

Commercial Trusts and the Japanese Financial Instruments and Exchange Act

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Beneficial interests of trust that are not materialized on paper are generally deemed as Type-2 securities in the Japanese Financial Instruments and Exchange Act (FIEA). Type-2 securities, such as beneficial interests of trust, are subject to laxer disclosure regulations than Type-1 securities, such as stocks and bonds, as well as financial instruments business regulations by the Act.

According to the FIEA, an issuer of beneficial interests of trust is (1) a settlor who has discretionary power of management of the trust property, (2) a trustee who has discretionary power of management of the trust property, contributed to the trust by investors with cash, in which the settlor becomes the first beneficiary by way of the trust contract, or (3) a settlor and a trustee in another trust other than in (1) and (2). Beneficial interests of trust as Type-2 securities are issued when (i) a settlor sells the beneficial interests of trust to a third party in trust, after which the settlor becomes the first beneficiary due to the trust contract, excluding a trust whose initial trust asset is collectively pooled and managed, or (ii) the trust contract becomes effective in another trust other than in (i).

The disclosure obligation is addressed to the issuer. The current definition of an “issuer of beneficial interests of trust,” described above, allows for the manipulation and arbitrage of regulations by means of structuring the trust scheme. A *de lege ferenda* trust itself should be an issuer, although a trust is not a juridical personality, because trust property is substantially segregated from the trustee’s individual

property and the trust is itself an entity. In addition to the trust itself, the person who is most suitable for disclosing true and fair view of the trust should be appointed as the disclosure obligation addressee.

The current regulations regarding when beneficial interests of trust are issued are justified because investors own beneficial interests of trust only after they are transferred by the settlor—who has become the first beneficiary—to the third party, namely the investors in the case of abovementioned (i).

Financial instruments business regulations will be applied when beneficial interests of trust are issued, publicly offered, distributed, underwritten, sold, or dealt. The scope of the regulations is coupled with the disclosure regulations via the definition of issuer and the point of issuance. Nevertheless, the definition of the disclosure regulations does not ensure the appropriateness of business regulations. For example, there could be loopholes within business regulations in cases where (a) the trustee has discretionary power of management of the trust property, (b) the trust property is not collectively pooled and managed, and (c) the settlor holds the beneficial interests of trust and becomes the first beneficiary. In this case, the issuer is the trustee, and the beneficial interests of trust as Type-2 securities are issued at the point of transfer of the beneficial interests of trust by the settlor to the third party. Financial instruments business regulations do not apply to the inducement and conclusion of the trust contract because self-offering by a trustee is not regulated by the FIEA and the securities are not yet issued at the point of conclusion of the contract. Therefore, disclosure regulations and business regulations should be decoupled.