



Minister Yamamoto received a courtesy call from Vu Van Ninh, Minister of Finance, Viet Nam (January 31)



Minister Yamamoto made an address at the meeting of the Working Group on the Selection of an Acquiring Party for the Ashikaga Bank (February 8)

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## **【Topics】**

### **Notes on the Annual Supervisory Policy for the Supervision of Major Banks and the Annual Supervisory Policy for Securities Companies**

The “Annual Policies for the Supervision of Major Banks, etc. for Administrative Year 2006” released to the public in August 2006 specified the priorities in dealing with the diversification of asset management techniques. “At major banks, etc., there is a trend to secure revenue through such new techniques as increasing, for example, “(i) credit derivatives trading, (ii) loans targeted at real estate funds, and (iii) alternative investments. Whether or not the risks associated with such new trading patterns are being accurately identified and managed must be verified.”

The “Annual Policies for the Supervision of Securities Companies, etc. for Administrative Year 2006” also released to the public in August 2006 specified its priorities. For customer protection, “investment trust businesses, investment corporations’ asset management businesses and investment advisory businesses must continue to be strictly checked as to whether there are any breaches of the duty of loyalty or the duty of care of a good manager with respect to customers”; and for the development of an adequate business operations system, “the importance of properly managing legal risks and rumor risks is deemed to be growing in line with the increase in potential conflict of interest, etc. due to the diversification and complexity of operations. Based on this reality, risk managements systems pertaining to securities companies, etc. must be examined through comprehensive interviews, etc.”

In consideration of these policies, the Financial Services Agency (FSA) conducted interviews with financial institutions between October and November 2006 for the purpose identifying the actual state of investments and loans geared towards real estate funds. Based on the interview findings, the FSA has decided to add the following notes to the corresponding Annual Policies as matters that require attention.

#### **1. Land Price**

- Land prices in the commercial districts of the three major metropolitan areas are increasing for the first time in 15 years. This is attributable to the dramatic increase thereof in some regions, which is pushing up the average rate of increase for the metropolitan areas in their entirety.
- The areas in which rent is actually increasing are limited to certain areas, such as central Tokyo. The increase in land prices so far appears to be largely driven by expectations of future rent increases.

#### **2. Also,**

The real estate fund market is expanding, as exemplified by suggestions that the balance of real estate owned by active real estate funds (based on book value) has more than doubled in the last 18 months.

#### **3. Under these circumstances,**

- (1) Trust banks seem to be getting tougher on screening trusts in consideration of the administrative action taken this spring with respect to real estate management and liquidation trusts.
- (2) On the other hand, efforts in non-recourse loans geared towards the real estate funds of major banks, etc. vary significantly between financial institutions. In general, however, they increased by approx. 30% from ¥5 trillion during the period ending in September 2005 to ¥6.6 trillion in the period ending in September 2006. It is necessary to pay close attention to whether appropriate risk management is being carried out in consideration of industry concentration risks, etc.
- (3) With respect to J-REIT investment companies, etc., it is necessary to continue keeping a close eye on the development status of their systems so as to execute operations in a fair and accurate manner, such as systems to prevent transactions that give rise to conflict of interest and systems for due diligence upon acquiring property.
- (4) With respect to securities companies, it is necessary to continue to closely observe their system of screening upon underwriting J-REIT, offering interest in private-placement real estate funds and putting together Commercial Mortgage Backed Securities (CMBS), etc. and how they provide an explanation to customers when selling those products.

According to these Annual Policies, the FSA will endeavor to enhance collaboration with the inspection divisions and to conduct supervisory administration in a strict, effective and efficient manner.

## Financial Inspections Pursuant to the Implementation of Basel II

### 1. Introduction

On December 26, 2006, the Financial Services Agency (FSA) published a document entitled “Financial Inspections Pursuant to the Implementation of Basel II”.

Basel II (a set of new capital adequacy requirements) is an accord that was reached in June 2004 by the Basel Committee on Banking Supervision following the revision of the existing capital adequacy requirements, whose objective is to achieve international harmonization of banking supervision in different countries. Specifically, it consists of three pillars: the first pillar relates to the minimum capital requirement, the second relates to self-supervision by financial institutions and supervisory review, and the third to market discipline. The aim thereof is to make financial institutions’ risk management more sophisticated. The first pillar requires the refinement of capital adequacy ratio calculations. Specifically, this requires the refining of credit risk measurement and the re-introduction of operational risk measurement into the calculation of capital adequacy ratio. The second pillar requires financial institutions to properly identify and manage the risks to which they are exposed as a whole, including those not covered within the framework of the first pillar. The third pillar requires improved effectiveness of market discipline by way of enhancement of information disclosure. Basel II is scheduled for implementation as of the year ending on March 31, 2007.

The following is an overview of “Financial Inspections Pursuant to the Implementation of Basel II”.

### 2. Overview of “Financial Inspections Pursuant to the Implementation of Basel II”

#### (1) Purpose of Formulation

As the existing financial inspection manuals are not compatible with the aforementioned Basel II reforms, we have decided to put together inspection checklists compatible with Basel II.

#### (2) Background to Publication

In October 2006, the Study Group for the Revision of the Financial Inspection Manual, whose members include experts and professionals from the private sector, was established under the auspices of the Inspection Bureau of the FSA, and began conducting studies. The Study Group held discussions from a specialized and technical perspective, covering topics not limited to conformation to Basel II.

In consideration of the discussions that have taken place within the Study Group, we launched procedures to invite public comments on sections that need to be made to conform to Basel II before other revised sections, taking into account the high level of interest especially among associated parties, and received a broad range of opinions from the general public. In consideration of the opinions, etc. received, we have published the final draft.

#### (3) Published Contents

In the “Financial Inspections Pursuant to the Implementation of Basel II”, we have specifically defined and published an inspection checklist with respect to the list of items to be verified regarding the standardized approach and the Internal-Ratings Based (IRB) Approach in: (1) integrated risk management systems; (2) capital management systems; (3) operational risk management systems; and (4) credit risk management systems. We have also formulated (5) our approach to the verification of integrated risk management systems as our future inspection policy for integrated risk management systems. These checklists, etc. are scheduled for introduction in inspections conducted as of April 2007.

The FSA is currently working on the revision of the totality of its financial inspection manuals, and as such the aforementioned checklists are due to constitute a part of the revision of all financial inspection manuals, together with other revisions sections.

The following is an explanation of the content of the checklists for the inspection of (1) integrated risk management systems; (2) capital management systems; and (3) operational risk management systems. ((4) The list of items to be verified regarding the standardized approach and the IRB approach and (5) the approach to verification of integrated risk management systems are omitted.)

### **3. Contents of Integrated Risk Management System Inspection Checklist**

#### **(1) What is Integrated Risk Management?**

Integrated risk management involves the execution of self-controlled risk management by identifying risks faced by financial institutions that have been assessed with respect to each risk category (credit risk, market risk, operational risk, etc.) in a comprehensive manner, including risks that are not included in the calculation of the capital adequacy ratio (credit concentration risks, interest rate risks in banking records, etc.), and by comparing and contrasting these with the financial institution's fiscal status (capital).

#### **(2) Main Inspection Items**

- Has an adequate integrated risk management system commensurate with the scale, characteristics, risk profile, etc. of bank operations been developed?
- Is the integrated risk management process that determines, assesses, monitors and controls risks facing financial institutions functioning effectively?
- In cases where an "integrated risk measurement technique" for measuring various risks quantitatively, based on standardized scale, represents the integrated risk measurement system, is said system being managed properly?

#### **(3) Matters Requiring Attention Upon Conducting Verification**

The checklist states that when an inspector verifies an integrated risk management system, it is important that he/she verifies whether an adequate integrated risk management system has been developed commensurate with the level of complexity and sophistication of the risk assessment method adopted by the financial institution, in addition to its strategic goals, as well as the scale, characteristics and risk profile of its operations, while showing utmost respect for the voluntary efforts made to develop and establish an integrated risk management system by the financial institution in question.

### **4. Contents of Checklist for Inspection of Capital Management Systems**

#### **(1) What is Capital Management?**

Capital management involves the implementation of capital enhancement measures, the assessment of the capital enhancement status and the calculation of the capital adequacy ratio.

#### **(2) Main Inspection Items**

- Are capital enhancement measures being implemented smoothly based on management plans, capital plans, etc.?
- Is the status of capital enhancement being properly assessed in consideration of the scale, characteristics and risk profile of operations of the institution in question?
- Is the capital adequacy ratio being calculated accurately as prescribed by decrees, etc.?

#### **(3) Matters Requiring Attention Upon Conducting Verification**

The checklist states that when an inspector verifies a capital management system, it is important that he/she verifies whether an adequate capital management system has been developed commensurate with the level of complexity and sophistication of the method of assessing the capital enhancement status adopted by the financial institution in question.

### **5. Contents of Checklist for Inspection of Operational Risk Management Systems**

#### **(1) Composition**

The FSA is currently working on the revision of the totality of its financial inspection manuals. The overall composition of the checklist for the inspection of operational risk management systems is slated to consist of the following:

1. Comprehensive operational risk management system (this section has just been published.)
2. Operational risk management systems
  - (Attachment 1) Clerical risk management systems
  - (Attachment 2) Computer system risk management systems
  - (Attachment 3) Miscellaneous operational risk management systems (i.e., systems to manage risks excluding clerical and computer system risks among those risks defined by the financial institution as

operational risks)

## **(2) What is Operational Risk?**

Operational risk refers to the risk of incurring losses due to inadequacies in a financial institution's operational processes, failures on the part of its executives/employees' activities or systems, or external phenomena (a portion of risks that is included in the calculation of capital adequacy ratio) as well as risks that are defined as "operational risks" by the financial institution itself (a portion of risks that is excluded from the calculation of the capital adequacy ratio).

Furthermore, comprehensive operational risk management refers to the determination, assessment, monitoring, control and reduction of operational risks in a comprehensive manner within the totality of the financial institution.

## **(3) Main Inspection Items**

- Has an appropriate comprehensive operational risk management system commensurate with the scale, characteristics, risk profile, etc. of operations been developed?
- Is the system for the comprehensive management of operational risks functioning effectively in the financial institution as a whole?
- If an operational risk measurement technique is being used, is the risk measurement system being managed properly?

## **(4) Matters Requiring Attention Upon Conducting Verification**

The checklist states that when an inspector verifies a comprehensive operational risk management system, it is important that he/she verifies whether an adequate comprehensive operational risk management system commensurate with the level of complexity and sophistication of the method of quantifying (measuring) operational risks adopted by the financial institution (including the Basic Indicator Approach (BIA) and the Standardized Approach (TSA)), as well as the scale, characteristics and risk profile of the financial institution's operations has been developed.

## **6. Conclusion**

These checklists are regarded purely as guidebooks for inspectors' use when inspecting financial institutions. Financial institutions are expected to make full use of their creativity and ingenuity in consideration of these checklists, etc., based on the principle of self-responsibility, and to take action in accordance with their scale, characteristics, etc.

Moreover, it is hoped that the sharing the checklists with financial institutions will lead to more efficient and effective inspections through two-way dialogues between financial institutions and inspectors during inspections, and will help improve the transparency of financial administration.

# **Supervisory Approach to Specific Insurance Businesses**

## **1. Amendment of Insurance Business Law**

Before the revised Insurance Business Law came into force in April 2006, insurance underwriters targeted at specific individuals without any legal restrictions (so-called unlicensed cooperatives) were outside the scope of the Insurance Business Law. This is because voluntary mutual assistance was deemed to be fundamental to so-called unlicensed cooperatives, and regulations to protect policyholders were basically regarded as unnecessary.

On the other hand, there have been an increasing number of disputes in recent years relating to "members only" insurance sold by so-called unlicensed cooperatives, due to the inadequate sales methods, poor financial foundations and the like. For this reason, the Insurance Business Law was amended and unlicensed cooperatives were brought under the scope of regulations by the Insurance Business Law for the purpose of protecting policyholders, etc.

As a general rule, unlicensed cooperatives have been subjected to supervision by the Financial Services Agency (FSA) as specific insurance businesses since April 2006.

## **2. Supervision of Specific Insurance Businesses**

The FSA is required to supervise specific insurance businesses to enable policyholders to use insurance products with peace of mind, by making specific insurance businesses run their operations in a sound manner in compliance with laws and regulations, etc.

Firstly, specific insurance businesses were obliged to file a notice with the FSA before engaging in any specific insurance activities by the end of September 2006; 389 organizations filed a notice by the end of September 2006.

In view of the protection of policyholders, specific insurance businesses are subject to regulations such as measures relating to insurance solicitation and business operations, transactions with specific parties, etc.

As appropriate supervision is required in order to make such regulations effective, the FSA has once again instructed the Local Finance Bureaus that are commissioned to handle supervisory affairs concerning specific insurance businesses to take an appropriate approach as described below, based on the “Supervisory Guideline for Small-claims and Short-term Insurance Businesses”, which is a supplementary issue of the Comprehensive Guideline for Supervision of Insurance Companies.

### **(1) Approach to Specific Insurance Businesses Operating Without Filing Notice**

If an entity is found to have been engaging in insurance business without having filed a notice based on the complaints, tip-offs, inquiries from law enforcement authorities, newspaper advertisements, etc., Local Finance Bureaus must actively make fact-finding efforts, including investigating the nature of operations by such means as making inquiries to the police, consumer affairs bureaus, etc. and by directly confirming it with the entity by phone (unless it causes problems for the law enforcement authorities).

If the investigation results reveal that the entity has been carrying out insurance activities without having filed a notice, the entity will be given a warning in writing, contacted directly by phone or through interviews, etc. and urged to rectify the situation. Furthermore, Local Finance Bureaus must endeavor to collaborate with law enforcement authorities and other relevant authorities.

### **(2) Fact-Finding Activities targeted at Specific Insurance Businesses, etc.**

Local Finance Bureaus must check the content of notices, etc. and verify whether there are any problems in the state of the approach taken by the entity based on legal provisions (measures related to business operations, prohibited acts relating to solicitation, management of personal information and outsourcing of operations), in addition to verifying whether or not there are any operational problems, etc., including checking its financial position and the terms and conditions of the insurance contract in view of protecting policyholders, etc.

Even after the content of the notice has been verified, Local Finance Bureaus must implement further fact-finding efforts with respect to business operations, etc., such as conducting interviews targeted at specific insurance businesses as necessary.

In the event that any problems based on the aforementioned fact-finding efforts are uncovered, local finance bureaus must request that a report be made under the Insurance Business Law as necessary, and must consider taking supervisory action if any serious problems are deemed to exist.

### **(3) Consideration for Smooth Transition of Specific Insurance Businesses**

Specific insurance businesses are required to take such approaches as turning into small-claims and short-term insurance businesses (refer to “Primer on Financial Literacy”) by the end of March 2008. Local Finance Bureaus must give advice, etc. according to the actual circumstances of each specific insurance business so that they could make the transition appropriately by the end of the transition period.

## The Distribution of Rating Results for Financial Inspections

The Financial Services Agency (FSA) has compiled a document entitled “The State of the Distribution of Financial Inspection Rating Results” concerning the Financial Inspection Rating System (FIRST) and disclosed it to the public on November 15 (available in Japanese only).

1. FIRST was institutionalized in July 2005. Having gone through a trial preparation period until December 2005, it was launched on a trial basis in January 2006.
2. The purpose of FIRST is to motivate financial institutions to make managerial improvements of their own accord by **rating\*** the results of financial inspections, and bringing about more efficient and effective inspections, etc.
3. In light of FIRST’s purpose as described above, it is sufficient for the rating results to be recognized only by the inspected financial institution, and it is deemed inappropriate to disclose them to outsiders on an individual basis due to the risk of rumors, etc.
4. However, the FSA has received many requests for the publication of the state of distribution of ratings from each type of business (financial institution) wanting to find out its own positioning.
5. In response to such requests, the FSA published the rating results of 137 financial institutions that had been notified of the rating and inspection results after being given advance notice (or being subject to the commencement of inspection in cases where no advance notice was given) in January 2006 or later and having finished the inspection by June 2006, such as the ratio of the number of areas in which they were given a rating of C or below in regards to each type of business and rating area.
6. The FSA intends to continue to accumulate data for “The State of Distribution of Financial Inspection Rating Results” in the future, and publish updates when a certain amount of data has been accumulated.

\* Rating A: A robust management system has been established by the management team.  
Rating B: An adequate management system has been established by the management team.  
Rating C: The establishment of the management system is inadequate and requires improvement.  
Rating D: The management system is either defective or has a serious defect.  
No overall rating is given.

## FY2006 Interim Financial Results of Major Banks

Following the announcement of FY2006 interim financial results by the major banks, the Financial Services Agency (FSA) added up the figures etc. announced by the respective banks and released the results on Wednesday, November 22.

Below is a summary of the FY2006 interim financial results for the major banks.

### 1. Interim Financial Results of Major Banks

With 1.6 trillion yen in net income, income levels turned out to be roughly the same year on year. While their interest income, which represents earnings from lending, showed a downward trend, fees and commissions income from investment trust and insurance product sales increased. However, their performance in the bond business (government bonds etc.) went from profits to losses, and their net core business profits dropped. On the other hand, the overall level remained the same as last year, thanks presumably to profits generated as a result of the reversal of bad loan allowances, as had also been the case for the last term, and also to exceptional factors, including improved pension asset management due to the newly-introduced retirement benefit accounting and the revision of the estimate period for deferred tax asset calculation purposes.

Their capital ratio also rose slightly to 12.3%, a 0.1 percentage point increase from the FY ending March 2006.

### 2. Non-Performing Loan Status at Major Banks

Balances of non-performing loans (loans subject to disclosure under the Financial Reconstruction Law) stood at 3.9 trillion yen in total, a 15.7% decrease from the FY ending in March 2006. Those

categorized as "in danger of bankruptcy" or worse stood at 2 trillion yen, a 15.1% decrease year on year, and those categorized as "Needs special attention" dropped by 16.5% year on year to 1.9 trillion yen.

The non-performing loan ratio fell to 1.5% from 2.9% from the FY ending in March 2005, a drop of 1.4 percentage points. This presumably reflects the fact that progress in the major banks' efforts to improve their asset portfolios remains an on-going process since the FY ending in March 2005, which was when they achieved their goal of halving the non-performing ratio.

(Note) An objective stated in the "Program for Financial Revival," established and announced in October 2002: "normalize the NPLs problems in FY 2004 by reducing major banks' NPL ratio to about half" (relative to the level of FY ending March 2002, or 8.4%).

## **Amendment to Regulations on Financial Statements Associated With Publication of New Accounting Standards**

The Accounting Standards Board of Japan (ASBJ) published "Tentative Solution on Accounting for Deferred Assets" and "Accounting Standards for Financial Instruments" on August 11, 2006, and "Accounting Standards for Measurement of Inventories" on July 5, 2006.

In conjunction with the publication of these new accounting standards, etc., the cabinet office ordinance regarding the amendment of the Regulations on Terminology, Format and Preparation Method of Financial Statements, etc. ("Regulations on Financial Statements") (Cabinet Office Ordinance No.88) was promulgated on December 26, 2006.

### **1. Amendment of Provisions on Scope of Deferred Assets, etc.**

#### **(1) Stock Issuing Expenses**

"Tentative Solution on Accounting for Deferred Assets" (practical solutions report) allows treasury stock disposal expenses—which previously could not be accounted for as deferred assets—to be accounted for as deferred assets on the grounds that new stock-issuing expenses and treasury stock disposal expenses have the same characteristics as expenses incurred in financial activities, such as financing activities that involve stock issuance, and that the invitation procedures for new stock issuance and treasury stock disposal must now comply with the same regulations under the Company Law. Also, new stock issuing expenses and treasury stock disposal expenses are now both to be treated as stock issuing expenses on the grounds that they have similar characteristics.

In response to the establishment of the practical solutions report, "new stock issuing expenses" was renamed "stock issuing expenses" in the Regulations on Financial Statements, etc., and the definition was amended to effectively cover treasury stock disposal expenses.

#### **(2) Debenture Discount and Expenses**

"Accounting Standards for Financial Instruments" were amended in response to the Corporate Calculation Regulations, allowing debentures in cases where the amount of revenue differs from the amount of debt to be valued at a fair price as of the end of the fiscal year. With respect to the amount of issued debentures declared on the balance sheet, the amended Accounting Standards state that the difference between the amount of revenue and the amount of debt must be calculated based on the amortized cost method (which involves adjusting the difference from the book value each year by a certain method until the redemption period), and as such the provision on debenture discount and expenses was deleted.

Following this amendment, debenture discount and expenses was deleted from the section on deferred assets in the Regulations on Financial Statements, etc.

### **2. Amendment of Provisions on Valuation and Indication of Inventory Assets**

The section entitled "Accounting Standards for Measurement of Inventories" divides inventory assets into (1) inventory assets owned for sales purposes and (2) inventory assets owned for the purpose of profiting from fluctuations in market prices (trading purposes), and lay down separate provisions for these two categories.

(1) For inventory assets owned for sales purposes ("inventory assets for sales purposes"), the statute

requiring selection of either the cost accounting method or the lower-of-cost-or-market-value method has been abolished. It is now required that the book value to the net sale price be reduced if the profitability of inventory assets deteriorates. (2) For inventory assets owned for the purpose of profiting from fluctuations in the market price (trading purposes) (“inventory assets for trading purposes”), a process to reflect the fluctuations in market price in the financial statements has been introduced, and a process for a year-end declaration of valuation gains has been approved. However, valuation gains or losses must be declared as a component of sales.

In response to the establishment of the new Accounting Standards, no separate provisions have been established for inventory assets in accordance to the purpose of ownership, and the existing provisions that permitted the lower-of-cost-or-market-value standard were deleted from the Regulations on Financial Statements, etc. Moreover, new provisions were established (1) for inventory assets for sales purposes, requiring, as a general rule, that the reduction in book value be indicated as a cost of sales item, and (2) for inventory assets for trading purposes, requiring, as a general rule, that the aforementioned assets be indicated as a sales component .

### **3. Application Period**

#### **(1) Provisions on Changes to the Scope of Deferred Assets, etc.**

These provisions are applicable to (consolidated) financial statements and interim (consolidated) financial statements presented in securities registration statements, securities reports and semiannual reports for the fiscal year (including the consolidated accounting year) and the interim (consolidated) accounting period ending September 30, 2006 or later submitted on or after the enforcement date of the Cabinet Office Ordinance (December 26, 2006).

#### **(2) Provisions on Valuation and Indication of Inventory Assets**

The provisions are applicable to (consolidated) financial statements for the fiscal year (including the consolidated accounting period) commencing April 1, 2008 or later.

## **Main Recommendations by Subcommittee on the Certified Public Accountants System of the Financial System Council**

Auditing work is becoming more complicated and sophisticated nowadays, in line with the increasingly diversified, complex and globalized scope of corporate activities. On the other hand, incidents that could undermine the credibility of audits have arisen, such as scandals involving audits conducted by Certified Public Accountants (CPAs), which have once again highlighted the importance of organized audits.

Based on such critical awareness, the Subcommittee on the Certified Public Accountant System of the Financial System Council had been deliberating on the approach to the CPA system and auditing firms since April 2006, and on December 22 compiled a report entitled “Improvement and Enhancement of the System of Certified Public Accountants and Auditing Firms.”

The main recommendations made in the report are as follows.

### **1. Enhancement of Auditing Firms’ Quality Control, Governance and Disclosure Systems**

#### **(1) Ensuring appropriate development and operation of business management framework in auditing firms**

The respective roles of the following staff at auditing firms should be clarified:

- i) Staff engaged in audit certification work;
- ii) Staff in charge of quality control such as screening; and
- iii) Staff involved in business-management-related decision-making, such as decisions related to the development of quality control frameworks.

#### **(2) Expansion of scope of employee qualifications at auditing firms to include non-CPAs**

#### **(3) Ensuring transparency of auditing firms themselves by requiring disclosure of information**

## **2. Enhancement of Independence and Status of Auditors**

### **(1) Development of Rules to Enhance Independence, etc.**

- 1) General provisions on maintaining independence should be developed.
- 2) Restrictions on employment of auditing firm employees after their retirement and restrictions on audits by firms whose retired employees now serve as directors for firm being audited should be expanded to be applied on a consolidated basis.
- 3) The rules set forth by the Japanese Institute of Certified Public Accountants (JICPA) regarding the reliance on certain companies for fees (more than 50%) should be strictly enforced.
- 4) The rotation of chief accountants engaged in audits of listed companies by large auditing firms should be made mandatory. (The current continuous auditing period of seven years and interval of two years currently maintained as a general principle in existing JICPA's rules should be amended to five years and five years, respectively.)
- 5) The rotation period upon initial public offering (IPO) should be shortened.

### **(2) Development of an Appropriate Framework for the Selection of Auditors, Determination of Audit Fees, etc.**

- 1) It is recommended that auditors' role in selecting auditors and determining audit fees be enhanced by replacing the right of approval with the right to adopt proposals, etc. (matters relating to Company Law).
- 2) Disclosure of audit fees by companies and auditors should be enhanced.
- 3) Disclosure upon the replacement of auditors by companies and auditors should be enhanced.
- 4) An obligation to report to the Financial Services Agency (FSA) in the event that a company fails to rectify dishonest or illegal acts that have materially impacted financial documents should be imposed.

## **3. Review of Approach to Supervision and Responsibilities with Respect to Auditing Firms, etc.**

### **(1) Diversification of Administrative Actions (Currently, there are three types: warning; suspension of operations; and order of dissolution)**

- i) Business improvement order
- ii) Order to dismiss directors, etc.
- iii) Implementation of specialized vocational education and training
- iv) Actions in response to extremely poor work performance by individual CPAs and work improvement decree

### **(2) Introduction of financial measures to prevent breaches**

### **(3) Introduction of a system for auditing firms in the form of limited liability framework**

(Requirements include establishment of: i) registration system, ii) minimum capital, iii) disclosure of financial documents, and iv) deposit of guarantee money, mandatory insurance, etc.)

### **(4) Permission for the Certified Public Accountants and Auditing Oversight Board (CPAFOB) to request reporting and conduct inspections with respect to auditing firms, etc. without waiting for a quality control review from the JICPA if deemed necessary for quality control purposes**

### **(5) Introduction of notification (registration), inspection and supervision with respect to foreign auditing firms**

In consideration of the recommendations stated in this report, the FSA plans to submit a bill for the amendment of the Certified Public Accountant Law at the ordinary session of the Diet.

**Release of Business Accounting Council Subcommittee on Internal Controls: Draft for Public Comment on standards for the implementation of evaluation by the management and audits by auditors under the internal control-reporting scheme**

With the enactment of the Financial Instruments and Exchange Law on June 7, 2006, an internal control-reporting scheme is slated to be introduced for business years beginning on or after April 1, 2008, under which listed companies will be required to have the management evaluate and auditors audit the effectiveness of internal controls to be described in their financial reports.

On the subject of standards for the implementation of evaluation by the management and audits by auditors under the internal control-reporting scheme, the Business Accounting Council Subcommittee on Internal Controls (chaired by Professor Shinji Hatta, Aoyama Gakuin University) put together a list of proposed standards, which it unveiled to the public in December 2005. As many subsequently expressed a desire that practical guidelines should be developed, something to assist in the process of applying the standards in practice (hereinafter referred to as "practice guidelines"), we decided to set up a working group (chaired by Professor Takashi Hashimoto, Aoyama Gakuin University) under the Subcommittee on Internal Controls, which working group subsequently examined proposed practice guidelines with the participation of accounting professionals etc., and then released practice guidelines in the form of a draft on November 21, 2006 to solicit public comment (the designated period for comment solicitation was until December 20, 2006).

In consideration of the comments on the draft for public comment, we are planning on further examining the proposals to have them established as standards and practice guidelines, respectively.

Practice guidelines indicate that which should serve as a set of standards developed from a perspective of steps to be taken in practice, granted that a necessary form of internal controls differs from company to company according to the particulars of their environment or their characteristics and should therefore be developed by each company in reliance on its own ingenuity. We have also examined the situation in the U.S., where a similar scheme has already been introduced. Taking into account a view held by some that, as a result of a very conservative approach applied, companies in the U.S. were incurring excessive cost burdens, attention was paid in developing the practice guidelines proposed here in Japan so as to create guidelines that are as specific as possible, so that an overly heavy-handed approach does not ensue and so that internal controls can be formulated, evaluated and audited efficiently and effectively, while the effectiveness of the scheme is ensured at the same time.

As with the proposed standards, the proposed practice guidelines are composed of three parts: formulation, evaluation, and audits, each of internal controls.

The following matters can be cited as salient features of the respective parts:

1. "Part I: Basic Framework of Internal Controls" presents a description of the process of formulation of internal controls in which an organization formulates a type of internal controls to be described in financial reports
2. "Part II: Evaluation of and Reporting on Internal Controls to be Described in Financial Reports" sorts out standards regarding evaluation and reporting:
  - Illustrating evaluation items with respect to company-wide internal controls
  - Describing in detail the method of "narrowing down" the scope of evaluation
  - Clearly defining the method and basis of judgment with respect to "material flaws" subject to disclosure
3. "Part III: Audits of Internal Controls to be Described in Financial Reports" sorts out standards regarding internal control audits:
  - Clearly defining the process of discussion between the management and auditors in regards to the scope of evaluation
  - Clearly stating that an audit plan is to be developed in combination with a financial statement audit and that any audit evidence may be used mutually
  - Clearly defining the degree of reliability of the sampling regarding evaluation of the internal control administration status

*\* The Council released the final version of the list of proposed standards on February 15, 2007.*

### **Release of Business Accounting Council Audit Subcommittee: Draft for Public Comment on Quarterly Review Standards**

Following the release by the Business Accounting Council Audit Subcommittee of the document entitled "Establishing Quarterly Review Standards (Draft for Public Comment)" on November 21, 2006, we solicited comments from the broad range of people, from the general public up, concluding on December 20.

The development leading up to the creation and public release of the Standards (Draft for Public Comment) is explained below:

Rapid changes that companies have experienced in recent years in their management environment have also demonstrated to us that business performance etc. can, as a result, also change significantly over a short period of time. Under such circumstances, disclosing information concerning business performance etc. to investors in a quicker and more timely fashion is essential, and companies are also expected to maintain internal practices whereby they keep track of information concerning business performance etc. in a timelier fashion and conduct appropriate management of their businesses accordingly.

This prompted discussion of the introduction of a quarterly reporting scheme under the auspices of the Securities Exchange Law, which subsequently took shape as new requirements under the Financial Instruments and Exchange Law, enacted in June 2006. Under this system, listed companies etc. will be required to submit quarterly reports for business years starting on or after April 1, 2008, and quarterly financial statements to appear in such reports must be audited and attested by a certified public accountant or auditing firm.

On the subject of audit attestations provided by certified public accountant or auditing firm to quarterly financial statements, the Business Accounting Council made the decision during its general assembly in January 2005 to develop quarterly review standards, an idea which the Council had been examining since September of the same year. Quarterly reports, which inherently necessitate timeliness and speed, need to be submitted by the date, as specified by government ordinance, within 45 days from the end of the quarterly accounting period. For that reason, simplified accounting procedures are permitted in some areas, and quarterly review procedures that consist mainly of inquiry and analysis are also slated for introduction with respect to audits for this purpose.

While timeliness and speed are thus required of quarterly reports, another challenge will be ensuring the reliability of audits. As the compilation of quarterly reviews is based on audits of annual financial statements, it is hoped these, implemented in proper concert with annual financial statement audits, should heighten the level of effectiveness of audits. More specifically, any quarterly review plan must be formulated in consideration of an understanding of the audited company and its operating environment, including internal controls, taken into consideration in the annual financial statement audits, as well as in consideration of any risks in regards to material false statements based on that understanding. It is therefore necessary that any important observations etc. during annual financial statement audits should be examined in the course of the quarterly review process as well and that quarterly review results should also be appropriately reflected in annual audit plans.

Taking into consideration the comments received, the Subcommittee will proceed to deliberate on the issue with a view to putting together a final version of the standards.

## **Organization, Staffing and Budget for FY2007**

### **1. Introduction**

The following is a brief explanation of the organization, staffing and budget relating to the Financial Services Agency (FSA), based on the Japanese government's draft budget for the fiscal year ending on March 31, 2008, approved by the Cabinet on December 24, 2006.

Approval has been granted for the development of the structures outlined below and a budget totaling approximately 22.1 billion yen, with a view in particular to enhancing market surveillance functions, promoting consumer protection measures, etc. and responding to the privatization of postal services, in order for the FSA to protect financial services customers and enable them to perform transactions securely and with peace of mind.

### **2. Organization and Staffing**

#### **(1) Enhancement of Market Surveillance Functions (41 staff members)**

1) In consideration of the expansion of the scope of regulations associated with the enforcement of the Financial Instruments and Exchange Law, the securities market surveillance framework will be

dramatically enhanced, with the appointment of two deputy secretaries general of the Executive Bureau of the Securities and Exchange Surveillance Commission (SESC) and the development of a supervisory framework.

2) The framework for the planning and devising of ever-changing markets and corporate disclosure systems will be enhanced.

**(2) Promotion of Consumer Protection Measures, etc. (9 staff members)**

The inspection and supervision framework aimed at protecting customers in the money lending industry and the counseling framework for financial services users will be enhanced. The framework for planning and devising systems to promote consumer protection measures, etc. will also be strengthened.

**(3) Response to the Privatization of Postal Services (12 staff members)**

In order to conduct supervision in a precise fashion with respect to the postal savings bank and the postal insurance company subject to supervision by the FSA under the Japan Post Privatization Law, an inspection and supervision framework geared towards the postal savings bank and the postal insurance company will be developed, featuring the newly-established position of Deputy Commissioner (in charge of supervision of postal savings and insurance).

**[Breakdown]**

	Number of Staff at End of FY2006	Increase in Staff for FY2007	Planned Reduction, Transfer, etc.	Number of Staff at End of FY2007
Planning and Coordination Bureau	304	10	▲18	296
Inspection Bureau	454	8	▲11	451
Supervisory Bureau	221	16	1	238
Securities and Exchange Surveillance Commission (SESC)	318	26	▲3	341
Certified Public Accountants and Auditing Oversight Board (CPAFOB)	43	4	—	47
<b>Total</b>	1,340	64	▲31	1,373

(Note) “Planned Reduction, Transfer, etc.” in the Planning and Coordination Bureau includes planned reduction as well as transfers, reductions, etc. associated with the handover of the Financial Intelligence Unit (FIU) to the National Police Agency.

**3. Budget**

(1) A budget totaling approximately 22.1 billion yen has been approved, including expenses associated with moving into the new office building.

(2) For the continued assurance of stability in the financial system, 48 trillion yen has been approved in the form of government guarantees earmarked for the Deposit Insurance Corporation of Japan (DICJ).

**[Reference] Government Guarantees for Deposit Insurance Corporation of Japan (DICJ)**

(Unit: trillion yen)

Account	FY2006	Draft Budget for FY2007
General account	19	19
Financial revival account	7	6
Account for prompt restoration of soundness of financial functions	5	4
Emergency response account	17	17
Account for enhancement of financial functions	2	2
Industrial revival account	0.15	-
Total government guarantees	50.15	48

**Summary of FSA Budget for FY2007  
(Rough Estimate Approved)**

Category	Initial Budget for FY2006 (A)	Unofficial Budget for FY2007 (B)	Year-on-year Change (B-A)	Year-on-year Percentage Growth (B-A)/(A)
	million yen	million yen	million yen	%
(Item) FSA	20,968	21,965	997	4.8
Personnel expenses	13,234	13,208	Δ26	Δ0.2
Other	7,735	8,757	1,022	13.2
Expenses for conducting inspection, supervision, etc.	848	809	Δ39	Δ4.6
Expenses for computerizing FSA administration	4,122	3,539	Δ583	Δ14.1
Expenses for conducting studies, research, etc. on financial system	236	286	50	21.1
Running expenses of councils, etc.	112	105	Δ7	Δ5.9
Expenses for attending international conferences, etc.	207	238	31	15.0
Expenses associated with moving into a new office building	-	1,552	1,552	
Other	2,210	2,227	18	0.8
(Item) Economic cooperation expenses	103	94	Δ10	Δ9.4
Total	21,072	22,059	987	4.7

(Note) 1. Figures may not be consistent with each other as each figure has been rounded off to the nearest million yen.

2. For continued assurance of financial system stability, 48 trillion yen has been approved as government guarantees earmarked for the Deposit Insurance Corporation of Japan (DICJ).

(Reference)

(Unit: million yen, %)

Category	Initial Budget for FY2005 (A)	Unofficial Budget for FY2006 (B)	Year-on-year Change (B-A)	Year-on-year Percentage Growth (B-A)/(A)
FSA bureaus, offices, etc.	14,408	16,612	2,204	15.3
Personnel expenses	9,075	9,644	569	6.3
Non-personnel expenses	5,333	6,968	1,635	30.7
SESC	3,764	3,897	133	3.5
Personnel expenses	2,960	3,131	171	5.8
Non-personnel expenses	804	765	Δ39	Δ4.9
CPAAOB	549	563	14	2.6
Personnel expenses	438	458	20	4.6
Non-personnel expenses	111	105	Δ6	Δ5.4
Total	18,721	21,072	2,351	12.6
Personnel expenses	12,473	13,234	761	6.1
Non-personnel expenses	6,248	7,838	1,590	25.4

(Note) Figures may not be consistent with each other as each figure has been rounded off to the nearest million yen.

## Minister Yuji Yamamoto's Visits to China, the UK and the USA

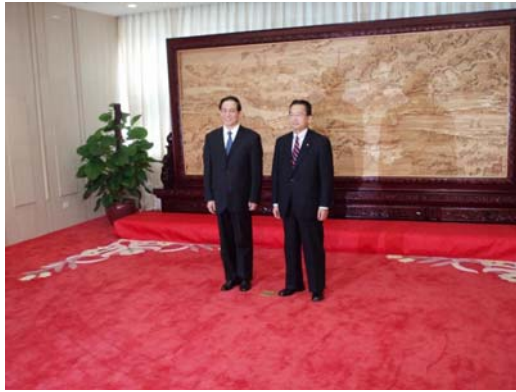
### [China]

Financial Services Minister Yuji Yamamoto visited China from December 26 to 28, 2006, where he met with Mr. Zhou Xiaochuan, Governor of the People's Bank of China, Mr. Liu Mingkang, Chairman of the China Banking Regulatory Commission (CBRC), Mr. Shang Fulin, Chairman of the China Securities Regulatory Commission (CSRC) and Mr. Li Kemu, Vice Chairman of the China Insurance Regulatory Commission (CIRC).

In a series of meetings, they agreed to further strengthen the cooperative relationship between Japanese and Chinese financial supervisory authorities, in response to *finance-related reciprocal cooperation* being declared a priority area at the recently held Japan-China summit meeting.

Furthermore, the Chinese side provided an explanation on the progress in the financial sector reforms currently underway in China, and the two sides exchanged opinions on making further improvements to the business environment in regards to private enterprise and other matters of consequence to the respective financial sectors of Japan and China.

Minister Yamamoto believes it is extremely important that this latest visit be used as a launching pad to deepen reciprocal cooperation and strengthen the relationship of trust between the financial authorities of the two countries, including holding working-level discussions on a regular basis.



Minister Yamamoto's visit to China:  
Meeting with Mr. Liu Mingkang, Chairman of the China Banking Regulatory Commission (CBRC)

**[UK and USA]**

Minister Yamamoto visited the UK and the USA from January 7 to 14, 2007.

In the UK, he met with Mr. Mervyn King, Governor of the Bank of England, Sir Callum McCarthy, Chairman of the Financial Services Authority and other such officials. He also inspected education and training facilities focused on educating young people and met interested parties in relation to the "Challenge Again" initiative. In the United States, he met Mr. Ben S. Bernanke, Chairman of the Federal Reserve Board (FRB), Mr. Christopher Cox, Chairman of the Securities and Exchange Commission (SEC), and Mr. Timothy F. Geithner, President of the Federal Reserve Bank of New York.

During this series of meetings, they exchanged opinions on the policy direction that Japan should pursue in the future and other matters with a view to improving the international competitiveness of the Japanese financial market. They also agreed to further deepen the collaboration between the financial authorities, amid the progress of globalization.

In consideration of the Minister's latest visit to these countries, the Financial Services Agency (FSA) recognizes the importance of promoting the trend *from savings to investments* more decisively and further improving the appeal of Japanese financial and capital markets in its capacity as an international financial center, through exchanges of views with financial authorities, market players and other parties within the rubric of the world's two biggest international financial centers. Accordingly, the FSA will establish a study group in the Financial System Council (provisional name: "Study Group on Globalization of Japanese Financial and Capital Markets") to examine policy measures with a view to building an internationally attractive market.

The Minister's trip was extremely fruitful in that he was able to hear directly from the financial authorities of- and market players in the UK and the United States—the two biggest international financial centers—and thereby enhance ties and dialogues therewith.



Minister Yamamoto's visit to the USA:  
Joint Press Conference with Mr. Christopher Cox, Chairman of the Securities and Exchange Commission (SEC)

\* For further information, please access [the FSA's website](#) > ["Press Conferences"](#) > ["Press](#)

[Conference by Yuji Yamamoto, Minister for Financial Services \(January 5, 2007\)](#) and [“Press Conference by Yuji Yamamoto, Minister for Financial Services \(January 16, 2007\)”](#)

## 【Primer on Financial Literacy】

### Small-Claims and Short-Term Insurance Businesses

“Small-claims and short-term insurance businesses” (hereinafter referred to as “SSIBs”) refer to businesses normally run by insurance companies such as the underwriting of life insurance, non-life insurance and medical insurance that are small in amount and short-term.

As SSIBs only engage in the underwriting of insurance in which the insurance money is small in amount and the period of insurance is short, it is deemed possible and rational to establish regulations that are different from those targeted at insurance companies, which assume the underwriting of expensive, long-term insurance. From this perspective, a framework has been established to enable even small operators to conduct a business by relaxing market entry regulations such as those on minimum capital requirements and product screening regulations, while imposing restrictions on insurance that can be underwritten by them.

The specifics of this framework are as follows.

Category	Small-Claims and Short-Term Insurance Businesses (SSIBs)	(Reference) Insurance Companies
<b>Market Entry Requirements</b>	<ul style="list-style-type: none"> <li>○ Registration system (register with Local Financial Bureau)</li> <li>○ Limited to joint stock companies and mutual corporations (However, non-profit organizations (NPOs), etc. that deal in products corresponding to insurance as at the enforcement date of the law are able to register in the corresponding corporation format.)</li> <li>○ Staffing aimed at facilitating operations</li> </ul>	<ul style="list-style-type: none"> <li>○ License system</li> <li>○ Limited to joint stock companies and mutual corporations</li> <li>○ Positive earnings outlook</li> <li>○ Staffing aimed at facilitating operations</li> </ul>
<b>Minimum Capital, etc.</b>	<ul style="list-style-type: none"> <li>○ Minimum capital, etc.: 10 million yen</li> <li>○ Annual premiums received: 5 billion yen or less</li> </ul>	<ul style="list-style-type: none"> <li>○ Minimum capital, etc.: 1 billion yen</li> </ul>
<b>Products Handled</b>	<ul style="list-style-type: none"> <li>○ Product screening (notice with right to issue ex-post-facto order)</li> <li>○ No limitation on types of products that can be handled (both life and non-life insurance products can be handled)</li> <li>○ Limited to insurance with nonrefundable premiums (insurance with payment at maturity, endowment insurance such as annuities, insurance with investment characteristics, etc. are unacceptable)</li> <li>○ Period of insurance must be no more than two years for non-life insurance and no more than one year for life insurance and medical insurance.</li> <li>○ The total amount insured must be no more than 10 million yen (However, a cap of 10 million yen is set separately for liability insurance in which the incidence of the insured event is low), and the cap with respect to each product category is as follows:               <ul style="list-style-type: none"> <li>(1) Ordinary severe disability and death: ¥3 million</li> <li>(2) Hospitalization benefits, etc. in the event of illness or injury: ¥800,000</li> <li>(3) Severe disability or death due to injury: ¥6 million</li> <li>(4) Non-life insurance: ¥10 million</li> </ul> </li> <li>○ No more than 100 people can be insured in total per policyholder.</li> <li>○ An identification system is required to consistently identify the amount insured, etc. with respect to each policyholder and insured person.</li> </ul>	<ul style="list-style-type: none"> <li>○ Product screening (approval or notice with right to issue ex-post-facto order)</li> <li>○ Licensed life insurance companies can only deal in first-sector products (life insurance) and third-sector products (medical, nursing and accident insurance), while licensed non-life insurance companies can only deal in second-sector products (non-life insurance) and third-sector products (medical, nursing and accident insurance).</li> <li>○ There is no limit on the amount or period. Insurance with investment characteristics is also acceptable.</li> </ul>
<b>Asset Management</b>	<ul style="list-style-type: none"> <li>○ Limited to deposits, Japanese government bonds (JGBs) and other such risk-free assets</li> </ul>	<ul style="list-style-type: none"> <li>○ Flexible as a general rule (shares, real estate, financing, etc. are acceptable)</li> </ul>

Currently, two SSIBs are registered (as of November 29, 2006). When concluding a contract with an SSIB in the future, it will be necessary pay attention to the aforementioned differences with insurance companies when doing so, with a sufficient understanding of the terms and conditions of the contract. In the event that an SSIB goes bankrupt, there is no safety net like the policyholder protection framework to which insurance companies are affiliated. However, SSIBs are obliged to deposit a certain amount of money in order to cover losses incurred by policyholders, etc. and to prevent the illicit use of said funds.

## **【Explanation of Laws and Regulations】**

### **Revision of Enforcement Order of Securities and Exchange Law Associated With Enforcement of Law for Amending Securities and Exchange Law and Other Financial Laws**

In conjunction with the phased enforcement of the Law for Amending the Securities and Exchange Law and Other Financial Laws (2006 Law No.65) enacted at the 164<sup>th</sup> ordinary session of the Diet, necessary amendments have been made to sections in the Enforcement Order of the Securities and Exchange Law and related Cabinet Orders in conjunction with the Take Over Bid (TOB) system and the large shareholdings reporting system.

The principal amendments are as described below.

#### **1. Development of Take Over Bid (TOB) System**

##### **(1) Numerical Standards for “Rapid Buy-Ups” Based on a Combination of On-Market and Off-Market Transactions, etc. in Cases Wherein TOB is Mandatory**

A new provision was established so that “rapid buy-ups” would refer to cases in which more than 10% of all outstanding shares are acquired either through purchase or through the acquisition of new issues in a period not exceeding three months, provided that more than 5% of it has been acquired by such means as off-market purchase.

##### **(2) Enhancement of Information Provided to Investors**

###### **a. Enhancement of Disclosure in TOB Notice**

It is now a requirement to provide a more specific description of the management policies after the execution of TOB and course of action, etc. as a shareholder (including whether there is any plan to additionally acquire share certificates, etc. and whether there are any prospects for delisting, etc.). Furthermore, considering that problems may arise in the form of conflicts of interest on the part of the management team, etc. in its relationship with shareholders when the management team, etc. becomes a bidder in a management buyout (MBO) or TOB made by the parent company centered around the shares of its subsidiary, if the TOB price has actually been calculated on the basis of a TOB price calculation and appraisal form obtained from a third party, it is now a requirement to attach a copy of such TOB price calculation and appraisal form to the TOB notice.

###### **b. Targeted Party’s Obligation to Declare Its Position**

Necessary provisions were developed with respect to specific matters to be stated in the *position statement report*, which is a disclosure document stating the targeted party’s opinions on the TOB. Moreover, it is now a requirement to submit a *position statement report* within 10 business days of the public notice of the commencement of TOB.

###### **c. Opportunity given to Targeted Party to Ask Questions to Bidder**

Necessary provisions were developed with respect to specific matters to be stated in the *position statement report* (a disclosure document stating the targeted party’s questions) and *response to questions* (a disclosure document stating the bidder’s response to the targeted party’s questions). Also, it is now a requirement to submit the *response to questions* within 5 business days of receiving the “position statement report”.

##### **(3) TOB Period**

###### **a. Length of TOB Period**

The length of the TOB period, which is currently between 20 and 60 calendar days, has been changed to between 20 and 60 business days.

###### **b. Cases in which Target Party Requests Extension of TOB Period and Extended TOB Period**

Previously, the targeted party was able to request an extension of the TOB period if the TOB period initially set by the bidder was less than a certain period. This “certain period” is now stipulated as 30 business days. Moreover, the extended TOB period is now stipulated as 30 business days. Furthermore, necessary provisions were developed for TOB notices, such as establishing a column in the “period of purchase, etc.” section wherein the extended period of purchase, etc. must be stated in cases where a request for extension has been received.

#### **(4) Flexible Approach to Amendment of Terms and Conditions of TOB and Withdrawal of TOB**

##### **a. Cases in which Reduction of TOB Price is Permissible**

The reduction of the TOB price, which is prohibited under the existing system, will soon be permissible in certain cases, namely, when the targeted party carries out a stock split, etc. or executes a gratis issue of stocks, etc.

##### **b. Cases in which Withdrawal of TOB is Permissible**

Withdrawal of TOB, which is only permissible in the case of merger, bankruptcy, etc. under the existing system, will also soon be permissible in cases where so-called anti-takeover measures are launched and cases where so-called anti-takeover measures are not terminated.

In regards to the reasons for withdrawal due to be added, withdrawal based on minor reasons will not be made permissible as is the case for the reasons for withdrawal that are currently accepted. Necessary provisions were developed for the criteria of minor reasons.

#### **(5) Development of Necessary Provisions for Partial Introduction of Obligation to Purchase All Shares**

A new provision was established to oblige the bidder to purchase all shares, etc. of the targeted party if the bidder’s shareholding ratio exceeds two-thirds of all outstanding shares, etc. after the TOB.

Furthermore, in cases wherein the bidder’s shareholding ratio exceeds two-thirds of all outstanding shares, etc. after the TOB, it is now a TOB requirement to execute TOB with respect to all shares, etc. with voting power as a general rule.

The same TOB period must be set with respect to all shares, etc. subject to TOB. It is now also a requirement that the difference in TOB price in the column be specified as the basis of calculation of the TOB price in the TOB notice.

#### **(6) Numerical Standards for “Rapid Buy-up” by Major Shareholders During Other Party’s TOB Period**

A new provision was established so that such “rapid buy-ups” would refer to the purchasing of more than 5% of all outstanding shares, etc. during the other party’s TOB period.

#### **(7) Scope of TOB Regulations regarding Purchase of Subsidiary’s Shares**

Under the existing system, TOB regulations are not applicable to cases in which shares of a subsidiary with more than 50% of the voting power are purchased from an extremely small number of shareholders.

In cases wherein the bidder’s shareholding ratio exceeds two-thirds after the TOB, the bidder is now obliged to engage in TOB, considering that TOB that results in delisting, etc. might put small shareholders with leftover shares in an extremely vulnerable position.

#### **(8) Other Provisions**

Necessary provisions were developed with respect to the method of calculating the shareholding ratio, with the exception of the prohibition of separate purchases, criteria of minor reasons concerning special parties, etc.

## **2. Development of Reporting System for Large Shareholdings**

### **(1) Securities to be Reported and Expansion of Scope of Securities requiring Indication of Rights relating to Securities to be Reported**

Investment securities, etc. were added to the list of securities to be reported.

## **(2) Significant Proposals, etc.**

The following matters have been stipulated as significant proposals, etc. made to directors or at the general meeting of shareholders that are not subject to the special reporting system:

- i. Disposal or transfer of material assets;
- ii. Large amount of debt;
- iii. Election or dismissal of representative director;
- iv. Material change to the directorship;
- v. Election or dismissal of manager or other significant employee;
- vi. Establishment, amendment or abolition of branch or other significant organization;
- vii. Reorganization, etc. under Japanese company law;
- viii. Significant changes in dividend policies;
- ix. Significant changes in policies relating to increases or decreases in capital
- x. Delisting, etc.; and
- xi. Listing of subsidiary's shares, etc.

## **(3) Base Date for Special Report**

Institutional investors who wish to submit a notice regarding the base date for making a special reports must choose from among the following combinations of days:

- i. Second and fourth Monday of each month (if there is a fifth Monday in the month, then the second, fourth and fifth Monday); or
- ii. The fifteenth day and last day of each month

## **(4) Purpose of Shareholding**

These necessary provisions were developed to render the disclosed information on the shareholding purpose more specific.

## **(5) Other**

These necessary provisions were developed in regards to double entries between joint shareholders that should be netted, the scope of nominal joint shareholders, the reasons for submitting amendment report, the criteria for minor reasons concerning deemed joint holders, etc.

## **3. Enforcement Date**

(1) The revised TOB system and the section relating to significant proposals, etc. under the revised reporting system for large shareholdings came into force on December 13, 2006.

(2) The other sections of the revised reporting system for large shareholdings are scheduled for introduction on January 1, 2007. Mandatory submission of electronic reports on large shareholdings, etc. via EDINET (Electronic Disclosure for Investors' NETwork) is scheduled to come into force on April 1, 2007.

## **【Featured】**

### **The Working Group on Information Technology Innovations and Financial Systems, Sectional Committee on Financial Systems of Financial System Council**

#### **“Towards the Establishment of an Electronically Registered Receivables Law (provisional name): Focusing on Approaches to the Establishment of an Electronically Registered Receivables Management Body”**

The Working Group on Information Technology Innovations and Financial Systems, Sectional Committee on Financial Systems of the Financial System Council (hereinafter referred to as “the Working Group”) published a report entitled “Towards the Establishment of the Electronically Registered Receivables Law (provisional name): Focusing on Approaches to the Establishment of an Electronically Registered Receivables Management Body” on December 21, 2006. The Working Group had been studying the implementation of an electronically registered receivables system for some time, and on July 6, 2005, published the “Summary of Discussions on Electronic Receivable Legislation from a Financial System Perspective (Memorandum from the Chairman)”. Moreover, in consideration of the Legislative Council of the Ministry of Justice’s dissemination of its studies on problems inherent in civil law related to electronically registered receivables in 2006, the joint conference of the Financial System Council compiled a report on various problems such as ensuring security in the settlement of electronically-registered receivables and customer protection. This article provides an overview of the report.

#### **I. Overview of “Towards the Establishment of the Electronically Registered Receivables Law (provisional name): Focusing on Approaches to the Establishment of an Electronically Registered Receivables Management Body”**

##### **1. Significance of Electronically Registered Receivables**

Bills as a form of credit between companies have long served as a financing method for businesses. However, their use has been diminishing in recent years due to the inherent risks of using paper media and cost considerations. Claims payable to specific persons also have double transfer risks and problems in regards to the cost of checking the existence of receivables, etc., which results in hindering the process upon financing with the use of receivables held by businesses.

Amid the progress in the spread of IT in economic circle and throughout society in general, it is hoped that an electronically registered receivables system will be institutionalized as a new system of putting the creation of rights, etc. into effect based on electronic records and ensuring security in conducting transactions and liquidity, for the purpose of overcoming these problems and developing a business-friendly financial environment, including for small and medium-sized enterprises (SMEs).

##### **2. Electronically Registered Receivables System and Role to be Performed by Management Body**

Electronically registered receivables are expected to enter broad use as a new means of financing through the transfer of receivables by electronic means in place of bills and claims payable to specific persons. In order for this to happen, it is indispensable to overcome the challenge of ensuring the credibility of the electronically registered receivables system, and more than anything else, it is important to respond to the need to ensure the security of transactions and liquidity as well as to the need for customer protection.

In particular, a management body of the aforementioned sort would constitute an organization involved in the management of registers that would defines the nature and attribution of rights to electronically registered receivables and would enforce discipline in regards to customer transactions through operational rules, etc. Said system will need to ensure fairness and impartiality as a public organ and function as a public trust winning entity.

### **3. Ensuring Stability in Settlements of Electronically Registered Receivables**

#### **(1) Necessity of Synchronized Management**

In an electronically registered receivables system, requests for registration of payments, etc. (deletion of records) to the management body must, as a general rule, be made by the creditor. The debtor cannot request the deletion of records unless the creditor gives approval. This prevents the risk of duplicate payments by the debtor, as the receivables are transferred in accordance with the creditor's response even if the debtor has made a payment, etc.

#### **(2) Synchronized Management Based On Management Records**

In order to prevent the risk of duplicate payments by the debtor, it would be effective to introduce a mechanism for the management body to delete the records based on its authority (synchronized management by the management body) without waiting for the creditor's request for the deletion of the registration of the receivables (request for deletion of registration) in cases where the debtor has completed the payment, etc.

#### **(3) Method of Performing Synchronized Management by Management Body**

One way for the management body to perform synchronized management through confirmation of the remittance of funds is to have the management body delete the relevant records when it is contacted by a financial institution and informed of the remittance of said funds from the debtor's account into that of the creditor.

### **4. Ensuring Appropriateness in Management Body's Operations**

#### **(1) Ensuring Fairness and Impartiality of Management Body**

The accrual of electronically registered receivables, etc. comes into effect based on records in the register. It is extremely important that fairness and impartiality is ensured within the management body responsible for managing the register.

#### **(2) Averting Bankruptcy of Management Body**

If the management body were to go bankrupt, it would not only have a major impact on customers, but might even cause economic and social havoc in Japan. Accordingly, bankruptcy on the part of the management body needs to be prevented at all cost. It is also necessary to build a mechanism to minimize inconvenience among customers in the event that said body does go bankrupt.

#### **(3) Ensuring Credibility of Register**

If there is an error in the records of the register, there is a risk of the assignee acquiring electronically registered receivables as a result of being misled to believe that the erroneous records are correct, which might undermine the security of transactions. It is therefore necessary to design such a system in a way that ensures the credibility of the register managed by the management body.

#### **(4) Requirements of Management Body**

In consideration of the above, a management body of the above-described sort will be required to adhere to the following strictures:

##### **(a) Scope of Operations**

It is considered appropriate for the management body to demonstrate specialization in the operations it provides in order to ensure fairness and impartiality and avert bankruptcy risks.

##### **(b) Financial Base**

A certain financial base is required so as to be able to invest in systems, etc. and to run the management body in a stable and continuous manner.

##### **(c) Ability to Execute Operations**

It is necessary to ensure the ability to execute operations to the extent required for the proper management of the register.

## **(5) Supervision**

In addition to looking into building a designation system, etc. by using debenture transfer bodies, etc. similar to the management body as reference, it is necessary to develop necessary provisions for inspection and supervision to ensure the effectiveness of various regulations targeted at the management body, while properly identifying the business status of the management body.

## **5. Customer Protection**

### **(1) Use by Consumers**

Customer protection is also a crucial issue. Although consumers are currently protected in terms of legislation, it is important to prevent disputes from arising, as it is detrimental to them for such disputes to arise in the first place.

### **(2) Protection of Customer Information**

The management body should be obliged to implement thorough measures to ensure confidentiality, customer identification and data security, as it oversees the management of a register of electronically registered receivables wherein customer information is compiled.

### **(3) Dissemination of Operational Rules to Customers, etc.**

As the use of electronically registered receivables will be controlled by operation rules, etc. established by the management body, it is important to take appropriate measures to ensure that said operation rules, etc. are made common knowledge. It is also necessary to give consideration to customers' computing environments, bearing in mind that IT-related knowledge and proficiency varies from customer to customer.

## **6. Other Issues**

### **(1) Relationship with Financial Instruments and Exchange Law, etc.**

Electronically registered receivables have the potential to be widely traded as financial instruments, as a wide range of applications is conceivable. With this in mind, it is necessary to look into applying the regulations of the Financial Instruments and Exchange Law.

### **(2) Netting of Electronically Registered Receivables**

It is necessary to examine what kind of approach would be appropriate in the netting of electronically registered receivables with a view to ensuring practical merits, security in settlement and customer protection.

### **(3) Standardization, etc.**

It is the hope that a suitable approach will be taken to the standardization of technologies, etc. for exchanging electronic data held by the management body based on currently operational practices.

## **7. Conclusion**

Upon designing an electronically registered receivables system, it will be important to not only take the view of ensuring credibility but also to attempt to ensure the growth potential of financial services through electronically registered receivables by taking a flexible approach to diverse business needs, IT innovation, etc. in the future. It is the hope that said legislation based on these views will see the widespread implementation of electronically registered receivables, and will lead to the sound progress of this system.

## **II. Future Approaches**

In consideration of the latest report and the discussions that have held within the Legislative Council, we are currently drafting legislation in conjunction with the Ministry of Justice. We hope to submit related bills at the ordinary session of the Diet this year.

## **【Hot Picks from the Financial World】**

\* We deliver the hottest information of the times in this section, selected from among questions and answers given at the Minister's press conferences, etc.

If you wish to find out more, we invite you to visit the "[Press Conferences](#)" section of Financial Services Agency's website.

### **[Insurance]**

**Q. All non-life insurance companies reported to the Financial Services Agency (FSA) about their respective deadlines for the third report on non-payment cases. I would like to hear the Minister's view on the deadlines they have set.**

A. Just recently, on November 17, from the standpoint of prompting them to look into cases of missed payments of ancillary insurance claims and to make additional payments to the insured, etc., we requested that non-life insurance companies report by Friday, December 8 matters including the timing of the completion of their final inquiry and all of them did submitted such a report. While we will scrutinize the content of their reports, I would also like to see them act responsibly, based on their respective management decisions, in their efforts to unravel the whole scope of non-payment cases and pay insurance claims to the insured, etc. in accordance with the inquiry completion timeframe that they have set.

(from [the press conference following a cabinet meeting on Tuesday, December 12, 2006](#))

**Q. I would like to hear your views on the recent discovery that major non-life insurance companies were charging too much in insurance premiums for 2x4 houses.**

A. I find regrettable the fact that such mistakes were being made at customer service counters in such a basic component of insurance, namely, charging excessive premiums. While this is not a case of non-payment, I still want the companies to devise ways to steadfastly improve their basic management practices

(from [the press conference following a cabinet meeting on Tuesday, December 12, 2006](#))

### **[Securities tax regime]**

**Q. Can you please share your views on the securities tax regime?**

A. Given the decision to discontinue the current securities tax regime after a one-year extension, which is different from the idea of a straightforward extension for which I have been expressing my support, that which I had requested did not quite receive full approval. On the other hand, do I have high hopes that how a future securities tax regime should be formulated will be discussed in further depth among the ruling parties, seeing that there is a plan to develop a final proposal, with the intention to introducing it in FY 2009, upon deliberating factors such as the state of securities markets and the asset holding patterns, particularly in regards to stocks, of individual investors, and examining steps to, for instance, expand the eligibility of profits and losses from different financial products for combined taxation purposes.

(from [the press conference following a cabinet meeting on Friday, December 15, 2006](#))

**[Selection of an acquiring party of Ashikaga Bank]**

**Q. Given that public bidding for the Ashikaga Bank acquisition has just closed, can I please ask what your impression is on how this bidding has developed?**

- A. We received a large number of applications. Although, regrettably, I cannot give you a detailed account of the number and content of those applications, I have found them to be quite reassuring. We now hope that the understanding of those in the residential and business communities in the region will be gained and also that the process ahead will be one in which transparency in the market in Japan for this type of transaction is ensured and the principle of market competition is in place with foreign companies also participating therein, and that, above all, it will produce a reasonable outcome. In any case, I feel quite encouraged by the large number of applications that we received.

(from [the press conference following a cabinet meeting on Tuesday, December 19, 2006](#))

**[Nikko Cordial]**

**Q. With respect to the issue of Nikko Cordial Corporation's engagement in inappropriate accounting procedures, the Securities and Exchange Surveillance Commission (SESC) recommended the FSA charge 500 million yen in penalties. I would first like to hear your views on this incident.**

- A. Nikko Cordial Corporation is indeed a leading financial institution in Japan. In that sense, this is a very unfortunate turn of events. I am well aware that properly disclosing corporate financial information is extremely important for securing the trust of investors. The case in question represents a situation where in the parent company of a securities company that operates as a broker in securities markets was charged with a statutory violation in relation to a disclosure obligation, an important area of its operation. I must say that I find it regrettable.

(from [the press conference following a cabinet meeting on Tuesday, December 19, 2006](#))

**Q. the Nikko side made a comment that could be interpreted to mean that they would be making corrections to their SPC consolidation, etc. for reasons different from those pointed out by the SESC. Please tell us of your view on the way Nikko is dealing with this issue.**

- A. Cordial Corporation said in its information for timely disclosure that: (a) the valuation gains from EBs that it had reported were incorrect, (b) it decided that NPIH should be consolidated because NPI had acquired NPIH, but that during the press conference that followed Nikko reportedly argued that: (a) the EB handling in question was an operational error on the part of one employee who made a mistake in the issuing procedure and that Nikko therefore had no intention of overstating its profits, and (b) the accounting procedures that it took when it excluded NPIH from the scope of consolidation were proper. According to an explanation provided to us by the SESC, however, Cordial Corporation had reported to the SESC that: (a) NPI Holdings, all of whose shares are owned by its subsidiary, Nikko Principal Investments, and which is effectively controlled by Nikko Principal Investments as well, should be covered in its consolidation scope, a fact that Nikko Cordial admits in its own words, and that (b) it had reported evaluation gains, which it should not have done, by making up false issue dates, etc. for EBs, which it admits to not consisting a simple operational error on the part of one employee. In any case, we are, as part of the administrative judgment procedures, now requesting that Nikko Cordial Corporation submit a written response by January 16 outlining the facts of the alleged violation and the subsequent penalties. Any disputes that may arise as to the facts uncovered by the SESC or any other related matter will certainly be discussed in an administrative judgment setting. Therefore, with Nikko's response to this case expected to be filed by January 16, we will meanwhile be waiting in anticipation for a solid answer from them.

(from [the press conference following a cabinet meeting on Friday, December 22, 2006](#))

**[General Overview of 2006]**

**Q. Today's press conference after the Cabinet meeting will be the last for the year. Please provide a general overview of the year and how you would rate it.**

- A. The Prime Minister stated that he has been working strenuously, and I too feel the same, as this is my first experience as a Cabinet member. Most of all, the Money-Lending Business Control and Regulation Law came into effect, as did the Trust Business Law. In addition, the prospects for promoting the "Challenge Again" initiative have become clear. In that sense, I have been able to come all this way, thanks to everybody's cooperation. I am relieved that progress has been made without any major hiccups.

(from [the press conference following a cabinet meeting on Tuesday, December 26, 2006](#))

**[Multiple Debt Problem]**

**Q. What are your thoughts on the measures, such as establishing a buffer or an inquiry counter?**

- A. As you may be aware, two elements are indispensable in the counseling framework, namely, debt consolidation and family budget management. The problem cannot be solved by either of these elements alone, and an extremely high level of expertise is required in both of them. If I am allowed to go further, it would be even better if someone plays the role of a counselor on psychological matters, to be in charge of encouragement. Expertise is required in three areas, and these tasks cannot be undertaken by a single person. Especially considering that multiple debtors are scattered all over the country, it is indispensable to develop a powerful prefectural and municipal promotion framework and a network of organizations.

(from [the press conference following a cabinet meeting on Tuesday, December 26, 2006](#))

**[Consolidation of Stock Exchanges]**

**Q. Do you think it is desirable for Japan's six largest stock exchanges to be consolidated into one exchange?**

- A. While I am aware of the news reports, I have no direct remarks on them. If I am allowed to take a freehand approach in considering this, I think it is definitely important for each stock exchange to further deepen their interaction with each other. In my mind, I suppose the Tokyo Stock Exchange (TSE) is like Ryogoku Kokugikan, and each region has a local league with a sumo ring where wrestlers can perform. As the plan to consolidate the six largest stock exchanges in Japan is about the enhancement of functions, I think it would be desirable if it involves exploring an approach to direct financing for what I call the new era, supporting it together with business companies, and growing together by complementing each other.

(from [the press conference following a cabinet meeting on Friday, January 5, 2007](#))

**[Bank of Japan]**

**Q. There are increasing prospects for the Bank of Japan (BOJ) to decide to implement another interest rate hike at the Monetary Policy Meeting and objections to this are growing. What are your views on another interest rate hike?**

- A. We fully understand that they have concerns over the economic climate from their respective standpoints. There are various causes of concern when the approach to monetary policy is considered assuming that economic trends vary from region to region, or put differently, there are winners and losers by region, before the House of Councilors election. However, at the macro level, the BOJ has exclusive control over monetary policy unilaterally, and we are in the position to show maximum respect for its decision.

(from [the press conference following a cabinet meeting on Tuesday, January 16, 2007](#))

**Q. The BOJ decided not to go ahead with another interest rate hike at the Monetary Policy Meeting. What are your thoughts on this decision? Some people have pointed out that this has left some issues in terms of dialogue between the BOJ and the market or the government. Your views on this will also be appreciated.**

- A. The BOJ exclusively controls monetary policy and made the judgment responsibly in consideration of the given conditions. However, what bothers me slightly over the relationship with the government is that the BOJ has some explaining left to do in the future, considering that the BOJ's message last year was to "raise the interest rate in January unless there is a catastrophe."  
(from [the press conference following a cabinet meeting on Friday, January 19, 2007](#))

**[Others]**

**Q. What is your perception of the new incident revealed at Dai-ichi Mutual Life Insurance Company relating to the non-payment of medical insurance claims concerning optional extras? How will the FSA deal with this matter?**

- A. Insurance companies and user protection are themes that we should always aim to address as a matter of top priority. It is extremely regrettable that this is still not strictly enforced. It is hoped that Dai-ichi Mutual Life Insurance Company will provide a sufficient explanation and demonstrate actual improvements in the future.  
(from [the press conference following a cabinet meeting on Friday, January 19, 2007](#))

**Q. In the press, there were some reports about 200 to 300 cases in which cash exceeding ¥100,000 had been transferred from ATMs at Shinkin Banks in the Kanto-Koshinestu region. Is the FSA aware of these facts? Are there other similar cases? Please explain how the FSA will respond to this situation in the coming weeks.**

- A. We have been informed of the incidents that arose at some Shinkin Banks where the transfer of cash exceeding ¥100,000 became possible. I will refrain from commenting on the details, as they relate to individual financial institutions. We will first identify and scrutinize the facts, and then take all possible measures to prevent such incidents from arising again.  
(from [the press conference following a cabinet meeting on Tuesday, January 23, 2007](#))

## **【Notice】**

### **○ Beware of Investment Salespersons Posing As Financial Services Agency (FSA) Staff!**

The Counseling Office for Financial Services Users at the Financial Services Agency (FSA) has recently received information about *persons involved in the sale of investment products, etc. impersonating FSA staff and solicitation based on claims that FSA staff are involved in the investment products, etc.*

FSA staff are NEVER involved in solicitation, portfolio development or any other such activities concerning investment products, so please exercise due caution against such activities. If you ever come across such activities, please inform the Counseling Office for Financial Services Users at the FSA.

### **○ Relocation of FSA Office (FY2007)**

From the end of FY2007 to the beginning of FY2008, the FSA will move out of Central Common Government Office No.4 into Central Common Government Office No.7 (hereinafter referred to as “Office No.7”), a new building under construction adjacent to the current location. The construction of Office No.7 commenced in January 2005 as part of the development project for Office No.7 and other structures in the south area of Kasumigaseki 3-chome, for the purpose of reconstructing the former Ministry of Education, Culture, Sports, Science and Technology and the former Board of Audit offices in the area. The new facility is scheduled for completion in September 2007. Office No.7 is a first-of-a-kind central common government office that is being developed in the form of a large-scale, joint public-private facility aimed at creating new business opportunities and using land effectively. The project involves the development of two skyscrapers adjacent to the 36-story Kasumigaseki Building (height: approx. 147m): a 33-story government office wing (height: approx. 157m) and a 38-story public/private office wing (height: approx. 176m).

The FSA is due to occupy the 2<sup>nd</sup> floor through to the 18<sup>th</sup> floor of the building’s public/private office wing, and will be making preparations for the relocation towards the end of the year, with the aim of commencing operations in Office No.7 in January 2008.



**Rendering of the FSA’s new office building (the FSA is due to move into the middle structure.)**