

ONGOING SECURITIES SETTLEMENT SYSTEM REFORM IN JAPAN



The implementation of a DVP system for NETD, including stock certificates, marked the halfway point for securities settlement system reform in Japan. The next challenge is to introduce changes geared toward the ultimate goal of dematerializing stock certificates. The following section highlights JASDEC's efforts in this area, specifically the DVP for NETD launched in May 2004 and the special features and structure of the book-entry transfer system for straight bonds that is scheduled to go online in January 2006.

SYSTEM IMPLEMENTED MAY 2004

DVP for NETD

BASIC STRUCTURE DVP for NETD is 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 produced by the pre-settlement matching system (PSMS). With this type of system, book-entry delivery of securities is processed on a trade-for-trade — or gross — basis, whereby at the end of the day each participant pays or receives the balance that remains when payable amounts for receipts of securities and receivable amounts for deliveries of securities are netted out. These procedures, already adopted by the Depository Trust & Clearing Corporation, effectively reduce securities settlement risk and facilitate efficient processing of numerous settlements.

Connecting PSMS and the DVP for NETD represents the last step on the road to achieving STP for securities settlement in Japan. Once the two systems are connected, PSMS-generated instruction data on settlements will be relayed to the DVP system automatically, obviating the need to input instructions through a separate process and bringing settlements to their respective quick conclusions.

CONTROLLING RISKS IN THE DVP FOR NETD Controlling risk in the DVP for NETD is a priority for us. Major risk-management efforts are outlined below.

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 same 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 to 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 satisfy a set standard for management soundness, such as a certain capital adequacy ratio, and will monitor each participant against this standard for any changes in status.
4. JASDEC DVP Clearing Corporation (JDCC), our recently established subsidiary, ensures thorough legal compliance with rules for risk management and netting.

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.*

JASDEC DVP CLEARING CORPORATION

In June 2003, we established JDCC as a wholly owned subsidiary to provide DVP settlement services. In April 2004, the company was licensed as a securities clearing agency to undertake securities obligations, in accordance with the Securities Exchange Law, and it launched DVP settlement services for NETD in May 2004.

LOCATION: Tokyo

DATE OF INCORPORATION: June 6, 2003

CAPITALIZATION: ¥310 million

SHAREHOLDER: Japan Securities Depository Center, Inc. (100% equity)

PRESIDENT AND CEO: Yoshinobu Takeuchi

NUMBER OF EMPLOYEES: Four directors (including one auditor) and eight full-time staff

BUSINESS CONTENT: Undertaking securities obligations and providing supplementary and related services.

Pre-Settlement Matching System (PSMS) 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 a PSMS and the creation of a DVP system that links to the PSMS. The PSMS is a system that electronically matches information related to 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) A system that simultaneously attaches specific conditions to the delivery of and payment for securities. International standards, recommended by the G30 and other organizations, require the application of a DVP system to all securities settlements to eliminate settlement risk.

2002

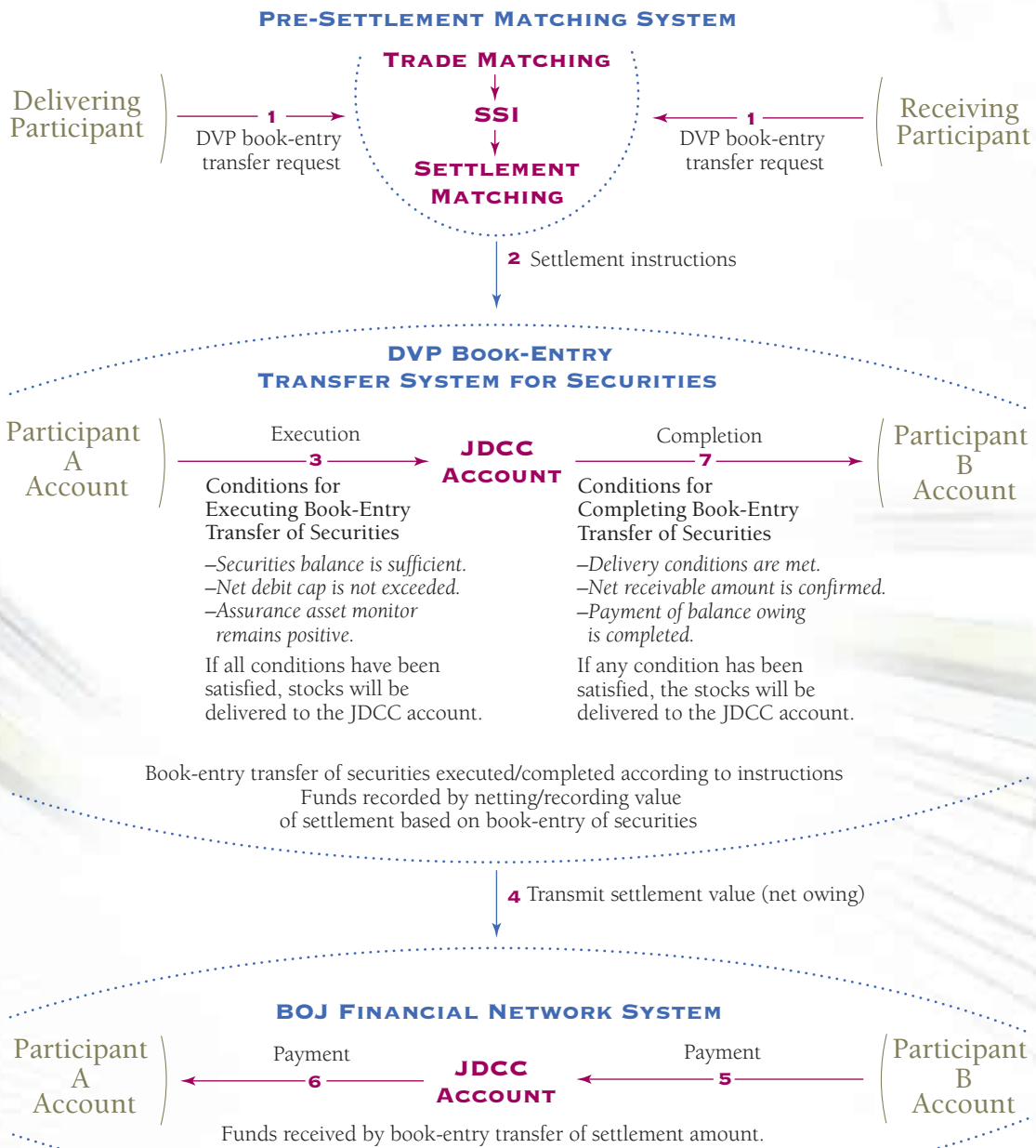
2003

2004

FEBRUARY Second phase of first stage of PSMS implemented. Covers convertible bonds, initial offerings and trades by nonresidents.

MAY Third phase of first stage of PSMS implemented. Covers government bonds, and listed futures and options.

MAY DVP for NETD went online.



Notes: 1. Assurance asset monitor = Value of assurance asset — Net debit
 2. JDCC: JASDEC DVP Clearing Corporation, a subsidiary of JASDEC
 3. SSI: Standing Settlement Instructions

NEW BOOK-ENTRY TRANSFER SYSTEM

CORPORATE AND MUNICIPAL STRAIGHT BONDS

SOLE BOOK-ENTRY TRANSFER INSTITUTION FOR STRAIGHT BONDS In Japan, registering agencies, which number about 160, 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 Law Concerning Book-Entry Transfer of Corporate Bonds, etc. 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 expect to raise SB liquidity, enhance settlement efficiency and set the stage for shorter settlement periods.

JASDEC announced a breakdown of the book-entry transfer procedures for corporate and municipal SBs in June 2003 and a summary of the book-entry transfer system processing in October 2003. It is our goal to place ourselves at the center of an STP system that electronically executes a series of procedures, from trade matching to securities and cash settlement.

TWO SETTLEMENT METHODS A choice of two settlement methods will be available: by DVP system and by non-DVP system, otherwise known as free-of-payment settlement. For the DVP system, we will apply the real-time, gross-net format known as BIS model 1, which transfer instructions settle for both securities and funds, with delivery of securities occurring at the same time as payment of funds. In August 2005, we will initiate a comprehensive test — our final check — to confirm connections with the systems of users, with a view to launching the book-entry transfer system for SBs in January 2006. In addition, management has prioritized the development of high-quality systems and the trouble-free conversion of existing SBs, with an outstanding amount of about ¥200 trillion, from their current registered status to book-entry status.

TRANSITION PERIOD By government ordinance, the prevailing Corporate Bond Registration Law will be abolished by January 5, 2008. JASDEC will establish a transition period lasting about two years, during which registered bonds will be issued either as book-entry transfer bonds, based on the new law, or actual delivery of bonds, based on the principles of the Commercial Code. With the approval of issuers and investors, it will become possible to convert an outstanding registered bond into a book-entry transfer bond for handling by our system. To maintain a smooth transition, we will continue to pursue activities that elevate awareness of book-entry transfer bonds.

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 canceling investment trusts, settlement systems for each type of investment trust, procedures for handling earnings dividends, and methods to ensure that the pool of some three 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 corporate and municipal bonds on its registry so investors may settle transactions without bond certificates.

SCHEDULE FOR CORPORATE AND MUNICIPAL STRAIGHT BONDS

2003

JANUARY The Law concerning Book-Entry Transfer of Corporate Bond, etc. goes into effect. (Abrogation of the Corporate Bond Registration Law expected within five years of the new law's implementation.)

JUNE JASDEC announced breakdown of book-entry transfer procedures for corporate and municipal straight bonds.

OCTOBER JASDEC announced summary of book-entry transfer system processing.

2004

MAY JASDEC announced connection specifications.

2006

JANUARY JASDEC expects to launch book-entry transfer system for straight bonds.

2005

AUGUST JASDEC plans to start comprehensive connection test.

2006-7

Registered bonds already in issue will be changed to book-entry bond status. By government ordinance, registered bonds will no longer be issued after January 2008.

2008

JANUARY End of temporary grace period applied to interest income tax on registered bonds.

