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Japan's New Financial ADR System

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October 2010 will mark the formal introduction of a new system of financial alternative dispute resolution (New Financial ADR) in Japan. In the past, alternative dispute resolution (ADR) has not been used as frequently in Japan as it has in other parts of the industrialized world, such as the United States and the European Union. However, though litigation is still the most utilized vehicle of dispute resolution by Japanese financial institutions, this will be changing, and changing soon.

Over the past two decades, disputes regarding financial instruments have skyrocketed and, as a result, the social consensus has flipped to ADR, as it more comprehensively covers all financial instruments and constitutes a means of settling disputes in a prompt and low cost manner. New Financial ADR in Japan will be modeled on the Financial Ombudsman Service (FOS) in the United Kingdom, but will not feature one comprehensive dispute resolution system in which one dispute resolution institution covers all disputes in the financial field. The New Financial ADR system is merely one step towards a foundation of comprehensive financial ADR such as FOS. It must be noted, however, that this all important first step was over seven years in the making, involving a great deal of discussion, debate, and compromise amongst many parts of Japanese government, business, and society.

Overview of Existing ADR in Japan

The following types of ADR currently exist in Japan: (1) judicial-type ADR, such as conciliation of civil affairs conducted by courts; (2) administrative-type ADR, conducted by administrative institutions such as the National Consumer Affairs Center of Japan; and (3) private sector-type ADR, which is organized by non-governmental commercial interests. The ADR employed in the financial field is the private sector-type ADR, which is organized by each industry group such as securities, banking, and insurance (including self-regulated groups such as the Japan Securities Dealers Association).

The resolution of disputes by the industry group organizations has proven to be far from effective. First, from a general investor's perspective, because these organizations were viewed as being creatures of their respective industries, they were thought to favor industry profits and disregard the protection of general investors and, thus, were not trusted or often used. When complaints were submitted to ADR, general investors often conceded that they were the ones at fault

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even when financial institutions had more knowledge and experience than those of the general investor. From the financial institutions' perspective, there was little incentive for the institutions to choose ADR because, two decades ago when issues concerning disclosure obligations (relating to risks inherent in investing in financial instruments) were first raised in Japan, many investor claims were dismissed and financial institutions were often the victors in any litigation filed against them. Even when a breach of an explanatory obligation by a financial institution was conceded in court, financial institutions still had no incentive to opt for ADR, given that the Japanese system of litigation does not offer class action suits or punitive damages, factors underlying the American companies' preference for alternative dispute resolution.

Some argue that even after the implementation of the New Financial ADR, most Japanese financial institutions may very well continue to opt for litigation when such an option is available, as there is a general sense of mistrust towards non-judicial means of dispute settlement within the industry. Additionally, many financial institutions fear the implementation of the New Financial ADR system, as they believe that such a set-up may lead to a large influx of new dispute filings.

In recent years, however, situations have frequently arisen, where the Japanese public has demanded more curbs on improper corporate behavior. The Akafuku scandal, in which a well known Japanese food producer sought to deceive consumers through the use of falsified product labels created an uproar and led to the strengthening of the Japanese consumer rights movement. The Livedoor scandal, in which a major Japanese internet company was found to have deceived investors through the use of fraudulently rosy financial data, helped strengthen the Japanese investor's rights movement. Through all these scandals, the general Japanese public was left with the impression that financial institutions continued to downgrade investor protection. These consumer- and investor-driven movements encouraged the development of the new system of financial ADR.

Details of the New Financial ADR System

The Financial Instruments and Exchange Act (the FIEA or the Act), which comprehensively regulates not only securities, but also a wide range of financial instruments, such as derivatives and funds, was enacted in June 2006. The FIEA establishes investor protection as one of its legislative purposes, but it primarily relates to the regulation of financial instruments and operates as an advanced means of preventing disputes amongst investors and various financial institutions. The New Financial ADR system, which was created by a June 2009 amendment to the FIEA, is meant to deal with every stage of financial-related disputes and, as such, strives to resolve disputes before they become significant and acts to ameliorate any post-ADR issues that may remain, thereby completing the FIEA's purpose to protect investors. Since the foundation of the New Financial ADR system applies to all related industries, new provisions were set out in 16 business related acts, such as the Banking Act, the Insurance Business Act, and FIEA itself.

Dispute Resolution Organizations

Under the New Financial ADR, there are organizations that are in charge of ADR. They are called "dispute resolution organizations" and are established by each

business category, namely banks, securities companies, life insurance companies, trust banking/trust companies, and non-bank money lending business operators.[1] Though not written directly into the language of the FIEA, the establishment of these dispute resolution organizations is in fact compulsory. The organizations are funded by fees paid by financial institutions in Japan.

Obligation of Financial Institutions

Once a designated dispute resolution organization is established, a financial institution must conclude a master agreement regarding execution of proceedings with the dispute resolution organization.[2] The master agreement must include language stating that (1) a financial institution is compelled to participate in the proceedings if a financial institution does not have any justifiable grounds for refusing participation when a consumer submits a claim to use the dispute resolution organization's ADR proceedings,[3] and (2) if a financial institution refuses disclosure without justification, a financial institution has an obligation to explain the circumstances behind the refusal and to provide pertinent documentation.[4]

The first requirement ensures the effectiveness of the ADR proceedings by compelling financial institutions to participate. The second requirement is basically a forced disclosure provision. As the new Financial ADR system is meant to assist in leveling the playing field between financial institutions and general investors, the FIEA has empowered investors in disputes with financial institutions with the ability to demand disclosure.[5] The company's disclosure obligation, however, is strictly confidential in nature. Dispute resolution committees, the bodies that administer the ADR proceedings, have a duty of confidentiality with respect to the materials submitted during an ADR proceeding, and materials used during the proceeding cannot be used in future litigation.

Resolution Procedures

As a general rule, a broad range of complaints and disputes related to financial instruments or services are covered by the New Financial ADR system. Not all businesses, however, fall within the new scheme. For example, real estate transactions (unless we are dealing with the now "toxic" real estate derivatives, such as mortgage-backed securities) are not included. There also are no written restrictions on users who are able to use ADR for financial disputes so individuals and corporate entities are included as users, and, in principle, financial institutions themselves are able to submit claims to dispute resolution organizations. In addition, neither a foreign entity nor a foreign individual shall be denied the ability to utilize the New Financial ADR system,[6] but a claimant can be denied access for frivolous claims. The individual dispute resolution committees have been empowered by the FIEA to deny a hearing to a claimant which they believe has filed frivolously or whose claim is not in line with the intent of the FIEA. Financial institutions may claim that certain arbitration demands are nothing more than an attempt at unjustly obtaining confidential corporate information. If such a claim is made, a dispute resolution committee may choose to halt proceedings as well.[7]

Dispute resolution committees execute dispute resolution proceedings and are appointed from attorneys, recognized judicial scriveners,[8] persons with experience in the financial institution business, consultants for consumers, and other relevant

parties.[9] The specific method of appointment and elimination of interested persons is voluntarily decided by each dispute resolution organization.[10] The kinds of rules or codes which a dispute resolution committee will rely on for making decisions are not clearly laid out by the Act. Strict verification,[11] such as that required in Japanese litigation, is not compulsory, and discussions have yet to reach any conclusion as to whether fact finding based on verification should be required or whether to seek a resolution which is agreeable to both parties, even if the method does not comply to strict judicial rules or precedents, a method used by some ADR systems.[12]

Some practitioners are concerned that in Japan, where, due to lack of experience, no best practices have been formally established, widely different approaches might be taken by each dispute resolution committee. Namely, there is the possibility for unbalanced conclusions, attaching too much importance to general investors' cases on the one hand and placing too much emphasis on financial institutions' profits on the other hand. There is the concern that unbalanced decisions would ultimately lead to a loss in trust towards the New Financial ADR system, which may lead to its ultimate failure. Issues related to best practices and consistency in award expectations will probably dominate any future discussion on the changes currently being implemented in the realm of Japanese financial ADR.

Effect of Using New Financial ADR Proceedings

The New Financial ADR system grants participating parties the ability to stop the clock on any statute of limitations which may correspond to any future possible court cases related to the dispute,[13] and further grants the ability to suspend related court proceedings while the parties are utilizing the New Financial ADR system.[14] More specifically, when an action is taken within one month from the close of dispute resolution proceedings, it shall be deemed that an action was taken at the time a request for dispute resolution proceedings was made.[15] It is possible for investors to proceed in parallel court proceedings to the dispute resolution proceedings, and it is also possible to use the ADR proceedings of the National Consumer Affairs Center of Japan. In this regard, the right to resolve a dispute in court will not be waived in Japan, which sometimes happens with Financial Industry Regulatory Authority arbitrations in the United States.

In addition, where financial institutions have not accepted dispute resolution proceedings or have not accepted a special conciliation proposal, the Ministry of Finance may issue an order compelling compliance if it is found that certain actions are necessary to ensure the appropriate operations of a financial institution's business.[16]

Impact of New Financial ADR System on Financial Institutions in Japan

On the compliance front, it seems that Japanese financial institutions have so far been focusing on not breaching the rules of business acts such as the FIEA, while showing less concern for general consumer protection. By creating the above described Financial ADR system, financial institutions now will be more directly exposed to consumers' claims, and as the number of cases will most certainly increase, additional breach of law claims likely will be brought to light through these arbitrations. Thus, it is apparent that financial institutions will have no choice but to

incorporate more of the consumer protection perspective into their compliance rules and even into their operations.

As alluded to above, some argue that even after the implementation of the New Financial ADR system, most Japanese financial institutions may continue to prefer litigation in dispute resolution scenarios, as there is a general sense of mistrust towards non-judicial means of dispute settlement within the industry. In addition, as stated above, disputes against financial institutions will probably boom as a result of this new legislation. Financial institutions are not viewing such an influx in claims positively. In Japan, as best practices have not yet been created, there is a risk that decisions may be too extreme by either being too biased toward general investors' protection or biased too heavily toward financial institutions' profit. If decisions favor general investors' protection, the above described financial ADR boom will likely become a certainty. To prepare for such a situation, financial institutions must ensure that they strengthen compliance more than ever before and work to take preventative action through internal audits.

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[1] Japan has a thriving, non-bank, high-interest loan industry which is not regulated by Japanese banking laws, but is instead regulated by laws specifically tailored for that industry called "KASHINGYOHO" in Japanese or the Money Lending Business Act in English.

[2] Financial Instruments and Exchange Act art. 37-7.

[3] Financial Instruments and Exchange Act art. 156-44, ¶ 2, Item 2.

[4] Financial Instruments and Exchange Act art. 156-44, ¶ 2, Item 3.

[5] The FIEA requires public disclosure of the financial institutions that refuse participation or disclosure without justification and the general claims made against them. Financial Instruments and Exchange Act art. 156-45, ¶ 1.

[6] A foreign financial institution, which has not been registered under the FIEA, is not considered to fall within the category of financial institutions that are subject to these disclosure obligations because the FIEA only applies to financial instruments businesses that have registered in Japan under the FIEA. The foreign financial institutions are not compelled to ascend to the forced jurisdiction of the FIEA-generated ADR organizations.

[7] Financial Instruments and Exchange Act art. 156-50, proviso to ¶ 4.

[8] Judicial scriveners represent one of the qualified legal professions in Japan. Their jobs are similar to that of an attorney, but are limited to acts in certain areas, such as representing their clients in the registration of real estate and the incorporation of companies, and representing clients in summary courts (courts with initial jurisdiction over (1) claims where the value of the subject matter of litigation does not exceed 1,400,000 yen, except for claims

pertaining to administrative case litigation, and (2) criminal cases where the maximum penalty is a fine), arbitration, and mediation proceedings, as well as in drafting legal documents to be presented to the courts.

[9] Financial Instruments and Exchange Act art. 156-50, ¶ 3.

[10] Financial Instruments and Exchange Act art. 156-44, ¶ 4, Item 2.

[11] Strict verification is a fact finding verification procedure by which evidence admissible to judges can only be examined through statutory procedures set out for such examinations at a public open trial.

[12] Satoshi Inoue, Norio Nakazawa, Toshiro Ueyanagi, *The Ideal Form of Financial ADR*, Kin'yu Homu Jijyo No. 1887, Jan. 5, 2010, at 58 – 61.

[13] Financial Instruments and Exchange Act art. 156-51.

[14] Financial Instruments and Exchange Act art. 156-52.

[15] Financial Instruments and Exchange Act art. 156-51, ¶ 1.

[16] Norio Nakazawa & Yasuo Nakajima, *The Summary of Alternative Dispute Resolution System in the Financial Field (Financial ADR System)*, Shoji Homu No. 1876, at 48.