(Provisional Translation)
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Financial Services Agency

Draft Blueprint for the Development of Institutional Frameworks Pertaining to Financial and Capital Markets

Introduction

In response to the recent global financial crisis, there have been various discussions held in Japan and overseas on such topics as over-the-counter (OTC) derivative transactions and hedge funds.

In view of these discussions and the actual condition of Japan's markets, the Financial Services Agency (FSA) decided to commence a detailed examination on the issues that Japan should address in preparation for the ordinary session of the Diet beginning early next year. In the "Development of Institutional Frameworks Pertaining to Financial and Capital Markets" issued on November 13, the FSA declared that it would conduct a survey of market participants and others on each of the following issues: (i) regulation of OTC derivative transactions, (ii) regulation of hedge funds, (iii) strengthening of securities clearing and settlement systems, (iv) consolidated regulation of securities companies, etc., and (v) ensuring investor protection and fair trade.

In addition to these issues being recognized in the recent financial crisis as important international issues, they were also recognized as problems that will need to be urgently addressed in Japan's financial and capital markets as well.

Based on the fact-finding survey of market participants and others, from the viewpoint of taking appropriate responses in the context of international discussions and the actual state of affairs of Japan's financial systems and financial industry, the FSA has compiled the "Draft Blueprint for the Development of Institutional Frameworks Pertaining to Financial and Capital Markets" as shown below. The FSA believes that the draft blueprint is conducive to improving the stability and transparency of Japan's markets and to ensuring investor protection through the implementation of measures for preventing the spread of financial crises in Japan and the regulation and supervision of financial instruments business operators and other market participants.

Going forward, the FSA intends to interview a broad range of market participants and others for a second time, before putting together its conclusions in a prompt manner.

I. Improving the stability and transparency of the settlement of OTC derivative transactions

Background

(1) Settlement risk for OTC derivative transactions that arose during the recent financial crisis

While large volumes of derivatives are traded over-the-counter among financial institutions, it has been pointed out that transparency of the market is insufficient, and that risk assessments are not necessarily being carried out properly.

Amid such circumstances, during the recent financial crisis, in Europe and in North America, where the majority of transactions take place (94.6% (as of June 30, 2009, based on BIS statistics)), concerns of financial institutions intensified over the risk that a counterparty to a transaction would be unable to settle due to bankruptcy (counterparty risk), especially for credit default swaps (CDSs) whose market infrastructure relating to settlement and clearing was inadequate. As a result, reductions in transactions were observed due in part to reductions in positions held at financial institutions and their avoidance of transactions, and concerns surfaced of a chain reaction of collapses by financial institutions (systemic risk).

(2) International developments

In response to this situation, the awareness of the importance of the following efforts increased across the world:

(i) reducing the settlement risk for financial institutions with respect to their transactions by making use of central counterparties (CCPs) (see Note) that act as counterparty to both trading parties, thereby centrally assuming the settlement risk and guaranteeing fulfillment of the transactions (hereinafter referred to as “mandatory CCP clearing”); and

(Note) The central counterparty (CCP) acts so as to minimize the settlement risk of claims/liabilities between the parties to a transaction. It does this by first assuming the debt from each party to the transaction and centrally offsetting (netting) the amounts to be paid and received, and then, on a daily basis, recalculating how much risk should be borne by the parties to the transaction in accordance with market trends (mark to market), and if it is a domestic CCP, demands collateral from the party concerned based on this calculation the following day. Moreover, from the perspective of strengthening their function of guaranteeing the fulfillment of transactions, CCPs are being required to strengthen their financial base, such as their equity capital.

(ii) sufficiently monitoring the status of transactions, thereby improving the market transparency;

In accordance with the increased awareness, the progress is being made internationally aimed at building infrastructures for the purpose of realizing mandatory CCP clearing of OTC derivative transactions and achieving improvements in market transparency, as well as legislating the regulatory frameworks postulating the infrastructure building.

Specifically, in light of the international agreement reached at the Summit on Financial Markets and the World Economy (hereinafter referred to as the “G20 Summit”), in the United States (US), a bill was introduced to Congress and is currently under discussion. The bill includes the mandatory use of CCPs for clearing standardized OTC derivative transactions, and requiring information on OTC derivative transactions to be reported to trade repositories. The European Commission has also publicized a communication similar to that of the bill in the US. Furthermore, at the G20 Summit, it was also agreed that non-centrally cleared

contracts should be subject to higher capital requirements.

(3) Present situations and developments in Japan

Clearing and settlement systems for securities and derivative transactions can be regarded as systemically important infrastructures that play both a role as a node for financial transactions and a role of blocking the spread of a crisis. Amid such circumstances, the present situation in Japan is that large amounts of interest rate derivative transactions are still being traded over-the-counter among participants. Consequently, an examination of institutional frameworks pertaining to mandatory CCP clearing is needed, with the focus on interest rate swaps – which account for a significant portion of transactions by Japan's financial institutions, and for which extensive cross-border trade relations have been built – and on CDS transactions – concerns over the stability of settlement for which were called into question during the recent financial crisis. Moreover, since last Autumn, considerations are being made in Japan to provide clearing services for interest rate swaps and CDS transactions.

Approach

(1) Ensuring the stability of settlement (mandatory CCP clearing, foreign CCPs, etc.)

(i) (a) As OTC derivative transactions are traded and settled over-the-counter, they entail the risk that a counterparty to a transaction will be unable to fulfill settlement due to its bankruptcy or other such reasons (counterparty risk). In particular, because counterparty risk becomes notable for large transactions, there is a risk of OTC derivative transactions of a large trading volume giving rise to concerns over market stability. For this reason, a possible effective measure would be to create a system in which CCPs would fulfill a role of blocking the spread of a crisis by making such transactions subject to mandatory CCP clearing.

(b) In order to achieve the reduction of settlement risk in Japan's markets promptly and effectively, it needs to be ensured at an institutional level that, in conducting mandatory CCP clearing, CCPs can identify the amount of risk which reflects the dynamics of Japan's markets in an appropriate and timely manner, and they can conduct necessary risk management quickly including participating financial institutions.

(ii) Based on an awareness of the issues described above, the mandatory CCP clearing of OTC derivative transactions conducted in Japan should ideally be undertaken by CCPs established in Japan. In particular, mandatory clearing at domestic CCPs would appear to be necessary for those OTC derivative transactions for which the clearing requirement of actual transactions is closely related to the necessary conditions for corporate bankruptcy in Japan.

(iii) At the same time, some market participants are also of the view that, if only clearing at domestic CCPs is made mandatory, there are concerns that Japan's OTC derivatives market may become hollowed out. For instance, more

transactions may be conducted overseas so as to avoid the domestic markets to reduce settlement risk. Consequently, given that most Japanese financial institutions conduct cross-border financial transactions, while bearing in mind such factors as economic rationality and the nature of the transactions, consideration also needs to be given to clearing mechanisms that include CCPs established in foreign countries.

In summary, while mandatory CCP clearing should ideally be achieved using domestic CCPs, a form of mandatory CCP clearing may also be sanctioned in which clearing is conducted through alliances between domestic CCPs and foreign CCPs (hereinafter referred to as the "link system"), in so far as they satisfy the requirements of CCPs as described above. Moreover, another possible measure may be to allow direct entry of foreign CCPs (in a form of branch etc.).

The intention of this initiative is, as described in the "Proposed Response" below, to first prepare an institutional framework related to CCPs for OTC derivative transactions. Moreover, in order to achieve stability of the settlement of OTC derivative transactions in Japan's markets, it is expected that the efforts being advanced in a private sector aimed at the commencement of clearing services by Japanese CCPs will take concrete shape as soon as possible.

(2) Improving market transparency (mandatory data storage and reporting of trade information)

(i) During the recent financial crisis, concerns over the settlement risk related to OTC derivative transactions, which was observed primarily in Europe and North America, was partly attributable to inadequate market transparency resulting in an insufficient understanding of the actual trade conditions. Furthermore, because of the inadequate market transparency, supervisory authorities also experienced difficulties when attempting to take action. Consequently, it would appear necessary to demand financial institutions to retain trade information and to report to the authorities, so as to ensure that the authorities can gain a full understanding of the actual state of OTC derivative transactions and they can then release part of that information to the market participants to improve market transparency.

(ii) In Japan, with respect to financial transactions including OTC derivative transactions, under the Financial Instruments and Exchange Act (FIEA), regulations are already in place relating to frameworks on the retention of trade information by financial institutions (financial instruments business operators, etc.) and reporting of such information to the authority.

(iii) On the other hand, as OTC derivative transactions are conducted bilaterally, at present, contracts and related information are not consolidated in one place as those of exchange-based transactions are. Furthermore, in order for the authority to gain sufficient understanding of actual trade conditions, it is important that they acquire information in a form which helps comprehend complex trade relationships and enables the identification of risk factors; and in order to achieve

this, the content of the trade information provided to the authority also needs to be standardized.

Recently, at trade repositories – the use of which is becoming more and more widespread among trading participants – coupled with the computerization of contract execution, trade information of the transacting parties is being stored centrally in a standardized form. Furthermore information on transactions cleared by CCPs is being stored centrally by the CCPs in a standardized form. In view of such circumstances, from the perspective of the authority having a sufficient understanding of actual trade conditions, a possible effective measure could be to enable the authority to acquire trade information from these trade repositories and CCPs.

However, as trade repositories and CCPs are not collecting trade information on all products at present, in view of the fact that market transparency could be ensured by directly acquiring trade information that satisfies the above requirements from trading participants in a comprehensive and timely manner, it is thought necessary to enable the acquisition of information directly from financial institutions at the same time.

Proposed Response

(1) Scope of the mandatory CCP clearing and the system of CCPs

(i) Mandatory CCP clearing of large-scale derivative transactions

○ It is necessary to include those trades within the scope of mandatory CCP clearing for which the transaction value in Japan is significant and that the reduction of settlement risk through centralized clearing would be deemed necessary for the stability of Japan's market (to be concrete, the "plain vanilla" interest rate swaps at present).

Although mandatory CCP clearing should ideally be undertaken by domestic CCPs, it is also necessary to consider ways to ensure that the settlement risk be reduced promptly, and that the economic rationality of Japan's market participants be maintained given that in reality trade relationships exist across nations.

From this perspective, in addition to mandatory clearing at domestic CCPs, it may be worthwhile allowing mandatory clearing using the link system between domestic CCPs and foreign CCPs that meet certain criteria as an option. Moreover, consideration could also be given to examining, as one of the possible measures, mandatory clearing at foreign CCPs.

○ If a foreign CCPs are to be permitted to enter into Japan's market through the link system, etc., in order to ensure stability and appropriateness for the provision of clearing services to Japan's financial instruments business operators, etc., certain entry requirements may be contemplated, such as:

・From the perspective of requiring risk management that appropriately reflects the dynamics of Japan's markets, foreign CCPs would be required to develop executive and administrative systems that are recognized as having a high degree of substitutability with the executive and administrative systems implemented by domestic CCPs to mitigate settlement risk, such as

"mark-to-market";

・Foreign CCPs shall be under the appropriate supervision of foreign authorities.

(ii) Mandatory clearing at domestic CCPs for derivative transactions that are closely related to execution under Japan's legal system

○ Necessity of clearing of derivative transactions, whose clearing requirements are closely related to the necessary conditions for corporate bankruptcy in Japan, should be judged at Japanese CCPs. Therefore, it is necessary that such transactions are centrally cleared at domestic CCPs for the stability of the domestic settlement of those transactions. In particular, perhaps the clearing of certain transactions, the turnover of which in Japan has reached a certain level, and for which mandatory CCP clearing is expected to contribute significantly to the reduction of settlement risk (to be concrete, iTraxx Japan CDS index is thought to be applicable at present) should be subject to mandatory clearing at domestic CCPs.

(iii) Business operators subject to the mandatory CCP clearing described in (i) and (ii) above

○ Given the purpose of mandatory CCP clearing, it would seem appropriate to make those financial instruments business operators, etc. with large-scale transactions subject to mandatory CCP clearing in the first instance, as the cost of transferring their positions to other financial institutions in the event of their bankruptcy (restructuring cost) may be significant.

Moreover, from the perspective of economic rationality of CCP, imposing the obligation of mandatory CCP clearing initially on financial instruments business operators, etc. with large-scale transactions also seem appropriate.

(iv) Strengthening the financial base of CCPs (domestically established) in parallel with mandatory CCP clearing

○ There is a strong need to strengthen the financial base of domestic CCPs, and the restrictions on major shareholders and capital requirement should be introduced.

* Specific level of capital requirement will continue to be examined.

(2) Data storage and reporting of trade information

○ From the perspective of improving market transparency, an institutional framework should be established that allows for the submission of trade information to the authority from the trade repositories and CCPs.

However, in addition to information submitted by the trade repositories and CCPs, the authority would also need to ensure ways to acquire information required for supervision through direct submission of information by financial institutions. (Details of trade information that the authority would actually need to attain in order to satisfy the above requirement should continued to be examined

while taking into account any future developments in international discussions.)

II. Strengthening the securities clearing and settlement systems, including for government bond transactions and stock lending transactions

Background

Transactions of Japanese government bonds (JGBs) are comprised of purchase-sale transactions and repos (loan transactions). The size of the market for repos (outstanding balance) is 81 trillion yen (balance as of October 31, 2009, Japan Securities Dealers Association (JSDA) statistics), and the balance of the call market is 16 trillion yen (balance as of October 31, 2009, Bank of Japan statistics). These figures illustrate that repos are positioned as a major means of financing by financial institutions in Japan's short-term money market.

With regard to purchase-sale transactions and repos of JGBs, the Japan Government Bond Clearing Corporation (JGBCC) has been providing clearing services including set-offs (netting) of cash payments, guarantee settlement and so on since 2005. At present, the JGBCC usage rate is dwelling at about 40 percent (based on Bank of Japan statistics) of all JGB purchase-sale and repo transactions. Amid these circumstances, when Lehman Brothers Japan went bankrupt in September 2008 and became incapable of making delivery of JGB certificates related to JGB purchase-sale and repo transactions in the JGB market, the amount of delays in delivery (settlement fails) for September 2008 subsequently accumulated to an unprecedented level of approximately 5.7 trillion yen in total. This resulted in market liquidity declining considerably in the repo market.

Furthermore, with regard to stock lending transactions, while transactions are being conducted bilaterally among financial institutions, institutional investors and so forth, compared to purchase-sale transactions of stock and JGB transactions, no system exists for delivery-versus-payment (DVP) settlement (where the delivery of securities and the payment of funds are performed simultaneously), and so settlement risk is not being reduced. In part because of this, when Lehman Brothers Japan went bankrupt, there were some business operators engaged in stock lending transactions who made delivery of shares to Lehman Brothers Japan but who could not take receipt of the corresponding funds.

Approach

With regard to the role of the JGBCC in the JGB market, at the time of the Lehman crisis in September 2008, although settlement fails in the market continued to occur up until the end of that October, the JGBCC by and large cleared up the settlement fails by the end of September (within two weeks after the collapse of Lehman Brothers Japan). Accordingly, in order to further utilize the risk-reduction function of the JGBCC, which was identified at the time of the Lehman crisis, it appears that measures need to be implemented for expanding the use of the corporation.

On this point, while market participants expressed views that were generally in

accord with the idea that greater use of the JGBCC is necessary, they also pointed out that in expanding the use of the JGBCC, its systems (financial base, personnel), capacity to procure funds/JGBs, and its operational performance are needed to be strengthened.

Furthermore, in order to reduce the settlement risk for JGBs and other securities, in addition to demonstrating the effects of concentrating clearing at the JGBCC, it appears that various measures need to be implemented without delay, including establishing and disseminating rules for handling settlement fails (fail practice) and shortening the settlement interval for JGBs.

Proposed Response

(1) Reduction of settlement risk for JGB transactions

○ Based on the presumption that the JGBCC, JSDA and other market participants will proceed with the following efforts, the FSA will consider the mandatory CCP clearing of JGB transactions as a statutory measure.

To that end, market participants are required to produce and publish a roadmap during the first half of next year which clarifies the deadlines for implementing each of the following efforts. (In light of the roadmap, mandatory CCP clearing could be adjusted to suit the timing of when shorter settlement intervals are to be achieved.)

(i) From the perspective of reducing the settlement risk for JGB transactions, the use of CCPs in JGB transactions should be expanded, and to that end, the system of the JGBCC shall be strengthened (specifically, the operation of new systems, and the improvement of the governance of the JGBCC; strengthening personnel, financial base, and procurement of liquidity and JGBs).

(ii) In order to reduce the settlement risk for JGB transactions and improve the merits for using CCPs, shortening settlement intervals and establishing and disseminating fail practices shall be pursued.

(2) Strengthening of the securities clearing and settlement systems relating to stock lending transactions

○ In order to reduce the settlement risk relating to stock lending transactions, considerations by the related parties should be advanced, and possibly the parties should promptly prepare and publish a roadmap that includes the timing for the mandatory use of CCPs or the development of rules for DVP settlement. (One possible target is for the roadmap to be prepared and published by the end of 2010.)

(3) Desirable structure of Japan's CCPs (improvement in the consistency of clearing systems)

○ There is a view that, if improvements can be made to the current situation where CCPs are separately established for each type of financial instrument (Japan Securities Clearing Corporation, JASDEC DVP Clearing Corporation, JGBCC, Osaka Securities Exchange, and Tokyo Financial Exchange), then this will contribute to make Japan's markets more competitive, including greater efficiencies

in provided services, in part, through cutting systems investment costs and other common costs.

It is hoped that, to start with, market participants will examine this point, giving due consideration to consistency of the clearing systems across different financial instruments.

III. Consolidated regulation and supervision of securities companies etc.

1. Introduction of consolidated regulation and supervision of securities companies

Background

(1) Current framework of regulation and supervision

With respect to securities companies (type I financial instruments business operators), from the perspective of ensuring investor protection and market fairness and transparency, the regulation and supervision of securities companies is, in principle, on a non-consolidated basis. This is intended to ensure the appropriateness of business operations as market intermediaries and the proper management of customer assets (see Note).

(Note) With regard to type I financial instruments business operator groups that are internationally active, the financial positions of the groups as a whole are assessed as a supervisory measure.

With regard to banks, in addition to the perspective of depositor protection, given that they serve a fund settlement function, regulation and supervision on a consolidated basis is in place, such as capital adequacy requirement on a consolidated basis and regulation on the scope of businesses permitted for group companies for the purpose of ensuring the stability of financial systems.

However, as the structures of securities companies continue to become larger and more complex (grouped), instances are now arising where it is difficult for the authority to ascertain the situations of business and risk management of the entire group. For this reason, in cases where a securities company provides large-scale and complex services as an entire group, there is a risk of the market intermediary function of the securities company becoming dysfunctional which could cause the adverse effects on a wide range of investors, and finally, could result in concerns about adverse effects on financial systems, as a consequence that the securities company suddenly fails due to financial or operational problems caused by its parent company or by its subsidiary or its sister company within the group.

(2) International developments

Internationally as well, in light of the experience in which the collapse of a leading US investment bank caused the cross-border effects on financial systems, national authorities are collaborating to monitor the operations and risk profiles of entire groups of major commercial banks and investment banks (including securities companies, etc.) that are active across national borders based on the agreement at the G20 Summit (supervisory college). Furthermore, as some overseas authorities

strengthen their supervision regarding the operations and risk profiles of foreign financial institutions operating in their countries, there are visible signs of them emphasizing the importance of business operations management, risk management and so forth on a consolidated basis.

(3) Regulation and supervision to be achieved

In view of the developments described above, in addition to supervisory measures, Japan, as the home-country authority, also needs to formally provide regulation and supervision on a consolidated basis for security companies that are engaged in large-scale and complex services as entire groups, especially which are internationally active. On the other hand, for financial groups whose home-country authorities are in other countries or regions, while monitoring of the operations and risk profiles of the entire groups should be done through regulation and supervision on a consolidated basis by the authorities in the relevant home countries, Japanese authority also needs to confirm business operations management, risk managements and so forth on a consolidated basis through regulation and supervision of Japanese subsidiaries of the groups. (Furthermore, closer cooperation with home-country authorities also needs to be developed through frameworks such as the supervisory college, by effectively using the information and other data that are obtained through the regulation and supervision of the Japanese subsidiaries.)

Approach

For securities companies that provide large-scale and complex services, and which operate with group companies in an integrated manner, it appears that solid and comprehensive risk management under proper business management on a group basis needs to be enforced. In view of this objective, capital adequacy requirement on a consolidated basis and other types of consolidated-based regulation and supervision should be formalized for securities companies whose overall operations and risks might be hard to identify under the current non-consolidated-based regulation and supervision.

On the other hand, for relatively small securities companies, given that their overall operations and risks can be monitored under the non-consolidated-based regulation and supervision, it appears that the current regulatory framework should be maintained.

Proposed Response

(1) Securities companies subject to consolidated regulation and supervision

○ Securities companies subject to consolidated regulation and supervision could be considered in the following way.

・ In determining which securities companies would be subject to group-wide consolidated regulation and supervision that includes parent companies, subsidiary companies and sister companies, qualitative judgments based on the nature of services might be necessary in addition to quantitative standards such

as the value of total assets.

- For banking groups, foreign-owned groups and other such groups for which it is regarded that the purpose of consolidated regulation and supervision have already been achieved through other industry laws or through the regulation and supervision conducted by foreign authorities, provisions may be needed to eliminate duplication of similar regulation and supervision. (However, it seems necessary that, for foreign-owned groups, conditions of the entire groups will have to be verified through the regulation and supervision of Japanese subsidiaries of the companies.)
- In cases that the parent company is a business corporation that implements risk-isolation measures, which means that the parent company does not conduct its operations with its securities subsidiary in an integrated manner, there is no need to make the group subject to group-wide consolidated regulation and supervision that includes parent companies. Instead, where necessary, consolidated regulation and supervision should target the said securities subsidiary and all of its subsidiaries. (In such cases, if a situation arises where the securities company is prevented from conducting appropriate business operations for reasons attributable to the parent company, then this should possibly be addressed by issuing orders for action against the major shareholder (see below).)

(2) Details of consolidated regulation and supervision

○ In view of the objective of enforcing solid and comprehensive risk management on a group basis, it seems that regulations including capital adequacy requirement on a consolidated basis and reporting requirement on sister companies and other group companies are needed. However, given that it is also considered that the goal of encouraging the diverse business development and the diversification and differentiation of management of securities companies under a registration system should continue to be maintained, the introduction of ex ante regulation, such as outright restrictions on the scope of business, should be avoided.

○ It seems that securities companies that provide large-scale and complex services as whole groups in an integrated manner should be subject to group-wide consolidated regulation and supervision which includes parent companies, sister companies and so forth, as the monitoring of operations and risk profiles of the entire groups is required.

On the other hand, when concerns arise over the financial position of a subsidiary of a securities company, it is likely that the financial position of the said securities company will also be adversely affected. Accordingly, for large securities companies, even in cases where they are not engaged in business in an integrated manner with their parent companies and they are not subject to group-wide consolidated regulation and supervision that includes their parent companies, consolidated regulation and supervision needs to be conducted which covers the securities company and all of its subsidiaries.

○ Taking into account the business model of securities companies, the current

framework for capital adequacy requirement, which is applied on a non-consolidated basis, focuses not just on the quality and quantity of equity capital, but also on liquidity. It seems appropriate that this perspective will also be incorporated when drafting capital adequacy requirement on a consolidated basis, and basically, regulation will be considered in a way that extends the existing non-consolidated-based regulation. Meanwhile, the so-called Basel II capital framework has taken root as an indicator of financial soundness for financial institutions with international operations. Consequently, for securities companies that apply Basel II capital regulation as they aim to expand internationally, perhaps it would be appropriate to allow for the application of the Basel II framework.

2. Strengthening regulations on major shareholders of financial instruments business operators

Background

The current system for type I financial instruments business operators and investment management business operators provides that, from the perspective of ensuring their soundness, major shareholders (in principle, a person holding 20% or more of the voting rights) of the operators shall be asked to submit notification to the authority, and in cases where a major shareholder does not satisfy eligibility criteria (previous administrative action history, criminal record, etc.), it can be ordered to sell its shares.

However, given that the system does not allow for business improvement orders to be issued to major shareholders of financial instruments business operators for the purpose of ensuring the appropriate business operations of the operators, even if a major shareholder were to take action that impedes the appropriate business operations of a operator, current laws and regulations do not allow for the major shareholders to be issued with orders for action needed for improving such situations.

* With respect to banks and insurance companies, from the perspective of ensuring sound and appropriate business management, orders for action can be issued to major shareholders who hold a majority of voting rights.

Approach

In view of the fact that the financial deterioration of a major shareholder might make it difficult for a subsidiary securities company to raise funds, and that a violation of the law or conflict of interest by a major shareholder might have an adverse effect on the management of a subsidiary financial instruments business operator, it appears that regulations on major shareholders relating to financial instruments business operators need to be strengthened.

Proposed Response

○ In such cases as where it is necessary for ensuring the appropriate business operations of a financial instruments business operator, more than just issuing an

order for a major shareholder to sell its stock, it appears that a system needs to be developed so that it allows for major shareholders who hold a majority of voting rights to be issued with business improvement orders.

○ There is a view that, in parallel with the above institutional developments, from the perspective of maintaining consistency with other industry laws, a registration system or other entry regulations should be adopted for major shareholders who could be issued with orders for action. The need for such system will continue to be examined from the perspective of avoiding over-regulation.

3. Consolidated prudential regulations of insurance companies

Background

With regard to groups led by insurance companies or insurance holding companies, from the perspective of protecting policyholders and so forth by ensuring the soundness of the group management, a certain level of regulatory and supervisory framework on a consolidated basis is already in place, such as inspections of and administrative action against group companies. However, the prudential standard (a solvency margin standard) is currently in place only for insurance companies on a non-consolidated basis.

In recent years, as organizational restructuring of the insurance industry has advanced, examples have been observed such as where the capital of an insurance company is increased using funds procured through loans by another company within the group. Hence, the need for having a quantitative understanding of the soundness of a group's entire financial standing has increased.

Moreover, one of the lessons learned from the recent financial crisis is that insurance companies can be adversely affected by problems attributable to the deterioration of business conditions for non-insurance companies within the same group. Given this, the G20 Summit and the Financial Stability Board have pointed out the need to establish the regulation of financial groups, and discussions on prudential standards on a consolidated basis have been advanced at the International Association of Insurance Supervisors. Under these circumstances, preparations are underway in the European Union (EU) for the introduction of solvency regulation on a consolidated basis in 2012.

Approach

With respect to groups led by insurance companies or insurance holding companies, for the purpose of ensuring protection of policyholders and so forth, there is a need for gaining a quantitative understanding of the financial position of the entire groups, and quickly identifying any risk of an insurance company being affected by the deterioration of business conditions for non-insurance companies within the same group. Based on this perspective, it would appear that prudential standards on a consolidated basis should be introduced, which would cover the entire group of companies.

Proposed Response

(1) Scope of application of prudential standards on a consolidated basis

○ For the purpose of protecting policyholders and so forth, there is a need to understand the risk of an insurance company being affected by the deterioration of business conditions of non-insurance companies within the same group. Given that this need is recognized regardless of the size or other such characteristics of the group, it would appear that the prudential standards on a consolidated basis should not just cover some part of groups, but should cover all groups led by insurance companies or insurance holding companies.

○ With respect to insurance holding companies, while they are able to hold general business companies as subsidiaries under the approval system, approval standards from the perspective of ensuring financial soundness are already in place, and so even if prudential standards on a consolidated basis were to be introduced, it would appear that, basically, maintaining the existing framework would be adequate.

(2) Timing for the introduction of prudential standards on a consolidated basis

○ With regard to prudential standards on a consolidated basis, while being mindful of consistency with international discussions, and taking into account the current state of the ongoing organizational restructuring of Japan's insurance industry, it appears that these standards should be introduced early.

IV. Hedge funds regulation

Background

(1) International developments

Hedge funds have not been necessarily regulated from the perspective of the stability of financial systems. As a result, it has been pointed out that, during the financial crisis in Europe and North America which began last autumn, hedge funds exacerbated the crisis such as through a reduction in leverage for transactions with investment banks and through massive sell-offs of managed stock to address the cancellation of contracts.

In view of the cross-border activities of hedge funds, a common understanding has emerged that the authorities in each country should regulate them from similar viewpoints wherever possible (to prevent evasion by utilizing the inconsistencies of regulation across countries), and international agreement was reached on appropriately regulating hedge funds through registration.

At present, discussions on the scope of hedge funds to be regulated, the content of the regulation and other such topics are continuing at various international fora, including at the International Organization of Securities Commissions (IOSCO), and Japan has been an active participant. Moreover, in the EU and the US, hedge fund regulations have been drafted and are currently under discussion by the parliament and congress respectively. Following are matters that are common to both the EU and US drafts, with other matters continuing to be examined.

・Scope of regulation:

Hedge fund managers (regulation according to the base laws of the countries in which the managers are located)

(persons who manage funds equal to or greater than a certain size posing potential systemic risk)

・Content of regulation:

Make it mandatory for managers to report to the authorities on their managed assets (leverage usage, etc.) on an ongoing basis, from risk management and other perspectives

(2) Japan's current regulatory framework

Under the FIEA, fund managers located in Japan are classified as investment management business operators, and are divided into (i) discretionary investment managers, (ii) investment trust managers, and (iii) collective investment schemes (self-managed).

Discretionary investment managers and investment trust managers are both regulated under a registration system. Collective investment schemes (self-managed) are, in principle, regulated under the registration system (notification system in the case of collective investment schemes for professionals). Managers under the notification system are also subject to reporting requirements and other types of supervision, and so regulations are in place in Japan which are equivalent to the international standard of "registration."

While there is no international consensus on a definition for "hedge fund managers," if we focus on the style of investment management (such as professional managers aimed at managing property entrusted by investors and increasing returns on them by utilizing such techniques as leverage, derivative transactions and long/short strategy), at present, we could classify them as being equivalent to either a discretionary investment manager or an investment trust manager.

Approach

During the recent financial crisis, stock prices in Japan fell more steeply than in Europe and North America, partly as a result of the sell-off of foreign hedge funds. In view of this fact, from the perspective of ensuring the stability of Japan's financial systems and preventing the evasion of regulations, perhaps hedge fund managers located in Japan should be regulated in a way that ensures consistency with international discussions.

In that case, it appears that care needs to be taken so that deliberation is conducted based on the main object of the hedge funds regulation aiming to address the systemic risk, while taking into account the actual circumstances in Japan.

Starting with the international developments described above and the state of the development of laws and regulations in Japan, the key issue for Japan to be considered is possibly the expansion of the items required to be reported by hedge

fund managers who are already registered.

Proposed Response

(1) Expansion of the scope of registration

○ Under the FIEA, hedge fund managers are subject to regulation as registered discretionary investment managers and as registered investment trust managers (see "Japan's current regulatory framework" above). Meanwhile, collective investment schemes for professionals, which are subject to the notification system, in effect, center on real estate funds, venture funds and so forth, and in terms of investment management businesses, their scale of operations is small. Accordingly, given that they have not been confirmed as falling under the category of hedge funds which could entail systemic risk (based on a fact-finding survey by the FSA), at present, there seems to be no need to change the regulation to make them subject to registration (see Note).

(Note) With respect to the managers of (self-managed) collective investment schemes for professionals, which are subject to the notification system, the FSA has decided to regularly conduct their monitoring, and in the future, will consider making them subject to registration institutionally as necessary, if hedge fund managers which could entail systemic risk are identified among them.

○ Collective investment schemes for professionals, which are based overseas, and in which the funds of Japanese investors are less than or equal to a certain percentage, are exempted from notification. At present, given that international discussion on these overseas-based funds is proceeding along the line that the authorities in the country where a fund is located should appropriately regulate it using a universally common set of standards, there seems to be no need to change the scope of Japan's notification system.

○ However, although the style of investment management, where investment trusts marketed to Japanese investors are set up abroad and given instructions directly from within Japan, is not covered by current regulations based on the FIEA, such investment management of hedge funds can be found in Japan, albeit infrequently. Consequently, it seems that persons conducting such investment management should be subject to registration.

(2) Expansion of the reporting requirements pertaining to the risk management of funds

○ With regard to the reports made by hedge fund managers to the authorities, in view of international discussion, it would appear that the items to be reported should be expanded in collaboration with other countries. These would include ongoing reports to the authorities on the risk management of managed assets.

V. Ensuring investor protection and fair trade

1. Revision of the professional investor system with regard to local governments

Background

Under the FIEA, investors are divided into “professional investors” and “general investors.” By applying regulations on the conduct of financial instruments business operators in accordance with this division, attempts are being made to make the regulation more flexible.

Currently, local governments are classified as “professional investors who can opt to become general investors.” Thus, if local governments do not opt to become general investors, the regulations on conduct of business, such as the obligation to deliver them documents, including a written description of risks, do not apply to financial instruments business operators. Amid such circumstances, it appears, however, that some local governments are purchasing complex financial instruments that require a high degree of financial knowledge.

Approach

As long as a local government does not opt to become a general investor, it will be treated as a professional investor. However, as the number of complex financial instruments that require a high degree of financial knowledge has been increased, given that some local governments do not necessarily have systems in place which enable them to make investment decisions based on necessary financial knowledge, only those local governments that seek to become professional investors change status to that of professional investors and the obligation for documents and so forth to be provided by financial instruments business operators should be waived for them.

Proposed Response

○ Given that some local governments do not necessarily have systems in place which enable them to make investment decisions based on necessary financial knowledge, from the perspective of further enhancing investor protection, perhaps they should be classified as “general investors who can opt to become professional investors.”

○ In the event it is decided to classify local governments as “general investors who can opt to become professional investors,” a need will arise for any local governments that wish to continue to be treated as professional investors to first become general investors and then opt to become professional investors once again. It appears, therefore, that a way will need to be devised to facilitate this procedure.

2. Regulation of unsolicited offers for overall derivative transactions

Background

Under the revised Financial Futures Trading Act which came into force in 2005 (the Financial Futures Trading Act was integrated into the FIEA when the FIEA was enacted in 2006), the prohibition of unsolicited offers was introduced on the basis of

damages incurred by users. Currently, under a Cabinet order authorized by the FIEA, only OTC financial futures transactions (including OTC foreign exchange (FX) transactions) are subject to the ban on unsolicited offers.

In recent years, contract for difference (CFD) transactions, which are similar to OTC FX transactions, have become widespread among individuals. Furthermore, with the 2009 revisions to the Commodity Exchange Act resulting in a ban on unsolicited offers being introduced for commodity derivative transactions as well, some derivative transactions at exchanges are also on track for becoming subject to the ban on unsolicited offers.

Approach

On the one hand, there is a view that overall derivative transactions, including exchange-based transactions, should be made subject to the ban on unsolicited offers, and that preventive measures should be taken against the occurrence of problems related to compliance with the principle of suitability.

On the other hand, there is another view, primarily among financial institutions, that such a ban would consequently impede the development of Japan's financial services, as financial institutions would no longer be able to provide clients with appropriate information on products. In particular, as there may be occasions when active solicitation of derivative transactions is needed in order to meet the hedge needs of client asset holdings, there is a view that such transactions should be exempted from the ban on unsolicited offers.

In light of these two different points of view, it appears that discussion needs to be deepened further on how unsolicited offers should be regulated for derivative transactions overall.

Proposed Response

○ The FSA will continue to exchange views with market participants and users on whether overall derivative transactions, including exchange-based transactions, should be made subject to the ban on unsolicited offers. The FSA will move forward with its examination so that a conclusion can be reached in the first half of 2010.

VI. Other

Development of a reporting system for short selling

Background

As permanent measures for the short selling of securities, traders are currently obliged to verify and flag whether a sale is a short sale or not, and in principle, the short selling at a price no higher than the latest market price is prohibited.

During the recent financial crisis, while taking into account trends in various foreign countries, the following temporary measures were also adopted in addition to the permanent measures described above (until January 31, 2010):

・A ban on naked short selling (introduced on October 30, 2008)

・An obligation to report and disclose any short positions which, in principle, equal or exceed 0.25% of the total outstanding stock (introduced on November 7, 2008)

In various foreign countries where short selling regulations were introduced initially as a temporary measure, movements have been seen to make the enhanced short selling regulations permanent or to extend the temporary measures. Some countries have also made it a requirement to report positions of derivative transactions including OTC derivative transactions, and a report published by the IOSCO in June 2009 on the regulation of short selling suggests including derivatives in the reporting system be considered.

Approach and Proposed Response

○ With regard to the system for reporting and disclosing short positions, which was introduced as a temporary measure, for the time being, the FSA will keep a careful watch on market conditions and will take action accordingly.

Meanwhile, while taking into account trends in other countries, the FSA will continue to consider in a comprehensive manner as to the future perpetuation of a system for reporting and disclosing short positions, including the following points:

・What items should be disclosed.

・Whether and how positions of derivative transactions including OTC derivative transactions should be required to be reported.

At such times, whether to review the method of reporting, including changing from the current system whereby clients report to exchanges via member securities companies, to a system whereby they report directly to the authority.

・How price regulation ought to be.