# Japan

Hajime Ueno and Akihiro Shiba, Nishimura & Asahi

www.practicallaw.com/6-500-8432

## MARKET AND LEGAL REGIME

**1. Please give a brief overview of the securitisation market in your jurisdiction. In particular:**

- **How active and/or developed is the market and what notable transactions and new structures have taken place recently?**
- **To what extent have central bank liquidity schemes assisted the securitisation market in your jurisdiction? Were retained securitisations common in the last 12 months?**
- **Is securitisation particularly concentrated in certain industry sectors?**

Because securitisation products were recognised as useful in past financial crises during the "lost decade", the securitisation market has rapidly developed. From April 2006 to March 2007, the actual issuance of securitisation products on an announced basis reached about JPY11 trillion (about US$121 million). However, having been adversely influenced by the economic depression and the global financial crisis originating from the subprime mortgage crisis, the demand for securitisation products decreased (despite no issues having arisen relating to securitisation products themselves in the Japanese market).

Since the start of 2008, the scale of securitisation business shrunk so much that, from April 2008 to March 2009, the actual issuance of securitisation products on an announced basis was about JPY4.8 trillion (about US$53 million). This represents a decrease of 39% compared to the previous financial year, despite the Bank of Japan's liquidity scheme, which has operated since October 2008 and includes temporary relaxing of the criteria for accepting asset-backed commercial paper (ABCP) as eligible collateral. However, the residential mortgage-backed securities originated by the Japan Housing Finance Agency (JHF RMBS) continue to be steadily issued.

Of the total volume of issued securitisation products, excluding products relating to real estate, governmental institutions and banks now make up about half of the total number of originators. The remainder seem to be composed mostly of leasing companies and credit loan companies.

(For further information on the types of securitisation/assets referred to throughout this chapter, *see Model Guide, table, Classes of receivables.*)

**2. Is there a specific legislative regime within which securitisations in your jurisdiction are carried out? In particular:**

- **What are the main laws governing securitisations?**
- **Is there a regulatory authority?**

### Main laws governing securitisations

The main laws governing securitisations are as follows:

- **Civil Code (*Minpo*).** This provides the general rules in private law, including rules on contracts such as sales or loans and security interests such as pledges (*shichi-ken*) or mortgages (*teito-ken*).
- **Company Law (*Kaisha-ho*).** KKs (*kabushiki kaisha*) or GKs (*godo kaisha*) (*see Question 4*) are incorporated under, and governed by, this statute. Rules relevant to these corporations are provided for and made under the statute.
- **Trust Law (*Shintaku-ho*).** Legal rules (other than regulations on trust business) relating to formulation, governance and rights of parties, as well as other rules relating to trusts, are provided for in this statute.
- **Commercial Code (*Shoho*).** This provides the general rules in commercial law, including rules on TK (*tokumei kumiai*) (*see Question 4*).
- **Law Concerning Liquidation of Assets (Securitisation Law) (*Shisan no Ryudo-ka ni Kansuru Horitsu*).** This is a statute introduced to induce and enhance securitisation transactions (initially introduced in 1998), and TMKs (*tokutei mokuteki kaisha*) and TMSs (*tokutei mokuteki shintaku*) (*see Question 4*) are incorporated or formed under, and governed by, this statute.
- **Law Concerning Investment Trusts and Investment Corporations (*Toshi Shintaku oyobi Toshi Hojin ni kansuru Horitsu*).** Investment trusts and investment corporations established or incorporated for purposes of asset management and investment are provided for, governed by and regulated under this statute and rules and regulations made under it.
- **Financial Instruments and Exchange Law (FIEL) (*Kin'yu-shohin-torihiki-ho*).** This statute is the main part of Japanese securities regulations. This law, as well as rules and regulations made under it, are relevant to and govern Japanese securitisations.

- **Special Measures Law Concerning the Claims Servicing Business (Servicer Law) (*Saiken-kanri-kaishu-gyo ni kansuru Tokubetsu-sochi-ho*).** Providing an exemption from the Lawyers Code (*Bengoshi-ho*) which prohibits non-attorneys from servicing claims that relate to "legal matters" such as litigation, this statute relates to servicing aspects of securitisation products.
- **Real Estate Specific Joint Ventures Law (*Fudosan-tokuteikyodo-jigyo-ho*).** The statute regulates certain types of joint ventures and investments in real estate.

### Regulatory authorities

The Financial Services Agency (FSA) generally supervises and inspects financial institutions or companies, and regulates transactions concerning securities, subject to the FIEL and/or other laws. Some aspects of securitisation can also be regulated by the Ministry of Justice or the Ministry of Land, Infrastructure, Transport and Tourism.

## REASONS FOR DOING A SECURITISATION

**3. Which of the reasons for doing a securitisation, as set out in the Model Guide, usually apply in your jurisdiction? In particular, how are the reasons for doing a securitisation in your jurisdiction affected by:**

- **Accounting practices in your jurisdiction, such as application of the International Financial Reporting Standards (IFRS)?**
- **National or supra-national rules concerning capital adequacy (such as the Basel International Convergence of Capital Measurement and Capital Standards: a Revised Framework (Basel II Accord) or the Capital Requirements Directive)? What authority in your jurisdiction regulates capital adequacy requirements?**

### Usual reasons for securitisation

Among the reasons set out in the Model Guide (*see Model Guide, Reasons for doing a securitisation*), the following are typical reasons for transactions in which financial institutions are the originators:

- Cheaper borrowing.
- Credit arbitrage.
- Balance sheet benefits.
- Capital adequacy (which is the primary reason).

The following are typical driving motives where a general operating company is the originator:

- Cheaper borrowing.
- Balance sheet benefits.
- Alternative source of funding.

### Accounting practices

To gain balance sheet benefits through off-balancing, it is necessary for the transfer of assets to an SPV to be regarded not as a financial transaction, but as a sales transaction, under the applicable accounting standards.

For consolidated financial statements, SPVs are required to be non-consolidated. Currently, the Accounting Standards Board of Japan and the International Accounting Standards Board are dealing with the convergence of Japanese generally accepted accounting principles (GAAP) and IFRS. If consolidation rules or off-balance requirements are substantially modified, the securitisation market would be influenced by modification, regardless of whether the originator was an operating company or a financial institution. This was the case when standards for off-balance of owned real estate were newly introduced and the structure of real estate securitisation was significantly influenced (for example, structures using sale and leaseback of a seller-originator's headquarters office building have become rare).

### Capital adequacy

Capital adequacy requirements under the Banking Law (*Ginko-ho*), which incorporated rules set under the Basel II Accord into Japanese law, are imposed on banks and other deposit-accepting financial institutions. Financial institutions make use of securitisation transactions to reduce their own risk assets to gain capital relief. Therefore, if capital adequacy requirements are substantially modified, these modifications will affect securitisation transactions originated by these financial institutions.

For further information on why these rules encourage financial institutions to securitise their receivables, see *Question 11* and *Model Guide, Capital adequacy*.

Under the Insurance Business Law (*Hoken-gyo-ho*), insurance companies must maintain a certain ratio of solvency margin to secure their capacity to honour their insurance policies. However, it seems that no securitisation product for insurance companies designed to deal with solvency margin requirements has been introduced on the Japanese market.

## THE SPECIAL PURPOSE VEHICLE (SPV)

### *Establishing the SPV*

**4. How is an SPV established in your jurisdiction? Please explain:**

- **What form does the SPV usually take and how is it set up?**
- **What is the legal status of the SPV?**
- **How is the SPV usually owned?**
- **Are there any particular regulatory requirements that apply to the SPVs?**

### Forms of SPV

SPVs used in Japanese securitisation transactions can be largely classified into two categories:

- Corporate types, that is, special purpose companies (SPCs).
- Trust types.

Partnership interests are rarely used in securitisation transactions.

SPCs used in most securitisations as holders of underlying assets take one of the following corporate forms:

- **KK.** This is a limited liability stock corporation incorporated under and regulated by the Company Law.
- **GK.** This is typically used for a closely held limited liability corporation which is also incorporated under and regulated by the Company Law. This form of corporation was newly introduced in 2007 under the Company Law.
- **YK (*yugen kaisha*).** This is a closely held limited liability corporation, which existed before the introduction of the Company Law, under which all YKs were automatically recategorised as KKs.
- **TMK.** This is a special purpose company incorporated under and regulated by the Securitisation Law for securitisation and other off-balance sheet transactions.
- **Investment corporation (*toshi hojin*).** This is a special purpose investment vehicle incorporated under and governed by the Law Concerning Investment Trusts and Investment Corporations, for asset management and investments. In practice, these are used almost solely for Japanese real estate investment trusts (J-REITs).

The form of trusts typically used as vehicles holding securitised assets is limited to ordinary trusts formed and established under the Trust Law. The other possible forms under Japanese law are:

- **TMS.** This is a special kind of trust governed and regulated by the Securitisation Law for securitisation and other off-balance sheet transactions. However, in practice, it has rarely been used. (It appears that there has been only one transaction using a TMS.)
- **Investment trust (*toshi shintaku*).** This is a special kind of trust designed for asset management and investments governed and regulated by the Law Concerning Investment Trusts and Investment Corporations. In practice, this is used solely for the purposes of mutual funds or unit trusts (*toshin*).

### Setting up an SPV

Requirements for incorporation of companies such as KKs, GKs, TMKs or investment corporations include:

- Preparation of the articles of incorporation of the SPC (*teikan*, or in cases of investment corporations, *kiyaku*).
- Execution and delivery of capital contributions relating to the SPC.
- Registration of the incorporation of the SPC with the competent legal affairs bureau.

Trusts are usually settled by agreement between the settlor and the trustee. Since the end of September 2008, declarations of trust have become a permissible measure to establish a trust. However, it appears that it has rarely been used in the context of a financial transaction.

### Legal status of SPVs

An SPC has its own legal personality. Trusts used as SPVs (whether TMS or other types of trusts) do not have their own legal personalities and their assets are held by and under the name of the relevant trustees. However, the trust assets would not be made available to the trustee's own creditors as long as the trustee had sufficiently segregated the trust assets from its own assets (and/or assets of other trusts for which it is acting as a trustee).

The commonly used forms of investments extended to or made into SPCs are:

- Bonds.
- Commercial paper.
- Loans.
- Preferred shares.
- TK interests (which arise from and are governed by a bilateral agreement (*tokumei kumiai*), between a business operator and a contributory, which is economically similar to a limited partnership).

For trusts used as SPVs, trust beneficial interests having priority over the most junior class of classified trust beneficial interests and/or loans extended to trusts are used. Bonds issued by a trust are generally rare.

### Ownership of SPVs

To set up an SPC as an "orphan" company, the common shareholder or member of the company is usually a general incorporated association (*ippan shadan hojin*; a non-profit corporation), or a limited liability CH (*yugen sekinin chukan hojin*; a non-profit and non-public-interest corporation which is now deemed as a general incorporated association by law), in which membership without contribution and contribution without voting rights are both permitted.

For trusts used as SPVs, a trust beneficial interest is usually divided into senior portions, which are sold and held by investors, and a junior (subordinated) portion, which is retained and held by the relevant originator. Generally, the trust agreement provides for mechanisms by which rights and authorities of the subordinated beneficiary (that is, the originator) are limited to the fullest extent possible to meet the demands and expectations of investors. In many cases, particularly relating to fundamental matters such as whether to authorise the trustee to reschedule or amend the conditions relating to underlying trust assets, determinations are made by exercising investors' voting rights in a meeting of senior beneficiaries, rather than conferring the right or power to determine these matters on the originator. However, where US GAAP applies to the originator, structures that limit the discretion of investors, the originator and the trustee (if relevant) are usually used (to achieve qualifying special purpose entity (QSPE) status under the US GAAP).

### Regulatory requirements

For TMKs and TMSs, certain regulatory requirements under the Securitisation Law and rules made under it apply. These regulations include a requirement to file the following with competent government agencies:

- A written "asset liquidation plan" relating to the securitisation transaction in which the relevant TMK takes part.

- Charter documents and so on of the TMK.
- Annual operation reports of the TMK.

**5. Is the SPV usually established in your jurisdiction or offshore? If established offshore, in what jurisdiction are SPVs usually established and why? Are there any particular circumstances when it is advantageous to establish the SPV in your jurisdiction?**

Recently, most SPVs used for securitisation have been established in Japan. Limited liability CHs (which were later abolished and, instead, general incorporated associations were introduced) were used as the parent SPCs (instead of Cayman SPCs). Use of domestic SPCs, instead of Cayman SPCs or other foreign SPCs, at both the asset holding level and the parent level, allow market participants to save time and costs relating to translation and so on. This makes it easier to monitor transactions following closing.

### *Ensuring the SPV is insolvency remote*

**6. Is it possible to make the SPV insolvency remote in your jurisdiction? If so, how is this usually achieved?**

It is possible to minimise insolvency risks by using the following methods:

- The parent entity of the SPV being an "orphan SPC" (that is, an SPC which is independent from and not controlled by any of the relevant transaction parties, and which would not have any incentive or motive to exercise its discretion, or other rights, including voting rights in favour of a particular transaction party).
- Any business, other than the relevant securitisation transaction, being prohibited and/or restricted under the relevant transaction documents and/or charter documents.
- Hiring of employees being prohibited or restricted.
- Any act changing its organisation, such as mergers, being prohibited or restricted.
- An independent director being appointed.
- An external credit enhancing instrument(s) being used.
- Carefully drafting terms and conditions of transactions agreements, such as waterfall provisions and limited recourse provisions.
- Powers vested in shareholders, members, beneficiaries or trustees of the SPV being properly restricted.
- Non-petition covenants being obtained from parties concerned.

### *Ensuring the SPV is treated separately from the originator*

**7. Is there a risk that the courts can treat the assets of the SPV as those of the originator if the originator becomes subject to insolvency proceedings? If so, can this be avoided/minimised?**

With proper incorporation and administration of the SPV, the legal personality of an SPC is separate from that of an originator. Therefore, any underlying asset transferred to an SPC is not regarded as being vested in the originator, as long as the corporate veil piercing theory is not applied (under which its legal personality would be disregarded in connection with the matter(s) in question). This is also true of cases where a trust is used as an SPV, because trust assets are regarded as being vested in the relevant trustee and are treated separately from each of the settlor (that is, the originator) and the trustee.

If the originator collects payments or repayments on the underlying assets as a servicer or otherwise, it is possible that the money that the originator temporarily takes custody of for the SPV can be treated as vested in the assets of the originator when the originator becomes insolvent (*see Model Guide, Collecting the receivables*). Therefore, measures must be taken to prevent this risk from being realised. Examples include an SPV reserving a certain amount of money payable to the originator to retain its ability to set off against the collected money, and appropriate and proper drafting of backup servicing triggers and mechanisms.

For risks of re-characterisations and avoidance issues, *see Questions 16 and 17*.

## THE SECURITIES

### *Issuing the securities*

**8. Are the securities issued by the SPV usually publicly or privately issued?**

Currently, very few securitisation products (that is, securities issued by the SPV such as shares, bonds, trust beneficial interests or TK interests) are issued and placed to investors through public offerings, except for JHF-RMBSs and J-REITs.

**9. If the securities are publicly issued:**

- **Are the securities usually listed on a regulated exchange in your jurisdiction or in another jurisdiction?**
- **If in your jurisdiction, please briefly summarise the main documents required to make an application to list debt securities on the main regulated exchange in your jurisdiction. Are there any share capital requirements?**
- **If a particular exchange (domestic or foreign) is usually chosen for listing the securities, please briefly summarise the main reasons for this.**

#### Choice of exchange

Equity securities issued publicly are usually listed on regulated exchanges in Japan, such as the Tokyo Stock Exchange (TSE). However, it appears that securitisation products have never been listed in Japanese markets, except for equity interests in J-REITs which are listed on regulated exchanges in Japan (most of which have been listed on the TSE). The TSE seems to be the most distinguished market in trading volume and reputation in relation to J-REITs and other types of securities.

Securitisation products issued in Euro-Yen markets are usually listed on a foreign exchange, such as the Irish Stock Exchange or the Luxembourg Stock Exchange to provide more liquidity to investors.

**Application for listing**

It is not practicable for a securitisation SPC to list its bonds on a Japanese trading market. For example, listing criteria for bonds for the TSE include:

- For domestic issuer's bonds, the issuer already being a listed company on the exchange (with limited exceptions).
- For foreign issuer's bonds, that the issuer substantially satisfies the same requirements that apply for a company to become a listed company on the exchange.

It is difficult for securitisation SPCs to satisfy these requirements. Therefore, it is highly unlikely, if not impossible, for a securitisation SPC (irrespective of whether a domestic SPC or a foreign SPC) to list its debt securities on a Japanese exchange.

### *Constituting the securities*

**10. If the trust concept is not recognised in your jurisdiction, what document are the securities issued by the SPV constituted by and how are the rights in them held?**

The trust concept has been recognised in Japan since the early twentieth century. Trust beneficial interests are used in securitisations as a type of financial instrument, together with other types of instruments such as shares, bonds, commercial paper or loans.

## TRANSFERRING THE RECEIVABLES

### *Classes of receivables*

**11. What classes of receivables are usually securitised in your jurisdiction? Please explain any particular reasons (for example, the strength of the origination market) why such receivables are usually securitised and the progress of the market in securitising new classes of receivables.**

Recently, a large proportion of securitisation products in Japanese markets have involved residential mortgage loans. RMBS are the most frequently issued products, which are issued for the purposes of capital relief rather than financing. While many commercial mortgages, auto loans, consumer loans, lease payment receivables and credit card receivables have been and are being securitised (typically to gain alternative financing of originators), the market size of securitisation of these receivables has shrunk since the beginning of 2008.

The market frequently sees repackaging products that re-securitise existing securitisation products as underlying assets, including CDO squareds (that is, collateralised debt obligations (CDOs) that are re-securitised as underlying assets). Other than those products, securitisation of asset classes known as exotic assets, such as receivables relating to franchise guarantees, can also be seen. Securitisation transactions relating to new asset classes have been seriously considered. However, following the market turmoil that began in 2008, the market appetite for new asset classes has deteriorated. Much of the eagerness for the introduction of securitisation transactions involving new asset classes has drastically decreased.

Recently, CB repackages (that is, transactions that economically disintegrate a convertible bond into warrant and debt), have often been used.

### *The transfer of the receivables from the originator to the SPV*

**12. How are the receivables usually transferred from the originator to the SPV (for example, assignment, novation, sub-participation, declaration of trust)? How is the transfer perfected? Are there any rules, requirements or exemptions that apply specifically to transferring receivables in a securitisation transaction?**

In many cases, receivables are transferred to the SPV through assignment by a sale and purchase, or by entrustment under a trust agreement. For synthetic securitisation, instruments or methods used to transfer risks are loan participations, or sub-participations, as well as credit default swaps (CDSs) and guarantees. Declarations of trust have become possible since the end of September 2008. However, it appears that declaration of trust has rarely been adopted in connection with a financial product.

The perfection of a transfer differs depending on the subject of the transfer. For example, if real estate is transferred, the transfer is perfected by registration in a property registry (*fudosan toki-bo* or *toki-kiroku*). With receivables, transfer is perfected by:

- Consent of, or notice to, the relevant debtor by an instrument bearing a certified date (stamped by a notary, for example).
- Registration (provided a notice to the relevant debtor satisfying certain formalities is also required to perfect against the debtor).

For transfer of trust beneficiary interests, transfer is perfected by consent of, or notice to, the relevant trustee by an instrument bearing a certified date (stamped by a notary, for example).

There is no special rule, requirement or exemption that applies specifically to a transfer of receivables in a securitisation transaction.

**13. Are there any types of receivables that it is not possible or not practical to securitise in your jurisdiction (for example, future receivables)?**

For the transfer of future receivables, depending on the length of time during which the assigned receivables accrue or are generated, the transfer can be determined as void because the transfer is against public policy. Therefore, it is necessary to limit this time to a reasonable period.

It is also difficult to securitise receivables that are subject to contractual restrictions or legislative restrictions or prohibitions (*see Question 14*). However, even if certain restrictions against a transfer apply, a synthetic securitisation is possible and these securitisations have been pursued in Japanese securitisation markets.

**14. How is any security attached to the receivables transferred to the SPV? What are the perfection requirements?**

Generally, security interests (such as mortgages, pledges, security interests by way of assignment (*joto-tanpo-ken*) and reserved ownerships (*ryuho-shoyuken*)) are, or are considered to be, automatically transferred with the transfer of the relevant receivables secured by law, without any separate action or agreement. If it is

unclear if automatic and accompanying transfer occurs by law, transaction parties carefully document accompanying transfers in the relevant transaction documents.

Security interests securing unspecified claims (that is, where secured obligations are not necessarily specified), such as umbrella mortgages (*ne-teito*) and umbrella pledges (*ne-shichi*), are not automatically transferred by law together with the assignment of the secured claims. Therefore, it is necessary to agree and document the transfer of these security interests (where possible) in the relevant transaction documents, which, in most cases, require the consent of the mortgagors, pledgors and other interested parties.

The perfection requirement for mortgages is registration in the relevant property registry.

The perfection requirement for pledges, security assignments, or reserved ownerships of tangible movable properties (excluding ships, aircraft, automobiles, and so on) is, with few exceptions, delivery (although not necessarily physical delivery) of the relevant tangible movable properties to the holder of the security interest.

The requirements for perfection for pledges on or security assignments in receivables are:

- Notice to, or consent of, the relevant debtor by an instrument bearing a certified date (stamped by a notary, for example).
- Registration (provided a notice to the relevant debtor satisfying certain formalities is also required to perfect against the debtor).

The perfection requirement for pledges over trust beneficiary interests is notice to, or consent of, the relevant trustee by an instrument bearing a certified date (stamped by a notary, for example).

### *Prohibitions on transfer*

**15. Are there any prohibitions on transferring the receivables or other issues restricting the transfer? For example, is a negative pledge enforceable, or are there any legislative provisions that affect the transfer of receivables (such as consumer or data protection rules)?**

#### Contractual restrictions

If receivables with a contractual prohibition on transfer are transferred in breach of the prohibition, the transferor is liable for compensation of damages of the debtor, and the transferee can hold joint or separate contractual or tortious liability, but the transfer itself is deemed effective. However, if the transferee has knowledge of or is grossly negligent concerning the contractual prohibition, the transfer is deemed ineffective in the first place.

#### Legislative restrictions

There are some receivables whose transfer is prohibited or restricted by legislation. For example, the transfer of receivables based on social insurance, such as health insurance or pension insurance, is prohibited by relevant statutes. Also, regardless of the type of receivable, it is possible that a transfer of future receivables that accrues over a long period of time can be determined as void, because the transfer is against public policy.

### *Avoiding the transfer being re-characterised*

**16. Is there a risk that a transfer of title to the receivables will be re-characterised as a loan with security? If so, can this risk be avoided and/or minimised?**

Depending on the terms of the relevant transaction, there is a risk that the transfer can be re-characterised as a secured loan. If a transfer is re-characterised as a financial transaction (that is, a loan with security, particularly in a reorganisation procedure (*kosei-tetsuzuki*) under the Corporate Reorganization Law (*Kaisha-kosei-ho*)), the SPV (or investors) only has preferential entitlement to receive distributions within the procedure. Further, it is possible that the amount of the claim of the SPV (or investors) is reduced during the procedure, which results in investors not receiving the amounts from the cash flow generated from the relevant asset that they expected before the reorganisation.

To minimise this risk, the interested parties must ensure the transaction is recognised as a true sale (that is, a transfer is not and would not be deemed as a transfer made to provide a security interest). There is no controlling authority or legal precedent relating to the true sale determination or analyses. Interested parties are advised to avoid, if possible, any feature or condition in the transaction that can or will result in (or lead to) the assertion or conclusion that the parties intended to conduct a loan with security transaction.

While there are several factors (such as credit enhancements provided by the originator not being excessive) seen as favourable in the determination of a true sale, none of them are an absolute legal condition. Therefore, deliberate determination and analyses are required in any given case. In most cases, rating agencies demand legal opinions to be obtained and submitted to them in relation to the true sale nature of the transaction, as a condition of their credit ratings of the securitisation products.

### *Ensuring the transfer cannot be unwound if the originator becomes insolvent*

**17. Can the originator (or a liquidator or other insolvency officer of the originator) unwind the transaction at a later date? If yes, on what grounds can this be done and what is the timescale for doing so? Can this risk be avoided or minimised?**

The originator can unwind the transaction at a later date if:

- A termination right under the Civil Code arising from a breach of contract or liability for defect warranty is exercised. Under the Civil Code, the buyer has a statutory right to terminate the relevant sale and purchase contract if there is breach of contract by the seller or when a latent defect is found in relation to the object of the sale transaction. In many other cases, the drafting of transaction agreements or of the transaction structure does not sufficiently prevent the exercise of these termination rights. Therefore the risks must be factored into the pricing rather than being absorbed through the structuring.

- Avoidance rights under the insolvency statutes (Bankruptcy Law (*Hasan-ho*), Civil Rehabilitation Law (*Minji-saisei-ho*) and Corporate Reorganisation Law), nullification rights under the Trust Law (in cases where trusts are used as SPVs) or nullification rights under the Civil Code are exercised and upheld by the competent courts. Avoidance rights under the insolvency statutes can be exercised by the originator, a liquidator or any other insolvency officer of the originator. In contrast, nullification rights under the Trust Law or the Civil Code can be exercised by a creditor to the originator if the relevant transaction is conducted by the originator when it has already become insolvent or when it is on the verge of insolvency. Therefore, in closing a securitisation transaction, careful and thorough attention must be paid to the credit standing of the originator and other criteria for the exercise of such rights (including the appropriateness of the amount of consideration paid for the transfer of the securitised assets) to prevent the exercise.
- The underlying receivables (that is, securitised assets) arise from a bilateral contract under which each of the parties has yet to complete the performance of their obligations (bilateral executory contract), and this contract is terminated. Under the insolvency statutes, in insolvency procedures, the insolvent debtor or the liquidator or insolvency officer can choose to terminate the bilateral executory contract. In concluding a securitisation, it is advisable to take the existence and the degree of these risks into consideration.

### *Establishing the applicable law*

**18. Are choice of law clauses in contracts usually recognised and enforced in your jurisdiction? If yes, is a particular law usually chosen to govern the transaction documents? Are there any circumstances when local law will override a choice of law?**

The governing law of a contract can be specified by agreement of the parties. However, application of certain types of mandatory rules, for example those on consumer or labour contracts, under otherwise applicable law cannot be overruled or pre-empted by agreement. It is common to choose Japanese law in domestic transactions, while the laws of any other jurisdiction can be chosen through negotiation by parties in cross-border transactions.

However, for the assignment of rights *in personam* (such as receivables), in relation to the effect against the obligor or other third party to the assignment, the law governing these rights overrides any other agreed governing law. In a similar way, in relation to the assignment or settlement of rights *in rem* (such as ownership or mortgage) in tangible movable properties or real estate, the law of the jurisdiction where the relevant property or real estate exists governs matters relating to the assignment's effect (including its legal formality requirements). This overrides anything contractually agreed. Separately, the parties cannot exclude the application of public laws.

If the application of foreign law results in a conclusion that is contrary to Japanese public policy, the application of foreign law is denied. Further, for matters relating to corporations themselves (such as rights of shareholders against corporations), the law under which the corporation was incorporated (not the law of the jurisdiction of the corporation's principal place of business) is considered to automatically apply as the governing law. However, to prevent corporate law shopping, under Japanese law, no foreign company (that is, a company incorporated or established under foreign law) that has its head office in Japan or whose main purpose is to conduct business in Japan, is allowed to continuously carry out transactions in Japan.

## SECURITY AND RISK

### *Creating security*

**19. Please briefly list the main types of security that can be taken over the various assets of the SPV in your jurisdiction, and the requirements to perfect such security.**

Where securitisation products take the forms of a loan, lenders or lenders' right(s) are usually secured by assets of the SPV. However, it is practically difficult, if not impossible, to issue bonds as secured bonds secured by the relevant collateral, due to the burdensome requirements, regulations and legal constraints in the Secured Bond Trust Law (*Tanpo-tsuki-shasai-shintaku-ho*). The main types of security that can be taken over the assets of an SPV are as follows:

- **Mortgage.** In relation to real estate, mortgages are commonly used. Registration in the relevant property registry is necessary to perfect a mortgage.
- **Pledge.** For financing transactions involving receivables and trust beneficiary interests, pledges are one of the principal forms of granting security. For pledges over receivables, a pledge is perfected by notice to or consent of the relevant obligor by or with an instrument bearing a certified date, or registration of the pledge. Registration only has the effect of perfection against third parties (in contrast to perfection against the obligor). Separate notice set out under the relevant statute is required to perfect against the obligor. To perfect pledges over trust beneficiary interests, notice to or the consent of the relevant trustee must be given by or with an instrument bearing a certified date.
- **Security assignments.** In relation to financing transactions involving receivables and tangible movable properties, security assignments are used as well as pledges. For tangible movable properties, a security assignment is, with certain exceptions, perfected by delivery. Physical delivery is not necessarily required. For receivables, the perfection requirements for assignments of receivables apply to the perfection of security assignments (*see Question 12*).
- **General security interests (*ippan tanpo-ken*).** TMK bonds are secured over all property belonging to the issuer TMK because of statutory security interests usually referred to as general security interests, unless otherwise excluded by the parties. A general security interest is granted by law without any requirement for perfection.

  If no security is granted, or if it is difficult to grant security, it is common practice to provide substitute mechanisms, such as a negative pledge clause and/or by incorporating other similar covenants and contractual arrangements.

For further information on taking security over assets in Japan, *see PLC Cross-border Finance Handbook 2010, Country Q&A, Japan.*

**20. How is the security granted by the SPV held for the investors? If the trust concept is recognised, are there any particular requirements for setting up the trust (for example, the security trustee providing some form of consideration)? Are foreign trusts recognised in your jurisdiction?**

Security is rarely granted unless securitisation products sold to investors are structured as loans (*see Question 19*). If security is granted, it is probably held by investors themselves rather than a security trustee. However, following the introduction of the new Trust Law, it has been made clear that establishment of security trusts is allowed, and security interests granted can be held by the security trustee in favour of the secured creditors as beneficiaries of it. While there have been media reports relating to use of security trusts in syndicated loans, security trusts have been rarely used.

Trusts set up under foreign laws are recognised in Japan. However, careful determination of the governing law is required, as the statute providing for the choice of law does not explicitly address governing laws for trusts. Further, it is necessary to ensure the trustee does not violate or fail to comply with the Trust Business Law (*Shintaku-gyo-ho*).

### *Credit enhancement*

**21. What methods of credit enhancement are commonly used in your jurisdiction? Are there any variations or specific issues that apply to the credit enhancement techniques set out in the Model Guide?**

The methods of credit enhancement can be divided into internal credit enhancement and external credit enhancement.

#### Internal credit enhancement

In Japanese securitisation transactions, typical methods to achieve internal credit enhancement, that is, credit enhancement mechanisms incorporated into the structure, such as cash flow arising from or generated by the securitised assets, but which are independent from the creditworthiness of any specific transaction parties, are as follows:

- **Creation of subordinated tranches.** Typically, securitisation products, that is, securities issued by or from SPVs, are divided into multiple tranches. As a minimum, there are usually senior pieces that are sold to investors and a subordinated (junior) piece which is usually retained and held by the originator of the transaction. However, if the credit enhancement provided by the originator is too large (that is, if the subordinated piece is too large in relation to the size of the senior pieces) the true sale nature of the transaction as a whole is jeopardised. Therefore, the originator must not provide too large a credit enhancement. There can also be mezzanine tranches, sold to investors, to provide credit support to the investors in the senior tranche(s). In many cases, subordinated tranches represent the over-collateralised portion of the assets being transferred to the SPV. (*See also, Model Guide, Tranching the securities.*)
- **Creation of retained spread.** A mechanism called a default trap is often used which allocates to the resources an amount for principal payment for the senior tranche, from excess interest spread, corresponding to the amount of defaulted underlying receivables returned to the originator, excluding the amount repurchased by the originator.
- **Repurchase options and obligations.** In many transactions, the originator is entitled to repurchase underlying receivables, typically when the receivables became defaulted receivables. Or the originator must repurchase underlying receivables in whole or in part, depending on the circumstances, if and when there are, for example, misrepresentations in the representations and warranties by the originator, or if there is a breach of covenant by the originator. These repurchases also function as credit enhancement provided to the investors by, and with costs borne by, the originator. However, as with the creation of subordinated tranches, since the provision of too large a credit enhancement by the originator jeopardises the true sale nature of the transaction, the extent to which these repurchase options or obligations apply must be carefully drafted and sized appropriately. (*See also Model Guide, Credit enhancement.*)
- **Cash reserve.** In many cases, cash reserves are funded by the SPV retaining a part of the proceeds from the sale of the securitisation products. Therefore, the cash reserve is also viewed as an internal credit enhancement provided at the risk of and with costs borne by the originator. This means that the size and purpose of the cash reserves needs to be carefully designed so the true sale nature of the transaction as a whole is not jeopardised. It is usually necessary to distinguish between cash reserves for providing credit support and cash reserves for liquidity support (*see Question 22*). (*See also Model Guide, Credit enhancement, Creating retained spread.*)
- **Early amortisation.** By requiring that the loans to or securities issued by the SPV are redeemed if and when certain trigger events occur, this mechanism provides some comfort to investors because investors are repaid or otherwise paid before the securitised assets incur losses exceeding, for example, the size of the subordinated piece.

#### External credit enhancement

In Japanese securitisation transactions, typical external credit enhancements, that is, credit enhancements provided by, and relying on the creditworthiness of, third party providers (*see Model Guide, Credit enhancement*), are as follows:

- **Letters of credit/commitment line.** In most ABCP programmes, credit enhancement is provided by the sponsoring banks in the form of letters of credit or extension of commitment lines. Asset-backed securities (ABS) and other categories of securitisation may also feature letters of credit or commitment lines as external credit enhancements.
- **Guarantee, surety or insurance.** Similar to letters of credit or commitment lines, external credit enhancement providers may provide credit support to the transaction through a guarantee. As with letters of credit and commitment lines, since the credit support would rely on the creditworthiness of the provider of the guarantee, following the recent financial markets turmoil, there are fewer parties with both sufficient credit and the willingness to provide such credit support.

- **Credit derivative.** As an alternative to insurance, guarantee or surety, for example, a credit protection can be purchased through a CDS.

### *Risk management and liquidity support*

**22. What methods of liquidity support are commonly used in your jurisdiction? Are there any variations or specific issues that apply to the provision of liquidity support as set out in the Model Guide?**

Common methods of liquidity support in Japan are:

- **Cash reserve.** As with cash reserves for credit enhancement purposes, liquidity support is provided to transactions through the SPV retaining a part of the cash proceeds of the securitisation products sold to investors.
- **Letter of credit/commitment line.** A letter of credit or a loan facility in the form of line of credit (a commitment line) is sometimes (but not frequently) used for liquidity support to securitisation transactions.

## CASH FLOW IN THE STRUCTURE

### *Distribution of funds*

**23. Please explain any variations to the Cash flow index accompanying Diagram 9 of the Model Guide that apply in your jurisdiction.**

Typical cash flow waterfalls in Japan are not significantly different from the cash flow index accompanying Diagram 9 (*see Model Guide, Diagram 9 and box, Cash flow index*). However, the payment of taxes and public dues usually comes first above all other items.

### *Profit extraction*

**24. What methods of profit extraction are commonly used in your jurisdiction? Are there any variations or specific issues that apply to the profit extraction techniques set out in the Model Guide?**

It is common for the originator to receive compensation or consideration for the value of the credit enhancement it provides to the transaction, such as payments as distributions on:

- The subordinated trust beneficial interests.
- TK interests.
- Preferred equity of the (originator-owned or held) SPC.

In addition, as set out in the Model Guide (*see Model Guide, Profit extraction*), the originator can in some cases take fees for:

- Administering the receivables contracts and collecting the receivables.
- Arranging or managing the portfolio of receivables.
- Acting as a swap counterparty.

However, controlling receivables after the receivables are transferred to the SPV can raise doubts as to whether the transaction is a true sale.

## THE ROLE OF THE RATING AGENCIES

**25. What is the sovereign rating of your jurisdiction? What factors impact on this and are there any specific factors in your jurisdiction that affect the rating of the securities issued by the SPV (for example, legal certainty or political issues)? How are such risks usually managed?**

The ratings assigned to the debts of the Japanese national government are according to:

- **Moody's.** Issuer Ratings of Aa2 for debts denominated in a foreign currency and Aa2 for debts denominated in JPY.
- **Standard & Poor's.** Long-Term Issuer Credit Ratings of AA for debts denominated in a foreign currency and in JPY, and T&C Assessment (the rating associated with the probability of the sovereign restricting non-sovereign access to foreign exchange needed for debt service) of AAA.
- **Fitch.** Long-Term Issuer Default Ratings of AA for debts denominated in a foreign currency and AA- for debts denominated in JPY. For example, these ratings reflect a balance between the country's exceptionally strong external balance sheet and its deteriorating public finance position, which is already among the weakest of the advanced economies (*Fitch's press release of 2 September 2009*).

It seems that no specific consideration has been given to "country risks", such as legal certainty or political issues. Due to the frequent occurrence of earthquakes in Japan, securitisation products relating to real estate are rated on the premise that these products are influenced by seismic risks. However, seismic risks are usually hedged by earthquake insurance, or by keeping geographical variance in relation to the overall portfolio.

## TAX ISSUES

**26. What tax issues arise in securitisations in your jurisdiction? In particular:**

- **What transfer taxes may apply to the transfer of the receivables? Please give the applicable tax rates and explain how transfer taxes are usually dealt with.**
- **Is withholding tax payable in certain circumstances? Please give the applicable tax rates and explain how withholding taxes are usually dealt with.**
- **Are there any other tax issues that apply to securitisations in your jurisdiction?**

#### Transfer tax

No transfer tax applies to the transfer of receivables. However, the taxes described below can apply:

- **Registration and licence tax.** A registration and licence tax (*toroku-menkyo-zei*) is levied on registration applicants, including for registrations of assignment of receivables or security interests in real estate. The rate for the registration of transfers of mortgages in real estate is 0.2% of the tax base of the receivables amount (or maximum amount for umbrella mortgages (*ne-teito*)) unless otherwise reduced, for example by the use of a TMK that satisfies certain criteria.

- **Stamp duty.** A stamp tax (*inshi-zei*) is levied by the national government on the parties to various contracts, for example sale contracts or transfer agreements. For example, for a contract:
  - for the assignment of real estate, a stamp tax of up to JPY540,000 (about US$5,940) is imposed (the amount differs depending on the value of the contract);
  - relating to assignment of receivables, a stamp tax of JPY200 (about US$2.2) applies.

**Withholding tax**

Income tax is withheld from earnings such as:

- Bond interest.
- Dividends of surplus from corporations.
- Profit dividends from TK operators.
- Profit dividends from certain kinds of trusts.

15% of interest income (20% if combined with residence tax) or 20% of dividend income or profit dividends from TK operators is withheld as income tax, except for cases where recipients are exempted entities (such as qualified financial institutions satisfying certain requirements).

**Other tax issues**

For financial instruments involving the use of an SPC, there is an issue of double taxation arising from corporation tax being levied on SPCs (separately from and in addition to the tax imposed at the investor level). This is except for TMKs and J-REITs that satisfy certain criteria, which are essentially treated as pass-through entities for tax purposes.

To avoid the issue of double taxation in using a GK or KK as an SPC, TK interests are often used to pass, tax free, all the profits and losses to the investors. TMKs and J-REITs can also be used to achieve pass-through entity status for tax purposes (*see above*).

## SYNTHETIC SECURITISATIONS

**27. Are synthetic securitisations possible in your jurisdiction? If so, please briefly explain any particularly common structures used. Are there any particular reasons for doing a synthetic securitisation in your jurisdiction?**

A number of balance-sheet synthetic CDOs have been introduced and placed on the market (*see Model Guide, table, Classes of receivables*). In balance-sheet synthetic CDOs, the typical structure is as follows:

- The originating bank purchases credit protections from an SPV by entering into CDS transactions with the SPV, in which financial assets such as loans and bonds held by the originator itself are designated as reference obligations.
- Under the CDS transactions, the originating bank pays a CDS premium to the SPV periodically.
- The SPV typically opens and maintains a bank account with the originating bank in its own name. The SPV deposits into the bank account the entire amount of the proceeds from the sale of the securitisation products (that is, the bonds or other securities issued by or from the SPV).
- The SPV services its debts owed to investors with the amounts received from the originating bank, such as the CDS premium and the interest payments on the bank deposit.
- The bank account is provided to the originating bank as collateral for the SPV's obligations under the CDS. This enables the originating bank to achieve "credit risk mitigation" under the domestic rules relating to the Basel II Accord.
- If a credit event occurs in relation to reference obligations (or reference entities), the SPV applies the funds in the bank account to credit protection payments to the originating bank. An amount equivalent to the relevant protection payment paid to the originating bank is then deducted from the amount of principal to be repaid to the investors in relation to securitisation products.

These balance-sheet synthetic CDOs are often used by depository financial institutions to manage their risk assets portfolios and to achieve capital relief under the capital adequacy rules.

## OTHER SECURITISATION STRUCTURES

**28. Which of the various structures, set out in the Model Guide or otherwise, are commonly used in your jurisdiction?**

Most SPVs only issue a single series of financial instruments, with master trust structures and ABCP conduits being the only practical exceptions. Certain legal obstacles have limited market participants' willingness to establish a structured investment vehicle (SIV) programme and only a quasi-SIV programme has been introduced in Japan.

For real estate securitisations, the most common structures involve the transfer of interests in real estate conducted indirectly through transfers of trust beneficial interests. In this case, the seller or originator of the real estate commonly both (in the following order):

- Entrusts the real estate to a trustee under a trust agreement (converting the ownership interest in the real estate into a trust beneficial interest).
- Transfers the trust beneficial interest to the SPV for securitisation purposes.

However, these steps need not be applied if either:

- The transaction is conducted under and in compliance with the Real Estate Specific Joint Ventures Law.
- The SPV is a TMK (a corporate form chosen to use a transaction scheme that is not subject to the Real Estate Specific Joint Ventures Law).

## REFORM

**29. Please summarise any reform proposals and state whether they are likely to come into force and, if so, when. For example, what structuring trends do you foresee and will they be driven mainly by regulatory changes, risk management, new credit rating methodology, economic necessity, or other factors?**

In relation to regulation of rating agencies, the National Diet (Japan's parliament) passed a legislative bill in June 2009 to amend the FIEL. The bill will introduce a registration system for rating agencies. Under the system, rating agencies registered with the FSA will be both:

- Subject to certain duties and regulations under the FIEL.
- Supervised by the FSA.

Rating agencies will not be obliged to register with the FSA. However, there will be restrictions on unregistered rating agencies offering financial instrument transactions using ratings.

It was reported that the new prime minister Mr Hatoyama's cabinet is willing to pass a bill that would put a moratorium of up to a few years on payments of bank loans for small and medium enterprises. However, in light of the relevant legislative bill submitted to the National Diet on 30 October 2009, it appears that the effect of this legislation on securitisation transactions would be fairly limited. This is mostly because banks or other financial institutions will only be obliged to try to (but not actually be obliged to) grant a moratorium or other arrangement to their debtors.

Discussions have begun in relation to an announced plan for substantial amendments to the Civil Code (particularly the laws relating to contractual rights and obligations). It is difficult to predict the likely effect these amendments will have on securitisation transactions, as the scope and contents of the amendments cannot be predicted.

## CONTRIBUTOR DETAILS

**Hajime Ueno**
*Nishimura & Asahi*

**T** +81 3 5562 8500
**F** +81 3 5561 9711/9714
**E** *h_ueno@jurists.co.jp*
**W** *www.jurists.co.jp/en*

**Areas of practice/expertise.** Hajime Ueno joined Nishimura & Asahi in 1999. He is a partner who works predominantly in the area of financial transactions (with an emphasis on Structured Finance/Securitisation), both international and domestic, including Banking, Capital Markets, Asset Management, Asset Finance, Acquisition Finance and Venture Capital/IP Finance, as well as areas of M&A, Compliance and Real Estate/Environment.

Mr Ueno is a graduate of the University of Tokyo (LLB, 1997), the Legal Training and Research Institute of the Supreme Court of Japan, and Harvard Law School (LLM, 2004). He is a member of the Japan Bar (1999) and New York Bar (2005), and has worked on secondment at the New York firm, Skadden, Arps, Slate, Meagher & Flom (2004 to 2005).

Fluent in both Japanese and English, Mr Ueno has co-authored a number of international and domestic publications, including Whole Business Securitizations are Gaining Strength in Japan (Asialaw Japan Review, July 2007) and Amended Japanese Trust Law Legalizes Security Trusts (Asialaw Japan Review, July 2007).

**Akihiro Shiba**
*Nishimura & Asahi*

**T** +81 3 5562 8500
**F** +81 3 5561 9711/9714
**E** *a_shiba@jurists.co.jp*
**W** *www.jurists.co.jp/en*

**Areas of practice/expertise.** Akihiro Shiba is an associate who works predominantly in the area of financial transactions (with an emphasis on Structured Finance/Securitisation and Asset Finance), both international and domestic, including Banking, Asset Management and Project Finance, as well as areas of M&A, and Civil and Commercial Disputes.

Mr Shiba is a graduate of the University of Tokyo (LLB, 2005) and the Legal Training and Research Institute of the Supreme Court of Japan. He was admitted to the Japan Bar in 2007 and speaks Japanese and English.


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Ark Mori Building
1-12-32 Akasaka, Minato-ku, Tokyo 107-6029 JAPAN
Tel: 81-3-5562-8500
Fax: 81-3-5561-9711/12/13/14
URL: www.jurists.co.jp Email: info@jurists.co.jp

Contact Person: Mr. Akira Kosugi (Managing Partner)
Total Number of Attorneys: 436
Languages Spoken: Japanese, English, Chinese (Mandarin) and French