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## ***Does Japan's Bond Administration System Remain "Hollow Words" in the New Company Law as Well?***

*Satori Inui,  
Associate Senior Economist*

The new Company Law slated for enactment in fiscal 2006 among its text also contains provisions concerning corporate bonds stipulated in the conventional Commercial Law. However, while dressed in the new mantle of a revamped Company Law, when it comes to a bond administration system established in the interest of protecting bondholders, it would appear that the so-called "hollow words" status of having a law on the books that cannot be utilized is destined to drag on in this legislation as well.

In Japan's bond market of the past, when a company's business fortunes began to list and the danger of defaulting on corporate debentures appeared at hand, the trustee bank would buy up the bonds in question and investors be saved from major losses. That practice is largely a thing of the past. The number of listed companies going belly up has increased, leading to cases in which defaults on publicly issued bonds have a direct impact on bondholders. At such times, it is the bond administrator that shoulders the role of acting on behalf of bondholders to preserve their rights. Flying in the face of this scenario, however, is the reality that the large majority of bonds are issued without establishing any bond administrators whatsoever.

### ***Increasingly Fewer Trustees on Public Issued Bond Market Too***

Under Article 297 of the current Commercial Law ("pre-revision Commercial Law") stipulating provisions vis-à-vis corporate bonds, following the revisions in 1993 the establishment of a bond administrating company (referred to by the name of "corporate bond administrator" in the Company Law) is required in place of the conventional trustee company. But there are also exceptions to this rule. In cases when the minimum face value of the bond is 100 million yen or more, or less than 50 bonds are issued, bonds may be issued without an administrating company (no trustee).

This clause has triggered a broad increase in bonds issued without trustees, a practice originally envisioned as an exception to the norm, as issuers strive to lower floatation costs by slashing fees paid to bond administrating companies. For example, of the 114 publicly issued straight bonds floated during the first half of the current fiscal year (excluding electric power company, bank and NTT bonds), 97 of those debentures were issued without trustees. On an issue value base, this is an 87% share.

The exception stipulation under Article 297 of the pre-revision Commercial Law generally reflects the conditions for “private placement” listed in the Securities and Exchange Law (including related government ordinances, same below). For public offerings the establishment of bond administrating companies is mandatory from the perspective of bondholder protection, with bonds lacking trustees permitted for private placements (because they are instruments limited to a narrow range of investors). The problem is that the pre-revision Commercial Law failed to adequately reflect the thinking present in the Securities and Exchange Law.

### **“Exceptions” Rise to Over 80%**

(Public issue straight bonds during first half of FY2005)

	Issues	Value (¥100 million)
Volume	114	21,620
With trustee	17	2,895
Without trustee	97	18,725
(% share)	(85.1)	(86.6)

Source: Japan Securities Dealers Association Materials.

Note: Total for general business bonds issued during April-September 2005 (excludes electric power company, bank and NTT bonds).

### ***Subtle Differences Between the Commercial Law/Company Law and Securities and Exchange Law***

There are two types of private placements stipulated under the Securities and Exchange Law: (1) “Small-lot private placements” limited to less than 50 investors; and (2) bonds issued and sold only to “accredited institutional investors” possessing professional knowledge and experience with securities (so-called “professional private placements”). The term “accredited institutional investor” in effect refers to securities companies, banks, insurance companies and other financial institutions.

With regard to the small-lot private placements listed in “(1)” above, the stipulation in the pre-revision Commercial Law was “less than 50 certificates.” With less than 50 bond certificates available, there is no possibility of more than 50 investors holding such bonds. With the number of investors so limited, it is possible to issue bonds without trustees.

The problem comes with the “professional private placements” in category “(2).” In the Commercial Law before revision, the condition for issuing bonds without trustees is that the par value be 100 million yen or more. While this is most likely based on the view that investors able to spend 100 million yen even at a minimum are “professionals,” the drawing of the line based simply on the amount of money being invested creates gaps with the spirit of the Securities and Exchange Law (which is rooted in perceived professional caliber as an investor.).

This point is carried over almost identically in the Company Law. While Article 702 of that legislation indicates the establishment of bond administrators, as in the pre-revised Commercial Law an exception is granted for bond value of 100 million yen or more. In other corporate bond-related stipulations, bond administrator authority and responsibility are strengthened and other improvements made. Yet regardless of how many steps are taken to enhance the bond control system, the truth is that there are very few opportunities to put those provisions to use. Even after the Company Law comes into force, it is believed that in almost all cases the exception clause will be utilized to issue bonds without trustees. It is difficult to find any incentive for the issuing companies to expressly establish administrators for these debentures. If bonds without trustees account for the majority of the issues on the market, even investors who prefer bonds with trustees (versus bonds without them) will effectively forego nearly all opportunities to invest in straight bonds if they decline to put their money into the non-trustee varieties. In that sense, therefore, the provisions pertaining to bond administrators would appear to amount to so many “hollow words.”

### ***Investment Professionals Not Necessarily Obligation Preservation Pros***

This poses the question of whether as long as someone invests over 100 million yen should they be viewed as an accredited institutional investor – in other words, a professional investor? Even if proceeding on this assumption, there will be certain professional investors who are not of genuine expert caliber when it comes to maintaining rights and debt collection. If the companies issuing the bonds continue to make interest payments and redemptions are made without a hitch, there is little need to raise a fuss over the presence or absence of bond administrators to collect on that debt. Plainly stated, the value of having bond administrators around is manifested when the bond teeters on the edge of default or actually goes into default. At such times, however, it will already be too late to whine about why no bond administrator is around. As was the case in the distant past, meanwhile, there is also no hope for the main bank of the issuing company to jump in and protect bondholders.

In summation, with regard to the necessity of bond administrators, the Company Law merely follows in the footsteps of the Commercial Law prior to its revision. This leaves a nagging impression that truly essential discussions on the topic of the bondholder protection system have yet to be advanced to an adequate degree.

( Contact : 81-3-3639-2756 )

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#### **Japan Center for Economic Research (JCER)**

Nikkei Kayabacho Bldg. 2-6-1 Nihombashi Kayabacho, Chuo-ku, Tokyo 103-0025, Japan  
Phone:81-3-3639-2810 / FAX:81-3-3639-2839 / E-mail:jcernet@jcer.or.jp