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MEMORANDUM

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LAW CONCERNING THE BOOK-ENTRY TRANSFER OF COMMERCIAL PAPER

This memorandum provides an explanation and outline of the recently enacted "Law Concerning the Book-Entry Transfer of Commercial Paper" of Japan (Law No. 75 of 2001; the "Law"), which became effective on April 1, 2002.

I. Background

The settlement system for securities is currently undergoing drastic reform in Japan. The new settlement system may eventually replace the issuance and transfer of paper certificates to be issued for corporate bonds and government bonds with electronic means. Such reforms have been driven by the demand to create a safer and more effective securities settlement system, adapted to the tumultuous changes taking place in domestic and foreign financial markets, which would also correspond with the paperless settlement system for securities that has recently been adopted in several foreign countries. As mentioned above, the scope of these reforms encompasses both corporate and government bonds.

The new "Law Concerning Amendment of the Laws Related to Reorganization of the Securities Market through Reform of the Securities Account Settlement System," proposing a much broader reorganization and amendment of the laws governing securities in Japan, passed the Diet on June 5, 2002. This new law includes an amendment that changes the name of the Law from "Law Concerning the Book-Entry Transfer of Commercial Paper" to "Law Concerning the Book-Entry Transfer of Bonds" and it will become effective on January 6, 2003 (with some exceptions). As a way of phasing-in these more comprehensive reforms, however, the Law has been enacted to allow for Commercial Papers ("CPs") to be held and traded in electronic form alone.

CPs were traditionally classified as promissory notes (*yakusoku-tegata*) under the Law on Bills (Law No. 20 of 1874), which requires the issuance and delivery of paper certificates in order to exercise or assign the rights attached to such CPs. Yet the characterization of CPs as promissory notes is problematic particularly in relation to the high costs associated to issue these certificates, principally due to revenue-stamp duties. Additionally, the traditional system has also caused difficulties relating to DVP (Delivery Versus Payment), since it is practically difficult to ensure delivery of the physical document at the exact time of payment. These cost-efficiency barriers have effectively obstructed the expanding market for CPs in Japan. In order to overcome such barriers, the Law recharacterizes CPs as short-term bonds that are not necessarily represented or evidenced by any physical

instrument or certificate, thereby giving rise to the expression of a "Paperless CP" (unless otherwise noted, the use of "CP" shall hereinafter denote a Paperless CP).

II. Definition of CP

As mentioned above, the Law defines a CP as a short-term bond, subject to the following conditions: (i) the full amount of the bond to be issued must be prescribed pursuant to a contract; (ii) the face value of each bond shall be a minimum JPY 100 million or more; (iii) the term for maturity of the bond shall be shorter than one (1) year and it shall be paid out as a lump sum; (iv) the interest applicable to the bond is due to be paid on the same day as the principal; and (v) the bond is different in that it is not secured as provided in Article 2 of the Secured Bonds Trust Law (Law No. 54 of 1874).

III. Transfer Agent

A. Designation of a Transfer Agent

A Transfer Agent acts as an administrator for all registrations made in a CP transfer account. The Transfer Agent must be sufficiently reliable and competent to operate the business of CP transfers in a consistent and continuous manner. Therefore, those entities that are permitted to be Transfer Agents for a CP account must be designated as such by the Authority.¹ To qualify for designation, the Transfer Agent must be a stock company (*kabushiki kaisha*) that has maintained a sound financial condition and satisfies all other conditions set forth at Article 3 of the Law. In addition, both the stated capital and the net asset value of the Transfer Agent must be more than JPY 500 million as prescribed by Cabinet Order.

In accordance with such conditions, the Law Concerning Central Depository and Clearing for Share Certificates and Other Securities (Law No. 30 of 1984; the "Central Depository Law") was also amended in order to provide for the formation of a Transfer Agent as a stock company (*kabushiki kaisha*) rather than as a public corporation. This amendment to the Central Depository Law became effective on April 1, 2002. It is expected that the Japan Securities Depository Center (JASDEC) will be designated as the exclusive Transfer Agent for all paperless corporate bonds, including CPs, while the Bank of Japan will be designated as the exclusive Transfer Agent for government bonds. The new settlement system for CPs will not be formally implemented in practice until the relevant changes to the JASDEC have been made and the transformed entity is ready to provide the desired services. According to the JASDEC, it is aiming to start operations as a stock company (*kabushiki kaisha*) on June 17, 2002, and as a Transfer Agent from the spring of 2003.

B. Services of a Transfer Agent

In order to prevent any expansion of the scope of services provided by a Transfer Agent,

¹ The "Authority" as used in this memorandum means the Prime Minister (or the Commissioner of the Financial Services Agency) and the Minister of Justice.

which may cause a negative effect on its financial condition, the Law, in principle, limits such scope to Central Custody and Book-Entry Transfer Services as defined in the Central Depository Law (Articles 8 and 9 of the Law). The Law also prescribes regulations for the services to be provided by each Transfer Agent and prohibits the Transfer Agent from applying any discriminatory treatment to its handling of specific CP holders or issuers (Articles 11 and 14).

C. *Supervision by the Authority*

In order to maintain the stability of its operations, the Transfer Agent is required to report, to the Authority, any errors or accidents arising in the course of its Book-Entry Transfer business or any changes to its trade name. Further, it must also obtain the approval of the Authority to perform certain acts, including the revision of its articles of incorporation or participation in a merger or business transfer (Articles 15 to 22 of the Law).

D. *Registration of CP*

The ownership of CPs is determined by records kept in the transfer account register that is administrated by the Transfer Agent. The Law provides that no certificates shall be issued for CPs (Articles 44 and 45). A dual register system, such as the client account register that is established under the Central Depository Law, is not initially provided for CPs. The Law provides for the settlement of CPs according to a single-layer system without Account Administration Agents and client accounts as used for stocks. Ultimately, however, under subsequent reforms that will become effective on January 6, 2003, the settlement system for all paperless bonds (including CPs) will operate as a multi-layer system by virtue of the indirect deposit, involving Account Administration Agents. These Account Administration Agents will consist of securities brokerage firms and banks.

E. *Registration of the Transfer Account and Effects of Transfer*

Notwithstanding this new system for the settlement of securities, the traditional type of CPs in the form of promissory notes (*yakusoku-tegata*) may still be issued as previous with the delivery of certificates to indicate ownership. Nonetheless, the assignment of a CP or the establishment of a pledge over a CP shall only take effect when the relevant acts are registered in the transfer account upon request (Articles 51 and 52 of the Law). Similarly, the establishment of a trust over a CP shall be perfected against third parties by virtue of registration regarding the trust assets in the transfer account of the trustee (Article 53 of the Law). The Law provides registered member is presumed to hold title to the CPs that are registered in its transfer account (Article 54). In addition, registered member that has acted without willful misconduct or gross negligence shall acquire title to the CP even when the record in its transfer account is registered erroneously or accidentally ("*zen-i-shutoku*") (Article 55 of the Law). The Transfer Agent shall be liable for the acquisition of such CPs where the total amount applicable to the CPs of a certain issue is found to exceed the total amount issued by the issuer due to such *zen-i-shutoku*.

F. Exception to the Commercial Code

Prior to the characterization of CPs as short-term bonds under the Law, the Commercial Code provisions regarding bonds did not apply to CPs, which were classified as promissory notes (*yakusoku-tegata*). The Law presently provides for certain exceptions to the Commercial Code (Law No. 48 of 1899) provisions regarding CPs, in order to ensure continuity between the rules that applied to CPs issued under the traditional system and CPs that shall be issued under the new system. For example, while bonds are normally issued by resolution of the board of directors under the Commercial Code, the Law allows for the issuance of each series of CPs by a representative director, who is designated by the board of directors, in accordance with specific terms established for such issuance as set forth in a board resolution. Furthermore, the provisions concerning bond registers or debenture management companies as well as the meeting of bondholders (as set forth in the Commercial Code) shall not apply to CPs (Article 59 of the Law).

G. Applicability to Other CPs

Article 62 of the Law includes those provisions regarding the registration of a transfer account, effects of transfer, and exceptions to the Commercial Code are applicable *mutatis mutandis* to other types of commercial papers in addition to the Paperless CPs that are expressly defined in the Law, including (i) the commercial papers described at Article 61-2, Para. 1 of the Insurance Business Law (Law No. 105 of 1995), and (ii) specified commercial papers described in Article 2, Para. 8 of the Law Regarding Asset Liquidation (Law No. 105 of 1998).

** For further advice or information on this subject, please contact your usual contact or any of the partners of the Financial Services & Capital Markets Group at ANDERSON MORI.*