Minutes of the Twelfth Meeting of the Working Group on Distributions of Securitized Products

1. Date
October 30, 2008 (Thursday) 15:00 to 17:00

2. Place
JSDA Conference Room

3. Participants
As stated in Appendix 1

4. Agenda
(1) Establishing internal procedures to collect and communicate details and risks of underlying assets
(2) The scope of securitized products

5. Summary of Proceedings
At the start of the meeting, a representative of the Financial Services Agency (FSA) gave the following explanation of recent actions in Japan regarding accounting for fair value.
- Continuing to respond to international activity regarding this issue, the Accounting Standards Board of Japan (ASBJ) has quickly moved to clarify measurement methods for fair value under Japan's accounting standards. On October 28 (Tuesday), the ASBJ issued a Q&A to clarify interpretations of the measurement methods for fair value in which it clearly stated that in cases where trading volume was extremely small or there was a large gap between the bid and the ask, it was appropriate to use a rationally calculated theoretical price rather than an extreme market price.
- In conjunction with this release, the Japanese Institute of Certified Public Accountants worked to disseminate ASBJ's Q&A under its Chairman's name to accounting firms. In addition, the FSA announced that they should also take into consideration the interpretations of the ASBJ in Basic Policy for Financial Inspections.
- The FSA intended to continue to provide support for proper accounting methods for financial products.

(1) Establishing internal procedures to collect and communicate details and risks of underlying assets

A. On the Self-regulatory Rules Draft

The following revisions are to be made to the current proposal.
- Separate categories will be shown for "Pre-distribution," Point-of-distribution," and "Post-distribution"
- "a procedure must be established" will be changed to "must establish a procedure"
- Items 3 and 4 of Article B-1 will be combined.
- A new Q&A giving examples of a "third party" will be produced clarifying that an "information vendor" is equivalent to a "third party."
- In the Q&A regarding communicating liquidity risk, "in accordance with the special features of individual products" will be inserted modifying "liquidity risk." In addition, "However, concerning the degree of risk, we don't always intend to communicate a quantitative indicator" will be included in the text at the end of the document.

The following point is to be made clear in the final report.
- "Others" will include the overseas group companies of JSDA member firms.

Multiple members gave the opinions below.

- Based on the reason that arrangers are separately providing appropriate information to investors making it unnecessary for the distributor to duplicate the communication of information in the case that the distributor does not formulate securitized products and only distributes them, shouldn't a clause be included to the effect that the distributor "need not establish a procedure" for providing information?
- I would like you to avoid requiring JSDA members to duplicate and go through the same process of collecting and analyzing information as arrangers when JSDA members are only distributing securitized products. If we put up too high a hurdle, it will be difficult for new participants to enter the market. Therefore, wouldn't an expression such as "it would be desirable for distributors to cooperate as much as practically possible" be appropriate in this case?

In response to these comments, the WG Chair or Deputy WG Chairs expressed the following opinions.

- Admittedly, to require JSDA members those do not formulate securitized products to have exactly the same information collecting capabilities as those that do formulate these products would be placing an excessive burden on the former. Nevertheless, whether JSDA members do or do not formulate securitized products, isn't it necessary for us to require that they establish reasonable information procedure s at the point of distribution and post-distribution? Moreover, what is important is to decide how to balance not making this requirement a barrier to market entrance to new distributors with winning the confidence of investors. I think it would be fine to keep the proposed self-regulatory rules draft as it is now and express our thinking regarding the case of JSDA members those are only distributing the securitized product in the final report.
- In the case of JSDA members that are only distributing securitized products, the proposed self-regulatory rules state that said distributors can get the information from the arranger and do not require that the information is to be acquired from the originator as in the case of formulation of securitized products. Therefore, there really is no need to create a separate clause to deal with the case of JSDA members those only distribute securitized products.
- I agree with the WG Chair on not inserting a clause stating "need not establish a procedure" for providing information in this case. Under the Supervision Guidelines, distributors by all means are required to set up a procedure without differentiating whether they are arrangers or not. Therefore, it is not desirable that we differentiate between arrangers and non-arrangers. What we have to think of as an actual problem is what should distributors do when the arranger that they got the securitized product from exits the market and is no longer available? From the point of view of the Supervision Guidelines, even in this case the distributors are required to establish a procedure that will communicate information to investors, but in practical terms it is impossible. Therefore don't we need to think about how to deal with this case?

In addition, a representative of the FSA expressed the view that while he thought that the self-regulatory rules couldn't cover all the different levels of setting up information procedures, it certainly sounded strange to be trying to put in an expression making it unnecessary to have information procedures in some cases.

The WG Chair proposed that treatment of cases where the JSDA members did not formulate the securitized products, but only distributed them, including secondary distribution and cases where the arranger had existed the market, be noted in the final report. The proposal was approved.

The Secretariat made the following proposals for areas of the current self-regulatory draft that were thought to need revision in technical terms.

- Since the phrase in Article B-1, Item 1 "while continuing to fully consider preserving the traceability of the securitized product" applies to the whole article, we suggest making this phrase the core text of Article B-1.
- Item 1 and Item 2 should be combined. The reason for putting them together is that "collecting" and "analyzing" are included together to start with in the Supervision Guidelines and the "target"

of “communicating” in Item 3 is not only collected information as in the current draft but analyzed information as well. We propose a structure where we combine “collecting” and “analyzing” in one article and then point toward their roles in “communicating.”
- “Post-distribution” also involves the collection of information, but such an expression has been omitted in the current draft. To clarify this point, we advise adding the process of collecting information.
- If “agency” is equivalent to the term “etc.” in “intermediary, etc.” in Article C-2, we recommend using “agency or intermediary” instead.

It was decided by the WG to reflect these proposals in the second draft of the self-regulatory rules.

An observer made the ensuing proposal.
- In the draft it says “when requested by the customer, make a clear explanation,” but I think this could give a mistaken impression to someone who has not heard WG discussion on this topic, because it sounds like there is still room for distributors to cover up information. If it should be perceived that way, it would have a negative influence on the development of the securitization market and, above all else, is clearly not the intent of this WG. Therefore, wouldn’t it be better to use an expression that communicates in a straightforward manner that the explanation is to be made even if the customer does not request it (eliminate “when requested by the customer”).

In reply, multiple WG members made the following comments.
- I understand your point, but actually, I think that there are many cases with information that is supposed to be collected and communicated but cannot be collected or communicated, and in those cases the customers pointedly do not bother to question the distributor because they have a good idea of the reason why the information cannot be collected or communicated. Given this situation, if we eliminate the phrase “when requested by the customer” as proposed, there is the concern that there will be many cases where the customers are going to have to listen to something they have no interest in hearing.
- To add further to that issue, since the information items that are lacking are clear when the standardized information reporting package (SIRP) is used, it is relatively easy to make the explanation (even if the customer doesn’t request it). However, when the SIRP is not used, a problem arises because it is not clear how much should be explained.
- In addition, since investors always ask for the reason if they want to know why some information cannot be communicated, the current text also is not beneficial for investors.
- I understand the purpose of the proposal, but if “when requested by the customer” is eliminated, there is a concern that some difficult situations will occur in practical terms. Having said that, clearly it would be bad to give the wrong impressions to people who don’t really know what we have been discussing in the WG. Therefore, it would be good to find an expression that strikes a good balance.

The Deputy WG Chair and other observer proposed the following.
- I think the problem with the expression “when requested by the customer” is that it projects a nuance that the action is limited to only when requested. Therefore, we need to provide a nuance that suggests the distributor will deal more proactively with the customer’s requests, such as “in accordance with the customer’s request” or “in response to the customer’s request.”
- How about “in accordance with the customer’s needs,” which suggests that the distributor will deal proactively with the customer when requested?
- Since regulations have their own legal style, isn’t the expression fine as is? However, I do understand the point that is being made here, so why don’t we insert a provision of cooperation in the general provisions at the top of the rules that requires distributors to be proactive in communicating information.

The WG Chair stated that he wished to make the issue of whether to leave the expression “as is” and add a provision of cooperation in the rules or to revise the expression to read “in accordance with the customer’s needs” a point of discussion at the next meeting. In addition, he said it would also be possible to note the point of proactive provision of information in the final report.

A WG member requested that the Secretariat produce a model for the in-house rules, to which a representative of the Secretariat replied that they would produce a draft proposal for discussion by the WG.

It was decided that the Secretariat would re-consider for the next meeting the title for the article on "Employees and Organizations," including maintaining consistency with other self-regulatory rules.

B. On Employees and Organizations

The WG Chair made the following statements.

- I think that it is not appropriate to use the self-regulatory rules to make all companies conform based on detailed standards on this issue because employees and organizations involve core elements of each company's business model or management decisions.
- Based on that stance, I think it is appropriate to indicate our fundamental thinking on employees and organizations and the necessary points for ensuring the effective establishment of systems in the final report and a Q&A document.

The Deputy WG Chair provided examples of the points regarding employees and organizations and it was decided to include them in the final report.

The Deputy WG Chair presented the following issues for underwriting examination related to the establishment of a distribution procedure.

- Announced on the day after the public release of the WG's Interim Report, the Securities and Exchange Surveillance Commission (SESC)'s Basic Inspection Policy and Inspection Program for Business Year 2008 noted that, "The recent subprime loan crisis has revealed the global extent of focuses of the securitized instruments market and its attendant risk management issues. One of the SESC inspection will thus be on the securitization process, namely underwriting examination, risk management, sales management and other related control systems of financial instruments firms that arrange, underwrite, and market such securitized instruments".

  Since "underwriting examination" is not a direct target this WG because of its sole focus on "distribution", no detailed discussion has taken place on this topic up to this point. Moreover, because the form of the issue of securitized products has been not stocks but bonds or notes, the focus of each company in securitization product underwriting examination has been on the so-called "disclosure examination" that places importance on checking for compliance with the disclosure requirement under the Financial Instruments and Exchange Act (FIEA). Nevertheless, if we take a lesson from what the SESC is looking at, perhaps we need to raise the bar not only on the establishment of procedures to ensure the traceability of securitized products as we have been discussing up to this point, but also the procedures for carrying out underwriting examination.

  Underwriting examinations are separately provided for in the JSDA's self-regulatory rules "Regulations Concerning the Underwriting, etc. of Marketable Securities." Therefore, I don't think this WG has to deal with them directly. However, I would like to call attention to the idea that companies need to be thinking of voluntarily setting up procedures for underwriting examination depending on the situation of the business, etc. they are involved with as part of their efforts to establish procedures to ensure the traceability of securitized products.

The WG Chair suggested that this reminder about underwriting examination be mentioned in the final report. WG members approved this proposal.

(2) The scope of securitized products

A. Regarding "(iii)"

WG members had the following proposals.

- The definition of "securitized products" includes the so-called "Liquidity type" and does not apply to the "Investment type." Since the products in "(iii)" in the current draft fall outside the definition to start with, it is strange to be creating a rule to exclude these products from "securitized products." Therefore, "(iii)" should be removed from the proposed self-regulatory rules. However, to clarify the definition, the content of "(iii)" should be included in the Q&A on the scope of securitized products.
- If "(iii)" was to be removed from the self-regulatory rules, shouldn't the term "based on related laws and ordinances" be revised to "based on related laws and ordinances or contracts, etc.?" At the very least, it should be made clear that hedge funds are excluded from the self-regulatory rules.

In response, other WG members had the following opinions.

- Certainly the definition of "securitized products" in the current draft can be read as indicating the "Liquidity type." Nevertheless, in actual fact, there are products that are difficult to categorize as the "Liquidity type" or the "Investment type" because they start off as the "Investment type" using specific units or corporate investment funds (Tokkin), purchase specific assets and then covert those specific assets to liquid products. Therefore, I think it is difficult to say that the definition of "securitized products" in the current draft only refers to "Liquidity type" products.
- Actually, they are no different than other investment trusts included in securitized products, but since they assume the structure of a money trust, shouldn't "(iii)" remain in the self-regulatory rules to clarify the definition?
- If "based on related laws and ordinances" is revised to read "based on related laws and ordinances or contracts, etc.," there is the concern that products, for example all investment trusts, will not be subject to the self-regulatory rules because the broad interpretation possible for "contracts, etc."

It was decided to leave "(iii)" as it is in the current draft, and to make it clear in the Q&A that hedge funds were not subject to the self-regulatory rules (Said Q&A to be discussed in the next WG meeting).

B. On "structured bonds or notes"

A WG member made the following requests.

- In the Q&A for structured bonds or notes, I would like the expression "will make the decision" to be revised to "the decision will be made." The reason for my request is to make it clear that the decision on whether the self-regulatory rules apply to the structured bonds or notes is not an independent decision by the JSDA, but a decision that the member firm and the JSDA make together.

In response, the WG Chair made the following statement.

- The final decision is to be made solely by the JDSA member firm.
- However, in the process of making the decision, as necessary the JSDA should offer advice if requested. The Q&A can remain "as is" and cases of interest in such requested advice can be included in the activities of the permanent WG following the enforcement of the self-regulatory rules.

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