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Deregulation and Tax Reform Issues

the path to a true global market

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Thank you for your kind introduction.

My name is Kimori, and I will make a presentation on deregulation and tax reform issues


- starting with trends of foreign investors in the Japanese securities markets,
- reviewing the success of securities settlement and tax reforms, and,
- pointing out issues for the future, as well as
- sharing my thoughts on the steps to be taken in the Japanese securities market to achieve global standards.



Introduction

- In the Japanese equity and JGB markets, foreign investors are representing an increasing proportion of trading volume and holding value, now having a larger influence on the market
- Recovery in corporate sector earnings and macro economic conditions is evidenced, but **impediments still persist**
- Initiatives on securities settlement and tax reform should better facilitate foreign investor activity, but the market needs to move forward faster, across the board
- Today, let us review the developments in recent years and share thoughts on the steps the market should take to achieve global standards

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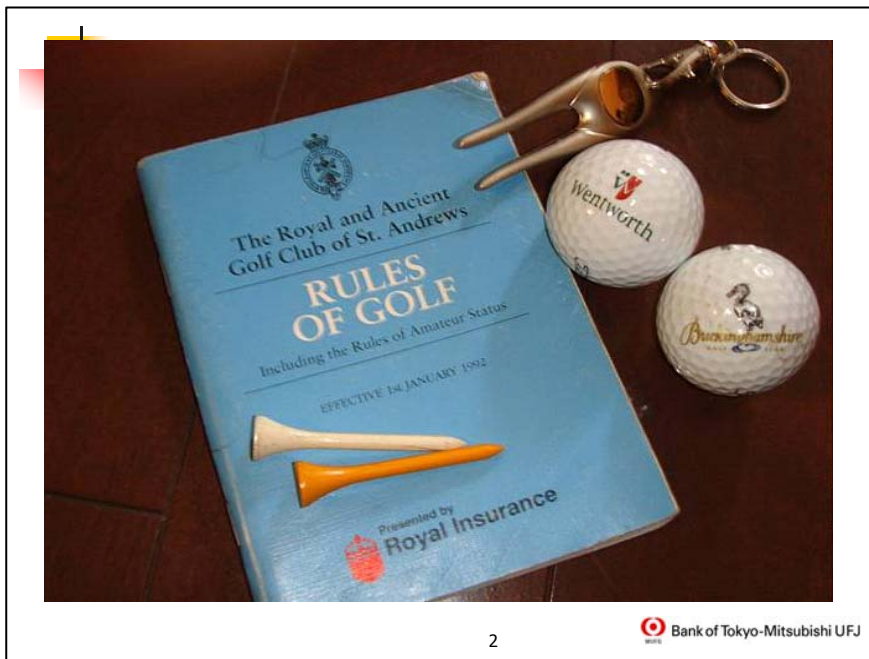


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In the Japanese equity and JGB markets, foreign investors are representing an increasing proportion of trading volume and holding value. Now, this sector has a larger influence in the market.

In the back ground of this increase, we saw recovery in Japanese corporate sector earnings, and, recovery in Japanese macro economic conditions, but, impediments for foreign investors still persist.

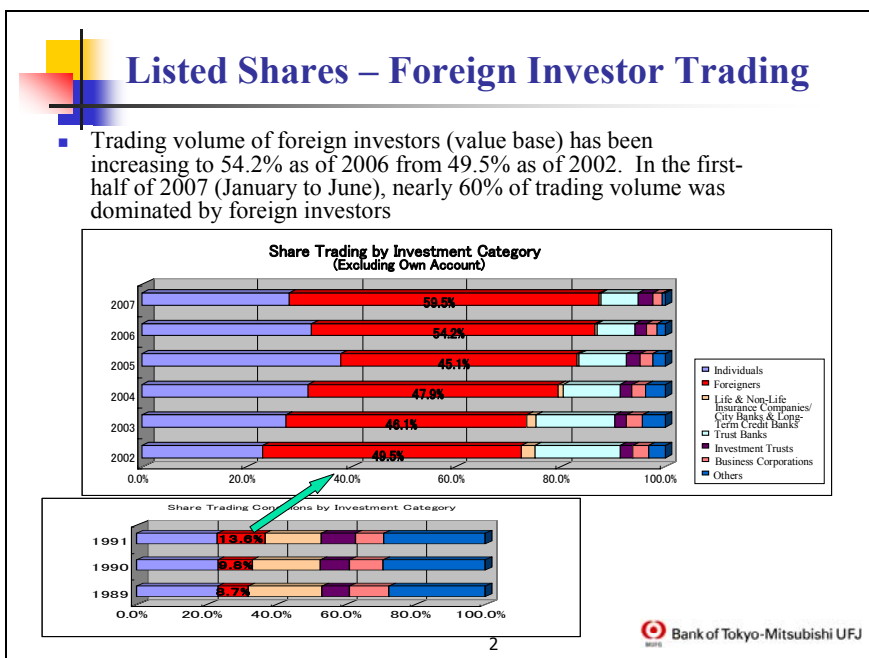
If you remove a loose impediment through the green, and the ball moves, you have to pay penalty in the game of golf. But not in our game of securities.



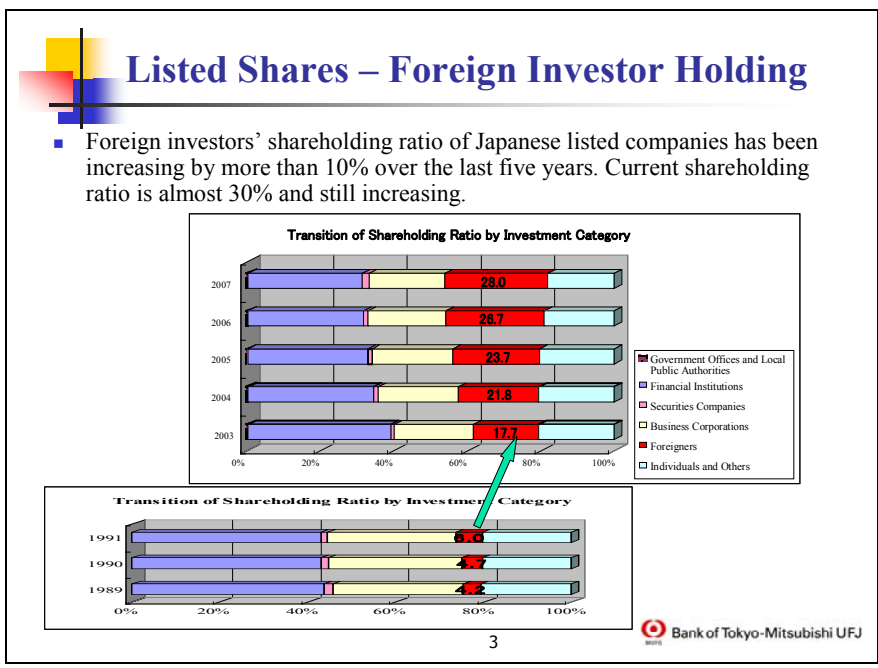
We have to make our ball move and roll. Let's roll on!

Ongoing initiatives on securities settlement and tax reform should facilitate foreign investor activity, but, I think, the Japanese market needs to adopt global standards at a faster pace and all relevant market constituents should join force.

First, I would like to start with four slides with charts showing the increasing trend of foreign investors activity in the Japanese market.

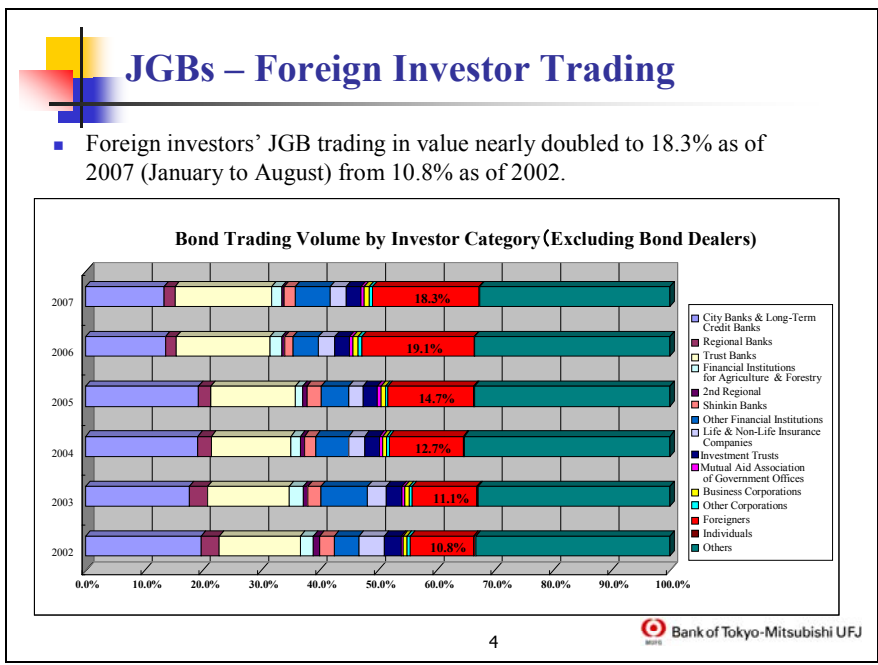


This slide shows how active foreign investors are in trading listed shares. Their portion of trading volume was about 10% in 1990, however, already in 2006 foreign investors represented more than 50%. In the first half of 2007, this climbed to nearly 60%.



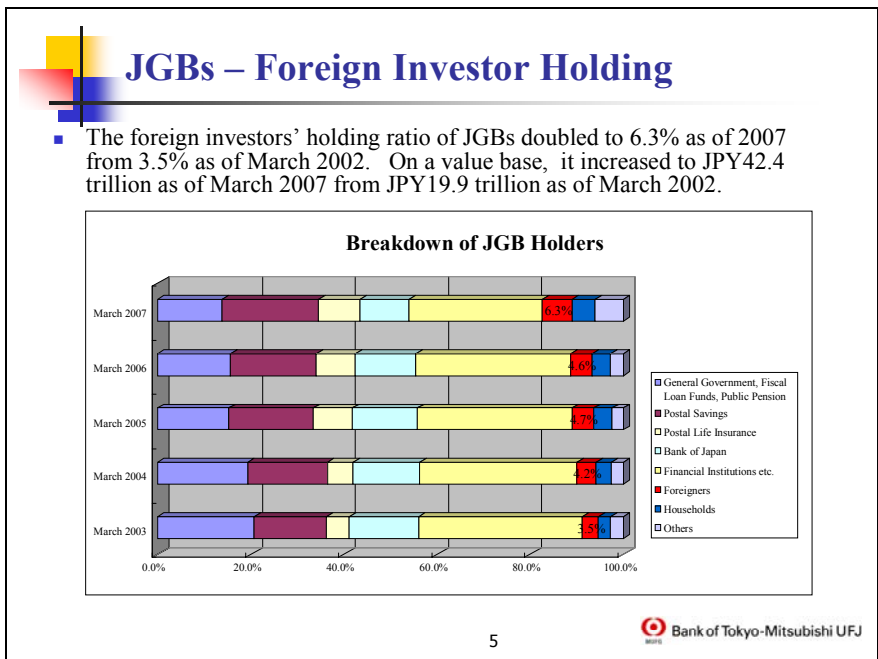
This slide shows that even on a balance basis foreign investor presence is rapidly increasing and strong.

In 1990, during the bubble economy period, foreign investors held about 5% of the market. This increased by more than 10% over the past five years and reached almost 30% in 2007.



This slide shows how active foreign investors are in trading JGBs. Not as much as listed shares, but you can still see an impressive growth.

The share of foreign investors' JGB trading nearly doubled over the past five years to represent close to 20% of the market.



And in this slide you can see that foreign investors represent a relatively small portion on a balance basis, but their share is growing strong. The holding ratio doubled over the past five years, to 6.3% of the market in 2007. Whereas foreign investor holding in the US and German government bonds is almost 40%. So in comparison, foreign investor holding in JGBs is still low.

As you see here, the foreign investors presence is growing in Japanese Securities markets. We might say, in this sense, the Japanese securities markets are becoming much more international.

On to the next set of slides:


- ### I. Securities Settlement & Tax Reforms
1. Securities Settlement System Reform
 2. Preferential Taxation on Dividends
 3. Tax Exemption on JGB interest
 4. Revision of The Company Law
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Here, I would like to review the initiatives that took place on securities settlement and tax reform.

I will focus on these 4 points that facilitated and are facilitating foreign investor activity.

1. Securities Settlement System Reform

- The Law Concerning Book-entry Transfer of Corporate and Other Debt Securities went into effect in January 2002
 - ✓ JGBs: dematerialization achieved in full from 2003
 - ✓ CBs / Munis: dematerialization conversion from 2006
- Law regarding Dematerialization of Stocks went into effect in June 2004
 - ✓ Shares: dematerialization scheduled from 2009
- Data centralization at CSDs achieved
 - ✓ JGBs: BOJ acting as CSD
 - ✓ CBs / Munis / Shares: JASDEC is CSD

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The first point is "Securities Settlement System Reform".


The Law concerning Book-entry Transfer of Corporate Bond and Other Debt Securities (in Japanese: *Shafuri-hou*) was enforced in January 2002. Subsequently, JGBs were fully dematerialized in 2003, and, Corporate Bonds and Municipal Bonds shifted to dematerialized from 2006. This process will be completed by January 2008.

The Law regarding Dematerialization of Stocks went into effective in June 2004, and the market is preparing to dematerialize share certificates. The target date is in January 2009.

By completion of dematerialization, all data on securities will be centralized at the CSDs. This is, BOJ for JGBs, and, JASDEC for other security types.

【Reference】 Settlement System Reform in Japan

	2001	2002	2003	2004	2005	2006	2007	2008	2009
Legislative Changes, others		■ Law regarding book-entry system of CPs	■ Law regarding book-entry system of Corporate Bonds	■ Law regarding dematerialization of Stocks		■ Revision of ComphayLaw		□ Abolishment of Bond Registration Law	
Cash		■ RTGS settlement						□ RTGS-XG (next generation)	
JGBs		■ RTGS settlement	■ New Book-entry system		■ PSMS ■ JGBCC (Clearing House)				
Corporate Bonds						■ PSMS ■ DVP Book-entry		□ Completion of Book-entry	
Commercial Papers			■ DVP Book-entry			■ PSMS ■ Level-up of DVP Book-entry			
Investment Funds							■ DVP Book-entry		
Stocks				■ DVP Book-entry					□ Dematerialization (new book-entry)


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This chart shows an overview of the settlement system reform in Japan.

Besides securities, for cash settlement, RTGS will be leveled up to RTGS-XG in 2008. RTGS exists already as Japanese Large Value Payment in cash, which is called BOJ-Net.

Now, we, the Japanese financial community, are proceeding a project to enlarge its capacity, which will start in October 2008. All large value payments will be executed by this new RTGS-XG.

Now, let's move on.




2. Preferential Taxation on Dividends

2-1. Withholding Tax Rates on Dividends

- Preferential withholding tax rates on dividends introduced from April 2003 to March 2009
- Permanent reduction is being requested as part of FY 2008 Tax Reform Plan


Type of Dividends	Withholding Tax Rates		
	April 1 st , 2003 to December 31 st , 2003	January 1 st , 2004 to March 31 st , 2009	After April 1 st , 2009
Dividends on Listed Shares (excluding dividends for major individual shareholders)	WHT rate: 10% (National Income Tax: 10%) (Local Residential Tax: Nil)	WHT rate: 10% (National Income Tax: 7%) (Local Residential Tax: 3%)	WHT rate: 20% (National Income Tax: 15%) (Local Residential Tax: 5%)
Dividends on Un-listed shares (including dividends of major individual shareholders receive)	WHT rate: 20% (National Income Tax: 20%) (Local Residential Tax: Nil)		

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The second point is "Preferential Taxation on Dividends".

The statutory withholding tax rate for dividends on listed shares was reduced from 20% to 10%.


Only National Income Tax applies to foreign investors so the effective rate is 7% now. This is a temporary measure that expires at the end of March 2009, but the industry is lobbying the authorities to have this measure continued on a permanent basis. At this stage, we do not know if it is legislated permanently or prolonged for a certain period only.



2. Preferential Taxation on Dividends

2-2. Revision of Double Taxation Treaties

- Pension funds and other foreign investors types additionally qualified to enjoy tax exemption
 - ✓Japan-US: effective from July 2004
 - ✓Japan-UK: effective from January 2007
 - ✓Japan-France: to be effective from January 2008


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Double taxation treaties are also being revised:

The Japan-US treaty was revised and became effective from July 2004, the Japan-UK treaty became effective from January 2007. The new Franco-Japan treaty was just passed and ratified by the French Parliament last week. It will be effective from January 2008.

By revising these treaties, pension funds (except in the French case) and other foreign investors types additionally become qualified to enjoy tax exemption.

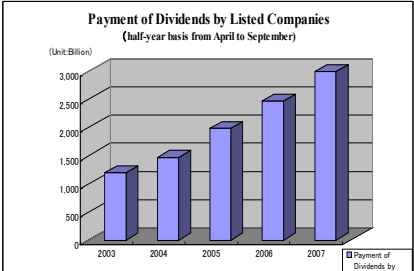
Revision of other treaties are also under negotiation.




2. Preferential Taxation on Dividends

2-3. Amount of Dividend Payments

- Dividend amounts increased through the past five years and first-half of FY2007 (April to September 2007) was up 17% from the previous year due to
 - ✓ improving corporate performance
 - ✓ higher dividend payout ratios
- Partially lead by increased investors activism, payout ratio higher (21% in 2004), but lags behind the US level (31% in same year)



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Dividend amounts increased steadily in the past five years.

In the first half of 2007, dividend payments were up 17% compared to previous year. The reason for this increase is the recovery in corporate performance, and higher dividend payout ratios. The louder voice of activist foreign investors may have also played its role.

Higher than historic levels, dividend payout ratios in Japan are lower than in the US. In 2004, the average of dividend payout ratio was 21 %. This figure is still low compared to 30% in the US.

I would like to add some words about this difference.

Japanese corporates still have traditional tendency to keep their profits to their reserves. And the stakeholders, including shareholders, admit it.

3. Tax Exemption on JGB interest

- 1999: Withholding tax exemption on foreign investor's JGB interest income commenced
- 2001: Expansion of Withholding tax exemption through introduction of Qualified Foreign Intermediary system
- 2002: Expansion of tax exemption to qualified foreign investment trusts
- 2004: Holding of TB/FB via QFI approved
- 2005: Uniformed tax format that covers both coupon JGBs and TB/FBs implemented / Submission cycle of Transfer Account Book and Application Form for Amendment relaxed to Quarterly
- From January 2005 to date: MOF actively promoting JGBs through investor relations presentations – to date a total of 9 sessions organized in the US, Europe and Asian regions

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The third point is "Tax Exemption on JGB interest".

With an aim to stimulate foreign investors' JGB holdings, a withholding tax exemption system for foreign investors was introduced in 1999. This system expanded gradually.

In 2001, the Qualified Foreign intermediary system was introduced, making it possible for foreign investors to enjoy tax exemption while depositing JGBs with QFI global custodians.

In 2005, a uniformed tax format that covers both coupon JGBs and TB/FB was implemented.

From January 2005, the Ministry of Finance started to actively promote JGBs in IR presentations.

We have seen that the foreigners holding percentage of JGB is only 6.3%. However if you consider that firstly the total size of issued JGB is over ¥700 trillion and 6.3% means ¥42 trillion (equivalent to \$350 billion), and secondly also the low yield of JGB, this is well done.

4. Revision of The Company Law

- **New "Company Law"** which replaces part of the Commercial Code went into effect in **May 2006**
 - ✓ The scope of dividend source expanded, in addition to profit reserves, dividends provided from capital surplus now allowed
 - ✓ "Triangular merger" made possible, as provisions concerning relaxation on compensation in merger allow for a Japanese company to take over another Japanese company by offering to pay foreign parent company shares in exchange of target company shares

N.B. For sellers, measure to defer taxation on capital gain were also implemented in May 2007.

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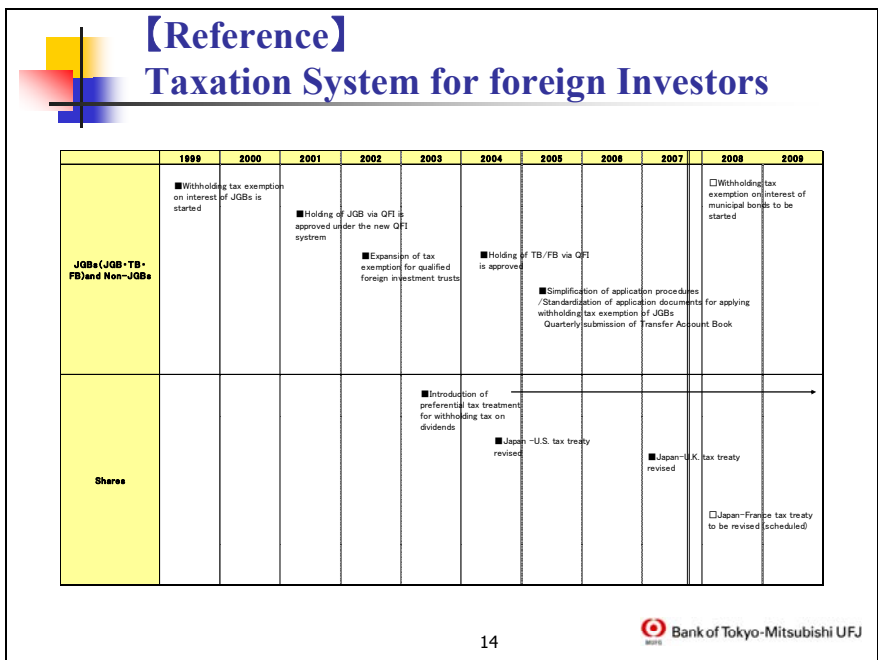
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The final point is "Revision of the Company Law".

The Company Law was revised and The New Company Law was enforced in May 2006. This revision expanded the scope of dividend source. This means that in addition to profit reserve, capital surplus can be used as a source of dividend payment.

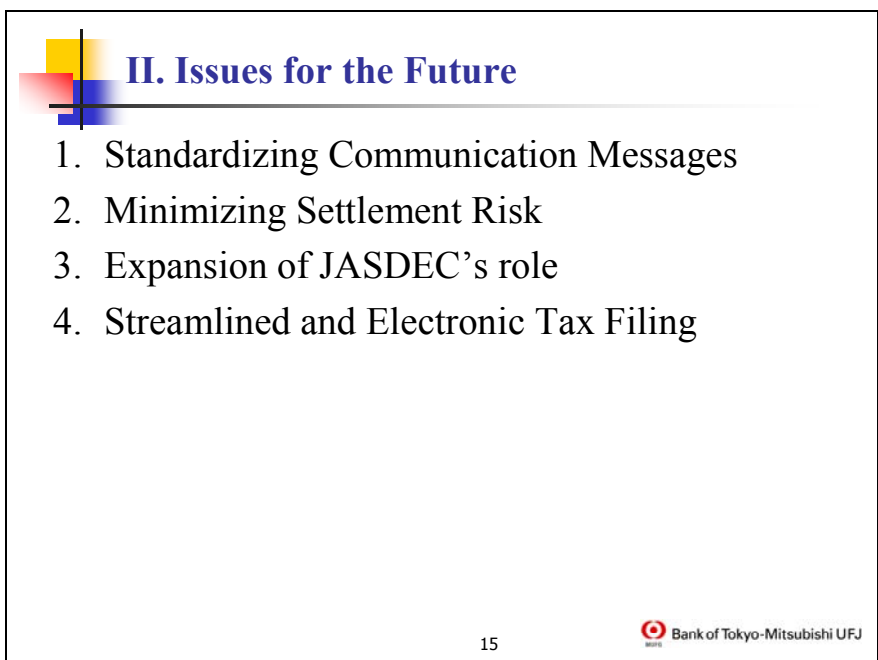
Also, triangular merger was made possible.

Last month, Citibank’s Japanese holding company announced to pay Citi Group shares to remaining shareholders of Nikko Cordial Securities. Earlier, a TOB was launched and now Nikko is a subsidiary of Citibank Japan Holdings. This is the first triangular merger in the market.



This chart is an overview of taxation system reforms for foreign investors.

The industry is lobbying for a withholding tax exemption system on corporate bonds to be included in the next tax reform.



Now I would like to move on to “Issues for the Future”.

Here, I would like to share my thoughts on

- the steps that the Japanese securities settlement market should take to achieve global standards, and
- whose market constituent should take a leading roll.

I will start by pointing out that the format of communication messages needs to be standardized.



1. Standardizing Communication Messages

- Especially in Europe, SWIFT is the leading and driving communication message format for securities settlement
- In Japan, SWIFT is a tool for cross border transactions
- CSDs (both BOJ and JASDEC) use unique message specifications for matching/settlement
- JASDEC has signed a MOU with SWIFT to implement UNIFI-XML (ISO20022)

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This is the first point.

“Standardizing Communication Messages” – a common issue for all of us in this room.

Needless to say, SWIFT is the leading and driving communication message format for securities settlement globally, and especially in Europe. In Japan, unique standards and a variety of customized messagings exist for domestic transactions, and SWIFT is widely perceived as a tool for cross border transactions.

Even CSDs use unique message specifications for pre-settlement matching and settlement of securities. That is BOJ in acting as CSD for JGBs, and, JASDEC the CSD for listed shares and corporate bonds and so on.


One of these CSDs, JASDEC, stepped up to challenge and has signed a Memorandum of Understanding with SWIFT to implement UNIFI-XML standards. I expect the other CSD, BOJ, will share the idea and importance of standardization.

This is a step forward for the Japanese market in joining the circle of this growing global consensus.

2. Minimizing Settlement Risk

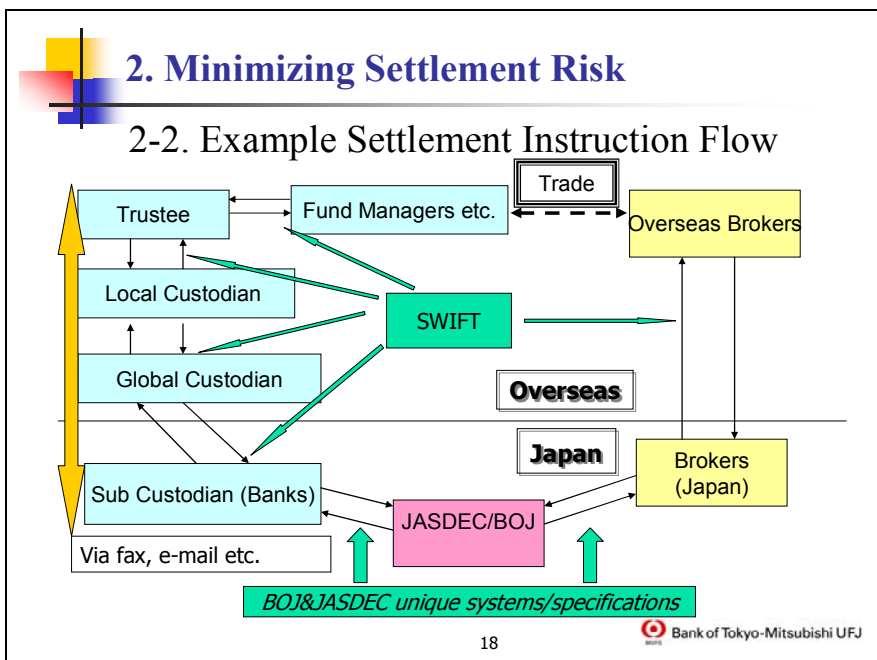
2-1. Current Situation

- T+3 Settlement is the current market practice in Japan
- A shorter cycle would add to minimizing settlement risk, but the geographical issue of Far Eastern time zone remains...
 - ✓ by the day trades are done in the US (T+0) it is already T+1 in Tokyo time
 - ✓ settlement instructions travel a long way and through a number of relevant institutions
- Higher standards in processing settlement instructions is a prerequisite, across all global participants in the chain

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Now on to the second issue of "Minimizing Settlement Risk".

T+3 settlement is still the current market practice in Japan, a country situated in the Far East and in a time zone ahead of other major markets. For example, by the time a US investor's purchase order is executed by its US broker today, it is already the next day T+1 in Tokyo time.

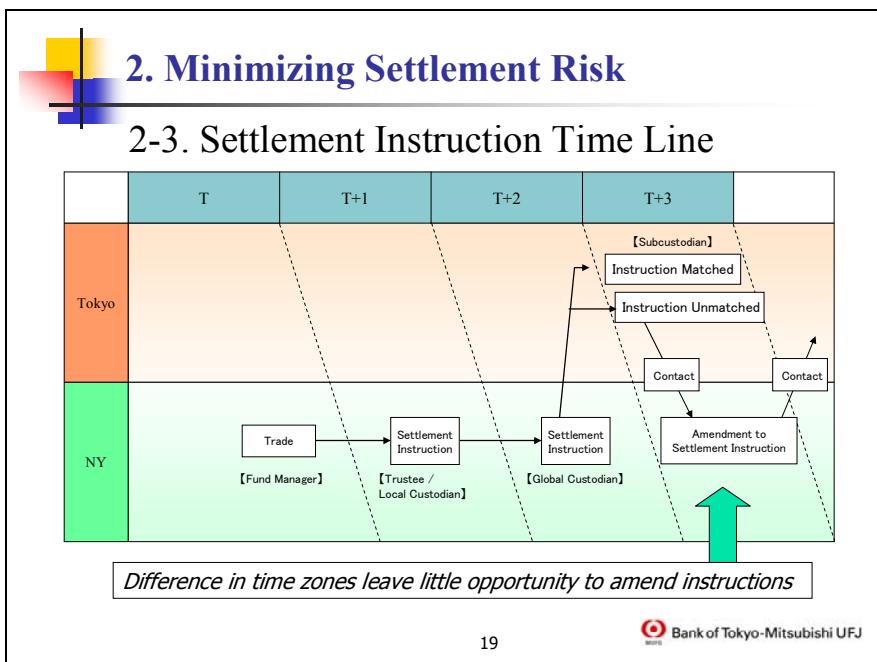


And as all of you well know, settlement instructions have long and winding *Pilgrim Journey* through a number of institutions, starting from the village or town of fund manager, its trustee, its local custodian, its global custodian, and finally they arrive at *Santiago de Compostella* of Sub-Custodian.

If the messaging is uniformed by SWIFT or by any other standard, it must be easy. But in reality, messages are often customized by each constituent, and they are transferred sometimes by Fax or E-mail.

Now, is there room for error or delay for trades to settle on T+3?

May the instructions and messages have safe journey !




This is rather a typical case. At least in the above example, there is no room for error or delay. This example may be an extreme case but there is no exaggeration in the point I will now make.

That is, a shorter cycle would add to minimizing the settlement risk that a foreign investor is exposed to. The fact is, all participants in the chain of settlement are required to achieve higher standards in processing instructions for this to work.

A different issue in the next slide.

3. Expansion of JASDEC's Role

- At time share certificates are dematerialized in January 2009, JASDEC would have cleared major milestones of the Securities Clearing and Settlement System Reform
- Being CSD for all security types except JGBs, different from its global peers, JASDEC's role does not cover
 - ✓ cash payment of interest/dividend income
 - ✓ tax related issues
- JASDEC's handling of withholding tax awaited, and should expand its contribution toward overall efficiency to areas outside security settlement

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The third point is The "Expansion of JASDEC's Role"

Over the past five years a number of milestones of the Securities Clearing and Settlement System Reform were set and achieved. Of course, JASDEC is at the center of these achievements, and the final milestone now set is dematerialization of share certificates from January 2009.

Even after this event, there will be a difference in JASDEC's role, compared to its global peers. JASDEC does not handle cash payment of interest and dividend income, nor does it handle tax related issues.

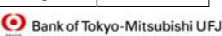
I invite JASDEC to study the handling of withholding tax.

With all other data on securities settlement centralized at JASDEC, adding tax to its role should expand its contribution towards overall efficiency in the market.


And on to my last point ...

【Reference】 CSDs in Major Markets

Name of Institutions		Japan	U.S.	Europe		Asia	
		Japan Securities Depository Center, Inc. (JASDEC)	The Depository & Clearing Corporation (DTCC)	Euroclear plc	Clearstream International SA	HKSCC (Hong Kong Securities Clearing Company)	
Date of Establishment		December, 1984	1973	1968	1970	May, 1992	
Securities Handled (Settlement)	Shares etc.	○	○	○	○	○	
	Investment Trusts etc.	○	○	○	○	○	
	JGBs	× (Settled at BOJ)	× (Settled at FED)	○	○	× (Settled at HKMA)	
	Non-JGBs	○	○	○	○	○	
	Short-term Financial Instruments	○	○	○	○	○	
Contents of Services	Cash Handling Services	Cash Settlement	× (Settled at JASDEC DVP Clearing Corporation)	○	○	○	
		Payment of Dividends Interests and Principal	×	○	○	○	
		Account at Central Bank	× (Settled at JASDEC DVP Clearing Corporation)	○	○	○	×
	Lending	×	○	○	○	○	
	Collateral Management	×	○	○	○	○	
	CA Information Services	○ (×)	○	○	○	○	
	CA-related Services	Handling of Withholding Tax	×	○	○	○	×
		AGM Invitation / Notification & PVS	×	△ (No PVS)	○	○	○
	Account Opening by Foreign CSD	×	○	○	○	×	

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(Unlike its global peers, JASDEC does not handle cash payment of interest and dividend income, nor does it handle tax related issues.)



4. Streamlined and Electronic Tax Filing

- Tax reforms to facilitate foreign investment in place
 - ✓ Tax exemption on JGBs (and Munis to come)
 - ✓ Preferential WHT rates on dividends
 - ✓ Pension fund friendly revised DTTs
- Paper documents submitted to tax offices are bulky and procedures are delicate
 - ✓ DTT application required per line/per beneficial owner in duplicate
 - ✓ Annual Renewal of CoRs
- Streamlined and Electronic Tax Filing awaited

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... which is "Streamlined and Electronic Tax Filing".


We have reviewed tax reforms to facilitate foreign investment.

Foreign investors are exempt from tax on JGBs interest income, preferential tax rates apply to dividends on listed shares, and pension funds can enjoy beneficial treatment set out in certain double tax treaties recently revised.

But of course, all this depends on certain conditions to be met, and appropriate tax documents to be submitted to the relevant tax office. These documents are bulky and procedures are delicate. For example, a tax application to have treaty rates apply is required in duplicate sheets, per line of security / per beneficial owner. In result, tens of thousands of documents are shipped out of our bank's Yen custody operations office in a year.

Certificate of Residency is a required accompanying document, and these CoRs need to be renewed once a year.


I hope that ongoing discussions between the authorities and the industry result in a more streamlined tax system where electronic tax filing is made possible.



Conclusion

- Investors set the tone and they require global standards
- Global standards can be achieved in the Japanese market, if all relevant market constituents move forward at an ever faster pace together

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And now my conclusion.

The Japanese security settlement market can only be as good as investors need it to be. And foreign investors clearly require global standards like they are made available to them in other major markets. True global standards are to be made in a manner of *de jure* now, not of *de facto*.

And for Japan, these standards can only be achieved if all relevant market constituents move forward together towards efficiency.

Wimbledon phenomenon is a word from which we should borrow wisdom. The yity is a true global market in my eyes. Japan is at a point where *sumo* wrestling in *Kuramae* arena is now global.

Do you know ? 2 top sumo wrestlers, called *Yokozuna* are from Mongol. And we see many others in the arena from Korea, China, Bulgaria, Georgia, Estonia, Russia, USA and so on. They all observe the standard rule of the Sumo game.

The path to a true global market, I am sure, is now ahead of us to run along together.

Thank you very much for you attention.
