Banking Regulation

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Contributing Editors:
Peter Hsu & Rashid Bahar

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Japan

Takashi Saito & Takehiro Sekine
Nishimura & Asahi

Introduction

While Japan is ranked as the third-largest economy in the strongly interconnected global economic system, Japanese banks have been faced with a severe economic environment, with historically low interest rates as well as a decreased birth rate and aging population in Japan. Accordingly, the banking regulations in Japan have engaged in enhancing the stability of the financial system, since the global financial crisis that started in 2008, and it has also been a major issue to reinforce the business bases for the banks. The banking regulations discussed below deal with various types of financial institutions. As of February 2020, there are more than 30 major banks, trust banks, etc., and approximately 100 regional banks, and more than 50 foreign banks have their offices located in Japan.

Regulatory architecture: Overview of banking regulators and key regulations

Key legislation and regulations

The primary law that regulates banks in Japan is the Banking Act (Act No. 59 of 1981) (the "**Banking Act**"), the purpose of which is: to preserve the credibility of bank services in view of their public nature; to achieve sound and appropriate management of bank services to ensure protection for depositors and facilitate the smooth functioning of financial services; and to thereby contribute to the sound development of the national economy. Under the influence of the discussions at international regulatory bodies and regimes, such as the Financial Stability Board (the "**FSB**"), the Basel Committee on Banking Supervision, and the Financial Action Task Force on Money Laundering (the "**FATF**"), the Banking Act and the relevant governmental orders and ordinances regulate fundamental issues concerning Japanese banks, including licences, governance, business scope, conduct, subsidiaries, accounting, resolutions, shareholders, bankholding companies, as well as mergers, company splits, and business transfers and acquisitions. They also regulate foreign bank branches and agency services on behalf of foreign banks.

Historically, banks in Japan have not been allowed to offer a broad array of universal banking services, and securities business by banks has been strictly regulated in Japan. However, banks may conduct limited securities services, if they are registered by the Prime Minister in accordance with the Financial Instruments and Exchange Act (Act No. 25 of 1948) (the "**FIEA**"), and have certain securities firms as their subsidiaries. The FIEA regulates banks as registered financial institutions (the "**RFIs**") in respect of their registration, governance, conduct, etc., related to their securities business.

While banks are allowed to engage in proprietary transactions, they must establish a special account for proprietary transactions if certain criteria are met with respect to the transaction

volume, and they must file a notification with the Prime Minister with respect to the account, the relevant division, accounting policy, etc., and manage the proprietary transactions in that account separately from the accounts for other transactions.

Key regulators

The principal regulator that supervises banks in Japan is the Financial Services Agency (the "**FSA**"). The FSA is an affiliated organ of the Cabinet Office, and the Prime Minister delegates a broad range of authorities to the Commissioner of the FSA, which cover both prudential supervision and consumer protection.

One of the mandates of the FSA is to issue guidelines that supplement the above laws and regulations, and the Inspection Manuals and the Supervisory Guidelines (including separate guidelines respectively for the three mega-banks and other major banks, etc. (the "**Major Banks, etc.**") and for small and medium-sized and regional financial institutions) have been important guidelines through which the FSA expresses its supervisory policy. The Supervisory Guidelines provide how laws and regulations should be applied in particular circumstances and how the procedures for licensing and regulatory sanctions should be operated, while the Inspection Manuals took the form of a comprehensive checklist intended to guide the FSA's inspectors about which aspects of the financial institutions they should look at when conducting on-site inspections. Although the Inspection Manuals played a key role during and after the financial crisis that accompanied the bubble economy collapse in Japan, it was recognised that the Inspection Manuals promoted a tendency to focus on formalistic, backward-looking and item-by-item checks. In June 2018, the FSA published its new supervisory approaches to shift to a more substantive, forward-looking and holistic analysis and judgment, and the Inspection Manuals were repealed in December 2019. Thereafter, the FSA has been issuing reports to present theme-specific approaches with respect to various issues such as prudential policy, compliance risk management, IT governance, and loan classification, write-offs and loan loss provisioning. These reports are not intended to be a checklist, but they are expected to provide perspectives which would facilitate dialogue between the FSA and financial institutions.

The Bank of Japan (the "**BOJ**") also monitors the business and assets of banks based on contracts to be concluded between the BOJ and each bank. If a bank refuses the surveillance by the BOJ without a just cause, then the BOJ may publish that fact and terminate the current account transaction with the bank. In addition, the Securities and Exchange Surveillance Commission of Japan undertakes surveillance on banks' securities-related business. Further, as discussed below, the Deposit Insurance Corporation of Japan (the "**DICJ**") is a key regulator with respect to troubled financial institutions.

Recent regulatory themes and key regulatory developments in Japan

Response to the financial crisis

After the recent global financial crisis, and subsequent international discussions that resulted in the Key Attributes of Effective Resolution Regimes for Financial Institutions, which were adopted by the FSB and endorsed by the G20 Heads of States and Government in 2011, several important rules were introduced in Japan to address the risks that financial institutions may face in financial crises.

The Deposit Insurance Act (Act No. 24 of 1971) (the "**Deposit Insurance Act**"), the principal law that deals with the protection of depositors and ensures settlement of funds pertaining to troubled financial institutions, was amended in 2013 to establish measures for the orderly resolution of assets and liabilities of financial institutions for ensuring financial system

stability, in addition to the already existing measures against a financial crisis, which consist of recapitalisation with public funds, financial assistance for an amount that exceeds the pay-off cost, and acquisition of the shares of troubled financial institutions. Under the amended Deposit Insurance Act, the Prime Minister may, following deliberation by the Financial Crisis Council, confirm the necessity to take certain measures for orderly resolution, when he/she finds that severe disruption may be caused in Japanese financial markets and any other financial systems, if appropriate measures are not taken with respect to a troubled financial institution. This confirmation (the "**Specified Confirmation**") classifies the subsequent procedures into two types, based on the status of the financial institution in question. If the troubled financial institution is able to satisfy its obligations in full with its assets, the DICJ may decide to provide the loan or the guarantee of obligations for that financial institution, or take certain other measures, so that the financial institution may perform its obligations with enhanced liquidity. On the other hand, if the financial institution in question is unable to satisfy its obligations in full with its assets, the DICJ may provide financial assistance to a financial institution that merges with or otherwise assumes the assets and obligations of the troubled financial institution, given that severe disruption is likely to be caused to the financial system in Japan by the discontinuation of business or default of obligations without such merger, etc.

In the case of the Specified Confirmation with respect to a financial institution unable to satisfy its obligations in full with its assets, the Prime Minister is to decide on the treatment of certain unsecured bonds, shares, and loans with contractual bail-in clauses, in the equity capital, etc. of the financial institution. Further, the Prime Minister may, following deliberation by the Financial Crisis Council, make a decision to the effect that a cancellation clause of certain contracts, to which the financial institution is a party, does not become effective, so that the troubled financial institution may avoid the automatic early termination when an orderly resolution measure under the Deposit Insurance Act is taken against the financial institution.

Auxiliary measures were also introduced for the orderly resolution to successfully proceed. When a petition has been filed against the financial institution for the commencement of bankruptcy proceedings, etc., the Prime Minister may express opinions on the timing of the relevant ruling or order, and other matters, to the court. Also, the above merger, etc. to proceed in accordance with the Deposit Insurance Act is exempt from certain provisions of bankruptcy laws that may impede swift liquidation. In peacetime, the Supervisory Guidelines require Global Systematically Important Banks ("**G-SIBs**") and other systemically important banks to report resolution and recovery plans annually, and when the group structure is largely changed.

With respect to the derivative transactions, the amendment of the FIEA in 2010 introduced mandatory clearing with the central counterparty, as well as the archiving and reporting of transaction information, which is to be disclosed by the FSA. Also, the financial instruments businesses operators (the "**FIBOs**") and the RFIs who undertake OTC derivative transactions must use an electronic data processing system after the 2012 amendment of the FIEA.

Reform to promote financial business in the changing environment

As Japanese banks face a severe business environment, the recent amendments to the Banking Act have been aimed to reinforce the financial intermediation function of the banks, with more flexible and efficient business operations and expanded business scope.

To improve the group-based business of the banks, the Banking Act was amended in 2016 to clarify the group management functions of banks and bank-holding companies, and added

to the business scope of bank-holding companies certain middle and back-office services common to the group companies to be performed on their behalf. Also, the regulations on outsourcing and funding among group companies were relaxed to enable the efficient use of resources in the group.

Historically, the business scope of banks and their subsidiaries have been strictly regulated in Japan, in consideration of the risks of non-banking business that may harm depositors. Banks are allowed to conduct (i) core banking services (which means: (a) acceptance of deposits and instalment savings, etc.; (b) lending of funds and the discounting of bills and notes; and (c) funds transfer transactions), (ii) exclusively enumerated services incidental to the core banking services, and (iii) certain other services specifically allowed under the laws. The scope of business of banks' subsidiaries is limited to certain finance-related services and ancillary services, in principle. Moreover, the Banking Act, together with the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (Act No. 54 of 1947) (the "**Anti-Monopoly Act**"), prohibits banks and bankholding companies from owning more than 5% and 15%, respectively, of the voting rights of other companies that do not fall under the types of subsidiaries and other specifically exempted companies, although there are certain exemptions for acquiring exceeding shares as a result of collateral execution, etc. While the shares in a company that a bank or a bankholding company holds as a limited liability partner or a non-executive partner, based on the type of partnership, may be exempted from the above 5% and 15% rule, they need to be careful about compliance with the rule if their affiliated company is involved in the partnership as a general partner or an executive partner.

However, the recent amendments of the Banking Act have gradually expanded their business scope, so that banks may have broader opportunities in addition to the core banking business. The amendment in 2016 introduced a new category of subsidiary, which made it easier for banks to invest in IT companies and regional trading companies. Also, the 2019 amendment of the relevant ordinance provided banks with more opportunities to support their clients in need of business succession by equity financing.

Moreover, mergers and acquisitions among banks have been and will be one of the fundamental solutions, especially for the regional banks, and an amendment of the Anti-Monopoly Act is expected to introduce a temporary relaxation of regional banks' M&A transactions.

IT / FinTech / Cyber security

IT and FinTech have also been major issues in the recent amendments to the Banking Act and the relevant laws and regulations, and there have been important amendments that relate to payment services. After the bankruptcy of one of the largest virtual currency exchanges service providers in 2014, and announcement of the guidance for a risk-based approach to virtual currencies by the FATF in 2015, the Payment Services Act (Act No. 59 of 2009) was amended in 2016 to regulate virtual currency exchange services, under which exchange services providers must meet financial, security and other requirements to be registered. The amendment of the Banking Act in 2017 introduced regulation on electronic payment service providers, under which an electronic payment service provider must be registered with the FSA and enter into a contract with the bank with which the service provider's customer has opened an account, so that the customer may be connected to the bank safely.

As for cyber security, the Supervisory Guidelines set out requirements for banks to establish a robust system structure against cyber attacks, and the FSA published cyber security guidelines in 2015 and updated them in 2018 to promote enhanced cyber security in the financial sector.

Bank governance and internal controls

Organisational structure

Under the Banking Act, a bank must be a stock company (*kabushiki-kaisha*) and must have in place the following administrative organs: (i) a board of directors; (ii) a board of company auditors, a supervisory committee or a nominating committee, etc.; and (iii) a financial auditor. A director engaged in the day-to-day business of a bank must have the knowledge and experience to be able to carry out the business management of a bank appropriately, fairly and efficiently. A director is also required to have sufficient social credibility, for which the director's past conduct, including any relationships with anti-social forces, will be examined. In addition, a director who is engaged in the day-to-day business operations of a bank must not engage in the day-to-day business operations of any other company without the authorisation of the Prime Minister.

The Supervisory Guidelines further state various requirements and viewpoints with respect to the governance of a bank, including appropriate board checks of the activities of the management, appropriate checks between divisions and appropriate functioning of the internal audit division. For instance, listed banks and listed bankholding companies are expected to have at least two independent outside directors.

The Supervisory Guidelines emphasise the function and independence of the internal audit division, with which the FSA conducts annual off-site hearings about the bank's risk management and compliance status, as well as the functions of the internal audit division.

In the Supervisory Guidelines, separating the departments is considered to be an important framework from various perspectives, such as separating the screening division from the sales and marketing divisions for appropriate credit risk management, separating the risk management division from the funds management division for appropriate liquidity risk management, separating the information system administrators from the system users for the protection of customer information, etc.

Remuneration

The Banking Act does not have specific provisions that regulate the amount, structure, procedure, etc. of the remuneration of the management. However, based on international discussions at the FSB, the Supervisory Guidelines provide viewpoints that should be considered with respect to the role of the remuneration committee, etc., and consistency between the bank's remuneration system and its risk management, so that the remuneration system of the banks does not provide incentives for excessive risk-taking by their management. Also, to deter such excessive risk-taking through market discipline, a governmental order under the Banking Act requires disclosure of important facts about remuneration, and a notice by the Commissioner of the FSA sets out the details of the information that must be disclosed.

Outsourcing of functions

Under the Banking Act, banks are required to take measures to ensure precise execution of its services if it entrusts them to a third party. The necessary measures include appropriate selection, monitoring, customer complaint handling, termination of the entrustment and substitution by another third party. The Supervisory Guidelines further present viewpoints with respect to the continuity of services, confidentiality and personal data protection.

Further, outsourcing core banking services is subject to strict regulation under the Banking Act, under which the entrusted third party is required to obtain a licence to conduct bank agency services, and the bank that entrusts such services is required to supervise the bank agent. Bank agency services under the Banking Act means performing any of the following

business activities on behalf of a bank: (i) acting as an agent or intermediary to enter into contracts to accept deposits or instalment savings, etc.; (ii) acting as an agent or intermediary to enter into contracts to lend funds or discount bills and notes; or (iii) acting as an agent or intermediary to enter into contracts for funds transfer transactions.

Bank capital requirements

Overview

Under the Banking Act, the Prime Minister is authorised to, and the Prime Minister delegates to the Commissioner of the FSA the authority to, establish criteria concerning whether the equity capital of a bank or a bankholding company is appropriate in light of circumstances such as the assets owned by that bank or bankholding company. In addition, the FSA is authorised to implement early corrective actions over banks and bankholding companies when such actions are necessary in light of the adequacy of the equity capital of a bank or that of a bank and its subsidiary companies, etc. Based on these authorities, the FSA has gradually implemented Basel III through its public notices since 2013.

Capital adequacy ratio

There are two ratios with respect to the capital adequacy of banks. Banks that have an overseas business base are subject to the uniform international standard, under which the banks need to meet the 8% Total Capital requirement, the 6% Tier 1 requirement, and the 4.5% Common Equity Tier 1 requirement. Banks that do not have an overseas business base are subject to the domestic standards, and these banks need to meet the 4% capital adequacy ratio in principle. Capital conservation and other buffers have been gradually implemented since 2016.

Liquidity standards

Banks that have an overseas business base are required to meet a 100% liquidity coverage ratio. If these bank fail to meet the liquidity coverage ratio, the FSA will request that these banks submit a report that explains the reasons for the failure and the measures to be taken to improve the liquidity coverage ratio, and will issue a business improvement order if necessary.

A public notice with respect to the Net Stable Funding Ratio, which was originally intended to come into effect in 2019, is yet to be implemented.

Leverage ratio

To inhibit an excessive accumulation of leverage, the FSA introduced the leverage disclosure requirement in 2015, but then the leverage ratio was integrated into the capital adequacy requirement in 2018. Banks that have an overseas business base are required to meet a 3% leverage ratio.

Total Loss Absorbing Capacity (TLAC)

The FSA's public notice to implement TLAC requirements was introduced in 2019. Currently, Mitsubishi UFJ Financial Group, Mizuho Financial Group and Sumitomo Mitsui Financial Group are designated as G-SIBs, and Nomura Holdings is designated as one of Domestic Systematically Important Banks (D-SIBs).

Rules governing banks' relationships with their customers and other third parties

Customer protection

Customer protection is one of the most important purposes of the Banking Act, and the Act generally prohibits banks from wrongfully using its advantageous position to put a customer at a disadvantage with respect to the conditions or implementation of a transaction.

In light of the information asymmetry between banks and their customers and the accountability of banks, the Banking Act, together with the Supervisory Guidelines, requires banks to provide information about the details of contracts, etc., and appropriate explanations based on the customer's knowledge, experience, financial condition and his/her purpose for entering the transaction.

Banks are also required to establish a system to protect the customers' interests in connection with transactions with a bank, the bank agent that has that bank as its principal bank, or the parent or subsidiary financial institution, etc. of the bank. More specifically, banks must take certain measures for this purpose, including developing a system to identify the subject transactions in an appropriate manner, developing a system to properly ensure the protection of the customer by separating the departments that conduct the relevant transactions, formulating and disclosing an implementation policy for the above measures, and keeping records of the relevant transactions.

Deposit insurance under the Deposit Insurance Act is part of the customer protection system in Japan, under which the DICJ is to pay insurance proceeds to depositors, etc. pertaining to insured events, such as a suspension of deposit refunds. The types of deposits to be insured under the Deposit Insurance Act include not only ordinary deposits, but also monetary in trust with principal guarantee, etc., but exclude certain deposits such as foreign currency deposits and negotiable deposits. While the deposits for the settlement purpose will be covered in full, the principal amount of most of the deposits will be insured up to 10 million yen.

Separately, securities business conducted by a bank as an RFI is subject to the regulations under the FIEA, and the RFIs owe a general duty to be sincere and fair to the customers, while various prohibited conduct is specifically stipulated in the FIEA. Also, certain provisions of the FIEA are applied *mutatis mutandis* to certain types of deposits which may cause a loss of the deposited principal amount due to interest rate fluctuations, etc.

From the data protection perspective, bank secrecy applies to banks based on the case law of the court. Although the rule is not clear, a bank may avoid violation of its confidentiality obligation (in terms of civil liability) if there is a good reason, taking into account the disclosed information and the purpose and manner, etc. of the disclosure. The Banking Act requires a bank to appropriately handle customer information that it acquires in the course of its services, and the Supervisory Guidelines require banks to establish an appropriate information management system, where leakage of customer information is swiftly analysed and reported to the FSA.

On the other hand, personal data protection is based on the statutory rules of the Act on the Protection of Personal Information (Act No. 57 of 2003) (the "**Personal Information Protection Act**"), which regulates the acquisition, use, outsourcing of treatment, disclosure, etc. of personal information. The Personal Information Protection Commission (the "**PPC**") is the principal authority to set forth guidelines and monitor business operators' compliance with the Personal Protection Act, but the PPC issues guidelines for specific business sectors jointly with the relevant authorities. The Guidelines on Personal Information Protection in the Financial Industry were issued jointly by the PPC and the FSA. Separately, the FIEA prescribes fire-wall regulation, under which information sharing by a FIBO or an RFI with its parent company, subsidiaries or other affiliated companies is prohibited, to prevent adverse effects to their customers.

Alternative dispute resolution

Banks are required to enter into a contract with the Japanese Bankers Association, a designated dispute resolution organisation under the Banking Act, in relation to their banking transactions.

Arm's length rule

The Banking Act prohibits a bank from conducting transactions with its related party (subsidiaries, major shareholders, parent bankholding company and its subsidiaries, etc.) that have terms and conditions disadvantageous to the bank, compared to the ordinary terms and conditions under which the bank effects transactions of the same type and the same volume under the same circumstances with other third parties, who are equal to the related parties in terms of the type, scope, creditworthiness, and other aspects of the business in which it engages. Transactions with a customer of the related party are also subject to this regulation. Further, as this regulation addresses harm to the sound and appropriate business operations of banks that may result from transactions with questionable terms and conditions, transactions that are unfairly disadvantageous to the related party or its customers are also regulated. However, an amendment of the relevant ordinance in 2016 relaxed this regulation so that a bank may conduct a transaction with another bank, which has the same bankholding company as its parent company, subject to governmental approval which may be given if the transaction in question is unlikely to damage the sound management of the bank and the bank clearly specifies the conditions for the relevant transaction.

Large exposure regulation

The Banking Act provides for a limit to the aggregate credit exposure to a single person or a group of related persons, so that the maximum loss that a bank could face in the event of a sudden counterparty failure may be limited to a level that does not endanger the bank's solvency. To meet the international standard, the regulation was amended in 2015 to cover the counterparty group more broadly, and the maximum amount for the credit exposure was set to be 25% of a bank's equity capital as a general rule (amended from the previous 40%), whereas credit exposure to a bank's major shareholder must not exceed 15% of the bank's equity capital.

Inbound cross-border banking activities

Historically, foreign banks that wish to engage in banking business in Japan had either to establish a local subsidiary in Japan as a separate entity and obtain a licence under the Banking Act, or open a foreign bank branch. If a foreign bank seeks to engage in banking business in Japan by opening branches in Japan, it must specify a single branch to serve as the principal base of that foreign bank's banking business in Japan, and must obtain a licence from the Prime Minister. Once the FSA confirms the appropriateness of the assets, business plan, representative and employees of a foreign bank branch, and the foreign bank obtains the licence, the principal foreign bank branch as specified above and the other branches and business offices of that foreign bank in Japan are deemed to be a single bank, the foreign bank's representative in Japan is deemed to be the director of the foreign bank branch that has been deemed to be a single bank, and therefore, the provisions of the Banking Act apply unless exempt in the Act, and the foreign bank branch is subject to the FSA's supervision. A foreign bank branch must always keep assets corresponding to its stated capital within Japan of at least the amount specified by the relevant order (currently 2 billion yen). The Supervisory Guidelines present the FSA's supervisory viewpoints, such as the position of the Japanese branch in the foreign bank's global strategy, appropriate staffing, and delegation of authority as well as supervision by the headquarters.

An amendment of the Banking Act in 2008 incorporated foreign bank agency services within the business scope of banks (Japanese banks as well as foreign bank branches) subject to the authorisation of the Prime Minister, while in principle the principal foreign bank (the foreign bank that entrusts a Japanese bank or a foreign bank branch with foreign bank agency

services) has to be a parent company, subsidiary, etc. of the entrusted bank. However, an amendment of the Banking Act in 2014 broadened the scope of foreign bank agency services to allow for banks to engage in services for foreign banks that do not have the above capital ties, as long as the foreign bank agency services are conducted outside Japan. In this case, foreign banks do not have to establish a bank or a bank branch in Japan.

AML/CFT

The Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007) (the "**Criminal Proceeds Act**") and the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949) (the "**Foreign Exchange Act**") are the principal laws that regulate matters related to anti-money laundering and combatting the financing of terrorism. Banks are required to check the identification of the counterparty (the name, domicile, and date of birth in the case of a natural person, and the name and principal place of business with respect to a judicial person) and maintain customer identification records and transaction records. Banks are also required to report suspicious transactions to the FSA. With respect to certain cross-border transactions and transactions that involve non-residents, the Foreign Exchange Act requires banks to check if the transaction in question is prohibited or requires governmental approval.

In 2019, the FSA issued the Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism (the "**AML/CFT Guidelines**"). Based on a risk-based approach as recommended by the FATF, the AML/CFT Guidelines clarify "required actions", which, if not taken, may result in the FSA taking necessary administrative actions such as issuing reporting orders and business improvement orders, and specify "expected actions" to be implemented by each financial institution. The FSA will also specify how it will monitor the implementation of the actions, and provide examples from previous monitoring activities or from foreign financial institutions of "cases of advanced practices", as a reference for financial institutions to pursue best practices. To evaluate and review each financial institution's management of the risks related to money laundering and terrorism financing, the AML/CFT Guidelines emphasise the importance of formulating PDCA, ensuring the involvement and understanding of the management, and defining the roles and responsibilities of the business division, the control division and the internal audit division.

Takashi Saito
Tel: +81 3 6250 6420 / Email: t_saito@jurists.co.jp

Takashi Saito is a partner at Nishimura & Asahi, specialising in banking & finance, especially in acquisition finance, subscription finance, syndicated lending, and other banking transactions as well as securitisations and other structured finance. In the field of acquisition finance where Mr. Saito is recognised as one of the leading lawyers in Japan, he has represented and advised major Japanese banks, mezzanine financiers and global and domestic private equity funds in a large number of acquisition financing transactions such as LBO/MBO. Mr. Saito also has an impressive reputation from *Chambers Asia-Pacific 2020* and *Global 2020*, *IFLR1000 2020* and *The Legal 500 Asia Pacific 2020* in the field of banking and finance.

Takehiro Sekine
Tel: +81 3 6250 6585 / Email: t_sekine@jurists.co.jp

Takehiro Sekine is a senior associate at Nishimura & Asahi, and advises on an extensive range of domestic and international financial transactions, including project finance, PPP/PFI, and venture capital finance. He has expertise in banking and securities regulations, and advises on various regulatory matters for domestic and foreign financial institutions. His experience covers complex group restructuring that involves banks and other financial institutions, as well as day-to-day compliance issues. Mr. Sekine is fluent in Japanese and English, and has experience working in London for a Japanese bank as a member of its EMEA legal division, after a year in the US where he obtained his LL.M. degree.

Nishimura & Asahi

Otemon Tower, 1-1-2, Otemachi, Chiyoda-ku, Tokyo, 100-8124, Japan
Tel: +81 3 6250 6200 / URL: www.jurists.co.jp

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