

Benefit or burden?

Taro Tsunoda and Ayako Kuyama of Anderson Mori & Tomotsune discuss regulation of credit ratings agencies, and warn it may discourage structural innovation

Like many other jurisdictions, Japan has implemented various measures in response to the global financial crisis. These measures include strengthening regulation of short sales by prohibiting naked short selling (i.e. short sales conducted without borrowing the subject securities), relaxing restrictions on the acquisition of the treasury stock of listed companies by increasing the upper limit on the daily purchase volume and lifting the restriction on the timing of purchases, and allowing the flexible application of capital adequacy requirements for banks under the Basel II regime. Tokyo Stock Exchange and Tokyo Financial Exchange are each considering establishing a central clearing system for OTC derivative transactions, and the Financial Services Agency of Japan may require credit default swaps to be settled through such a system.

One measure directed at remedying a key contributing factor to the crisis is the regulation of the credit rating business. In Japan this is dealt with under the Act for Partial Amendment to the Financial Instruments and Exchange Act enacted on June 17 2009 and promulgated on June 24 2009 (Act No. 58 of 2009) amending the Financial Instruments and Exchange Act (the FIEA, Act No. 25 of 1948). The legislation introduces regulations on the credit rating business in Japan for the first time and is expected to become effective no later than June 23 2010.

The new regulations

The sub-prime mortgage crisis revealed several flaws in credit rating practices in the context of structured finance transactions: conflicts of interest between credit rating agencies, originators or issuers of structured products, other interested parties and investors in such products; scepticism regarding the quality and integrity of rating practice; insufficient disclosure of rating standards and processes; and the unexamined reliance of investors on credit ratings to the exclusion of duly considering the inherent risks of structured products. Attention on these issues worldwide has ultimately led to the introduction of regulation on credit rating agencies in major financial markets, including Japan.

The Amended FIEA introduces a non-mandatory registration system of credit rating agencies and requires registered credit rating agencies to comply with certain obligations in order to ensure their independence and to prevent conflicts of interest. The Amended FIEA also implements certain measures to maintain the quality, integrity and transparency of the rating process. In order to avoid over-regulation, no regulation of the substance of credit rating opinions is provided in the Amended FIEA.

Due to the global nature of the rating business, the new regulations are designed to be consistent with similar regulations implemented in other countries. More specifically, the new regulations are designed to conform to the Code of Conduct Fundamentals for Credit Rating Agencies published by the International Organization of Securities Commissions (Iosco).

The two key terms that determine the scope of the new regulations are credit rating and credit rating business.

Key definitions

The term credit rating is defined in the Amended FIEA as “grades expressed in codes or scores (and those items analogous thereto as defined under the relevant cabinet office ordinance) that reflect the results of assessments of the credit standing of financial instruments or juridical persons (and other entities similar to juridical persons as defined in the relevant cabinet office ordinance); provided that those grades that are determined primarily in reference to factors unrelated to credit assessment will be excluded from the definition of credit rating under the relevant cabinet ordinance”.

Market risk rating and investment fund rating (where the rating is substantially affected by currency risk or skills and the competency of fund managers and thus is not generally considered to be a

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credit rating in current practice) are expected to be excluded in the as-yet-unpublished ordinance.

“Credit standing of a juridical person” is generally understood to mean the degree of likelihood of the occurrence of credit events in respect of the relevant juridical person (e.g. bankruptcy and default on payment, and acceleration of due date of debts). Likewise, the “credit standing of a financial instrument” is generally understood to mean the degree of likelihood of the occurrence of credit events of the relevant financial instrument (e.g. default on payment, suffering a loss of principal and acceleration of due date, and restructuring of such financial instrument).

Credit rating business is defined in the Amended FIEA as “the business of assigning credit ratings and providing or making publicly available such credit ratings”. Certain activities that would otherwise fall within the scope of credit rating business will expressly be excluded from the definition under the relevant cabinet office ordinance if it is determined that non-regulation of these activities would not weaken investor protection.

One of the principal reasons for regulating the credit rating business is that investors use credit ratings to make investment decisions; therefore, the credit rating business is not subject to the new regulations in circumstances where the credit rating is not so used. It is expected that, similarly, the relevant cabinet office ordinance will provide that if the intended scope of recipients of a credit rating is limited to issuers (and certain other parties related to the issuers) of the subject financial instrument, provision of such credit rating will not be regulated as a credit rating business because non-regulation in such case is unlikely to weaken investor protection.

Registration of credit rating agencies

A credit rating agency that satisfies certain requirements provided for in the Amended FIEA may, but is not required to, register (individuals are not eligible for registration). Most credit rating agencies are expected to apply for registration primarily because certain restrictions will be imposed on the sale of financial products that are rated by an unregistered credit rating agency. In addition, Japan-based credit rating agencies that engage in the rating business in the US and EU countries may benefit from registering in the event the US and EU countries require foreign rating agencies conducting the rating business in their respective jurisdictions to be regulated in their home jurisdictions.



Foreign juridical persons applying to register must, in principle, have an office in Japan; but (i) certain foreign juridical persons that are appropriately supervised in their home countries may be exempt from such domestic office requirement if so provided for in the relevant cabinet office ordinance, and (ii) if rejection of an applicant on the grounds that it has no office in Japan would hinder execution of a treaty or other international agreement to which Japan is a party, the application cannot be rejected solely on the grounds that the applicant has no office in Japan.

For registered agencies

Registered credit rating agencies are subject, in relevant part, to the following regulations under the Amended FIEA:

1. Operating standard. A registered credit rating agency must perform its business fairly, faithfully and independently without being influenced by the party seeking a credit rating for its financial product or other interested parties. A registered credit rating agency is also required to conduct its business in compliance with its rating policies.

2. Management and administration systems. To ensure the quality of its business operations and to prevent conflicts of interest between the credit rating agency, interested parties and investors, a registered credit rating agency must establish appropriate management and administration systems. The details of such requisite systems will be provided for in the relevant cabinet office ordinance and are expected to be in conformity with the Code of Conduct Fundamentals for Credit Rating Agencies published by Iosco.

3. Documentation. A registered credit rating agency must establish and publish its rating policies, prepare and keep books and records, submit business reports to the regulators, and make explanatory documents available for public inspection.

4. Restrictions on providing ratings. If there exists a close relationship (as defined in the relevant cabinet office ordinance) between a registered credit rating agency (including its directors, officers or employees) and certain persons that have interests in the credit rating of the subject matter in question (so-called interested parties), the registered credit rating agency is prohibited from providing a credit rating or making a credit rating available to the public with regard to matters specified in the relevant cabinet office ordinance. The relevant cabinet office ordi-



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nance, as yet unpublished, is expected to define close relationship to include circumstances where the analyst in charge of the credit rating of a security owns that security; such an analyst would be prohibited from providing the credit rating.

A registered credit rating agency that has advised interested parties on certain matters (which are to be provided in the relevant cabinet office ordinance) that would materially affect the credit rating of the interested parties is prohibited from providing a credit rating or making a credit rating available to the public in respect of such matters (i.e. a credit rating agency is prohibited from concurrently rating and advising with respect to the same subject matter). Certain types of conduct – such as explaining rating policies upon the request of the issuer of securities – are exempt from the prohibition. The relevant cabinet office ordinance is also expected to exempt other types of conduct that are considered not to weaken investor protection taking into consideration the nature of the advice given by the registered credit rating agency in question.

5. Supervisory power of the regulators. A registered credit rating agency (and its related entities) will be subject to the supervisory power of, and inspection by, regulators, including the Securities and Exchange Surveillance Commission of Japan. The term related entities is defined as the registered credit rating agency's subsidiaries, its parent company, and sister/brother companies that engage in the business of providing credit ratings, or giving or making available such credit ratings. Accordingly, the headquarters of foreign credit rating agencies may be subject to inspection by Japanese regulators in the event that their Japanese subsidiaries that are registered credit rating agencies are subject to inspection in Japan.

6. Treatment of ratings by unregistered credit rating agencies. Unregistered credit rating agencies are not prohibited from engaging in the credit rating business. However, financial instruments traders (e.g. securities firms) and registered financial institutions (e.g. banks and other deposit taking institutions that are authorised to engage in certain securities business under the FIEA) that solicit the purchase of financial products rated by unregistered credit rating agencies must (a) notify customers that the credit rating of the financial instru-

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ment being offered was provided by an unregistered credit rating agency and (b) provide customers with the outlines of the regulations that would have been imposed if such credit rating agency had been registered and certain other matters provided for in the relevant cabinet office ordinance (this requirement is expected to become effective no later than December 23 2010).

Practical implications for structured finance

Business model

As explained above, in order to ensure the independence and the fairness of the credit rating process, a registered credit rating agency is prohibited from rating a financial product with respect to which it has consulted on matters that would materially affect the credit rating of such financial product, and, as a result, ratings agencies may no longer be able to provide certain structuring consultation under the Amended FIEA. Although the scope of the prohibition on concurrently providing consulting and rating services is not yet determined (it will be provided for in an as-yet-unpublished cabinet ordinance), it is expected that rating agencies will be prohibited or restricted to some extent from consulting on the composition of the assets underlying structured products on the assumption that such advice would be provided with a view to obtaining a higher credit rating on the structured products.

Such restriction would likely have a substantial impact on structured finance transactions for which credit rating typically requires an evaluation of non-public information provided by the originator or the issuer of the subject securities. It is also the nature of these transactions for the credit rating to enhance the grade of the structured products. As a result, the originator or issuer of the subject securities communicates closely with the credit rating agency during the course of credit rating process in order to obtain a desired credit rating for a given tranche of the structured product (this is unlike the credit rating process of traditional debt securities of corporate issuers in which the credit rating can be determined by evaluating (in most cases) publicly available information of the issuer and thus does not require the issuer to consult with the credit rating agency on the rating of the subject securities).

Although provision of certain consulting services is expected to be exempt from the scope of such prohibited activities under the relevant cabinet office ordinance, drawing a line between permitted and prohibited consulting services might not be easy as it would likely entail a fact-specific enquiry and thus would require careful analysis of each specific transaction.

Amending rating policies

In addition, the new regulations on rating policies may hinder the timely execution of certain structured finance transactions – particularly those



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involving innovative structures. Under the Amended FIEA, a registered credit rating agency is required to conduct its business in compliance with its rating policies, and any amendments of the rating policies must be published in a timely manner. Because unprecedented issues affecting credit rating are likely to arise with innovative structured products, credit rating agencies assessing such innovative products may be required to revise their rating policies so that they can assign and provide credit rating in compliance with their rating policies, which may delay the issuance of the subject structured products.

Explanation requirements

The Amended FIEA could also have an impact on the way structured products are marketed. As noted above, under the Amended FIEA, financial instruments traders (and registered financial institutions), when soliciting the purchase of structured products that have credit rating assigned by an unregistered credit rating agency, will be required to provide certain explanations to their customers. In order to satisfy such requirement, it will first be necessary to ascertain whether the subject financial products were rated by an unregistered or a registered credit rating agency. This may not be as easy as it may first seem because the definition of credit rating is not

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clear enough to allow every rating to be definitively identified as a credit rating within the meaning of the Amended FIEA. Moreover, it is not unusual for a structured product to have underlying assets that are also structured products. In such case, the layers of structured products (with each layer of structured products rated by a different credit rating agency) would make it difficult or burdensome to comply with the explanation requirements.

The extent of the burden of the explanation requirements will not be clear until the details are provided in the relevant cabinet office ordinance, but it is possible that the requirements will be so complicated as to effectively prohibit the marketing of structured products that are rated by an unregistered credit rating agency.

The introduction of regulations on the credit rating business is a significant step toward enhancing investor protection. At the same time, however, it would be unfortunate if the new regulations impeded the sound development of structured finance transactions. Practitioners and market participants must pay close attention to the further development of the new regulations by reviewing, in particular, the forthcoming relevant cabinet office ordinances which will complete the outline of the regulations provided in the Amended FIEA.



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