

Structured Finance Newsletter

Introduction of Regulations on Credit Rating Business, and Other Pertinent Issues - Amendments to Financial Instruments and Exchange Act

Pursuant to the "Act for Partial Amendment to the Financial Instruments and Exchange Act, etc." enacted in the 171st ordinary session of the Diet on June 17, 2009 and promulgated on June 24, 2009 (Act No. 58 of 2009; the "**Amendment Act**"), it has been determined to introduce regulations on the "credit rating business" in the Financial Instruments and Exchange Act (the "**FIEA**"¹).

The provisions concerning the credit rating business in the Amendment Act shall become effective as of the date to be designated by a Cabinet Order. This date will fall no later than June 23, 2010 (Article 1 of the Supplementary Provisions to the Amendment Act)².

The introduction of the credit-rating regulations pursuant to the Amendment Act reflects "The Role of Credit Rating Agencies in Structured Finance Markets, Final Report" published by the International Organization of Securities Commissions (IOSCO) on May 28, 2008³, as well as legislation in the U.S., Europe and other regions regulating credit rating agencies. It is important to take into account the current state and future directions of international regulations when assessing the credit-rating regulations in Japan.

1. Overview of the regulations on the credit rating business

"Credit ratings" which are to be regulated by the Amendment Act generally means "*grades expressed in codes or scores, reflecting the results of assessment of the credit standing of financial instruments or corporations (except grades defined by a Cabinet Office Ordinance as grades to be determined primarily in reference to factors other than credit assessment)*" (Article 2, Paragraph 34 of the Amended FIEA). Further, "credit rating business" means "*the act of both assigning and providing or making publicly available (such credit ratings) in the course of business*"⁴ (Article 2, Paragraph 35 of the Amended FIEA).

Corporations or other persons engaged in the credit rating business may obtain registration from the Prime Minister⁵ (Article 66-27 of the Amended FIEA), and those having obtained such registration are

¹ The FIEA as amended by the Amendment Act is hereinafter referred to as the "**Amended FIEA**."

² Note however that Article 38, Item 3 of the Amended FIEA (see 2.) shall become effective as of the date to be designated by a Cabinet Order which is no later than December 23, 2010 (Article 1, Item 3 of the Supplementary Provisions to the Amendment Act).

³ <http://www.fsa.go.jp/inter/ios/20080609-1.html>

⁴ Excluding acts found less likely to result in insufficient protection of investors given the scope of persons who are the subjects of the relevant act or other aspects of the relevant act, as stipulated in a Cabinet Office Ordinance.

⁵ The authority of registration is delegated to the Commissioner of the Financial Services Agency (FSA) (Article 194-7, Paragraph 1 of the Amended FIEA).

required to comply with the following obligations as "credit rating agencies" (Article 2, Paragraph 36 of the Amended FIEA):

- To establish a business management system (including measures to control quality of its business and measures to ensure appropriate performance of business operations such as prevention of conflicts of interest; Article 66-33 of the Amended FIEA);⁶
- Not to act as follows (Article 66-35 of the Amended FIEA):
 - In the case that a close relationship as defined in the relevant Cabinet Office Ordinance exists between the relevant credit rating agency, its directors or employees and the persons involved in the rating (*kakutsuke kankeisha*)⁷, to provide or make publicly available credit ratings of any of the matters defined by the relevant Cabinet Office Ordinance in which such persons involved in the rating have interests;
 - In the case that the relevant credit rating agency has given advice to persons involved in the rating regarding any of the matters defined by the relevant Cabinet Office Ordinance which have a material effect on the credit rating of the persons involved in the rating, to provide or make publicly available such credit rating ("prohibition of concurrent provision of consulting services"; except for cases provided by a Cabinet Office Ordinance); and
 - Other acts provided in the relevant Cabinet Office Ordinance.
- To formulate and publish the rating policies, etc.⁸ (Article 66-36, Paragraph 1 of the Amended FIEA);

⁶ Although details are yet to be stipulated in a Cabinet Office Ordinance, it is expected to take into account the considerations provided in the "Code of Conduct Fundamentals for Credit Rating Agencies" published by the IOSCO. Such considerations include a review function responsible for periodically reviewing the methodologies and models, allocation of personnel with expertise and skills (more particularly, allocation of personnel who have appropriate knowledge and experience, ensuring sufficient resources to carry out high-quality credit assessments, ensuring allocation of adequate personnel and financial resources to monitoring and updating ratings, and so on), and ensuring the requisite level of expertise and resources if the credit rating agency uses separate analytical teams for determining initial ratings and for subsequent monitoring of structured finance products (Statement of the Director-General of the Planning and Coordination Bureau of the FSA at the Committee on Financial Affairs of the House of Representatives (the "**House of Representatives Financial Committee**") on April 15, 2009).

⁷ Persons having interests in the matters to be rated, as defined by a Cabinet Office Ordinance (Article 66-33, Paragraph 2 of the Amended FIEA).

⁸ Although details are yet to be stipulated in a Cabinet Office Ordinance, the Ordinance is expected to set out (i) the "rating assignment policy" which provides for the definition of rating, the process of rating assignment, reasonable measures to ensure sufficient quality of the information to be used in the rating assignment, and other related matters; and (ii) "rating providing policy, etc." which provides for the matters to be presented in providing credit ratings, measures to ensure that assigned credit ratings are provided to the public without delay, and other related matters (such as the codes of credit ratings, dates of rating assignments, information on whether rated persons are involved or not, and the limitations of the credit ratings). In addition, the rating policies, etc. is expected to provide, for instance, methods to distinguish between the credit ratings of general corporate bonds and those of complex financial instruments (Statement of the Minister for Financial Services and the

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- To prepare and keep books and records, submit business reports and make explanatory documents available for public inspection (Articles 66-37 to 66-39 of the Amended FIEA);
 - To comply with government orders to improve business operation and other actions made for the purpose of supervision (Articles 66-41 to 66-44 of the Amended FIEA); and
 - To undergo or be subject to inspections by the Securities and Exchange Surveillance Commission or other competent agencies (Article 66-45, and Article 194-7, Paragraph 2, Item 3-2 of the Amended FIEA).

Note that registration of the credit rating business is not mandatory and depends only upon voluntary participation. Rating agencies without such registration (hereinafter, the "**Unregistered Rating Agencies**") are still allowed to conduct a credit rating business. While the credit-rating regulations under the Amendment Act do not apply to such Unregistered Rating Agencies, however, the financial instruments dealers and registered financial institutions (collectively "**Financial Instruments Dealers**") shall be subject to certain codes of conduct when using credit ratings assigned by the Unregistered Rating Agencies, as explained in 2. below.

2. Effect on Financial Instruments Dealers

In general, Financial Instruments Dealers which solicit customers to conclude contracts regarding financial instruments transactions by using credit ratings assigned by the Unregistered Rating Agencies are required to notify to customers of (i) the fact that the person or company having assigned the relevant credit rating has obtained no registration, and (ii) the significance of registration and other matters designated by a Cabinet Office Ordinance (Article 38, Item 3 of the Amended FIEA).

Note that the above notification obligation still applies even where the customers that are being solicited are professional investors (see Article 45, Item 1 of the Amended FIEA).

3. Effect on issuers of securities, etc.

The credit-rating regulations under the Amendment Act do not directly apply to persons other than credit rating agencies and Financial Instruments Dealers (such as issuers of securities).

As already mentioned, however, since the following regulations apply to credit rating agencies: (i) restriction on the providing of credit ratings to persons who have a close relationship with the credit rating agency; and (ii) prohibition of the concurrent provision of consulting services, it may be restricted for issuers of securities, etc. to use credit ratings or to receive consulting services from credit rating agencies.

Details of the restrictions in (i) and (ii) above are to be stipulated in a Cabinet Office Ordinance. In terms of the restriction in (ii) above (i.e., prohibition of the concurrent provision of consulting services), for

Director-General of the Planning and Coordination Bureau of the FSA at the House of Representatives Financial Committee on April 21, 2009).

instance, it would likely prohibit credit rating agencies from providing advice as to how to structure underlying assets of securitized instruments with a view to obtaining higher ratings.⁹

Thus, not only persons who intend to conduct a credit rating business or Financial Instruments Dealers, etc., but also issuers of securities, deal arrangers and other persons concerned, will need to carefully examine the Cabinet Office Ordinances to be stipulated in due course regarding (i) restrictions on the providing of credit ratings to persons having a close relationship with credit rating agencies, and (ii) prohibition of the concurrent provision of consulting services.

See 4. below for the abolishment of the rating requirements relating to the Shelf Registration System.

4. Future developments over the use of credit ratings in connection with the Shelf Registration System, the BIS Rules, etc.

Use of credit ratings under the current law includes (i) use in the so-called "rating requirements" for submission of Securities Registration Statements through the reference method (i.e., a simplified form of submission by reference to other documents) and in Shelf Registration System (Article 5, Paragraph 4, Item 2 of the FIEA; Article 9-4, Paragraph 5, Item 1(v) and Item 3 of the Cabinet Office Ordinance on Disclosure of Corporate Information, etc.; Article 23-3, Paragraph 1 of the FIEA), and (ii) use in the calculation of capital adequacy ratios of banks, etc. (Article 14-2 of the Banking Act, etc.; so-called "BIS Rules").

Reform of these current systems has been a topic of discussion at various forums including the First Subcommittee of the Sectional Committee on the Financial System of the Financial System Council. It has been proposed that use of credit ratings in (i) the requirements for submission of Securities Registration Statements through reference method, and (ii) the BIS Rules, should be permitted only in cases where credit ratings are assigned by (registered) credit rating agencies (Report of the Subcommittee (issued on December 17, 2008)¹⁰ at I-4(4)).

Further, the report issued by the Disclosure Working Group of the Subcommittee on the same date¹¹ proposes the abolishment of the rating requirements for Shelf Registration System applications in (i) above (for instance, an alternative requirement be such that "*the total nominal value of the bonds offered or sold upon disclosure in the past five years amounts to JPY 10 billion or more*") (the same report at II-1(2)).

⁹ Statement of the Director-General of the Planning and Coordination Bureau of the FSA at the House of Representatives Financial Committee on April 21, 2009. In the actual framing of the Cabinet Office Ordinance, however, the authority has taken the stand that the Ordinance should be built flexibly in line with the practice and also effectively in light of communications between credit rating agencies and issuers (Statement of the Director-General of the Planning and Coordination Bureau of the FSA at the Committee on Financial Affairs of the House of Councilors on June 2, 2009).

¹⁰ http://www.fsa.go.jp/singi/singi_kinyu/tosin/20081217-2/01.pdf

¹¹ http://www.fsa.go.jp/singi/singi_kinyu/tosin/20081217-2/02.pdf

As to the use of credit ratings in the BIS Rules, the financial regulatory authorities are yet to take any definite stance. This issue will be addressed at various international forums,¹² and continuous focus will be needed on this issue.

Although regulation of the credit rating business has become definite to some extent with the promulgation of the Amendment Act as described above, use of credit ratings in other situations, and other related issues are yet to be clarified. We assume that issuers which refer to the rating requirements in the Shelf Registration System for corporate bonds, and banks and other institutions which are subject to the BIS Rules should both still closely monitor the process of deliberation in the future.

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¹² Statement of the Director-General of the Planning and Coordination Bureau of the FSA at the House of Representatives Financial Committee on April 15, 2009.