Provisional and unofficial translation

Report by the First Subcommittee of the Sectional Committee on the Financial System of the Financial System Council

～Toward Building Reliable and Vibrant Markets～

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Introduction

The global financial and capital markets have plunged into a state of great turmoil caused by the U.S. subprime loan crisis, highlighting problems associated with the business model of pursuing short-term gains through highly leveraged products. In this situation, it is urgent that countries around the world work together actively to stabilize the financial system, prevent a recurrence of the financial crisis, and strengthen the financial system.

At the same time, the importance of financial intermediary functions remain unchanged in terms of supporting economic activities and attaining adequate resource allocation. To this end, the financial and capital markets are expected to play a pivotal role. Japan in particular needs to make constant efforts to strengthen the competitiveness of its markets in order to ensure sustainable economic growth and facilitate the people’s asset building, in view of the country’s aging and shrinking population.

Based on the recognition of these problems and issues, the First Subcommittee of the Sectional Committee on the Financial System of the Financial System Council held five sessions of deliberations beginning in October this year on ways to build market infrastructures that are fair and transparent and provide a high level of diversity and convenience. The deliberations focused on the following issues, from the standpoint of strengthening the competitiveness of Japan's financial and capital markets, while giving due consideration to the global market turmoil caused by the U.S. subprime mortgage problem:

- (i) A framework for regulation of credit rating agencies;
- (ii) Alliances among financial instruments and commodity exchanges; and
- (iii) Review of the disclosure systems.

As for the review of the disclosure systems, the Disclosure Working Group set up under our Subcommittee held deliberations from the experts' viewpoints.

This report summarizes the outcome of the deliberations held by the First Subcommittee. We hope that relevant parties will implement measures to put in place an appropriate institutional framework in light of the contents of this report.

I. Introduction of regulation of credit rating agencies

1. Background and perspectives on problems and issues

Credit ratings have significant influence over investment decisions as they are widely used in the financial and capital markets as a reference source of credit risk assessment for investors when they make investment decisions. Credit rating agencies that assign and provide credit ratings for a wide range of users play an important role as elements of the information infrastructure of the financial and capital markets. Therefore, they are supposed to exercise their functions in an appropriate manner, corresponding to their important role.

While credit rating agencies provide information and opinions that serve as important factors for investment decisions, they have, unlike investment advisory business operators, no direct involvement in specific transactions of financial instruments based on a contractual relationship with customers. Therefore, they have not been subject to regulation in Japan and most other countries around the world.

However, in relation to corporate accounting scandals that have emerged in the United States since the end of 2001 and the subprime loan problem that has come to light since the summer of 2007, a variety of questions have been raised about credit rating agencies, including the following:

*Whether credit rating agencies fully verified the validity of their rating methodologies, such as use of data (including whether they acquired truthful, accurate, and sufficient data) and modeling, when they assigned credit ratings.

*Whether potential conflicts of interest are inherent in the business model in which credit rating agencies receive fees from issuers and arrangers.

*Whether credit rating agencies have made sufficient disclosure to investors and other market participants with regard to matters necessary for them to understand the assigned credit ratings, such as historic rating data and the meaning and limits of credit ratings.

In addition, it has been pointed out that investors may have relied excessively on credit ratings and may have failed to give due consideration to the risks of securitized products.

In light of the above-mentioned questions, the following international initiatives have been implemented:

*The International Organization of Securities Commissions (IOSCO) released a set of specific items that credit rating agencies should reflect in their voluntary rules (Code of Conduct Fundamentals for Credit Rating Agencies) in December 2004, and revised

it in May 2008.

*The Leaders that participated in the Summit on Financial Markets and the World Economy in November 2008 agreed to exercise strong oversight over credit rating agencies in a manner consistent with the agreed international code of conduct.

*The Credit Rating Agency Reform Act was enacted in the United States in September 2006. As a result, regarding credit rating agencies employed under the framework of public regulation and oversight (NRSRO[1]), regulation based on a registration system was introduced. In December 2008, the Securities and Exchange Commission approved the revised rule that prescribes the specifics of the regulation.

*In Europe, the Economic and Financial Affairs Council of the European Union (EU) decided at a meeting in July 2008 on the policy of introducing a registration system. In November, the European Commission released proposals for regulation of credit rating agencies.

If we take into consideration the importance of credit rating agencies' role in the financial and capital markets, responses to the various problems pointed out regarding them, and international developments toward introducing and strengthening regulation of them, it becomes apparent that Japan needs to introduce regulation of credit rating agencies.

In addition, it is necessary for Japan to review and revise the public use of credit ratings from the viewpoint of preventing investors from relying excessively on them.

2. Basic concept of regulation

(1) Legal basis

Given that credit rating agencies have significant influence over investment decisions and play an important role as elements of the information infrastructure of the financial and capital markets, regulation of credit rating agencies should be regarded as a means to ensure full utilization of the functions of the capital markets and to protect investors. Therefore, it would be appropriate to introduce the regulation by amending the Financial Instruments and Exchange Act.

(2) Scope of regulation

Regarding the scope of regulation, it would be appropriate to target the agencies whose credit ratings are widely used in the financial and capital markets and which could thus have significant influence over investment decisions, rather than introducing a

[1] NRSRO stands for Nationally Recognized Statistical Rating Organization.

comprehensive regulation of credit risk-related opinions indicated by ratings and grades in general, from the viewpoint of limiting the scope of regulation to a reasonable range so as to avoid imposing excessive constraints on expression of opinions regarding credit risks as a whole.

(3) Framework of regulation

It is important that the basic principle of the regulatory framework should be to ensure that the primary functions of credit ratings are properly exercised in terms of supporting credit risk analysis by investors, rather than regulating the contents of specific credit ratings.

In light of the above and internationally shared perspectives on problems and issues, it would be appropriate if the regulation is to be aimed at ensuring the following:

(i) independence of credit rating agencies from issuers, etc of the products they rate, and prevention of conflicts of interest

(ii) the quality of, and fairness in, the rating process

(iii) transparency for market participants, such as investors

(4) International consistency

As transactions of financial instruments are conducted across national borders, credit ratings are also used on a global scale. In light of these practices, it is important to ensure the effectiveness of regulation of credit rating agencies through cooperation with other countries under an internationally consistent framework.

From this viewpoint, Japan would basically need to establish a framework of regulation in ways to ensure that credit rating agencies comply with the IOSCO's code of conduct, but also would have to take into consideration the U.S. and European frameworks of regulation, given the substantial influence of U.S.-based rating agencies in Japan and the importance of cooperation with the U.S. and European authorities.

3. Specific regulatory measures

In light of 2 above, it would be appropriate to categorize specific regulatory measures based on the IOSCO's code of conduct into four major pillars (duty of good faith, information disclosure, establishment of control systems and prohibited acts).

(1) Duty of good faith

As credit rating agencies play an important role as elements of the information infrastructure of the financial and capital markets, they are supposed to exercise appropriate functions corresponding to this role.

Therefore, from the viewpoint of ensuring the independence, fairness and integrity of credit rating agencies, it would be appropriate to stipulate, as a general principle of the regulation of the agencies, that they should conduct operations in a fair and conscientious manner in their capacity as independent entities.

(2) Information disclosure

(i) Timely information disclosure

In order to enhance the usefulness of credit ratings for market participants, it is necessary to ensure the transparency and timeliness of disclosure of information regarding credit ratings.

As credit ratings are assigned based on the rating methodologies established by credit rating agencies, it is essential for the interests of market participants that the rating methodologies and processes be properly disclosed. In addition, from the viewpoint of promoting investors' understanding of the meaning and limitations of credit ratings, it is essential to clarify the attribution and limitations of each credit rating, including by ensuring that credit ratings on structured products are treated separately from those on ordinary corporate bonds. It is also essential to provide, when assigning or reviewing credit ratings, explanations regarding major factors that constitute the basis of rating opinions, including the structure of the financial instruments, in reports and other materials.

In light of this, it would be appropriate to require credit rating agencies to specify and publish their policy and procedures regarding the assignment and publication of credit ratings (hereinafter referred to as the "rating policies") and operate in compliance with them.

As the rating policies is a basic information item necessary for investors' use of credit ratings, its timely disclosure is essential. It would therefore be appropriate to require credit rating agencies to quickly announce any revisions made to the rating policies

(ii) Periodic information disclosure

In addition to the disclosure of the rating policies, periodic disclosure is necessary with regard to the general nature of compensation arrangements with issuers of the rated financial instruments and comparable historical performance data.

Therefore, it would be appropriate to require credit rating agencies to periodically compile explanation documents and make them available for public viewing.

(3) Establishment of control systems

In light of 2 above, the establishment of control systems for ensuring an appropriate and fair execution of operations is particularly important. It would therefore be appropriate to require credit rating agencies to establish control systems regarding their own independence, the prevention of conflicts of interest, the quality control and fairness of the rating process, legal compliance, information management, compliance with the rating policies (see (2) (i) above).

Regarding the establishment of control systems, it is necessary not only to formulate a code of conduct and other rules on the activities of credit rating agencies but also to ensure their effectiveness.

In addition, from the viewpoint of ensuring the functioning of market discipline and encouraging voluntary improvement efforts through the enhancement of the transparency of the operations of credit rating agencies, it would be appropriate to require the agencies to describe in their explanation documents the status of their development of control systems (see (2) (ii)).

(4) Acts to be prohibited

Regarding matters that require a particularly high level of integrity from the viewpoint of ensuring the independence of credit rating agencies, preventing conflicts of interest and ensuring the fairness of the rating process, it is necessary to prohibit certain acts, rather than merely leave agencies to decide how to act on their own through their establishing control systems.

Specifically, in cases where a credit rating agency has a close relationship with the issuers of the financial instruments to be rated (e.g. cases where an analyst holds financial instruments to be rated), it is necessary to prohibit the ratings of such financial instruments.

The United States and Europe are currently considering introducing and/or strengthening regulation of credit rating agencies. Above all, with respect to a rule which proposes prohibiting credit rating agencies from providing, together with rating services, certain consulting services for issuers of the rated financial instruments or for arrangers of the rated structured financial products, Japan should basically consider introducing a similar measure while keeping a close watch on the status of future deliberations in the United States and Europe.

In any case, Japan must act quickly and flexibly when the IOSCO’s code of conduct is

revised at some future point or when it has become necessary to take additional action in light of the deliberation status of the introduction and enhancement of regulation in the United States and Europe.

4. Framework for registration, inspection and supervision

(1) Framework for registration

Regarding a legal framework for ensuring the effectiveness of regulation, it would be appropriate to adopt a registration system, in light of the fact that a registration system is applied to financial instruments business operators under the Financial Instruments and Exchange Act and from the viewpoint of avoiding creating a major barrier to new entries into the credit rating business.

As for the nature of the registration system, one possible option is to make the system restrictive for new entry by stipulating that a rating agency needs to be registered in order to assign credit ratings for use under public systems in Japan. However, given that an international review of the public use of credit ratings is underway from the viewpoint of rectifying investors' excessive reliance on credit ratings, it would not necessarily be appropriate to define the scope of regulated credit rating agencies directly on the basis of eligibility for public use of credit ratings.

Rather, it would be more appropriate to grant registration if certain conditions are met, while ensuring that, for investors, credit rating agencies that could have significant influence over investment decisions are subject to regulation, by adopting the arrangements described in (2) below with regard to credit ratings assigned by registered credit rating agencies.

(2) Benefits of registration

If a non-restrictive registration system is to be introduced, it would be necessary to develop an appropriate legal framework concerning credit ratings assigned by registered credit rating agencies and those assigned by others from the viewpoint of ensuring the fairness, neutrality and independence of the rating process as mentioned above and ensuring investors' appropriate understanding of the rating methodologies as well as the assumptions and limitations of credit ratings.

In this respect, it is necessary to take some measures to prevent a situation in which credit ratings assigned by entities not subject to regulation (unregistered entities) are made available to investors without clarification as to whether the credit ratings have undergone the rating process that conforms to the regulatory framework and as to the rating methodologies as well as the assumptions and limitations of the credit ratings, thereby distorting investment decisions or otherwise undermining the significance of the

introduction of regulation.

Therefore, in order to enable investors to clearly recognize the significance and limitations of credit ratings, it would be appropriate to prohibit financial instruments business operators and registered financial institutions, which could have significance influence over the interest of a number of investors, from using credit ratings assigned by unregistered entities when soliciting customers to conclude contracts regarding financial instruments, unless they make it clear to investors that the credit ratings do not conform to the regulatory framework for the rating process and unless they provide specific explanations regarding the rating methodologies, assumptions, data and limitations of the credit ratings.

(3) Requirements for registration

If a registration system is to be adopted as requirements for entry, the requirements for registration would constitute specific restrictions on the entry into the credit rating business.

(i) Development of control systems

As the development of control systems by credit rating agencies is particularly important for regulation of the agencies, this should constitute one of the requirements for registration. This would make it possible for the regulatory authorities to check matters such as the assurance of independence, the prevention of conflicts of interest, the quality control and fairness of the rating process, and compliance, through the examination of the applicant entity's control systems.

(ii) Establishment of local commercial presence

In light of the fact that proposals for regulation announced by the European Commission included the obligation for credit rating agencies to establish legal entities (subsidiaries) in the EU region, it would be appropriate for Japan to make the establishment of local commercial presence mandatory in principle from the viewpoint of ensuring the protection of investors and the effectiveness of inspection and supervision. However, it may be possible for the Japanese regulatory authorities to ensure the protection of investors and the effectiveness of inspection and supervision without requiring the establishment of commercial presence in Japan, by exchanging information with their overseas counterparts. Therefore, it would be appropriate to develop a regulatory framework that may grant exemption from the obligation to establish commercial presence in Japan in light of investor protection, the principle of reciprocity, and international cooperation.

(4) Relationship with existing systems

If a registration system is adopted, a certain framework of regulation and supervision should be applied to the registered credit rating agencies (hereafter referred to as "credit rating service providers" (tentative name)). In this case, it would be necessary to adjust the relationship between the registration system and the following existing systems.

(i) Designated Rating Agency System

It would be appropriate to integrate the designated rating agency system, which is used under the Financial Instruments and Exchange Act, etc., into the credit rating service provider system.

This will ensure that credit ratings assigned by registered credit rating service providers continue to be recognized as corresponding to ratings assigned by "designated credit rating agencies."

(ii) External Credit Assessment Institutions

There is a system in place under which the FSA Commissioner designates credit rating agencies (External Credit Assessment Institutions (hereafter referred to as "ECAIs")) whose credit ratings may be used in the calculation of banks' capital adequacy ratios. Given that this system has been established in relation to the calculation of benchmarks for the soundness of banks based on the concept of the Basel II framework and is thus outside the purpose and objectives of the Financial Instruments and Exchange Act, it would be appropriate to maintain the ECAI system and require credit rating agencies to be a "credit rating service provider" for designation as an ECAI, thereby ensuring consistency between the two systems.

(5) Framework for inspection and supervision

In order to ensure the effectiveness of regulation of credit rating service providers, it would be appropriate to develop a framework for inspection and supervision that specifies the following matters under the above-mentioned registration system:

(i) credit rating service providers' obligations to compile and submit periodic business reports

(ii) supervisory order for production of reports and on-site inspections

(iii) regulatory authority to order a credit rating service provider to improve its business operations when it is deemed necessary to do so from the viewpoint of ensuring appropriate and fair business operations of the credit rating service provider and protecting the investors using its credit ratings.

In addition, in light of credit rating service providers' important role in the financial and capital markets, when supervisory actions, such as the issuance of a business improvement order, with significant implications for the general public, including investors, are taken, it is essential to ensure public awareness thereof. Therefore, it would be appropriate to develop a framework for dissemination of information to this end.

Also, it is necessary to consider whether to introduce supervisory actions with a stronger deterrent effect in cases of serious violation of laws and regulations.

It is necessary to keep in mind that the spirit of principles-based regulation should not be impaired in actual practices of inspection and supervision under the above-mentioned framework.

(6) Cooperation on enforcement with overseas authorities

Given the global scale of credit rating agencies' activities, cooperation on enforcement with overseas authorities is essential for effective oversight of the agencies. To this end, it would be necessary to develop a framework for exchanges of information with overseas authorities about inspection and supervision.

5. Others

Among possible factors behind investors' excessive reliance on credit ratings and their failure to make their own analysis and assessment of the risks involved in securitized products are the widespread public use of credit ratings and the insufficient provision of information useful for their own assessment of credit risk.

With the thorough publicity of the meaning and limitations of credit ratings to investors, it is desirable that relevant parties take measures to put in place an environment conducive to providing market participants such as investors with easy access to information necessary for investment decisions, including information regarding the underlying assets of securitized products and the risks involved therein.

II. Alliances among financial instruments exchanges and commodity exchanges

1. Outcome of past deliberations

Regarding alliances among financial instruments exchanges and commodity exchanges, this Subcommittee put forward the following recommendations in a report issued on December 18, 2007, from the viewpoint of strengthening the international competitiveness of Japanese exchanges and improving convenience for users at the same time:

*In order to strengthen the business foundation and international competitiveness of Japanese exchanges, it is necessary to put in place institutional frameworks enabling them to offer a full product line-up, ranging from stocks, bonds, financial derivatives to commodity derivatives, as soon as possible by such means as forming groups through capital alliances among exchanges.

*There may also be views that the Commodity Exchange Act should be integrated into the Financial Instruments and Exchange Act in the future. However, in order to put in place institutional frameworks as soon as possible, the most pressing task is to enable the mutual extension of the products traded, including through capital alliance, under the Financial Instruments and Exchange Act while commodity derivative transactions continue to be regulated under the Commodity Exchange Act.

*It is appropriate to authorize the opening of a commodity derivatives market by the subsidiaries of financial instrument exchanges and to also provide financial instruments exchanges themselves with an option of opening such a market.

2. Basic concept of putting in place institutional frameworks

In response to the above report, the FSA called for the “establishment of frameworks for alliances among financial instruments exchanges and commodity exchanges” in the Better Market Initiative adopted on December 21, 2007, and stipulated that “consideration will be given by the end of 2008,”and that, “Following this consideration, the relevant revisions will be implemented promptly.”

While the government should quickly draw up specific proposals for enabling financial instruments exchanges and commodity exchanges to form alliances, it is necessary to give consideration to the following basic points in doing so:

(1) Allowing flexible options for mutual entry

In allowing financial instruments exchanges and commodity exchanges to form alliances, it would be appropriate to put in place institutional frameworks that would give them flexible options as to how they form the alliance, from the viewpoint of enabling efficient and effective operation of the markets while ensuring appropriate governance.

Specifically, it would be appropriate to give a financial instruments exchange the option of either operating both a financial instruments market and a commodity market for itself or operating a commodity market through a subsidiary or through a sister company that belongs to the same group under a holding company structure.

In addition, if a financial instruments exchange or the group to which it belongs is to be allowed to open a commodity market, it is necessary to consider ways to enhance convenience, such as giving market access to the same scope of market participants as prescribed under the Commodity Exchange Act and allowing the use of a clearing organization for transactions of financial instruments.

(2) Streamlining regulation and oversight of exchanges

When a financial instruments exchange and a commodity exchange or their groups are allowed to form alliances and sell each other's products, regulators must ensure appropriate oversight from the viewpoint of ensuring the soundness and appropriateness of both of the financial instruments market and the commodity market.

However, if an exchange or its group remains subject to dual oversight, this could impose excessive regulatory burden on them.

Therefore, the relevant regulatory authorities should, through close cooperation with each other, streamline their regulation and oversight of exchanges and their groups to the extent possible without undermining the purposes of the relevant laws and regulations, while properly maintaining their respective oversight.

(3) Enhancing cooperation between financial and commodity market regulators

If the alliances among financial instruments exchanges and commodity exchanges advance, the relations between the financial instruments and commodity markets are expected to become increasingly close, leading to an expansion of liquidity in both markets through arbitrage trading conducted across the market boundary.

In light of expected benefits like this, the regulators of financial instruments and commodity markets should allow financial instruments exchanges and commodity exchanges to form alliances while cooperating closely with each other to prevent inappropriate transactions that could undermine the protection of investors.

We hope that with due consideration of the above matters, relevant parties will make efforts to put in place institutional frameworks that will enable financial instruments exchanges and commodity exchanges to form alliances with a high level of convenience and in an efficient manner while ensuring the fairness of transactions.

III. Review of disclosure system

In order for investors to make investment decisions, it is essential that easy-to-understand, useful information is made easily available to them when they need it. From this viewpoint, efforts should be made to reform the disclosure system with due consideration of the practical processes of securities transactions as well as the needs of investors and securities issuers.

(1) Shelf Registration System

Compared with the time when the Shelf Registration System had just been established, access to issuer information has become markedly easy now because of the introduction of an electronic disclosure system (Electronic Disclosure for Investors' NETwork (EDINET)) and other factors. However, the public awareness requirements under the Shelf Registration System are still useful in that they are relevant for supplementary information provision.

The acquisition of a credit rating from a designated rating agency is one of the public awareness requirements. However, it would be appropriate to consider replacing this requirement with another, in light of the fact that credit ratings are originally just a type of expression of opinions regarding credit risk and in line with an international agreement to review the public use of the ratings.

In addition, it would be appropriate to reform the Shelf Registration System in order to enhance its convenience, including by allowing securities issuers to state in their Shelf Registration Statements the upper limit of the outstanding amount of issued securities instead of the planned aggregate amount of issuance.

(2) Prospectus System

In order to make it easier for investors to understand and use prospectuses regarding investment trusts, which are popular investment products, the prospectus system has been improved so as to provide information that matches the needs of investors through measures such as classifying prospectuses into the mandatory prospectus, which contains information critical to investment decisions, and the on-demand prospectus, which contains detailed information. However, the use of this system is often neglected, leading to criticism that excessively voluminous, difficult-to-understand prospectuses are in circulation.

Therefore, it would be appropriate to ensure that the mandatory prospectus provides information important for investment decisions in an easy-to-understand and succinct manner so as to facilitate investors’ use of the prospectus. In addition, the use of the on-demand prospectus should be promoted through measures such as the simplification of the procedures for its electronic provision to investors, thereby helping to reduce costs for

securities issuers and sellers and contributing to increased benefits for investors. It is desirable not only that the authorities reform the prospectus system but also that relevant parties, including asset management companies and financial instruments brokers, make further efforts to enhance the convenience of prospectuses.

(3) Concept of secondary distribution of securities

As securities transactions are becoming increasingly complex and diverse, it is necessary to reform the existing disclosure system, which automatically requires information disclosure in cases where a securities sale is deemed to be a secondary distribution, that is, where the securities are offered on the uniform conditions and where the number of persons solicited is 50 or more.

Accordingly, it would be appropriate to review and revise the concept of the secondary distribution and make regulation related to the secondary distribution more flexible in light of the purpose of the legal disclosure system, which is to ensure appropriate disclosure of information necessary for investors to make investment decisions, while taking into consideration the practical work processes involved in securities transactions. For example, regulation should be conducted with due consideration of factors such as: whether investors have information-gathering and analyzing capabilities; whether there is a secondary market for the relevant securities in Japan; whether there is a situation of asymmetric information between investors and sellers; and the presence or absence of information disclosure and the level of disclosure, including disclosure made in foreign countries, the specific nature of transactions and the type of securities.

The above-mentioned reform of the disclosure system should be implemented in line with “Review of Disclosure System,” a report issued by the Disclosure Working Group set up under this Subcommittee.

IV. Other issues

With respect to the procedures for changing between the professional and non-professional investor status under the Financial Instruments and Exchange Act, currently, customers who have changed from the professional investor status to the non-professional investor status are automatically returned to the professional investor status after the expiration date (i.e., one year from the date of the change), even if they wish to retain the non-professional investor status, unless they apply again for the non-professional investor status. As the current system may hinder thoroughly ensuring the confirmation of the intention of customers and the smooth execution of transactions, it is appropriate to consider reforming the current rule so that, in principle, the effect of the investor status change continues indefinitely unless the customer applies for a change of status again.

Furthermore, the current system does not allow customers who have changed from the professional investor status to the non-professional investor status and vice versa to return to their original status during the one-year period until the expiration date. In this regard, it may be possible to consider allowing customers to change their investor status before the expiration date, and in such case, attention should be paid to the smooth operation of the actual practice and to ensuring the confirmation of the intention of customers.