FSA Newsletter February 2006

Panel discussion at "Symposium on How to Spend Money and Local Communities in Osaka" (December 17)

Kaoru Yosano (Minister for Financial Services) receives Report "Legislation for Investment Services Law (provisional title)" from Hideki Kanda (Chairman of First Subcommittee of Financial System Council) (December 22)

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[Topics]

Revision of Comprehensive Guideline for Supervision of Small- and Medium- Sized and Regional Financial Institutions

The Financial Services Agency (FSA) revised the Comprehensive Guideline for Supervision for Small- and Medium-Sized and Regional Financial Institutions (hereinafter referred to as "Supervision Guideline for RFIs") intended for small- and medium-sized and regional financial institutions (hereinafter referred to as "RFIs") on December 22, 2005.
The latest revision is primarily aimed at making the Supervision Guideline for RFIs properly reflect the ongoing changes in the environment and new awareness for supervisory purposes that are reflected in a wide range of provisions incorporated in the Comprehensive Guideline for Supervision of Major Banks, etc. (hereinafter referred to as "Supervision Guideline for Major Banks"), which was newly established recently (October 28, 2005).
The revision process has involved examining the necessity and suitability of applying individual provisions of the Supervision Guideline for Major Banks to RFIs, while retaining the basic structure of the Supervision Guideline for RFIs and its status as an "all-in-one-type handbook" for Local Finance Bureau staff to supervise RFIs, which pursue business models that are different from those of major banks, focusing on region-based relationship banking. The revised Supervision Guideline for RFIs also reflects the views indicated in the Program for Further Financial Reform released on December 24, 2004, such as thorough implementation of user protection rules, improvement in the management (governance) of financial institutions, and enhancement of information disclosure.
As a result, the Supervision Guideline for RFIs, as a whole, has adopted a large number of provisions that require RFIs to be supervised in a manner identical to major banks, as a natural consequence for being deposit-taking institutions, including provisions for governance and general risk management. On the other hand, quite a few provisions have been deliberately excluded, such as requirements applied to major banks *per se*, provisions characterized as "best practices," and provisions with a limited scope of application.
Specifically, new provisions to deal with violation of laws and regulations by executives and those relating to the screening for the approval of major shareholders have been introduced into the Supervision Guideline for RFIs, due to their growing importance in recent years. Furthermore, such provisions as those on the sharing of system networks among financial institutions, Internet banking, and system integration risk and project management have also been added in response to RFIs' efforts in the area of system enhancement. Other additions include provisions on security measures for ATM systems, which aims at protecting users from financial crime, while allowing a certain degree of flexibility in the measures taken to ensure security.
Furthermore, a number of provisions have been incorporated to enhance and clarify the already-existing provisions; they include provisions on governance at companies with auditors and accompanying provisions to introduce regular interviews regarding internal audits, provisions to tackle organized crime, and provisions on the management of general risks concerning systems. Provisions regarding the appropriateness and sufficiency of information disclosure have also been enhanced, where the concept of the standard interest rate for determining restructured loans is clarified.
Other than the above, substantial enhancements in crisis management systems have been sought by incorporating a part on business continuity plans (BCPs), while provisions on supervisory checkpoints with respect to various risks, provisions on coordination with the inspection branch, and provisions on the supervision of bank holding companies have been included in the Supervision Guideline for RFIs after being modified as necessary for RFIs and staff of the Local Finance Bureaus.
On the other hand, a number of provisions in the Supervision Guideline for Major Banks have not been brought into the Supervision Guideline for RFIs, as they are either unique to major banks or more like "best practices," and are deemed not appropriate to be uniformly applied to RFIs, such provisions include those on the quality of required capital, improvement of profitability, and integrated risk management. Also, provisions such as those on governance at companies with overseeing committees, country risks and overseas operational control, and private banking have been deliberately left out from the latest revision due to their highly limited applicability at present, in light of the business and other features of RFIs. Instead, reference is made to the Supervision Guideline for Major Banks.

The major amendments are as described above. Most of these provisions became applicable on their announcement on December 22, 2005. The FSA will strive to reflect them smoothly in the actual supervision process.
As a reminder, since the revision has been made basically in response to the establishment of the Supervision

Guideline for Major Banks, there are issues that require further study. Further revision will be performed, for example, to clearly define specific checkpoints of the provisions on the qualifications of executives of financial institutions ("Fit and Proper" rule), develop rules and systems for risk management of financial institutions and structures for the inspection and supervisory authority towards the introduction of Basel II (new capital adequacy requirement), and develop provisions in response to the review on the bank agent system through the revision of the Banking Law.

Financial Results of Regional Banks for First Half ended September 30, 2005 (Based on Preliminary Announcements)

With regional banks announcing their interim financial results for the half year ending September 30, 2005, the Financial Services Agency aggregated the data announced by the banks and released the results on December 9. (Note: Subsequently updated on December 20 based on revised business results.)
The summary of regional banks' interim financial results for the half year ending September 30, 2005 are shown below.

1. Profit and Loss Status
Operating profits from the core business of all regional banks combined amounted to 1,000.7 billion yen, showing a slight increase compared to 962.4 billion yen in the half year ending September 30, 2004. While operating profits slightly increased, interim net income grew gradually to 459.0 billion yen from 413.2 billion yen during the same period in the previous year, partly due to the decrease in losses from the disposal of non-performing loans (NPLs), thus reaching a high level for a semiannual figure.

2. Status of Capital Adequacy Ratio
The capital adequacy ratio (on a non-consolidated, weighted average basis) was 9.6 percent, up 0.2 percentage points from 9.4 percent in the fiscal year ending March 31, 2005.

3. Status of NPLs
The balance of NPLs (loans disclosed under the Financial Reconstruction Law) decreased by 665.3 billion yen to 9,702.1 billion yen from 10,367.4 billion yen in the fiscal year ending March 31, 2005.
The ratio of NPLs to total credit decreased by 0.3 percentage points to 5.2 percent from 5.5 percent in the fiscal year ending March 31, 2005, showing a steady decline as a whole.

* Regional banks consist of:
113 banks including 64 regional banks, 48 regional banks II and Saitama Resona Bank for fiscal year ending March 31, 2005 and the interim period ending September 30, 2005; and
114 banks including 64 regional banks, 49 regional banks II and Saitama Resona Bank for fiscal year ending March 31, 2004 and the interim period ending September 30, 2004.

Summary of Hedge Fund Survey Results and Discussion Points

1. Hedge funds have rapidly grown in recent years, and regulatory authorities, etc., in each country are paying more attention to hedge funds and the impact of their growth on the market. As cross-border activities of hedge funds are claimed to have become more vigorous, especially due to the expansion of the market, further cooperation among regulatory authorities is considered necessary. In view of these circumstances, regulatory authorities, etc., in each country are making proposals and taking various measures with respect to hedge funds.

2. In the Program for Further Financial Reform announced on December 24, 2004, the Financial Services Agency (FSA) pledged to *deal with hedge funds* as part of its efforts to *build an internationally-open financial system and globalize financial administration*, which is one of the key challenges under the Program.

3. Accordingly, the FSA conducted a fact-finding survey on hedge funds targeted at Japanese financial institutions,

compiled the findings, summarized the points under discussion in relation to hedge funds including references to international debates, and published the survey results on December 13 (English version: December 22), 2005.

4. In Japan, there is currently no clear definition of hedge funds. For the purpose of this survey, hedge funds were defined as funds with three components: (i) use of leverage, (ii) charge of performance fee, and (iii) use of hedge fund strategies. The FSA sent a questionnaire to 1,251 financial institutions under its jurisdiction, and requested them to respond on a voluntary basis.

   (Note) As this survey was aimed at identifying the actual state of hedge funds in Japan, including what kind of financial products are regarded as hedge funds by the surveyed companies, the interpretation of the definition of the three components mentioned above was left to the surveyed companies. It should be noted that because the interpretation might vary between the surveyed companies, there is no guarantee that the survey results are an accurate representation of the actual state of hedge funds in Japan.

5. The survey results revealed that hedge funds handled by the surveyed financial institutions over the five-year survey period from April 1, 2000 to March 31, 2005 totaled (i) approximately ¥5.9 trillion in sales and (ii) approximately ¥2.5 trillion in amount raised for establishing the funds. Holdings amounted to approximately ¥6.1 trillion as of March 31, 2005.
   The survey results also revealed that hedge funds established by Japanese financial institutions have dramatically increased both in number and in amount since the fiscal year ended March 31, 2004. (The global market size for hedge funds is claimed to have roughly trebled from US$324 billion (approx. ¥35.6 trillion) in the beginning of 2000 to US$1 trillion (approx. ¥110 trillion) in the beginning of 2005.
   Other major characteristics of hedge funds revealed by the survey include: half of all hedge funds are sold to financial institutions such as banks, shinkin banks and shinyo kumiai (credit cooperatives); sales to individual investors have substantially increased over the five-year survey period; and hedge funds established in Japan accounted for only 40% of all hedge funds sold, indicating that many hedge funds established in foreign countries were being sold in Japan.

6. In the process of compiling the survey results, efforts made in other countries to deal with hedge funds were mentioned as well. For example, in the United States, the 1940 Investment Advisers Act was amended in 2004, which involved redefining the number of customers at which the obligation of registration arises, and obliging certain hedge fund investment advisers to be registered with the Securities and Exchange Commission. In the U.K., although there are no regulations on hedge funds themselves, funds that have not obtained the approval of the Financial Services Authority (hedge funds, etc.) are not allowed to be sold to general investors as a rule. Moreover, various international organizations have been holding discussions and debates on hedge funds recently, including the International Organization of Securities Commissions (IOSCO) and the European Commission.

7. In consideration of these survey results and the international discussions, the points under discussion with respect to hedge funds include:
   (i) How should risk management capabilities of hedge fund investors be identified and enhanced?
   (ii) Are sales restrictions required for general investors who have limited risk management capabilities?
   (iii) How should the management structure of hedge fund management companies be identified within the existing inspection and supervision framework?
   (iv) What kind of framework would be appropriate to continually keep a close eye on the hedge fund transactions of Japanese financial institutions?

   * For further information, please access the link titled "Summary of Hedge Fund Survey Results and the Discussion Points" (December 22, 2005) in the "Press Releases" section of FSA's official website.

Organization, Staffing and Budget for FY2006

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 March 31, 2007 approved by the Cabinet on December 24, 2005.

Approval has been granted for the development of the following structures—especially the enhancement of a market administration structure—and a budget totaling approximately 21.1 billion yen, in order for the FSA to continue properly fulfilling its duties in light of the transition of the Japanese financial system into a new phase.

2. Organization and Staffing

(1) Enhancement of Market Administration Structure (40 staff members)

(i) The Financial Markets Division and the Corporate Accounting and Disclosure Division of the Planning and Coordination Bureau will be structurally enhanced by such means as the appointment of a Deputy Commissioner for Market Operations and Deputy Commissioner for Disclosure Affairs. In addition, the Executive Bureau of the Securities and Exchange Surveillance Commission (SESC), which currently consists of two divisions and three offices, will be restructured into an organization of five divisions and one officer, in consideration of the increasingly diversified and sophisticated market surveillance functions.

(ii) In view of the partial amendments to the Securities and Exchange Law, a civil penalties investigation structure will be developed to deal with misrepresentations in securities reports, etc. Moreover, an inspection structure targeted at auditing firms, etc., a supervision structure targeted at foreign exchange margin trading businesses, a user inquiry structure and other such structures will be enhanced.

(2) Development of Effective and Efficient Inspection and Supervision Structures (24 staff members)

(i) In view of the partial amendments to the Insurance Business Law, etc., inspection and supervision structures targeted at small-claims and short-term insurance businesses will be developed, and in light of the partial revision of the Banking Law, etc., a supervision structure targeted at bank agents will be developed.

(ii) In order to address the growing importance of cross-industry supervision tasks, the Financial Conglomerate Office will be established. In addition, inspection and supervision structures will be developed in conjunction with the introduction of a rating system in financial inspections aimed at conducting inspections more efficiently and effectively, including the appointment of a rating examiner.

[Breakdown]

	Number of Staff at End of FY2005	Staff Cutback	Increase in Staff in FY2006	Number of Staff at End of FY2006
Planning and Coordination Bureau	289	▲ 4	16	304 (Note)
Inspection Bureau	454	▲ 6	6	454
Supervisory Bureau	203	▲ 3	21	221
Securities and Exchange Surveillance Commission (SESC)	307	▲ 5	19	318 (Note)
Certified Public Accountants and Auditing Oversight Board (CPAAOB)	41	—	2	43
Total	1,294	▲18	64	1,340

(Note) The number of staff at the Planning and Coordination Bureau and SESC at the end of FY2006 includes changes due to staff transfers.

(Reference) Staff cutback in FY2005 was "17" and the increase in the number of staff was "109", a net increase of "92".

3. Budget

(1) A budget totaling approximately 21.1 billion yen has been approved, including expenses required to develop

the system of Electronic Disclosure for Investors' NETwork (EDINET).

(2) For continued assurance of financial system stability, 50.15 trillion yen has been approved as government guarantees earmarked for the Deposit Insurance Corporation of Japan (DICJ).

(3)

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

(Unit: trillion yen)

Account	FY2005	Draft Budget for FY2006
General account	19	19
Financial revival account	14	7
Account for prompt restoration of soundness of financial functions	6	5
Emergency response account	17	17
Account for enhancement of financial functions	2	2
Industrial revival account	0.15	0.15
Total government guarantees	58.15	50.15

Summary of FSA Budget for FY2006

(Rough Estimate Approved)

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)
	million yen	million yen	million yen	%
(Item) FSA	18,612	20,968	2,357	12.7
Personnel expenses	12,473	13,234	760	6.1
Other	6,138	7,735	1,596	26.0
Expenses for conducting inspection, supervision, etc.	835	848	13	1.5
Expenses for computerizing FSA administration	2,380	4,122	1,742	73.2
Expenses for conducting studies, research, etc. on financial system	218	234	16	7.3
Running expenses of councils, etc.	105	112	6	6.2
Expenses for attending international conferences, etc.	215	207	Δ8	Δ3.6
Other	2,385	2,212	Δ173	Δ7.3
(Item) Economic cooperation expenses	110	103	Δ6	Δ5.8
Total	18,721	21,072	2,350	12.6

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

(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.

[Explanation of Laws and Regulations]

In this section, we provide an explanation of the major amendments to the relevant Cabinet Order in conjunction with the enforcement of the provisions relating to the new examination system (January 1, 2006) under the Act to Amend Part of the Certified Public Accountant Law (Law No.67, 2003).

Revision of Relevant Cabinet Order associated with Enforcement of Act to Amend Part of Certified Public Accountant Law

(1) Complete Revision of Practical Training Rules for Junior Accountants, etc.

a. In order for practical training bodies, etc. to be authorized, criteria must be fulfilled such as having the facilities where conventional operations can be executed in a fair and accurate manner, and having sufficient social credibility. In addition, it is necessary to ensure the appropriateness of practical training more than ever before, as practical training is now positioned as a requirement for Certified Public Accountant (CPA) registration. Accordingly, the practical training rules prepared by the authorization applicant must now meet additional requirements; for example, the practical training methods, etc., must meet the requirements set forth in the Cabinet Order.
   Moreover, pursuant to the revision of the Certified Public Accountant Law, only bodies and organizations are entitled to become practical training entities. Accordingly, the provisions on CPA instructors (existing practical training entities who are individuals) were abolished.

b. In the practical training contents, "Laws and Regulations relating to CPA Services" were modified to "Laws and Regulations and Professional Ethics relating to CPA Services" in consideration of the importance of professional ethics required on the part of CPAs at present.

c. As for the method of practical training, the practical training period of one year or more is no longer a requirement. Instead, it is now a requirement to earn a certain number of credits. Furthermore, practical training methods have been defined and the necessary number of credits has been set with respect to each method in order to confirm the level of proficiency upon the approval of credits.

(2) Partial Revision of Rules on Work Assistance, etc. by Junior Accountants, etc.

The revision of the Certified Public Accountant Law involved deleting the provision which sets forth that the period of work assistance, etc. and the period of practical training shall be at least three years in total. Accordingly, similar provisions have been deleted.

(3) Partial Revision of Registration Rules for CPAs, etc.

In conjunction with the abolition of the junior accountant system, the provision on the registration of junior accounts has been deleted.

(4) Partial Revision of CPA Examination Rules

Paragraph 2, Article 1 of the Enforcement Order of the Certified Public Accountant Law exempts from financial accounting theory anyone who has engaged in accounting-related or audit-related clerical duties or services prescribed by the Cabinet Order for seven years or more at a large corporation under the provisions of the Law on Special Provisions for Commercial Code concerning Audits, etc., of Joint Stock Companies such as listed companies, national government, local authorities or other corporations set forth in the Cabinet Order. Accordingly, such corporations and clerical duties or services have been defined.

[Financial System Council]

Report by First Subcommittee, Sectional Committee on Financial System, Financial System Council: "Legislation for Investment Services Law (provisional title)"

1. Foreword

The First Subcommittee of the Sectional Committee on Financial System of the Financial System Council headed by Hideki Kanda (Professor of Graduate Schools for Law and Politics, University of Tokyo) compiled a report titled "Legislation for the Investment Services Law (provisional title)" on December 22, 2005.

The First Subcommittee compiled the Interim Report describing the basic concept, etc. of the Investment Services Law (provisional name, hereinafter referred to as "Investment Services Law") on July 7, 2005. The Subcommittee invited opinions widely on the Interim Report in September 2005, and in response, more than 100 opinions were submitted, including those from financial groups, bar associations, etc. The First Subcommittee resumed deliberations on October 5, 2005 and studied the major points under discussion and other such matters towards the enactment of the Investment Services Law based on the Interim Report, while drawing upon these opinions. The latest report was compiled as a result of lively discussions that took place at nine public meetings convened over a three-month period.

This paper provides a summary of the report, excluding matters relating to the Take Over Bid (TOB) system and the large shareholding report system, which are explained in a separate paper.

2. Background, Purport and Objective of Investment Services Law

(1) Background to Investment Services Law

As financial instruments outside the existing scope of user protection have been found to be sold fraudulently in some cases, the First Subcommittee has been recommending the enhancement of measures to protect users individually from such financial instruments. Legislative action has been taken based on these recommendations, as exemplified by the application of the revised Securities and Exchange Law to collective investment schemes following the revision of the said Law (enforced in December 2004) and the introduction of restrictions on foreign exchange margin trading pursuant to the amendment of the Financial Futures Trading Law (enforced in July 2005).

However, there are "loopholes" in the existing legal framework for user protection, as evident in the recent reports on losses incurred by many general investors due to funds conducting businesses which use Tokumei-Kumiai (TK) as its vehicle and cases involving improper interest rate swaps with clients of some financial institutions. It is absolutely imperative to develop a comprehensive and cross-sectional framework to protect users from a wide range of financial instruments. From this standpoint, the First Subcommittee's report recommended the enactment of the Investment Services Law.

(2) Purport and Objective of Investment Services Law

The first purport and objective of the Investment Services Law is to thoroughly implement user protection rules and enhance user convenience. "Loopholes" outside the scope of the existing legal framework for user protection will be closed, the existing vertically-divided business law will be revised, and the same rules will be applied to financial instruments with the same economic functions. On the other hand, user protection requirements will be fulfilled and user convenience will be improved while promoting financial innovation by establishing a flexible regulatory structure, including relaxing the regulations prescribed with general investors in mind when they are applied to cases in which the customer is a professional investor.

The second purport and objective is to ensure market functions to shift funds "from savings to investment", and the third is to adapt to the globalization of financial and capital markets.

3. Coverage of Investment Services Law

(1) Basic Concept

The Interim Report states that financial instruments to be covered by the Investment Services Law (hereinafter referred to as "investment instruments") should include as wide a range of financial instruments as possible which fulfill the following criteria:

(i) Contribution of money and possible return of money, etc.;

(ii) Relates to assets, indexes, etc.; and

(iii) Takes risks with an expectation of higher returns (economic utility).

"Risk" in (iii) above is regarded as either "market risk" or "credit risk," whereas "return" is defined primarily in the context of expectations for "monetary profits".

(2) Treatment of Deposits, Insurances, etc.

As for the treatment of deposits based on the above definition, it is deemed appropriate at this point to apply the Investment Services Law to foreign currency deposits which have the risk of falling in value below the yen-denominated principal due to exchange rate fluctuations, as well as yen-capital-guaranteed, yen-denominated derivative deposits that can materially cause a reduction in the principal due to early-withdrawal penalties, on the grounds of being products with strong investment characteristics. As for the treatment of insurances, it is deemed appropriate at this point to apply the Investment Services Law to variable insurance, annuities and foreign-currency-denominated insurance, on the grounds of being products with strong investment characteristics.

Syndicate loans and asset-backed loans (ABL) will not be regulated following the latest legal revision, due to the fact that most loan providers are financial institutions who make a business out of lending. However, further studies should be conducted, while keeping an eye on the spread of participants, etc.

It is deemed appropriate to include derivative transactions into the scope of application of the Investment Services Law, including interest rate and currency swaps, credit derivatives and weather derivatives.

(3) Prospects for Financial Services and Markets Act

As for the prospects for a British-type Financial Services and Markets Act, the First Subcommittee's report considers that recent problems and cases are difficult to deal with under the current laws, and as a matter of urgency, it would be appropriate to firstly work on promptly enacting such a law with respect to "financial instruments with investment characteristics" to which the application of comprehensive and cross-sectional regulations have generally been agreed upon. The First Subcommittee will continue to vigorously study a more comprehensive regulatory framework targeted at financial instruments in general, in consideration of the progress in the enactment and implementation of the Investment Services Law, the characteristics of various types of financial instruments, the medium and long-term modality of the financial system, etc.

4. Regulation on "Investment Services Business (provisional name)"

(1) Scope of Investment Services Business

It is deemed appropriate that "sales and solicitation," "asset management and providing advice" and "administration of assets" are within the scope of "investment services business (provisional name)". The scope of the core business is greater than existing securities businesses, whose core business is regarded as sales and solicitation.

(2) Treatment of Banking Business, Insurance Business, Trust Business, etc.

It is deemed appropriate to exclude banking businesses, insurance businesses, trust businesses, etc., from the scope of registration of investment services business, considering that they are subject to sophisticated business regulations based on licensing systems, etc., under the Banking Law and the like, and even products without investment characteristics (settlement deposits, etc.) are regulated, not to mention that conflict of interest (the basis of Article 65 of the Securities and Exchange Law) and the possibility of banks abusing their dominant positions are still crucial points of discussion. The existing framework of Article 65 of the Securities and Exchange Law will be maintained, including the registered financial institutions system.

It is also deemed appropriate to regard bank agencies, non-life insurance agents, life insurance agents and trust bank agencies as banking businesses, etc., and therefore exclude them from the scope of registration of

investment services business.

(3) Flexible Regulatory Structure of Investment Services Business

It is deemed appropriate to build a flexible regulatory structure by creating the following three categories according to the scope of the business while assuming cross-sectional coverage of investment services businesses:

(i) "First business (provisional name)", which involves all operations associated with all investment instruments;

(ii) "Second business (provisional name)", which involves asset management relating to investment instruments such as sale of illiquid investment instruments and providing investment advice on investment instruments; and

(iii) "Brokerage business (provisional name)", which involves brokering deals entrusted by other investment service companies (affiliate system).

Entry into investment services business will be deregulated, as it is deemed appropriate to shift to a registration system, including investment trust management business, discretionary investment management business, etc., which are currently based on a licensing system.

5. Codes of Conduct of Investment Services Business

(1) Basic Framework

As for the basic framework of the Investment Services Law, it is deemed appropriate to apply the codes of conduct to financial instruments with the same economic functions, regardless of the type of business, assuming that they have the general characteristics relating to the sale of financial instruments, etc. Accordingly, it is deemed appropriate to apply the codes of conduct under the Investment Services Law, even to businesses outside the scope of the registration system for investment services business such as banking businesses if they sell or solicit for deposits, insurance, etc. with strong investment characteristics.

(2) Main Codes of Conduct

It is deemed appropriate to regard the compatibility principle under the Investment Services Law as a code similar to the existing Securities and Exchange Law (Article 43-1), not only the development of structures (Article 12-2-2 of the Banking Law, Article 13-7 of the Enforcement Regulations of the Banking Law, etc.).

It is deemed appropriate to place the duty to provide an explanation as a code of conduct under the Investment Services Law, similar in content to the one under the Financial Instruments Sales Law (a civil obligation). This will make it possible to take supervisory action directly in the event that a business breaches the duty to provide an explanation. It is deemed appropriate to review the content of the Financial Instruments Sales Law and conduct studies with the aim of enhancing the provisions, including adding a "transaction framework" with respect to the duty to provide an explanation.

For the prohibition of unsolicited calls, it is deemed appropriate to establish, for the purpose of user protection, a general framework that can dynamically deal with cases in which conformity with the compatibility principle can hardly be expected, while assuming the same scope of application as the existing one (financial futures transactions). Further, it is deemed appropriate to prohibit repeated calls through the introduction of new regulations, including looking into the possibility of applying such regulations to financial futures transactions at stock exchanges.

For the disclosure of commissions, it is deemed appropriate to make it obligatory to disclose commissions paid directly or indirectly by the customer to a business (trust fees and sales commissions for investment trusts, management expenses of variable annuities, etc.).

6. Other

(1) Distinction between Professional Investors and General Investors

For the purpose of building a flexible regulatory structure to both protect users in an appropriate manner and facilitate the supply of risk capital, investors are divided into professional investors (such as institutional investors) and general investors in an effort to build a flexible regulatory structure. There are four categories of investors: (i) a professional investor who does not have the option to be reclassified as a general investor; (ii) a professional investor who has the option to be reclassified as a general investor; (iii) a general investor who has the option to be reclassified as a professional investor; and (iv) a general

investor who does not have the option to be reclassified as a professional investor.
As for the codes of conduct that are inapplicable to professional investors, it is deemed appropriate to make the codes of conduct aimed at rectifying the information gap (such as the duty to issue documents to clients) inapplicable, while making those aimed at ensuring fairness in the market (such as prohibition of misrepresentation, prohibition of compensation for losses, etc.) applicable.

(2) Collective Investment Schemes (Funds)
Considering the reports on losses incurred by many general investors due to funds conducting businesses which use Tokumei-Kumiai (TK) as its vehicle, it is deemed necessary to establish effective, comprehensive, cross-sectional regulations with respect to funds. The Interim Report stated the need to apply to funds: (i) disclosure requirements; (ii) business regulations and codes of conduct relating to sales and solicitation; and (iii) minimal regulatory framework for administration of assets, fund manager's fiduciary responsibilities, investment report, etc. On the other hand, the First Subcommittee's report states that it would be appropriate to focus on looking into business regulations that enable the administration to take the quickest and most direct action against violators with respect to funds targeted at general investors (sales and solicitation including private offering and asset management).

(3) Civil Liability Clause (Review of Financial Instruments Sales Law)
It is deemed appropriate to examine the Financial Instruments Sales Law with the aim of making it easier to use for customers, in light of judicial precedents which recognized civil liability in tort with respect to financial instruments.

(4) Disclosure Requirements
As for disclosure requirements, its is deemed appropriate to divide investment instruments into corporate-finance-type instruments and asset-finance-type instruments according to their characteristics, and develop disclosure requirements with respect to each classification.
Furthermore, it is deemed appropriate to introduce a quarterly reporting system and further develop the internal control system for financial reporting with respect to listed companies before doing so for other disclosing companies depending on the liquidity of investment instruments, while improving the disclosure system of some investment instruments with limited liquidity due to transfer restrictions (such as instruments whose holders are within a certain scope and are identifiable) by directly providing the disclosure documents instead of public disclosure.
As for the scope of qualified institutional investors, it is deemed appropriate to expand the scope of qualified institutional investors with respect to business corporations, look into paving the way for certain non-business corporations and individuals to become qualified institutional investors, and substantially relax or abolish the restrictions on the number of qualified institutional investors subject to solicitation (capped at 250) for small-scale private placement.

(5) Organization of Stock Exchanges with Self-regulatory Functions
A stock exchange that is incorporated in the form of a stock corporation is required to have its self-regulatory functions executed independently of other operations, due to the risk of conflict of interest arising between its commercial nature as a stock corporation and the stock exchange's operations with public characteristics. As the environment surrounding the stock exchange and the market operator's policies for designing its market vary from exchange to exchange, the market operator should be able to choose the organizational structure at its own discretion, in consideration of quality control of the trading floor.
In the event of the listing of a stock exchange that is incorporated in the form of a stock corporation, it is deemed appropriate to demand the stock exchange to ensure the organizational independence of its self-regulatory functions, and to inspect the existing system (including regulations on major shareholders) and take appropriate measures if necessary, considering the recent revision of company laws.

(6) Self-Regulatory Organizations (SROs)
While the functions of self-regulatory organizations (SROs) vary under the existing business laws, it is deemed appropriate under the Investment Services Law to give each SRO the same functions as the Japan

Securities Dealers Association (JSDA), which has the strongest characteristics as an SRO.
To ensure regulatory effectiveness without imposing legal obligations to become a member of an SRO, it is advised that a framework be developed to make non-members establish in-house rules which take SRO rules, etc., into account.
In addition, it is deemed appropriate to develop a framework to accredit operations relating to the resolution of complaints and mediation of disputes involving private organizations other than SROs under the Investment Services Law in order to ensure the reliability of such operations, and promote the resolution of complaints and mediation of disputes through such voluntary efforts.

7. Afterword

It is a matter of urgency that the Investment Services Law—a comprehensive and cross-sectional law on financial and investment services—be enacted promptly, for the purpose of further promoting structural reform in financial and capital markets and creating a dynamic financial system. To this end, work is currently being done to submit relevant bills at the ordinary session of the Diet this year (Bill for Partial Revision of Securities and Exchange Law, etc. and Bill for Establishment, etc, of Related Laws associated with Enforcement of Law for Partial Revision of Securities and Exchange Law, etc. (provisional name)).

* For further information, please access FSA's official website > "Councils" > "Financial System Council" > The 1st Subcommittee's Report 2005 "Dec.22" and "Ref."

Report by Working Group on Takeover Bid (TOB) System, etc., First Subcommittee, Sectional Committee on Financial System, Financial System Council: "Takeover Bid (TOB) System, etc."

In response to the rapid increase and the diversification of mergers and acquisitions (M&A) in recent years, the Financial Services Agency (FSA) established the Working Group on Takeover Bid (TOB) System, etc. under the First Subcommittee of the Financial System Council in July 2005, with the mission to deliberate on the modalities of the TOB system and other matters. The Working Group convened eleven times and engaged in vigorous deliberations, and reported the results of studies to the First Subcommittee of the Financial System Council on December 22. The key areas which require review in the existing system according to the report are outlined below.

1. Recommendations on Scope of Application of TOB Regulations

Under the existing system, there is an obligation to resort to TOB if the shareholding ratio after the purchase of shares will exceed one-third of all outstanding shares, even if the purchase involves an extremely small number of buyers. This is the so-called "1/3 rule". Suppose that someone buys up to 32% of all outstanding shares outside the market and subsequently purchases 2% all outstanding shares within the market; by performing such a trade, it is possible to acquire more than a third of all outstanding shares, etc., without resorting to TOB. It would be appropriate to take necessary measures so that TOB regulations would clearly be applicable to cases in which, for example, the total shareholding ratio resulting from off-exchange transactions performed within a certain period and transactions within the stock exchange, etc., exceeds one-third of all outstanding shares.

2. Recommendations on Ensuring Transparency in TOB Regulations and Modality of TOB Period, etc.

Disclosure by the bidder in TOB procedures plays an important role for shareholders and investors to make a proper investment decision. It would be appropriate to further enhance disclosure by the bidder in TOB notices, etc.
The targeted company's opinion on the TOB is also an important piece of information for shareholders and

investors to make a proper investment decision. Therefore, it would be appropriate to oblige the targeted company to announce its opinions.
Furthermore, it would be appropriate to provide a certain institutional framework to give the targeted company the opportunity to ask the bidder questions in its statement of opinions if the targeted company has any questions for the bidder when announcing its opinions.

3. Recommendations on the TOB Period

Under the current system, the TOB period is between 20 and 60 days, depending on the choice of the bidder. In order to ensure that shareholders and investors are given sufficient time to carefully consider the TOB, it would be appropriate to redefine the TOB period in terms of business days, taking into consideration TOB launched at a time when there are consecutive holidays, etc.
In addition, it would be appropriate to approve the extension of the TOB period by the targeted company by up to 30 business days, if, for example, the target company makes a counteroffer and shareholders need to be given sufficient time to carefully consider the counteroffer.

4. Recommendations on So-called Anti-takeover Measures and Modality of TOB Regulations

Under the existing system, TOB can be withdrawn only if the targeted company goes bankrupt or merges with another company or in other limited cases. However, it is permissible to withdraw the TOB, if so-called anti-takeover measures are serious obstacles to achieving the objectives of the TOB—for example, in cases where the targeted company, or its subsidiary, decides to issue new shares or stock purchase warrants or decides to sell its material assets, or if the so-called anti-takeover measures would definitely not be cancelled.
Under the existing system, it is not permissible to change the terms and conditions of TOB to the disadvantage of subscribing shareholders, such as reducing the TOB price. However, it would be appropriate to allow the reduction of the TOB price if the share price is diluted as a result of a share-split, etc., executed by the target company, provided that the reduction is proportionate to the dilution.

5. Recommendations on Ensuring Fairness between Investors and Shareholder Protection in TOB

Under the existing system, if the total number of subscribed shares, etc., exceeds the number of purchases planned, the bidder is allowed to not purchase all or some of the oversubscribed portion based on the percentage method.
However, TOB that leads to delisting, etc. might put small shareholders in an extremely vulnerable position as a result of having leftover shares. Therefore, it would be appropriate to oblige the bidder to buy all shares if, for example, the shareholding ratio exceeds two-thirds of all outstanding shares after the TOB.

6. Recommendations on Investor Protection in Event of Competition over TOB

If there is competition over the purchase of shares, etc. that have an impact on corporate control (for example, while one party is engaged in TOB, another party buys huge volumes of the shares, etc., on the stock exchange) it is conceivable to make TOB mandatory. However, it would be appropriate to look into making TOB mandatory under fairly strict conditions, so that it is not overregulated.

In addition to the above, the Working Group **recommends that it would be appropriate to conduct necessary review on the modality of the large shareholding report system, while giving due consideration to the impact, etc., on the securities market, in order to enhance transparency and fairness in securities transactions.**
Specifically, as for the reporting deadline, frequency, etc. under the special reporting system which allows less frequent reporting in order to prevent institutional investors from being burdened by excessive workloads, it would be appropriate to bring forward the reporting deadline as much as possible, to have the shareholding status as at the base date reported, for example, within five days rather than two weeks. In regards to this matter, it has been pointed out that reporting should not have a shorter deadline or be less frequent under the special reporting system. If the reporting deadline is to be shortened or the reporting frequency is to be reduced, further studies should be conducted as to whether or not there is any room for regulatory improvements, etc., so as to ensure that even institutional investors would properly submit

general reports according to the purpose of shareholding. Moreover, upon determining whether or not the submission of large shareholding reports should become mandatory, it would be appropriate to make streamlining efforts such as allowing joint shareholders to calculate the shareholding ratio by netting the figures that have been redundantly declared by both parties.
At present, if a party performs a transaction that results in a shareholding ratio of more than 10%, the said party is required to submit a general report even if it is subject to the special reporting system. It is necessary to conduct a review so that a general report will be submitted when the performed transaction leads to a reduction in the shareholding ratio from more than 10% to below 10%.

These recommendations include many legal matters. The FSA plans to vigorously work on the recommendations, in conjunction with dealing with the "Bill for Investment Services (provisional title)" which is scheduled to be submitted at the ordinary session of the Diet.

Report by Subcommittee on Internal Controls, Business Accounting Council: "Evaluation and Auditing Standards for Internal Control Reported in Financial Reports"

Recent incidents of improper disclosure are claimed to have been caused partly by the failure of internal controls for ensuring the reliability of disclosure to function effectively. In the United States, the Sarbanes-Oxley Act has enforced mandatory evaluation by the management and mandatory audits by Certified Public Accountants (CPAs) with respect to internal controls for financial reports since 2004. In response to such a trend, the Subcommittee on Internal Controls of the Business Accounting Council headed by Shinji Hata (Professor at Graduate School of Aoyama Gakuin University) has deliberated on the standards for evaluation by the management and audits by CPAs, etc. with respect to the effectiveness of internal controls for financial reports, and compiled its report titled "Evaluation and Auditing Standards for Internal Control Reported in Financial Reports" on December 8, 2005.
The draft standards presented in the report consist of three parts: (1) "I. Basic Framework of Internal Control" that describes the definition and the conceptual framework of internal control itself, which the management has the role and responsibility to develop and operate; (2) "Evaluation and Reporting of Internal Control for Financial Reports", which shows the approach to evaluation by the management with respect to the effectiveness of internal controls for financial reports; and (3) "III. Auditing of Internal Controls for Financial Reports", which explains the approach to the standards of audits conducted by CPAs, etc.

1. Basic Framework of Internal Control

Internal control is basically a process that is carried out by all members of the company, in order to fulfill four corporate objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reports; (3) compliance with laws and regulations relating to business activities; and (4) preservation of assets. It is comprised of six basic elements: (1) control environment; (2) response to risks and evaluation; (3) control activities; (4) information and communication; (5) monitoring and; (6) IT support. Among them, internal controls aimed at ensuring the reliability of financial reports are defined as "internal controls for financial reports", and are subject to the evaluation and audit based on the draft standards.

2. Evaluation and Report of Internal Control for Financial Reports

The management assumes the role and the responsibility to develop and operate internal controls, and is required to directly evaluate the effectiveness of internal controls for financial reports and report the results in the form of an internal control report to the public. Upon evaluating the effectiveness of internal controls, the management must first evaluate internal controls that have a material impact on the financial reports as a whole (company-wide internal control), and evaluate the internal controls relating to operations based on the results.

3. Audit of Internal Controls for Financial Reports

The auditor in charge of auditing the financial statements of the company audits the evaluation of the effectiveness of internal controls for financial reports performed by the management, to determine the appropriateness of the evaluation results. The auditor compiles the audit results in the form of an internal control audit report, and submits it to the management.

The report by the Subcommittee on Internal Controls describes the modality of internationally accountable and effective standards that are consistent with the company laws of Japan, verifies the implementation status, etc., in the United States where the system was introduced before Japan, and incorporates measures to prevent costs, etc., from becoming excessive, in consideration of debates over whether or not mandatory evaluation by the management and mandatory audits by auditors with respect to internal controls for financial reports would be an excessive burden.

Furthermore, for the draft standards presented in the said report, there have been many requests for the development of detailed practical guidelines (implementation standards) that would be applicable at the working level. Accordingly, the Subcommittee decided to conduct further studies on implementation standards, and established a working group headed by Nao Hashimoto (professor at Graduate School of Aoyama Gakuin University) under the Subcommittee in December 2005.

The report submitted by the First Subcommittee of the Financial System Council on December 22, 2005 recommends that evaluation by the management and audits by CPAs be made mandatory based on the report by the Subcommittee on Internal Controls, in order to ensure the appropriateness of financial reports of listed companies. It also recommends the introduction of a system that obliges the management to confirm the appropriateness of statements in securities reports at the same time.

【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. How will the Investment Services Law change and affect, for example, the world of finance or the financial sector in the future?

A. In the financial sector, banks, life insurance companies, non-life insurance companies, shinkin banks and shinyo-kumiai (credit cooperatives) have their businesses regulated by their respective business laws. The Investment Services Law is undoubtedly a cross-sectional law, but my vision is that its top priority is to prepare against pitfalls that are not expected by investors, and my understanding is that it does not directly regulate the existing financial world.

(from the press conference following a cabinet meeting on Thursday, December 22, 2005)

Q. The enactment of the "Financial Services Law" was hotly debated around 1999, only to be crushed subsequently as a result of a tug of war between government ministries and agencies. On reflection, what are your views on the fact that it was seven years too late having had discussions of the Investment Services Law?

A. Scams such as those that solicit for investment and promise high rates of interest have actually been around since 1945, and malicious businesses have been punished by applying laws that were effective at the time. It is the demand of the times that a law with universal coverage—that is, an investor protection law—has become necessary due to the diversification of investment vehicles of late. On the other hand, the law also incorporates the idea that opportunities to make investments freely should not be destroyed by investor protection.

(from the press conference following a cabinet meeting on Thursday, December 22, 2005)

Q. The Livedoor incident led to the suspension of trading of all stocks at the Tokyo Stock Exchange (TSE) yesterday, and forced the TSE to delay the afternoon session by 30 minutes from today onwards. What is your evaluation of such a measure taken by the TSE?

A. The TSE management should fully acknowledge that a stock exchange deserves to be called a stock exchange only if it can fulfill transactions, and that a stock exchange that cannot fulfill transactions will have the worthiness of its existence questioned. While it is understandable in some aspects that trading was suspended due to abnormal circumstances, they should do everything to improve the reliability and processing capacity of the system in the future. While I have already requested this strongly when the system crashed, I would once again like to urge the TSE management to take proper action in this area.

(from the press conference following a cabinet meeting on Thursday, January 19, 2006)

Minister's Statement on the matter of the TSE

The TSE is set to take measures including shortening the afternoon trading session by 30 minutes today. This situation is not normal. It is hoped that the situation will be restored back to normal as soon as possible, as it is an urgent issue.

The TSE has been criticized both in Japan and overseas for what has been happening. Restoring confidence in the TSE is crucial to the Japanese economy, and is extremely important for the purpose of restoring the reliability of TSE itself as a stock exchange. TSE must lavishly make investments to

improve the reliability and processing capacity of the system, as I have repeatedly stated since the system crashed in November. I intend to strongly inform Mr. Nishimuro of our point of view on this matter.

(from the press conference following a cabinet meeting on Friday, January 20, 2006)

Q. The TSE has announced a number of countermeasures since the suspension of trading. What is your evaluation of the measures presented by the TSE at this point, to the extent that they have been revealed so far, such as system enhancements and partial restrictions on trading?

A. System enhancements understandably take a certain amount of time, due to the preparation of machines, the development of systems and so on. However, the time taken should be minimized to prepare against this kind of situation.

(from the press conference following a cabinet meeting on Friday, January 20, 2006)

Q. Sumitomo Mitsui Financial Group announced last Friday that it will execute recapitalization and increase its capital by about 600 billion yen, with the intention of repaying public funds ahead of schedule. What is your evaluation of such a move?

A. Public funds were injected when the entire financial sector was under tough conditions. It is very preferable that they now have an intention to and are able to return the public funds. I hope each financial institution will further restore its soundness after repaying the public funds.

(from the press conference following a cabinet meeting on Tuesday, January 10, 2006)