

Points to Note concerning Settlement Failure for Stocks

September 29, 2017 Version

Japan Securities Dealers Association

This translation is prepared solely for information purposes. The Japanese version should be referred to for the accurate content of the report.

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I. Background

Partly because of rising consciousness in reduction of settlement risks triggered by the Lehman Brothers collapse and other events, most jurisdictions in major overseas markets have either moved to T+2 stock settlement cycle or are deliberating the timing of such a move.

In light of this, the “Working Group on Shortening Stock Settlement Cycle” (hereinafter, “WG”) was established in July 2015 under the Japan Securities Dealers Association’s “Council on Securities Delivery and Clearing/Settlement Systems Reform,” and has conducted cross-industrial detailed studies towards realization of the implementation of T+2 stock settlement cycle. The WG released its “Final Report of the Working Group on Shortening Stock Settlement Cycle in the Japanese Market” in June 2016.¹

The Final Report states that non-resident transactions account for approximately 60% of those in the Japanese equity market, and that, because many related parties, both domestic and foreign, stand between the parties in transactions with non-residents, including overseas brokers and global custodians, and transactions with non-residents tend to be influenced by time differences and their own local holidays, an increase in the settlement failure is envisaged if no measure is taken. Under these circumstances, it was decided to compile measures for avoidance of settlement failure to be incorporated into guidelines.

Consequently, the WG and one of the WG’s sub-working groups (“Customer Side Sub-Working Group”) and its subordinate sub-working group (“Practice Review Group concerning Settlement Failure”) conducted studies on specific details. These “Points to Note concerning Settlement Failure for Stocks” (hereinafter, “Points to Note”) are a summary of those results.

Furthermore, the Points to Note focus on matters related to the avoidance of settlement failure, and there are plans to reflect matters relating to handling of settlement failure of non-exchange stock transaction deliveries in the Points to Note as necessary, taking account of the results of studies such as the one conducted by the Practice Review Group concerning Settlement Failure.²

II. Purpose

The shift to T+2 for stocks might exacerbate the risk of settlement failure, so the purpose of the Points to Note is to prescribe the market practices for avoiding settlement failure in the Japanese markets.

¹ The Final Report states the expected implementation date for T+2 settlement cycle is to be right after the consecutive non-business days in April or May 2019.

² In terms of matters relating to settlement failure for non-exchange stock transaction deliveries, the Final Report indicates that the basic policy for handling in an occurrence of a settlement failure on a record date shall refer to the “Guidance for Clearing Participants upon Occurrence of Settlement Failures on a Record Date,” created by the Japan Securities Clearing Corporation, so that there can be consistency.

The Points to Note will not in any way restrict the rights of market participants permitted by law, and practice in line with the Points to Note is anticipated to foster smooth execution, so more market participants are expected to adopt practice in line with the Points to Note.

In addition, both domestic and foreign market participants and trading parties are also expected to adopt practice that respects the Points to Note as it become more well-known and there is more awareness among market participants.

Furthermore, the Points to Note are not intended to prevent the use of measures other than the Points to Note in accordance with agreements between both domestic and foreign market participants and trading parties.

III. Definition of Terms

Terms in the Points to Note are defined as follows.

a) Stocks

The following items as prescribed in Paragraph 2, Article 2 of Japan Securities Depository Center, Inc. (hereinafter, "JASDEC") "Operational Rules Regarding Book-Entry Transfer of Shares, Etc." and Item 1, Paragraph 2, Article 4 of JASDEC DVP Clearing Corporation (hereinafter, "JDCC") "Business Rules."

Stocks; stock acquisition rights; corporate bonds with stock acquisition rights; investment units; rights offering for investment corporations; preferred equity investments; investment trust beneficiary rights; beneficial rights of trust issuing certificates of beneficial rights; foreign stock certificates, etc.

b) Non-exchange stock transaction deliveries

Transfers in the Book-Entry Transfer System for Shares, etc. operated by JASDEC other than transfers cleared on an exchange.

c) JASDEC Participant

Members conducting non-exchange stock transaction deliveries and Indirect Account Management Institutions.

d) Delivering participant

The JASDEC Participant bearing the obligation to deliver the relevant securities to the receiving participant for settlement of a purchase and sale transaction, etc.

e) Receiving participant

The JASDEC Participant that agreed to receive the relevant securities relating to the purchase and sale transaction, etc. from the delivering participant.

f) Settlement failure

Failure by the delivering participant in the transaction to hand over securities on the settlement date by the settlement cut-off time for securities delivery.

g) Market participants

Persons/entities that accept transactions from trading parties and execute such settlements, etc. (e.g., securities companies, sub-custodians, and trust banks).

h) Trading parties

Persons/entities that invest in stocks (e.g., individual investors, foreign investors, institutional investors, and securities companies).

i) Corporate gifts

A service freely provided by an issuer such as the issuance of discount vouchers for a company's products and services to shareholders for the issuer's objective of securing individual resident shareholders and increasing the awareness of the company's own products and services.

IV. Market Participants' Obligation of Good-Faith Efforts

Since settlement failure is anticipated to have various impact (see "V. Impact of Settlement Failure"), market participants shall make all possible efforts to avoid settlement failure, and if a settlement failure unavoidably occurs, act in good faith to resolve the settlement failure as soon as possible.

V. Impact of Settlement Failure

The following are the main anticipated impacts upon the occurrence of settlement failure for stocks.

1. Impacts of settlement failure at normal times (other than on the record date)

(1) Settlement risks

Settlement risk due to an increase in the outstanding balance upon the occurrence of settlement failure.

(2) Impacts on subsequent transactions

Impact on subsequent transactions (e.g., market settlement, establishment of ETF, participation in a takeover bid, establishment of collateral, and transfer of control between business entities) upon the occurrence of settlement failure.

2. Impacts of settlement failure on the record date³

(1) Impacts on shareholders' rights

a) Dividends

The inability to pay the dividends that normally would have been paid to shareholders affected by a settlement failure.

b) Voting rights at a general meeting of shareholders

The inability to allocate voting rights (that can be directly exercised to the issuing company by shareholders recorded in the shareholder register) that normally would have been allocated to shareholders affected by a settlement failure.

(2) Rights handling

Where there is handling of rights such as in the case of a corporate merger when there is an outstanding settlement, it may be possible to deliver stocks and the number of units after the handling of rights or an inability to deliver the stocks.

The following are specific examples of rights handling.

a) Stock split

b) Stock merger

c) Allotment of stocks without contribution

d) Allotment of stock acquisition rights without contribution

e) Paid-in capital increase

f) Stock swap, stock transfer, corporate merger

g) Corporate split, stock distribution

h) Delisting

(3) Corporate gifts

Inability to allocate corporate gifts that normally would have been provided to shareholders affected by a settlement failure.

³ According to the Act on Book Entry of Corporate Bonds and Shares, generally, persons/entities (participants) holding balances (balances already received) in the book-entry transfer account registers on the record date are recorded in the shareholder register. Since there is a direct link between persons/entities (participants) holding balances in the book-entry transfer account registers on the record date and shareholders recorded in the shareholder register entitled to exercise the rights of shareholders, adequate consideration needs to be given to the fact that remedy of shareholders' rights for participants not holding a balance in the book-entry transfer account registers upon occurrence of a settlement failure on the record date is limited to alleviating the economic disadvantage between the account management institutions.

VI. Causes of Settlement Failure

The following items are main causes for the occurrence of settlement failure.

- a) Inability to procure stocks that should have been delivered
- b) Settlement instructions did not match
- c) Unable to resolve the gridlock
- d) Administrative error, mistaken order

VII. Measures to Avoid Settlement Failure

Market participants shall take the following measures to avoid settlement failure.

1. Confirmation of settlement information at the order execution phase

Market participants shall endeavor to thoroughly confirm the information relating to settlement controlled by market participants (so-called standing settlement instruction [SSI] information) and pre-settlement matching items from the order execution phase by reviewing the operations with systems for their assistance and issuing alerts to departments and relevant parties involved in relation to order execution such as front office departments.

*Pre-settlement matching items: Referred to as items for collation in the pre-settlement matching system provided by JASDEC. Refer to the “Pre-settlement Matching System Connection Specifications (procedural edition [domestic transactions] and [non-resident transactions]).” Specifically, pre-settlement matching key, settlement date affixed, issue code, form of securities, quantity, settlement conditions code, delivering settlement agent, receiving settlement agent, etc.

2. Acceleration of settlement instructions

To avoid inconsistencies in order execution and settlement instructions with trading parties, market participants will endeavor to quickly provide allocation instructions and settlement instructions to facilitate quick pre-settlement matching in JASDEC.

In addition, market participants shall send settlement instructions to JASDEC without delay.

3. Ensuring accuracy of settlement instructions

Market participants shall appropriately confirm the details recorded in the settlement instructions, etc. sent in accordance with 2. above, and endeavor to quickly ensure that

the settlement instructions are matched. Any mismatch will be quickly confirmed with the trading parties and correct settlement instructions sent.

4. Guiding principles for the settlement date

On the settlement date, market participants shall endeavor to respond as follows within the scope of their authority and discretion while confirming with trading parties as necessary.

(1) Guiding principles relating to pre-settlement matching for non-resident transactions

- a) In terms of pre-settlement matching relating to unmatched or mismatched non-resident transactions, unless otherwise agreed between the trading parties, pre-matching shall be completed by the settlement matching cut-off time.
- b) Coordinate as much as possible in order to resolve items that despite being matched cannot be released due to gridlock with non-resident transactions.

(2) Guiding principles concerning settlement (DVP settlement of non-exchange stock transaction deliveries, etc.)

- a) An awareness of the upper limit on the Net Debit Cap and a short-fall in the Margin Value in terms of risk management under JDCC so that settlement cannot be delayed.
- b) Aim for quick resolution through methods such as Settlement Facilitation Payment if exceeding the upper limit on the Net Debit Cap or there is a short-fall in the Margin Value in terms of risk management.
- c) Use and process effectively not only for same day transfer requests, but also previous-day transfer requests.
- d) Consider the impact in the entire market for outstanding settlements of non-resident transactions in particular, with the delivering participant to take settlement failure avoidance measures, such as procurement through the borrowing of stocks at the earliest possible timing, to complete settlement by the settlement cut-off time (market practice).

5. Guiding principles to avoid settlement failure on the record date

Market participants shall endeavor to respond as follows within the scope of their authority and discretion while confirming with trading parties as necessary, to prevent settlement failure for non-exchange stock transaction deliveries on the record date.

- a) For transactions just before the record date, pay special attention to the location of balances such as order execution after confirmation that there is a balance at the time of order.
- b) Aim to resolve settlement failure as much as possible through settlement failure avoidance measures such as borrowing stocks on the same day.

- c) Due to concerns of a chain reaction impacting on Japan Securities Clearing Corporation (hereinafter, “JSCC”), issues for which settlement failure is prohibited by JSCC should not have settlement failure for non-exchange stock transaction deliveries.
- d) After confirming settlement failure in JSCC at 1:00 p.m. on the settlement date, resolve the settlement failure by the 3:30 p.m. non-exchange stock transaction deliveries cut-off time.⁴
- e) Where measures for stocks cannot be completed by the 3:30 p.m. non-exchange stock transaction deliveries cut-off time on the settlement date and there is compliance with certain conditions such as the existence of remaining balance at transferor, investigation will be made to see if delivery can be made with additional transfer to the extent feasible.⁵

6. Establishing market participants’ structure

Market participants shall endeavor to establish the system necessary to respond to avoiding settlement failure noted above.

⁴ Transfers to resolve settlement failures are transfers that do not pass through JSCC, so this does not necessarily resolve the settlement failure within JSCC itself.

⁵ It is important to note that the relationship between the acceptance cut-off time and the number of items that can be accepted on JASDEC for execution of additional transfers means not all additional transfers can necessarily be executed.

Appendix: Types of cut-off times

1. Exchange transactions

Time	Operations
1:00 p.m.	Cut-off time for delivery and receipt of securities with JSCC settlement

2. Customer transactions (non-resident transactions)

Time	Operations
12:20 p.m.	Settlement matching cut-off time
12:40 p.m.	Settlement cut-off time for delivery and receipt of securities (market practice)
2:00 p.m.	Cut-off time for delivery and receipt of securities for DVP settlement of non-exchange stock transaction deliveries ^{*1}
3:30 p.m.	Cut-off time for delivery and receipt of securities for non-exchange stock transaction deliveries (non-DVP)

3. Customer transactions (domestic transactions)

Time	Operations
1:30 p.m.	Cut-off time for delivery and receipt of securities for DVP settlement of non-exchange stock transaction deliveries (Stock lending) ^{*1}
2:00 p.m.	Cut-off time for delivery and receipt of securities for DVP settlement of non-exchange stock transaction deliveries (other than stock lending) ^{*1}
3:30 p.m.	Cut-off time for delivery and receipt of securities for non-exchange stock transaction deliveries (non-DVP)

4. Other (additional transfers)

Time	Operations
5:00 p.m.	Cut-off time for submitting request to deal with additional transfer ^{*2}

*1 The cut-off time for acceptance of settlement instructions relating to the securities transfer request when using the pre-settlement matching system (linked cut-off time) is 10 minutes before each respective cut-off time.

*2 The Final Report indicates dealing with “additional transfers” as flexibly as possible, so Japan Securities Depository Center, Inc. plans to release a separate “Business Processing Outline” and additions and amendments will be made as necessary according to such details.