

Toward Vitalization of the Corporate Bond Market

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Japan Securities Dealers Association

Study Group to Vitalize the Corporate Bond Market

The Study Group to Vitalize the Corporate Bond Market (“the Study Group”) was established on July 1, 2009 and has worked as a forum to discuss various issues relating to the current conditions and ideas for vitalization of the Japanese corporate bond market. A wide range of market participants and experts have been involved in the discussions.

The Study Group has held 17 meetings, including some held by the Working Group for Study Group to Vitalize the Corporate Bond Market,” a sub-committee established under the Study Group. Based on its discussions, the Study Group prepared the present report, entitled “Toward Vitalization of the Corporate Bond Market.”

In this report, we summarize the problems currently existing in the Japanese corporate bond market and indicate concrete measures to realize a more efficient corporate bond market with higher transparency and liquidity.

Vitalization of the corporate bond market in Japan is a key element in Japan’s new economic growth strategy. Therefore, we expect that this issue will be considered and tackled actively by both the public and private sectors.

The Study Group is committed to continuing its efforts to understand the needs of issuers, investors, and market participants for vitalization of the corporate bond market, prepare recommendations as necessary, and assist in taking various measures.

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Chapter I Current conditions and vitalization issues of the Japanese corporate bond market

1. Introduction

- (1) Going through various system reforms, the corporate bond market in Japan has developed as a free and efficient market and has played an important role in corporate financing. After the global financial crisis in 2008, the market has shown steady recovery, and the issuance of corporate bonds, mainly by high-rated companies, increased by 2,550 billion yen to 11,390 billion yen in 2009 from the previous year (+29%).
- (2) However, comparing the Japanese corporate bond market with those in the United States and Europe (i.e., Euromarket), corporate bond issuance is not as robust, with an outstanding amount as of the end of December 2009 of only 59,450 billion yen, approximately one-tenth that of the U.S. market. Looking at the ratio of outstanding amount to GDP, Japan's ratio is an extremely low 13% compared with 48% in the United States. We see the same comparative trend in the Europe market (Euromarket). Additionally, the importance of corporate bonds as a fund management tool is significantly lower in Japan compared with the United States and Europe. Clearly, the Japanese corporate bond market remains a small market compared with the U.S. and European markets.
- (3) Although various types of companies actively issue corporate bonds in the U.S. and Europe (Euromarket), the issuance of corporate bonds in Japan is still limited to fairly high-rated companies in specific sectors. Looking at corporate bond holdings in Japan, the main holders are banks (depository institutions) with individual investors, investment trusts, and foreign investors being relatively minor players.
- (4) Furthermore, as many investors hold corporate bonds until redemption in Japan, the liquidity of corporate bonds is low and the secondary market is small.
- (5) As indicated below, there are many complex factors behind the small size of the corporate bond market in Japan. Although there are some factors that cannot be overcome easily, we believe that there are many other factors that can be prevailed over with the steady efforts of market participants and the relevant government agencies. Market participants need to correctly recognize and make efforts to overcome these factors.
- (6) We believe that vitalization of the corporate bond market will promote the diversification and decentralization of financing methods by private companies as well as the expansion of asset management opportunities for investors, leading to strengthening of the financial and capital markets. This in turn will result in the active and steady development of the Japanese economy. To this end, we need to take measures to vitalize the corporate bond market in our daily business and establish a solid and liquid market.
- (7) Since the 2008 global financial crisis, vitalization of the corporate bond market has become a particularly important and urgent issue. At the onset of the financial crisis, the short-term money market became extremely tight and many companies shifted to

bank loans. In some cases, it was difficult to borrow money from banks, and new and rollover issuance conditions were very unfavorable in the corporate bond market. In light of these circumstances, private corporations clearly recognized the need to diversify their financing methods. Similarly, it has become increasingly essential to develop a corporate bond market with high transparency and liquidity that enables steady financing of large amounts of money on a long-term basis.

Because strengthening the equity capital of banks and other financial institutions has become a major issue of global financial regulatory reform following the financial crisis, we believe that banks' loan activities will change accordingly. We expect that improving the corporate bond market function within a new regulatory environment will result in the proper development of financing mechanisms, including bank loans, and contribute to the advancement, enhancement, and stability of Japan's financial and capital markets.

- (8) Furthermore, developing the infrastructure of the corporate bond market in Japan and creating a more efficient corporate bond market with higher transparency and liquidity will increase the participation of foreign corporations and investors including those from Asia. It will also help the Japanese financial and capital markets play a role suitable for the economic scale of Japan in the global market. Building a market that is useful for such professional investors as institutional investors will also contribute to improving the diversity of corporate bond issuers, market usability, and diversification of asset management methods for investors, as well as enable us to utilize human resources and information-analysis skills held by Japanese financial institutions and market participants for corporate bond issuance and financing by Asian and other foreign companies. It will also assist the Japanese capital market in playing an important role as a main market, internationally and in Asia.
- (9) Based on the viewpoint mentioned above, this report describes what problems the Japanese corporate bond market faces, and provides concrete measures for realizing a more efficient corporate bond market with higher transparency and liquidity. We expect that vitalization of the Japanese corporate bond market will be an important factor in Japan's new economic growth strategy and believe that the public and private sectors should actively cooperate in advancing the measures described in the report.

2. Factors characterizing the corporate bond market in Japan and its problems

- (1) The Japanese corporate bond market has developed its flexibility and efficiency through system reforms such as the abolishment of regulations on corporate bond issuance limits and revision of the trustee company system (1993), the abolishment of grade criteria for corporate bond issuance and deregulation of bond covenants (1996), and the electronic registration of corporate bond certificates (2006). The credibility of corporate financial reporting has been boosted by developing accounting standards and enhancing the audit system. The above actions have also increased the attractiveness of corporate bonds as financial instruments among investors. Because many companies recently have issued corporate bonds targeting individual investors, corporate bonds are also becoming an attractive investment instrument for individual investors.

- (2) On the other hand, in spite of the system reforms mentioned above, the corporate bond market in Japan is still small. As has been pointed out, the background to this situation lies in the complex interaction of various factors such as those indicated below:
- (i) Looking at the flow of funds in Japan, while the public sector is significantly short of funds, private non-financial corporations tend to have a surplus of funds. Particularly, in a situation where economic growth is slow and capital investment is restrained, the demand for long-term funds has been sluggish and many companies have issued corporate bonds not to raise new long-term funds but to roll over their existing long-term borrowings.
 - (ii) In an environment marked by low corporate finance demand, because of the government's active supportive measures and financial policies to help private corporations and intensifying loan competition among financial institutions, including banks, (see (iii) below for details), private corporations have been able to finance themselves at lower cost with bank loans rather than corporate bond issuance for a long period of time..
 - (iii) The "Chicken or the Egg" problem; i.e., the inactive issuance of corporate bonds results in and is caused by the low liquidity of corporate bonds, has yet to be solved. Consequently, the liquidity of corporate bonds remains low, and as a result, conditions in the secondary market have not been properly reflected in the primary market in a timely manner. Additionally, although we need to improve the transparency of corporate bond prices in the secondary market, the Reference Statistical Prices [Yields] for OTC Bond Transactions published by Japan Securities Dealers Association are not sufficiently reliable to serve the role of properly reflecting secondary market conditions. Furthermore, we have not developed a settlement and clearing system and a corporate bond repo market that can contribute to stimulating the secondary market.
 - (iv) Due to corporate bond underwriting practices, flexible issuance in accordance with needs is difficult because the issuable period of corporate bond is limited and the issue timing is concentrated. Corporate bond issuance procedures are not flexible and agile because the roles and responsibility sharing among securities companies conducting underwriting examinations (Type I Financial Instruments Business Operators), issuer, audit corporation, and certified public accountant have not been defined and the handling rules for comfort letter have not been clarified. Furthermore, the pot system, which is popular in the U.S. and Europe as a standard method of determining the conditions of issuance, has not been established in Japan, and as a result, the conditions of issuance cannot be quickly set.
 - (v) Due to the small size of the corporate bond market in Japan, some Japanese institutional investors have not established an adequate research system nor fostered sufficient analysts to conduct a credit analysis of corporations, a mid- to long-term issue in the market. Moreover, when investing in a corporate bond, investors in some cases significantly rely on external rating agencies, and tend to adopt a similar investment strategy to those adopted by other institutional investors. Individual investors have difficulty obtaining information on corporate

bonds.

- (vi) There was no sufficient tax exemption system for investment in corporate bonds by non-residential investors until June 2010, when such a system was introduced to promote investment in and holding of corporate bonds by foreign investors. Consequently, up to now, the corporate bond market was not a good place to actively invest in for investors with a higher risk appetite.
 - (vii) Defaults by issuing companies have been very rare in Japan. Therefore, we have not accumulated sufficient data on the relationship between the credit risk of the issuers and issuance conditions.
 - (viii) In many cases, a negative pledge giving all corporate bonds the same priority is attached to a corporate bond. As a result, when the issuer is in default, there is a concern that the rights of corporate bond holders will be subordinate to the rights of other creditors. As the covenants that are also attached to debts other than the corporate bonds are not fully disclosed, the preferred or deferred relationship between corporate bonds and other debts is unclear. This point should be improved from the perspective of investor protection.
 - (ix) In an investment environment where there have been very few corporate bond defaults corporate bond administrators have not been appointed in many cases except for corporate bonds targeting individual investors. Therefore, there is no consensus about the role of a corporate bond administrator and the preservation attachment for corporate bond holders when the corporate bond is in default, and no discussion has been held regarding cost sharing.
 - (x) As laws and regulations, the concept of bankruptcy, and the role of financial institution in the corporate reconstruction process in Japan are different from those in the United States and Europe, many people in Japan believe that only companies that have a certain level of credit strength can issue corporate bonds.
 - (xi) There remain taxation complexities in the market, such as different tax treatments depending on the type of assigner of a corporate bond. This is one of the factors that impedes higher liquidity for corporate bonds.
- (3) One of the reasons why the corporate financing structure in Japan relies heavily on bank loans rather than corporate bond issuance is that the risk premium of bank loans is lower than that of corporate bonds due to the reasons listed from (i) to (iii) below. Therefore, the funding cost of borrowing is cheaper than that of corporate bond issuance. If an appropriate spread could be set that reflects the credit risk, market liquidity, and the handling of pledges regardless of bank loans or corporate bonds, corporate bonds would become more attractive for issuers of corporate bonds as well as for investors, contributing to the diversification of financing methods for corporations and the variety of investment instruments for investors. While it is pointed out that setting an appropriate risk premium on bank loans is an important issue for the financial system in Japan, it is necessary to reduce the risk premium gap between bank loans and corporate bonds by improving the efficiency, transparency, and liquidity of the corporate bond market. This issue needs to be solved by both market participants and banks by tackling their own issues one by one based on their

individual viewpoints as well as through cooperation with each other in establishing more transparent and sound market practices.

- (i) In circumstances where companies have less demand for funds because of the sluggish economy, banks have made transactions with borrowers from a mid- and long-term viewpoint and/or under a comprehensive service scheme, including settlements and foreign exchange. Due to the public supportive measures and financial policy and intensifying lending competition among banks, lenders cannot set loan interest rates that are appropriate for the real credit risk of the borrower. We have to carefully analyze and determine how to evaluate the compensation gained by banks that provide comprehensive financial services and the long-term credit risk involved, and how to compare the cost of corporate bond issuance based on liquidity.
 - (ii) Banks lend money based on detailed information such as the pledge provided by a borrower company and the short-term funding requirements of the borrower, while the issuance of and the investment in corporate bonds are based on disclosed information such as timely disclosure by securities exchanges, prospectuses, and securities reports. In this manner, banks obtain a broader and more detailed range of information that seems to affect their loan conditions. We need to consider how the market evaluates and determines the above facts.
 - (iii) Financial institutions such as banks have taken provisional measures through the management of pledges provided by borrowers before executing loans. Also, when the borrower falls into management difficulties, banks not only preserve and recover the debts, but in some cases also play a certain role in the insolvency, reorganization, or reconstruction process of the borrower. The higher risk premium for corporate bonds may partly be due to the possibility of having to take these actions on behalf of corporate bond holders if the issuer defaults.
- (4) Corporate bonds are more specific in nature than shares, and their issuing conditions vary in each case. A syndicate loan is also an agile funding method with high liquidity that is similar to a corporate bond. To vitalize the corporate bond market, we need to develop infrastructure taking into consideration the similarity of corporate bonds to syndicate loans.
 - (5) Credit default swap (CDS) transactions have recently increased in the United States and European markets, with some large-sized companies in Japan also actively conducting CDS transactions. We need to promote the sound development of CDS transactions and the CDS market in Japan, as it supplements the liquidity of the corporate bond market. We also need to carefully monitor the relationship between the CDS market and the corporate bond market.
 - (6) As a result of the fiscal crisis, some developed countries have recently run up huge financial deficits, focusing attention on the purchase levels and the secondary market prices of government bonds in capital markets. Therefore, we need to keep a close eye on how trends in the government bond market affect the corporate bond market.

3. Measures taken to vitalize the corporate bond market

- (1) While the vitalization of Japanese corporate bond market largely relies on changes in the economic environment, capital demand of corporations, and interest rate trends, market participants need to actively exchange opinions to create a corporate bond market that is flexible and can fully respond to the sharp changes in corporate finance and asset management conditions, appropriately share awareness of common issues, and seek solutions.
- (2) For this purpose, it is necessary to develop and review infrastructure and market practices that increase market efficiency, transparency, and liquidity. We believe it is important for market participants to actively take necessary action according to the measures described in Chapter II and Chapter III below while sharing a clear view of steps for realizing such measures.

Chapter II Measures for vitalization of the corporate bond market in Japan

I. Primary market

1. Review of underwriting examination by securities companies

- (1) Issuers pointed out the following regarding the underwriting examination conducted by securities companies and ensuring the flexibility of corporate bond issuance:
 - (i) Listed companies are required to comply with the quarterly disclosure, internal control reporting, and confirmation document requirements under the Financial Instruments Exchange Act (hereinafter referred to as the “FIEA”) for the purpose of ensuring timely disclosure of financial and corporate information, and are subject to an audit and review by a certified public accountant or audit corporation. Given that the financial statements are prepared using such a comprehensive quality control system, securities companies should simplify and adopt a flexible process for the underwriting examination.
 - (ii) Currently, companies tend to avoid the issuance of corporate bonds during periods when a quarterly report needs to be submitted between the determination of corporate bond issuance conditions and payment for the bonds. Securities companies also are generally conservative in their underwriting examinations even after the submission of a quarterly report. These attitudes limit and concentrate the issuable period for corporate bonds and thus impede flexible issuance.
- (2) We understand that securities companies need to conduct a certain level of checking in their underwriting examinations to protect investors. However, to simplify and flexibly carry out the underwriting examination, it is suggested that those using prospectus must take for responsibility for it. It is also necessary to clearly indicate the policy under the FIEA on how to share the responsibilities in the case an error is found in the financial information of a prospectus, and to fully disseminate such a policy to the relevant people.
- (3) To promote flexible issuance of corporate bonds and reducing compliance costs, we

need to discuss the following items, review the underwriting examination process by securities companies, and find a way to cease the above mentioned market practices concerning underwriting examinations:

- (i) Underwriting examination scheme of securities companies;
- (ii) Roles and handling of comfort letter;
- (iii) Principles to clearly share responsibilities under the FIEA and full dissemination of them.

○ Concrete measures for the future

Japan Securities Dealers Association (hereinafter referred to as the “JSDA”) will hold a discussion on this matter in cooperation with the Financial Services Agency, the Japanese Institute of Certified Public Accountants, issuers, and securities companies, and conclude the discussion by December 2010.

2. Establishment of rational determination process for corporate bond issuance conditions

- (1) While securities companies conduct a bond demand estimate survey in the process of determining conditions of issuance, the resultant conditions do not properly reflect market conditions, due to duplicated or false demands. It is pointed out that this is one of the factors that triggers “sale at a discount” (sale under conditions inferior to the conditions of issuance) of corporate bonds in the secondary market.
- (2) In the U.S. the so-called “pot system” is commonly used for the determination of corporate bond issuance conditions. The “system” eliminates the duplicated or false investor demand and increases the transparency of the conditions determination process. It also standardizes the corporate bond issuance procedure and shortens the period required for issuance, resulting in smoother issuance of corporate bonds.
- (3) We have seen some corporate bond issuances that used the pot system in Japan. We believe that it is necessary for market participants to establish a guideline as necessary in order to share common views on practical issues such as thorough control of client data by securities companies and find a solution as soon as possible for the purpose of full introducing the pot system in Japan.

○ Concrete measures for the future

JSDA will make a list of major issues, discuss them with issuers, institutional investors, and securities companies, and take necessary measures by December 2010.

[References]

○ Pot system

The pot system sets an allotment for which the underwriting companies are jointly responsible (i.e., pot) for the purpose of enabling the lead manager to determine the issuance conditions for corporate bonds based on an accurate assessment of investor demand. Large-sized investor demand is gathered and collected in the pot and all the underwriters share the information to eliminate duplicated or false demand.

3. Measures to cope with default risk

For vitalization of the corporate bond market, it is necessary to develop and construct a lower-rated corporate bond market that enables not only high-rated issuers but also corporations with relatively higher credit risk credit risk is relatively high to use the corporate bond market. We plan to develop the following measures that will protect investors when business conditions deteriorate at issuing companies or companies default on their corporate bonds, for the purpose of expanding the investment in corporate bonds issued by companies with relatively higher credit risk .

3.1 Granting of covenants and information disclosure

(1) Granting of covenants

- (i) Since the abolishment of grade criteria and deregulation of the financial special contract in 1996, issuers can flexibly grant covenants on corporate bonds issued in and after 1996 reflecting the financial condition of the issuer. We believe that such a flexible scheme should be maintained and enhanced in the future for vitalization of the corporate bond market.
- (ii) On the other hand, currently, the covenants granted on a corporate bond issue mainly cover the negative pledge clause (a clause prohibiting the issuer from creating any security interest over certain property specified in the provision) and cross acceleration.
- (iii) While the negative pledge clause is a special agreement for the purpose of protecting investors that prohibits the issuer from creating a security interest over other non-secured debts, it is usually effective only among corporate bonds. In 2009, only two corporate bonds targeting individual investors had covenants covering other debts and loans. On the other hand, in loans, a certain preservation measure is generally taken in response to the condition of the debtor at the time of executing the loan. In this regard, a corporate bond that was issued before the loan is likely to defer to other debts and loans from a property preservation viewpoint. Therefore, it has been pointed out that the granted covenants would affect the recovery of debt in the case of a corporate bond default by a company with relatively higher risk.
- (iv) In future, when we promote expanding issuance of and investment in corporate bonds issued by corporations with relatively higher credit risk, it will be necessary to develop an environment where various kinds of covenants can be granted flexibly to reflect the capital and financial policies of the issuer and to meet the needs of investors, with such covenants being fully reflected in the issuance conditions for corporate bonds.
- (v) For this purpose, based on examples in the United States, we need to prepare and illustrate by example a model of standard covenants for corporate bonds issued by corporations with relatively higher credit risk, for use as a reference by issuers, investors, and securities companies. It will also be necessary to disseminate market practices that enable us to grant flexible covenants and determine

reasonable issuance conditions.

- (vi) Among the issues we should address in future regarding the use of secured corporate bonds issued by corporations with relatively higher credit risk is the relationship of these corporate bonds to the order of priority of loan pledges.

○ **Concrete measures for the future**

JSDA will hold a discussion about this matter in cooperation with issuers, securities companies, the Japanese Institute of Certified Public Accountants, and corporate bond administrators (such as banks and trust banks), and summarize the discussion report by March 2011.

(2) Disclosure of information on covenants

- (i) What covenants are granted affects the holder of a corporate bond when the corporate bond is in default and the holder tries to recover the debt. Therefore, it is important for the holders to check the covenants granted on other corporate bonds and loans. They cannot be confident in making an investment in a corporate bond without proper disclosure of covenants granted on other debts.
- (ii) In Japan, covenants granted on a corporate bond are disclosed in a prospectus as a disclosure item at the time of issuance. Covenants of debts including loans are disclosed in the annual securities report.
- (iii) As of the end of fiscal year ended March 2009, 219 companies disclosed the covenants of loans and other debts in their annual securities reports. Many covenants relate to financial indicators such as the maintenance of net assets and the maintenance of profits. There were a few companies that disclosed covenants relating to default such as cross acceleration.
- (iv) In the United States, covenant information on corporate bonds and loans is disclosed as follows:
 - a. The annual report Form 10-K discloses basic information such as the type of covenants, whether or not the covenants are granted, and the compliance status (We don't know the details, as no indication is made as to which covenants are granted on which debts).
 - b. If the corporate bond or the loan is subject to important events that require submission of the current report Form 8-K, the detailed information is disclosed on that form.
- (v) For the purpose of developing an environment where investors can be confident in making an investment in corporate bonds, we need to discuss the following issues based on the disclosure system in the United States, and take measures to properly disclose the necessary information on covenants from an investor protection viewpoint.
 - a. Disclosure in an annual securities report (promotion of disclosure of covenants about default);

- b. Statutory disclosure equivalent to the current report Form 8-K in the U.S.;
- c. Timely disclosure required by securities exchanges.

○ Concrete measures for the future

JSDA will hold a discussion about this matter in cooperation with issuers, securities companies, the Japanese Institute of Certified Public Accountants, corporate bond administrators, the Financial Services Agency, and securities exchanges, and conclude the report by December 2010.

3-2 Corporate bond management

(1) Credit risk of corporation and corporate bond management

- (i) A corporate bond administrator is in principle appointed at the time of issuance of the corporate bonds under the Companies Act and acts as a statutory agent of corporate bond holders to monitor the financial condition of the issuer and preserve/recover the debts at the time of default.
- (ii) Currently, while the corporate bond administrator is appointed for corporate bonds targeting individual investors, most corporate bonds targeting institutional investors do not appoint a corporate bond administrator.
- (iii) It is necessary to maintain the current system that enables a corporation with relatively lower credit risk and having a high profile in the corporate bond market to issue corporate bonds flexibly at lower cost. On the other hand, for the purpose of promoting issuance of and investment in corporate bonds of a corporation with relatively higher credit risk, it must be possible to grant various covenants as mentioned in 3-1 above on such corporate bonds. We also need to develop an environment where the corporate bond administrator can sufficiently fulfill the role of monitoring financial condition and preserving/recovering debts and where such covenants can be properly reflected in the issuance conditions.
- (iv) We also need to prepare a system whereby the absence of a corporate bond administrator would not damage the credibility of the corporate bonds issued by such companies and the corporate bond market as a whole if the credit risk increases due to deterioration in the business conditions of the issuer.
- (v) We can choose two approaches regarding the appointment of corporate bond administrators: (a) appoint a corporate bond administrator for all corporate bonds; or (b) appoint a corporate bond administrator for corporate bonds issued by a corporation with relatively higher credit risk. For the time being, while discussing the tasks taken by the corporate bond administrator, we believe it is useful to establish Approach (b) as a market practice.
- (vi) In the case of corporate bonds issued by a corporation with relatively higher credit risk, we need to prepare and illustrate by example a standard model of appointing a corporate bond administrator that can be used as a reference for issuers, investors, and securities companies, and establish the appointment of a corporate

bond administrator as a market practice.

- (vii) Currently, many main banks play the role of corporate bond administrator. Some market participants are concerned that a conflict of interest could occur before or after a corporate bond default if, in future, corporate bond issuers become more diversified and more corporations with relatively higher credit risk issue corporate bonds. Therefore, we need to take measures to increase the credibility and transparency of tasks assumed by corporate bond administrators as well as discuss what tasks are to be assumed by them.

(2) Corporate bond management in the future

- (i) One of the reasons why many issuers do not appoint a corporate bond administrator is that issuers are doubtful about whether the tasks assumed by the corporate bond administrator justify the cost incurred by the issuer. On the other hand, corporate bond administrators point out that their responsibilities as corporate bond administrators are substantial under the Companies Act.
- (ii) The relationship between the responsibilities and costs of the corporate bond administrator should be considered carefully based on the fact that the credit risk of the issuer closely relates to the responsibilities of the corporate bond administrator. We need to define the tasks assumed by corporate bond administrators and also establish a system whereby these various factors can be properly reflected in the costs through a market mechanism.
- (iii) Tasks assumed by corporate bond administrators in the United States (i.e., Trustees”) are significantly different before and after a corporate bond default. Particularly, the tasks before default include only administrative processes, such as receiving a disclosure document including the annual report on a regular basis, and do not include the tasks of requesting financial information, monitoring, and review.
- (iv) Based on the tasks of a trustee in the United States, we need to consider that, for example, the tasks of a corporate bond administrator would be limited to the preservation and recovery of debts after the default of corporate bond, or that we would set different requirements for appointing a corporate bond administrator and for its tasks depending on the credit risk of the issuer or the type of investors.
- (v) It is possible that the position and the rights of corporate bond holders would be affected by an event concerning the corporate bond issuer besides default, such as mergers and acquisitions (M&A). Therefore, we need to discuss how to handle event risk as one of the issues relating to the tasks assumed by corporate bond administrators.

○ Concrete measures for the future

JSDA will discuss the above (1) and (2) in cooperation with corporate bond administrators, issuers, securities companies, the Ministry of Justice, and the Financial Services Agency, and conclude a report by June 2011.

[References]

○ Trustees in the United States

(1) Appointment

- (i) The trustee of a corporate bond issue in the United States is equivalent to the “Corporate bond administrator” stipulated by Article 702 of the Companies Act in Japan, and is entrusted to manage a corporate bond issue as a representative of the corporate bond holders. Under the Trust Indenture Act of 1939, the appointment of a trustee is required at the time of issuance of corporate bonds that are public offerings and have principal in excess of 10 million dollars. The trustee is responsible for taking proper action at the time of default to preserve corporate bond rights.
- (ii) A business corporation that is established under U.S. law and whose net assets are 150,000 dollars or more can act as a trustee.

(2) Measures under the Trust Indenture Act of 1939 for preventing conflicts of interest

- (i) The conflict of interest between the trustee and the corporate bond holders after a corporate bond default is strictly restrained under the Trust Indenture Act. For example, the employees and officers of the trustee are prohibited from serving as employees or officers of the issuer, the trustee cannot have a controlled/controlling relationship with the issuer directly or indirectly, and the trustee cannot have 10% or more interest in securities of the issuer. If the trustee is also a creditor, it must resign its position as trustee, or solve the conflict of interest within 90 days of the default.
- (ii) If the trustee is a creditor of the issuer, even if the trustee resigns at the time of the corporate bond default, the debts recovered by the trustee up to a maximum of the last six months will be returned to the issuer and these assets and properties managed in a special account.

(3) Tasks

- (i) Before default on a corporate bond issue
Basically, the trustee conducts administrative tasks such as receiving regular disclosure documents, including an annual report and a quarterly report. These tasks are provided in the indenture.
- (ii) After default on a corporate bond issue
 - a. Under the Trust Indenture Act and in accordance with the prudent man rule, the trustee is required to act for the purpose of maximizing the interest of the corporate bond holder. It requests the issuer to submit the financial information and notify the delay of payment of principal and interest directly to the corporate bond holders.
 - b. The trustee sometimes files the bankruptcy, participates in the creditor

committee of the bankruptcy court, and prepares a business restructuring plan.

- c. The compensation received by the trustee after the default of corporate bond is generally recognized as a preferred claim that is indispensable for the bankruptcy process and the indenture usually provides it.

II. Secondary Market

1. Development of infrastructure for disseminating corporate bond price information

- (1) If we want to increase the issuance volume of corporate bonds, we need to expand the secondary market for corporate bonds and ensure the liquidity of corporate bonds. For this purpose, we need to increase the transparency of the secondary market to properly disclose transaction prices and quotations.
- (2) In Japan, JSDA manages the system of Reference Statistical Prices [Yields] for OTC Bond Transactions as an infrastructure of corporate bond price information. Under the system, JSDA receives the quotation information from securities companies and publishes the average price, median price, and highest and lowest prices in each issue.
- (3) The Reference Statistical Prices [Yields] for OTC Bond Transactions (hereinafter referred to as the “Reference prices”) are widely used by investors and market participants, and are indispensable infrastructure in the financial and securities markets. The Reference prices are used as a reference purchase/sell price of corporate bond, for the fair value appraisal as a pledge, for the calculation of base price of investment trusts, and as a reference price and indicator at the time of determining the issuance conditions for corporate bonds.
- (4) However, as the Reference price sometimes diverges from the actual price (such as the execution price and the bid offer) and has a time lag, it is pointed out that we need to review and improve the system.
- (5) We need to consider the following based on the system in the United States and the United Kingdom to improve the transparency of corporate bond price information and build credibility for the information:
 - (i) Publication of transaction price
 - a. For the time being, we will publish the transaction price once a day after the trading hour finishes for issues with high liquidity. As the next stage, we will expand the frequency, timeliness, and coverage based on the transaction volume and other factors;
 - b. We will maintain the anonymity of investors (people who made transactions);
 - c. We will reduce the cost of securities companies and users by using an existing system such as the one operated by the Japan Securities Depository Center, Inc. (JASDEC).

(ii) Improvement of credibility of the Reference price

To improve the credibility of the Reference price, we will immediately consider the following ideas and implement them.

a. Review of the designated reporting member system

- Publicize the name of the designated reporting members;
- The designated reporting members shall be Association members who are capable of executing the transaction;
- Others

b. Putting off the reporting deadline

- Consider putting off the reporting deadline and the publication timing for the purpose of ensuring the credibility of calculation of the Reference price by the designated reporting members in cooperation with the market participants and users.

c. Others

○ **Concrete measures for the future**

JSDA will hold a discussion about this matter in cooperation with securities companies, institutional investors, and the Japan Securities Depository Center, Inc. (JASDEC), and concluded the discussion by June 2011 regarding (5)-(i) and prepare and implement measures immediately regarding (5)-(ii).

[References]

1. TRACE in the United States

- (1) The Trade Reporting and Compliance Engine (TRACE) is a system developed and operated by Financial Industry Regulatory Authority (FINRA) since July 2002, and now provides market participants (chargeable) and individual investors (free of charge) with transaction data (transaction volume, transaction price, purchase or sell, execution time, and yield) for approximately 30,000 corporate bonds on a real-time basis.
- (2) The members are required to report the transaction data of corporate bonds in the secondary market to FINRA within 15 minutes pursuant to the rules of FINRA, and FINRA publicizes the data as mentioned in the above (1) to the public.
- (3) Although there were some controversial discussions over the introduction of TRACE in 2002, TRACE is now one of the main infrastructures in the U.S. corporate bond market. This spring, it expanded its reporting coverage to securitized products.

2. BondMarketPrices.com in the U.K.

- (1) BondMarketPrices.com has been operated by Xtrakter since the end of 2007 and currently provides individual investors with price information on corporate bonds with high liquidity and ratings (remaining period before the expiration of one year or longer, rating of A- or higher, and issuance size of 1 billion Euro or larger) and with a certain transaction volume (transaction volume of 15,000 to 1,000,000 Euro). The data publicized at 17:30 are the highest and lowest prices and median price, and those publicized at 21:00 are bid/offer prices at the end of the transaction hours.
- (2) In Europe, in the wake of the global financial crisis in 2008, a new regulatory system is expected to be introduced in late 2010 to ensure (and enhance) the transparency of bond transactions. Accordingly, ways to improve and amend BondMarketPrice.com system are now under consideration.

2. Development of repurchase transaction (repo) market for corporate bonds and enhancement of functions of settlement and clearance systems

To vitalize the corporate bond secondary market, it is necessary to develop and enhance infrastructure such as a corporate bond repo market and a settlement/clearance system. We believe that such efforts would also contribute to expansion of the primary market.

(1) Development of corporate bond repo market

- (i) Although the corporate bond repo market is expected to work as a financing and fund management tool for market participants and as means of avoiding fails, the need for repo transactions is not so large given the current corporate bond issuance size.
- (ii) We need to hold necessary discussions about how to enhance the securities settlement service functions in advance based on the corporate bond repo market and the lending functions in the United States and Europe in order to cope with the growth in issuance size and the expanding needs of corporate bond repo transactions in the future.

(2) Enhancement of functions of settlement and clearing systems

- (i) A clearing house is indispensable to mitigate settlement risk, to improve the usability of investors and market participants, and to ensure liquidity. However, at the moment, as the issuance size and the transaction of corporate bonds are limited and thus, the netting effect of corporate bonds is not very large, we have not established a settlement agency like the one for government bonds.
- (ii) We need to hold discussions about the establishment of a clearing house for corporate bonds and other functional enhancements of a settlement and clearing system for corporate bonds in order to meet the growth of issuance size and the growing need for a clearing house.

○ Concrete measures for the future

Under the efforts to enhance the securities settlement and clearing system in the future, JSDA will list problems and hold discussions about the issues described in the above (1)

and (2) in cooperation with securities companies, institutional investors, relevant infrastructure organizations, the Financial Services Agency, and the Ministry of Justice, and summarize actions and measures to be taken in the future, by June 2011.

III. Market infrastructure and market practice

1. Taxation

(1) Efforts to ensure wide use of the tax-exemption system for interest on corporate bonds held by non-residents

In June 2010, the “Tax-exemption system for interest on corporate bonds held by non-residents (a 3-year temporary measure)” was enacted. This measure intends to promote the investment in and the holding of corporate bonds by foreign investors. JSDA and market participants need to disseminate this system and properly apply it on a practical basis to ensure its wide use, as well as cooperate with the relevant organizations and agencies to establish this system as a permanent one.

(2) Handling of interest on corporate bonds under unified taxation treatment for financial income

To increase individual investors’ investment in and holding of corporate bonds and public bond investment trusts, we need to create an environment where individual investors will be able to easily accept the investment risks. On the taxation side, it will be very useful to promote the unification of the financial income taxation system and allow individual investors to include their capital loss and default loss on corporate bonds and public bond investment trusts to the aggregation of their financial income for the purpose of taxation. In this case, it is necessary to discuss and solve the so-called “Problem of taxable and non-taxable treatment.” JSDA and market participants need to continue promoting the unification of tax treatment of financial income in cooperation with the relevant organizations and agencies.

○ Concrete measures for the future

JSDA will continuously make efforts to disseminate the tax-exemption system for interest on corporate bonds for its wide use and properly apply it on a practical basis in cooperation with market participants, as well as take actions to establish the system as a permanent one and unify the taxation system of financial income in cooperation with the relevant organizations and agencies.

2. Providing corporate bond investment education, development of basic data on the corporate bond market, and investors relations to promote corporate bonds

(1) It has been pointed out that there are few opportunities to educate individual investors about corporate bonds and that no sufficient basic data are provided for the investment in and the analysis of corporate bonds, such as which corporate bonds are issued and traded, interest rates, and prices.

(2) Some institutional investors have not established an adequate research system and fostered enough analysts to conduct a credit analysis of individual issues, which has become a mid- to long-term issue in the market. Moreover, when investing in a

corporate bond, investors in some cases significantly rely on external rating agencies, and tend to adopt a similar investment strategy to those adopted by other institutional investors.

- (3) IR for corporate bonds is important as an interactive communication tool between the issuer and investors, and therefore, some people insist that the issuer should carry out IR activities proactively and continuously.
- (4) In addition to enhancing and organizing corporate bond investment education programs and the basic data on the corporate bond market, it is necessary to exchange opinions with institutional investors, and actively encourage corporate bond IR activities by issuers for the purpose of promoting further understanding of corporate bond investment.

○ Concrete measures for the future

In cooperation with the relevant organizations and agencies, JSDA will hold a discussion about this matter in reference to efforts in the United States and Europe based on the needs of investors, market participants, and issuers, and take necessary measures by June 2011.

3. Promotion of internationalization of the corporate bond market and enhancement of collaboration with Asian and other markets

- (1) To implement the concrete measures mentioned above, we need to establish a market that can serve as a good example for the development of corporate bond markets in emerging countries from an international viewpoint. Additionally, we need to fully open the Japanese corporate bond market to the global participants and make it easy to use not only for domestic but also overseas issuers and investors.
- (2) The Asian Bond Markets Initiative (ABMI) - an initiative agreed upon at the meeting of financial ministers in ASEAN + three countries (Japan, China, and Korea) - is a scheme to comprehensively consider and take measures to foster the bond market in Asia, promote the issuance of local currency-denominated bonds, expand demand, and improve the regulatory framework and relevant infrastructure.
- (3) JSDA and market participants will continue their cooperation with and support for the ABMI. They also need to take measures that can promote globalization of the Japanese corporate bond market by actively conducting promotional activities and exchanging opinions with foreign market participants to make the Japanese corporate bond market easy to use by foreign issuers and investors, including those in Asia.

○ Concrete measures for the future

JSDA and market participants will continue their cooperation with and support for the ABMI, and make efforts to promote globalization of the Japanese corporate bond market by actively conducting promotional activities.

Chapter III Policies and measures for the future

1. JSDA will hold a discussion about the individual issues described in Chapter II to determine measures to be taken in the future in cooperation with the administrative agencies, relevant organizations, and market participants. It will strive to realize such measures as soon as possible.
2. JSDA will report to the Study Group the results of the discussion mentioned above and actions taken, and conduct necessary follow-up actions.
3. For vitalization of the corporate bond market, the Study Group will continue its efforts to further understand the needs of issuers, investors, and market participants, prepare recommendations as necessary, and actively take actions to realize necessary measures.

END

(Attachment)

1. Establishment of “Study Group to Vitalize the Corporate Bond Market”
2. Members of the Study Group to Vitalize the Corporate Bond Market
3. Discussions of the Study Group to Vitalize the Corporate Bond Market
4. Establishment of the “Working Group for the Study Group to Vitalize the Corporate Bond Market”
5. Members of the “Working Group for the Study Group to Vitalize the Corporate Bond Market”
6. Discussions of the “Working Group for the Study Group to Vitalize the Corporate Bond Market”
7. Overseas Research Report on Vitalization of the Corporate Bond Market (Summary)
8. Comparison of Japanese and U.S. corporate bond markets

Establishment of “Study Group to Vitalize the Corporate Bond Market”

July 1, 2009
Japan Securities Dealers Association

1. Establishment

For the enhancement of functions and stability of financial and capital markets in Japan, it is necessary to vitalize the corporate bond market to diversify the mid- and long-term financing methods for corporations and the asset management methods for investors.

For this purpose, we have established the “Study Group to Vitalize the Corporate Bond Market” (hereinafter referred to as the “Study Group”) as an advisory organization to the chairman of Japan Securities Dealers Association and have asked a wide range of market participants and experts to participate in the Study Group to discuss the current conditions and various issues for the vitalization of the Japanese corporate bond market.

2. Organization and operation

- (1) The Study Group shall consist of market participants and experts.
- (2) The chairman of the Association shall appoint the chairman and the vice-chairman of the Study Group from among the Study Group members.
- (3) The Chairman may ask the people concerned to participate in the Study Group meeting if necessary.

3. Working group

- (1) The Chairman may establish a working group if necessary.
- (2) The members of the working group shall be selected by the Chairman.

4. Secretariat

Japan Securities Dealers Association shall play a role as a secretariat of the Study Group in cooperation with the relevant organizations.

END

Members of the Study Group to Vitalize the Corporate Bond Market

Chairman:	Toshihiko Fukui	(President, The Canon Institute for Global Studies)
Vice-Chairman:	Naoyuki Yoshino	(Professor of Faculty of Economics at Keio University)
Members:	Toshio Utsunomiya	(Senior Executive Vice President, Rating and Investment Information, Inc.)
	Katsuhiko Ota	(Director, Nippon Steel Corporation)
	Yoichi Kato	(Executive Officer, Mitsubishi UFJ Morgan Stanley Securities Co.,Ltd)
	Mitsunori Kanesaka	(Advisor, Mizuho Securities Co.,Ltd.)
	Yukihiro Kitano	(Managing Executive Officer, The Sumitomo Trust & Banking Co.)
	Tetsuya Kubo	(Senior Managing Director Head of Investment Banking Unit , Sumitomo Mitsui Banking Corporation)
	Katsunori Sago	(Member of the Board Head, Equities and FICC Divisions, Goldman Sachs Japan Co.,Ltd)
	Masaru Takei	(Managing Director, Tokyo Electric Power Company)
	Michihisa Tanimoto	(Managing Director, Sumitomo Life Insurance Company)
	Ayumu Fukazawa	(Managing Director, Credit Suisse Securities (Japan) Ltd.)
	Toshinao Matsushima	(Managing Director, Daiwa Securities Capital Markets)
	Naoki Matsumura	(Executive Partner, Ernst & Young ShinNihon LLC)
	Akira Maruyama	(Deputy President , Nomura Securities Co., Ltd.)
	Masaaki Mizuno	(Senior Managing Director, Nikko Cordial Securities Inc.)
Hironaga Miyama	(Senior Executive Officer, Tokyo Stock Exchange)	
Shoji Murata	(Senior Managing Director, Japan Securities Depository Center, Inc.)	
Observers:	Planning and Coordination Bureau, Financial Services Agency Financial System Stabilization Division, Ministry of Finance Financial Markets Department, Bank of Japan Economic and Industrial Policy Bureau, Ministry of Economy, Trade and Industry	

Total: 18 members (titles omitted, in the order of the Japanese syllabary)

* Change of members

Masaaki Yamagishi (Director, Mitsubishi UFJ Trust and Banking Corporation): Resigned on April 7, 2010

Takashi Morisaki (Managing Executive Officer, The Bank of Tokyo - Mitsubishi UFJ,Ltd): Resigned on April 19, 2010

Masayoshi Nakamura (Managing Director, Mitsubishi UFJ Securities, Co., Ltd.): Resigned on April 30, 2010

Discussions of the Study Group to Vitalize the Corporate Bond Market

Date of Meeting		Agenda/Hearing
First Meeting	July 16, 2009	<ol style="list-style-type: none"> 1. Operation of the Study Group 2. Issues for vitalization of the corporate bond market (free discussion) 3. How to proceed with discussions at the Study Group <ul style="list-style-type: none"> • Establishment of “Working Group for the Study Group to Vitalize the Corporate Bond Market”
Second Meeting	September 9	<ul style="list-style-type: none"> ○ Current condition of the corporate bond market and issues for vitalization <ul style="list-style-type: none"> • Masahiko Igata (Executive Research Director, Nomura Institute of Capital Markets Research) • Yoichi Shimoyama (Manager, Capital and Exchange Market Office, Treasurer Office of Mitsubishi Corporation) • Yuji Kage (Ex-Permanent Director, Pension Fund Association)
Third Meeting	September 28	<ul style="list-style-type: none"> ○ Current condition of the corporate bond market and issues for the vitalization <ul style="list-style-type: none"> • Nobuaki Ohmura (President, Daiwa SB Investments) • Koyo Ozeki (Director of Credit Research, PIMCO Japan Limited) • Kazuhiro Yoshii (System Research Director, Daiwa Institute of Research)
Fourth Meeting	October 16	<ol style="list-style-type: none"> 1. Current condition of the corporate bond market and issues for vitalization <ul style="list-style-type: none"> • Naotaka Nakajima (Managing Director, Tobu Railway Co., Ltd.) • Katsuhiko Ohta (Executive Officer, Nippon Steel Corporation: Member of the Conference) 2. Direction of discussion in the future at the Study Group to Vitalize the Corporate Bond Market (draft)
Fifth Meeting	May 25, 2010	<ol style="list-style-type: none"> 1. Toward vitalization of the corporate bond market (draft) 2. Free discussion
Sixth Meeting	June 22	<ol style="list-style-type: none"> 1. Toward vitalization of the corporate bond market (draft) 2. Establishment of Section of the “Study Group to Vitalize the Corporate Bond Market”

Establishment of the “Working Group for the Study Group to Vitalize the Corporate Bond Market”

July 16, 2009

Study Group to Vitalize the Corporate Bond Market

1. Establishment

Based on discussions at the Study Group to Vitalize the Corporate Bond Market, we decided to establish the “Working Group for the Study Group to Vitalize the Corporate Bond Market” (hereinafter referred to as the “WG”) that lists the issues involved in and discusses measures for vitalization of the corporate bond market.

2. Organization

The WG shall consist of the members, market participants, and experts.

3. Operation

- (1) The WG shall have a chief, a position occupied by the Vice-Chairman of the Study Group.
- (2) In the case where a member of the Study Group is absent from the WG meeting or the discussion planned at the WG meeting is about a specific area or issue, such member may have its agent attend the meeting or present its opinions in writing.
- (3) The members of the Study Group may attend the WG.
- (4) The chief shall ask the people concerned to attend the WG meeting if necessary.
- (5) Whether or not the discussion is disclosed and other administration rules of the WG shall be the same as those defined in the “Operation of the ‘Study Group to Vitalize the Corporate Bond Market.’”

4. Reporting

The discussions held at the WG shall be reported to the Study Group in a timely manner.

5. Secretariat

Japan Securities Dealers Association shall play a role as secretariat of the WG in cooperation with the relevant organizations.

END

Members of the “Working Group for the Study Group to Vitalize the Corporate Bond Market”

Chief:	Naoyuki Yoshino	(Professor of Faculty of Economics at Keio University)
Members:	Yuchi Aoki	(Senior Vice President Planning Dept. Investment Banking Unit, Sumitomo Mitsui Banking Corporation)
	Masahiko Igata	(Senior Managing Director, Research, Nomura Institute of Capital Markets Research)
	Yuji Ikegami	(Director of Corporate Bond Investment Trust Department, Japan Securities Depository Center, Inc.)
	Tomoyuki Iwasa	(Vice President, Fixed Income Division of Credit Suisse Securities (Japan) Ltd.)
	Shigeta Esaki	(Head of Finance Dept.-1, Accounting & Finance Div. of Nippon Steel Corporation)
	Koyo Ozeki	(Head of Asia-Pacific Credit Research, PIMCO Japan Limited)
	Hideo Kitano	(Managing Director, Financial Products Department, Nomura Securities Co., Ltd.)
	Ichinori Kitahara	(Managing Director, Structured Finance Division, Rating and Investment Information, Inc.)
	Kinya Kuramoto	(Director, Global Investment Banking Planning Department of Daiwa Securities Capital Markets)
	Yasuro Koizumi	(Managing Director, Capital Markets Division of Goldman Sachs Japan)
	Keiichiro Shiragami	(Chief Researcher, Trusted Assets Planning Department of The Sumitomo Trust & Banking Co.)
	Kazunori Shirahata	(Manager, Financial Market Product Department of Nikko Cordial Securities Inc.)
	Akira Tagaya	(Leader, Administration and Planning Group, Derivative Products Department of Tokyo Stock Exchange)
	Tsuyoshi Tsuchida	(Executive Director, Debt Capital Market Department, Mitsubishi UFJ Morgan Stanley Securities Co., Ltd)
	Katsuyuki Tokushima	(Chief Researcher, Financial Research Division, NLI Research Institute)
	Izumi Nemoto	(Head of Capital Markets, Treasury, FX and Banking Relations, Treasurer Office of Mitsubishi Corporation)
	Naoki Matsumura	(Executive Partner, Ernst & Young ShinNihon LLC)
	Hirofumi Miyahara	(General Manager, Fixed Income Investment Department of Sumitomo Life Insurance Company)
	Tatsushi Yajima	(Senior Manager, Finance Group, Accounting & Treasury Department of Tokyo Electric Power Company)
	Kazuhiro Yoshii	(System Research Director, Daiwa Institute of Research)
	Masanori Yoshimura	(Chief Manager, Corporate & Investment Banking Strategy Division of The bank of Tokyo - Mitsubishi UFJ, Ltd.)
	Yutaka Wakabayashi	(Senior Manager, Strategic Research Department of Mizuho Securities)

Observer: Planning and Coordination Bureau, Financial Services Agency

Financial System Stabilization Division, Ministry of Finance
Financial Markets Department, Bank of Japan
Economic and Industrial Policy Bureau, Ministry of Economy, Trade and Industry

Total: 23 members (titles omitted, in the order of the Japanese syllabary)

* Change of members

Takatoshi Kawamata (Group Manager, Trusted Assets Planning Department of Mitsubishi UFJ Trust and Banking Corporation): Resigned on April 7, 2010

Yoichi Kato (Executive Officer, Mitsubishi UFL Morgan Stanley Securities Co.,Ltd): Resigned on May 1, 2010

Discussions of the “Working Group for the Study Group to Vitalize the Corporate Bond Market”

Date of meeting		Agenda/Hearing
First Meeting	October 5, 2009	○ Current condition of the corporate bond market and issues for the vitalization (free discussion)
Second Meeting	October 30	1. Structural problems of the Japanese corporate bond market (free discussion) 2. How to solve the problem of centralizing the issuance timing due to quarterly disclosure
Third Meeting	November 16	1. How to handle the default risk • Katsuyuki Tokushima (Chief Researcher, NLI Research Institute) • Theodore Paradise (Partner, Davis, Pork, and Wardwell LLP) 2. Enhancement of functions of settlement and clearing system
Fourth Meeting	December 14	1. Current condition of the corporate bond market and issues for vitalization • Toshiya Yamaguchi (Chief, Capital Group, Finance Department of Nissan Motor Company) • Toshihide Nishimura (Director, Accounting Department of Taiheiyo Cement Corporation) 2. Development of infrastructure of corporate bond price information
Fifth meeting	December 24	1. Summary of Tax Reform in the Fiscal Year ending March 2010 (New tax-exemption system for bond income of non-residents) 2. Development of infrastructure of bond price information 3. Discussion issues relating to the primary market
Sixth Meeting	January 25, 2010	1. Corporate financing • Izumi Nemoto (Vice-Director, Capital and Foreign Exchange Market Office, Treasurer Office of Mitsubishi Corporation) 2. Recommendations on listing of bonds and MTN on Tokyo Stock Exchange • Shigehito Inukai (Professor of Faculty of Law at Waseda University)
Seventh Meeting	February 1	1. Credit risk pricing in the bank loans • Yutaka Ohkubo (Representative Director and President, The Risk Data Bank of Japan, Limited) 2. Discussion issues relating to the primary market
Eighth Meeting	April 6	○ Overseas research report on vitalization of the corporate bond market
Ninth Meeting	April 16	○ Concrete measures for vitalization of the corporate bond market
Tenth Meeting	April 27	○ Toward Vitalization of the Corporate Bond Market (draft)
Eleventh Meeting	May 17	○ Toward Vitalization of the Corporate Bond Market (draft)

Overseas Research Report on Vitalization of the Corporate Bond Market (Summary)

June 22, 2010

This material summarizes, by theme, the result of research on the corporate bond market in the U.S. and Europe conducted by the secretariat of the “Working Group for the Study Group to Vitalize the Corporate Bond Market” in February 2010.

1. Corporate bond issuance

(1) United States

- (i) Although the issuance volume of corporate bonds in the United States. shrunk immediately after the financial crisis in 2008, in 2009 it recovered to almost the same level as before the crisis, to 903.6 billion dollars. Particularly, high-yield bonds reached 147.8 billion dollars, accounting for approximately 16.4%, the highest level in recent years.
- (ii) In the United States it is recognized that the bond market with sufficient depth and liquidity is basically positioned at the center of the debt market.
- (iii) Issuers (especially blue-chip companies) tend to select the public offering of corporate bonds as their financing method, due to a lower financing cost and flexibility of issuance.
- (iv) In the United States, many people think that private placement is chosen by a corporation that has difficulties in conducting a public offering, and bank loans are for corporations that have difficulties in accessing the corporate bond market.
- (v) Investment in high-yield bonds in the United States is very active, although there are some differences in the asset management scheme and management stance from those of the investment grade bonds.

(2) Europe (Euromarket)

- (i) In the European corporate bond market, although corporate bond issuance was very difficult in a certain period of time after the financial crisis in 2008, the market recovered and the issue volume of corporate bond reached a record high in 2009.
- (ii) In Europe, after the financial crisis, corporations increasingly put emphasis on the diversification of financing methods rather than focusing on the costs associated with corporate bond issuance. This is a main reason for the sharp increase in corporate bond issuance.
- (iii) In 2009, the high-yield bond issuance increased when bank loans decreased. In the European high-yield bond market, the majority of issuers have BB or B rating and issuers’ sectors are limited to stable ones. In contrast, issuers in the United States include corporations with CCC or CC rating and their sectors vary.

- (iv) Major corporate bond investors are “real money investors,” such as asset management companies, pension funds, and insurance companies. Although some banks invest in corporate bonds, the investment size is not very large compared with the total size of the corporate bond market.

2. Quarterly disclosure and corporate bond issuance (in the United States)

- (1) In the case where a listed company issues a corporate bond after closing its books, the basic procedure is that the underwriter conducts due diligence after the issuer submits and registers the quarterly report Form 10-Q or the annual report Form 10-K, and then the corporate bond is issued.
- (2) On the other hand, even if a company wishes to issue a corporate bond between the period immediately after the book closing and before the submission and registration of the quarterly report Form 10-Q or the annual report Form 10-K (namely the “Gray area”), there are many practical relief measures for issuance, such as conducting “Extra due diligence” by the underwriter and executing a claim compensation agreement with the issuer in the case of the issuance of investment grade bonds.
- (3) As described above, the usability of corporate bond is very high in the United States and in practice, there is no problem of shortening or concentration of issuable period, resulting in the prevention of mobile corporate bond issuance that is currently seen in Japan even though the quarterly disclosure system has also been introduced in the United States

3. Determination process of issuance conditions (United States.)

- (1) In the United States., the so-called “pot method” (note) is widely used when determining corporate bond issuance conditions. The pot system increases the transparency of the determination process of issuance conditions, standardizes the corporate bond issuance procedure, and shortens the period required for issuing a corporate bond.
- (2) An investment grade bond is generally issued in one or two days (it is not rare that the bond is issued in only one day). On the other hand, high-yield bond issuance requires a certain period of time to allow investors to make a credit decision, and it usually takes about one month, including the road show.
- (3) The issue price is determined based on the price of existing bonds in the secondary market and the price of comparable issues. The lead manager prevents the issue price from declining by gathering demands at least two or three times the issue volume.

(Note) The pot system is to set a part for which the underwriting companies are jointly responsible (i.e., pot) for the purpose of enabling the lead manager to determine corporate bond issuance conditions based on an accurate demand of investors. The demand of large-sized investors is gathered and collected in the pot and all the underwriters share the information, in order to eliminate duplicated or false demand.

[References] Condition in Europe

In the Europe, almost all the corporate bond offerings adopt the pot system. In the case of corporations that frequently issue a corporate bond, as it is possible to check issuance conditions through the yield curve in the secondary market, the bond is generally launched within a day.

4. How to handle default risk

4-1 Granting of and disclosure of covenants (United States)

- (1) In the United States, various covenants are granted on a corporate bond, especially high-yield bonds with higher default risk, to prevent the corporate bond from deferring to bank loans and other debts.
- (2) Major types and details of covenants granted on a corporate bond in the United States. are as follows:
 - (i) **Restriction of merger, acquisition, and transfer**
It prohibits the issuer and/or its subsidiaries from being merged with or acquired by another company or to transfer substantially all its assets to another company.
 - (ii) **Negative pledge**
It prohibits the issuer and/or its subsidiaries from creating any security interest over other corporate bonds or debts such as loans.
 - (iii) **Cross default**
If other debts are in default, the corporate bond is also in default.
 - (iv) **Cross acceleration**
If other debts are in default and the debt is due and payable earlier than expected, the corporate bond is also in default.
 - (v) **Change of control**
In the case where a predefined certain event in connection with the control of issuer (e.g., sale of substantially all the assets, change of a certain number (or more) of holders of voting rights, and change of the majority of directors) occurs and its rating is downgraded, it gives the corporate bond holders the right to claim the issuer to repurchase their corporate bond at a predefined price.
- (3) Some high-yield bond issuers use both corporate bonds and bank loans. However, in such a case, the focus is not on giving the complete pari-passu among debts but on ensuring transparency through the disclosure of information such as covenants.
- (4) The covenants information of corporate bond is disclosed in a prospectus, the annual report Form 10-K, and the current report Form 8-K, and investors can easily access the detailed information.
- (5) The basic covenants information of corporate bonds and loans is disclosed in the annual report Form 10-K, including the types of covenants, whether or not the covenants are granted, and the compliance status (We don't know the details, as no indication is made

as to which covenants are granted on which debts).

- (6) The details of the covenants are disclosed in a prospectus in the case of a corporate bond, and if the corporate bond or the loan is subject to the important events that require the submission of the current report Form 8-K, the detailed information is disclosed in Form 8-K, and investors and holders of the corporate bond can easily access the information.

4-2 Trustee (United States)

(1) Appointment

- (i) The trustee of a corporate bond in the United States is equivalent to the “Corporate bond administrator” under Article 702 of the Companies Act in Japan, and is a person entrusted to manage the corporate bond as a representative of corporate bond holders. Under the Trust Indenture Act of 1939, the appointment of a trustee is required at the time of issuance of corporate bonds that are public offerings and have principal in excess of 10 million dollars. The trustee is responsible for taking proper action at the time of default to preserve corporate bond rights.
- (ii) A business corporation that is established under the U.S. law and whose net assets total 150,000 dollars or more can act as a trustee.

(2) Measures under the Trust Indenture Act of 1939 for preventing the conflict of interest

- (i) The conflict of interest between the trustee and the corporate bond holders after a corporate bond default is strictly restrained under the Trust Indenture Act. For example, the employees and officers of the trustee are prohibited from serving as employees or officers of the issuer, the trustee cannot have a controlled/controlling relationship with the issuer directly or indirectly, and the trustee cannot have 10% or more interest in securities of the issuer. If the trustee is also a creditor, it must resign its position as trustee, or solve the conflict of interest within 90 days of the default.
- (ii) If the trustee is a creditor of the issuer, even if the trustee resigns at the time of the corporate bond default, the debts recovered by the trustee up to a maximum of the last six months will be returned to the issuer and these assets and properties managed in a special account.

(3) Tasks

- (i) Before the default of corporate bond
Basically, the trustee implements administrative tasks such as receiving regular disclosure documents, including an annual report and a quarterly report. These tasks are provided in the indenture.
- (ii) After the default of corporate bond
 - a. Under the Trust Indenture Act and in accordance with the prudent man rule, the

trustee is required to act for the purpose of maximizing the interest of the corporate bond holder. It requests the issuer to submit the financial information and notify the delay of payment of principal and interest directly to the corporate bond holders.

- b. The trustee sometimes files the bankruptcy, participates in the creditor committee of the bankruptcy court, and prepares a business restructuring plan.
- c. The compensation received by the trustee after the default of corporate bond is generally recognized as a preferred claim that is indispensable for the bankruptcy process and the indenture usually provides it.

5. Infrastructure of corporate bond price information

5-1 TRACE in the United States.

- (1) The Trade Reporting and Compliance Engine (TRACE) is a system developed and operated by Financial Industry Regulatory Authority (FINRA) since July 2002, and now provides the market participants (chargeable) and individual investors (free of charge) with the transaction data (transaction volume, transaction price, purchase or sell, execution time, and yield) on approximately 30,000 corporate bonds, excluding the bonds under Rule 144A, by each transaction on a real-time basis.
- (2) The members are required to report the transaction data on corporate bonds in the secondary market to FINRA within 15 minutes pursuant to the rules of FINRA, and FINRA publicizes the data as mentioned in the above (1) to the public.
- (3) Although there were some controversial discussions for the introduction of TRACE in 2002, TRACE is now one of the main infrastructures in the U.S. corporate bond market.
- (4) This spring, TRACE decided to expand its reporting coverage to the information on bonds issued by the GSE (government-sponsored enterprises), information on the primary market, and the securitized products.

5-2. BondMarketPrices.com in the U.K.

- (1) BondMarketPrices.com has been operated by Xtrakter since the end of 2007 and currently provides individual investors with the price information of corporate bonds with high liquidity and ratings (remaining period before the expiration of one year or longer, rating of A- or higher, and the issuance size of 1 billion Euro or larger) and with a certain transaction volume (transaction volume of 15,000 to 1,000,000 Euro). The data publicized at 17:30 are the highest and lowest prices and median price and those publicized at 21:00 are bid/offer prices at the end of the transaction hours.
- (2) In Europe, in the wake of the global financial crisis in 2008, a new regulatory system is expected to be introduced in late 2010 to ensure (and enhance) the transparency of bond transactions. Accordingly, ways to improve and amend the BondMarketPrice.com system are now under consideration.

6. Corporate bond repo market

- (1) The size of repo and bond-lending market in the United States reached 2,500 billion dollars on an outstanding basis as of the end of December 2009, and the outstanding of corporate bonds is approximately 100 billion dollars (6%). Major lending services of corporate bonds include the tri-party repo by a clearing bank and a fail cover system by National Securities Clearing Corporation (NSCC), both of which are popular and widely used.
- (2) In Europe, the corporate bond lending service provided by Euroclear is widely used.

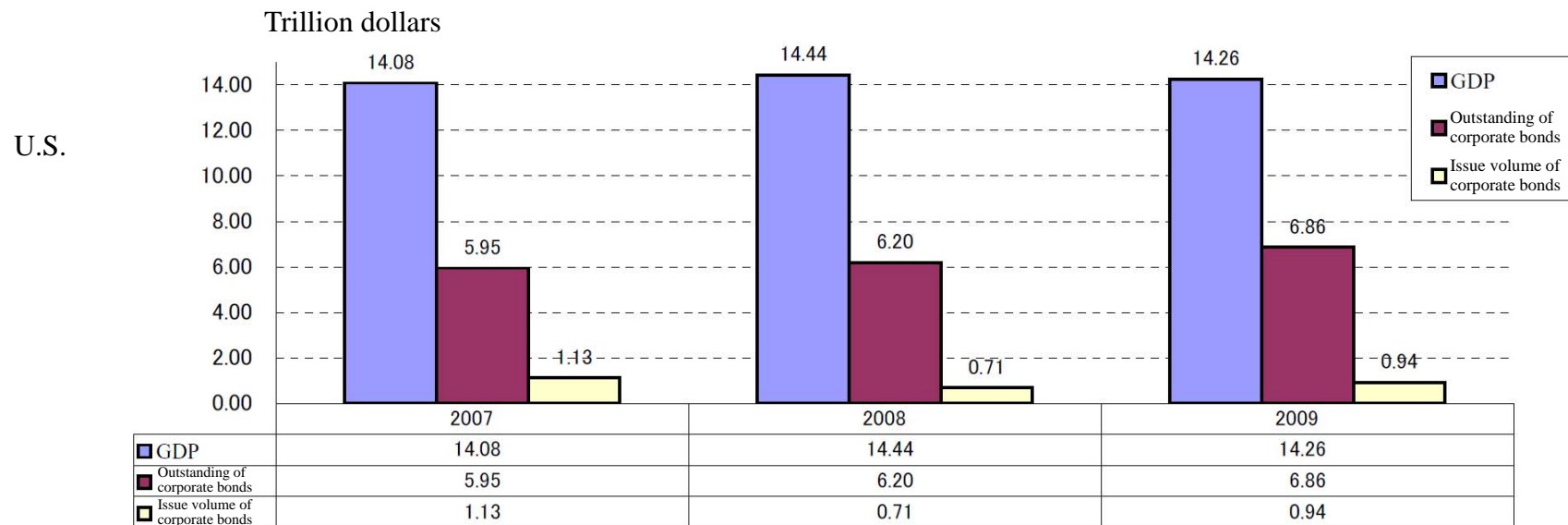
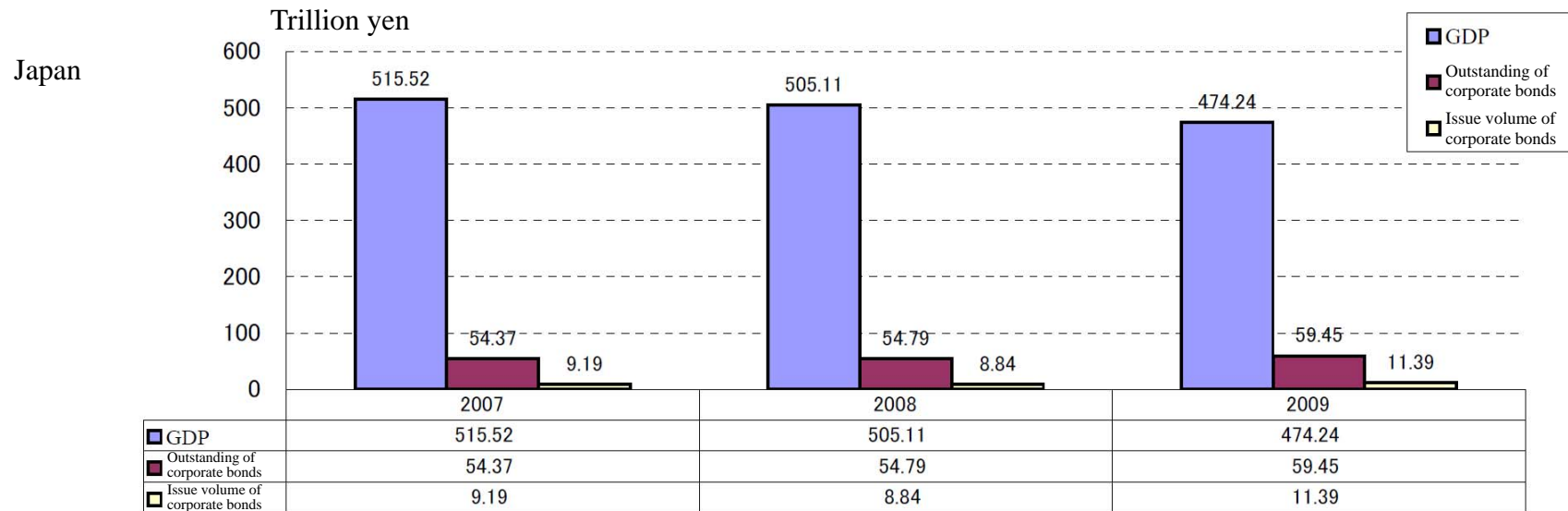
7. Corporate bond investment by individual investors and education for investors (United States)

- (1) In the United States, individual investors usually make an investment in corporate bonds through a mutual fund. Although direct investment in corporate bonds has increased recently, it still remains at a low level
- (2) FINRA and SIFMA (Securities Industry and Financial Markets Association) have made great efforts in educating investors as one of the important issues. SIFMA opens a website “InvestinginBonds.com” for individual investors.

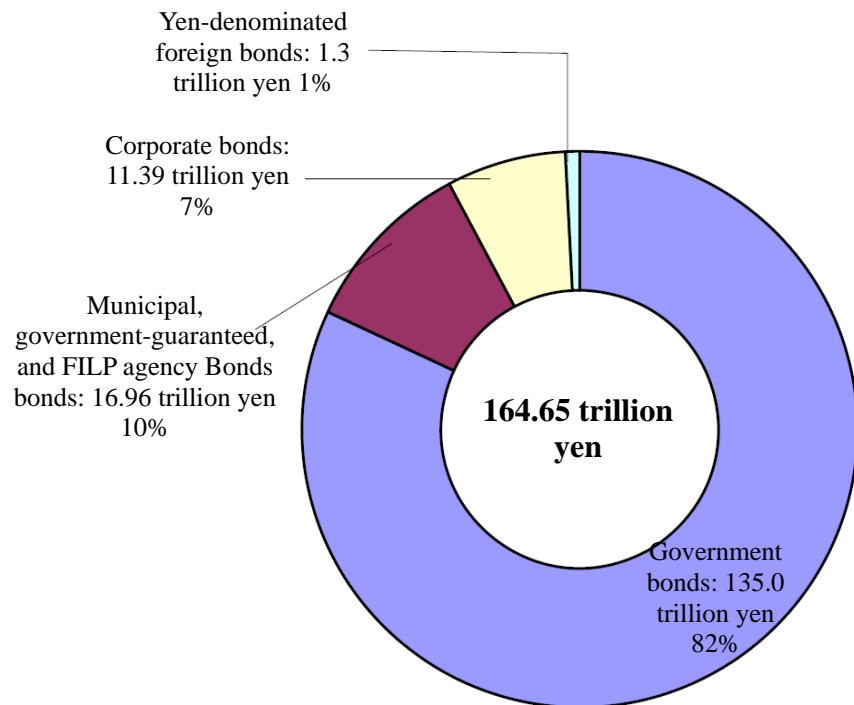
END

Comparison of Japanese and U.S. corporate bond markets

1. GDP, outstanding of corporate bonds, and issue volume

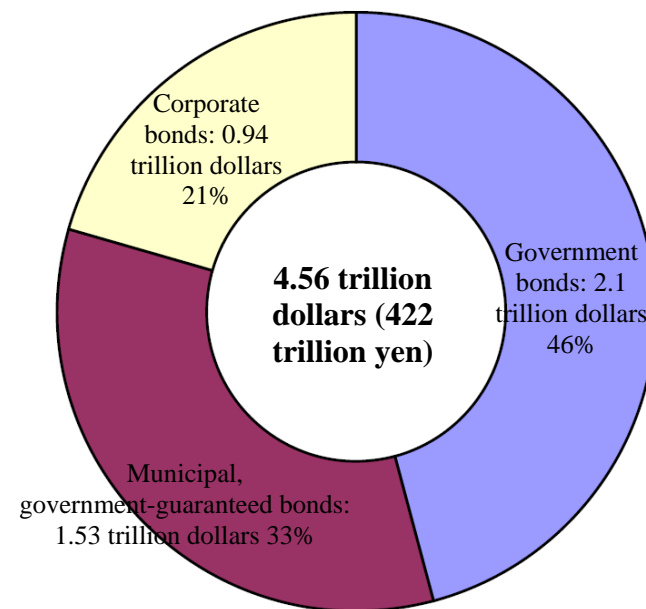


2. Issue volume and ratio of public and corporate bonds
Japan (2009)



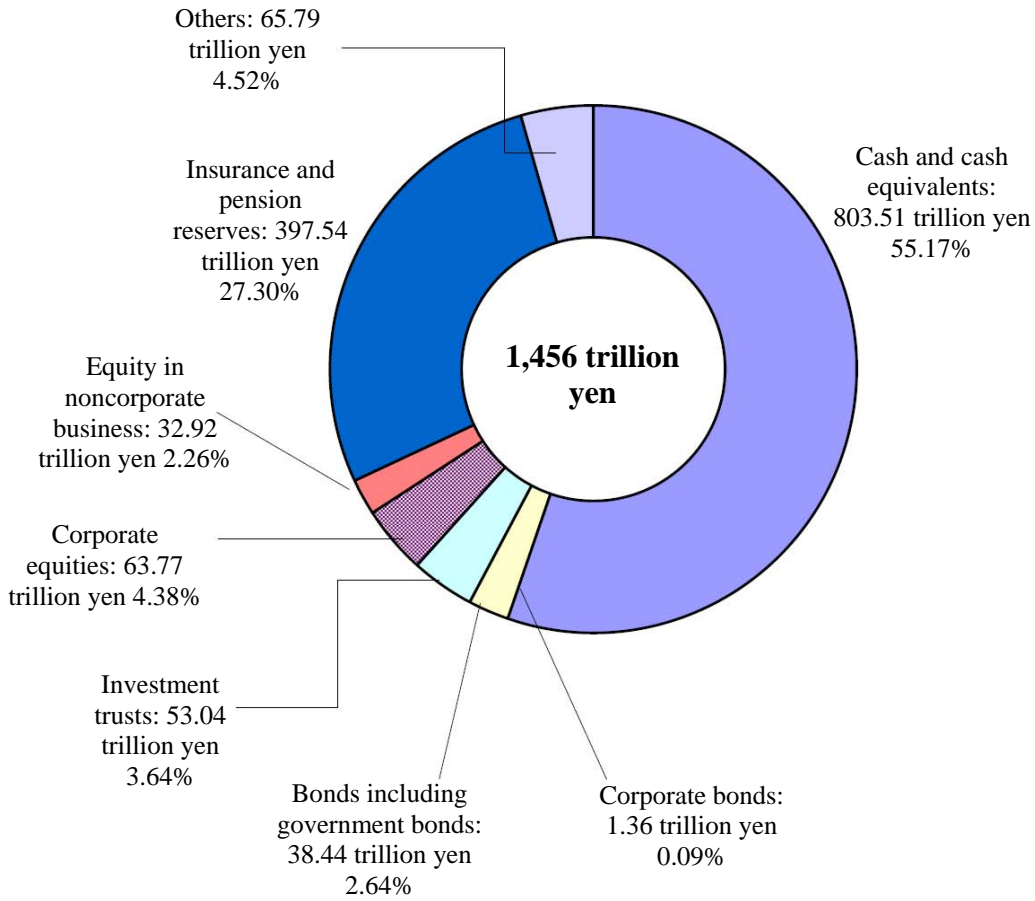
(Source: Japan Securities Dealers Association)

U.S. (2009)



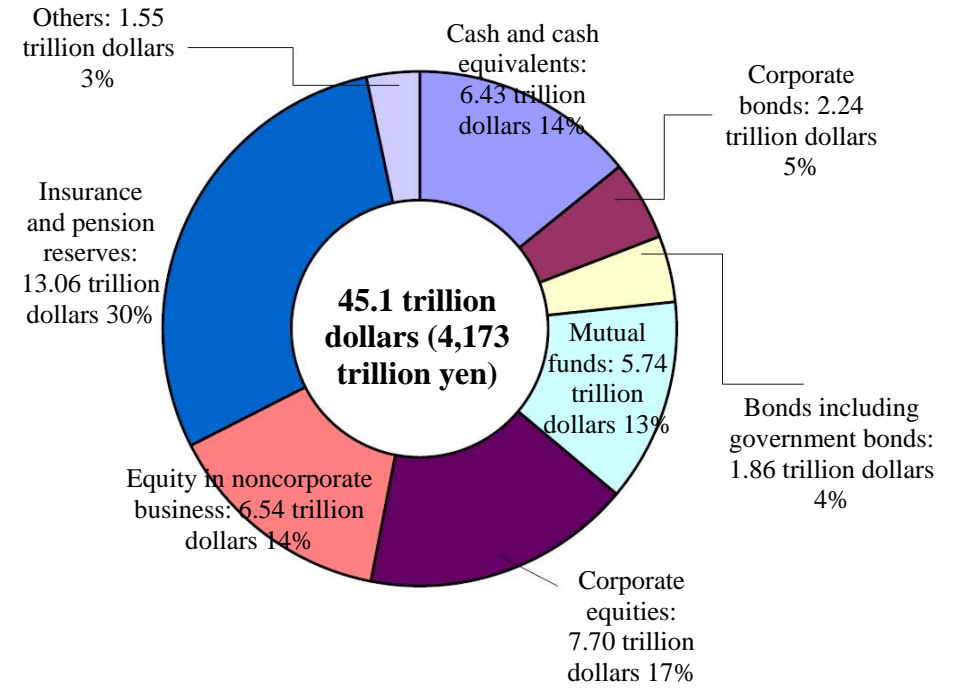
* Calculated as 1 dollar = 92.5 yen
[Source: Securities Industry and Financial Markets Association]

3. Individual Financial Assets
Japan (as of the end of December 2009)



(Source: Flow of funds statistics by the Bank of Japan)

U.S. (as of the end of December 2009)

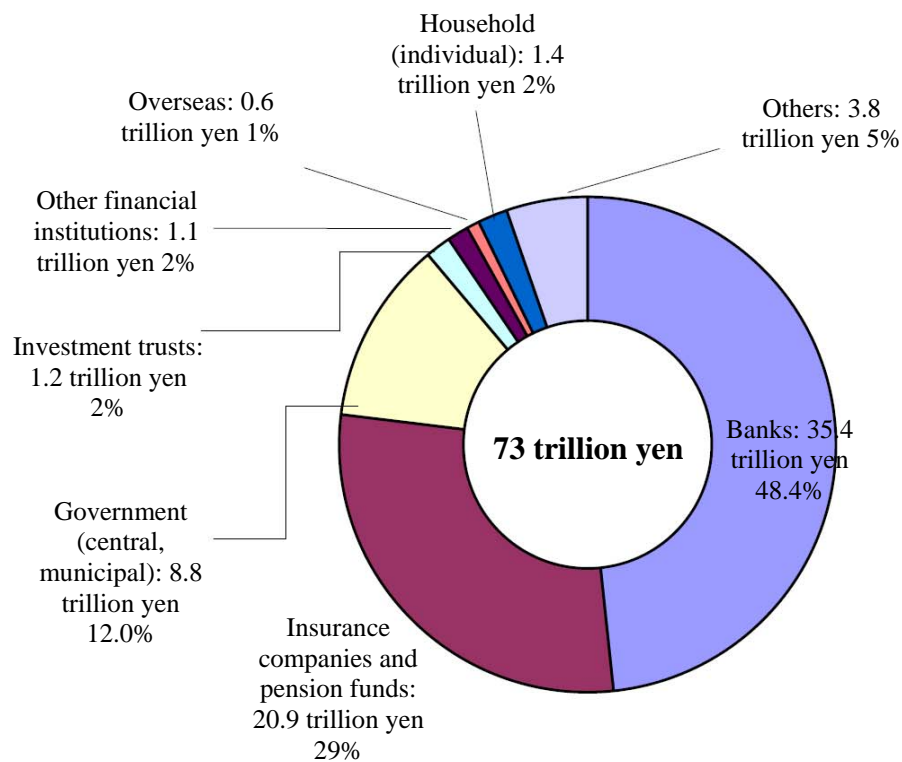


* Calculated as 1 dollar = 92.5 yen

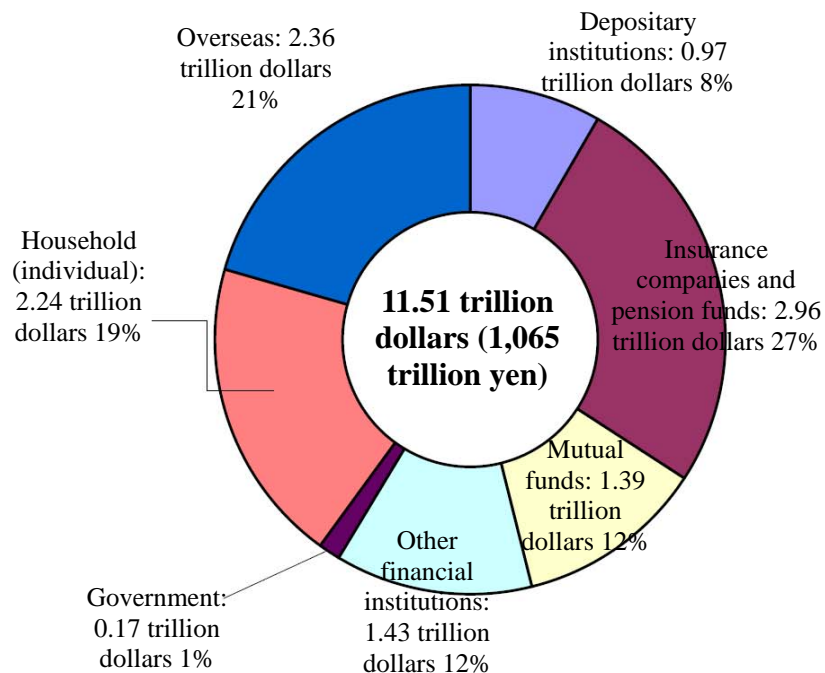
[Source: Flow of Funds Accounts of United States (Federal Reserve statistical release)]

4. Holding of corporate bonds and other bonds by type of investors

Japan (as of the end of December 2009: Corporate bonds)



U.S. (as of the end of December 2009: Bonds)

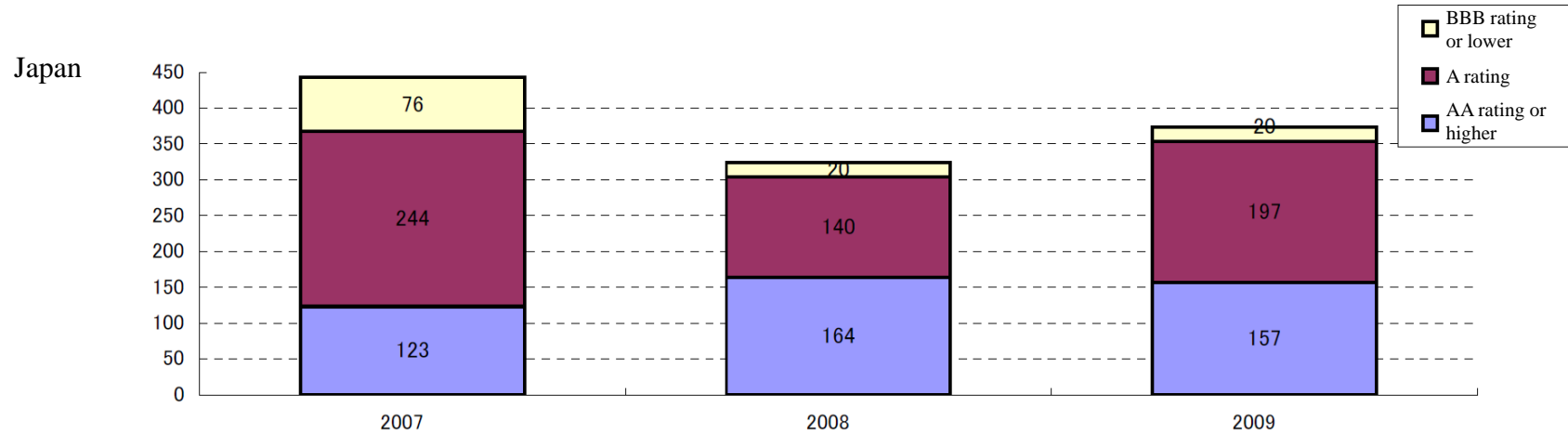


* Calculated as 1 dollar = 92.5 yen

(Source: Flow of funds statistics by the Bank of Japan)

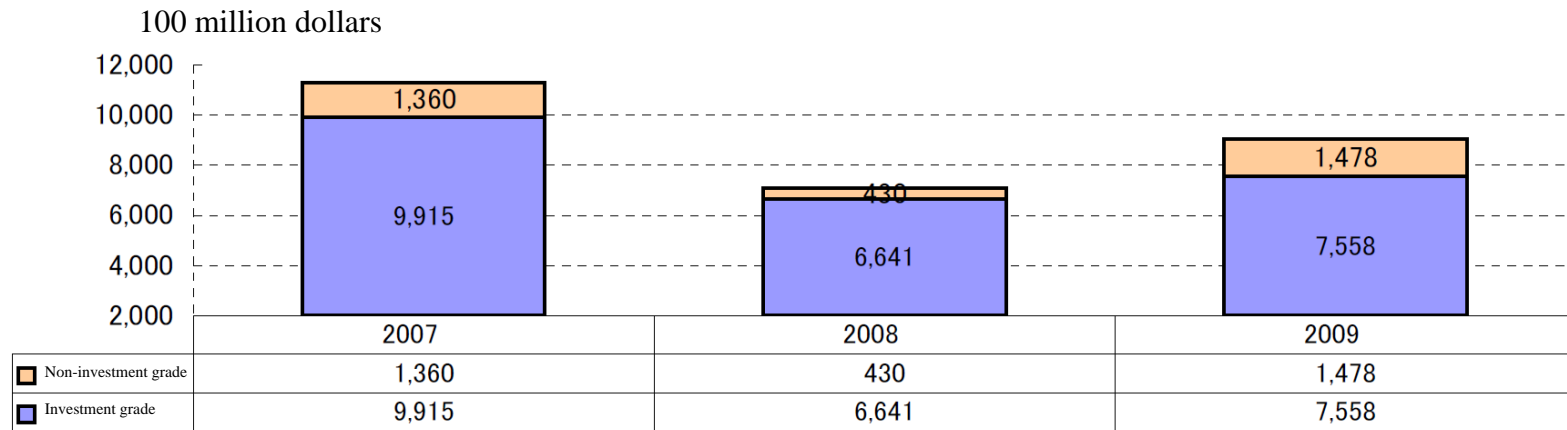
(Note) Including bonds issued overseas by U.S. corporations
(Source: Federal Reserve Flow of Funds Accounts of the United States)

5. The number of corporate bond issued by rating



(Source: Japan Securities Dealers Association)

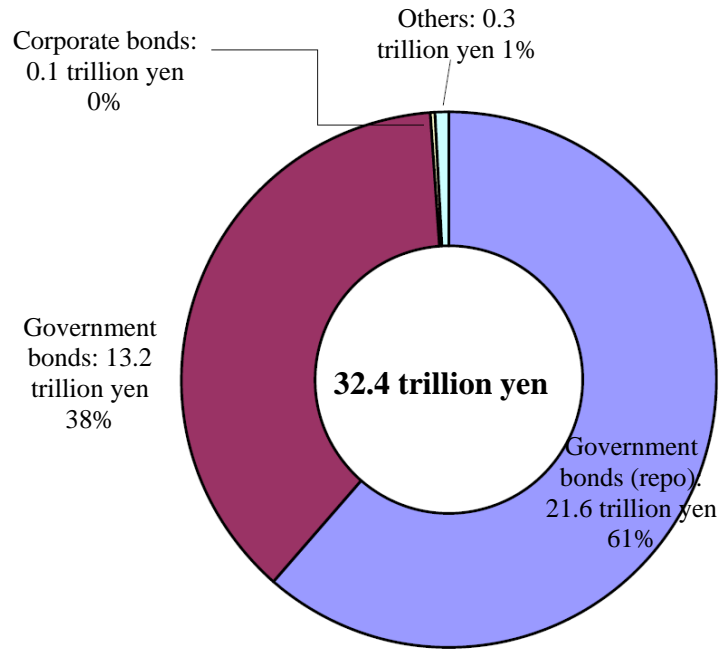
U.S.



[Source: Securities Industry and Financial Markets Association]

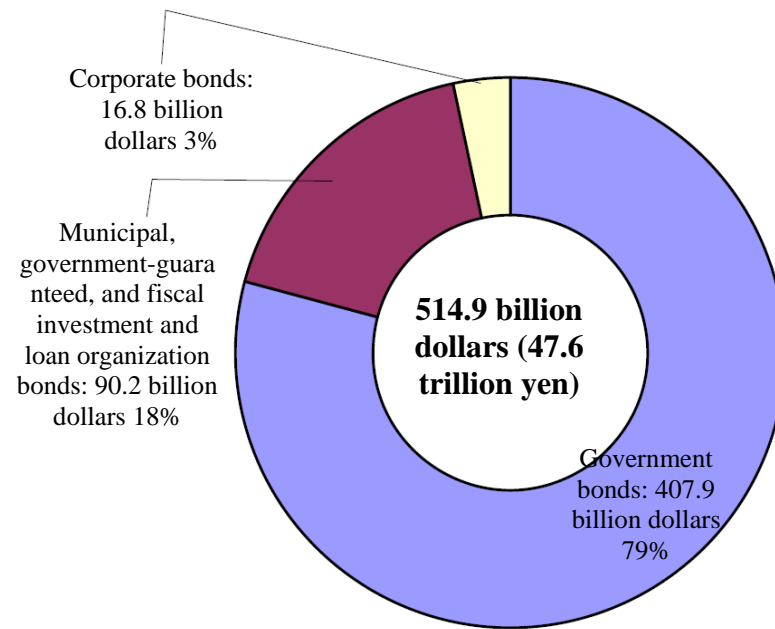
6. Trading volume of public and corporate bonds (daily)

Japan (2009)



(Source: Japan Securities Dealers Association)

U.S. (2009)



[Source: Securities Industry and Financial Markets Association]

* Calculated as 1 dollar = 92.5 yen