IX

Bond Market Challenges and Opportunities

A. Corporate Bond Market Characteristics and Issues

The Japanese corporate bond market has developed its flexibility and efficiency through system reforms such as the abolishment of regulations on corporate bonds issuance limits and the revision of the trustee company system (1993), the abolishment of eligibility standard 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 have recently issued corporate bonds targeting individual investors, corporate bonds are also becoming an attractive investment instrument for individual investors.

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, this situation lies in the complex interaction of various factors such as the following:

(i) As for the flow of funds in Japan, while the public sector has been significantly short of funds, private nonfinancial 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 SME corporate finance demand, resulting from the government's supportive measures and financial policies to help SMEs and intensifying loan competition among financial institutions, including city banks and regional banks, large corporations and SMEs have long been able to finance themselves at lower cost with bank loans rather than corporate bond issuance.

(iii) The so-called chicken-or-egg problem—the inactive issuance of corporate bonds results in and is caused by low liquidity in the corporate bond market—has yet to be solved. Consequently, the liquidity of corporate bonds remains low. As a result, conditions in the secondary market have not been properly reflected in the primary market in a timely manner. Additionally, although market participants need to improve the transparency of corporate bond prices in the secondary market, the Reference Statistical Prices (Yields) for OTC Bond Transactions published by the JSDA was not sufficiently reliable to serve the role of properly reflecting secondary market conditions (see Chapter IV. E). There may be room for further development and improvement of a settlement and clearing system and corporate bond repo market that can contribute to stimulating the secondary market (see Chapter X.B).

(iv) Due to corporate bond underwriting practices, flexible issuance in accordance with needs is difficult because the issuable period of the publicly offered corporate bonds is limited and the issue timing is concentrated. The publicly offered corporate bond issuance procedures are not flexible nor agile because the roles and responsibilities among securities companies conducting underwriting examinations (Type I Financial Instruments Business Operators), issuer, audit corporations, and certified public accountants have not been defined and the handling rules for the comfort letter have not been clarified. Furthermore, the pot system, which is popular in Europe and the US as a standard method of determining the conditions of issuance, has not been established in Japan; 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 trained sufficient analysts to conduct credit analysis of corporations, which has been a mid- to long-term issue in the market. Moreover, when investing in corporate bonds, investors in some cases significantly rely on external rating agencies and tend to adopt a similar investment strategy with 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 nonresident investors until June 2010, when such a system was introduced to promote investment in and the holding of corporate bonds by foreign investors. Consequently, the corporate bond market is not a good place to actively invest for investors with a higher risk appetite.

(vii) Defaults by issuing companies have been very rare in Japan. Therefore, sufficient data on the relationship between the credit risk of the issuers and issuance conditions have not been accumulated yet.

(viii) In many cases, a negative pledge giving all corporate bonds the same priority is attached to corporate bonds.[56] As a result, when the issuer is in default, there is a concern that the rights of corporate bondholders 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 Japan, a commissioned bank or commissioned person (Corporate Bonds Manager) has not been appointed in many cases except for corporate bonds targeting individual investors. Therefore, there is no consensus about the role of a commissioned bank or commissioned person (Corporate Bonds Manager) and the preservation attachment for corporate bondholders when a corporate bond is in default. There also has been no discussion held regarding cost sharing.

(x) As laws and regulations, the concept of bankruptcy, and the role of financial institutions in the corporate reconstruction process in Japan are different from those in Europe and the US, 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 corporate bonds. This is one of the factors that impede higher liquidity for corporate bonds.

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 in (a), (b), and (c). This is particularly significant in Japan. Therefore, the funding cost of borrowing is cheaper than that of

[56] A negative pledge clause is a covenant provision in a bond agreement whereby the issuer agrees not to pledge any assets if such pledging would result in less security for the agreement's bondholders.

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 setting an appropriate risk premium on bank loans is an important issue for the strengthening of 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 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. The related party has 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. The related party needs 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.

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 corporate bonds. To vitalize the corporate bond market, it is necessary to develop infrastructure while taking into consideration the similarity of corporate bonds to syndicate loans.

Credit default swap (CDS) transactions have recently increased in the European and US markets, with some large-sized companies in Japan also actively conducting CDS transactions. It is necessary to promote the sound development of CDS transactions and the CDS market in Japan, as it supplements the liquidity of the corporate bond market. It will also be necessary to carefully monitor the relationship between the CDS market and the corporate bond market.

B. Reducing the Blackout Period and Expanding Funding Sources

The professional securities market as shown above will increase the convenience for Japanese and Asian issuers and holders of corporate bonds by reducing the blackout period in Japan, simplifying or omitting issuance procedures, omitting procedures in the secondary market, and reducing procurement-related costs, including disclosure costs. This can be done through the establishment of a public issue market for Professional Investors that eschews the legal disclosure requirements applied to retail investors.

The expansion and diversification of funding sources (greater distribution of debt portfolios) can be carried out by

(i) creating a professional issuing market employing English-language disclosure, increasing convenience for overseas issuers; and
(ii) limiting market participants to institutional investors and other professionals to ease the obligation of disclosure for issuing companies, and thus expand opportunities for funding for Japanese and regional issuers.

C. Inconvenience of the Current Disclosure System for Public Offering

Many Japanese corporate bond issuers have critical views of the current disclosure system. The Japanese public offering market for domestic corporate bonds has been subjected to strict disclosure requirements that were originally designed for the Japanese retail investors. In reality, most of the bonds issued have been purchased by Professional Investors. On the other hand, existing private placement markets in Japan are not easy to use for issuers and investors. They do not have a secondary market. As a result, due to strict restrictions, the chance and the period that issuers can make quick and timely issuance of corporate bonds in the Japanese domestic market are extremely limited through the year in comparison to the Eurobond market.

Instead, domestic securities regulations for retail investors, such as legal disclosure regulations, will not apply in the TPBM. By excluding ordinary and amateur investors, such as private individuals, and catering exclusively to Professional Investors, this new market will be able to waive the legal obligation of disclosure that is applied to retail investors.

D. Underwriting Examination (Due Diligence) by Securities Companies

1. Current Practice of Underwriting Examination by Securities Companies

a. Public Offering

All public offerings in the Japanese domestic bond market are subject to an underwriting examination (due diligence), which are conducted in line with JSDA Rules Concerning Underwriting, etc. of Securities and Detailed Rules Relating to Rules Concerning Underwriting, etc. of Securities (hereafter JSDA Underwriting Rules) by each underwriting syndicate member's Underwriting Examination Department or Underwriting Examination Board who is obliged to manage the underwriting examination independently from underwriting business promotion units such as corporate finance groups, debt capital markets, and investment banking groups. Unless JSDA Underwriting Rules are fulfilled and approved by the Underwriting Examination Department or the Underwriting Examination Board, the securities company is not allowed to underwrite the bonds.

Also, the JSDA Underwriting Rules require the lead manager(s) to obtain a comfort letter. Exempt issuers such as sovereign and quasi-sovereign issuers may be outside the scope of the comfort letter.

The JSDA Underwriting Rules specify what items need to be checked from the viewpoint of the FIEA and other relevant rules and regulations. The major items of the present underwriting examination, to be conducted by the (lead) underwriting securities company, are referenced in Table 46.

Table 46: Excerpt of Underwriting Examination Items from the Rules and Detailed Rules Concerning Underwriting, Etc. of Securities

Excerpt of Rules Concerning Underwriting, Etc. of Securities	Excerpt of Detailed Rules Relating to the Rules Concerning Underwriting, Etc. of Securities
(Underwriting Examination Items of Corporate Bond Certificates) Article 18 When a Regular Member Underwriter underwrites the public offering or secondary distribution of Corporate Bond Certificates, it must conduct a strict examination on at least the Underwriting Examination Items set forth in each Item below: (1) Eligibility; (2) Financial condition and cash flow; (3) Purpose of use of the funds to be raised; (4) Proper disclosure of company's business, etc.; and (5) Other matters that the Regular Member deems necessary. 2. In case other Regular Member Underwriter underwrites the public offering or secondary distribution of Corporate Bond Certificates under the shelf registration (registration prescribed in the Article 23-3, paragraph 1 of the FIEA; the same shall apply hereinafter), and if the Underwriting is subject to either of the criteria set forth in each Item below, it shall examine the matters that it deems necessary in its judgment and responsibility regardless of the Article 12, paragraph 1 and the preceding paragraph: (1) The amount of each Corporate Bond Certificate is 100 million yen or more; or (2) The total amount of the corporate bonds divided by the minimum amount of each Corporate Bond Certificates is less than 50. 3. Details of the Underwriting Examination Items prescribed in paragraph 1 shall be defined in the Detailed Rules.	(Details for Underwriting Examination Items of Corporate Bond Certificates, etc.) Article 11 When underwriting the public offering or a secondary distribution of Corporate Bond Certificates prescribed in the provision of Article 18, paragraph 3 of the Rules, the details of Underwriting Examination Items shall be set forth in each Item below: (1) Eligibility; Whether it falls under anti-social forces, and whether there is a relationship with anti-social forces; (2) Financial condition and cash flow (i) Soundness of the financial conditions and cash flow; (ii) Analysis of changes in the financial conditions, business performance, and cash flow; (3) Purpose of use of the funds to be raised (i) Appropriateness of the purpose of use of the funds to be raised; (ii) Proper disclosure of the purpose of use of the funds to be raised; (iii) Appropriation of funds raised in the past. (4) Proper disclosure of company's business, etc. (i) Appropriateness of company information disclosed such as the business risks, completeness of the scope of the disclosure, and adequacy of the representation of the disclosed information; (ii) Proper disclosure of the status after the end of the latest business year.

FIEA = Financial Instruments and Exchange Act.
Source: JSDA.

b. *Private Placement*

The JSDA Underwriting Rules will not officially apply to SN-PP, QII-PP, or Offers to Professional Investors. Underwriting examinations will be conducted depending on an underwriter's judgment on its necessity. In the private placement scheme, an underwriter may acquire a comfort letter as long as the relevant parties agree.

2. Critical Feedback on the Practice of Underwriting Examination

In light of the stagnant issuance of corporate bonds in Japan, the JSDA started its initiative for the vitalization of Japan's corporate bond market by establishing a dedicated study group in 2008 in which the practice of underwriting examination was recognized as one of the major subjects to be further deliberated.

In fact, issuing companies and other stakeholders in Japan's corporate bond market indicated various critical impediments in Japan's bond issuance environment and the current practice of underwriting examination as follows:

a. *Issuers' Viewpoint*

(i) Listed companies are already required to comply with the prescribed quarterly disclosure, internal control reporting, and confirmation document requirements under 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 more 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 (see also section C for related information).

b. *Underwriting Securities Companies' Viewpoint*

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 has been suggested that those compiling a 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 cases when an error is found in the financial information of a prospectus, and to fully disseminate such a policy to the relevant stakeholders

3. Framework of the Underwriting Examination by Securities Companies

On 25 May 2011, JSDA formulated based on the above deliberation, the Guideline for Corporate Bond Underwriting Examination under the Shelf Registration System by the Securities Company, and notified it to securities companies.

4. Basic Framework of Underwriting Examination for Bonds under Shelf Registration System by a Securities Company

In order to enhance the contents of underwriting examination from the viewpoint of investor protection and to enhance a more flexible bond issuance, the review of underwriting examination practices has been carried out as follows:

(a) Development of the Basic Framework of Underwriting Examination of Corporate Bonds

In order to ensure a more flexible corporate bond issuance, when examining continuous disclosure of corporate bonds, a securities company shall carry out, as a general rule, at the time of submission of a securities report, a confirmation to issuing company that made a shelf registration and to auditors by means of Common Questions. At the time of submission of a quarterly report, it shall conduct an in-house examination, focusing on quarterly reports, press releases made by issuing company that made a shelf registration, rating information, and other publicly disclosed information; and update its underwriting stance.

(b) Review of the Basic Contents of Underwriting Examination of Corporate Bonds

(i) When conducting an underwriting examination of corporate bonds on the assumption that the quality assurance of the financial statements, etc. by an issuing company that made a shelf registration and auditors have been made sufficiently, the underwriting securities company shall examine by focusing on the capacity of paying bond principal and interest and disclosure of risk factors (analysis and disclosure of certain matters affecting the future cash flow generation force) that are considered to have a large impact on investment decisions by investors.

(ii) When conducting an underwriting examination of financial statements, etc., the underwriting securities company shall stand in a position to analyze the financial statements, etc. from the outside, and if it finds any suspicious events or there is a concern that a suspicious event has occurred, it shall collect additional information from the issuing company and auditors, and deepen the study.

(iii) For Common Questions that are available in examining continuous disclosure of corporate bonds, in order to ensure they reflect the real status of each issuing company that made a shelf registration, a sample of the Common Questions shall be compiled and reviewed as needed in the future.

5. How to Conduct Underwriting Examination of Financial Statements, Etc. by the Lead Underwriting Securities Company

For the underwriting examination of financial statements, etc. by the lead underwriting securities company, the Guideline for Underwriting Examination of Financial Statements, Etc. has been compiled based on the securities regulations and precedent cases in the US market, and after having made deliberations and analysis as stated below:

(a) Civil Responsibility under Financial Instruments and Exchange Act Regarding False Statements, Etc. of Financial Statements, Etc.

(i) When a lead underwriting securities company underwrites securities, if there was a misstatement or lack of statements regarding material facts in the financial statements that have been audited by the auditor, it may bear the liability together with the issuing companies and auditors for damages to investors under Article 21(1) iv. of the FIEA, and it may also bear the same liability as a user of a prospectus under Article 17 of the FIEA. This liability prescribed by the FIEA states that if such a securities company does not prove that it has paid "due care," it cannot be exempted from such liability (FIEA, Article 17, proviso).

(ii) The discipline required by Article 17 of the FIEA is based on the expectation regarding the roles and functions of the lead underwriting securities company as a gatekeeper on the accuracy of the description of the financial statements, etc. On the other hand, as the definition of due care is somewhat ambiguous, there is criticism that the underwriting examination by the lead underwriting securities company becomes overly conservative and impedes the flexible offering or secondary distribution of securities.

(b) Regarding Due Care

The due care that the lead underwriting securities company must pay can be understood as follows:

(i) As the lead underwriting securities company carries out the underwriting examination from the standpoint of the outsider who cannot enter the internal controls related to the accounting system and financial reporting of the issuing company, such a lead underwriting securities company is considered not to be required to conduct again the same act as an audit by auditors with due care.

(ii) For this reason, it is thought to be rational and practical that the lead underwriting securities company examines focusing on the presence or absence of the facts that may suspect the appropriateness of trust on the audit certificates made by the auditor as an expert.

(c) Formulation of Guideline for Underwriting Examination of Financial Statements, Etc.

(i) In order to streamline and improve the efficiency of practices relating to underwriting examination in the lead underwriting securities company, based on the above arrangement of the basic idea, the (Draft) Guideline for Underwriting Examination of Financial Statements, Etc. has been compiled to deal with how to confirm the presence or absence of suspected facts that will make audit certificates untrustworthy and matters to be noted and confirmed for making an underwriting decision.

(ii) This (draft) guideline is to be applied when conducting the underwriting examination for corporate bonds, while the underlying principles can be applied to the entire underwriting examination of securities.

(iii) On 9 May 2012, based on the above consideration and targeting the underwriting examination of offering or underwriting of the secondary distribution of shares, etc. and corporate bonds (except for the underwriting of the initial public offering), the Guideline for Underwriting Examination of Financial Statements, etc. was compiled and notified to the securities companies by the JSDA.

6. Positioning and Treatment of Comfort Letter

(1) When the lead underwriting securities company conducts an underwriting examination, it shall request auditors to create a comfort letter in order to conduct an investigation, etc. regarding the accuracy of the financial information that is described in the Securities Registration Statement, etc. in connection with the offering or sale of shares, etc. or bond certificates, and the posterior changes of the financial information.

(2) A comfort letter is a research report on the issuing company and is created according to the Summary of the Letter from Auditors to Lead Underwriting Securities Company by Japanese Institute of Certified Public Accountants and JSDA. It is also based on the Practical Guidelines of Japanese Institute of Certified Public Accountants: Audit and Assurance Practice Committee Report No. 68 About the Letter from Auditors to Lead Underwriting Securities Company.

(3) The JSDA and the Japanese Institute of Certified Public Accountants have exchanged views regarding identification and analysis of challenges in the practice of treatment of the comfort letter in view of ensuring the accuracy and reliability of financial information and disclosure documents to investors, reduced issuing company burden, timely issuance of corporate bonds, and practical feasibility by certified public accountants. It is desired that further deliberation on and development of specific measures, such as a compilation of questions to be addressed to auditors from underwriting securities companies, are made through the continuous exchange of views.

E. Determination Process for Corporate Bond Issuance Conditions

The establishment of a rational determination process for corporate bond issuance conditions is necessary.

While securities companies conduct a bond demand estimate survey in the process of determining conditions of issuance, the resultant conditions do not necessarily reflect market conditions due to duplicated or false demands. This is one of the factors that triggers a sale at a discount, or a sale under conditions inferior to the conditions of issuance, of corporate bonds in the secondary market.

For instance, in the US the so-called pot system is commonly used for the determination of corporate bond issuance conditions. The system eliminates the duplicate 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.

Market participants have seen some corporate bond issuances that used the pot system in Japan. Market participants believe that it is necessary to establish a guideline to share common views on practical issues, such as thorough control of client data by securities companies, and to find a solution as soon as possible for the purpose of establishing a rational determination process for corporate bond issuance conditions. Introducing the pot system in Japan may be one option. In any case, careful examination is required.

F. Measures to Cope with Default Risk

For the 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 to use the corporate bond market. The JSDA and market participants plan to develop the following measures that will protect investors when business conditions deteriorate in 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.

1. Granting of Covenants and Information Disclosure

(a) Granting of Covenants

(i) Since the abolishment of eligibility standard and the 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. The JSDA believes that such a flexible scheme should be maintained and enhanced in the future for vitalization of the corporate bond market.

(ii) Currently, covenants granted on corporate bonds issue mainly cover the negative pledge clause (a clause prohibiting the issuer from creating any security interest over a certain property specified in the provision) and cross acceleration.

(iii) While the negative pledge clause is a special agreement to protect investors that prohibits the issuer from creating a security interest over other nonsecured 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, for 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, corporate bonds that were issued before the loan are likely to defer to other debts and loans from a property preservation viewpoint. Therefore, theoretically, the granted covenants may affect the recovery of debt in the case of a corporate bond default by a company with relatively higher risk.

(iv) In the future, when the JSDA and market participants 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. Yet, difficulties can arise when the bond issuer disapproves the covenants to avoid the issue.

(v) Taking into consideration examples in the US, the JSDA and market participants need to prepare a model of standard covenants for corporate bonds issued by corporations with relatively higher credit risk as a reference for issuers, investors, and securities companies. It will also be necessary to disseminate market practices that enable fundraisers to grant flexible covenants and determine reasonable issuance conditions. But, in Japan, as a general practice, the secured bank loans system has been established; it may be difficult to introduce the US system directly.

(vi) Among these issues, the JSDA and market participants should address the use of secured corporate bonds issued by corporations with relatively higher credit risk and the relationship of these corporate bonds to the order of priority of loan pledges.

(b) Disclosure of Information on Covenants

(i) The type of covenants granted affects the holder of corporate bonds when the corporate bond is in default and the holder tries to recover the debt. Therefore, it is important for holders to check the covenants granted on other corporate bonds and loans. Holders cannot be confident in making an investment in corporate bonds without proper disclosure of covenants granted on other debts.

(ii) In Japan, covenants granted on corporate bonds are disclosed in a prospectus as a disclosure item at the time of issuance. In the standard form, covenants of debts including loans are to be disclosed in the annual securities report. However, it may be difficult to say whether that is a standard practice in Japan.

(iii) As of the end of FY2009, 219 companies had disclosed the covenants of loans and other debts in their annual securities reports. Many covenants relate to financial indicators such as maintenance of net assets and maintenance of profits. There were a few companies that disclosed covenants relating to default such as cross acceleration.

(iv) In the US, covenant information on corporate bonds and loans is disclosed as follows:

   (1) The annual Form 10-K discloses basic information such as the type of covenants, whether or not the covenants are granted, and the compliance status. JSDA does not know these details, as no indication is made as to which covenants are granted on which debts.

(2) If the corporate bond or loan is subject to important events that require submission of the current report Form 8-K, the detailed information is disclosed on that form. Form 8-K is a very broad form used to notify investors of any material event that is important to shareholders or the US Securities and Exchange Commission (SEC). This is one of the most common types of forms filed with the SEC. After a significant event like bankruptcy or the departure of a Chief Executive Officer, a public company generally must file a current report on Form 8-K within 4 business days to provide an update to previously filed quarterly reports on Form 10-Q and/or annual reports on Form 10-K. Form 8-K is required to be filed by public companies with the SEC pursuant to the Securities Exchange Act, 1934 (as amended). A Form 10-K is an annual report required by the SEC that gives a comprehensive summary of a public company's performance. Although similarly named, the annual report on Form 10-K is distinct from the often glossy "annual report to shareholders," which a company must send to its shareholders when it holds an annual meeting to elect directors (though some companies combine the annual report and the 10-K into one document). The 10-K includes information such as company history, organizational structure, executive compensation, equity, subsidiaries, and audited financial statements, among other information.

(v) For the purpose of developing an environment where investors can be confident in making an investment in corporate bonds, the JSDA and market participants need to discuss the following issues based on the disclosure system in the US, and take measures to properly disclose the necessary information on covenants from an investor-protection viewpoint.

(1) Disclosure in an annual securities report (promotion of disclosure of covenants about default)
(2) Statutory disclosure equivalent to the current report Form 8-K in the US
(3) Timely disclosure required by securities exchanges.

2. Commissioned Company for Bondholders

(a) Credit Risk of Corporation and Commissioned Company for Bondholders

(i) A commissioned company for bondholders is in principle appointed at the time of issuance of corporate bonds under the Companies Act and acts as a statutory agent of corporate bondholders to monitor the financial condition of the issuer and preserve or recover the debts at the time of default.
(ii) While the commissioned company for bondholders is appointed for corporate bonds targeting individual investors, most corporate bonds targeting institutional investors do not appoint a commissioned company for bondholders.
(iii) It is necessary to maintain the current system that enables a corporation with relatively lower credit risk and 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 is possible to grant various covenants as mentioned above on such corporate bonds. Market participants also need to develop an environment where the commissioned company for bondholders can sufficiently fulfill the role of monitoring financial condition and preserving or recovering debts, and where such covenants can be properly reflected in the issuance conditions.

(iv) Market participants also need to prepare a system whereby the absence of a commissioned company for bondholders 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) Market participants can choose two approaches regarding the appointment of a commissioned company for bondholders: (a) appoint a commissioned company for bondholders for all corporate bonds, or (b) appoint a commissioned company for bondholders of corporate bonds issued by a corporation with a relatively higher credit risk. For the time being, while discussing the tasks of the commissioned company for bondholders, it is useful for market participants to establish approach (b) as a market practice.

(vi) In the case of corporate bonds issued by a corporation with relatively higher credit risk, market participants will need to prepare and illustrate by example a standard model of appointing a commissioned company for bondholders that can be used as a reference for issuers, investors, and securities companies, and establish the appointment of a commissioned company for bondholders as a market practice.

(vii) Many house banks of the issuers, referred to as main banks in Japan, play the role of a commissioned company for bondholders. Some market participants are concerned that a conflict of interest could occur before or after corporate bonds default if, in the future, corporate bonds issuers become more diversified and more corporations with relatively higher credit risk issue corporate bonds. Therefore, market participants need to take measures to increase the credibility and transparency of tasks assumed by the commissioned company for bondholders, as well as discuss what tasks they are to assume.

(b) Commissioned Company for Bondholders in the Future

(i) One of the reasons why many issuers do not appoint a commissioned company for bondholders is that issuers are doubtful about whether the tasks assumed by the commissioned company for bondholders justify the cost incurred by the issuer. On the other hand, commissioned companies for bondholders point out that their responsibilities as a commissioned company for bondholders are substantial under the Companies Act.

(ii) The relationship between the responsibilities and costs of the commissioned company for bondholders should be considered carefully based on the fact that the credit risk of the issuer closely relates to the responsibilities of the commissioned company for bondholders. Market participants need to define the tasks assumed by a commissioned company for bondholders and also establish a system in which these various factors can be properly reflected in the costs through a market mechanism.

(iii) Tasks assumed by a commissioned company for bondholders in the US (Trustees) are significantly different before and after corporate bonds default. Particularly, the tasks before default include only administrative processes, such as receiving a disclosure document, including the annual report, on a regular basis. They do not include the tasks of requesting financial information, monitoring, and review.

(iv) Based on the tasks of a Trustee in the US, there is a need to consider that, for example, the tasks of a commissioned company for bondholders will be limited to the preservation and recovery of debts after the default of corporate bond, or that different requirements will be set for appointing a commissioned company for bondholders 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 bondholders will be affected by an event concerning the corporate bond issuer besides default, such as a merger or acquisition. Therefore, market participants need to discuss how to handle event risk as one of the issues relating to the tasks assumed by a commissioned company for bondholders.

G. Bond Investment Education and Bond Investor Relations

There are few opportunities in Japan to educate individual investors about corporate bonds and there is not sufficient basic data provided for the investment in and the analysis of corporate bonds, such as which corporate bonds are issued and traded, interest rates, and prices.

Some institutional investors have yet to establish an adequate research system and nurtured enough analysts to conduct credit analysis of individual issues, which has become a mid- to long-term issue in the market. Moreover, when investing in corporate bonds, investors, in some cases, significantly rely on external rating agencies, and tend to adopt a similar investment strategy with those adopted by other institutional investors.

Investor relation activities for corporate bonds are important as an interactive communications tool between the issuer and investors. Some parties insist that the issuer should carry out investor relation activities proactively and continuously.

In addition to enhancing and organizing corporate bond investment education programs and basic data on the corporate bond market, it is necessary to exchange opinions with institutional investors and actively encourage corporate bond investor relation activities by issuers to promote further understanding of corporate bond investment.

H. Opportunities for the Japanese Market and Its Participants

ASEAN+3 Multi-Currency Bond Issuance Framework

The ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) is a policy initiative under the Asian Bond Markets Initiative (ABMI) to create a nexus among domestic professional bond markets in the region to help facilitate intraregional transactions through standardized bond and note issuance and investment processes.

The implementation of AMBIF is expected to benefit not only AMBIF issuances, but the Japanese—and other ASEAN+3—bond markets at large. ABMI and Japanese policy bodies and regulatory authorities are focused on achieving a suitable balance between bank loans and capital market funding opportunities for corporates. AMBIF was created to provide an additional bond and note issuance avenue for these corporates. In Japan, AMBIF focuses on the issuance and listing of bonds and notes on TPBM (please see Chapter II.H and Chapter III.H for more details on the TPBM legal framework and listing practices, respectively).