FSA Newsletter January 2006

Masazumi Gotoda (Parliamentary Secretary) giving keynote speech at symposium on how to use money and thoughts on local communities (December 17)

Kaoru Yosano (Minister of State for Economic & Fiscal Policy and Financial Services) making an address at conference on facilitating small- and medium-sized enterprises (SME) financing (December 13)

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[Topics]

Major Banks' Financial Results for First Half ending September 30, 2005 <<Based on Preliminary Announcements>>

The major banks' financial results for the first half ending September 30, 2005 are outlined below.

1. Profit and Loss Status

Operating profits from core business of all the major banks combined amounted to 2.0 trillion yen in the first half ending September 30, 2005, which was similar to the level in the first half ending September 30, 2004 (1.8 trillion yen).

In the first half ending September 30, 2005, the net income of all the major banks combined substantially increased to 1.6 trillion yen, and at the same time, all the major banks recorded positive net income. This can be largely attributable to extraordinary factors: losses from the disposal of non-performing loans (NPLs), which had amounted to 1.1 trillion yen in the first half ending September 30, 2004, reversed a gain of 0.2 trillion yen, as the reversal of the allowance for credit losses increased, while write-offs of loans and provisions for the allowance for credit losses decreased.

2. Status of Capital Adequacy Ratio

The capital adequacy ratio of major banks (based on non-consolidated weighted average) was 11.6%, which turned out to be exactly the same as in the fiscal year ended March 31, 2005.

3. Status of NPLs

The balance of NPLs (loans disclosed under the Financial Reconstruction Law) decreased by 1.3 trillion yen to 6.1 trillion yen overall from the fiscal year ended March 31, 2005 (7.4 trillion yen).

The percentage of NPLs decreased by about 0.5 percentage points to 2.4% from the fiscal year ended March 31, 2005 (2.9%). The percentage of NPLs decreased at all major banks, so the banks are deemed to be steadily improving the soundness of their assets.

Implementation Framework of the Second Pillar of Basel II

The Financial Services Agency (FSA) has announced the implementation framework of the second pillar (supervisory review process) of Basel II (the new capital adequacy framework, which is due to be carried out from the end of March, 2007).

1. Key Features of the Second Pillar of Basel II

The second pillar - supervisory review process emphasizes that financial institutions should fulfill their self-responsibility for appropriately assessing and managing various risks they face, and maintaining sufficient capital according to such risks including those not covered within the first pillar (minimum capital requirements). It also mentions that supervisors should review and evaluate risk management methods which are adopted by individual financial institutions on their own initiative and take appropriate supervisory actions as necessary.

(Reference) Basel II (the new capital adequacy framework) establishes the following four key principles in the second pillar.

Principle 1: Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2: Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate action if they are not satisfied with the result of this process.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

* Basel Committee on Banking Supervision, *"International Convergence of Capital Measurement and Capital Standards: A Revised Framework"*, June 2004.

The approach of the FSA to the second pillar of Basel II is the implementation of three-tier supervision below.

(1) Communicate the supervisory expectations and induce efforts of individual financial institutions to achieve the comprehensive risk management (in response to Principle 1).
(2) Review the effectiveness of the comprehensive risk management system (in response to Principle 2).
(3) Establish early warning thresholds for individual risks (in response to Principles 3 and 4).

The ultimate objective of the financial administration, in light of the second pillar of Basel II, is that each financial institution maintains and improves its soundness by advancing its own risk management function that is commensurate with its scale and risk profile, etc. Promoting these efforts, together with those for the third pillar of Basel II (market discipline) described in the later section, is consistent with the principles of financial supervision in Japan, where the principle of self-responsibility and market discipline form the foundation which is supplemented by supervisors.

2. Relationship with the First Pillar (Minimum Capital Requirements)

Basel II consists of he first pillar (which seeks to improve the accuracy of the calculation method of capital adequacy ratio which is an important indicator of a financial institution's soundness), the second pillar (which seeks to promote self-disciplined risk management by financial institutions and enforce review by supervisors), and the third pillar (which seeks to enhance market discipline). The three pillars complement each other for the purpose of ensuring the soundness of financial institutions.

The first pillar aims to improve the accuracy of risk measurements and advance risk management function, in order to overcome the limitations and problems in the existing capital adequacy requirements (Basel I).

(Note) The FSA has released a draft of the new capital adequacy requirements for public comment from interested parties three times: (1) October 28, 2004, (2) March 31, 2005 and (3) December 28 2005.

The second pillar emphasizes that financial institutions should appropriately assess and manage the entire risks including those risks which are not covered in the calculation of the minimum capital requirement under the first pillar system, in light of their scale and risk profile, etc. It also mentions that supervisors should review and evaluate risk management methods of individual financial institutions and take such appropriate supervisory actions as periodic reporting and interviews as necessary, while assigning maximum respect to efforts to be made by each financial institution on its own initiative. The second pillar thereby aims to complement the first pillar and encourage financial institutions to achieve a more appropriate self-disciplined risk management.

3. Evaluation of Comprehensive Risk Management System

Based on this approach, the supervisory perspectives to review a comprehensive risk management system will be included in supervisory guidelines summarizing the FSA's basic approach to the supervision process so as to encourage each financial institution, having considered these perspectives, to build an appropriate and comprehensive risk management system in accordance with the scale of its business and risk profile, etc, and to build a process for assessing its capital adequacy in relation to its own risk.

The FSA will assess, review and evaluate the effectiveness of a comprehensive risk management system established by each financial institution via such means as periodic reporting and interviews with the management of each institution, while assigning maximum respect to efforts to be made by each financial institution on its own initiative. The FSA will conduct its supervisory reviews and evaluations in accordance with the "Evaluation of Comprehensive Risk Management System" that will be described below.

Evaluation of Comprehensive Risk Management System

Risk-taking is an essential element in financial intermediation. As the financial institutions' operations continue to diversify, it is becoming increasingly important for the management of financial institutions to gain a comprehensive understanding of various risks and to prepare appropriate management systems on its own initiative to deal with such risks. When reviewing risk management systems of financial institutions, the fundamental role of the FSA is to supplement their own efforts to manage risks. Pursuant to this approach, the FSA will, in implementing the second pillar of Basel II, review whether each financial institution appropriately assesses and manages the entire risks including those risks which are not covered in the calculation of the minimum capital requirement under the first pillar.

(Reference) Examples of risks mentioned in "The International Convergence of capital Measurement and Capital Standards: a Revised Framework" issued by the Basel Committee on Banking Supervision (June 2004). (This list is not exclusive.)
Credit risk, operational risk, market risk, interest rate risk in the banking book, liquidity risk and other risks (reputational risk, strategic risk, etc.)

Financial institutions need to establish a clear risk management policy that is commensurate with the size, characteristics and complexity of their businesses, and assess the various risks inherent in each business department aggregately and quantitatively. It is also necessary to maintain sufficient level of capital both in terms of quality and quantity in comparison with such aggregated risks. (Note)

(Note) It has been recognized as the best practice to quantify the volume of risks in each business department to the extent possible, and allocate capital accordingly to each department within the range of the institution's overall level of capital. By doing so, the volume of risks taken by individual institutions can be limited within the scope of their capital. At the same time, financial institutions are expected to conduct an appropriate management of risks and returns in relation to their business plans, using, for instance, quantitative indicators such as risk-adjusted profit of each business department.

For the reasons, the FSA will revise the "Comprehensive Guideline for Supervision of Small- and Medium-sized and Regional Financial Institutions," in line with the perspectives clarified in the recently-published "Comprehensive Guideline for Supervision of Major Banks, etc.," in order to assess financial institutions' preparedness in terms of the comprehensive risk management systems as well as the capital adequacy assessment process. However, as the scale and the risk profile of each financial institution could vary significantly, due care must be paid to avoid uniform and inflexible application of regulations. Rather, it is important to ensure that the FSA's review will be implemented in a manner that is in line with the actual development status of the risk management system at each financial institution. In doing so, the FSA will respect the internal management system and quantification method assumed by each financial institution to the maximum extent in accordance with the actual development status, and where necessary, it will foster a further advancement of risk management system at each institution.

4. Enhancement of the Early Warning System

On the other hand, an appropriate mechanism for supervisory intervention on individual risk categories needs to be established in order to supplement the above-mentioned supervisory reviews/evaluations of the comprehensive risk management system based on self-responsibility of each financial institution. For example, in order to avoid situations where an unsatisfactory management system of key individual risks affects the soundness of the financial institution, those financial institutions with a high probability of materializing such risks need to be observed with focused attention.

The FSA introduced an Early Warning System in 2002, as a framework whereby remedial actions are prompted to financial institutions with capital adequacy ratios above the required minimum (not subject to prompt corrective actions) at an early stage. The Early Warning System is a tool that enables the FSA to monitor such aspects of each financial institution as profitability, credit risk, market risk, and liquidity risk, and in accordance with the results of such monitoring, the FSA requests individual institutions to submit reports or order operational improvement as necessary if those financial institutions could not satisfy certain thresholds that are pre-determined for each of these risks commonly for each institution.

In light of such a characteristic and method of the Early Warning System, it would be effective and efficient to utilize the existing early warning thresholds that focus on specific indicators for individual risks, as a tool to implement the second pillar of Basel II, together with the aforementioned FSA's approach to encourage each financial institution to make its own efforts to build a comprehensive risk management system, and to review its effectiveness. Such a combination of supervisory approaches would be desirable in terms of the compliance costs paid by financial institutions, and of the continuity of the financial administration.

With regards to the "interest rate risk in the banking book" and "credit concentration risk" which are explicitly regarded as important risks to be covered under the second pillar, the FSA will incorporate its supervisory measures for those two risks into the framework of the Early Warning System, so as to ensure that these risks are managed in an appropriate manner on an individual basis.

(Note) For more information on the "interest rate risk in the banking book" and "credit concentration risk", please refer to the press release titled "Implementation Framework of the Second Pillar of Basel II" (November 22, 2005).

In the framework of the Early Warning System, the FSA conducts interviews in order to analyze the cause, review the appropriateness of the risk management and remedial actions taken by financial institutions which fall below the pre-

determined level. Also as necessary, the FSA requests a written report in accordance with Article 24 of the Banking Law, or issue a business improvement order in accordance with Article 26 of the Banking Law when the necessity is acknowledged to deliver a successful implementation of a business improvement plan.

In such a framework, supervisory actions such as interviews have to be taken as a part of the "Stability Improvement Measure" concerning the interest rate risk in the banking book, or of the "Credit Risk Improvement Measure" concerning the credit concentration risk of the financial institutions that fall below the above-mentioned threshold. Even in such circumstances, however, it does not mean that the management of the financial institutions concerned is automatically regarded as unsound, and thus, the FSA does not necessarily make an immediate request for improvement of the management.

Furthermore, even in the case where an improvement is needed in individual institutions, special attentions should be paid to appropriately select the method and the timing of the improvement plan in order to contain potential influences of the improvement actions on the financial market and financial intermediaries for small- and medium-sized enterprises.

If a need is recognized after the implementation of this supervisory framework, the FSA will flexibly review the framework as well as its implementation method.

5. Supervisory Approach for Small- and Medium-Sized and Regional Financial Institutions

The above framework also applies to small- and medium-sized and regional financial institutions. The fundamental approach of the FSA is to utilize the framework to review and evaluate the system for a comprehensive management of various risks at each financial institution, in tandem with the Early Warning System including those for the "interest rate risk in the banking book" and the "credit concentration risk".

It must be noted, however, that the comprehensive risk management is basically intended to apply for financial institutions with large-scale and complicated risks in order for them to assess and manage a wide range of risks as a whole. On the other hand, there exist some small- and medium-sized and regional financial institutions for which it may not be appropriate to immediately require a highly sophisticated comprehensive risk management system, in light of their scale and risk profile. Therefore, the Early Warning System will form the basis for the supervision of these financial institutions, and in the course of conducting interviews and requesting reports based on the Early Warning System, the FSA may encourage individual institutions – where necessary, to establish a desirable level of system for comprehensively managing various risks, commensurate with the scale and risk profile of each institution.

6. The Third Pillar

Basel II seeks to improve the effectiveness of market discipline by enhancing disclosure, and requires financial institutions to disclose the capital adequacy ratio, its breakdown, the volume of risks by each risk type held by individual financial institutions, the calculation methods of each risk and so forth.

The draft of the third pillar (the FSA has already released the proposed disclosure items for public comments from interested parties, in conjunction with the draft of the first pillar. For more information, please refer to FSA's official website aforementioned.) shows the disclosure items in compliance with Basel II, and requires financial institutions to disclose information relating to these items at least once a year (twice a year in the case of banks), based on financial institutions' duty of disclosure set forth in the Banking Law, etc. It also has provisions for financial institutions to make efforts to disclose such information on a semiannual and quarterly basis, depending on the actual status of each financial institution. Moreover, banks that adopt Internal Ratings-Based Approach (credit risk) or Advanced Measurement Approaches (operational risk) need to properly disclose information on a semiannual and quarterly basis as well, and such disclosure policy is defined in the requirements for the approval of each approach. International standard banks are also due to be treated in the same manner because of their characteristics.

* For more information, please refer the "Implementation Framework of the Second Pillar of Basel II" (November 22, 2005) of the "Press Releases" section on the FSA's website.

Intensive Screening of Securities Reports for Fiscal Year Ended March 31, 2005

1. Overview of Intensive Screening

Companies whose fiscal year ends on March 31—the most common date chosen for the fiscal year end—are required to respond to a *questionnaire* regarding information deemed to be significant for disclosure. The questionnaire, which must be submitted to the Local Finance Bureaus, the Fukuoka Local Finance Branch Bureau and the Okinawa General Bureau (hereinafter referred to as "Local Finance Bureaus, etc.") by the companies submitting a securities report at the same as the securities report and semiannual report, forms the basis of intensive screening.

Nationwide, 3,335 companies that submitted their respective securities reports for the fiscal year ended March 31, 2005 (submission deadline: June 30, 2005) were intensively screened by the Local Finance Bureaus, etc., having jurisdiction over the disclosing companies, with respect to the disclosure status of two items: (1) *the corporate governance situation*; and (2) *information on the parent company, etc., of the company submitting securities reports*.

2. Summary of Screening Results

Companies deemed to have given inappropriate statements as a result of the screening conducted by the Local Finance Bureaus, etc., were urged to correct the statements. As a result, a corrected report was submitted by 167 companies.

Typical examples of inappropriate statements found as a result of the intensive screening are shown below.

(1) Corporate Governance Situation

Item	Description
1	The organization for internal audit and auditors' audit is not described even though there is such an organization.
	The organization for internal audit and auditors' audit is described but the staff and/or audit procedures are not.
	Internal audit, auditors' audit and accounting audit are coordinated as necessary but there is no description of such coordination.
2	There is no description of any outside director or outside auditor with personal, equity, business or other stakeholding relationships despite the existence of such director and auditor.
3	The name of the Certified Public Accountant (CPA) who performed the auditing tasks is not provided. The name of the auditing firm to which he/she belongs is not provided.
	The screening system is not described in cases where an audit certificate is provided by an individual CPA.
	There is no description of auditing assistants even if there are such assistants.
	There are accounting auditors who have engaged in audit-related work continuously for more than seven years but there is no description of the number of years in which they were involved in audits.

(2) Information on Parent Company, etc., of Company submitting Securities Reports

1	"Information on parent company, etc., of company submitting securities reports" is missing.
5	In cases where the parent company, etc., is listed, the name of the stock exchange is not provided as required.

3. Afterword

The latest intensive screening revealed many inappropriate statements on disclosure items relating to *corporate governance situation* and *information on the parent company, etc., of the company submitting securities reports*, including some missing entries. It should be understood that disclosure is required by law to provide useful information for making investment decisions in the interests of investor protection; accordingly, when submitting a securities report, please thoroughly check the instructions for preparing the reports and disclose the relevant information in a proper fashion.

Survey on Non-payment of Fringe Claims by Non-life Insurance Companies

1. Overview of Reporting Request

In order for an insurance company to run a non-life insurance business, it is absolutely imperative that claims are properly paid. Recently, however, there have been incidents that undermine confidence in non-life insurance businesses: it was found that in many cases, non-life insurance companies have failed to pay fringe claims, especially claims for extra expenses.

(Note) "Non-payment of fringe claims" refers to the failure to pay fringe claims for extra expenses (consolation payments, condolence payments, loaner car expenses, etc.) which should have been paid in the event of an accident covered by insurance but were not on the grounds that the policyholder did not apply for the payment of such claims, even though the core claims have been paid.

With this situation in mind, on September 30, the Financial Services Agency (FSA) demanded all non-life insurance companies (48 companies) to report on the following pursuant to the Insurance Business Law by October 14:

1) The number of cases in which fringe claims were not paid even though there had been reasons to pay claims over the past three years (from April 2002 to June 2005) and the payment completion status;
2) Analysis of the causes of the non-payment of fringe claims, including the modality of the claims payment management system; and
3) Measures to prevent such non-payment from recurring based on the analysis of the causes.

2. Results of Survey on Non-payment of Fringe Claims

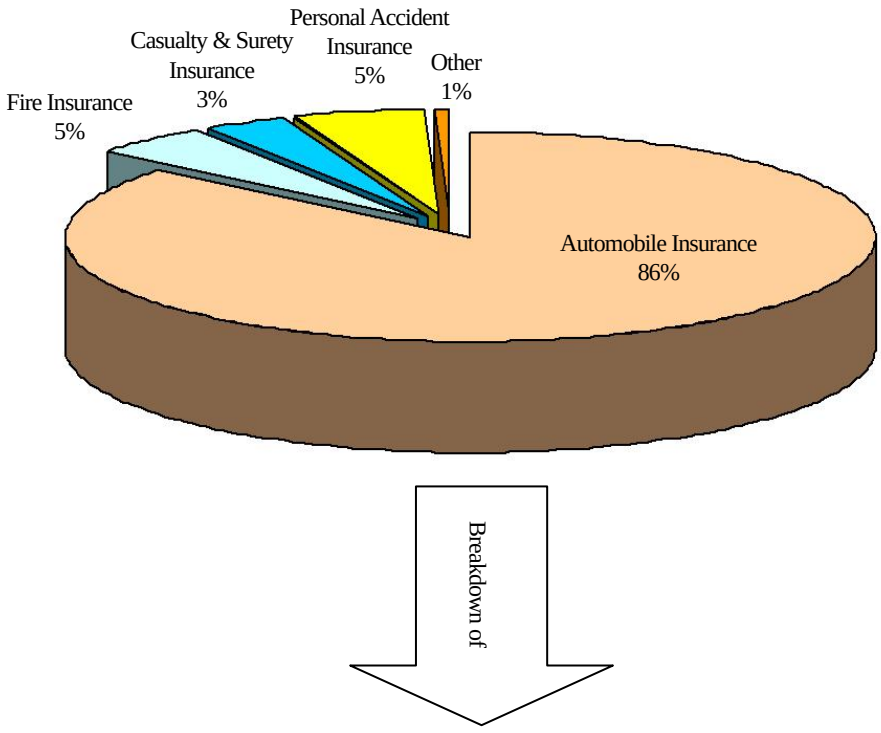
(1) Number of Cases and Amount of Non-payment of Fringe Claims and Payment Status

Non-payment of fringe claims occurred at 26 out of all the 48 non-life insurance companies. The number of non-payment cases totaled 180,614, and the amount of non-payments totaled approximately 8,403 million yen. On average, the amount of non-payment was 46,000 yen per case.

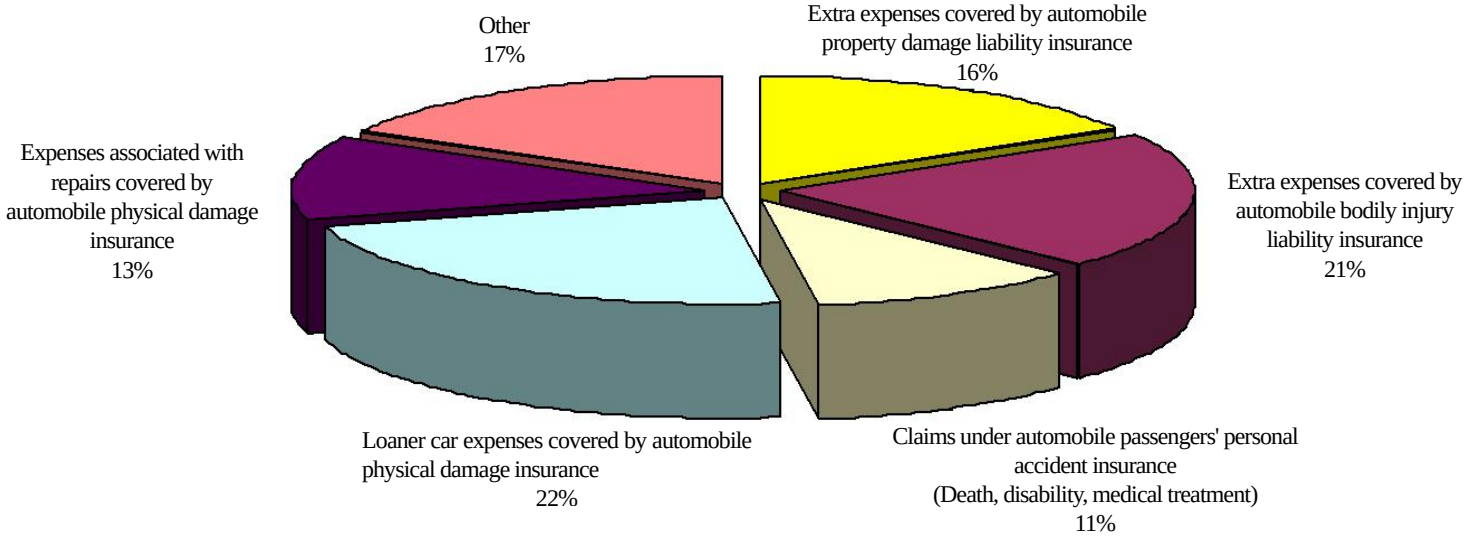
The 22 companies that reported to have not had any non-payment of fringe claims either did not handle fringe claims in the first place or handled only a small number of fringe claims.

As shown in Graph 1, **approximately 90% of all cases of non-payments were related to claims for extra expenses for automobile insurance.**

[Graph 1: Number of Non-payment Cases by Insurance Type]



[Graph 2: Breakdown of Automobile Insurance]



[Reference]

◆ **Compensation to Other Party** ◆

Extra expenses covered by automobile property damage liability insurance: Insurance money paid in the event of causing damage to the other party's property, for the purpose of buying a cake, etc., in extending an apology to the other party.

Extra expenses covered by automobile bodily injury liability insurance: Insurance money paid in the event of causing death or injury to another person, for the purpose of making consolation payments, etc., to the person or his/her family.

◆ **Compensation to Policyholder** ◆

Claims under automobile passengers' personal accident insurance: Insurance money paid in a fixed amount or at a fixed rate depending on death or severity of injury in the event of causing the death or injury of a passenger (driver and fellow passenger).

Loaner car expenses covered by automobile physical damage insurance: Insurance money paid for covering expenses borne as a result of using an alternative vehicle or other means of transport, etc. while the car is being repaired.

Expenses associated with repairs covered by automobile physical damage insurance: Insurance money paid for cleaning up the accident site, extending an apology to neighbors, and other such purposes that are outside the scope of restoration and repairs coverage by the master contract.

(2) Systemic Problems which Caused Non-payment of Fringe Claims

The following problems were identified in non-life insurance companies in which non-payment of fringe claims were revealed.

1) Problems in Internal Coordination in Product Development Stage

- Not enough preparation is being done on the payment system when the product development division and related divisions have discussions upon product release/update, including gaining a thorough understanding of the nature of the product and supporting systems.
- There are no rules on matters to be discussed between related divisions or on the schedule for the development and sale of new products.

2) Poor Efforts made to Ensure Customers' Understanding

- Explanation and guidance on products are inadequate, as to what kind of fringe claims exist in addition to core claims.
- No clear explanation or guidance is provided in regards to how to make an insurance claim in the event that reasons for paying fringe claims arise, in addition to core claims.

3) Problems in Payment Division

- The staff's attention is focused on affairs related to the payment of core claims such as determining the amount of damages and negotiating out-of-court settlements, resulting in inadequate confirmation and guidance of the terms and conditions of the insurance policy and insurance claims made by the policyholder.
- The system of secondary checking by managers, etc., in the payment division is inadequate in view of preventing the non-payment of fringe claims.

- The content of the appraisal manual, etc., is neither structured nor exhaustive.
- Even though there was a clause stipulating that claims for a certain amount of extra expenses would be paid regardless of whether or not such expenses were actually incurred in the event of an accident, it was misunderstood that the payment criteria would not be met unless the extra expenses were actually incurred as in the case of paying typical non-life insurance claims.
- In cases where the staff member in charge varied from claim item to claim item (personal injury, automobile passengers' personal accident, self-sustained personal accident), the staff members did not collaborate with each other even if they were working on the same accident. On the other hand, in cases where a single staff member was in charge of all claim items covered by insurance, the staff member only registered the accident for claims including automobile bodily injury liability insurance which involve out-of-court settlement, etc., and other such affairs, but failed to register the accident for automobile passengers' personal accident insurance.

4) Systemic Problems

- The system is inadequate for checking and preventing non-payments and for encouraging payments (example: system for checking the terms and conditions of the insurance policy against the nature of the accident, system that raises an alarm in the event of non-payment, etc.)
- For some claim items, there is no framework that makes the system carry out checks; manual checks are solely replied upon as a result.

5) Problems in Inspection, Internal Audits, etc.

- There is a lack of inspection and audit items, in view of preventing non-payment of fringe claims.
- The management team is not sufficiently informed of the inspection and audit results.
- Even if the non-payment of claims has been revealed in some items, checks are not adequately performed as to whether or not similar non-payment of claims has occurred in other items.

(3) Preventive Measures to be taken by Non-life Insurance Companies

Non-life insurance companies are striving to take the following measures to prevent the recurrence of non-payments, based on the analysis of the causes as described above.

1) Building a System that Addresses All Staff in the Product Development Stage

- Define areas to be reviewed in order to prevent non-payments in the product development stage and lay down rules, etc., for the progress management of product development aimed at collaborating with related divisions, etc.

2) Review of Procedures, Forms, etc., for Payment Process

- Conduct a review including raising awareness by adding new fringe claims items in the appraisal manual and the payment check sheet used by the payment manager and staff.

3) Training Programs, etc.

- Conduct a training program for the prevention of non-payment of fringe claims targeted at staff especially in the payment division.

4) System Support

- Add a warning display function for non-payment of fringe claims.

5) Addition to List and Periodic Execution of Back-check

- Add the fringe claims payment system to the list of items that are subject to verification when conducting a business inspection or internal audit.

Some non-life insurance companies are striving to take the following preventive measures in addition to the above.

- In building a system that addresses all staff in the product development stage, some non-life insurance companies are establishing a special organization consisting of executives, etc., of the liability services division, product development division, systems division, etc., in order to look into the system in light of the business routines for claims payment and quality control.
- Some non-life insurance companies are reviewing the content of insurance claim forms so that they could be fully understood by customers and the paid claims could be checked between the customer and the insurance company.
- Some non-life insurance companies are conducting assurance tests targeting staff, especially in the payment division, in order to ascertain how much knowledge they have absorbed.
- For systems, some non-life insurance companies are introducing a function that prevents the payment process from being completed unless there is confirmation on whether or not it is necessary to pay fringe claims.

- Some non-life insurance companies are making a list of cases with potential non-payments and conducting business inspection and internal audit on a regular basis to determine whether there are any non-payments.

3. Action taken by FSA

These non-payments were caused not only by the way in which individual cases were processed, but also by flaws in the fringe claims system spanning from product development to payment management, and are deemed to be attributable to structural problems such as faults in the governance system and internal control system. Accordingly, the FSA issued a Business Improvement Order to the 26 companies in which non-payments occurred pursuant to Article No.132 (1) of the Insurance Business Law and other provisions on November 25, to address the following:

(1) Improvement and enhancement of the governance system;
(2) Review and improvement of the system for providing explanation to customers;
(3) Review and improvement of the product development system;
(4) Examination and review of the payment management system, etc.

Further, the FSA requested the 22 companies reported to have not had any non-payment of fringe claims to review and improve similar systems for the payment of claims.

4. FSA's Approach for the Future

The FSA will continue to encourage life insurance companies and non-life insurance companies to improve and develop their respective claims payment management systems through inspection and supervision, in consideration of the claims-payment-related problems identified as a result of the reporting request issued to the companies. Further, the FSA will look into measures, including revising the comprehensive supervision guidelines for insurance companies, taking into account the analysis results of the causes of such serious problems as the inappropriate non-payment of claims and the non-payment of fringe claims.

[Explanation of Laws and Regulations]

In this section, we provide a detailed explanation of the background and the nature of Cabinet Order for the Establishment, etc., of Relevant Ordinances for Enforcing Part of the Law for the Partial Amendment of the Securities and Exchange Law, Ordinance of Cabinet Office concerning the Partial Amendment of the Ordinance of Cabinet Office, etc., concerning the Disclosure of Corporate Information, etc., and Ordinance of Cabinet Office concerning Civil Penalties against Breach of Duty of Continuous Disclosure.

Cabinet Order and Ordinances of Cabinet Office concerning Enforcement of the Law for the Partial Amendment of Securities and Exchange Law, etc., in December

The Law for the Partial Amendment of the Securities and Exchange Law (2005 Law No.76) was adopted at the 162nd ordinary session of the Diet, and revised the existing provisions to: (1) enforce the disclosure of corporate information of foreign companies, etc., in English; (2) impose the duty of disclosure on the parent company, etc. of listed companies; (3) introduce a civil penalty system against the breach of duty of continuous disclosure; and (4) review the Take Over Bid (TOB) system. In conjunction with its enforcement on December 1, 2005, cabinet order and ordinances of cabinet office were amended as necessary (excluding (4), which was already enforced in July 2005).
The key amendments to cabinet order and ordinances of cabinet office are as follows.

(1) Disclosure of Corporate Information of Foreign Companies, etc., in English (Introduction of English Disclosure System)

a. Foreign company reports (documents similar to securities reports in a foreign country which are written in English and disclosed overseas) and their supplementary documents (supplementary materials written in Japanese) shall be submitted within four months of the last day of the fiscal year. From December 1, 2005 onwards, securities reports, etc., of foreign Exchange Trade Funds (so-called "foreign ETFs") shall be deemed to correspond to "foreign company reports" (Enforcement Ordinance of the Securities and Exchange Law).

b. A foreign company report may be submitted if the Commissioner of the Financial Services Agency (FSA) determines that the submission of a foreign company report instead of a securities report would not undermine public interest or investor protection, or if other such requirements are met. In conjunction with the introduction of such English-based disclosure system, securities companies, etc., are now held accountable to investors as buyers of securities (duty to provide an explanation that disclosure will be in English) (Cabinet Order for Disclosure of Information, etc., on Specific Securities, Cabinet Order concerning Regulations, etc. for Securities Companies' Activities, etc.).

(2) Introduction of Disclosure System for Information on Parent Company

a. A parent company, etc., with the obligation to submit a status report of the parent company, etc., (disclosure of shareholding status of the parent company, etc., of a listed company by shareholder) shall be defined as any person/entity that directly or indirectly holds the majority of voting power of the listed company. If a foreign company, etc., is a parent company, etc., the said report shall be submitted within three months of the last day of the fiscal year of the parent company, etc. (Enforcement Ordinance of the Securities and Exchange Law).

b. The form of the status report of the parent company, etc., shall be set. A company that submits documents similar to securities reports in a foreign country and makes them available for perusal in Japan shall not be required to submit a status report of the parent company, etc. (Ordinance of Cabinet Office concerning the Disclosure of Corporate Information, etc.)

(3) Introduction of Penalty System against Breach of Duty of Continuous Disclosure

a. For civil penalties against the breach of duty of continuous disclosure (penalties against misstatements in securities reports, etc.), beneficiary certificates, etc., of investment trusts set forth in the Law Concerning Investment Trusts and Investment Corporations shall serve as securities that correspond to share certificates which form the basis of calculating the amount of penalties. In addition, in cases where there are no issues of listed or over-the-counter securities that could serve as the basis of calculating penalties, the amount remaining after subtracting total liabilities from total assets in the balance sheet shall serve as the basis of calculating penalties (Enforcement Ordinance of the Securities and Exchange Law).

b. For civil penalties against the breach of duty of continuous disclosure, the hearing procedures for determining the amount of penalties, the calculation method of the market value, etc., which serves as the basis of calculating the

amount of penalties, etc., have been stipulated (Cabinet Ordinance concerning Procedures for Judgment under the provision of Section 2, Chapter 6-2 of the Securities and Exchange Law and the Cabinet Ordinance concerning Determining Total Market Value, etc., under the provision of paragraph 1-2 (a), Article 172-2 of the Securities and Exchange Law).

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【Primer on Financial Literacy】

* This section provides easy-to-understand explanations on financial terms and various questions related to financial matters which tend to be too specialized and hard to understand.
  Keywords of the month: "**civil penalty system"** and **"procedures for judgment".**

In order to broaden the base of participants in the securities market and allow everyone—including individual investors—to participate in the market with peace of mind, it is important to ensure fairness and transparency in the securities market and establish a market that can win investors' trust. To this end, **a civil penalty system was introduced in April 2005 as an administrative measure designed to impose a financial burden on violators of the Securities and Exchange Law, with the aim of preventing illegal acts which undermine confidence in the securities market and ensuring the effectiveness of regulations.**
Violations subject to penalties are: (1) unfair trading (insider trading, market manipulation, spreading of rumors or deception); (2) misstatements in issued and disclosed documents such as securities registration statements; and (3) misstatements in continuously-disclosed documents such as securities reports ((3) became subject to penalties on December 1, 2005).

The steps leading up to the civil penalty payment order are as shown in the Appendix.
The Securities and Exchange Surveillance Commission (SESC) conducts an investigation (a). If any violations of laws/regulations subject to civil penalties are identified as a result, the SESC makes a recommendation to the Prime Minister and the Commissioner of the Financial Services Agency (FSA) (b). In response, the FSA Commissioner decides to institute procedures for judgment and appoint Administrative law judges (c and d, respectively). After the Administrative law judges go through the procedures for judgment (e), the Administrative law judges prepare a decision proposal on the case and submit it to the FSA Commissioner (f), who in turn decides to issue an order to pay the civil penalties (civil penalty payment order) based on the decision proposal (g and h).

The civil penalty payment order is designed to be issued after an administrative hearing (procedures for judgment) in order to carefully implement the new penalty system.
As a general rule, the procedures for judgment take place **with open doors based on a deliberation body consisting of three Administrative law judges.** Anyone who has been involved in the investigation of the case is not allowed to take charge of the case as an Administrative law judge. In addition, there are provisions to ensure fairness and impartiality in the procedures for judgment: for example, various powers in the procedures for judgment (such as making decisions on the hearing of opinions and examination of evidence) are stipulated as powers unique to Administrative law judges.

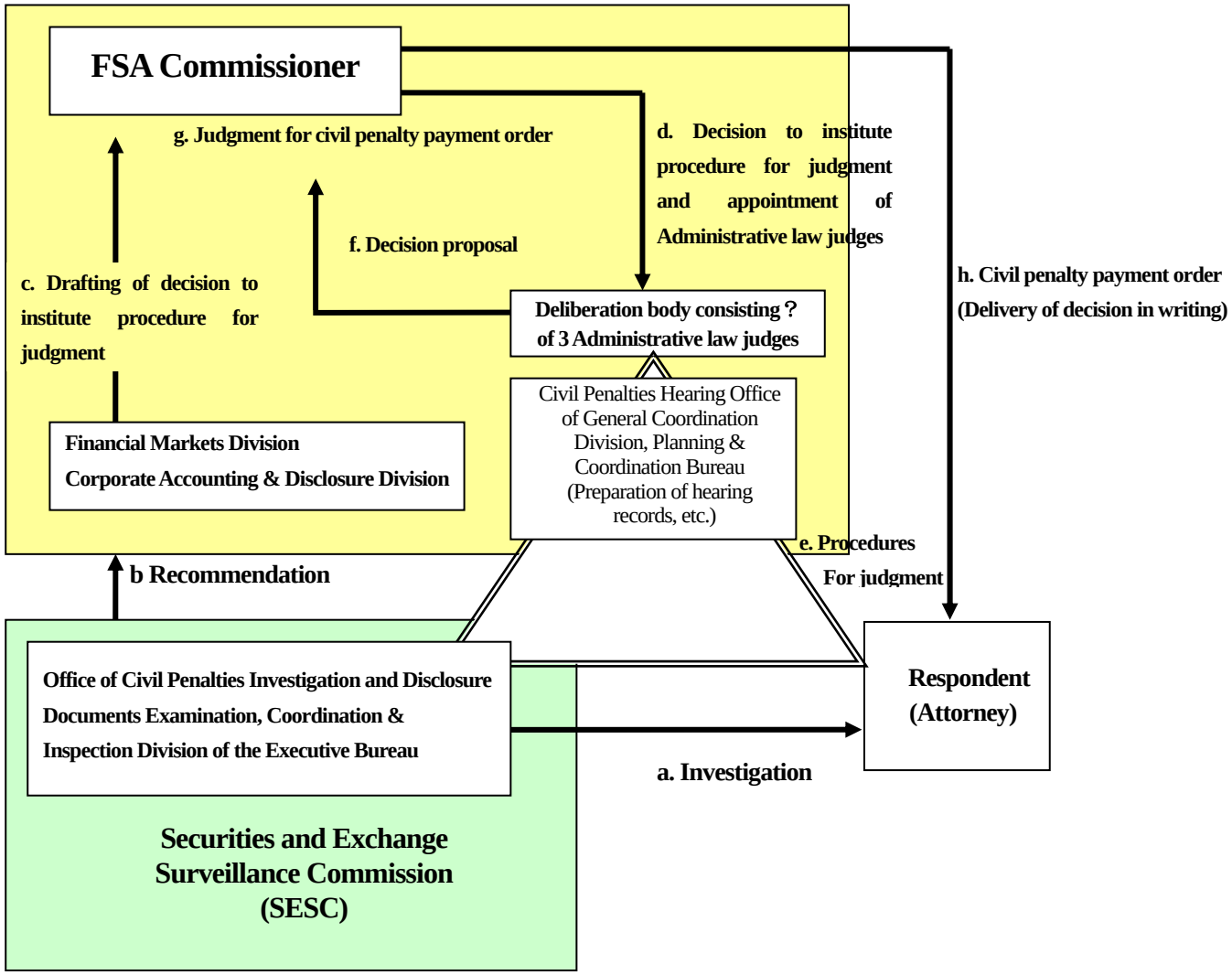
It should be noted that in the procedures for judgment, **the party subject to the civil penalty payment order (respondent) or his/her attorney can appear on the hearing date to state his/her opinions and petition for the examination of various types of evidence** (examples: questioning of unsworn witnesses (so-called "witnesses" in judicial trials), expert opinions, submission of documentary and/or material evidence). (However, no hearing will be held if the respondent submits a plea accepting the facts of the violation and the amount of the civil penalty as stated in the notice of the decision to institute procedures for judgment prior to the date of the first hearing).
On the other hand, **officials designated by the FSA Commissioner (designated officials) on the administration side can also participate in the procedures and file for evidence and take other necessary actions in the procedures for judgment.**
After going through the aforementioned procedures for judgment, Administrative law judges prepare a decision proposal on the case and submit it to the FSA Commissioner, who in turn issues a civil penalty payment order based on the decision proposal if any facts of violations are identified.

The Civil Penalties Hearing Office of the General Coordination Division, Planning and Coordination Bureau assists the Administrative law judges on the hearing dates, and performs court-clerk-like duties such as preparing and managing hearing records and ensuring the appearance of respondents and unsworn witnesses. (The Civil Penalties Hearing Office also takes charge of duties associated with the payment and collection of penalties after a judgment has been made for a civil penalty payment order).

The FSA is committed to striving to establish a securities market in which everyone—including individual investors—can participate with peace of mind, through the precise implementation of the civil penalty system.

[Appendix]

Steps Leading Up to Civil Penalty Payment Order



【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.

Q. The Tokyo Stock Exchange (TSE) is planning to review its listing rules next year, in order to ban listed companies from issuing "golden shares" as a general rule. What do you think about TSE's decision or policy to prohibit "golden shares" as a general rule?

A. TSE is a place where all shares are traded. If it just prevents companies with certain types of shares permitted under the Companies Act from being listed, it means they are being rejected on the grounds of TSE's listing criteria despite being permitted under the Companies Act. Such a scenario seems impossible, as a matter of logic.

It is probably impermissible to undermine other shareholders' rights by suddenly creating "golden shares" or by other such means. It would be a completely different story if they were created with the consent of most of the shareholders, but if a company arbitrarily creates them, it would have the effect of severely restricting or nullifying the voting rights of other shareholders, so I think it is not permissible as a matter of logic.

However, if a company with "golden shares"—as corporate defense measures permitted under the Companies Act—is to be listed for the first time, the fact would be known by the public and be broadly known by the shareholders. If a company is deemed not to fulfill the listing criteria because of its "golden shares", then the listing criteria would be narrowing down the types of shares permitted under the Companies Act. This would not be logical.

As a matter of course, various rights granted to shareholders as a result of holding the shares should not be restricted by the creation of "golden shares".

(from the press conference following a cabinet meeting on Tuesday, November 22, 2005)

Q. The interim financial results of all major banks became available yesterday. Their results were at the highest level ever. What is your view on the latest interim financial results? Also, what do you think will be the future challenges for major banks?

A. If you look at it on an annual and semiannual basis, it is certainly wonderful that they made a profit. It is proof that they are making management efforts, striving to improve efficiency and pushing ahead with streamlining to a certain extent.

However, they still have debts and losses from the past in the form of losses carried forward. The amount is something like 12 to 13 trillion yen. It may still take a while until this issue is completely resolved. Therefore, in the next stage, a number of challenges remain: in terms of finance or taxation, separately from the bank management, they must determine when to eliminate the losses carried forward, when they can really start paying dividends after eliminating them, when they can start paying corporation tax, and how they should pay back the injected capital.

(from the press conference following a cabinet meeting on Friday, November 25, 2005)

Q. Mizuho Securities caused market turbulence yesterday by placing a massive erroneous sell order for a stock that was newly listed. Trading of the stock is suspended all day today. First of all, would you please give us your views on this problem, and also how the FSA intends to deal with it in the coming days?

A. It is highly regrettable that a human error led to such a serious situation. It is also very unfortunate that the error caused Mizuho Securities to incur a loss and exerted a serious blow to the company's profit and loss picture.

Personally, I earnestly hope that the issue will be resolved promptly to ensure that confidence in the Tokyo Stock Exchange will remain intact. As for Mizuho Securities, I have no reason to be concerned about the adequacy of the company's funds available for settlement, as it is a member of the Mizuho Financial Group.

Trading will be suspended all day today for reasons of an abnormal order in accordance with the rules of the Tokyo Stock Exchange. The 13th will probably be the date of stock delivery. I think that various possible solutions will be explored before the day. I believe that the majority of the more than 600 thousand shares that were sold have already been bought back. At this point, it is not known how many are still left. In my opinion, a resolution should be urgently sought for these shares.

Aside from the question of how experienced the person who operated the terminal is, I think it is necessary to examine Mizuho Securities' system and the system of the Tokyo Stock Exchange, although there probably was no error on the part of the Tokyo Stock Exchange, so as to find out whether or not it would have been possible to mechanically halt the human error.

What the FSA has to do first and foremost is to find out facts in detail. Once we have the details, we will then move on to the determination of what is required under laws and regulations.

(from the press conference following a cabinet meeting on Friday, December 9, 2005)

Q. In connection with the incident of an erroneous order for shares by Mizuho Securities, facts began to emerge slowly about the dealing departments of other securities corporations having bought substantial numbers of these shares, following the placement of the erroneous order. Would you please share your thoughts on this?

A. I realize that transactions were consummated on the exchange floor in a legal sense. However, dealing departments' buying up shares to profit, instead of providing broker services to process customer's orders, while being fully aware that the order had been placed by mistake does not paint a nice picture. I think that even securities companies' management should abide by the aesthetics of conduct. A while ago, a book was published that contained numerous heart-warming anecdotes. This latest conduct is not something that can make its way into the book.

(from the press conference following a cabinet meeting on Tuesday, December 13, 2005)