
A Review of the Newly Enacted Securities Settlement System Reform Law

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The Securities Settlement System Reform Bill, which includes the key Corporate Bond Settlement Bill, was passed by the Diet on 5 June 2002. The aim of the new law, which will abolish the Corporate Bond Registration Law, is to introduce a new paperless book-entry system for a wide range of securities. However, there are a number of outstanding issues, including the settlement system for equities and other securities not covered by the new legislation.

1. Towards Paperless Securities Settlement

Securities settlement is the process that begins after a transaction has taken place on a securities market and is completed when the seller delivers the securities and the purchaser pays the consideration. This process used to involve the physical transfer of securities certificates, but this entailed the risk that the certificates might be lost as well as the cost of handling them and left much to be desired in terms of efficiency and security. Now that securities transactions are conducted on a massive international scale, not only the actual securities certificates but also all related documentation needs to be done away with if a securities market is to develop properly.

In Japan the question of how to achieve paperless securities trading has been one of the main issues in attempts to reform the country's securities settlement systems. In its June 2000 report "Reform of Japan's Securities Settlement Systems in the 21st Century" the Financial System Council's First Subcommittee lists the following shortcomings of the current systems: (1) the existence of separate settlement systems for each type of security; (2) the efficiency losses caused by the delay in introducing paperless settlement; (3) the delay in switching to online processing of related documentation; and (4) the failure to adopt delivery versus payment (DVP)¹ as an effective means of reducing settlement risk.

¹ This avoids a situation where either the securities fail to be delivered in spite of the fact that payment has been made or payment fails to be made in spite of the fact that the securities have been delivered.

Let us now take a brief look at the various securities settlement systems that co-exist in Japan.

There are two different systems for settling government bond transactions: a book-entry system and a registration system.² In both cases, the Bank of Japan acts as settlement entity and transactions are conducted using the Bank's online system (BOJ-NET). Since January 2001, settlement has been on a real time gross settlement (RTGS)³ basis, which means that delivery and payment are made for each transaction.

In equity transactions the Japan Securities Depository Center (JASDEC) acts as settlement entity, and settlement can be done by book-entry as share certificates are deposited with the Center. Delivery versus payment has also been possible since May 2001 for stock exchange transactions. However, as of end-January 2002, only 49.7% of outstanding shares had been deposited with the Center. This figure needs to increase if the system is to be effective.

Corporate bond transactions are settled by means of a registration system in which more than 160 financial institutions act as registration agents under the Corporate Bond Registration Law. Although the fact that bonds are registered means that there is no need for certificates, the securities companies and registration agents involved in a transaction used to have to exchange documents in order to register transfer of ownership. Since 1997, however, registration agents have been able to use an online system run by Japan Bond Settlement Network (JBNet). Nevertheless, not all agents are linked to the network, and many transfers of ownership still have to be registered using paper documents. Similarly, although delivery versus payment has been possible using JBNet and BOJ-NET since 1998, only 36% of the requests for registration of transfer using JBNet in fiscal 2001 were DVP transactions.

The legal and technical arrangements in Japan for settling government bond, equity and corporate bond transactions therefore vary from one class of securities to another, and developments towards paperless settlement have taken place separately. However, there is no logical reason why, in a trading environment where most of the administration is paperless, there should be more than one settlement system. Indeed, in its above mentioned report the Financial System Council recommended that there

² Generally speaking, there are two kinds of paperless settlement: by book-entry and by registration. With the former, certificates are deposited with the settlement agent and the rights to the underlying securities transferred by amending the entry in the agent's book without having to transfer the certificates. With the latter, no certificates are issued and the rights to the underlying securities are transferred by amending the registration in the registration agent's book.

³ This is one type of delivery versus payment, where receipt of the securities and receipt of the consideration are done on a gross basis for each trade. The absence of a time lag between the two means that the risk of a settlement default is reduced considerably.

should be a single legal system of securities settlement for all classes of securities to foster the spread of paperless settlement.

2. The Paperless Book-Entry System Introduced by the Corporate Bond Settlement Law

The Securities Settlement System Reform Bill came before the Diet on 15 March 2002 and was passed by the Diet on 5 June 2002. As well as the key Corporate Bond Settlement Law, the aim of which is to introduce a new paperless book-entry system for corporate, government and municipal bonds, the Law establishes a legal framework for clearing houses and introduces a new type of government bond. The rest of this report explains the details of the new settlement system and its likely impact.⁴

1) Legal framework for settling transactions involving a wide range of securities

The Corporate Bond Settlement Law was preceded by the Short-Term Corporate Bond Settlement Law, which enabled paperless settlement of commercial paper transactions and came into effect on 1 April 2002. The Corporate Bond Settlement Law is an amended version of the Short-Term Corporate Bond Settlement Law. Whereas the latter dealt only with commercial paper, the former aims to provide a single legal framework for the paperless book-entry settlement of transactions involving a wide range of securities, including corporate, government and municipal bonds and investment trust beneficiary rights (see Table 1). It aims to address the problem that Japan has separate settlement systems for each class of security.

However, the Corporate Bond Settlement Law does not cover equities and equity-related securities. The amendment to the Central Securities Depository Law (Depository Law) was also included in the Securities Settlement System Reform Law, and the Depository Law will cover those securities listed in the right-hand column of Table 1.

⁴ This report does not deal with new types of government bonds such as strips and floaters, which are also introduced by the Securities Settlement System Reform Law.

Table 1 Coverage of the Corporate Bond Settlement Law and the Amended Depository Law

| Corporate Bond Settlement Law | Amended Depository Law |
|--|---|
| <p>① Corporate bonds (excluding those with stock acquisition rights)</p> <p>② Government bonds</p> <p>③ Municipal bonds</p> <p>④ Investment company bonds as defined by the Investment Trust and Investment Company Law</p> <p>⑤ Bonds issued by mutual companies as defined by the Insurance Business Law</p> <p>⑥ Special bonds as defined by the Asset Securitization Law</p> <p>⑦ Rights required to be indicated on bonds issued by corporations governed by special laws</p> <p>⑧ Beneficiary rights in investment trusts or non-Japanese investment trusts as defined by the Investment Trust and Investment Company Law</p> <p>⑨ Beneficiary rights in loan trusts</p> <p>⑩ Beneficiary rights in special-purpose trusts as defined by the Asset Securitization Law</p> <p>⑪ Rights pertaining to bonds issued by non-Japanese governments or corporations</p> <p>(In the case of ①, ④-⑦, and ⑪, securities converted to share certificates are excluded.)</p> | <p>① Share certificates, equity warrants and stock acquisition rights (shinkabu yoyaku-ken)</p> <p>② Investment securities as defined by the Investment Trust and Investment Company Law</p> <p>③ Preferential participation certificates and preferential participation warrants issued by cooperative society financial institutions</p> <p>④ Preferential participation certificates, preferential participation warrants, convertible bonds and preferential participation warrant bonds issued by special-purpose companies as defined by the Asset Securitization Law</p> <p>⑤ The following securities when they are converted to ①-④ above:</p> <ul style="list-style-type: none"> • Corporate bonds • Investment company bonds as defined by the Investment Trust and Investment Company Law • Bonds issued by mutual companies as defined by the Insurance Business Law • Special bonds as defined by the Asset Securitization Law • Bonds issued by corporations governed by any other special laws <p>⑥ Bonds issued by non-Japanese governments or corporations (1) with stock acquisition rights or (2) coming under ⑤ above</p> |

Source: NRI.

2) Establishment of a new book-entry system in the wake of the abolition of the Corporate Bond Registration Law

The passing of the Securities Settlement System Reform Bill means the abolition of the Corporate Bond Registration Law. As a result, the problem whereby, under the present system, each registration agent has to manage bond serial numbers and bonds cannot be registered in the name of a nominee will be solved.

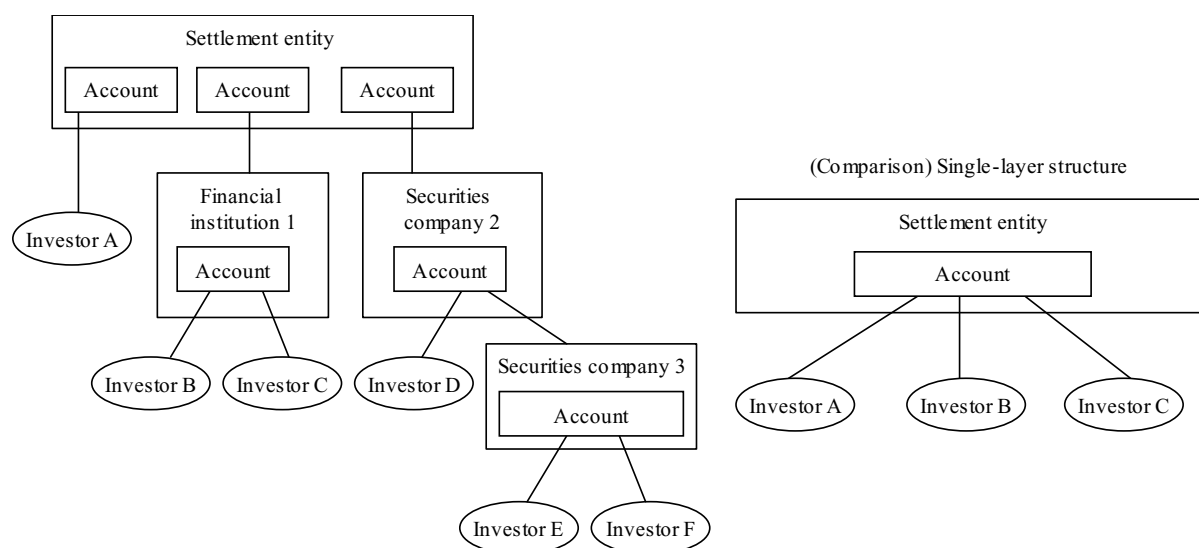
Instead of bonds being registered, as under the Corporate Bond Registration Law, bonds will be entered in the settlement entity's account books. As with commercial paper issued under the Short-Term Corporate Bond Settlement Law, no bond certificates will be issued under this system and investors will simply own the rights to the bonds entered in their accounts.

Under the new Corporate Bond Settlement Law settlement entities are to be corporations authorized by the ministries in charge. The fact that the amended version of the Depository Law, which states that the Japan Securities Depository Center may also engage in the kind of business covered by the Corporate Bond Settlement Law, means that the Center may act as sole settlement entity not only for the securities listed in the right-hand column of Table 1 ("share certificates, etc.") but also for those listed in the left-hand column ("corporate bonds, etc."). As the Corporate Bond Settlement Law contains a special provision that would allow the Bank of Japan to act as settlement entity for government bonds, the division of labor could be between the Bank of Japan as settlement entity for government bonds and the Japan Securities Depository Center as settlement entity for all other classes of security. Prior to the amendment to the Depository Law included in the Securities Settlement System Reform Law, there was another amendment to the Depository Law which was passed on 20 June 2001 and became law on 1 April 2002, by which the Japan Securities Depository Center is due to become a corporation, and preparations for this are now under way.⁵

Securities companies and financial institutions are allowed to open accounts with a settlement entity, and, as Figure 1 indicates, securities companies and financial institutions that do this are also allowed to open customer accounts for others. Such securities companies and financial institutions are called "account management agents." This multilayered structure makes it unnecessary for every market participant to open an account with a settlement entity. Indeed, it has been suggested that the single-layer structure of the Short-Term Corporate Bond Settlement Law, which requires each market participant to open an account with a settlement entity, could overburden the settlement system.

⁵ The fact that the Japan Securities Depository Center used to be a foundation meant that it was restricted in its access to funds and the way it could use them. As a corporation it will have greater access to funds and be able to respond to business opportunities more quickly.

Figure 1 New Book-Entry System (multilayer structure)



Source: NRI, from "Outline of Securities Settlement System Reform Bill".

Finally, the provisions in the Corporate Bond Settlement Law pertaining to corporate bonds will basically also apply, with appropriate modifications, to other securities covered by the Bill.

3) The establishment of an Investors' Protection Trust and dealing with entry errors

The Corporate Bond Settlement Law stipulates that, if an error occurs when an account entry is made under the new book-entry system, the party (i.e., the settlement entity or account management agent) responsible for the error will be obliged to correct it and compensate the investor (unless the latter is an accredited institutional investor) for any loss caused. In such a case, the account management agent below the responsible party would have joint and several liability. For example, if Securities Company 2 in Figure 1 was responsible for the error, Securities Company 3 would have joint and several liability.⁶

The type of entry error that appears to have been anticipated most is excessive entry. Let us suppose, for example, that Securities Company 2 enters by mistake in Investor D's account that Investor D owns 20 bonds of type X (when Investor D actually owns only 10 bonds) and that Investor E unwittingly purchases 10 of these bonds from the account with the excessive entry. As a result of the excessive entry, the nominal value of the bonds entered in the account exceeds the total nominal value of

⁶ The fact that Financial Institution 1 does not bear joint and several liability means that the system as a whole does not bear it.

the bonds issued and thus the excess amount has to be reduced by amending somebody's account. If the error was found before Investor E buys the bonds, the amendment can be made to Investor D's account. However, the fact that the value of these extra 10 bonds has been credited to Investor E's account means that Investor E has a right to them and that once Investor E has purchased the bonds their value cannot be deducted from his account. What therefore happens is that Securities Company 2, which was responsible for the error, is required to purchase the extra 10 bonds on its own account and write off the amount. Until it writes off the amount, it is responsible for paying interest and principal on the extra 10 bonds as well as for making good any other related losses that arise.

The Corporate Bond Settlement Law envisages the possibility that, in such a situation, the account management agent or the settlement entity might be unable to meet its obligations and become bankrupt as a result. To deal with this, the Law proposes the establishment of an Investors' Protection Trust. The settlement entity would be the trustor, the trust company the trustee, and the investor who had suffered the loss (unless he was an accredited institutional investor) the beneficiary, while the trust assets would be provided by the account management agent and the settlement entity. If the account management agent or the settlement entity commenced bankruptcy proceedings before the investor had been compensated for the loss caused by the entry error, the investor would be entitled to receive the same amount in compensation from the Trust. Although it has been decided that the maximum amount of compensation from the Trust will be set out in a government ordinance, the figure of ¥10 million has been mentioned in the public debate on the matter.⁷

3. Establishing the Legal Framework for a Clearing House

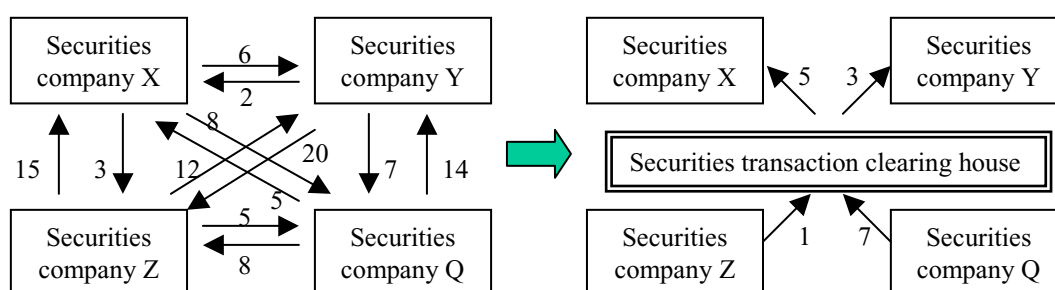
As well as introducing a new book-entry system, the Securities Settlement System Reform Law makes provision for establishing the legal framework for a clearing house by amending the Securities and Exchange Law.

A clearing house is responsible for affirming the amount of the securities and the payment before a securities transaction is settled. Clearing houses often serve as a central counterparty that guarantees settlement by acting as the sole purchasing counterparty to all sales and the sole selling counterparty to all purchases. An agency of this kind makes it easier to net transactions involving more than two counterparties and should reduce the amount of unsettled transactions. In addition, crediting or debiting all amounts to the clearing house's account reduces the counterparty credit risk solely to that against the clearing house.

⁷ Financial System Council report "Ensuring Investor Protection following the Reforms to Japan's Securities Settlement System," 15 February 2002.

The amended version of the Securities and Exchange law included in the Securities Settlement System Reform Law defines the new concept of "securities obligation underwriting" and states that this will be the function of a "securities transaction clearing house." "Securities obligation underwriting" means underwriting the obligation incurred by one securities company entering into a securities transaction with another securities company. When a securities company enters into a transaction on behalf of a client, it can transfer the obligation resulting from the transaction to a securities transaction clearing house. Although a securities transaction clearing house must be a corporation licensed by the Prime Minister, a stock exchange can also obtain approval and engage in securities obligation underwriting (see Figure 2).

Figure 2 Establishment of a Securities Transaction Clearing House



Source: NRI, from "Outline of Securities Settlement System Reform Bill".

In Japan the institution responsible for establishing each market is responsible for clearing transactions involving equities and other securities listed on the country's stock exchanges and the JASDAQ market, and in 1999 the Tokyo Stock Exchange and the Osaka Securities Exchange started to act as a central counterparty even in the absence of a legal definition of what constituted a clearing house capable of acting as a central counterparty. As it has been pointed out how inefficient it is to have a separate clearing function for each market, in January 2002 the Japan Securities Dealers Association and the country's five stock exchanges agreed to set up a single clearing house.

However, there are no clearing houses for government and corporate bonds. Given the start of real time gross settlement of government bond transactions and the likely increase in issuance of government bonds, it has been pointed out that there is an urgent need for a clearing house, and the subject is currently being discussed by a study group with a secretariat provided by the Japan Securities Dealers Association.

The role of clearing houses has also come under review in Europe and the United States, where a wave of rationalization is currently taking place. As the passing of the

amended version of the Securities and Exchange Law produces a legal definition of the term "clearing house," clearing houses could become much more widespread in Japan.

4. Outstanding Issues

Now that the Securities Settlement System Reform Bill has been passed by the Diet and becomes effective on 6 January 2003,⁸ the next issue is share certificates, which the new law does not cover.

As was mentioned above, the paperless settlement of equity transactions by depositing share certificates with the Japan Securities Depository Center will not be fully effective unless a greater proportion of shares on issue are deposited with the Center. In its intermediate draft (of April 2001) of the proposed amendment of the Commercial Code, the Financial System Council's Company Law Subcommittee included dematerialization of share certificates as one of the items for amendment. Some of the items in the draft were included in the Commercial Code Amendment Law passed by the Diet in the autumn of 2001,⁹ and a second batch of items was presented as a bill on 18 March 2002 and was passed on 22 May 2002. However, neither of these two included any provision for dematerialization of share certificates, and this issue is high on the agenda for 2003 and beyond. Attention therefore remains focused on how the process of rationalizing Japan's system of securities settlement will continue.

⁸ The abolition of the Corporate Bond Registration Law is due to take effect not later than five years from the day the Securities Settlement System Reform Law becomes effective. The actual day on which the abolition takes effect will be decided by a government ordinance.

⁹ For further details of the amendments to the Commercial Code see Motomi Hashimoto, "Commercial Code Revisions: Promoting the Evolution of Japanese Companies," NRI Papers No. 48, May 1, 2002.