(Provisional Translation)
December 17, 2009
Financial Services Agency

Main Points of the Draft Blueprint for 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 ordinary session of the Diet beginning early next year. In the "Development of Institutional Frameworks Pertaining to Financial and Capital Markets" issued on November 13, the FSA declared that it would conduct a survey of market participants and others on each of the issues discussed below.

Based on this fact-finding survey, the FSA has compiled the "Draft Blueprint for the Development of Institutional Frameworks Pertaining to Financial and Capital Markets" as shown below.

Going forward, the FSA intends to interview a broad range of market participants and others for a second time, before putting together its conclusions in a prompt manner.

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 Proposed 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, mandatory CCP clearing could be achieved through alliances between foreign CCPs and domestic CCPs that meet certain requirements. Moreover, consideration could be given to examining, as one of the possible measures, mandatory clearing at foreign CCPs.
* If entry of foreign CCPs based on alliances or other manners is to be permitted, perhaps certain entry requirements should be established, such as requiring that these organizations perform the functions generally equivalent to those of domestic CCPs.

(ii) Perhaps the clearing of 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.

(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 (repurchase arrangement) 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 Proposed 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, including the JGBCC should aim to produce and publish a roadmap for the following efforts during the first half of next year:

(i) Strengthening the systems of JGBCC in order to increase the use of its clearing services; and

(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 perhaps 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.

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 goes bankrupt due to financial or operational problems

caused by companies within the group, making its market intermediary function dysfunctional.

Approach and Proposed Response

Regulation and supervision on a consolidated basis should be formalized for securities companies whose overall risks might be hard to be identified under the current non-consolidated-based regulation and supervision: e.g. securities companies that provide large-scale and complex services as an entire group.

(1) Securities companies subject to consolidated regulation and supervision

In determining which securities companies would be subject to consolidated regulation:

(i) qualitative judgments based on the nature of services might be necessary in addition to quantitative standards such as the value of total assets;

(ii) provisions may be needed with regard to securities companies under banking groups or foreign groups to eliminate duplication with other industry laws or with regulation and supervision by foreign authorities;

(iii) in cases where the parent company is a business corporation not recognized as conducting its operations with its securities subsidiary in an integrated manner, consolidated regulation and supervision should target the said securities subsidiary and all of its subsidiaries where necessary.

(2) Details of consolidated regulation and supervision

Although it appears that capital regulation on a consolidated basis and reporting requirements on sister companies are needed, introduction of ex ante regulation, such as outright restrictions on the scope of business, should be avoided.

Consolidated regulation and supervision of the entire group, including the parent company, should be conducted with regard to securities companies whose operations and risk profile require monitoring on the entire group basis. For other large securities companies, consolidated regulation and supervision needs to be conducted which covers the securities company and all of its subsidiaries.

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

Background

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

Approach and Proposed Response

It appears that a framework is needed that would allow for issuing business improvement orders against the major shareholders who hold the majority of voting rights of the financial instruments business operator concerned in cases where such

an order is necessary to ensure that the business operations of the financial instruments business operator is conducted in an appropriate manner.

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 Proposed 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 should 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, and taking into account the current state of the ongoing organizational restructuring of Japan's insurance industry, it appears that these standards should be introduced early.

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 Proposed Response

(1) Expansion of the scope of registration

Under the FIEA, regulation is imposed on hedge fund managers 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 not been confirmed at present as falling under the category of hedge funds which could entail systemic risk, there seems to be no need to change the regulation to make them subject to registration.

The style of investment management where foreign investment trusts marketed to Japanese investors are set up and given instructions directly from within Japan are not covered by the current FIEA. However, since such investment management can be found in Japan, albeit infrequently, it should 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, the items to be reported should be expanded in collaboration with other countries. They would include ongoing reports to the authorities on the risk management of managed assets.

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 Proposed 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 Proposed 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.

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 Proposed 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 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) what items should be disclosed, (ii) whether and how positions of derivative transactions including OTC derivative transactions should be required to be reported, and (iii) how uptick rule requirement ought to be.