(Provisional Translation)
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Financial Services Agency

Main Points of the Development of Institutional Frameworks Pertaining to Financial and Capital Markets

Introduction

In response to the recent global financial crisis, there have been various discussions held in Japan and overseas on such topics as over-the-counter (OTC) derivative transactions and hedge funds.

In view of these discussions and the actual condition of Japan's markets, the Financial Services Agency (FSA) decided to commence a detailed examination on the issues that Japan should address in preparation for the current ordinary session of the Diet. In the "Development of Institutional Frameworks Pertaining to Financial and Capital Markets" published on November 13 2009, the FSA announced that it would conduct a survey of market participants and others on each of the issues discussed below.

Based on this survey, the FSA has published the "Draft Blueprint for the Development of Institutional Frameworks Pertaining to Financial and Capital Markets" on December 17, 2009, and undertaken further round of public consultation involving market participants, etc. Based on the feedback, the FSA has finalized the document "Development of the Institutional Framework Pertaining to Financial and Capital Markets" as shown below.

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

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

I. Improving the stability and transparency of the settlement of OTC derivative transactions

Background

During the recent global financial crisis, the risk of being unable to fulfill settlement due to bankruptcy of a counterparty to a transaction became intensified in Europe and North America, partly because the market infrastructure relating to the settlement and clearing of credit default swaps (CDSs) and other OTC derivative transactions had been inadequate. For this reason, progresses are being made internationally in requiring the use of central counter party (CCP) for clearing OTC derivative transactions (mandatory CCP clearing), and in efforts aimed at

improving the transparency of markets.

Approach and Response

(1) Scope of the mandatory CCP clearing, and the system of CCPs

(i) Clearing of OTC derivative transactions of a large trading volume (currently, "plain vanilla" interest rate swaps) needs to be subject to mandatory CCP clearing with a view to preventing contagion and reducing settlement risk in Japan's markets.

* In order to reduce settlement risk in Japan's markets promptly and effectively, clearing should ideally be concentrated in CCPs established in Japan (domestic CCPs).

At the same time, given that most Japanese financial institutions conduct international transactions, alternative options such as mandatory CCP clearing through alliances between foreign CCPs and domestic CCPs or mandatory clearing at foreign CCPs, given that they meet certain requirement standards, should also be admitted.

* If the entry of foreign CCPs based on alliances or by direct means are to be permitted, entry requirements equivalent to those required for domestic CCPs would need to be established, as well as introducing a system for the regulator to monitor to ensure that these requirements are being met continuously.

(ii) It is necessary that OTC derivative transactions of a certain turnover which are closely related to execution under Japan's legal system (currently, iTraxx Japan CDS index transactions) should be subject to the mandatory clearing at domestic CCPs. However, in determining the necessity of clearing, international protocol which is typically employed among market participants should be respected. Furthermore, it is necessary to achieve the necessary conditions such as early establishment of domestic CCPs and examining optimal clearing costs at these CCPs through close discussions between these CCPs and market participants.

(iii) To start with, it seems appropriate to make financial instruments business operators, etc. with large-scale transactions subject to the mandatory CCP clearing described in (i) and (ii) above as the cost of transferring the position held at times of bankruptcy to other financial institutions could be tremendous.

(iv) It would appear that, in parallel with the mandatory CCP clearing, regulations on major shareholders and regulations on capital should be introduced for domestic CCPs.

(2) Data storage and reporting of trade information

(i) From the perspective of ensuring the overall transparency of markets and enabling authorities to gain an adequate understanding of the actual conditions of OTC derivative transactions, information on OTC derivative transactions should be submitted to the authority from trade repositories and from CCPs.

(ii) In addition to (i), the authority also needs to be able to require that financial institutions submit information directly to it.

II. Strengthening the securities clearing and settlement systems, including for government bond transactions and stock lending transactions

Background

With regard to transactions of Japanese government bonds (JGBs), the clearing services offered by the Japan Government Bond Clearing Corporation (JGBCC) are utilized for only about 40 percent of all transactions. When Lehman Brothers Japan went bankrupt in September 2008 and was no longer able to make delivery of JGB certificates in the JGB market, delays in delivery (settlement fails) subsequently accumulated to an unprecedented level, and liquidity in the JGB repo market declined considerably.

With regard to stock lending transactions, no mechanism exists for Delivery-versus-Payment (DVP) settlement (where the delivery of securities and the payment of funds are performed simultaneously), and settlement risk is not being reduced.

Approach and Response

(1) Reduction of settlement risk for JGB transactions

In order to further utilize the risk-reduction function of the JGBCC, which was identified at the time of the Lehman crisis, market participants should aim to produce and publish a roadmap for the following efforts during the first half of this year:

(i) Strengthening the systems of JGBCC in order to increase the use of its clearing services; and clarifying interpretation of related laws and regulations, etc. in using JGBCC as necessary

(ii) Shortening the settlement interval, and establishing and disseminating rules for handling settlement fails.

In addition, the FSA will consider the mandatory CCP clearing of JGB transactions as a statutory measure. (The timing of implementing this measure could be matched to the time when the settlement interval for JGB trades is shortened.)

(2) Strengthening of the securities clearing and settlement systems relating to stock lending transactions

The parties concerned should urgently prepare and publish a roadmap that would include plans for the mandatory CCP clearing or for DVP settlement. One possible target is for the roadmap to be prepared and published by the end of 2010.

(3) Desirable structure of Japan's CCPs (improvement in the consistency of clearing systems)

In order to improve the current situation where CCPs are separately established for each type of financial instruments (divided among five organizations), it is hoped that, to start with, market participants will start examination on ways to improve

clearing functions, giving due consideration to consistency of the clearing systems for different financial instruments, considering what kind of measures contributes to reducing settlement costs.

III. Consolidated regulation and supervision of securities companies etc.

1. Introduction of consolidated regulation and supervision of securities companies

Background

Currently, the regulation and supervision of securities companies is , in principle, on a non-consolidated basis. However, as the structures of securities companies continue to become larger and more complex (grouped), there is a risk that a situation may arise such as where a securities company that conducts its operations as an entire group suddenly fails due to financial or operational problems caused by companies within the group, consequently making its market intermediary function dysfunctional.

Approach and Response

Regulation and supervision on a consolidated basis should be formalized for securities companies, such as those providing large-scale and complex services as an entire group, whose overall risks might be hard to identify under the current non-consolidated-based regulation and supervision.

(1) Securities companies subject to consolidated regulation and supervision

(i) All of large securities companies above a certain value of total assets should be made subject to consolidated regulation and supervision that covers the securities company per se and their subsidiaries.

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

In this case, when group-wide consolidated regulation and supervision has already been conducted based on other industry laws, provisions are needed to eliminate duplication of similar regulation and supervision. In addition, when a parent company of the securities company is subject to regulation and supervision by foreign authorities, or the parent company does not conduct its operation with its securities subsidiary in an integrated manner, appropriate measures should be adopted taking the actual circumstances of the regulation and supervision, etc. into consideration.

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

(2) Details of consolidated regulation and supervision

Although it seems that regulations including capital adequacy requirement on a consolidated basis and reporting requirement on sister companies and other group companies are needed, ex ante regulation, such as outright restrictions on the scope of business, should not be introduced.

Concerning capital adequacy requirement on a consolidated basis, for securities companies that apply Basel II capital regulation as they aim to expand internationally, the application of the Basel II framework will be allowed.

2. Strengthening regulations of major shareholders of financial instruments business operators

Background

Current laws and regulations do not provide for the authority to issue business improvement orders and other orders against major shareholders of financial instruments business operators.

Approach and Response

In such cases as where it is necessary to ensure the appropriate business operations of a financial instruments business operator, the institutional framework will be developed so that it enables the authority to issue business improvement orders against major shareholders who hold a majority of voting rights.

3. Consolidated prudential regulations of insurance companies

Background

A certain level of regulatory and supervisory framework is already in place with regard to groups led by an insurance company or an insurance holding company. However, the prudential standard (a solvency margin standard) is currently in place only for insurance companies on a non-consolidated basis.

In recent years, the need for having a quantitative understanding of the soundness of a group's entire financial standing has increased as organizational restructuring of the insurance industry is advanced. Moreover, discussions are underway on prudential standards on a consolidated basis, as it has been pointed out internationally that problems attributable to the deterioration of business conditions for non-insurance companies within a group can trigger an adverse effect for insurance companies, which is a lesson drawn from the recent global financial crisis.

Approach and Response

From the perspective of protecting policyholders and so forth, the prudential standards on a consolidated basis, should be introduced, which would cover the

entire group of companies led by an insurance company or an insurance holding company.

(1) Scope of application of prudential standards on a consolidated basis

The standards cover all groups led by an insurance company or an insurance holding company.

(2) Timing for the introduction of standards of consolidated financial soundness

While being mindful of consistency with international discussions, it is appropriate that these standards should be introduced early, taking into account the current state of the ongoing organizational restructuring of Japan's insurance industry.

IV. Hedge fund regulation

Background

(1) International developments

In view of the cross-border activities of hedge funds, a common understanding has emerged that the authorities in each country should regulate them from similar viewpoints wherever possible. In the European Union and the United States, there have been discussions on making hedge fund managers subject to registration, and on making it mandatory for managers to report to the authorities on their managed assets on an ongoing basis, from risk management and other perspectives.

(2) Japan's current regulatory framework

Regulation based on the Financial Instruments and Exchange Act (FIEA) is imposed on fund managers located in Japan, as (i) discretionary investment managers, (ii) investment trust managers, and (iii) collective investment schemes (self-managed). Regulations have been in place in Japan which, on the whole, are equivalent to the international agreements of "registration".

Approach and Response

(1) Expansion of the scope of registration

Under the FIEA, regulation is imposed on managers who use the same style of invest management as what is so called hedge fund as registered discretionary investment managers and as registered investment trust managers. Given that no collective investment schemes for professionals, which are subject to a notification system, has been confirmed at present as falling under the category of hedge funds which could entail systemic risk, there is no need to change the regulation to make them subject to registration.

The style of investment management (excluding investment management that is classified as discretionary investment management) where a foreign investment trust is set up and given instructions directly from within Japan is not covered by the

current FIEA. However, since such investment management can be found in Japan, albeit infrequently, it will also be subject to registration.

(2) Expansion of the reporting requirements pertaining to the risk management of funds

With regard to the reports made by hedge fund managers to the authorities, in view of international discussion and also taking into account the actual condition of investment management, the items to be reported including ongoing reports to the authorities on the risk management of managed assets need to be expanded in collaboration with other countries.

V. Ensuring investor protection and fair trade

1. Revision of the professional investor system with regard to local governments

Background

Currently, local governments are classified as “professional investors” who can opt to become “general investors”. It appears, however, that some local governments purchase complex financial instruments that require a high degree of financial knowledge.

Approach and Response

Given that local governments do not necessarily have systems in place which enable them to make investment decisions based on necessary financial knowledge, they should be classified as “general investors” who can opt to become “professional investors” from the perspective of further enhancing investor protection.

2. Regulation of unsolicited offer for overall derivative transactions

Background

Currently, under the Order for Enforcement of the FIEA, only OTC financial futures transactions (including OTC FX transactions) are subject to the ban on unsolicited offer. In recent years, CFD transactions, which are similar to OTC FX transactions, have become widespread, while the most recent revisions to the Commodity Exchange Act have made some derivative transactions on exchanges also subject to the ban on unsolicited offer.

Approach and Response

On the one hand, there is a view that overall derivative transactions, including transactions on exchanges, should be made subject to the ban on unsolicited offer, and that preventive measures should be taken against the emergence of problems

related to compliance with the principle of suitability. On the other hand, there is another view, primarily among financial institutions, that such a ban would consequently impede the development of Japan's financial services as financial institutions would no longer be able to provide clients with appropriate information on products.

In light of these different points of view, the FSA will continue to exchange views with market participants and users on whether overall derivative transactions, including transactions on exchanges, should be made subject to the ban on unsolicited offer. The FSA will move forward with its examination so that a conclusion can be reached in the first half of 2010.

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

Background

In recent times, cases of fraud have been occurring among dealers of collecting investment scheme (fund) interests (corresponding to Type II financial instruments business operators) and investment management firms of fund assets (corresponding to investment management business operators), such as them misappropriating funds contributed by investors.

With securities companies, in cases where there are facts that could trigger the commencement of bankruptcy proceedings, it is possible for the authority to file a petition for the commencement of such proceedings.

Approach and Response

The FSA will develop systems which allow the authority to file petitions for the commencement of such proceedings for all types of financial instruments business operators, including non-securities companies, in cases where there are facts that could trigger the commencement of bankruptcy proceedings.

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

Background

Under the current Trust Act and Trust Business Act, the authority is able to file a petition for the removal of a trustee such as when a trust business' license or registration is rescinded. However, the appointment of new trustees and so on is left to the discretion of the interested parties concerned. Therefore, it may take time to coordinate the appointments and so forth, and it may become difficult for trust property to be managed appropriately.

Approach and Response

From the perspective of protecting beneficiaries, the FSA will develop systems

which allow the authority to file petitions such as for the appointment of new trustees and so forth in the event a trust business has had its license or registration rescinded.

VI. Other

Development of a reporting system for short selling

Background

With regard to the short selling of securities, the following permanent measures are currently in place:

(i) An “uptick rule requirement” which prohibits, in principle, short selling at prices no higher than the latest market price; and

(ii) Requirements for traders to verify and flag whether or not the transactions in question are short selling; ,

Furthermore, during the recent global financial crisis, the following temporary measures were also adopted (until January 31, 2010):

- A ban on naked short selling
- An obligation to report and disclose any short positions which, in principle, equal or exceed 0.25% of the total outstanding stock

In various foreign countries, it has been witnessed to make the enhanced short selling regulations permanent, or to extend the temporary measures. Proposals have also been put forward internationally to consider including derivatives in the reporting system.

Approach and Response

With regard to the system for reporting and disclosing short positions, that was introduced as a temporary measure, for the time being, the FSA will keep a careful watch on market conditions and will take action accordingly.

Meanwhile, while keeping in mind a view that the current short selling regulation in Japan, including uptick rule, is relatively strict internationally and taking into account trends in other countries, the FSA will continue to consider in a comprehensive manner as to the future perpetuation of a system for reporting and disclosing short positions, including in terms of (i) how price regulation ought to be, (ii) whether and how positions of derivative transactions including OTC derivative transactions should be reported, and (iii) what items should be disclosed.