010. Co-chair of International Bar Association's Asia Pacific Regional Forum and member of Japan Federation of Bar Associations' International Activities and Strategy Committee since 2021. Practice areas include advising Japanese companies on cross-border M&A, overseas expansion, governance and compliance; international trade law and human rights in business contexts.

Jun Tsutsumi

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Joined NRI in 1991. Initially worked on developing trading systems for securities brokerages. Involved in core system redevelopment project for Japanese investment bank's local subsidiary while on assignment at NRI Europe from 1996 to 2000. Seconded to Nomura Securities from 2003 to 2006. Returned to NRI from 2006 in risk management/IT governance consultant role. Appointed to current position in October 2021 after serving as general manager of ERM Business Planning Department.



Background and intent of Japan's economic security law

Jun Tsutsumi: To begin, could you explain the background and intent of the economic security law enacted by the National Diet on May 11?



Hideaki Umetsu: You can get an idea of what the law is about from its official title, [which translates into English as] “act on promoting national security through integrated economic measures.”

Two points bear noting. First, because the law aims to “promote” economic security, it’s not a purely regulatory law. While it of course has regulatory elements, it combines both mandates and incentives. Second, its official title does not include the term “economic security.” When testifying before the Diet about the legislation, both Prime Minister Kishida and Economic Security Minister Kobayashi said the government has no official definition of “economic security.” For some, such nebulousness may be a stumbling block to understanding the law, but I personally think it’s key to understanding the law’s intent.

Before the law was passed, the government formed an expert panel on promoting economic security in response to a proposal from within the Liberal Democratic Party. From the outset, economic security has been explained in terms of two concepts: strategic autonomy and strategic indispensability. Both were mentioned repeatedly in Kishida and Kobayashi’s Diet testimony.

Strategic autonomy means possessing essential goods and technologies critical to Japan’s national survival. Strategic indispensability means that from a national security standpoint, it’s important for Japanese products and technology to be globally indispensable by virtue of being the best available. The government’s explanation of economic security revolves around these two concepts.

Tsutsumi: Economic security has rapidly emerged as a national priority, partly in response to Russia’s invasion of Ukraine.

Umetsu: The government has been working on beefing up economic security for quite a while. For example, it amended the Foreign Exchange and Foreign Trade

Act some years ago. It also has been tightening inbound FDI regulations and export controls through such means as clarifying constructive-export controls and requiring foreign investors to report even minority investments in advance. Additionally, a law regulating land use and land-use studies in the vicinity of key facilities and on isolated islands took effect in June 2021. It allows the government to monitor ownership and use of strategically important land by ensuring transparency with respect to land acquisitions. Such legislative actions to upgrade economic security have been a common thread running through the Abe, Suga and now Kishida premierships.

Tsutsumi: Could you briefly explain the new economic security law's four priorities?

Umetsu: The first is making supply chains more resilient. The government, including even PM Kishida, has pledged to support this process through incentives in the aim of ensuring stable supplies of economically and societally important goods.



NOTE

1) Electric power, gas, petroleum products, water utilities, rail transport, trucking, marine shipping, aviation, airports, telecommunications, broadcasting, postal services, financial services and credit cards.

The second is ensuring core infrastructure's security and reliability. To do so, the law newly requires infrastructure operators to file advance notice of plans to install or perform maintenance on certain infrastructure. This objective relies more on mandates than incentives. Additionally, key infrastructure projects in 14 industries¹⁾ must be reviewed in advance by the government if national security or public safety would be materially affected by the infrastructure being out of service. Outsourcing of such infrastructure's operation or maintenance likewise must be reported and reviewed in advance. Even after approving a project, the government may issue additional recommendations to adapt infrastructure to changes in the international backdrop.

The third is supporting development of designated key technologies through public-private collaboration and information sharing in areas such as aerospace, AI and marine and quantum technologies.

The fourth is shielding sensitive patent applications from public disclosure. This

one may not be directly relevant to the financial sector. Patents grant an exclusive right to exploit patented technologies for, say, 20 years in exchange for publication of nearly all patents. As a general rule, all patents are published based on a belief in the importance of spurring technological innovation by making patents' content available to all interested parties. Although shielding a patent from publication is fundamentally at odds with the rationale behind granting patents, the Japanese Patent Office may do so in the case of military and other technologies that may be misused if they become public knowledge.

Impact on financial sector

Tsutsumi: Which of the four priorities will have the biggest impact on the financial sector?



Umetsu: Mainly the first and second, especially the latter. Financial services and credit cards are two of the 14 industries designated in the economic security law as societal infrastructure businesses.

Tsutsumi: The financial services industry stands apart from the other 13 in that it encompasses vastly more companies and is also more diverse, comprising investment banks, broker/dealers, insurers and over 500 commercial banks inclusive of small ones.

Umetsu: The 14 industries are limited to designated societal infrastructure businesses by a Cabinet ordinance. Key companies in each of these businesses will be designated as societal infrastructure providers by the competent minister based on criteria prescribed in ministerial ordinances. The financial institutions to be designated as societal infrastructure providers are not yet known, but I expect they'll be chosen based on metrics such as customer deposits in the case of banks.

Minister Kobayashi has repeatedly mentioned the importance of striking a balance between economic security and businesses' economic freedom. He said that the criteria for designating societal infrastructure providers will be set with broad input from concerned parties, including businesses. Companies designated as societal infrastructure providers will be required to notify the government in advance

of any plans to expand their capacity or outsource operation or maintenance of infrastructure. However, this requirement will apply only to designated key infrastructure and key operations/maintenance, defined as those that, if compromised from the outside, would impair the stability or reliability of Japan's core IT systems or other core infrastructure.

Tsutsumi: In Japan, vendors provide IT infrastructure to financial institutions in the form of SaaS. My understanding is that the financial institutions, not the SaaS providers, would be “societal infrastructure providers” under the new law. Does that jibe with your interpretation?



Umetsu: Yes. Under the economic security law, SaaS vendors that provide financial IT infrastructure don't qualify as designated societal infrastructure providers themselves. The party required to file notices with the government is the designated societal infrastructure provider, not its vendors. On the other hand, the law says the notices must contain certain information about suppliers of designated key infrastructure. This information would pertain to SaaS providers. The notices must also include information about designated key infrastructure's constituent equipment, devices or software that could be used to commit designated malicious acts. However, the specific information to be reported remains to be finalized in ministerial ordinances.

While SaaS providers have no obligation to provide information, they will be asked to do so by their financial institution customers. Unless they provide the requested information, the financial institutions won't be able to install their products. SaaS providers will consequently have to provide information required by the government to make sales to financial institutions.

Tsutsumi: Regarding infrastructure's constituent equipment, devices and software, the US, for example, maintains a sanction list of blacklisted manufacturers. Do you think Japan will use the same approach?



Umetsu: I frankly don't know. Government reviews will focus on the extent to which the equipment, device or software could be used to commit designated malicious acts. These acts are not slated to be prescribed in a ministerial or Cabinet ordinance. According to the Diet proceedings, they will presumably include at least cyberattacks. The government plans to issue basic guidelines with more details. In any case, the meaning of "designated malicious acts" is highly nuanced, so it's unlikely to be fully delineated in a Cabinet ordinance.

Minister Kobayashi's Diet testimony offers some clues to what the government's policy might look like. For example, he replied to one question by saying Japan is unlikely to adopt the US's blacklist approach for two reasons. First, there are so many vendors capable of supplying key infrastructure that identifying them all in detail is not feasible. Second, a blacklist, if publicly disclosed, could be used to circumvent the economic security law. That said, the government understands it must provide enough clarity for companies to comply with the law. I expect it will confer with business lobbies to strike a workable balance.

Another point Kobayashi mentioned in his Diet testimony is the importance of coordinating with allies. Japan could opt for a cooperative arrangement with other countries, but the US and EU's lists may not be a good fit for Japan because they are shaped by national, societal and historical factors that differ from Japan's situation. They may also reflect non-security considerations such as human rights.

Tsutsumi: In the software industry, outsourcing arrangements with multiple layers of subcontractors are sometimes used nowadays. In such cases, should all the subcontractors be listed on the notice filed with the government?

Umetsu: Yes, in a case where a contractor outsources important maintenance to a subcontractor, for example, the subcontracting arrangement would have to be disclosed on the notice, albeit under the provisions of a ministerial ordinance. The extent to which the government would enforce the requirement to report the subcontracting arrangement is unclear. However, the point of the reporting requirement is to prevent malicious acts, so I believe that subcontractors would have to be listed on the notice.

Tsutsumi: What about cases where information about a contractor or subcontractor like, for example, the name of its CEO is available in the public domain but the identities of any beneficial shareholders are not publicly known? Will any exception be made for such information that is not readily available?

Umetsu: We don't know yet but the filer could ask its contractors for any information required to file the notice.

Milestones leading up to new law's effective date

Tsutsumi: What is the timeline for the law's effectuation?

Umetsu: The law will be phased into effect within 18 months from November 18, 2022 (six months after its official publication date). Its incentives will generally take effect earlier than its mandates. Its provisions on supply chain resiliency, the law's first objective, are set to take effect by February 18, 2023. Its provisions related to core infrastructure are scheduled to take effect mostly by November 18, 2023, and entirely by February 18, 2024. Designated societal infrastructure providers will be granted a six-month grace period from their designation date to give them time to comply with the law.

Tsutsumi: Even with a six-month grace period, I would think they'd want to start preparing as much as possible now. Do you agree?

Umetsu: Although we don't yet know which companies will be designated as societal infrastructure providers, I think it's important for companies that expect to be designated to prepare by reconfirming the contours of their supply chains and getting in touch with their contacts at their supply chain partners.

Tsutsumi: Will infrastructure installed before the law takes effect be grandfathered?





Umetsu: Minister Kobayashi explicitly told the Diet that the law won't be applied retroactively in light of the costs that businesses could incur. And the text of the law does not contain a retroactivity clause. However, if the government determines that legacy systems are increasingly at risk of malicious acts, businesses may be informed of the risk under the new law.

Tsutsumi: I think companies will have to file notices of hardware upgrades, for example. In our case, we would not have to provide information to our installed base of financial institutions but we would do so going forward for any financial institutions newly installing even the same system.

Umetsu: In the case of key infrastructure, you may be required to provide information to new customers. Designated key infrastructure is to be designated by ministerial ordinances, which can be amended relatively quickly because the process involves only a single ministry. The definition of designated key infrastructure consequently may evolve flexibly in response to changes in the international or societal backdrop.

Tsutsumi: Listening to you, I now understand the new economic security law's importance. I also feel compliance could be quite costly. Companies will have to figure out how to comply with the law as efficiently and effectively as possible.

We plan to proceed with preparations to comply with the law under your guidance. Thank you for sharing your knowledge today. (Recorded on May 18, 2022)

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