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TOKYO (Dow Jones)--Corporate law changes under consideration in Japan's upper house of parliament could, if enacted, make illegal the corporate structure of many foreign firms operating in the country, business groups said Thursday.

The changes have already passed the Diet's lower house, but only recently have attracted the attention of foreign companies operating in Japan and groups representing them.

These groups, including the International Bankers Association, the American Chamber of Commerce in Japan and the European Business Council, are lobbying the government to change the legislation before it passes the upper house and becomes law possibly sometime in the next month.

"We can't understand the reason behind this move," said Jakob Edberg, policy director at the European Business Council in Tokyo. "It seems this is hitting the securities firms the worst."

Article 821 of the proposed Corporations Law states that "foreign companies with a main office in Japan or whose primary purpose is to conduct business in Japan cannot continue transactions in Japan."

That means that foreign firms won't be able to operate as a branch in Japan if their head office or headquarters is in another country and was established purely for the purposes of managing operations in Japan.

The trouble is, nearly all foreign securities businesses in Japan have this structure, which they adopted when setting up in the country. They used this structure to work around a requirement in Japan that banks and securities operations of the same group operate independently.

A large number of foreign asset management firms, including hedge funds operating in Japan, along with foreign businesses in other sectors, including the pharmaceutical industry, would also be affected. Overall, these corporate law changes are the most wide reaching in 60 years in Japan.

If the new rules are passed without any change, the affected firms would have to transfer their operations to a Japanese company structure, which could be costly.

"Potentially, 95% of the foreign securities community would have to convert their business to KK form," said Christopher Wells, executive partner at legal firm White & Case. KK stands for Kabushiki Kaisha and means public company. For large companies it would be "extremely costly", he said.

Some firms might have to move, for example, thousands of contracts to a new company and the movement of assets to a new Japanese structure could generate significant tax liabilities, he said.

Firms affected could include the biggest names in the global securities industry.

"Mistake Or A Lack Of Serious Consideration"

An official at the Ministry of Justice, which drafted the legislation, declined to comment on article 821 and said that people who were in a position to comment weren't immediately available. The official said the ministry needed more time to answer questions faxed to the ministry earlier Thursday by Dow Jones Newswires.

Japan's main opposition Democratic Party of Japan is also lobbying the government on the issue.

"Very simply, it's just a mistake or a lack of serious consideration," said Tsutomu Okubo, a Democratic Party member of the House of Councillors, the Diet's upper house. "I'm afraid of the market impact."

"Japan needs foreign money, and our stance is to enhance foreign investment and promote safe and transparent infrastructure," he said. "That's why we're working hard because we're competing with Singapore and Shanghai."

Business groups said they were at a loss as to why the Japanese government would push through legislation with potentially damaging implications. Okubo said the justice ministry likely drafted the changes to the law to clear up what has always been a gray area for foreign firms operating in Japan.

"The law department decided to clarify the law, but didn't investigate the implications," Okubo said. "I don't think the government had enough time to investigate the impact on business, including the market."

Aside from making the company structure of many foreign firms illegal, the new law would also mean branch managers of many foreign securities firms could be personally liable for the operations of the firm.

"Those who conduct transactions in violation of the above regulation shall, jointly with the foreign company, bear responsibility for repaying to the counterparty any debt that arises from the transactions concerned," the article reads.

White & Case has proposed an addition to article 821 that basically would allow any government agency to exempt companies from the impact of the article, but that wouldn't necessarily help firms in other sectors outside the financial services industry.

"This train is coming and some of these firms are going to be standing on the tracks when it arrives," said Christopher Wells. "Right now, it is hard to get a handle on how much disruption would occur outside the financial sector, but it could be even worse than in the financial sector."

Democratic Party's Okubo said it is also possible that even if the article is passed, the government could postpone its implementation until December 2006 at the latest.

Others say that the new law also contravenes the General Agreement on Trade and Services, administered by the World Trade Organization.

"In all sectors, other than financial services, (the new law) contravenes (the agreement) and in financial services it could be argued to contravene it," said a person familiar with the issue.

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