



# Recent Developments of Securities Markets Reforms in Japan

Financial Services Agency (FSA), Japan  
December 2003



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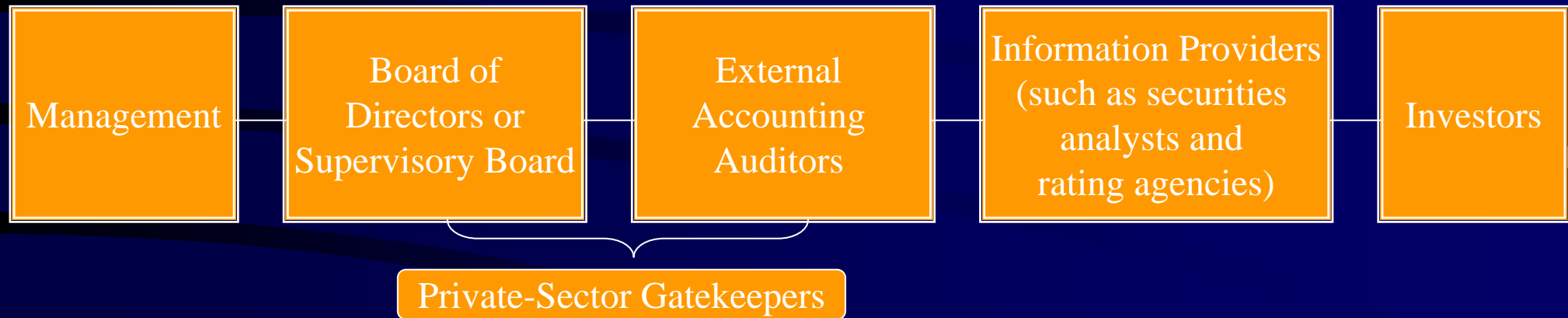
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# I. Structural Problems of “Financial Reporting Supply Chain” (1)

## 1. “Financial Reporting Supply Chain”

### (1) Structure of Chain



### (2) Problems (Pointed out)





# I. Structural Problems of “Financial Reporting Supply Chain” (2)

## 2. Global Issues, Initiatives and Discussions

### (1) Objective

Improving and Enhancing investors’ confidence in securities markets

### (2) Initiatives

U.S. : Sarbanes-Oxley Act of 2002

Japan : Comprehensive Program for Promoting Securities Markets Reforms

(announced in August 2002)

Enhancement of corporate governance system

(amendments of the Commercial Code in 2001 and 2002)

EU

### (3) Global Issues

Corporate Governance

Auditor Independence and Auditing Oversight

Accounting and Auditing Standards

Disclosure

Securities Analysts

Rating Agencies



# I. Structural Problems of “Financial Reporting Supply Chain” (3)

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## (4) Global Discussions

G8 Summit

G7 Finance Ministers and Central Bank Governors

FSF (Financial Stability Forum)

IOSCO (International Organization of Securities

Commissions)

OECD

## (5) Note

Difference in seriousness of corporate scandals and fraudulent accounting practices among jurisdictions



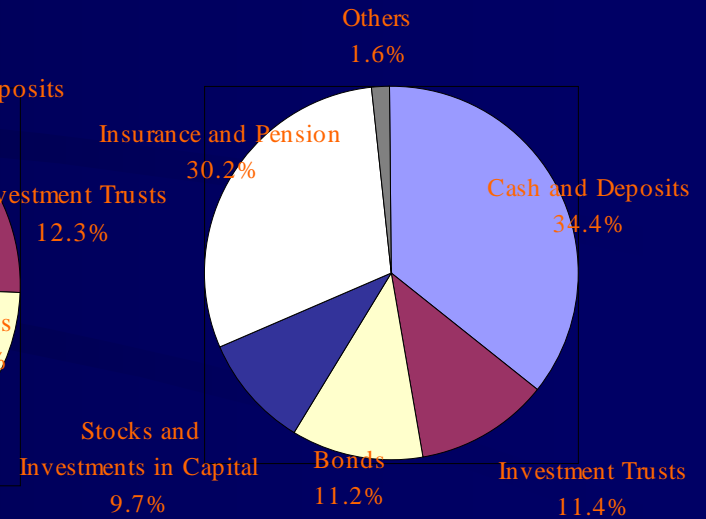
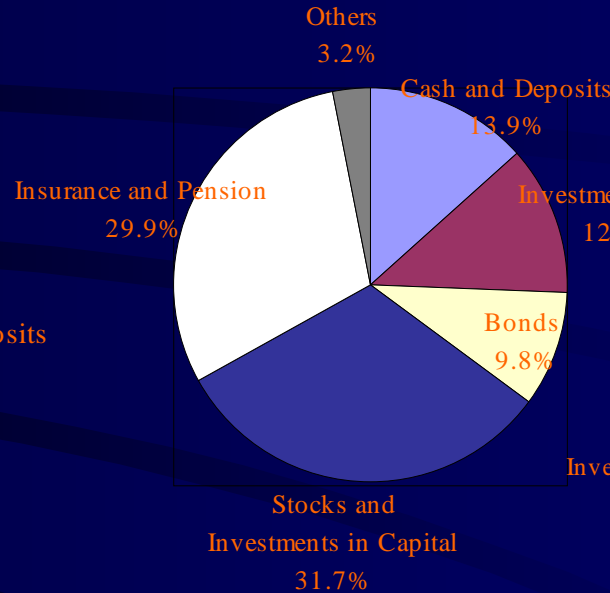
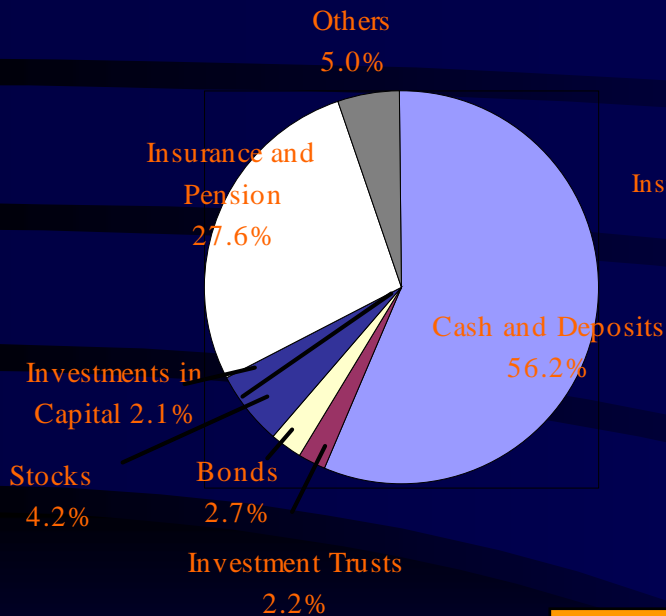
# II. New Comprehensive Program for Promoting Securities Markets Reform (August 6, 2002) (1)

## Composition of Individual Financial Assets

Japan(end-June 2003)

US(end-June 2003)

Germany (end-December 2002)



**Priorities : Shift toward direct finance**

**Further promotion of securities markets with participation of a wide range of investors**

**New Comprehensive Program**



## II. New Comprehensive Program for Promoting Securities Markets Reform (August 6, 2002) (2)

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### 1. Development of securities markets easy to access for everyone

- Expanding the securities marketing channel through securities companies
- Promoting sales of securities through banks
- Developing environment for reliable investment trust and investment advisor services
- Promoting investment knowledge / providing information to investors
- Requesting tax measures that promote active participation by investors

### 2. Establishment of fair and transparent securities markets investors can invest with confidence

- Strengthening the organization and function of the Securities and Exchange Surveillance Commission (SESC)
- Enhancing accounting and auditing system
- Ensuring fair transactions in securities markets
- Enhancing disclosure
- Strengthening corporate governance from an investors' viewpoint



## II. New Comprehensive Program for Promoting Securities Markets Reform (August 6, 2002) (3)

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### 3. Establishment of efficient and competitive securities

#### markets

- Reviewing comprehensively the Japanese markets from a medium-to-long term perspective
- Developing rules on stock exchanges, OTC markets and private offering markets
- Promoting reform of the securities settlement system
- Promoting securitization





# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (1)

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## 1. Schedule and Major Points

### Schedule

- The Japanese government made the Cabinet decision and submitted a bill to the current regular Diet (the Japanese legislature) session on March 14 to comprehensively revise the CPA Law.
- The Diet passed the bill on May 30.
- The amendment will be in principle effective in April 2004.

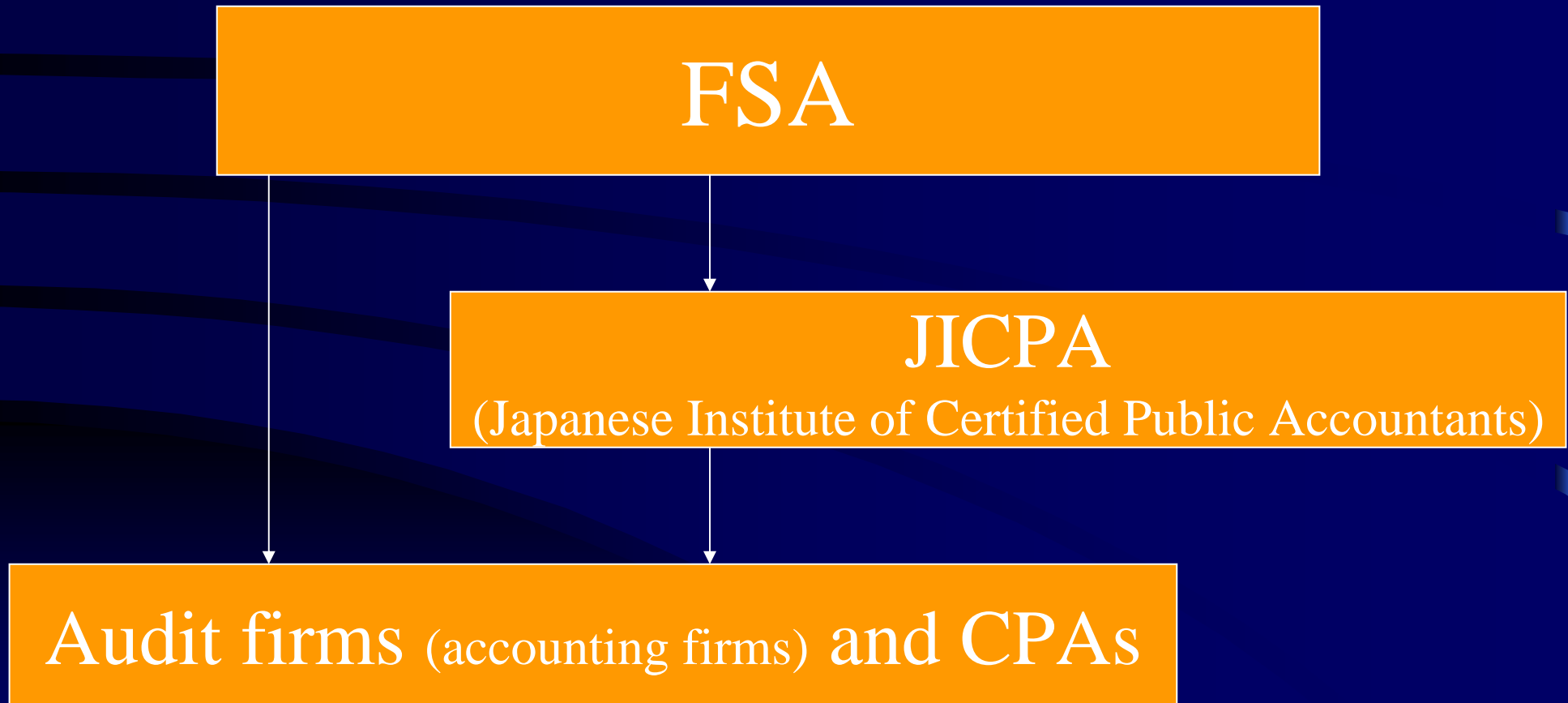
### Major Points

- Enhancing auditor oversight
- Strengthening auditor independence
- Reviewing CPAs examinations to increase the number and enhancing quality of CPAs



# III. Comprehensive Revision of the Certified Public Accountants Law in Japan (2)

## 2. Current auditor oversight structure in Japan





# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (3)

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## 3. Enhancing auditor oversight (1)

### Enhancement of the system of quality control review

- Quality control review by the JICPA will be monitored and reviewed by the CPA and Auditing Oversight Board ("CPAAOB"), an independent third-party board established within the FSA.
- Members of the CPAAOB will be appointed by the Prime Minister with the consents of both Houses of the Diet. The term of office of the members will be three years. The members will exercise their authorities independently. The CPAAOB will have its Executive Bureau including the Secretary-General.
- The JICPA will be required to make reports on the quality control review of its members' auditing to the CPAAOB.
- The CPAAOB will have the authority to inspect CPAs and audit firms in this respect.
- The CPAAOB will be authorized to issue recommendations for administrative actions or directions against CPAs, audit firms or the JICPA to the FSA.



# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (4)

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## 3. Enhancing auditor oversight (2)

### Enhancement of the government oversight function

- Introducing the general authority of on-site inspections of audit firms (Currently on-site inspections of audit firms shall be conducted for the purpose of taking disciplinary actions.)
- Introducing the authority of administrative direction against audit firms (in addition to the current authority of the FSA to take such disciplinary actions as business suspension orders against audit firms)
- Introducing business improvement order against the JICPA (in addition to the current authority of the FSA to take such disciplinary actions as an order for revocation of the resolution of the JICPA's general meeting)

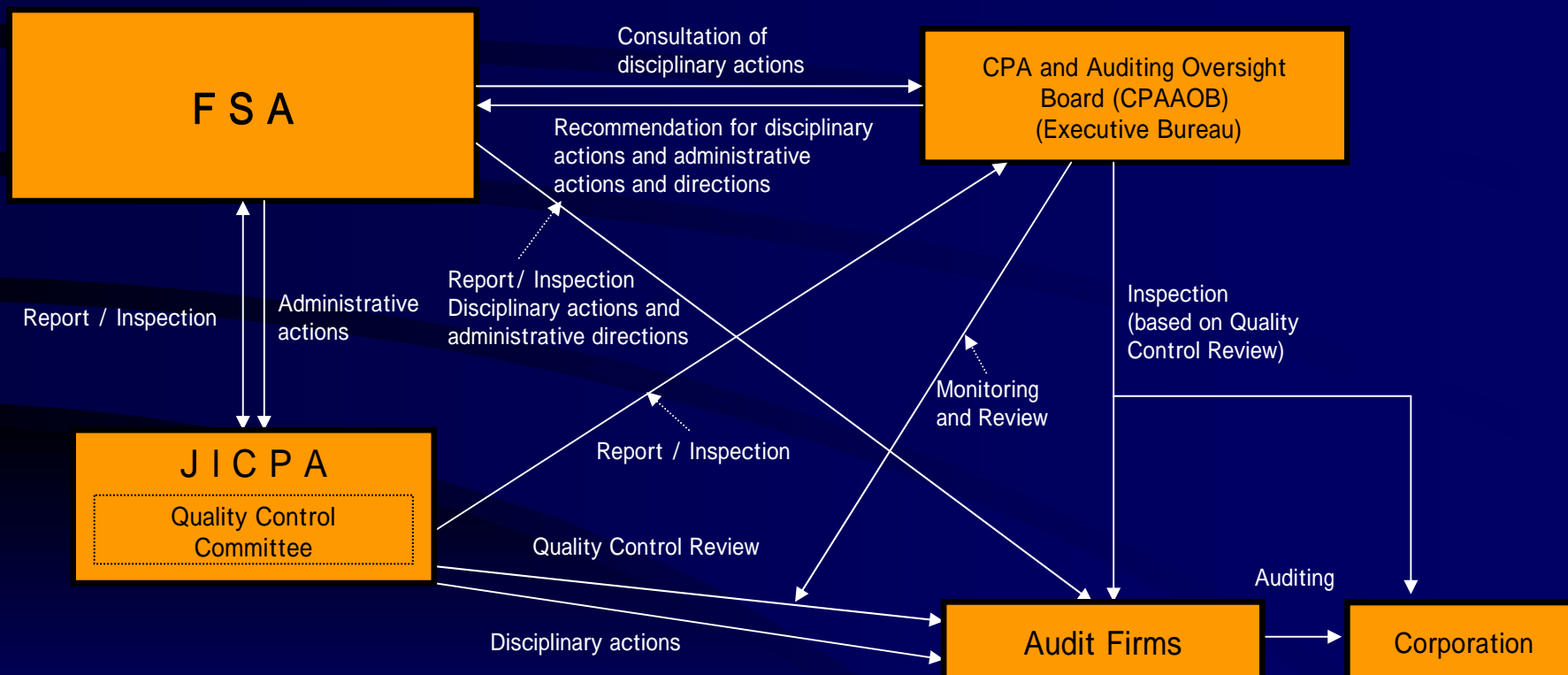
### Enhancement of the JICPA's oversight function

- Introducing the legal authority for the JICPA to conduct quality control review (Currently the JICPA's quality control review is pursuant to the Constitution of the JICPA, and there is no explicit provision in the CPA Law.)

# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (5)



## 3. Enhancing auditor oversight (3)





### III . Comprehensive Revision of the Certified Public Accountants Law in Japan (6)

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#### 4. Strengthening auditor independence (1)

Importance of avoiding involvement in business judgement and auditing own works

Introducing an explicit provision in the CPA Law that CPAs shall have a mission and responsibility to conduct their services with independence, fairness and integrity for the protection of investors

# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (7)



## 4. Strengthening auditor independence (2)

### Concrete Measures

- prohibition of providing certain non-audit services (which are prescribed by Ordinance of Cabinet Office) to an audited large corporation (Provision of tax accounting services by audit firms is already prohibited under the current law.)
- prohibition of providing certain non-audit services through subsidiaries and affiliate entities of audit firms
- requirement of rotation of engagement partners and review partners
  - A partner of an audit firm will be prohibited from engaging in auditing of a large corporation over certain consecutive period (prescribed by Cabinet Order as 7 years).
  - There shall be “time out” period (prescribed by Cabinet Order as 2 years).
- prohibition of assuming office as a director or an officer to which a CPA or a partner of an audit firm provides auditing services for the preceding year



# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (8)

## 5. Reviewing CPAs examinations to increase the number and enhancing quality of CPAs (1)

### (1) Background

In view of increase in the needs for auditing in volume and quality, the objective of this revision is to increase the number of CPA while maintaining high quality, by reviewing the system of CPAs examinations so that larger number of qualified people including financial experts in enterprises may take.

### (2) Present Situations

Total number of CPAs : 14,873 (end of December 2003)

Total number of junior CPAs : 5,347 ( " )

(Note) The junior CPAs system shall be abolished under the revised CPA Law.

Annual number of successful candidates for junior CPAs

- 1998 : 672
- 2001 : 961
- 2002 : 1,148
- 2003 : 1,262





# III . Comprehensive Revision of the Certified Public Accountants Law in Japan (9)

## 5. Reviewing CPAs examinations to increase the number and enhancing quality of CPAs (2)

### (3) Target

Annual number of successful candidates    2,000 ~ 3,000

Total number of CPAs    about 50,000 by 2018

### (4) Measures for increasing the number of CPAs

- Simplification of the present system of CPA examination
- Extension of partial exemption from CPAs examinations to persons who have certain professional qualifications

### (5) Enhancing quality of CPAs

- Requirement for taking continuing professional educational program by the JICPA



# IV. Enhancement of Corporate Governance

## 1. Enhancement of Corporate Statutory Auditors System

Legally separate and independent body from the board of directors

Enhancement of the system

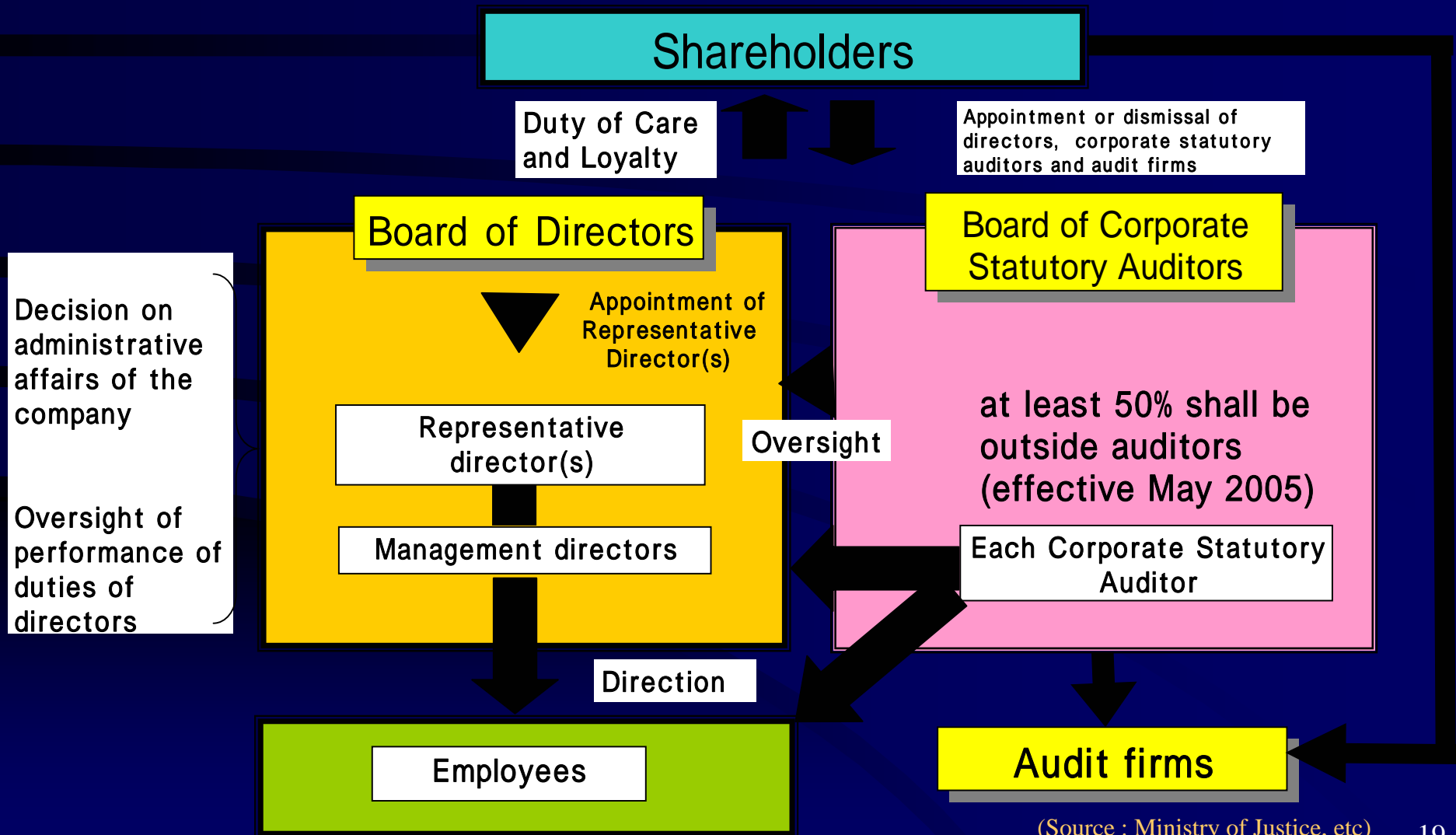
- Increase in the required number of outside corporate statutory auditors (one at least half, effective in May 2005)
- Strengthening the requirement for the definition of an outside corporate statutory auditor (no director or employee relationship for preceding 5 years no director or employee relationship, effective in May 2005)
- Extending the term of office of corporate statutory auditors (3 years 4 years, effective in May 2002)

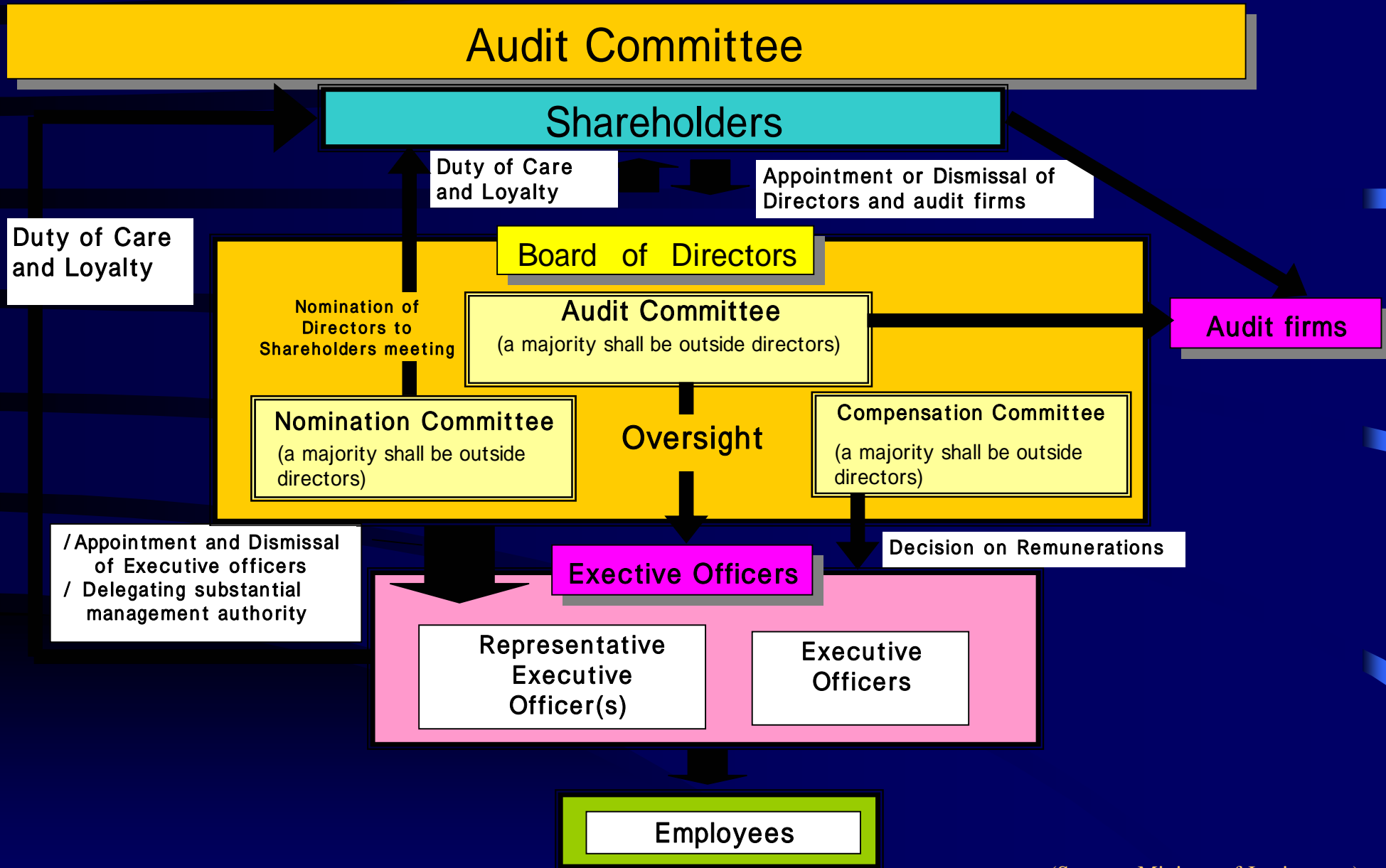
## 2. Introduction of an Option of the Committees System including nomination, audit and compensation committees for large corporations (effective in April 2003)

- Each of the three committees is to consist of three or more directors, and in each committee a majority shall be outside directors.

## 3. Freedom to choose between these two options by large corporations "competition between governance systems"

# Board of Corporate Statutory Auditors





(Source : Ministry of Justice, etc.)



# V. Developments of Internationally Consistent Accounting and Auditing Standards (1)

## 1. Development of internationally consistent accounting standards

Accounting Standards	Status	Implemented for financial statements for fiscal years beginning on or after
Consolidated Financial Statements	Revised June 1997	April 1, 1999
Consolidated Cash Flow Statements	Issued March 1998	April 1, 1999
Research and Development Costs	Issued March 1998	April 1, 1999
Interim Consolidated Financial Statements	Issued March 1998	April 1, 1999
Retirement Benefits	Issued June 1998	April 1, 2000
Deferred Taxes	Issued October 1998	April 1, 1999
Fair Value Accounting for Financial Instruments	Issued January 1999	April 1, 2000
Foreign Currency Transactions and Financial Statements	Revised October 1999	April 1, 2000
Impairment of Fixed Assets	Issued August 2002	April 1, 2003 (voluntary basis) April 1, 2005
Business Combinations	Issued October 2003	April 1, 2006



## V. Developments of Internationally Consistent Accounting and Auditing Standards (2)

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### 2. Activities by the Accounting Standards Board of Japan

(ASBJ : private accounting standards setting board established in July 2001)

- Stock options (under deliberation)

### 3. New Auditing Standards (effective in March 2003)

- Risk approach
- Internal control
- Going concern



# VI. Strengthening Disclosure System

## 1. Strengthening Disclosure System (effective in April 2003)

Enhanced disclosure of governance-related information

- such matters as internal control system, risk control system, directors' compensation, and audit fees

Enhanced disclosure of risk information

- such matters as dependence on specific counterparties and serious legal actions

Enhanced disclosure of MD&A (Management's Discussion and Analysis)

## 2. Introduction of Quarterly Disclosure System by Stock Exchanges

Quarterly disclosure system already implemented in the markets for emerging corporations

Schedule of introduction of quarterly disclosure system in the large markets (such as Section I and II of the Tokyo Stock Exchange (TSE) and the JASDAQ )

Mandatory disclosure of "quarterly overview" to the listed companies from April 2003

Voluntary quarterly disclosure of financial and operational information from April 2004



## VII. Strengthening of the JSDA Rule on Securities Analysts

The JSDA introduced the rule on securities analysts in January 2002. In response to the recent global developments, the JSDA strengthened the rule on January 15, 2003 (effective in April 2003).

1) Research independence

Securities analysts must be institutionally independent from the investment banking departments. Especially, securities analysts' compensation should not be linked to the performance of the investment banking businesses.

2) Disclosure of conflicts of interest

Member firms are required to disclose any conflicts of interest situation of themselves and their research analysts in relation to subject companies.

3) Prohibition of the pre-disclosure to the subject company

Member firms are prohibited to disclose research reports to subject companies before their publications.

4) Review process of the research report

Member firms are required to establish review processes which ensures integrity and objectivity of research reports.

5) Strict control of information

Information obtained through research processes is required to be appropriately controlled.

6) Maintenance requirement of the research reports

Members are required to maintain research reports for 3 years after their publications.

The JSDA is considering further enhancement of the rule in line with the IOSCO principles.





## VIII. International Development of Securities Exchanges (1)

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### 1. Schedule

December 2002      Report by the First Subcommittee of the Financial System Council titled “Promotion of Securities Markets Reform” (“Report”)

March 14, 2003      A bill for amending the Securities and Exchange Law was submitted to the current regular Diet Session based on the Report.

May 23, 2003      The Diet passed the bill.

April 2004      The amendment will be effective.



## VIII. International Development of Securities Exchanges (2)

### 2. Domestic installment of terminals by overseas securities exchanges

#### (1) Previous response by the FSA

Case by case response to requests for installing terminals in Japan by overseas securities exchanges

#### (2) Proposals by the Report (which are included in the bill)

Enactment of definite rules from the viewpoint of investors' protections and ensuring transparency, properly considering international developments

Requiring approval by the FSA, but not requiring licensing for opening of a securities market if required rules are met (an approval requirement will be less strict than the licensing requirement for domestic securities exchanges)

#### Establishment of rules

- Overseas securities exchanges which shall be recognized as being subject to proper regulations and supervisions by overseas securities regulators and as proper self-regulatory organizations for ensuring fairness of transactions and protecting investors
- Framework of exchange of information between the FSA and overseas securities regulators
- Monitoring requirements such as reporting requirement of trading volumes and being subject to supervisory actions by the FSA



## VIII. International Development of Securities Exchanges (3)

### 3. Overseas development of Japanese securities exchanges (Remote Membership and Cross Membership)

Allowing membership of Japanese exchanges to overseas securities companies without requiring establishment of a branch in Japan

Requirement for the membership

- Framework of exchange of information including MOUs between the FSA and overseas securities regulators
- Framework of cooperation on provision of information between Japanese securities exchanges and overseas securities exchanges
- Appointment of a representative in Japan
- Monitoring requirements such as reporting, and supervisory actions



## VIII. International Development of Securities Exchanges (4)

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### 4. Development for Alliances and Consolidations of securities exchanges at home and abroad

- Abolition of the current prohibition of having more than 5% of voting powers of Japanese securities exchanges

- New prohibition of having a majority of voting powers and new requirement for approval of having in principle 20% or more of voting powers of Japanese securities exchanges

- Allowing an establishment of a securities exchange holding company