(Provisional Translation)
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Financial Services Agency

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 current ordinary session of the Diet. In the "Development of Institutional Frameworks Pertaining to Financial and Capital Markets" published on November 13, 2009, the FSA decided to 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.

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 published the "Draft Blueprint for the Development of Institutional Frameworks Pertaining to Financial and Capital Markets" on December 17, 2009. Following another round of public consultative exercise regarding the blueprint, aimed at obtaining a broader range of opinions from market participants and others, the "Development of Institutional Frameworks Pertaining to Financial and Capital Markets" has been finalized as shown below. The FSA believes that this document is conducive to improving the stability and transparency of Japan's financial system 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.

In addition, in cases where administrative penalty has been imposed on fund sales agents and trustee companies, at present a risk exists concerning the protection of investors and beneficiary assets, owing to the fact that the FSA does not have the authority to initiate bankruptcy procedures of the fund sales agents or appointment of alternative trustees, etc. Therefore in order to protect the investors and beneficiaries, improvements to the system to deal with such situations will be made.

Going forward, the FSA further takes steps to improve the system, including the presentation of a draft bill for consideration at the Diets during the current session.

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

During the recent global financial crisis, in addition to the fact that financial institutions in the US and Europe traded vast amounts of OTC derivatives on a bilateral basis, they have not necessarily conducted risk appraisals relating to individual trades or stored and accumulated trade information appropriately, resulting in (1) heightened concerns on counterparty risks for OTC derivative trades owing to concerns of default of traders of individual transactions, (2) heightened concerns of systemic risk among financial institutions, due to lack of transparency within the OTC derivatives market.

In response to such concerns, it has been considered that the following objectives need to be achieved through developing the systems relating to central clearing of OTC derivatives:

- To deter a materialization of counterparty risks of OTC derivative transactions (risks associated with an individual financial institution becoming bankrupt, etc.) from resulting in a materialization of risks within the overall OTC derivatives market.

- For individual trades that are centrally cleared, to ensure that individual financial institutions mark-to-market and manage collaterals adequately,
- To ensure that CCPs mark-to-market on a daily basis for trades that have been centrally cleared, timely and appropriately grasp the risk to the trades reflecting the developments of Japanese market, and seek from financial institutions appropriate levels of collateral proportional to the risk incurred, thereby contributing to risk management of the market as a whole,
- To ensure that CCPs obtain appropriate information required for the clearance of OTC derivative transactions.

Also, concerns relating to settlement risks associated with OTC derivative trades are partly due to the fact that the trade and settlement occurs bilaterally, and so lacks market transparency and that the nature of the trade remains unclear. Supervisory authorities also experienced difficulties in determining the necessary course of action due to the inadequate market transparency.

Therefore, it is important for the authorities to establish systems in which they can require CCPs to provide information related to OTC derivative transactions that are centrally cleared and acquire bilateral trade information that are not centrally cleared, thereby:

- Enabling the authorities to strengthen the monitoring of OTC derivative transactions during normal times as well as to take swift and appropriate actions in an emergency; and,
- Enabling the authorities to provide the market with partial information in order to enhance the transparency and predictability of the market.

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

(i) (a) There is a risk of OTC derivative transactions of a large trading volume giving rise to concerns over market stability through a materialization of counterparty risk of large transactions. For this reason, such transactions should be 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 CCPs are required to thoroughly implement necessary risk management in conducting their business by identifying the amount of risk which reflects the developments of Japanese markets in an appropriate and timely manner through daily mark-to-market and by promptly seeking from financial institutions appropriate levels of collateral proportional to the risk incurred.

(c) It is necessary to consolidate information of transactions such as information of Japanese financial institutions and their counterparties involved in the transactions into CCPs by means of mandatory CCP clearing. This enables CCPs to appropriately acquire information of transactions subject to mandatory CCP clearing and the authorities to grasp the full picture of Japan market by requiring information from CCPs. In addition, it is also necessary that the authorities publish part of acquired information in order to enhance transparency of the market of Japan.

(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.

(iii) However, 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, it is appropriate to sanction a form of mandatory CCP clearing in which clearing is conducted through an alliances between a domestic CCP and a foreign CCP (hereinafter referred to as the “link system”), or through direct entry of a foreign CCP (in the form of a branch, etc.) in so far as they satisfy the requirements of CCPs as described above.

However, whilst the international protocol which is typically employed by market participants should be respected, central clearing by domestic CCPs is required with respect to OTC derivative transactions for which the clearing criteria relates closely to the corporate bankruptcy criteria under the domestic law. For such transactions, domestic CCPs who have thorough understanding of the domestic legislations should be appropriately involved (see Note) in the determination of the necessity of clearing and maintain the right to voice opinions where necessary as contracting party of the transactions.

(Note) At present, certain foreign CDS clearing houses provide under their operational regulations that where the trade participants do not undergo determination by themselves, they undertake the decision.

The intention of this initiative is, as described in the “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 together with gaining the understanding of the market participants.

(2) Improving market transparency (mandatory data storage and reporting of information regarding transactions that are not centrally cleared)

With respect to OTC derivative transactions that are centrally cleared, information of the transactions will be consolidated into CCPs and CCPs can acquire information of the transactions in a standardized form such that comprehending complex trade relationships and the identification of risk factors are enabled.

On the contrary, information of bilateral transactions that are not centrally cleared is not necessarily consolidated. However, it is expected that with the computerization of contract execution advancing, trade information of those transactions would be stored centrally in trade repositories. Therefore, it is necessary that the authorities can acquire information from trade repositories besides from CCPs.

In addition, as trade repositories and CCPs are not collecting trade information on all products at present, it is also necessary that the authorities can attain necessary information by means of requiring information directly from financial institutions. Therefore, a regulatory framework that enables the authorities to require financial institutions to report their transaction information in a way that is consistent with information reported by trade repositories and CCPs.

Furthermore, it is also necessary that the authorities provide part of their acquired information with the market so that transparency and predictability of the market is enhanced.

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, mandatory clearing using the link system between domestic CCPs and foreign CCPs and mandatory clearing at foreign CCPs will be admitted, provided that they meet a set of entry requirements as mentioned below.

○ For foreign CCPs entering into Japan's market through the link system and direct entry, it is necessary that a regulatory framework equivalent to the one applicable to domestic CCPs is created in order to ensure stability and appropriateness for the provision of clearing services to Japan's financial instruments business operators, etc.

Under such framework, the FSA will supervise whether the foreign CCPs continuously satisfy the following entry requirements:

・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”, from the perspective of requiring risk management that appropriately reflects the dynamics of Japan’s markets;

・Foreign CCPs will 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

○ As for OTC derivative transactions for which the clearing criteria relates closely to the corporate bankruptcy criteria under the domestic law, whilst the international protocol which is typically employed should be respected, domestic CCPs who have thorough understanding of the domestic legislations should be appropriately involved in the determination of the necessity of clearing. Also, domestic CCPs need to maintain the right to assert their views concerning the determination as the contractual party, given that they assume liabilities associated with the transactions. Therefore, in respect of such trades, central clearing by domestic CCPs is necessary for the stability of the domestic settlement of those transactions. In particular, 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.

However, in implementing the central clearing for these trades by domestic CCPs, it is first required to achieve necessary conditions such as the early establishment of domestic CCPs and examining optimal clearing costs at these CCPs through close discussions between such CCPs and market participants .

(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 88 trillion yen (balance as of November 31, 2009, Japan Securities Dealers Association (JSDA) statistics), and the balance of the call market is 18 trillion yen (balance as of November 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.

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 this 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).

Furthermore, if clarification on interpretation of related laws and regulations and treatments on industrial practice are necessary in using JGBCC, these issues should be promptly addressed.

(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.

However, there is an opinion that exchanges should do both clearing business and trading business of their financial products in an integrated manner from the viewpoint of smooth and effective risk management operation.

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 and what kind of measures contributes to reducing clearing costs in Japan.

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 cooperation among authorities and 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, solid and comprehensive risk management under proper business management on a group basis needs to be enforced. In view of this objective, it is appropriate to formalize capital adequacy requirement on a consolidated basis and other types of consolidated-based regulation and supervision 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, the current regulatory framework should be maintained.

Response

(1) Securities companies subject to consolidated regulation and supervision

(i) When concerns arise over the financial position of a subsidiary of a securities company, it is likely that the financial position of the securities company will also be adversely affected. For the reason, all of large securities companies above a certain value of total assets should be made subject to consolidated regulation and supervision that covers the securities company per se and their subsidiaries.

(ii) Among them, those securities companies that provide services as whole groups together with their parent companies and sister companies should be subject to monitoring of operations and risk profiles of the entire groups including their parent companies. Therefore, those securities companies will be subject to group-wide consolidated regulation and supervision that covers their parent companies and sister companies and so forth.

In this case,

(a) when group-wide consolidated regulation and supervision has already been conducted based on other industry laws, provisions are needed to eliminate duplication of similar regulation and supervision.

(b) when a parent company of the securities company is subject to regulation and supervision by foreign authorities, or the parent company does not conduct its operations with its securities subsidiary in an integrated manner, appropriate measures should be adopted taking the actual circumstances of the regulation and supervision, etc. into consideration. (It seems necessary that, for foreign-owned groups, conditions of the entire groups are verified through cooperation among authorities and the regulation and supervision of Japanese subsidiaries.)

In order to make the above judgments, securities companies referred to in (i) are required to provide some information regarding their parent companies including the situation of their regulation and supervision and financial positions.

In cases such as (i) and (ii), if a situation arises where the securities company is prevented from appropriately conducting business operations for reasons attributable to the parent company, then this will be addressed by issuing orders for action against the major shareholder (see below).)

<u>(2) Details of consolidated regulation and supervision</u>

○ 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, ex ante regulation, such as outright restrictions on the scope of business, should not be introduced.

○ 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. 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, the application of the Basel II framework will be allowed.

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.

(Note) 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, regulations on major shareholders relating to financial instruments business operators need to be strengthened.

In addition, current regulatory framework, in which major shareholders (in principle, a person holding 20% or more of the voting rights) are subject to reporting requirements, etc., will be maintained.

Response

○ In such cases as where it is necessary to ensure the appropriate business operations of a financial instruments business operator, besides just issuing an order for a major shareholder to sell its stock, the institutional framework will be developed so that it enables the authority to issue business improvement orders against major shareholders who hold a majority of voting rights.

○ 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.

○ In the development of above institutional frameworks, from the perspective of avoiding over-regulation, it is appropriate to enable the authority to issue necessary orders under the notification system.

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 is appropriate that prudential standards on a consolidated basis should be introduced, which would cover the entire group of companies.

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 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, it is appropriate that these standards should be introduced early, taking into account the current state of the ongoing organizational restructuring of Japan’s insurance industry.

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 from autumn 2008, 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,” managers who use the same style of investment management as hedge fund manager (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), could be generally classified as being equivalent to either a discretionary investment manager or an investment trust manager. However, at present, discretionary investment managers or investment trust managers who use the same style of investment management as hedge fund managers are limited in Japan.

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, it is appropriate that hedge fund managers located in Japan are regulated in a way that ensures consistency with international discussions.

In that case, 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 the expansion of the items required to be reported by hedge fund managers who are already registered.

Response

(1) Expansion of the scope of registration

○ Under the FIEA, managers who use the same style of invest management as 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 is 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 is no need to change the scope of Japan's notification system.

○ However, the style of investment management (excluding invest management that is classified as discretionary investment management) where a foreign investment trust is set up 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, managers conducting such investment management will 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 and also taking into account the actual condition of invest management, the items to be reported including ongoing reports to the authorities on the risk management of managed assets need to be expanded in collaboration with other countries.

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.

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 for housebound seniors who are mainly targets of unsolicited offers. In addition, there are views that the view that unsolicited offers inhibit the financial innovation is not true because the market size of FX transactions has been expanded in spite of the tightening regulations on them, and that the ban on unsolicited offers is an effective regulation on malicious business operators.

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. Moreover, there is a view that even if the ban on unsolicited offers is to be introduced, it should be introduced as self-regulation by the industry.

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.

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.

3. Expansion of the right for the authority to file a petition for commencement of bankruptcy proceedings for all types of financial instruments business operators

Background

In recent times, cases of fraud have been occurring among dealers of collective investment scheme (fund) interests and investment management firms of fund assets, which are now subject to regulation under the FIEA. Examples include such sellers (corresponding to Type II financial instruments business operators) and investment management firms (corresponding to investment management business operators) misappropriating funds contributed by investors. In the event the authority identifies this kind of case, it has taken swift and strict administrative action against the said business operator, such as rescinding their registration or suspending their business operations, in an attempt to limit the extent of damage. However, even if administrative action is taken, the fund assets still remain under the management of the business operator.

Under the Act on Special Treatment of Corporate Reorganization Proceedings and Other Insolvency Proceedings of Financial Institutions, from the perspective of commencing treatment in a timely and appropriate manner in the event of bankruptcy of a financial institution, and preventing any increases in processing costs and so forth due to delays in the commencement of treatment, the authorities (the Commissioner of the FSA) is permitted to file a petition for commencement of bankruptcy proceedings for certain types of financial instruments business operators (securities companies) in cases where there are facts that could trigger the commencement of bankruptcy proceedings.

However, with respect to financial instruments business operators aside from securities companies (Type II financial instruments business operators, investment management business operators, etc.), which are not subject to the law, the authority is not able to file petitions for the commencement of bankruptcy proceedings.

For this reason, in instances like the above, there is a risk of further funds flowing from financial instruments business operators that are not subject to the filing of petitions by the authority for the commencement of bankruptcy proceedings based on the said law. Moreover, there are also cases where fund assets are not processed steadily, and funds are not returned promptly to contributors and so forth.

Approach and Response

When a case of fraud arises for a dealer of a collective investment scheme (fund) interests (corresponding to a Type II financial instruments business operator) or a investment management firm of fund assets (corresponding to an investment management business operator) and the authority has taken administrative action, it would be an effective way for the authority to issue an order for the commencement of bankruptcy proceedings and place fund assets under the control of a bankruptcy trustee supervised by the court for the purpose of limiting the extent of damage to investors. However, under the current system, petitions for the commencement of bankruptcy proceedings can only be filed by oneself or by a creditor. The only response available to the authority is to make recommendations for voluntary bankruptcy. Consequently, from the perspective of investor protection, in cases where there are facts that could trigger the commencement of bankruptcy proceedings, the scope for which the authority is able to file petitions for the commencement of bankruptcy proceedings will be expanded from only some financial instruments business operators (securities companies) to all financial instruments business operators.

4. Expansion of the right for the authority to file a petition for the appointment, etc. of new trustees such as when a trust business' license is rescinded

Background

In the event a trust business has had its license or registration rescinded, although the trustee has an obligation to keep custody of the trust property, with the dispersal and loss of its human resources and with the suspension of transactions with its trading partners, it is expected that its capacity to manage property will decline over time. Therefore, a new trustee or an administrator of trust property needs to be appointed promptly once a trustee is removed.

However, under the Trust Act, the removal of trustees, the appointment of new trustees and the appointment and removal of administrators of trust property is basically left to the discretion of the interested parties concerned. Under the Trust Business Act, courts are able to remove trustees upon petition by the authority, however, there is no mechanism by which petitions can be filed by the authority for the appointment of new trustees or the appointment or removal of administrators of trust property. As a result, it may take time to coordinate the appointment and so forth of a new trustee or an administrator of trust property, and it may become difficult for trust property to be managed appropriately.

(Note) Just last year, a case occurred in which a trust business had its license rescinded. Because the case related to a trust contract based on the former Trust Act, in which the appointment, etc. of administrators of trust property by the court's own authority is permitted, procedures for the appointment of an administrator of trust property were carried out smoothly. However, in the future, supposing a trust business has its license or registration rescinded, under the current legal system, by reason of the above, it may take time to coordinate the appointment and so forth of a new trustee or an administrator of trust property, and it may become difficult for trust property to be managed appropriately.

Approach and Response

Under the current legal system, it may take time to coordinate the appointment and so forth of a new trustee or an administrator of trust property and it may become difficult for trust property to be managed appropriately, as explained above. Therefore, from the perspective of protecting beneficiaries, the FSA will develop systems which allow the authority to file petitions such as for the appointment of new trustees or administrators of trust property in the event a trust business has had its license or registration rescinded.

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 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 keeping in mind a view that the current short selling regulation in Japan, including uptick rule, is relatively strict internationally and 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:

- How price regulation ought to be.
- 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.
- What items should be disclosed.