

SPURRING GREATER CONFIDENCE IN THE JAPANESE MARKET

Reform of the securities settlement system has become an urgent priority in Japan. Dematerialization—paperless securities—and the reduction of settlement risks paralleling shorter settlement periods have gained favor in global financial markets. It is therefore important to Japan to establish integrated STP schemes linking a DVP system to the PSMS. JASDEC is also working on its own securities settlement system to enhance the reputation of the Japanese market in the eyes of overseas investors.

PSMS

Electronic CP

Pre-Settlement Matching System

The move toward STP for securities settlement has acquired greater urgency as a means of reducing settlement risks and lowering costs. The indispensable steps toward implementing STP in Japan are the introduction of the PSMS and the creation of a DVP system that links to the PSMS.

Expanding PSMS to handle DVP for non-exchange transaction deliveries

The third phase of the first stage in our development of the PSMS, which went online in May 2003, has expanded the system to cover transactions for government bonds and stock exchange-traded futures and options. We also added a transmission function that routes net asset value on investment trusts as well as information on the subscription and redemption of such trusts by investment trust management companies to trust banks.

In the second stage, we will be working to connect the system to DVP for non-exchange transaction deliveries (NETD). Once linked, PSMS-generated instruction data on settlements will be relayed to the DVP system automatically, obviating the need to input instructions through a separate step and bringing the settlement process to a smooth conclusion.

DVP for NETD

We plan to apply a gross-net type DVP settlement system that links book-entry transfer of stocks and other securities with payment of funds, based on settlement instruction data generated by the PSMS. Under this structure, each book-entry delivery of securities will be processed on a trade-for-trade—or gross—basis, while payment of funds will be made on a net basis, wherein each participant pays or receives at the end of the day the balance that remains when payable amounts for receipts of securities and receivable amounts for deliveries of securities are offset.

Connecting the PSMS and the DVP for NETD will mark a major step forward in realizing STP for securities settlement in Japan.

CONTROLLING RISKS IN THE DVP FOR NETD

We are preparing several schemes for the DVP system, based on a risk-control perspective.

1. **PRINCIPAL RISK MANAGEMENT:** *We will limit risk by having our clearing subsidiary hold assets for each DVP participant that exceeds the balance owing by that DVP participant.*
2. **LIQUIDITY RISK MANAGEMENT:** *We will establish participant funds and credit lines with banks to maintain an appropriate level of fund liquidity and offset possible participant default on final payment. To avert a shortfall in fund liquidity, we have set a net debit cap for each DVP participant.*
3. **PARTICIPANT MANAGEMENT:** *We will require DVP participants to meet certain financial criteria, and we will watch for any change in status.*

** We will establish a clearing subsidiary to execute fund netting with participants, thereby separating the netting function from our book-entry function and ensuring compliance with rules for risk management and netting.*

Pre-Settlement Matching System (PSMS) This system electronically matches information, such as trade reports and investment instructions, on trades and settlements among institutional investors, securities firms, trust banks and other entities, once stock certificates or other securities have been traded.

Delivery versus payment (DVP) This system establishes a strong connection between the delivery of and payment for securities. International standards, recommended by the G30 and other organizations, require the use of a DVP system in all securities settlements to eliminate settlement risk.

PROGRESS ON PSMS AND
DVP SYSTEMS

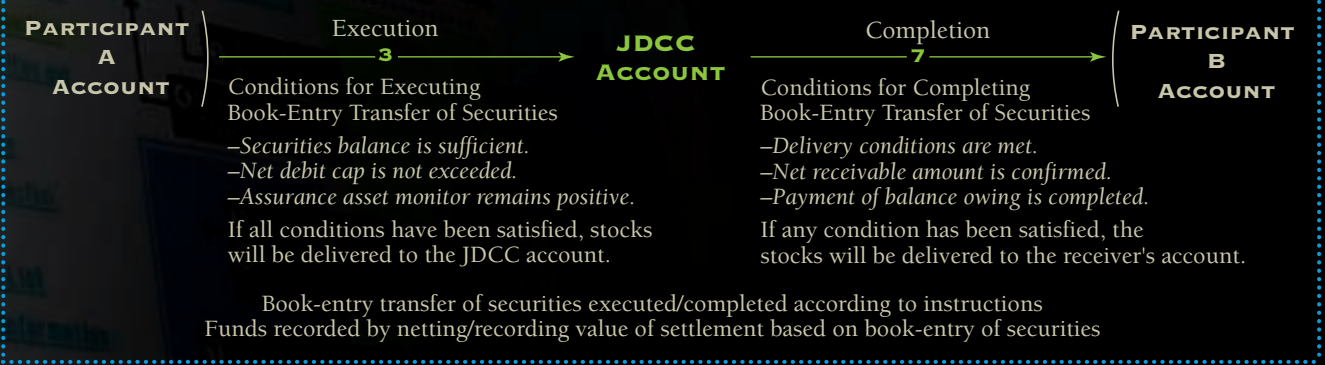
- 2001 MAY** DVP for exchange trade transfers begins.
- SEPTEMBER** First phase of first stage of PSMS implemented.
(Covers stock transactions by domestic institutional investors.)
- 2002 FEBRUARY** Second phase of first stage of PSMS implemented.
(Covers convertible bonds, initial offerings and trades by nonresidents.)
- 2003 MAY** Third phase of first stage of PSMS implemented.
(Covers government bonds and stock exchange traded futures and options.)
- 2004 MAY** Anticipated start of DVP for NETD.

LINKING PSMS AND DVP SYSTEMS

PRE-SETTLEMENT MATCHING SYSTEM



DVP BOOK-ENTRY TRANSFER SYSTEM FOR SECURITIES



4 Transmit settlement value (net owing)

BOJ FINANCIAL NETWORK SYSTEM



- Notes:
- 1. Approval from BOJ required to use the BOJ Financial Network System.
 - 2. Assurance asset monitor = Value of assurance asset — Net debit
 - 3. JDCC: JASDEC DVP Clearing Corporation, a subsidiary of JASDEC.
 - 4. SSI: Standing Settlement Instructions.

Preparing to Handle Corporate and Municipal Straight Bonds and Investment Trust Beneficiary Rights

JASDEC is studying approaches for handling corporate straight bonds and local government bonds, as well as investment trust beneficiary rights in 2005.

Corporate and Municipal Straight Bonds

In Japan, registering agencies, which number about 150, are used to settle the majority of corporate bond transactions through registration. These agencies execute the required book-entry transfer and essentially dematerialize the securities into registered bonds. In January 2003, introduction of the Transfer of Corporate Debt Securities Law enabled a new system for corporate and municipal straight bonds (SBs).

This law confirms the trend toward paperless securities and consolidates SB settlement operations with JASDEC, wherein the Company is the sole book-entry transfer institution for SB settlement. To execute this duty, we will adopt a book-entry transfer system for SBs to realize a DVP system and take us one step closer to the use of STP for securities settlement in Japan. Through these efforts, we aim to raise SB liquidity, enhance settlement efficiency, and set the stage for shorter settlement periods in the future.

Discussions in our Subcommittee on Corporate and Municipal Straight Bonds led to an implementation document for a book-entry transfer system for SBs. The document addresses the scope of eligible bonds; the participation format for interested parties; the content of the book-entry transfer account ledger; the procedures for issuing, transferring and redeeming bonds; bond settlement methods for all DVP systems; payment methods for principal and interest; and schemes for switching outstanding bonds to the new system.

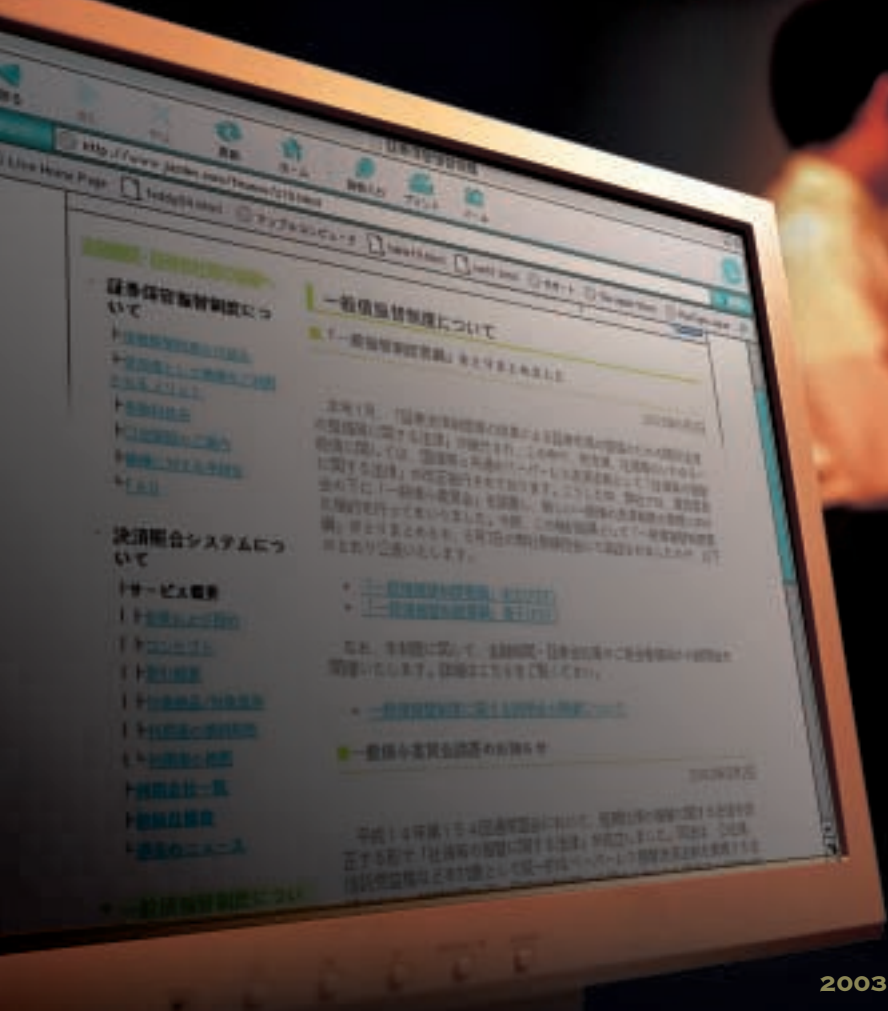
We will utilize this document as a guide to determine book-entry operations and to develop the appropriate computer systems.

Investment Trust Beneficiary Rights

The basic legal framework for a book-entry system applied to investment trust beneficiary rights is similar to that applied to commercial paper (CP) and SBs. We will dispense with processes previously deemed necessary to accommodate certificated beneficiary rights, and we will utilize book-based records on such aspects of investment trusts as subscription, transfer and redemption to streamline book-entry operations.

Our Subcommittee on Investment Trusts is discussing the scope of eligible investment trusts, the procedures for establishing, distributing and redeeming investment trusts, the application of DVP for each type of investment trust, procedures for handling earnings dividends, and methods to ensure that the pool of some two million beneficiary certificates already issued will make a smooth transition to the new system.

Registered Bonds The Corporate Bond Registration Law (1942) allows a registering agency to register municipal and corporate bonds on the registry that the registering agency maintains so investors may settle transactions without bond certificates.



TRANSITION SCHEDULE FOR
CORPORATE AND
MUNICIPAL STRAIGHT BONDS

- 2003** **JANUARY 6** Transfer of Corporate Debt Securities Law goes into effect. *(Abrogation of the Corporate Bond Registration Law expected within five years of the new law's implementation.)*
- 2005** **SECOND HALF OF 2005** JASDEC plans start of book-entry transfer system for SBs.
- 2006-07** Registered bonds already in issue will be changed to book-entry bond status.
- 2008** **JANUARY 5** Temporary grace period applied to interest income tax on registered bonds ends. *(No more registered bonds will be issued.)*

TRANSITION SCHEDULE FOR EXISTING REGISTERED BONDS

The Corporate Bond Registration Law, which regulates existing registered bonds, will be abolished by January 5, 2008. JASDEC is thus working toward the start of book-entry transfer of new corporate and municipal bonds in the second half of 2005. We will then establish a transition period lasting about two years during which we anticipate trouble-free conversion of existing bonds from registered status to the book-entry status used in our system.

Creation of Book-Entry Transfer System for Electronic Commercial Paper

On January 10, 2003, JASDEC was designated as a book-entry transfer institution, under the Transfer of Corporate Debt Securities Law. The Company launched a book-entry transfer system for CP on March 31, 2003.

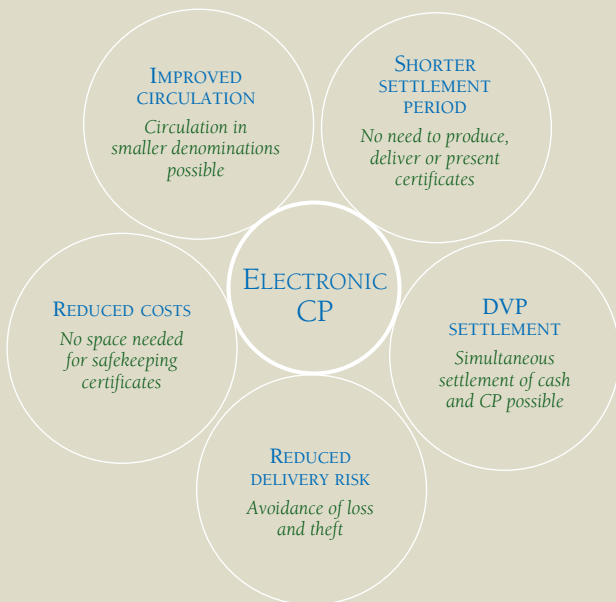
The development of a book-entry transfer system for dematerialized CP was prompted by a strong appeal from companies using CP to procure funds. JASDEC began discussions on such a system in January 2002, first identifying the primary points of a system for CP and then moving on preparations for implementation, including the creation of computer systems.

CP in the conventional paper form, or paper-based CP, is prepared in certificates of certain denominations, and these certificates must be delivered or presented to the assigned holder at settlement. Our system, however, dematerializes CP, from issuance through redemption, and records ownership and transfer of rights in a transfer account book. The use of “paperless” or “electronic” CP shortens the settlement period, removes the risks inherent in transporting certificates and eliminates the cost of safekeeping the certificates—all drawbacks of paper-based CP.

PROMOTING ELECTRONIC COMMERCIAL PAPER

As of June 30, 2003, the book-entry transfer system for electronic CP covered 85 issues, and the account balance stood at ¥424 billion. We plan energetic marketing and promotional campaigns, including information forums and advertisements, to encourage more issuers and investors to utilize electronic CP.

FEATURES OF THE BOOK-ENTRY TRANSFER SYSTEM FOR COMMERCIAL PAPER



The book-entry transfer system for CP utilizes a gross–gross-type DVP settlement system. This feature makes settlement safer and more efficient than with paper-based CP.

Paper-based CP is also hampered by a limited assortment of denominations in circulation, because the stamp duty that is charged on each certificate encourages issuers to cut the burden of cost by issuing large-denomination certificates. Electronic CP circumvents this restriction, allowing the issue and transfer of CP in smaller denominations and thus presenting greater investment flexibility.

The current paper-based CP market counts an average issuing balance of slightly more than ¥20 trillion. JASDEC expects remaining paper-based CP to be converted into electronic CP soon.

Commercial paper in Japan CP is issued by companies as a measure for procuring unsecured short-term funds. To date, in Japan, only companies with a rating for CP above a set mark have been able to issue CP in the form of promissory notes of less than one year in duration and more than ¥100 million in value. Under the Transfer of Corporate Debt Securities Law, CP is viewed as a short-term corporate bond rather than a note, and processing, from issuance to redemption, is handled electronically through JASDEC's computer systems.

MILESTONES IN HANDLING ELECTRONIC
COMMERCIAL PAPER

2002 APRIL 1 The Law Concerning Transfer of Short-Term Corporate and Other Debt Securities was introduced

2003 JANUARY 6 The law was amended and renamed the Law Concerning Book-Entry Transfer of Corporate and Other Debt Securities (Transfer of Corporate Debt Securities Law)

JANUARY 10 JASDEC was designated as a transfer institution under the Transfer of Corporate Debt Securities Law

MARCH 31 JASDEC commenced book-entry transfer services for commercial paper

Electronic CP Book-Entry
Transfer System
Issuing Flow

