Securities Market in Japan 2014

JAPAN SECURITIES RESEARCH INSTITUTE

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The book is a translation of "Illustrated Guide: 2014 Securities Markets in Japan" (prepared by the Japan Securities Research Institute), which was published in Japanese, into English. It includes quotations from or references to descriptions of laws and regulations such as the Financial Instruments and Exchange Act; however, it is the laws and regulations in Japanese themselves that have legal effect and the translations given herein are only for your reference. For legal matters, see the laws and regulations in Japanese described in the official journal.

PREFACE

We have issued a revised edition of Securities Markets in Japan every two years since we began publishing this book in 1973. This is the English version of the 2014 edition of The Securities Markets in Japan: An Illustrated Guide. Robert R. Hamilton, the president of Mediator Corporation, provided the translation and rewriting of the revised sections, and Howard Brandt, of H. Brandt Editorial Consulting, handled proofreading and some light editing. We are also grateful for the cooperation of the authors of the Japanese-language original to The Securities Markets in Japan: An Illustrated Guide in verifying the content of the English translation.

Seldom has there been a period where the function and role of securities markets have been more in the spotlight. Following the Lehman Shock, or what could be better called the runaway market crisis, and the sovereign debt crisis in Europe, the financial anxiety in markets provided an opportunity for the world to fundamentally rethink the relationships between markets and financial systems and governments. In recent years, moreover, the impact of the aggressive monetary easing policies of central banks on financial markets has been very much in the public eye. To understand such trends in financial and capital markets, it is essential to understand the systems and functions of the securities markets, including their regulatory and historical background.

Partially because of the beneficial effects of the government's so-called Abenomics economic policies, Japan is emerging from its prolonged period of economic stagnation and recovering some of its vitality. Recently, foreign investors have shown rekindled interest in Japan's securities markets. Among other positive signs, the number of initial public offerings (IPOs) and the stock trading value of individual investors are on the rise. Additional signs of changing times include the steady and pervasive advance of IT systems and the emphasis on corporate governance.

Japan's securities trading systems have evolved and expanded since the passing of the Financial Instruments and Exchange Act (FIEA) in 2006. FIEA provides for the comprehensive regulation of investment activities in Japan's financial markets. And adjustments to market systems have come through successive reforms of FIEA and other measures to keep up with the changes in financial and capital markets, corporate activities, and other influences. Since the publishing of the 2012 version of this book, a variety of adjustments have been implemented in the regulatory framework, including establishing systems to support an integrated stock exchange, initiating major reforms to insider trading regulations, upgrading the monetary penalty system for violations, and revising the Investment Trust and Investment Corporation Act.

There also have been major movements on more visible fronts. In January 2014, the Tokyo Stock Exchange Group, Inc., and the Osaka Securities Exchange Co., Ltd., merged their operations, giving birth to the Japan Exchange Group, Inc. (JPX). The JPX is integrating its markets and implementing strategies for Asian and other markets. In the asset management market, the government introduced a preferential tax treatment investment system to promote asset formation through investment by individuals. The Nippon Individual Savings Account (NISA) came into effect in January 2014.

Establishing securities markets with high usability and vitality is an urgent task to ensure the viability of Japan's economy. It is our hope that a wide range of people interested in the reform of Japan's financial and securities markets and in the status of the country's securities markets today will find this book a useful reference.

June 2014

MANABU MORIMOTO
President
Japan Securities Research Institute

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CHAPTER I

The Securities Market and the National Economy

1. What Is a Security?

The financial markets provide a marketplace through which funds are channeled from sectors with idle cash (lenders) to cash-short sectors (borrowers), and the types of financing arranged on these markets are divided in terms of intermediaries into indirect and direct financing. Indirect financing means a form of transaction in which a financial institution acquires a primary security (due bills and notes, etc.) from a borrower with a fund raised by issuing an indirect security (certificates of deposit and insurance policies, etc.). In direct financing, a borrower raises funds by issuing a primary security (equity and debt securities, etc.) to lenders through a market intermediary. The marketplace on which direct financing is arranged is the securities market, which is divided into an issue market (where securities are issued and distributed) and a trading market (where securities are bought and sold).

Generally, the term "security" refers to instruments that give their legal holders the rights to money or other property. They are designed to facilitate the assignment of such rights and have the characteristic of combining rights and certificates. More specifically, they are issued in various forms, such as stocks and bonds issued by business corporations; notes, checks, and bills of lading; government securities issued by national governments; and municipal bonds issued by local public bodies. Of these, securities traded in the securities markets are called "securities under the Financial Instruments and Exchange Act (FIEA)," as defined in Paragraphs 1 and 2, Article 2, of that law. Paragraph 1 defines securities whose interests are represented by securities or certificates that are physically issued as listed in the table on the following page. In addition to those formerly provided for in the Securities and Exchange Law, new types of securities, such as mortgage securities and securities representing financial options contracts, have been included in the new definition. Item 21 of the paragraph provides that securities and certificates so designated by government ordinance, including bonds issued by educational institutions, shall be deemed to be securities under the law.

Table I-1. The Definition of Securities under the Provisions of Paragraphs 2-1 and 2-2 of FIEA

Paragraph 2-1 Securities

1. Government securities
2. Municipal bond securities
3. Bonds issued by special public corporations
4. Specified corporate bonds as provided for in the Act on the Liquidation of Assets
5. Corporate bonds
6. Subscription certificates issued by special public corporations
7. Preferred shares as provided for in the Law Concerning Preferred Shares in Cooperative Financial Institutions
8. Preferred subscription certificates or new preferred subscription rights certificates as provided for in the Act on the Liquidation of Assets
9. Stock certificates or subscription right/warrant certificates
10. Beneficiary certificates of investment trusts or foreign investment trusts
11. Investment certificates or bonds issued by investment corporations or investment certificates issued by foreign investment corporations
12. Beneficiary certificates of loan trusts
13. Beneficiary certificates of special-purpose trusts as provided for in the Act on the Liquidation of Assets
14. Beneficiary certificates of certificate-issuing trusts as provided for in the Trust Law
15. Commercial paper
16. Mortgage securities
17. Foreign securities: foreign certificates that have the attributes of any type of securities as defined in Items 1 through 9 and Items 12 through 16 hereof
18. Beneficiary certificates of foreign loan claims trusts
19. (Financial) options securities or certificates
20. Foreign depository securities or receipts
21. Securities or certificates designated by government ordinance

Paragraph 2-2 Deemed Securities

(General description of the former clause)

Interests represented by securities that are listed in the preceding paragraph in cases where no physical certificates are issued

(Latter clause)

1. Beneficiary interests in trusts
2. Beneficiary interests in foreign trusts
3. Partnership interests in general or limited partnership companies (*gomei gaisha or goshi gaisha*), as designated by government ordinance, or interests in limited liabilities companies (*godo gaisha*)
4. Partnership interests in foreign corporations, with the attributes of interests defined in any of the preceding items
5. Interests in collective investment schemes as comprehensively defined
6. Interests in foreign collective investment schemes
7. Other interests as designated by government ordinance

Source: Based on Toshiro Ueyanagi, Yutaka Ishitoya, and Takeo Sakurai, *Shin Kin'yu Shohin Torihiki-ho Handobukku*, Nippon Hyoronsha, 2006, and Etsuro Kuronuma, *Kin'yu Shohin Torihiki-ho Nyumon*, Nihon Keizai Shimbun, 2006, and the Financial Instruments and Exchange Act as listed in e-Gov's legal data service.

Paragraph 2 of Article 2 sets forth the definition of deemed securities. First, interests represented by securities that are listed in the preceding paragraph are deemed to be securities by themselves in cases where no physical certificates are issued. For example, interests represented by bonds or stocks held under a book-entry transfer system are deemed equivalent of those securities listed in Paragraph 1. The latter part of the paragraph then goes on to define deemed securities as interests other than those represented by securities or certificates. The scope of the definition has been substantially widened compared with that of the former law, and, specifically, there are comprehensive provisions in Item 5 of the paragraph for FIEA to be applicable to various types of collective investment vehicles, or funds. In Item 7, interests designated by government ordinance, including claims on loans to educational institutions, are provided for as deemed securities. In addition to securities, FIEA applies to derivative transactions in domestic financial instrument and over-the-counter markets and foreign markets.

2. Corporate Financing

The term "business corporation" (excluding financial service institutions) means economic entities whose objective is to make a profit from such activities as the production and sale of goods or services. Business corporations invest funds in real assets (such as facilities and inventories) to carry out production and marketing activities on a continuing basis.

Funds raised by business corporations are divided into internal funds (those generated in the ordinary course of the production and sale of goods or services) and external funds (those raised from external sources), according to the method employed to raise them. Technically, internal reserves and depreciation charges are included in internal funds. As the company is not required to repay the principal of, or pay interest or dividends on, such funds, they are considered the most stable means of corporate financing. In actuality, however, business corporations cannot meet their funding requirements with internal funds alone, and many of them have to rely on external funds. External funds are divided into the proceeds resulting from loans and the issuance of equity and debt securities, according to the method employed to raise them. Loans are obtained primarily from banking institutions. This method of raising funds with debt securities is termed "indirect financing." In addition to those issued at the time of their incorporation, business corporations issue additional equity shares (an increase of capital) to finance the expansion of their production capacity or for other purposes. As business corporations are not required to repay the principal thus raised, or pay interest thereon, the proceeds from the issuance of equity shares constitute the most

Table I-2. Percentage of Funds Raised and Invested by the Corporate Sector

(balances at fiscal year-end)

	1985	1990	1995	2000	2005	2010	2012
Management							
Cash and demand deposits	7.6	6.6	9.1	13.3	15.5	18.4	18.4
Time deposits	14.8	12.8	10.8	7.7	4.1	6.3	6.2
CDs	1.2	1.1	2.6	3.3	1.5	1.8	2.0
Trusts	1.4	0.7	1.3	0.3	0.3	0.3	0.3
Investment trusts	0.6	0.2	0.4	1.0	0.7	1.8	0.2
Securities	25.9	30.9	24.2	22.9	36.4	19.4	23.3
(equity shares)	23.5	28.1	22.6	19.6	33.4	16.3	20.2
(debt securities)	2.3	2.8	1.6	3.3	3.0	3.1	3.1
Inter-business credits	35.2	30.5	35.3	33.5	24.4	27.1	24.5
Others	13.2	17.2	16.3	18.2	17.1	24.9	25.0
Total	483.5	835.7	783.2	738.9	950.3	792.6	840.6
Financing							
Borrowing	39.5	36.5	40.2	36.2	22.4	31.3	29.0
Securities	38.1	43.1	38.6	42.0	58.2	42.5	46.7
(equity shares)	33.9	37.3	32.7	35.2	52.9	35.2	40.5
(corporate bonds)	2.6	2.3	3.8	5.3	4.1	5.8	5.1
(foreign currency bonds)	1.6	2.6	1.5	0.6	0.8	0.8	0.7
(CPs)	–	0.8	0.6	0.9	0.4	0.7	0.4
Inter-business credits	17.0	14.6	15.4	16.2	12.8	15.4	13.9
Others	5.5	5.8	5.8	5.6	6.6	10.8	10.4
Total	760.6	1,358.7	1,351.7	1,198.0	1,421.8	1,056.7	1,135.1

Notes: 1. In percentages and trillions of yen.
2. Time and savings deposits include foreign currency deposits.
3. Figures in parentheses are a breakdown of securities, and equity shares include equity subscriptions.
4. Investment of equity shares is based on market prices and that of new shares issued in the years up to fiscal 1990, inclusive, is based on the capital plus capital reserve and that for fiscal 1995 through 2012 is based on the market prices.

Source: Compiled from the Flow of Funds Account data published on the web site of the Bank of Japan.

stable form of funds among external funds. As is the case with equity shares, corporate debt securities are also an instrument for raising funds from the capital markets, and issuers have to redeem them on or by a predetermined date of redemption and pay a definite rate of interest on them. Corporate debt securities are largely divided into straight bonds (SB), bonds with subscription rights, and structured bonds (see Chapter V). As the securities underlying equity shares or corporate debts are held directly by the providers of funds, this method of raising funds is called "direct financing."

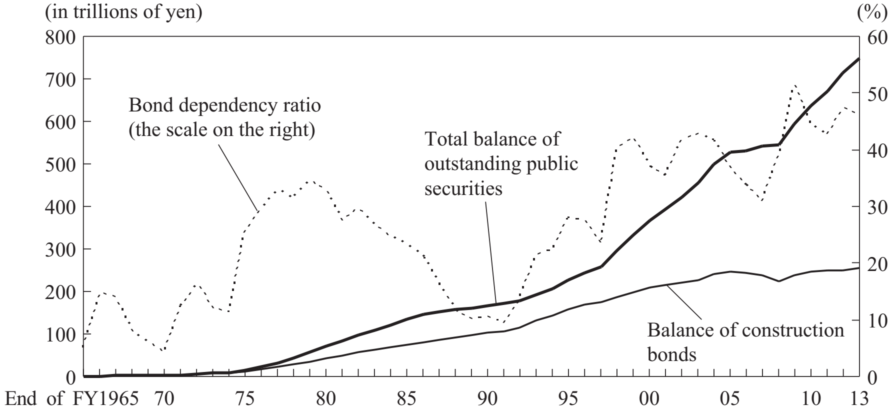
A survey of changes that have occurred in the amount of funds raised from external sources as a percentage of the outstanding balance of financial debts shows that bank borrowings have tended to decrease since 1990. In the 2000s, funds raised through the issue of securities have outpaced those obtained through bank borrowings, suggesting that the weight of corporate financing structure has shifted from indirect to direct financing. This may be explained by the fact (1) that following the liberalization and internationalization of the financial markets since the 1980s, businesses have actively sought to raise funds by selling new shares and bonds on the market and (2) that large-scale companies in particular have sought to improve their financial structure by repaying loans. Although at one point the proportion of loan financing rose after the financial crisis in 2008 curtailed the functioning of the capital market, currently financing through securities, mainly equity, is steadily recovering. With the establishment of emerging markets and the liberalization and abolition of regulations on the issue of debt securities, small-to-medium-sized firms can now obtain financing through the capital market. Consequently, financing through the issue of securities is expected to retain its importance in future.

3. The Securities Market and Public Finance

Public finance is a type of economic activity carried out by the government (national and local). More specifically, it is a government activity undertaken to finance administrative services (law enforcement and education, etc.) and public investment with taxes and other revenues. In practice, the government adjusts its fiscal policies in response to economic trends. When government expenditures exceed revenues, the deficit is met mainly by issuing public debt securities (government and municipal debt securities).

A survey of changes that have occurred in the balance of outstanding public securities and the government's dependency on debt financing shows that the government had issued special government bonds (deficit-financing) in fiscal 1965, the first time since the end of World War II, under a supplementary budget and also that the government has issued a series of construction bonds on a continuing basis since fiscal 1966. However, both the bond dependency ratio and the balance of outstanding government debt securities had remained at a low level until the first half of the 1970s. As tax revenues had leveled off due to an economic slowdown that began in the second half of the 1970s, the government had no choice but to issue a large amount of government bonds, and their outstanding balance had increased sharply to ¥71 trillion at the end of fiscal 1980 ($693 billion*). As a result, government debt securities had come to carry an increasing weight in the securities market, and the influence of government fiscal policies on the securities market had taken on a growing importance. With a view to improving the market's

Chart I-1. Changes in the Balance of Outstanding Public Securities and the Degree of Dependence on Public Securities



Notes: 1. The figures and percentages for fiscal years up to 2009 are on an actual basis, while those for the fiscal year 2010 are forecasts. The bond dependency ratio for fiscal 2011 is calculated on the basis of the original budget while the total balance of outstanding public securities is calculated on the basis of the budget after supplementary budgets.

2. On the basis of ordinary government bonds.

Source: Compiled on the basis of the data drawn from the Ministry of Finance.

financial condition, the government has adopted a fiscal restructuring policy since fiscal 1981. Helped by economic recovery, the government had succeeded in lowering the dependency on deficit financing and in curbing increases in the balance of outstanding public securities in the second half of the 1980s. Since the 1990s, however, the bond dependency ratio has risen sharply due to a contraction of tax revenues caused by a prolonged recession and the implementation of a series of fiscal stimulus packages. As a result, the balance of outstanding government debt securities is expected to reach about ¥750 trillion ($7.3 trillion) at the end of fiscal 2013 (ended March 2014).

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

Looking at the ownership structure of Japanese government bonds (JGB) as shown in the table on the next page, the ownership of private financial institutions has risen dramatically from 30% to 60% since the end of fiscal 2007. The sharp rise can be attributed to the inclusion of postal savings (Japan Post Bank) and postal insurance (Japan Post Insurance) under the categories of banks and life, nonlife, and other insurance companies. At the end of FY2012, the market value of Japan Post Bank's JGB holdings amounted to about ¥144.0 trillion ($1.4 trillion) while Japan Post Insurance's holdings

Table I-3. Changes in JGB and Short-Term Government Bill Ownership by Investor Type

(in percentages)

Types of investors	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
General government	1.3	2.4	3.5	4.0	3.4	2.1	1.6	2.9	1.6	2.6
Public pension funds	7.1	7.8	8.1	8.8	9.8	10.1	9.2	8.3	7.5	7.1
Fiscal loan funds	9.8	9.0	8.0	4.5	2.5	1.1	0.2	0.1	0.1	0.7
Postal savings funds	13.7	15.4	17.2	18.9	–	–	–	–	–	–
Postal insurance funds	7.8	7.8	7.9	8.4	–	–	–	–	–	–
Bank of Japan	14.8	13.5	12.2	9.9	8.5	8.2	8.9	9.0	9.7	12.0
Private financial institutions	38.6	35.9	33.5	33.3	61.8	64.5	67.8	67.8	68.1	64.9
Banks	24.0	20.8	19.7	18.3	36.6	38.5	40.8	41.5	41.3	37.5
Life, nonlife, and other insurance companies	7.2	7.6	7.7	8.1	16.6	17.9	18.5	18.4	19.2	19.2
Pension funds	3.0	2.9	3.1	3.4	3.4	3.2	3.4	3.2	3.1	3.0
Other private financial intermediaries	4.4	4.6	3.0	3.4	5.2	4.9	5.2	4.7	4.5	5.2
Overseas	3.6	4.0	4.4	5.9	7.4	7.0	5.6	7.1	8.3	8.7
Households	2.2	3.0	3.7	4.3	4.5	4.5	4.1	3.6	3.0	2.5
Others	1.1	1.3	1.7	2.0	2.1	2.5	2.6	1.4	1.7	1.4

Notes: 1. Since fiscal 2007, figures for Banks and for Life, nonlife, and other insurance companies have included figures for Japan Post Bank Co., Ltd., and Japan Post Insurance Co., Ltd.
2. Other private financial intermediaries include securities investment trusts and securities companies.
3. Others are composed of nonfinancial corporations and private nonprofit institutions serving households.
4. Previous to fiscal 2007, figures included short-term discount bills (TB) and financing bills (FB), while treasury bills (T-Bill) have been included since fiscal 2008. As of February 2009, TB and FB were integrated into T-Bills.
5. Figures are based on a retroactive revision made on March 25, 2013.
6. Figures for fiscal 2012 are preliminary figures.

Source: Ministry of Finance, Saimu kanri ripoto 2013 (Debt Management Report 2013), p. 158. Compiled from the Flow of Funds Account data published on the web site of the Bank of Japan.

amounted to about ¥65.2 trillion ($636 billion). While banks, including the Japan Post Bank, remain the leader in JBG ownership, their share is declining. Premising their investments on long-term ownership, public pension funds; life, non-life and other insurance companies; and private pension funds have become a stable investor base with a total JBG ownership of 29.3% at the end of FY2012. Among other JGB ownership categories, the percentage held by overseas investors has been rising since FY2010. This increase is likely due to growth in demand for JGBs as safe assets in the light of the sovereign debt crisis in Europe and other factors. In contrast, the upward trend in percentage ownership of Japanese households that had existed since the introduction of JGBs (10-year, variable rate) for individuals in 2002 has fallen into decline due to lower interest rates and the start of maturity redemptions of the JGBs for individuals in January 2011.

4. Financial Assets Held by the Household Sector

The household sector of Japan has consistently run a surplus (over saving). Although the ratio of nominal household surpluses to the nominal gross domestic product (GDP) has sharply dropped since the mid-1990s, it had remained stable at about 8% prior to that. The prolonged over saving has brought about a huge accumulation of households' financial assets, at the end of FY2012 standing at close to ¥1,600 trillion ($15.6 trillion).

A survey of changes that have occurred in the management of financial assets of the household sector found the following three characteristics. First, while time deposits continuously carried the largest weight within financial assets, their weight has tended to decrease since the 1980s. Meanwhile, the component ratio of cash and demand deposits has risen since the 1990s. The rise is probably the result of a preference for liquidity by depositors in the face of a series of bank failures starting in the mid-1990s and the continued super-low-interest-rate climate. Second, the ratios of insurance and annuities rose almost consistently through to the end of FY2000 and have since stayed high. This trend likely reflects that Japan has already become an aging society. Third, the weight of securities in household financial assets has been falling since the 1990s. The decline can be primarily attributed to the low levels of the stock market that has struggled since the bursting of the Japanese economic bubble. There was an especially large decline in the weight of securities in household financial assets, particularly for stocks, following the Lehman Shock in September 2008. Even considering the recent sharp jump in stock prices since November 2012, it is difficult to say that there has been a recovery in the weight of securities in household financial assets.

A comparison of household investment in financial assets between Japan and the United States (including, in the case of the latter, those of nonprofit-making institutions providing services to households) as of the end of March 2013 shows a large difference in the preference of investors for types of assets. While Japanese households invest 81.4% of their funds in cash deposits, insurance funds, and pension funds and 14.6% of their funds in securities (including investment trusts), their American counterparts invest 45.2% of their funds in the former and 51.9% in the latter. While it is necessary to take the social security systems, retail loan services, and other differences between

Table I-4. Percentage Composition of Financial Assets of Individuals

(at fiscal year-end)

	1980	1985	1990	1995	2000	2005	2010	2012
Cash and demand deposits	9.8	7.7	7.2	8.2	11.6	21.0	23.6	24.0
Time deposits	48.7	44.9	40.2	41.9	42.5	29.7	31.6	30.0
Trusts	4.5	4.0	3.7	3.4	1.5	0.4	0.2	0.1
Insurance funds	13.4	16.3	20.8	25.4	27.2	25.8	28.4	27.6
Investment trusts	1.2	2.3	3.4	2.3	2.4	3.4	3.6	4.5
Securities	16.1	19.7	19.6	13.9	9.7	15.3	8.6	8.1
(equity shares)	13.2	16.0	16.9	11.5	7.7	13.0	6.2	7.8
(debt securities)	2.8	3.7	2.6	2.5	2.0	2.3	2.4	1.9
Others	6.3	5.2	5.2	4.9	5.1	4.4	4.1	5.6
Total	372.0	626.8	1,017.5	1,256.5	1,388.8	1,516.6	1,480.6	1,568.4

Notes: 1. In percentages and trillions of yen.
2. Time and savings deposits include negotiable and foreign-currency deposits.
3. Figures in parentheses are a breakdown of securities, and equity shares include equity subscriptions.
4. Equity shares are based on market prices.

Source: Compiled from the Flow of Funds Account data published on the web site of the Bank of Japan.

Table I-5. Comparison of Japanese and U.S. Household Assets Composition (at June 30, 2013)

	Japan	United States
Cash and demand deposits	54.1%	13.0%
Bonds	2.0%	8.7%
Investment trusts	4.5%	11.1%
Securities and equity subscriptions	8.1%	32.1%
Insurance funds	27.3%	32.2%
Others	4.1%	3.0%

Notes: U.S. household assets include non-profit making institutions providing services to households.

Source: Compiled from the Bank of Japan's "Comparison of the flow of funds between Japan and the United States" (October 4, 2013).

the two countries into account, these figures suggest that while Japanese households prefer assets that guarantee principal, their American counterparts choose investment performance.

A caveat to this argument may be that we have already seen signs of change in the risk preferences of Japanese households, as witnessed by the

Table I-6. Changes in In- and Out-Bound Securities Investment (on a settlement basis)

(¥100 million)

CY	Equity securities			Debt securities (excluding bills)			Net balance
	Bought	Sold	Net	Bought	Sold	Net	
1997	325,576	292,457	33,119	245,763	217,889	27,874	60,993
1998	310,360	291,119	19,241	244,564	236,268	8,296	27,538
1999	620,385	508,397	111,988	472,872	495,751	−22,879	89,109
2000	835,593	837,932	−2,339	571,013	470,246	100,767	98,429
2001	779,015	741,061	37,954	522,905	504,878	18,027	55,981
2002	644,372	657,039	−12,667	582,775	618,928	−36,153	−48,819
2003	790,641	692,870	97,771	619,163	641,269	−22,106	75,666
2004	1,161,630	1,056,357	105,273	727,773	683,161	44,612	149,885
2005	1,675,176	1,548,934	126,241	873,775	811,451	62,324	188,565
2006	2,671,452	2,590,472	80,981	1,035,501	970,532	64,969	145,950
2007	3,371,648	3,330,228	41,419	1,123,120	1,023,179	99,941	141,360
2008	2,640,366	2,714,152	−73,786	895,747	933,021	−37,274	−111,060
2009	1,453,977	1,453,694	283	504,203	574,104	−69,900	−69,617
2010	1,736,099	1,717,710	18,389	695,100	688,976	6,125	24,513
2011	1,974,084	1,971,556	2,528	884,363	838,985	45,379	47,906
2012	1,867,789	1,846,517	21,272	811,683	790,007	21,676	42,948

Note: Up to 2004, figures were compiled as "Changes in In- and Out-Bound Securities Investment (on a settlement basis)." Since 2005, figures have been compiled as "International Transactions in Securities (based on reports from designated major investors)."
Source: Compiled from materials listed on the web site of the Ministry of Finance.

increased popularity of the online trading of stocks and foreign currencies since the 1990s. Moreover, a stronger direct link has been forged between households and the securities market with the introduction of such systems as the defined contribution pension plan in 2001 and the Nippon Individual Saving Account (NISA), a small amount investment tax exemption scheme, in January 2014. On the flip side, financial products and services are becoming increasingly complex, requiring an improvement in the quality of retail sales operations and the greater dissemination and understanding of financial knowledge among Japanese households.

5. Investment Behavior of Foreigners (Inbound Investment)

Over a period of years after the war, international financial and capital

Table I-7. Balance of Inbound Investment and Related Indicators

Year-end	Equity securities (¥b)		Debt securities (¥b)		TOPIX	Interest rate (%)	¥/$ (¥)
2000	63,222	(30.4)	32,981	(15.8)	1,283.67	1.640	114.90
2001	49,563	(24.7)	33,546	(16.7)	1,032.14	1.365	131.47
2002	40,757	(21.4)	27,799	(14.6)	843.29	0.900	119.37
2003	60,085	(28.2)	27,108	(12.7)	1,043.69	1.360	106.97
2004	77,393	(31.2)	33,846	(13.6)	1,149.63	1.435	103.78
2005	132,842	(40.8)	41,428	(12.7)	1,649.76	1.470	117.48
2006	149,277	(43.5)	49,579	(14.5)	1,681.07	1.675	118.92
2007	142,031	(39.4)	60,203	(16.7)	1,475.68	1.500	113.12
2008	68,625	(23.4)	50,650	(17.3)	859.24	1.165	90.28
2009	76,372	(26.6)	42,236	(14.7)	907.59	1.285	92.13
2010	80,537	(26.5)	42,877	(14.1)	898.80	1.110	81.51
2011	65,841	(20.8)	45,730	(14.5)	728.61	0.980	77.57
2012	83,556	(22.9)	49,504	(13.5)	859.80	0.795	86.32

Notes: 1. Debt securities covers only bonds and notes.
2. Figures given in parentheses are component ratios (%) to the total debts to overseas lenders.
3. Interest rate means secondary market yield of newly issued 10-year government bonds.
4. ¥/$ represents the closing spot rates on the Tokyo market.

Source: Compiled on the basis of data from the Bank of Japan.

Table I-8. Percentages of Japanese Stocks and Bonds Held by Investors of Different Regions

(%)

Year-end	U.S.A.	Europe	Asia	Others
Equity securities				
2006	41.5	50.3	2.0	6.2
2007	44.2	45.1	3.1	7.6
2008	49.8	37.6	3.6	8.9
2009	53.9	36.5	1.7	7.9
2010	46.6	36.0	7.7	9.7
2011	46.0	35.5	8.9	9.6
2012	44.3	37.2	8.4	10.1
Debt securities (bonds and notes)				
2006	12.7	59.7	14.2	13.4
2007	12.5	60.7	13.9	12.9
2008	13.2	53.0	15.4	18.4
2009	16.4	47.5	19.4	16.6
2010	14.9	43.1	21.8	20.2
2011	11.0	39.3	30.7	19.0
2012	8.9	38.0	31.4	21.7

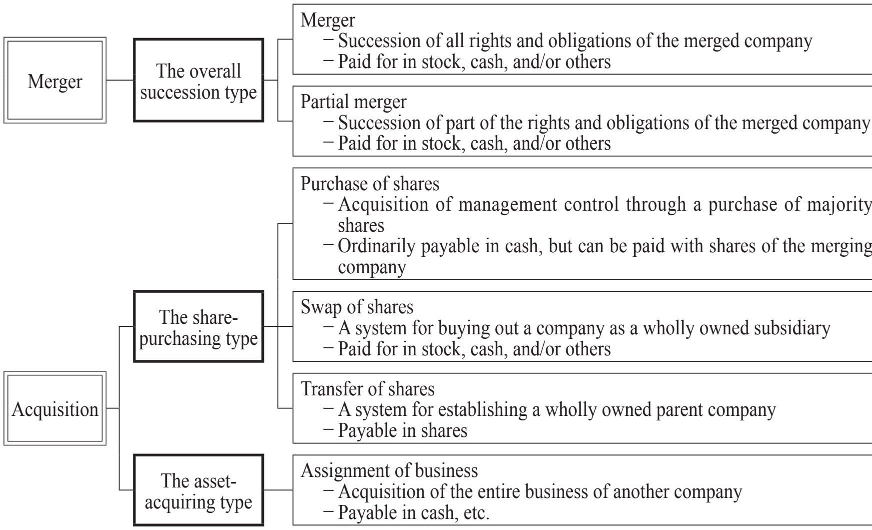
Note: The figures for Europe include Eastern European nations and Russia.
Source: Compiled on the basis of data from the Bank of Japan.

transactions were banned, in principle. However, since the Foreign Exchange and Foreign Trade Control Law was amended in December 1980 (the new Foreign Exchange Control Law), the system of licensing international financial and capital transactions was changed to a prior reporting system, making them free in principle. Furthermore, by virtue of an amendment to the new Foreign Exchange Control Law in April 1998 (one the main reforms under what was locally called "the Japanese version of the Big Bang"), the prior reporting system of currency transactions was abolished, completely liberalizing direct financial transactions with overseas customers.

A survey of inbound investment made by foreign investors in recent years shows that they have consistently net bought Japanese stocks except for selloffs in the markets that occurred in 2000 and 2002 after the bursting of the IT (information technology) bubble. However, foreign investors reversed direction in 2008 after the Lehman Shock, becoming net sellers. Furthermore, the volumes of stocks bought and sold by foreign investors have increased sharply since 1999—with the result that the difference between the two has fluctuated widely. The sharp increase in the trading volume of stock seems to reflect their rediscovery of the investment value of Japanese stocks when the uncertainties of Japan's financial system receded. Foreign investors also have consistently net bought Japanese debt securities (both bonds and notes). There has been net selling of debt securities by foreign investors in some years, but these temporary reversals involved selling to cover arbitrage positions. This situation happened in 1999 after the abolition of securities transaction taxes, during the depreciation of the yen in 2003, and during the financial turmoil in 2008 and 2009. As was the case with stocks, the volume of bond transactions has stepped up since 1999—with the result that the difference between purchases and sales has fluctuated substantially. This trend may be explained by active arbitrage trading by foreign hedge funds and the expanded market for medium-term government notes (with a maturity of two to five years).

Looking at the trend in stock (debt), the total market capitalization of stocks increased sharply in 1999 from in the previous year. However, in the period following the bursting of the IT bubble to the end of 2002, the balance declined. Although the balance turned upward again toward the end of 2003 due to a recovery in stock prices, increasing to ¥149 trillion ($1.5 trillion) at the end of 2006, by 2010 it had dropped to ¥81 trillion ($790 billion) because of the Lehman Shock. In terms of regional breakdown, the share of American investors has remained at a high level while the share of European investors, on the other hand, has consistently declined. The total amount of domestic debt securities held by overseas investors, long- and medium-term bonds and notes combined, has increased to approximately ¥50 trillion ($488 billion) in recent years from ¥30 trillion ($293 billion). This trend probably reflects the

Chart I-2. Classification of Mergers and Acquisitions



Source: Mikako Maekawa, Daisuke Nodera, and Madoka Matsushita, "M&A no kihon" (The Basics of M&A), Nikkei Bunko, p. 73, *Nihon Keizai Shinbun.*

expansion in arbitrage positions by foreign hedge funds. By region, unlike in the case of stocks, European investors still hold close to 40% of the total despite a downward trend, while American investors' share has fallen under 10%. On the other hand, there has been notable growth in the share of domestic debt securities held by Asian investors, which exceeded 30% at the end of 2012, approaching the share of European investors.

6. Mergers and Acquisitions (M&A)

In practice, "M&A" means a transaction through which the management of one company is transferred to another company or by virtue of which one company participates in the management of another company—for the purpose of managing the existing resources of both companies involved. In the United States, the merger and acquisition (M&A) market has developed since the 19th century. In Japan, due to amendments to the M&A-related laws and other factors, the number of M&A deals picked up sharply after 1999. Although the number of deals started to decline following 2007 because of financial crises, it has been back on the rise recently. M&A deals have gone from 834 in 1998 to 1,848 in 2012 according to a survey conducted by

RECOF Corporation.

Acquisitions are divided into those aimed at purchasing the controlling shares and those aimed at acquiring the underlying assets of another company. As all joint-stock companies, more particularly publicly held companies, face the potential risk of being acquired by another company through a hostile takeover bid (TOB), they have to have hostile M&A defense measures. However, as overly defensive measures carry the risk of shutting out potential takeover bidders who are willing to offer higher stock prices for such companies or could undermine management's efforts to maximize their corporate (or share) value, such defense measures do not go down well with shareholders in Western countries. In the United States, corporations use court decisions, such as the Unocal standard and the Revlon standard, as a yardstick to weigh the advisability of their defense measures. The former is based on the idea that the appropriateness of defense measures should be balanced against threats to the corporate value, while the latter represents a judgment modifying the advisability of defense measures.

In Japan, the Companies Act was enacted in June 2005 and was enforced in May 2006. Under this law, a Japanese subsidiary of a foreign company can acquire a Japanese company in exchange for the shares of its foreign parent (this is called "a triangular merger"). This provision came into force in May 2007, establishing the necessary conditions for cross-border M&As. On the other hand, this law also provides for M&A defense measures, allowing companies to resort to most of the defense measures. However, as few Japanese companies have experienced hostile M&A, it has become necessary to maintain a balance between the protection of shareholders' interests, defense against hostile takeover, and disclosure of corporate affairs. To meet such necessity, the Ministry of Economy, Trade and Industry (METI) and the Ministry of Justice jointly released Guidelines for Defending Corporate Value in May 2005. It contains three principles: (1) The principle of securing and improving corporate value and the common interests of the company and its shareholders (the adoption, invocation, and abolition of takeover defense measures will be effected with the aim of ensuring and improving corporate value); (2) the principle of prior disclosure of such defense measures and the respect of the will of shareholders (prior to the adoption of a defense measure, its objectives and contents must be disclosed, and its adoption should be made subject to the reasonable consent of the shareholders); and (3) the principle of the justification and advisability of such defense measures (defense measures should be justifiable and appropriate for the prevention of a takeover). METI's Corporate Value Study Group followed up on these principles, releasing a report in June 2008 (Takeover Defense Measures in Light of Recent Environmental Changes).

CHAPTER II

The History of the Japanese Securities Market

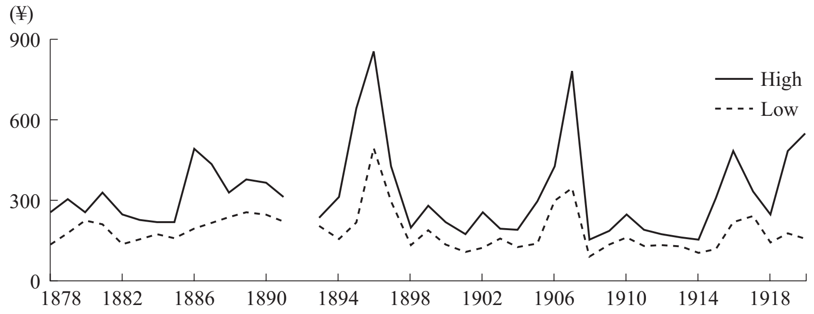
1. The Securities Market in the Prewar Period

If we take the point of origin of Japan's security market to be the first issuance of securities, it occurred in 1870 with the issue of a foreign currency denominated government bond bearing 9% interest in London, England. If we consider the birth of a secondary market based on a legal ordinance, it happened in 1878 with the establishment of stock exchanges in Tokyo and Osaka. Whichever definition is used, Japan's securities market has been in existence for about 140 years. The stock exchanges started off as markets for trading in public debt, such as old and new public bonds and *Chitsuroku* bonds. Although the stocks of the exchanges and of banks were later listed, public debt accounted for most of the trading for some time. Around 1886, there was a period of rapidly emerging mainly railway and textile companies that ushered in more active trading in stocks.

The formation of joint stock companies in Japan was not related to the huge capital investments that are required to develop heavy industry. Instead, the joint stock company was introduced to deal with the low level of capital accumulation in the economy. In conjunction with that action, schemes were established to facilitate the paying in of capital, such as the stock installment payment system and stock collateral loans. As a result, the joint stock companies set up in the Meiji era were mostly small companies primarily involved in light industry. They really could be considered joint stock companies in name only in terms of their generally intended function of raising larger amounts of capital. The turning point for that function in Japan came with the shift in the composition of industry toward heavy industry prompted by World War I. Only then did the country see a sharp increase in large albeit mainly zaibatsu-related companies with paid-in capital exceeding ¥5 million.

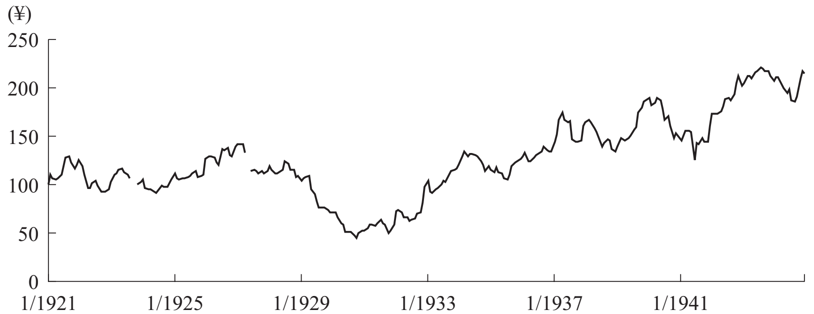
There were practically no shares of major companies listed on stock exchanges in the secondary market because the zaibatsu held exclusive ownership of their group companies. And as a result of the lack of investment capital and inadequate credit provision by banks before World War II, the secondary market developed mainly around future transactions called

Chart II-1. Changes in Stock Prices (Long-term margin transactions) (1878–1920)



Source: Complied from *Tokyo shoken torihikisho no nijyunen shi-kisoku to tokei* (A 20-year History of the Tokyo Stock Exchange-Regulations and Statistics).

Chart II-2. Stock Price Movement (Major Stock Price Index) (1921–1944)



Source: Complied from *Tokyo shoken torihikisho tokei nenpo* (Tokyo Stock Exchange Annual Statistics Reports) and *nisho tokei geppo* (Japan Securities Exchange Monthly Statistics Reports).

settlement dealings and margin transactions. Even the main trading issues of exchanges' stock were subject to speculative investment. For that reason, the prewar stock market can be characterized as speculative. Another characteristic that can be pointed out in retrospect is the imposition of wartime regulations. Following the Showa depression, the government sought to achieve economic recovery by devaluing the currency to promote exports and by creating inflation through expansive government spending, principally on the military. After the outbreak of the Sino-Japanese War, the government implemented a wartime regime and imposed regulations on the securities market. The government restricted the issuance of securities for nonessential,

Table II-1. Issues Listed on the Tokyo Stock Exchange

(as of end of 1878)

Bonds:	New and old public bonds, *Chitsuroku* public bonds, *Kinroku* public, bonds, *Kigyo* public bonds
Stocks:	Tokyo Stock Exchange, Daiichi National Bank, Tokyo Kabutocho Rice Merchant Association, and Tokyo Kakigara-cho Rice Merchant Association

Source: Complied from *Tokyo shoken torihikisho no gojyunen shi* (A 50-year History of the Tokyo Stock Exchange).

Table II-2. Number of Issues Listed on the Japan Securities Exchange, by Industry

(as of May 31, 1945)

Subscription certificates, 2; banks, trust companies, and insurance companies, 64; investment companies, colonization companies, and securities companies, 28; stock exchanges, 2; railroad and electric railroad companies, 62; transportation and communication companies, 28; gas and electric utilities, 43; mining companies, 86; shipbuilding and machinery companies, 232; steel companies, metal companies, and smelting companies, 81; textile industrial companies, 58; sugar manufacturing and milling companies, 18; food processing companies and fisheries companies, 29; chemical companies, 65; ceramics companies, 25; paper and pulp, printing, and tanning companies, 26; other industrial companies, 31, rubber and tobacco companies, 23; land, building, and warehousing companies, 17; commercial companies, 46

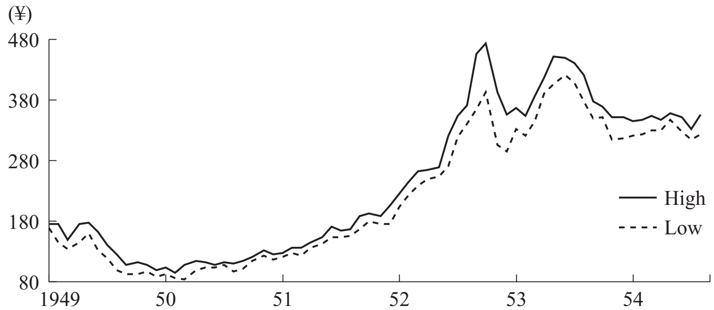
Source: Japan Securities Exchange.

nonurgent industries, instituted planned corporate bond issuance, put controls on stock prices, and introduced a licensing system for securities companies. Japan's 11 stock exchanges, furthermore, were merged into the Japan Securities Exchange.

2. The Period of Postwar Economic Rehabilitation (1945−54)

After the war, Japan was placed under the control of the general headquarters (GHQ) of the supreme commander for the Allied powers. There was immediate movement within Japan's securities industry to reopen the market. At one point, in fact, the Ministry of Finance decided to restart the stock exchanges on October 1, 1945. The GHQ did not approve of this, and the market was not reopened. The securities industry continued to enthusiastically lobby for a restart of market operations, but GHQ rejected the idea as premature and

Chart II-3. Stock Price Movements



Source: Compiled from Nomura Securities' *Shoken tokei yoran* (Manual of Securities Statistics).

Table II-3. Number of Members and Listings of Each Exchange at Establishment

	Establishment	Members	Listings
Tokyo Stock Exchange	May 16, 1949	116 official members, 12 specialists	681
Osaka Securities Exchange	May 16, 1949	76 official members, 11 specialists	523
Nagoya Stock Exchange	May 16, 1949	50 official members, 8 specialists	268
Kyoto Stock Exchange	July 4, 1949	41 members	217
Kobe Stock Exchange	July 4, 1949	34 members	189
Hiroshima Stock Exchange	July 4, 1949	28 members	119
Fukuoka Stock Exchange	July 4, 1949	29 members	181
Niigata Stock Exchange	July 4, 1949	24 members	176
Sapporo Securities Exchange	April 1, 1950	17 members	103

Source: Complied from *shoken torihiki iinkai hokokusho* (a Securities and Exchange Commission Report).

instead gave priority to economic reform (land distribution, the dismantling of the zaibatsu, and labor and political and social reforms. Consequently, it took nearly four years to reopen the stock exchanges, during which time the Japan Securities Exchange remained closed. This has been the only blank period in the operation of exchanges in the history of the securities market in Japan.

Despite trading being halted on the floors of the stock exchanges and official secondary market, the demand for securities trading persisted even in the confusion of postwar Japan. Securities trading naturally emerged at the offices of securities companies in the form of over-the-counter (OTC) trading. When it became clear, moreover, that the stock exchanges were not going to restart anytime soon, "group transactions," which involved institutionalized OTC trading at fixed places and times in parallel with the OTC trading at individual securities companies, also got under way. By the end of 1945, group transactions, which first emerged in Tokyo and Osaka, had spread to exchanges in Nagoya, Niigata, Kyoto, Kobe, Hiroshima, and Fukuoka, among others.

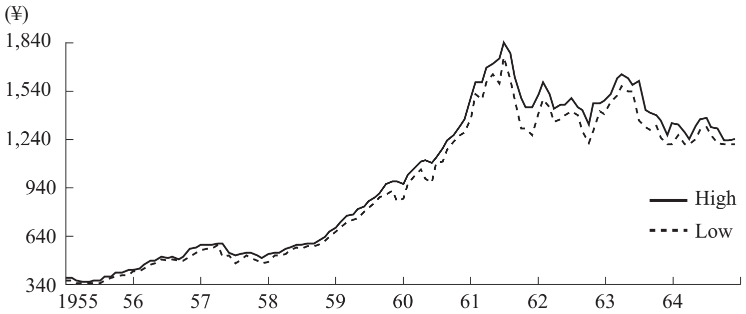
It would, of course, have been difficult to reopen the stock exchanges merely by continuing the prewar exchange organization and securities legislation. To democratize the securities industry, the Japanese government commenced the formulation of a new legal framework. In 1947, it promulgated the Securities and Exchange Law, which drew on the Securities and Exchange Act of the United States. Initially, only those articles of the law dealing with the Securities and Exchange Commission, which was patterned after the U.S. Securities and Exchange Commission (SEC), were enforced. Then a full-scale revision of the law was promulgated in 1948. This amended law formed the legal framework for the new postwar securities market, replacing the licensing system for securities companies with a system of registration with the regulatory authority and putting in place such regulations as the separation of banking and securities businesses.

Stock exchanges were established in Tokyo, Osaka, Nagoya, and other cities from May 1949. GHQ, however, instructed Japan's Securities and Exchange Commission to ensure the strict observance of its Three Principles of Market Operation: (1) recognize transactions in order of occurrence, (2) concentrate trading on exchanges, and (3) prohibit future trading. All exchanges pledged to strictly follow these principles, enabling the long-awaited reopening of stock exchanges (participants in group transactions and the issues they had traded moved en masse to these stock exchanges and restarted trading on a cash transaction basis only). Because, however, it was difficult to match buys and sells based only on actual demand, a movement got under way in the industry to push for the revival of prewar margin transactions for the purpose of introducing temporary demand. Since the management of the exchanges and GHQ were against this proposal, a margin trading system modeled on the U.S. margin trading system was introduced in 1951.

3. The Securities Market during the First Period of Rapid Economic Growth (1955−64)

As made clear in the title of an economic white paper issued in 1956, *The*

Chart II-4. Stock Price Movements (TSE's Modified Stock Price Average) (1955−1964)



Source: Compiled from Nomura Securities' *Shoken tokei yoran* (Manual of Securities Statistics).

Table II-4. Changes in Assets of Stock Investment Trusts and Bond Investment Trusts (Principal basis)

(millions of yen)

	Stock Investment Trusts					Bond Investment Trusts				
	Sales (A)	Cancellation (B)	Redemption (C)	Year-end principal	Net asset change (D=A–(B+C))	Sales (A)	Cancellation (B)	Redemption (C)	Year-end principal	Net asset change (D=A–(B+C))
1955	26,381	31,792	13,640	59,519	−19,051					
1956	51,431	27,163	16,039	67,748	8,229					
1957	92,544	16,178	7,199	136,915	69,166					
1958	106,412	25,741	7,890	209,695	72,780					
1959	182,480	58,876	3,219	330,081	120,385					
1960	362,066	87,945	–	604,202	274,120					
1961	588,205	155,751	9,810	1,026,845	422,643	244,490	88,470	–	156,020	156,020
1962	347,116	229,174	14,161	1,130,627	103,781	83,819	107,160	–	132,679	−23,341
1963	331,873	274,226	17,884	1,170,388	39,761	109,857	71,021	–	171,515	38,836
1964	330,158	293,573	45,415	1,161,558	−8,829	122,332	84,811	–	209,036	37,521
1965	196,829	349,502	42,556	966,328	−195,229	120,665	110,132	–	219,569	10,533

Source: Compiled from *Shokenshintaku sanjyunen shi* (30-year History of Securities Investment Trusts).

Post-War Period Is Over, in the last half of the 1950s Japan had finished with its postwar recovery and was heading into its first period of rapid economic growth. Japan's *Jinmu* and *Iwato* booms in the mid-1950s and from 1958 to 1961, respectively, were representative of the change. Against a backdrop of

Table II-5. Categories of Investible Custody Securities and Investment Uses

(millions of yen)

	Total Assets Under Management	Category			Investment Area	
		Special debt		Corporate bonds	Deposited collateral	Others
			Of above, bank debentures			
Sept. 1958	62,701	61,984	61,384	568	53,812	5,283
Sept. 1959	108,347	107,602	105,381	673	88,793	19,420
Sept. 1960	146,076	144,875	141,666	969	116,061	30,015
Sept. 1961	139,833	138,552	134,794	1,239	116,988	22,845
Sept. 1962	154,284	152,127	143,946	2,005	129,030	25,254
Sept. 1963	209,197	205,337	196,967	3,386	156,319	52,877
Sept. 1964	249,079	244,685	235,557	3,714	195,891	53,189

Source: The Securities Bureau of the Ministry of Finance, *Nenpo* (Annual Report).

favorable growth in corporate performances, stock prices rose almost universally during the period from the latter half of 1955 to July 1961. An investment trust boom at the time also contributed to the rising securities market.

Japan had introduced a postwar securities investment trust system in 1951, but the market for these investment trusts struggled until 1955. From 1956 on, however, stock prices surged, and the outstanding principal of investment trusts expanded sharply. The securities market became such a force in the investment trust market that it was known as "the whale in the pond." Another factor in the bull market was the system of "investable custody." Under that system, securities companies borrowed bank debentures (primarily discount debentures) that they had sold in the market on a commission basis from unspecified multiple customers for a predetermined fee through a custody system. The securities companies then raised capital from small and medium-sized financial institutions or in the call money market by using the securities as collateral and invested it in stocks or bonds through their own proprietary trading accounts. In this manner, against the backdrop of an expanding economy and bullish securities market, OTC trading value rose sharply, and the number of companies approved to sell their securities OTC grew rapidly, concentrated mainly on start-up and growth companies. To deal with the rapid expansion in the OTC market, the Tokyo, Osaka, and Nagoya stock exchanges each established Second Sections.

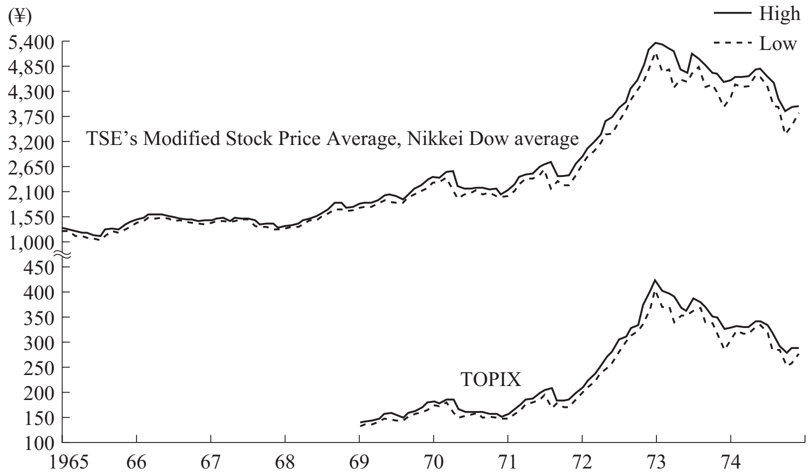
Japan, though, was striving to balance its current account, and when the balance of payments fell into the red it tightened the money supply. When the interest rate was raised in July 1961 to improve the balance of international payments, Japanese companies began liquidating their stockholdings. In combination with corporations' focus on increasing capital, this trend caused a worsening in the demand-supply balance for stocks. The resultant drop in stock prices forced an end to the investment trust boom, as the mechanism that had been driving up stock prices reversed and caused further declines in stock prices. The increase in the official discount rate also produced a rise in the number of redemptions of bond investment trusts, especially by companies. This action placed a great financial burden on the securities companies, which were forced to buy bonds that were being removed from the pool of investment trust assets. These factors became a cause of panic in the securities market.

For that reason, the market took such steps as urging business corporations to rearrange their financing plans (cutting back or postponing their planned increase of capital) and persuading city (commercial) banks to make loans secured by bonds to four bond investment trusts. Despite these efforts, stock prices kept declining, partially because of the market reaction to the assassination of U.S. president Kennedy. To deal with the issues, the industry formed stock purchasing organizations. In January 1964, banks and securities companies contributed capital to create the Japan Joint Securities Co., Ltd., while in January 1965 a group of securities companies jointly established the Japan Securities Holding Association. Both of these organizations carried out share purchasing operations in the market and assumed ownership of shares held by investment trusts with the aim of improving the demand and supply balance in the stock market. In the latter part of May 1965, however, the news that Yamaichi Securities Co., Ltd., was on the verge of bankruptcy hit the market, plunging it into a state of panic.

4. The Securities Market during the Second Period of Rapid Economic Growth (1965−74)

The curtain opened on the 10-year period from 1965 onward with a securities panic. At the end of the first half of fiscal 1964 (September 30, 1964), the cumulative earnings of securities companies in Japan amounted to a loss of ¥26.4 billion. And Yamaichi Securities' performance had deteriorated particularly badly; by March 31, 1965, the company had racked up a loss of ¥28.2 billion, compared with total capital of only ¥8 billion. On May 21, 1965, it finally was revealed that Yamaichi Securities was on the brink of failure. To avoid a loss of confidence in the market, a move was made to bail the company out. In the late night on May 28, the government invoked Article 25 of the Bank of Japan Law and announced that Yamaichi Securities would

Chart II-5. Stock Price Movement (TSE's Modified Average, Nikkei Dow, TOPIX) (1965−1974)



Sources: Compiled from data the *Shoken tokei yoran* (Manual of Securities Statistics), the *Nihon Keizai Shimbun*, and the *Tosho tokei nenpo* (TSE Annual Report).

receive a special loan from the Bank of Japan without any required collateral and for an unlimited amount (in actual fact some collateral was secured). Stock prices continued to fall following the announcement but staged a rally when the government made clear that it intended to issue deficit-covering bonds for the first time since the war.

The panic in the securities market also served as the basis for a reorganization of the securities industry. The government amended the Securities and Exchange Law, introducing a licensing system for securities companies. This forced many securities companies to combine their operations, or merge, to prepare for the new system. In combination with the securities companies that had their registration revoked around the time of the securities panic and those that dissolved their operations, the number of securities companies at the time of the conversion to the new licensing system declined to 277 companies, compared with 593 companies at the end of 1963.

During the decade from 1965 to 1974, progress was made in internationalizing Japan's securities market. In 1964, Japan become an Article 8 nation of the International Monetary Fund (IMF), joined the Organization for Economic Cooperation and Development (OECD), and publicly promised to liberalize capital transactions. Consequently the government implemented measures to liberalize the capital market in five stages beginning in July 1967. This process steadily eased the restrictions on ownership of Japanese stock by

Table II-6. Changes in Number of Securities Companies

	Changes in the number of companies		Companies at financial year-end	Number of Business Offices	Total Capital (in ¥ mil.)	Per-Company Capital (¥ mil.)
	Increase	Decrease				
FY1948	959	11	948			
1949	292	113	1,127	1,889	3,014	2.7
1950	18	209	936	1,601	3,454	3.7
1951	11	109	838	1,642	3,767	4.5
1952	71	73	836	1,794	6,683	8.0
1953	52	52	836	2,105	10,115	12.1
1954	11	83	764	1,997	10,713	14.0
1955	2	66	700	1,901	10,826	15.5
1956	7	55	652	1,848	12,022	18.4
1957	7	77	582	1,904	18,062	31.0
1958	7	32	557	1,984	19,569	35.1
1959	15	26	546	2,233	29,221	53.5
1960	36	30	552	2,565	39,094	70.8
1961	48	10	590	2,841	74,991	127.1
1962	23	12	601	2,934	78,114	130.0
1963	8	16	593	2,893	100,573	169.6
1964	0	82	511	2,424	126,118	246.8
1965	0	86	425	2,109	125,599	295.5
1966	2	30	397	2,009	118,632	298.8
1967	0	113	284	1,869	119,955	422.4
1968	0	7	277	1,572	119,904	432.9

Note: Figures for "Number of Business Offices" and "Capital" for the years preceding 1959 are as of the end of the calendar year concerned.
Source: The Securities Bureau of the Ministry of Finance, *Nenpo* (Annnual Report).

Table II-7. Changes in Stock Ownership Among Investor Categories

FY		1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975
National and local government organizations		0.3%	0.2%	0.3%	0.3%	0.3%	0.3%	0.2%	0.2%	0.2%	0.2%	0.2%
Corporations	Financial institutions	26.8%	29.8%	30.6%	32.0%	31.9%	32.3%	33.9%	35.1%	35.1%	35.5%	36.0%
	Securities companies	5.4%	5.4%	4.4%	2.1%	1.4%	1.2%	1.5%	1.8%	1.5%	1.3%	1.4%
	Business corporation, etc.	21.0%	18.6%	20.5%	21.4%	22.0%	23.1%	23.6%	26.6%	27.5%	27.1%	26.3%
	Foreign corporations	1.9%	1.7%	1.7%	2.1%	3.1%	3.0%	3.4%	3.4%	2.8%	2.4%	2.5%
Corporate investor total		55.1%	55.5%	57.2%	57.6%	58.4%	59.6%	62.4%	66.9%	66.9%	66.3%	66.2%
Individual	Individuals and others	44.4%	44.1%	42.3%	41.9%	41.1%	39.9%	37.2%	32.7%	32.7%	33.4%	33.5%
	Foreign investors	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.2%	0.1%	0.1%	0.1%	0.1%
Individual investor total		44.6%	44.3%	42.5%	42.1%	41.3%	40.1%	37.4%	32.8%	32.8%	33.5%	33.6%

Note: Investment trust portion is included in financial institutions.
Source: Compiled from *Kabushiki bunpu jokyo chosa* (Survey of Stock Distribution Status).

foreigners, which were finally fully lifted with the exception of certain stock categories on the First Sections of the stock exchanges. The liberalization of capital transactions was not limited to foreign investors; foreign issuers and intermediates were also able to operate in Japan's securities market. In 1970, the Asian Development Bank started issuing yen-denominated foreign bonds in Japan. Foreign corporations followed suit and began to offer their shares in 1972. The Tokyo Stock Exchange established a Foreign Section for them in 1973. Around the same time, foreign securities companies commenced setting up operations in Japan. Merrill Lynch opened a Tokyo branch in 1972, becoming the first foreign securities companies to receive a securities business license in Japan.

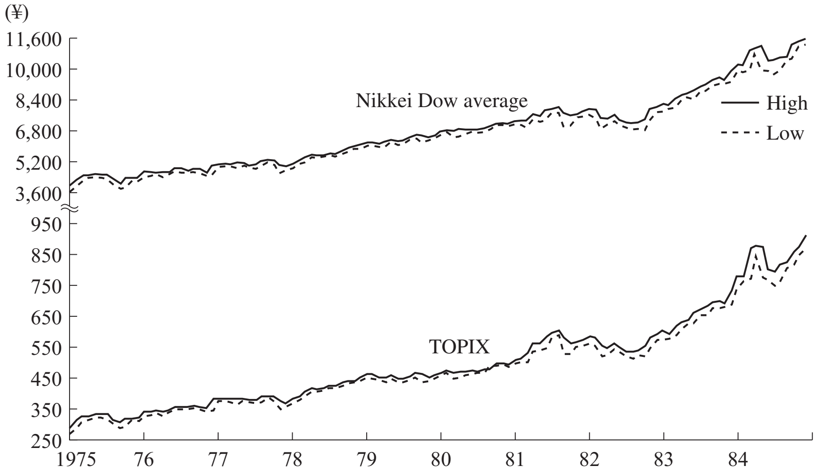
The liberalization of capital transactions also meant that it was now possible for foreign companies to acquire Japanese companies. Japanese companies countered this new possibility by focusing on building stable shareholder bases. If companies held shares in each other, this reduced the number of shares available in the market, making it easier to defend against takeover attempts. Share crossholdings were viewed from the perspective of takeover prevention. Later, after Japanese companies switched the form of their capital increases from making rights issues to existing shareholders at par value to making public offerings of stock at market prices, issuers also pursued share crossholdings from the point of view of the desirability of high share prices when floating shares at market value. As a result, there was a change in the shareholding composition of the market, with the proportion of corporate shareholdings increasing and the proportion of individual investor shareholdings declining.

5. Measures Taken to Cope with the Oil Crises (1975–84)

At the end of the previous 10-year period, there had been a succession of major events, including the Nixon Shock (1971), the introduction of a floating exchange rate system (1973), and the first oil shock (1973). A second oil shock occurred later, in 1979. With Japanese companies practicing energy conservation management in the face of back-to-back oil crises, the government seemed intent on getting through the crises using a fiscal expansion strategy. Underpinning that strategy was the massive issuance of deficit-covering Japanese government bonds (JGBs).

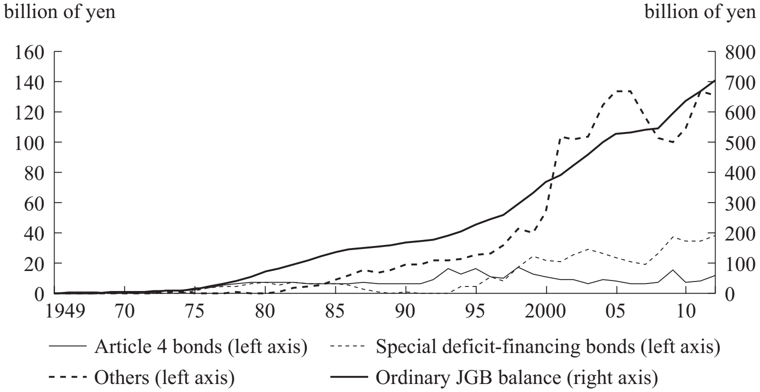
As previously mentioned, government bond issuance after the war got started in fiscal 1965. The main feature of those bonds was that they were issued at low interest rates without regard to market conditions and were forcibly allocated among financial institutions belonging to the underwriting syndicate according to their capital strength. Maintaining this artificially fixed,

Chart II-6. Stock Price Movement (Nikkei Dow and TOPIX) (1975−1984)



Sources: Compiled from data from the *Nihon Keizai Shimbun*, the *Tosho tokei nenpo* (TSE Annual Report), and the *Shoken tokei yoran* (Manual of Securities Statistics).

Chart II-7. Change in JGB Issuance and Outstanding Balance



Notes: 1. JGB issuance amounts are calculated on a proceeds basis.
2. Special deficit-financing bonds include temporary-bridging, tax-reduction offset, and disaster-recovery special public bonds.
3. Others represents the total of pension plan funding special deficit-financing bonds, reconstruction bonds, FILP bonds, and refunding bonds.
4. Article 4 bonds are public bonds issued to cover national expenditures in accordance with Article 4 of the Public Finance Act.

Source: The web site of Japan's Ministry of Finance.

low interest rate market meant that financial institutions could not be permitted to sell the JGBs in the market freely. Since at the time the government was trying to keep JGB issuance within the scope of the growth in the money supply, the Bank of Japan was purchasing almost all JGBs that had been held by the financial institutions for more than one year (liquidity policy). The reason, in fact, that JBG issuance after the oil shocks was called massive was that JGB issuance from fiscal 1975 on exceeded growth in the money supply.

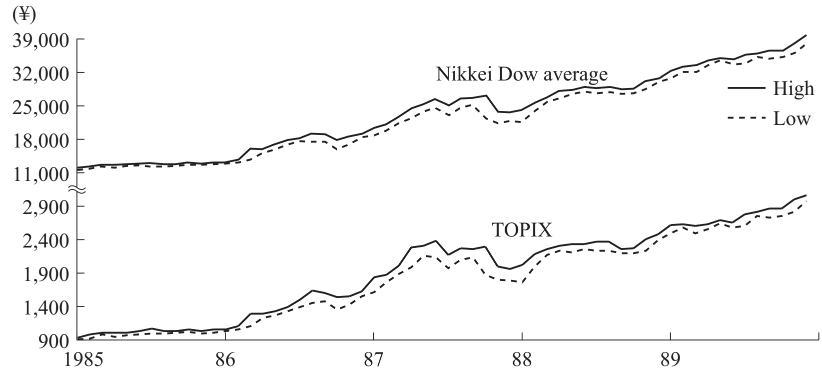
With the massive issuance of JBGs, the liquidity policy reached its limits, making it impossible to avoid issuing JGBs in the public market. Accordingly, the government approved, with some restrictions, JGB sales on the bond market in 1977. Following this change, the restrictions on sales were liberalized in stages, resulting in the deregulation of the market. The interest rate yields for JGB subscribers, on the other hand, were the base rates given by the regulated interest rate structure in Japan. To deregulate these rates would force the government to change its artificially regulated interest rate policy. For that reason, there was a great deal of resistance to the deregulation of the JGB market within the government, and deregulation proceeded at a snail's pace. When, however, the designated underwriting syndicate refused to underwrite the planned issuance of JGBs in June 1981, the issuance conditions for JGBs were deregulated, setting the stage for the deregulation of the different types of long-term interest rates.

Yet another type of internationalization besides the massive issuance of JGBs occurred at this time. During the period from 1975 to 1984, Japan's trade surplus with the United States ballooned, causing trade and economic friction between the two countries. Perceiving the reason for the problem to be the closed nature of Japan's financial, capital, and service markets, the United States demanded the overall reform of Japan's economic structure. As part of that process, the two countries formed the Japan-U.S. Yen/Dollar Committee. The United States argued that deregulated financial and capital markets driven by a market mechanism would enable the optimum allocation of capital in Japan. It therefore pushed strongly for the removal of various restrictions placed on those markets by the Japanese government that it considered obstructive to open markets. In this manner, the two types of internationalization formed the basis for financial deregulation in Japan.

6. Developments before and after the Economic Bubble (1985–89)

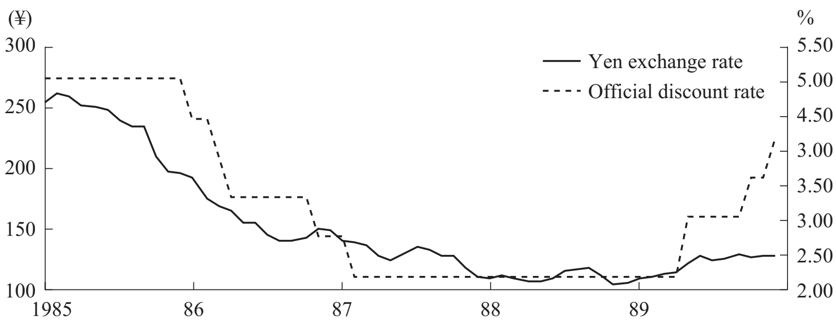
In a Japan-U.S. Yen/Dollar Committee Report released in 1984, the United States brought pressure on Japan to liberalize its financial and capital markets and to internationalize the yen. The Japanese government responded by liberalizing the domestic financial market through such actions as deregulating

Chart II-8. Stock Price Movement (Nikkei Dow and TOPIX) (1985–1989)



Sources: Compiled from data from the *Nihon Keizai Shimbun* and the *Shoken tokei yoran* (Manual of Securities Statistics).

Chart II-9. Yen to US$ Exchange Rate and Japan's Official Discount Rate



Source: Web site of the Bank of Japan.

interest rates on bank deposits. It also moved to improve foreign financial institutions' access to the Japanese market through such measures as opening up membership on the Tokyo Stock Exchange (TSE). As a first step toward internationalizing the yen, the government liberalized the Euroyen market. The TSE, meanwhile, heeded the request of the government to open its membership by revising the fixed number of membership seats in its Articles of Incorporation in 1985 and accepting its first round of new members. A total of three rounds were eventually conducted, resulting in seats on the TSE for 25 foreign securities companies.

The deregulation of interest rates began in 1985 with the deregulation of interest rates on large deposits. After that, the deregulation of interest rates on

Table II-8. Stock Trading Composition by Investor Category

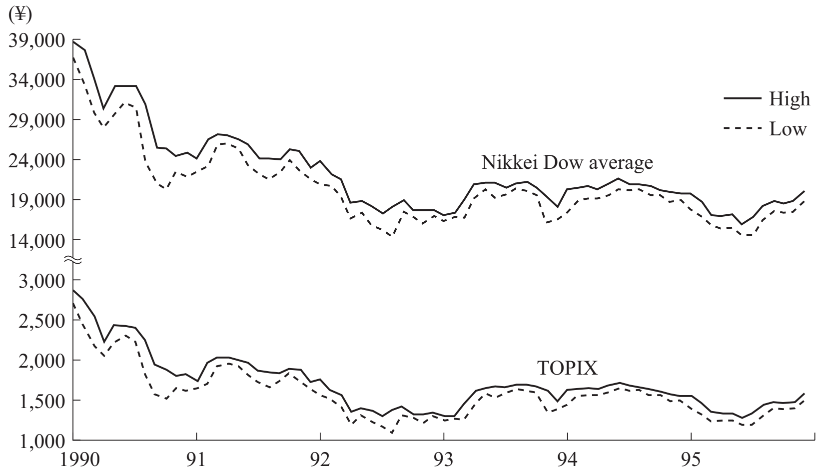
	Total Brokerage Trading	Individuals	Foreigners	Life and Non-Life Insurance Companies	Banks	Investment Trusts	Corpora-tions	Others
1983	1,250.7	59.5%	15.9%	1.3%	3.5%	4.4%	9.3%	6.1%
1984	1,344.5	54.6%	17.3%	1.2%	5.3%	4.4%	11.5%	5.7%
1985	1,615.6	49.5%	15.4%	1.2%	10.6%	5.0%	11.6%	6.6%
1986	2,772.0	41.7%	13.8%	1.1%	16.1%	5.4%	15.4%	6.5%
1987	3,683.4	36.8%	12.4%	1.0%	21.5%	5.6%	17.0%	5.8%
1988	3,979.2	34.8%	9.1%	1.2%	24.7%	6.8%	17.7%	5.7%
1989	3,395.1	32.3%	10.8%	1.2%	25.4%	10.0%	14.6%	5.7%

Notes: Total brokerage trading equals the buying and selling of all securities companies on the first and second sections of the TSE, Osaka, and Nagoya exchanges.
Source: Compiled from the *Tosei yoran* (Tokyo Stock Exchange handbook).

deposits progressed rapidly. As a result, the Bank of Japan's open interest rate for fund raising jumped to 53% in 1989, from 7.5% at the end of 1984, greatly increasing fund procurement costs for banks. Major corporations concurrently shifted their financing from bank loans to security issuance, resulting in a decline in the balance of loans being extended by major banks to their core customer base (heavy industry). To cope with the loss of business, the leading Japanese banks expanded the scope of their loan operations to include real estate, construction, and other industries and launched international operations. They also began planning to enter the securities business, creating friction between the banking and securities industries.

In 1985, the Plaza Accord was signed, after which the yen appreciated sharply against the U.S. dollar. The rate movement raised concerns about a strong yen-related economic recession in highly export-dependent Japan. The Bank of Japan's reaction was to implement successive reductions in the official discount rate from January 1986 onward, and the economy responded by entering a recovery phase. Amid this low interest rate climate, Black Monday rocked the U.S. market on October 19, 1987, causing nations around the world to initiate monetary easing to avert recessions. Japan, meanwhile, was still in an economic recovery phase, and its official discount rate remained at a low level. Consequently, land, stock, and other prices continued to rise. Against this backdrop of asset inflation, corporations began taking advantage of their ability to raise capital through loans and securities, using financial engineering, or zaitech, to boost their financial income. Financial institutions, hurt by the decline in loan balances, also aggressively invested capital in securities. Heated investment in securities pushed the Nikkei Dow index up

Chart II-10. Stock Price Movement (Nikkei Dow and TOPIX) (1990−1995)



Sources: Compiled from data from the *Nihon Keizai Shimbun* and the *Shoken tokei yoran* (Manual of Securities Statistics).

from ¥12,716.52 (September 30, 1985) before the Plaza Accord to a record high of ¥38,915.87 at the end of 1989.

New trading methods were also introduced during this period, commencing with bond futures trading in 1985. Stock index futures were introduced in 1987, and stock index options in 1989. Tokyo's securities market thus gained a full complement of cash, future, and option transactions.

7. The Reform of the Financial System after the Stock Market Scandals (1990−95)

The debate on financial system reform began in Japan in the mid-1980s. It arose in response to the global trend toward financial deregulation and to the change in the financing methods of Japanese corporations. The Financial System Research Council took the lead in the debate and considered revisions in the specialized financial institution systems that separated long-term interest rates from short-term interest rates, commercial banks from trust banks, and the banking industry from the securities industry. These systems were the pillars of the postwar financial system in Japan. The Financial System Research Council, however, was positive about banks being allowed to enter the securities business and decided that the best approach would be to allow mutual entrance into the banking, trust and securities businesses based

Table II-9. Establishment of Securities Subsidiaries of Banking Institutions

	Companies Starting New Securities Business
Jul. 1993	IBJ Securities (currently Mizuho Securities), LTCB Securities (currently UBS Securities), and Nochu Securities (currently Mizuho Securities)
Nov. 1993	Sumitomo Trust Securities (liquidated in 2000) and Mitsubishi Trust Securities (currently Mitsubishi UFJ Morgan Stanley Securities)
Jul. 1994	Asahi Securities (dissolved in 1999)
Aug. 1994	Yasuda Trust Securities (currently Mizuho Securities)
Nov. 1994	Sakura Securities (currently Daiwa Securities), Sanwa Securities (currently Mitsubishi UFJ Morgan Stanley Securities), Daiichi-Kangyo Securities (currently Mizuho Securities), Fuji Securities (currently Mizuho Securities), Mitsubishi Diamond Securities (currently Mitsubishi UFJ Morgan Stanley Securities), and Sumitomo Capital Securities (currently Daiwa Securities)
Mar. 1995	Tokai International Securities (currently Mitsubishi UFJ Morgan Stanley Securities)
Apr. 1995	Hokkaido Takushoku Securities (dissolved in 1998)
May 1995	Mitsui Trust Securities (terminated business in 1999)
Oct. 1995	Toyo Trust Securities (liquidated in 1999)
Nov. 1996	Shinkin Securities and Yokohama City Securities (both liquidated in 1999)
Aug. 1997	Tokyo Forex Securities (currently ICAP Totan Securities), and Nittan Brokers Securities (currently Central Totan Securities)
Nov. 1997	Ueda Tanshi Securities (dissolved in 2001)
Oct. 1998	Hitachi Credit Securities (currently DBJ Securities)

Sources: Complied from data from the *Nihon Keizai Shimbun*, the Securities Bureau of the Ministry of Finance, Nenpo (Annual Report). "The First Year of the Financial Supervision Agency", and "The First Year of the Financial Services Agency."

on wholly owned subsidiaries. It requested the Securities and Exchange Council to revise the system separating the banking and securities industries. But the Securities and Exchange Council was wary of allowing banks into the securities business, recognizing that the securities industry overall was far less enthusiastic about this idea than the banking industry. The Securities and Exchange Council nevertheless decided to approve mutual entrance through subsidiaries on the condition that firewalls were established between subsidiaries and parent companies. And for the time being bank subsidiaries, including indirectly owned subsidiaries, were prohibited from operating in the stock brokerage market. The Institutional Reform Law was enforced in June 1992 based on those conditions, and mutual entrance into these financial sectors became a reality.

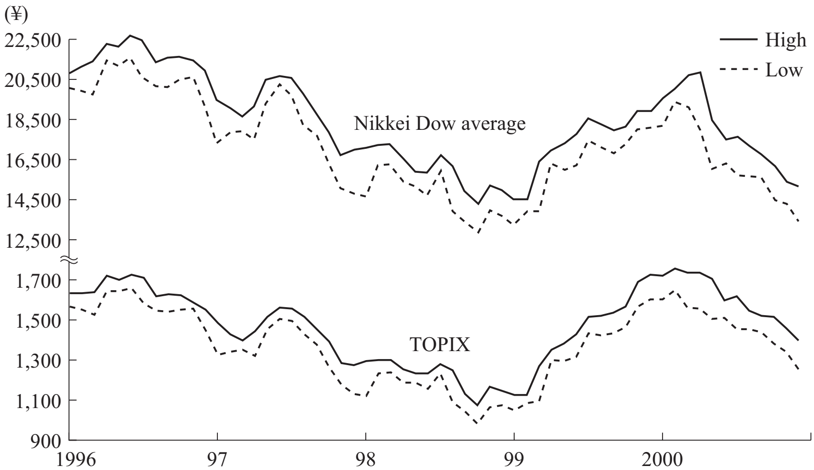
Around the time that the debate on financial system reform was dying down, the uncovering of major financial and securities scandals shook the banking and securities industries. For the securities industry it was the discovery through a tax audit that during the financial bubble major securities companies had been compensating their largest corporate clients for losses incurred (at August 1991, total compensation by the four major securities companies and 13 second-tier companies had reached approximately ¥172 billion). Dealings with members of known crime syndicates and market manipulation charges also surfaced, escalating the problems into a social issue. Most of the loss compensation was done through *eigyo tokkin* accounts (discretionary accounts managed by the securities company for *tokkin*, a form of corporate investment fund). The commonly used methods involved arranging to have the client earn a profit on transactions disguised as bond transactions or shifting losses between corporate clients with differing fiscal year-ends to avoid reporting the loss by temporarily transferring securities with losses at book value between their accounts in a process called *tobashi*.

Since under the existing law loss compensation for trades after the fact was not illegal, the Securities and Exchange Law was immediately amended to ban securities trading under a discretionary account and loss compensation before or after the fact. Criticism mounted that “excessive profits due to the regulator’s protection of market participants, problematic administration, and fixed rate commissions had made loss compensation possible,” and it was said that “what the solution requires is not the banning of loss compensation or the punishment of securities companies, but the implementation of financial system reform itself.” In September 1991, the Provisional Council for the Promotion of Administrative Reform recommended the liberalization of brokerage commissions, the promotion of new market entrances, and the separation of the market surveillance organization from the Ministry of Finance. In July 1992, the authorities established the Securities and Exchange Surveillance Commission. The rest of the Provisional Council’s recommendations were included in the financial Big Bang reforms that came later, contributing to the formation of a new framework for Japan’s financial and capital markets.

8. The Debate on, and Enforcement of, the Financial System Reform Law (1996–2000)

The bursting of the economic bubble left deep scars on the economy. The trauma from the collapse of stock prices emerged in the form of securities scandals, while that from the collapse of land and real estate prices emerged as the nonperforming loan problem in the financial industry. The nonperforming loan problem in particular lingered without the implementation of any fundamental solution—the banking industry struggled for close to 10 years to get out from under its bad debt. During this long process, foreign

Chart II-11. Stock Price Movement (Nikkei Dow and TOPIX) (1996–2000)



Sources: Compiled from data from the *Nihon Keizai Shimbun* and the *Shoken tokei yoran* (Manual of Securities Statistics).

companies and investors and financial transactions flowed out of the Japanese market, making the so-called hollowing out of the financial market a real rather than hypothetical problem. Japan's way of addressing the issue was the financial Big Bang initiative proposed by then prime minister Ryutaro Hashimoto in 1996. The goals of the initiative were to wrap up the cleanup of nonperforming loans by 2001 and rebuild the Japanese financial market into an international market comparable to the New York and London markets based on the principles of "free, fair, and global."

Discussions on financial reform took place in the Securities and Exchange Council, the Financial System Research Council, the Insurance Council, the Council on Foreign Exchange and Other Transactions, and the Business Accounting Council. Those discussions resulted in recommendations to change Japan's established bank intermediation based capital allocation system (indirect financing) to a market-based capital allocation system (direct financing). Passed in October 1988, the Financial System Reform Law increased and improved asset management methods, paved the way for services based on vigorous intermediation, set up a market system with special characteristics, and established a framework for trading that users could trust. Among its many revisions, the deregulation of commissions on stock brokerage and the shift to a registration system for securities business provided incentive for securities companies to reform their business models. Its elimination of the obligation to trade stocks only on exchanges, on the other hand, promoted

Table II-10. Schedule for Reforming the Securities Market During the Big Bang

	FY1997	FY1998	FY1999	FY2000	FY2001
I. Investment Vehicles (Attractive investment instruments)					
1. Diversity of the types of bonds					
2. Diversity of derivatives products					
3. Developing Investment Trust Products					
(1) Introduction of Cash Management Account (wrap account)					
(2) OTC sales of investment trusts products by banks					
(3) Private placement of investment trusts					
(4) Investment company type funds					
4. Review of the definition of securities					
5. Enhancement of corporate vitality and efficient use of capital					
II. Markets (An efficient and trust framework for transactions)					
1. Improvement of transaction system on stock exchanges					
2. Improvement of OTC (JASDAQ) market system					
3. Deregulation of sales solicitations by securities firms for unlisted, unregistered stock					
4. Improvement of share lending market					
5. Improvement of clearing and settlement system					
6. Strengthening inspection, surveillance and enforcement systems					
7. Strengthening disclosure					
III. Financial Intermediaries (Diverse investment services to meet client needs)					
1. Deregulating brokerage commissions					
2. Diverse activity by intermediaries					
3. Use of holding company structure					
4. Strengthening asset management					
5. Enhancing monitoring system for soundness of securities companies					
6. Entry regulations for securities companies					
(1) Licensing system reform					
(2) Enhancing mutual entry into banking, securities and trust businesses					
7. Investor protection related to exits of intermediaries from the market					
(1) Strict separation of client assets from securities companies' own assets					
(2) Enhancing the securities Deposit Compensation Fund scheme					
Review of the taxation related to securities					
Shift to the new administrative regime					

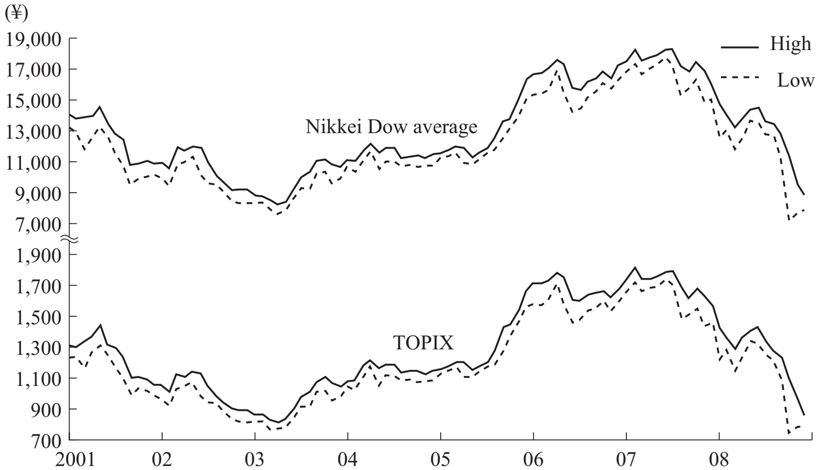
Source: Drawn from the Securities and Exchange Council's report "Comprehensive Reform of the Securities Market—For a Rich and Diverse 21st Century"

competition between markets.

Almost at the same time as the financial Big Bang initiative was being proposed, major financial institutions experienced business and financial crises that led to bankruptcies. Among troubled banks were Hokkaido Takushoku Bank, Ltd., the Long-Term Credit Bank of Japan, Ltd., and the Nippon Credit Bank, Ltd. The list of securities companies included second-tier Sanyo Securities Co., Ltd., and one of the four major securities companies, Yamaichi Securities Co., Ltd. These companies previously would have been rescued by being absorbed by or merged with other major financial institutions. But there were no financial institutions with the financial strength to do so. The myth that banks could not fail was shattered, and the convoy system of financial regulation came to an end.

Forced into action by the crisis, the major financial institutions reorganized beyond traditional corporate lines, condensing into four major financial groups. The new groups also, furthermore, began reorganizing their affiliated securities companies to restrict second-tier and small to medium-sized

Chart II-12. Stock Price Movement (Nikkei Dow and TOPIX) (2001−2008)



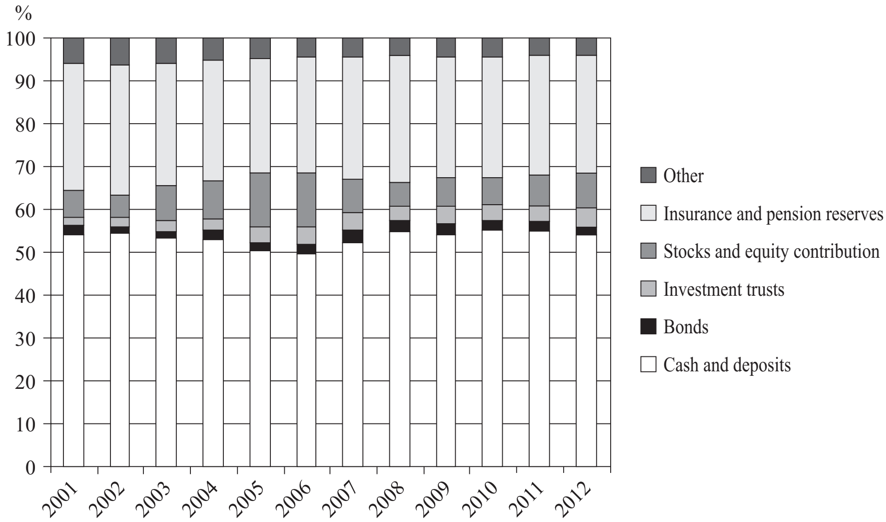
Sources: Compiled from data the *Nihon Keizai Shimbun*, the *Tosho tokei geppo* (TSE Monthly Report), *Shoken tokei nenpo* (Securities Statistics Annual Report), and the web site of the Tokyo Stock Exchange.

securities companies. Amid such major changes as the shift to a registration system and the deregulation of commissions in the securities industry, an information technology (IT) revolution occurred. This resulted in a rush into the market of securities companies with online brokerage businesses and other new business models, producing a change in key market players.

9. Developments Since the Big Bang (2001−2008)

Entering the 2000s, the nonperforming loan problem reached a turning point. Prime Minister Junichiro Koizumi championed structural reform and oversaw the final clearing of this bad debt from the banking sector based on a Financial Revitalization Program in October 2002 that prioritized eliminating nonperforming loans. The clearing of nonperforming loans had been proceeding slowly in the banking sector through write offs to bad loan reserves. A different approach was needed because this method was not providing a fundamental solution to the problem. Banks were henceforth permitted to directly dispose of their nonperforming loans and proceeded to remove these bad debts from their balance sheets. Because unlike the indirect method this approach threatened dangerously low levels of capital reserves at banks, a rise in bankruptcies in the corporate sector, and an increase in unemployment,

Chart II-13. Changes in the Composition of Household Assets



Source: Web site of the Bank of Japan.

the government took steps to control its adverse effects. It injected capital into banks to maintain the stability of the financial system and established restructuring mechanisms for corporations. These mechanisms included the enactment of the Civil Rehabilitation Act and of the function of the Resolution and Collection Corporation (RCC) and the setting up of the Industrial Revitalization Corporation of Japan (IRCJ).

Under the slogan of "From Savings to Investment," Japan's government also implemented policies and programs to shift to a market-based financial system with a strongly rooted securities market at its core in which a diverse range of investors would participate. The policies and programs included the Basic Policies for Economic and Fiscal Management and Reform (June 2001); the Program for Structural Reform of Securities Markets (August 2001); and the Program for Promoting Securities Markets Reform (August 2002). These policies and programs put an emphasis on the expansion and improvement of sales channels (lifted a ban on banking and securities joint branch offices and introduced a securities intermediary system); the diversification of financial instruments and services (lifted a ban on wrap accounts, etc.); and the fairness and transparency of the financial business (thorough disclosure and the greater supervisory oversight of audit corporations, etc.).

The authorities aimed at establishing a market that participants would have confidence in and that would attract a wide range of investors. Thanks to their reforms, the allocation of household financial assets into risk-class assets, such as equities, bonds, investment trusts, and other securities, trended upward until 2006. The reforms also, however, resulted in an increase in the number and volume of complex financial products and transactions that demanded a comprehensive set of regulations to ensure the thorough observance of investor protection rules and the coverage of an expanding and increasingly diversified range of investment instruments. In response, the government revised the Securities and Exchange Law, reintroducing it as the Financial Instruments and Exchange Act.

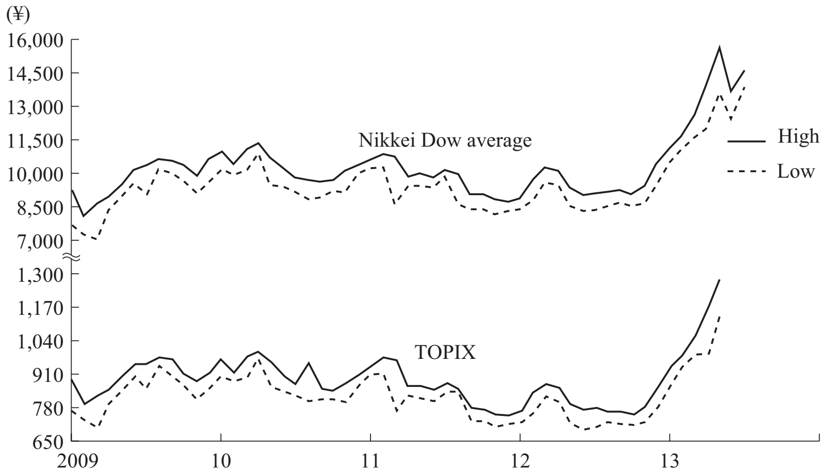
In the aftermath of the financial Big Bang, inter-market competition between exchanges got under way in earnest. The competition was focused on attracting new listings and more transaction volume. The exchanges started targeting new listings around 2000, launching start-up company markets and growth companies whose shares they successively listed on exchanges. In the battle for greater transaction volume, Tokyo Stock Exchange quickly took the lead. The TSE introduced electronic stock trading and off-floor trading, strengthening its dominant position. The concentration of stock trading on the TSE, however, produced a notable decline in support for regional stock exchanges, leading to successive reorganizations that began around 2000.

10. Developments after the Lehman Shock

The Lehman Shock began with a liquidity crisis among European and U.S. financial institutions that resulted from a collapse in U.S. housing prices and from subprime loan defaults beginning about summer 2007. This market crisis escalated into a global financial crisis and a simultaneous recession in the global economy after Lehman Brothers Holdings filed for Chapter 11 bankruptcy protection. Countries dealt with the crisis based on huge amounts of public spending and monetary relaxation. The global economy then turned its sights to a process of recovery fueled by the growth of emerging countries.

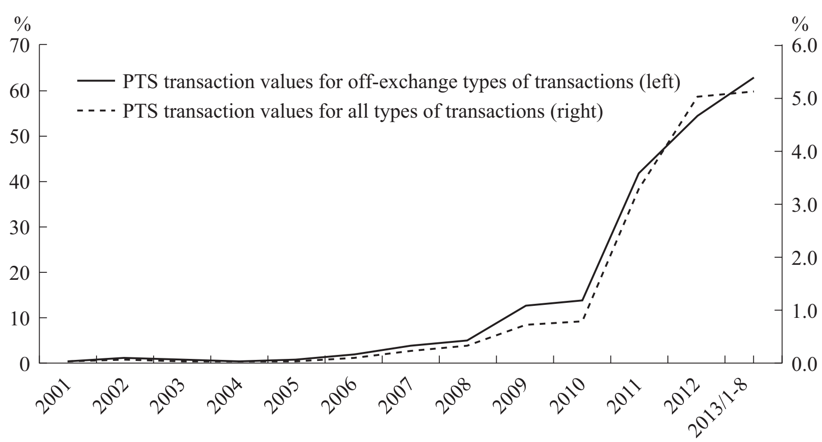
During a change of government in Greece in October 2009, however, the incoming government discovered that the ratio of public debt to gross domestic product (GDP) for fiscal 2009 was not the 4% level publicly asserted by the outgoing government but, in fact, was going to rise to 12.7%. This discovery kicked off the emergence of the Greek sovereign debt problem, an issue that quickly spread through the PIIGS countries (Portugal, Ireland, Italy, Greece, and Spain), which had similar large current account and fiscal deficits. Then financial institutions in the United Kingdom, Germany, and France became enveloped in the crisis because they held large amounts of the sovereign debt of these countries, and thus it became a European sovereign debt crisis. The holding out of the opposition party in the United States against the

Chart II-14. Stock Price Movement (Nikkei Dow and TOPIX) (2010 onward)



Sources: Compiled from data the *Nihon Keizai Shimbun* and the web site of the Tokyo Stock Exchange.

Chart II-15. Transactions on Proprietary Trading Systems



Source: Produced based on information on the website of the Japan Securities Dealers Association.

raising of the national debt ceiling to avoid a U.S. default only served to aggravate the situation. Although agreement was reached on raising the debt ceiling, Standard and Poor's reduced the U.S.'s credit rating on long-term bonds from AAA to AA+. The global economy continues to hover in a state of instability because of these and other factors.

Japanese financial institutions suffered far fewer losses from the subprime loan problem, European sovereign debt crisis, and other financial shocks than those of other nations, but the financial crisis originating in the United States and Europe had its impact on the Japanese economy. In fall 2008, the Japanese stock market experienced successive sharp declines. Of the leading 10 day-to-day declines recorded in the TOPIX to the end of 2011, the top 4 are from this period. The Nikkei average also fell to the point of breaking through 7,000.

In recent years, there has been further structural change in the Japanese securities market. On January 4, 2010, the Tokyo Stock Exchange updated its trading system, paving the way for the full-scale introduction of high-frequency trading (HFT). The successive liberalization of regulations, moreover, has resulted in an increase in the use of proprietary trading systems (PTS). PTS now account for about 5% of total stock market trading value and are increasing.

Inter-market competition, meanwhile, has driven up exchanges' system costs. And trends overseas of a major restructuring of exchanges that goes beyond country borders has reduced Japan's share of the global securities market. In recognition of the changing business climate, Japan's securities market took a major step toward increasing its international competitiveness and reducing system costs with the January 2013 merger of the Tokyo Stock Exchange and the Osaka Securities Exchange.

CHAPTER III

The Stock Issuing Market

1. New Issues of Stocks in the Primary Market

For the purpose of the Companies Act, companies are classified into joint stock companies (*kabushiki kaisha*); general partnerships (*gomei-gaisha*); limited partnerships (*goshi-gaisha*); and limited liability companies (*godo-gaisha*). Of these, joint stock companies have a number of advantages against the others in that i) ownership interest in a company is divided into shares of stock; ii) investors may recoup contributed capital simply by selling their shareholdings; iii) investors shall be held liable only to the extent of capital contributed by them (limited liability); and iv) others. These advantages help a joint stock company to raise a large amount of capital from various investors.

The shares issued by a joint stock company are capital securities, or narrowly defined securities, in that they represent certain claims and rights of their investors. Shareholders contribute capital in exchange for their shareholdings, which give them privileges to i) participate in the management of the company (by attending general shareholder meetings and exercising voting rights that are proportionate to their shareholdings); ii) claim distribution of profits; iii) claim residual corporate assets (shareholders have proportionate rights to claim residual corporate assets upon liquidation); and iv) file derivative suits. Issued shares, unlike bonds, are not redeemable except when shares are repurchased by the company or upon liquidation. Because contributed equity may not usually be repaid by the company, shareholders wishing to monetize their holdings can only do so by selling them in the market. For the benefit of increased liquidity, stock is divided into a standard unit of shares and often represented by physical securities, or share certificates. On the other hand, with corporate bonds, another class of capital securities, the repayment value is backed by the issuer.

The legal framework for stocks has undergone substantial changes by a series of amendments to the Commercial Code introduced since 2001. Pursuant to the amendments that took effect on October 1, 2001, par value stock was abolished and all stocks are now issued with no par value. Accordingly, the

Table III-1. Recent Amendments to the Commercial Code Relating to Equity Financing

The amendments made in 2001: Those enforced on October 1, 2001: A revision of the system of acquiring and holding one's own shares (the ban on holding treasury shares was lifted); the abolition of the system of issuing shares with face value (under this system, all shares are issued without par value); the abolition of the requirement of net asset value (a minimum of ¥50,000 or $487.8 at the rate of ¥102.50 to the dollar); the abolition of the *tan'i-kabu* system in favor of *tangen-kabu* system; and the relaxation of the legal reserve system, etc. Those enforced on April 1, 2002: The institution of the equity warrant system and the abolition of regulation of the stock option system, the electronification of corporate documents, and a revision of regulation of the classes of stocks (the lifting on the ban of tracking stock*), etc. The amendments made in 2002 (enforced in April 2002): A revision of regulation of the classes of stocks, the institution of the system relating to lapses of stock certificates, and the rationalization of the procedure for reducing capital, etc. The amendments made in 2003 (enforced on September 25, 2003): The acquisition of one's own shares by a resolution of the board of directors under the provisions of the articles of incorporation and a revision of the method of computing a limit on interim dividends, etc. The amendments made in 2004 (enforced on October 1, 2005): The adoption of a system of not issuing stock certificates and the introduction of a system of serving notices by electronic means, etc. The amendments made in 2005 (enforced on May 1, 2006): A revision of regulations to make the share transfer system more flexible, the rationalization of the system of retiring shares, a revision of regulations relating to the issue of share certificates, and the abolition of fractional shares, etc.

*The ban on tracking stock (under this system, dividends are paid not out of the earnings of a company as a whole but out of the earnings of a specific division or a subsidiary of such company) was lifted.

Table III-2. Forms of Issuing New Shares

Payment required
Capital increase through a public offering Capital increase through a third-party allocation of new shares Capital increase through a rights offering The exercise of subscription rights
Payment not required
Stock split Merger Stock swap Stock transfer

par value—based *tan'i-kabu* round-lot system was replaced by the new, discretionary *tangen-kabu* system. Under the amendments enforced on April 1, 2002, i) new subscription rights/warrants were introduced, ii) the regulation of stock options was relaxed, and iii) multiple classes of stock may now be issued by a single company.

The Commercial Code as amended in 2004 and the Law Revising the Law Concerning the Book-Entry Transfer of Corporate Bonds, etc., for Streamlining Settlement of Transactions in Stocks, etc., that was promulgated in the same year introduced a system allowing electronic bookkeeping for shares, paving the way for the dematerialization of share certificates of public companies on January 5, 2009. The Companies Act that came into effect on May 1, 2006 allowed transfer restrictions on any and/or all of classes of stock and issuance of class shares subject to wholly call. In the 2013 outline of revisions of the Companies Act, the authorities went further by also considered introducing a "squeeze out" system where controlling shareholders of a company may force minority shareholders to sell their shares to them.

2. Forms of Issuing Shares

Shares issuance is first done when a joint stock company is established. Joint stock company establishment can be roughly divided into incorporators only establishment or by subscription establishment. When a company is established only with the funds contributed to its capital stock by its promoters, this method of establishing a company has the advantage of its shares being fully subscribed to, but it has a drawback in that the number of shares it can issue is limited to the funds its promoters can raise. On the other hand, establishing a company with the capital raised by publicly offering its shares to an unspecified large number of investors is called "establishment through a public offering of shares." While a large amount of capital can be raised through this method, one major drawback is that it takes time to successfully complete the public offering, and when its shares are not fully subscribed to by investors during the public offering period, the company cannot be established. Under the old provisions of the Commercial Code, the par value of shares issued by a company at the time it was established had to be ¥50,000 or more, but this restriction was abolished—and the requirement of par value has been liberalized—by virtue of the 2001 amendment to the Commercial Code.

Issuing new shares after the company was established in order to raise funds, to transfer the control of its management to a third party, or to enhance the liquidity of its shares is a general practice followed by joint stock companies.

Table III-3. Funds Raised by Equity Financing

(Billions of yen)

	Rights offering		Public offering		Third party allotment		Exercise of subsc. rights		Preferred stock and others		Total	
	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount	No.	Amount
1998	0	0	8	278.2	32	688.0	28	86.4	5	471.0	73	1,523.6
1999	0	0	28	349.7	75	2,347.3	62	252.9	25	6,989.4	190	9,939.3
2000	2	0.82	24	494.1	46	922.8	87	105.6	4	107.3	163	1,629.8
2001	3	32	18	1,201.5	57	477.2	85	37.4	5	216.1	168	1,932.2
2002	0	0	19	153.3	62	484.4	78	276.3	36	996.8	195	1,910.7
2003	2	1.5	35	567.2	84	223.2	121	36.6	74	2,532.2	316	3,359.2
2004	1	2.7	78	750.2	129	572.6	228	99.5	50	1,362.6	486	2,784.9
2005	2	3.7	74	650.8	150	778.1	336	166.9	45	1,167.8	607	2,763.5
2006	0	0	69	1,447.7	145	416.5	371	151.3	26	559.7	611	2,575.1
2007	1	8.1	60	457.0	117	662.1	347	165.0	12	795.5	537	2,079.6
2008	1	0.1	27	341.7	93	395.8	240	20.9	9	593.7	370	1,352.1
2009	0	0	52	4,966.8	115	714.6	169	18.8	28	474.0	364	6,174.3
2010	1	0.7	50	3,308.9	88	535.6	159	24.6	10	73.6	308	3,942.7
2011	0	0	45	967.8	66	395.2	171	26.1	7	69.3	289	1,458.4
2012	1	0.4	53	451.8	71	159.3	174	21.8	17	1,275.5	316	1,908.4

Source: Web page of the Tokyo Stock Exchange.

Usually, the method of issuing new shares is divided into paid-in capital increase and stock splits (and gratis issues). Issuing new shares against the payment for them by shareholders is called paid-in capital increase, and the company can raise its equity capital by this method. Paid-in capital increase is also divided on the basis of investors to whom shares are issued into rights offering, allotment of new shares to a third party, and public offering.

By definition, a stock split, the act of splitting one share into two or more shares, does not by itself increase the assets or the capital of the company. However, new shares issued through a stock split play an important role. The stock split increases the number of the company's shares outstanding on the market, and the fall in the per share price caused thereby enhances their liquidity, making it easier for the company to raise funds through equity financing. Until 2001, there was a rule banning any stock split that reduces the per share, net asset value to less than ¥50,000, but this rule was abolished by virtue of the 2001 amendment to the Commercial Code. This step was taken because of widespread complaints among venture businesses—those that have high growth potential and whose shares are traded at high prices despite limited net assets—that on account of the restrictions against a stock split, they could not improve the liquidity of their shares. In a similar vein, the rule relating to the authorized total number of shares was changed in such a way as to allow the company to increase its authorized total simply by adopting a resolution of the board of directors, instead of changing the relevant provisions of its articles of incorporation, which required a special resolution of a general meeting of shareholders.

Other cases in which the company is authorized to issue new shares include the exercise of new share subscription rights, a new type of warrant introduced by the April 2002 amendment to the Commercial Code; equity swaps with one's subsidiaries under the equity swap system; and allocation of shares to shareholders of one's subsidiaries under the stock transfer system.

3. Procedures for Issuing New Shares

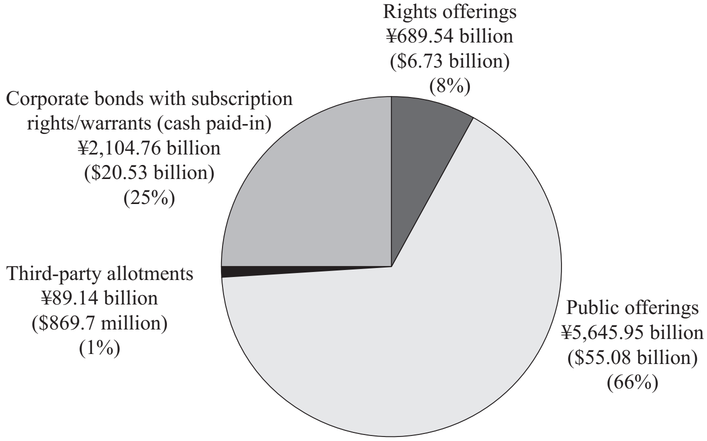
New share issuance may be done in exchange for capital paid in by investors in the form of public offerings, third-party allotments, or rights offerings.

In a rights offering, shareholders on record as of a specified record date are given subscription rights in proportion to their stockholdings. In the case of public companies, grant of subscription rights or allotment of new shares to nonshareholders are only subject to board approval. On the other hand, a third-party allotment by a private company, under the Companies Act, in principle, requires a special resolution at the general shareholders meeting, but when provided for in the Articles of Incorporation may be conducted by ordinary resolution. A rights offering to existing shareholders is a means of capital raising that is neutral to control of corporations, in that it does not affect proportionate ownership of the shareholders. Offerings of rights at par used to be the dominant measure of equity financing, but such offerings are no longer common, partly due to the elimination of par value under amendments to the Commercial Code in 2001.

Public offerings grant subscription rights to the general public. Public offerings raise more capital for issuers than offerings of rights at par, which was once prevalent along with par value stock, by the excess of the issue price over par, while investors were deprived of the opportunity to earn the premium, which, in turn, lowered their incentive to subscribe. In the buoyant years from the early seventies to the late eighties, new share issuance dominated equity financing. Although public offerings declined in the nineties, they are still a primary means of raising equity capital.

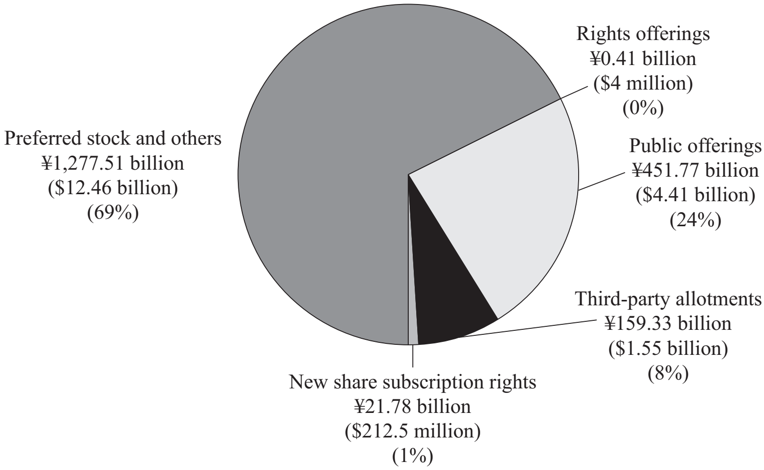
A third-party allotment raises capital by granting subscription rights to certain third parties, including banks or business corporations with special relationships with the issuer and/or its director(s). This method is often used to bail out troubled companies, strengthen relationships with corporate partners, and form a business and capital alliance rather than simply to raise capital.

Chart III-1. Equity Financing in 1989 by TSE-Listed Companies, by Type of Financing (Total capital procured : ¥8,529.39 billion) US$=102.50 yen



Source: Tokyo Stock Exchange, *Monthly Statistics Reports.*

Chart III-2. Equity Financing in 2012 by TSE-Listed Companies, by Type of Financing (Total capital procured : ¥1,908.9 billion) US$=102.50 yen



Source: Web page of Tokyo Stock Exchange.

Additionally, it has found notable use recently as a measure for fending off hostile takeovers. Third-party allotments cause dilution of ownership of existing shareholders. They may be approved by board resolution except when terms of rights are unequivocally advantageous to the grantee(s), where a special resolution at the general shareholders meeting will be required (advantageous issuance). In accordance with a Cabinet Office Ordinance that came into effect as of February 2010, issuers making capital increases by third party capital allocation have an obligation to explain the rationality and necessity of the capital increase in their securities registration statements.

Other changes for new share issuance procedures under the Companies Act that was enforced in 2006 include i) the replacement of subscription date by a subscription period system; ii) the prohibition of reinstitution of rights offerings; and iii) the unified procedures for approval for issuance (determination, etc. of classes, issuance amount, floor on issue price) and advantageous issuance of new shares by way of third-party allotments.

4. The Current State of New Issue Market

New shares are usually issued i) in exchange for capital contribution (equity financing in the forms of public offerings, third-party allotments, rights offerings, exercise of subscription rights, etc.); ii) in conjunction with stock splits (and gratis issues); and iii) for the purpose of corporate acquisitions. (Share counts are reduced when treasury stock is cancelled.) In 2012, the leading source of new shares issued by listed companies was equity financing (4.31 billion shares), followed by stock splits and gratis issues (3.76 billion shares). The amendments to the Commercial Code in 1991 defined stock splits as a notion that encompasses stock dividends, gratis issues, and reclassification of paid-in capital in excess of par into capital stock in conjunction with such issues.

Recently, equity financing is the leading source of new shares. Listed companies on the Tokyo Stock Exchange raised ¥1.9 trillion ($18.5 billion*) in equity in 2012. By contrast, equity financing, except for initial public offerings, is more selectively used in the United States and the United Kingdom because it tends to cause earnings dilution and consequently push down the stock price. Over the past years, equity financing in Japan has undergone many changes. During the period of rapid economic growth, corporations mostly used the dependable method of rights offering at par to raise equity capital, because investors did not have enough accumulation of financial assets, while issuing companies suffered a chronic shortage of funds. (Stock par value was eliminated in 2001.) In those days, business corporations mostly relied on bank borrowings for their funding requirements, and the stock

Table III-4. The State of Issuing New Shares by Listed Companies

(in thousands of shares)

Year	Paid-in capital increase	Rights offering	Public offering	Allotment to a third party	Preferred stock, conversion of a corporate bond cum equity (stock) warrant of the convertible bond type into shares, etc.	The exercise of equity warrants	Stock split	Others	Total
1975	11,208,343	10,069,329	522,069	60,959	555,986	–	3,317,692	574,654	15,100,691
1976	5,096,356	3,173,059	986,078	57,080	880,139	–	3,528,729	177,301	8,802,387
1977	7,004,703	5,055,820	1,218,824	183,356	546,703	–	3,762,386	65,645	10,832,736
1978	4,906,531	2,387,691	1,071,412	444,375	1,003,023	–	2,677,987	△154,435	7,430,084
1979	4,696,470	1,470,800	1,151,803	236,944	1,836,923	–	2,323,957	171,436	7,191,866
1980	5,900,618	1,761,008	1,619,438	311,354	2,208,818	–	3,270,677	34,846	9,206,243
1981	10,621,006	5,624,372	2,360,917	99,890	2,535,827	–	3,542,488	64,632	14,228,128
1982	4,919,006	1,932,416	1,760,389	111,822	1,102,860	11,519	4,265,996	318,347	9,503,352
1983	4,231,828	1,005,145	513,645	589,154	2,006,283	117,601	4,208,030	24,857	8,464,718
1984	5,312,713	1,170,322	778,686	319,665	2,835,670	208,370	4,033,612	169,830	9,516,159
1985	5,580,645	909,635	590,696	118,126	3,514,706	447,179	4,390,653	93,169	10,064,468
1986	4,503,842	371,191	346,883	78,308	2,831,297	876,161	3,939,802	621,924	9,065,569
1987	8,600,184	547,900	718,327	314,650	4,753,694	2,265,611	3,300,518	510,942	12,411,644
1988	9,052,096	849,464	1,286,177	169,633	4,623,233	2,123,587	4,004,200	96,212	13,152,509
1989	12,467,106	803,396	3,558,558	94,151	5,522,653	2,488,346	5,906,047	44,848	18,418,003
1990	4,733,374	758,546	1,284,250	252,593	1,859,145	578,839	8,283,600	1,632,879	14,649,854
1991	1,604,596	420,553	39,850	182,776	600,930	360,485	3,451,047	1,581,058	6,636,703
1992	766,227	244,895	2,180	190,340	139,205	189,605	1,584,403	414,121	2,764,752
1993	1,605,059	87,091	4,150	479,440	347,764	686,612	901,948	1,147,000	3,654,008
1994	1,530,474	24,152	33,360	543,846	445,479	483,635	2,330,679	1,190,447	5,051,602
1995	1,433,831	249,876	10,400	490,557	343,684	339,311	1,015,654	359,334	2,808,819
1996	2,546,611	455,200	200,883	583,427	506,753	800,348	847,835	1,873,163	5,267,610
1997	3,093,475	204,686	93,250	1,493,319	1,034,959	267,261	551,076	251,712	3,896,265
1998	3,641,490	7,707	97,337	2,380,126	1,079,024	77,295	168,263	22,696	3,832,450
1999	9,627,895	–	54,599	8,402,531	976,593	194,170	742,946	61,952	10,432,793
2000	3,709,565	87,140	84,200	2,621,987	835,744	80,492	1,599,465	1,158,762	6,467,792
2001	4,526,944	143,051	49,760	3,328,896	935,912	69,324	624,199	3,330,016	8,481,160
2002	4,260,986	–	238,268	2,719,749	546,153	756,815	692,917	1,412,881	6,366,784
2003	4,541,171	20,352	431,517	2,995,729	679,841	413,729	333,448	5,931,549	10,806,168
2004	5,659,174	18,193	516,166	1,586,466	2,404,691	1,133,656	2,975,260	24,497	8,658,931
2005	11,393,111	53,120	616,574	2,957,298	6,241,871	1,524,246	3,051,215	△13,967,015	477,311
2006	7,459,697	–	1,638,972	850,680	4,450,694	519,349	6,713,875	△1,201,938	12,971,634
2007	5,341,133	80,862	409,532	1,521,236	2,928,468	401,032	11,749,106	△3,504,021	13,586,219
2008	3,542,021	6,998	687,868	1,549,130	1,119,159	178,863	120,552	△542,754	3,119,819
2009	22,418,250	–	12,049,714	3,192,219	6,846,482	329,833	16,193,816	238,890	38,850,955
2010	10,464,418	68	7,548,008	1,935,650	835,992	144,697	877,229	△860,938	10,480,708
2011	6,391,284	–	2,947,644	2,283,962	839,211	320,465	1,842,238	625,267	8,858,789
2012	4,309,521	34,504	2,371,349	663,776	1,024,399	215,492	3,759,441	576,904	8,645,867

Sources: Tokyo Stock Exchange, *Shoken tokei nenpo* (Annual Report of Securities Statistics) and *Shoken tokei geppo* (Monthly Report of Securities Statistics).

market was a marginal marketplace for raising capital. However, as the economy slowed down after the oil shocks, the funding needs of businesses were reduced, and due in part to the necessity of securing a strong stockholder base, public offerings at market price became the prevalent means of raising equity among business corporations. Meanwhile, the weight of rights offerings also shifted from that based on par value to that based on a median of par and market values. In the second half of the eighties, as debt financing was increasingly deregulated, the issuance of corporate bonds with subscription rights/warrants increased, and so did their conversion and exercise. Particularly, as the banks came under pressure to meet Tier 1 capital requirements imposed by the Basel regulatory standards, they scrambled to shore up their capital base and accounted for about half of equity financing in the period.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

In the nineties, there was a marked decline in capital increases because of stagnant stock prices. At the time, new rules to ensure sound issuing of public stock offerings at market price were instituted. Among them, the Japan Securities Dealers Association adopted a profit distribution rule in March 1992 that required issuing companies to raise their dividend payout ratio to 30% or more and the Ministry of Finance, which was then responsible for securities regulation, issued guidelines requiring issuing companies to meet or exceed the threshold of 10% in their return on equity (ROE) in December 1993. These rules were abolished in March 1994, and the stock issuing market was fully liberalized. For all that, the public stock offerings market remained in the doldrums. However, following the global financial crisis that kicked off in 2008, the market picked up as companies sought to shore up their weakened financial bases by making paid-in capital increases. The public stock offerings market was particularly active in 2009, with the number of shares issued in public offerings reaching a record high of 12.0 billion shares. However, this figure fell to 750 million shares the following year.

5. New Shares Underwriting

The method of issuing shares may be divided into direct offering and indirect offering, public offering, and private placement.

When the issuing company itself performs the administrative procedures necessary for issuing shares and sells them to investors, this is called "direct offering (or self-offering)." Although this method helps the issuing company save the fees payable to an intermediary, it is not an easy task to perform the technically complicated procedures and sell the shares to an unspecified large

Table III-5. Number of Lead Managers in Underwriting Shares of Securities Companies (IPOs)

Existing stock exchanges and start-up markets in 2012

Securities Company	Existing Markets		Mothers		JASDAQ	
	No. of co.	%	No. of co.	%	No. of co.	%
Nomura	2	28.6	8	34.8	7	50.0
Daiwa	4	57.1	6	26.1	5	35.7
SBI	–	–	5	21.7	–	–
SMBC Nikko	–	–	2	8.7	–	–
Mitsubishi UJF Morgan Stanley	1	14.3	1	4.3	–	–
Mizuho	–	–	1	4.3	–	–
Mizuho Investors	–	–	–	–	1	7.1
SMBC Friend	–	–	–	–	1	7.1
Total	7	100.0	23	100.0	14	100.0

Source: PRONEXSUS, *Kabushiki Kokai Hakusho* (White Paper on Public Listings).

number of investors. When the issuing company commissions a specialist intermediary to handle the public offering of its shares, this is called "indirect offering." The intermediary provides the issuing company with expert advice, handles the distribution of shares and performs the necessary administrative procedures on behalf of the issuing company, and takes over the shares remaining unsold after the public offering period. At present, almost all shares are offered through the indirect offering method.

A "public offering" is the public solicitation of an unspecified large number of investors for the purchase of new shares, and "private placement" is the private solicitation of a specified small number of investors to purchase them. In public offerings of new shares, indirect offering through underwriting securities companies is the general rule.

In the case of an indirect offering, the issuing company concludes an underwriting agreement with a securities company. Underwriting agreements are divided into standby underwriting (the underwriting securities company commits itself to buying up the shares remaining unsold) and firm commitment underwriting (it agrees to buy up the entire issue from the start). Today, the latter has become the general practice.

When the total amount of shares offered is too large, a securities company alone cannot accept the underwriting risk involved. Therefore, a number of securities companies often get together to form an underwriting syndicate. Of these, the firm that plays the leadership role in organizing the syndicate members and in negotiating the terms and conditions of the underwriting agreement is called "the lead manager." And the group of securities companies that assumes no underwriting risk and only sells the shares is called "the selling group."

In an initial or secondary offering, it is necessary to have a strategy for balancing supply and demand. Using an over-allotment option allows the securities firm that is the lead manager of an offering to borrow shares from existing shareholders and sell them if demand is greater than the original scheduled number of shares. In Japan, lead managers of offerings have been able to use the over-allotment option based on the underlying underwriting agreement since January 31, 2002. It allows the sales of additional shares up to 15% of the scheduled number of shares in the initial or secondary offering. The short position arising when the lead manager uses the over-allotment option is cleared differently depending on whether the price in the secondary market has risen or fallen compared with the initial offering price after the offering. When the price of the shares has fallen the lead manager purchasing the excess shares in the secondary market (syndicate cover). When the price of the shares has risen, the lead manager exercises a greenshoe option (right to acquire additional shares from the issuing company or from investors who have lent shares).

6. Private Equity Market

Public offerings and other equity financing that raise capital from the general public are mostly conducted by public companies that have their shares traded on an exchange or other public market. However, that does not mean that equity financing by private companies faces special legal restriction. Far from it. Equity financing regulations for private companies can be said to be less strict than those for public companies. The notification statement does not require information concerning the operating performance or financial conditions of the issuer because, unlike the registration statement, it is not intended to disclose information to investors. Under the Financial Instruments and Exchange Act and cabinet office ordinance currently in force, furthermore, in cases where the proceeds from a proposed offering (of primary or secondary shares) are less than ¥100 million, the issuer is exempt from filing a registration statement, and a notification statement is filed in its place, regardless of whether the solicitation is extended to 50 persons or more or not. Furthermore, if the proceeds from an offering do not exceed ¥10 million or fewer than 50 persons are solicited, the issuer is not, in principle, required to file a notification statement.

However, when viewed from the standpoint of general investors, private equity investments, given the limitations on information available to them,

Table III-6. Criteria for Requirement to Submit Securities Registration or Notification Statements Under the Financial Instruments and Exchange Act and Cabinet Office Ordinance

		No. of Investors*	
		Less than 50	50 or more
Issue Amount	100 million yen or more	Not necessary	Securities Registration Statement
	10 million yen or greater but less than 100 million yen	Not necessary	Securities Notification Statement
	Less than 100 million yen	Not necessary	

**Notes:* 1. Under the current FIEA and Cabinet Office Ordinance, even when the number of investors solicited is less than 50, if the issuer has made an offering of the same type of securities within six months previously and the combined number of investors solicited is 50 or more, the determination of whether a registration or notification statement is required must be made based on the total issuance amounts of the offerings.

2. In accordance with a revision of administrative orders effective April 1, 2003, issuance regulations have been liberalized as follows.

(1) Under specified condition of the number of qualified institutional investors being 250 or less, etc., the number of professional investors (qualified institutional investors) may be deducted from the count of the number of investors being solicited.

(2) In determining the issuance amount for a professional investor private equity offering where only qualified institutional investors are counterparties and there is little possibility of sales to anyone other than qualified institutional investors, equities, etc. and equity related products are to be included. In this case, regardless of the number of investors, the registration statement is required only for issues of 100 million yen or more (for solicitations of investor groups of less than 50, please see note 1 above).

involve higher risks. More than anything else, the problem with private equity investments is that the funds invested in them are not easily recoverable due to lack of liquidity. At one time, not only was there no market, but also securities companies themselves were prohibited by regulations from trading in private equity shares and, in practical terms, trading was even difficult on the OTC market. Since it was difficult to recover funds until the company went public, investment in private equity was limited to a small number of investors, such as venture capital funds, which have the economic wherewithal to tolerate the high risks and long investment periods associated with such investments.

In recognition of the necessity of stimulating business startups and nurturing venture-type companies, the JSDA relaxed some of its regulations in June 1997, and launched a public quotation system (Green Sheet) for private equity or unlisted shares. Securities companies became able to solicit investment in private equities for issues of OTC securities that met a certain standard of

Table III-7. Green Sheet Issue Designations

Designation by special feature of issuer, indicated by securities company when registering on Green Sheet 1. Emerging issues A category for the stocks, etc. of issuers that have been determined to appropriate for inclusion in the green sheets based on their growth potential and other factors in a review done by the registering securities company. 2. Ordinary issues A category for the stocks, etc. of issuers that have been determined to appropriate for inclusion in the green sheets in a review done by the registering securities company. 3. Investment trust and SPC issues A category for preferred subscription and investment certificates of issuers that have been determined to appropriate for inclusion in the green sheets in a review done by the registering securities company.

Note: The Regional system, a category for stocks, etc. of issuers that fit neither into the Emerging or Phoenix categories, was abolished on April 1, 2005. The Phoenix system, a category for delisted or deregistered issues that have been determined to appropriate for inclusion in the green sheets for the purpose of maintaining liquidity in a review done by the registering securities company, was abolished on March 31, 2008.
Source: JSDA website

information disclosure and for which the securities companies provide publicly announced buy and sell quotes. The Green Sheet market provided a new way for companies to source capital in their pre-public listing stage. Moreover, as part of the reform of the securities market, efforts were made to strengthen and expand the Green Sheet market. In addition, Green Sheet issues were incorporated into the Securities and Exchange Law (now the FIEA) on April 1, 2005, making them subject to insider trading regulations.

Through this process, Japan established a market for private equities. At the same time, fierce competition grew up among stock markets resulting in successive lowering of listing requirements. These factors combined to greatly reduce the time required to go from corporate establishment to public listing of shares.

CHAPTER IV

The Stock Trading Market

1. The Structure of the Stock Trading Market

The stock trading market on which shares are traded consists of a trading market opened on a stock exchange, a proprietary trading system (PTS) operated by private companies authorized under the 1988 amendment to the Securities and Exchange Law, and the off-exchange trading of listed stocks that was made possible by virtue of the same amendment, which abolished the duty to centralize securities trading on stock exchanges.

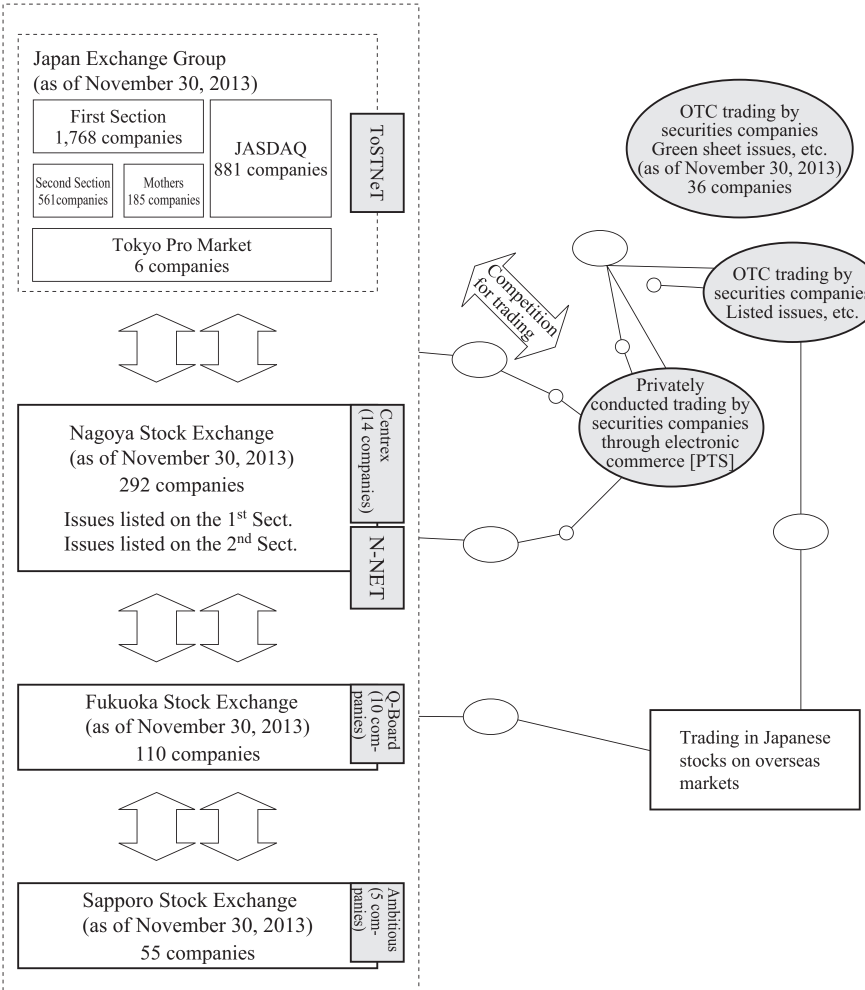
The exchange market is provided by stock exchanges, and there are four stock exchanges in Japan: the Japan Exchange Group (JPX) formed from the combination of the Tokyo and Osaka exchanges, Tokyo and the Nagoya, Sapporo, and Fukuoka exchanges. Stock exchanges used to be membership organizations consisting of securities companies. However, under the 2000 amendment to the Securities and Exchange Law, they are authorized to change their status as joint stock companies, and the Japan Exchange Group and the Nagoya Stock Exchange have already done so.

Shares of listed stocks that meet certain listing requirements are traded by auction during fixed trading hours. With a view to ensuring the fairness of trading, stock exchanges as self-regulatory organizations manage and supervise the trading process and the business conduct of securities companies.

In addition, shares of companies that are not listed on a stock exchange or not registered with the over-the-counter (OTC) market are traded over the counters of securities companies, and such transactions have been are reported to the Japan Securities Dealers Association (JSDA; this is called "the green-sheet market"), but the volume of trading in these issues is quite limited. Off-exchange trading of shares listed on the Tokyo Stock Exchange (ToSTNeT) accounts for 8.0% of all trading in listed shares. Certain securities companies have opened a proprietary trading system (PTSs) on their own mainly for the purpose of matching orders received after business hours.

Since a few years ago, breakdowns of the trading computer systems have occurred at securities companies and stock exchanges, erroneous orders have passed undetected, and other irregularities such as buy or sell orders with no

Chart IV-1. Inter-market Competition in Japan



intention of execution have occurred on repeated occasions. As a result, in January 2010, the Tokyo Stock Exchange introduced its new worldclass high-speed trading system "arrowhead" to enhance confidence in its market.

2. Volume of the Stock Trading Market

As of December 31, 2011, the number of companies listed on the nation's stock exchanges (including multiple listings) stood at 3,592, of which 2,279 were on the Tokyo Stock Exchange (TSE). The number of shares listed on the TSE had increased to 383.3 billion, with a total market capitalization of ¥255.9 trillion ($2.50 trillion*). And the value of listed shares traded on all of Japan's stock exchanges was ¥255.8 trillion ($2.50 trillion).

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

The concentration of stock trading on the TSE is extremely high. The TSE accounts for about 60% of the nation's listed stocks, and the number of issues listed only on regional stock exchanges stood at 1,292. In terms of value only, the TSE accounts for a little under 90% of the nation's stock trading. The heavy concentration of stock trading on the TSE may be explained by the fact that the stock markets have taken on a hierarchical structure, with the First Section of the TSE at the top, and that business corporations that are bent on enhancing their social status have sought to list their stocks on the First Section. Therefore, blue-chip corporations have tended to converge on the First Section of the TSE. And as shares are actively traded in large volumes and on a highly liquid market, the externality of the order flow—trading flows to where shares are actively traded—was at work accelerating the concentration of orders.

The number of stocks listed on the JASDAQ market (formerly the over-the-counter market), which had become a regular stock exchange in December 2004, stood at 881 at November 30, 2013, with a total market capitalization of ¥11.47 trillion ($111.9 billion), and the total value of shares traded on this market during 2012 amounted to ¥5.10 trillion ($49.7 billion). These figures far exceeded the Second Section of the TSE, with which the JASDAQ market competes for business in terms of the number of shares listed (881 vs. 561); total market capitalization (¥11.47 trillion vs. ¥5.44 trillion); and trading volume (¥5.10 trillion vs. ¥901.2 billion).

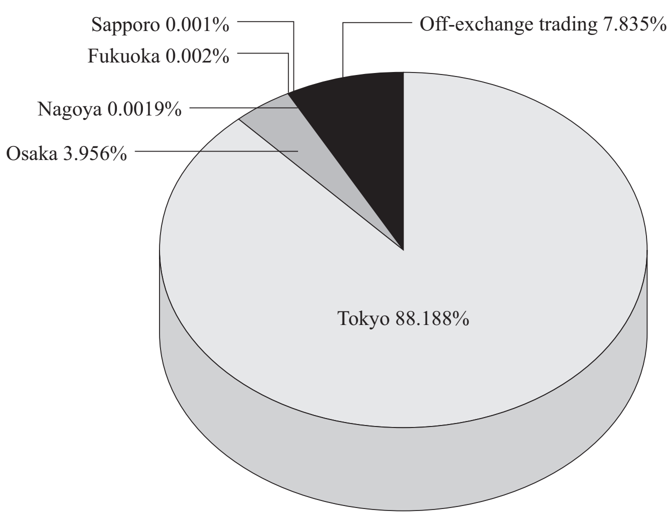
Other emerging stock markets include the Mothers market opened on the TSE in November 1999, the NASDAQ Japan market established on the Osaka Securities Exchange in June 2000, the Centrex market of the Nagoya Stock Exchange, the Ambitious market of the Sapporo Stock Exchange, and the Q-Board market of the Fukuoka Stock Exchange. Competition among the

Table IV-1. Trading Volumes of Major Stock Exchanges and the OTC Market

Year		2004	2005	2006	2007	2008	2009	2010	2011	2012
Trading Volume (in 1,000 shares)	TSE 1st Sect.	357,034,276	508,310,426	477,894,218	545,835,876	541,576,224	552,098,670	511,695,772	524,646,772	519,754,423
	TSE 2nd Sect.	18,313,846	39,978,729	20,822,649	15,146,248	11,775,067	10,202,351	7,315,086	9,850,350	7,703,508
	OSE 1st Sect.	5,919,585	7,940,742	5,657,666	5,145,304	5,734,251	6,369,508	4,884,700	6,505,596	5,260,315
	OSE 2nd Sect.	4,203,150	6,199,427	3,946,858	3,178,646	3,879,093	4,428,690	2,763,250	5,827,921	2,702,625
	JASDAQ	10,749,746	37,179,736	21,306,415	12,291,369	11,288,330	13,461,273	7,780,105	11,627,350	11,347,773

Sources: Japan Securities Dealers Association, Tokyo Stock Exchange, Osaka Securities Exchange.

Chart IV-2. Trading Volume, by Stock Exchanges (2011)



Source: Tokyo Stock Exchange, *Toshi yoran* (TSE Fact Book), 2012.

stock exchanges for winning over candidates for stock listings has since become increasingly fierce. In August 2007, JASDAQ joined the race with NEO, its version of a new market for venture businesses.

Subsequently, as NASDAQ of the United States withdrew from the market, NASDAQ Japan changed its name to Hercules. And in October 2010, the Hercules, JASDAQ, and NEO markets merged to become a new JASDAQ market.

In July 2013, the cash markets of the Tokyo Stock Exchange and Osaka Securities Exchange, forming the Japan Exchange Group (JPX). As a result, JPX is now part of the same group as JASDAQ, the Mothers market, and the TOKYO PRO Market.

US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

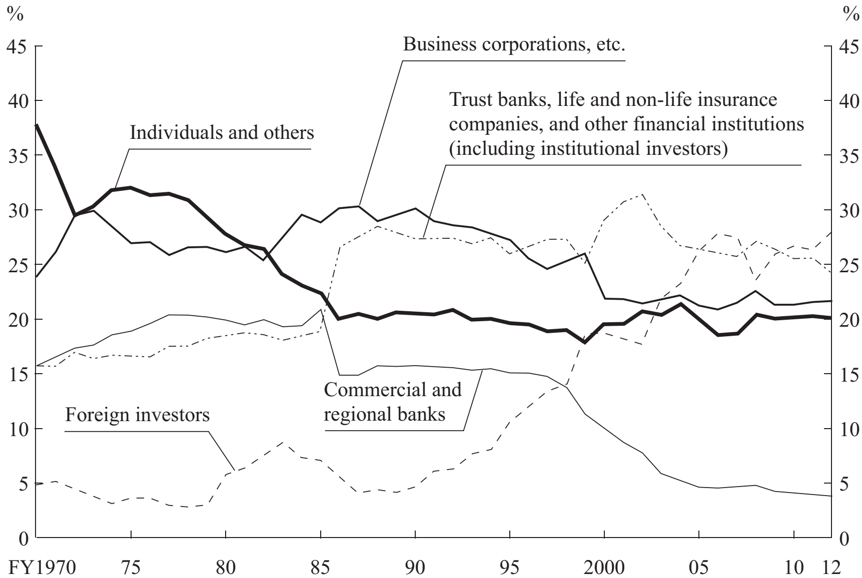
3. The Structure of Share Ownership

Following the liquidation of the *zaibatsu* (great industrial or financial conglomerates or holding companies) after the war, shares held by them were released to the stock market for distribution among individual investors. And the ratio of shares held by individual shareholders rose to 69.1% in 1949. However, as not many of them could afford to hold these shares for the long haul, they liquidated their holdings soon after they had acquired them, with the result that the ratio of individuals' shareholdings declined rapidly. And due in part to the fact that some investors had cornered these shares, groups of companies that had belonged to former *zaibatsu* started cross-holding one another's shares to strengthen their group solidarity.

In the 1960s, capital transactions were liberalized. For fear of a hostile takeover by foreign firms taking advantage of liberalized capital transactions, Japanese firms sought to build a strong shareholder base, and the ratio of the shareholdings of business corporations and financial institutions was increased. Subsequently, the system of issuing shares at par value was changed to one of issuing at market price, making it necessary for them to maintain their share prices at a high level if only to enable them to raise equity funds with the issuance of fewer shares. And this helped push up the ratio of the shareholdings of business corporations in the years to 1975. Meanwhile, encouraged by the long-continuing bull market, financial institutions also continued to build their equity portfolios and increased the ratio of their stock holdings until the end of the speculative bubble in 1989.

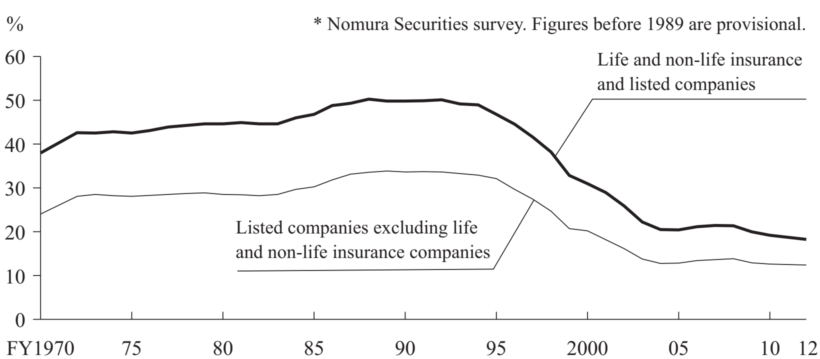
The corporate domination of the shareholdings structure thus brought about had an important impact on the formation of stock prices. While individuals and institutional investors bought stocks as an investment to earn yields (profit-earning securities), business corporations or financial institutions bought shares for the purpose of strengthening corporate affiliations or business tie-ups as a means of gaining control of the management. Therefore, these corporations held such shares for the long haul (management-stake securities) without regard to yields on investment, and yields on such shares tended to decline. As a result, the prices of such shares rose to a level that was beyond the reach of individual investors who invested in shares on the basis of the yield they produced. And as individual investors had no choice but to aim at making capital gains under such circumstances, the rate of turnover of their investments had of necessity to increase. This was why individual investors took to highly speculative investment, bringing about a special

Chart IV-3. Changes in the Ratio of Shares Held by Different Categories of Investors



Source: Kabushiki bunpu jokyo chosa (A Survey of the State of Distribution of Shares), FY2012.

Chart IV-4. Ratios of Cross-Shareholdings



Source: Sankei Biz, September 5, 2013.

structure of the stock market in this country.

However, as unrealized capital gains on stock investment shrank sharply due to steep falls in stock prices after the burst of the speculative bubble, holding shares was no longer an attractive investment for business corporations. What is worse, stock prices have dropped below their acquisition cost since the autumn of 2001, and as the system of valuing their shareholdings at their market prices was introduced applicable to the term that ended September 2001, banks had to deduct 60% of the unrealized losses from their earned surplus. In the 2000s, cross-shareholdings among nonfinancial companies started to rise again as defensive measures against corporate takeovers and other uninvited contests for corporate control. Although stock prices jumped recently beginning at the end of 2012, the cross-shareholdings ratio has remained level.

4. Stock Prices and Indicators for Investment (1)

Theoretical prices of assets such as land and stocks represent rents or dividends, as the case may be, capitalized by a certain rate of return of capital (interest rate plus risk premium). As only a small part of such assets is actually bought or sold, the total asset value is computed by multiplying the total of such assets by the prices formed through such transactions. For instance, the total market valuation of stocks listed on the First Section of the TSE as of November 28, 2013, was ¥446.16 trillion ($4.35 trillion), but the value of shares actually traded on that day was ¥1.97 trillion ($19.20 billion). This indicates that the total market valuation of stocks listed on the TSE is computed on the basis of share prices formed through the trading of a little under ¥2 trillion worth of shares. (Actually, it represents a sum total of the market valuation of all listed stocks, and the above explanation is intended to simplify the picture.)

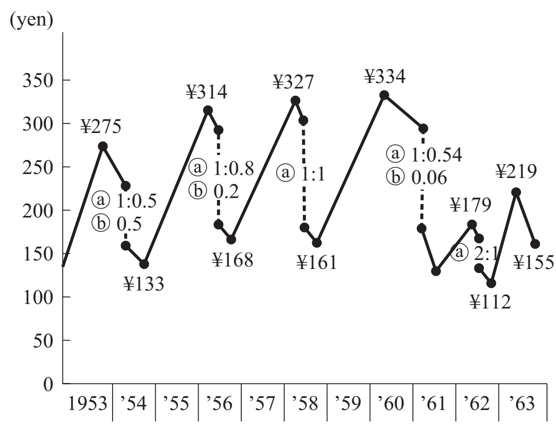
At this stage, whether the given price of a stock is high or low is judged by comparing its dividend yield with the market interest rate then prevailing. In other words, an investment opportunity to generate better-than-average earnings, working through competition among investors who seek such investment opportunities, equalizes the dividend yield on a given stock to the market rate then prevailing. However, if oligopoly strengthens in a given industry group and the earnings gap among companies belonging to the same industry group widens, those with higher growth potential tend to reinvest a larger portion of their profit as retained earnings. (Typical of this tendency are the former IBM and Microsoft, which had no dividends until the end of 2002.) Under such circumstances, dividend yields cannot be computed, and the level of stock prices becomes irrelevant as an indicator for investment.

Table IV-2. Stock Split-ups and Changes in Divisor

Issue	Before stock split-ups		After stock split-ups	
	No. of shares	Stock price	No. of shares	Stock price
A	10	$20	20	$10
B	10	10	10	10
C	10	6	10	6
Total	30	36	40	26
Dow divisor	3		2.1667	
Modified Dow average	12		12	

Sources: J. H. Lorie and M. T. Hamilton, *The Stock Market*, 1973 (Japan Securities Research Institute, Japanese translation *Shoken kenkyu*, Vol. 51, 1977, pp. 73ff,)

Chart IV-5. Stock Price and Capital Increase of Toray Industries



Notes: ⓐ Rights offering.
ⓑ Free distribution of shares.

As highly profitable business enterprises increase their capital by reinvesting their earnings instead of issuing new shares, their per share profit increases and the price of their stock rises proportionately thereto. If their stock price rises too high, small investors cannot buy their shares, with the result that the marketability and liquidity of their shares suffer. Therefore, such companies seek to recover the marketability of their shares by lowering their stock prices by means of stock split-ups or stock dividends—forms of issuing new shares that do not require payment for the new shares.

If a significantly large number of companies follow this capital management policy, such practice is bound to affect the stock price indicator. Assuming that other conditions remain unchanged, a stock split-ups at the rate of one to two would half the price of such shares. However, as the number of shares a shareholder of such company holds would increase twice as a result of the stock split-ups, and the company's price would be halved, the total market value of the shares held by such a shareholder would not change. The Dow scaled average represents the average of original stock prices as seen from the standpoint of pre-stock split-ups shareholders. The Dow Jones Industrial Average is computed by changing the divisor each time stock split-ups or other dilutions occur.

5. Stock Prices and Indicators for Investment (2)

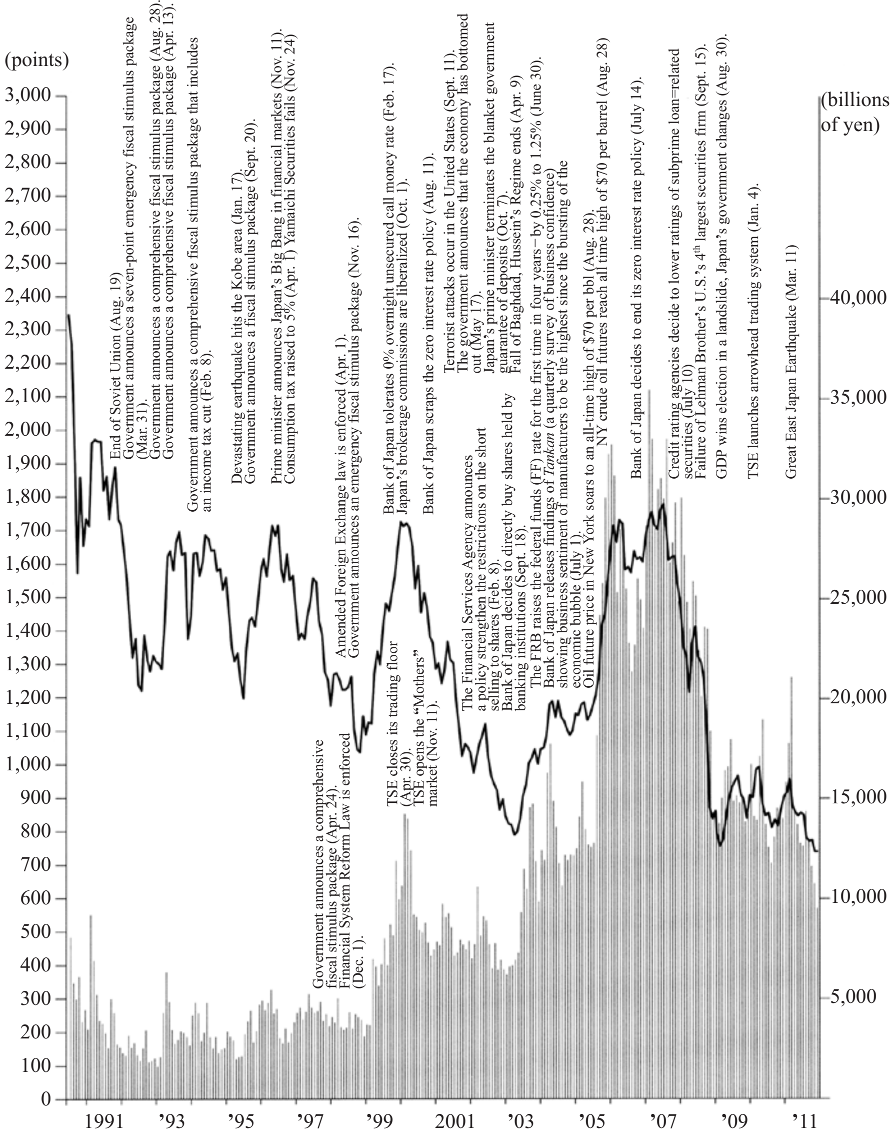
In Japan, the *Nihon Keizai Shimbun* (the *Nikkei Daily*) has devised several Dow indexes (the Nikkei average), typical of which is the Nikkei 225. This is an index that measures changes in the stock prices of 225 leading issues listed on the TSE representing various industry groups. Whenever a stock split-ups or dividend is reported or whenever any of the 225 issues is replaced by another issue, the Nikkei average is computed by using a changed divisor. The Nikkei 225 started with a divisor of 225. Subsequently, however, the divisor has continued to decrease and dropped to 25.480 on November 28, 2013, with the result that its multiple has risen to 8.830. This means that when the simple average of the stock prices of the 225 issues rises or falls ¥20, the Nikkei average will increase or decrease ¥176.6 The Dow average is designed to restore the continuity of stock prices on the basis of the total market value of the original shares (shares before the stock split-ups) held by an investor when shares are issued without requiring payment therefor (stock split). However, it actually shows a rise or fall several times larger than what occurred in the simple average of stock prices. Such being the case, the Nikkei average is misleading, and mounting demand for its replacement with another index is being voiced among investors.

Acknowledging that the Nikkei average no longer reflects fairly the changed market reality brought about by the information technology (IT) boom, in April 2001 the *Nihon Keizai Shimbun* (Nikkei) replaced as many as 34 issues out of the 225 issues at a stroke. However, as the stock prices of IT-related issues fell sharply in June of the same year, the new Nikkei average dropped more sharply than the old Nikkei average would have, and this also drew the strong criticism of investors.

As the Nikkei average is an unweighted average computed on the basis of

Chart IV-6. Changes in the TOPIX and Trading Volume

TOPIX: Jan. 4, 1968 = 100 points, end-of-month figure
The Tokyo Stock Price Index (TOPIX) calculates the total value of the market by multiplying the price of each domestic stock on the First Section of the TSE by the number of shares issued and outstanding and indicates share price movement based on total movement in capitalization.



simple average stock price, it is strongly affected by a rise or fall in the prices of scarce stocks or high-priced stocks. This is why market watchers pointed out the possibility of a manipulation of the stock index when trading in the Nikkei stock index futures increased sharply in the first half of the 1990s. As a result, the *Nihon Keizai Shimbun* developed a new index called the Nikkei 300 in 1994 to supersede the Nikkei 225.

Indexes of total market value that are designed to remedy these shortcomings of the Dow average are the New York Stock Exchange Composite Index, Standard & Poor's (S&P) 500 index, and the TOPIX. The TOPIX represents the total market value of all issues listed on the First Section of the TSE computed on the basis of their total market value of 100 as of the TOPIX's base day (January 4, 1968). Characteristics of the TOPIX are (1) that it covers all issues listed on the First Section of the TSE and therefore has become an index that reflects changes occurring in the nation's industrial structure and stock price trends and index that can avert the discontinuity that might occur when its component issues are replaced by others; (2) that one can easily determine changes occurring in the scale of the market as measured in terms of its total market value; and (3) that it is weighted by the number of shares of listed issues and therefore is relatively immune to a rise or fall in the prices of scarce stocks or high-priced stocks.

6. Stock Prices and Indicators for Investment (3)

As room for the discretionary implementation of capital management policy grew and diversified, the weight carried by capital gains in determining an investment policy increased and the importance of dividends or return on investment as an indicator for investment decreased. Therefore, the comprehensive yield that adds dividends to capital gains has been used. And a growing number of investors have come to attach importance to the price earning ratio (PER), which is the quotient of the per share stock price divided by profit; that is, a reciprocal of return on investment.

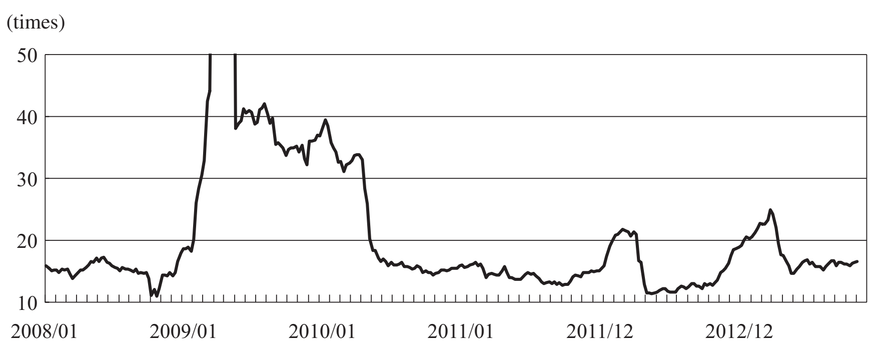
The reason that the PER became a popular indicator for investment was the growth potential of issuing companies. In other words, as companies with high-growth potential continued to follow capital management policies that attached importance to retained earnings and the reinvestment of profit, dividend yield (a traditional indicator for investment) decreased, making it difficult for brokerage firms to put out buy recommendations on such shares. A phenomenon representative of this was what was known as the yield revolution—in which dividend yield fell below bond yield—that occurred in the United States in 1958. In Japan, also, a similar situation occurred in the 1960s.

Table IV-3. Earnings Ratio of the First Section of the TSE (by investment periods and weighted average %)

Year bought \ Year sold	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1994	−13.1	1.1	−2.5	−4.5	0.5	3.4	0.5	−1.4	−1.6	1.0	2.4	4.5	4.5	1.9	0.2	0.5	0.3	0.3
1995		17.7	3.2	−1.4	4.2	7.1	3.0	0.3	0.0	2.7	4.1	6.2	6.1	3.2	1.2	1.4	1.2	1.1
1996			−9.4	−9.8	0.1	4.6	0.3	−2.3	−2.3	1.0	2.7	5.2	5.1	2.0	0.1	0.4	0.2	0.2
1997				−10.2	5.2	9.7	2.9	−0.8	−1.1	2.6	4.3	6.9	6.7	3.2	0.9	1.2	0.9	0.8
1998					23.1	21.3	7.7	1.7	0.9	4.9	6.5	9.3	8.7	4.6	2.0	2.2	1.8	1.7
1999						19.5	0.7	−4.6	−4.1	1.5	4.0	7.4	7.1	2.7	0.1	0.5	0.2	0.2
2000							−15.1	−14.7	−10.8	−2.5	1.1	5.5	5.4	0.8	−1.9	−1.3	−1.4	−1.3
2001								−14.3	−8.6	2.1	5.7	10.2	9.3	3.3	−0.1	0.4	0.1	0.1
2002									−2.5	11.4	13.3	17.4	14.7	6.6	2.1	2.4	1.9	1.6
2003										27.4	22.1	24.9	19.4	8.5	2.9	3.1	2.4	2.1
2004											17.1	23.6	16.9	4.2	−1.4	−0.4	−0.7	−0.7
2005												30.5	16.8	0.2	−5.5	−3.6	−3.4	−3.0
2006													4.5	−12.2	−15.1	−10.6	−9.0	−7.7
2007														−26.2	−23.5	−15.2	−12.2	−9.9
2008															−20.8	−9.1	−6.9	−5.3
2009																4.4	0.9	0.5
2010																	−2.4	−1.4
2011																		−0.4

Source: Japan Securities Research Institute, *Kabushiki toshishuekiritsu* (Rates of Return on Common Stocks), 2012.

Chart IV-7. Forward Looking PER of the First Section of the TSE



Source: Compiled by Daiwa Institute of Research based on data from Tokyo Stock Exchange and *Toyo Keizai magazine*.

In such a situation, the need arose to link the growth potential of a company to the level of its stock price one way or another in order for brokerage firms to put out buy recommendations on such shares, and the answer was the PER. In other words, the PER shows multiples of earnings at which the underlying shares are bought and sold. Therefore, when the shares of a company traded are at a high multiple, it means that the market believes that the company has high growth potential. Actually, securities companies compare the PER of an issue with the industry average or with other issues belonging to the same industry group, on the basis of which they determine whether the issue is overvalued or undervalued. What is more, the PER is used not only as an indicator of share prices of individual issues but also as a measure to compare the stock price level of a country with the levels of other countries. Today, it has thus become one of the typical indicators of stock prices.

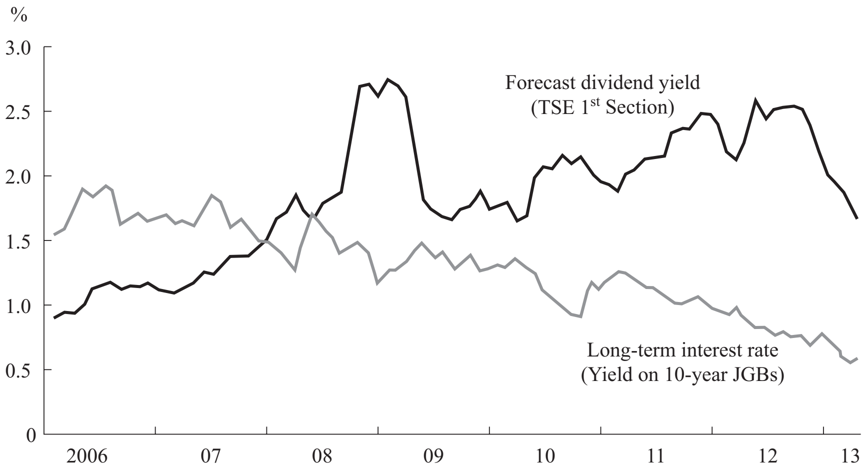
However, while stock yield can be compared with an objective indicator (such as market interest rates), the PER has a drawback in that it can be compared with other indicators only relatively. For instance, as is often pointed out, the PER of the S&P 500, one of the major stock indexes of the United States, has moved between 15 and 30 since the war, but the Nikkei 225 of Japan has risen as high as 80 in the past. (At November 29, 2013, the unconsolidated PER of the TSE First Section stood at 25.68.) The difference between the levels of the PERs of the two countries was attributed to the difference in the business accounting system (notably, the method of depreciation) and the cross-shareholding system of Japan. To be sure, it is possible that these factors affected the PER level of Japan. More important is the fact that there was no valid PER level to start with.

7. Stock Prices and Indicators for Investment (4)

While the PER shows the relationship between per share earnings and stock prices, earnings vary depending on the method used to calculate them. Particularly, depreciation charges are deducted from taxable income (which, therefore, cuts into earnings), but investment in plants and equipment underlying such depreciation contributes significantly to future earnings. Therefore, a stock price indicator based on earnings could sometimes mislead investors when they make an investment decision.

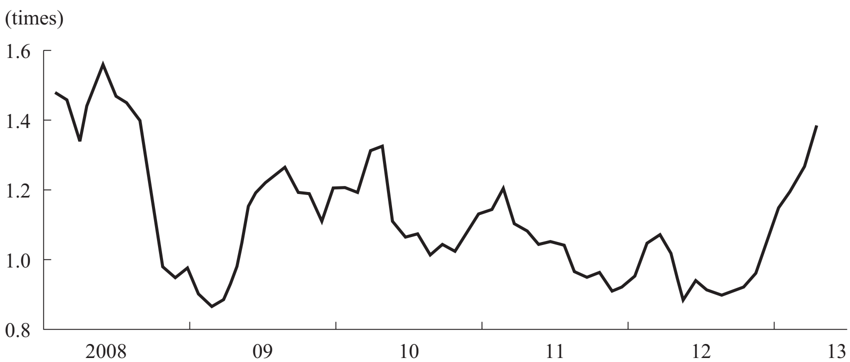
The price/cash flow ratio (PCFR) is an indicator designed to reflect the growth potential of a company based in its share price. The PCFR is computed by dividing the stock price then prevailing by the sum of the after-tax income and depreciation charges for the term, minus any dividends and officers' bonuses. As depreciation charges are retained and reinvested at a later date, they are an important factor to take into account in assessing the growth

Chart IV-8. Dividend Yields of TSE First Section Companies and Long-Term Interest Rates



Note: Figures include period up to April 30, 2014.
Sources: Tokyo Stock Exchange and Bank of Japan.

Chart IV-9. Average Consolidated PBR Ratios of TSE First Section Companies



Note: Figures for 2013 are at the end of April, all others are at the end of December.
Source: Tokyo Stock Exchange.

Table IV-4. Calculation for PER, PBR, PCFR

$$\text{PER} = \frac{\text{Stock price}}{\text{Per share after-tax income}}$$

$$\text{PBR} = \frac{\text{Stock price}}{\text{Per share net asset value}}$$

$$\text{PCFR} = \frac{\text{Stock price}}{\text{After-tax income + depreciation charges} - \text{(dividend + officers' bonus)}}$$

potential of the company, as they indicate its real earnings and cash flow.

The PCFR is generally used in comparing the stock price of a company with the stock prices of other companies belonging to the same industry group and particularly in evaluating the stock prices of high-tech companies whose future competitiveness is largely determined by the scale and components of their capital investment.

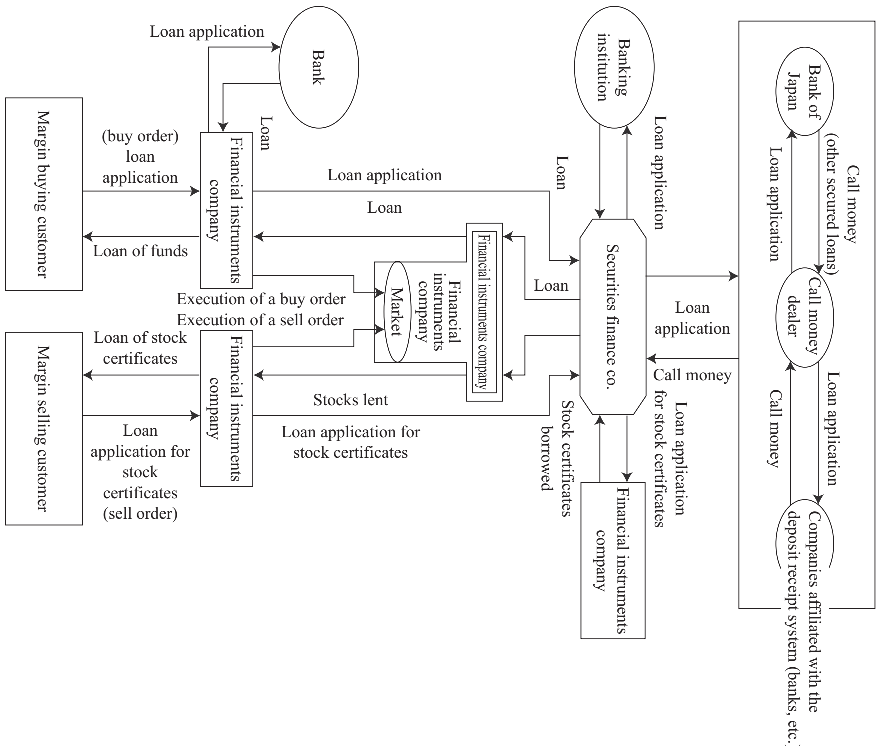
Another frequently used indicator for investment is the price book value ratio (PBR), which shows the relationship between net asset value owned by a company and its stock price. The PBR of a company is computed by dividing its stock price by its per share net assets. The net assets of a company represent the sum of the capital and earned surplus, etc., which is called equity capital, and they are computed by deducting liabilities (debt, etc.) from the total assets listed on the debit side of the balance sheet. In other words, it is the net assets that would remain after repaying all the debts of a company out of the proceeds of its assets when the company is dissolved at a certain point of time. The PBR is an indicator that compares the stock price of a company prevailing at a given time with its per share liquidation net asset value. Therefore, when the PBR of any company falls below one (or below its per share liquidation net asset value), the stock price of such company is often considered undervalued.

It is to be noted, however, that the use of the PBR as an indicator for investment is based on the assumption that it reflects the actual per share book value of its issuing company. If the actual asset value of the land and shareholdings of a company falls below book value of the land and shareholdings on account of an unrealized loss, the stock price of such issue, even when its PBR is below one, cannot be considered undervalued. If such a situation arises, and the stock market functions efficiently to a certain degree, companies will have to actively seek to merge with, or acquire, another company. In fact, a string of corporate mergers and acquisitions (M&A) did happen on the U.S. stock markets when Tobin's q (a modified version of the PBR) fell below one. The PBR of the First Section of the TSE stood at 1.1 on November 29, 2013.

8. The Margin Trading System (1)

Shin'yo torihiki (margin trading) is a system crafted on the model of the margin trading conducted in the United States and was introduced into Japan in June 1951 with a view to stimulating speculative demand for securities trading. Margin trading is a transaction in which an investor buys a certain number of shares of a stock, or sells unowned shares, with funds borrowed from a financial instruments company (securities company) by depositing a margin

Chart IV-10. Outline of Margin Trading and Stock Lending Transactions



・Margin Trading (between a customer and a financial instruments company)
Collateral: Shares bought (or the proceeds from the sale of the shares sold).
Margin: 30% or more of the market price of the shares bought (or sold) on margin. (When a substitute security is deposited, such security will have a collateral value of up to 80% or less of its market price.) However, the minimum amount of the margin in all cases is ¥300,000.

・Stock lending transaction (between a financial instruments company and a securities finance company)
Collateral: The shares bought by a customer (or the proceeds from the sale of such shares).
Guarantee deposit: 30% or more of the market price of the shares bought or sold by the customer. (When a substitute security is deposited, such security will have a collateral value of up to 80% or less of its market price.)

Note: The margin rates and the percentage of the collateral value of securities mentioned above are subject to change from time to time.

with such financial instruments company. This method thus gives the investor the advantage of buying or selling a certain number of shares without owning the full amount of funds required to pay for such shares or the full number of shares to be sold. On the other hand, the financial instruments company that receives such an order from its customer must settle the transaction on the fourth business day from the date of such transaction. As there was no stock lending market or securities financing market in the early days, a securities finance company was created to help financial instruments companies reduce their burden of having to provide cash or stock certificates for the settlement of such margin trading. This is called a stock lending transaction.

The lending transaction is one in which a securities finance company lends a financial instruments company, through the settlement organization of a stock exchange, funds or stock certificates that are approved as "margin trading issues" under an exchange's system and that are needed to settle a margin transaction. The securities finance company can save costs and expenses by internally offsetting applications for a loan of shares of a certain stock against those for lending shares of the same stock—more specifically, by lending the money it collects from a margin selling investor (or stock certificates it collects as collateral from a margin buying investor). When a shortage of funds develops after offsetting, the securities finance company meets the shortage by borrowing the amount of such shortage from a bank, the call market, or the Bank of Japan. When a shortage of stock certificates develops after offsetting, it can borrow them by inviting bids from financial instruments companies and institutional investors (see the chart on the next page). Stocks that can be margin traded or lent for margin trading purposes are called margin trading issues or loanable issues. Margin trading issues are selected from among listed stocks, etc., based on standards set by the financial instruments exchange. On the other hand, loanable issues are selected from the perspective of ensuring liquidity to handle speculative demand based on their liquidity or the number of holders. Moreover, there are added restrictions on the amounts that can be borrowed.

The securities finance companies are the successors to the agencies that had handled the deferred settlement of short-term futures transactions (time bargains) before the war and that were recognized as moneylenders after the war under the Law Concerning the Regulation of the Money-Lending Business. These agencies filled the gap created by deferred settlement by making the payment (or by delivering stock certificates) on behalf of the buyer (or the seller) and by taking delivery of stock certificates (or funds) as collateral as the case may be. Because the role securities finance companies play in the market has grown along with expansion in margin trading, to strengthen their function the government made them subject to licensing by the Ministry of Finance in April 1956. Since then, there has been significant consolidation among securities finance companies serving each regional stock exchange. Presently, they have been consolidated into two firms: Japan Securities Finance (Tokyo) and Chubu Securities Finance (Nagoya).

Table IV-5. Comparison of Standardized and Negotiable Margin Transactions

	Standardized margin transactions	Negotiable margin transactions
Margin deposit	30% or more of trade	30% or more of trade
Loan rate (negative interest)	Rate set by financial instruments exchange	Agreement by parties
Repayment due date	Up to six months	Agreement by parties
Eligible issues	Issues approved by exchange	In principle, all listed stocks
Rights processing	As determined by exchange	Agreement by parties
Financing	Available	Not available

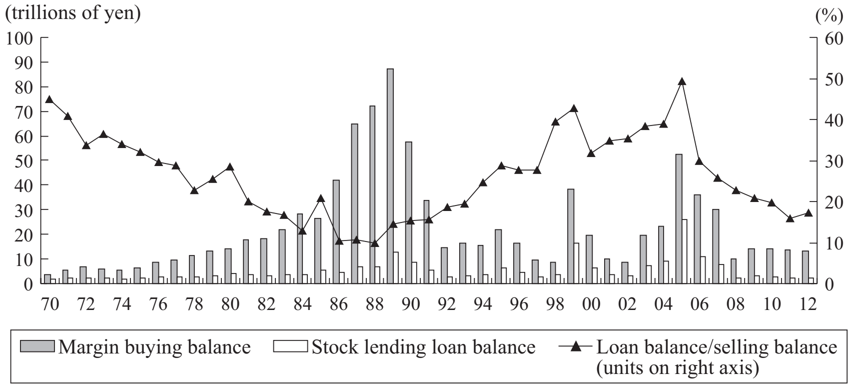
Source: Complied using data from the Web site of the Tokyo Stock Exchange.

9. The Margin Trading System (2)

In 1998, the restrictions on financial instruments companies borrowing stock without going through securities finance companies and on borrowing and lending stock between themselves (the so-called stock lending market) were lifted. At the same time, the regulator approved negotiable margin transactions, allowing financial instruments companies to freely determine prices, interest rates, and contract terms between themselves and their customers. At this juncture, financial instruments exchanges also began to determine prices, interest rates, and contract terms, etc., for margin transactions on their markets, leading to these transactions being called standardized margin transactions (see Table IV-6 above). Negotiable margin transactions rapidly became popular after they started to be used in Internet trading in Japan in 2003, and recently account for about 20% of all margin purchase balances.

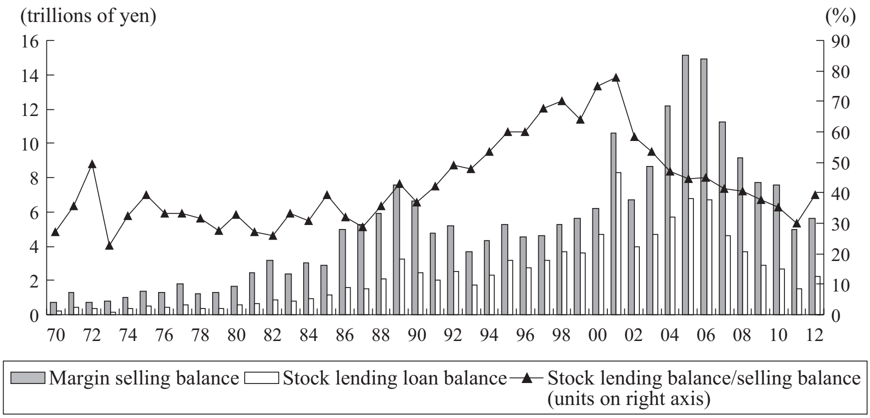
Looking at the proportion of stock lending loan balances in margin stock buying balances, the dependency of financial instruments companies on stock lending transactions almost uniformly declined up to 1988 because of their growing ability to finance themselves out of internal reserves. However, the market's dependency on stock lending transactions began to rise again in the 1990s. Factors included the deterioration in the financial positions of financial instruments companies following the bursting of the economic bubble, the emergence of Internet trading, and a recovery in stock market prices starting in April 1999. In 2005, the dependency of financial instrument companies on stock lending transactions neared the 50% mark. Since then, the dependency on stock lending transactions has taken a downward path because of the decline of stock market prices and the greater diversification of financing sources for financial instrument companies. On the other hand, looking at the balance of shares used in lending transactions, the traditionally small amount

Chart IV-11. Proportion of Margin Loan Trading in Overall Trading Value



Note: Margin buying balance is total of standardized and negotiable system balances.
Source: Complied using data from the Web site of the Tokyo Stock Exchange.

Chart IV-12. Margin Transactions and Stock Lending Balances



Note: Margin selling balance is total of standardized and negotiable system balances.
Source: Complied using data from the Web site of the Tokyo Stock Exchange.

of margin sales began to rise in the latter half of the 1990s as cases of financial instruments companies borrowing shares from securities finance companies on their own proprietary accounts to settle buy orders increased. By 2000, financial instrument companies' dependency on stock lending transaction had risen to 70%. Since then, this dependency has continued to fall because of the expanding number of sources of stock lending following the lifting of restrictions on the stock lending market.

The margin transaction system and margin deposit operations have changed and diversified along with the development of the securities market in Japan. The margin transaction system was revised frequently to expand the number of available issues as a measure for controlling volatility in the market, with Second Section issues being added in December 1991 and the OTC introducing a margin transaction system in 1997. Margin deposit operations have changed as well. Stock lending transactions became available for the JASDAQ market in April 2004 and a stock lending finance issues system for non-loanable issues was introduced in October 2005. Moreover, a commercial financing system became available for financial instruments companies that needed cash to settle their margin buying trades in negotiable margin transactions.

In addition to their licensed-based stock lending business, securities finance companies also (1) offer collateral loans for public bonds and general collateral loans to financial instrument companies or their clients, (2) run a commercial stock lending business other than the stock lending business for financial instruments companies, and (3) act as intermediates in bond lending transactions.

10. Diversification of the Securities Trading System

The basic function of the stock market is to efficiently allocate funds by finding a price at which all demands are matched with supply available. At a stage in which information technology (IT) had not developed fully, securities trading necessarily had to be concentrated in one place in order to achieve that purpose. In fact, a number of stock exchanges had been established in different regions where there was a need for securities trading large enough to justify their establishment, and trading in listed securities was required to be conducted on these stock exchanges. However, if there was a lack of pertinent information or costs or delays in the transmission and execution of orders, no arbitrage transaction—a practice that plays the role of eliminating a price difference—took place even when an opportunity to make a profit by taking advantage of a difference in the price of one and the same stock between stock exchanges arose. Under such circumstances, the duty to concentrate securities trading on the stock exchange was necessary to avert the occurrence of what is known as "the fragmentation of the market."

However, the securities markets have shifted to computerized trading systems thanks to the development of information technology, and stock exchanges where orders are processed manually on the trading floor have become a rarity in the world. That is, elements of securities trading integration information transmission and execution of orders; delivery of securities, set-

Table IV-6. Annual Trading on PTS of Stocks Listed on Financial Instruments Exchanges (Trading Value)

(millions of yen, %)

	Exchange transactions (A)	Off-exchange transactions (B)		Total (A+B)	Proportion of PTS trading in exchange transactions (C/A)	Proportion of PTS trading in off-exchange transactions (B/A)	Proportion of PTS trading in total of exchange and off-exchange transactions (C/A)
			Of that amount, trading value on PTS (C)				
Sept.-Dec. 2000	74,204,639	6,379,023	2,167	80,583,662	0.003	0.034	0.003
2001	225,238,725	19,964,909	40,516	245,203,634	0.018	0.203	0.017
2002	209,229,406	15,971,952	156,798	225,201,358	0.075	0.982	0.070
2003	255,342,134	15,938,880	101,578	271,281,014	0.040	0.637	0.037
2004	357,286,089	21,149,823	115,983	378,435,912	0.032	0.548	0.031
2005	534,774,213	27,302,434	227,916	562,076,916	0.043	0.835	0.041
2006	725,688,187	39,685,779	724,671	765,373,966	0.100	1.826	0.095
2007	795,118,610	50,594,459	1,952,081	845,713,069	0.246	3.858	0.231
2008	605,409,781	42,565,639	2,148,689	647,975,420	0.355	5.048	0.332
2009	390,224,627	23,843,769	2,992,802	414,068,396	0.767	12.552	0.723
2010	375,467,734	22,641,307	3,135,641	398,109,041	0.835	13.849	0.788
2011	362,765,321	30,840,688	12,871,938	393,606,004	3.548	41.737	3.270
2012	322,994,625	32,813,879	17,832,055	355,808,504	5.521	54.343	5.012
Jan. 2013	45,154,874	3,492,853	2,484,956	48,647,727	5.503	71.144	5.108
Feb.	48,921,558	3,838,261	2,516,894	52,759,819	5.145	65.574	4.770
Mar.	54,736,404	6,102,130	3,038,332	60,838,534	5.551	49.791	4.994
Apr.	77,287,224	6,361,727	3,997,961	83,648,951	5.173	62.844	4.779
May	91,839,171	7,041,176	4,613,133	98,880,347	5.023	65.517	4.665
June	61,660,546	5,881,935	3,503,019	67,542,481	5.681	59.556	5.186
July	60,106,118	5,699,034	3,861,741	65,805,152	6.425	67.761	5.868
Aug.	47,106,560	5,015,118	3,172,471	52,121,678	6.735	63.258	6.087
Sept.	47,948,554	6,749,696	3,044,733	54,698,250	6.350	45.109	5.566
Oct.	54,742,103	6,171,098	4,116,058	60,913,201	7.519	66.699	6.757

Source: Japan Securities Dealers Association.

tlement, and custody are integrated by the computer networks and processed in real time, realizing a situation in which balanced prices can be found through the computer networks installed at a plural number of markets. The idea of market operation based on such an infrastructure of securities trading is called inter-market competition. Meanwhile, as the number of institutional investors in the securities market has grown, the need for a guarantee of anonymity and for a trading system designed to minimize the market impact cost has increased, and special forms of trading (large-lot transactions and basket trade) also have increased. As complex trading rules can be instituted without difficulty in the case of a computerized trading system, a trading system capable of meeting such needs can be provided at a low cost.

These technological innovations make it difficult to distinguish the trading systems provided by private companies from that provided by the traditional securities exchanges. In the United States, the Securities and Exchange Commission (SEC) has acknowledged the similarity of functions performed by the two types of trading systems and has adopted the Alternative Trading System (ATS) and has authorized the Electronic Communication Network (ECN), a type of ATS, as a securities exchange. In Japan, also, the regulators have authorized negotiated trading in listed securities following the lifting of the ban against off-exchange securities trading and have added a PTS to the types of business that can be handled by securities companies.

CHAPTER V

New Issues of Bonds in the Primary Market

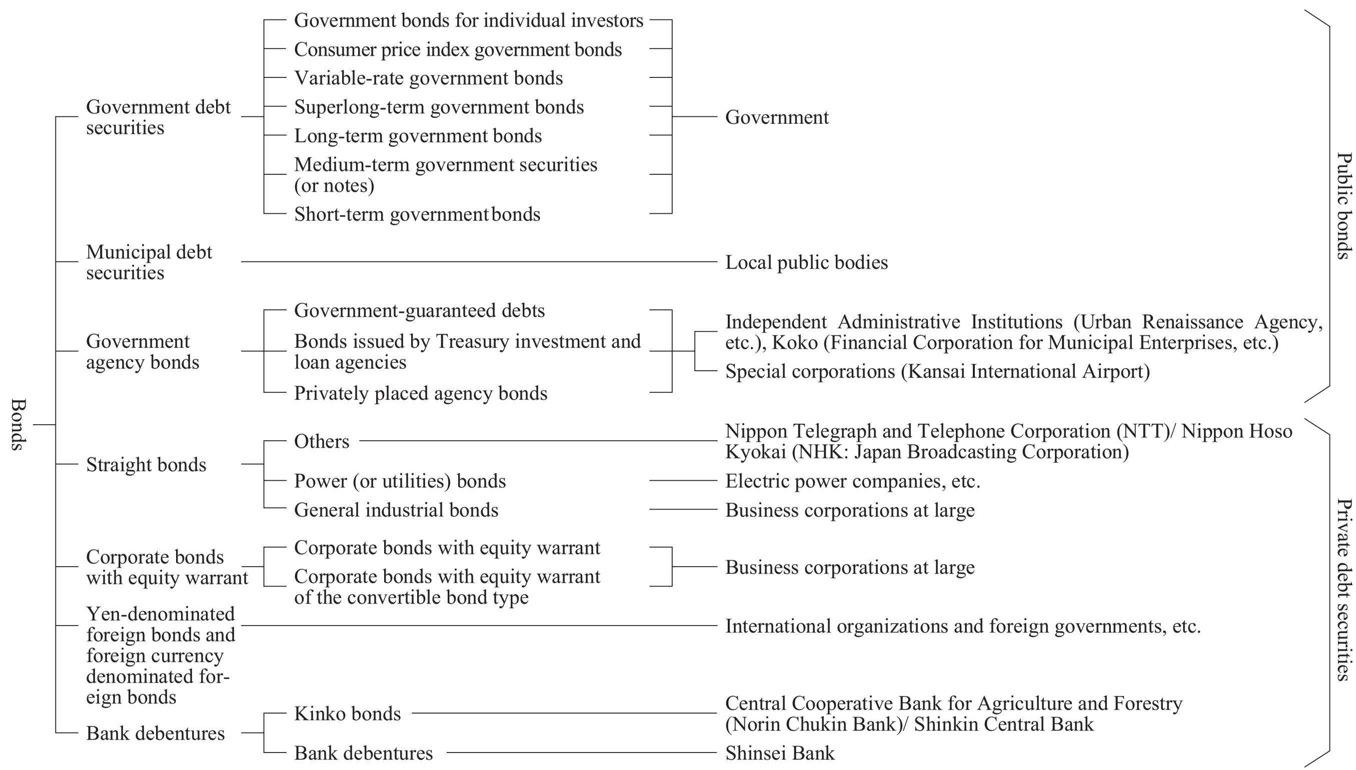
1. Types of Bonds

The term "bonds" generally refers to debt securities issued by governments and other public entities as well as by private companies. The issuance of bonds is a means of direct financing, through which the issuer raises funds, but, unlike equity financing, the issuer has an obligation to repay the principal at maturity. Bonds are classified by type of issuer into government debt securities, municipal debt securities, government agency bonds, bank debentures, corporate bonds (industrial bonds), and foreign bonds.

Government debt securities are those issued by the national government, and they are classified as short-term bills (maturing in one year or less), medium-term notes (maturing in two to five years), long-term bonds (maturing in six to ten years), or superlong-term bonds (maturing in ten years or more) to distinguish an issue's term to maturity. In fiscal 2002 (ended on March 31, 2003), the government introduced the STRIPS and (variable-rate) retail ten-year Japanese government bond (JGB) programs. Under the former program, the principal and individual interest payment components of JGBs designated by the Ministry of Finance as "book-entry securities eligible to strip" may be traded as separate zero-coupon government bonds (All fixed-rate JGBs issued on and after January 27, 2003, are eligible for the program). Subsequently, the government started issuing ten-year CPI (consumer price index)-linked bonds, five-year bonds for retail investors, forty-year fixed-rate bonds, and three-year bonds for retail investors in fiscal 2003, 2005, 2007, and 2010 respectively.

Municipal debt securities can be roughly divided by type of funds into "public sector funds" and "private sector funds." The former are raised through treasury investment or loan agencies or municipal government and financial institutions, while the latter are raised in the public market or underwritten by banks and other financial institutions. Among these funds, the funds raised in public markets are divided into nationally placed municipal bonds, jointly offered local government bonds, and municipal bonds targeting

Chart V-1. Types of Bonds



Note: Local government bonds represent debt issued under local government laws and fiscal policies. However, only those publicly placed or underwritten by banks or other financial institutions based on the issue of debt securities are included in public bonds.

local residents (mini-local bonds). While the municipal bonds underwritten by banks and other financial institutions are called bank, etc. underwritten bonds, they come in two types, funds borrowed on deeds from banks and other financial institutions or debt securities issued in the market.

Government agency bonds are debt securities issued by various government-affiliated entities, such as independent administrative institutions. Agency issues can be categorized into government-guaranteed debts and non-guaranteed debt, with the latter being further divided into Fiscal Investment and Loan Program (FILP) bonds that are publicly placed bonds and privately placed bonds issued by certain special public financial institutions. The three categories of debt securities mentioned above are sometimes collectively called "public bonds."

Bank debentures are debt securities issued by certain banking institutions under special laws. They are principally issued in the form and maturities of five-year interest-bearing and one-year discount debentures. In addition, as bank debentures and government agency bonds fall within the category of "bonds issued by special public institutions, etc., under special laws" stipulated in Article 2, Paragraph 1, Item 3 of the Financial Instruments and Exchange Act, they are sometimes called "special bonds (*tokushusai*)." Corporate bonds are those issued by private-sector companies and are also known as industrial bonds. In addition to nonfinancial enterprises, banks and consumer finance companies may also issue corporate bonds. Foreign bonds are defined as debt securities issued in Japan by non-Japanese governments or corporations. Those denominated in yen, in particular, are separately classified as yen-denominated foreign bonds.

2. The Present State of the Bond Issuing Market

The total value of public and corporate bonds issued in fiscal 2012 (ended March 31, 2013) increased 3.6% from the previous year to ¥204.1 trillion ($1.99 trillion). Of this amount, ¥175.0 trillion, or 86% of the total value, was accounted for by government bonds, underscoring their dominant presence in the public and corporate bond market in Japan. Up until fiscal 2008, JGB issuance had been on the decline along with the upswing in the central government's financial position, but given the deterioration in the government's finances caused by the slump in the economy following the Lehman Shock in September 2008, it has been on the upswing since fiscal 2009. JGB issuance can be broken down into superlong-term government bonds (¥28.0 trillion, or $273 billion); long-term government bonds, including those sold to individual investors and those whose interest rates are linked to the consumer price index (¥31.9 trillion, or $311 billion); medium-term government notes (¥66.4

Table V-1. The Value of Bonds Issued

(¥100 million)

FY	Total of public bonds publicly offered		Government securities		Government securities sold on the market		Superlong-term bonds		Long-term bonds		Inflation-indexed bonds	
	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued
2011	739	1,830,126	72	1,672,834	72	1,554,703	12	261,360	8	313,600	0	0
2012	742	1,915,680	73	1,749,568	73	1,582,430	12	280,681	7	318,720	0	0

FY	Medium term bonds (5 year)		Medium term bonds (4, 2 year)		Individual investor bonds		Short-term discount bonds		Bonds subscribed to by the Bank of Japan	
	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued
2011	8	310,358	12	345,138	20	24,257	12	299,990	–	118,131
2012	6	324,209	12	340,082	24	18,748	12	299,991	–	167,138

FY	Municipal bonds		Government-guaranteed bonds		Bonds issued by investment and loan agencies	
	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued
2011	394	66,627	61	33,311	212	57,353
2012	392	65,768	71	47,221	206	53,122

FY	Total of private bonds publicly offered		Straight bonds		Asset backed corporate bonds		Corporate bonds with convertible bonds type new share subscription rights	
	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued
2011	401	85,098	394	82,773	5	2,000	2	325
2012	423	83,809	416	81,524	4	2,000	3	285

FY	Bank debentures		Discount bank debentures		Interest-bearing bank debentures	
	No. of issues	Amount issued	No. of issues	Amount issued	No. of issues	Amount issued
2011	284	34,377	48	5,174	236	29,203
2012	220	30,002	18	3,068	202	26,934

FY	Nonresident bonds (yen denominated)		Yen-denominated foreign bonds	
	No. of issues	Amount issued	No. of issues	Amount issued
2011	76	19,939	76	19,939
2012	51	11,421	51	11,421

FY	Total of bonds	
	No. of issues	Amount issued
2011	1,500	1,969,540
2012	1,436	2,040,912

trillion, or $648 billion); Treasury bills (¥30.0 trillion, or $293 billion), and bonds for retail investors (¥1.9 trillion or $18.5 billion). In fiscal 2012, ¥6.6 trillion ($64.4 billion) worth of municipal bonds were publicly offered—7 times greater than the volume (¥940 billion) of those issued 20 years ago (fiscal 1990). The increase is basically due to the deterioration in the fiscal position of local governments, resulting in the introduction of publicly offered municipal bonds targeting local residents in fiscal 2001 and publicly offered joint local government bonds in fiscal 2003.

In fiscal 2012, among debt securities issued by government agencies, government-guaranteed bonds amounted to (¥4.7 trillion) and FILP agency bonds (¥5.3 trillion). Following the reform of the fiscal investment and loan program, the Government Housing Loan Corporation issued ¥50 billion worth of the first FILP agency bonds in fiscal 2000. Since then, the combined value of FILP agency bonds issued has grown notably.

The amount of bank debentures issued in fiscal 2012 stood at ¥3.0 trillion ($29.3 billion), continuing to decline from the ¥43 trillion ($419.5 billion) recorded in fiscal 1995. Looking at issuance by category, discount debentures were (¥0.3 trillion, or $2.9 billion) and coupon debentures (¥2.7 trillion, or $26.3 billion). In particular, the annual value of discount debentures issued has decreased sharply from the ¥30 trillion ($292.7 billion) issued in fiscal 1995. Behind this drop was the steady decline in operations of long-term credit banks as suppliers of long-term capital to industry. Bank of Tokyo-Mitsubishi (now the Bank of Mitsubishi-Tokyo UFJ)'s ceased issuing bank debentures in March 2002, followed by similar decisions by Mizuho Corporate Bank in March 2007 and Aozora Bank in September 2011.

The total issue value of corporate straight bonds has followed an upward trend in issuance, reaching ¥10 trillion ($97.6 billion). The desire of companies to obtain a safe source of funding in the aftermath of the Lehman Shock has prompted an increase in issuance. However, in recent years, issuance has dropped a little, to ¥8.2 trillion ($80 billion).

After recovering from the default on Argentine government debt in 2002, the issuance of yen-denominated foreign bonds increased for several years. Recently, however, issuance has fluctuated strongly under the influence of such external factors as exchange rates.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

3. Methods of Issuing Public Bonds

Government securities are issued in the public market or directly to individual investors or underwritten by the public sector. This section deals with the

Table V-2. Categories of Government Securities (Notes 1 to 4)

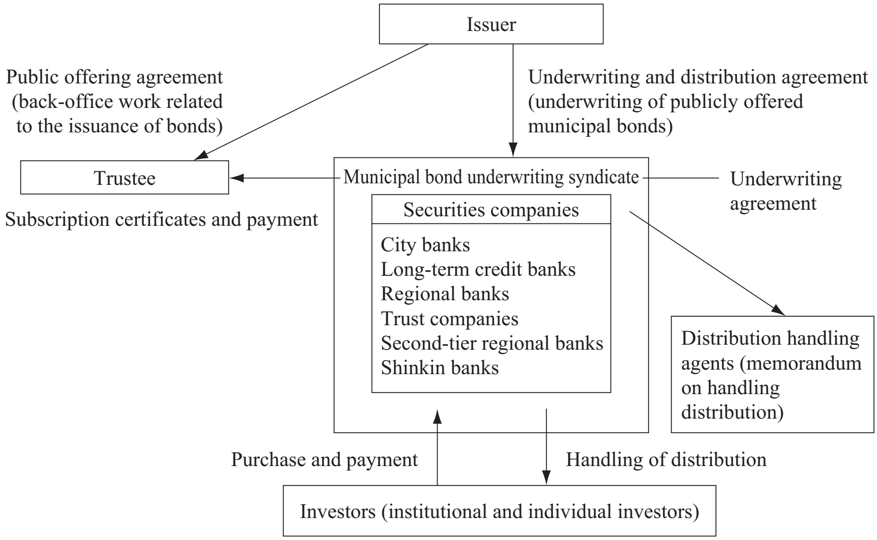
Maturity	Short term (Discount)	Medium term	Long term
	6 month, 1 year	2 year, 5 year	10 year
Type of issue	Discount	Interest-bearing bonds	
Minimum denomination	¥10,000,000	¥50,000	¥50,000
Issuance method	Public offering BOJ switch	Public auction OTC sales (based on subscriptions to offering)	Public auction OTC sales (based on subscriptions to offering)
Auction method	Price-competitive auction Conventional style	Price-competitive auction Conventional style	Price-competitive auction Conventional style
Non-price Competitive Auction	Non-price Competitive Auction I	Non-Competitive Bidding Non-price Competitive Auction I Non-price Competitive Auction II	Non-Competitive Bidding Non-price Competitive Auction I Non-price Competitive Auction II
Transfer restriction	Yes[2]	No	No
Issuance frequency (FY2012 Plan)	1-year discount bonds: monthly 6-month discount bonds: up to total of ¥0.9 trillion	Monthly	Monthly

Maturity	Superlong term			JGBs for individual investors	Inflation-indexed bonds	Floating interest rate bonds
	20 year	30 year	40 year	3-year, 5-year fixed rate, 10-year floating rate	10 year 1	15-year 1
Type of issue	Interest-bearing bonds					
Minimum denomination	¥50,000	¥50,000	¥50,000	¥10,000	¥100,000	¥100,000
Issuance method	Public auction	Public auction	Public auction	OTC sales (based on subscriptions to offering)	–	–
Auction method	Price-competitive auction Conventional style	Price-competitive auction Conventional style	Yield-competitive auction Dutch auction[3]		–	–
Non-price Competitive Auction	Non-price Competitive Auction I Non-price Competitive Auction II	Non-price Competitive Auction I Non-price Competitive Auction II	Non-price Competitive Auction II		–	–
Transfer restriction	No	No	No	Yes[2]	Yes[2]	No
Issuance frequency (FY2011 Plan)	Monthly	8 times annually	Quarterly	3-year fixed interest: monthly 5-year fixed and 10-year floating rate: quarterly	Note[4]	Not scheduled

Notes: 1. There have been no additional issues of 15-year floating rate JGBs or inflation-indexed JGBs since they were first issued in May 2008 and October 2008, respectively.
2. Short-term discount bonds are transferable only to corporations (including certain trustees); JGBs for individual investors are transferable only to individuals; and inflation-linked bonds are transferable only to qualified corporations. Short-term discount bonds are transferable only to corporations (including certain trustees); JGBs for individual investors are transferable only to individuals; and inflation-linked bonds are transferable only to qualified corporations.
3. The fiscal 2012 issuances of 30-year bonds in April, June, and July were in principle all reopenings of the March 2012 issuance, while the issuances in October, December, and January 2013 were in principle all reopenings of the September 2013 issuance. The March 2013 issuance was partially the same issue as the fiscal 2013 issuance. For 40-year bonds issuance in fiscal 2012, the May, August, and November 2012 and February 2013 issuances were in principle all reopenings of the May 2012 issuance.
4. The government is considering revisions to make these issues more marketable, such as offering a principle guarantee on maturity, and may start reissuing these bonds in future depending on market conditions.

Source: Based on Ministry of Finance, *Debt Management Report 2012*, p. 38.

Chart V-2. Organization of Underwriting Publicly Offered Municipal Bonds at a Glance



Source: Daiwa Securities SMBC, *Saiken-no joshiki* (What Bonds are All About), 2009.

former two methods of issuance. When issued in the market, JGBs are primarily sold through public auctions based on competitive bidding on price (or on yield, the same hereafter), as underwriting by syndicates was discontinued in fiscal 2006. In accordance with the terms of offering set forth by the Ministry of Finance, auction participants submit their bid prices and amounts, which are aggregated to determine the issue price and amount. Depending on the type of securities to be auctioned, the issue price is set either in a conventional auction, where bonds are issued to successful bidders at their respective bid prices, or in a Dutch auction, where the issue price (yield) is set at the lowest price (highest yield) among accepted bids. Other than competitive bidding, two-, five-, and ten-year fixed-rate JGBs are also offered through a noncompetitive bidding process that facilitates small and medium-sized bidders and through Non-price Competitive Auctions I and II reserved for special participants (23 companies are designated as of July 2013).

To issue municipal bonds, a local public body must prepare a budget plan that defines the use of proceeds from the proposed bond issue and obtains the approval of the local assembly. The actual issuance is also subject to consultation with the Minister of Internal Affairs and Communications (MIC) or the governor of the prefecture concerned (local bond consultation system). Even when the issuer is authorized to issue a municipal bond, the proceeds of such bonds can be used only for authorized projects—to finance a publicly run corporation, for equity contributions and loans, and to roll over maturing debts, etc. As of fiscal 2012, 32 prefectures and 20 cities that have been designated by an ordinance of the Ministry of General Management ("designated cities") have issued municipal bonds through public offerings. In most cases, the issuer negotiates the terms of issue with an underwriting syndicate that handles its public offering, under which the underwriting syndicate buys up whatever bonds remain unsold after the public offering. Municipal bonds publicly offered on the joint issuing market (municipal bonds jointly issued by 35 local public bodies) in and after fiscal 2003 are also handled by underwriting syndicates, but the municipal bonds targeted at local residents introduced in March 2002 generally commission local financial institutions to handle the underwriting and subscription administration.

The issuance of government-guaranteed bonds is planned as part of the Fiscal Investment and Loan Program, and annual ceilings on the issue amount must be approved by the Diet. They are issued by way of either an underwriting syndicate or issued by separate and individual bidding by competing underwriters. In the former method, the terms of issue are determined based on the results of recent JGB monthly competitive price auctions; in the latter, the terms are bid for competitively along with the lead manager position for the offering. FILP agency bonds are also issued as interest-bearing bonds, and in issuing them, the issuing agency usually selects a lead manager, which, in turn, forms an underwriting syndicate.

4. Methods of Issuing Corporate Bonds

The issuance of straight bonds had in the past been subject to strict regulation, and the corporate bond trustee system was the core of those regulations. Against the backdrop of the main bank system in Japan at the time, the banks had an extremely strong influence on individual corporate straight bond issues under the corporate bond trustee system. Even in the overall corporate bond market, banks had a greater voice than securities companies. However, as the role played by the bond trustee company system declined in the 1980s, the Commercial Code was amended in 1993 to drastically change the system, and the regulations on the issuance of corporate bonds have been substantially eased.

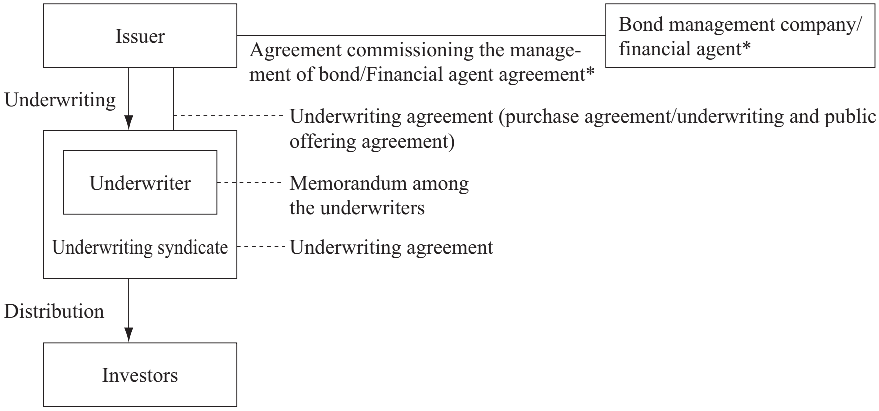
The issuing corporation appoints managing securities companies and other underwriters that together constitute an underwriting syndicate, a bond manager or a fiscal agent, and providers of other relevant services and obtains a preliminary credit rating. When preparations are completed, the underwriting syndicate, under the leadership of managers, conducts pre-marketing in order

Table V-3. Brief History of Matters Relating to the Corporate Bond System Reform

Date	Matters
Apr. 1985	Bond credit-rating agency starts working
Apr. 1987	A proposal method is introduced in deciding on terms of issue of NTT bonds
Apr. 1988	The proposal method is recognized as one applicable to the issuance of all corporate bonds. With the adoption of this method, the Bond Issuing Association finally goes out of existence. (The Bond Issuing Consultation Meeting established in 1949 was renamed the Bond Issuing Association in 1968. It served as a bond-issuing control organization composed of trustee companies [banks] and lead-managing securities companies. Under its control, there was no room for one-on-one negotiation for issuing terms between an issuer and an underwriting securities company.)
Nov. 1990	Requirements for issuing bonds are changed to abolish the quantitative requirements, and conditions are unified into rating requirements.
June 1992	The Institutional Reform Law is promulgated.
Apr. 1993	The same law is enforced.
July 1993	Following the enforcement of this law, the Industrial Bank of Japan, the Long-Term Credit Bank, and the Central Cooperative Bank for Agriculture and Forestry enter the bond underwriting market by establishing their securities subsidiaries. Subsequently, trust banks, city (commercial) banks, and regional banks follow suit.
June 1993	The Diet (parliament) passes an amendment to the Commercial Code.
Oct. 1993	With the enforcement of the amendment, the regulation putting a ceiling on the issuance of bonds is abolished, and a bond management company system is introduced in the place of the bond trustee company system.
Nov. 1993	A five-year corporate note is issued for the first time.
Sept. 1995	A corporate bond is issued without establishing a bond management company by taking advantage of the proviso to the article prescribing the establishment of a bond management company.
Jan. 1996	The requirements for issuing bonds are abolished, and the requirements for issuing unsecured bonds and the duty to establish a debt restriction clause are also abolished.
June 1998	The period of delivery and settlement for bonds, etc., is shortened from T + 7 to T + 5.
Apr. 1999	The Diet passes the bill on nonbank corporate bonds (The law went into effect on May 20).
Oct. 1999	The period of delivery and settlement for bonds, etc., is shortened from T + 5 to T + 3.
Oct. 1999	The ban on the issuance of straight bonds by commercial banks is lifted.
June 2001	The Diet passes the Bill on the Transfer of Short-Term Bills (commercial paper, etc.) (The Law was enforced on April 2003.)
June 2002	The Diet passes the Bill concerning the Establishment of Relevant Laws to Improve Securities Markets through the Reform of the Securities Settlement System (The Securities Settlement System Reform Law). (The Law was enforced in Jan. 2003.) As a result, the Bond Registration Law will be repealed within five years from Jan. 2003.
June 2004	The Law Concerning Transfer of Bonds and Stocks (the amended Bond Transfer Law) was adopted and is to be enforced within the next five years. By virtue of this law, a book-entry share system will be instituted, obviating the need to issue stock certificates and bonds with an equity warrant.
June 2006	The Law for Partially Amending the Securities and Exchange Law, etc. (Financial Instruments and Exchange Act) was enacted and enforced.
Sept. 2007	The Financial Instruments and Exchange Act was fully enforced.
Jan. 2008	The Corporate Bond Registration Law and related government ordinances and regulations were repealed. (Jan. 4)

Source: Takeshi Goto, *Shasai shijo no shin-tenkai* (New Developments in the Bond Market), Japan Securities Research Institute, *Shoken keizai kenkyu* (JSRI Journal of Financial and Securities Markets), Vol. 18, March 1999.

Chart V-3. Mechanism of Underwriting Corporate Bonds



Note: The issuer signs this agreement with a trustee company in the case of a mortgage bond.
Source: Daiwa Securities SMBC, *Saiken no joshiki* (What Bonds Are All About), 2009.

to build a book for the bonds. Along with this process, the issue terms of the bonds are finalized and the offering begins. The book-building method is one under which the lead manager asks syndicate member companies to survey investors' interest in the bonds and then decides on the issuing terms on the basis of the findings of that survey. Recently, many issuers employ "spread pricing," a method under which the interest of investors is measured in terms of a spread over the yield of a JGB or an interest rate swap with the same term, to determine the issuing rate.

During recent years, annual corporate straight bond issuance has remained around the ¥8 trillion mark ($78.0 billion) and featured mainly issues with high ratings and a notably small proportion of issues with low rating. The reason behind this trend is that major institutional investors have limited their investment in corporate bonds to issues with ratings of A or higher. Conversely, most of the issuers of BBB rated bonds are infrastructure-related companies, such as railways and telecommunications, some of which target the retail investor market. Furthermore, in contrast to the United States, there are hardly any BB rated issues with high yields circulating in the market. In 2009, to stimulate the overall corporate bond market, JSDA formed the Study Group to Vitalize the Corporate Bond Market, in which a wide range of measures are being discussed by representatives of securities companies, financial institutions, institutional investors, and related bodies.

Among bank debentures, the Aozora Bank, Shinsei Bank, and other long-term credit-related banks had issued discount bank debentures in the past but issuance has been on the wane in recent years. Among other categories, interest-bearing bank debentures are issued in two ways: issuing debentures through a public bond offering on a fixed day and selling them during a certain selling period. The selling period for the latter method is normally established twice a month. Debentures issued through a public offering are sold to institutional investors in units of ¥10 million or more, while those sold through a selling method are sold to individual investors in units of ¥10,000. However, issuance of these debentures has been on the decline recently because of the increased diversification of funding sources.

5. Credit-Rating Agencies and the Credit Rating of Bonds

Credit rating is a classification of credit risk, indicated by a rating symbol based on investigations of the certainty of payment of the principal of, and interest on, a bond, and it is ordinarily given by an credit rating agency specializing in rating credit. Originally, the system had developed in the bond market of the United States and is believed to have taken root during the Depression of the 1930s. It was introduced to Japan in the 1980s, and obtaining a credit rating has become general practice among issuers of corporate bonds.

In assigning a credit rating to a given bond issue, a credit-rating agency investigates and verifies to see if the issuer has any collateral to back up its obligation and if it has a special financial contract and, if it has preferential or subordinated creditors, analyzes its financial position and business; determines its capacity to pay the principal of, and interest on, the proposed bond; and assigns a symbol shown in table V-4 on the basis of findings of such investigations. Normally, any debt security with an AAA rating indicates that its issuer has the highest credit standing and is virtually free from the uncertainties of paying the principal of and interest on the obligation. The creditworthiness of a bond declines as its rating goes down, in order, from AAA to AA, A, and BBB, and a bond with any of these four ratings is called an investment-grade bond. Bonds with a credit rating of BB, B, CCC, CC, or C are called "junk bonds." As these bonds carry high credit risk, their issuer offers a high yield to attract buyers. Thus, they are called "high-yield bonds," and their market has developed on a relatively large scale in the United States. This type of junk bond primary market did not exist in Japan because of a policy that excluded bonds that did not meet the eligibility standards from the market. However, today no such regulations restrict the issuance of junk bonds because the eligibility standards were abolished in 1996. Nevertheless, few BBB-rated bonds, let alone junk bonds, have been offered on the market.

Having suffered severely from the financial crisis, corporate bond issuance

Table V-4. Definitions of Credit-Rating Symbols

Symbol	Rating and Investment Information	Symbol	Moody's Investor Service
AAA	Highest creditworthiness supported by many excellent factors.	Aaa	Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk
AA	Very high creditworthiness supported by some excellent factors.	Aa	Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.
A	High creditworthiness supported by a few excellent factors.	A	Obligations rated A are considered upper-medium grade and are subject to low credit risk.
BBB	Creditworthiness is sufficient, though some factors require attention in times of major environmental changes.	Bbb	Obligations rated Baa are subject to moderate credit risk. They are considered medium grade and as such may possess certain speculative characteristics.
BB	Creditworthiness is sufficient for the time being, though some factors require due attention in times of environmental changes.	Bb	Obligations rated Ba are judged to have speculative elements and are subject to substantial credit risk.
B	Creditworthiness is questionable and some factors require constant attention.	B	Obligations rated B are considered speculative and are subject to high credit risk.
CCC	Creditworthiness is highly questionable and a financial obligation of an issuer is likely to default.	Ccc	Obligations rated Caa are judged to be of poor standing and are subject to very high credit risk.
CC	All of the financial obligations of an issuer are likely to default.	Cc	Obligations rated Ca are highly speculative and are likely in, or very near, default, with some prospect of recovery of principal and interest.
C	R&I believes that all of the financial obligations of an issuer are in default.	C	Obligations rated C are the lowest rated class and are typically in default, with little prospect for recovery of principal or interest.

Source: Taken from the websites of Ratings and Investment Information, Inc., and Moody's Corporation.

began to show signs of recovery globally from summer 2009. In Japan as well, the recovery trend in corporate performances and robust demand from financial institutions, particularly regional financial institutions, supported a rebound in demand for corporate bonds with credit ratings of A or higher. However, with the exception of bonds with relatively stable earnings, such as railway companies, bonds with low credit ratings have not received the same positive treatment in Japan, despite the reverse trend in Europe and the United States, and their issuance remains at low ebb. One explanation is that—fearful of default and averse to risk—most of the institutional investors in Japan do not invest their funds in assets other than those with a credit rating of A or higher.

Designated rating agencies now include both domestic players, such as the

Table V-5. Corporate Bonds Offering Amounts by Ratings

(millions of yen, %)

	FY2008			FY2009			FY2010		
	No. Issues	Issuance amount	Proportion of issuance	No. Issues	Issuance amount	Proportion of issuance	No. Issues	Issuance amount	Proportion of issuance
AAA	54	1,985,000	21.4	26	745,000	7.6	59	1,360,000	14.1
AA +	46	1,371,000	14.8	33	680,000	6.9	35	675,000	7.0
AA	63	1,483,900	16.0	53	1,471,000	14.9	46	1,654,000	17.2
AA −	55	2,440,800	26.4	87	3,259,200	33.1	59	1,956,000	20.3
A +	36	1,343,200	14.5	62	1,648,000	16.7	43	937,200	9.7
A	19	275,000	3.0	47	719,000	7.3	78	1,377,300	14.3
A −	19	253,000	2.7	42	928,700	9.4	53	877,800	9.1
BBB +	5	50,000	0.5	16	195,000	2.0	42	676,600	7.0
BBB	5	60,000	0.6	9	204,300	2.1	12	105,100	1.1
BBB −	0	0	0.0	0	0	0.0	2	10,000	0.1
Total	302	9,261,900	100.0	375	9,850,200	100.0	429	9,629,000	100.0

	FY2011			FY2012		
	No. Issues	Issuance amount	Proportion of issuance	No. Issues	Issuance amount	Proportion of issuance
AAA	23	480,000	6.0	2	70,000	0.9
AA +	24	620,000	7.7	41	965,000	12.0
AA	41	888,000	11.1	76	1,648,000	20.6
AA −	66	2,140,400	26.7	79	2,171,400	27.1
A +	59	1,546,000	19.3	46	896,000	11.2
A	73	1,219,000	15.2	80	1,569,000	19.6
A −	44	665,000	8.3	37	338,000	4.2
BBB +	28	321,000	4.0	23	278,100	3.5
BBB	17	147,600	1.8	10	78,400	1.0
BBB −	0	0	0.0	0	0	0.0
Total	375	8,027,000	100.0	394	8,013,900	100.0

Note: Complied on terms of issue date basis. Transportation and broadcast bonds included. Highest credit ranking from an agency used.
Source: I-N INFORMATION SYSTEMS, LTD.

Rating and Investment Information (R&I) and the Japan Credit Rating Agency (JCR), and global agencies, such as Standard & Poor's and Moody's and Fitch. They recently also started rating municipal and FILP agency bonds.

6. Bond Management

A drastic reform of the conventional corporate bond trustee system was carried out by amending the Commercial Code in June 1993. Under this amendment, the conventional name "bond trustee company" was changed to "bond

Table V-6. Appointment, Power, and Liability of the Bond Manager under the Companies Act

Item	Substance	Article
Appointment and Power		
When a bond manager has to be appointed	A corporation issuing a bond must appoint a bond manager. However, when the face value of a bond certificate is in excess of ¥100 million, and in such other cases as may be prescribed by an ordinance of the Ministry of Justice as one which poses no threat to the protection of bondholders, the issuer need not appoint a bond manager.	Article 702 of the New Companies Act
Qualifications for becoming a bond manager	Banks, trust companies, and equivalent financial institutions	Article 703
Matters commissioned	The bond manager will be commissioned to receive payments, to safeguard credit, and to take other steps necessary for the management of bonds on behalf of bondholders.	Article 702
Duty of the bond manager	The bond manager must manage the bonds fairly and honestly on behalf of bondholders ("the fair and honest management duty"). The bond manager owes a duty to bondholders to manage the bonds with a good manager's care ("fiduciary duty as a good manager"). The exercise of contracted power based on an agreement commissioning the management of the bond is included in the management of the bond.	Article 704
Power of the bond manager	The bond manager has the power to receive payments related to the bonds and to take any and all steps in and out of court that are necessary to safeguard the exercise of rights related to the bonds on behalf of bondholders. When the bond manager deems it necessary to take such steps, it has the power to investigate the state of business and property of the issuer with the permission of the court.	Paragraphs 1 and 4 of Article 705
Special regulation of the power of the bond manager	When the bond manager plans to take the steps described below, it must obtain a resolution of a bondholders meeting. (1) A moratorium on the payment for the entire bond, exemption from liability, or settlement (2) Actions taken to file a lawsuit relative to the entire bond, bankruptcy proceedings, rehabilitation proceedings, or special liquidation of its issuer ("lawsuit" includes court-mediated settlement) Under the law, the bond manager has the power to take these actions if the bond management agreement so prescribes.	Paragraphs 1 and 2 of Article 706 Item 8, Article 676
Power of the bond manager in taking steps for the protection of creditors	When a bondholder wants to object to any action taken by the issuer, he must obtain a resolution of a bondholders meeting, in principle, but the bond manager can express its objection on behalf of bondholders. To do this, however, the agreement commissioning bond management can institute a provision otherwise.	Paragraghs 1 and 2, Article 740
Liability		
Liability (damages)	When the bond manager takes an action in violation of the Companies Act or any resolution of the bondholders, meeting, it is jointly liable for damages.	Paragraph 1 of Article 710
Legal special liability (damages)	The bond manager is liable for damages: (1) When the bond manager has received from the issuer of a bond collateral for the obligation represented by such a bond or when the issuer has taken an action extinguishing such obligation within three months prior to a default on the redemption of, or on the payment of interest on, the bond, or the suspension of payment by its issuer (2) When the bond manager has received from the issuer collateral for the obligation or repayment with respect to the credit of the bond manager (3) When the bond manager transfers its credit to a company controlling, or controlled by, such bond manager, or to another company that has a special relationship with the bond manager (4) When a bond manager who has a credit to the issuer of the bond concludes an agreement with the issuer authorizing it to dispose of the property of the issuer for the purpose of offsetting such credit, or when the bond manager concludes an agreement to take over any obligations of any company that owes a debt to the issuer. (5) When a bond manager that owes a debt to the issuer offsets such debt by taking over a credit to the issuer.	Paragraph 2 of Article 710
Exemption of debt	The bond manager is exempt from debt when it has not been derelict in its management of the bond, or when it is established that any loss caused to the bondholders is not blamable to an action taken by the bond manager	Proviso to Paragraph 2 of Article 710
Resignation of the bond manager and its liability	(1) The bond manager may resign with the consent of the issuer and a bondholders' meeting. (However, the bond manager must appoint in advance a successor who will take over its job.) (2) In case the bond manager has an unavoidable reason to resign, it may resign with permission of the competent court. (3) The bond manager may resign based of the causes prescribed in the agreement commissioning the management of the bond. (However, such agreement must have a provision designating a succeeding bond manager that will take over the job.) *) A bond manager that resigns after the issuer has defaulted on the redemption of the bond or on the payment of interest on such bond, or that has resigned for reasons prescribed in the agreement commissioning the management of the bond within three months prior thereto, is not exempted from liability to pay damages under Paragraph 2 of Article 710.	Article 711 Article 712

Source: Compiled from the data drawn from Akihiro Sato, *Shinkaishaho de kawatta kaisha no shikumi* (The Changed Company System under the New Companies Act), Nihon Horei, 2005, pp. 179 and 181.

management company," and its function was clarified. More specifically, (1) the establishment of a bond management company was made mandatory, in principle, and the eligibility for becoming one is restricted to banks, trust companies, and companies that have received a license under the Mortgage Bond Trust Law; (2) services to be provided by a bond management company are restricted to the management of bonds that have been issued and are outstanding; and (3) the power, duty, and liability of the bond management company has been clarified. Put another way, the back-office services provided by the trust company at the time a bond is offered will not become the core services of the bond management company, and the services to be provided by the bond management company after a bond is issued are restricted to bond management.

As a result of the amendment, the possibility of a bond trustee company being involved in the issuance of bonds of individual issuers has been legally removed, and the power of the conventional bond trustee system regulating individual issuers has thus come to an end. The amendment has resulted in the following changes: (1) The fee the trustee bank had been collecting was renamed "bond management fee," and it was sharply lowered; (2) by instituting exceptional provisions with respect to the mandatory establishment of a bond management company (this applies when the face value of a bond certificate is in excess of ¥100 million), issuers can appoint a fiscal agent in lieu of a bond management company, and instances of making do with a fiscal agent have since increased; and (3) as the services to be provided by the bond management company have been clarified, the lump purchases of defaulted bonds that trustee banks had been making were discontinued, and this practice has since become established.

Under the New Companies Act adopted in June 2005 (enforced in May 2006), a bond management company is now known as a "bond manager," and its liability and power have been expanded. More specifically, (1) under the former Commercial Code, the term "management of bond" referred only to the exercise of power legally granted to the bond management company and did not include the exercise of power based on an agreement, etc., commissioning the management of bonds (contractual power); under the new Companies Act, however, the exercise of the contractual power is included in "the management of bonds" and the bond manager owes the duty of impartiality and good faith and the duty to exercise reasonable care and skill in exercising such contractual power; (2) when the agreement commissioning the management of bonds contains a provision to that effect, the bond manager may act in relation to filing a lawsuit and taking bankruptcy or rehabilitation proceedings for the bond as a whole without obtaining a resolution of the bondholders' meeting; and (3) in taking steps to protect the creditors in the case of a capital reduction or a merger, the bond manager may, in principle, object to such capital reduction or merger without obtaining a resolution of the bondholders, meeting.

7. Corporate Bonds with Subscription Rights/Warrants and Structured Bonds

Subscription rights/warrants give their issuer an obligation to either issue new shares or transfer shares in its treasury at a predetermined price to the rights/warrants holder upon the exercise of their rights/warrants within a prescribed period.

Corporate bonds with subscription rights/warrants are divided into those that in effect correspond to convertible bonds and those with undetachable warrants. Corporate bonds with subscription rights correspond to the former and refer to bonds (1) from which the rights cannot be detached or separately transferred, (2) whose issue value is equal to the amount of money payable upon the exercise of the rights, and (3) for which the exercise of the subscription rights are always based on the contribution in kind of the corporate bonds (debt equity swap). Except in the case of a stock split, the conversion price is fixed at the time of its issue. In certain cases, however, the conversion price of rights may be revised downward when the price of its underlying stock falls. Among these cases, bonds issued under the condition that the conversion price can be adjusted downward with a frequency of one or more times every six months are called "corporate bond with subscription rights with adjustable conversion price (MSCBs: moving strike convertible bonds)." Because of market concerns about this type of "death spiral" financing, however, few of these types of bonds have been issued recently. On the other hand, as corporate bonds issued with detachable warrants are deemed a concurrent offering of corporate bonds and equity warrants, only those with undetachable warrants are included in the definition of "corporate bonds with subscription rights/warrants." In such case, the money to be paid upon the exercise of warrants should be paid additionally, and the bond remains outstanding.

"Structured bond" is the name popularly given to a bond structured with derivatives. In recent years, various types of structured bonds have been issued. A bond linked to the Nikkei average is a structured bond that incorporates Nikkei average options trading. In general, when the Nikkei average rises, the deal generates a higher return, but when it falls, the option is exercised, causing a loss, and the bond price falls below its par value. A corporate bond with a clause to convert it into shares of another company ("exchangeable bond" or EB) is a bond that incorporates a stock option of a company. In general, when the stock price of such company rises, the deal generates a

Table V-7. Kinds of Structured Bonds

Variable Cash Flow Bonds Step-up Bond: A bond issued initially with a coupon rate that is lower than the going rate then prevailing and that rises after the lapse of a certain period. By its very nature, the issuer often issues such a bond with a call option. Step-down Bond: A bond issued initially with a coupon rate that is higher than the going rate then prevailing and that declines after the lapse of a certain period. Deep-Discount Bond: This bond carries an interest rate lower than the going rate throughout its life, but it is issued at an under-par price to help its holders make up for the lower coupon by a redemption gain. Reverse Floater Bond: The coupon rate of this bond falls when the interest rate rises, and the coupon rate rises when the interest rate declines. This is a kind of derivative bond.
Index Bonds Stock, interest rate, or bond-index-linked bond: These are bonds whose redemption principal is linked to the Nikkei average, whose coupon rate is linked to the Nikkei average, whose coupon rate is linked to the interest swap rate, or whose redemption principal is linked to the Japanese government bond futures price. Exchange Rate Index Bond: Most of these dual-currency bonds are divided into those with a principal and coupon in yen that are redeemable in a foreign currency and into reverse dual-currency bonds with a principal and coupon redeemable in yen that carry a coupon in a foreign currency. As the amount of principal is normally larger than the coupon, dual-currency bonds carry a larger risk of exchange rate fluctuation.
Bonds with Options Exchangeable Bonds (EB): Issuers of this bond may at their discretion pay redemptions with a pre-fixed number of shares of another company. For the purchaser, this means the sale of a call option, and under this arrangement, the coupon increases by as much as the option premium. Other Bonds with Options: Included in this kind are callable bonds (the issuer can call the bond in advance of its maturity at the discretion of the issuer); puttable bonds (its holder can demand redemption in advance of its maturity); and knock-in, dual-currency bonds (a dual-currency bond with an exchange-rate option).

Source: Compiled on the basis of the data drawn from web site of Hephaistos Investment Research.

higher return because the holder can acquire the option fee, but when the price of its stock falls, the option is exercised, and the holder has to accept the share at a fallen price and suffers a loss. However, unlike in the case of a bond linked to the Nikkei average, the holder can hold the share until its price recovers. Recently there have been fewer issuances of structured bonds because of repeated cases of these bonds being sold to investors who did not adequately understand the risks involved, resulting in occasional court cases contesting whether securities companies had violated their obligation to properly explain these products before selling them.

CHAPTER VI

The Secondary Markets for Bonds

1. Trading of Bonds

Not many investors acquire bonds at the time of issuance and hold them until maturity. Instead, after holding the bonds for some time, investors usually sell their holdings for the purpose of realizing profits. Some also trade bonds in circulation according to changing conditions in financial markets. While there is no such central location, the conceptual marketplace where bonds change hands from one investor to another is referred to as the bond secondary market. The size of this market is usually measured in terms of trading volume or the value of bonds traded there.

In recent years, the bond trading volume in the secondary market has continued to increase. It grew by a factor of almost 50 from ¥58 trillion ($565.9 billion) in fiscal 1975 to ¥2,672 trillion ($26.1 trillion) in fiscal 1985, and by almost 70 to ¥3,989 trillion ($38.9 trillion) in fiscal 1995. After a slight decline in the trading volume to levels around ¥3,000 trillion ($29.3 trillion) in the late 1990s, the trading volume turned upward again, reaching ¥4,153 trillion ($40.5 trillion) in fiscal 2000 and breaking into the quadrillion level at ¥12,535 trillion ($122.3 trillion) in fiscal 2007. Since then the trading volume has edged down somewhat, but even recently has maintained a high level of nearly ¥8,000 trillion ($78.5 trillion).

The sharp increase in the trading volume of bonds may be explained by a number of factors, including the following. First, the government has continuously been issuing massive amounts of JGBs, resulting in a large increase in those outstanding in the market. Second, brokers/dealers and other financial institutions started to actively deal in bonds for trading gains (banks were authorized to deal in JGBs and other bonds in 1984). Third, the government started to auction off financial bills (FB) and treasury bills (TB) (integrated into T-bills in 2009), which are now actively traded by market participants with short-term cash management needs. The growing so-called flight-to-quality trend among investors amid a worsening in Japan's investment environment against the backdrop of the turmoil in financial markets and other factors also played a part.

Table VI-1. The Scale of Bond Purchasing and Selling

(trillions of yen, %)

Fiscal year	Over the counter	Exchange	Total
1975	56 (96.6)	2 (3.4)	58 (100.0)
1980	281 (96.9)	9 (3.1)	290 (100.0)
1985	2,515 (94.1)	157 (5.9)	2,672 (100.0)
1995	3,935 (98.6)	54 (1.4)	3,989 (100.0)
2000	4,148 (99.9)	5 (0.1)	4,154 (100.0)
2005	7,224 (100.0)	1 (0.0)	7,225 (100.0)
2007	12,534 (100.0)	0 (0.0)	12,534 (100.0)
2008	10,512 (100.0)	1 (0.0)	10,513 (100.0)
2009	7,905 (100.0)	1 (0.0)	7,906 (100.0)
2010	7,723 (100.0)	1 (0.0)	7,724 (100.0)
2011	8,408 (100.0)	0 (0.0)	8,408 (100.0)
2012	8,515 (100.0)	0 (0.0)	8,516 (100.0)

Notes: 1. The bond purchasing and selling value of exchanges = their trading volume on the exchanges × 2.
2. These figures include the purchasing and selling value of repurchase agreements.
Source: The Japan Securities Dealers Association and stock exchanges.

Table VI-2. The Value of Purchasing and Selling, by Type of Bond

(trillions of yen, %)

FY	Govt. bonds	Municipal bonds (incl. private placement)	Govt.-guaranteed bonds	Corporate bonds	Bank debentures	Corporate bonds with equity warrant	Total, including others
2000	3,972 (95.6)	44 (1.1)	33 (0.8)	44 (1.1)	45 (1.1)	9 (0.2)	4,154 (100.0)
2005	6,901 (95.5)	56 (0.8)	81 (1.1)	80 (1.1)	30 (0.4)	1 (0.0)	7,225 (100.0)
2007	12,323 (98.3)	75 (0.6)	34 (0.3)	51 (0.4)	18 (0.1)	1 (0.0)	12,534 (100.0)
2008	10,361 (98.6)	39 (0.4)	19 (0.2)	52 (0.5)	13 (0.1)	1 (0.0)	10,513 (100.0)
2009	7,813 (98.8)	23 (0.3)	15 (0.2)	28 (0.4)	11 (0.1)	2 (0.0)	7,906 (100.0)
2010	7,620 (98.7)	22 (0.3)	15 (0.2)	35 (0.5)	12 (0.2)	1 (0.0)	7,724 (100.0)
2011	8,300 (98.7)	19 (0.2)	16 (0.2)	40 (0.5)	10 (0.1)	1 (0.0)	8,408 (100.0)
2012	8,417 (98.8)	16 (0.2)	15 (0.2)	36 (0.4)	14 (0.2)	1 (0.0)	8,516 (100.0)

Notes: 1. The bond purchasing and selling value of exchanges = their trading volume on the exchanges × 2.
2. These figures include the purchasing a selling value of repurchase agreements.
Source: The same as above.

Additionally, government securities outweigh by far other categories of bonds in overall fixed income trading volume. The dominance of government debts stems mostly from the difference in liquidity, which in turn is mainly because government debts are considered risk free in Japan.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

2. Participants in the Secondary Bond Market

Looking at the OTC bond market by type of investors or transaction parties, trading is dominated by bond dealers, such as securities companies. In trading bonds, it is important that the transaction needs of market participants be met as quickly as reasonably possible. That said, due to the large number of issues and wide variety of transaction forms, it is not easy to rapidly locate a matching counterparty for a particular transaction. Therefore, in most bond transactions, securities companies or dealer banks act as the counterparty, buying or selling as principal to facilitate client trading. Furthermore, securities companies trade bonds based on their own market view, which adds to their overall trading volume. Following bond dealers, entities grouped as "others" account for the next largest share of the total volume. This group includes the Bank of Japan, which functions as the underwriting agent for JGBs as well as buying and selling a range of debt securities as part of its open market operations. Nonresident investors also are playing an increasingly large role in the Japanese bond market as a means of investing in yen. They are active players in the short-term JGB market, trading T-bills, and others. Among other categories, city banks (large commercial banks) and trust banks trade large volumes of bonds. In response to the recent difficult investment environment, city banks vigorously engage in bond trading in pursuit of trading profits as well as resell municipal and other bonds underwritten by them based on their own market view. It should also be noted that trust banks have traditionally allocated large shares of assets under management or administration, including pension assets, to bonds.

When measured in terms of net trading volume, almost all business categories have been net buyers of bonds in recent years. The backdrop to this trend has been ongoing low interest rate climate caused by the stagnation in the economy, various financial crises, and other issues. The continued trend among many business categories to be net buyers of bonds can be attributed to financial institutions' reduced risk tolerance in their loan portfolios. Another contributing factor to the net buyer trend has been the flight of risk money into the low-risk, high-liquidity JGB market in reaction to the depressed stock market and the turmoil in the securitization and commodity

Table VI-3. Trends in Bond Transactions, by Type of Transaction Parties

(¥10 billion)

	FY2000	FY2005	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
City (commercial) banks	15,978 (3,454)	23,335 (7,458)	25,102 (990)	28,411 (2,553)	29,087 (3,706)	28,479 (−1,267)	46,511 (−1,997)	40,149 (−2,861)
Regional banks	2,739 (615)	2,741 (652)	3,624 (604)	3,733 (1,002)	4,479 (1,172)	4,794 (1,210)	5,894 (1,021)	5,768 (647)
Trust banks	11,611 (1,683)	19,656 (4,182)	24,190 (4,086)	20,089 (3,976)	24,176 (7,599)	25,044 (6,481)	24,793 (8,251)	22,322 (8,137)
Agriculture-related banking institutions	1,997 (686)	2,012 (580)	1,814 (32)	2,665 (1,336)	4,430 (2,999)	4,699 (3,722)	3,356 (2,221)	3,098 (2,126)
Other banking institutions	5,839 (1,322)	5,534 (2,253)	8,917 (3,649)	7,708 (3,258)	5,794 (3,277)	5,792 (3,140)	5,437 (2,334)	4,259 (2,595)
Life and property casualty insurance companies	5,512 (1,074)	3,281 (770)	3,756 (941)	4,594 (1,234)	3,651 (1,743)	4,204 (1,472)	4,583 (1,896)	4,838 (1,629)
Investment trusts	4,821 (3,107)	3,265 (2,398)	3,220 (1,978)	2,920 (1,498)	2,856 (1,890)	2,981 (2,100)	2,881 (2,101)	3,080 (2,281)
Public employees mutual aid associations	498 (−25)	917 (591)	786 (611)	635 (459)	368 (245)	309 (206)	277 (166)	299 (213)
Business corporations	480 (341)	916 (709)	1,130 (960)	1,113 (886)	1,301 (1,250)	1,360 (1,261)	1,013 (932)	1,209 (1,098)
Nonresident investors	12,948 (2,815)	20,642 (3,346)	30,233 (5,808)	28,834 (8,184)	26,835 (8,473)	31,992 (11,901)	36,902 (14,891)	34,133 (15,995)
Others	22,403 (−15,871)	42,409 (−20,232)	44,845 (−22,043)	45,856 (−25,859)	53,330 (−34,211)	49,322 (−29,842)	52,737 (−31,389)	58,918 (−30,366)
Bond dealers	118,334 (149)	150,900 (−298)	195,292 (−450)	173,876 (182)	168,735 (248)	176,958 (−395)	179,035 (−570)	164,804 (−1,173)
Total (including other investors)	206,892 (847)	280,468 (4,693)	347,880 (−36)	326,109 (1,552)	331,212 (1,319)	341,953 (1,880)	369,000 (1,253)	348,505 (1,432)

Notes: 1. The figures given in the upper line represent the total of purchases and sales of bonds, and those given in parentheses in the lower line represent the difference between purchases and sales of bonds.
2. Figures exclude those of *gensaki* transactions.

Source: The Japan Securities Dealers Association.

markets. Interestingly, amid this net buyer trend, city (commercial) banks have become net sellers since fiscal 2010. This reversal likely reflects the commercial banks desire to capture some profit given recent stable bond prices. On the other hand, the "others" category has become a consistent and substantial net seller of bonds because primary JGBs issued by auction are settled via the BOJ and reported as sales by the central bank.

3. OTC Bond Market Trading

Depending on where transactions take place, the secondary market for bonds may be divided into exchange markets and over-the-counter markets where securities are traded over-the-counter by securities companies and other investors.

An overwhelming majority of bond transactions takes place over the counter rather than on exchanges. This is due to the following reasons: 1) there are so many issues of bonds that it is practically impossible to list all of them on exchanges; 2) due to the wide variety of transaction forms and other specifications that different buyers and sellers require, it is difficult to instantly locate a matching counterparty for a particular transaction; 3) tax on bond interest varies according to the tax profiles of bondholders; and 4) corporate investors, who account for the bulk of the bond trading volume, tend to trade in large lots and often carry out complex transactions involving more than one issue. On account of these reasons, bond transactions do not lend themselves to trading on exchanges, where the terms of transactions need to be standardized. Bonds are rather more efficiently traded over the counter, where trades are executed based on the terms individually negotiated between buyers and sellers.

The Tokyo Stock Exchange and the Nagoya Stock Exchange have bond trading facilities, but very few issues except for JGBs and corporate bonds with subscription rights and warrants are listed there.

Unlike exchange markets, where all orders for a particular security are concentrated in a single marketplace, OTC trading, in essence, is a decentralized transaction process based on one-to-one negotiation that is conducted over the counter at individual securities companies. In that sense, it may be said that the counter of each securities company is a market in itself and that there are as many OTC markets as there are securities companies. A wide variety of transactions may be executed over the counter once an investor and a securities company agree on their terms. Private placement bonds as well as publicly offered bonds may be traded, and the delivery and settlement procedures are to be agreed upon between the buyer and the seller. The transaction price can also be decided between the two parties, often in reference to the

Table VI-4. Bond Trading by Market

(¥10 billion, %)

		Government bonds	Bonds with subscription rights/warrants	Others
FY2006	Exchange	0	107	0
	OTC	956,614	118	24,097
FY2007	Exchange	0	62	0
	OTC	1,232,317	62	21,059
FY2008	Exchange	0	60	0
	OTC	1,036,070	72	15,042
FY2009	Exchange	0	56	0
	OTC	781,286	52	9,175
FY2010	Exchange	0	28	0
	OTC	762,029	70	10,174
FY2011	Exchange	0	40	0
	OTC	829,983	46	10,773
FY2012	Exchange	0	30	0
	OTC	841,743	45	9,759

Note: The figures for exchange trading volume are double those actually reported by exchanges to account for both buy and sell sides of transactions.
Source: The Japan Securities Dealers Association.

Table VI-5. Breakdown of Major Bond Categories, by Outstanding Balance and Number of Issues

(¥10 billion, No. of issues)

		Government bonds	Municipal bonds (public offering)	Government-guaranteed bonds and investment and loan bonds	Straight bonds and asset-backed bonds	Bonds with subscription rights/ warrants	Band debentures (interest bearing and discount)
End of FY2000	Number of issues	266	728	504	2,807	711	2,619
	Outstanding balance	367	16	35	50	10	48
End of FY2005	Number of issues	332	1,386	925	2,560	110	2,247
	Outstanding balance	666	31	53	52	1	25
End of FY2007	Number of issues	372	1,836	1,108	2,561	84	1,978
	Outstanding balance	681	37	55	54	1	22
End of FY2008	Number of issues	396	2,010	1,200	2,489	55	1,838
	Outstanding balance	676	40	58	56	1	20
End of FY2009	Number of issues	411	2,208	1,350	2,524	41	1,664
	Outstanding balance	716	44	61	60	1	18
End of FY2010	Number of issues	424	2,376	1,474	2,636	32	1,514
	Outstanding balance	754	48	63	62	1	16
End of FY2011	Number of issues	449	2,501	1,634	2,684	21	1,272
	Outstanding balance	781	51	64	63	1	15
End of FY2012	Number of issues	470	2,643	1,772	2,733	17	1,163
	Outstanding balance	814	54	66	61	1	14

Note: Outstanding balance figures are in trillions of yen.
Source: The Japan Securities Dealers Association.

prices of the relevant financial products.

In OTC trading, a securities company first buys bonds that a client offers to sell and then resells them to another client afterward. When a client wants to buy bonds, it sells them out of its inventory or sells short. These types of transactions are generally referred to as “principal transactions.”

4. Publication of Reference Prices for OTC Bond Trading

As OTC bond trading is a negotiated process between a securities company and a client, it is difficult for a third party to discover the price at which a transaction is consummated. Publication of prices and other information concerning OTC bond transactions not only helps efficient and orderly trading of bonds but is also of critical importance from the standpoint of investor protection by promoting the formation of fair prices and facilitating investors’ access to trading at the best possible price. Publication of bond prices is thus indispensable for the development of bond markets.

With a view to providing investors, securities companies, and others with reference information, the JSDA instituted the Program for Publishing Reference Prices (Yields) for OTC Bond Transactions, which publishes (midpoint between buy and sell quotes) quotes for publicly offered public and corporate bonds that meet certain criteria. The program was originally instituted in August 1965 by the Bond Underwriters Association of Japan for publishing OTC Quotes for Industrial Debentures and was succeeded by the Tokyo Securities Dealers Association, the predecessor of the JSDA, which began the publication of OTC Quotes for Public and Corporate Bonds in March 1966. The initiatives were implemented with a backdrop of social necessity to promote the formation of fair prices and efficient and orderly trading for JGBs, issuance of which had been resumed after the war. The program has since undergone many changes and improvements in response to the changing environment surrounding the bond market. During that period, the number of published issues has ballooned from about 300 when the system was introduced to approximately 7,900. In August 2002, the JSDA changed the name of the data to reference prices (yields) from standard quotes with the intent to clearly indicate that it is for reference purposes. At the same time, the program was enhanced by publishing high, low, and median values of surveyed quotes in addition to their averages, which was the only data previously published. That system continues today.

Since the program started publishing bond quotes 40 years ago, its use has evolved from the original purpose of providing price references for OTC bond trading in Japan. In addition to that role, it has become widely used for mark to market valuation for financial reporting and tax accounting purposes

Table VI-6. The System of Reference (Yields) Table for OTC Bond Quotations

Outline (1) Purpose To publish quotations reported by member companies appointed by the Japan Securities Dealers Association to be used as reference by member companies of the association and their clients in trading bonds over the counter between them. *Note*: In August 1965, the Bond Underwriters Association started publishing quotations on OTC industrial bonds. Subsequently, the Tokyo Securities Dealers Association started publishing OTC bond quotations in March 1966, and improvements have been made on several occasions thereafter. (2) Computation of reference price (yields) table for OTC bond transactions The JSDA receives reports from its member companies affiliated with the system (18 securities companies as of December 31, 2013) on quotations as of 15 hours of each trading day. And the JSDA computes the reference prices (yields) of a given issue on the basis of an arithmetic average of quotations on issues with respect to which it has received reports from five or more member companies.

and the valuation of collateral for different types of transactions. This expanded function demands an even greater degree of confidence in the system. As a result, in 2013 a review was made of the quotation system primarily with regard to publishing reference prices for corporate straight bonds. The new system arising from that review is expected to start up in 2015.

5. Book-Entry Bond Transfer System

In the past, investors have held bonds in various forms—more specifically, in physical certificates that had been issued by the issuer; in registered form, where bondholders are registered on the registry at the registrar designated for the issue; and as book-entry JGBs, where physical certificates are deposited with the BOJ so that trades can be settled by book-entry transfers (within a system established in 1980) among the accounts of brokers and other system participants.

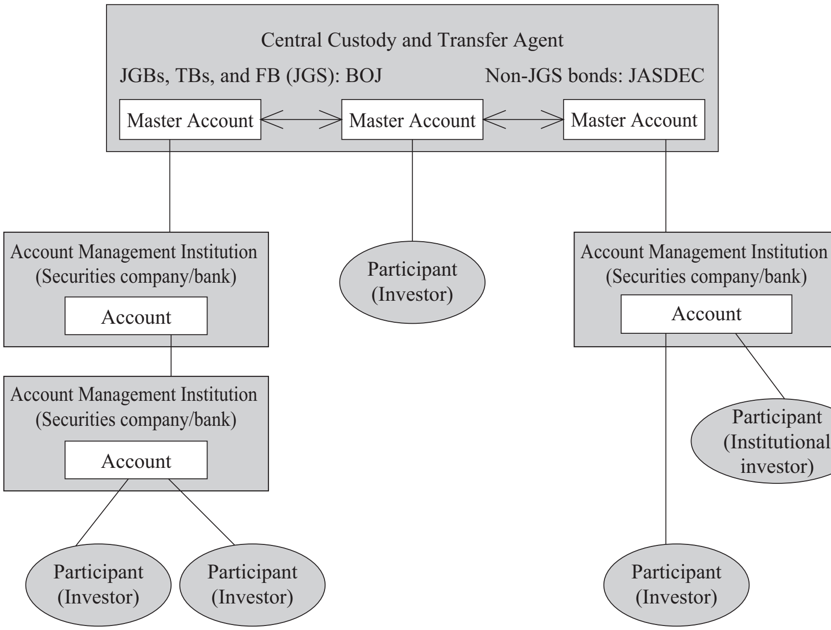
In recent years, however, with the increasing bond trading volume and a growing call for a flexible framework and an expedited process for the settlement of transactions, certificates, which need to be physically delivered, or registered bonds, whose transfer requires amendment in records of bond-specific registries, hardly stood the test of practical use, while the book-entry transfer system for JGBs had several shortcomings. This situation first led to the argument for the review of the current settlement procedures for bonds and, later, for the complete overhaul of the securities settlement system in Japan. There was a growing perception that Japan urgently needed to renovate the existing system to create a safer and more efficient infrastructure that would make the country's securities markets globally competitive. Against

Table VI-7. History of the Program for Publishing Reference Prices (Yields) for OTC Bond Transactions

	Kinds of selectable issues	No. of selected issues
Over-the-counter quotes announced in March 1966 -Date of announcement (Thursday of each week)	Government securities, municipal bonds, government-guaranteed bonds, coupon bank debentures, corporate bonds, telegraph and telephone (TT) coupon bonds subscribed to by subscribers, discount TT bonds, and such other bonds as may be recognized by the Japan Securities Dealers Association (JSDA)	No. of issues announced: 280 (as of May 12, 1966)
January 1977 Announcement of benchmark and standard quotes (the benchmark quotes are announced every day except Saturday), and the standard quotes are announced once a week (Thursday)	(1) Benchmark quotes (for institutional investors) are selected from such issues whose volume of trading correctly reflects the movement of the market. (2) Standard quotes (for small-lot investors) are selected from one of government securities, municipal bonds, special bonds, bank debentures, corporate bonds, and yen-denominated foreign bonds, other than those listed in (1) above in terms of maturities and interest rates.	(1) Benchmark quotes: Issues announced: 14 (as of January 31, 1977) (2) Standard quotes: Issues announced: 77 (as of January 27, 1977)
August 1978 The method of announcing benchmark quotes was changed (bid quotations and asked quotations are announced). Benchmark quotes are announced daily (except on Saturday), and standard quotes are announced once a week (Thursday).	The same as above.	(1) Benchmark quotes: Issues announced: 19 (as of Aug. 31, 1978) (2) Standard quotes: Issues announced: 137 (as of Aug. 31, 1978)
January 1992 Standard quotes on OTC issues are announced daily.	One of the government securities, municipal bonds, government-guaranteed bonds, bank debentures, corporate bonds, and yen-denominated foreign bonds that are not listed is selected in terms of kinds, maturities, and interest rates.	Issues announced: 208 (as of January 31, 1992)
April 1997 No. of selectable issues was sharply increased (the new system started operating.)	Publicly offered but unlisted bonds (with a remaining life of one year or longer) that maintain a fixed interest rate throughout their life and redeem their principal in a lump sum were selected.	Issues announced: 1,746 (as of May 1, 1992)
December 1998 The duty to concentrate its trading on the exchange market was abolished.	Publicly offered bonds (with paid-in principal, interest, and redemption money all paid in yen) are selected.	Issues announced: 2,867 (as of December 1, 1998)
August 2002 Name of system changed to "Reference (Yields) Table for OTC Bond Quotations." In addition to average values, highs, lows, and midpoints are published.	The same as above	Issued announced: 4,198 (as of August 1, 2002)
Decision made to revise the calculation method for corporate straight and other bonds and announce quotes earlier (to be implemented in 2015).	The same as above	Issued announced: 7,931 (as of December 2, 2013)

Note: Selected issues reported on and after August 5, 2002, were transferred to the system of publishing reference statistical data on bonds traded.

Chart VI-1. Structure of Book-Entry Transfer System



this background, the securities settlement system reform law was enacted in June 2002, and, pursuant to its provisions, the existing legislation for book-entry transfer was later amended and renamed the Law Concerning the Book-Entry Transfer of Corporate Bonds and Other Securities with objectives including the complete dematerialization of securities, the shortening of settlement cycles, and the reduction in settlement risk. The amended law provided for the legal framework of new book-entry transfer systems for corporate and government securities. On the basis of that framework, the BOJ renovated the existing JGB book-entry system in January 2003, and the Japan Securities Depository Center (JASDEC) started operating a new central custody and book-entry transfer system for securities, including nongovernment bonds in January 2006.

These book-entry transfer systems have a multitier, tree-like structure, with a central custody and transfer agent–the BOJ in the case of JGBs, TBs, and FBs and JASDEC, in the case of the other eligible securities–on the top tier, from which account management institutions, securities companies, and other institutions with respective master accounts in the system and system participants, other securities companies, and investors that have an account at one

Table VI-8. Bonds under Custody and Book-Entry Transfer Volume

(No. of transactions, millions of yen)

		Increase: new issues	Decrease: redemptions and retirement by purchase	Transfer	Number of participating issues (at fiscal year-end)
FY2005	Number of transactions	9,931	–	13,920	19,270
	Transaction volume	6,406,615	–	8,947,334	6,406,615
FY2006	Number of transactions	38,740	1,210	211,083	65,456
	Transaction volume	34,215,248	721,180	99,748,483	181,334,701
FY2007	Number of transactions	33,245	15,128	484,041	72,817
	Transaction volume	40,491,108	12,840,198	240,536,068	241,002,170
FY2008	Number of transactions	33,961	38,830	492,394	73,298
	Transaction volume	37,812,077	38,539,738	223,475,737	240,274,559
FY2009	Number of transactions	31,642	38,176	411,272	71,202
	Transaction volume	38,124,350	32,846,953	132,878,030	245,552,257
FY2010	Number of transactions	29,501	36,849	439,327	67,788
	Transaction volume	37,212,947	32,691,251	146,347,996	250,073,952
FY2011	Number of transactions	26,664	35,619	439,867	60,701
	Transaction volume	32,955,046	30,589,808	156,713,049	252,439,190
FY2012	Number of transactions	27,326	33,476	471,798	58,486
	Transaction volume	33,558,410	33,213,581	143,537,681	252,784,020

Note: The JGB book-entry system began on January 10, 2005.
Source: JASDEC.

Table VI-9. Reforms of Bond Delivery and Settlement System

Date	Changes effected
April 1994	Delivery versus payment (DVP) of government bonds through the Bank of Japan network starts.
April 1997	System of T+3 government bond rolling settlement starts.
October 1999	System of T+3 general bond rolling settlement starts.
January 2000	Real-time gross settlement (RTGS) of government bonds starts.
January 2003	Transfer of Corporate Debt Securities Law (paperless trading in bonds, etc.) is enforced. Paperless trading in government bonds starts.
May 2004	DVP trading in bonds other than government bonds starts.
May 2005	Trading in government bonds through a settlement organization starts.
January 2006	Paperless issuance of and paperless trading in bonds other than government bonds are scheduled.
April 2012	Settlement of JGBs scheduled to be shortened (T+2)

of the account management institutions cascade down as subsequent tiers or branches. Bond holdings of system participants are registered or recorded in the transfer account book kept by the account management institution at which they have an account. In principle, all bonds are deposited with the central custody agency at the time of issuance, and the entire issue is dematerialized. None of those book-entry bonds may be withdrawn over their life in the form of either physical certificates or registered bonds.

The previously mentioned Securities Settlement System Reform Law also provided measures to affect the abolition of the Corporate Bond Registration Law following the set up of the book-entry transfer systems.

6. Secondary Market Yields and Terms of Bond Issues

Those who raise funds by issuing bonds look for a method that offers the lowest-possible cost. On the other hand, investors who buy bonds choose issues that offer the highest-possible return at the lowest-possible risk. In theory, the issue terms of a bond (subscriber's yield to maturity) are determined at a level where opportunities for arbitraging its subscriber's yield to maturity and the secondary market yield of outstanding issues of a nature similar to that of the bond are exhausted. When such opportunities are exhausted, it is said that "issue terms that adequately reflect the secondary market conditions have been established."

Important conditions for efficient arbitrage to occur include the following:

Chart VI-2. Changes in Issue Terms of Bonds (yields)

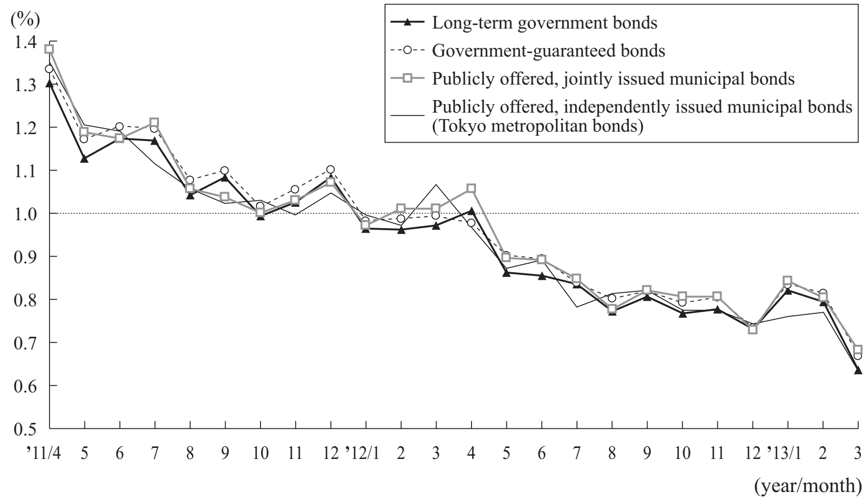
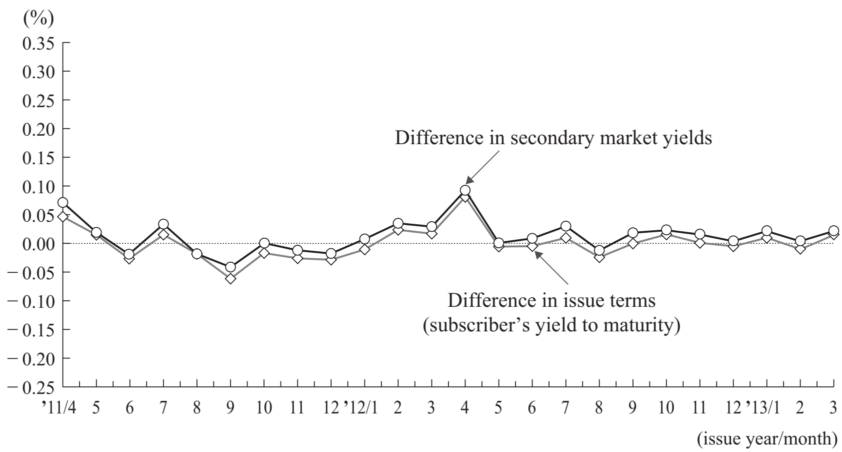


Chart VI-3. Changes in the Difference in Issue Terms and Secondary Market Yields between Publicly Offered, Jointly Issued Municipal Bonds and Government-Guaranteed Bonds



Notes: 1. The difference in secondary market yields are the differences in the Reference Prices for OTC Bond Trading on the day before determining the issue terms for jointly issued municipal bonds and government-guaranteed bonds (both10-year bonds).

2. The difference in issue terms (subscriber's yield to maturity) is the yield on jointly issued municipal bonds minus the yield on government-guaranteed bonds (both10-year bonds).

the outstanding balance and trading volume of comparable bonds are sufficiently large, new bonds are issued regularly, and the secondary market yields of comparable bonds are available for reference at the time of pricing new issues. This has been demonstrated in the bond market in Japan in that yields at the issue of particular types of bonds have come into line with yields of their comparables as the amount of new issues of the bonds and secondary trading volume of the comparables increased.

More specifically, amid the continued massive issue of government bonds, the proportion of bond issuance through public auctions that more closely reflect market conditions has steadily increased under a market-oriented national debt management policy, replacing the previous emphasis on non-competitive, syndicated underwriting, where issue terms were based on the official discount rate or other benchmarks. Currently, in principle, all government bonds (excluding those for retail investors) are issued through auctions (the syndicated underwriting program for JGBs was discontinued in March 2006).

The market-oriented transition of bond issuance has also been witnessed in pricing spreads among bonds with different credit qualities. For example, yields at the issue of government-guaranteed bonds and local bonds were determined in reference to the yield at issue of 10-year JGBs that had been issued earlier in the month. From time to time in the past, the spreads of issues among the three classes of bonds deviated from market spreads. In recent years, however, as investors started to focus more on differences in credit quality, the spreads of issues among the three classes have increasingly tended to move more in line with credit spreads prevailing in the market. Another case in point that demonstrates the increased market orientation in bond issuance is that a growing portion of government-guaranteed bonds is now issued through a competitive bidding process (as individual issues). Investors are also showing an increasing tendency to differentiate corporate bonds based on credit ratings by rating agencies and other factors. In response to this, many issuers go through a premarketing process to identify and estimate investors' demand and determine the terms of issue accordingly.

7. *Gensaki* Market for Bonds (1)

A repurchase agreement (a conditional purchase or sale) is a form of trading between a seller and a buyer of debt securities whereby the seller (or the buyer) agrees to repurchase (or resell) the securities at an agreed-upon price at a stated time. When the holder of bonds sells them to a buyer under an agreement to buy them back (a *gensaki* sell transaction), the holder can raise funds temporarily. When an investor buys bonds from a seller under a repurchase

Chart VI-4. Trading Mechanism of Repurchase Agreements

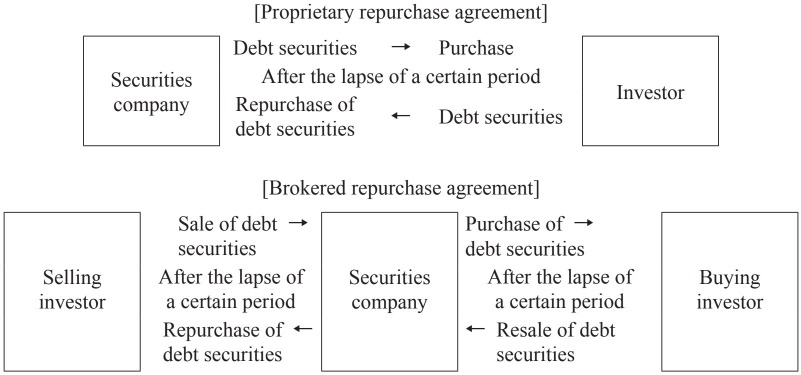


Table VI-10. Turnover and Balance of Repurchase Agreements

(¥10 billion)

FY	Turnover of bonds (A)	Turnover of repos (B)	B/A	Balance of repos
2000	414,783	209,710	50.5	2,686
2005	722,379	441,714	61.1	3,017
2007	1,253,438	905,505	72.2	4,953
2008	1,051,184	724,941	69.0	2,326
2009	790,513	410,389	51.9	1,589
2010	772,273	435,882	56.4	1,891
2011	840,802	471,755	56.1	2,538
2012	851,547	502,992	59.1	2,354

Source: The Japan Securities Dealers Association.

agreement to sell them back to the seller (a *gensaki* buy transaction), the investor can earn a certain amount of interest by investing funds for a short period. When a securities company acts as an intermediary and arranges a repurchase agreement by introducing a buyer who wants to invest idle cash in bonds to a seller who wants to raise funds by selling bond holdings, such a deal is called a brokered repurchase agreement. When a securities company that is in need of short-term cash sells bonds out of its inventory to an investor under a repurchase agreement, it is called a proprietary repurchase agreement. As the repurchase (or resale) price includes an amount equivalent to a return on investment or financing charge based on an agreement by the buyer

Table VI-11. Balance of Repurchase Agreements, by Major Investor Groups

(¥10 billion)

Fiscal year-end	FY2005		FY2006		FY2007		FY2008		FY2009		FY2010		FY2011		FY2012	
	Selling balance	Buying balance	Selling balance	Buying balance	Selling balance	Buying balance	Selling balance	Buying balance	Selling balance	Buying balance	Selling balance	Buying balance	Selling balance	Buying balance	Selling balance	Buying balance
Regional banks	0	2	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Trust banks	0	21	0	12	0	18	0	8	0	68	0	88	0	97	0	13
Agriculture-related banking institutions	0	0	0	1	0	1	0	0	0	2	0	2	0	6	0	2
Other banking institutions	91	64	52	24	21	14	15	26	0	11	0	1	0	105	0	84
Investment trusts	0	73	0	73	0	92	0	92	0	75	0	65	0	143	0	206
Business corporations	1	55	1	37	3	31	0	31	0	47	0	43	0	82	0	50
Nonresident investors	1,147	1,255	1,728	1,012	1,960	1,760	678	466	446	446	538	560	616	1,200	511	1,293
Others	62	227	14	454	179	866	173	985	210	494	155	219	121	264	70	195
Bond dealers	1,716	1,300	1,623	1,794	2,790	2,163	1,460	697	933	446	825	539	1,800	618	1,772	511
Total	3,017	3,017	3,418	3,418	4,953	4,953	2,326	2,326	1,589	1,589	1,518	1,518	2,538	2,538	2,354	2,354

Source: The Japan Securities Dealers Association.

and seller, the price does not usually tally with the market price of the bond prevailing at the time of its repurchase (or resale). Repurchase agreements can also be concluded for commercial paper (CP) and certificates of deposit (CDs) and CPs issued overseas.

Despite some annual fluctuation, *gensaki* transactions have maintained a significant level of trading volume because they conveniently meet the short-term funding and cash management needs of investors. The outstanding balance of *gensaki* transactions reached almost ¥27 trillion ($263.3 billion) at the end of fiscal 2000, compared with ¥7 trillion ($68.3 billion) in the late 1980s. Although there have been some dips in the balance since then due to an accommodative monetary policy, the balance has grown overall, partially because of the massive issuance of JGBs. Along with the BOJ's lifting of quantitative easing measures and other factors, the balance reached ¥50 trillion ($487.8 billion) at the end of fiscal 2007. Recently, the balance has been around ¥24 trillion ($234.1 billion).

Previously, the overwhelming majority of *gensaki* transactions were for short-term government securities (TBs and FBs). Despite intensifying competition against other increasingly diversified money market instruments these government bills have dominated the *gensaki* market, as the bills, which have maturities and credit quality more suitable for *gensaki* transactions, have been increasingly issued to the public. More specifically, these short-term government securities dominated the market because 1) in 1986 the BOJ stopped reselling FBs that it had underwritten in the secondary market, shifting this operation to the *gensaki* market; 2) since 1999 the government has been issuing all FBs, in principle, directly to investors through public auctions; 3) the TB program got started in 1986; and 4) the issuance of both TBs and FBs has been regular and of large volume. Although the *gensaki* market developed against the backdrop of this expansion of the short-term government securities market, interest-bearing JGBs have taken center stage in recent years, partially because of the massive overall issuance of government bonds.

8. *Gensaki* Market for Bonds (2)

In an effort to modernize and strengthen the international competitiveness of Japan's money market, the *gensaki* market underwent a reform to improve its functions as a repo market that facilitates the need for both short-term financing and bond borrowing, and thus what came to be called new *gensaki* transactions started in April 2001.

Up to that point, *gensaki* transactions were bought and sold much like the transactions commonly known as repo trades in the U.S. and Europe but had various shortcomings that cried out for reform. In particular, the *gensaki* market did not have functional risk management facilities or standard rules for dealing with counterparty default. By this reform, new measures were instituted and existing provisions were enhanced for risk management and other purposes, establishing the *gensaki* market in accordance with global standards.

The newly introduced provisions for risk management and other purposes (clauses in the repurchase agreement) may be summed up as follows:

(1) Risk control clause

The amount of collateral (bonds) shall be adjusted flexibly so as not to cause a shortage of collateral on account of a fall in the price of bonds submitted as collateral.

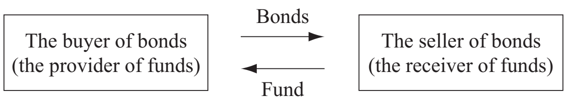
1) The application of the ratio for computing the purchase/sale value of bonds (the haircut clause)

Under this clause, the unit price of bonds (collateral), on the basis of which a repurchase agreement is concluded is fixed at a level that is a certain percentage point lower than the price prevailing at the time the repurchase agreement is concluded, so that the value of the collateral will not be affected even when the market price of the underlying bonds falls.

2) The introduction of management of collateral, etc. (the margin call clause)

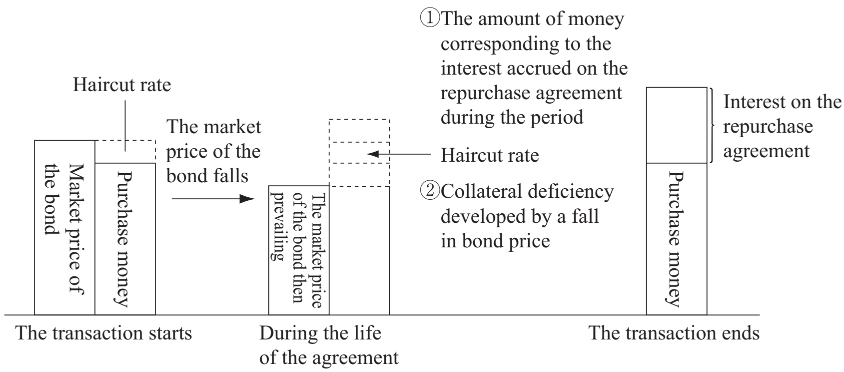
Chart VI-5. Working Mechanism of the New *Gensaki* Transaction System

1. Start of transaction



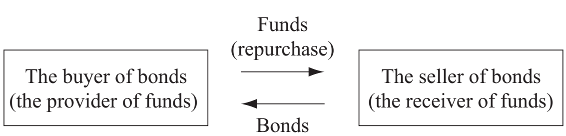
- Purchase money for bonds
  The market price of the bonds prevailing at the time a deal is struck ÷ (1 + haircut rate) × number of bonds traded

2. Control of credit risk during the life of the agreement



- Credit given to the seller of the bonds by the buyer of the bonds (the provider of funds).
- In the case referred to above, the buyer of the bonds can demand collateral (cash and/or bonds) of the seller, the value of which is equal to the credit given him (margin call).

3. End of transaction



- Money to repurchase the bonds is necessary for the seller at the time the transaction is consummated.
- The money of the buyer is needed to purchase the bonds at the time the transaction started + interest accrued on the repurchase agreement.

Under this clause, when the market value of the underlying bonds changes during the period of the repurchase agreement, the amount of credit extended to a party to the repurchase agreement is maintained by adjusting the collateral.

3) The introduction of the repricing system

In a case in which the market price of the underlying bonds falls sharply from that which prevailed at the time of the repurchase agreement, the parties to the agreement agree to cancel the agreement and renegotiate a new agreement on the basis of a price then prevailing, on terms and conditions identical to those of the agreement thus canceled.

(2) Substitution of underlying bonds

Under this clause, the seller of bonds can replace the underlying bonds with other bonds with the consent of the buyer, allowing the seller to use the underlying bonds if necessary.

(3) Institution of a netting-out system

If the other party goes into default for any reason, such as bankruptcy, the value of all transactions covered by the agreement will be reassessed based on market prices, and the difference between claims and obligations will be settled.

9. Bond Lending

When investors have shorted bonds (or sold bonds that they do not own) and failed to buy them back before the settlement date, they turn to bond lending services to borrow bonds to deliver. Such transactions are also known as *saiken* repo (bond repos) in Japan. When the collateral is cash, bond lending is also used to procure or invest money on a short-term basis similar to *gensaki* transactions. Since market participants can obtain bonds through bond lending facilities after trades are consummated, they can sell bonds that they do not own (sell short) when they feel that the bond market is too expensive or particular issues are overvalued. Such operations contribute to greater liquidity in the market.

Bond lending was instituted by legislation in 1989, following the lifting of the practical ban on bond short selling. In fear of potential effects on the financial health of brokers and dealers and bond pricing, market participants had previously been requested to refrain from selling bonds short. The ban, however, was lifted to help encourage active market making in cash bonds, and arbitrage between cash bonds and futures and bond borrowing and lending was introduced as one of the means to locate bonds to deliver. Initially, cash collateral bond borrowing and lending was restricted in light of potential

Chart VI-6. Working Mechanism of Bond Lending (secured with cash deposit)

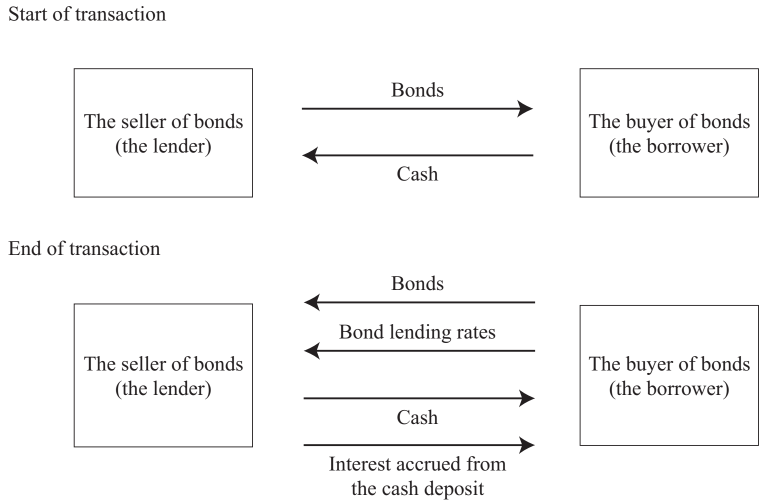


Table VI-12. The Balance of Bond Lending Transactions, by Types of Collateral (on the basis of delivery and face values)

(billion yen)

Year and Month	Bonds lent				Bonds borrowed			
	Secured transactions	Secured by cash deposit	Unsecured transactions	Total	Secured transactions	Secured by cash deposit	Unsecured transactions	Total
FY1996 year-end	1,661	1,451	575	2,236	2,073	1,704	1,313	3,386
FY2000 year-end	5,823	5,713	181	6,004	4,438	4,276	687	5,125
FY2005 year-end	7,658	7,534	239	7,897	8,547	8,426	979	9,526
FY2006 year-end	8,190	7,834	363	8,552	8,838	8,579	1,061	9,899
FY2007 year-end	9,478	8,669	395	9,872	9,944	9,664	667	10,611
FY2008 year-end	6,863	6,679	246	7,109	6,863	6,674	246	7,109
FY2009 year-end	8,227	8,005	275	8,502	8,227	8,005	275	8,502
FY2010 year-end	7,360	7,155	284	7,644	7,360	7,155	284	7,644
FY2011 year-end	8,357	8,347	207	8,565	8,357	8,347	207	8,565
FY2012 year-end	8,357	8,318	227	8,584	8,357	8,318	227	8,584

Note: Breakdowns of bond lending transactions have been published since January 1997. A partial revision was made to the calculation method in January 2009.
Source: The Japan Securities Dealers Association.

conflicts with the *gensaki* market and other considerations, and, subsequently, most transactions were uncollateralized. However, with credit fears rising, the bond lending market remained stagnant and cash collateral bond borrowing and lending transactions were effectively deregulated in 1996 in order to invigorate the market.

When viewed from a legal standpoint, a bond lending transaction is deemed to be a contract for a loan for consumption. A borrower borrows bonds for the purpose of consumption and, when due, the borrower has only to return bonds identical in kind and quantity with those originally borrowed. Bond lending transactions may be broadly classified into "unsecured transactions" and "secured transactions" depending on whether they are collateralized or not. Secured bond lending transactions may be further divided into "cash-collateralized transactions" and "securities-collateralized transactions" by the type of collateral being pledged. Cash-collateralized transactions used to borrow specific bond issues are called SC *torihiki* (specified collateral trades), while those for financing and cash management without such specification are termed GC *torihiki* (general collateral trades). The size of the bond lending market (in terms of the balance of outstanding loans) has generally been growing since cash-collateralized transactions were deregulated in 1996. The market has grown from approximately ¥34 trillion ($331.7 billion) at the end of fiscal 1996 (including approximately ¥17 trillion in cash-collateralized transactions) to ¥86 trillion ($839.0 billion) at the end of fiscal 2012 (including approximately ¥83 trillion in cash-collateralized transactions). The majority of bond lending transactions are conducted with government securities.

CHAPTER VII

The Derivatives Market

1. Futures Trading

"Futures trading" refers to an agreement to buy or sell a specific amount of a commodity or financial instrument at a particular price on a stipulated future date. The history of futures trading is as old as that of commodities trading. However, it is generally believed that the precursor of today's fully developed futures market emerged in Japan as the account-balancing trading in rice (the rice market) conducted in Osaka in the Edo period (1603–1868). This was a method that made it possible for parties to consummate a transaction by organizing one-on-one negotiated transactions in such a way as to enable them to settle the difference without delivery of the underlying commodity or financial instrument and is considered the beginning of Japan's futures trading. By inheriting this tradition, stock futures were traded in the form of margin transactions on the stock exchange in Japan in prewar years. After the war, margin transactions were prohibited by the General Headquarters (GHQ) of the Supreme Commander for the Allied Powers (SCAP) in Japan in order to curb speculative transactions, but some people claim that margin trading with individual investors had been partly revived on the stock market.

In 1972, the Chicago Mercantile Exchange started trading in currency futures. The Chicago Board of Trade started trading in futures on fictitious bonds called benchmark issues in 1974, and the Kansas City Board of Trade started trading in stock index futures in 1982. And these types of futures trading spread to the stock exchanges of other countries around the world, including the introduction of trading in securities futures in Japan. Long-term government bond futures trading that started on the TSE in 1985 was the first financial futures trading conducted in Japan. More products emerged in quick succession: the OSE's "Osaka Stock Futures 50 (OSF50)" in 1987; the OSE's Nikkei 225 futures trading and the TSE's TOPIX futures trading in 1988; and the Tokyo Financial Exchange Inc. (TFX)'s Japanese yen short-term interest-rate futures, U.S. dollar short-term interest rate futures, and yen-dollar currency futures in 1989.

Table VII-1. Years in Which Major Financial Futures of the World Were Listed

Year	Other countries	Japan
1972	Currency futures (mark-dollar and yen-dollar) (Chicago Mercantile Exchange, CME)	
1976	TB futures (CME)	
1977	Treasury bond futures (Chicago Board of Trade, CBOT)	
1981	Eurodollar interest rate futures (CME)	
1982	S&P 500 futures (CME); T-note futures (CBOT); U.K. government bond futures and pound interest rate futures (London International Financial Futures and Options Exchange, LIFFE)	
1984	FTSE 100 futures (LIFFE)	
1985		Long-term government bond futures (Tokyo Stock Exchange, TSE)
1986	French government bond futures (Marché à Terme International de France, MATIF), Nikkei average futures (Singapore International Monetary Exchange, SIMEX)	
1987	Japanese government bond futures (LIFFE)	
1988	CAC40 futures; PIBOR (Paris interbank offered rate) futures (MATIF); BUND futures (LIFFE)	TOPIX futures (TSE), Nikkei 225 futures (Osaka Securities exchange, OSE)
1989	Euroyen interest rate futures (SIMEX)	Euroyen short-term interest rate futures (Tokyo International Financial Futures Exchange, TIFFE)
1990	Euromark interest rate futures (LIFFE); Nikkei average futures (CME); DAX futures and BUND futures (Deutsche Terminborse, DTB)	
1993	Japanese government bond futures (SIMEX)	
1996	Euroyen interest rate futures (LIFFE); NASDAQ 100 futures (CME); KOSPI 200 futures (KSE)	Medium-term government bond futures (TSE)
1997	E mini S&P 500 futures (CME)	
1998	EURIBOR futures (LIFFE), Euro STOXX 50 futures (EUREX)	
1999	E mini NASDAQ 100 futures (CME)	
2000	S&P CNX Nifty Index futures (NSE)	
2001	Single stock futures (LIFFE), E Mini Russell 2000 futures (CME)	
2004	Single stock futures (One Chicago)	
2005	VIX index futures (CFE)	
2006		Exchange FOREX margin contracts (TFX)
2008	RTS index futures (RTS)	Nikkei 225 mini (OSE)
2010	CSI 300 futures (CFFEX)	

Note: CBOT: Chicago Board of Trade, CFE: CBOE Futures Exchange, CFFEX: China Financial Futures Exchange, CME: Chicago Mercantile Exchange, DTB: Deutsche Terminbörse (presently Eurex), ICE: ICE Futures U.S., KSE: Korea Stock Exchange (presently KRX), LIFFE: London International Futures and Options Exchange (presently NYSE Liffe), MATIF: Marché à Terme International de France (presently NYSE Liffe), NSE: National Stock Exchange of India, RTS: Russian Trading System (presently Moscow Exchange), SIMEX: Singapore International Monetary Exchange (presently SGX), TSE: Tokyo Stock Exchange; OSE: Osaka Securities Exchange; TFX: Tokyo Financial Exchange.

Strictly speaking, futures contracts are traded on the exchange. However, while a futures contract can be assigned to a third party, a margin has to be deposited to provide against nonperformance of the contract. A forward contract is a transaction made between parties. While it cannot be assigned to a third party, it does not require the deposit of a margin. Transactions in currency or interest-rate futures are forward contracts often negotiated between a bank and its client, and they are called forward-exchange agreements (FXA) or forward-rate agreements (FRA). Along with swap trading, these two types of transactions played a leading role in boosting the derivatives markets around the world in the 1990s.

2. Bond Futures Trading

Trading in securities futures (Government National Mortgage Association [GNMA] certificates) first started in 1974 in the United States. Trading in 10-year government bond futures was conducted on the Tokyo Stock Exchange in 1985—the year in which they were issued in massive amounts—which was the first financial futures trading in Japan. In 1989, superlong-term (20-year) government bond futures (discontinued in 2002) were listed on the Tokyo Stock Exchange, and trading in U.S. Treasury bond futures—which had the largest trading volume in the world—started on the Tokyo Stock Exchange in 1989. (The trading of treasury bond futures was suspended in Japan in 1998.) With the trading in medium-term (5-year) government note futures that started on the Tokyo Stock Exchange in 1996, Japan had finally developed a product mix comparable to that of other countries.

Bond futures are generally traded on the basis of a fictitious issue called a benchmark issue whose price is believed to indicate the level of yield curve then prevailing. Therefore, the price of bond futures is formed in the belief that the prices of individual bonds are above the yield curve of the benchmark issue or above a yield curve that runs parallel to it. Because a seller can choose an issue just as in a regular settlement, the seller chooses the most reasonably priced issue at that point in time, but the price of the issue to be delivered is computed by multiplying the price of the benchmark issue by a conversion factor prescribed by the exchange.

One of the characteristics of the bond futures trading conducted in Japan is that issues are traded in units with a total par value of ¥100 million ($0.98 million), about 10 times as large as that of other countries. (This compares with $100,000 in the case of treasury bond futures traded on the Chicago Board of Trade, or 100,000 Eurodollars in the case of BUND futures traded on the EUREX.) This is due to the fact that in cash bond transactions, bonds whose value falls short of ¥100 million are treated as a fraction of a trading

Table VII-2. The Trading Mechanism of Bond Futures

	Medium-term govt. note futures	Long-term govt. bond futures	Superlong-term govt. bond futures
Object of trading	Standardized 3%, 5-yr. Japanese govt. bond	Standardized 6%, 10-yr. Japanese govt. bond	Standardized 6%, 20-yr. Japanese govt. bond
Object of delivery	Interest-bearing 5-yr. govt. notes with a remaining life of 4–5 yrs and 3 mos.	Interest-bearing 10-yr. govt. bonds with a remaining life of 7–11 yrs.	Interest-bearing 20-yr. govt. bonds with a remaining life of 15–21 yrs.
Contract month	Mar, Jun, Sep, Dec cycle (3 contract months traded at any one time)	Mar, Jun, Sep, Dec cycle (3 contract months traded at any one time)	Mar, Jun, Sep, Dec cycle (3 contract months traded at any one time)
Delivery date	20th day of Mar, Jun, Sept, or Dec	20th day of Mar, Jun, Sept, or Dec	20th day of Mar, Jun, Sept, or Dec
Last trading day	7 business days preceding the delivery date	7 business days preceding the delivery date	7 business days preceding the delivery date
Trading hours	0845–1102, 1230–1502, 1530–2300	0845–1102, 1230–1502, 1530–2300	0845–1102, 1230–1502, 1530–2300
Trading unit	¥100 million in par value	¥100 million in par value	¥100 million in par value
Price asked	¥0.01 per par value of ¥100	¥0.01 per par value of ¥100	¥0.01 per par value of ¥100
Daily price limit	Standard: Base price ±¥1.00 1st Expansion: Base price ±¥2.00 Maximum: Base price ±¥3.00	Standard: Base price ±¥1.00 1st Expansion: Base price ±¥2.00 Maximum: Base price ±¥3.00	Standard: Base price ±¥1.50 1st Expansion: Base price ±¥3.00 Maximum: Base price ±¥4.50
Circuit breaker mechanism	If there is no trade execution at a price outside the upper (lower price) limit for five minutes following a buy (sell) order for the central contract month placed (or executed) at the upper (lower) price limit, trading is suspended for 10 minutes.		

Table VII-3. Trading in Bond Futures

	Medium-term government note futures		Long-term government bond futures		Superlong-term government bond futures	
	No. of deals	No. of contracts	No. of deals	No. of contracts	No. of deals	No. of contracts
2009	0	0	6,765,074	57,220	–	–
2010	0	0	8,021,458	49,335	–	–
2011	0	0	6,883,210	71,292	–	–
2012	0	0	8,769,717	77,546	–	–
2013	0	0	9,132,122	98,944	–	–

Source: The web site of the Tokyo Stock Exchange.

unit. As bond futures trading is usually compared with other countries in terms of the number of contracts, futures traded in Japan tend to be underestimated. It is said that another characteristic of the bond futures market of Japan is that it is concentrated in trading in long-term government bond futures. This reflects the fact that the maturities of government bonds are heavily concentrated in 10-year issues, as with cash bond trading, which is not unique to the bond futures market.

Since the mid-1990s, however, the concentration of cash government bond trading on the benchmark issue, which was a phenomenon peculiar to Japan, has eased. Since the end of March 1999, the practice of designating a government bond as a benchmark issue has been discontinued, with 10-year government bond futures assuming the role played by benchmark issues. Among new products, contract for difference (CFD) futures on mini-long-term government bonds, which are one-tenth the amount of normal bonds, were listed on the Tokyo Stock Exchange from the end of March 2009, but trading accounts for less than 1% of long-term government bond futures.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

3. Stock Index Futures Trading

The first stock index futures contract was listed in the United States in 1982. In Japan, the Osaka Securities Exchange started trading *kabusaki* 50, a futures contract for a basket of 50 stocks, in 1987. That product was followed in 1988 by the listing of Nikkei 225 futures on the Osaka Securities Exchange and TOPIX futures on the Tokyo Stock Exchange. Nikkei 300 futures were listed on the Osaka Securities Exchange in 1994. In 1998, High-Tech 40, Financial 25, and Consumer 40 stock index futures started to be traded on the Osaka Securities Exchange and sector index futures contracts for three industries, electric appliances, transportation equipment, and banks, were listed on the Tokyo Stock Exchange. The Tokyo Stock Exchange launched S&P/TOPIX 150 stock index futures in 2001, while three futures contracts based, respectively, on the MSCI Japan, the FTSE Japan, and the Dow-Jones Industrial Average indices were listed on the Osaka Securities Exchange (OSE) in 2002. RN (Russell Nomura) Prime Index futures commenced trading on the OSE in 2005, followed by Nikkei 225 mini-futures on the OSE in 2006, and the TOPIX mini, TOPIX Core30, and TSE REIT index futures on the TSE in 2008. In 2010, the TSE introduced the Nikkei Stock Average, TOPIX, and TOPIC Core30 dividend indexes, while the Tokyo Financial Exchange launched Nikkei 225 equity margin contracts. In 2012, the OSE began trading Nikkei Stock Average Volatility Index futures and NY Dow Jones

Table VII-4. The Trading Mechanism of Stock Index Futures

	Nikkei 225 mini futures	Nikkei 225 futures	TOPIX futures
Object of trading	Nikkei stock average	Nikkei stock average	TOPIX
Contract month	Mar, Jun, Sep, Dec cycle (2 contract months traded at any one time)	Mar, Jun, Sep, Dec cycle (5 contract months traded at any one time)	Mar, Jun, Sep, Dec cycle (5 contract months traded at any one time)
Trading unit	Nikkei stock average × 100	Nikkei stock average × 1,000	TOPIX × ¥10,000
Price asked	In units of ¥5	In units of ¥10	In units of 0.5 point
Maturity	On the 2nd Friday of Mar, Jun, Sept, or Dec	On the 2nd Friday of Mar, Jun, Sept, or Dec	On the 2nd Friday of Mar, Jun, Sept, or Dec
Last trading day	One business day preceding maturity	One business day preceding maturity	One business day preceding maturity
Trading hours	0900–1315, 1630–0300 next day	0900–1315, 1630–0300 next day	0900–1135, 1145–1515 1630–2330
Daily price limit	Standard: Base price ± 8% 1st Expansion: Base price ± 12% Maximum: Base price ± 16%	Standard: Base price ± 8% 1st Expansion: Base price ± 12% Maximum: Base price ± 16%	Standard: Base price ± 8% 1st Expansion: Base price ± 12% Maximum: Base price ± 16%
Circuit breaker mechanism	If there is no trade execution at a price outside the upper (lower price) limit for five minutes following a buy (sell) order for the central contract month placed (or executed) at the upper (lower) price limit, trading is suspended for 10 minutes.		

Table VII-5. The State of Trading in Stock Index Futures

	Nikkei 225 mini futures		Nikkei 225 futures		TOPIX futures	
	No. of deals	No. of contracts	No. of deals	No. of contracts	No. of deals	No. of contracts
2009	104,738,309	303,508	25,368,919	330,664	15,190,781	338,228
2010	125,113,769	357,736	22,483,722	378,651	14,902,519	368,395
2011	117,905,210	469,198	19,294,064	305,212	14,608,165	367,394
2012	130,443,680	688,044	19,523,347	378,804	15,192,439	427,564
2013	233,860,478	673,736	30,907,691	420,037	22,714,121	594,299

Sources: The web site of the Tokyo Stock Exchange and the Osaka Securities Exchange, *Futures & Options Report*.

Industrial Average futures. Prior to all these domestic listings for Nikkei 225 futures, the Singapore International Monetary Exchange (SIMEX, now SGX-DT) started trading SIMEX Nikkei 225 futures in 1986, followed in 1992 by dollar-denominated Nikkei 225 futures on the Chicago Mercantile Exchange (CME). There were also yen-denominated Nikkei 225 futures on the CME, but they no longer exist. In addition to dollar-denominated Nikkei 225 futures, SIMEX now also trades mini-futures.

Out of many futures contracts based on a variety of Japanese stock indexes or listed on different exchanges, the OSE Nikkei 225 futures are the most actively traded, while the TOPIX futures, Nikkei 225 mini-futures, and SGX Nikkei 225 futures contracts, are quite liquid, creating a rather unique situation in which there is more than one contract having good liquidity among the stock index futures. In recent years, the United States and German markets have also come to have multiple stock index future contracts with good liquidity.

Since June 1989, the last trading day falls, as is the case with the United States, one business day prior to maturity, and the final settlement price is decided on the basis of a special quotation (SQ) that is computed on the basis of the opening prices of component issues on the date of maturity. In addition to a three stage daily price limit, the stock exchanges in Japan have instituted a system temporarily suspending trading (called the circuit breaker system) applicable not to the cash market but to stock index futures trading, which gives them the power to suspend trading when stock prices fluctuate violently. This system imposes restrictions on changes in stock prices in a manner different from the circuit breaker system of the United States, which suspends both cash and futures markets at the same time.

4. Financial Futures Trading

Currency futures trading started in the United States in 1972, and Eurodollar short-term interest rate contracts were the first interbank futures listed on a U.S. exchange, in 1982. In Japan, Euroyen futures, Eurodollar short-term interest rate futures (trading was suspended in 1998), and Japanese yen-U.S. dollar currency futures (contracts were delisted in 1992) were simultaneously listed on the Tokyo International Financial Futures Exchange in 1989. These contracts were followed by the TIFFE/TFX listings of dollar-yen futures in 1991; 1-year Euroyen futures in 1992 (trading was suspended in 1998); Euroyen LIBOR futures in 1999; 5-year and 10-year yen Swapnotes in 2003 (trading was suspended in 2007); and Exchange FOREX margin contracts (Click 365) on U.S. dollars, Euros, UK pounds, and Australian dollars in 2005. In 2009, the TFX listed overnight (O/N) uncollateralized call rate and general collateral (GC) spot-next (S/N) repo rate interest futures, and added margin contracts for Nikkei stock average, FTSE 100, and DAX indexes (Click 365) in 2010.

Table VII-6. The Trading Mechanism of Financial Futures

	3-month Euroyen interest rate futures	U.S. dollar-Japanese yen exchange FOREX margin contracts	Australian dollar-Japanese yen exchange FOREX margin contracts
Trading unit	Principal ¥100 million	US$10,000	A$10,000
Indicating method	100 minus rate of interest	Exchange rate in yen	Exchange rate in yen
Bid and asked	0.005 (¥1,250)	0.01 (¥100)	0.01 (¥100)
Contract month	Mar, Jun, Sep, Dec, cycle (20 contract months traded at any one time)	None	None
Last trading day	Two business days preceding the third Wednesday of the contract month (transactions effected on the day of maturity must be done by 11:00)	None	None
Final settlement date	Business day following the last trading day	None	None
Final settlement method	Making up differences (the final settlement price is equal to ¥100 less TIBOR rounded to four decimal places)	Making up differences	Making up differences
Price limit	None	None	None
Trading hours	0845–1130, 1230–1530, 1530–2000	Mon. 7:10 am to 6:55 am following day Tues. to Thurs. 7:55 am to 6:55 am following day Fri. 7:10 am to 6:00 am following day	Mon. 7:10 am to 6:55 am following day Tues. to Thurs. 7:55 am to 6:55 am following day Fri. 7:10 am to 6:00 am following day

Financial futures trading in the United States began with futures and futures options on commodity exchanges while European countries introduced financial futures exchanges for these products. In Japan, the market is split with bond and stock futures and futures options trading on the stock exchanges, while interbank interest rate and currency futures and options are traded on the TFX, a separate market established by some banks and securities companies.

On the TFX, trading has born concentrated from the start in yen short-term rate futures, with little trading in other futures. To increase the liquidity of these financial futures, the market-making system was introduced for dollar short-term rate futures and yen-dollar currency futures in 1990, dollar-yen currency futures in 1991, and options on yen short-term rate futures in 1992.

Table VII-7. Financial Futures Trading

	3-month Euroyen interest rate futures		U.S. dollar-Japanese yen exchange FOREX margin contracts		Australian dollar-Japanese yen exchange FOREX margin contracts	
	No. of deals	No. of contracts	No. of deals	No. of contracts	No. of deals	No. of contracts
2009	13,066,020	962,534	20,198,781	216,080	17,793,787	109,895
2010	11,274,925	11,742,991	27,551,634	287,035	34,272,436	179,005
2011	7,201,901	533,328	31,441,164	228,004	41,589,199	246,374
2012	4,734,503	393,954	9,212,876	162,674	16,500,368	126,604
2013	5,044,236	410,310	20,120,943	161,213	10,256,158	136,975

Source: Tokyo International Financial Futures Exchange, Annual Statistics.

However, their liquidity has not improved much.

Meanwhile, in April 1996 TIFFE introduced a TIFFE-SPAN (Standard Portfolio Analysis of Risk) system on the basis of which the amount of margin commensurate with the risks involved is computed. Moreover, in an effort to stimulate financial futures trading, it linked the prices of its products to those of the London International Financial Futures and Options Exchange and extended its trading hours in the same year. It made efforts to stimulate trading by introducing the night-trading system for dollar-yen currency futures in 1997 and by extending the night-trading hours in 1998. Since 1995, however, TIFFE/TFX's business, which had grown during the first half of the 1990s, has been decreasing on account of the extremely low interest rate climate.

5. Options Trading

Options trading refers to an agreement to trade the right to buy or sell a specific amount of a commodity or a financial instrument at a fixed price (the exercise price) within a specified period in the future. The right to become the buyer is called a call option, and the right to become the seller is called a put option. The history of option trading goes back to antiquity. According to Aristotle, the first known option agreement was written by Thales (ca. 620–ca. 555 BC), a Greek philosopher, on the sale of an olive press. The Chicago Board Options Exchange (CBOE) established in 1973 is the first fully developed option market. By organizing individual deals negotiated between parties, a mechanism of cash settlement was created, as is the case with futures trading, to enable investors to participate in transactions without requiring the delivery of the underlying commodity or financial instrument. And this

Table VII-8. Years in Which Major Financial Options of the World Were Listed

Year	Other countries	Japan
1973	U.S., options on individual stocks (CBOE)	
1974	U.S., options on individual stocks (AMEX, PHLX, PCX)	
1978	U.K., options on individual stocks (LTOM)	
1982	Currency options (PHLX), T-bond futures options (CBOT)	
1983	S&P 100 options; S&P 500 options (CBOE); S&P 500 futures options (CME)	
1984	Currency futures options (CME), FTSE 100 options (LIFFE)	
1987	Pound interest rate futures options (LIFFE), options on French individual stocks (MONEP)	
1988	French government bond futures options (MATIF); CAC40 options (MONEP); BUND futures options (LIFFE)	
1989		Bond OTC options (OTC); Nikkei 225 options (OSE); Nikkei 225 options (OSE); TOPIX options (TSE)
1990	Options on individual German stocks (DTB); Euroyen interest rate futures options (SIMEX); PIBOR futures options (MATIF); Euromark interest rate futures options (LIFFE); DAX options and BUND futures options (DTB)	Long-term government bond futures options (TSE)
1991		Euroyen short-term rate futures options (TFX)
1992	Nikkei average futures options (SIMEX)	
1994	NASDAQ100 options (CBOE), Japanese government bond futures options (SIMEX)	
1997	KOSPI 200 options (KSE)	Options on individual stocks (TSE, OSE)
1998	EURIBOR futures options (LIFFE), Euro STOXX 50 options (EUREX)	
2000	U.S., options on individual stocks (ISE)	
2001	S&P CNX Nifty Index options	
2006	VIX index options (CBOE)	

Note: CBOT: Chicago Board of Trade, CFE: CBOE Futures Exchange, CFFEX: China Financial Futures Exchange, CME: Chicago Mercantile Exchange, DTB: Deutsche Terminbörse (presently Eurex), ICE: ICE Futures U.S., KSE: Korea Stock Exchange (presently KRX), LIFFE: London International Futures and Options Exchange (presently NYSE Liffe), MATIF: Marché à Terme International de France (presently NYSE Liffe), NSE: National Stock Exchange of India, RTS: Russian Trading System (presently Moscow Exchange), SIMEX: Singapore International Monetary Exchange (presently SGX), TSE: Tokyo Stock Exchange; OSE: Osaka Securities Exchange; TFX: Tokyo Financial Exchange.

was an epoch-making idea in the history of options trading.

The options trading started by the CBOE in 1973 spread to other financial products, such as currency options trading, bond options trading, and bond futures options trading, in 1982; stock index options trading in 1983; and to currency futures options trading in 1984. And it has since spread to major financial markets world wide. In Japan, OTC bond options trading (trading in bonds with options) was introduced in April 1989. The Osaka Securities Exchange introduced Nikkei 225 options in June, the Tokyo Stock Exchange introduced TOPIX options in October, and the Nagoya Stock Exchange introduced Options 25 in October 1989 (discontinued in 1998). The Tokyo Stock Exchange introduced long-term government bond futures options in 1990, and TIFFE introduced yen short-term rate futures options in 1991. In addition, the Osaka Securities Exchange introduced Nikkei 300 options in 1994, and both the Tokyo Stock Exchange and the Osaka Securities Exchange introduced options on individual stocks in 1997. In 1998, the Osaka Securities Exchange introduced three industry-specific stock index options (High-Tech 40, Consumer 40, and Financial 25).

Listed options are traded on exchanges. While they can be assigned to a third party, the seller is required to deposit a margin with the exchange to provide against defaults on the contract. OTC options trading is a one-on-one transaction, and it cannot be assigned to a third party, but the seller is not required to deposit a margin. Unlike stock options and stock index options, many of the currency or interest rate options are traded with banks or securities companies on the OTC market.

6. Bond Options Trading

Treasury bond (T-bond) options trading (on the Chicago Board Options Exchange) and T-note options trading (on the American Stock Exchange) conducted simultaneously in 1982 constituted the first trading in listed bond options. And T-bond futures options were traded on the Chicago Board of Trade for the first time in 1982. In Japan, the first bond options trading was conducted on the OTC market in the name of "trading in bonds with options" in April 1989. Trading in long-term government bond futures options started in 1990, and trading in medium-term government note futures options (discontinued in 2002) started in 2000, both on the TSE.

Unlike bond futures trading, which is conducted on the basis of a benchmark issue, OTC bond options are traded on the basis of individual issues, such as government bonds, corporate bonds, or foreign bonds. Because they are traded on the OTC market, bond options agreements cannot be assigned to a third party (most of the transactions are for government bonds). As with government bond futures trading, bond options are traded in units of ¥100 million ($0.98 million) in par value. Because their life (from the date of contract to the date of delivery) is restricted to a maximum period of one year,

Table VII-9. The Trading Mechanism of Bond Options

	OTC bond options	Long-term government bond futures options	Medium-term government note futures options
Object of trading	All debt securities other than convertible bonds and warrant bonds	Call options or put options on long-term government bond futures	Call options and put options on medium-sterm government note futures
Contract months	Free	2 closest of Mar, Jun, Sep, and Dec. (quarterly months) plus a maximum of two other closest contract months	2 closest of Mar, Jun, Sep, and Dec. (quarterly months) plus a maximum of two other closest contract months
Last trading day	—	The last trading day of the month immediately preceding Mar, Jun, Sep, and Dec.	The last trading day of the month immediately preceding Mar, Jun, Sep, and Dec.
Delivery date	Within one year and 3 months from the date of contract	The business day following the date of trading	The business day following the date of trading
Unit of trading	Par value of ¥100 million	One contract on long-term government bond futures	One contract on long-term government bond futures
Price asked	—	¥1 per par value of ¥100	¥1 per par value of ¥100
Exercise price	Free	21 prices at ¥0.5 intervals, additional prices set according to price movement in underlying futures.	21 prices at ¥0.5 intervals, additional prices set according to price movement in underlying futures.
Price limit	—	Up or down ¥3 from the margin requirement reference standard price prevailing on the immediately preceding trading day	Up or down ¥3 from the margin requirement reference standard price prevailing on the immediately preceding trading day
Circuit breakers	—	When circuit breaker mechanisms are in place for the underlying futures contracts	When circuit breaker mechanisms are in place for the underlying futures contracts
Method of exercising the right	Free	American option	American option

and as they cannot be resold to a third party, contracts usually run a relatively long period—six months or one year.

By contrast, long-term government bond futures options are available in the form of listed American options (the option can be exercised any day during its life), and their trading mechanism is similar to that of long-term government bond futures. Whereas long-term government bond futures have only three contract months with a maximum period of nine months, long-term government bond futures options offer up to four contract months with a maximum period of six months. In addition, compared with OTC bond

Table VII-10. Trading in Bond Options

	OTC bond options (¥100 million)		Long-term government bond futures options		Medium-term government note futures options	
	Value of trading	Price outstanding	No. of deals	No. of contracts	No. of deals	No. of contracts
2009	2,523,151	33,493	2,433,217	3,338	–	–
2010	1,535,838	40,044	1,999,282	3,779	–	–
2011	1,703,814	38,086	1,853,672	12,455	–	–
2012	1,821,819	39,372	2,283,839	15,954	–	–
2013	1,872,723	37,841	1,692,752	13,415	–	–

Sources: The web sites of the Tokyo Stock Exchange and the Japan Securities Dealers Association.

options, transactions in long-term government bond futures and long-term government bond futures options are concentrated in those with a short remaining life.

In Western countries where options trading has long been conducted, investors are quite familiar with the system. However, in Japan, where there is no custom of options trading, investors utilize options trading less often than futures trading. Particularly, the amount of long-term government bond futures options trading is far smaller than that of long-term government futures trading. This is because investors' interest is concentrated in outright transactions that deal only in options, and covered transactions are not made in conjunction with underlying assets (namely, long-term government bond futures). On the other hand, in conducting OTC bond options trading, investors follow the strategy of combining underlying assets with covered call or target buying.

7. Stock Index Options Trading

Trading in listed options on individual stocks started in 1973 on the Chicago Board Options Exchange (CBOE). In 1983, the CBOE introduced S&P 100 options (the first stock index options). The Chicago Mercantile Exchange (CME) listed S&P 500 futures options (the first stock index futures options ever) and the New York Stock Exchange (NYSE) listed the New York Stock Exchange Composite Stock Index futures options in 1983. In Japan, a series of stock index options have been listed—the Nikkei 225 stock index options on the Osaka Securities Exchange in June 1989, Options 25 on the Nagoya Stock Exchange in September of the same year (discontinued in 1998), and the TOPIX options on the Tokyo Stock Exchange in 1989. In 1994, the

Table VII-11. The Trading Mechanism of Stock Index Options

	Nikkei 225 options	TOPIX options
Object of trading	Call options and put options on Nikkei stock average	Call options and put options on TOPIX Call options
Contract months	Jun and Dec contracts are nearest 10 months Mar and Sep contracts are nearest 3 months, other contract months are 6 months	5 closest of Mar, Jun, Sep, and Dec (quarterly months) plus a maximum of 3 other closest contract months
Trading unit	Nikkei stock average × 1,000	TOPIX × ¥10,000
Price asked	¥50 or less: ¥1; over ¥50 up to ¥1,000: ¥5; over ¥1,000: ¥10	0.1 points for prices up to 20 points, 0.5 points for prices over 20 points
Maturity	The 2nd Fri. of the delivery month	The 2nd Fri. of the delivery month
Last trading day	The 1st business day prior to the maturity	The 1st business day prior to the maturity
Trading hours	0900–1515, 1630–0300 the next day	0900–1130, 1145–1510, 1630–2325
Strike price	Initially, 16 strike prices at ¥250 intervals; 16 strike prices for closest contract months at ¥125 intervals	Quarterly month contract: 13 prices at 50-point intervals (in case of the month prior to the latest trading month, same as in non-quarterly month contract) Non-quarterly month contract: 19 prices at 25-point intervals
Method of exercising the right	European option	European option
Price limit	Standard: Base price ±13% 1st Expansion: Base price ±17% Maximum: Base price ±21%	Movement above and below the base price (TOPIX futures price limit + allowable range for asking price)
Circuit breaker mechanism	In principle, when futures prices reach daily upper or lower limits, a halt is called in trading.	Circuit breaker triggered when TOPIX futures trading is halted.

Nikkei 300 stock index options were introduced on the Osaka Securities Exchange (discontinued in 2010). Three industry-specific stock index options (High-Tech 40, Consumer 40, and Financial 25, discontinued in 2002) were also introduced on the Osaka Securities Exchange in 1998, and S&P/TOPIX 150 options (discontinued in 2002) were listed on the Tokyo Stock Exchange in 2001. Meanwhile, trading in the Nikkei average futures options started in 1992 on the Singapore International Monetary Exchange (SIMEX, or the present SGX-DT).

In Japan, listed stock index options (the Nikkei 225 options) are most actively traded on the Osaka Securities Exchange. Unlike stock index futures, other stock index options are virtually not traded in Japan. (The liquidity of the Nikkei average futures options traded on the SGX is quite low compared

Table VII-12. The State of Trading in Stock Index Options

	Nikkei 225 options		TOPIX options	
	No. of deals	No. of contracts	No. of deals	No. of contracts
2009	34,986,005	1,590,726	52,523	17,608
2010	43,791,011	1,762,715	120,040	9,677
2011	45,192,519	1,977,396	21,342	2,704
2012	48,763,723	3,179,067	22,683	5,267
2013	57,269,727	3,212,114	386,231	40,406

Sources: The web sites of the Tokyo Stock Exchange and the Osaka Securities Exchange.

with that of the Nikkei average futures traded on the SGX.)

A comparison of the trading mechanisms of the Nikkei 225 options, the TOPIX options, and the SGX's Nikkei average futures options shows that while domestically traded stock index options are based on cash stock options, the Nikkei average futures options traded on the SGX are based on futures options. Another difference in the trading mechanisms is that the Nikkei 225 options and SGX's Nikkei average futures options offer long-term options. In addition, the trading method and the trading unit are the same as those of stock index futures. In computing the amount of margins, all exchanges have adopted the method of meeting margins in accordance with risks called Standard Portfolio Analysis of Risk (SPAN) developed by the Chicago Mercantile Exchange, and there is no significant difference among them. Among market measures, when the circuit breaker mechanism is tripped in stock index futures trading, options trading is also halted.

8. Securities Options Trading

Options on individual stocks listed on the Chicago Board Options Exchange in 1973 were the first call options on individual stocks. In 1977, put options were also listed on the same exchange. While the options on individual stocks were first listed and then stock index options were listed in other countries, in Japan stock index options were introduced in 1989 first and options on 20 individual stocks (officially called equity options) were listed afterward on the Tokyo Stock Exchange and the Osaka Securities Exchange in July 1997 (seven of them were listed on both exchanges). Since then, option trading has been extended to all listed securities along with a name change to "securities options." As of the end of 2013, 170 issues are traded on the Tokyo Stock Exchange and 154 issues (of which 111 issues are also listed on another exchange) are traded the Osaka Securities Exchange.

Table VII-13. The Trading Mechanism of Securities Options

	Marketable securities options (TSE)	Individual securities options (OSE)
Object of trading	Call options and put options on domestically listed marketable securities	Call options and put options on domestically listed marketable securities
Contract month	4 (current & next month + 2 closest of Mar, Jun, Sep, and Dec)	4 (current & next month + 2 closest of Mar, Jun, Sep, and Dec)
Date of delivery	5th day from the exercise of the right	5th day from the exercise of the right
Maturity	The 2nd Fri. of the delivery month	The 2nd Fri. of the delivery month
Last trading day	The 1st business day prior to maturity	The 1st business day prior to maturity
Trading unit	The trading unit of the underlying stock	The trading unit of the underlying stock
Price asked	7 stages from ¥0.5 to ¥5,000 depending on the price of the underlying security	16 stages from ¥0.1 to ¥20,000 depending on the price of the underlying stock
Exercise price	5 prices at 16 stages from ¥25 to ¥5 million depending on the price of the underlying stock, with additional prices available after based on market	5 prices at 16 stages from ¥25 to ¥5 million depending on the price of the underlying stock, with additional prices available after based on market
Position limit	A trading position equivalent to 1% of the number of listed securities (0.7% when the annual turnover volume of the listed security going back 1 year from the record date is less than 10% of the outstanding number of said security)	A trading position equivalent to 1% of the number of listed securities (0.7% when the annual turnover volume of the listed security going back 1 year from the record date is less than 10% of the outstanding number of said security)
Trading hours	0900–1130 1230–1510	0900–1515 1630–0300 next day
Method of exercising the right	European option	European option

Table VII-14. Trading in Securities Options

	TSE securities options		OSE securities options	
	No. of deals	No. of contracts	No. of deals	No. of contracts
2009	662,813	103,340	408,752	20,907
2010	834,941	299,216	390,805	179,947
2011	601,156	30,565	1,231,796	6,152
2012	433,602	60,962	120,545	2,565
2013	1,129,358	136,525	23,723	957

Sources: The web site of the Tokyo Stock Exchange and the Osaka Securities Exchange, *Futures & Options Report.*

Soon after the Chicago Board Options Exchange was established, the advisability of introducing securities options to Japan was considered. However, it is said that their introduction was postponed for more than 20 years for fear that they might compete with margin trading, a major source of income for small to medium-sized securities companies.

The mechanism of trading in securities options adopted by the TSE and the OSE is more or less the same. It is basically identical to that of stock index options but differs from that of stock index options trading in that the securities certificate underlying an option must be delivered to the buyer and that the final settlement price is decided on the basis of the closing price of the underlying certificate.

Although it was thought that securities options might compete with margin trading, they were not as actively traded as they were in Western countries. This is because there is no tradition of trading in options in Japan, investors are not familiar with options trading, and, unlike their Western counterparts, few individual investors are interested in options trading. Options are traded in combination with their underlying assets. In Japan, capital gains earned from trading underlying equities and from securities options are subject to separate taxation. However, investors are not allowed to offset gains and losses between these two categories. This is believed to have discouraged individual investors from participating in securities options trading. In other countries, brokers and dealers are granted preferential treatment for their market making in relatively illiquid options. In the similar move, the Osaka Securities Exchange and Tokyo Stock Exchange introduced the Securities Options Market-Maker Program and TSE Securities Option Supporter system, respectively. These actions, however, have not resulted in any significant increase in the trading of these options in Japan.

9. OTC Derivatives Trading

The market on which derivatives trading achieved remarkable growth around the world in the 1990s was not the exchanges but the OTC market. Particularly, spurred by the liberalization of interest rates, the interest rate swap trading that started in 1982 has spread not only to banking institutions, but also to business corporations and has come to play the leading role on the derivatives market. As statistics on derivatives trading conducted on the exchanges have been well kept, it is easy to follow changes occurring in their trading, but because there is no organization that keeps track of the derivatives trading conducted on the OTC market, it is extremely difficult to find out how it is doing. To remedy the situation, the Bank for International Settlements (BIS) decided to investigate, beginning in 1995, the derivatives markets

Table VII-15. OTC Trading in Securities Derivatives

Trading

(presumed capital, ¥100 million)

No. of transactions	Total		Forward trading		Forward trading in OTC index, etc.		OTC options trading		OTC index swaps	
FY2008	570,254	564.0%	698	0%	145,234	25%	49,345	9%	374,977	66%
FY2009	2,770,912	385.9%	12,975	0%	1,889,671	68%	298,051	11%	570,215	21%
FY2010	3,484,893	25.8%	10,878	0%	3,165,082	91%	305,223	9%	3,710	0%
FY2011	3,216,317	−7.7%	7,491	0%	2,864,886	89%	335,667	10%	8,273	0%
FY2012	2,361,235	−26.6%	297	0%	2,052,821	87%	297,054	13%	10,063	0%
Amount of transactions	Total		Forward trading		Forward trading in OTC index, etc.		OTC options trading		OTC index swaps	
FY2008	880,211	−40.4%	2,170	0%	238,815	27%	601,710	68%	37,516	4%
FY2009	986,973	12.1%	2,321	0%	490,547	50%	459,655	47%	34,449	3%
FY2010	794,200	−19.5%	3,340	0%	447,230	56%	601,710	68%	37,516	4%
FY2011	694,677	−12.5%	1,828	0%	348,191	50%	321,668	46%	22,991	3%
FY2012	440,416	−36.6%	1,265	0%	231,222	53%	178,515	41%	29,413	7%
Term-end balance	Total		Forward trading		Forward trading in OTC index, etc.		OTC options trading		OTC index swaps	
FY2008	692,908	−4.8%	698	0%	34,420	5%	562,821	81%	94,969	14%
FY2009	355,640	−48.7%	1,074	0%	31,467	9%	237,269	67%	85,832	24%
FY2010	351,568	−1.1%	1,014	0%	23,799	7%	244,861	70%	8,148,969	23%
FY2011	176,572	−49.8%	373	0%	7,784	4%	128,886	73%	39,531	22%
FY2012	126,452	−28.4%	345	0%	2,609	2%	86,233	68%	37,264	29%

The State of Brokered Trading

(presumed principal, ¥100 million)

No. of transactions	Total		Forward trading		Forward trading in OTC index, etc.		OTC options trading		OTC index swaps	
FY2008	1,092,238	90.2%	548	0%	76,324	7%	207,172	19%	808,194	74%
FY2009	1,408,246	28.9%	94,993	7%	114,767	8%	45,571	3%	1,150,915	82%
FY2010	878,841	−37.6%	203	0%	7,439	1%	58,398	7%	812,801	92%
FY2011	60,367	−93.1%	349	1%	7,527	12%	45,706	76%	6,785	11%
FY2012	32,686	−45.9%	277	1%	4,527	14%	21,834	67%	6,048	19%
Amount of transactions	Total		Forward trading		Forward trading in OTC index, etc.		OTC options trading		OTC index swaps	
FY2008	3,933,794	19.1%	39,188	1%	432,340	11%	3,214,731	82%	247,534	6%
FY2009	2,162,877	−45.0%	4,180	0%	494,092	23%	834,086	39%	830,520	38%
FY2010	1,460,524	−32.5%	2,005	0%	407,624	28%	933,077	64%	117,819	8%
FY2011	1,271,939	−12.9%	401	0%	371,352	29%	830,656	65%	69,532	5%
FY2012	1,166,949	−8.3%	1,592	0%	345,161	30%	754,986	65%	65,210	6%

Note: Figures next to annual total amounts represent percentage changes from the previous fiscal year. Percentages in parentheses elsewhere represent shares of respective types of transaction in the total for the year.

Source: The web site of the Japan Securities Dealers Association.

along with—and on the occasion of—the triennial investigation of the foreign exchange markets to grasp the state of trading in derivatives on the OTC market world wide.

According to a survey of the OTC derivatives market, including FX spot transactions, conducted in April 2013, the daily average notional value of OTC derivatives traded in Japan was $374.2 billion, representing an increase of 20% from the figure in the previous survey in April 2010 (the results compare against a daily global total of $7.688 trillion and an increase of 28%). By contract type, FX swaps were $169.6 billion (up 1% from the 2010 survey); interest rate swaps were $55.9 billion (up 32%); FX forwards were $35.2 billion (up 11%); interest rate options were $8.5 billion (up 52%); currency options were $6.4 billion (up 27%); currency swaps were $6.4 billion (up 186%); forward-rate agreements (FRA) were $36% up 36%). The total notional value of the outstanding OTC derivatives contracts of financial institutions in Japan as of the end of June 2013 stood at $50.0 trillion, up 27% from June 2010, relative to the total of $693 trillion and a 9% increase worldwide. The breakdown of the total by contract type was 71.5% in interest rate swaps (compared with 70.6% in the 2010 survey); 8.3% in interest rate options (vs. 8.6% previously); 6.3% in foreign exchange forwards and swaps (vs. 5.4%); 4.9% in FRAs (vs. 5.3%); 3.9% in currency swaps (vs. 3.4%); and 5.1% in others (vs. 6.7%). By underlying instrument, foreign exchange and interest rate derivatives contracts increased 36% and 28%, while credit derivatives fell 5%. Equity and commodity derivative contracts also decreased 35% and 48%, respectively.

Meanwhile, the JSDA has been publishing the current state of OTC derivatives trading on a semiannual basis since the second half of fiscal 1999. These statistics divide OTC derivatives transactions into two categories: those conducted by securities companies for their own accounts (the state of principal trading) and those between clients brokered by securities companies (the state of agency trading). The former shows the number and total value of transactions and the ending balance of contracts in each term, while the latter shows the number and total value of transactions. The data is further divided into forward transactions in securities, forward transactions in OTC securities indexes and others, OTC options transactions (excluding bond options transactions) in securities, and swap transactions in OTC securities indexes and others.

10. Credit Derivatives Trading

"Credit derivatives trading" refers to trading in credit risks involved in loans and corporate bonds in the form of swaps and options. While conventional

Table VII-16. Credit Derivatives Trading in Japan

(outstanding balance of presumed principal in millions of dollars)

	OTC trading	Credit default swap			Total return swap			Credit spread product			Credit-linked bond			Other products		
	Total	Total	Sell	Buy	Total	Sell	Buy	Total	Sell	Buy	Total	Issue	Purchase	Total	Sell	Buy
June 2003	22,914	21,727	6,973	14,754	377	0	377	21	10	11	734	0	734	55	55	0
Dec. 2003	24,592	23,540	6,586	16,954	11	0	11	31	15	16	955	0	955	55	55	0
June 2004	30,478	28,922	9,854	19,069	3	0	3	23	11	12	1,470	0	1,470	60	55	5
Dec. 2004	46,701	45,101	18,275	26,826	3	0	3	24	13	11	1,512	0	1,512	60	55	5
June 2005	80,266	78,762	34,106	44,656	3	0	3	26	14	12	1,415	0	1,415	60	0	60
Dec. 2005	99,165	97,980	47,184	50,796	3	0	3	16	9	7	1,162	0	1,162	4	0	4
June 2006	144,617	143,423	69,667	73,756	91	44	47	14	7	7	1,085	0	1,085	4	0	4
Dec. 2006	184,879	183,215	87,896	95,319	43	20	23	0	0	0	1,605	0	1,605	13	0	13
June 2007	275,229	271,386	125,760	145,656	814	48	766	0	0	0	3,004	0	3,004	24	0	24
Dec. 2007	389,231	381,949	180,054	201,895	820	0	850	0	0	0	6,427	33	6,344	35	0	35
June 2008	562,222	554,208	260,369	293,839	631	0	631	0	0	0	7,342	163	7,179	42	0	42
Dec. 2008	390,160	382,395	178,986	203,409	349	0	349	0	0	0	7,201	348	6,853	215	0	215
June 2009	894,196	887,258	435,314	451,944	384	10	374	0	0	0	5,662	382	5,280	890	620	270
Dec. 2009	1,029,791	1,022,920	497,235	525,685	522	10	512	0	0	0	5,661	403	5,258	689	575	114
June 2010	1,116,517	1,110,429	549,404	561,025	207	11	196	0	0	0	5,344	470	4,874	537	418	119
Dec. 2010	1,144,710	1,137,087	559,653	577,434	2,001	900	1,101	0	0	0	5,215	470	4,745	407	282	125
June 2011	1,157,661	1,151,536	571,934	579,602	278	12	266	0	0	0	5,642	727	4,915	204	68	136
Dec. 2011	1,116,847	1,111,618	557,973	553,645	195	13	182	0	0	0	4,649	581	4,068	386	187	199
June 2012	1,105,391	1,098,892	551,264	547,628	209	13	196	0	0	0	6,038	2,105	3,933	252	145	107
Dec. 2012	1,047,913	1,040,913	511,460	529,453	473	99	374	0	0	0	6,302	2,792	3,510	226	133	93
June 2013	1,061,005	1,055,263	518,435	536,828	542	399	143	130	65	65	4,868	3,030	1,838	203	117	86

Source: Bank of Japan, *A Survey of Regular Market Reports Concerning Derivatives Trading.*

derivatives trading bought or sold market risks, credit derivatives trading deals in credit risks. Credit risks trading may be characterized as trading in guarantees in that it not only deals in guarantees against default but also provides a variety of products that cover the risk of declining creditworthiness caused by a deterioration of business performance.

Credit derivatives are traded largely in three typical types: credit default swaps (CDS), total return swaps (TRS), and credit-linked notes (CLN). A CDS is a type of options trading that guarantees the credit risks involved in a loan, and when the borrower defaults on a loan underlying the CDS the damage caused by such default is guaranteed. A CDS derives its name from the form in which the payment of a premium is swapped. A TRS is a deal that swaps the total profit or loss (coupon and evaluated profit or loss) with the market rate, and it is used when the holder of a credit cannot sell it. And a CLN is a deal that links credit risks to a bond issued by the issuer of the underlying notes. Therefore, it may be said that a CLN is a CDS based on a bond instead of a guarantee. A CLN is redeemed in full on maturity unless the company designated in the contract defaults on its obligations, but when the company defaults the CLN is redeemed at a reduced value prior to maturity. While a CDS is concluded under the assumption that the guaranteeing company has an adequate capacity to guarantee, a CLN is guaranteed by the purchase of a bond. Therefore, a CLN can be concluded regardless of the credit standing of the investor.

According to the data published by the Bank of Japan, the total notional value of outstanding credit derivatives in Japan has been accelerating in growth since 2003, multiplying by a factor of 83 from the end of December 2002 to the end of June 2011. The total notional value amounted to \$1.1 trillion, or 4.4% of the global total of \$24.8 trillion according to the June 30, 2010 estimates published by the BIS. However, at June 30, 2007, the Japanese market only accounted for \$275.2 billion, or 0.5%, of the global total of \$51 trillion, suggesting that Japan's credit derivative market is finally drawing in line with its OTC derivative market, which accounts for 7.2% of global totals.

CHAPTER VIII

The Securitized Products Market

1. Securitized Products

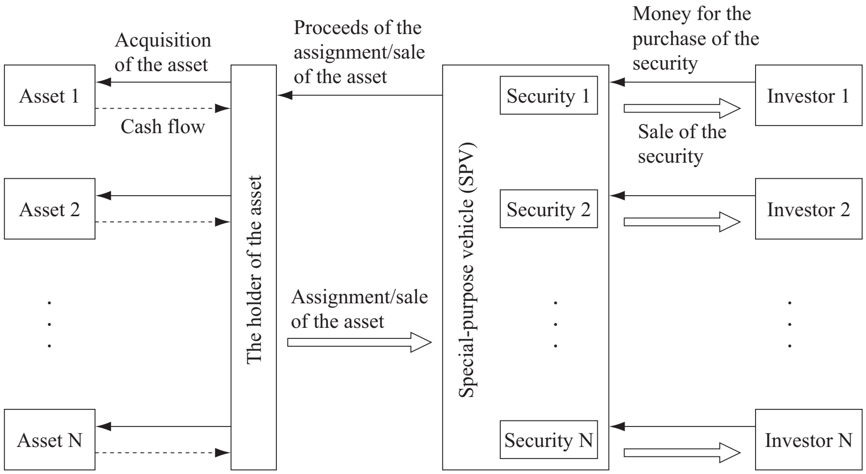
The income-generating assets of a company are pooled separately from its balance sheet into a special-purpose vehicle (SPV), and the SPV issues a security backed by the cash flow to be generated by such assets and sells the security to investors. This method is called “securitization.” And the security issued through such a process is generally called a “securitized product.” Business enterprises use their assets—such as auto loans, mortgage loans, leases receivable, business loans, and commercial real estate—as collateral to back up their securitized products. As defined by the Asset Liquidation Law, intellectual property (such as copyrights and patents) also can be securitized.

When viewed from the standpoint of asset holders, securitization of assets has the advantage of enabling them to use the proceeds of the assignment or sale of such assets that they obtain at the time of issue in exchange for cash flows that may be generated by the assets over a future period of years. In other words, asset holders can monetize uncertain future cash flows into current income. At the same time, the practice offers asset holders the advantage of freeing them from the risk of a fall in the price of their assets. In addition, in case any holder of a piece of less-liquid commercial real estate wants to issue a security by putting up such real estate as collateral, such asset holder may easily sell the security by issuing it in small denominations to attract a larger number of small investors.

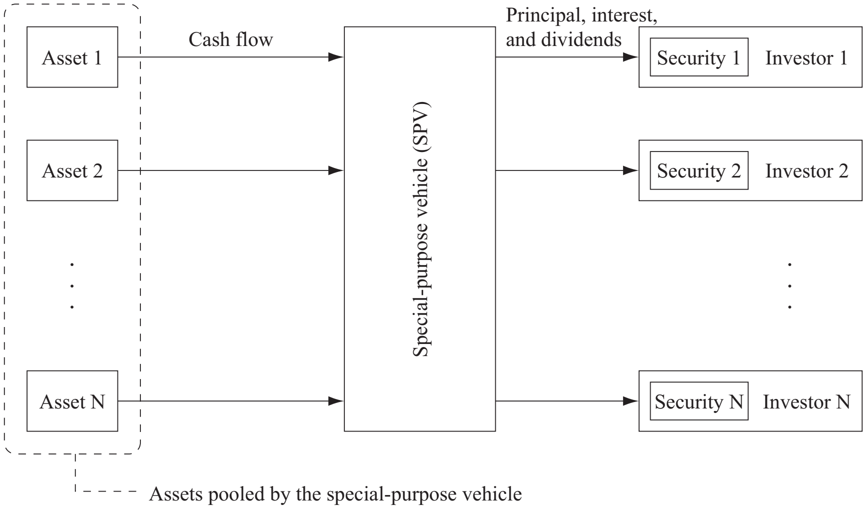
When viewed from the standpoint of investors, securitized products give them an additional choice of investments that have a new character. More specifically, first, a security backed by a piece of real estate gives them an opportunity to invest in real estate that otherwise they cannot afford to buy outright with a small sum of money. Second, as asset holders can issue different classes, or tranches, of securities (“the senior/subordinated structure”) at one and the same time with varying levels of credit risks, they offer investors the opportunity to purchase a security that meets their needs. The issuers of asset-backed securities—Security 1 to Security N on chart VIII-1—simply tailors their terms of issue to best suit the needs of Investor 1 to Investor N,

Chart VIII-1. Conceptual Chart of Securitized Products

At the time a securitized product is issued



After the securitized product has been issued



instead of making them uniform. For instance, by issuing securities with different characters—differentiation of the order of priority for the payment of interest and redemption of principal or granting credit-enhancing conditions (credit enhancement)—the scope of choice for investors can be enlarged. By adding such new wrinkles, investors can restructure their portfolios into more efficient ones.

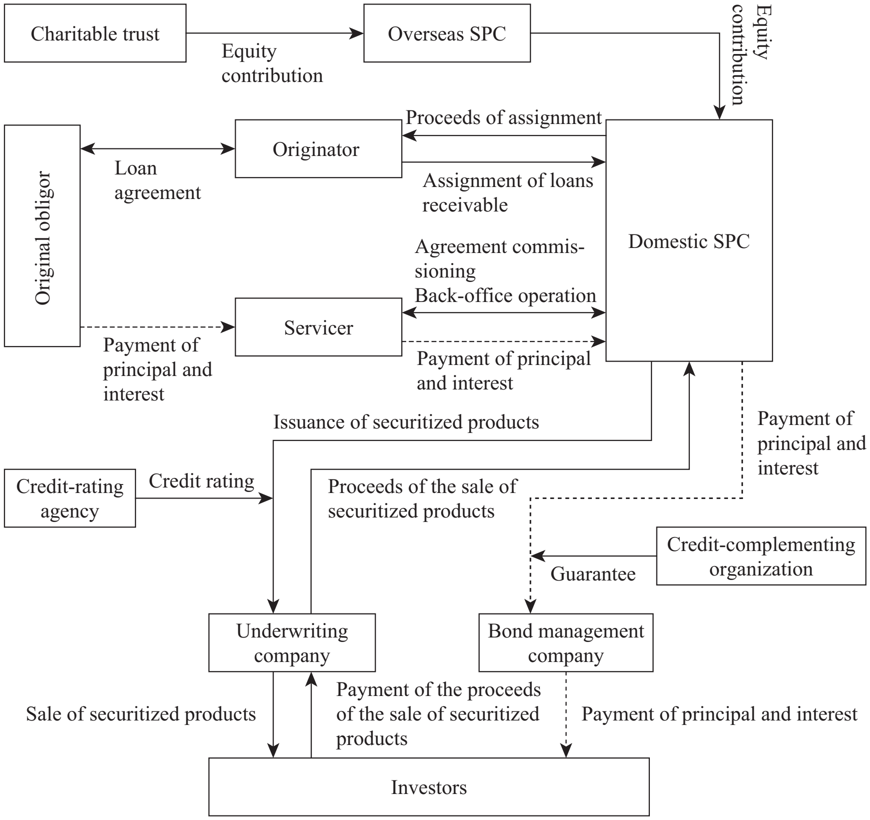
2. Basic Mechanism of Issuing Securitized Products

Generally, many of the securitized products are issued through the mechanism described below. First, the holder of assets ("originator") such as mortgage loans and accounts receivable that are to be securitized assigns them to a SPV. By doing so, such assets are separated from the balance sheet of the originator and become assets of the SPV, which becomes the holder of the assets. An SPV may take the form of a partnership, a trust, or a special-purpose company (SPC). An SPC established under the Asset Liquidation Law is called *tokutei mokuteki kaisha* (TMK, or a specific-purpose company). To ensure bankruptcy remoteness (no impact even if the company, etc., held by the SPC goes bankrupt), an overseas SPC is generally set up as a subsidiary through what are called charitable trusts under U.S. and U.K. laws using what is termed a "declaration of trust," and the domestic SPC established as a subsidiary of the overseas SPC. In terms of originators, the entity responsible for the debt is called the original obligor.

The next step is to formulate the terms of issue of the securitized product to be issued by the SPV. If the originator opts for the trust method, it issues beneficiary certificates like those of a trust company. If it chooses the SPC method, it issues the kinds of securities decided upon by the SPC, but it does not have to issue them on one and the same terms of issue. In short, it can design each type (tranche) of security with a different character by differentiating the order of priority with respect to the payment of interest and redemption of principal, by varying maturities, or by offering the guarantee of a property and casualty insurance company. By adding such variation, the originator can issue securities that meet the diverse needs of investors. In the order of priority for payment, such securities are called "senior securities," "mezzanine securities," or "subordinated securities."

When the originator plans to sell its securitized products to an unspecified large number of investors, it should make them readily acceptable to investors by offering them objective and simple indicators (credit ratings) for independently measuring the risks involved. In addition, there are other players involved in different processes of securitized products, such as servicers, who manage assets that have been assigned to an SPV and securitized and also

Chart VIII-2. General Working Mechanism for Issuing Securitized Products



recover funds under commission from the SPV, and bond management companies, which administer the securitized products (corporate bonds) purchased by investors. Firms that propose such a mechanism for securitizing assets and that coordinate the issuing and the sale of such products are called "arrangers," and securities companies and banks often act as arrangers.

3. Description of Major Securitized Products

Securitized products are divided into several groups according to the types of assets offered as collateral and the character of the securities issued. Those belonging to the group of products that are backed by real estate and the

Table VIII-1. Classification of SPVs

Types	SPVs established under basic laws	SPVs established under special laws
Company type	Special-purpose company (SPC) Domestic: − Joint stock company (Commercial Code) − Limited liability company (Limited Liability Companies Act) Overseas: − SPC (foreign governing law)	Specific-purpose company–TMK (Asset Liquidation Law) Investment corporation (Investment Trust Law)
Trust type	General trust (Trust Law and Trust Business Law)	Specific-purpose trust (SPT) (Asset Liquidation Law) Investment trust (Investment Trust Law)
Partnership type	Silent partnership (Commercial Code), general partnership (Civil Code)	Silent partnership, general partnership (Real Estate Specified Business Law)

Source: Prepared by the author from various materials.

claims collateralized by it are residential mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and real estate investment trusts (REIT). RMBSs are issued in retail denominations against a portfolio that pools home mortgage loans. The first securitized product based on residential mortgage loans was the residential mortgage loan trust launched in 1973. However, this product failed to attract the attention of both issuers and investors because of too much limitation. Nevertheless, as the scheme based on SPC became available thereafter, thanks to the enforcement of the SPC Law, the volume of this type of issue has increased since 1999. Although bonds backed by housing loans that have been issued by the Japan Housing Finance Agency since 2001 were not issued through an SPC, they may be included among the RMBSs. CMBSs are backed by loans given against the collateral of commercial real estate (office buildings, etc.). The mechanism of issuing them is almost the same as that for RMBSs. The REIT that became available by virtue of enforcement of the Investment Trust and Investment Corporation Law in May 2000 is an investment trust in that it can only invest in assets backed by real estate.

Another group consists of asset-backed securities (ABS, narrowly defined), such as accounts receivable, leases receivable, credits, auto loans, and consumer loans, etc. Sales of these products began to increase following the enforcement of the Specified Claims Law in June 1993. As these collateralized assets are a collection of relatively small assets and can be dispersed, they are highly suitable for securitization. What is more, as the laws governing the products have since been developed, they are securitized more extensively than the real estate backed group.

Table VIII-2. Features of Major Securitized (or Similar) Products

Underlying claims	Securities issued	Originator	Governing laws	Basic scheme
Housing loans receivable	Residential mortgage-backed securities	Banks and other financial institutions	Asset Liquidation Law, Trust Law, Trust Business Law, and Financial Instruments and Exchange Act	A banking institution that holds mortgage credits assigns them to an SPC; the SPC, in turn, issues a bond backed by such credits or entrusts them to a trust bank, which, in turn, issues beneficiary certificates backed by them.
	Japan Housing Finance Agency bonds backed by housing loans receivable (RMBS)	Japan Housing Finance Agency	Japan Housing Finance Agency Law and Financial Instruments and Exchange Act	Housing loans receivable held by the Japan Housing Finance Agency are given in trust to a trust bank, and a specified corporate bond backed by the beneficiary certificates of a trust is issued at that time through an SPC.
Commercial mortgage credits and rental revenues	Commercial mortgage-backed securities	Business corporations, banks, and banking institutions	Asset Liquidation Law, Trust Law, Trust Business Law, and Financial Instruments and Exchange Act	The originator assigns the commercial mortgage credits and rental revenues, etc., to an SPC, the SPC, in turn, issues a bond backed by such credits or entrusts them to a trust bank, which, in turn, issues beneficiary certificates backed by them.
Real estate	Real estate–specific joint venture products	Authorized or registered firms	Special law (Real Estate–Specific Joint Venture Law)	An equity contribution is invited from a large number of retail investors, and the funds thus pooled are jointly invested in real estate by taking advantage of the scheme of a voluntary association, an anonymous association, or a real estate investment trust.
	Real estate investment trusts (REIT)	Owners of property purchased by an investment trust	Investment Trust and Investment Corporations Act and Financial Instruments and Exchange Act	An investment company issues units of investment and purchases a piece of real estate and real estate loan claims with the proceeds of such units in accordance with instructions given by a management company.
Mortgage loans receivable created on land, buildings, and superficies	Mortgage securities	Mortgage securities companies	Mortgage Securities Law and Financial Instruments and Exchange Act	Mortgage securities are issued by registering mortgage loan receivables of the mortgage securities company, and jointly held equity in mortgage securities is sold to investors.
Fiscal Loan Fund loan receivables	Fiscal Loan Fund loan-backed securities	Government	Asset Liquidation Law and Financial Instruments and Exchange Act	The government entrusts the loan receivables from its Fiscal Loan Fund to a trust company. Beneficiary certificates issued on the loans are then sold to an SPC, which issues securities with the loans as the underlying assets.
Leases receivable, credit card receivables, and installment credit accounts and notes receivable	Asset-backed securities (ABS), (ABCP)	Business corporations	Asset Liquidation Law, Trust Law, Trust Business Law, and Financial Instruments and Exchange Act	A business corporation that holds lease credits assigns them to an SPC; the SPC, in turn, issues a bond backed by such credits or entrusts them to a trust bank, which, in turn, issues beneficiary certificates backed by them.
General loans	Collateralized loan obligations (CLO)	Banks	Asset Liquidation Law, Trust Law, Trust Business Law, and Financial Instruments and Exchange Act	A banking institution that holds mortgage credits assigns them to an SPC; the SPC, in turn, issues a bond backed by such credits or entrusts them to a trust bank, which, in turn, issues beneficiary certificates backed by them.
Bonds	Collateralized bond obligations (CBO)	Banks and other bondholders	Asset Liquidation Law, Trust Law, Trust Business Law, and Financial Instruments and Exchange Act	The banks and other bondholders that hold a number of bonds assign them to an SPC; the SPC, in turn, issues a bond backed by such credits or entrusts them to a trust bank, which, in turn, issues beneficiary certificates backed by them.

Other securitized products are called collateralized debt obligations (CDO), which are securities issued against the collateral of general loans, corporate bonds, credit risks of loans that are held by banking institutions). For instance, loans to small and medium-sized business enterprises that are securitized may be considered CDOs. And CDOs are subdivided into collateralized loan obligations (CLO) and collateralized bond obligations (CBO).

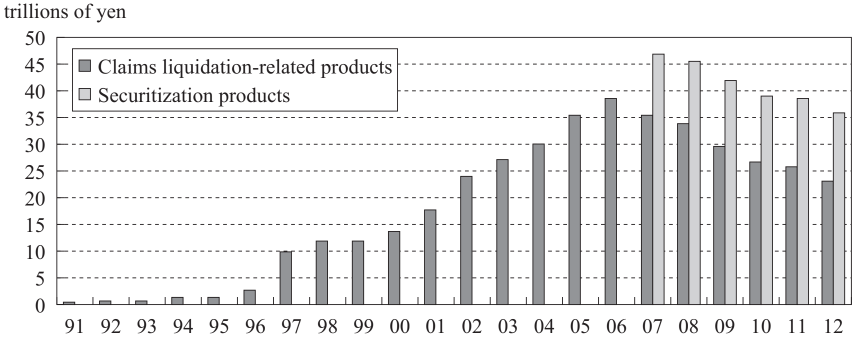
Moreover, since the eligibility requirements for issuing commercial paper (CP) were abolished in 1996, an increasing number of business corporations have come to use asset-backed commercial paper (ABCP).

4. The Size of the Market

In 2011, the Bank of Japan announced retroactively balances for securitized products back to fiscal 2007, which were previously unavailable figures. According to these statistics, the balance of securitized products outstanding as of March 31, 2012, stood at almost ¥36 trillion ($351.2 billion). When compared with that of stocks and equity investment (¥678 trillion or $6.61 trillion); industrial bonds (¥74 trillion or $722.0 billion); and bank debentures (¥14 trillion or $136.6 billion), their share of private-sector financing as a whole is not very large. In contrast, the similar balance (of ABS and government agency mortgage pools combined) in the United States, which is considered the most advanced in securitizing claims, stood at about ¥299 trillion ($2.9 trillion) at the end of fiscal 2012.

However, it is noteworthy that the scale of the securitized products market that stood at a mere ¥400 billion ($3.90 billion) at the end of fiscal 1989 has increased sharply thanks to the enforcement of the Specified Claims Law in 1993 (repealed in 2004) and the Special-Purpose Companies Law in 1998 and the Asset Liquidation Law in 2000. This also suggests that assets that can be used as collateral have diversified and that asset securitization has found a growing number of applications. Looking back, the issuance of securities backed by installment credits, which was made possible by the enactment of the Specified Claims Law, was the engine of growth of the market. As these assets have short maturities and can be readily pooled for diversification, they carry relatively low risks and can be securitized, and such attributes have been a factor in expanding the scale of the market for them. Since 2000, following the enforcement of the Asset Liquidation Law, the securitization of mortgage loans, as well as of loans to business corporations and the government, has expanded dramatically. This may be explained by the fact that, pressed by the need to raise the capital adequacy ratio in compliance with the BIS requirements, as well as in response to the prompt corrective measures issued by the Financial Services Agency, banks have sought to unload loan

Chart VIII-3. The Balance of Claims Liquidization-Related Products



Year-end	91	92	93	94	95	96	97	98	99	00	01
Asset-liquidation products	0.5	0.6	0.7	1.3	1.4	2.7	9.8	11.9	11.9	13.7	17.8
Securitized products	–	–	–	–	–	–	–	–	–	–	–
Year-end	02	03	04	05	06	07	08	09	10	11	12
Asset-liquidation products	24.0	27.2	30.1	35.5	38.5	35.5	33.8	29.6	26.7	25.8	23.2
Securitized products	–	–	–	–	–	46.9	45.5	41.9	39.0	38.6	35.8

Source: Complied on the basis of the data drawn from *Nichigin shikin junkan-hyo* (Flow-of-Funds Statement of the Bank of Japan).

Table VIII-3. Changes in Composition of Collateralized Assets, etc.

	2007	2008	2009	2010	2011	2012	Percentage composition
Asset-liquidation products	35.4	33.7	29.6	26.7	25.8	23.2	64.8
Loans	24.3	23.4	20.9	18.6	17.5	15.7	44.0
Loans made by private-sector banking institutions	20.7	19.6	17.6	16.0	15.2	13.6	38.1
Residential mortgages	9.1	8.9	8.3	7.7	7.4	6.6	18.5
Consumer loans	1.8	1.8	1.5	1.2	1.1	0.9	2.5
Loans to business enterprises and the government	9.8	8.9	7.8	7.1	6.7	6.1	17.1
Installment credits	3.6	3.8	3.3	2.6	2.3	2.1	5.9
Securities other than stocks	0.3	0.3	0.0	0.0	0.0	0.0	0.0
Industrial debentures	0.3	0.3	0.0	0.0	0.0	0.0	0.0
Deposits	1.7	2.8	2.1	1.3	1.2	1.2	3.2
Intercompany and trade credits	9.1	7.3	6.6	6.8	7.1	6.3	17.5
RMBS issued by the Japan Finance Housing Agency	6.8	7.6	8.4	9.0	10.1	10.6	29.6
Real estate-related credits	4.6	4.2	3.9	3.3	2.7	2.1	5.9
Total	46.9	45.5	41.9	39.0	38.6	35.8	100.0

Source: Compiled on the basis of the data drawn from *Nichigin shikin junkan-hyo* (Flow-of-Funds Statistics of the Bank of Japan).

assets from their balance sheets. After reaching a peak in fiscal 2006, the volume of securitized products has gone into decline under the impact, etc., of the weakening of the economy set off by the subprime loan crisis.

Looking at the composition of assets, etc., underlying securitized products at the end of fiscal 2012, RMBS issued by the Japan Housing Finance Agency (JHF) had the largest share, followed in order by residential mortgages, intercompany and trade credits, and loans to business enterprises and the government.

"Securitized products" are defined as the total of claims liquidation-related products, RMBS issued by the JHF, and real-estate related securities. Claims liquidation-related products is an item on the Flow-of-Funds Statistics compiled by the Bank of Japan including asset-backed securities (ABS) issued by structured financing SPCs and trusts, asset-backed securities (ABS) and beneficiary rights in monetary claim trusts. Although RMBS issued by the JHF and real-estate related securities are not issued by SPCs and trusts, they are include in "securitized products" because they are considered to be securitized products in practical terms.

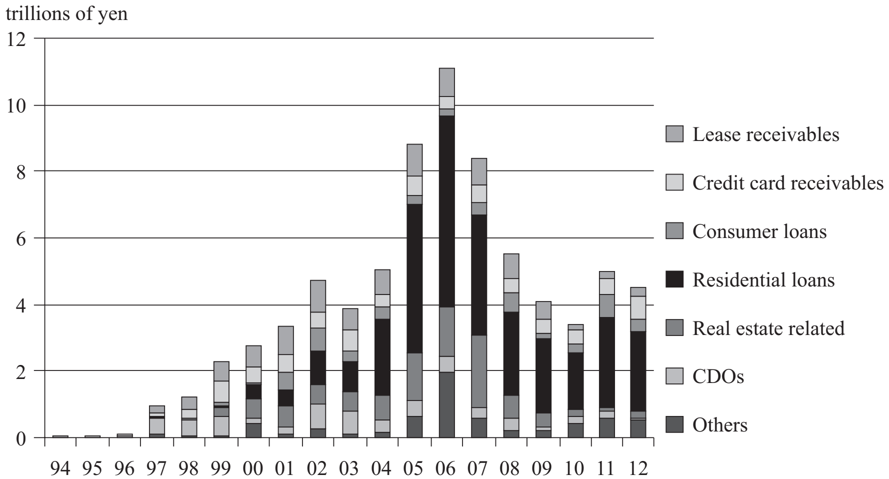
*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

5. New Issue Market for Securitized Products

As the bulk of securitized products are issued in private placement transactions between the parties concerned, it is difficult to accurately grasp the size of their market. To remedy this shortcoming, underwriters that are involved in the transactions and credit rating agencies have been tracking the market on their own. According to Deutsche Securities Inc., a leading underwriter, the total value of securitized products issued in Japan was about ¥4.5 trillion ($43.9 billion) in 2012. Although securitized products issuance reached a peak of ¥11 trillion ($107.3 billion) in 2006, it went through a period of decline under the impact of the weakening of the economy kicked off by the subprime loan problem and has remained level since.

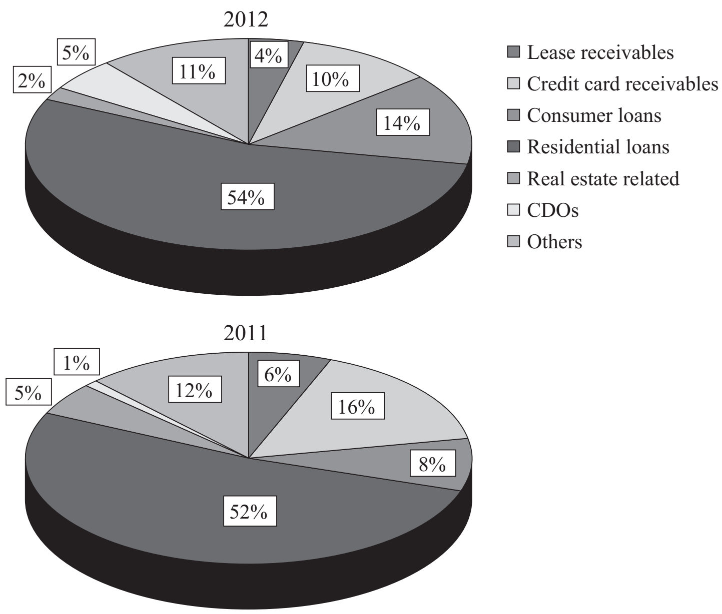
Even considering securitized products by types of collateral, issuance levels have tended to be flat over the past few years. However, while residential mortgage loans and credit card credits have exhibited a recovery trend, real estate-related, lease, and other credits have declined—a result that reflects the differences in the underlying assets. Residential mortgage loans account for nearly 50% of the underlying assets used as collateral, a trend that has not changed over the past few years. This trend reflects that lending banks are actively securitized mortgage loans of their own origination and that the issuance of RMBS by the Japan Housing Finance Agency has remained at a high

Chart VIII-4. Securitized Products Issuance



Source: Securitization department of Deutsche Securities Inc.

Chart VIII-5. Component Ratios of Collateral Assets



Source: Securitization department of Deutsche Securities Inc.

level.

According to the data compiled by the Japan Securities Dealers Association, the total value of such publicly offered securitization products had steadily increased since 1997, the year in which the association had started tracking the data. After hitting a peak of ¥0.58 trillion ($5.7 billion) in 2002, however, the total has declined, falling to ¥0.2 trillion ($2.0 billion) in 2012. This figure represents only 4.0% of privately placed ABSs. The popularity of privately placed ABSs is thought to be the result of considerations with regard to investor protection framework, taxes, and disclosure cost.

It appears that the underwriting of these securitized products is concentrated in major brokers/dealers and bank-affiliated securities companies. According to a league table posted on Mizuho Securities' website published by Thomson-Reuters Corporation, a major information provider, top underwriters of those securitized products in 2012 were, in order of total underwriting volume, Mizuho Financial Group, Mitsubishi UFJ Morgan Stanley, Nomura Holdings, Sumitomo Mitsui Financial Group, and Daiwa Securities Group. Although the list has shown some movement over the past few years, it has been minor. It may be said that the results reflect their capabilities in distributing securitized products and procuring collateral assets, as well as securitization expertise that meets client needs.

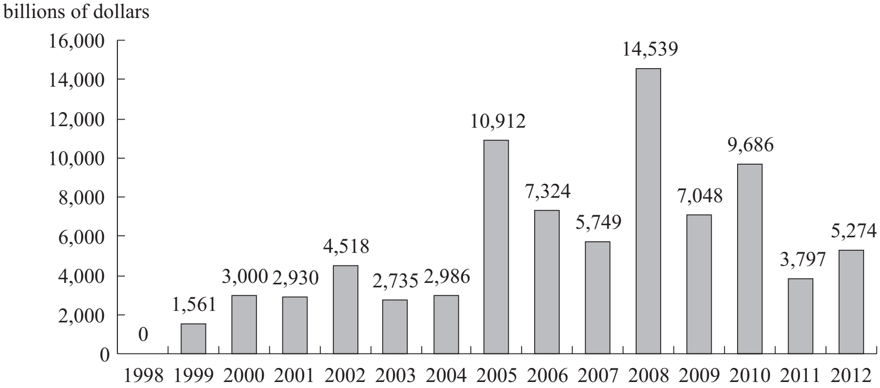
6. Secondary Market for Securitized Products

With the exception of beneficiary certificates of real estate investment trusts (REITs; to be discussed later), trading in securitized products is not concentrated in stock exchanges at present. This is perhaps because, as is the case with bonds, securitized products and their transactions are too complex and varied to lend themselves to exchange trading. And this has led to the dependence on an over-the-counter interdealer market for their trading. In this section, we will overview the present state of the interdealer market of securitized products by use of data on "TMK bonds" published by the Japan Securities Dealers Association (JSDA), which is in a position to obtain data on interdealer transactions.

Data on the trading amounts of TMK bonds compiled on the basis of JSDA reports for the years prior to 1998 are not available. According to these reports, the trading amount of TMK bonds has fluctuated frequently, reaching a peak in 2008.

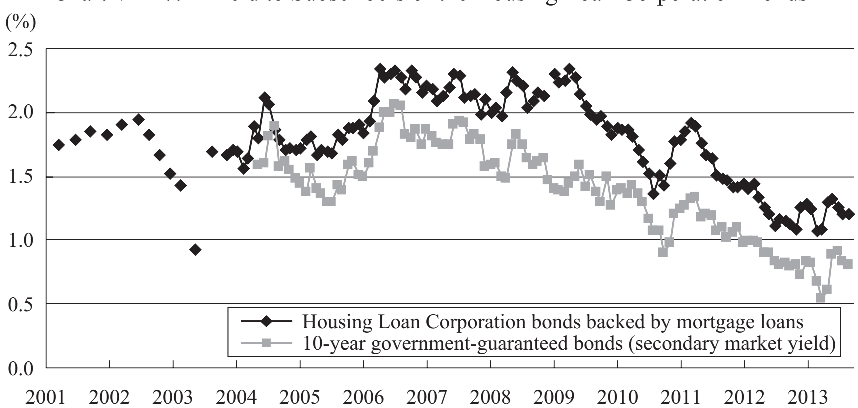
A comparison of TMK trading amounts with those of other bonds in 2012 shows that TMK bond trading amounted to ¥0.5 trillion ($4.88 billion), and those of corporate straight bonds and utility bonds stood at ¥34.9 trillion ($340.5 billion) and ¥3.1 trillion ($30.2 billion), respectively. Although these

Chart VIII-6. The Amount of Specified Corporate Bonds Traded



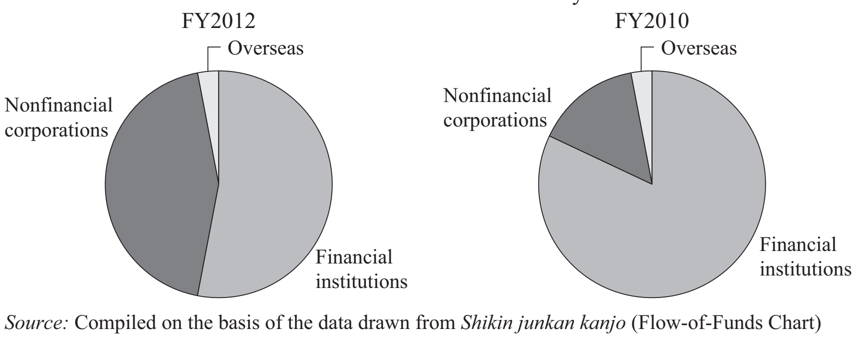
Source: Compiled on the basis of the data drawn from the Japan Securities Dealers Association.

Chart VIII-7. Yield to Subscribers of the Housing Loan Corporation Bonds



Source: Compiled on the basis of the data drawn from *Kinyu keizai tokei geppo* (Monthly Report on Financial and Economic Statistics) of the Bank of Japan.

Chart VIII-8. Breakdown of Buyers



Source: Compiled on the basis of the data drawn from *Shikin junkan kanjo* (Flow-of-Funds Chart) of the Bank of Japan.

issues constitute only a part of the securitized products market, it may be said that the asset-backed securities market of this country still remains underdeveloped. The number of securities companies that offer them is quite limited, and their liquidity is considerably low. On the other hand, a large number of securities companies make market in RMBS issued by the Japan Housing Finance Agency, the bonds are classified as FILP bonds for statistical purposes, and their market seems to have a certain degree of liquidity.

As their trading market is yet to attain maturity, it is difficult to precisely measure their secondary market yields, and they have to be substituted with yields at issue. Measured in terms of yields at issue, the most highly liquid Housing Loan Corporation bonds are traded at a higher yield than government-guaranteed bonds. Reinvestment risk occasioned by early mortgage loan repayment and lower liquidity may be a factor behind this.

According to the balance of financial assets and liabilities of the Flow-of-Funds Accounts of the Bank of Japan, most of the holders of credit securitization–related products (securitized products) are nonfinancial corporations and banking institutions. This is due to the fact that it is difficult to sell them to households because of the complexity of their structure and the lack of adequate explanation of their mechanism. As a result, few individual investors hold credit securitization–related products at present, but it may be said that investment trusts incorporating securitized products have the potential of meeting their investment needs in the coming years.

7. New Issue and Secondary Markets for the Beneficiary Certificates of Real Estate Investment Trusts

On September 10, 2001, the Japan Building Fund Investment Corporation and the Japan Real Estate Investment Corporation listed their certificates on the Tokyo Stock Exchange and became the first public real estate investment trusts (REITs) in Japan. These real estate investment trusts owe their birth to the amendment of the Investment Trust Law enforced in November 2000, which makes it possible to form trust funds through a real estate investment trust scheme. In addition, the Tokyo Stock Exchange instituted a rule granting a special exception to the securities listing regulations in favor of real estate investment trust certificates and enforced it on March 1, 2001. By the end of 2010, the number of listed issues increased to 35.

The basic mechanism of REITs is this: investment corporations or investment managers called investment trust management companies pool funds of investors, invest such funds primarily in real estate, and distribute the investment income (including rent income) to investors. The three types of securities defined in the Investment Trust Law—beneficiary certificates of

Table VIII-4. The Listing Requirements of the Tokyo Stock Exchange

Item	Listing requirements
Eligibility for becoming an asset management company	The investment trust management company, the trust company for an investment trust without instruction by trustor, or an entity that otherwise manages assets of a REIT applying for listing must be a member of the Investment Trust Association.
Ratio of real estate to the total value of assets managed	The ratio of real estate is expected to be 70% or higher.
Ratio of real estate and related assets and liquid assets to the total assets under management	The ratio of real estate is expected to be 95% or higher.
Per unit net asset value	Expected to increase to ¥50,000 or more by the time it is listed.
Total net asset value	Expected to increase to ¥1 billion or more by the time of listing.
Total asset value	Expected to increase to ¥5 billion or more by the time of listing.
Auditor's opinion	(a) The financial statements for the two immediately preceding terms are fair and accurate and contain no false statements. (b) The audit reports for the two immediately preceding terms contain the remarks "unqualified opinion" or "qualified opinion with an exception."
No. of units listed	Expected to increase to 4,000 or more by the time it is listed
Major beneficiaries or investors	The total number of units owned by major beneficiaries or investors is expected to be 75% or less of the total units listed.
No. of beneficiaries or investors	Their number (except major beneficiaries or investors) is expected to increase to 1,000 or more at the time of listing.

Source: Compiled on the basis of the data drawn from the home page of the Tokyo Stock Exchange.

Table VIII-5. Statistics Relating to REITs Listed on the Tokyo Stock Exchange

Fiscal year	No. of issues listed	Total net asset value (¥100 mil)		Amount of certificates traded (¥100 mil)
2001	2	2,314		810
2002	6	4,451	46	2,061
2003	10	7,088	100	5,057
2004	14	11,062	182	11,791
2005	26	18,937	297	20,551
2006	39	29,539	472	35,040
2007	41	35,910	811	74,428
2008	40	38,405	779	39,926
2009	40	38,733	618	22,423
2010	35	38,813	881	26,645
2011	34	40,211	1,058	28,664
2012	37	43,644	1,384	32,213

investment trusts with instruction by trustor, beneficiary certificates of investment trusts without instruction by trustor, and investment securities of investment corporations—may also be issued by real estate investment trusts. The first type of trust is managed by a trust company that holds the assets in custody in accordance with instructions given by the management company. The second type is managed by a trust bank in accordance with its own judgment. And the third is commissioned to a management company by the investment corporation that holds the assets. All of the certificates of the REITs listed on the Tokyo Stock Exchange are investment securities issued by investment corporations.

One of the advantages investors can derive from REITs is that they are able to invest in real estate with a small amount of money, and they can enjoy liquidity in freely trading their investments in the market. Another is that REITs offer diversification to their investment portfolio. REIT dividends may be expensed provided that a REIT meets certain requirements, including distributing more than 90% of its income to its certificate holders.

One problem that the managers of REITs have to address is the possibility of a conflict of interests between investors and the manager of a REIT with respect to any investment of its assets commissioned to a third party. In other words, it is feared that the management company may force the REIT to buy a piece of real estate held by its stockholders at a high price. To avoid the occurrence of such a situation, it is desirable to require the REIT to fully disclose information concerning its investments. And investors should consider getting involved in the management of investment companies through a general meeting of investors.

8. Risks and Credit Enhancement of Securitized Products

As the structure of securitized products is complex, credit rating is widely used as a criterion for making an investment decision. And in order to package assets into a securitized product that merits a high credit rating, a device for controlling various risks has to be built into the product. The substance of risks varies depending on the kind of underlying assets and the participants in the scheme, but one thing in common among them is the default risk, or the probability that the issuer may fail to pay its interest or principal promptly when due. The default risk of a securitized product is largely divided into two kinds: the risk of changes occurring in the cash flow generated by the underlying assets (bad debt or arrears) and the risk of bankruptcy of parties involved in the securitization of assets (the debtor, the SPC, or the originator).

The risk involved in the cash flow may be reduced by taking various credit-enhancing measures. Unlike general corporate bonds, whose credit rating

Table VIII-6. Main Credit Enhancing Measures

Credit enhancement (external)	Recourse of the originator	The originator owes recourse to a certain part of the assets sold to the SPC. Off-balance sheet accounting may not be authorized depending on the extent to which the originator owes such recourse.
	Credit default swap	The purchaser of a swap pays a certain amount of money in premium in exchange for a guarantee of credit risk of a specified claim.
	Financial guaranty insurance	A property and casualty insurance company provides insurance covering the entire default risk.
Credit enhancement (internal)	Spread account	The balance of funds remaining after deducting the amounts paid to the investors and fees from the cash flow of the underlying assets is deposited in a spread account to be used as compensation money in case of default.
	Over collateral	The credit standing of the security is enhanced by selling such part of the underlying assets whose value is in excess of the amount of the security issued to the special-purpose vehicle (SPV).
	Senior/subordinated structure	By designating part of the security issued as subordinated debt, the credit standing of the rest of the issue is enhanced.

is determined by the credit risk of their issuers, the credit rating of a securitized product must be based on the results of examinations of assets underlying each product. The arranger who underwrites and markets the securitized product and the originator negotiate with a credit-rating agency to obtain a high rating. There are various credit-enhancing measures to choose from for different schemes employed for issuing a securitized product, but they may be largely divided into two: an external credit-enhancing measure that utilizes external credit (such as banking institutions) and an internal credit-enhancing measure that gives the structure of the security the function of enhancing its credit. There are two methods of external credit enhancement: indirect and direct. The former complements cash flows from underlying loan assets, and the latter complements that of a securitized product. The indirect method has a drawback in that it cannot eliminate risks associated with a servicer or any other party involved in securitization. As a means of enhancing internal credit, a senior subordinated structure is commonly used. In Japan, however, the subordinated securities are often held by the originator because, among other reasons, there are few investors who are willing to purchase them.

A large part of the risk of changes in cash flows from underlying assets can be covered by credit enhancing measures. However, the risk of bankruptcy of the parties involved in securitization is a serious problem. As assigned claims and receivables of a bankrupt originator are typically subject to bank-

Table VIII-7. Typical Risks of ABS

Overall risks of ABS	Outline	Measures necessary to avoid risks
Credit risk	There is a risk of a failure to generate an expected cash flow due to a default of the originator.	A review of credit-enhancing measures is needed. In the case of an underlying asset that consists of many credits, steps must be taken to diversify such underlying assets.
Prepayment risk	If the issuer redeems the security ahead of its maturity, the investors will be exposed to prepayment risks.	It is necessary to develop techniques such as a collateralized mortgage obligation (CMO) and a security with a period of deferment that adjusts the relationship between the underlying assets and the cash flow generated by the security issued thereby.
Liquidity risk	When the funds flow out rapidly from the market, the holder cannot sell the security in a timely manner because the liquidity of the securitized product is not adequate, and the holder is thus exposed to a liquidity crunch.	The development of a market for trading ABSs is a must. And the subordinated security can be traded widely among the investors.
Risks of the parties concerned	Outline	Measures Necessary to Avoid Risks
Originator's risk	Once the claims of the originator sold to the SPC are recognized as part of the bankruptcy estate, the investors have the risk of forfeiting their right to receive the payment of the principal and interest of the security.	The transfer of the claims is not for securing a loan but is their true sale. The assets have been separated from the balance sheet, and the transaction has conditions necessary for counteracting against a third party.
Servicer risk	The commingling risk: A servicer of receivables that went bankrupt may mingle the funds it had received before it went bankrupt with its own funds without remitting them to the SPV.	The designation of a backup servicer capable of putting up excess collateral. Payment of remittances received from debtors directly into the account of the SPV. Management of a lock-box account.
SPC risk	Bankruptcy remoteness must be established so that the SPC of an asset securitization scheme itself will not go bankrupt or will not be affected by the bankruptcy of other companies.	The substance of business must be clearly defined, and an SPC in which the originator has no equity interest must be founded by establishing a charitable trust. The commencement of bankruptcy proceedings must be averted by making the charitable trust its beneficial shareholder.

ruptcy proceedings, investors carry the risk of nonpayment of their principal and interest. Therefore, it is important to check whether there is any risk in the business of any party concerned or whether the party is shielded from the risk of other parties concerned. Risks are complexly intertwined, and they are summed up in table VIII-7.

9. The Enactment of Securitization-Related Laws

The existing legal system of Japan is built around business-specific laws, and the regulatory system of financial products is vertically divided along the lines of business-specific laws. As these laws contain many provisions regulating or banning business activities outright, it was pointed out that to spur the development of new business, such as the securitization of assets, the existing laws have to be amended, and new laws must be enacted.

As regards the securitization of assets, the Specified Claims Law was enacted as an independent law in 1993. Since the enforcement of this law, the legal infrastructure has been developed steadily. Under and thanks to the Specified Claims Law, the liquidation and securitization of assets classified as specified claims, such as leases receivable and credit card receivables, started. Thereafter, various laws were enacted to help the banking institutions meet the capital ratio requirements imposed by the Bank for International Settlements (BIS) and to encourage the securitization of their assets to deal with the bad loan problem that had become serious since the turn of the decade of the 1990s.

Under the Special-Purpose Company (SPC) Law and Asset Liquidation Law enacted as the revised SPC Law, structures incorporating SPVs, including specific-purpose companies (TMK) and specific-purpose trusts (SPT), may be used for securitizing specified assets designated in the provisions of the said laws (real estate, designated money claims, and beneficiary certificates issued against such assets in trust) in the form of asset-backed securities (such as senior subscription certificates, specified corporate bonds, and specified promissory notes, etc.). Under the SPC Law, the system of disclosing an asset liquidation plan and individual liquidation projects was introduced, in addition to the disclosure requirements of the Securities and Exchange Law (the Financial Instruments and Exchange Act now).

In 1998 the Perfection Law was enacted as a law prescribing exceptions to requirements under the Civil Code for the perfection of the assignment of receivables and other properties, and it was amended in 2005. The Civil Code provides the legal requirements for the assertion of the assignment of nominative claims (claims with named creditors) against obligors or third parties. Designated claims were transferable, but the provisions of the Civil Code had been a major hurdle standing in the way of securitizing them. And the Perfection Law set forth simple procedures for the perfection of such interests.

The Servicer Law, enacted to account for exceptions to the provisions of the Practicing Attorney Law, allows accredited joint stock companies to provide the services of administering and collecting debts. Under the Servicer Law, a debt collection company may be established to provide a bad debt

Table VIII-8. Chronology Relating to the Securitization of Assets

Aug. 31	The Mortgage Securities Law is enacted.
June 73	Housing loan companies raise funds by offering beneficiary certificates of housing loan claim trusts.
Sept. 74	Housing loan companies raise funds by offering mortgage-backed securities.
Jan. 88	The Law Concerning the Regulation of Mortgage-Backed Securities Business is enforced.
Apr. 92	The Law Concerning the Regulation of Business Relating to Commodity Investment (the Commodity Fund Law) is enforced.
Apr. 93	The Securities and Exchange Law designates beneficiary certificates of housing loan claim trusts as securities.
June 93	The Law Concerning the Regulation of Business Relating to Specified Claims, etc. (the Specified Claims Law) is enforced.
July 93	The ban on the issuance of CPs by nonbanks is lifted.
Apr. 95	The Specified Real Estate Joint Venture Law is enforced.
Apr. 96	As a method of liquidizing assets under the Specified Claims Law, the issuance of asset-backed securities (ABS and ABCP) is authorized, making it possible to issue them other than under the Specified Claims Law.
June 96	Beneficiary certificates of general loan claim trusts (including loans secured by real estate) are designated as securities under the Securities and Exchange Law.
Feb. 98	The Securities Investment Trust Law is amended (and the ban on company type investment trusts and privately placed investment trusts is lifted).
Apr. 98	A total plan for the liquidation of land and claims is announced.
June 98	A total plan for financial rehabilitation is announced.
Sept. 98	The Law Concerning Securitization of Specified Assets by Special-Purpose Companies (the SPC Law) is enforced.
Oct. 98	The Law Concerning Exceptions to Requirements under the Civil Code for the Perfection of Assignment of Receivables and Other Properties (the Perfection Law) is enforced.
Jan. 99	A statement of opinion on establishing accounting standards for financial products is published. (The financial component approach to conditional transfer of financial assets is adopted.)
Feb. 99	The Act on Special Measures Concerning Debt Administration and Collection Business (the Servicer Law) is enforced.
May 99	The Law Concerning Corporate Bond Issuance, etc., by Nonbank Financial Companies for Lending Operations (the Nonbank Bond Law) is enforced.
Nov. 00	With the enforcement of the Asset Liquidation Law, the scope of assets eligible for securitization is expanded to include a broad range of property rights.
Nov. 00	The Law Concerning Investment Trusts and Investment Corporations (the Revised Investment Trust Law) is enforced, expanding the assets that can be securitized to real estate, etc.
Sept. 01	The revised Servicer Law is enforced.
Dec. 04	The Trust Business Law is amended, and the system requiring trust companies of the management type to register is launched.
Dec. 04	The Specified Claims Law is repealed.
Oct. 05	The Exceptional-Case Law of Assignment of Obligations was amended to the Exceptional-Case Law of Assignment of Movables and Obligations.
May 06	The Companies Act is enforced.
Dec. 06	The Trust Law is amended and provided for business, personal, and purpose trusts.
Oct. 07	The Financial Instruments and Exchange Act is enforced.
Nov. 11	Revised Asset Liquidation Law enforced.

collection service without conflicts with the Practicing Attorney Law. By amending the Equity Contribution Law, the Nonbank Bond Law conditionally lifted the ban imposed on nonbanks on the issuance of corporate bonds and CPs for the purpose of raising capital for lending operations and on ABSs.

As a result of the revision of the Securities and Exchange Law as required by the Financial System Reform Law and the enforcement of the Financial Instruments and Exchange Act, beneficiary certificates of and trust beneficiary interests in assets that are deemed eligible for securitization by the provisions of the Asset Liquidation Law and mortgage certificates under the Mortgage Securities Law are now legally considered securities. Furthermore, pursuant to the enactment of the Investment Trust Law as revised, real estate was included in eligible assets, which paved the way for the issuance of REIT securities.

CHAPTER IX

The Financial Instruments Exchanges (1)

1. The Function of the Financial Instruments Exchanges

The basic function of a stock exchange is to enhance the liquidity of securities, to help form fair prices that reflect supply and demand, and to promptly publish the prices thus formed by establishing a highly organized market and concentrating supply and demand in a single market.

The purpose of a stock exchange is to establish a securities market for trading securities and to run the securities market in such a way as to facilitate the fair and efficient trading of securities in the public interest and for the protection of investors. Its basic mission is to provide a fair and transparent market. The securities market operated by a stock exchange, moreover, has the function of providing a marketplace that enhances the liquidity of securities and helps form fair securities prices so that investors can invest in securities free from anxiety and businesses can raise funds smoothly by issuing securities.

Furthermore, published prices serve as a base for assessing the collateral or asset value of securities and as an important indicator of general business trends. Because securities markets operated by stock exchanges perform an important role in supporting the economic activities of the nation, a license must be obtained from the prime minister to open an exchange, and the operation of that exchange must be subject to the supervision of the prime minister.

Stock exchanges were required to be membership organizations under the old Securities and Exchange Law. An amendment of that law, however, allowed stock exchanges to change their legal status to that of a joint stock company. Starting with the Osaka Securities Exchange (OSE) in April 2000, the Tokyo Stock Exchange (TSE), Nagoya Stock Exchange, and JASDAQ reorganized as joint stock companies. The enforcement, furthermore, of the Financial Instruments and Exchange Act in September 2007 provided for the establishment of either a self-regulatory committee or a self-regulatory corporation by an exchange. Subsequently, in October of the same year, the Tokyo Stock Exchange founded a self-regulatory corporation, while the Osaka

Chart IX-1. Organizational Structure of the Japan Exchange Group (Holding Company)

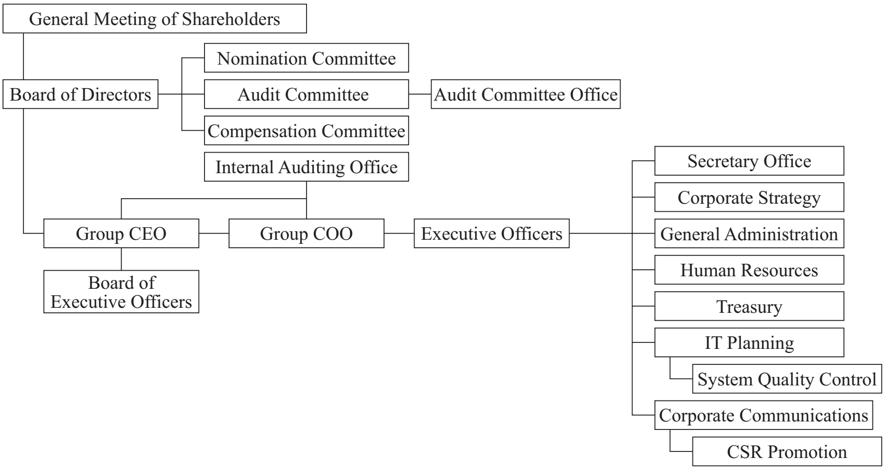


Chart IX-2. Organizational Structure of the Tokyo Stock Exchange (Market Operator)

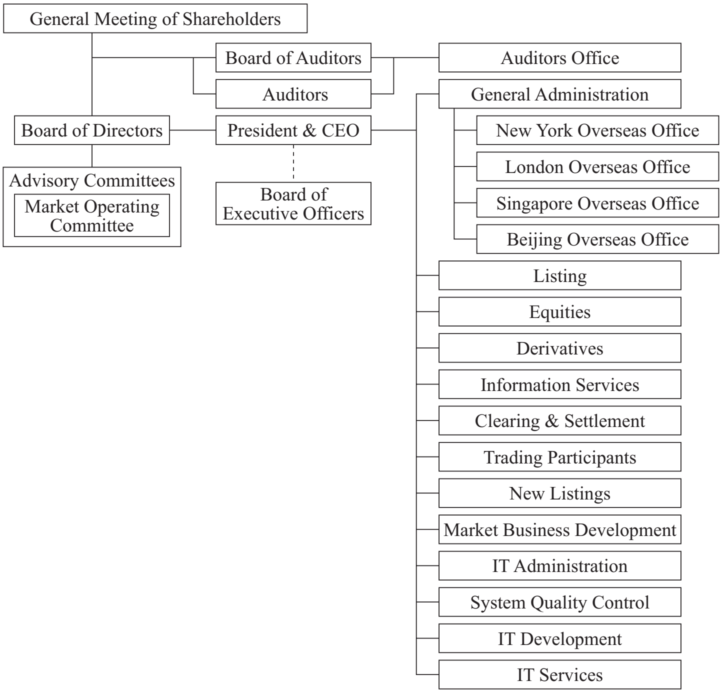


Chart IX-3. Organizational Structure of Osaka Securities Exchange (Market Operator)

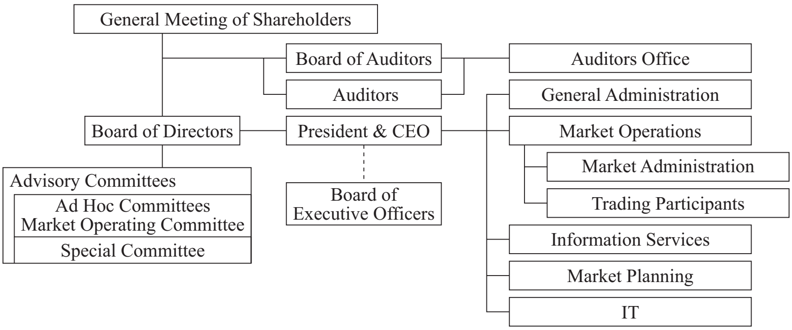
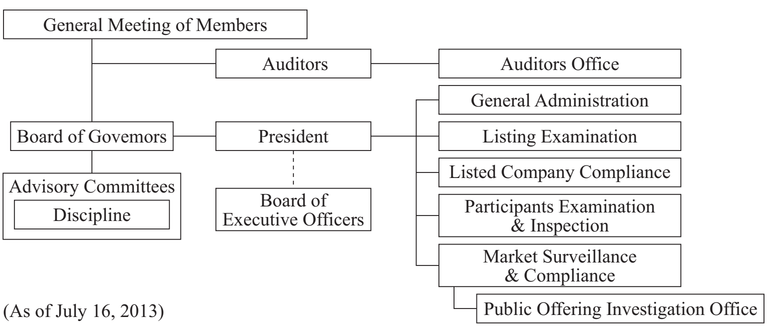


Chart IX-4. Organizational Structure of Tokyo Stock Exchange Regulation (SRO)



(As of July 16, 2013)

Securities Exchange formed a self-regulatory committee.

These moves were prompted by potential conflicts of interests between the public role of a securities exchange as a self-regulating body and the for-profit orientation of an exchange as a joint stock company, where exchanges sought to reinforce the independence of their highly public function to ensure self-regulation of the market.

Recently, the intensifying cross-border market competition created by the development of electronic financial trading systems has led to many alliances and mergers among exchanges overseas. To respond to this trend, in January 2013 the TSE and OSE combined their operations to solidify their positions in the domestic market and to enhance their global competitiveness by upgrading the appeal and convenience of their markets.

2. The Listing System

The stock exchange imposes listing requirements from the viewpoint of investor protection and examines the listing applications of securities companies to see whether they satisfy the listing requirements. The listing requirements comprise technical and eligibility requirements. After the stock exchange receives an application from a company wishing to list its stock, the exchange checks first whether or not the listing applicant meets the technical requirements and then the eligibility requirements.

The technical requirements include (1) those relating to the number of shareholders; tradable shares (number of shares owned by shareholders other than large shareholders and other specified persons, market value of tradable shares, ratio of tradable shares); and market capitalization of the shares listed from the standpoint of ensuring smooth trading in shares and forming fair prices; (2) those relating to the number of years that have elapsed since the establishment of the issuing company; the net worth; and the amount of profit earned from the standpoint of maintaining the suitability for listing in terms of continuity of business, financial position, and profitability, etc.; (3) those relating to absence of opinion acknowledging false or improper statements and being audited by an audit firm included in the Japanese Institute of Certified Public Accountants' (JICPA) Listed Company Audit Firm Register from the standpoint of ensuring proper disclosure of the state of the company's business; and (4) those relating to the appointment of a transfer agent, the tangen trading unit, the classes of shares, restricted shares, and appointment of a designated custody and transfer agent from the standpoint of preventing forgeries and other troubles in the share transfer process as well as ensuring smooth operation in connection with transactions.

The eligibility requirements are (1) that the issuing company is a going concern and has a stable earnings base, (2) that it carries out its business fairly and in good faith, (3) that it has in place an adequate and functional framework for corporate governance and internal control, (4) that it is in a position to make a fair corporate disclosure, and (5) that it complies with the conditions that are deemed necessary by the stock exchange from the standpoint of public interest and investor protection. Examination of fulfillment of these eligibility requirements is made on the basis of the documents submitted by, and hearings conducted on, the issuing company.

Generally, a newly listing company is first listed on the Second Section, and when it meets the listing requirements for the First Section it is allowed to transfer to the First Section. However, if the company is judged to be capable of meeting the technical listing requirements of having 2,200 or more shareholders, 20,000 units or more of tradable shares, a ratio of tradable

Table IX-1. The Listing Requirements of the Second Section of the Tokyo Stock Exchange

October 22, 2013

Criteria	
Amount of net assets (Expected at listing)	Consolidated: ¥1 billion or more (plus positive value for non-consolidated net assets)
Amount of profit	Consolidated: ¥500 million or more for the most recent two years
No. of shareholders (Expected at listing)	800 or more[1)]
Tradable shares[2)] (Expected at listing)	At the time of initial listing a. No. of tradable shares: 4,000 units or more b. Market value of tradable shares: ¥1 billion or more c. Ratio of tradable shares: 30% or more of the shares listed
Market capitalization of the shares listed (Expected at listing)	¥200 billion or more
No. of years in existence	Three years or more in continuous operation with a board of directors in place, calculated from the end of the prior business year
Financial statements, etc.	The financial statements for the latest two years contain no false statements
Auditor's opinion	"Unqualified opinion" or "qualified opinion" for the latest two years (or three years for those whose amount of profit falls within the purview of b above) "Unqualified opinion" for the latest year
Others	- Audited by a registered listed company audit firm - Appointment of a shareholder services agent - Number of shares in Tangen trading units - Restriction on stock transfer - Appointment of designated custody and transfer agent

Notes: 1. No. of shareholders means the number of shareholders who own one or more units of shares.
2. Tradable shares mean shares listed except for those held by directors and other officers of the issuer and by shareholders who own 10% or more of shares listed and shares held in treasury, if any.

October 22, 2013

Eligibility Requirements
Corporate continuity and profitability: A business is operated continuously and a stable revenue base is present.
Soundness of corporate management: A business is carried out fairly and faithfully.
Effectiveness of corporate governance and internal management system of an enterprise: Corporate governance and internal management system are properly prepared and functioning.
Appropriateness of disclosure of corporate information, etc.: The applicant is in a state where disclosure of the corporate information, etc. may be carried out in an appropriate manner.
Other matters deemed necessary by the Exchange from the viewpoint of the public interest or the protection of investors

shares of 35% or more, and a market capitalization of ¥25 billion or more by the time it actually lists, it will be allowed to list directly on the First Section.

3. The Listing Management System

With a view to carrying out the proper management of listed securities and their issuers as well as to protecting investors, stock exchanges have instituted various rules relating to the management of listings and have sought to ensure the effectiveness of these rules by requiring issuers to promise to observe them in the listing agreement they sign at the time of listing.

In the case of the Tokyo Stock Exchange, its listing regulations include rules requiring listed companies to make timely disclosure of information regarding any material corporate matters, a code of conduct requiring companies to adhere to appropriate behavior, and rules concerning changes in market section classification and the delisting of securities.

Rules Requiring Timely Disclosure of Material Corporate Matters: To ensure the formation of fair market prices and to foster the sound development of a financial instruments market, it is extremely important for listed companies to make proper disclosure in a timely manner of information concerning material corporate matters that may influence the investment decision making of investors, the very basis on which stock prices are formed. The Tokyo Stock Exchange has established rules as part of its listing regulations requiring listed companies to make timely disclosure of material corporate information.

Code of Corporate Conduct: The Tokyo Stock Exchange has introduced a code of corporate conduct in its regulations. The multifold purposes of requiring proper conduct by listed companies are to raise awareness of their role as members of the financial instruments market, to ensure greater transparency by enhancing the disclosure of corporate information, and to achieve the proper operation of investor protection measures and market functions.

Changing Section Classifications: The Second Section of the Tokyo Stock Exchange was established separately from the First Section in 1961 initially with a view to better protecting investors with regard to problems with being attracted from the then immature over-the-counter market into the exchange market. At present, the principal difference between the First and Second Sections is generally perceived as liquidity. The Tokyo Stock Exchange's listing regulations stipulate the criteria for assignment to the First Section and the criteria for reassignment from the First Section to the Second Section.

Criteria for Delisting Stocks: A stock may be delisted whenever it meets any of the conditions set forth in the criteria for delisting stocks in the listing

Table IX-2. Outline of Tokyo Stock Exchange's Code of Corporate Conduct

October 22, 2013

Compliance Items (Violations may be subject to action)	Desirable Items (Observance voluntary)
• Third-party capital increase rules • Prohibition of stock split, etc., that could cause turmoil in the secondary market • Rules pertaining to issue of MSCB, etc. • Duty to exercise of voting rights in writing, etc. • Duty to carry out framework improvement to facilitate exercise of voting rights for listed foreign companies • Duty to appoint an independent director • Duty to appoint a board of directors, an audit board or committee, and an accounting auditor • Duty to select a certified public accountant or public audit firm to provide the audit certificate of the accounting auditor • Duty to carry out necessary structural development for ensuring the appropriateness of activities • Rules pertaining to introduction of takeover defense measures • Rules pertaining to disclosure of MBOs, etc. • Rules pertaining to significant transactions, etc., with controlling shareholders • Audit by an audit firm placed on the TSE's Listed Company Audit Firm Register • Prevention of insider trading • Elimination of any influence by criminal and extremist elements • Prohibition of behavior destructive to the functioning of the secondary market or the rights of shareholders	• Effort to transition to and maintain a desirable investment unit level, etc. • Make efforts to unify trading unit • Create management structure that includes independent directors • Framework improvement to enable proper functioning of independent directors • Provide information on independent directors, etc. • Framework improvement to facilitate exercise of voting rights • Issue documents to holders of nonvoting stock • Framework improvement to prevent insider trading • Framework improvement, etc., to eliminate influence of criminal and extremist elements • Respect for the TSE's corporate governance principles for listed companies • Establish a system for proper response to changes in accounting standards, etc. • Fair provision of supplementary explanatory materials on details of business performance

regulations.

When any stock is in danger of falling within the purview of the criteria for delisting stocks, the issue will be put on the watch list to notify general investors. When any stock actually falls within the purview of the delisting criteria, the issue will be put on the liquidation list to publicize the information and allow the trading of such issue to continue for a specified period (ordinarily one month).

4. The Stock Trading System (1)

Floor auction is the most widely used trading method on the stock exchanges. In the case of the Tokyo Stock Exchange, the trading hours are divided into two sessions: the morning session, from 9 a.m. to 11 a.m., and the afternoon session, from 12:30 p.m. to 3 p.m.

Table IX-3. Criteria for Delisting Stocks (the Tokyo Stock Exchange)

October 22, 2013

Item	Delisting criteria
① No. of shareholders	Less than 400 (with a grace period of one year)
② Tradable shares	a. No. of tradable shares: less than 2,000 units (with a grace period of one year) b. Market value of tradable shares: less than ¥500 million (with a grace period of one year) c. Ratio of tradable shares: less than 5% of the shares listed (except when prescribed documents are submitted)
③ Trading volume	Either the average monthly trading volume over the past one year is less than ten units or no trades were made for the past three months
④ Market capitalization	When the market capitalization of the shares listed falls short of ¥1 billion and if it fails to increase to ¥1 billion within the succeeding nine months (or three months if recovery plans are not submitted)
⑤ Negative net worth	If the issuer falls into negative net worth for two consecutive terms (The grace period is extended for another year if such issuer has a credible plan to wipe out the negative net worth within a year through rehabilitation proceedings.)
⑥ Bankruptcy, etc.	When the issuer becomes insolvent or falls into a situation requiring rehabilitation or reorganization proceedings or liquidation or an equivalent situation (However, if such issuer discloses a rehabilitation/reorganization plan and the market capitalization over one month thereafter remains above ¥1 billion, the listing will be maintained.)
⑦ Suspension of business activities	When a listed issuer suspends its business activities or falls into a situation similar thereto
⑧ Inappropriate mergers	When the stock exchange determines that a listed company that acquired another company has in effect failed to survive the merger and that the surviving company has failed to meet standards equivalent to the initial listing requirements within three years of such merger
⑨ Deterioration in soundness of transactions with controlling shareholder	When the stock exchange determines that there has been a marked deterioration in the soundness of transactions between the company and its controlling shareholder within three years of a change in the controlling shareholder due to a third-party allotment
⑩ Delays in securities filings	When a listed issuer fails to file an annual or quarterly securities report together with an auditor' s report or quarterly review report within one month following the statutory deadline (if another deadline has been approved for filing, when the listed issuers fails to file within 8 days following that deadline)
⑪ False statements or adverse opinion	- When a false statement is made in a securities filing and the competent stock exchange finds that maintaining order on the exchange could be difficult without immediate delisting of the issue - When an audit report contains an improper opinion or no auditors' opinion and the competent stock exchange finds that maintaining order on the exchange could be difficult without immediate delisting of the issue
⑫ Securities on Alert	• When despite the issue meeting criteria to be designated as securities on alert, the competent stock exchange determines that there is no likelihood of improvement in the issuing company's internal control system, etc. • When during the process of designating the issue as securities on alert, the competent stock exchange determines that there is no likelihood of improvement in the issuing company's internal control system, etc., • When despite having designated the issue as securities on alert, the competent stock exchange determines that there is no likelihood of improvement in the issuing company' s internal control system, etc.
⑬ Breach of the listing agreement	When a listed company seriously violates the listing agreement or pledge concerning timely disclosure or when it becomes no longer a party to the listing agreement
⑭ Undue restrictions on shareholders' rights	When shareholders' rights or exercise thereof are unduly restricted
⑮ Others	Suspension of a listed issuer by the bank, failure to appoint a shareholder services agent, certain restrictions on share transfers, becoming a wholly owned subsidiary of another company, cancellation of the custody and transfer agent agreement, wholly call, involvement with antisocial groups, and when the competent stock exchange finds that the delisting of a given stock is in the public interest or appropriate for the protection of investors

Table IX-4. Methods of Concluding Transactions

Itayose method

A memo (on a board) about an order received at the time an opening price is decided

(Asked price)	(Price)	(Bid price)
H(2) I(4)	Market Quotation	K(1) M(3)
○○○	¥503	
○○○	¥502	T(1)
○○	¥501	P(5) N(2)
G(1) F(1) E(1)	¥500	A(4) B(3) C(2) D(1)
S(2)	¥499	○○○
R(4)	¥498	○○○
	¥497	

Zaraba method

A memo (on a board) about a *Zaraba* order for a given issue received

(Asked price)	(Price)	(Bid price)
	Market Quotation	
○○○	¥503	
○○○	¥502	
○D(2) C(4)	¥501	
B(3) A(3)	¥500	
	¥499	F(3) G(2)○
	¥498	○○○
	¥497	○○○

Notes: 1. Letters represent securities companies.
2. Figures given in parentheses represent the number of trading units, each consisting of 1,000 shares.
3. ○○○ are blanks to be filled with securities companies bidding or asking prices and the number of trading units.
4. In the case of the *Itayose* method, all bid and asked prices are considered to have been proposed simultaneously (simultaneous outcry).

The *Itayose* Method

a. First, a sell order for 6,000 shares at a market-asked price without limit (2,000 shares by H securities company and 4,000 shares by I securities company) is matched against buy orders for 4,000 shares at a market-bid price without limit (1,000 shares by K securities company and 3,000 shares by M securities company). At this point, 2,000 shares at a market-asked price without limit are left unmatched.
b. Then, assuming that the opening price will be ¥500, the remaining unfilled sell orders for 2,000 shares at a market-asked price without limit and those for 6,000 shares at an asked price of ¥499 or less (2,000 shares by S securities company and 4,000 shares by R securities company) are matched against buy orders for 8,000 shares at a bid price of ¥501 or more (5,000 shares by P securities company and 2,000 shares by N securities company and 1,000 shares by T securities company). As a result, sell orders for 12,000 shares at an asked price and buy orders for 12,000 shares at the bid price are matched.
c. Lastly, a sell order for 3,000 shares at an asked price of ¥500 (1,000 shares by E securities company, 1,000 shares by F securities company, and 1,000 shares by G securities company) are matched against buy orders for 10,000 shares at a bid price of ¥500 (4,000 shares by A securities company, 3,000 shares by B securities company, 2,000 shares by C securities company, and 1,000 shares by D securities company). However, there are only 3,000 shares offered for sale at an asked price of ¥500, while there are buy orders for 10,000 shares at a bid price of ¥500. In such cases, all the sell orders for 3,000 shares at an asked price of ¥500 are matched against the buy orders for 1,000 shares each from A, B, and C securities company at an asked price of ¥500. As a result, the opening price is decided at ¥500, and orders for a total of 15,000 shares are consummated at such price.

The *Zaraba* Method

a. When the contents of an *Ita* (board) are as shown in the chart, a buy order of M securities company for 2,000 shares at a bid price of ¥500 can be consummated by matching the sell order of A securities company for 2,000 shares out of its original sell order for 3,000 shares.
b. When N securities company places a buy order for 10,000 shares at a bid price without limit, it can be consummated by matching it against the remaining 1,000 shares offered for sale by A securities company at an asked price of ¥500 and a sell order of B securities company for 3,000 shares at an asked price of ¥500 and then a sell order of C securities company for 4,000 shares at an asked price of ¥501 and a sell order of D securities company for 2,000 shares at an asked price of ¥501.
c. If K securities company places a sell order for 5,000 shares at an asked price of ¥499, a contract can be concluded by matching it against a buy order of F securities company for 3,000 shares at a bid price of ¥499 and a buy order of G securities company for 2,000 shares at a bid price of ¥499.
d. As a result, the following trading agreements can be concluded

Selling securities company	Buying securities company	Contracted price	No. of shares
A securities company	M securities company	¥500	2,000 shares
A securities company	N securities company	¥500	1,000 〃
B securities company	N securities company	¥500	3,000 〃
C securities company	N securities company	¥501	4,000 〃
D securities company	N securities company	¥501	2,000 〃
K securities company	F securities company	¥499	3,000 〃
K securities company	G securities company	¥499	2,000 〃

e. In such a manner, asked and bid prices are offered without interruption during the session hours, and when buy orders (sell orders) are matched against sell orders (buy orders), trading agreements are concluded.

There are mainly two types of orders: a limit order, by which a customer limits the acceptable price, and a market order, which is executed immediately at the price available in the market without restrictions or limits. Limit orders can be made in such increments as ¥1 or ¥10, with the allowable price increments being determined according to the price range of the stock. As of January 2014, the smallest price increment is ¥1. However, to enable the execution of even smaller increments the Tokyo Stock Exchange plans to introduce one decimal point limit trades (¥0.1) as the smallest trading increment in July 2014. The allowable price for a limit order is restricted to a fixed price range based on the closing price of the previous trading day, which also controls any sharp movement in stock prices.

Trading of shares on the exchange floor is conducted in accordance with the price-priority rule (under which a buy/sell order with the highest/lowest bid/offer price takes precedence over the others) and the time-priority rule (when there is more than one order offering or bidding at the same price, the order placed the earliest takes precedence over others) and by either the Itayose method (single-price auction using an order book) or the Zaraba method (continuous auction).

The *Itayose* method is a system that is used to determine the opening or first price when trading commences or resumes on the floor. All buy and sell orders for a given issue are matched according to the price-priority rule to find a single price that clears all market orders and meets certain other conditions.

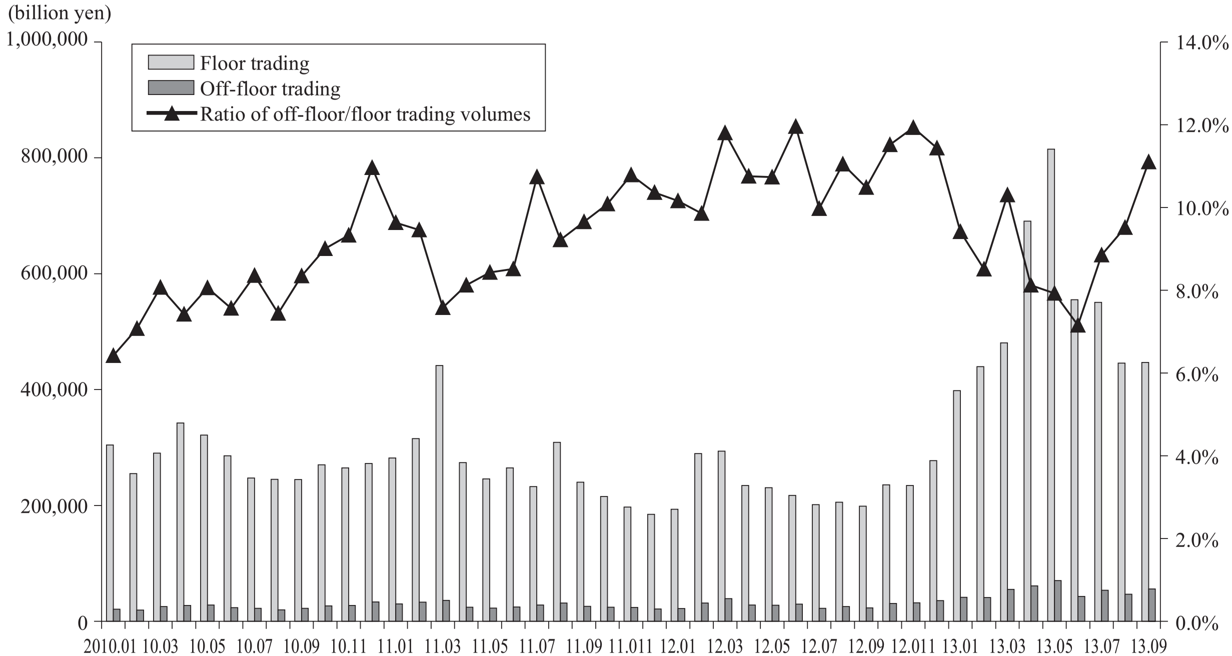
The *Zaraba* method is a system by which, following the establishment of the opening price by the Itayose method, trades are executed in a continuous auction, in principle, through the end of a session. By this method, a newly placed buy/sell order is matched against the existing sell/buy order that has the highest precedence based on price priority and then on time priority in order to determine the execution price.

5. The Stock Trading System (2)

Floor trading is the predominant form of securities trading conducted on the stock exchange. To complement the floor trading system, stock exchanges introduced off-floor trading systems in the second half of the 1990s.

During the initial period that followed the introduction of these systems, the systems were used solely for executing cross transactions due in part to the restriction that required orders to be placed via fax. However, the Tokyo Stock Exchange automated its off-floor trading system to improve efficiency and convenience with the introduction of ToSTNet in June 1998 and expanded its trading system by adding new classes of transactions.

Chart IX-5. A Comparison of the Trading Value of Floor Trading and Off-Floor Trading of the Tokyo Stock Exchange



Note: The ratio of off-floor/floor trading volumes denotes the ratio of the yen trading volume of off-floor transactions to that of on-floor transactions (units on right axis).

The Tokyo Stock Exchange has continuously improved this trading system to meet the various transaction needs of investors, including the extension of its trading hours in January 2008 and establishing it as an independent market from the trading floor.

ToSTNet, the off-floor trading system of the Tokyo Stock Exchange, accommodates the following four types of transactions: single-stock trading, basket trading, closing-price trading, and off-floor corporate share repurchases.

Single-Stock Trading: Under the single-stock trading system, investors can effect transactions in an individual stock issue at a price within plus-minus 7% (¥5 when 7% of the price is less than ¥5) of the last price of the issue on the floor or some other reference price as specified.

Basket Trading: The basket-trading system enables investors to trade baskets of a minimum of 15 stocks worth at least ¥100 million in aggregate value within plus-minus 5% of the value of the basket based on the last prices of the component issues on the floor or some other reference prices as specified.

Closing-Price Trading: Under the closing-price trading system, off-hour orders of investors are matched based on time priority before the morning and afternoon sessions and after the afternoon sessions at the closing prices of the preceding session of floor trading (i.e., the closing prices of the previous day, those of the morning session, or those of the afternoon session) or some other reference prices as specified.

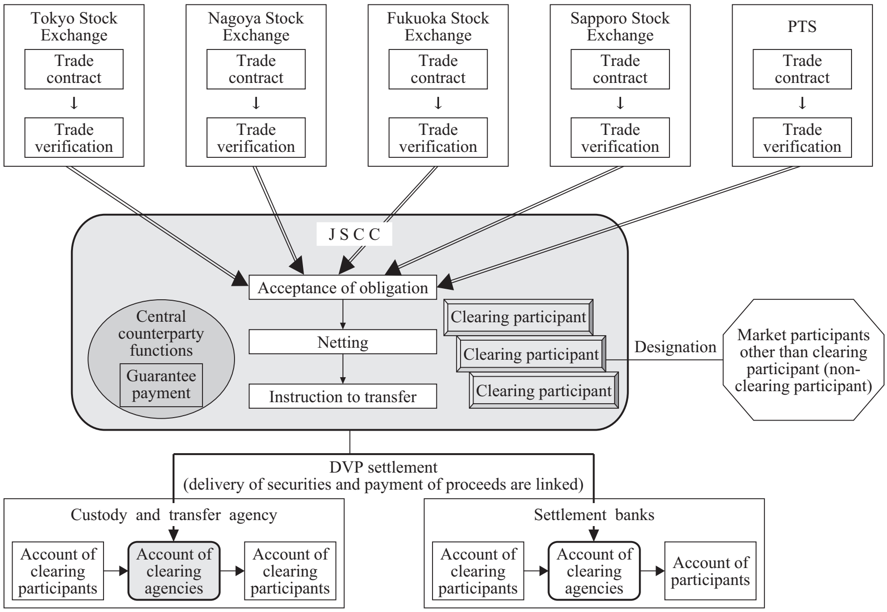
Off-Floor Corporate Share Repurchases: This is a method of trading shares off the floor before the morning session at the previous day's closing prices or some other reference price as specified. Buyers eligible for the facility are limited to listed companies that intend to repurchase their own shares.

6. The Clearance and Settlement System (1)

Securities trading executed on the exchanges is cleared and settled through the Japan Securities Clearing Corporation (JSCC). Since January 2003, all the clearing and settlement carried out for each market has been unified under the JSCC.

Those who are qualified for handling clearing and settling securities transactions through the JSCC are called "clearing participants." Clearing participants settle with the JSCC the securities transactions that have been conducted on participating exchanges. Meanwhile, securities transactions conducted by those not qualified ("non-clearing participants") are first settled with clearing participants designated by respective non-clearing participants, which, in turn, clear such transactions with the JSCC on behalf of non-clearing

Chart IX-6. Delivery and Settlement Using JSCC (Exchange Transactions)

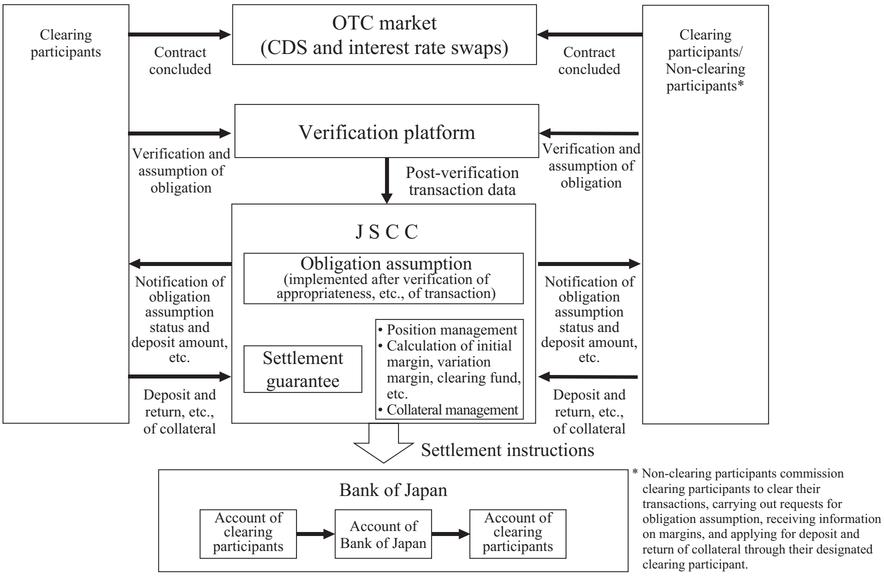


Notes: 1. As transactions were settled and the account transfer of securities and proceeds was carried out independently at each stock exchange, the system of delivery of securities and payment of their proceeds varied from one stock exchange to another.
2. As of July 2010, the JSCC began assuming obligations of transactions done on PTSs.

participants. The main functions performed by the JSCC are (1) to assume obligations, (2) to permit the netting of security positions and fund transfers, (3) to issue transfer instructions, and (4) to make a settlement guarantee.

Upon the execution of a transaction on a stock exchange, the JSCC assumes associated obligations (for the seller to deliver the securities sold and for the buyer to make payment for them) and, at the same time, acquires claims corresponding to both obligations. The JSCC nets long and short positions (by issue) and the proceeds and payments (of all transactions) for each clearing participant and settles the net balances. Based on this process, the JSCC helps to enhance efficiency in securities deliveries and fund payments and to streamline operations. Following netting, the JSCC instructs ("transfer instructions") the Japan Securities Depository Center to make transfers of net securities positions and the Bank of Japan or a bank designated by JSCC as ("the fund settlement bank") to make a transfer of the netted amount between the accounts of the JSCC and each clearing participant. Throughout the series of netting and settlement processes, the JSCC performs and guarantees the

Chart IX-7. Delivery and Settlement Using JSCC (OTC Derivatives Transactions)



settlement of a trade as the settlement counterparty against the trade counterparty ("settlement guarantee"). Thanks to this arrangement, parties can trade securities without regard to the settlement risk of original trade counterparties.

The JSCC also performs clearing and settlement functions for OTC trading. It has expanded its scope in recent years, offering clearing and settlement services for securities traded on proprietary trading systems (PTSs) in 2010. After the global financial crisis, moreover, the regulatory reform of OTC derivatives transactions has proceeded in all countries, with each country being obligated to clear and settle standardized OTC derivative transactions through a central clearing house (central counterparty clearing). For its part, the JSCC commenced clearing and settlement services for credit default swaps (CDS) transactions in 2011 and for interest rate swaps in 2012. In October 2013, the JSCC merged with the Japan Government Bond Clearing Corporation and thereby added OTC JGB transaction clearing and settlement services.

7. The Clearance and Settlement System (2)

With a view to eliminating the risk involved in the settlement of transactions in shares (and other securities handled by the Japan Securities Depository Center), in general, and the risk of a default in the payment of the principal, in particular, after the delivery of underlying securities, the JSCC has introduced a delivery-versus-payment system (DVP settlement) system,.

To lessen the risk and to ensure the efficiency of settlement, the JSCC has incorporated various features into its DVP system. Among other things, it has added the netting facility to its version. Under the traditional DVP system, a buyer basically cannot take delivery of shares until such time as payment for them (via fund transfer) has been verified. This, however, could undermine the overall efficiency of settlement, including payment and delivery between clearing participants and non-clearing participants or customers, etc., so improvements have been made so that buyers can take delivery of the shares earlier. More specifically, a buyer's clearing participant may take delivery of securities of a value equivalent to the following three amounts:

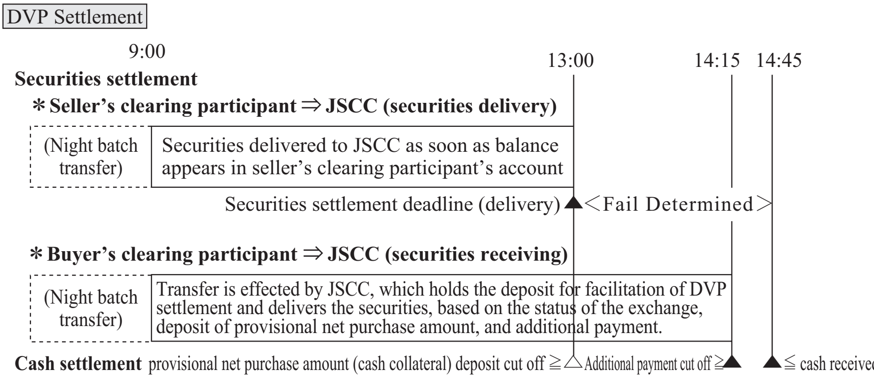
(1) The provisional net purchase amount deposited with the JSCC as cash collateral. The provisional net amounts will be adjusted by the amount of failed deliveries, if any, at 2:15 p.m., when cash is due from paying participants, and at 2:45 p.m., when cash is paid to receiving participants).
(2) The deposit for the facilitation of DVP settlement (voluntarily deposited with the JSCC).
(3) The securities delivered to the JSCC for settlement purposes.

In the event that a participant should fail to deliver a security on the settlement date of a DVP trade (known as a "fail"), the JSCC will carry over the delivery of and payment for the security to the following day, when delivery and payment are netted for settlement against the deliveries and payments for transactions of the said participant due to be settled on that day. However, as, in principle, trades are supposed to be settled on the settlement date, prolonged fails cannot be tolerated. For this reason, the DVP settlement rules also provide for penalties for damages resulting from settlement delays and the right of a buyer participant who has been assigned a failed position to buy in (or to force the failing seller to buy and deliver the required security).

8. The Book-Entry Transfer System for Stocks, Etc.

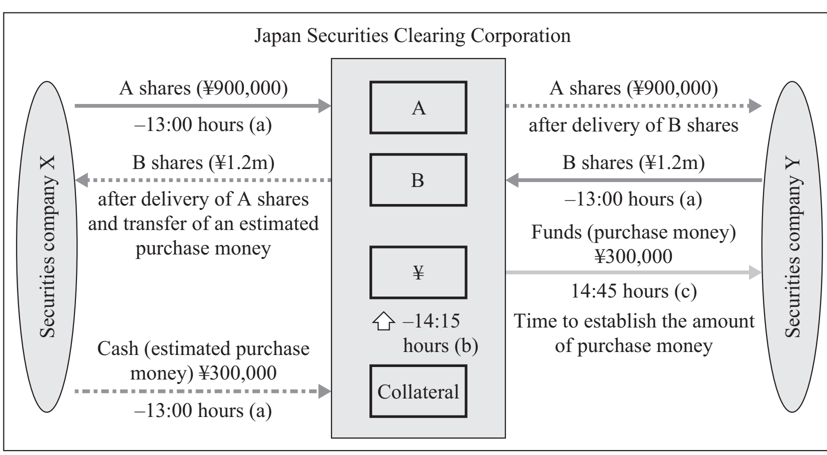
Following the abolishment of stock certificates for publicly listed companies, stock certificate shares are being electronically deposited and transferred based on the collaboration of the Japan Securities Depository Center, Inc. (JASDEC), the central depository for shareholder ownership rights, and account management institutions, which are securities firms, etc., that have set up transfer accounts.

Chart IX-8. DVP Settlement Timetable



Note: The receiving of securities by the buyer's clearing participant is carried out in a way that eliminates the risk of principal default versus the cash payer JSCC through nonperformance of obligations or of delivery of collateral.

Chart IX-9. The DVP Scheme



Deadline for settlement:

a. Deadline for the delivery of securities and the deposit of the estimated purchase money (cash collateral): 13:00

b. Deadline for the payment of purchase money: 14:15

c. Time for the receipt of purchase money: 14:45

Securities eligible for the book-entry transfer system for stocks, etc., include stocks listed on domestic public exchanges; convertible-type corporate bonds (CB); investment units, such as real estate investment trusts (REIT); and preferred shares of cooperative financial institutions, new share subscription rights, beneficiary certificates of exchange-traded funds (ETFs), Japanese depositary receipts (JDR), and others.

The features and functions of the book-entry transfer system for stocks, etc., are

(1) Shareholders' ownership rights are administered based on the records of the transfer account book, with transfers of shares being processed through the transfer account.

(2) Account management institutions inform JASDEC of the identification of beneficiary shareholders, including their names and addresses along with their share ownership data. JASDEC then compiles the information to periodically report to respective issuers (general shareholder notification).

(3) Companies produce their records of voting rights for general meetings of shareholders and retained earnings distributions based on a register of beneficiary shareholders drawn up from the general shareholder notification.

(4) Minority shareholders, etc., can exercise their rights by applying to JASDEC to have a notification sent to the issuer verifying their shareholdings, duration of ownership, and other particulars (individual shareholder notification). They can then exercise their rights for a limited period of time following receipt of the notification.

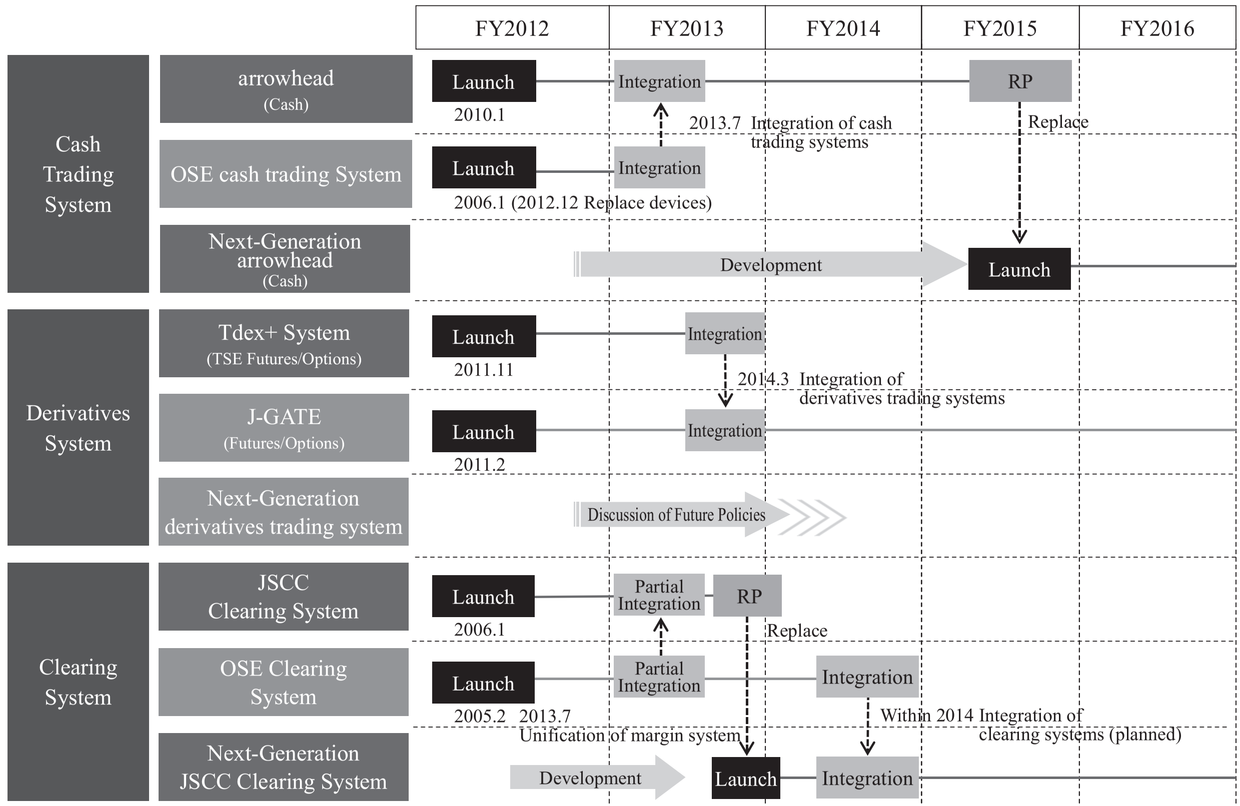
The main benefits that are expected from transition to the electronic book-entry transfer system include (1) shareholders can eliminate the risks of loss, theft, or forgery of certificates that are held at their own risk, and they also do not need to submit certificates to the issuer for replacement in the event of a corporate name change or change in the share trading unit; (2) issuers can save costs associated with issuance, such as printing costs and stamp duties, as well as those associated with corporate reorganization (such events as corporate mergers, stock exchanges, stock transfers) for collecting old certificates and distributing new ones; and (3) securities companies can reduce the risks and costs associated with the storage and transport of certificates.

9. System Development at Financial Instrument Exchanges (1)

The following is a summary of the trading system, the market information system, and the settlement and clearance system that support the stock market.

The trading system for the TSE's cash equity market is a system for entering and matching orders, preparing transaction reports, and inquiring into the

Chart IX-10. System Integration Schedule for JPX Group



Source: IT Master Plan, Japan Exchange Group, March 2013 state of the order book. The system processes stock, corporate bonds with subscription rights, etc. (convertible bonds), and other transactions from floor trading and the off-floor ToSTNeT market. Orders from a trading participant are mainly entered through the trading partner's in-house system or through a direct connection to the TSE's trading system.

The computerization of securities trading at the TSE started with the TSE2 trading system (the old stock trading system) that went into operation in January 1982. The current stock trading platform consists of arrowhead, launched in January 2010, and the ToSTNeT system, which came online in November 2011. In handling the floor trading transactions, arrowhead utilizes triple redundant servers to provide the high-speed processing of orders, with an average response time of one millisecond, and of such trading information as orders, transactions, and the order book. These features make it a highly reliable system with flexible scalability for rising volume capacity. The TSE plans to upgrade arrowhead's processing power and to expand and improve its other functions during the system's renewal, which is scheduled for FY 2015. The other system of the trading platform, the ToSTNeT system, handles off-floor transactions.

The Japan Exchange Group, Inc. (JPX) commenced operations in January 2013. In July 2013, it amalgamated the cash equity markets of the TSE and OSE while also integrating the stock and CB trading system of the OSE into the TSE's arrowhead and ToSTNeT systems.

The objective of the market information system is to provide investors with information on security prices, thereby facilitating fair price formation and smooth trading of securities. The system furnishes market information concerning issues eligible for the trading system to trading participants (financial institutions), information venders, newspapers, and news agencies.

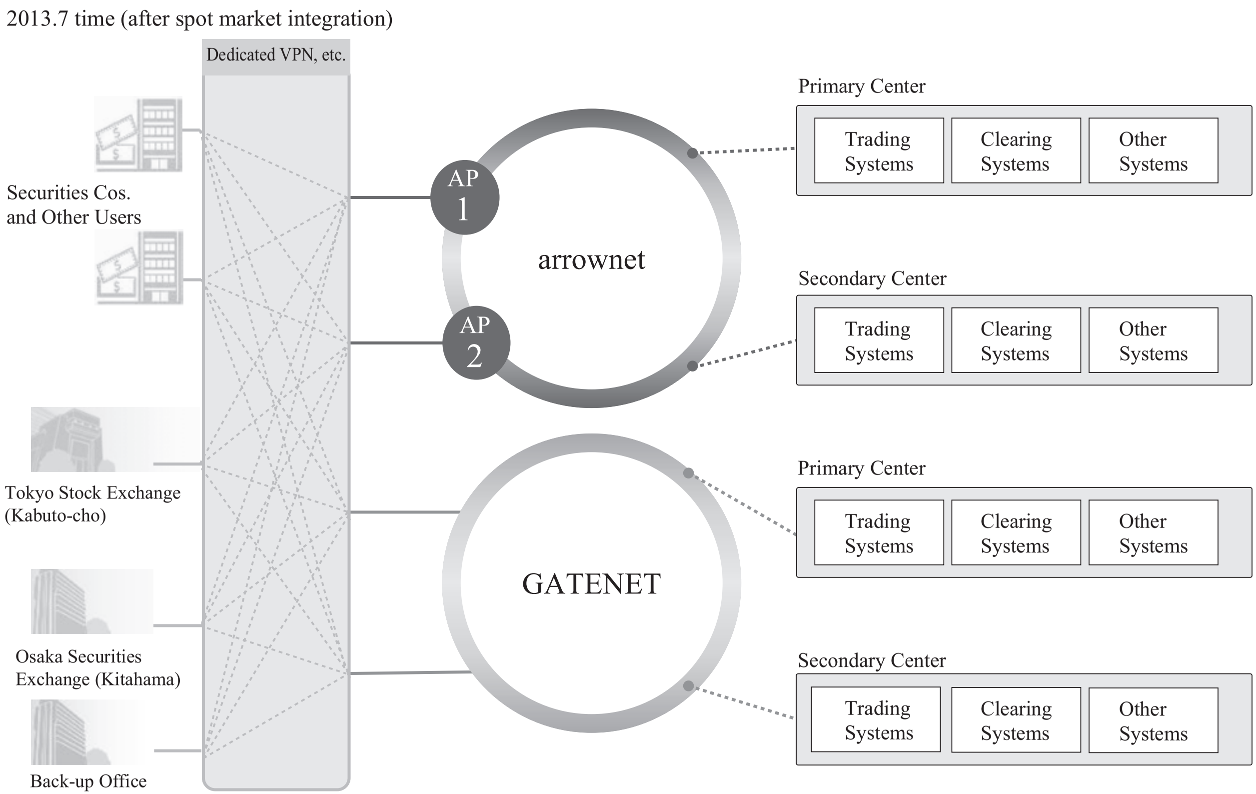
The settlement and clearance system for stocks and CBs is designed to support delivery and other operations for the settlement and clearance of transactions executed on the TSE and other markets. Since January 2003, the JSCC has acted as the cross-market clearing organization for all domestic exchanges. The data for this process from trading participants, etc., is passed through the TSE's dedicated arrownet network.

10. System Development at Financial Instrument Exchanges (2)

The following is a summary of the trading system and the settlement and clearance system that support the derivatives market.

The derivatives trading system is a system for entering and matching orders, preparing transaction reports, and inquiring into the state of the order book, etc., of the derivative markets of the OSE and TSE. The system

Chart IX-11. JPX Group Systems



Source: IT Master Plan, Japan Exchange Group, March 2013 processes futures, options, and other transactions from floor trading and the off-floor market. Orders from a trading participant are mainly entered through the trading partner's in-house system or through a direct connection to the TSE's trading system.

The OSE's trading system for derivatives, J-GATE, has the same functions and transaction formats used by the systems of major overseas markets. In introducing the system, the OSE reviewed the complex transaction system peculiar to Japan to address the shift among investors to algorithmic and other advanced and diversified trading methods. The system is based on the CLICK XT™ system of the NASDAQ OMX Group to promote the further globalization of the market and demonstrates world-class performance as well as a high degree of stability and reliability. The TSE's Tdex+ trading system for derivatives, meanwhile, is based on the LIFFE CONNECT® system of the NYSE Group.

Following the launch of JPX in January 2013, plans were made to amalgamate the derivatives markets of the TSE and OSE on the OSE market in March 2014, with the trading systems being integrated with J-GATE. Although J-GATE previously used the OSE's GATEWAY network to connect with external systems, the network since has been integrated with the TSE's arrownet.

The clearing and settlement systems for the derivatives market were integrated into the JSCC system in July 2013, and the margin deposit systems related to the derivatives transactions of the OSE and TSE since have been unified. But while the TSE uses the JSCC for its settlement and clearance operations, the OSE is still using its own settlement and clearance system for these operations. The JSCC is scheduled to take over all settlement and clearance operations sometime in 2014.

The foreign exchange (FX) system, meanwhile, has its own trading, clearing and settlement, and market data systems. All FX operations are carried out by the OSE FX system.

CHAPTER X

The Financial Instruments Exchanges (2)

1. The Evolution of the Start-up Market

During the period after World War II when all stock exchanges were closed, stock trading had to be done on the OTC market in so-called group transactions. In fact, the OTC market remained active even after the country's stock exchanges were reopened, resulting in the establishment of an OTC authorization system in June 1949 to provide some control over active trading. That system was abolished in 1961 after the Tokyo Stock Exchange, Osaka Securities Exchange, and Nagoya Stock Exchange set up Second Sections that absorbed almost all authorized OTC issues. Amid Japan's high economic growth, however, there remained a need for unlisted companies to procure funding. So the JSDA introduced the OTC registration system (equity OTC market) in February 1963. This was the origin of today's JASDAQ market of the Tokyo Stock Exchange. The OTC registration system became the new OTC market in 1983 and served to complement the conventional stock exchanges, particularly as a capital market for growth and start-up companies.

In 1999, though, the Tokyo Stock Exchange created a start-up market called Mothers. This new market strengthened investor protection through enhanced disclosure requirements, making it possible for companies with high growth prospects to list even if they had negative net worth or were not yet profitable. Start-up companies were thus able to obtain funding through securities issued at an early stage of their development, while investors were given an opportunity to invest early in these growth companies. Scandals among some of the listed companies, however, quickly overrode the merits of the Mothers market and prompted the TSE to raise the listing requirements. Investor protection was further fortified under the Financial Instruments Exchange Act with the introduction of quarterly financial reporting requirements and the mandatory establishment of internal control systems.

Listings on Mothers peaked in 2004 and have continued to fall ever since. The discovery in 2010 of multiple cases of companies submitting false performance reports on an ongoing basis and starting even before their listings, moreover, dramatically deteriorated confidence in the market. Consequently,

Table X-1. History of the JASDAQ Market

Nov. 1983	New over-the-counter (OTC) market is launched.
Dec. 1998	The Securities and Exchange Law defines the JASDAQ market as an OTC securities market (in parallel with other exchange markets).
Apr. 2002	JASDAQ selects J-Stocks and starts publishing the J-Stock index.
Dec. 2004	JASDAQ acquires a stock exchange license and changes its name to the JASDAQ Securities Exchange.
Aug. 2007	JASDAQ establishes the NEO market.
Oct. 2010	JASDAQ, NEO, and Hercules markets merge, forming the new JASDAQ market. JASDASQ-TOP20 issues selected and publication of index begins.
July 2013	TSE and OSE combine their businesses, with the TSE continuing to operate JASDAQ

Table X-2. History of the Mothers Market

Nov. 1999	Mothers market is launched.
Nov. 2000	Listing system for foreign companies established. To ensure a sound market: • Require check prior to listing application (verification of soundness of business between company and underwriter). • Enhance degree of detail of inspections in listing screening (increased scope of survey of relationships with anti-social forces, etc.).
May 2002	Mothers listing criteria reviewed: • Newly establish delisting criteria regarding sales. • Newly establish listing screening standards and delisting criteria regarding market capitalization. • Newly establish requirements for first public offering.
Sep. 2003	Start publishing TSE Mothers Index.
Dec. 2006	Undertake first phase of a comprehensive listing system improvement program. • Require new applicants to obtain a letter of recommendation from the managing underwriter.
Nov. 2007	Undertake second phase of a comprehensive listing system improvement program. • Abolish provisions for moving from main exchange to Mothers market (clarify Mothers' position as a start-up market). • Abolish sales-related listing criteria. • Liberalize sales-related delisting criteria (no longer applicable after 5 years on market).
Nov. 2009	Take steps to raise confidence in market. • Newly establish "appropriateness of business plan" as a listing criteria. • Newly establish stock price related delisting criteria. • Require holding of information meeting at least twice a year.
Mar. 2011	Take steps to raise confidence in market and stimulate market • Require listed companies to be audited by an audit firm registered with exchange. • Newly establish requirement to choose whether to stay on Mothers after 10 years. • Introduce listing screening policy in line with market concept (confirm appropriateness of business plan).

in 2011 the Tokyo Stock Exchange undertook a review of Mothers' listing system and implemented measures to raise confidence and stimulate activity in the market. Among those measures, the exchange added the requirement for listed companies to be audited by an audit firm registered in JICPA's Listed Company Audit Firm Register. The TSE also changed its listing screening policy to one of evaluating whether the business plans of companies seeking to list were achievable in the long term.

2. Start-up Market Concepts

Mothers Market Concept

In 1999, the Tokyo Stock Exchange launched its Mothers market under a concept that differentiated Mothers from the TSE's First and Second Sections. The TSE established a listing system for Mothers to bring out the special characteristics of, to increase investor confidence in, and to vitalize trading on this new market. Companies wishing to list on Mothers are required to demonstrate high growth potential based on their business models, business environment, or other means. Eligibility for listing and thereby accessing the capital market is open to a broad range and number of growth companies and is not restricted by business scale or category. Among Mothers' listed companies are those with only several tens of employees and those in such infrastructure fields as information and telecommunications that boast thousands of employees.

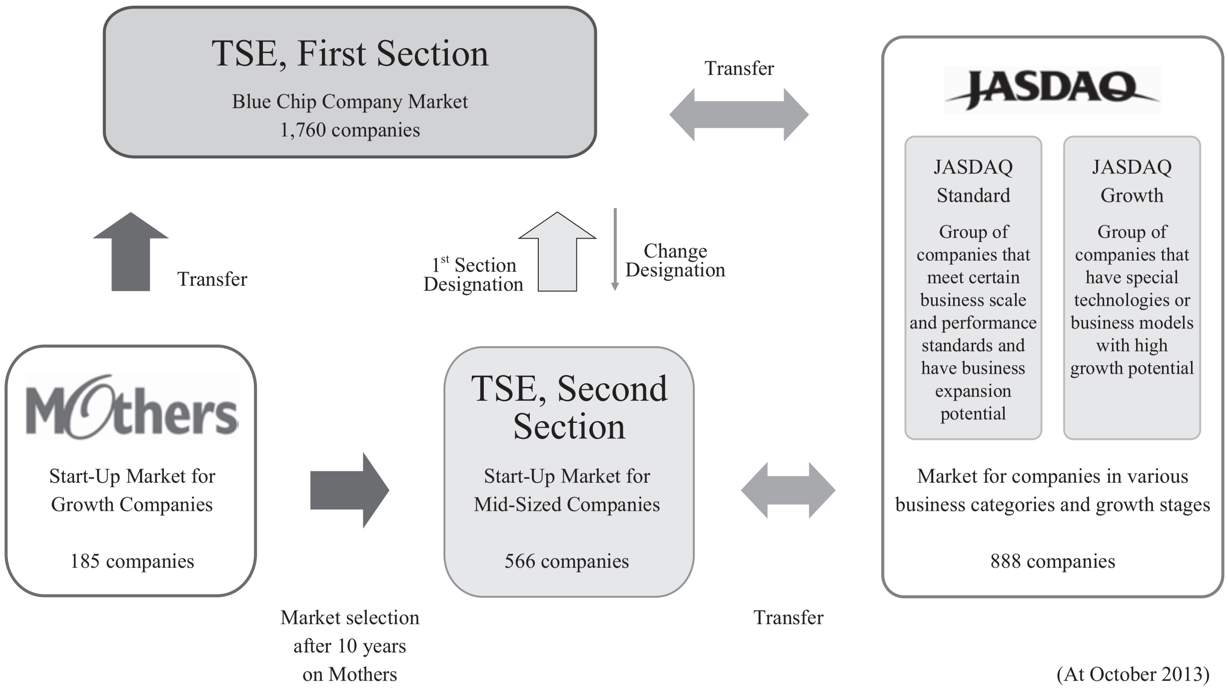
To clarify its start-up market concept, the Tokyo Stock Exchange in 2011 established a process of verifying whether companies listed on the Mothers market matched that concept. Companies enjoy relatively lax listing criteria for the first 10 years, after which they are compelled to choose whether to stay on the Mothers market under more strict criteria or move to the Second Section of the TSE. To stay on Mothers, they must have a total market capitalization of ¥4 billion or more or submit a report prepared by an independent specialist affirming the company's continued high growth potential.

JASDAQ Market Concept

JASDAQ's policy as the largest start-up market in Japan is "to support the growth of new industries and small to midsized start-up companies by providing them with access to equity capital and to offer attractive investment opportunities for investors." Based on this policy, JASDAQ is divided into the two sections of JASDAQ Standard and JASDAQ Growth to enable the supply of equity capital to a broad range of companies.

JASDAQ Standard is for companies of a certain business size and results that are expected to expand. JASDAQ Growth is for companies with

Chart X-1. Positioning of Mothers and JASDAQ Markets within Tokyo Stock Exchange



(At October 2013)

outstanding technology or business models and ample growth potential.

Underlying the JASDAQ market are the concepts of confidence, innovation, and regional and global business. These three concepts guide JASDAQ's continuous development as the largest start-up market in Japan and as an original benchmark for start-up markets globally.

3. Start-up Market Listing Systems

Outline of Listing Criteria for Start-up Markets

The listing criteria for start-up markets are similar to those for the First and Second Sections of exchanges in that they comprise qualitative (formal requirements) and quantitative (eligibility requirements) criteria. When a stock exchange receives an application from a company wishing to list on the start-up market, it screens for eligibility based on these qualitative and quantitative criteria.

Mothers Listing Criteria

The Mothers market targets growth companies that have an eye on moving up to the First Section of the exchange as soon as possible. A requirement for listing, therefore, is that the company have high growth potential and a letter of recommendation to that effect from its managing underwriter.

As with the First and Second Sections, the formal requirements for listing on Mothers include liquidity-related standards, such as the number of shareholders and tradable shares; the market capitalization; and such going concern related standards as the number of consecutive years in business, regular audits by a listed audit firm, and compliance with standards related to the disclosure of business information. Among the notable points about the requirements is that the initial public offering must be 500 trading units or more and the lack of standards regarding profits and net assets.

The eligibility requirements for the Mothers market take into account the market concept. They revolve around whether the company seeking to list is in a position to disclose its business, its risk, and other of its relevant information and the reasonableness of its business plan and whether it has or is expected to develop the operating base necessary to execute that plan.

JASDAQ Listing Criteria

The listing requirements for JASDAQ differ somewhat for JASDAQ Standard and JASDAQ Growth. But in general, the formal requirements are those of First and Second Sections for the number of shareholders, the market capitalization of tradable shares, net assets, and profits. JASDAQ also requires a ¥500 million or more market capitalization of tradable shares on the initial

Table X-3. Listing Criteria for the Mothers and JASDAQ Markets

October 22, 2013

Quantitative Criteria (Formal Requirements)			
	Mothers	JASDAQ	
		Standard	Growth
Amount of net assets (Expected at listing)	—	¥200 million or more	Correct amount
Amount of profit (or market capitalization at time of listing)	—	(Consolidated) Profits of at least ¥100 million over the most recent year (or market capitalization of ¥5 billion or more	—
No. of shareholders (Expected at listing)	300 shareholders or more		
Tradable shares[2] (Expected at listing)	a through c must be satisfied. a. No. of tradable shares: 2,000 units or more b. Market value of tradable shares: ¥500 million or more c. Ratio of tradable shares: 25% or more of the listed stocks	Market value of floating shares: ¥500 million or more	
Public or secondary offering	Public offering of at least 500 trading units by the time of listing	Public or secondary offering of at least 1,000 trading units or 10% of listed shares which ever is larger by the time of listing	
Market capitalization of the shares listed (Expected at listing)	¥1 billion or more	—	
No. of years in existence	Established a board of directors and have had continuous operations for more than a year counting backward from the listing application date	—	
Financial statements, etc.	The financial statements for the latest two years contain no false statements		
Auditor's opinion	"Unqualified opinion" or "qualified opinion" for the latest two years "Unqualified opinion" for the latest year		
Others	- Audited by a registered listed company audit firm - Appointment of a shareholder services agent - Number of shares in Tangen trading units - Restriction on stock transfer - Appointment of designated custody and transfer agent		

Notes: 1. No. of shareholders means the number of shareholders who own one or more units of shares.
2. "Tradable Shares" refers to listed shares excluding shares held by parties with a special interest such as officers, shares owned by the company itself, and shares held by persons who individually own 10% or more of listed shares.
3. One unit is the minimum number of shares necessary for 1 voting right.
4. An audit firm that is registered in the registry of listed company audit firms based on the Registration System for Listed Company Audit Firms of the Japanese Institute of Certified Public Accountants (including audit firm which is subject to quality control reviews by the Japanese Institute of Certified Public Accountants)

Qualitative Criteria (Eligibility Requirements)		
Mothers	JASDAQ Standard	JASDAQ Growth
(Reasonableness of the business plan) The listing applicant has developed reasonable and suitable business plans, and has developed the operating base necessary for executing such business plans, or there is reasonable expectation that it will develop such operating base.	(Going concern) No obstacles to continuing business operations	(Company growth potential) Have high growth potential
(Soundness of corporate management) The company is carrying out business in a fair and faithful manner.	(Reliability of corporate conduct) No suggestion that the company's conduct will disrupt the market.	
(Effectiveness of corporate governance and internal management system of an enterprise) Corporate governance and internal management system are developed in accordance with the size, corporate maturity, etc. of the enterprise, and functioning properly.	(Establishment of sound corporate governance and effective internal control) Company has established a corporate governance and internal control system in line with its size and the system functions effectively.	(Establishment of sound corporate governance and effective internal control) Company has established a corporate governance and internal control system in accordance with its stage of development.
(Appropriateness of the disclosure of corporate information, risk information, etc.) The company is able to make disclosure of the corporate information, risk information, etc. may be carried out in an appropriate manner.	(Adequate corporate disclosure) The company has the organization and systems to make proper disclosure of its business details, etc.	
Other matters deemed necessary by the Exchange from the viewpoint of the public interest or the protection of investors		

day of listing, but has no requirements for the number of tradable shares or the ratio of tradable shares to issued shares. JASDAQ also accommodates the special characteristics of its JASDAQ Standard and JASDAQ Growth sections by setting separate net assets and profits criteria.

The eligibility requirements for JASDAQ also consider the special characteristics of each section. They include such criteria as the lack of obstacles to continuing business operations and evidence of high growth potential. In addition, there are different net asset and profit criteria for JASDAQ Standard and JASDAQ Growth.

4. The Listing Administration System

The listing administration system for the start-up market operates much like the system for First and Second Sections. Stock exchanges have established listing administration rules and conclude an agreement with listing companies regarding compliance with those rules.

The Timely Disclosure of Business Information for Start-up Markets

The Tokyo Stock Exchange has established a list of requirements regarding the timely disclosure of corporate information in its listing regulations. It requires listed companies to provide timely and accurate disclosure of any material corporate information.

Timely disclosure requirements are basically the same whether companies list on the First and Second Sections, on Mothers, or on JASDAQ. One difference for companies on the Mothers market is the requirement to hold an investor information meeting at least twice a year. And JASDAQ Growth section companies are obliged to formulate and submit a medium-term business plan to the exchange, to hold an investor information meeting about that plan, and to and make the plan public.

Corporate Code of Conduct

Start-up markets and First and Second Sections have similar codes of conduct. The JASDAQ Growth section, however, grants listed companies a grace period in the application of some aspects of its code of conduct.

Delisting Criteria for Start-up Markets

The Tokyo Stock Exchange has delisting criteria built into its listing requirements. An issuing company that meets any of those criteria may be delisted. Securities under supervision and securities on alert on its Mothers start-up market face the same conditions for avoiding delisting as those on the TSE’s First and Second Sections.

Table X-4. Criteria for Delisting Stocks (Tokyo Stock Exchange)

October 22, 2013

	Mothers	JASDAQ
① No. of shareholders	Less than 150 (with a grace period of one year)	
② Tradable shares	When any of a through c occur. a. No. of tradable shares: 1,000 units or more (with one year grace period) b. Market value of tradable shares: ¥250 million or more (with one year grace period) c. Ratio of tradable shares: 5% or more of the listed stocks	When either a or b occur. a. No. of tradable shares: less than 500 units (with one year grace period) b.B. Market value of tradable shares: less ¥250 million or more (with one year grace period)
③ Negative net worth	If the issuer falls into negative net worth for two consecutive terms[1] (The grace period is extended for another year if such issuer has a credible plan to wipe out the negative net worth within a year through rehabilitation proceedings.)	If the issuer falls into negative net worth for two consecutive terms (The grace period is extended for another year if such issuer has a credible plan to wipe out the negative net worth within a year through rehabilitation proceedings.)
④ Trading volume	Either the average monthly trading volume over the past one year is less than ten units or no trades were made for the past three months	—
⑤ Sales	Less than ¥100 million for the most recent one year.[2]	—
⑥ Market capitalization	When the market capitalization of the shares listed falls short of ¥500 million and if it fails to increase to ¥500 billion within the succeeding nine months (or three months if recovery plans are not submitted)	—
⑦ Stock price	When the stock price falls below 10% of the public offering price at the time of initial listing after 3 years have elapsed since listing and fails to increase back to 10% or more within 9 months (or three months if recovery plans are not submitted).[3]	When the stock price falls below ¥10 yen and does not recover to ¥10 or above within three months.
⑧ Performance	—	When the operating income and the cash flow in operating activities for the 4 most recent consolidated fiscal years are negative and this state is not resolved within 1 year.[4]
⑨ Profits	—	(Only for Growth Section) When consolidated operating income of a company that had negative operating income for the consolidated fiscal year of a listing application does not become positive within 1 year after remaining negative for 9 fiscal years after listing.
⑩ Bankruptcy, etc.	When the issuer becomes insolvent or falls into a situation requiring rehabilitation or reorganization proceedings or liquidation or an equivalent situation (However, if such issuer discloses a rehabilitation/reorganization plan and the market capitalization over one month thereafter remains above ¥500 million, the listing will be maintained.)	
⑪ Suspension of business activities	When a listed issuer suspends its business activities or falls into a situation similar thereto	
⑫ Inappropriate mergers	When the stock exchange determines that a listed company that acquired another company has in effect failed to survive the merger and that the surviving company has failed to meet standards equivalent to the initial listing requirements within three years of such merger	
⑬ Deterioration in soundness of transactions with controlling shareholder	When the stock exchange determines that there has been a marked deterioration in the soundness of transactions between the company and its controlling shareholder within three years of a change in the controlling shareholder due to a third-party allotment	
⑭ Delays in securities filings	When a listed issuer fails to file an annual or quarterly securities report together with an auditor's report or quarterly review report within one month following the statutory deadline (if another deadline has been approved for filing, when the listed issuers fails to file within 8 days following that deadline)	
⑮ False statements or adverse opinion	• When a false statement is made in a securities filing and the competent stock exchange finds that maintaining order on the exchange could be difficult without immediate delisting of the issue • When an audit report contains an improper opinion or no auditors' opinion and the competent stock exchange finds that maintaining order on the exchange could be difficult without immediate delisting of the issue	
⑯ Securities on Alert	• When despite the issue meeting criteria to be designated as securities on alert, the competent stock exchange determines that there is no likelihood of improvement in the issuing company's internal control system, etc. • When during the process of designating the issue as securities on alert, the competent stock exchange determines that there is no likelihood of improvement in the issuing company's internal control system, etc. • When despite having designated the issue as securities on alert, the competent stock exchange determines that there is no likelihood of improvement in the issuing company's internal control system, etc.	
⑰ Breach of the listing agreement	When a listed company seriously violates the listing agreement or pledge concerning timely disclosure or when it becomes no longer a party to the listing agreement	
⑱ Undue restrictions on shareholders' rights	When shareholders' rights or exercise thereof are unduly restricted	
⑲ Others	Suspension of a listed issuer by the bank, failure to appoint a shareholder services agent, certain restrictions on share transfers, becoming a wholly owned subsidiary of another company, cancellation of the custody and transfer agent agreement, wholly call, involvement with antisocial groups, and when the competent stock exchange finds that the delisting of a given stock is in the public interest or appropriate for the protection of investors	

Notes: 1. Excluding cases where negative worth has continued for three years following listing.
2. Excluding cases where the company has posted a profit and where the company's sales have been less than ¥100 million for five years following listing.
3. Limited to Mothers-listed companies listed on or after November 9, 2009.
4. Excluding JASDAQ Growth-listed companies in their first consolidated fiscal year following that of the listing application.

After reviewing its Mothers listing system, the exchange has established new delisting criteria for sales and stock prices on the Mothers market. The exchange took this step to earn greater trust among Mothers' investors, to enhance the appeal of the Mothers market, and to prevent any sudden changes in the quality of the management of a company following its listing on Mothers.

Similarly, JASDAQ does not suffer companies with collapsed business models to remain on the market. Its delisting criteria are designed to maintain or improve the overall quality of its issuers. Newly established criteria include business performance standards to ensure investor confidence in the market and stock price standards that eliminate issues with stock prices that have languished at low levels for a certain period of time. Following, moreover, the separation of issuers into the JASDAQ Standard and JASDAQ Growth sections, the exchange revised its delisting criteria in line with the special characteristics of each section.

5. An Outline of the OTC Stock Market

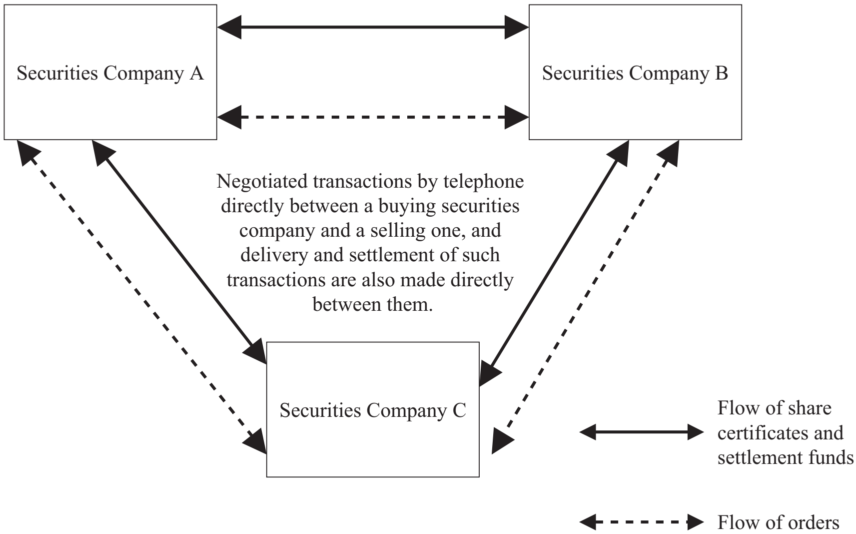
What Is OTC Trading?: In addition to shares traded on stock exchanges, shares are also traded over the counter. As only those listed issues that meet certain listing standards may be traded on exchanges, issues that are not eligible for exchange trading need to be traded elsewhere, outside listed exchanges. Such shares are traded between brokers/dealers or between customers and brokers/dealers over the counter in negotiated transactions known as "over-the-counter (OTC) transactions." While trading and other activities involving listed shares are regulated by the competent stock exchange, OTC stock trading is regulated by the "Regulations Concerning Over-the-Counter Securities" of the JSDA and by other rules.

OTC transactions include transactions in unlisted shares (including unlisted shares issued by listed companies); transactions effected in the OTC securities market; and off-exchange transactions in exchange-listed shares.

An Outline of the OTC Stock Market: As OTC trading becomes active, information about quotes and prices is exchanged among securities companies and distributed to investors, and the market becomes more organized. After the war, OTC trading remained active even after the reopening of stock exchanges. In 1962, actively traded OTC issues were moved to the Second Section of the stock exchanges, but stocks continued to be actively traded over the counter to such an extent, in fact, that an OTC stock market, an organized market where OTC securities that meet the registration requirements of the JSDA are traded, was launched in February 1963.

As solicitation for investments was restricted in the early years, the OTC

Chart X-2. Form of Trading in OTC Stocks



stock market was generally characterized as a market for the liquidation of stock holdings. To remedy the situation, the legal framework was enhanced by the 1971 amendment to the Securities and Exchange Law, and, in 1983, the OTC stock market was defined as a market that complements exchange markets and was reorganized drastically into the JASDAQ market for trading shares of small to medium-sized companies with reasonable track records. The JASDAQ market has since grown larger as a market for emerging companies, and it was redefined as an "OTC securities market" under the Securities and Exchange Law in 1998, but it exists only in law following the upgrading of the JASDAQ market into the JASDAQ Securities Exchange in December 2004.

Because a need arose for trading unregistered or unlisted stocks, the JSDA established the green sheet system in July 1997, enabling sales solicitations for such issues meeting certain disclosure standards as green sheet issues. Another category of traded unregistered or unlisted stocks is the Aozora issues or private equity issues.

6. OTC Securities, Etc.

Aozora Issues: Issuers of unlisted or unregistered stocks are not required by law to disclose their corporate information, and, in principle, JSDA rules

Table X-5. A Brief History of the OTC Market

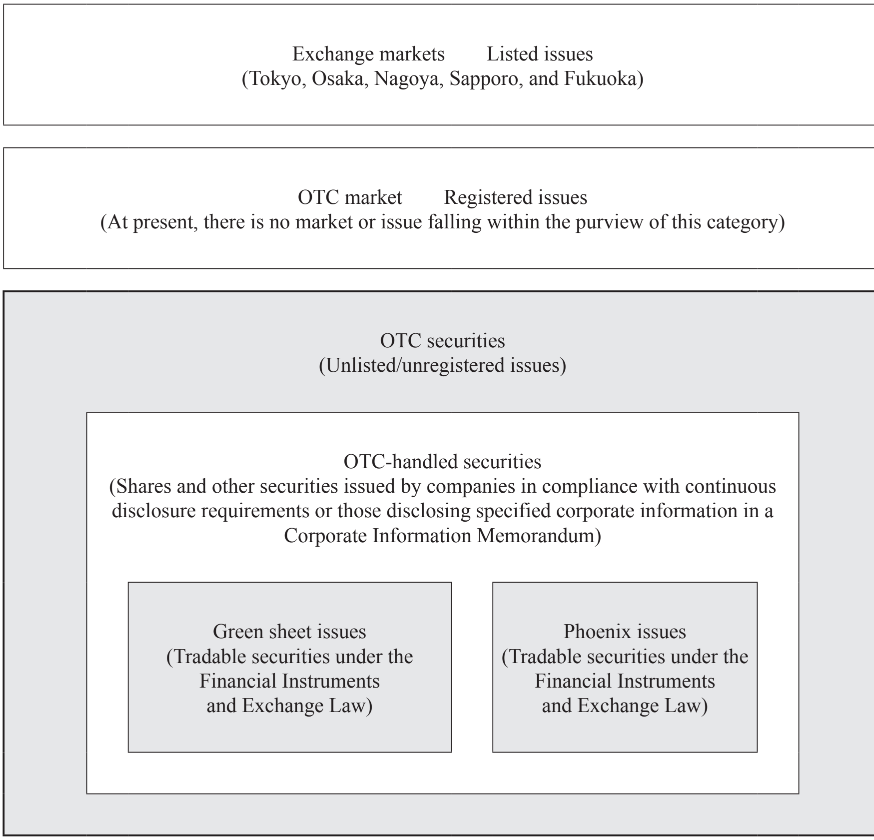
1945	Group trading in shares emerges spontaneously after the war.
1949	A system of trading in OTC-authorized issues is launched in June under the regulations of the JSDA.
1961	The stock exchanges create the Second Section, into which OTC-authorized issues are absorbed, and the OTC authorizing system is terminated.
1968	The OTC registration system is launched in February.
1976	The OTC market broker Japan OTC Securities, Inc., is established.
1983	A new OTC market (the JASDAQ market) is launched.
1991	The JASDAQ system comes into operation.
1992	The Prohibited Acts Rule is applied to the JASDAQ market.
1997	The green sheet system is launched.
1998	The JASDAQ market becomes the OTC securities market for the purpose of the Securities and Exchange Law.
2001	Japan OTC Securities changes its name to JASDAQ, Inc., and takes charge of the market.
2004	The JASDAQ market becomes a stock exchange in December.
2005	Green sheet issues become "to-be-handled securities" for the purpose of the Securities and Exchange Law (now FIEA) in April, and the regulations of insider trading are applied to green sheet issues.
2008	The Phoenix issue system is spun off from the green sheet system into an independent system.
2012	Report by Roundtable on the Green Sheet Issue System published.

prohibit securities companies from soliciting investment in such issues. This is because soliciting the investing public, including individual investors, for an order to buy or sell a security on which no pertinent corporate information is available would subject the public to significant risks and cause various problems from the standpoint of the protection of investors, and such self-regulations have been in place for a long time.

However, brokers/dealers may accept unsolicited orders for such issues and trade them with customers as so-called Aozora issues (OTC securities) in negotiated transactions. The regulations pertaining to such transactions (including those prohibiting them from accepting market orders or affecting when-issued or margin transactions) are contained in the Regulations Concerning Over-the-Counter Securities of the JSDA.

The April 2004 amendment to the Securities and Exchange Law authorized a company to issue an equity product in private placements limited to qualified institutional investors. Under this amendment, securities companies are allowed to solicit only qualified institutional investors for the purchase of such shares on the condition that they do not resell their holdings to anyone other than qualified institutional investors.

Chart X-3. The Concept of OTC Securities



- An OTC securities market is currently defined under the Financial Instruments and Exchange Act as one operated by an approved financial instruments business association, but, as the JASDAQ market (currently, the OSE JASDAQ market) was converted to an exchange market, there is actually no OTC market at present.
- OTC securities also include OTC-handled securities and green sheet issues, which are subject to self-regulation by the JSDA in addition to statutory rules and regulations.
- As off-floor transactions in exchange-listed shares are also conducted as negotiated transactions on PTSs, they are regulated by the rules of the JSDA.
- Solicitation of investment in unlisted OTC securities issued by listed companies requires the production by the issuer of a Securities Information, etc., Report at the point of distribution.

OTC-Handled Securities: Securities whose issuers regularly disclose specified corporate information in the form of "Corporate Information Memorandum" are considered to carry less risk than other unregistered issues. And the regulations of the JSDA define them as "over-the-counter—handled securities," or OTC securities eligible for solicitation by promoting brokers/dealers.

A Corporate Information Memorandum is a type of disclosure material required by the JSDA and prepared in accordance with the format for the "corporate information" section of a securities report pursuant to the Financial Instruments and Exchange Act. It shall be accompanied by annual financial statements with an audit report that includes the opinion of certified public accountants or persons with equivalent designation that the company's financial statements are unqualified or qualified in light of the provisions of the Financial Instruments and Exchange Act or in conformity with those of the Companies Act. Such memorandum shall also contain forward-looking statements as to the outline of the company's business plan, its feasibility, and other aspects. In the case of a company in compliance with continuous disclosure requirements, a securities report or a securities registration statement with an unqualified or qualified opinion of the auditor can be substituted for the Corporate Information Memorandum.

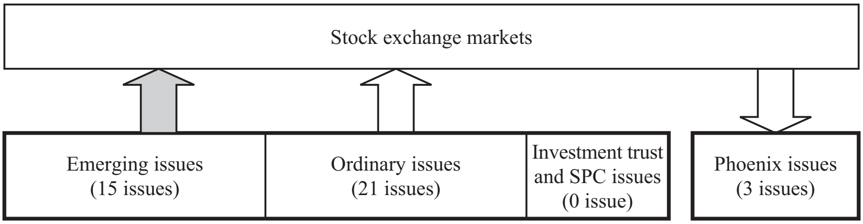
At present, the ban on solicitation for the purchase of OTC-handled securities is partially lifted for primary or secondary offerings of securities on the condition that the transfer of such shares is restricted for two years based on an agreement among the issuer, securities companies, and investors and that the issuer publishes a Corporate Information Memorandum. The ban is fully lifted for unlisted securities of listed companies based on the condition that the issuer publishes a Corporate Information Memorandum.

7. The Green Sheet System (1)

An Outline of the Green Sheet System

Even after the listing standards of exchanges had been eased to allow some of the loss-making companies to go public, it was deemed necessary to improve the market for issuing and trading unlisted shares in order to improve the financing environment for venture businesses. Aware of this, the JSDA amended its regulations concerning OTC securities in July 1997 to allow its member brokers to solicit customers for investment in securities, including OTC-handled securities, filing a Corporate Information Memorandum so that brokers may market such securities at times, including, but not limited to, the course of a primary or secondary offering or private placement, provided that the brokers continuously publish quotes and other relevant market information

Chart X-4. The Relationship between the Green Sheet System Issue System and the Stock Exchange



Note: By the end of September 2013, a total of 12 green sheet issues had switched their listings to exchange markets. Number of issues shown above are as the end of September 2013.

Chart X-5. Changes in the Green Sheet Market

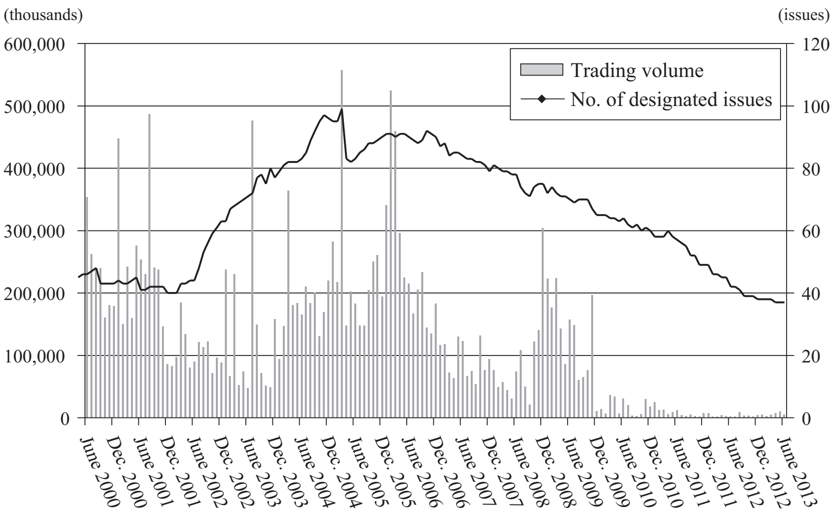


Table X-6. Comparison of the Total Market Capitalization (as of the end of September 2013)

(billions of yen)

Green Sheet*	125
Mothers (TSE)	21,759
JASDAQ (TSE)	101,260
Centrex (Nagoya)	193
Q-Board (Fukuoka)	511
Ambitious (Sapporo)	182
TOKYO PRO Market	36

*The figure for the green sheet market is based on the last trade prices.

for the securities. This trading framework is called the green sheet system.

When a securities company wishes to solicit customers for investment in a security as a green sheet issue, it must, after having conducted a preliminary review, file an application with the JSDA. The JSDA will then designate such issue to one of the categories for green sheet issues according to its attributes, after having verified (1) that the issuer does not restrict the transfer of the security in question, (2) that stock certificates conform to the form designated by the JSDA, and (3) that the issuer has appointed a transfer agent for share administration services.

Green sheet issues are divided into three categories: emerging issues (securities issued by emerging venture companies that have growth potential and aspire to go public); investment trust/SPC issues (certificates of investment trusts, including real estate investment trusts, or REITs); and ordinary issues (other securities). The JSDA spun off the previously included Phoenix issues into a separate system in 2008. A handling member sponsoring issues for green sheet designation is required to review the issuer of such security with respect to specified criteria in accordance with independent guidelines of its own.

Regulations on insider trading in green sheet issues (defined as "tradable securities" in Article 67, Paragraph 18, of the Financial Instruments and Exchange Act) were set out in the amendment to the Securities and Exchange Law of April 2005. Based on the regulations, handling members are charged with responsibility for guiding the issuers of securities that they sponsor into making timely disclosure of corporate information, including quarterly reports, on an equivalent basis with listed companies, as well as publishing such information through the TDnet disclosure service of the TSE.

In the past, only sponsoring members that had applied for green sheet designation of an issue were allowed to make solicitation for investment in the issue in question. Under the April 2005 amendment to the relevant regulations, however, the JSDA newly created associate handling memberships that allow member companies other than handling members to make solicitations involving such issues by merely publishing their quotes and reporting trades. In addition, other member brokers are allowed to trade in green sheet issues within the framework of the system.

8. The Green Sheet System (2)

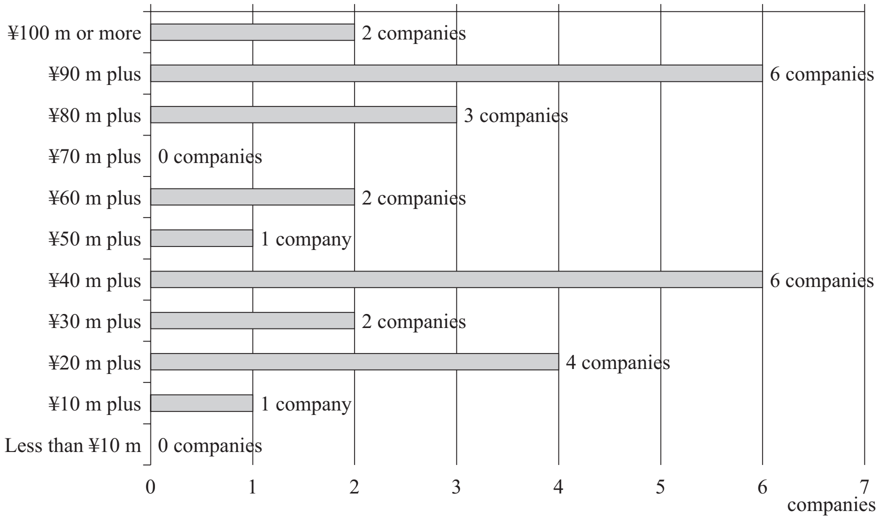
Examination of Issues: As previously described, there are three types of green sheet issue designation. Because the green sheet system was originally designed to give venture businesses with growth potential access to financing opportunities in the capital market, the main category is the emerging issues.

Table X-7. Recent Business Results and Dividends of Emerging and Ordinary Issues

Levels of profit	Operating profit	Current profit	After-tax profits
¥30 m or more	7/12 companies	6/9 companies	5/9 companies
¥10 m to less than ¥30 m	1/8	2/7	3/7
¥0 to less than ¥10 m	2/7	1/10	1/9
A deficit of ¥0 to ¥10 m	0/2	1/3	1/4
A deficit of ¥50 m to less than ¥10 m	1/6	1/6	1/6
A deficit of ¥100 m to less than ¥50 m	0/1	0/1	0/1
A deficit of more than ¥100 m	–	–	–

Notes:
- Figures in parentheses denote "the number of companies that paid dividends/the number of companies falling into the category."
- The study covers 36 issues under green sheet designation as of the end of September 2013.

Chart X-6. Amounts of Capital Raised at the Time the Issue was Categorized as Emerging and Ordinary Issues



Note: 1. The survey covers 27 issues that underwent financing at their point of designation as of the end of September 2013.
2. When any firm makes a public offering of its shares with a total value of larger than ¥100 million, the issuer must file a securities report, and this disqualifies the issuer for the status of green sheet.
3. For small firms that need no large-scale financing, a cheaper financing cost, and speedy financing are important.

Since issuers of securities in this category need to possess certain levels of perceived growth potential, a member broker sponsoring an issue for green sheet designation is required to conduct a prescribed review of issuers before making an application. More specifically, the securities company is required to verify the commitment of the issuer to legal compliance and its sense of social responsibility (e.g., whether the business of the issuer serves a useful purpose for society, whether the growth of its business has any social value, and whether it has been observing the relevant laws and regulations) to see whether the issuer has adequate internal governance processes and a framework for making timely disclosure (e.g., whether its executives are aware of the importance of making full and timely disclosure, whether it has a system of checks and balances built into its management structure, and whether it has in place a proprietary or outsourced system that is capable of making such disclosure) and importantly, whether its audit report contains a going-concern clause and whether it has growth potential (e.g., whether it prepares a business plan based on reasonable grounds, whether it has a profitable business model, and whether its business has perceived growth potential in light of the size and growth of the market addressed by the issuer and its competitiveness therein) and how much risk is involved in investments by the issuer (e.g., whether its business interruption risk is not assessed to be excessive, whether its financials and financing are sound, and whether its relationships with its affiliates are regular and normal).

If an issuer of an emerging issue fails to report earnings half as large as initially projected for the fiscal year following the year of designation, or if a sponsoring handling member finds an emerging issue unfit for inclusion in the category upon biennial reviews conducted every two years thereafter, such issues will be reassigned to the category of ordinary issues.

Revocation of Green Sheet Designation: In the past, designation as a green sheet issue was revoked only when there was no longer a sponsoring handling member. Subsequently, however, green sheet issues have come under the jurisdiction of various laws and regulations, and it was decided in April 2005 that the JSDA may revoke the green sheet designation of an issue contingent upon certain events occurring to the issue or its issuer.

Such events, as mentioned above, include listing on stock exchanges, the commencement of bankruptcy proceedings, rehabilitation or reorganization proceedings or corporate liquidation, bank suspension, discontinuation of business activities, delays in filing the Corporate Information Memorandum, false statements in disclosure documents, failure to obtain an unqualified or qualified opinion from the auditor, failure of a handling member to make proper and timely reports of corporate information concerning an issue it sponsors, termination of the transfer agent, restricting transfer of shares, becoming a wholly owned subsidiary, and when revocation is considered appropriate in the light of the public interest or investor protection.

9. The Green Sheet Issue System (3)

Trading in Green Sheet Issues

Because they are OTC trading, green sheet issues usually take the form of negotiated transactions. Japan Securities Agents, Ltd., did launch a proprietary trading system (PTS) in July 2003, but since PTS operations were later terminated in June 2010, most trades continue to be negotiated transactions between securities companies and their customers.

Trading in green sheet issues is conducted from 9 a.m. to 3 p.m., including the intersession period of listed markets between 11:31 a.m. and 12:29 p.m. Securities companies may make investment solicitation and accept orders for green sheet issues at any time.

A broker shall obtain from the customer who conducts a transaction in green sheet issues for the first time a letter confirming that he or she will invest with full understanding of the green sheet system and the risks associated with green sheet issues. In addition, in soliciting customers for investment in a green sheet security, a broker must give a full and fair explanation of the issue and issuer using the Corporate Information Memorandum as well as deliver and make explanation about a document that is required to be delivered prior to the conclusion of a contract under Article 37, Paragraph 3, of the Financial Instruments and Exchange Act.

Handling members and associate handling members shall publish nonbinding bid or offer quotes and other market information concerning the green sheet issues they sponsor, in principle, on a daily basis, and the JSDA compiles such information for public dissemination. (Please note that members of the green sheet system, unlike market makers in the United States, do not have obligations to execute trades according to their quotes.)

Securities companies that have accepted orders from, or have entered into transactions with, their customers must report such orders or transactions to the JSDA by 5 p.m. on the same day, and the JSDA, in turn, must publish such information on its website and elsewhere.

In addition to the prohibition of insider trading as provided for in the amendment to the Securities and Exchange Law of April 2005, the JSDA regulations concerning green sheet issues ban member brokers/dealers from accepting market orders; effecting margin or when-issued transactions with customers; prearranging trades with other brokers/dealers; or engaging in excessive trading, kiting, bear-raiding, or other improper trading practices.

Transactions in green sheet issues shall be settled and the securities traded shall be delivered, in principle, on the fourth business day counting from and

Chart X-7. The Flow of Solicitation for Investment in Green Sheet Issues

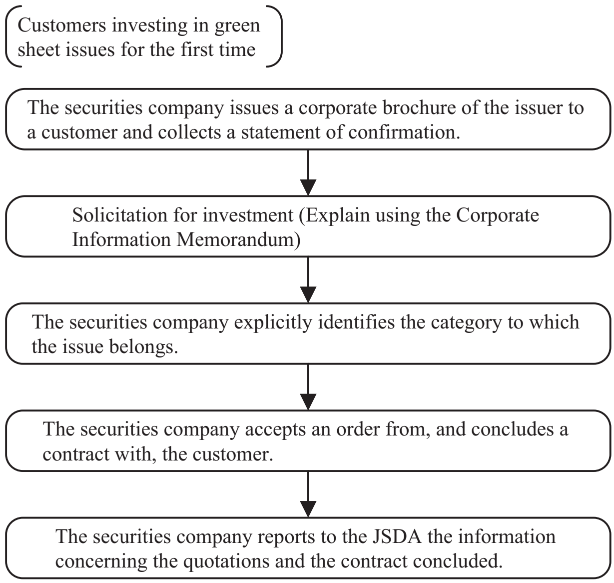
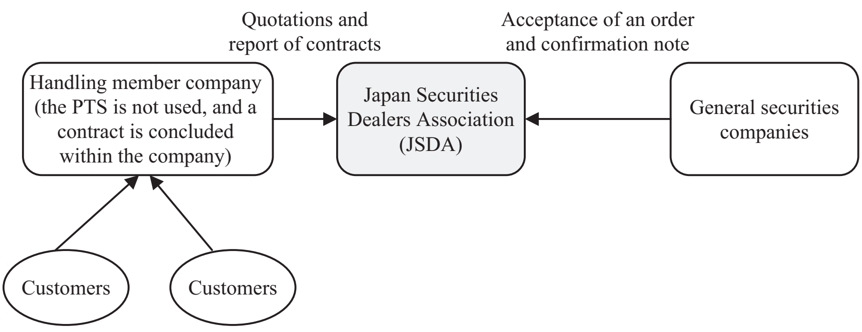


Chart X-8. An Outline of Trading in Green Sheet Issues and Confirmation Note



including the trade date (T + 3 settlement). As green sheet issues are not eligible for custody with the Japan Securities Depository Center, Inc., share delivery and trade settlement take place directly between buyers and sellers. Starting April 2005, the JSDA has been monitoring trading in green sheet issues for irregularities, including insider trading. In response to such irregularities, the JSDA will suspend trading in the issue, and no transactions may be conducted during the trading suspension.

10. Phoenix Issue System

The Phoenix issue system is an OTC trading system launched by the JSDA on March 31, 2008, to provide a marketplace for issues that had been delisted from stock exchanges. Phoenix issues started off as a category in the green sheet issue system. In response to the successive delisting of large-cap issues, such as Seibu Railway, Kanebo, and Livedoor, however, the JSDA established a separate system for Phoenix issues to improve investors' opportunities to cash out of delisted issues and to provide the necessary framework for delisted companies to have a second chance at re-listing (nevertheless, they are still handled issues).

Traditionally, many issuers of shares that were delisted from stock exchanges provided an inadequate degree of disclosure on their business activities compared with listed companies, which were obliged to provide disclosure according to the regulations, etc., of the Financial Instruments and Exchange Act. As a result, securities companies were, in principle, prohibited by the JSDA from soliciting sales of securities issued by delisted companies. For that reason, investors holding these delisted shares could not utilize securities companies in their search for buyers. Unable to discover buyers on their own, individual investors in particular were stuck with holding the shares until the company revitalized itself and re-listed.

As in the green sheet issue system, handling members apply for designation of issues as Phoenix issues by notifying the JSDA of OTC securities covered by its self-regulatory rules that have been delisted from stock exchanges after verifying that the issues meet certain conditions with regard to the commissioning, etc., of share administration. The notification must also have an unqualified or qualified opinion from the auditor of the delisted company attached. In sponsoring these issues, handling members have an obligation to provide buy and sell quotes on a continuous basis. In addition, companies with Phoenix issues are obligated to provide disclosure in the same manner as when listed. The Phoenix system differs substantially from the green sheet system in that no review by handling members is required for designation and in that it utilizes the stock, etc., transfer system to give investors an opportunity to cash out their holdings through the stock exchange even after the decision to delist the stock.

After Phoenix issues have been trading on the system for a specified period of time and their issuers have undergone a certain amount of revitalization, those companies that aspire to re-list are expected to move to the green sheet system and utilize that system in the interests of developing a stable

Table X-8. Comparison of the Green Sheet Issue and Phoenix Issue Systems

	Green sheet issue system	Phoenix issue system
Eligible securities	Stocks, bonds with new share subscription rights, preferred notes, and corporate investment trusts	Stocks and bonds with new share subscription rights attached that have been delisted
Designation required	Yes	Yes
Obligation for handling member to review issue	Yes	No
Criteria for losing designation	Yes	Yes
Investment solicitation	Handling members and associate handling members	With the exception of investors selling on their on own volition, only handling members and associate handling members
Confirmation	Yes	Yes (unnecessary for sales)
Trading process	Negotiated transaction	Negotiated transaction
Delivery and settlement	Direct (in principle, 4 business days or T + 3)	Directly through JASDEC's transfer system (in principle T + 3)
Trading hours	0900 to 1530	0900 to 1530
Reporting and disclosure obligations for quotes and orders	Yes	Yes
Disclosure materials	Corporate Information Memorandum and securities report (Financial statements for the two previous terms must be accompanied by an auditor's opinion stating fair representation)	Corporate Information Memorandum and securities report (Financial statements with only an auditor's opinion stating fair representation for the previous term are acceptable)
Timely disclosure requirements	Items specified by the JSDA	Items specified by the JSDA
Insider trading rules	Applied	Applied

shareholder base, etc., in preparation for re-listing.

11. Professional Investors Markets—TOKYO PRO Market

The TOKYO PRO Market is a market for professional investors operated by the Tokyo Stock Exchange. It is based on the TOKYO AIM market launched by the TSE in June 2009 in collaboration with the London Stock Exchange (LSE). TOKYO AIM, Inc., was originally operated as a partnership (ownership: TSE 51%; LSE, 49%). In March 2012, however, the TSE acquired LSE's stake and merged Tokyo AIM with the TSE in July 2012. TOKYO AIM was established under the professional investor market system provided

Table X-9. Comparison of TOKYO PRO Market's and Other Markets' Listing Standards

	Other Japanese equity markets	TOKYO PRO Market
Disclosure language	Japanese	Japanese or English
Accounting standards	Japan GAAP	Japan GAAP, IFRS, U.S. GAAP, and other approved standards (agreed on by J-Nomad and auditor and approved by TOKYO AIM)
Listing criteria	Minimum shareholders, capitalization, sales, profit, etc.	No set requirements Criteria judged by J-Nomad (similar process as with LSE's AIM)
Auditor's report	Two most recent years	Last fiscal year only
Internal control reports	Required	Not required
Quarterly reports	Required	Not required
Investors	No restrictions	Only professional investors* and non-Japan residents

* *What are professional investors?*

■Specified investors

✓ Qualified institutional investors (i.e., financial institutions), listed companies, and private companies with over ¥500 million in capital

✓ Government agencies, the Bank of Japan, and regional public authorities

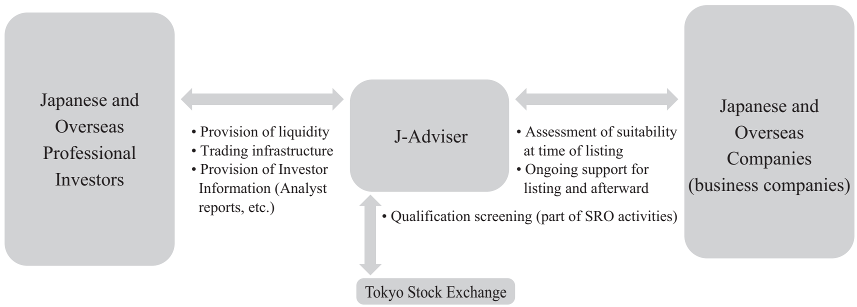
■Approved specified investors

✓ Companies outside the above conditions

✓ Individuals with over ¥300 million in net assets (including financial assets) and with at least one year of investment experience

■Entities not domiciled in Japan

Chart X-9. Role of J-Adviser



* What is the J-Adviser System?

- Role

✓ Listed companies must retain a J-Nomad at all times.

✓ Assess and confirm the appropriateness of companies wishing to list on TOKYO AIM

✓ Provide ongoing support after the listing to ensure the company maintains its qualification.

- Eligibility

✓ Companies with experience in corporate finance and the necessary staff versed in this area.

- There are currently 7 J-Advisers
- SMBC Nikko Securities Inc.
- OKINAWA J-Adviser Co., Ltd.
- Daiwa Securities Capital Markets Co., Ltd.
- Nomura Securities Co., Ltd.
- Phillip Securities Japan, Ltd.
- Mizuho Securities Co., Ltd.
- Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.

(Japanese kana syllabary order, at December 2013) for by the enactment of the December 2008 revision of the Financial Instruments and Exchange Act (FIEA) and was succeeded by the TOKYO PRO Market.

Placing orders on traditional exchanges is not limited to any special category of investor. The professional investors market system, conversely, restricts trading to specified investors and nonresidents. Where fund procurement is limited to professional investors, securities registration statements are not required, and issuers need only make public financial information, etc. (called specified securities information), using the format and method stipulated by the TSE. Companies already listed on the exchange, moreover, need not submit securities reports and need only make public financial information, etc. (issuer information), using the TSE-stipulated format and method. The submission of internal control system reports and quarterly disclosure are voluntary. By premising requirements on the fact that only professional investors—those capable of analysis and making investment decisions—will invest in the market, the cost burden of issuing has been reduced in comparison with traditional stock exchanges.

The statutory penalties for falsifying financial information, etc., and for insider trading apply as much to the professional investor market system as to the large shareholdings reporting and tender offer systems. Chart X-9 details how the TOKYO PRO Market aims to provide a flexible but disciplined market system for issuers and investors through the J-Adviser system (approved adviser system) within the previously mentioned legal framework. This operational method, which has the J-Adviser system at its core, has been drawn substantially from the Nomad (Nominated Adviser) system of the LSE's Alternative Investment Market (AIM). Under the system, specialists in corporate finance, etc., who have been approved as J-Advisers are required to guide a company through the admission process and to fulfill a duty to provide advice and instruction on timely disclosure and other regulatory matters following listing.

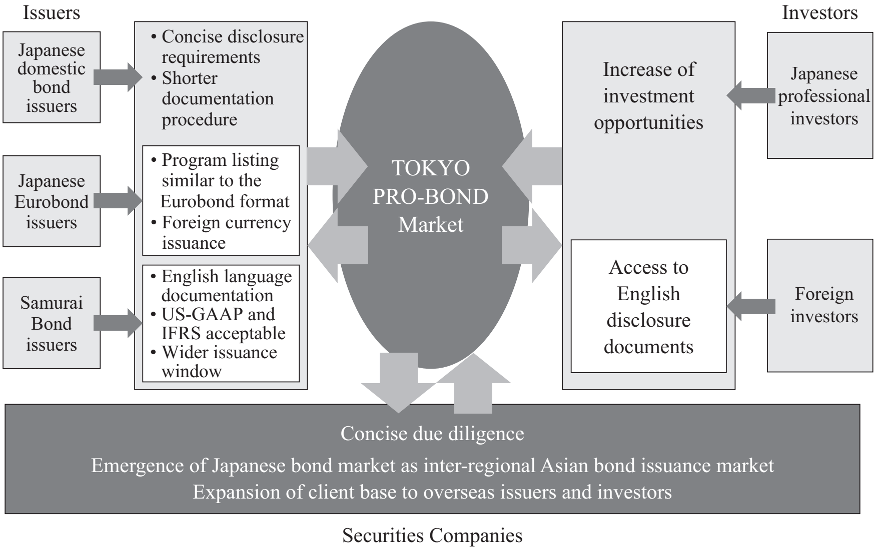
At December 31, 2013, the TOKYO PRO Market had seven J-Advisers and six listed companies.

12. Professional Investors Markets—TOKYO PRO-BOND Market

The TOKYO PRO-BOND Market is a bond market for professional investors operated by the Tokyo Stock Exchange.

Professional investors dominate the domestic bond market, but the disclosure system and business practices stipulated in the Financial Instruments and Exchange Act are protective of investors in general. Foreign issuers face a particularly high hurdle because of the costs of at least twice-yearly

Chart X-10. Benefits of Using the TOKYO PRO-BOND Market



disclosure in Japanese.

In consideration of these conditions, the TOKYO PRO-BOND Market was established in May 2011 with the goal of enabling the flexible and expeditious issue of bonds similar to the Euromarket. It also sought to further enhance the convenience of the market for such participants as foreign and domestic issuers, investors, and securities companies and other related industry bodies, thereby contributing to the development of Japan's bond market as Asia's core market.

The market is separate from TOKYO AIM's equity market and does not follow the same rules. For example, there is no J-Nomad system. Trading is restricted to specified investors, and nonresidents and individual investors are, in principle, excluded.

The TOKYO PRO-BOND Market requires listed issuers to provide information disclosure on their bonds consisting of specified securities information at the time of issue and issuer filing information annually on an ongoing basis. These disclosure documents must be prepared using the method and format stipulated by the Tokyo Stock Exchange. However, since they can be provided in English, they feature a high degree of flexibility and freedom, such as allowing the use of the disclosure format used in the Euromarket.

In particular, the disclosure system enables significant cost savings for foreign issuers because the point of issue and ongoing filing of disclosure

Table X-10. Comparison of Disclosure Systems for TOKYO PRO-BOND Market and Other Japanese Bond Markets

	Other Japanese bond markets	TOKYO PRO-BOND Market
Disclosure target group	Investors, including general investors	Specified investors, etc.
Main regulator of disclosure materials	Government (format as specified by Japan FSA)	Tokyo Stock Exchange (Euro and other formats possible)
Language	Japanese	Japanese, English or both
Accounting standards	J-GAAP, International Financial Reporting Standards (IFRS)*	J-GAAP, IFRS, US-GAAP, and other standards the Tokyo Stock Exchange recognizes as equivalents
Issuance disclosure documents	Securities registration statement or shelf registration statement	Specified securities information
Regular disclosure documents	• Securities report • Quarterly or interim business report	Issuer information
Regular disclosure frequency	Interim or quarterly	Annually

Note: Conditional to establishment of proper procedures and systems for the preparation of consolidated financial statements based on IFRS, the use of IFRS for consolidated statements is optional.
In addition, a company may use financial statements produced for disclosure in their own country or another country if the JAPAN FSA has approved the documents as "meeting standards of public interest and investor protection."

information can be provided entirely in English. The system offers the additional advantage of a much wider issue window compared with the private or Samurai foreign bond issuance market because no lag time is required for the translation of the issue's disclosure documents.

In principle, there are only two listing requirements for the TOKYO PRO-BOND Market. They are (1) that the issue or program must have a credit rating from a rating agency (no specific grade required) and (2) that the lead underwriter of the issue must be on the Lead Managing Underwriter List of the Tokyo Stock Exchange. In addition, similar to euro medium-term notes (MTNs) debt issuance programs can be listed on the market, allowing for expeditious and flexible bond issuance in response to interest and exchange rate movements.

The TOKYO PRO-BOND Market system is designed on the assumption that, as with other publically offered bonds, trading is done on the OTC market. Consequently, those trades also are included in the JSDA's Reference Prices (Yield) for OTC Transactions.

CHAPTER XI

Prohibited and Regulated Acts of Securities Trading

1. Introduction

With a view to establishing a fair securities market and enhancing its credibility, the Financial Instruments and Exchange Act (FIEA) has established various prohibited and regulated acts. They include a ban on market manipulation (see section 2 below); insider trading by persons associated with the companies concerned (see section 3 below); and discretionary-account trading and massive promotional campaigns on particular securities by brokers/dealers (see section 4 below). In addition, the Financial Instruments and Exchange Act requires trade participants to disclose certain transaction-related information, such as filing large shareholding reports to ensure the fairness of securities transactions (see section 5 below).

However, it is practically impossible to list in the Financial Instruments and Exchange Act all unfair trading in connection with securities transactions. In addition, as those transactions are complex and their structure changes rapidly, new methods that were unforeseeable at the time of legislation could emerge later. Faced with such issues, the Financial Instruments and Exchange Act's Article 157 bans unfair transactions in broad terms. More specifically, it prohibits the use of wrongful means, schemes, or techniques with regard to the sale, purchase, or other transaction of securities, etc. (Item 1 of the article); the acquisition of money or other property by misrepresenting important matters or omitting important matters necessary for avoiding misunderstanding with regard to the sale, purchase, or other transaction of securities, etc. (Item 2); and the use of false quotations in order to induce the sale, purchase, or other transaction of securities, etc. (Item 3). The article is considered to be a general provision that comprehensively prohibits wrongful acts, including new types of unfair trading yet to emerge.

In addition to the above, Article 158 of the FIEA prohibits the spreading of rumor, use of fraudulent means, assault, or intimidation for the purpose of carrying out the sale, purchase, or other transaction of securities, etc., or causing a fluctuation of quotations on securities, etc. Article 168 prohibits the publishing of false quotations on market prices of securities, etc. Restrictions

Table XI-1. Main Provisions Relating to the Ban on Unfair Trading

	Contents	Article of the Financial Products and Exchange Act
General provisions	· Prohibition of wrongful acts	Art. 157
Market manipulation	· Prohibition of wash transactions or prearranged transactions	Art. 159, Para. 1
	· Prohibition of transactions aimed at manipulating securities prices	Art. 159, Para. 2, Item 1
	· Prohibition of making a representation with the aim of manipulating securities prices	Art. 159, Para. 2, Items 2 and 3
	· Prohibition, in principle, of stabilization transactions	Art. 159, Para. 3, and Art. 20–26 of the Order for Enforcement of the Law
	· Prohibition of purchase for own account during the stabilization period	Art. 117, Para. 1, Item 22 of the Cabinet Office Ordinance Concerning Financial Instruments Business, Etc.
	· Prohibition of spreading of rumors or use of fraudulent means, assault, or intimidation	Art. 158
	· Prohibition of securities companies from getting involved in an artificial formation of stock prices	Art. 117, Para. 1, Item 20 of the Cabinet Office Ordinance Concerning Financial Instruments Business, Etc.
	· Prevention of use of corporate share repurchase for manipulating stock prices	Art. 162, Para. 2
Insider trading	· Prohibition of insider trading	Art. 166 and 167
	· Duty of officers to report securities transactions and the duty to restitute profits made in short-term trading	Art. 163 and 164
	· Prohibition of short selling by officers	Art. 165
	· Prohibition of disclosure of information and inducement of insider trading	Art. 167-2
	· Prohibition of accepting orders that are suspected to be in violation of insider trading regulations	Art. 117, Para. 1, Item 13 of the Cabinet Office Ordinance for Enforcement of the FIEA
False representation	· Prohibition of public notice, etc., of false quotations	Art. 168
	· Restriction on the expression of opinion in newspapers, etc., for consideration	Art. 169
	· Prohibition of representation of an advantageous purchase, etc.	Art. 170
	· Prohibition of representation of a fixed amount of dividends, etc.	Art. 171
Tender offers	· Regulations on tender offers	Art. 27, Para. 2 through 22
	· Filing of large shareholding reports	Art. 27, Para. 23 through 28
Others	· Prohibition of loss compensation	Art. 39
	· Restriction on proprietary trading and excessive trading	Art. 161
	· Regulations on short selling	Art. 162
	· Prohibition of massive promotional campaign of particular securities	Art. 117, Para. 1, Item 17 of the Cabinet Office Ordinance Concerning Financial Instruments Business, Etc.
	· Restriction of front-running	Art. 117, Para. 1, Item 10 of the Cabinet Office Ordinance Concerning Financial Instruments Business, Etc.
	· Ban on deliberate market manipulation by means of trading securities for own account	Art. 117, Para. 1, Item 19 of the Cabinet Office Ordinance Concerning Financial Instruments Business, Etc.

on expression of opinions in newspapers, etc., in exchange for consideration are stipulated in Article 169, while Articles 170 and 171 prohibit representation of an advantageous purchase, etc., and that of a fixed amount of dividends, etc., respectively.

2. Regulation of Market Manipulation

Market manipulation is an act of artificially influencing securities prices that would otherwise be determined by the securities market through natural supply and demand. With a view, therefore, to ensuring fair price formation in securities markets and protection of investors, the Financial Instruments and Exchange Act prohibits market manipulation and imposes heavy penalties for the violation thereof.

Acts of market manipulation are largely divided into the following five types: 1) wash transactions, 2) prearranged transactions, 3) price manipulation, 4) representation made for the purpose of manipulating securities prices, and 5) stabilization transactions.

A wash transaction is a transaction in which the same person places purchase and sale orders during the same time frame with no actual change in ownership occurring. With prearranged trades, similar transactions are carried out in collusion with different persons. In both cases, the intention is to mislead other investors into thinking trading in the security is very active; the requisite for being deemed a wash transaction is the existence of someone who's purpose is to mislead other investors regarding trading status.

Price manipulation refers to an act of engaging in transactions that could possibly cause a fluctuation in securities prices for the purpose of misleading (inducing) other persons into believing that, despite intentional price manipulation, the prices are determined by natural supply and demand, and thus inducing them to purchase or sell the securities. (Supreme Court ruling on the Kyodo Shiryo case, July 20, 1994)

Stabilization transactions are transactions done for the purpose of pegging, fixing, or stabilizing the prices of specific securities. However, when primary offerings and secondary distributions are made, there is the concern that flooding the market with the securities could result in a large decline in the security price, making it difficult to float the issue. For that reason, stabilization transactions are only permitted with primary offering or secondary distribution of securities pursuant to the provisions of a cabinet order.

The offence of market manipulation carries a punishment of imprisonment with work for not more than 10 years or a fine of not more than ¥10 million. In some cases, both penalties can be inflicted and the property gained through market manipulation confiscated and, if it cannot be confiscated, the value

Table XI-2. Provisions of the Financial Instruments and Exchange Act Relating to Market Manipulation

Wash transactions	No person shall, for the purpose of misleading other persons about the state of securities transactions, conduct fake sale and purchase of securities without purpose of transfer of right (Art. 159, Para. 1, Items 1 through 3).
Prearranged transactions	No person shall, for the purpose of misleading other persons about the state of securities transactions, conduct sale and purchase of securities at the same time and price, etc., based on collusion with another party (Art. 159, Para. 1, Items 4 through 8).
Price manipulation	No person shall, for the purpose of inducing the sale and purchase of securities in securities markets, conduct sales and purchases of securities that would cause fluctuations in the prices of the securities (Art. 159, Para. 2, latter part of Item 1).
(False) Representation	No person shall, for the purpose of inducing the sale and purchase of securities in securities markets (1) spread a rumor to the effect that the prices of the securities would fluctuate by his/her own or other party's market manipulation (Art. 159, Para. 2, Item 2) or (2) intentionally make misrepresentation or a representation that would mislead other parties with regard to important matters when making sale and purchase of securities (Art. 159, Para. 2, Item 3).
Stabilization transactions	No person shall conduct sales and purchases of securities in violation of a cabinet order for the purpose of pegging, fixing, or stabilizing the prices of the securities (Art. 159, Para. 3).

thereof shall be collected from the offender. If market manipulation is conducted by trading securities for the purpose of gaining property benefits (indirect financial benefits), the offense is subject to a punishment of imprisonment with work for not more than 10 years or a fine of not more than ¥30 million. The offense is also subject to an Administrative Monetary Penalty Payment Order. Moreover, there are provisions on liability for compensation for damages claims for investors in violation of market manipulation regulations (Article 160 of the FIEA).

By the Cabinet Office Ordinance Concerning the Financial Instruments Business, Etc., securities companies are prohibited from accepting the entrustment of orders from customers with the knowledge or expectation that acceptance of the entrustment may lead to artificial market manipulation and are required to have in place trading surveillance systems for the prevention of such violations.

3. Prohibited and Regulated Acts of Corporate Insiders

Regulations concerning the acts of corporate insiders are largely classified into two categories: those prohibiting insider trading per se and those designed for its prevention.

(1) The Prohibition of Insider Trading

"Insider trading" refers to acts of effecting the sale, purchase, or other type of transaction of securities pertaining to any unpublished corporate information that may significantly influence the decision making of investors before such information is publicized by an insider of a listed company who has come to know the information through the performance of his/her duties or due to his/her position. If such transactions were to take place, the investing public would be put at a significant disadvantage and the credibility of the securities markets would be seriously undermined.

With a view to effectively checking insider trading and in keeping with the modernization of the securities market, Japan's insider trading regulations were introduced in an amendment to the Securities and Exchange Law in April 1989. The regulation framework has since been extended to include company splits, corporate share repurchases and other activities, with the relevant legislative changes effected thereafter. In 2013, further amendments expanded the scope of criminal charges and Administrative Monetary Penalty Payment Orders to include 1) disclosure of information and inducement of insider trading by a corporate insider and 2) expand the scope of regulation to include REIT transactions.

Since the introduction of the regulation, penalties for insider trading have been increased stepwise to punishment by imprisonment with work for not more than five years or a fine of not more than ¥5 million. In some cases, both penalties can be inflicted with a fine of not more than ¥500 million in the case of a legal entity. And the property gained through insider trading shall be confiscated and any deficient amount collected from the offender. In addition, when receiving an Administrative Monetary Penalty Payment Order, the offender must pay an amount equivalent to the profit made (half the profit in the case of disclosure of information and inducement of insider trading by a corporate insider) to the government treasury.

(2) Preventing Insider Trading

Along with the prohibition of insider trading, the officers and principal shareholders of listed companies, etc., are required to officially report any transactions in the shares of the company concerned. They are required to return to the company any short-term trading profit they have made in the shares of the company held for a period of six months or less, and they are prohibited from selling the securities, etc., of the company in excess of the share certificates, etc., of the company that they hold.

Checks by securities companies on orders they receive and internal

Table XI-3. An Outline of the Targets of Regulations, Materials Facts, Methods of Announcement Relating to the Regulation of Insider Trading

Item	Outline
1. Targets of regulation (1) Persons associated with the company	(1) Directors of a listed company (directors, officers, agents, key employees) → information not announced to the public that came to their knowledge (2) Persons who have the right to inspect the books and accounting records of the company (for example, those who hold 3% or more of the outstanding shares of the company) → Information not announced to the public that came to their knowledge in the course of the exercise of the right to inspect the books and accounting records of such company (3) Persons who have the power vested in them by laws and regulations to inspect the books and accounting records of listed companies (for example, officials of the regulatory agencies) → Information not announced to the public that came to their knowledge in the course of the exercise of such power (4) Persons who have concluded a contract with a listed company (for example, banks, securities companies, certified public accountants, lawyers, etc.) → Information not announced to the public that came to their knowledge in the course of negotiating, signing, and performing a contract. (5) In case any person referred to in (2) or (4) above is a corporation or director, etc., of such corporation → Information not announced to the public that came to such person's knowledge in the course of performing his/her official duty
(2) Recipients of information	(1) Persons who have received information concerning a material fact from persons associated with the company (2) Directors of a corporation to which the person who has received information concerning a material fact from a person associated with the company belongs and who have learned of information not announced to the public in the course of the performance of their duty
2. Material facts (1) Matters decided	A decision made by a decision-making body of a listed company to carry out or not to carry out the matters set forth below: The issuance of new shares, a decrease in capital, the acquisition or disposal of its own shares, a stock split, a change in the amount of dividend, a merger with another company, transfer of business, dissolution of the company, commercial production of a newly developed product or commercial application of a new technology and assignment or acquisition of fixed assets
(2) New facts	When any of the facts set forth below has occurred: A loss caused by a disaster; a change in major shareholders; a development that could cause a delisting of its shares; lawsuits relating to a claim against the property right of the company; an administrative disciplinary action ordering the suspension of business, etc.; a change in the parent company; a petition for bankruptcy of the company; a failure by the company to honor its notes or bills falling due; suspension of business with its bank; or the discovery of natural resources, etc.
(3) Information on settlement of accounts	When newly announced results, projected or actual, are significantly at variance with those announced earlier: Sales (10% or more up or down); recurring profit (30% or more up or down, and its ratio to the total net assets is 5% or more up or down); net profit (30% or more up or down, and its ratio to the total net assets is 2.5% or more up or down)
(4) Others	Material facts, other than those listed in (1) – (3) above, relating to the management, business, or property of a listed company that have a profound influence on the investment decisions the investors make
(5) Material facts related to subsidiaries	(1) to (4) above apply
3. Methods of announcing information	Twelve hours must elapse after the company that has issued the stock in question has disclosed its material facts to two or more news media. When a company has notified the stock exchange on which its stock is listed, and the stock exchange has offered the information thus notified on its web site for public inspection.

Note: Any person who had been associated with any listed company and had learned of a material fact of such company as set forth above and who is no longer associated with such listed company is subject to these regulations for one year after that person dissolves association with the company.

frameworks of listed companies (to manage and control corporate information and regulate employee trading of company shares) and posting information on J-IRISS play a critical role in preventing insider trading. J-IRSS stands for Japan-Insider Registration & Identification Support System, a searchable database where securities companies regularly register information on their customers and listed companies post information on their directors.

4. Prohibited and Regulated Acts for Financial Instruments Firms (Securities Companies) and Their Employees, Officers, and Directors

Various regulations have been set out for financial instruments firms (securities companies) and their employees, officers, and directors from the standpoint of ensuring the protection of investors, the fairness of transactions, and other aspects of trading.

(1) Business Relationship with Customers

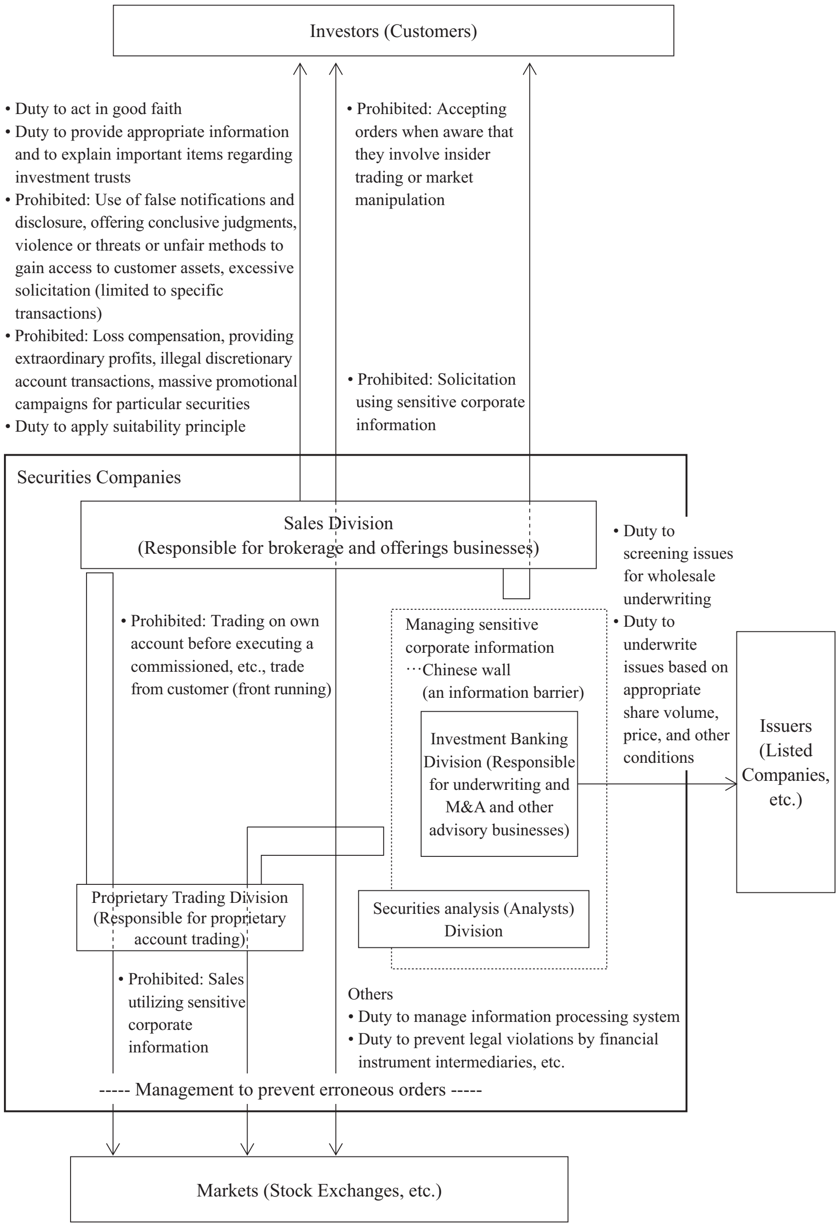
Business with customers must be executed in good faith and fairly. Securities company personnel have a duty to provide customers with appropriate information and the use of false notifications or disclosure, fraudulent means, violence or threats or other unfair methods to gain access to customers' assets is banned as is the use of excessive solicitation. While these regulations aim to protect investors, overprotection must also be avoided. To ensure fairness in transactions, personnel are barred from compensating customers for losses, providing them with extraordinary profits or concluding a discretionary investment contract with customers without establishing the appropriate management system—even if the customer requests such services. Moreover, to maintain the fairness of the market, securities companies are prohibited from accepting orders from customers when aware that the transactions involve insider trading or market manipulation.

Securities companies must conduct their business operations in such a way as to avoid being deficient in protecting investors, such as solicitations that are recognized as inappropriate for the customer in light of his/her level of knowledge, experience, and financial resources and the purpose of concluding the financial instruments transaction contract (Suitability Principle).

(2) Management of Sensitive Corporate Information

Through their underwriting and M&A-related advisory and other businesses, securities companies have access to undisclosed information that could influence the stock price, etc., of issuers (sensitive corporate information). To prevent unfair trading based on such information, securities companies are

Chart XI-1. Prohibited and Regulated Acts of Securities Companies (Duties and Prohibited Acts)



required to establish appropriate systems. Specifically, securities companies commonly set up an information barrier or Chinese wall between the investment banking and similar divisions that regularly deal in sensitive corporate information and the rest of their operating divisions to enable the management of information sharing in-house. In addition, personnel are forbidden to use sensitive corporate information to solicit customers (mainly targeting sales divisions) and in trading (mainly targeting proprietary trading divisions).

(3) Management to Prevent Erroneous Orders

Securities companies are required to establish management systems to prevent erroneous orders (name of issue, number of shares, share prices, etc.).

(4) Management of Information Processing Systems

Securities companies are tasked with adequately managing the information processing systems (computer systems) used to conduct their businesses.
Besides the previously mentioned areas, Article 117, Paragraph 1 and Article 123, Paragraph 1 of the Cabinet Order for Enforcement of the FIEA and the self-regulation rules of the Japan Securities Dealers Association and stock exchanges, etc., set out various strongly advised or required management systems for securities companies.

CHAPTER XII

Financial Instruments Business (Securities Business)

1. Overview of Financial Instruments Firms (Securities Companies) (1)

While the Financial Instruments and Exchange Act (FIEA), a comprehensive overhaul of the former Securities and Exchange Law, was fully enforced in September 2007, the basic legal framework regulating securities companies remains intact. The FIEA defines the financial instruments businesses as including Type I and Type II Financial Instruments Businesses, Investment Advisory and Agency Business, and Investment Management Business (Article 28 of the FIEA). What has traditionally been known as securities business is included in Type I Financial Instruments Business, and, accordingly, securities companies are required to register with the prime minister as financial instruments firms (Article 29).

The securities business registration system that had been in place since 1948, when the Securities and Exchange Law was first enacted, was replaced by a licensing system in April 1968. The licensing system was designed to help stabilize the management of securities companies by curbing excessive competition and obligating them to specialize (ban, in principle, on concurrently operating nonsecurities business), thus strengthening the investor protection. As a result, the regulatory regime increasingly took on a defensive bias, and virtually no companies entered the securities business anew.

As the securities market developed, the types of financial products handled by securities companies became increasingly diverse. Furthermore, as the years rolled on into the 1990s, customer needs for securities services started to change and vary, from private equity and asset securitization to M&A advisory, asset management, and online brokerage, against the background of the nation's shifting industrial structure, aging population, dying traditional long-term employment practices, and ongoing information technology revolution (such as the proliferation of the Internet).

The licensing system did play a role in stabilizing the management of securities companies. On the other hand, there turned out to be a number of drawbacks, including a detriment to creativity in business approaches, such as branch network management and the development of new products and

Table XII-1. The Scope of Business of Securities Companies (Type I Financial Instruments Business), and Requirements

1. Type I Financial Instruments Business (Article 28 Paragraph 1, Items 1–5 of the FIEA)	Refusal of Registration (= registration requirements) (Article 29-4, Paragraph 1 of the FIEA, Article15 of the FIEA Enforcement Order)
(1) Sale or purchase of securities, market transactions of derivatives or foreign market derivatives transactions; intermediary, brokerage, or agency service for the transactions listed above; intermediary, brokerage, or agency service for the entrustment of the transactions listed above; brokerage for the clearing of securities, etc.; secondary distribution of securities; or the handling of public, primary offering or secondary distribution of securities or the handling of the private placement of securities (2) Over-the-counter transactions of derivatives or intermediary, brokerage, or agency service therefor (3) Underwriting of securities (4) Sale or purchase of securities or intermediary, brokerage, or agency service therefor, which is conducted through an electronic data processing system and in which a large number of persons participate simultaneously as a party or parties of the transaction (business of operating a proprietary trading system (PTS business) (5) Acceptance of deposit of securities, etc., in relation to the transactions, etc., listed above ("safekeeping") or book-entry transfer of stocks or corporate bonds *Notes:* 1. An authorization from the prime minister is required for conducting acts provided in (4) above (Art. 30, Paragraph1). 2. Acts provided in (5) above are defined as primary business in the FIEA rather than as incidental business in the former SEL.	(1) An applicant who had his/her registration rescinded and for whom five years have not passed since the rescission; an applicant who has been punished by a fine for violating the provision of any applicable law or regulation and for whom five years have not passed since the imposition of the fine (2) An applicant with an officer, etc., who is bankrupt or has received certain criminal punishment and for whom five years have not passed since the completion of the sentence (3) An applicant without appropriate personnel resources to properly conduct the financial instruments business (4) An applicant with stated capital or net worth of less than ¥50 million (5) An applicant that is not a stock company (6) An applicant whose additional business other than incidental or registered/approved concurrent business is found to be against the public interest or to pose difficulty in risk management (7) An applicant whose major shareholder (with 20% or more of voting rights) is disqualified for registration (8) An applicant with a capital-to-risk ratio less than 120% (9) An applicant with a trade name that is the same as or similar to that of an already existing financial instruments firm Minimum Capital Requirement (Article 15, Paragraphs 7 and 11 of the FIEA Enforcement Order) (1) Business of conducting wholesale underwritings as a lead manager ¥3 billion (2) All other underwriters ¥500 million (3) Business of operating PTS ¥300 million (4) All other Type I financial instrument businesses ¥50 million
2. Incidental businesses (Article 35, Paragraph1, Items 1–15)	
(1) Lending or borrowing of securities, or intermediary or agency service thereof (2) Making a loan of money incidental to a margin transaction (3) Making a loan of money secured by securities held in safekeeping for customers (4) Agency service for customers concerning securities (5) Agency service of the business pertaining to the payment of profit distribution or proceeds from redemption at maturity or at the request of an investment trust (6) Agency service of the business pertaining to the payment of dividends or refunds or distribution of residual assets with regard to investment certificates of an investment corporation (company-type investment trust) (7) Conclusion of a cumulative investment contract (8) Provision of information or advice in relation to securities (9) Agency service of the business of any other financial instruments firm, etc.	The following items are newly included as incidental businesses under the FIEA. (10) Custody of assets of a registered investment corporation (11) Provision of consultation to any other business with regard to assignment of a business, merger, spin-off, share exchange or share transfer or intermediation thereof (12) Provision of management consultation to any other business (13) Sale or purchase of currencies and other assets related to derivative transactions or intermediary, brokerage, or agency service thereof (14) Sale or purchase of negotiable deposits or other monetary claims or intermediary, brokerage, or agency service thereof (15) Management of assets under its management as investment in specified assets defined in the Investment Trust Law
3. Other businesses requiring registration (Article 35, Paragraph 2 of the FIEA; Article 68 of the Cabinet Office Ordinance Concerning Financial Instruments Business, etc.)	
(1) Conducting a transaction on a commodity exchange (2) Conducting a transaction in a derivative contract on a commodity price or other benchmark (3) Money-lending business or intermediary service for money lending (4) Business pertaining to real estate transactions or real estate leases (5) Real estate specified joint enterprise (6) Commodity portfolio management business (7) Business of investing property entrusted under an investment management contract in assets other than securities or rights pertaining to derivative transactions (8) Among the 23 other businesses designated by a cabinet office ordinance, the main business include: (i) intermediary, brokerage, or agency service for trading gold; concluding agreements or intermediary, brokerage, or agency service for concluding agreements for (ii) partnerships (iii)	anonymous partnerships, and (iv) loan participation; (v) insurance agency business; (vi) intermediary service for forming a trust by will or concluding a contract concerning the disposition of deceased estate; (vii) production, sale, and commissioned operation of computer programs; (viii) financial institution agency business; (ix) intermediary, brokerage, or agency service for a transaction of emission rights or derivatives thereof; (x) investment of property, except that entrusted under an investment management contract, in assets other than securities or rights pertaining to derivative transactions (e.g., management of a fund that invests in monetary claims); (xi) management of real estate; (xii) management, under entrustment, of an investment corporation or a specific-purpose company (TMK); (xiii) guarantee or assumption of debt or intermediary or other service thereof; (xiv) introduction or referral to any other business for a customer; and (xv) promotion or advertisement of any other business.

Notes: 1. A financial instruments firm may, in addition to the above, engage in a business for which approval has been obtained from the prime minister (approved business, Article 35, Paragraph 4 of the FIEA).

2. A discretionary investment contract is now included as one of investment management services that a financial instruments firm may provide without special approval from the prime minister.

services and a lower sense of self-reliance on the side of securities companies. Increasingly concerned about such negative fallout, the government amended the Securities and Exchange Law as part of the Financial System Reform Law. Specifically, in December 1998 a new registration system replaced the licensing system, and restrictions on the concurrent operation of nonsecurities business were eased. (Under the same amendment, banking institutions are also allowed to engage in the securities business by registration.)

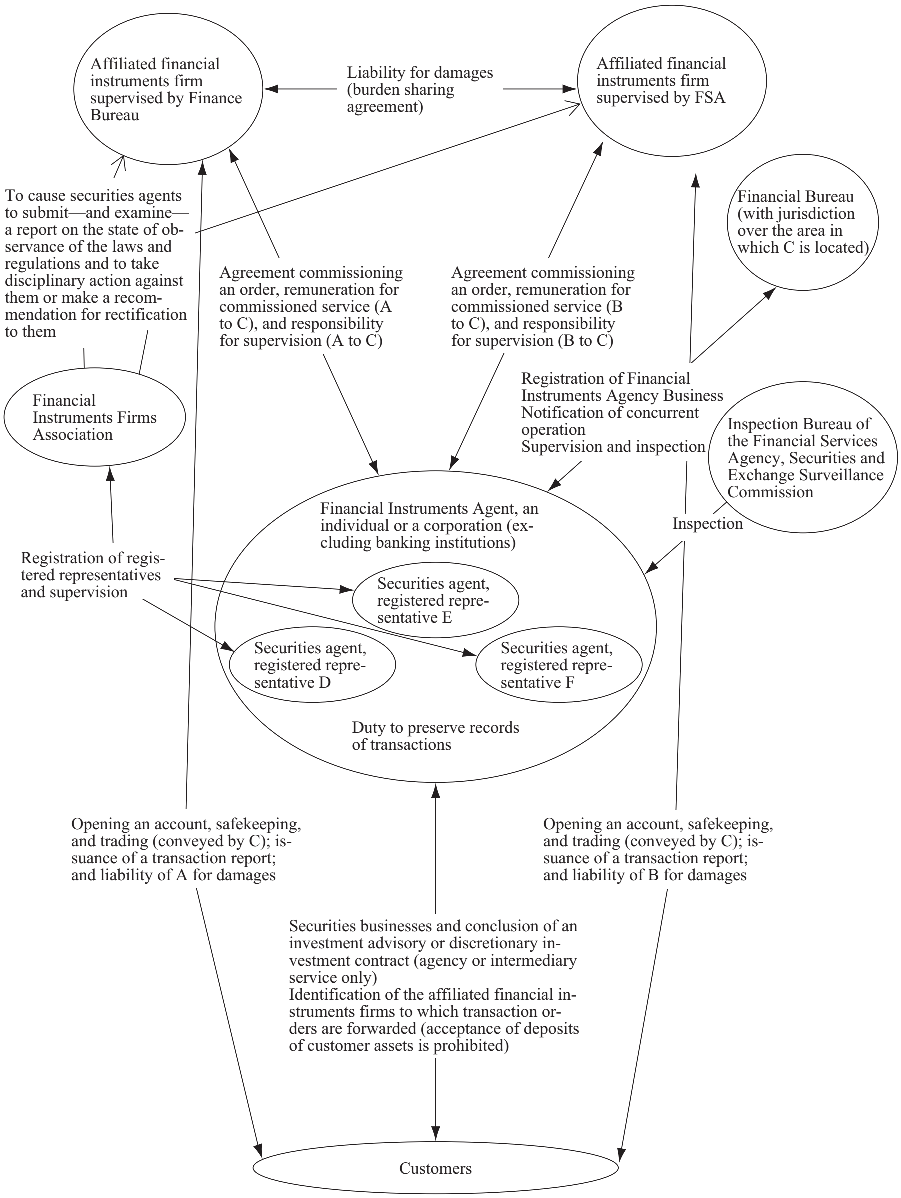
With the objective of providing an equal and uniform investor safeguard across various financial products and services with considerable risk, the FIEA was subsequently enacted to cover a wider range of objects, including collective investment schemes and derivative transactions. The FIEA is comprehensive legislation that combines the Securities and Exchange Law, the Financial Futures Trading Law, and the Law for Regulating the Securities Investment Advisory Business (Investment Advisor Law) and aims at achieving effective regulation of a unified financial instruments business across a securities-related industry once vertically segmented into securities business, financial futures trading business, and investment advisory business.

2. Overview of Financial Instruments Firms (Securities Companies) (2)

The former securities intermediary service is redefined as "Financial Instruments Intermediary Service" under the FIEA. The term "Financial Instruments Intermediary Service" means services comprising the following acts conducted under entrustment from a financial instruments firm, an investment management business, or a registered financial institution (see section 12 of this chapter): (i) intermediation for the sale or purchase of securities; (ii) intermediation for the sale or purchase of securities conducted in an exchange market or market transactions of derivatives; (iii) handling of a public, primary offering or secondary distribution of securities or handling of a private placement of securities; and (iv) agency or intermediary service for the conclusion of an investment advisory contract or a discretionary investment contract (Article 2, Paragraph 11 of the FIEA). As is common with the items listed above, the provider of the service does not have customer accounts but solicits customers and redirects their orders for transactions to brokers/dealers, etc., from which it receives a commission.

Compared with the former definition, intermediary service for derivative transactions and agency or intermediary service for the conclusion of an investment advisory contract or a discretionary investment contract are newly included in the new financial instruments intermediary service. In spite of the expanded coverage, however, underlying regulatory principles remain intact.

Chart XII-1. An Outline of Securities Agents



Note: More than one agreement commissioning an order is allowed.
Source: Compiled on the basis of the data drawn from materials published by the Financial Services Agency.

The provisions of the FIEA are designed to ensure the protection of investors by instituting a number of preventive measures. More specifically, they require all financial instruments intermediary service agents to be registered and prevent any disqualified person from becoming an agent. The FIEA makes all agents subject to the same set of prohibited and regulated acts that are applicable to financial instruments firms (the prohibition of loss compensation, the duty to observe the principle of suitability, etc.); explicitly defines agents under the control and authority of securities companies employing them; and holds these securities companies legally responsible for supervision and damage compensation. The FIEA also gives the regulatory authority power to inspect and supervise financial instruments agents.

Registration requirements for financial instruments agents under the FIEA are essentially identical to those under the former law. The requirements are less stringent than those for financial instruments firms to facilitate their market entry. More specifically, 1) either an individual or a legal entity can register as an agent and a legal entity does not need to be a stock company and 2) there are no minimum requirements for capital, net worth, or capital-to-risk ratio. However, they can only solicit investors for orders and redirect such orders to their broker/dealer. They are not allowed to take a deposit of cash or securities from their customers. (For this reason, they are exempt from joining an investor protection fund.) As is the case with registered representatives of financial instruments firms, salespersons of financial instruments agents shall be qualified as registered representatives and register with the Japan Securities Dealers Association (JSDA) (as an authorized Financial Instruments Firms Association).

Agents may be affiliated with one or more securities companies. As of the end of August 2013, for example, there were 764 actual financial instruments agents (528 companies and 236 individuals) acting as a total of 1,041 agents (767 companies and 274 individuals). According to the FSA's "Sales Agents for Financial Instrument Firms," many agents are affiliated with mid- and small-sized securities companies and Internet securities companies seeking to expand their sales networks, such as the 235 agents affiliated with Ace Securities and the 200 agents affiliated with SBI Securities. As registered financial institutions may also conduct financial instruments agency business, banking institutions may provide a securities agency service with respect to stocks, corporate bonds, and foreign bonds (please see section 12 of this chapter). As a result, major securities companies are eager to conclude securities agency service contracts with regional financial institutions.

3. Overview of Financial Instruments Firms (Securities Companies) (3)

For quite some time after the war, securities companies in Japan had one characteristic in common: heavy reliance on the stock brokerage business both in terms of revenues and business volume. In the process, (1) there developed a bipolarization of securities companies—integrated securities companies that hired a large number of employees and ran multifaceted securities business on a large scale, on the one hand, and small and midsized securities

Table XII-2. The Number of Securities Companies and Their Capital and Employees

Year-end	Securities companies (head office)			No. of Business Offices (incl. head offices)	Capital (in ¥ bil)	No. of employees	
	Members of the Stock Exchange	Nonmembers of the Stock Exchange	Total			No. of Office Bound Employees	No. of Registered Representatives
2006	130 (13)	177 (21)	307 (33)	2,196 (37)	22,078	16,607	76,054
2007	128 (13)	188 (17)	316 (30)	2,270 (32)	22,712	17,879	81,260
2008	123 (12)	199 (16)	322 (28)	2,336 (32)	22,638	18,002	81,198
2009	118 (11)	189 (14)	307 (25)	2,254 (27)	18,856	16,043	77,265
2010	115 (10)	184 (13)	299 (23)	2,220 (24)	18,289	16,143	75,913
2011	113 (8)	179 (14)	292 (22)	2,211 (24)	19,585	15,911	76,776
2012	103 (6)	168 (11)	271 (17)	2,138 (17)	17,349	13,372	69,684
2013	101 (6)	159 (10)	260 (16)	2,109 (17)	16,975	12,348	71,916

Notes: 1. Figures in parentheses represent the number of branches of foreign securities companies in Japan included in the figures above them. Their Tokyo branches are counted as head offices.
2. In terms of 2013 figures, the number of branches and the total amount of capital are as of the end of July and the number of employees is as of the end of June, which does not include 2,778 registered representatives employed by financial instruments intermediary service agents (as of the end of June 2013).
3. Foreign securities firms are excluded from the amount of capital.
4. By virtue of an amendment dated April 16, 2003, the definition of "commissioned registered representative" and qualification requirements were abolished.

Source: Japan Securities Dealers Association, *Shoken gyoho* (JSDA Monthly Report), *Gyomu houkousho* (JSDA Operation Report), etc.

Table XII-3. Changes in the Number of Domestic Securities Companies through New-Entry Mergers and Discontinuation of Business

	No. of New Entrants	Through a Merger	Discontinuation
1993–96	19	− 3	
1997–2001	80	− 36	− 22
2002	11	− 9	− 9
2003	7	− 4	− 7
2004	7	− 5	
2005	20	− 3	− 2
2006	25	− 1	− 2
2007	22	− 2	− 10
2008	22	− 6	− 9
2009	4	− 7	− 19
2010	9	− 6	− 13
2011	4	− 6	− 6
2012	2	− 8	− 10
2013 (Jan. to Aug.)	3	− 7	− 6

Notes: 1. The 19 companies that entered the stock market during the years from 1993 through 1996 had been established as securities subsidiaries of banks under the Financial System Reform Law.
2. The term "merger" includes assignment of business to another firm.
3. The number of companies that have discontinued their business is as of the date on which they have quit their membership of the Japan Securities Dealers Association and one or two years after they had suspended their operations.
4. Figures do not include entries and exits due to reorganization, such as the establishment of local subsidiaries by foreign securities companies (which have increased rapidly since 2006).

Source: Japan Securities Dealers Association, *Shoken gyoho* (JSDA Monthly Report).

Table XII-4. No. of Securities Companies, by Capitalization

The Amount of Capital	End of 2008	End of Sept. 2013
¥50 bil or more	14	12
¥10 bil or more and less than ¥50 bil	19	17
¥3 bil or more and less than ¥10 bil	39	43
¥1 bil or more and less than ¥3 bil	47	38
¥300 mil or more and less than ¥1 bil	101	81
¥50 mil or more and less than ¥300 mil	74	53
Total	294	244

Note: Excludes foreign securities companies.

companies that relied on the brokerage business generated by registered representatives working on commission, on the other—and (2) the large integrated securities companies—Nomura, Daiwa, Nikko, and Yamaichi, collectively referred to as the "Big Four"—captured a large share of the market in all segments of the securities business. And they had gained an oligopolistic control of the market as a group by creating a network of affiliated small securities companies. This was a characteristic of the postwar securities market of Japan, unknown before the war or in other countries. And this structure was maintained until the latter half of the 1990s with only minor changes.

However, in the early 1990s, after the speculative bubble finally burst, the securities slump worsened and Yamaichi Securities and a number of smaller securities companies went bankrupt in the process. Meanwhile, a number of firms that were armed with a unique business style and focused on selected segments of the securities business have entered the market, making it increasingly fluid. Incidentally, during the period from May 1997, after Ogawa Securities went bankrupt, to the end of August 2013, a total of 216 securities companies had dropped out of the market either by voluntary dissolution or through an assignment of business to, or a merger with, another company, while there were 216 market entrances (see the chart on the next page). In addition, a number of foreign securities companies have opened branches in Japan. Since 1990, some of them have increased their shares in the equity and derivatives trading markets, largely thanks to increases in orders received from their overseas customers. They are playing a major role in new types of business, such as the securitization of assets, packaging structured bonds, and M&A—to such an extent, in fact, that the oligopolistic control of the Japanese securities market by the Big Four has been virtually broken.

In 1998 two leading securities companies—Daiwa and Nikko—entered into capital and business tie-ups with financial institutions, domestic or foreign, and carried out a far-reaching change in their business organization by dividing operations into a wholesale division and a retail division (Daiwa changed its corporate structure into a holding company structure in 1998, and Nomura and Nikko did likewise in 2001). And many securities companies, large and small, started to overhaul their traditional Japanese-style employment systems by introducing a new compensation system based on performance. Moreover, large securities companies have shed some of their small and midsized affiliated securities companies in an effort to increase the overall efficiency of their operations, while leading banks and other business corporations have picked them up with a view to using them as vehicles for entering the securities market (see section 13 of this chapter). At the same time, many securities companies have tried to claw their way out of the securities market slump and meet changes occurring in the market environment by reforming their operations. And such efforts have brought about a big change in the business organization, the personnel administration system, and the competitive structure of the securities market.

4. Securities Businesses (1)—The Principal Businesses (1)

The principal businesses that securities companies are authorized to conduct under the FIEA have been expanded to include safekeeping and book-entry transfer services. By product, principal businesses may be largely divided into those relating to stocks, bonds, investment trusts, and derivatives. By type of service, they may be largely divided into those relating to (1) dealing—proprietary trading; (2) brokerage—agency trading; (3) investment banking—underwriting; and (4) public offering and private placement—distribution of securities.

The bulk of the securities-related business of brokers/dealers in the secondary market is the brokerage business of executing customer orders on stock exchanges, and the rest is the proprietary trading conducted for their own account. As not many customer orders for bonds—except for convertible bonds, whose prices are linked to underlying stock prices—are executed on stock exchanges, most bond orders are executed by matching them against the positions of securities companies' proprietary accounts (bond dealing). Along with stock exchanges, securities companies play an important role in forming fair prices and maintaining the liquidity of securities through their broker/dealer functions.

In addition to underwriting publicly offered new issues of public bonds (government securities, etc.), nonconvertible bonds of business corporations, and equity securities (stocks and bonds with subscription rights) of public companies, securities companies also underwrite the shares of companies to be listed on exchanges, etc., in the process of initial public offerings. The term "underwriting" means an act of acquiring a security by a securities company with the aim of ensuring successful issuance of a new security or secondary distribution of shares by reselling them to others and, if so agreed, purchasing the unsold portion of the security, if any. More specifically, the act of acquiring new security from the issuer is called "wholesale underwriting" (and the securities company that negotiates a wholesale underwriting agreement with the issuer is called "the managing underwriter"), and acquiring the security from a wholesale underwriter is called "sub-underwriting." The term "public offering" means the act of soliciting investors for the purchase of new-issue securities and selling them. Beneficiary certificates of investment trusts are also sold in public offerings, in addition to the new-issue securities mentioned above. Secondary distribution means the placing of already issued securities and includes block sales of major shareholders, etc.

Table XII-5. Business Volume Handled by TSE Member Companies

	Cash Stock Transaction Value (trillions of yen)			Underwriting and Distributions (100 millions of yen)		Handling of Public and Distributions (100 millions of yen)		
	Propri-etary	Agency	Traded on margin (%)	Stocks	Bonds	Stocks	Bonds	Beneficiary certificates of investment trusts
2001/3	194	316	11	70,418	310,878	17,478	165,966	709,796
2002/3	188	271	12	14,701	332,079	18,455	183,771	630,223
2003/3	180	236	14	16,240	420,062	23,642	207,617	345,314
2004/3	262	402	19	29,427	445,017	42,918	234,572	441,715
2005/3	287	503	20	36,652	509,186	51,296	248,142	501,677
2006/3	441	886	21	47,813	558,784	71,394	340,810	799,629
2007/3	525	982	18	50,427	417,929	66,840	242,514	754,676
2008/3	552	1,036	16	17,614	553,961	26,654	351,305	702,061
2009/3	381	665	18	19,485	509,049	28,005	309,318	506,129
2010/3	291	540	21	48,210	330,872	67,244	219,282	549,085
2011/3	243	595	16	23,373	353,167	37,122	222,042	622,565
2012/3	152	537	15	N.A	N.A	N.A	N.A	N.A
2013/3	177	672	17	N.A	N.A	N.A	N.A	N.A

Notes: 1. The accounting year runs from April 1 to March 31 of the following year.
2. Figures are double actual volume because both sales and purchases are included.
3. Special members are not included. The total number of Tokyo Stock Exchange member companies, including foreign securities companies, as of March 31, 2013, stood at 91.
4. From FY2002 on, the method of computation was changed.

Source: Compiled on the basis of the data drawn from Shoken of the Tokyo Stock Exchange, etc.

Under the 1998 amendment to the Securities and Exchange Law, over-the-counter derivative trading and PTS services were newly authorized. The former refers to an act of effecting or entrusting to effect with a customer a forward or options transaction of a stock or a stock index or a swap contract involving, for example, a stock index and an interest rate off the exchange. Actually, most of these OTC derivative contracts are embedded in and sold as structured bonds (such as equity-linked bonds). The PTS service matches orders from investors by utilizing an electronic information processing system. As the PTS service requires specialized technical expertise and advanced risk management skills, securities companies wishing to provide the PTS service must be authorized to do so by the prime minister (see section 1 of this chapter).

Table XII-6. PTS Transactions

(millions of yen)

	Trading on Exchange (A)	Trading off Exchange (B)	Total Trading (A+B)	PTS Transactions (C)	Proportion of PTS Trading on Exchange (C/B)	Proportion of PTS Trading off Exchange (C/(A+B))
2005/3	368,350,873	21,100,338	389,451,480	124,839	0.6%	0.0%
2006/3	642,298,900	30,507,011	672,805,911	338,675	1.1%	0.1%
2007/3	723,734,608	42,810,934	766,545,542	854,916	2.0%	0.1%
2008/3	762,223,285	49,610,445	811,833,730	2,140,465	4.3%	0.3%
2009/3	521,094,825	36,357,081	557,451,906	2,073,204	5.7%	0.4%
2010/3	395,500,588	24,483,714	419,984,302	3,089,794	12.6%	0.7%
2011/3	397,576,761	24,801,215	422,377,976	4,937,196	19.9%	1.2%
2012/3	335,080,193	32,298,843	367,379,035	15,202,634	47.1%	4.1%
2013/3	382,653,161	36,328,078	418,981,239	21,246,585	58.5%	5.1%

Notes: 1. The accounting year runs from April 1 to March 31 of the following year.
2. Figures are actual volume because only one side of the transaction is included.
3. Major PTSs include SBI Japannext and Chi-X.

Source: Compiled on the basis of statistical data from the PTS Information Network.

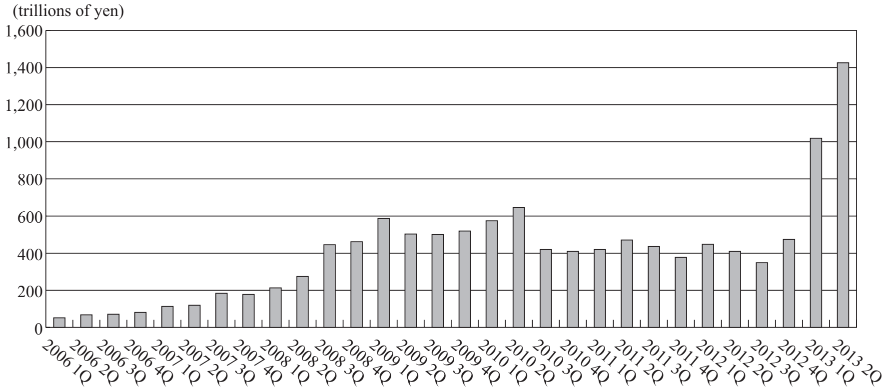
5. Securities Businesses (2)—The Principal Businesses (2)

Because the Financial Instruments and Exchange Law combined the Securities and Exchange Law and the Financial Futures Trading Act, Type 1 Financial Instruments Business includes financial futures, etc., as well as securities derivatives. Moreover, the OTC derivatives business no longer requires authorization from the authorities.

The underlying assets of derivatives can comprise financial products, such as securities, deposits, and currencies (Article 2, Paragraph 24) and financial indexes, such as price, interest rate, and weather indexes (Article 2, Paragraph 25). In the 2012 amendment of the FIEA, the definition of financial product was expanded to include commodities (excluding rice). The main customers for derivatives are financial institutions or institutional investors. In addition to acting as swap intermediaries, securities companies typically use OTC stock options as sweeteners for structured bond issues or conclude interest or currency swap agreements with companies issuing foreign currency denominated bonds when underwriting the issue.

Although individual investors are not frequently users of OTC derivatives, other than Nikkei 225 mini-futures (Osaka Securities Exchange), foreign exchange (FX) transactions are among the products that they use relatively

Chart XII-2. OTC FOREX Margin Transactions



Notes: 1. Figures compiled based on reports from association members and special members.
2. Trading volume includes both buy and sell sides, including agency transactions.
3. Foreign currency amounts have been converted into Japanese yen using the spot rate at the end of each period.

Source: The Financial Futures Association of Japan.

often. Investors use OTC FX transactions to purchase or sell currencies by depositing a margin with the broker and settle the transaction usually on a net basis. These OTC transactions got their start in Japan when some commodity traders became the first to use them following the deregulation of foreign exchange transactions through the 1998 amendment of the Foreign Currency and Exchange Law. These FX transactions enable high leverage factors of 20 times on average and up to 100 times on small margins.

Without any laws or regulations, problems did occur in the FX market, resulting in the 2005 revision of the Financial Futures Trading Act, currently included in the Financial Instruments and Exchange Act. The revised law introduced a registration system for FX business, which steadily eliminated many of the bad operators. As a result, there was a sharp expansion in the use of FX transactions, as can be seen in chart XII-2. Moreover, in a bid to make FX transactions more transparent, the Tokyo Financial Futures Exchange (TIFFE, now TFX) listed an FX product in 2005 called Click 365. The OSE followed suit later, listing FX transactions in 2009. The ceiling on leverage in FX transactions was lowered to 50 times in August 2010 and again to 25 times in August 2011.

Today, investors have shifted from face-to-face transactions with brokers to online brokers for FX transactions, with Internet trading specialist FX firms, such as Kawase Dot Com and Kawase Online, aggressively developing

Table XII-7. OTC CDF Transactions on Securities

	Sept. 2010	Mar. 2011	Sept. 2011	Mar. 2012	Sept. 2013	Mar. 2013
Number of Accounts	109,260	136,446	137,424	145,258	145,967	101,196
Margin Deposit Balance	67	66	80	82	87	63

(Transactions)

	Individual stock-related	Stock index related	Bond elated	Other securities related	Total
Fiscal 2010					
Transaction amount (100 millions of yen)	1,066	109,233	1,265	102	111,666
Number of transactions	118,315	2,950,538	25,224	9,070	3,103,147
Open interest (100 millions of yen)	16	84	36	1	137
Fiscal 2011					
Transaction amount (100 millions of yen)	1,458	60,614	1,622	50	63,744
Number of transactions	154,570	2,623,063	37,745	3,985	2,819,363
Open interest (100 millions of yen)	18	88	71	1	178
Fiscal 2012					
Transaction amount (100 millions of yen)	2,900	48,698	1,738	18	53,354
Number of transactions	175,639	1,821,359	32,925	394	2,030,317
Open interest (100 millions of yen)	15	120	111	0	246

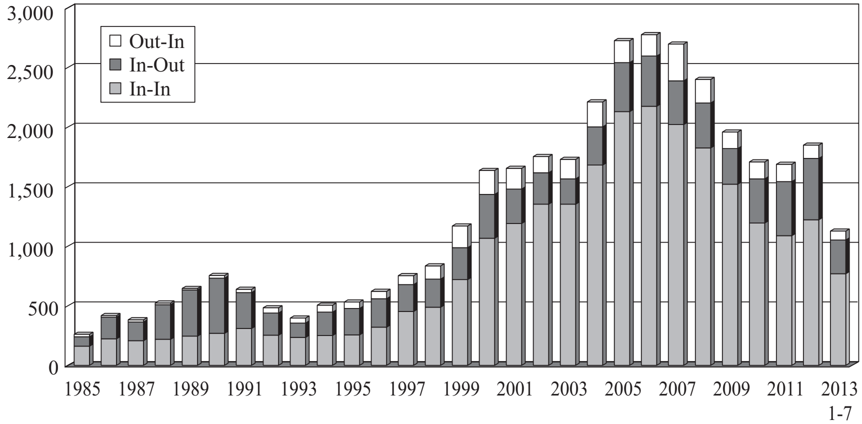
Note: Transaction amounts and open interest are on a notational principal basis. Open interest is as of end of fiscal year. Figures represent the sum of transaction value, etc. of JSDA regular and special members.
Source: The Financial Futures Association of Japan

the market. This type of OTC trading, where investors can place orders with low margins and settle the contracts on a net basis, is called contract for difference (CFD transaction) and is available not only for FX but for securities, indexes, interest rates, and commodities. First emerging in the United Kingdom, CFDs are now available from a number of brokers in Japan (see table XII-6).

6. Securities Businesses (3)—Incidental Business, Concurrent Business, and Other Businesses

In addition to the principal businesses outlined in the foregoing, securities companies may conduct businesses incidental to their principal businesses and other businesses that require notification to the authorities. Management

Chart XII-3. Changes in the Number of M&As Involving Japanese Companies



Note: The 2013 figures include only those from the period from January to July.
Source: Compiled from the data section of marr magazine, Recof.

Table XII-8. Ranking of Advisors on Published M&As Involving Japanese Companies (January – June 2013)

Rank	Advisors	Amount (in 100 millions of yen)	No. of Deals
1	Mitsubishi UFJ Morgan Stanley	12,470	29
2	Nomura	10,446	56
3	Sumitomo Mitsui Financial Group	9,850	67
4	Daiwa Securities Group Inc.	7,853	30
5	PLUTUS Consulting	4,293	26
6	GCA SAVVIAN Group	4,261	15
7	Goldman Sachs	4,212	8
8	A.G.S. Consulting	4,192	16
9	YAMADA Consulting Group	4,099	8
10	Partners Consulting	3,992	5

Note: Excluding real estate deals.
Source: Thomson Financial.

Table XII-9. Number of Wrap Accounts and Assets Under Management

(100 millions of yen)

	Discretionary investment		Investment advisory		Total	
	No. of acc.	Amount	No. of acc.	Amount	No. of acc.	Amount
March end 2008	41,615	7,469	496	40	42,111	7,508
March end 2009	37,138	4,571	417	22	37,555	4,593
March end 2010	41,773	5,696	317	22	42,090	5,718
March end 2011	43,509	5,890	260	17	43,769	5,907
March end 2012	42,467	5,799	5	6	42,472	5,805
March end 2013	51,758	7,689	0	0	51,758	7,689
June end 2013	59,596	8,655	0	0	59,596	8,655

Note: A wrap account is an account that is managed for a flat fee covering management, administrative, and trading commission expenses.
Source: Compiled from statistics produced by the Japan Securities Investment Advisers Association.

of assets of investment trusts, those entrusted under discretionary investment contracts, or properties pertaining to collective investment schemes used to require notification only, but, under the FIEA, securities companies are required to make registration in order to conduct this type of "investment management business" (Article 28, Paragraph 4). The registration requirements, however, are virtually identical to those for Type I Financial Instruments Business.

The volume of margin trading, or transactions in securities that are lent on margin to customers or financed by margin loans extended to them, began to increase around 1999, and in and after 2004 it has been accounting for approximately 20% of agency transactions (see table XII-5). The term "securities lending and borrowing" refers to the lending and borrowing of stock or bond certificates and is also known as stock lending or bond repurchase agreements (repo). As a lending broker demands a borrowing investor to pledge cash collateral, these transactions may also be considered financing secured by stock or bond certificates. This practice makes it easier for securities companies to finance stocks, bonds, and cash and hence to accept large orders or basket orders from customers. For this reason, it contributes to the formation of fair prices of securities and improves the liquidity of the market. Particularly, the balance of bonds lent under repurchase agreements outstanding at the end of March 2013 amounted to ¥86 trillion ($839 billion) and the repo market has grown to become one of the largest securities markets.

By "consultation to any other business operator with regard to a business assignment, merger, company split, share exchange or share transfer, or intermediation for these matters" is meant the M&A consulting service that an investment bank provides to its clients with respect to the spinning off of a business division, the computation of an IPO price, or an acquisition offer, etc.

Major securities companies, including the Big Three and second-tier brokers, also registered as investment management service providers and have started to market a "wrap account" discretionary investment service and to launch and manage collective investment schemes to invest in nonpublic companies, real estate, and others. As of the end of March 2013, according to a survey by the Japan Securities Investment Advisers Association, there were a total of 59,596 wrap accounts in the industry, holding approximately ¥865.5 billion. Major brokers, foreign affiliates, and securities subsidiaries of megabanks focus on M&A; structuring of private equity funds; and securitization (defined as business to trade monetary claims and requires notification), collectively known as investment banking services, along with securities underwriting, which is often conducted in association with these services.

In addition, following the deregulation of brokerage commissions (fully deregulated in October 1999), low-commission online stockbrokers offering service over the Internet have emerged, and their share of the market has been increasing rapidly. The number of online brokers stood at 57, with the number of accounts rising to 18.16 million at the end of March 2013. The value of cash stock and margin transactions of these online brokers during the period between October 2012 and March 2013 amounted to ¥131.19 trillion ($805.7 billion), accounting for 31.7% of the total value of agency transactions, and the online brokers sold ¥607.7 billion worth of investment trust units according to the *JSDA Monthly Report* for June 2013. Growth in the business of Internet brokers was particularly notable.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

7. Revenue and Expenditure of Financial Instruments Firms (Securities Companies)

Sources of revenue for securities companies include 1) brokerage commission; 2) management and underwriting fees; 3) selling concessions from public offerings and secondary distributions; 4) trading income (net of trading losses); 5) financial income in the form of interest on loans made in conjunction with margin transactions and lending fees on shares lent to customers, lending fees on shares and bonds lent in conjunction with transactions other than margin transactions (such as repos), interest on the cash deposited as collateral for shares or bonds borrowed, interest, and dividends and other

Table XII-10. Revenue and Expenditure of General Trading Participants of TSE

(millions of yen)

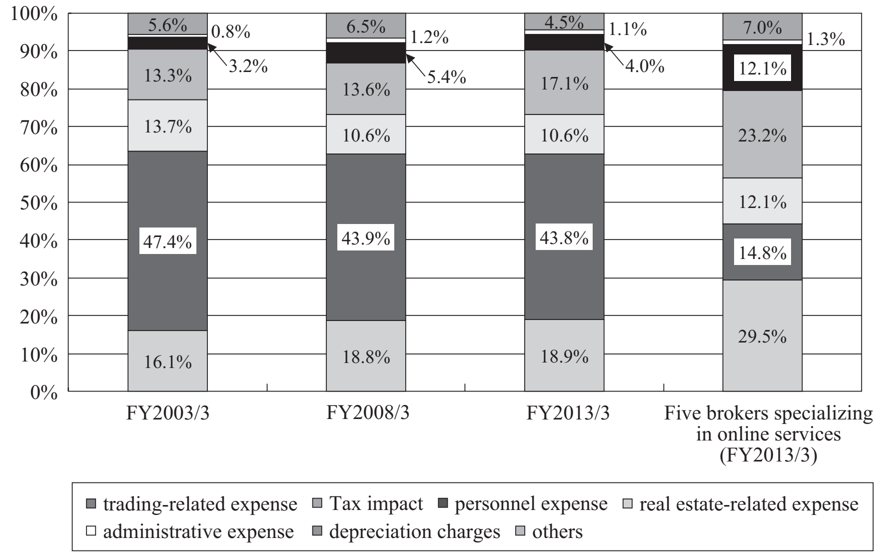
	Term ending March 2003	Ratio to net operating income	Term ending March 2013	Component ratio	Mar. 2013/ Mar. 2003
No. of trading participants	108 companies		91 companies		
Commissions received	1,348,538	66.5%	1,642,878	62.4%	121.8%
Brokerage comm.	487,174	24.0%	441,654	16.8%	90.7%
Underwriting fees	125,754	6.2%	115,111	4.4%	91.5%
Selling concession	138,578	6.8%	442,282	16.8%	319.2%
Other fees and commissions	596,912	29.5%	643,726	24.4%	107.8%
Trading Profit/loss	555,923	27.4%	826,036	31.4%	148.6%
Stocks, etc.	179,789		114,720		63.8%
Bonds	325,709		631,998		194.0%
Others	50,405		79,288		157.3%
Financial income	341,662	16.9%	436,350	16.6%	127.7%
Margin trading	35,985		50,239		139.6%
Other interest	305,677		386,111		126.3%
Financial expenses	219,580	10.8%	271,930	10.3%	123.8%
Margin trading	22,586		10,386		46.0%
Other interest	196,994		261,544		132.8%
Total of net operating revenue	2,026,543	100.0%	2,633,334	100.0%	129.9%
Total of operating revenue	1,893,393	93.4%	2,101,719	79.8%	111.0%

Note: Component ratios represent percentages of the net operating revenue.
Source: Compiled from *Earnings Summary of General Trading Participants*, TSE.

distributions on securities held in inventory; and 6) other fees and commissions, including those received in connection with incidental or concurrent businesses, chief of which are agency fees received from investment trust management companies for handling the payment of dividends and other distributions and fees from investment banking customers for the provision of information and advice, etc., on best capital policies and M&A opportunities.

On the other hand, expenditures of securities companies consist of 1) selling and administrative expenses (personnel expenses, rent and other real estate expenses, administrative costs, trade-related expenses, etc., and 2) financial expenses (interest and fees on brokers' loan and stock certificates borrowed from securities finance companies in connection with margin transactions, interest and fees on brokers' loans and bonds borrowed in

Chart XII-4. Expense Structure of General Trading Participants of the TSE



Note: The five brokers specializing in online services refer to SBI, Matsui Securities, Rakuten Securities, Monex Inc., and Kabu.com Securities.
Source: Compiled from the TSE's Earnings Summary of General Trading Participants and from investor relations materials (nonconsolidated) from the five online brokers.

connection with repos, interest on bank loans and outstanding bonds, etc). Revenues generated from the securities business are called "operating income."; Deducting financial expenses from that amount yields "net operating income," and net operating income less selling and administrative expense is called "operating profit." Nonoperating income or loss is added to operating profit to reach "current (or recurring) profit." Profit or loss, if any, from the sale of investment securities or real estate holdings and losses due to capital contribution to affiliates, subsidiaries, etc. (such as nonbank lenders) are further added or deducted as extraordinary profit.

Looking at income trends since 2009, commissions and trading profits have been on the decline, driven down by a sluggish market caused by the credit crisis in the United States that spilled over into Europe and the more recent Great East Japan Earthquake. When viewed over the past decade, brokerage and underwriting fees have decreased, while selling concession and other fees and commissions have increased. The increase of market shares of online brokers offering discount brokerage services has been pressuring agency commission revenue, while interest and fees on margin transactions have been growing.

Within other fees and commissions, it is believed that an amount equivalent to 60% of selling concession is commission income from the sale of beneficiary certificates of investment trusts. The remainder is accounted for by incomes derived from intra-group fees and information and advice fees, both of which have been on the rise in recent years. As for expenses, personnel costs are the largest component, but as a performance-based compensation system has been introduced at many securities companies in recent years those costs are increasingly more variable than fixed. As for online brokers, personnel costs account for less, while administrative costs, real estate expenses, including system-related costs and trade-related expenses, are larger, which demonstrates a focus on the stock brokerage business.

8. Financial Condition of Financial Instruments Firms (Securities Companies)

Reflecting—and because of—the uniqueness of their business, the balance sheets of securities companies appear to be larger than they actually are. The biggest items on their balance sheets are “loans against the collateral of securities” and “borrowings against the collateral of securities.” These are deposits made in connection with the lending and borrowing of securities (see section 6). Funds received from the borrower of a bond or other security to secure them are treated as borrowings, while funds deposited with the lender of a bond or other security to secure them are treated as loans. The trading account is one that arises from the dealing of securities, and a net long position in cash securities (securities held for trading purposes) is entered on the debit side, and a net short position is entered on the credit side of the balance sheet. Derivatives (futures, options, and swaps) are marked to market, and unrealized gains are entered under the item of derivatives transactions on the debit side and under unrealized losses on the credit side. In case a transaction was not settled after execution, an amount equivalent to the value of securities sold is entered under the item of collateral account on the debit side, and an amount equivalent to the value of securities purchased is entered on the credit side. Securities companies hold both long and short positions in a security for the purpose of speedy execution of customer orders involving cash security, derivatives, or bond repos, as well as the pursuit of arbitrage gains, and, instead of netting them out, they are required to adhere to the accounting process with stringent risk management.

Incidentally, a loan to facilitate margin trading is made in an amount equivalent to the amount required to make the margin purchase of a security by a customer, and cash collateral is deposited with a securities finance

Table XII-11. Major Accounts of Securities Companies (253 companies) as of the end of March 2013

Assets	In ¥ mil	Liabilities and capital	In ¥ mil
Cash and deposits	3,875,783	Trading products	30,118,449
Deposit	3,654,794	(Trading securities, etc.)	(19,448,399)
Customer-specific money in trust	(3,163,678)	(Derivatives trading)	(10,670,031)
Trading products	46,071,530	Collateral-for-contract account	1,580,970
(Trading securities, etc.)	(34,756,331)	Debt on margin trading	1,245,856
(Derivatives trading)	(11,315,179)	(Debt for margin trading)	(690,180)
Collateral-for-contract account	1,449,273	(Money received for securities lent for margin trading)	(555,614)
Assets for margin trading	2,751,457	Money borrowed to secure securities	50,563,857
(Money lent for margin trading)	(2,462,482)	Deposit received	2,400,855
(Cash collateral deposited to secure the securities lent for margin trading)	(288,912)	Guarantee money received	2,700,797
Loans made against the collateral of securities	49,886,370	Short-term debt	12,347,067
Short-term guarantee money submitted	2,265,740	Total of current liabilities	102,930,108
Short-term loans	687,984	Long-term liabilities	4,320,943
Total of current assets	111,981,427	Total liabilities	107,321,475
Tangible fixed assets	165,945	Capital	1,807,895
Intangible fixed assets	342,499	Capital surplus	3,036,141
Investment, etc.	1,151,521	Retained earnings	1,388,829
(Investment securities)	(791,188)	(Net profit/loss for the term)	(496,932)
Total of fixed assets	1,660,180	Total capital	6,320,241
Total of assets	113,641,827	Total of liabilities and capital	113,641,827

Note: These figures exclude those of companies that have suspended their operations. Totals may not match sums.
Source: Compiled from materials prepared by the Japan Securities Dealers Association.

company as borrowed securities deposit. On the other hand, the cash for conducting margin trading is borrowed from a securities finance company, and it is equivalent to the amount that needs to be paid to a customer for the securities sold on margin. Securities companies are required to keep customer assets segregated from their own assets and to hold them in an outside trust (see section 11); this system is called “segregated customer asset trust.” Ceilings on the ratio of individual products to the total net worth were used to control risks. However, as new products have since increased and the lesson was learned from Black Monday of 1987 (the market crash on Wall Street), the industry and the authorities became painfully aware of the need to control risk on a total basis, while the International Organization of Securities Commissions (IOSCO) called for the international harmonization of

Table XII-12. Capital-to-Risk Ratios of Trading Participant Members of the TSE (97 companies as of the end of June 2013)

The minimum ratio	206.0%
The maximum ratio	1733.4%
The median ratio	454.8%
The average ratio	525.6%
Distribution	
Those in the range of	
100%	0 company
200% to 299%	12 companies
300% to 399%	26
400% to 499%	20
500% to 599%	10
600% to 699%	12
700% to 799%	8
800% or higher	9

Source: Compiled from materials produced by the Tokyo Stock Exchange.

Table XII-13. An Outline of the Risk-to-Capital Ratio Requirements for Type I Financial Instruments Firms (Securities companies)

(Article 46-1, Paragraph 1 of the FIEA and Article 178 of the Cabinet Office Ordinance Concerning Financial Instruments Business, etc.)

Primary capital ratio = (non-fixed primary capital ÷ the equivalents of various risks) × 100%	
Non-fixed primary capital = Tier I item (equity capital) + complementary item (reserve for subordinated debt) − deducted assets (fixed assets, etc.)	Equivalents of various risks = market risk+customer risk + fundamental risks
Market risk = risk of loss that may arise from a fall in the prices of securities held by securities companies Customer risk = risk of a loss arising from the default by the other party to a transaction effected by securities companies Fundamental risks = risks that may arise in the ordinary course of business by mistakes made by members of the administrative department of securities companies	

securities regulations. Against this backdrop, securities companies have been subjected to requirements for their capital adequacy ratio. (The requirements were put into effect in 1990, and a law institutionalizing them was enacted in 1992.)

As securities companies handle products whose prices fluctuate in the market, their revenues are vulnerable to sudden changes in market prices.

Table XII-14. Orders Issued on the Basis of the Primary Capital Ratio to Take an Early Remedial Measure

Primary capital ratio		
140% or less	Required to notify the regulatory agency	Art. 179 of the Cabinet Office Ordinance Concerning Financial Instruments Business, etc
120% or more	Obligated to maintain ratio at such a level	Art. 46-6, Para. 2 of the FIEA
Less than 120%	- Denial to accept a registration application - Orders to change the method of business and deposit its property	Art. 29-4, Para. 1–6 and Art. 53, Para. 1 of the FIEA
Less than 100%	Orders to suspend business for a period of three months or less	Art. 53, Para. 2 of the FIEA
Less than 100% and has no prospects for recovery	Cancellation of registration	Art. 53, Para. 3 of the FIEA

Therefore, a framework of capital-to-risk ratio regulations was put into place so that they can maintain their solvency and protect the interests of their customers even when the prices of their assets fall by providing for a sufficient amount of liquid assets against various risk contingencies.

9. Financial Instruments Firms Associations (1)

The Japan Securities Dealers Association is regarded as the Authorized Financial Instruments Firms Association under the FIEA. Under the FIEA, an authorized association may be established only by financial instruments firms (securities companies, etc.) and shall be authorized by the prime minister (Article 67-2, Paragraph 2 of the FIEA). The JSDA aims to ensure the fair and smooth sale and purchase of securities, etc., and to contribute to the protection of investors and to enable the establishment of a market where over-the-counter securities are traded (Article 67, Paragraph 1 and 2). The principal functions of the association are (1) to undertake self-regulation and market administration and (2) to serve as a trade association of securities dealers (see table XII-15). At present, the Japan Securities Dealers Association (JSDA) is the only organization established under the FIEA.

In 1940, the government ordered securities companies to form one securities dealers association in every prefecture for the purpose of facilitating the wartime control of the securities market. After the war, the Japan Federation of Securities Dealers Association was established in 1949 as a national federation. Subsequently, however, there emerged a body of opinion that in

Table XII-15. Principal Functions of the Japan Securities Dealers Association

1. Self-regulatory and market management functions	(1) Drawing up and enforcing self-regulatory rules	With a view to facilitating the efficient operation of the securities market, the JSDA establishes various forms of self-regulatory rules applicable to securities companies and endeavors to ensure the fairness and efficiency of securities trading. The principal rules regulate: OTC trading in stocks and bonds, underwriting of securities, off-exchange trading in listed stocks, safe custody of securities, code of conduct of directors and officers, internal control system of member companies, qualifications and registration of registered representatives, advertising of member companies, solicitation and management of customers of member companies, financial instrument agent business, segregation and management of customers' assets, settlement of disputes with customers, and standardized accounting methods of securities companies.
	(2) Auditing, monitoring, and self-regulating	The JSDA inspects member companies to see whether their employees observe the laws and regulations (compliance) and the rules of self-regulation in carrying out business activities and whether they have an adequate internal control system; monitors the operation of member companies and checks to see whether they segregate customers' assets; and takes actions to discipline their directors and employees who have violated the laws, regulations, and self-regulation rules
	(3) Qualification tests, qualification renewal training and registration of registered representative	The JSDA conducts qualification tests of registered representatives; of the personnel in charge of management and control and carries out training for the renewal of qualifications. (The administrative work relating to the registration of registered representatives is commissioned by the Commissioner of the FSA).
	(4) Settlement of securities-related disputes through the mediation of the JSDA and the handling of trade-related complaints of investors	Consultation regarding a complaint concerning the business carried out by a member firm or by financial instruments intermediary service agents and mediation of a dispute between a member firm and a customer pertaining to securities transactions (Complaint consultation and dispute mediation have been commissioned to the Financial Instruments Mediation Assistance Center (FINMAC), a non-profit organization)
	(5) Services provided by the recognized personal information protection organization	The organization provides services for the proper handling of personal information of members of the JSDA as a recognized personal information protection organization under the Act on the Protection of Personal Information
	In addition to general improvement of the securities market, such as a securities settlement reform, changes and amendments to the trading rules of the equity market, and measures to deal with new financial products (including new types of investment trusts and securitization-related products), the JSDA performs the following market administration functions.	
	(6) Enhancement and improvement of the bond market	1. JSDA establishes and reviews the rules concerning transactions and practices in the over-the-counter market of bonds 2. JSDA publishes reference prices (yields) for OTC bond transactions 3. JSDA collects materials and compiles statistics concerning the bond market
	(7) Management of off-exchange trading of listed stocks	1. JSDA takes steps to ensure the fairness and efficiency of off-exchange trading in listed stocks and the protection of investors 2. JSDA collects and publishes data on the volume of listed stocks traded off exchange and publicly announces in real time price quotations, contract, and other information on listed shares traded on PTSs
	(8) The expansion of the Green Sheet market	1. JSDA manages Green Sheet and Phoenix issues (designation and cancellation) 2. Publishes information concerning Green Sheet issues (corporate information of their issuers, quotations, and trading volume, etc.) 3. Takes steps to improve the Green Sheet system and the unlisted securities trading system
2. Collective duty of securities companies, organizations	Services to promote the sound development of financial instruments business and financial instruments market	1. Investigates and studies the financial instruments market and publishes opinions 2. Establishes a common platform for the securities market 3. Makes public statistical material, etc., on the stock and bond markets 4. Disseminates knowledge about financial instruments, indexes, and markets and educates investors 5. Communicates and exchanges views with market-related organizations 6. Implements education and training programs 7. Supports actions to eliminate antisocial forces 8. Conducts international business and international exchange

Table XII-16. Permissible Forms of Business by Registered Representatives (JSDA Rules: Article 2, Regulations Concerning Qualification and Registration, etc., of Sales Representatives of Association Members)

Class 1 Sales Representative	Sales representative who is authorized to engage in all acts of a sales representative with the exception of designated over-the-counter transactions of derivatives
Margin Transaction Sales Representative	Sales representative who is authorized to engage in all Acts of a Sales Representative by a Class 2 Sales Representative and acts of a sales representative relating to margin transactions (including "when-issued" transactions)
Class 2 Sales Representative	Sales representative who is authorized to engage in all Acts of a Sales Representative related to any securities with the exception of stock subscription rights or covered warrants (excluding Acts of a Sales Representative related to securities derivative transactions or transactions in bonds with options, and limited to the cases prescribed by the detailed rules regarding margin transactions)
Special Member Class 1 Sales Representative	Sales representative who is authorized to engage in all Acts of a Sales Representative related to the business of a registered financial institution (with the exception of designated over-the-counter transactions of derivatives, financial instruments intermediary service, or brokerage with written orders)
Special Member Class 2 Sales Representative	Sales representative who is authorized to engage in all Acts of a Sales Representative related to transactions of public and corporate bonds, commercial papers, investment trust certificates, etc. (excluding Acts of a Sales Representative related to securities derivative transactions or transactions in bonds with options)
Special Member Class 4 Sales Representative	Sales representative who is authorized to engage in all Acts of a Sales Representative related to "Specified Financial Instruments Business" (marketing of investment trusts and other specified acts of an insurance company or other financial institution)

order to improve the self-regulatory functions of the securities industry it was necessary and proper to consolidate the securities dealers associations into a single body. In deference to this view, 33 associations were consolidated into 10 in 1968, and a single national body, the JSDA, was formed, with the former 10 associations reorganized as regional subdivisions of the JSDA. At present, there are 9 regional associations: Hokkaido, Tohoku, Tokyo, Nagoya, Hokuriku, Osaka, Chugoku, Shikoku, and Kyushu. (The regional associations of Kyushu and South Kyushu were consolidated into one in 1995.)

Since securities company scandals came to light in 1991, pressure to strengthen the self-regulatory function of the JSDA has mounted, and the status of the JSDA was changed from a public-service corporation under the Civil Code to a legal entity under the Securities and Exchange Law, and the Ministry of Finance (the present Financial Services Agency) commissioned the JSDA to handle the registration of registered representatives. This helped define the status of the JSDA as a self-regulatory organization of the securities industry. Under the regulations of the JSDA, registered representative qualifications are classified into Class I registered representatives; margin trading registered representatives; Class II registered representatives; Special Member Class I registered representatives, Special Member Class II registered representatives, and Special Member Class IV registered representatives. (The definition of commission-registered representatives and their qualification requirements were abolished by virtue of the 2003 amendment to the regulations.) In July 1998, the Bond Underwriters Association of Japan was consolidated into the JSDA, and in July 2004 the JSDA was reorganized into a structure consisting of the Self-Regulation Division, the Securities Strategy Division, and the General and Administration Division. As the JASDAQ Stock Exchange was established (see chapter 10) in December 2004, the OTC securities market was closed, and the JSDA consolidated the Securities Information Center under its wing in April 2005.

Financial institutions that are engaged in the securities business under registration made pursuant to the provisions of Article 33-2 of the FIEA (see section 11) have joined the JSDA as special members since 1994. As of the end of September 2013, the JSDA had 260 regular members (16 of them were foreign securities companies) and 213 special members (including 132 banks, 14 foreign banks, 39 *shinkin* banks (credit unions), 11 life insurance companies, 5 property and casualty insurance companies, and 12 others).

10. Financial Instruments Firms Associations (2)

Unlike the Securities and Exchange Law, the Financial Instruments and Exchange Act (FIEA) provides for the comprehensive regulation of a diverse range of collective investment schemes (so-called funds) and investment trust beneficiary certificate sales businesses. Self-offerings by funds, sales of investment trust beneficiary certificates, and some other businesses are defined under the FIEA as Type II Financial Instrument Businesses (“Type II businesses”). Because financial instruments, such as funds, etc., are not highly circulated, the registration requirements for Type II businesses are lenient, such that even individuals may register as businesses. The underlying assets of funds, investment trust beneficiary certificates, and similar products cover a wide range of real estate, specified instrument, and other assets. Registered Type II businesses, therefore, are not solely securities companies; many real estate companies also have entered the market.

As a result, the number of registered Type II businesses had risen to 1,276 as of August 2013, exceeding by four times the number of Type I Financial Instruments Businesses (securities companies, financial futures companies, etc., hereinafter referred to as “Type I businesses”). The lax registration

Table XII-17. Numbers of Registered Financial Instruments Firms and Related Financial Instruments Firms Associations

Business Category	Registered Firms (at Aug. 31, 2013)	Related Financial Instruments Firms Associations	
Type I	283	(Approved) Japan Securities Dealers Association	260 Regular members (at Sept. 30, 2013)
		(Recognized) Financial Futures Association of Japan	154 Regular members (at Sept. 30, 2013)
Type II	1,276	(Recognized) Type II Financial Instruments Firms Association	33 Regular members (at Aug. 2013)
Investment advisory and agency	1.023	(Recognized) Japan Investment Advisers Association	508 Investment advisory and agency members (Oct. 2013)
Investment management	315		245 Investment management members (Oct. 2013)
		(Recognized) The Investment Trusts Association, Japan	85 Investment trust members (Sept. 2013)
			45 REIT members (Sept. 2013)
Total	2,897 (total number of registrants)		
	2,087 (actual number of firms)		

Note: Of the 283 Type I businesses, 23 (FX specialists) are not members of JSDA, but have joined the Financial Futures Association of Japan. Because some firms are registered under multiple business categories and with multiple associations, the totals do not match the sum of the individual numbers.

Sources: Produced using the Financial Services Agency's "List of Recognized Financial Instruments Firms Association" and "List of Registered Financial Instruments Firms" and data from associations' websites.

• In addition to the above, there are firms deemed to be Qualified Institutional Investors that do not have to register, most of which are not members of any of the above financial instruments firms associations.

When one or more investor is a Qualified Institutional Investor and other investors (general investors) number 49 or less among investors in a collective investment scheme (fund), under the Special Provisions Concerning Specially Permitted Businesses for Qualified Institutional Investors, the financial instruments firm is exempt from registration and may conduct management and self-offering of the fund by submitting notification of such to authorities.

Reference: Essentially, firms or individuals with special investment skills have been allowed to participate in the market without registering and only a duty to submit notification of their businesses in order to enable them to offer their superlative investment instruments to professional investors at low cost. Of course, there are firms or individuals within this group that achieve excellent results and become members of one of the above associations, thereby being covered by self-regulatory rules. However, there are also firms or individuals that clearly have gathered together one Qualified Institutional Investor and 49 individual investors with the intention of using the provisions as a legal loophole to avoid registration of a Type II business or investment management business. Other firms use the provisions as a method to persuade investors that their business is as good as guaranteed by the Financial Services Agency because they have submitted a notification. The fact that almost all of these firms are not subject to self-regulatory rules seems to be a problem.

requirements, however, have resulted in lawsuits regarding the solicitation for self-offerings, etc., of funds and other incidents requiring administrative discipline because of legal violations.

To address such issues, the Type II Financial Instruments Firms Association was established in November 2010 and designated a recognized Financial Instruments Firms Association (FIEA, Article 78, Paragraph 1). The association aims to contribute to the fair and smooth operation of Type II businesses as well as to their sound development and to investor protection. It was set up taking into account the already in place self-regulatory systems of the self-regulatory organizations (SROs) for Type II businesses, investment trust businesses, agency businesses, etc.

Establishing an "approved" association in Japan requires the consent of the prime minister of Japan. But "recognized" associations need only be acknowledged by the prime minister following their establishment. The Japan Securities Dealers Association is the only "approved" association in Japan's securities market. The country's "recognized" associations, however, include the Financial Futures Association of Japan; the Japan Investment Advisers Association; the Investment Trusts Association, Japan; and, of course, the Type II Financial Instruments Firms Association. The major difference between the two types of associations is that "approved" associations are able to establish and operate OTC markets (refer to section 9).

Other than that single difference, "approved" and "recognized" associations carry out the same self-regulatory operations. The associations are responsible for (1) forming rules and regulations, (2) inspecting members to determine their state of compliance with laws and ordinances and self-regulation rules, (3) disciplining members that have violated laws and ordinances and self-regulation rules, (4) resolving complaints and disputes involving members' businesses, (5) mediating conflicts about members' businesses, and (6) carrying out sales representative registration operations when so commissioned by the government authorities. Acting as a trade association is another possible function of these associations.

There are 2,087 registered financial instruments firms in Japan, with some firms being registered under multiple business categories and some being members of multiple SROs. In contrast, there are 3,038 organizations classified as Qualified Institutional Investors that are not registered despite carrying out self-offerings of funds just like Type II businesses. Almost all of these Qualified Institutional Investors are not covered by self-regulatory rules.

11. Investor Protection Fund

The purpose of an investor protection fund is to protect the claims that general

Table XII-18. Investors Eligible for Compensation, Compensation Procedures, and Sources of Funds of the Investor Protection Fund

Those eligible for compensation	(1) Eligible persons (Art. 79-20, Para. 1)	"General Customer" that conducts a Subject Securities-Related Transaction with a Financial Instruments Firm (excluding a Qualified Institutional Investor, central or local government, or any other person specified by a Cabinet Order)
	(2) Scope of customer assets eligible for compensation (Art. 79-20, Para. 3)	i) Money or securities deposited as a margin for exchange transactions of derivatives, etc., or money or securities deposited as guarantee money for margin transactions, etc.; ii) money belonging to the account of or deposited by a customer with regard to a transaction pertaining to Financial Instruments Business (such as advance payment for purchase, proceeds from a sale that has not been withdrawn, etc.); iii) securities (securities deposited for sale or held in safekeeping); and iv) other customer assets specified by a Cabinet Order
Compensation procedures	Notice and recognition (Art. 79-53 and -54)	When the Fund receives a notice from a financial instruments firm or the Prime Minister, it shall recognize whether or not there is any difficulty for the firm to perform the obligation to return or refund customer assets pertaining to such notice.
	Public notice of recognition (Art. 79-55)	When a Fund has granted recognition to the effect that it is difficult for a financial instruments firm ("Notifying Financial Instruments Firm") to perform the obligation to return or refund customer assets, it shall give a public notice that prompts the relevant customers to file a claim for the return or refund of their assets.
	Payment of claims eligible for compensation	A Fund shall, when having made a payment to General Customers, acquire claims eligible for such compensation of the amount commensurate with its payment. The Fund shall collect the claims from the bankrupt financial instruments firm through bankruptcy proceedings.
	Loans to a "Notifying Financial Instruments Firm" (Art. 79-59)	When the financial position of a "Notifying Financial Instruments Firm" has deteriorated to such a point that, while it does not yet face difficulties in returning and refunding customer assets, loans from the Fund could facilitate expedited return or refund, the Fund may make loans to such "Notifying Financial Instruments Firm."
Source of funds	Investor Protection Fund (Art. 79-64 and 79-65)	Burden charges collected from member financial instruments firms shall be the source of funds.
	Borrowing (Art. 79-72)	Borrowings from financial institutions may be made with the approval of the Prime Minister of Japan and the Minister of Finance.

customers have on the securities companies they deal with. As we saw in section 1 of this chapter, the 1998 amendment to the Securities and Exchange Law changed the licensing system of securities companies to a less-demanding registration system, encouraging nonsecurities companies to enter the securities market, and relaxed restrictions against conducting side business, liberalizing the lines of business that securities companies can undertake. And this created the need to take measures to protect investors from any unforeseen loss that they may suffer from insolvency of the securities companies

Table XII-19. An Outline of the Investor Protection Fund

	Japan Investor Protection Fund	Securities Investors Protection Fund
No. of members (at the time the fund was established)	235 companies (224 domestic and 11 foreign-affiliated companies)	46 companies (1 domestic and 45 foreign-affiliated companies)
Scale of the fund	¥30 billion at the time of establishment, and ¥50 billion at the end of March 2001	¥10 bil at the time of establishment (¥3 bil in cash and ¥7 bil guaranteed) and ¥5 bil in cash and ¥5 bil guaranteed after April 2001
Burden charge on members	A fixed amount and a fixed rate of burden charge (computed on the basis of the operating income and the number of registered representatives). The total of annual burden charge is ¥4 bil.	1% of the customer assets, and a bank guarantee of an amount equivalent to 50% of margin trading requirement. When the fund falls ¥1 bil or more short of ¥10 bil, members are asked to contribute an additional burden charge.
Remarks	The fund has taken over the compensation service provided by the Deposited Securities Compensation Fund and its entire assets and liabilities.	Members are required to have their books audited by outside auditors.
	The two organizations were consolidated in July 2002 into the Japan Investor Protection Fund. As of March 31, 2013, there were 253 member firms and the size of the fund was approximately ¥55.4 billion.	

they deal with. The government instituted provisions in the 1998 amendment to the Securities and Exchange Law (the present FIEA) with a view (1) to preventing bankruptcy of securities companies, empowering the Financial Services Agency to take an early remedial measure on the basis of the capital-to-risk ratio (Article 53 of the FIEA; see section 8 of this chapter) and as a framework to protect investors in case the securities companies they deal with went bankrupt; (2) to requiring securities companies to manage their customer assets separately (Articles 43-2 and 3); and (3) to establishing an investor protection fund (Articles 79-20 through 80). In line with this, the Law Concerning Special Exception to the Bankruptcy Proceedings of Financial Institutions (the Law Dealing with the Bankruptcy of Financial Institutions, for short) was amended, and this amended law is applicable to securities companies.

The system of the segregated custody of securities is designed to recover the assets of customers in preference to other creditors of a security company if it goes bankrupt by holding the cash and securities of its customers separately from its proper assets. It is done in two ways: 1) securities of its customers are kept separately and 2), with respect to a customer's cash and substitute securities deposited with the securities company as collateral for margin trading, etc., that are impossible to physically identify when they are rehypothecated, the securities company deposits in an outside account an amount equal to its customers' claim, net of their liability, to the securities company (this is called "customers' separate fund"). If this system of separate management were strictly enforced, customers would not suffer any unforeseen loss even if their securities company went bankrupt. However, the rub is that the customers' separate fund is computed only once a week, and the possibility of misappropriation of its customers' fund by a securities company cannot be ruled out.

Therefore, with a view to strengthening the protection of investors, investor protection funds were established as legal entities under the Securities and Exchange Law (currently under the FIEA). To accomplish the above purpose, the investor protection fund (hereinafter referred to as the "fund") will 1) pay a specified amount of money (up to ¥10 million) per customer to insure the repayment of his/her assets in the case of bankruptcy of a securities company and 2) make loans to securities companies to facilitate the prompt return of customer assets.

To enable the fund to provide such services, it is empowered by law to 1) perform any and all acts that are necessary to preserve customer assets held by securities companies, 2) become a trust manager of securities companies, and 3) create a fund for the protection of investors to secure the necessary funds and collect burden charges from its member companies. Members of the fund must be financial instruments firms. More than one investor protection fund may be created, and securities companies (Type 1 Financial Instruments Firms) must participate in one of them.

12. The Securities Business of Banking Institutions

Since 1948 banking institutions had been prohibited, in principle, from doing securities business under Article 65, Paragraph 1 of the Securities and Exchange Law (SEL). As the Banking Law did not explicitly authorize banking institutions to conduct certain business related to public bonds or brokerage with written orders, which were provided for as exceptions to the above prohibition (Article 65, Paragraph 2 of the Securities and Exchange Law), banking institutions (except for trust banks, which could pass their customer orders on to a securities company) did not conduct securities business. Since 1975, the government has issued massive amounts of debt securities. With a view to facilitating the sale of its debt securities, the government enacted a new Banking Law in 1981 explicitly authorizing banking institutions to trade in bonds, and it also correspondingly amended the Securities and Exchange Law. Accordingly, banking institutions started selling public bonds over the counter in 1983 and dealing in bonds in 1984.

Table XII-20. Balance of Investment Trusts, by Seller (as of Sept. 30, 2013)

(100 millions of yen)

	Securities companies		Banks (registered financial institutions)		Direct sales (investment trust management companies)		Total
Stock investment trusts	357,428	57.3%	261,581	41.9%	5,243	0.8%	624,252
Bond investment trusts	124,241	86.4%	854	0.6%	9	0.0%	143,818
MMFs	14,555	77.8%	4,138	22.1%	21	0.1%	18,713
Total	496,223	64.6%	266,573	34.7%	5,273	0.7%	768,069

Note: These figures are based only on beneficiary certificates publicly offered, and those for bond investment trusts do not include MMFs.
Source: Compiled from statistic produced by the Investment Trusts Association, Japan.

Subsequently, the following services have been added to types of securities businesses that banking institutions are allowed to provide: 1) brokerage for transactions in bond futures (1988); 2) trading, etc., and involvement in private placement of commercial papers (CPs), foreign certificates of deposit (CDs), beneficiary certificates of mortgage bond trusts, etc. (1992); 3) handling of OTC derivatives of securities and public offerings of beneficiary certificates of investment trusts (1998); and 4) securities agent business (2004). Moreover, the registration system of securities companies and the system of authorizing certain securities businesses instituted in 1998 are also applied to banking institutions. And banking institutions that have registered under this system are called "registered financial institutions." The provisions remained intact under the FIEA after its full enforcement in September 2007, with the only change being the number of the article (Article 65, Paragraph 1 and 2 of SEL became Article 33, Paragraph 1 and 2 of the FIEA).

These were the types of securities business that financial institutions were allowed to directly engage in. On the other hand, the 1992 Financial System Reform Law authorized banks, securities companies, and trust banks to enter one another's markets through subsidiaries. And over the period between 1993 and 1995, banking institutions established 19 securities subsidiaries. (Subsequently, the number has decreased to 2 on account of bankruptcies of parent banks, mergers, business combinations, or other reasons.) At first, with a view to preventing potential adverse effects, the regulatory agency (1) restricted the scope of business that the securities subsidiaries of banks may conduct (i.e., the prohibition of stock brokerage, etc.) and (2) required the installation of a firewall between securities subsidiaries and their parents. The restrictions on the scope of business have been lifted in stages, and the stock

Table XII-21. Firewall between Parent Bank/Banking Subsidiary and Securities Subsidiary/Parent Securities Company (Article 44-3, FIEA)

(1) Arm's-length rule	A financial instruments firm, etc., or officers or employees thereof shall not conduct the sale, purchase, or other transactions of securities or over-the-counter transactions of derivatives with the parent/subsidiary bank of the financial instruments firm, etc., under terms and conditions that are different from the ordinary terms and conditions and possibly detrimental to the fairness of transactions;
(2) Prohibition of tying credit with the sale of a security	A financial instruments firm, etc., or officers or employees thereof shall not conclude a contract concerning a securities transaction, etc., with a customer knowing that the parent/subsidiary bank of the financial instruments firm, etc., has granted credit to the customer on the condition that said contract should be concluded with the financial instruments firm, etc.;
(3) Prohibition of acts in the investment advisory and investment management businesses with conflicts of interest with customers	A financial instruments firm, etc., or officers or employees thereof shall not conduct or give advice to conduct any unnecessary transaction for the purpose of securing the interest of the parent/subsidiary bank of the financial instruments firm, etc.;
(4) Prohibition and restriction of acts likely to undermine the protection of investors, impair the fairness of transactions, or compromise the credibility and integrity of the securities markets (Art. 153 and 154 of the Cabinet Office Ordinance Concerning Financial Instruments Business, etc.)	i) Arm's-length rule relating to the sale of assets and other transactions;
	ii) Prohibition of conclusion of a financial instruments transaction contract knowing that the parent/subsidiary bank of a financial instruments firm, etc., is conducting the transaction in assets, etc., at terms and conditions beneficial to itself;
	iii) Provisions requiring the disclosure of conflicts of interest in underwriting securities issued by an obligor to the parent/subsidiary bank;
	iv) Restrictions against underwriting securities issued by the parent/subsidiary bank;
	v) Prohibition of selling an underwritten security with financing provided by the parent/subsidiary bank;
	vi) Restrictions against selling an underwritten security to the parent/subsidiary bank;
	vii) Restriction of exchanging unpublished information concerning an issuer, etc., or customer, etc., between a parent company and its subsidiary without prior written consent;
	viii) Prohibition of acts in connection with joint visits of representatives from parent and subsidiary legal entities that may mislead customers to identify the two entities as one;
	ix) Prohibition of acts in the investment advisory and investment management businesses that aim to manipulate the price of a security the offering of which is lead managed by the parent/subsidiary financial instruments firm or parent/subsidiary bank with the purpose of influencing the terms of the offering; or
	x) Prohibition of acts in the investment advisory and investment management businesses of subscribing to a security the offering of which is underwritten by the parent/subsidiary financial instruments firm or parent/subsidiary bank when the offering is not fully subscribed.

brokerage business was deregulated in October 1999. With respect to the firewall, the prohibition of making joint visits (of representatives from both parent and subsidiary companies) and the lead manager restrictions on securities subsidiaries for public offerings of securities issued by a certain customer of their parent bank have been relaxed, and the ban on opening banking and securities joint branch offices was lifted in September 2002. At the same time, the interpretation of provisions relating to brokerage with written orders was relaxed. In March 2005, banks were allowed to introduce customers to securities companies as initial public offering (IPO) candidates

Table XII-22. Banking and Securities Joint Branch Offices and Financial Instrument Intermediary Business of the Three Largest Financial Groups

Banking and Securities Joint Branch Offices of Mega Bank-Groups

Banks	Securities companies	Number of joint branch offices
Mizuho Bank, Ltd.	Mizuho Investors Securities Co., Ltd.	Planet Booth, 168 (as of July 2013)
The Bank of Tokyo-Mitsubishi UFJ, Ltd.	Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.	MUFG Plaza, 30 (as of Mar. 2013)
Sumitomo-Mitsui Banking Corporation	SMBC Friend Securities Co., Ltd.	5 (as of Mar. 2013)

Source: Compiled from the IR information, etc., published by the companies. The collaborative business of Sumitomo-Mitsui Banking Corporation and SMBC Friend Securities was transferred in 2011 to SMBC Nikko Securities.

Contribution from Intermediary Business to the Retail Operation of Mitsubishi UFJ Morgan Stanley Securities (FY2013/3)

	Assets under custody	Outstanding account	Sale of investment trusts	Retail JGB	Retail foreign bonds
Total	25,799 (27,492)	276 (278)	2,314 (1,053)	240 (407)	5,413 (4,738)
% of total	11.3% (13.0%)	20.2% (19.8%)	14.6% (8.3%)	81.6% (81.1%)	52.6% (53.7%)

Note: Assets under custody and outstanding accounts figures are as of the end of March 2011. Percentages are of total amounts. The top figures in the total line are domestic totals, including financial institutions, while the figures below in parentheses are comparative figures from 2010.
Source: Compiled from the databook provided for the FY2012 investor information meeting of the Mitsubishi UFJ Financial Group.

Table XII-23. Benefits of Collaboration of Mizuho Bank and Mizuho Investors Securities

	FY2007/3	FY2008/3	FY2009/3	FY2010/3	FY2011/3
Combined profits (100 millions of yen)	35,354	27,508	14,393	15,103	16,594
Combined assets under management (100 millions of yen)	28,179	28,131	26,292	30,260	29,949
Combined new accounts	11,159	8,622	12,495	8,131	6,385

Source: Compiled from Mizuho Investors Securities' FY2010 Business Report. Mizuho Investors Securities was absorbed in a merger with Mizuho Securities in January 2013 (currently, Mizuho Securities).

(business lead service). In June 2009, the joint position regulations prohibiting officers and employees of securities companies and banks from working on both sides of the firewall were lifted, allowing them to share confidential information of corporate customers as long as the clients did not opt out of this arrangement. As a result, megabank groups are developing joint banking and securities businesses.

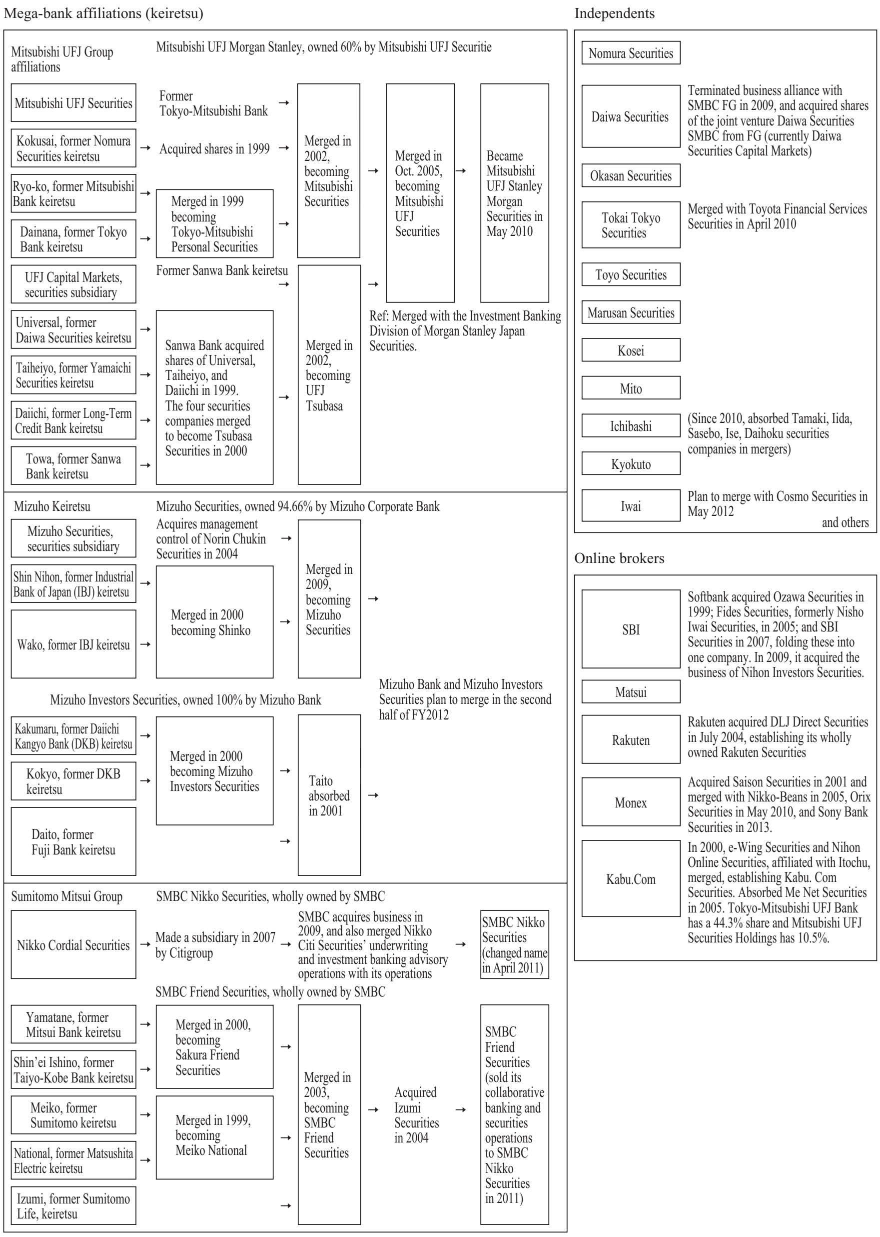
13. The Competitive Landscape of the Securities Industry

In the securities industry of Japan, the Big Four securities companies not only had commanded the largest share in all segments of the market but also had many small and midsized securities companies as their affiliates (called "keiretsu companies"), and the structure of competition used to be characterized as the "Big Four oligopoly." However, the Big Four oligopoly broke down in the 1990s as (1) Yamaichi Securities went bankrupt in 1997; (2) Daiwa and Nikko split up their companies into two divisions in 1998—the wholesale division (providing underwriting, M&A, and other services to corporate customers as well as catering to the needs of institutional investors by, for example, providing liquidity by use of proprietary capital) and the retail division (providing individual investors with a brokerage service and offering the sale of investment trusts); and (3) Nomura, Nikko (later changed name to Nikko Cordial), and Daiwa liquidated their holdings of shares in their affiliates. Following an accounting scandal, Nikko Cordial was acquired by Citigroup in 2007 and currently is called SMBC Nikko Securities.

The business strategy of the former Big Four was to increase their shares in the brokerage market and win the mandate as the lead manager of equity financing by taking advantage of their share in brokerage. To achieve such goals, they sought to build a nationwide network of branches, hire a large number of employees loyal to their company, and lure many member companies of the stock exchanges under their umbrella. However, as such strategy entailed huge costs and risks, only a small number of securities companies could afford to pursue the strategy by providing full-line services (and by diversifying the sources of income thereby). In consequence, there came into existence only a few big and integrated securities companies that adopted the Japanese-style employment system with many affiliated brokers.

Their business strategies and management systems had played an important role during the rapid economic growth period as mechanisms nimbly supplying large amounts of capital to cash-starved industries of the country. As the years rolled on into the 1990s, however, the basic structure of the Japanese economy drastically changed, causing a mismatch between their business strategy and reality. The challenges facing today's Japanese economy

Chart XII-5. Mega-Bank Securities Subsidiaries and Independent Securities Companies



are to improve the effectiveness of the use of funds to reorient the structure of its industries and to provide for the aging of its population. The roles the securities industry is expected to play in the coming years are 1) to find and incubate emerging companies by promoting private equity investments; 2) to help legacy industries and incumbent businesses expedite their renovation and streamlining by advising them on the securitization of assets, M&A, and other measures and by underwriting the securities they issue; and 3) to direct household savings into the securities markets by offering investment advice based on quality research and professional investment management services.

To accomplish this, it is necessary for securities companies to train and secure specialists by spinning off business divisions according to their specialties. What is more, the practice of maintaining an extensive network of affiliates no longer makes economic sense, and the shares of affiliates the parent securities companies hold will have to be liquidated. Meanwhile, banks and other corporations that are keen to enter the securities business have bought the shares that parent securities companies wanted to dispose of, and reorganization of the banking industry has resulted in the merger and consolidation of bank-affiliated brokers. Some brokers also have been bought out by the management (MBO). The *keiretsu* of brokers, therefore, is no longer rigid.

CHAPTER XIII

Asset Management Service

1. Investment of Individual Financial Assets

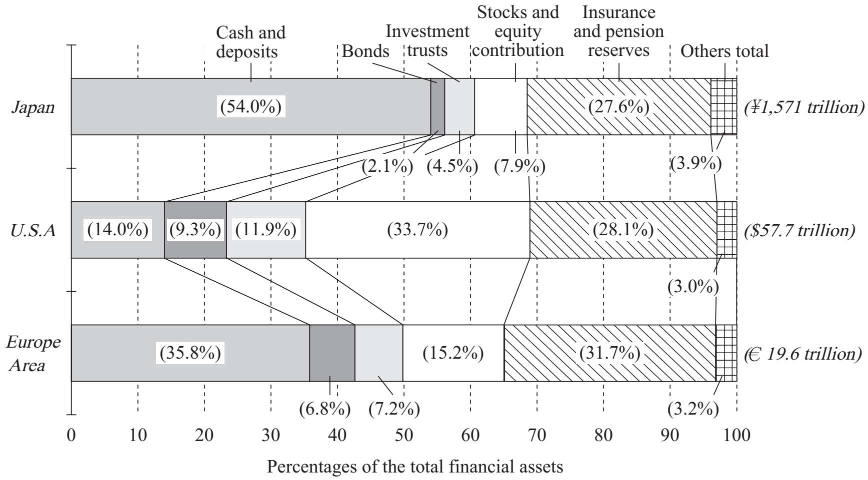
According to a 2013 first-quarter survey by the Bank of Japan, “Comparison of the Flow of Funds between Japan, the United States, and Europe,” at the end of March 2013 individuals in Japan had ¥1,571 trillion ($15.3 trillion) worth of financial assets. Of this amount, 54.0% was invested in cash and deposits and 14.5% in securities investments (stocks and equity contributions, 7.9%; investment trusts, 4.5%; bonds, 2.1%).

Compared with the United States, with 14.0% in cash and deposits and 54.9% in securities investments, and Europe, with 35.8% in cash and deposits and 29.2% in securities investments, Japan’s individual financial assets are heavily skewed toward cash and deposits and thinly invested in securities. In the 2012 survey by Japan FSA’s Central Council for Financial Services Information, 46.7% of respondents said that they focus on “security” as their reason for selecting financial products, while 24.7% said “liquidity.” Only 16.9% of respondents said that they focus on profitability.

Individual financial assets in Japan thus are mainly invested in low-risk bank deposits, with little preference for more profitable securities, particularly stocks. Certainly during Japan’s era of deflation the heavy investment in bank deposits probably turned out to be the right call. With, however, the introduction of an inflation target in Japan and the implementation of massive quantitative easing to achieve that target, it is possible that the focus on safety carries with it the risk that the real value of cash will erode because of inflation. As a countermeasure, the government introduced a preferential tax treatment investment system in January 2014 to promote the shift from “Savings to Investment” (NISA, a small-amount investment tax exemption plan). The goal of the system is to support asset formation and to expand the supply of growth capital from households.

Asset management companies include trust banks, life insurance companies, and discretionary asset management firms that manage the pension and insurance reserves of individuals. Representing people’s insurance for the future, those reserves account for 27.6% of individual financial assets.

Chart XIII-1. Composition of Household Assets (at March 31, 2013)



Source: Bank of Japan, "Comparison of the Flow of Funds between Japan, the United States, and Europe."

Table XIII-1. Outline of Nippon Individual Savings Account (NISA)

Eligible Investors	Any residents of Japan aged 20 years or more.
Tax-Exempt Income	Dividends, coupons, and capital gains from listed stocks, investments trusts, etc.
Tax-Exempt Investment Amount	Maximum of ¥1 million in new investment annually (Total tax-exempt investment amount is ¥5 million)
Tax Exempt Period	Maximum of 5 years *After initial 5-year period, possible to continue program by reinvesting in the NISA account.
Allowed Investment Period	April 2014 to March 2023 (10 years)
Number of Accounts	One account per person

Investment trust management companies are also asset management companies, handling investment trusts that account for 4.5% of individual financial assets. Either indirectly or directly, asset management companies play an important role in financial asset formation by individuals in a society with low birth and mortality rates.

These asset management companies also contribute to growth in corporate performances and to the sound development of the economy—and therefore society—through the following two functions. To begin with, they fulfill a role in achieving the efficient allocation of capital by supplying growth companies with capital through the market. This function is especially pronounced when the asset management companies use active investment policies. Furthermore, they work to raise stock prices by exercising the voting rights of their customers in the general meetings of shareholders of the companies they are invested in and contribute to improving corporate governance.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

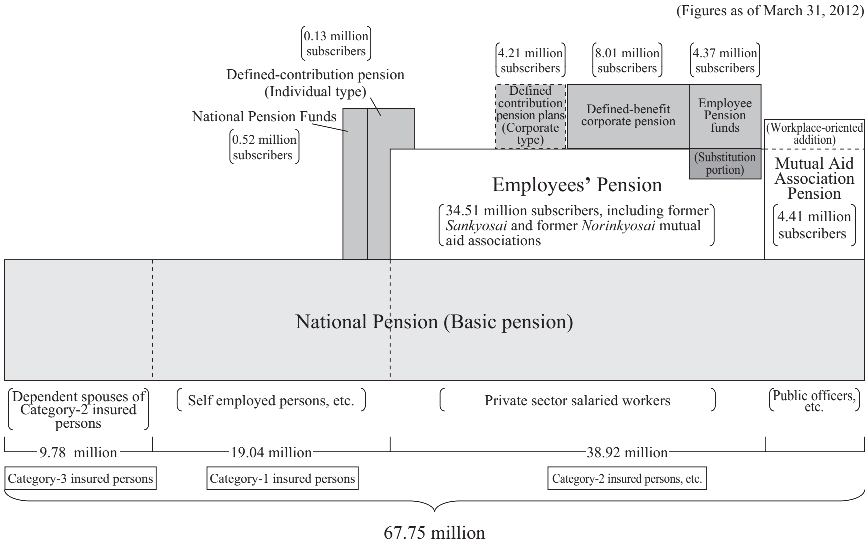
2. Pension Fund Management

Japan's pension plan system is a three-tier system consisting of (1) a foundational national pension (basic pension) common to all citizens supplemented by (2) employee pension plans (employee pension and mutual aid association pensions) and (3) corporate pension plans (employee pension funds, defined-benefit corporate pension, and individual-type defined-contribution pension) for civil servants and private-sector salaried employees. Of these plans, the national pension and employee pension plans utilize a pay-as-you-go system that provides support shared among generations in the form of public pensions, while corporate pension plans use a funding system in the form of private pensions.

Employee pension funds comprise a substitutional portion received from the public employees' pension insurance system and their own fund termed the "plus alpha" portion. In the past, the substitutional portion formed the core of these funds. Following the bursting of the economic bubble in Japan, however, difficult asset management conditions resulted in the substitutional portion placing a heavy burden on employee pension funds. Companies one after the other reacted by either terminating the funds or returning the substitutional portion to the government and converting their funds to defined benefit pension funds. Defined benefit pension funds do not have this substitutional portion, allowing for flexible system planning with the agreement of the labor force. The corporate type of defined contribution pension plan differs from the previous pension system with fixed benefits (defined benefit corporate pension) in that the contributed premium of each individual is clearly segregated, with pension benefits being determined based on the total of a fixed premium and investment income.

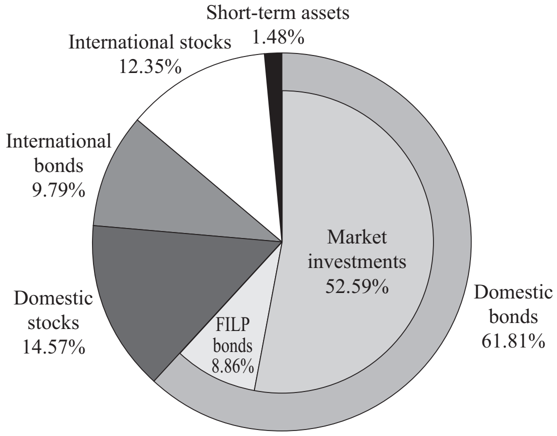
The management of pension plans must be safe and efficient in the interest of protecting future benefits. With the exception, therefore, of a few large-scale pension funds that manage investments in-house, asset management of the pension fund is commissioned to outside experts. According to the 2011

Chart XIII-2. Structure of Pension System



Source: Ministry of Health, Labour and Welfare

Chart XIII-3. Asset Allocation at the End of FY 2012



Source: Government Pension Investment Fund (GPIF) fiscal year asset management survey by the Pension Fund Association, the allocation of corporate pension funds to asset managers was trust banks, 48.8%; discretionary asset management companies, 28.5%; and life insurance companies, 22.2%. By composition of fund assets, domestic bonds accounted for 27.2%, domestic stock for 17.4%, foreign stock for 16.3%, the general account of life insurance companies for 14.0%, foreign bonds for 12.0%, and others for 8.8%. Asset management experts, of course, are not always the answer. Given the pension fund scandal and other incidents uncovered in 2012, there is a need for thorough risk management and diversified portfolio investment for employee pension funds that address the concerns raised by the separately managed substitutional portion.

The cumulative reserves of the national pension and employee pension plans are administered and managed by the Government Pension Investment Fund (GPIF). At the end of 2012, the asset composition of the funds managed by the GPIF were domestic bonds, 61.8%; domestic stock, 14.57%; foreign stock, 12.35%; and foreign bonds, 9.79%, indicating a heavy weighting on domestic bonds. Because of this conservative approach, there is ongoing discussion of such methods of improving investment returns as promoting more diversified investment, implementing risk management systems overseen by a governance structure, and practicing long-term investment policies with stocks.

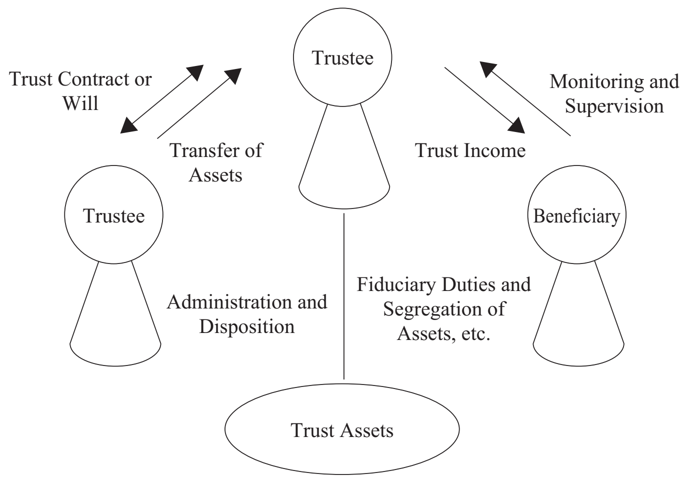
3. Asset Management of Trust Banks

Entrustment occurs when (1) an entity (trustor) transfers its rights to property to an entity that can be depended on (trustee) based on a trust or some other legal agreement and when (2) the trustee is enabled to legally manage and dispose of the entrusted property on behalf of the trustor or a third party (beneficiary). In the case of the entrustment of a fund-based company pension plan trust, for example, the company's pension fund is the trustor and beneficiary, while the trust bank is the trustee. Because the system is premised on the dependability of the trustee, trust banks have a duty of due care, of prudent management, of loyalty, and of segregated asset management.

Trust banks can service pension funds in three different ways. They can manage the funds based on their own discretion (designated asset management–type trust) or not become involved in management but only administer the assets (specified asset management–type trust) or be an intermediary trustee (general manager) representing the trustees and insurers in acting as the general manager for dealings with the trustor when the administration function is commissioned to multiple trust banks and insurance companies.

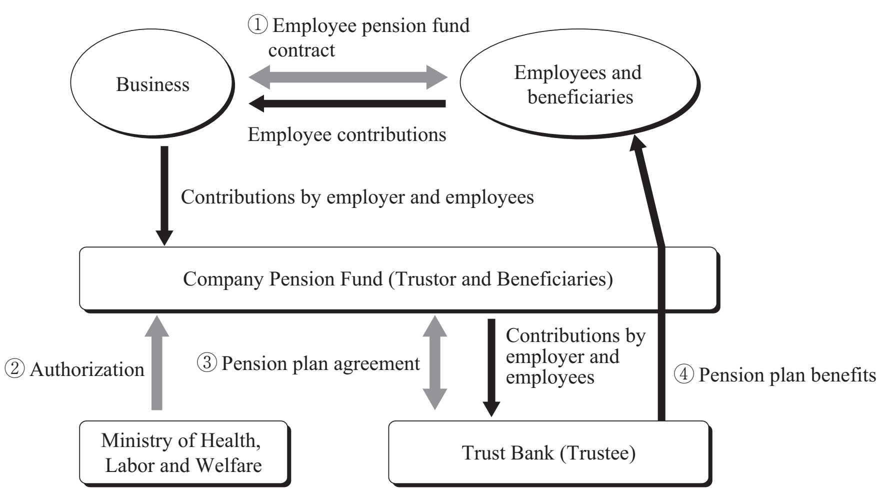
The two main features of trust bank operations are the high proportion of

Chart XIII-4. Trust Scheme



Source: Trust Companies Association of Japan

Chart XIII-5. Fund-Type Company Pension Plan Trust Scheme



Source: Trust Companies Association of Japan pooled asset management and passive investment policies in comparison with discretionary asset management.

Pooled asset management combines the assets of multiple funds into one account. Compared with the independent management of assets, where the assets entrusted by each fund are kept separate and investment is made in specific securities, etc., this system enables even small-scale funds to diversify their investments. Another advantage is that the asset management fees and transaction costs are cheaper. On the other hand, with independent management it is easier to manage assets according to the needs of each fund involved than it is with pooled asset management.

Passive management is an investment method that aims to achieve a return in line with movement in a specified benchmark (index). In comparison with active management, where a manager makes trading decisions based on the investment value of individual securities with the aim of outperforming a benchmark, passive management has the advantage of keeping trading turnover costs low as well as curtailing management fees because detailed research and analysis is not required for individual securities. Moreover, in contrast with discretionary asset management companies, trust banks' businesses encompass not only asset management but also fund administration. Synergies between these two businesses scale up the economic benefits to the trust bank, as do the relatively large assets under management and the amount of business involved. These benefits combine to provide an advantage to the client in terms of lower asset management fees. With passive management, on the other hand, clients can only expect benchmark asset performance.

4. Asset Management of Life Insurance Companies

Life insurance policyholders pay a premium based on the likelihood of their living or dying. There are generally two types of life insurance; mortality insurance that insures a policyholder against death and annuities that provide for their livelihood in old age. Life insurance companies (insurers) accumulate the insurance premiums received from policyholders into a liability reserve to provide for future claim distributions and invest them. There are two types of accounts used to manage the investment of insurance premiums. The general account guarantees the policyholder a certain fixed amount of benefits regardless of how the general account performs, while the special account policies pay out benefits that vary based on asset management performance. Under a general account life insurance policy, the insurer promises to pay a certain amount of benefits, and the policyholder agrees to pay a premium that is commensurate with the promised benefit. The premium is computed on the

Table XIII-2. Asset Composition

(%)

	Cash and deposits	Call loans	Money trusts	Securities	Loans	Tangible assets	Others	Total assets
FY2008	1.6%	0.9%	0.8%	73.9%	16.4%	2.2%	4.3%	100.0%
FY2009	1.6%	0.7%	0.7%	76.7%	14.7%	2.1%	3.5%	100.0%
FY2010	1.8%	0.6%	0.6%	77.3%	13.7%	2.1%	3.8%	100.0%
FY2011	1.1%	0.8%	0.6%	78.8%	12.9%	2.0%	3.8%	100.0%
FY2012	1.0%	0.8%	0.6%	80.7%	11.7%	1.9%	3.4%	100.0%
Figures excluding Japan Post Insurance Co., Ltd.								
FY2008	1.3%	1.1%	1.1%	71.6%	16.0%	3.2%	5.7%	100.0%
FY2009	1.2%	0.8%	0.9%	75.3%	14.1%	3.1%	4.5%	100.0%
FY2010	1.6%	0.6%	0.8%	76.3%	13.1%	3.0%	4.6%	100.0%
FY2011	1.0%	0.8%	0.8%	78.4%	12.1%	2.8%	4.1%	100.0%
FY2012	1.1%	1.0%	0.7%	80.8%	10.8%	2.5%	3.0%	100.0%

Source: Trust Companies Association of Japan

Table XIII-3. Composition of Securities under Management

(100 millions of yen, %)

	JGBs		Regional bonds		Corporate bonds		Stocks		Foreign securities		Other securities		Total
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount
FY2008	1,238,909	53.8	98,160	4.3	274,568	11.9	156,318	6.8	400,361	17.4	133,768	5.8	2,302,088
FY2009	1,279,887	52.4	109,678	4.5	264,538	10.8	186,618	7.6	429,571	17.6	171,206	7.0	2,441,501
FY2010	1,323,987	53.4	119,164	4.8	252,835	10.2	162,149	6.5	457,384	18.4	164,288	6.6	2,479,809
FY2011	1,412,757	54.9	131,630	5.1	253,429	9.8	147,444	5.7	469,267	18.2	161,074	6.3	2,575,603
FY2012	1,487,692	53.5	139,346	5.0	251,551	9.0	167,256	6.0	559,864	20.1	176,735	6.4	2,782,448
Figures excluding Japan Post Insurance Co., Ltd.													
FY2008	542,176	36.9	52,597	3.6	192,431	13.1	156,318	10.6	391,526	26.7	133,768	9.1	1,468,820
FY2009	603,711	36.9	58,396	3.6	195,162	11.9	186,618	11.4	422,989	25.8	171,206	10.5	1,638,086
FY2010	682,957	40.0	56,606	3.3	191,930	11.2	162,149	9.5	450,147	26.4	164,288	9.6	1,708,079
FY2011	813,135	44.4	53,851	2.9	191,154	10.4	147,434	8.1	463,081	25.3	161,074	8.8	1,829,732
FY2012	922,966	44.9	52,361	2.5	186,713	9.1	167,246	8.1	550,842	26.8	176,735	8.6	2,056,866

Source: Trust Companies Association of Japan premise of an assumed basic rate comprising such factors as assumed mortality rate, assumed ratio of expenses, and assumed rate of return. Since the assumed basic rate is set conservatively, a positive difference can occur between the assumed and actual rate. When this happens, a portion of the profit is returned to policyholders as a dividend.

According to the 2013 issue of *Trends in the Life Insurance Business*, published by the Life Insurance Association of Japan, of the total assets under management by life insurance companies at the end of fiscal 2012, securities accounted for 80.7%, while loans accounted for 11.7%. The recent trend has been an increase in the amount of securities coupled with a decrease in loan holdings. Looking at the breakdown of securities, Japanese government bonds made up the greatest portion (53.5%), followed by foreign securities (20.1%, of which equities accounted for 1.9% and bonds, etc., 18.2%); Japanese corporate bonds (9.0%); Japanese equities (6.0%); and Japanese regional bonds (5.0%). The recent trend in securities is to increase bond holdings (government, corporate, and regional) and decrease domestic equity holdings.

In recent years, insurance companies have come to focus more on asset liability management (ALM) because of the introduction of mark-to-market accounting and stricter regulations on solvency margins. Liability reserves, which account for most of insurance company liabilities, are superlong liabilities with a duration (average) of more than 10 years. As such, in their asset management strategies, the insurance companies have increasingly favored investment in 20-year and other superlong Japanese government bonds. On the other hand, insurance companies also are cautiously investing in high-price volatility risk stocks and foreign bonds, which carry an exchange rate risk. In addition, there is a trend toward using currency hedges to avoid currency risk when investing in foreign securities.

Targeting group pension plans, special account insurance offers several options. In a policy with a Class 1 rider, the assets of multiple customers are managed as a pool based on the investment policies of the life insurance company. In a Class 2 rider policy, the assets of each customer in the group are managed separately using investment polices that reflect the wishes of the individual customer. Within a Class 1 rider policy, there also are balanced-type consolidated accounts for which the life insurer determines the allocation among asset classes and separate designed investment accounts that reflect individual customer preferences in asset allocation.

5. Asset Management of Discretionary Asset Management Companies

Discretionary asset management companies manage the assets of customers based on a discretionary management contract that gives those companies the necessary authority to make investment decisions and investments on behalf of their customers. Among the major customers of these companies are institutional investors, such as pension funds, financial companies, and sovereign wealth funds. Discretionary management companies can be considered the business sector where liberalization and internationalization has progressed the most, even in the financial industry, which has low barriers to entry for non-financial or foreign companies. As a category for investment specialists, the asset management company category includes investment trust management companies and fund managers that sell units in group investment schemes, such as venture capital funds, as well as discretionary management companies.

The Japan Securities Investment Advisers Association is a self-regulatory body for the discretionary asset management industry. It is designed to protect investors by ensuring the fair and smooth operation of members' asset management business. It also contributes to the sound development of the asset management business and related matters. The asset management industry's business and other activities contribute significantly to the capital market. In consideration of this important role, the association also works to improve corporate governance by collecting and announcing information about voting on resolutions at general meetings of shareholders of listed companies that are members of the association, by forming study groups on corporate governance, and by carrying out discussions and research.

A special feature of discretionary asset management companies in comparison with trust banks is a relatively high proportion of active investment and customized asset management services that closely reflect the wishes of customers. When commissioned to handle the management of assets, they leave the administration side of the business to trust banks and other financial institutions. Reacting to the AIJ Investment Advisory Co., Ltd., pension plan fraud scandal in 2012 and other incidents, trust banks are expanding and reinforcing their monitoring systems by strengthening their independent party checking function and other measures.

Allocation of the assets of customers is done based on investment guidelines and other agreements determined through discussions with pension funds and additional customers. The trend in recent years has been a reduction in the proportion of Japanese stocks and an increase in the proportion of domestic bonds in assets under management. Factors involved include an increase in the percentage of risk-adverse public pension funds in entrusted assets and in the percentage of risk-adverse corporate pension funds. Along with the diversification of the investment needs of pension funds, these funds are not limited to such traditional investment instruments as stocks and bonds but also involve investments in the stocks and bonds of high-growth emerging

Chart XIII-6. Investment of Pension Assets by Investment Advisory Service Companies

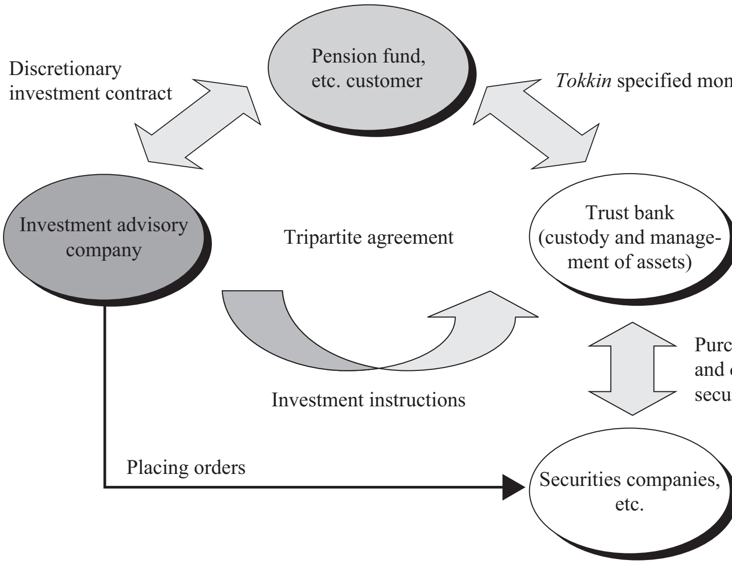


Table XIII-4. Country and Regional Allocation of Assets Under Management

	Japan			United States		Europe		Asia		Others	
	Stocks	Bonds	Real estate related securities	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds	Stocks	Bonds
2004/3	39.35%	21.30%		7.15%	9.07%	4.19%	5.89%			3.05%	2.38%
2005/3	35.90%	21.36%		6.83%	9.93%	4.41%	6.72%			2.75%	2.73%
2006/3	42.92%	17.48%		6.56%	8.96%	4.23%	5.86%			3.08%	2.92%
2007/3	38.82%	18.22%		6.60%	9.54%	4.65%	6.69%			3.58%	3.64%
2008/3	26.83%	29.84%	0.10%	6.16%	9.59%	4.64%	7.51%			4.07%	3.82%
2009/3	18.78%	36.29%	2.73%	6.42%	10.26%	4.05%	8.28%			2.96%	3.05%
2010/3	19.69%	34.33%	2.77%	7.54%	10.00%	4.70%	7.20%			3.80%	3.50%
2011/3	17.43%	35.84%	3.30%	5.68%	9.06%	3.97%	5.86%	0.75%	0.22%	2.59%	6.82%
2012/3	16.84%	35.23%	3.57%	5.74%	9.84%	3.36%	5.71%	0.81%	0.61%	2.51%	7.10%
2013/3	18.54%	32.11%	2.91%	6.32%	10.33%	3.70%	6.24%	0.89%	0.67%	2.79%	6.26%

Source: Japan Securities Investment Advisers Association.

countries and alternative investments that target absolute rather than relative returns, such as real estate related securities and hedge funds.

6. Asset Management of Investment Trusts

Investment trusts are a type of collective investment scheme based on pooling small investments from many investors and have three significant features. First, they enable the diversification of small investments. Using investment trusts allows individual investors to lower their risk through diversification just the same as institutional investors even with small investments. For example, investment in an investment trust fund that has diversified its investments into more than one thousand stocks and over 40 countries starts from about ¥10,000 (about $98 dollars).

The second feature is that investment trusts are managed by professionals. Building the optimum investment portfolio based on macroeconomic analysis as well as financial trends and stock price analysis requires advanced knowledge, analytic capabilities, and investment technology. Through investment trusts, even individual investors can benefit from the skills of professional fund managers.

The third feature of investment trusts is transparency. The marked-to-market net asset value of these funds is published on a daily basis, and Japanese laws have beefed up disclosure requirements.

An investment trust with instructions from trustors is representative of schemes adopted in Japan. Assets collected from investors (beneficiaries) through subscriptions by distributing companies, such as securities companies and registered financial institutions, are managed by a trustor (investment trust management companies) and held in safekeeping and administered by a trustee (trust banks).

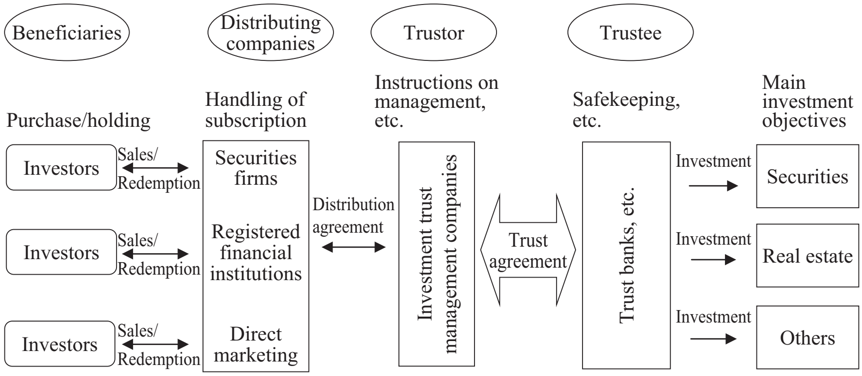
When the investment trust system was first set up, government regulators only approved investments in Japanese stocks. However, over the 60-year history of the industry the investment regulations have gradually been liberalized, and today it is possible to create a truly wide range of investment instruments based on the products available. For example, by including short-term money products, they can structure investment trusts, such as money reserve funds (MRFs), that mimic bank deposits. Furthermore, since the approval of investment in real estate and commodities, individual investors can take a stake in office buildings, gold, oil, and other investments through investment trusts.

Entry into the market has also been liberalized from a limitation to only approved companies associated with major securities companies to a registration system that requires only that companies meet certain conditions. As a

Table XIII-5. Trends in the Liberalization of Investment Trust Regulations in Japan

1951	Securities companies begin investment trust management business
1959	Investment trust management companies made independent of securities companies
1961	Ban on inclusion of public bonds lifted (Bond investment trusts established)
1970	Ban on inclusion of foreign securities lifted
1978	Ban on use of forward exchange contracts lifted
1986	Ban on inclusion of OTC-registered stocks lifted
1987	Ban on use of derivatives for hedging purposes lifted
1990	Foreign-affiliated investment management companies enter market
1993	Bank-affiliated investment management companies enter market
1995	Ban on use of derivatives for other than hedging purposes lifted (Bull/Bear funds established)
	ETFs introduced
	Ban on conducting both discretionary asset management and commissioned investment trust management businesses lifted
1998	Financial System Reform Law passed (Japanese Big Bank)
	Deregulation converts investment trust management companies from licensing to approval system
	Ban on outsourcing asset management lifted
	Ban on investment trusts being sold through banks on an agency basis lifted
1999	Ban on fund of funds (FoFs) lifted
2001	Real estate investment trusts (REITs) introduced
2007	Further deregulation converts investment trust management companies from approval to registration system
2008	Ban on inclusion of commodities lifted

Chart XIII-7. The Structure of Investment Trusts with Instructions from Trustors



Source: The Investment Trusts Association, Japan.

result, the industry has grown from only about 10 companies at one time to over 100 investment trust management companies. Moreover, with the lifting of the bans on outsourcing asset management and on investing in a fund of funds, investment trusts can also indirectly offer their customers access to the investment services of foreign asset management companies. Although sales are still restricted to securities companies, sales access points have been expanded through direct distribution by investment management companies and by agency sales by banks and other registered financial institutions.

CHAPTER XIV

Investment Trusts

1. Summary

An investment trust is a financial instrument that raises money from two or more investors in order to establish a large fund that it invests in a variety of assets, such as stocks and bonds, under the management of an investment specialist, and the profits earned through that investment are then distributed among the investors in proportion to their contributions.

The investment trust allows investors to indirectly enter various asset markets even with a small amount of money as well as to enjoy the benefits of scale economies (cost reduction) and efficient diversified investment (diversification of risks) that are generated through a joint investment with other investors, also allowing them to take advantage of information analysis and investment sophistication gained by having the investment managed by specialists. The repayment of the principal of an investment trust is not guaranteed, because its earnings depend upon its performance. There are a variety of investment trusts depending on investment instruments and methods, including one that is similar to deposit and savings accounts and another that is like derivatives trading in that it aims at achieving higher earnings by assuming higher risks.

The overall structure of the investment trust system is stipulated in the Investment Trust and Investment Corporation Act. Regulations concerning the actions of investment trust management companies, the key players in the management of investment trusts, are defined in the Financial Instruments and Exchange Act. Investor protection is also provided by self-regulatory rules established by The Investment Trusts Association, Japan, an approved self-regulatory organization under the Financial Instruments and Exchange Act.

Investment trusts play a major role in making investments for the general public and have the economic benefit of helping companies to raise money. They also perform the function of contributing to the reasonable determination of prices in the securities markets as an institutional investor.

Chart XIV-2 shows the growth of the total net assets of publicly offered

Chart XIV-1. Investment Trust Concept

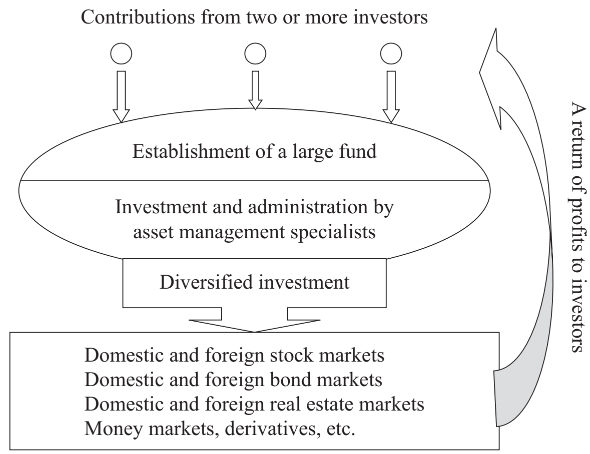
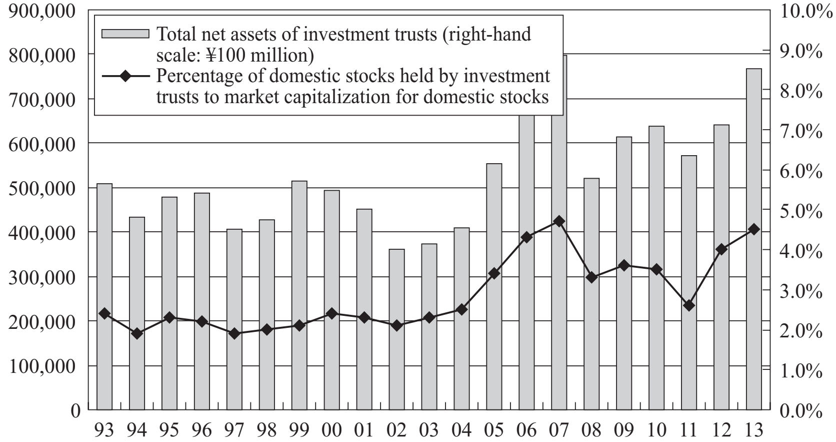


Chart XIV-2. Trend of Total Net Assets of Publicly Offered Investment Trusts and Their Positions



Note: Figures for 2013 are those at the end of September (at the end of June for the percentage of investment trusts to household financial assets).

Sources: Total net assets figures obtained from the Investment Trust Association, Japan; percentage of investment trusts to household financial assets obtained from the Bank of Japan (Flow of Funds Account).

investment trusts in Japan. The total net assets reached a peak in 1989 and declined after the bubble economy burst. The market rebounded temporarily in around 2005 along with the recovery of the stock market and other factors, only to drop 35% year on year again after the global financial crisis in 2008. Nevertheless, the decline in the market appears to have bottomed out in January 2009. Still, in 2012 Japan accounted for only 2.7% of the global investment trusts net asset total of more than $26.84 trillion (¥2,300 trillion), a small portion compared with Japan's approximate 8% share of the world gross domestic product (GDP). This suggests that there is a high growth potential for investment trusts in Japan, so it is expected that investment trusts will grow as a core product, accelerating the shift from "saving" to "investing" in the future.

2. History of Investment Trusts

The investment trust, a collective investment scheme, has penetrated both developed countries as well as emerging countries in various forms since its birth in the U.K. in the late nineteenth century.

In Japan, investment trusts existed before the war, but the current system began with the enforcement of the Securities Investment Trust Law in June 1951. It was not naturally generated from demands from investors as in the West but was politically introduced for a supply-and-demand adjustment of stocks substantially released as a result of the break-up of the zaibatsu conglomerates (democratization of securities) and in order to raise money for revivifying industries during the postwar period, when there was a severe lack of funds. Legislated in light of the prewar money trust, it was launched in the form of both the contractual-type stock investment trust and the unit-type stock investment trust.

The Securities Investment Trust Law was partially amended in 1967 after the securities crisis, to establish the code of conduct for investment trust management companies; to clarify the fiduciary duty of investment trust management companies to beneficiaries (persons who process operations for others in trust are required to act only for the benefit of the others); and to adopt and strengthen provisions on prohibited activities. In 1995, a major reform was conducted, mainly for the purpose of advancing deregulation and greater disclosure.

The large amendments to the law made in 1998 were associated with implementation of the Financial System Reform Law under "free, fair, and global" principles. As a result of the amendments, the corporate-type investment trust, the mainstream in the U.S. and Europe, was introduced from the standpoint of promoting the globalization of the investment trust business,

Table XIV-1. History of the Investment Trust in Japan

System	Products	Marketing	Management
The Securities Investment Trust Law was implemented (1951)	Investment trusts were launched in the form of unit-type investment trusts (1951)	Investment trusts were available at securities companies	The assets were invested mainly in domestic stocks
	Launch of open-type investment trust (1952)		
Investment trust management business was separated from securities companies (beginning operations in 1960)	Bond investment trusts were established (1961)		The weight of domestic bonds substantially increased (1961)
The Securities Investment Trust Law was amended to add provisions for the duties of loyalty of investment trust management companies to beneficiaries and the duty of disclosure, etc. (1967)			
			Foreign securities began to be included in assets of investment trusts (1970)
		The marketing of foreign investment trusts in Japan was liberalized (1972)	
	The medium-term government bond investment trusts were established (1980)		
Investment trust management companies entered the investment advisory business (1984)			
Foreign companies entered Japanese investment trust management business (1990)			
	MMFs were established (1992)		
Bank affiliates entered investment trust management business (1993)		Investment trust management companies started to sell investment trusts directly (1993)	
Investment trust reform was determined (1994) and implemented (1995)	Nikkei 300 Exchange Traded Fund was established (1995)		Investment restrictions were deregulated, including utilization of derivatives for purposes other than hedging (1995)
The Financial System Reform Law was implemented (1998)		Banks and insurance companies started to sell investment trusts (1998)	
	Private placement investment trusts were launched (1999)		
Trustee responsibility of investment fund management companies was defined (2000)	Corporate-type investment trusts were established (2000)		Target of investment trusts expanded to a variety of fields, including real estate (2000)
Portfolio valuation method of bond investment trusts shifted to market value accounting (2001)	Real estate investment trusts were established (2001)	The Law on the Sales of Financial Products was implemented (2001)	Some MMFs' net asset value fell below their principle amount (2001)
	In-kind contribution ETFs were listed (2001)	Sales of investment trusts started at post offices (2005)	
The Financial Instruments and Exchange Act was implemented (2007)			Target of investment trusts expanded to commodities (2008)

Source: Author of the chapter.

deregulating the establishment of new funds by changing from an approval system to a filing system, and allowing investment trust management companies to outsource the management of the fund to outside companies. Distribution channels were also expanded to financial institutions, and banks became able to distribute investment trusts. Disclosure was enhanced by obligating investment trusts to disclosure requirements under the Securities and Exchange Law.

In 2000, investment objects were expanded to those other than securities. This allowed investment trust management companies to establish the "real estate investment trust." The law was renamed "the Investment Trust and Investment Corporation Act," deleting the word "Securities." Amendments were made to include additionally the duties of reasonable care and skill (investment fund management companies are required to give instructions on asset management of investment trusts as good managers) in the rules of conduct for investment trust management companies. Distribution channels were further expanded due to the start of marketing investment trusts at post offices in 2005, before the privatization of Japan's postal system.

In 2006, in relation to the enactment of the Financial Instruments and Exchange Act (implemented at end of September 2007), the Investment Trust and Investment Corporation Act was amended to relegate provisions on the rules of conduct for investment trust management companies.

3. Forms of Investment Trusts

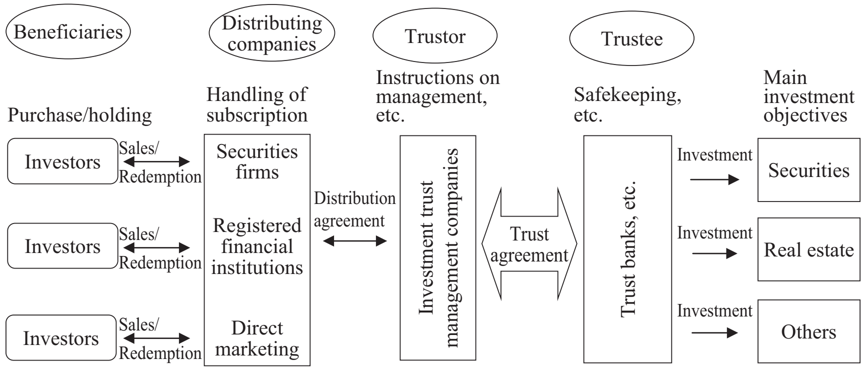
Investment trusts are broadly classified into the contractual type and the corporate type.

Contractual Type (Investment Trust)

Some contractual-type investment trusts take such legal form as a trust or a common fund in most of the world; however, in Japan the contractual type of investment trust takes the legal form of a trust and is subclassified into investment trusts with investment instructions from trustors or without investment instructions from trustors.

An investment trust with investment instructions from trustors consists of three entities: the trustor, the trustee, and the beneficiary. The trustor is an asset management company (investment trust management company) registered with the Financial Services Agency. It carries out product development, prepares a trust deed and files it with the authority, and provides investment instructions to a trustee (it has the authority to outsource the investment instructions to outside companies). The trustee is a trust company or a bank concurrently engaging in the trust business of holding and administrating

Chart XIV-3. The Structure of Investment Trusts with Instructions from Trustors



Source: Partially adjusted flowchart from the Investment Trusts Association, Japan's report on "Investment Trusts in Japan 2012."

assets under investment trusts according to a trust agreement. Investors obtain the position of beneficiary by accepting a beneficiary certificate and receive the profits arising from investment management as dividends or by redeeming the certificate.

In the case of investment trusts without investment instructions from trustors, the trustee enters into a trust agreement with two or more investors and combines their funds into a trust asset, which is then invested mainly in certain assets excluding securities and held and administrated by the trustee without instructions from the trustors.

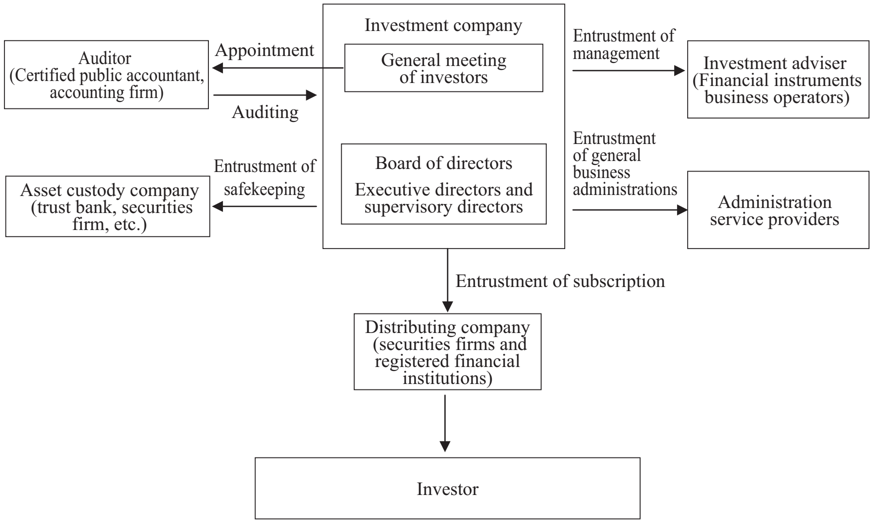
Chart XIV-3 shows the structure of an investment trust with instructions from trustors that is generally adopted in Japan.

Corporate Type (Investment Corporation)

The corporate type is operated in a legal form that is similar to a corporation. In Japan, an investment corporation with a corporate veil is established and operated by officers who are appointed by an investors meeting, but it must entrust its business, such as asset management, custody of the fund's assets, general business administration, and the handling of subscriptions, to outside companies. Investors obtain the position of shareholder by accepting share certificates (investment certificates) issued by the investment corporation and receive the profits arising from the investment management as dividends. Chart XIV-4 illustrates such a structure.

Both the contractual type and the corporate type include the open-end type and the closed-end type. Which type they are grouped into depends on the claims of investors to redeem issued certificates. The open-end type accepts

Chart XIV-4. The Structure of Corporate-Type (investment corporation) Investment Trusts



Source: The Investment Trusts Association, Japan, "Investment Trusts in Japan 2012."

the beneficiary's request and redeems the certificates at market price by selling trust assets, while the closed-end type does not accept the beneficiary's request to redeem the beneficiary's certificates. The latter ensures liquidity by listing its issued certificates. In Japan, contractual-type investment trusts are principally of the open-end type, while corporate-type investment trusts, in particular, real estate investment trusts, are of the closed-end type.

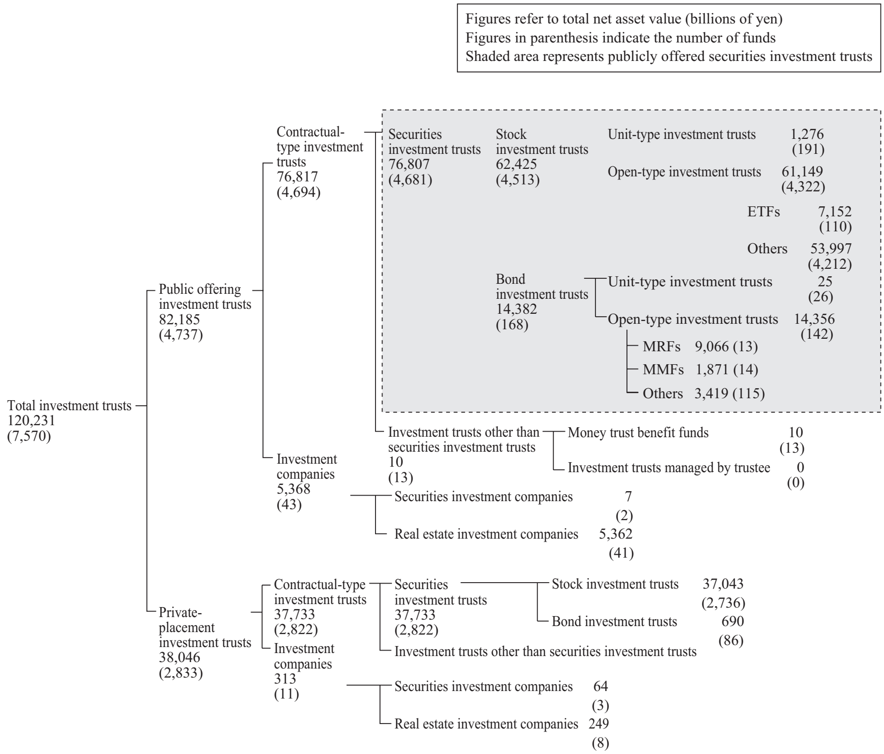
4. Investment Trust Products

The total net assets of broadly defined investment trust products amounted to ¥120 trillion ($1.2 trillion) in Japan as of September 2013. They are classified by a variety of methods.

Public Offering of Investment Trusts and Private Placements of Investment Trusts

A public offering of investment trusts is offered to 50 or more unspecified investors, while a private placement is sold to eligible investors or professional investors stipulated in the Financial Instruments and Exchange Act or to fewer than 50 investors. A private placement, the establishment of which was made possible by the 1998 amendment to the Order for Enforcement of the

Chart XIV-5. Overview of Investment Trusts (as of the end of September 2013)



Source: The Investment Trusts Association, Japan.

Investment Trust and Investment Corporation Act, has the margin to freely design products only with the approval of the investors, because a private placement is subject to less-rigid investment restrictions than a public offering. Therefore, privately placed funds attract the attention of large investors, in particular institutional investors, and rapidly increase in volume as funds invested by variable annuities.

Stock and Bond Investment Trusts

The Japanese tax laws define stock investment trusts as funds that hold even a small number of stocks, and bond investment trusts are funds that invest not in stocks but only in bonds. Bond investment trusts include funds that invest mainly in long-term bonds and Money Management Funds (MMF) and Money Reserve Funds (MRF) that invest in short-term money market vehicles.

Unit-Type and Open-Type Investment Trusts

Unit-type investment trusts are funds that do not allow additional subscriptions after having accepted funds in principal value only during their initial subscription period, while open-end investment trusts are funds that do accept additional subscriptions at market value after their establishment. In Japan, investment trusts were launched in the form of the unit type, which was similar to savings instruments, in 1951; however, open-end investment trusts have currently become a mainstream financial instrument, just as in foreign countries.

Classification by Investment Object

The Investment Trusts Association, Japan, offers a product classification according to the object of investment of the funds, so that investors can select funds easily. The prospectus of funds clearly describes into which classification the funds fall.

Exchange-Traded Funds (ETF)

Among open-type funds, funds whose net asset value fluctuates closely with securities price indexes, including the stock index, and whose units are listed and traded on exchanges like stocks are called ETF. They are formed by the in-kind contribution of stocks by designated participants and others, and the units/shares of many ETFs can be exchanged for the component stocks held in a timely manner. This creates arbitrage opportunities with the component stocks, a mechanism that keeps the gap between the traded prices of the fund on the exchange and the indexes targeted by the fund within a small range.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

5. Sale of Investment Trusts

The subscription and sale of investment trusts had been engaged in only by securities firms in Japan since the establishment of investment trusts in 1951. (Some investment trust management companies started direct marketing in the 1990s.) The entries of financial institutions, including banks, in 1998 and some post offices in October 2005 expanded the distribution network rapidly. As a result, there was a substantial change in the breakdown of the total net assets of investment trusts by distribution channels, as described in chart XIV-6. Financial institutions, including banks, accounted for 35% of public offerings of investment trusts and 42% of public offerings of stock investment trusts as of the end of September 2013. Banks had about a 70% share in private offerings of investment trusts. In contrast, investment trust management

Chart XIV-6. Breakdown of Total Net Assets of Public Offering Investment Trusts by Distribution Channel

(as of the end of September 2013)

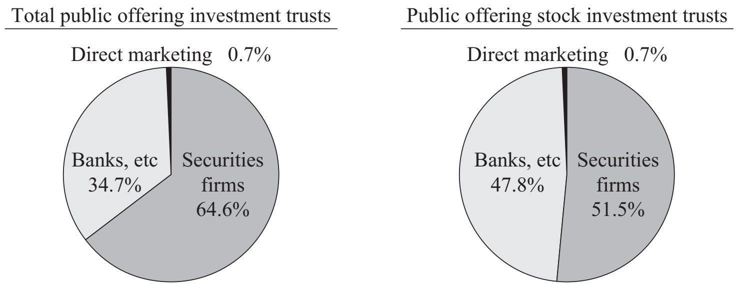


Chart XIV-7. Trend in Breakdown of Total Net Assets of Public Offering Stock Investment Trusts by Distribution Channel

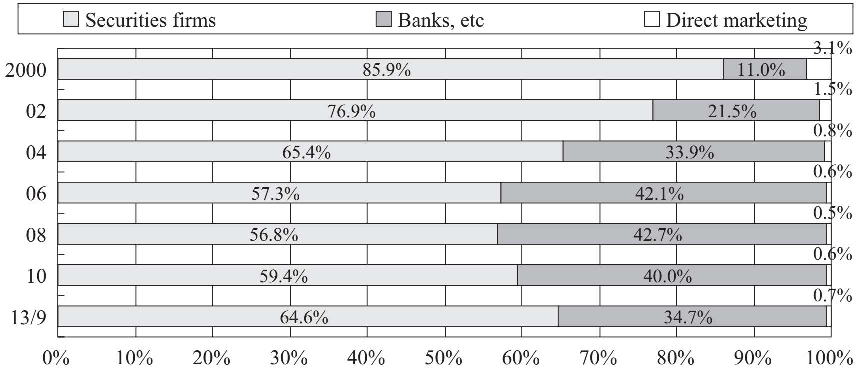
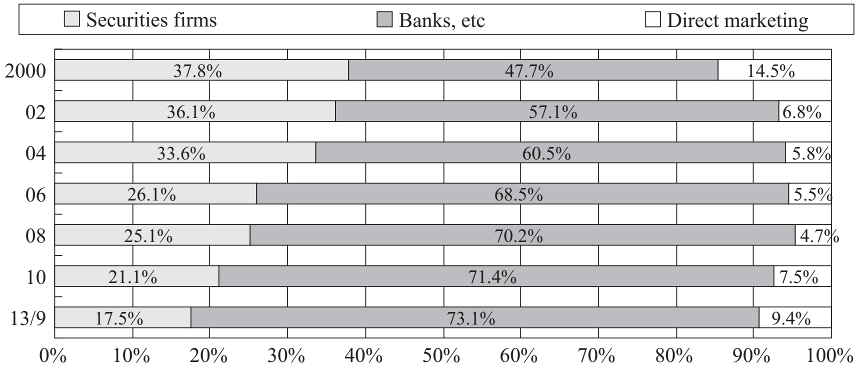


Chart XIV-8. Trend in Breakdown of Total Net Assets of Total Private Placement Investment Trusts by Distribution Channel



Source: All the above are based on statistics of the Investment Trusts Association, Japan.

companies saw weak growth in direct marketing, partially due to the exit of large companies related to securities firms (as such companies absorbed the sales).

Investment trusts are generally available over the counter in distributing companies and through their sales agents. Recently, the number of online transactions has also grown. According to a survey conducted by the Investment Trusts Association, Japan, in 2012, 14.8% of all respondents answered that they had acquired investment trusts online.

Distributing companies are subject to the Financial Instruments and Exchange Act, Financial Products Sales Act and the regulations of the Japan Securities Dealers Association, and they are obliged to comply with the rules on sales of the Investment Trusts Association, Japan. For example, they must comply with the Suitability Rule, which requires distributing companies not to engage in inappropriate solicitation activities in light of customers' knowledge, experience, investment purpose, and assets and to assume "accountability" for risk factors, including market and credit risk, and for important portions in the structure of transactions and to maintain the "duty of sincerity toward customers" not to conduct "prohibited activities" at the time of sale, such as providing conclusive evaluations. Depository institutions, such as banks, shall be required to take measures to prevent customers from mistaking investment trusts for deposits at the sale of investment trusts, including explaining that they are not covered by the deposit insurance system. As a part of the enhancement of accountability at the implementation of the Financial Instruments and Exchange Act in 2007, the "duty to deliver documents before concluding contracts" was introduced. It is not required to perform the duty when the eligible prospectus has been delivered to customers. For investment trusts, the requirement is satisfied by delivering the eligible prospectus.

The sales commission for investment trusts, which had been determined by the funds, was liberalized in Japan as a result of amendments to the business rules of the Investment Trusts Association, Japan, in 1998. At present, different companies can charge different commissions even for the same fund. There have also been reductions in commissions and a diversification of commission systems.

6. Investment Management of Investment Trusts

Investment trusts invest mainly in "specified assets" defined by the cabinet order under the Law for Investment Trusts and Investment Companies. (As of September 2011, the specified assets consist of 10 types of assets, including securities, real estate, and rights on derivatives.) Funds investing mainly

Chart XIV-9. Distribution of Assets of Investment Trusts in Japan (as of the end of September 2013, total publicly offered securities investment trusts)

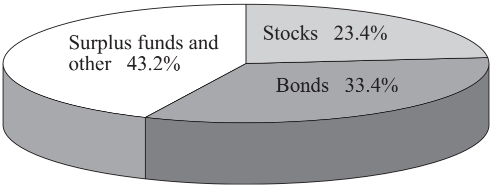


Chart XIV-10. Ratio of Foreign Investments to Total Investments in Japan (Total publicly offered securities investment trusts)

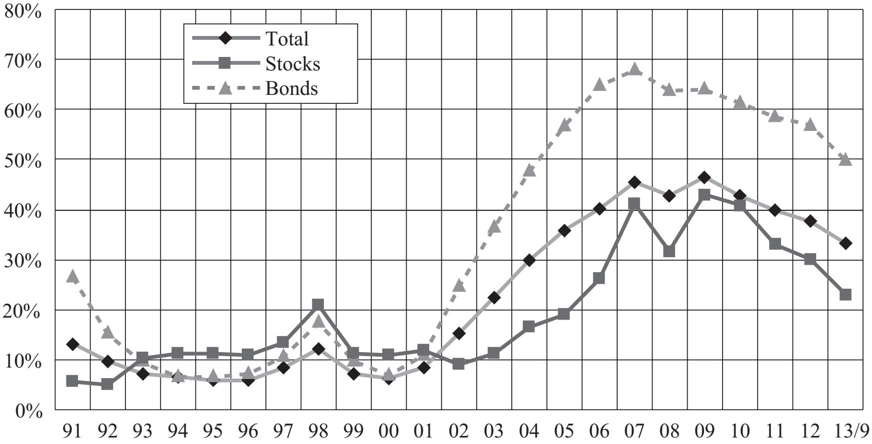
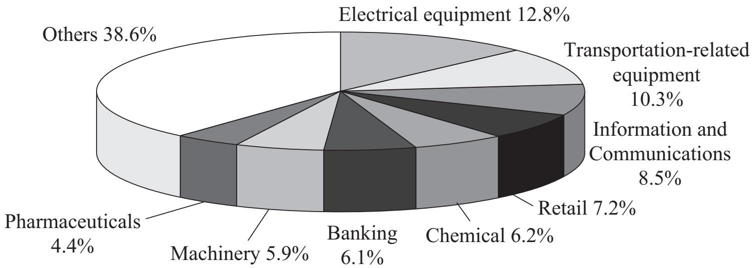


Chart XIV-11. Breakdown of Industry Groups among Domestic Stock Held by Investment Trusts (publicly offered stock investment trusts as of the end of September 2013)



Source: All of the charts on this page are based on data from the Investment Trust Association, Japan.

in securities are called securities investment trusts.

Chart XIV-9 shows the distribution of assets under the management of publicly offered securities investment funds as of September 2013. Partially reflecting a growth in the total net assets of funds that pay dividends frequently, such as monthly distribution funds, bonds hold a large share in assets under management. Looking at the proportions of domestic and foreign investment, the ratio of foreign investments to total investments had surged up to the mid-2000s due to the continuing ultralow interest rate in Japan and the higher popularity of investments in emerging countries. Moreover, blue-chip stocks are being given preference in the selection of the domestic stocks included in the funds, such as electric and transportation machinery (automobiles, etc.) and communications stocks.

In operating business activities, investment trust management companies, which invest their assets according to the investment policies described in the prospectus of funds, are subject to the Special Provisions Concerning the Investment Management Business of the Financial Instruments and Exchange Act. They assume the duties of sincerity to customers, loyalty to the beneficiaries, and reasonable care and skill; they also are prohibited from undertaking these activities: (a) transactions between managing assets and the investment trust management company or its directors/executive officers; (b) transactions among funds under management (excluding certain portions); (c) transactions for the purpose of its own benefit or the benefit of other parties by taking advantage of the changes in price of specific financial instruments resulting from such transactions; (d) transactions whose terms are different from those of ordinary transactions and that affect adversely the benefits of beneficiaries; (e) transactions of securities and other transactions for its own account by using information obtained through transactions for investment management; and (f) cases in which an investment trust management company or some third party provides beneficiaries or a third party with compensation to offset a loss or increase profit.

Additionally, the Investment Trust and Investment Corporation Act imposes a restriction on investment trust management companies prohibiting them from giving instructions to acquire stocks of the same issuing company when the number of stocks held by all investment trusts managed by the given investment trusts management company exceeds 50% of the total number of outstanding stocks of that same issuing company. The Investment Trusts Association, Japan, has voluntary rules concerning investment instruments and restrictions on allocation.

The Investment Trust and Investment Corporation Act stipulates that an investment trust management company exercises the rights of shareholders, including voting rights, on portfolio stocks. Investment trust management companies disclose their basic policies on and the results of the exercise of voting rights on their web sites.

7. Customer Base of Investment Trusts

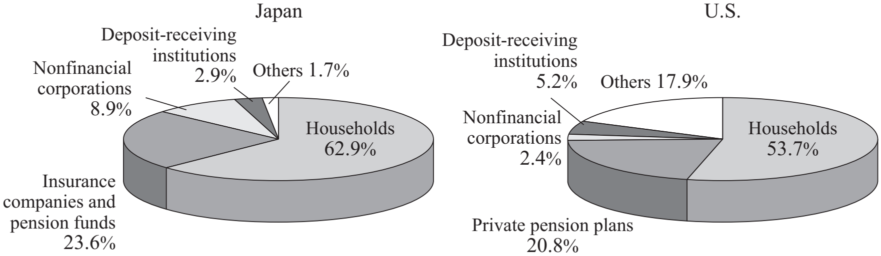
Chart XIV-12 shows the breakdown of beneficiaries of investment trusts (in terms of value). About 60% of investment trust assets are held by households, with the remaining 40% accounted for by insurance companies, pension funds, business firms, and financial corporations. Japanese households hold a high share of investment trusts, much like U.S. households, but privately held pensions are thought to account for a lower share compared with the United States, while business firms and financial corporations account for a higher proportion.

Though households are a core holder of investment trusts, the penetration of investment trusts into household financial assets is low. A 2012 survey that was conducted by the Japan Securities Dealers Association indicates that holders of investment trusts include only 7.7% of the adult population. That ratio is extremely down from the level of more than 16% in 1988 during the bubble economy. The penetration shows a sign of recovery after reaching a low of 6.1% in 2003. By age group, the holding rate of investment trusts is 10% in people aged 60 or more, while it is only 1% to 3% for people in their 20s. It is noticeable that the holding rate is extremely low in young people. This indicates an environment in Japan in which financial assets held by individuals are concentrated among the elderly. In the U.S., though the group of those aged 45 or more comprise the top group, the groups of those aged 35−44 and those less than 35 stood at 52% and 32%, respectively, demonstrating an environment in which the average penetration of investment trusts among households is above 40%.

In 2012, the amount subscribed to by individuals averaged ¥4.41 million for unit-type publicly offered stock investment trusts for which statistics are available, while in terms of the numbers of subscribers, the category of ¥1 million−¥3 million accounted for one third of the total subscribers.

Many investors previously answered that they had no specific investment purpose as their reason for buying investment trusts (Japanese traditionally save money for unexpected purposes, i.e., “for a rainy day”). Recently, more and more individuals are buying investment trusts for “their retirement” and for “diversifying the risk on assets.” In the U.S., the majority of individuals buy investment trusts for their retirement. In many cases, Americans continuously purchase the trusts via accounts for defined contribution assets plans, including the 401k. (This results in a higher holding rate among the young and middle-aged groups.) In contrast, many buyers do not have any specific purpose in Japan. In many cases, they do not make monthly payments into

Chart XIV-12. Breakdown of Holders of Investment Trusts (as of the end of 2012)



Sources: The Bank of Japan, "The Flow of Funds Accounts" of the FRB.

investment trusts; rather, they invest a good sum of money at one time, which is estimated to be largely dependent on the movement of the securities markets.

According to a survey of individuals conducted in 2012 by the Investment Trusts Association, Japan, the average investment trust holder earns an annual after-tax income of ¥4.41 million ($43,024) and holds total savings of ¥11.98 million, including investment trusts of 1.6 types of funds amounting to ¥4.47 million.

8. Disclosure of Investment Trusts

Until 1997, disclosure of investment trusts was covered not by the Securities and Exchange Law but by the framework defined in the Securities Investment Trust Law (now the Investment Trust and Investment Corporation Act). Following the deregulation of the establishment of funds, in which the filing system replaced the approval system, as a result of the enforcement of the Financial System Reform Law in 1998, the Securities and Exchange Law (now the Financial Instruments and Exchange Act) was applied to investment trusts the same as to stocks, etc. Therefore, publicly offered investment trusts are now subject to both the Investment Trust and Investment Corporation Act and the Financial Instruments and Exchange Act in terms of disclosure. Details of disclosure are summarized as follows.

Issuance Disclosure

As issuance disclosure, the Financial Instruments and Exchange Act requires investment trust management companies to file "securities registration statements" with the regulatory authorities (for public inspection) and to deliver the "prospectus" to individual investors at the time of subscription. The mainstream open-end investment trusts are continuously (daily) offered after the establishment of funds by initial subscription. This means that there is a large difference between open-end investment trusts and stocks, in that the latter are offered only at IPO and capital increases; otherwise, investors purchase issued stocks in secondary markets. Given these characteristics in a subscription form of investment trust, the prospectuses were split into two volumes to provide investors with "easy for investors to understand" information in 2004: a "prospectus for all investors (simplified significantly in 2010)," which distributing companies are required to deliver to all investors entering into contracts in advance, and a "prospectus on request," which distributing companies delivered to investors upon their request.

As issuance disclosure, the Investment Trust and Investment Corporation Act requires investment trust management companies to "notify the details of trust deeds" to the regulatory authorities and to "deliver documents describing the details of trust deeds" to the investors. Descriptions in the prospectus are substituted for the latter.

Periodic Disclosure

In terms of disclosure after the establishment of investment trust funds, the Financial Instruments and Exchange Act requires investment trust management companies to file their "securities reports" to the regulatory authorities after the end of each accounting period (for public inspection). (Semiannual reports are also filed when funds settle accounts once a year.) It is required that financial statements, etc., gain an audit certification from a certified public accountant or an audit firm that has no particular connection with the investment trust management company.

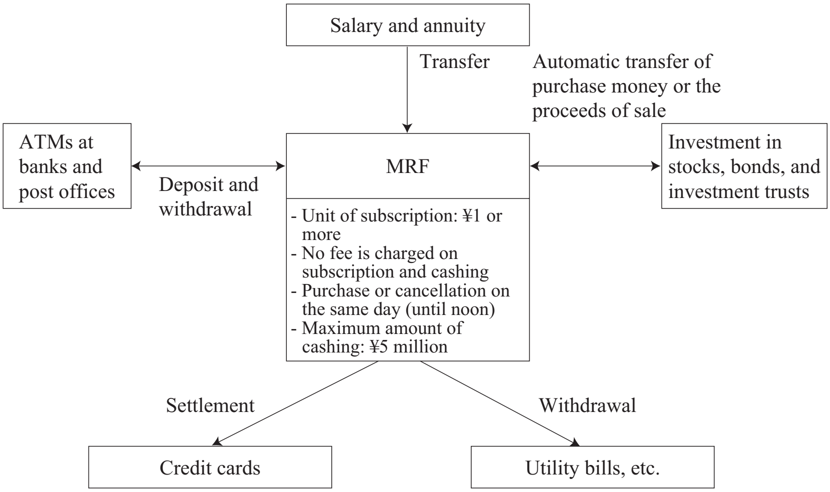
As for periodic disclosure, the Investment Trust and Investment Corporation Act requires investment trust management companies to deliver "financial reports" to individual investors.

In addition, the Investment Trusts Association, Japan, has established "timely disclosure" provisions as self-regulatory rules that should be posted on the web site of each investment trust management company, and this disclosure is performed at least monthly for each fund.

9. Services and Products Based on Investment Trusts

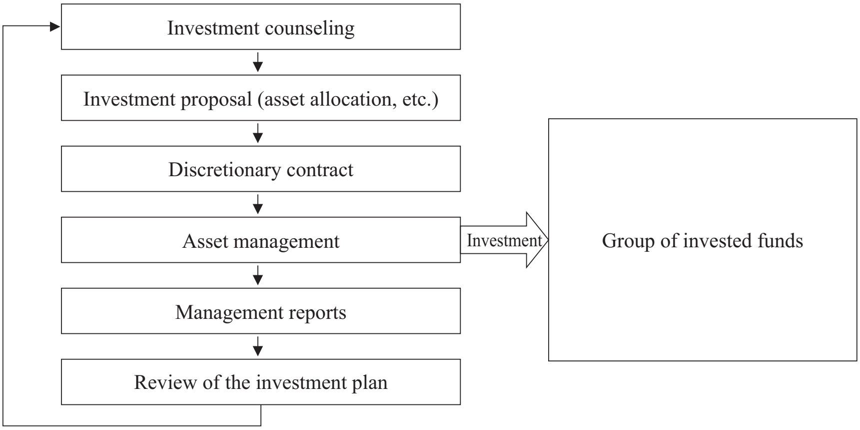
Comprehensive securities accounts: The account is to combine the securities trading accounts of securities firms and money reserve funds (MRFs), open-end bond investment trusts for the account, via auto transfer. Recently, the MRFs are replaced with bank accounts in some cases. The account invests its remaining idle monies, including the interest on bonds, dividends on

Chart XIV-13. Outline of a Securities General Account



Source: Author of chapter.

Chart XIV-14. Flow of Investment Trust Wrap Accounts (example)



Source: The above chart is based upon information on the web site of Nomura Securities Co., Ltd.

stocks, and proceeds from the sale of securities, in MRFs and also offers such services as payment on the acquisition of securities, cash advance on ATMs, and securities- backed loans. The accounts were established in October 1997 on the model of the CMA (Cash Management Account) funds developed in 1977 by Merrill Lynch in the U.S. The Investment Trusts Association, Japan, imposes rules on MRFs on investment management, including one stipulating that the average maturity of portfolio assets should be restricted to 90 days or a shorter period in light of liquidity and security.

Investment Trust Wrap Accounts

A wrap account is a product that securities firms bundle and for which they offer a set of asset management services, including the determination and rebalancing of asset allocation and the selection of individual issues and management reports, only for annual fees to customers' balance of assets (no commission resulting from trading). Investment trust wrap accounts, which invest their assets in investment trusts only, were commercialized following liberalization of sales commissions for investment trusts in 1998 and after obtaining permission to engage in discretionary investment management business by securities firms. Wrap accounts are also commercialized to offer asset management services with individual issues, such as stocks, as a result of the complete liberalization of stock trading commissions in October 1999.

Defined Contribution Pension Plans (Japanese 401k)

Partially backed by the increasing mobility of the employed and a deterioration in the financial positions of DB (defined benefit) corporate pensions, DC (defined contribution) pension plans offering high portability began to be offered in October 2001. The participants in corporate DC plans invest their company contributions (contributions to the reserves by employees have been permitted as of January 2012), and participants in individual DC plans invest their own distributions in investment instruments, including investment trusts, stocks, bonds, and bank deposits, on their own responsibility. Their performances are reflected in future receivable pensions. Many investment trust companies offer low-cost funds exclusively for defined contribution pension funds.

Variable Annuities

Variable annuities, which were launched in 1999, are products offered by insurance companies. Just as with the defined contribution pension plan, they also invest premiums from policyholders in investment trusts, and receivable pension amounts are determined by their performance. In addition to securities firms, banks have also begun selling these products.

10. Foreign Investment Trusts

The sale of foreign investment trusts established under foreign laws in foreign countries was liberalized in 1972. Initially, foreign investment trusts were subject to regulations stating that they should be invested mainly in foreign currency denominated assets and that a weighting of yen-denominated assets was limited to below 50% of the total assets, in consideration of the effect on domestic investment trusts. However, foreign private placement investment trusts were introduced into Japan, as foreign investment trusts were not subject to the Securities Investment Trust Law. At that time, private-placement investment trusts had yet to be recognized in Japan.

As a result of amendments to the Securities Investment Trust Law in 1998, foreign investment trusts have become subject to the same regulations as Japanese investment trusts under the revised act. Namely, the amendments require foreign investment trust management companies to file the same notification as Japanese investment trusts at the sale of foreign investment trusts in Japan and to allow Japanese courts to issue an order to prohibit or stop the sale of foreign investment trusts if inappropriate investment management of foreign investment trusts impairs the profits of domestic investors and if there is an emergent necessity to prevent further losses to investors. It is also permitted to introduce yen-denominated funds into Japan, for which fundamentally the same tax system as Japanese investment trusts is applied to foreign investment trusts. The disclosure system is common to Japanese and foreign investment trusts, including preparation and delivery of a prospectus and financial reports. The Japan Securities Dealers Association establishes "standards on the selection of foreign investment trusts" in the fair, "conventional regulations on dealing in foreign securities" to set the requirements for foreign funds available in Japan.

Table XIV-2 shows the trend of total net assets of foreign investment trusts sold in Japan for 20 years. The total net assets had been dependent on the effects of exchange rates, etc. Foreign investment trusts surged in sales in Japan after 1997, reflecting a higher demand in high-yield foreign bonds and a tendency toward a weaker yen during the continued ultralow interest rate. The ratio of foreign investment trust assets to total investment trust assets, including domestic investment trusts, was above 13% in 2004. After that, the growth in sales of overseas registered investment trusts came to a halt due to the recovered popularity of domestic stock funds and an increase in monthly distribution funds registered in Japan. Stock investment trusts increased, and real estate and alternative funds grew also, after 2004 when stock prices recovered globally though broadly defined bond funds, including MMFs, continued to be mainstream. Looking at foreign investment trusts by country of

Table XIV-2. Total Net Assets of Foreign Investment Trusts in Japan (¥100 million) and Their Ratio to Total (public offering) Investment Trusts

End of year	Total net assets of foreign investment trusts (A)	Total net assets of domestic investment trusts (B)	Total (C) (A + B)	(A) / (C)
1993	7,090	507,375	514,465	1.4%
94	5,412	434,083	439,495	1.2%
95	5,365	479,571	484,936	1.1%
96	5,795	486,680	492,475	1.2%
97	15,236	406,495	421,731	3.6%
98	29,352	327,393	356,745	8.2%
99	35,099	513,536	548,635	6.4%
2000	36,084	493,992	530,076	6.8%
01	41,426	452,807	494,233	8.4%
02	47,147	360,160	407,307	11.6%
03	54,427	374,356	428,783	12.7%
04	62,411	409,967	472,378	13.2%
05	79,670	553,476	633,146	12.6%
06	87,104	689,276	776,380	11.2%
07	82,427	797,606	880,033	9.4%
08	51,473	521,465	572,938	9.0%
09	59,306	614,551	673,857	8.8%
10	58,800	637,201	696,001	8.4%
11	52,358	573,274	625,632	8.4%
12	57,839	640,638	698,477	8.3%
13/9	59,625	768,068	827,693	7.2%

Note: The total net assets of domestic investment trusts are the total net assets of publicly offered securities investment trusts in Japan.
Sources: Total net assets of foreign investment trusts and domestic investment trusts were taken from the Japan Securities Dealers Association and the Investment Trusts Association, Japan, respectively.

establishment, Luxembourg investment trusts enjoyed an overwhelming share of the market in the past, but Cayman investment trusts have increased their share since around 2005. At the end of March 2013, Luxembourg, Cayman, and other investment trusts accounted for 44.9%, 40.5%, and 14.6% in terms of total net assets, respectively.

CHAPTER XV

The Information Disclosure System

1. The Information Disclosure System in the Securities Market

When a company lists its security on the securities market opened on a stock exchange, the issuer of such security is required by the Financial Instruments and Exchange Act and by the regulations of the stock exchange to disclose information concerning certain matters of its business. Such regulations are called disclosure regulations, and they consist of statutory disclosure rules under the Financial Instruments and Exchange Act and the timely disclosure required by the securities exchanges.

There are four types of statutory disclosures: (1) issuance disclosure, which requires companies to disclose information concerning certain matters when they publicly offer securities on the primary market; (2) periodic disclosure, which requires companies whose securities are listed and traded on the securities market to disclose information concerning certain matters on a continuing and regular basis; (3) tender offer disclosure and (4) large holding disclosure (5% or larger shareholdings). The latter two types of statutory disclosure are required under the Financial Instruments and Exchange Act.

On the other hand, timely disclosure, which is required by the exchanges, obliges companies to continuously disclose their information after listing their securities on the exchanges, and the type of information required is classified into (1) information on listed companies; (2) information on subsidiaries; and (3) other information, such as supplemental information on majority shareholders, etc. The type of information is categorized as (1) determinations, (2) occurrences, and (3) information on financial results.

Companies that are required to make the issuance disclosure and the periodic disclosure are also required by the Companies Act to disclose certain information. The disclosure of accounting documents required to be made by the Companies Act is aimed at protecting the interest of shareholders and bondholders and at regulating the amount that can be paid in dividends. In contrast, the disclosure required to be made under the Financial Instruments and Exchange Act and under exchanges' regulations is designed to disclose information concerning the state of business of listed companies to help the

Chart XV-1. The Scheme of the Disclosure System on the Securities Market

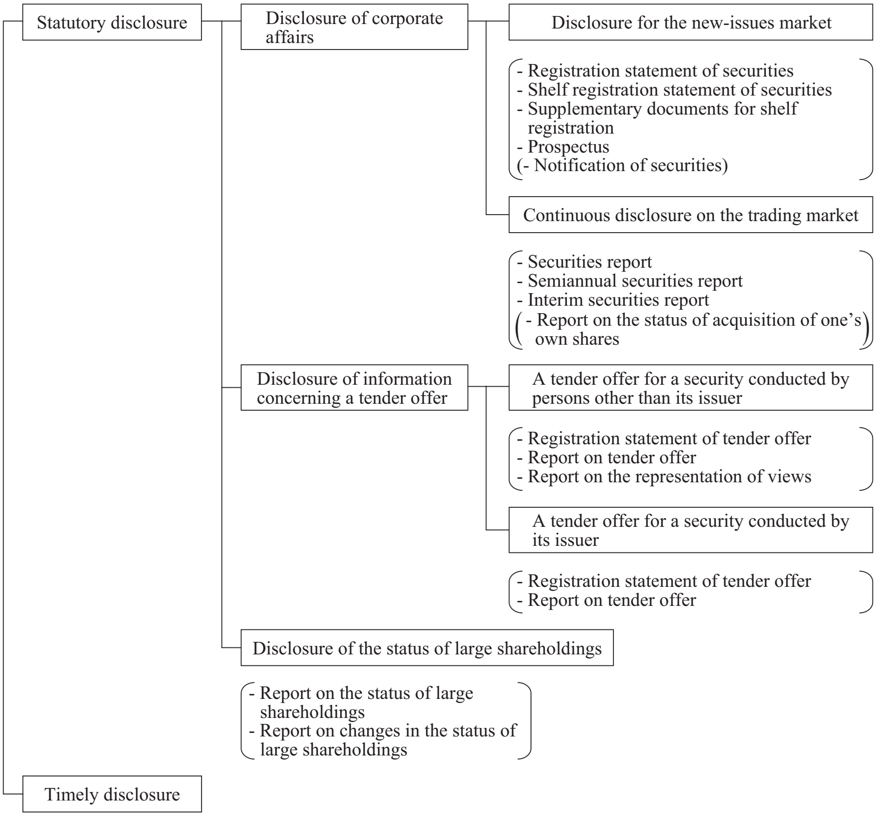


Table XV-1. Disclosure Systems under the Commercial Code and under the Financial Instruments and Exchange Act

Disclosure System under the Financial Instruments and Exchange Act		Disclosure System under the Commercial Code
Furnishing information necessary for investors to make an investment judgment	Purpose of disclosure	Report on profits available for dividends and the company's capacity for offering security for loans (solvency)
Investors (including those who are not shareholders of the company at a given time)	Targets for which the disclosure is intended	Shareholders and creditors
Providing disclosure through EDINET and stock exchanges, replying to investor requests for disclosure	Method of disclosure	Preparation of computing documents, keeping of such documents at the head office, and publication of a summary of annual settlement of accounts

investors to make informed and reasonable investment decisions.

2. The System of Disclosing Corporate Information under the Financial Instruments and Exchange Act

(1) Issuance Disclosure

When a company publicly offers, or makes a secondary distribution of, a security whose aggregate value is ¥100 million ($0.98 million) or more, the issuer of such security must, in principle, file a securities registration statement with the prime minister. On the primary market, information is disclosed through the securities registration statement. Concretely, the statement shall describe (1) matters pertaining to said offering or sale, (2) the trade name of the issuing company, (3) the name of the business group to which it belongs, (4) the financial position of the issuing company, and (5) important information on other material matters concerning its business. In addition, when a securities company solicits customers for the purchase of a newly issued security, it is required to provide investors with a prospectus that furnishes them with information concerning the issue that is deemed necessary for them to assess its value and to make an informed investment decision.

*US dollar conversions from yen are at the exchange rate of ¥102.50 to US$1 prevailing on January 31, 2014.

(2) Periodic Disclosure

The issuer of securities listed on an exchange must file with the prime minister a securities report for each business year within three months after the expiration of such business year. The securities report constitutes the main document of statutory disclosure for the secondary market. More specifically, it must provide (1) the name of the issuer, (2) the name of the business group to which it belongs, (3) information concerning the state of its finances, and (4) information on other material matters concerning its business. In turn, the securities report thus filed is made available for public inspection through the EDINET. Moreover, companies that are required to make continuous disclosure must regularly file quarterly reports, interim reports, and reports on the state of a repurchase of their own shares, where necessary.

Issuers of securities that are traded on the financial instruments market are expected to disclose sufficient information concerning their corporate affairs, on the basis of which the prices of securities will be formed. If they do not disclose information that is to their disadvantage, the prices of their securities will be formed on the basis of an erroneous assessment of their value that does not reflect such withheld information. This is why the law requires the issuers of securities to disclose all pertinent information, good or bad, in their

Table XV-2. Statutory Disclosure Documents Required to be Filed

Division		Documents filed	Cases requiring the filing of documents (a summary)
Disclosure of corporate affairs	Disclosure of information concerning the issuance of new shares	Registration statement of securities	If a company issuing new shares or selling outstanding shares through a public offering whose total issuing or selling price is ¥100 million ($1.2 million at the rate of ¥83.15 to the dollar) or more and such company plans to solicit 50 or more investors for the purchase of its new shares or plans to sell to or solicit 50 or more investors for the purchase of outstanding shares on uniform terms and conditions, it must file a registration statement. * Small amount offering: In the case of a company issuing new shares or selling outstanding shares through a public offering whose total issuing or selling price is less than ¥500 million ($6.01 million), the contents of the registration statement of securities required to be filed by such company are simplified. * Incorporating system: A company that has been filing securities reports continuously for one year may substitute a registration statement of securities other than matters relating to the securities publicly offered or distributed on the secondary market with a securities report and a semiannual securities report filed in its place. * Reference system: When transactions of issued securities fulfill certain requirements of the securities market with which the issuer has been filing securities reports for a year and the issuer's corporate information has broadly been disclosed, the description that one should refer to the last securities reports, etc., may be substituted with a registration statement of securities concerning matters other than the offer or sale of securities.
		Shelf-registration statement	When any issuer who is authorized to file a registration statement of securities under the reference system plans to issue new shares or sell outstanding shares through a public offering whose total issuing or selling prices are ¥100 million ($1.2 million) or more, such issuer may file a shelf-registration statement of its shares.
		Supplementary documents to be filed with a shelf-registration statement	When a shelf-registration statement of a security has taken effect, and when the issuer of such security plans to issue new shares or sell outstanding shares whose total issuing or sell prices are ¥100 million ($1.1 million) or more, such issuer is required to file supplementary documents relating thereto.
	Periodic disclosure	Securities report	Any company that is (1) the issuer of a security to be listed on a stock exchange; (2) the issuer of securities stipulated by cabinet order as those similar to distribution conditions in (1); (3) the issuer of a security who is required to file a registration statement of securities when it issues new shares or sells outstanding shares through a public offering; or (4) the issuer of a security the number of whose owners was 1,000 or more at the end of any of the latest five years (excluding certain cases), is required to file a securities report.
		Quarterly securities report	Among companies required to submit a securities report, issuers of securities listed on stock exchanges or or stipulated by cabinet order as being similar in terms of distribution conditions must file quarterly securities reports.
		Extraordinary securities report	If any material fact has occurred in a company, that company must file an extraordinary securities reports.
		Report on the state of acquisition of one's own shares	Any issuer of a security listed on a stock exchange or stipulated by cabinet order as being similar in terms of distribution conditions and that has passed a resolution at a general meeting of its shareholders or at a board of directors' meeting to acquire its own shares must file a report.

securities reports, and why it contains penal provisions to discipline issuers who file a securities report containing false statements.

3. Other Disclosures to Be Made under the Financial Instruments and Exchange Act

(1) Disclosure Relating to a Tender Offer

The act of soliciting an unspecified large number of persons through a public notice for an offer to purchase or to sell shares and of purchasing such shares off of the exchange is called a "tender offer." If any person other than the issuer of a listed stock who is required to file a securities report proposes the purchase of such shares outside the market of a stock exchange, he must, except in cases that fall within the purview of certain requirements, such as the purchase will result in the ownership of more than 5% of the securities, etc., purchase such shares through a tender offer. The tender offerer is obligated to serve a public notice of (1) the purpose of the tender offer; (2) the purchase prices, etc.; (3) the number of stocks to be purchased; (4) the period during which stocks will be purchased; and (5) other items stipulated in other cabinet ordinances ("public notice for commencing tender offer") and must also file the tender offer notification with the prime minister. In addition, the tender offerer must, on the day immediately following the day on which the tender offer period has expired, serve a public notice or make an announcement indicating the number of sell offers received, the number of shares it has actually purchased, and the method of payment to be made to sellers and file with the prime minister a tender offer report furnishing information about such matters.

The regulation on tender offers is designed to disclose information for investors in advance and give shareholders equal opportunities to sell their stocks from the standpoint of ensuring the transparency and fairness of off-exchange trading when the transactions would have effects on the control of the target corporation.

(2) Disclosure of Large Shareholdings

When the number of shares of a listed company held by a person exceeds 5% of its outstanding shares (large-volume holders), such person is principally required to file a large shareholdings report with the prime minister within five days (excluding Sundays and other holidays as may be stipulated in cabinet orders) from the date when such person's holding rate is above 5% (called the "5% rule"). The large shareholdings report must furnish information concerning (1) matters relating to the ratio of shares held by such person, (2) matters relating to the funds acquired by such person for the purpose of

Table XV-3. Transitions in Tender Offer Bid (TOB) System

	Major Developments
1971	• Public tender offer system introduced
1990	• Principles set down for forcing tender offers • Percentage share offer that triggers obligation to make tender offer decreased from 10% to 5% • Prior notification system abolished • Duration of offer extended • Shareholders' withdrawal rights expanded
2001	• Along with the deregulation, in principle, of purchasing treasury shares, system for making tender offers for a company's own shares introduced
2003	• Scope of acquisitions exempt from the TOB system enlarged
2004	• TOBs restricted to companies with equity securities • Electronic notification system introduced
2005	• ToSTNeT transactions made independent of market transactions
2006	• Disclosure for TOBs upgraded (purpose of acquisition, basis of price calculation, disclosure for MBOs) • Regulations implemented concerning the combined acquisition of shares on and offmarket • Obligation introduced for investor purchasing large stake in company during TOB by another party to also make a TOB • Details given for lowering TOB price when share split occurs • Reasons for withdrawing TOB expanded • Obligation introduced for targeted company to submit an opinion report • Obligation introduced for investor making TOB to answer targeted company's questions (reply to submitted questions) for the purpose of making the opinion report • Calculation of duration of TOB set using business days • Targeted company allowed to demand extension of TOB • Obligation introduced for TOB investor to acquire all tendered shares
2008	• Specified listed securities added to securities eligible for TOBs • Monetary penalty system introduced regarding TOB regulations

purchasing such shares; and (3) the purpose for which such person has acquired such shares. And when the percentage of shareholdings of such person increases or decreases by 1% or more, such person must file a revised report indicating the change that occurred in the percentage of such person's holdings of such shares.

This disclosure is required because the actions of a single person holding a large volume of shares can have large effects on the formation of stock prices at the market.

4. Timely Disclosure System of Financial Instruments Exchanges (The

Table XV-4. The Tender Offer Process

1. Commencement of a Tender Offer
   - Make a notice of commencement of a tender offer. (A public notice of a tender offer furnishing information concerning the objective of the tender offer, the purchase price, the number of shares to be purchased, and the period of the tender offer is published in a national daily newspaper.)
   - A registration statement of tender offer is filed with the prime minister on the day the public notice is published, and copies of it are forwarded to the target company, the stock exchange on which the shares are listed, and the person who has filed the registration statement of tender offer with respect to the target company.

2. The Period of a Tender Offer (for 20 business days or more and 60 business days or less, in principle)
   - Issue a circular of tender offer to shareholders who plan to sell their holdings of the share certificates of the target company.
   - The purchase price shall be uniform and universal and a tender offerer in principle may not make certain changes in the terms of purchase, including lowering of the purchase price and shortening of the purchase period.
   - A tender offerer in principle may not withdraw the offer or cancel contracts pertaining to a tender offer and shall offer to acquire the entire issue of shares, etc., subject to the tender offer in the event that the holding of the tender offerer after the completion of the tender offer should exceed two-thirds of the said shares, etc.
   - Any shareholder who has offered to sell his holdings under the tender offer may terminate the contract any time he chooses during the tender offer period.
   - A subject company, or the issuer of the shares subject to a tender offer, shall submit a subject company's position statement to the prime minister and send copies of the statement to the tender offerer and relevant securities exchange(s).
   - The tender offerer is prohibited, in principle, from purchasing the shares of the target company through any manner other than the tender offer.

3. End of the Tender Offer
   - The tender offerer serves a public notice or announces the number of shares bought through the tender offer and files a report on the tender offer with the prime minister.
   - The tender offerer forwards to shareholders who have offered to sell their holdings a notice indicating the number of shares the tender offerer has bought from such shareholders.
   - The tender offerer pays for the shares it has bought without delay.

Stock Exchanges)

As described in the head of this chapter, stock exchanges require listed companies to disclose corporate information according to their regulations. For example, the Tokyo Stock Exchange stipulates in the regulations of the exchange governing the listing of securities that listed companies shall, in a timely fashion, disclose information having effects on investors' decisions and defines concrete matters to be disclosed and procedures for disclosing such matters (see table XV-6). These listed companies need to disclose both

Table XV-5. The Flow of a 5% Shareholding Report

1. The Duty to File a Large Shareholding Report
   - A holder or joint holders of shares, etc., whose holding ratio of the shares, etc., issued has exceeded 5% shall submit to the prime minister a large shareholding report, which shall include the name(s), address(es), and business(es) of the holder or joint holders, an item concerning the holding ratio of shares, etc., the purpose of holding, an item concerning the fund for acquisition, and other items within five days from the date of such occurrence and send copies of the report to the issuer and relevant securities exchange(s).
   - A large shareholding report pertaining to shares, etc., held by a institutional investor, excluding the cases where the holding ratio of shares, etc., exceeds 10%, shall, notwithstanding the provision above, be submitted to the prime minister within five days from the (bimonthly or more frequent) reference date when the holding ratio of shares, etc., has exceeded 5% for the first time (special provisions for reporting large shareholdings).

2. The Duty to File Other Reports
   - Any large shareholder whose percentage of holdings has increased or decreased by 1% or more of the outstanding shares of a listed company after he had filed a large shareholdings report must file with the prime minister a report on the change in his shareholdings within five business days, in principle, from the day on which such change has occurred and forward a copy of the report to the stock exchange on which such stock is listed and to the issuing company of such shares.
   - When any large shareholder who had filed a large shareholdings report finds any inadequacy in the contents of such report, such large shareholder must file an amended report with the prime minister.

3. Public Inspection of Reports
   - The prime minister and the stock exchange on which such stock is listed must make these reports available for public inspection for five years.

the resolutions and decisions adopted by their executive body promptly after such resolutions or decisions were adopted and any developments caused by external factors at the time the companies had learned of such developments.

In addition, listed companies are obliged to provide stock exchanges with concise information on inquiries from the stock exchanges immediately if required and to disclose the details of information immediately when the securities exchanges deem it necessary and proper. This applies to a case where corporate information is leaked to outsiders before it is made public and its securities are traded on the basis of unconfirmed information. When listed companies do not disclose information according to such regulations, the stock exchange concerned may (1) designate the securities issued by the listed company as disclosure-delinquent issues and publicize such fact to alert the investors to the issuer's failure to disclose material information; (2) require them to file a report describing these facts and measures (revised reports), which is made available for public inspection, if necessary, to improve the

Table XV-6. Main Points of Corporate Information Required by Timely Disclosure (in the case of the Tokyo Stock Exchange)

1. Decisions taken by a listed company	1. Offering of new shares to be issued, treasury stocks to be allocated, and new share subscription rights to be issued or treasury new share subscription rights to be transferred and sale of shares and new share subscription rights 2. Shelf registration and the commencement of a survey of demand 3. Decrease in capital 4. Decrease in capital reserve or profit reserve 5. Acquisition of one's own shares 6. Allotment of shares or equity warrants without change 7. Free allotment of shares or new share subscription rights 8. Stock split or consolidation 9. Change in the amount of dividends (a change in dividends) 10. Swap of shares 11. Stock transfers 12. Corporate merger 13. Breakup of the company 14. Assignment or acquisition of business, in whole or in part 15. Liquidation (except in the case of a merger) 16. Commercialization of a new product or technology 17. Business tie-up or termination of business tie-up 18. Transfer or acquisition of shares or equities involving changes in the scope of subsidiaries or other matters involving a change in a scope of subsidiaries 19. Transfer or acquisition of fixed assets 20. Borrowing of fixed assets based on a lease 21. Suspension or abolishment of all or part of a business(es) 22. Application for delisting the shares of the company 23. Petition for bankruptcy, commencement of rehabilitation proceedings, or commencement of reorganization proceedings 24. Commencement of new business 25. Tender offer for the purchase of shares of the company by another person or for the purchase of its own shares 26. Representation of views on a proposed tender offer 27. Granting stock options 31. Change in the number of shares constituting a trading unit of shares, the abolition, or the institution, of the regulation providing for the number of shares constituting a trading unit 32. Change in fiscal year (Change in the end of the business year) 33. Application to the prime minister of the Cabinet of possibility of negative worth or default on repayment of deposits held in trust, etc. (Notification under the provision of Article 74.5 of the Deposit Insurance Law) 34. Application for intercession in line with procedures for special mediation according to the Special Mediation Act 35. Important matters concerning early redemption of listed bonds, etc. or calling a general meeting of bondholders and other important matters concerning rights of listed bonds 36. Change in appointed certified public accountant, etc. 37. Annotation of matters relating to assumptions of a going concern 38. Submission of request to extend submission deadline for securities report or quarter report 39. Termination of commission of stock transfer agency 40. Submission of internal control report indicating lack of disclosure of material items or non-disclosure of evaluation results 41. Amendments to the articles of incorporation 42. Other material matters relating to the management, business, property, or the listed stock of the company
2. Facts arising relative to a listed company	1. Losses caused by a disaster or those suffered in the course of business 2. Change in major shareholders or in the largest shareholder 3. Facts that could cause a delisting of the shares of the company 4. Filing of a law suit or decision by the court against the company 5. Provisional disposition order or decision, etc. 6. Administrative disciplinary action taken against the company, such a the termination of license or suspension of business operations or their equivalent, or a charge of a violation of a law or regulation brought against the company by a regulatory agency 7. Changes in the status of controlling shareholders or of other associated companies 8. Start of bankruptcy procedures, tendering procedures, or rehabilitation procedures or application or notification of the foreclosing of corporate security rights 9. Default on promissory note, etc. or suspension from making transactions in note factoring market. 10. Commencement of bankruptcy proceedings, rehabilitation proceedings, reorganization proceedings, or liquidation or a petition or notice of the exercise of a security right by the parent company 11. Inability to collect on or extend collection on debts 12. Termination of business with customer 13. Receiving financial aid, such as forgiveness of debt 14. Discovery of natural resources 15. Request to halt issue of shares or new share subscription rights 16. Request to hold general meeting of shareholders 17. Unrealized loss on securities investments 18. Forfeiture of benefit of time on maturing corporate bonds 19. Material facts regarding rights to call a meeting of holders of listed security debt, such as bonds, or other rights regarding listed security debt 20. A change in the certified public accountant employed by the company 21. Approval of extension or prolonging of submission of securities report or quarterly business report 22. Qualified opinion or non-disclosed opinion or qualified opinion with an exception relating to assumptions of a going concern in the external audit of the financial statements 23. Qualified opinion or non-disclosed opinion in an internal control audit report 24. Receipt of a notice of cancellation of an agreement for commissioning stock administration service 25. Other material matters relating to the management, business, property, or the listed stock of the company
3. Information concerning the settlement of accounts of a listed company	1. The substance of settlement of accounts (annual, semiannual, and quarterly) 2. Modification of projected sales and earnings 3. Modification of a projected dividend

Note: In addition to the above, listed companies are required to disclose material decisions and new developments related to subsidiaries and other items related to shareholders, etc., with a controlling interest

Source: Tokyo Stock Exchange, *Securities Listing Requirements, Guidebook for the Timely Disclosure of Corporate Information*.

situation; and (3) take measures to impose monetary penalties or designate the securities as closely monitored issues because of a serious violation of the listing agreements if there is no sign of improvement of the situation even through the above measures.

Promptness is a feature of timely disclosure. For example, stock exchanges require listed companies to disclose their financial results immediately after their determination. In response, the listed companies disclose earnings summaries of financial results according to the given format. The earnings summaries carry more importance in terms of helping investors to learn about financial results because the earnings summaries are released earlier than the securities reports.

5. Electronic Disclosure

Previously, the statutory and timely disclosure of corporate information had been made in the form of documents and had been made available for public inspection at the regional financial bureaus and stock exchanges. At present, both statutory and timely disclosures are generally made electronically available through the Internet. This digitization allows investors to view disclosed information more fairly and immediately and helps the issuers to reduce the administration costs of disclosure. The introduction of the XBRL (Extensible Business Reporting Language), a next-generation standard language, is being promoted for electronic disclosure systems in foreign countries to help bring about more-efficient preparation, distribution, and reuse of electronic financial information and increase the convenience for investors. In Japan, preparation for the introduction of the XBRL for statutory disclosure and timely disclosure has been going on since 2008.

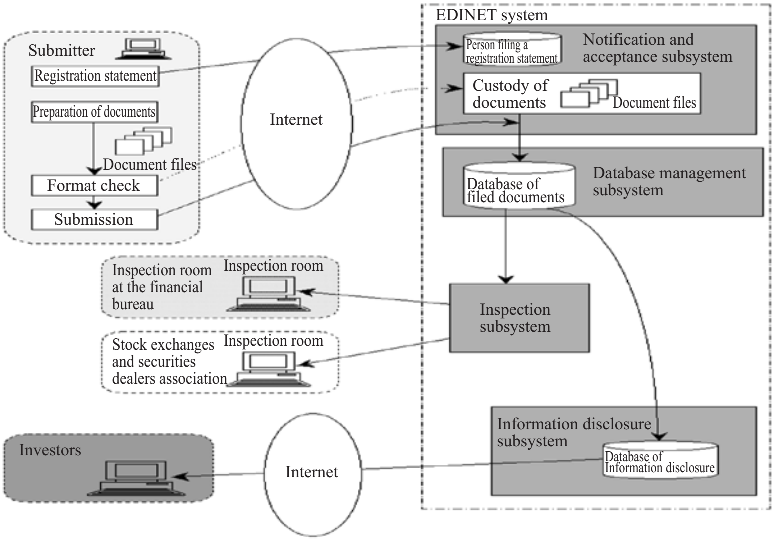
(1) Electronic Disclosure for Investors' Network (EDINET)

EDINET is a system that enables electronic filing and public inspection of documents disclosed under the Financial Instruments and Exchange Act. The disclosure documents had previously been disclosed through the printed media. More specifically, persons who are required to file securities reports now file disclosure documents furnishing their corporate information with the competent regional financial bureaus online through the Internet, and the financial bureaus, in turn, offer such information for public inspection on the screens of computer monitors installed at their inspection rooms. In addition, investors can also inspect such documents through the Internet.

(2) Timely Disclosure Network (TDnet)

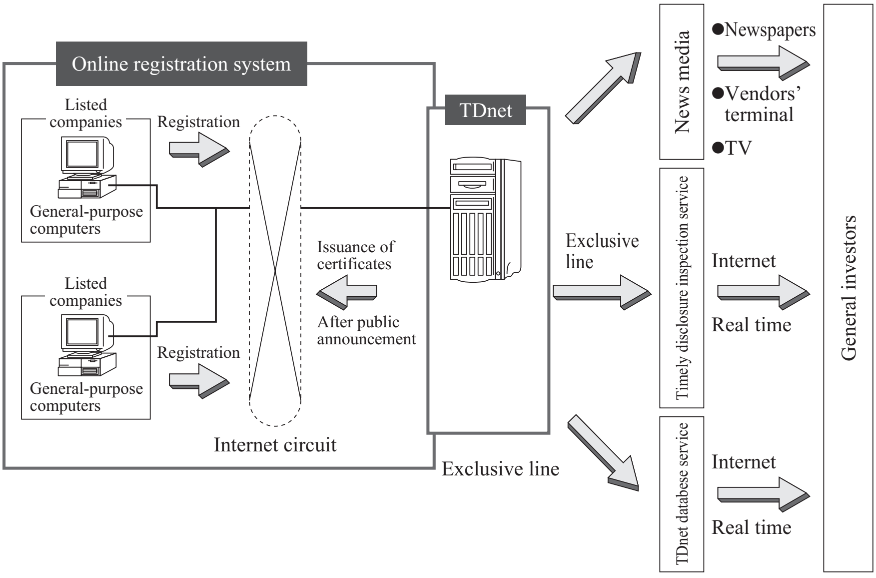
TDnet is a system designed to enable comprehensive electronic processing of

Chart XV-2. Conceptual Chart of the EDINET System



Source: Financial Services Agency, *Guide to the EDINET.*

Chart XV-3. Flow of Information Disclosure via TDnet



Source: Tokyo Stock Exchange, *Handbook of the TSE 2007.*

a series of disclosure procedures for listed companies. They include (1) providing corporate disclosure information to the stock exchange, (2) furnishing the stock exchange with disclosure information in advance of public disclosure, (3) disclosing such information to the news media, (4) allowing public inspection, and (5) building a disclosure information database. At present, TDnet is used to communicate timely disclosures of companies listed on other stock exchanges in Japan. Information disclosed through TDnet is available for the day on which it is disclosed and for 30 days thereafter under the timely disclosed information service, which is jointly operated by the stock exchanges throughout the country via the web sites of these stock exchanges.

6. Recent Moves of Information Disclosure

(1) Legislation of Quarterly Disclosure

Twice-a-year (annual and semiannual) disclosure of business results has been common practice in Japan. However, as the business results of a growing number of companies have changed rapidly in recent years, many investors felt the need to have access to such results more frequently than before. To meet such need, listed companies were, under the regulations of the stock exchanges, obligated to disclose financial results quarterly; this was subsequently enforced as a quarterly reporting system by law as a result of the implementation of the Financial Instruments and Exchange Act.

(2) Enhancement of Corporate Governance and Internal Control

Following a rash of false statements in securities reports and window-dressing settlements of large companies in recent years, stock exchanges have required listed companies to file a written confirmation statement regarding compliance with exchange disclosure regulations and a report of corporate governance to ensure the credibility of the information disclosure system. The Financial Instruments and Exchange Act also requires listed companies to file a written confirmation on the appropriateness of internal control reports and securities reports, which value the system necessary for ensuring the appropriateness of documents pertaining to financial calculations and other information on the listed company and business group to which it belongs.

(3) Movement toward Introduction of International Financial Reporting Standards (IFRS)

In recent years, there has been progressive movement internationally toward the introduction of International Financial Reporting Standards (IFRS), accounting standards developed by the International Accounting Standards

Table XV-7. Outline of the Written Confirmation Statements and Reports

Submitted Documents	Written confirmation of compliance with stock exchanges' regulations	Outline of timely disclosure (included in corporate governance reports)	Written confirmation attached to securities reports
Purpose	To maintain and enhance the confidence of investors in the security market		
Content	The representative attests that they will comply with the regulations, etc., of the stock exchange and will observe the measures stipulated by the stock exchange based on its regulations, etc.	Report on the status of establishment of disclosure policies, organization, and procedures, and on the status of the establishment of a monitoring system for the timely disclosure system.	The representative attests that the content of the company's securities reports, etc., is in accordance with the Financial Instruments and Exchange Act.
Date of submission	When the representative has changed	When any details have changed	At the time a securities report, etc., is filed
Method of publication		Public inspection (web sites of the stock exchanges)	Public inspection (EDINET)

Board (IASB).

In total, over 100 countries now use or plan to use the IFRS as their own accounting standards. In the EU, companies listed in the region have been required to use the IFRS since 2005. And financial statements prepared based on the IFRS are accepted in the United States.

Japan is also moving toward the introduction of the IFRS. Since 2010, listing companies have been allowed to voluntarily adopt IFRS on condition, among other requirements, that the companies conduct international financial or business activities. However, in fact, only a few companies took advantage of this option. In response, in 2013, with a view to expanding voluntary adoption of IFRS, the requirements were relaxed. As a result, it is expected that the number of companies adopting IFRS will increase.

CHAPTER XVI

Securities Taxation

1. Transitions in Securities Taxation (1)

Basically, the income tax system of Japan is based on comprehensive taxation (taxation upon the total income). It traces its origin to a recommendation made soon after the war by the Shoup Report on Japanese Taxation. Under the Shoup taxation system enforced in 1950, not just interest and dividends but also capital gains from the sale of securities (the whole amount of a capital loss from the sale of securities was deductible) were subject to comprehensive taxation. After the end of the Allied military occupation, however, the Japanese government authorized separate taxation on interest and exempted from tax, in principle, capital gains from the sale of securities primarily from the policy standpoint to encourage accumulation of capital—with the result that the ideal of comprehensive taxation on income has disintegrated rapidly. And it was a sweeping reform of the taxation system carried out in 1987–1989 that helped the basic framework of the present income tax system take shape. At that time, the structure of income taxation was changed from one consisting of 15 brackets (10.5%–70%) to a flat one consisting of five brackets (10%–50%), and the financial income taxation system was overhauled thoroughly, including the uniform separate withholding taxation on interest income; the abolition of the tax-exempt savings system, in principle; and separate taxation, in principle, on capital gains from the sale of securities.

The structure of income tax rates was amended to 4 brackets (10%–37%) in the fiscal 1999 tax reform and to 6 brackets (5%–40%) in the fiscal 2006 tax reform. In the fiscal 2013 tax reform, from the perspective of correcting income disparity and reviving the income redistribution function, starting with income tax for 2015, the rate for taxable income in excess of ¥40 million was set at 45%.

In the fiscal 1999 tax reform, the basic corporate income tax rate was reduced to 30% from the existing 34.5%. The basic corporation tax rate was further cut to 25.5% in the fiscal 2011 tax reform. As a result, the effective corporate tax rate as of January 2013 was 35.64%.

Table XVI-1. Securities Taxation Evolution Timeline (1949−2002)

Year	Major amendments	Income tax brackets
1949	Shoup recommendation	
1950	A comprehensive taxation of interest, dividends, and capital gains from the sale of securities is enforced.	8 brackets (20%−55%)
1951	The optional separate withholding tax (50%) on interest is revived.	
1952	The withholding tax on dividends (20%) is revived.	
1953	Securities capital gains are exempted from income tax, in principle. The securities transaction tax is instituted (0.15% of the value of stock transaction). A uniform separate withholding tax on interest (10%) is instituted.	11 brackets (15%−65%)
1954	The withholding tax on dividends is reduced (20% to 15%).	
1955	Interest is exempted from income tax. The withholding tax on dividends is lowered (15% to 10%).	
1957	The separate withholding tax only on interest on short-term savings is revived (10%).	13 brackets (10%−70%)
1959	The separate withholding tax on interest on long-term savings is revived (10%).	
1961	Securities capital gains tax is levied on certain large-lot transactions.	
1962		15 brackets (8%−75%)
1963	The withholding tax rate on interest and dividends is lowered (10% to 5%).	
1965	The withholding tax rate on interest and dividends is raised (5% to 10%). The system of not requiring declaration and the optional separate withholding tax on dividends (15%) are introduced.	
1967	The withholding tax on interest and dividends is raised (10% to 15%). The optional withholding tax on dividends is raised (15% to 20%).	
1969		16 brackets (10%−75%)
1970		19 brackets (10%−75%)
1971	The optional separate withholding tax on interest (20%) is revived.	
1973	The optional withholding tax on interest and dividends is raised (20% to 25%). The securities transaction tax is raised (0.15% to 0.3%).	(The taxable income applicable to tax rate brackets is raised in 1971 and again in 1974.)
1976	The optional withholding tax on interest and dividends is raised (25% to 30%).	
1978	The withholding tax rate on interest and dividends is raised (15% to 20%). The optional withholding tax rate on interest and dividends is raised (30% to 35%). The securities transaction tax is raised (0.3% to 0.45%).	
1981	The securities transaction tax is raised (0.45% to 0.55%).	
1984		15 brackets (10.5%−70%)
1987	A sweeping tax reform	12 brackets (10.5%−60%)
1988	- The *maruyu* system is abolished, in principle.	
1989	- Uniform separate withholding tax on interest (20%) (products similar to financial products are also subject to the uniform separate withholding tax). - Securities capital gains are taxed, in principle (introduction of a separate withholding tax of 1% of the stock transaction value). - The securities transaction tax is lowered (0.55% to 0.3%).	5 brackets (10%−50%)
1995		(In 1995, the taxable income applicable to tax rate brackets is raised.)
1996	Securities capital gains tax is normalized (5% of deemed capital gains to 5.25%). The securities transaction tax is lowered (0.3% to 0.12%).	
1998	The securities transaction tax is lowered (0.12% to 0.06%).	
1999	The securities transaction tax is abolished.	4 brackets (10%−37%)
2001	A tax exemption system launched for small-amount capital gains from the sale of stocks held long term.	
2002	Special brokerage account system established (implemented January 2003).	

Looking at major trends in Japan's securities taxation system during the late 1990s and early 2000s, the government built taxation systems for stock options, special-purpose companies, and corporate-type investment trusts. Effective April 1999, it abolished the securities transaction tax and the exchange tax (imposed on futures and option transactions), which had long been issues of concern. Further measures followed with the introduction of the Angles taxation system in 2000 and the tax-exemption system for profits on small sales amounts of stocks being held for the long term (a ¥1 million special tax exemption on stocks, etc., held for one year or more) and an emergency investment tax break (a tax exemption on up to ¥10 million of principal) in 2001. The establishment of the special account system was included in the tax revisions for fiscal 2002 and launched on January 1, 2003. During the same period, the government reorganized its small-amount tax-exemption system for small-sum savings of the elderly, etc. (*Maruyu* savings system for the elderly, etc.), converting it into a small-amount tax-exemption system for handicapped persons, etc.

2. Transitions in Securities Taxation (2)

In recent years, the reforms in the securities taxation system have focused mainly on revisions in the preferential tax system for dividends and capital gains on listed stocks, etc., and expanding the scope of offsetting losses against gains.

During this period, there have been regular revisions in the tax rate. In the fiscal 2003 reform, the government introduced a non-declaration requirement system that imposed only a fixed withholding tax of 20% (15% in income tax and 5% in local inhabitants' tax) on dividends and capital gains from listed stocks, etc., and distributions of gains from publicly offered stock investment

Table XVI-2. Securities Taxation Evolution Timeline (Since 2003)

Year	Major amendments	Income tax brackets
2003	Non-declaration system introduced for dividends from dividends and capital gains from listed stocks, etc. The tax exemption system for small-amount capital gains from the sale of stocks held long term abolished	
2004	Preferential tax rate on dividends and capital gains from publicly offered stock investment trusts Tax rate reduced on capital gains from the sale of unlisted stock (26%→20%).	
2007	The expiration date of application for a preferential tax rate extended for a year for dividends on and capital gains from the sale of listed stocks, etc.	6 brackets (5%−40%)
2009	Mechanism introduced enabling netting of dividends and capital gains and losses from listed stocks, etc. Preferential tax rate on dividends and capital gains of listed stocks, etc. extended for three more years Set up of a tax-free system for small amount investment (to be introduced when rules on tax rates implemented)	
2011	Preferential tax rate on dividends and capital gains of listed stocks, etc. extended for two more years Introduction of tax-free system for small amount investment postponed for two years (starting 2014)	
2013	Tax system for public bonds, etc., changed and scope of profit and loss netting expanded (starting 2016)	

Table XVI-3. Outline of Taxes on Dividends and Capital Gains and Losses from Listed Stocks, etc.

	To 2008/12	2009/1 to 2013/12	From 2014/1
Tax rate	10%	Base: 20%	20%
		Preferential rates: Capital gains: 10% Dividends, etc.: 10%	
Withholding tax rate	10% (no declaration necessary)	10% (no declaration necessary)	20% (no declaration necessary)
Netting of annual profits and losses	—	Netting of annual capital gains and losses and dividends From 2009/1: Possible on tax return From 2010/1: Possible with withholding tax account as well From 2016/1: Possible with interest and capital gains and losses on public bonds, etc.	

Note: Special income tax for reconstruction levied from 2013 to 2037.
Source: Illustrated Taxation System of Japan, 2013 edition, page 105, compiled by Hirotaka Unami.

Table XVI-4. Outline of Nippon Individual Savings Account (NISA)

Eligible for Tax Exemption	Small amounts of dividends and capital gains on listed stock in tax-free account.
Tax-Exempt Investment Amounts	Annual (1) new investments and (2) existing investments in listed stocks, etc., up to a maximum of ¥1 million in market value (unused portion cannot be carried over to next year).
Total Tax-Exempt Investment Amount	Maximum of ¥5 million (¥1 million × 5 years)
Tax Exempt Period	10 years from 2014 to 2023
Holding Period	Maximum of 5 years, investments can be sold at any time (however, sold portion cannot be replace with new investment)

Source: Complied from Ministry of Finance materials.

trusts. At the same time, the government introduced a preferential tax rate of 10% covering the period up to the end of 2007, or fiscal 2007. In the fiscal 2004 tax reform, the government extended this preferential tax rate to cover taxable gains from publicly offered stock investment trusts. In the fiscal 2007 tax reform, the government carried over the preferential tax treatment for dividends and capital gains from listed stocks etc., for another year. From the point of view of abolishing the preferential tax rate at the end of 2008 and smoothly transitioning to the new system, the government also introduced a special two-year measure extending the preferential tax rate on capital gains of ¥5 million or less and dividends of ¥1 million or less to 2009 and 2010, respectively. However, the fiscal 2009 tax system reform extended the preferential tax rate to December 31, 2011, and the tax reform for fiscal 2011 extended it another two years. To help fund the restoration of the area stricken by the Great East Japan Earthquake, a special income tax for reconstruction is being levied from 2013 to 2037.

Looking at the trend in the scope of allowing netting of losses against gains, the fiscal 2003 tax reform made it possible for investors to offset losses on redemptions (terminating agreement) of publicly offered stock investment trusts on equities, etc., for the year. The fiscal 2004 tax reform added a tax deduction carryforward system (three years) for capital losses on publicly offered stock investment trusts. To reduce the risk of investing in equities for individual investors, the fiscal 2008 tax reform added a mechanism allowing investors to offset capital losses on listed stocks, etc., against dividends beginning with 2009. Although application of this mechanism was limited to investors who chose to declare their securities income, from 2010 it became possible to also do so using an income tax withholding account. Furthermore, the fiscal 2013 tax reform made it possible to offset income against losses for interest and capital gains or losses from public bonds, etc., and income, etc., from listed stocks starting in 2016.

The tax exemption on dividends and capital gains on small investments in listed stocks, etc., in tax-free accounts, in other words NISA, was introduced in January 2014.

3. Taxation on Interest

Interest on deposits, savings, and bonds and on profits distributed by jointly invested trust accounts and bond investment trusts are treated as interest income, and a tax is withheld at a uniform rate of 20% (20.315% including the special income tax for reconstruction) separately from other incomes. In addition to these incomes, compensation money for benefits of periodical deposit, interest on mortgage securities, profits from a gold investment account, exchange gains made from a foreign currency investment account, and gains made from single-premium endowment insurance will be subject to a separate withholding tax, as is the case with interest income. However, interest on IBRD (International Bank for Reconstruction and Development) bonds; IDB (Inter-American Development Bank) bonds; and ADB (Asian Development Bank) bonds are subject to the comprehensive taxation due to exemption from duty of withholding at source.

For specified discount bonds or debentures, an 18% separate withholding

Table XVI-5. Interest Taxation System

Division	Division of income	Outline
Interest on deposits, savings, and bonds Profits distributed by jointly managed investment trusts, bond investment trusts, and investment trusts managing publicly offered bonds	Interest income	Separate withholding tax (20%, including 5% in inhabitants' tax)
Redemption gains from discount bonds and debentures that do not qualify as specified discount bonds and debentures	Miscellaneous income	Comprehensive taxation (A separate withholding tax of, in principle, 18% is levied on specified discount bonds and debentures, which are not subject to inhabitants' tax; the tax is 16% for certain bonds or debentures)
Tax-exempt savings system		Tax-exempt interest income earned from a small-amount deposit by the handicapped (on principal of up to ¥3.5 million) Tax-exempt interest income earned from a small-amount investment in public bonds by the handicapped (on principal of up to ¥3.5 million) Tax-exempt interest income earned from postal savings by the handicapped* (on a principal of up to ¥3.5 million) Tax-exempt saving-for-housing (pension) system (on principal up to ¥5.5 million)

Note: Special income tax for reconstruction levied from 2013 to 2037.

tax (18.378% including the special income tax for reconstruction) is imposed on the discount portion (redemption gain) at their issuance. Similarly, redemption gains on discount bonds issued by the Trans-Tokyo Bay Highway Corporation and the Organization for Promoting Urban Development are subject to a 16% separate withholding tax at issuance (16.336% including the special income tax for reconstruction). The redemption gains on discount bonds or debentures that do not qualify as specified discount bonds or debentures are deemed to be miscellaneous income and are thus subject to comprehensive taxation. The redemption gains on coupon bonds are also subject to comprehensive taxation.

Tax-exempt systems of interest income include the tax-exempt small-amount savings system for handicapped persons and the tax-exempt system of interest income for employee assets formation savings system (tax-exempt system for assets formation).

The tax-exempt small-amount savings system for handicapped persons includes a tax-exempt system for interest income on small-sum savings for

Table XVI-6. The Status of Taxation on Interest Income, Etc. (2011)

(millions of yen)

Division	Amount paid		Withholding tax
		Taxable amount	
Public bonds	10,547,310	459,836	68,975
Corporate bonds	3,019,296	515,958	77,394
Deposits (Banks)	1,004,696	866,785	130,018
Deposits (Others)	878,483	588,863	88,329
Jointly invested trusts	25,819	13,403	2,011
Bond investment trusts	123,418	111,374	16,706
Redemption gains from discount bonds	2,899	2,899	522
Others	520,511	467,429	83,971
Total	16,122,429	3,026,546	467,925

Notes: 1. Taxable amount includes not only that paid to individuals but also that to corporations.
2. Amount paid and withholding tax on the redemption gains from discount bonds include not just those paid to individuals but also to corporations.
3. As fractions were rounded to the nearest whole number, the figures may not add up to the actual total amounts.

Source: Compiled on the basis of the data drawn from the web site of the National Tax Agency of Japan (http://www.nta.go.jp).

handicapped persons (*Maruyu* savings for handicapped persons, etc.) and one for interest income on small-amount public bonds for handicapped persons (special *Maruyu* for handicapped persons, etc.). Both of these systems have an upper limit of ¥3.5 million for tax-exempt principal, making earnings on a total of ¥7 million or less of principal tax free when both types of systems are used. The government abolished a previously available tax-exempt system for interest income on postal savings for handicapped persons, etc., after the privatization of postal services. Now qualified handicapped persons include persons with a physical disability certificate, wives of insured persons receiving survivors' basic pension benefits, and recipients of widow's pension benefits.

The tax-exempt system for asset formation includes the workers' asset-formation savings for homes (asset formation for home-building savings) and the workers' asset-formation pension savings plan (asset-formation pension savings). These savings are designed to encourage workers to buy houses and stabilize their retirement life, and interest, etc., on combined principals of ¥5,500,000 or less would be nontaxable. However, the asset-formation pension savings investing in life insurance and property insurance, etc., have a nontaxable upper limit of ¥3,850,000.

4. Taxation of Dividends

In principle, not taking into consideration the special income tax for reconstruction, the balance of dividends, distributions of gains from publicly offered stock investment trusts, and other applicable securities income earned by stockholders or investors after the payment of a 20% withholding tax (15% in income tax and 5% in local inhabitants' tax) is subject to comprehensive taxation. When the comprehensive tax is levied on dividend income, the income tax law allows the deduction of a certain percentage of dividend income (tax credits for dividends) to avoid double taxation.

For distributions, etc., of gains on publicly offered stock investment trusts and for dividends paid on listed stocks other than those paid on large shareholdings (those paid to a shareholder who holds 3% or more of the outstanding shares of a corporation), the payee of dividends had the option of paying

Table XVI-7. An Outline of Dividend Income Taxation

<table>
<tr><td colspan="3">Division</td><td>From 2009 to 2013</td><td>From 2014</td></tr>
<tr><td colspan="3">Distributions from publicly offered investment trusts, etc.</td><td colspan="2" rowspan="2">Election of non-declaration or comprehensive taxation methods
Non-declaration (20% withholding tax—15% income tax and 5% inhabitants' tax)
Preferential tax rate (to 2013)
(10% withholding tax—7% income tax and 3% inhabitants' tax)
Or
Comprehensive taxation
Dividend tax credit (5% to 40% income tax and 10% inhabitants' tax)
Note: 20% separate taxation method can be selected to net capital losses on stocks against other annual securities income. (15% income tax and 5% inhabitants' tax)
Preferential tax rate (to 2013)
(10%—7% income tax and 3% inhabitants' tax)</td></tr>
<tr><td rowspan="3">Dividends on profit, distributions of retained earnings, and others</td><td colspan="2">Dividends on listed stocks, etc. (other than to those paid to large shareholders)*</td></tr>
<tr><td colspan="2">Other than the above</td><td colspan="2">Comprehensive taxation (Dividend tax credits) (5% to 40% income tax and 10% inhabitants' tax)
(20% withholding tax—20% income tax only)</td></tr>
<tr><td></td><td>Dividend paid at one time less or equal to:
¥100,000 × $\frac{\text{Dividend computational period}}{12}$</td><td colspan="2">Non-declaration method
(20% withholding tax—20% income tax only)</td></tr>
</table>

Notes: 1. "Dividends on listed stocks, etc. (other than those paid to large shareholders)" means those paid to shareholders holding less than 3% of the outstanding shares of the listed company.
2. Special income tax for reconstruction levied from 2013 to 2037.

Source: Based on the web site of the Ministry of Finance.

Table XVI-8. Taxation of Dividend Income (withheld at source) (2011)

(millions of yen)

Division	Total tax paid			Tax withheld at source
		General taxation	Special tax rate applied	
Dividends on profit or interest income, distribution of retained earnings, and dividends, etc.,/ on interest on fund corporations	12,606,043	6,951,261	2,894,980	1,575,213
Distributions of profits of investment trusts (excluding bond investment trusts and publicly offered asset management bond investment trusts, etc.) and distributions, etc., of profits of investment trusts with specific investment purposes	654,662	1,204	399,419	31,129
Remittance to optional withholding tax account	912,966	–	912,966	63,717
Total	14,173,671	6,952,466	4,207,364	1,670,059

Notes: 1. Bond investment trusts and management investment trusts of publicly offered public bonds, etc., are not included in "investment trusts."
2. "General taxation" and "Special tax rate applied" include dividends received by corporations.
3. As fractions were rounded off to whole numbers, the figures may not add up to the actual total amounts.

Source: Compiled on the basis of the data drawn from the web site of the National Tax Agency of Japan.

a comprehensive tax or non-declaration of dividend income (those who preferred the payment of a withholding tax on their dividend income). For a limited period, stockholders and investors have enjoyed a preferential tax rate of 10% (10.147% in 2013) on this income. However, from 2014 to 2037, the rate will be 20.315%, after which a tax rate of 20% will be applied. In addition, as a result of being able to offset capital losses on stocks against dividends, investors have been able to choose the separate taxation method since 2009, which also carried a preferential tax rate of 10% (10.147% in 2013) for a limited period, to be bumped up to 20.315% from 2014 to 2037, after which it will be 20%. Moreover, as of 2010, investors are able to combine dividends, etc., from listed stock, etc., in their withholding tax accounts. The term "listed stock, etc.," refers to shares that are listed on domestic and foreign stock exchanges and includes such shares as ETFs (exchange-traded funds).

Meanwhile, dividends on unlisted stocks and those received by large individual shareholders are subject not to the preferential 10% dividend tax but to comprehensive taxation after paying a 20% withholding tax (20.42% from 2014 to 2037). In this case, shareholders have the right to select the non-declaration of dividends paid at one time less or equal to the amount divided by ¥100,000 by a dividend-computation period. However, local inhabitants' tax is subject to comprehensive taxation.

Distributions of publicly offered stock investment trusts are treated as a dividend income when investors opt for the comprehensive tax method, entitling the investor to tax credits, but the rate of deduction varies depending on the ratio of foreign currency denominated assets and non-stock assets of the stock investment trust concerned. If the percentage of either foreign currency denominated assets or non-stock assets is 75% or more, the deduction of dividends is not allowed. For profits distributed by a privately placed stock investment trust (see section 9 below), such dividends less withholding tax are subject to comprehensive taxation (dividends are deductible).

For the purpose of computing the amount of dividend income, interest paid on a debt incurred to acquire stocks, etc., may be deducted from the taxable income. However, this is recognized only when the investor chooses the non-declaration method (comprehensive taxation).

5. Adjustment of Double Taxation Relating to Dividends

Profits generated by a business corporation through its business activities should, basically, be returned to the owner of that corporation. However, corporate income is usually taxed twice: corporate income tax and individual income tax (dividend tax and capital gains tax). Ultimately, it is individuals who have the duty of paying taxes. Therefore, some adjustments have to be made to avoid double taxation. This is the question of consolidating corporate tax and an individual's income tax. Ideally, all forms of double taxation of corporate income—be it retained earnings or dividends—should be rectified. However, adjustments are chiefly made to the dividend portion.

The method employed to adjust for double taxation related to dividends varies according to whether the recipients are individuals or corporations. In the case of individual shareholders, a dividend tax credit system is applied that makes 10% of their dividend income (and 2.8% for inhabitants' tax) deductible from their tax liability. However, in the case of those whose taxable income exceeds ¥10 million, 5% of such part of their dividend income that pushes their taxable income over and above ¥10 million (and 2.8% for inhabitants' tax) is deductible. For instance, when individual shareholders have a total taxable income of ¥13 million (¥9 million in general income and ¥4 million in dividend income), they are entitled to a tax deduction of ¥250,000 (¥100,000 $(=($¥10 m $-$ ¥9 m$) \times 0.1) +$ ¥150,000 $(=($¥13 m $-$ ¥10 m$) \times 0.05)$. The entire amount of dividends received on the shares of wholly owned subsidiaries, etc. is not counted as taxable income. For dividends received on the shares of an affiliate (a more than 25%-owned company), dividends less interest paid is not counted as taxable income, and 50% of dividends received from other sources less interest on debts is not counted as taxable income.

In foreign countries, the imputation system has broadly been adopted as a method to adjust for double taxation. The method of dividend-received deductions employed in Japan and the partial imputation method employed in the United Kingdom are both types of imputation methods. Other methods used to adjust for double taxation include the dividend paid deduction method (which authorizes deduction of dividends paid on the corporate level from corporate taxable income as with interest paid) and the comprehensive business income tax method (CBIT). As interest and dividends are not deductible from taxable income on the corporate level, they are subject to corporate tax, but such interest and dividends received by individuals are not subject to income tax.

6. Capital Gains Taxation (1)

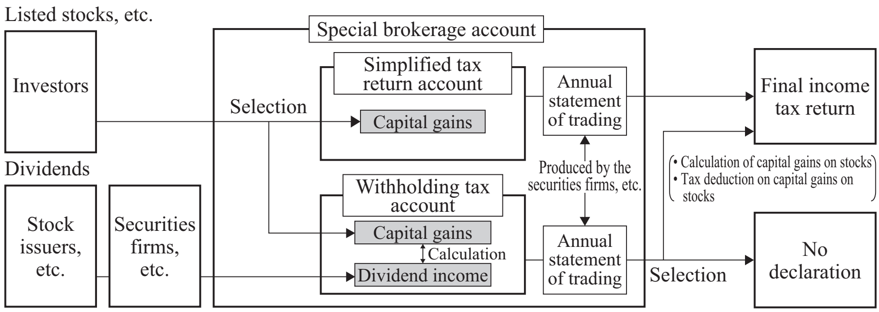
In 2003, the system of opting for a separate withholding tax or for the separate filing of an income tax return on the sale of stocks, etc., was abolished, and these taxes were unified into the separate filing system. In other words, not taking into account the special income tax for reconstruction, a 20% tax

Table XVI-9. Outline of the Capital Gains Taxation System for Stocks, Etc.

Division	Outline
(1) Listed stock, etc. Stocks listed on a stock exchange, domestic or foreign; subscription certificates of the Bank of Japan; bonds with equity warrants; OTC-registered bonds of the convertible bond type with equity warrants; listed preferred subscription certificates of the Shinkin Central Bank and Chukin Bank (the Japan Finance Corporation for Small Business [JFS]; shares of exchange-traded funds (ETF); beneficiary certificates of real estate investment trusts (REITs or listed investment certificates of listed real estate investment trusts); investment securities, such as unlisted shares of a listed company; and publicly offered stock investment trusts, etc.	A 20% separate income tax (of which 5% is local inhabitants' tax) is levied on self-assessed capital gains.(The rate is lowered until the end of 2013.) (In addition, investors who use a special brokerage account are exempted from the duty to file a return or can take advantage of a simplified procedure for filing an income tax return.)
(2) Other stocks, etc	A 20% separate income tax (of which 5% is local inhabitants' tax) is levied on self-assessed capital gains.

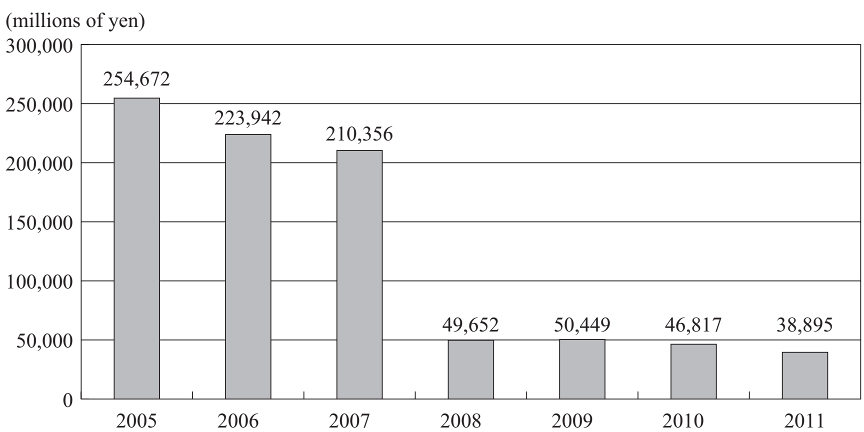
Note: Special income tax for reconstruction levied from 2013 to 2037.

Chart XVI-1. Illustration of the Special Brokerage Account



Source: Based on the web site of the Ministry of Finance.

Chart XVI-2. Withholding Taxes on Capital Gains on the Sale of Listed Stock, Etc., Managed in Special Brokerage Accounts



Source: Based on the website of the National Tax Agency of Japan.

rate (a 15% income tax and a 5% inhabitants' tax) is applied to an amount of income arrived at by deducting the cost of acquiring or selling the security and interest paid on the fund used for the purchase of such security from the proceeds of such security. Up to the end of 2013, the capital gains from the sale of listed stocks, etc., are subject to a 10% preferential tax rate (10.147% in 2013), rising to 20.315% from 2014 to 2037, with the normal 20% income tax rate taking effect after that. Previous to 2003, capital losses from the sale of stocks, etc., were deductible only from capital gains from the sale of other stocks, etc., if any, made during the same year, and it was not permissible to carry forward any unused losses. However, from 2003 on, investors have been able to carry forward capital losses from the sales of listed stocks, etc., for three years starting with the year following their occurrence. Also, since 2009, investors have been able to deduct capital losses on listed stocks, etc., from dividends, etc., received from listed stocks, etc. Moreover, from 2016, the tax system for public bonds, etc., will change, with investors being allowed to offset income against losses for interest and capital gains or losses from public bonds and income, etc., from listed stocks.

Along with the abolition of the separate withholding tax system, the authorities sought to lessen the reporting burden on investors by establishing a special brokerage account system. Under this type of account, a securities company computes capital gains or losses, as the case may be, for its customer from the sale of shares of a listed stock, etc., made through a special brokerage account. The account is divided into two categories: the income tax withholding account and the simplified income tax return account (no tax is withheld). When an investor sells his shareholdings through the income tax withholding account, his securities company withholds the income tax, obviating the need for the investor to file an income tax return. Furthermore, from 2010, it became possible for the securities company to deposit listed stock, etc., dividends of customers that are subject to withholding tax in the income tax withholding account set up for the customers, enabling the customer to include capital gains or offset capital losses against dividend income. However, if an investor using such an account also files a final return, the investor is also allowed to include capital gains or to offset capital losses from the sale of such shares through another account. When an investor opts for the income tax withholding account and does not file a final return, the capital gains are not included in the total amount of his income for the purpose of income tax and local inhabitants' tax, and the spousal deduction is not affected. By contrast, if an investor opts for the simplified income tax return account, such an investor may file a simplified version of the income tax return by attaching to it an annual statement of stock trading made under a special brokerage account received from his securities company.

Currently, securities companies must send an annual statement of stock trading to the customer and the tax office no matter what type of special brokerage account is selected by the customer.

7. Capital Gains Taxation (2)

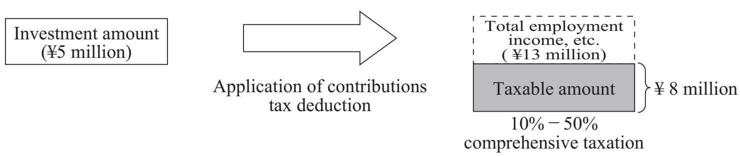
Although the tax system for capital gains on public bonds, etc., will change in 2016, in principle, capital gains from the sale of bonds are tax deductible.

However, capital gains on the sale of bonds issued by the Japan Housing Finance Agency, Okinawa Development Finance Corporation, Urban Renaissance Agency, and foreign government bodies and discount bonds issued overseas (zero-coupon bonds) are subject to comprehensive taxation. Bonds similar to zero-coupons bonds, including bonds with an extremely low rate (deep discount bonds); bonds whose principal and interests are separately traded (STRIPS bonds); and bonds with an interest computation period of

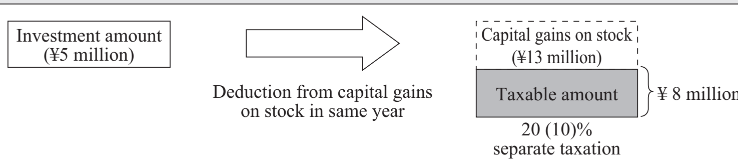
Chart XVI-3. An Outline of the Angels Taxation System

Preferential tax measures for start-up investment (selective application of methods 1 and 2)

1. When an investment is made in any venture-stage firm (specified small-to-midsize firm), the investor may apply the contributions tax deduction for up to ¥10 million (implemented in the fiscal 2008 tax revisions).



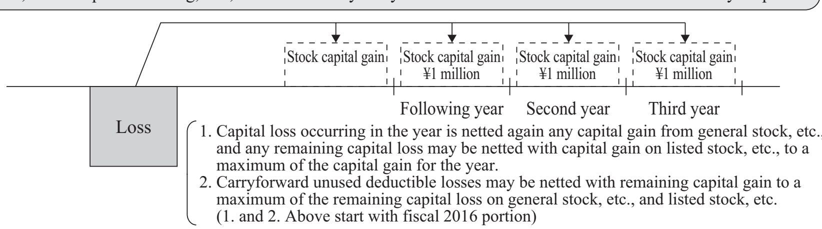
2. There is a reduction in capital gains on the stock when an investment is made in a start-up firm (specified small-to-midsize firm).



Note: 1. When preferential tax measures 1 or 2 are applied, the acquisition costs of the stock of the start-up firm is the amount less the tax deduction stated above.
2. Tax exemption on capital gains on general stock, etc., or on listed stocks, etc. (starting with fiscal 2016 income).

Preferential tax measures following investment

3. Should the business of the start-up firm (specified small-to-midsized firm) fail, and a loss to be suffered from the sale, etc., of stock prior to listing, etc., the investor may carry forward unused deductible losses for a three-year period.



Note: When an investor sells specified shares acquired before April 30, 2008, and held for more than three years within three years of listing or before listing by reason of a merger, the resulting capital gains are reduced by half.

Source: *Illustrated Taxation System of Japan,* 2013 edition, page 107, compiled by Hirotaka Unami.

one year or more (deferred payment bonds) are also are subject to comprehensive taxation.

Created under the 1997 amendment to the taxation system, the "Angels taxation system" is a special measure designed to encourage individual investors (angels) to invest in venture-stage firms or start-ups. The special measure applies to shares (specified shares) of venture-stage firms or start-ups (specified small-to-midsize firms) that meet certain requirements. The taxation system has been revised several times since the establishment of this plan. Most recently, the special tax treatment reducing the rate on capital gains for specified small-to-midsize firms to 50% was extended for two years in the fiscal 2005 tax revisions. The fiscal 2007 tax revisions added another two years and liberalized the eligibility requirements for the special tax treatment and rationalized the approval process. This special tax treatment was abolished by the fiscal 2008 tax revisions. However, at the same time, the government set up a contributions tax deduction system for investors that invest in these types of venture companies (specified start-up small-to-middle sized firms) during their start-up period. Specified start-up small-to-middle sized firms also of necessity qualify as specified small-to-middle sized firms.

The current features of the Angels taxation system are (1) since April 1, 2008, investors that have acquired stock in a specified small-to-midsize firm through direct investment may apply the contributions tax deduction for up to ¥10 million of the amount invested in said company (investors may choose to apply either (1) or (2) per stock issue); (2) investors may deduct the acquisition costs of shares of a specified small-to-midsize firm from their capital gains in the same year; (3) when investors suffer losses from the sale of the specified stocks up to a day before listing date, or when they suffer losses from the dissolution and liquidation of issuers, these losses are deductible from gains on the sale of stocks in the same year. Unused deductible losses may be carried forward for three years starting with the next year.

8. Taxation of Nonresidents

The Income Tax Law of Japan divides individuals into residents and nonresidents, and in the case of nonresidents, etc., taxes are imposed only on incomes they earn from domestic sources. Residents are individuals who have a domicile in Japan or a temporary residence at which they have been living for one year or more. All individuals other than residents are deemed nonresidents. The method of imposition of income tax varies depending on whether the nonresident has a permanent establishment (PE) in Japan or not. In principle, when a non-resident has established a PE in Japan, the individual is subject to the same declaration-based (withholding tax applies to some

Table XVI-10. Outline of Matters Related to Taxation of Nonresidents, Etc.

<table>
<tr><th rowspan="2">Non resident category
Type of income</th><th colspan="3">Nonresidents with a permanent establishment in Japan</th><th rowspan="2">Nonresidents without a permanent establishment in Japan</th><th rowspan="2">Withholding tax</th></tr>
<tr><th>Nonresidents, etc., with a fixed office or other designated place of business</th><th colspan="2">Nonresidents, etc., engaged in construction, installation, or assembly work for more than one year or as an agent or other representative meeting certain stipulated requirements.</th></tr>
<tr><td>Business income</td><td colspan="3" rowspan="3">Comprehensive taxation (Note 1)</td><td>Tax deductible</td><td>None</td></tr>
<tr><td>Asset income</td><td rowspan="2">Comprehensive taxation (Note 2)</td><td>None (Note 1)</td></tr>
<tr><td>Other income sourced in Japan</td><td>None</td></tr>
<tr><td>Distribution of business profit of partnership</td><td colspan="3" rowspan="4">Separate withholding tax followed by comprehensive taxation</td><td>Tax deductible</td><td>20.42%</td></tr>
<tr><td>Compensation for sales of land, etc.</td><td rowspan="3"></td><td>10.21%
20.42%</td></tr>
<tr><td>Compensation for personal services</td><td>20.42%</td></tr>
<tr><td>Rental income, etc., from real estate</td><td>15.315%</td></tr>
<tr><td>Interest, etc.</td><td colspan="2" rowspan="9">Separate withholding tax followed by comprehensive taxation (notes 3, 4, 5)
Attributable to domestic business</td><td colspan="2" rowspan="9">Separate withholding tax
Not attributable to domestic business</td><td>15%</td></tr>
<tr><td>Dividends, etc.</td><td>20.42% (Notes 4, 5)</td></tr>
<tr><td>Loan interest</td><td>20.42%</td></tr>
<tr><td>Usage fees, etc.</td><td>20.42%</td></tr>
<tr><td>Salary or other remuneration for personal services, public pension income, severance pay, etc.</td><td>20.42%</td></tr>
<tr><td>Prize money from business advertising and promotion</td><td>20.42%</td></tr>
<tr><td>Annuity income, etc., from life insurance contract</td><td>20.42%</td></tr>
<tr><td>Interest payment from investment savings plan</td><td>15.135%</td></tr>
<tr><td>Distribution of profit from anonymous partnership, etc.</td><td>20.42%</td></tr>
</table>

Notes: 1. Income from the sale of stocks, etc., by nonresidents with a permanent establishment in Japan is subject to a 15.135% tax under the separate taxation system. However, income from the sale of listed stocks, etc. is eligible for a preferential tax rate of 7.147% up to December 31, 2013.
2. Income from the sale of stocks, etc., by nonresidents without a permanent establishment in Japan is subject to a 15.135% tax under the separate taxation system.
3. Interest and interest payments from investment savings plans received by nonresidents with a permanent establishment in Japan is subject to a 15.135% tax under the separate withholding tax system.
4. Dividends, etc., on listed stocks, etc. are eligible for the preferential tax rate of 7.147% up to December 31, 2013. The 15.135% tax rate will apply from 2014 to 2037.
5. Nonresidents with a permanent establishment in Japan use the comprehensive or none-declaration tax system for dividends, etc. (excluded those subject to the separate withholding tax system).

Source: Complied from "*Withholding Tax Basics*," FY2013 edition, National Tax Agency of Japan.

income) tax treatment as a resident. In other cases, the individual is subject to the separate withholding tax system, which deals with taxable income related issues based on withholding tax only. To be deemed to have established a PE in Japan, a party must (i) have a fixed office or other designated place of business or (ii) be engaged in construction, installation, or assembly work for more than one year or be an agent or other representative meeting certain stipulated requirements.

(1) Nonresidents with a PE in Japan: On interest on deposits and savings and dividends, etc., and profits distributed by bond investment trusts, a 15.315% separate withholding tax is imposed. Dividends, etc., on listed stocks, etc., of domestic corporations are taxed differently based on the way PE was determined. In the case of a PE based on (i) above or a PE based on (ii) above where the income can be attributable to the domestic business, the dividends, etc., are subject to comprehensive taxation after withholding at the source of 7.147% in 2013, and 15.135% from 2014 to 2037. However, like an individual with permanent residence, the party may elect to use either the non-declaration or separate taxation system. In the case of a PE based on (ii) above where the income cannot be attributable to the domestic business the separate withholding tax method applies.

(2) Nonresidents without a PE in Japan: On interests on deposits and savings and dividends, etc., distributed by bond investment trusts, a 15.315% separate withholding tax is imposed just as above. As with case (ii) in (1) above where the income cannot be attributed to the domestic business, dividends, etc., on listed stocks, etc., of domestic corporations are subject to the separate withholding tax. The above tax rates include the special income tax for reconstruction.

Japanese government securities owned by nonresidents are tax exempt. For instance, interest on government securities held by a nonresident without a permanent establishment in an account with a specified central custody and transfer agent or a qualified foreign intermediary is exempted from income tax under certain conditions.

In addition to the foregoing, income tax rates applied to nonresidents and foreign corporations are finally determined in accordance with the tax treaties Japan has signed with various countries, and nonresidents should study these treaties.

9. Taxation of New Products

(1) New Types of Investment Trusts

Profits received from a privately placed stock investment trust of the contractual type are, in principle, subject to a withholding tax and then are taxed

Table XVI-11. New Taxation Framework for Investment Trusts

<table>
<tr><th colspan="3">Classification</th><th>Profit distribution</th><th>Cancellation (redemption) gains[1]</th><th>Capital gains</th></tr>
<tr><td rowspan="2">Contractual type</td><td colspan="2">Privately placed stock investment trusts</td><td>Taxable as dividend income (20% separate withholding tax)</td><td>Taxable as dividend income (20% separate withholding tax). Separate taxation method applies to portion deemed capital gains.</td><td>20% of the capital gains is taxed separately on the basis of self-assessment</td></tr>
<tr><td colspan="2">Privately placed asset-management trust</td><td colspan="2">20% separate withholding tax</td><td>Tax deductible</td></tr>
<tr><td rowspan="3">Corporate type</td><td rowspan="2">Publicly offered</td><td>Open-end type</td><td>Taxed as dividend income (10%[2] of the dividend is withheld)</td><td>Taxed as dividend income (withholding at source of 10%).[2] A portion deemed as capital gains or losses from the sale is subject to separate taxation, based on self-assessment.</td><td>10%[2] of the capital gains is taxed separately on the basis of self-assessment</td></tr>
<tr><td>Closed-end type</td><td rowspan="2">Taxed as a dividend income (20%[3] of the dividends is withheld)</td><td rowspan="2">Taxed as dividend income (withholding at source of 20%).[3] A portion deemed as capital gains or losses from the sale is subject to the separate taxation, based on self-assessment.</td><td rowspan="2">20%[3] of the capital gains is taxed separately on the basis of self-assessment</td></tr>
<tr><td colspan="2">Privately placed</td></tr>
</table>

Notes: 1. Since contract cancellations are not possible with closed-end trusts, this applies only to liquidations or redemptions.
2. 20% in and after January 2014
3. A 10% rate applies to closed-end investment trusts that are listed up to December 2013.
4. Special income tax for reconstruction levied from 2013 to 2037.

Source: Primer on Taxation, 2013 edition, page 179, Daiwa Institute of Research Ltd.

Table XVI-12. Taxation on Stock Options

	At grant of stock options	At exercise of stock options	At the sale of stocks
Qualified stock options	–	–	Separate taxation on (selling price - exercise price) on the basis of self-assessment
Non-qualified stock options	–	Comprehensive taxation on (market value of stocks at exercise-exercise price)	Separate taxation on (selling price - market value of stocks at exercise) on the basis of self-assessment

Note: Taxed as income on the sale of stocks.

comprehensively together with other incomes of the recipients of such profits. The tax credit for dividends is also applied, and when the recipient meets certain requirements, he is exempted from the requirement of filing an income tax return. Capital gains made by selling beneficiary certificates of such investment trusts are subject to a withholding tax. Profits received from an investment trust managing privately placed bonds and redemption gains are subject to a withholding tax, and capital gains are tax exempt. Tax rates related to open-ended investment trusts of the company type are the same as those applied to listed stocks. In other words, on dividends received from open-end investment trusts, a withholding tax of 20.315% from 2014 is imposed before comprehensive taxation or non-declaration. A credit for dividends is not applied when the comprehensive taxation is selected on dividends. Capital gains from the sale of company-type investment trusts are subject to the separate taxation of 20.315% from 2014 based on self-assessment. On the other hand, dividends received from closed-end or privately placed investment trusts are subject to a withholding tax in principle and then to comprehensive taxation. In general, a taxation system is selected that does not require the declaration of such income when certain requirements are satisfied. Provided that a credit for dividends is not applied when the comprehensive taxation is selected on dividends. Capital gains from the sale of closed-end or privately placed investment trusts are subject to the separate taxation of 20.315% from 2014, based on the self-assessment. For REITs (real estate investment trusts), dividends and capital gains from the sale of listed REITs are subject to the same taxation as listed stocks. However, a credit for dividends is not applied when comprehensive taxation is selected on dividends.

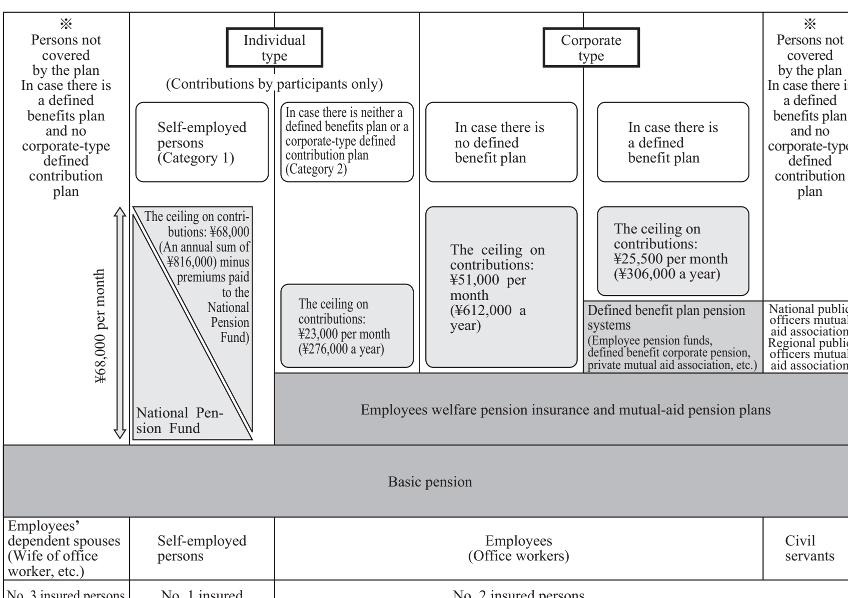
(2) Stock Options

The stock option is a system under which a company grants its officers and employees the right to purchase its stocks at a certain price (exercise price) for a certain period (exercise period). The company then pays its officers and employees remunerations linked to any increase in its stock price. The stock option is classified into a qualified stock option and a non-qualified stock option, depending on whether it satisfies requirements stipulated in the Special Taxation Measures Law or not. The former is tax deductible on economic benefits gained from its exercise (the difference between the market price and the exercise price). Separate taxation is imposed on the difference between the selling price and the exercise price of stocks issued on the exercise based on self-assessment when the stocks are sold. For the latter, comprehensive taxation is imposed on economic benefits gained from its exercise. Separate taxation is imposed on the selling price of stocks issued on the exercise, deducting the market price of the exercise based on self-assessment when the stocks are sold.

10. Tax Treatment of Pension-Type Products

To cope with the changes that have occurred in recent years—a swollen unfunded corporate pension obligation, a growing shortage of public pension funds, the introduction of international accounting standards, and an increasing slackness in the job market—a defined contribution pension plan (the Japanese version of the 401 (k) plan) was introduced in October 2001. The defined contribution pension plan is a private pension plan whereby an employee participating in the plan gives instructions about investing his contributions, with the understanding that pension benefits may vary depending on the results of such investment. It is divided into the individual type and the corporate type, in which the company makes contributions on behalf of its employees. In order to encourage the spread of pension products based on such a system and to enhance the efficiency of the management of such plans, it is essential to give a certain tax incentive. And in devising such a taxation system, due care must be exercised to strike a suitable balance

Chart XVI-4. Beneficiaries of Defined Contribution Pension, Ceiling on Contributions, and the Existing Pension System



Source: The web site of the Ministry of Health, Labor and Welfare (http://www.mhlw.go.jp).

Table XVI-13. Tax Treatment of Defined Contribution Pension Plans

<table>
<tr><th colspan="3">Division</th><th>Individual type</th><th>Corporate type</th></tr>
<tr><td colspan="3">Contribution stage:</td><td rowspan="2"></td><td rowspan="2">Counted as a loss of the employer and not added to the salary of the employee</td></tr>
<tr><td rowspan="2"></td><td colspan="2">Premiums paid by employer</td></tr>
<tr><td colspan="2">Premiums paid by employee</td><td colspan="2">Premiums to small-scale company mutual aid association are deducted as a loss (Note)</td></tr>
<tr><td colspan="3">Management stage:</td><td colspan="2">Special corporate income tax is applied (frozen until end of fiscal 2013)</td></tr>
<tr><td colspan="3">Benefits payment stage:</td><td colspan="2"></td></tr>
<tr><td rowspan="6"></td><td rowspan="2">Old-age benefits</td><td>Pension</td><td colspan="2">Miscellaneous income (deduction for public pensions is applied)</td></tr>
<tr><td>Lump sum</td><td colspan="2">Retirement income (deduction for retirement income is applied)</td></tr>
<tr><td rowspan="2">Disability benefits</td><td>Pension</td><td colspan="2" rowspan="2">Income and inhabitants' taxes are deductible</td></tr>
<tr><td>Lump sum</td></tr>
<tr><td colspan="2">Lump-sum payment at the time of death</td><td colspan="2">Taxed as an inheritance income</td></tr>
<tr><td colspan="2">Lump-sum payment at the time of withdrawal</td><td colspan="2">Occasional income</td></tr>
</table>

Note: Premium payments by employees for Corporate type of plan started in January 2012.

between the taxation system for such pension plans and that for other pension plans and to ensure the portability of benefits (the possibility of transferring pension assets when changing jobs). The government has taken the following tax measures applicable to defined contribution pension plans.

(1) At the contribution stage: Premiums paid to a pension plan of the individual type by a self-employed person are eligible for income deduction (deduction for small-scale enterprise mutual aid premium). Premiums paid to corporate pension plans by a company are counted as a loss of such company and are not counted as an income of the employee for whom such premiums are paid. As of January 2012, matching contributions by employees have been approved for corporate pension plans. Therefore, the entire amount of contributions by employees is eligible for the deduction for the small-scale enterprise mutual aid premium.

(2) At the management stage: The balance of reserves for a pension plan of the individual type and that of the corporate type are subject to a special corporate tax of 1.173% (1% in national tax and 0.173% in local tax). However, this provision has been frozen until March 31, 2014.

(3) At the stage of benefit payment: (i) Old-age pension benefits: The beneficiary can receive pension benefits from the reserve in five or more annual installments or in a lump sum. When the beneficiary opts for benefits in

installments, such benefits are deductible from taxable income. The amount deductible varies according to the age of the beneficiary and the amount of income the beneficiary receives from publicly managed pension plans. However, a minimum benefit of ¥1.2 million is recognized for those who are 65 years of age or older or ¥700,000 for those who are less than 65 years of age. Benefits paid in a lump sum are eligible for retirement income deductions. (ii) Benefits for the physically handicapped: When a beneficiary is seriously disabled, the beneficiary can receive the payment of benefits from the month in which he or she is disabled, and the benefits are exempted from income tax and inhabitants' tax. (iii) Death benefits: Death benefits paid in a lump sum to the survivors when the subscriber died are deemed as an inherited property, and up to ¥5 million for each legal heir is exempted from inheritance tax. (iv) Withdrawal benefits: Benefits paid in a lump sum upon withdrawal from a pension plan are subject to income tax and inhabitants' tax.

CHAPTER XVII

The Securities Regulatory System

1. Applicable Laws (1)—The History of the Securities and Exchange Law

In 1948, the Japanese government enacted the Securities and Exchange Law under the guidance of the General Headquarters (GHQ) of the Allied Powers. Because the law was basically a U.S. law introduced in Japan "as is" and enacted in haste, revisions soon became necessary. For example, to better suit Japan's markets, the government sought to replace the disclosure and fraud prevention approach typical of U.S. regulations with stronger surveillance functions by the securities industry and stock exchanges. In 1952, it abolished the Securities and Exchange Commission set up along the lines of the U.S. SEC, the executive agency of the law in the United States, and followed up in 1953 with liberalization of regulations. Over the years, the law has been regularly revised to cope with issues as they arose. In 1965, in response to problems of improper conduct toward customers in the securities industry, the authorities changed the authorization system from a registration system to a licensing system while also imposing a strict code of conduct for directors, officers, and employees of securities companies. In 1971, in reaction to clear cases of misleading accounting practices by listed companies, the authorities reinforced the disclosure system by expanding the scope of companies required to submit securities reports and by introducing semiannual and extraordinary reporting systems. At the same time, they strengthened the civil liability of companies regarding fraudulent disclosure. Insider trading regulations were introduced in 1988 in response to an incident where a bank tried to sell its shares in a company that had incurred huge losses before the fact became public. In 1990, in addition to revising the public tender offer system for shares, the authorities introduced a disclosure system for large shareholdings. In 1991, when securities scandals triggered by the bursting of the economic bubble revealed that securities companies had been providing loss compensation to their best corporate clients for large losses incurred in their trading accounts, the authorities introduced punitive regulations to prevent loss compensation or insuring the losses of clients. The following year, the

Table XVII-1. Major Amendments to the Securities and Exchange Law

Year	Purpose of revisions
1952	Abolish Japan's Securities and Exchange Commission.
1953	Simplify disclosure system, strengthen surveillance of securities firms and exchanges, and enable margin transactions.
1965	Switch over to license system for securities firms and strengthen regulations by introducing code of conduct for directors, officers, and employees of securities firms; administrative rules for securities firms; registration system for securities representatives; and inspection correction ordinance orders by the Minister of Finance.
1971	Expand scope of obligation to submit securities reports, introduce semiannual and extraordinary reporting system, increase civil liability for falsifying securities and business information reports, and introduce tender offer system.
1981	Lift restrictions on public bond trading by banks.
1985	Lift restrictions on futures trading by financial institutions.
1988	Introduce insider trading regulations, expand and improve periodic disclosure, and simplify procedures for issuance disclosure.
1990	Introduce a disclosure system for large shareholdings (5% rule) and undertake full-scale revision of tender offer system to conform to international standards.
1991	Prohibit loss compensation or insurance and discretionary trading accounts.
1992	Establish the Securities and Exchange Surveillance Commission, establish and strengthen inspection and audit system by reinforcing function of SROs, enable banks to participate in securities business through subsidiaries, and legally define, etc., securities, and provide legal framework for private offerings.
1997	Establish and strengthen punitive measures for disclosure violations, unfair trading practices and legal violations discovered by inspections, and audits by surveillance authorities and implement necessary revision in line with the introduction of a stock option system, etc.
1998	Establish OTC derivatives trading, set up system for company-type investment trusts by securities investment corporations, expand scope of securities definition, expand scope of disclosure system, shift to disclosure on a consolidated basis, remove obligation for listed securities to trade on exchanges, introduce PTS's, deregulate brokerage commissions, strengthen unfair trading practices regulations, switch to registration system for securities firms, abolish diversification restriction on securities firms, diversify securities intermediary services, convert to violations surveillance approach for regulations to ensure the financial soundness of securities firms, introduce system to ensure thorough compliance by securities firms regarding segregated management of customer assets, and launch Investor Protection Fund system.
2000	Achieve incorporation of exchanges as joint stock companies and promote electronification of prospectuses and reports, etc.
2003	Introduce securities intermediary system, expand scope of private offering to promote investment in venture companies, strengthen disclosure by listed companies with reference to the U.S. Sarbanes-Oxley Act, and achieve establishment of securities exchange holding companies.
2004	Introduce best execution for customer orders, upgrade PTS's, introduce rules for green sheet issues, improve the prospectus system, lift restrictions on securities intermediary services by banks, liberalize tender offer system, introduce monetary penalty system, revise civil-liability system, strengthen inspection authority of Securities and Exchange Surveillance Commission.
2005	Introduce disclosure obligation for parent companies, expand scope of application of monetary penalty system, expand scope of application of tender offer system, and introduce English-language disclosure in line with globalization of securities trading.

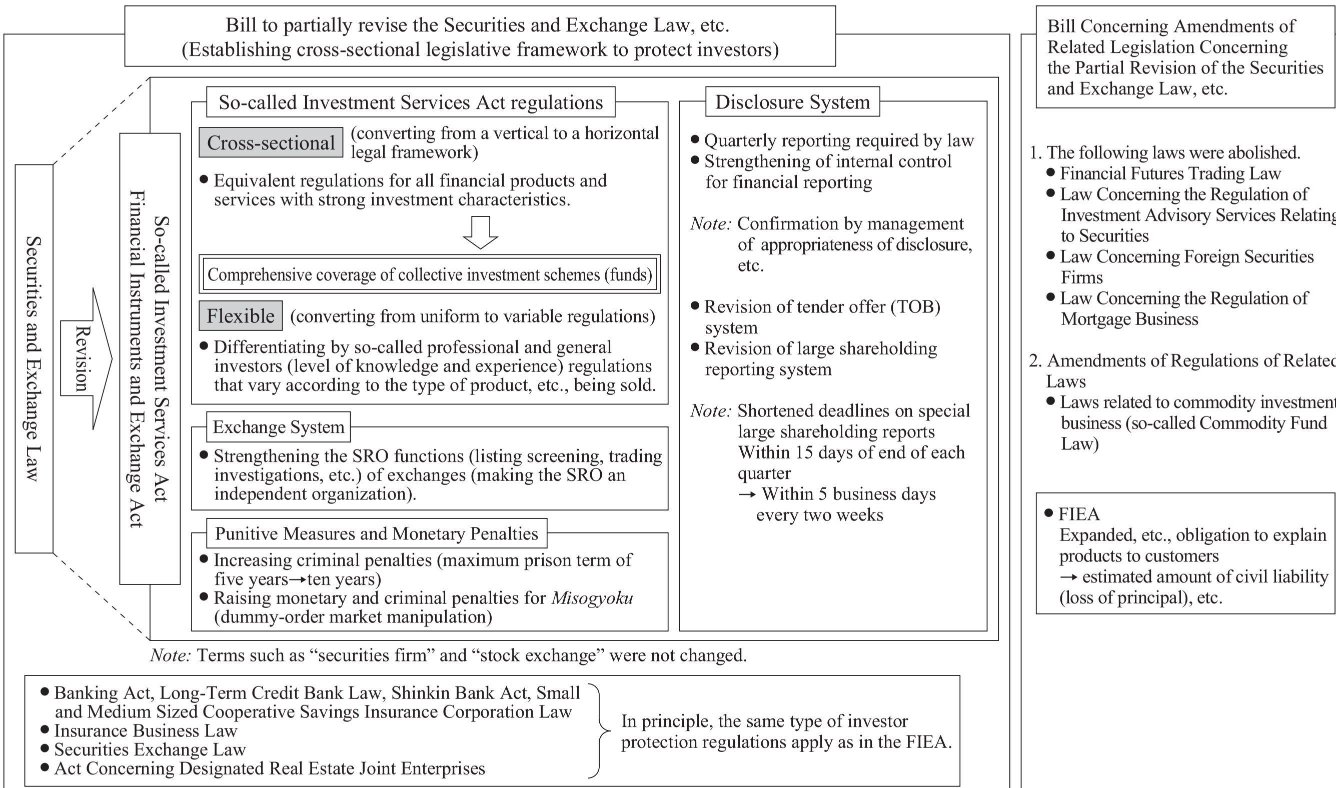
authorities also took steps to deal with various issues that had been raised regarding the securities industry and the regulatory system through such actions as establishing the Securities and Exchange Surveillance Commission and clarifying the role of self-regulatory organizations (SROs). Despite these efforts, securities scandals continued to occur, resulting in the authorities further strengthening punitive measures in 1997. Then major reforms (Japan's financial "Big Bang") aimed at revitalizing financial markets got under way in 1998. In one phase of those reforms, the structure of the securities market was revised in 2003, followed by further revisions in 2004 aimed at shifting Japan's financial system to one built around the market function. In 2005, in light of the occurrence of major securities incidents involving Livedoor, Seibu Railways, and others, the authorities revised the disclosure regulation and the tender offer regulation.

2. Applicable Laws (2)—Shifting to the Financial Instruments and Exchange Act

In 2006, the Securities and Exchange Law underwent major revisions and was renamed the Financial Instruments and Exchange Act (FIEA). The purpose of the new law was to introduce cross-sectional regulations and flexibility into the financial system. One prime example of the move to cross-sectional application was the introduction of measures to ensure the same types of rules applied to all financial instruments with similar economic functions and investment risks. The government achieved this goal by expanding the FIEA's scope of application and by revising various related laws and regulations. More specifically, it extended the scope of application to include not only general investment trust beneficiary rights and mortgage securities, etc., but also collective investment schemes, making it possible to implement regulations comprehensively. In addition, it revised various related laws to establish a regulatory framework where financial instruments not covered by the FIEA but sharing many of the same aspects were subject to similar rules (see section 3.). Another example of the move to cross-sectional application was the revision of traditionally vertically compartmentalized regulations to standardize the registration of sales and solicitation, investment advisory, asset management, and asset administration, etc., businesses under the umbrella of financial instruments firms with the aim of applying as common a code of conduct as possible.

The authorities introduced flexibility into the law through 1) disclosure regulations, 2) industry regulations, and 3) separating rules for dealing with different classes of investors. More specifically, they placed strict disclosure obligations on highly liquid securities, strengthening the disclosure system

Chart XVII-1. Transition from Securities and Exchange Law to Financial Instruments and Exchange Act



Source: Materials produced by the FSA.

by requiring listed companies to provide quarterly reports, internal control system reports, and verification statements from auditors. In contrast, illiquid securities, in principle, are exempt from these disclosure regulations. While all financial instruments businesses are required to register under the comprehensive industry regulations, businesses are classified into the three categories of Type I and Type II Financial Instruments Businesses, Investment Advisory and Agency Business, and Asset Management Business, with separate rules applying for each category. In addition, customers are classified into professional investors and general investors, with various exceptions to the general industry code of conduct applying to dealing with professional investors.

Since then, the government has seeming implemented reforms to the FIEA on an annual basis. In 2013, there was a major reform of the insider trading regulations. The backdrop to those reforms was the emergence of problems related to the regulatory coverage and sanctions in cases of so-called capital increases through public offerings insider trading. To deal with the issue, regulations were introduced for communicating sensitive information and recommending transactions and monetary penalties for violations by asset management companies were increased. Based on practical experience with the regulations in recent years, reforms have been made related to what actions fall within their scope and which do not.

3. Applicable Laws (3)—Securities Market Related Laws and Regulations

The original concept behind the FIEA was to apply the same types of rules to similar financial instruments based on legislation covering investment services. However, the law never quite attained this goal because jurisdiction was split up among administrative authorities, and many financial instruments had distinctly different features. Nevertheless, from the point of view of investor protection, other laws were revised so that as much as possible they shared common rules with the FIEA for financial instruments not covered by the FIEA but having the same economic function. For example, such related laws as the banking, insurance, and investment trust laws implemented provisions equivalent to the FIEA's code of conduct, perhaps the most important area for customer protection. Specifically, these laws have advertising, regulations; disclosure obligations; behavior prohibitions; and loss compensation prohibitions, etc. (Art. 13-4, Banking Act; Art. 300-2, Insurance Business Act; Art. 24-2, Trust Business Act). The Commodity Exchange Act (currently the Commodity Futures Trading Act) was also reformed to include similar regulations for its financial instruments; the revisions implemented advertising

Table XVII-2. Banking Act, Insurance Business Act, and Trust Business Act

1. Acts that have sales and solicitation rules equivalent to those of the FIEA for deposits, insurance policies, and investment trusts with strong investment characteristics

(Points of view on which regulations have been implemented for each act)

	Banking Act (*Tokkin* or special money deposits, etc.)	Insurance Business Act (Specified policies, etc.)	Trust Business Act (Specified trust contracts)
Advertising, etc., regulations	• In the case of derivative deposits, if the bank has the right to extend the term of the deposit, it must indicate to the customer that the interest rate could fall below the market rate to the detriment of the customer.		
Deliver written documentation obligation	• Exceptions to the obligation - When a foreign currency deposit, etc., document was delivered within the past year - When a similar document was delivered within the past year *Note:* Stages established for contract process (deliverable before signing, deliverable within 3 months of signing) • In the case of derivative embedded deposits, the prior-to-contract documentation must contain the same content as the items shown in advertisements, etc.	• Documentation delivered prior to contract must contain notes on material items in accordance with provisions in supervisory guidelines regarding the contract outline and cautionary information. Eg.: The contract outline is dictated on the statutory level, while cautionary information is dictated on the cabinet office ordinance level. • Items covered in documents delivered at time of signing policy can be adjusted in line with items included in the policy, etc. Eg.: Items regarding the type and content of the policy can be omitted from the delivered documentation if contained in the policy, etc.	• Exceptions to the obligation to deliver prior-to-contract documentation (Documentation regarding a similar contract has previously been delivered, the customer has made clear that no documentation is necessary, etc.)
Prohibited behavior	• Generally prohibited behavior for banking business • Concluding a contract without adequate explanation necessary for understanding prior-to-contact documentation or foreign currency deposits, etc., documentation	• Generally prohibited behavior for concluding or soliciting purchase of insurance policy • Concluding a policy without adequate explanation necessary for understanding prior-to-policy documentation	• Generally prohibited behavior for underwriting trusts • Concluding a contract without adequate explanation necessary for understanding prior-to-contract documentation
Specified investors (contract classes)	• One type (*Tokkin*, etc., contract)	• One type (Specified policy, etc.)	• One type (Specified trust contract, etc.)

2. Business scope of banks and insurance companies (Auxilliary businesses)

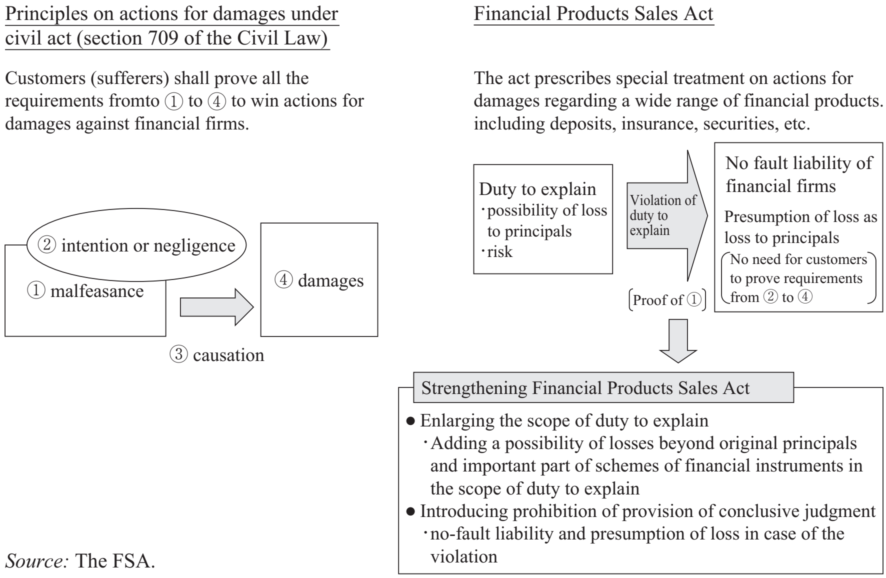
- Expanded to include agency or intermediary business for concluding investment advisory and discretionary asset management contracts (banks only).
- Expanded to include emissions rights derivative transactions (intermediary and consulting services for emissions rights trading also permitted as auxiliary businesses).

3. Business scope of banking and insurance company subsidiaries

- Business scope of securities subsidiaries expanded (full scope of financial instruments businesses).
- Scope of financial-related businesses expanded (private placements, investment advisory, asset management of funds, emissions rights trading, emissions right derivatives trading, etc.).

Source: The FSA.

Chart XVII-2. Enhancement of Civil Liability for Sales of Financial Products



Source: The FSA.

regulations and inserted an obligation to explain financial products in a manner appropriate to the customer. Furthermore, loss compensation was prohibited and made punishable by penalties (Art. 213-2, Art. 218 (1) (2); Art. 214-3; and Art. 358-2).

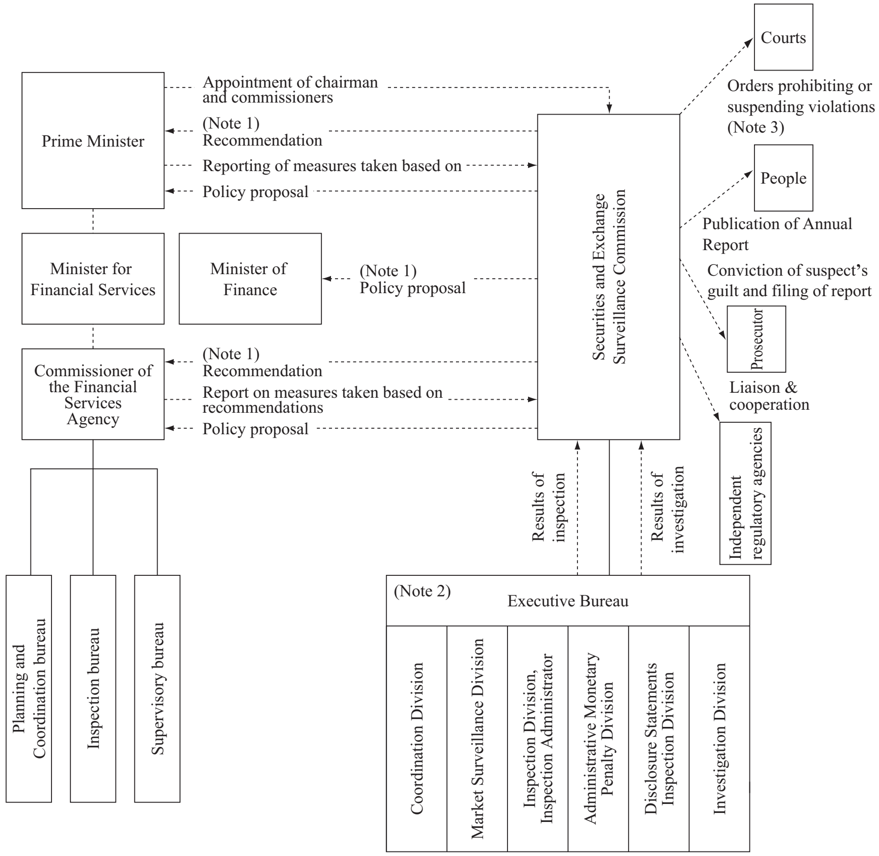
The FIEA incorporates part of the Investment Trust and Investment Corporation Act (Investment Trust Act), which forms one of the two pillars of investment trust regulations. In other words, most of the business and code of conduct regulations regarding the investment trust intermediary business and asset management business of investment corporations have been included in the FIEA, leaving the Investment Trust Act focusing solely on investment trust regulations.

The Financial Instruments Sales Law governing sales, etc., of financial instruments was formulated in 2000 to provide cross-sectional rules regarding the sale and solicitation of sales for deposits, investment trusts, insurance, securities, and other financial instruments. Due to its relative lack of use in litigation, however, the law was revised in 2006 at the same time the FIEA came into force to make it easier for customers to press civil liability suits. Specifically, the law expanded the scope of the obligation to explain products to customers, including requirements to explain not just the risk of loss of principal due to market or credit risk, but also the possibility of losses in excess of principal and the essential features of the transaction scheme (Art. 3, Par. 1, Items 2, 4, 6). The law also added a suitability rule (Art. 3, Par. 2) and a prohibition on making investment decisions on behalf of clients (discretionary services) and civil liability for any such services provided (Art. 4 and 5). These revisions enable the courts to make a decision on whether, based on the suitability rule, the seller fulfilled the obligation to explain the financial product, establishing responsibility to compensate the customer for damages, which are presumed to be any loss of principal (Art. 6).

4. Enforcement (1)—Transitions in the Regulatory Framework

After the 1952 abolishment of the U.S.-modeled Securities and Exchange Commission (see section 1.), the Ministry of Finance took over the regulation of securities. Rather then using the legal provisions set out in the former Securities and Exchange Law, the ministry depended more on unwritten rules called administrative guidance as a regulatory method. After administrative guidance was recognized to have contributed to a security scandal in 1991, however, the method came under severe criticism. In response, the ministry bolstered its market surveillance by establishing the Securities and Exchange Surveillance Commission (SESC) and transferring surveillance to this body. Further change came in 1997 when the government set up the Financial Supervisory Agency, later to become the Financial Services Agency (FSA) to which the Ministry of Finance transferred the financial system planning and law drafting functions in 2000. The SESC became part of the FSA at that time. Through this process, the major portion of securities regulation in Japan congealed into a system administered by the FSA and the SESC and policy shifted from preventative administration to regulatory violation surveillance. During the period when the government was formulating the Financial Instruments and Exchange Act, the enforcement of its regulations became an issue and was discussed in various venues (Achieving Rule Enforcement, Financial System Council, March 30, 2005). Because the architects of the former Securities and Exchange Law had designed it to be enforced mainly through criminal litigation, regulatory authorities had to proceed with caution, resulting in an insufficient degree of enforcement. Taking this experience into consideration, the formulators of the Financial Instruments and Exchange Law aimed to reduce the degree of dependence on criminal litigation and achieve a framework in keeping with the trend toward enforcement through surveillance. Two of the main points in the plan were upgrading the monetary penalty system and establishing a financial alternate dispute resolution (ADR) system. A monetary penalty system had already been introduced in 2004 as a measure to curtail violations by imposing a financial burden on

Chart XVII-3. Conceptual Flowchart of Securities Trading Surveillance



Note: Recommendations can be filed with the prime minister or the FSA commissioner. Policy proposals can be filed with the prime minister, the FSA commissioner, or the minister of Finance (Articles 20 and 21 of the Establishment Law).

Source: Compiled on the basis of the data drawn from the materials of the Securities and Exchange Surveillance Commission.

perpetrators, but in 2008 the authorities reinforced the system by revising the scope of application and increasing its severity by revising the fine calculation method (see next section).

The financial ADR system had been under discussion as a necessary measure to promote since the formulation period of the Financial Instruments and Exchange Act. Making this a reality, the 2009 amendments of 16 laws, including the FIEA, established a new ADR system (with financial services

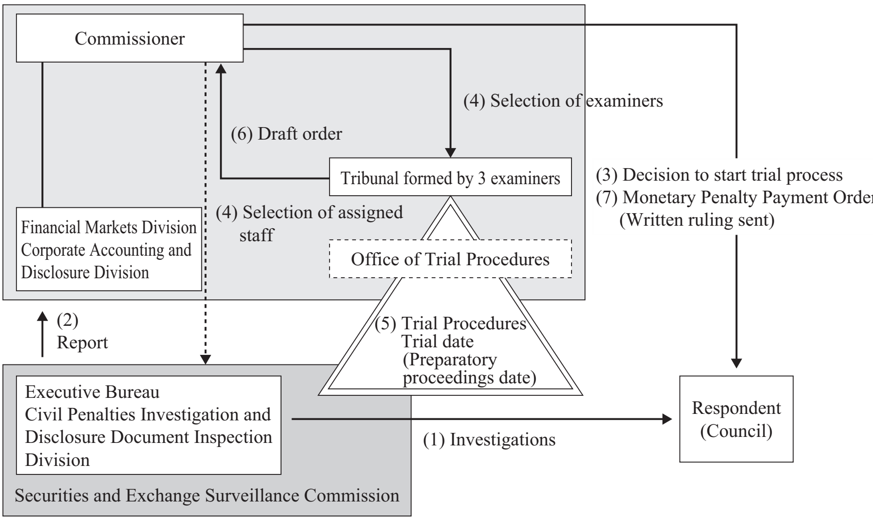
ADR at its core). Presently, the Financial Instruments Mediation Assistance Center; the Life Insurance Association of Japan; and the Japanese Bankers Association have been designated as ADRs under the system. In this manner, the enforcement framework was established and strengthened by including private citizens and regulatory authorities in the process.

5. Enforcement (2)— Financial Services Agency

The executive authority for the Financial Instruments and Exchange Act lies with the prime minister of Japan, the top minister of the cabinet, who, in turn, oversees the Financial Services Agency (FSA). In actual practice, with some exceptions, the prime minister delegates this authority to the commissioner of the FSA as stipulated in Article 194-7 (1) of the FIEA. For example, the commissioner may issue an Order to Improve Business Operations to Financial Instrument Firms and Registered Financial Institutions (Art. 51, Art. 51-2) or an order to suspend operations or rescind their registration or approval (Art. 52, Art. 52-2). The commissioner is also required to issue an Administrative Monetary Penalty Payment Order if certain conditions are met. Specifically, the order is triggered in the following cases: non-submission or misrepresentation of Securities Registration Statement and other reports (Art. 172, Art. 172-2, Art. 172-3, Art. 172-4); non-submission or misrepresentation of the public announcement of the start of an offering or the Tender Offer Notification (Art. 172-5, Art. 172-6); non-submission or misrepresentation of Large Shareholder Reports and other reports (Art. 172-7. 172-8); non-submission or misrepresentation of information on specified securities for professional markets and falsifying issuer information (Art. 172-9, Art. 172-10, Art. 172-11); and unfair trading practices, such as circulating rumors, fraud, market manipulation, and insider trading (Art. 173, Art. 174, Art. 174-2, Art. 174-3, Art. 175).

When one of these conditions is met, an Administrative Monetary Penalty Payment Order is decided through a trial procedure—in principle with a panel of three examiners and in public (Art. 180, Art. 182)—with the respondent being allowed to make a statement and submit documentary and material evidence regarding the allegations (Art. 184, Art. 185-3). The examiners may hold hearings, request appraisals by experts, and visit and inspect the work site, etc. (Art. 185, Art. 185-2, Art. 185-4, Art. 185-5). The final order is decided based on a draft produced by these examiners (Art. 185-6, Art. 185-7). Based on this process, it is possible for the FSA to enforce its regulations even in cases where it cannot move aggressively even if they warrant criminal penalties because there is not enough cause or proof to take legal action (see Table XVII-3 for FY2013 Administrative Monetary Penalty Payment

Chart XVII-4. Process Leading to Issue of Administrative Monetary Penalty Payment Order



Note: Assigned staff are selected by the FSA Commissioner to assert and verify the violations, etc., in the trial proceedings. They submit preparatory documents and give evidence, etc.
Source: Financial Services Agency

Orders).

The inspection authority for issuing disciplinary action by order or measures by the FSA is delegated by the commissioner to the commission (Art. 194-7 (2)-(4)). The commission members carry out their investigation within the permissible scope and when considered necessary, the law provides that the commission may report the matter to the prime minister or the FSA commissioner for administrative disciplinary action (Law for Establishing the Financial Services Agency, Art. 20). In fiscal 2012, the FSA implemented administrative disciplinary actions, etc., based on such reports in 15 cases with Type I financial instrument firms, 9 cases with Type II financial instrument firms, 12 cases with investment advisors and agents, and 6 case with asset management companies.

6. Enforcement (3)—Securities and Exchange Surveillance Commission

The Securities and Exchange Surveillance Commission comprises a chairman and two other committee members appointed by the prime minister with

Table XVII-3. FY2013 Administrative Monetary Penalty Payment Orders (At November 28, 2013)

Misrepresentation of facts in securities reports, etc.
Chronicle Corp. (5/10, ¥64.43 million)/G. Taste Co., Ltd. (5/23, ¥101.45 million)/Oki Electric Industry Co., Ltd. (6/5, ¥16.8 million)/Japan Care Service Corp. (7/8, ¥21 million)/Meiji-Machine Co., Ltd. (8/5, ¥82.71 million)/OBIC Co., Ltd. (8/5, ¥8.85 million)/KYCOM-Holdings Co., Ltd. (11/27, ¥27 million)
Insider trading
Person receiving insider information from an employee from a company negotiating a contract with Micron Technology, Inc. (4/16, ¥0.12 million)/Person receiving insider information from employee of company making a tender offer for SXL Co., Ltd. (5/23, ¥0.79 million)/insider trading by director of subsidiary of Ishiihyoki Co., Ltd. (6/5, ¥3.12 million)/Person receiving insider information from director of Kenko.com, Inc. (6/21, ¥0.21 million)/Person receiving insider information from an employee from a company negotiating a contract with Tokyo Electric Power Company, Inc. (TEPCO) (6/27, ¥0.06 million)/Person receiving insider information from an employee from a company negotiating a contract with TEPCO (6/27, 14.68 million)/Insider trading by employee of Cosel Co., Ltd. (7/8, ¥1.92 million)/Person receiving insider information from employee of AnGes MG, Inc. (8/23, ¥1.02 million)/ Person receiving insider information from employee of company making a tender offer for So-net Corporation (9/27, ¥2.89 million)/Insider trading by employee of Toda Corporation (10/17, ¥0.52 million)/ Person receiving insider information from a person negotiating a contract with company making a tender offer for OST Japan Group, Inc. (11/27, ¥1.45 million)/Person receiving insider information from employee of company negotiating contract with subsidiary of Noritsu Koki Co., Ltd. (11/27, ¥0.47 million)
Market manipulation
Manipulation regarding stock of Kagetsu Kanko Co., Ltd., and one other stock (4/1, ¥1.07 million)/The Gifu Bank, Ltd. (4/6, ¥1.53 million)/Mammy Mart Co., Ltd. and one other stock (6/21, ¥0.12 million)/21Lady Co., Ltd. (7/18, ¥3.6 million)/CK SAN-ETSU Co., Ltd. (10/17, ¥5.96 million)/EPG Co., Ltd. (11/8, ¥7 million)/STEP Co., Ltd. (11/8, ¥5.91 million)

Note: Figures in parentheses are the date of the order and the amount of the fine.
Source: The FSA's web site.

the approval of the upper and lower houses of parliament (Law for Establishing the Financial Services Agency, Art. 10 to 12). The commission has the authority delegated by the FSA commissioner to require a wide range of people related to financial instruments firms and registered financial institutions to produce or submit for inspection reports and materials (FIEA Art. 56-2, Art. 60-11, Art. 63, Art. 66-22, Art. 75, Art. 79-4, Art. 79-77, Art. 151, Art. 156-15, Art. 156-34). The commission also has the authority to demand the production or submission for inspection of reports and materials from the submitters of Securities Registration Statements or Large Shareholdings Reports and tender offers (FIEA Art. 26, Art. 27-22, Art. 27-330, etc.) Based on this process, the commission mainly carries out the following tasks: market analysis screening (daily market surveillance) involving a review of the securities trading activity of financial instruments firms; securities inspections involving wide-ranging and detailed branch inspections of financial instruments

Table XVII-4. SESC Recommendations by Business Year (At November 30, 2013)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Total	1	1	3	1	5	7	6	7	5	7	10	10	11	11	13	10	13	17	8	15	7	2	170
Falsifying Securities Reports, etc.	–	1	–	–	–	1	1	3	1	3	3	2	2	4	1	2	4	4	2	4	–	–	38
Spreading rumors and other interventions	–	–	1	–	1	–	–	2	1	–	2	–	1	1	–	2	2	3	1	4	1	–	22
Market manipulation or price fixing	1	–	–	–	–	–	1	1	1	1	–	2	2	1	3	4	–	3	1	1	–	1	23
Insider trading	–	–	2	–	3	1	4	1	2	3	5	6	6	5	9	2	7	7	4	6	2	1	76
others	–	–	–	1	1	5	–	–	–	–	–	–	–	–	–	–	–	–	–	–	4	–	11

Source: Materials produced by the Securities and Exchange Surveillance Commission

firms and registered financial institutions; disclosure inspections to ensure the appropriateness of disclosure by submitters of Securities Registration Statements and reports; and monetary penalty investigations undertaken to determine whether certain behavior requiring an Administrative Monetary Penalty Payment Order, such as unfair trading practices or disclosure violations, has occurred. In the case of a criminal act investigation, such as the misrepresentation of material facts in a Securities Registration Statement or report or market manipulation, officials of the commission are authorized to arbitrarily investigate by questioning, inspecting, and keeping documents in custody (FIEA Art. 210). In such criminal investigations, the officials also have search and seizure authority within the scope of the warrant issued by a judge (FIEA Art. 211).

After the commission has made its recommendations based on its securities investigations, the FSA commissioner issues orders to improve business operations, rescinds registration, or suspends operations. When the commission recommends action as a result of its monetary penalty investigations, the commissioner issues an Administrative Monetary Penalty Payment Order when he/she is convinced that regulations have been violated. Furthermore, when the commission is convinced that irregularities have been committed following a criminal investigation, it must report the case to the Public Prosecutors Office (FIEA Art. 226 (1)) (see Table XVII-4 for SESC reporting status).

From the perspective of strengthening enforcement, one area that is receiving attention recently is business injunctions or suspension orders issued by the courts (FIEA Art. 192 (1)). In the 2008 revision of the FIEA, the Securities and Exchange Surveillance Commission was given the authority to petition for these legal actions. It first used this power to deal with a business operator not registered as a financial instruments business operator in 2010

(Nov. 17, Daikei Co., Ltd.). It has continued to do so (for example, Benefit Arrow Co., Ltd., in June 2011).

7. Enforcement (4)—Self-Regulatory Organizations

A self-regulatory organization (SRO) is a private organization that in the public interest as well as its own establishes rules for its members and punishes violations of those rules. There are various SROs in Japan's securities markets, but here we will cover the Japan Securities Dealers Association (JSDA) and the Tokyo Stock Exchange (TSE).

The JSDA is an authorized financial instruments firms association approved by the prime minister pursuant to Article 67-2 of the FIEA. Its members comprise financial instruments firms and registered financial institutions. The purpose of the association as defined in Article 67, Paragraph 1 of the FIEA is to ensure fair and smooth trading of securities and other transactions and to contribute to the sound development of the financial instruments business and to the protection of investors. To fulfill that purpose, the JSDA has formulated many rules and regulations for its members, including self-regulatory, unified conduct, dispute resolution, and other rules. The JSDA is also empowered to take disciplinary action when its members violate these association rules and regulations, its articles of association, laws and regulations, and disciplinary action taken by administrative authorities. Its scope of disciplinary action includes reprimand, imposition of monetary penalties, suspension or limitation of membership or expulsion, or the issuing of a formal warning (JSDA Articles of Association, Art. 28, Art. 29).

The TSE is a corporation licensed by the prime minister of Japan as a financial instruments exchange able to operate a financial instruments market (FIEA Art. 2 (16), Art. 80 (1)). With the authorization of the prime minister, the self-regulation-related services of the TSE have been commissioned to Tokyo Stock Exchange Regulation, a separate SRO body pursuant to Article 85 of the FIEA. Those services include the listing and delisting of financial instruments, inspections of compliance of members with laws and regulations, etc., and other measures specified by cabinet office ordinance for the purpose of ensuring fair trading practices (FIEA Art. 84 (2)). Tokyo Stock Exchange Regulation's organizational structure contains a listing examination department that screens listing applicants for suitability; a listing compliance department that maintains and improves the quality of the financial instruments, etc., listed on the exchange; a market surveillance and compliance department that investigates and seeks to prevent unfair trading practices; and a participants examination and inspection department that monitors compliance and implements disciplinary action, etc. Under rule 34 of the TSE's

Table XVII-5. SRO Disciplinary Action (TSE and the JSDA) from FY2005 to FY2013

Cases disciplined by both the TSE and the JSDA

Company	Reason for disciplinary action	TSE	JSDA
Sanei Securities Corporation	Buying, etc. listed securities for the purposes for manipulating the price of said listed securities, etc.	¥5 million penalty (Oct. 7, 2010)	Reprimand (Oct. 7, 2010)
Toyo Securities Co., Ltd.	Insufficient trading management system to prevent accepting orders related to falsifying price formation.	¥20 million penalty (April 16, 2010)	Reprimand (Sept. 10, 2010)
SBI Securities Co., Ltd.	Insufficient management of electronic information processing system related to financial products trading.	Warning (May 14, 2010)	Reprimand (June 15, 2010)
Cosmo Securities Co., Ltd.	Serious lack of business and marketing management structure resulting in organizational and multiple violations and other inappropriate behavior and the overlooking of said behavior.	Warning (Mar. 16, 2010)	¥20 million penalty (Mar. 16, 2010)
BNP Paribas, Tokyo Branch	Placing orders for the purpose of stabilizing the price of a specific listed financial product.	¥50 million penalty (Feb. 16, 2010)	¥30 million penalty (Feb. 16, 2010)
Kabu.com Securities	Failure to implement necessary and appropriate measures to prevent unfair trading practices related to sensitive corporate information.	¥5 million penalty (Oct. 20, 2009)	¥20 million penalty (Oct. 20, 2009)
Mitsubishi UFJ Securities	Insufficient internal control system for management of individual customer information.	Warning (Aug. 11, 2009)	Reprimand (Aug. 11, 2009)
Rakuten Securities	Insufficient management of electronic information processing system for financial instruments business, etc.	¥3 million penalty (June 12, 2009)	¥10 million penalty (June 12, 2009)
Monex Securities	Insufficient management of electronic information processing system for financial instruments business, etc.	¥3 million penalty (June 12, 2009)	¥10 million penalty (June 12, 2009)
SBI E Trade Securities	Failure to implement necessary and appropriate measures in the management of trading, etc., of customer securities to prevent unfair trading practices related to sensitive corporate information.	Warning (June 27, 2008)	Reprimand (June 27, 2008)
Maruhachi Securities	Brokerage and execution of a series of purchases of a listed security in order to maintain its price.	Three-day suspension of trading (May 28, 2008)	¥200 million penalty (May 28, 2008)
Deutsche Securities	Proprietary trading based on sensitive corporate-related information.	¥3 million penalty (May 28, 2008)	¥5 million penalty (May 24, 2008)
Maruhachi Securities	Concluding contracts for discretionary account trading.	¥30 million penalty (Dec. 26, 2007)	¥50 million penalty (Dec. 26, 2007)
Mizuho Securities	Attempt to receive, etc., undisclosed information from parent company.	Warning (Dec. 18, 2007)	¥2 million penalty (Dec. 18, 2007)
Toyo Securities	Taking order from customer without delivering written document containing best-execution policy.	Warning (Oct. 12, 2007)	Reprimand (Oct. 12, 2007)
Dojima Kanto Securities	Insufficient trading management system to prevent unfair trading practices by customers.	Warning (Oct. 12, 2007)	Reprimand (Oct. 12, 2007)
Rakuten Securities	Insufficient management of electronic information processing system related to securities business.	Warning (Aug. 10, 2007)	Reprimand (Aug. 10, 2007)
Eiwa Securities	Falsifying price formation.	¥12 million penalty (Aug. 10, 2007)	¥10 million penalty (Aug. 10, 2007)
H.S. Securities	Carrying out underwriting of issue at notably inappropriate price.	Warning (June 1, 2007)	¥30 million penalty (June 19, 2007)
Mitsubishi UFJ Securities	Trading for proprietary account using sensitive corporate-related information.	Warning (Mar. 9, 2007)	Reprimand (Mar. 9, 2007)
Daiwa Securities	Accepting orders knowing that transactions could be considered insider trading.	Warning (Jan. 19, 2007)	¥5 million penalty (Jan. 19, 2007)
Japan Asia Securities	Concluding contracts for discretionary account trading.	Warning (Dec. 1, 2006)	Reprimand (Dec. 1, 2006)
Maruhachi Securities	Concluding contracts for discretionary account trading.	¥10 million penalty (Dec. 1, 2006)	¥30 million penalty (Dec. 1, 2006)
Calyon Capital Markets Asia	Short selling in violation of government ordinance.	¥10 million penalty (Oct. 20, 2006)	¥5 million penalty (Sep. 13, 2006)
H.S. Securities	Insufficient trading management system to prevent accepting orders related to falsifying price formation.	Warning (June 30, 2006)	¥5 million penalty (June 30, 2006)
JPMorgan	Falsifying price formation, etc.	¥25 million penalty (Mar. 29, 2006)	¥20 million penalty (Mar. 29, 2006)
Mizuho Securities	Insufficient management of electronic information processing system related to securities business.	¥10 million penalty (Mar. 22, 2006)	Reprimand (May 19, 2006)
Nihon Kyoei Securities	Insufficient trading management system to prevent accepting orders related to falsifying price formation.	Warning (Mar. 10, 2006)	¥2 million penalty (Mar. 10, 2006)
Rakuten Securities	Insufficient management of electronic information processing system related to securities business.	Warning (Mar. 10, 2006)	Reprimand (Dec. 16, 2005)
Maruhachi Securities	Concluding contracts for discretionary account trading.	¥10 million penalty (July 22, 2005)	¥30 million penalty (July 22, 2005)
Sanko Securities	Attempting to manipulate market prices for financial products, etc., by using marketing drives for such products.	¥12 million penalty (Feb. 21, 2013)	¥10 million penalty (Feb. 21, 2013)
Nomura Securities	Not having necessary and proper systems in place to manage sensitive corporate client information and using said sensitive information for solicitation.	¥200 million penalty (Oct. 31, 2013)	¥300 million penalty (Oct. 31, 2013)
Takagi Securities	Not having necessary and proper systems in place to manage sensitive corporate client information.	¥5 million penalty (Sept. 12, 2012)	Reprimand (Sept. 21, 2012)
Livestar Securities	Inadequate management of electronic data processing system for financial instruments firms, etc.	¥3 million penalty (Aug. 29, 2012)	Reprimand (Feb. 21, 2013)
SMBC Nikko Securities	Not having necessary and proper systems in place to manage sensitive corporate client information and inappropriate solicitation.	¥80 million penalty (Aug. 7, 2012)	¥200 million penalty (June 19, 2012)

Trading Participant Regulations, violations of laws or rules and regulations by participants are punishable by revocation of trading qualifications, suspension or restriction of trading, and monetary penalties or official warnings, etc.

In this manner, the JSDA and the TSE can regulate their members through disciplinary actions. Because these SROs share much the same membership, there are cases where both SROs punish the same violation as well as ones where only one body disciplines a dual member. The TSE is typically the one to discipline cases where insufficient internal control systems in a company have resulted in mistaken orders that have had a significant impact on the market, while the JSDA is typically the one to discipline such cases as problems with internal control system, etc., which do not have a significant impact on the market but are nonetheless regulatory violations.

8. Enforcement (5)—International Securities Regulations

Built around the membership of the Inter-American Association of Securities Commissions, which was established in 1974, the International Organization of Securities Commissions (IOSCO) was formed in 1983, with Japan's regulatory authority becoming a member in 1988. A global organization, IOSCO

Table XVII-6. Major IOSCO Committees

Presidents Committee	Meeting once a year during the IOSCO Annual Conference, the Presidents Committee is attended by ordinary and associate members, as well as by affiliate members in some specific cases.
The IOSCO Board	The Board oversees the entire IOSCO organization and is comprised of the regulatory authorities of 32 countries, including Japan. Surveys and discussions on policies are carried out by eight IOSCO committees: Issuer accounting, auditing and disclosure; Regulation of Secondary Markets; Regulation of Market Intermediaries; Enforcement and Exchange of Information; Investment Management; Credit Rating Agencies; Commodities Derivatives Markets, and Individual Investors.
Growth and Emerging Markets Committee	This is the largest IOSCO committee at IOSCO, made up of 88 members. With the goal of promoting the development and efficiency of emerging markets, the committee makes recommendations on establishing principles and minimum levels of regulation requiring compliance, the provision of educational programs and technical support, the exchange of information, and the transfer of technology and expertise.
Regional Committees	There are four regional committees—Africa/Middle East, Asia-Pacific, European, and Inter-American—that discuss specific issues pertinent to their own regions.

Sources: Prepared using information from the websites of IOSCO and the FSA.

Table XVII-7. Major Areas Addressed by IOSCO Public Documents

(1) Regulator	Online securities trading (83) (120) (159)
(2) Self-regulation	Self-regulation in general (53) (200) (225); Converting exchanges to corporations (119) (200) (225); Effective self-regulation (110)
(3) Enforcement of securities regulation	Financial services outsourcing (184); Market manipulation (103); Cross-border regulations (Online trading) (83) (120) (159); Money laundering (26) (103) (205)
(4) Cooperation in regulation	International cooperation (76) (83) (86) (111) (126) (159); Online trading (83); Derivative trading (111); Scope of cooperation (Information sharing) (17) (86) (248); Protecting the interests and assets of victims of fraud (55); Regulations for unregulated regions (41); Cooperation on financial conglomerates (88) (101) (102)
(5) Issuers	Disclosure (1) (15) (16) (24) (32) (38) (39) (61) (62) (71) (81) (118) (120) (132) (141) (145) (159) (182) (242); Accounting (182); Insider trading (145); Global offerings (1) (16) (38) (61) (71); Online trading (83) (120) (159); Internal supervisors (229); Inspections (133) (134) (199) (229) (231); Financial services outsourcing (184)
(6) Collective investment schemes	Regulations for and inspections of investment (managers) (40) (69); Conflicts of interest for investment managers (108); Risk assessment (136) (137) (156); Commissions (157) (178) (225); Anti-market timing (207); Disclosure (59) (131) (144) (158) (169); Money laundering (205); Hedge funds (142) (226) (253); Index funds (163); CIS integration (179); Commissioning authority and functions (113); Structures (60) (107); Investor education (117) (140); Customer protection (57); CIS assessment values (91) (92) (93) (253); International cooperation (52) (54)
(7) Market intermediaries	Regulations in general (8) (79); Disclosure (97) (116); Capital-related regulations (14) (77) (78) (79) (89) (97) (105) (116) (122) (201); licensing and registration systems (178); Risk management (35) (78) (105) (122) (128); Online trading (83) (159); Identification of customers (167); Money laundering (146); Conflicts of interest for analysts (152); International cooperation (49)
(8) Secondary market	Regulations in general (90) (42); Converting exchanges into corporations (200) (225); Derivative trading (6) (22) (85) (111) (143); Defaults and market turmoil (22) (29) (49) (138); Online trading (83) (120) (120) (159); Market transparency (27) (124) (147) (161) (168); Unfair trading practices (85) (103) (143) (145) (208); Securities clearing and settlement (74) (123); Margin requirements (22) (50); Short selling (96)

Notes: 1. Public documents categories are based on IOSCO's Objectives and Principles of Securities Regulation.
2. The numbers in parentheses are the IOSCO numbering system for public documents.

Source: The IOSCO web site.

had 205 member organizations as of November 2013, representing the regulators of 90% of the world's securities markets. To date, the organization has published a wide range of principles, policies, standards, guidance, codes, recommendations, and practices regarding securities trading that have been implemented in many countries. Of all of the documents published by IOSCO, perhaps the most comprehensive coverage of the significant and basic concepts of the organization is given by Objectives and Principles of Regulation, which IOSCO formulated in September 1998 and revised in June 2010. The document sets out 30 principles of securities regulation based on the three objectives of securities regulations; 1) the protection of investors; 2) ensuring that markets are fair, efficient, and transparent; and 3) the reduction of system risk. For practical implementation, the principles have been grouped into the eight categories of 1) the regulator, 2) self-regulation, 3) enforcement of securities regulation, 4) cooperation in regulation, 5) issuers, 6) collective investment schemes, 7) market intermediaries, and 8) the secondary market (In the June 2010 revision IOSCO added the category of auditors, credit rating agencies, and other information providers and increased the number of principles slightly to 38). This document indicates the form of securities regulations that IOSCO is aiming for, and most of the other papers issued by the organization focus on one of the principles set out in this document. In actual fact, there are many cases where the principles stated in this document are used verbatim in other papers.

IOSCO's documents have a strong influence on Japan's securities regulators, which have taken steps to implement its policies through laws and self-regulatory systems. The Financial Services Agency closely follows IOSCO trends and publishes them on its web page. One example of these IOSCO principles being set in Japanese legislation is the International Conduct of Business Principles. Formulated in 1990, these principles deal with the market intermediaries category. Of the seven principles regarding conduct in the securities business covered by this paper, the first principle, honesty and fairness, and the fourth principle, information about customers, were put into the former Securities and Exchange Law through an amendment in 1992 in the form of an obligation to be sincere and fair in securities trading and the requirement to apply a suitability principle in sales and solicitation of sales of securities. With IOSCO's importance in international markets continuing to grow, it is likely that Japan will align its securities regulatory framework with emerging trends through ongoing revisions.

APPENDIX

Chronology of Events Related to Securities

(1870−2013)

Date	Event
Apr. 23, 1870	The Japanese government publicly offers 9% coupon bonds on the London market (the first government bond ever to be so offered).
Oct. 13, 1874	The stock trading ordinance is enacted (the nation's first securities law), but it is not enforced.
May 4, 1878	The stock exchange ordinance is promulgated.
May 15, 1878	The Tokyo Stock Exchange is established.
June 17, 1878	The Osaka Securities Exchange is established.
Mar. 4, 1893	The Exchange Law is promulgated.
Mar. 9, 1899	The Commercial Code is promulgated (the basic law of today's Joint Stock Companies Act).
Mar. 15, 1920	Stock prices crash, touching off a reactionary depression.
1928	The Tokyo Stock Exchange and the Osaka Securities Exchange mark their 50th anniversaries. The Tokyo Stock Exchange computes a stock price index for the first time (Fisher's ideal index, monthly average) and starts publishing it.
July 17, 1937	Fujimoto Bill Broker Securities forms a securities investment partnership–the first investment trust.
Mar. 11, 1943	The Japan Securities and Exchange Law is promulgated. On June 30, the Japan Securities Exchange is established, and the 11 stock exchanges are abolished to become branch exchanges of the Japan Securities Exchange.
Sept. 26, 1945	The GHQ releases a memorandum (dated Sept. 25) banning the resumption of business by the securities exchange.

Dec. 1945	Investors start group trading in stocks in Tokyo and Osaka.
Mar. 28, 1947	The Securities and Exchange Law (of 1947) is promulgated.
July 23, 1947	The Securities and Exchange Commission is established.
Apr. 13, 1948	The Securities and Exchange Law (of 1948) is promulgated, and it makes securities companies subject to registration.
Jan. 31, 1949	The GHQ announces a policy authorizing the resumption of securities trading.
Feb. 12, 1949	Securities companies hold inauguration meetings of stock exchanges in Tokyo (Feb. 12), Osaka (Feb. 15), and Nagoya (Mar. 7).
July 4, 1949	Stock exchanges in Fukuoka, Hiroshima, Kobe, Kyoto, and Niigata start floor trading.
Apr. 1, 1950	The Sapporo Stock Exchange starts floor trading.
June 1, 1951	The Securities Investment Trust Law is promulgated and enforced, and stock investment trusts start operating on June 15.
Aug. 1, 1952	The Securities and Exchange Commission is abolished, and its function is transferred to the Security Section of the Finance Bureau of the Ministry of Finance.
Sept. 10, 1952	The Securities and Exchange Council is created.
Apr. 2, 1956	The stock exchanges in Tokyo and Osaka open a bond trading market.
Oct. 2, 1961	The stock exchanges of Tokyo, Osaka, and Nagoya open Second Sections.
July 18, 1963	President Kennedy of the United States proposes the creation of an interest equalization tax, and stock prices on the Tokyo Stock Exchange crash on July 19.
May 21, 1965	Talks about the rehabilitation of the near-bankrupt Yamaichi Securities are reported, plunging the market into a semi-crash.
Oct. 1, 1965	The amended Securities and Exchange Law is enforced; among other things, it requires securities companies to obtain a license from the government.
Mar. 3, 1971	The Law Concerning Foreign Securities Firms is promulgated.

Feb. 13, 1973	The government shifts the exchange rate system to a floating exchange rate system.
1975	The Ministry of Finance starts issuing a massive amount of government securities, and the turnover of bonds on the OTC market increases sharply.
Dec. 1, 1980	A new Foreign Exchange Law is enforced, and in- and outbound securities investment is liberalized, in principle.
Apr. 20, 1984	The Law Concerning the Custody and Transfer of Stock Certificates is promulgated.
Dec. 24, 1985	Merrill Lynch and five other foreign securities firms are admitted to the Tokyo Stock Exchange for the first time.
Nov. 25, 1986	The Law Concerning the Regulation of Investment Advisers Relating to Securities is enforced.
Oct. 20, 1987	Following Black Monday on the New York market, stock prices on the Tokyo Stock Exchange register a record one-day drop (down 14.9%), and Black Monday spreads across the world.
Sept. 3, 1988	The Tokyo Stock Exchange (TOPIX) and the Osaka Securities Exchange (the Nikkei 225) start trading in stock index futures in earnest.
June 12, 1989	The stock exchanges in Osaka (the Nikkei 225); Nagoya (Option 25, on Oct. 17); and Tokyo (TOPIX) start trading stock index options.
Dec. 29, 1989	The Dow Jones average (the Nikkei average) shoots up to an all-time high of 38,915.87.
June 26, 1992	The Law Concerning Realignment of Related Laws for a Reform of the Financial System and the Securities Trading System is promulgated, and the Securities and Exchange Surveillance Commission is launched on July 20.
Apr. 1, 1994	The brokerage commission securities companies charge on block trading is liberalized.
Sept. 8, 1995	The Bank of Japan cuts the discount rate to an all-time low of 0.5%.
Jan. 1, 1996	The regulation of the issuance of corporate bonds is abolished.

Nov. 11, 1996	Prime Minister Ryutaro Hashimoto instructs his cabinet to come up with ideas for a sweeping financial system reform to revive the Tokyo market in preparation for the 21st century (a Japanese version of the "financial Big Bang").
June 13, 1997	The Securities and Exchange Council, the Financial System Research Committee, and the Insurance Council submit reports on measures to be taken to achieve the goals of the Japanese Big Bang.
Nov. 3, 1997	San'yo Securities, Hokkaido Takushoku Bank (Nov. 17), and Yamaichi Securities (Nov. 22) go virtually bankrupt.
Apr. 1, 1998	The government starts carrying out Big Bang reforms, the amended Foreign Exchange Law is enforced, and the brokerage commission on a trade worth ¥50 million ($476,000) or more and less than ¥1 billion ($9.52 million) is liberalized.
June 22, 1998	The Financial Supervisory Agency is launched.
Aug. 6, 1998	The Financial Council is launched.
Oct. 16, 1998	Eight laws related to financial reconstruction are promulgated.
Dec. 1, 1998	The Financial System Reform Law is enforced.
Dec. 15, 1998	The Financial Reconstruction Commission is launched.
Apr. 1, 1999	Securities companies start managing their customers' assets separately from their own.
Oct. 1, 1999	The brokerage commission on stock transactions is liberalized.
Nov. 11, 1999	The Tokyo Stock Exchange launches Mothers, a market for high-growth and start-up stocks.
Mar. 1, 2000	The Niigata Stock Exchange and the Hiroshima Stock Exchange are consolidated into the Tokyo Stock Exchange.
Mar. 17, 2000	The regulatory agency cancels the securities registration of Minami Securities, the first such cancellation ever in Japan.
May 8, 2000	The Osaka Securities Exchange opens the NASDAQ Japan market, later converted to the Hercules market for start-up companies on Dec. 16, 2002.

May 31, 2000	The Securities and Exchange Law as amended in 2000 is promulgated, and the portion of the Securities and Exchange Law that provides for reorganizing stock exchanges into joint stock companies is enforced on Dec. 1. The Law Concerning the Sale of Financial Products is promulgated.
July 1, 2000	The Financial Services Agency goes into operation.
Mar. 1, 2001	The Kyoto Stock Exchange is consolidated into the Osaka Securities Exchange.
Apr. 1, 2001	The Osaka Securities Exchange reorganizes itself into a joint stock company.
June 1, 2001	The system of electronically disclosing the contents of securities reports (EDINET), etc., goes into operation.
Oct. 1, 2001	The amended Commercial Code—lifting the ban on treasury stocks and instituting the system of trading units of shares—is enforced.
Nov. 30, 2001	The amended securities taxation system (which reduces the tax rate applicable to capital gains made by individuals from the sale of shares) is enforced.
Jan. 2002	The Stock Acquisition Corp. (which buys shares held by banking institutions) is established.
Apr. 1, 2002	The special measure for the protection of the entire deposit of investors expires, and the blanket government guarantee of deposits is partially lifted.
June 6, 2002	The Securities Settlement System Reform Law is enacted.
Nov. 29, 2002	The Bank of Japan starts buying up cross-held shares released by banks.
Apr. 28, 2003	The Nikkei average drops to a 21-year low of ¥7,607.
Dec. 1, 2004	The ban on banking institutions against engaging in the securities agent business is lifted.
Dec. 13, 2004	The JASDAQ Stock Exchange opens for business.
Apr. 1, 2005	The blanket government deposit guarantee is scrapped (excluding deposits used for settlement purposes).
Dec. 8, 2005	A trading error involving shares of the newly listed J-Com Co. occurs. The related transactions are settled in cash for investors on Dec. 13.

Jan. 16, 2006	The Livedoor scandal occurs, leading to the Murakami fund problem in June.
June 14, 2006	The Financial Instruments and Exchange Act is published and goes into effect Sept. 30, 2007.
Aug. 2007	Subprime mortgage loan problem looms large in U.S. markets and spreads to European markets as well.
Sept. 15, 2008	Lehman Brothers Holdings Inc. files for protection under Chapter 11 of the U.S. Bankruptcy Code, creating the Lehman Shock that spins the world into financial crisis.
Jan. 5, 2009	Japan implements a fully dematerialized registration system for stocks.
July 21, 2009	The Osaka Securities Exchange sets up FX markets and begins trading.
Aug. 30, 2009	The Democratic Party of Japan wins the national elections and Japan's ruling party changes.
Jan. 19, 2010	Japan Airlines Co., Ltd., files with the Tokyo District Court for protection under the Corporate Reorganization Law becoming the largest business failure in Japan's post-war history.
Feb. 4, 2010	European markets plunge due to the sovereign debt crisis in Greece.
Sept. 10, 2010	The Incubator Bank of Japan, Limited declares its bankruptcy to the FSA, which announces the first ever triggering of the government's deposit insurance cap system.
Mar. 11, 2011	Great East Japan Earthquake occurs, followed by a hydrogen explosion at Tokyo Electric Power Company's Fukushima nuclear power facility on March 13.
June 2011	U.S. Fitch Ratings downgrades Greece's long-term government debt to "CCC."
July 13, 2011	Standard & Poor's downgrades U.S. long-term government debt from "AAA" to "AA."
June 4, 2012	Fears about the direction of the U.S. and global economies, drove down TSE's Nikkei average to a low for the year, at 8,295.63. The TOPIX index also fell to its lowest point in 28-and-a-half years, setting a new post-economic bubble low.

Dec. 16, 2012	The Liberal Democratic Party won the national lower house elections by a landside, returning to power.
Jan. 1, 2013	The Tokyo Stock Exchange Group, Inc. and Osaka Securities Exchange Co., Ltd., merged their operations, giving birth to the Japan Exchange Group, Inc. (JPX)
April 4, 2013	The Bank of Japan introduced a quantitative and qualitative monetary easing program aimed at achieving 2% inflation in the Japanese economy within two years.
Aug. 9, 2013	The Ministry of Finance announced that the national debt had risen to ¥1,008.6 trillion as of June 30, 2013.

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