November 29, 1999
Financial Law Board

Note on Legal Issues on Financial Derivatives Transactions and Illegal Gambling*

1. Issues:

It was once the case that some derivatives transactions such as interest rate and cross-currency swaps, futures and interest rate and cross-currency options, which are now regarded as "basic" financial derivatives transactions (or products), entailed the risk of constituting illegal gambling under the Criminal Code (Criminal Code, Arts. 185 and 186). Additionally, there has been speculation that relatively new derivatives transactions related to securities (such as equity swaps), FRAs (forward rate agreements), FXAs (forward exchange agreements) and credit derivatives transaction also involve the possibility of being subject to criminal penalties for gambling. These situations became a prime factor for discouraging the participation in such derivatives transactions through market players[1]. Since there were no clear standards about these financial derivatives transactions[2] to indicate what kinds of derivatives transactions constituted illegal gambling, or what kinds of requirements had to be met, to avoid the application of the criminal law relating to gambling, the debate surrounding derivatives transactions and the risk of penalties for gambling has become one of the factors causing legal uncertainty for interested parties in financial transactions in the Japanese financial markets.

Several reforms under a ministerial ordinance and other enactments, especially the establishment of new laws and reform of existing laws, the enactment of governmental ordinances and ministerial ordinances (excepting certain provisions) under the Law for the Preparation of Related Laws about Reform of Financial Systems (so-called the Financial System Reform Law), which was implemented as of November 1, 1998, identified most of these

* We would like to thank Professor Atsushi Yamaguchi (Tokyo University) and Professor Hitoshi Saeki (Tokyo University) for helpful comments and suggestions. However, the views expressed here belong to the Financial Law Board.

[1] YOSHIHARU FUKUSHIMA, DERIBATHIBU TORIHIKI NO HOUMU TO RISUKU KANRI (Judicial Affairs and Risk Management of Derivatives Transactions), at 27 et. seq.

[2] In this report, the terms "financial derivatives transactions" and "financial transactions" include those related to securities and securities index, not only those related to interest rate and currency.

financial derivatives transactions as the business of financial institutions such as banks and securities companies. By virtue of this fact, such transactions have generally been considered to be "legalized" to that extent[3]. Nevertheless, various financial derivatives transactions, which are actually currently utilized, are not in fact covered by the above new regulations in terms of the participants and the precise kinds of transactions. According to these situations, there still remains some legal uncertainty as to whether derivatives transactions may correspond to the penalty for gambling[4] and, indeed, some uncertainty on other related points.

In light of the above situation, this Note examines whether it is possible to establish a proper standard for the application of the crime relating to gambling to certain financial derivatives transactions.

2. The constituent requirements of the crime relating to gambling:

Criminal Code, Art. 185 (the offense for simple gambling) stipulates an active subject as a person who gambles (provided that, this shall not apply when the bet of an object is made only for momentary amusement), but it does not define "gamble". Nevertheless, it is generally regarded that this provision follows the former context of this same Article before it was reformed[5], and generally "gambling" is defined as "an act to bet on the advantages and disadvantages of the benefit in terms of property by adventitious victory or defeat"[6]. "A person who indulges in gambling as a habitual practice shall be more strictly punished with penal

[3] Eiji Chatani, *"Kin'yu sisutemu kaikaku no tame no Kankei horitsu no seibinado ni kansuru horitsu" no Gaiyo* (Summary of The Law for Preparation of The Regulations Relates to The Reform of The Financial System), KIN'YU HOUMU JIJÔ, no. 1522, at 19, Nikko Shyouken Houmu-bu, *Kaisei shyouken torihiki hô no Kaisetsu (1)-Yuka Shouken ni kansuru Teigi kiteinado* (Explanation of the Reformed Securities and Exchange Law (1) - The Definition and Regulation about Securities), SHOUJI HOUMU, No. 1528, at 33, etc.

[4] Securities and Exchange Law, Art. 201, Financial Futures Trading Law, Arts 7 and 96, and the Commodity Exchange Law, Arts. 145 and 157, are generally understood as special regulations of the crime relating to gambling in the Criminal Code (Art. 185), and punish certain acts outside an exchange carried out by net settlement (i.e., settlement by payment of a difference of amounts). Nevertheless, by the Financial Systems Reform Law, it has become out of the extent of the object for punishment in terms of the constituent requirements as long as a party who is allowed to practice the relevant acts by the respective law regulating the business, basically relating to banks and securities companies, deals with such transactions. Though some issues are still left regarding whether the extent of application of these articles is clear enough or whether the classification of possible acts to be punished is appropriate in the view of constituent requirements, these issues are not discussed in this report.

[5] "About a game of chance, a person who plays for stakes or gambles on its property…"

[6] NORIYUKI NISHIDA, KEIHÔ KAKURON (Itemized Discussion of the Criminal Code), at 376.

servitude" (Criminal Code, Art. 186, Para. 1).

In financial derivatives transactions such as swaps and options, the existence of contractual obligations to pay money (or obligations to deliver an object) and its amount or quantity are determined by the numerical value (an interest rate, an exchange rate, a stock price, etc.) at a prospective specific point of time. Because of this, a derivatives transaction has the possibility of being considered to constitute a "bet on the advantages and disadvantages of the benefit in terms of property" by the occurrence of an "adventitious" fact. As a result, financial derivatives transactions are regarded as having the potential for corresponding to the constituent requirements of the crime relating to gambling. If some transaction is regarded as illegal by corresponding to that crime, not only will the parties be punished, but also the contractual effectiveness of the relevant act may be denied as offending "public orders and good morals" (Civil Code, Art. 90).

3. The ground for punishment of crimes relating to gambling and substantial unlawfulness:

There are different views on the grounds for prosecuting crimes relating to gambling (the legitimate interest to be protected thereby), and the existence of "substantial illegality" for acts which correspond to this crime are controversial. There is a view that the penalty should be understood by laying stress on the protection of individual property[7]. Yet, according to a commonly accepted interpretation of the existing laws, illegality is comprehended as an economic cultural crime which endangers the economic structure of society in general[8]. The precedent of the Supreme Court gave rise to this concept[9].

If the legal interest to be protected under the crime relating to gambling is general and abstract as above, it seems difficult to clarify the denotation of the constituent requirements of this crime related to its legal interest to be protected, and also to have a limited interpretation about the constituent requirements in light of its substantial illegality. This type of problem is common to Public Indecency (Criminal Code, Art. 174), and Distribution, etc. of Obscenity (Criminal Code, Art. 175), both of which are thought to have the same kind (or similar nature) of protected legal interest.

---

[7] RYÛICHI HIRANO, KEIHÔ GAISETSU (Outline of the Criminal Code), at 250 et. seq.

[8] EN NAGAI, *Sakimono torihiki ni taisuru Tobaku-zai Seihi no Genkai* (The Limit of The Result of Crime Relating to Gambling towards Futures Trading), KANAGAWA DAIGAKU HÔGAKU KENKYÛ JO KENKYÛ NENPÔ no. 10 (1989), at 107.

[9] 4 KEISHÛ 2380 (Sup. Ct. Nov. 22, 1950).

4. The possibility of punishing financial derivatives transactions:

Since financial derivatives transactions have already been socially acknowledged as a legitimate economic act, the conclusion that all of these transactions are regarded as illegal on the ground that they fall under a crime relating to gambling and that the party ought to be punished (moreover, the relevant act is considered to be against public orders and good morals (Civil Code, Art. 90), and the contractual force may be denied], is not easy to accept for persons who engage in those transactions. Besides, this theory is apparently not appropriate as compared with the roles which financial derivatives transactions actually accomplish (various risk hedges, an adjustment of supply and demand, offering diversified transaction methods or investment opportunities, etc.) in contemporary Japan as an international economic society, as well as in the other nations. Additionally, where one of the parties to a financial derivatives transaction is based overseas, the possibility that peculiar difficulties may arise due to the application of Japanese law would become one of the causes of anxiety towards the legal infrastructures of the Japanese financial markets for overseas parties. Therefore, it is necessary to seek a logical framework by which to eliminate the application of crimes relating to gambling to financial derivatives transactions, which are considered as socially legitimate. From this perspective, we would like to submit the following arguments for consideration.

[1] The limitation at the level of the constituent requirements:

There can be an argument that financial transactions (or certain of these transactions) do not constitute “gambling” at the level of the constituent (objective) requirements of the crime relating to gambling. In other words, since the constituent requirements of a crime are the types of illegal actions in substance, it would be possible to interpret that certain transactions inherently lack the requisite illegality, and then do not satisfy the constituent conditions. Under this theory, financial derivatives transactions would be eliminated from the subject of punishment of gambling at the level of the constituent requirements of the crime. This way of thinking is the most concise from a practical viewpoint.

This approach has an unfamiliar aspect for the traditional way of thinking that formally interprets a crime without considering the substantial unlawfulness in terms of the role and functions of constituent requirements of the crime. Besides, as mentioned above, since a commonly accepted theory has traditionally assumed abstract legal interests to be protected in terms of grasping the ground for punishment by the crime relating to gambling or its legal interests to be protected, this approach seems a little difficult to be taken as an interpretation of

the matters which lie between financial derivatives transactions and the crime relating to gambling under the present circumstances. However, it seems to be desired as the direction of future legislation in terms of practical precision as a norm for trading participants.

[2] The lack of unlawfulness - justifiable (business) act:

This theory leads to the conclusion that while financial derivatives transactions premise that they correspond to the constituent requirements of the crime relating to gambling (or entail such a possibility), financial derivatives transactions escape from punishment as a result of a lack of the requisite unlawfulness because they are regarded as justifiable acts (Criminal Code, Art. 35).

A justifiable act, which is stipulated in the Criminal Code, Art. 35, is generally classified as an ordinance act, which is "an act performed in accordance with laws and ordinances" (the fist half of the same Article) and a justifiable business act which is "an act performed in carrying on lawful or proper business" (the latter half of the same Article).

I. An ordinance act:

An ordinance act is practiced as a right or duty by written laws and orders. Such acts are justified even if they technically correspond to constituent requirements of a crime.

An ordinance act is usually further classified into the following three types[10]. First, an act which is regarded as a right or duty of a person who conducts such act under the provisions of law. For example, arrest and detention of the accused and the defendant based on the Criminal Procedure Act (Arts. 60 and 199, etc.), and also an arrest in flagrante delicto by a private individual (the same, Art. 213) and a disciplinary punishment of a person in parental authority (Civil Code, Art. 822), etc. Second, an act which is removed from illegality for policy reasons. For instance, a voucher with the prize money under the Voucher with Prize Money Act, and a betting ticket under the Horseracing Act, etc. Third, an act which is indicated as legitimate as a caution by law. When it is logically possible to admit the absence of illegality, this categorization clarifies legitimacy especially by establishing regulations and prevents deviation by setting a technical limitation about the method and range of behavior. Sterilization under the

[10] SHIGEMITSU DANDÔ, KEIHÔ KÔYÔ SOURON (The Elements of the Criminal Code, General Remarks), at 203 et. seq, DAI KOMENTÂRU KEIHÔ DAI 2 KAN (Article by Article Detailed Commentary on the Criminal Code, Vol. 2), at 259 et. seq.

Protection of Mother's Life and Health Act and the dissection of a corpse under the Dissection and Preservation of Corpse Act are given as examples.

Because the laws (especially laws regulating certain businesses) provide that banks and securities companies can be engaged in financial derivatives transactions[11], when a party practices financial derivatives transactions in accordance with the relevant laws, it has the full possibility of corresponding to the above-mentioned final type among the three types of an "ordinance act". Nevertheless, strictly speaking, the relevant laws do not necessarily prevent "deviation by setting a technical limitation about the method and range" for all financial derivatives transactions. Because of this, it seems necessary to verify the substantial legality of the relevant transactions besides the existence of the regulations in statutes.

II. A justifiable business act:

A justifiable business act, whose unlawfulness would be denied, is regarded as an act which is appropriate in light of the national general custom and the spirit of the law, or as a business act which is socially established.

Even though there is no provision of direct application in the relevant laws, a business act, the legitimacy of which is admitted as a social concept, is denied unlawfulness[12]. From this perspective, even if there were no regulations existing in the law regulating the business concerning financial derivatives transactions, if the relevant transaction is recognized as appropriate by general social concepts, its illegality would be denied[13]. However, when the ground of law does not exist, it is practically difficult to certainly consolidate the foundations of the transaction's lawfulness. Consequently, the existence of regulations in statutes is considered as the primary ground of the relevant transaction's legitimacy, and it seems rather desirable in terms of clearness of legal standard. Yet, in order to be denied illegality as appropriate business, it appears

[11] Banking Law, Art. 10, Para. 2, items 14 and 16, Banking Law Enforcement Regulations, Art. 13-2, Securities and Exchange Law, Art. 2, Para. 8, item 3-2, and Art. 34, Para. 2, item 5, Order relating to Securities Companies, Art. 24, etc.

[12] DAI KOMENTÂRU KEIHÔ DAI 2 KAN (Article by Article Detailed Commentary on the Criminal Code, Vol. 2), at 274, etc.

[13] Before the enforcement of the Financial Systems Reform Act, that is, even before there was no detailed law regulating the relevant business concerning financial derivatives transactions, financial derivatives transactions which had social equivalence, such as those mentioned later, should have been considered as avoiding illegality.

also to be necessary that the legitimacy of the relevant act from the social standpoint is verified.

5. Factors regarding the justification of financial derivatives transactions:

Under the Financial System Reform Law and the relevant cabinet order and ministerial ordinances, a wider range of financial derivatives transactions has been authorized as the activities of financial institutions. As a result, even though some financial derivatives transactions technically fulfill the constituent requirements of illegal gambling, the possibility that their illegality is denied on the basis that they constitute "ordinance acts" (see 4. [2] I) or "justifiable business acts" (see 4. [2] II) has become higher[14].

Nevertheless, if the ground to deny illegality as a justifiable act is eventually the fact that the relevant act is socially acceptable, provisions in statutes are not always decisive factors to judge whether the relevant act is socially acceptable, although such provisions are important indicative factors. Consequently, for instance, when a bank enters into a highly speculative transaction which has little economic rationality or necessity, such a transaction could theoretically be regarded as illegal gambling, even if the transaction takes a form of an FRA (forward rate agreement) included in the list of the authorized activities of banks[15]. On the other hand, the illegality of transactions shall be denied when such transactions are regarded as socially acceptable, even if such transactions have no legal basis in statutes (for example, in the case of transactions falling between the authorized activities of financial institutions or new types of transactions) or are made by parties not authorized to enter into financial derivatives transactions under the laws regulating businesses[16].

Therefore, it is worthwhile to discuss the substantial factors to be considered in deciding whether certain financial derivatives transactions shall be deemed socially acceptable and their illegality be avoided, regardless of whether the relevant types of transactions have their legal basis in statutes[17].

---

[14] Even before the Financial Systems Reform Law was enacted, socially accepted financial derivatives transactions should have been regarded as legal. (see note 13).

[15] Yukiko Ozawa and others, *Kin'yu Sisutemu Kaikaku-ho no Deribathibu Torihiki (1)-Ginnko-hen* [Derivatives Transactions Under The Financial System Reform Act (1) - Bank Edition], KIN'YU HOUMU JIJÔ, no. 1539, at 23.

[16] For example, transactions between a foreign financial institution and a Japanese non-financial business or between a Japanese trading company and a Japanese non-financial business.

[17] The discussion here is helpful, as discussed in the text of 4 [1], to determine the range of

It has been argued that factors regarding substantial justifiability or social acceptability of financial derivatives transactions include (i) the nature of parties involved (whether parities involved are entities having sufficient financial base and knowledge such as financial institutions), (ii) the purpose of the transaction (hedging or speculation), (iii) leverage ratio, (iv) maximum amount of loss (the size of the transaction), and (v) whether risk is taken by the trader or their customers. It appears, after all, that (1) social acceptability of the purpose of the transaction and (2) social acceptability of the transaction itself are two important factors[18].

As for the former factor (1), financial derivatives transactions for hedging purpose, that is, transactions to avoid, reduce and diversify the risk of fluctuation in value of financial transactions and assets, can be regarded as socially acceptable. It is appropriate to judge whether parties to a transaction have a hedging purpose according to the objective factors of the transaction itself, not according to the fact that the parties actually had such purpose in their mind. In addition, financial derivatives transactions can be justified when at least one party has a hedging purpose[19]. Moreover, in today's society and economy, financial derivatives transactions for speculation (transactions to make a profit) with unspecified parties, as well as hedging purpose, can be justified in certain situations. Although transactions for speculation have often been regarded as undesirable for the purpose of market participants, transactions for speculation should be regarded as lacking illegality as long as such transactions are executed under certain reasonable rules and the parties to the transactions have sufficient ability, knowledge and experience (see explanation about the factor (2) below), just as in the case of trying to make profits by investing in “cash” stocks.

The latter factor, (2) social acceptability of the transaction itself, is relevant to the following points: (i) whether the relevant transaction brings satisfactory effects in comparison with its purpose (e.g., hedging foreign currency risk); (ii) leverage ratio; and (iii) maximum amount of loss (the size of the transaction). In principle, financial derivatives transactions should be regarded as socially acceptable unless such transactions are extremely unreasonable or inappropriate where the transaction is not at all economically reasonable. In addition,

---

exceptions in applying illegal gambling to certain financial derivatives transactions to be regarded as out of the scope of the constituent requirements in future legislation.

[18] Osamu Sakuma, *Deribathibu Torihiki (Kin’yu Hasei Shohin) ni taisuru Keiji Kisei* (The Penal Prohibition towards Derivatives Transactions), KEIZAI TO KEIHO-NAKAYAMA KEN’ICHI SENSEI KOKI SHUKUGA RONBUNSHÛ (2) [Economics and the Criminal Code - The Collected Theses of Prof. Kenichi Nakayama Celebrating his Seventieth Year (2)], 1997, at 221.

[19] “Hedging purpose” of transactions is not necessarily limited to the traditional hedging purpose mentioned in the text. It seems to be possible that such transactions that financial institutions divide and sell out the risks belonging to themselves or other businesses in order to transfer or avoid the risks generally have justifiable purposes. See O. Sakuma, *supra* note 18, at 222.

financial derivatives transactions should be regarded as socially acceptable as long as parties to transactions are financial institutions or other institutional investors which have adequate asset size and knowledge and experience on general financial transactions and financial derivatives transactions, and such transactions are executed under reasonable rules.

6. Issues to be addressed in the future:

As discussed above, even after the enactment of the Financial System Reform Law, there remains legal uncertainty with respect to whether financial derivatives transactions ought to be regarded as illegal gambling. Therefore, it is desirable to reduce the degree of legal uncertainty by legislation.

There are two possible options with respect to such legislation. First, it is possible to stipulate general standards for avoiding illegality, apart from the current provisions of the laws regulating certain businesses (further discussion is necessary with regard to the appropriate form of such legislation). This option would be based on the understanding that socially acceptable financial derivatives transactions should avoid classification as illegal even if such transactions technically fulfill the constituent requirements of the offense of illegal gambling. Second, it is also possible to stipulate that financial derivatives transactions which fulfill certain standards or requirements shall not fulfill the constituent requirements of the crime of illegal gambling. This option seems similar to the approach of Financial Services Act in the United Kingdom[20]. The first option seems to better match the current legal system because we can acknowledge the continuity between this approach and the method of the Financial System Reform Law. However, the second option is more desirable in that such legislation clearly denies the possibility for financial derivatives transactions to be penalized.

[20] Financial Services Act of 1986 in England, Art. 63 stipulates that the act defined by the Regulation 1, Art.12, attached to the said Act, ("Dealing in Investments") falls outside the scope of the application of the crime relating to gambling, and the Regulation 1, Art. 12 defines "Dealing in Investments" as "Buying, selling, subscribing for or underwriting investments or offering or agreeing to do so, either as principal or as an agent".