

Tentative Translation

Abstract of the Final Report of the Working Group on Shortening Stock Settlement Cycle in the Japanese Market

June 30, 2016

Working Group on Shortening
Stock Settlement Cycle

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 of Study

Background of study

- In light of major overseas markets' trend of shortening stock settlement cycle (towards T+2), a “working group on shortening stock settlement cycle” (WG) was established in July 2015 to start detailed discussion for realizing T+2 in Japan.
- WG started the study aiming at presentation of key aspects related to T+2 settlement flow and target implementation time within 2015, and coordination of other remaining tasks by June 2016.
- On December 29, 2015, WG published its interim report presenting policies on key tasks surrounding shortening stock settlement cycle (towards T+2) and the target schedule for implementation of T+2 settlement cycle.
- After its publication of the interim report, WG worked on the studies of the tasks raised in the interim report as remaining tasks for study, and published the study results at WG to date as the final report.
- Outlined in this material are the policies on each task presented in the final report and the target schedule for the implementation of T+2 settlement cycle.

II. Policies on each Task (1) Acceleration of Loan Transaction Handling & Improvement of Trade Environment

Study Item

There is a need to re-examine operation flow in stock lending transactions, because T+1 and T+0 stock lending transactions will become more important for short coverage and fail coverage, etc. respectively, in association with implementation of T+2 settlement cycle.

Policies

- Establishment of Guidelines, etc.
 - To enhance efficiency and accuracy in the stock lending transaction operational process, the guidelines or other rules to cover the following items will be established:
 - Market value to be used for the calculation of collateral value, etc.;
 - Handling of prioritization of stocks to be returned when there are multiple loan balance legs;
 - Balance management upon occurrence of corporate action;
 - Partial revision, etc. of “Master Agreement on the Borrowing and Lending Transactions” and memorandum.
- Migration of T+2 Stock Lending Transactions to T+1 Cycle
 - Promote standardization and enhancement of efficiency of the operational process through the establishment of the above-mentioned guidelines, and secure hours available for loan trade execution for market participants as much as possible (specific timing is subject to ongoing study)
- Dealing with T+0 Stock Lending Transactions
 - To expand scope of the market participants for T+0 stock lending transactions, promote participation of broad range of participants.
 - To enhance efficiency of the operational process, promote utilization of the stock lending DVP settlement for T+0 stock lending transactions and JASDEC to consider revision of system processing details for stock lending DVP (subject to ongoing study).

II. Policies on each Task

(2) Rules on Settlement Failure

Study Item

Settlement failure ratio is estimated to rise to some extent, especially in transactions with non-residents. There is a need to review rules on settlement failure to promptly cope with it.

Policies

- Rules on Settlement Failure for JSCC Settlement
 - For JSCC to establish “Guidance for Clearing Members upon occurrence of settlement failures on a record date” which describes standard manner for operational handling after settlement failure occurred on a record date, detailed the contents of the said Guidance.
As it was decided that the said Guidance could be the reference for all investors, including overseas investors, also upon occurrence of settlement failure in the settlement for non-exchange transaction deliveries (mentioned below), it shall be borne in mind in the study of the future revisions, and English translation of the Guidance will also be prepared.
 - Current rate of charge for settlement failure will be maintained. Counting method of charge for settlement failure will be changed to calendar day basis from the prevailing business day basis.
- Rules on Settlement Failure for settlement of non-exchange transaction deliveries
 - Establish “Guidelines on settlement of non-exchange stock transaction deliveries” to cover the following:
 - Measures to prevent settlement failure in settlement of non-exchange stock transaction deliveries: Subject to ongoing study having in mind situations, such as awareness building for overseas investors, and on an assumption of including these measures into the Guidelines
 - Treatment upon occurrence of settlement failure on a record date in settlement of non-exchange stock transaction deliveries: To be consistent with the Guidance established by JSCC, set forth the rules in the Guidelines to “refer to JSCC Guidance.”
- Other
 - As a remedial measure upon occurrence of settlement failure on a record date, policies are to flexibly deal with “additional transfer” as much as possible. Also, broader study, not only the operational aspects, would become necessary for remedy in the rights of beneficial shareholders, such as voting rights

II. Policies on each task

(3) Transactions with Non-Residents

Study Items

- There is a need to study measures on transactions with non-residents, because post-trade handling in such cases will become tight, considering time differences with European and U.S. markets and holidays.
- Settlement failure ratio is estimated to rise to some extent, especially in transactions with non-residents. There is a need to study flexible measures to avoid settlement failures in order to settle transactions as scheduled.

Policies

- In order to make settlement instructions on non-resident transactions earlier and more accurate, and also to take prompt measures in such cases as matching discrepancies, promote establishment of the structure for avoidance of settlement failure (such as to accelerate and enhance accuracy of settlement instructions and respond to inquiry (early resolution of discrepancy, partial settlement, etc.)) on the part of the parties involved in the market, including overseas entities, through market infrastructure organizations and domestic parties involved.
- Upon disseminating information overseas, English documents should also be prepared and dissemination of information should be started at early stage through market infrastructures and domestic parties involved.
- As to flexible measures, such as partial settlement, coordinate as necessary on a bilateral basis, as it is considered to advance subsequent settlement process and to be beneficial for a reduction of the settlement failure ratio.

II. Policies on each task (4) Revision in Cut-off Times in Clearing & Settlement Infrastructures

Study Items

- Study whether revision is necessary for settlement cut-off times in clearing and settlements infrastructures, in light of the fact that daily operations processes on the settlement day would become much tighter due to the move to T+2 and the needs to secure available hours for execution of T+0 stock lending transactions.
- In addition, study whether revision is necessary for cut-off time for error correction at stock exchanges, and for data distribution schedule from JSCC.

Policies

- Various settlement cut-off times are set to remain unchanged upon implementation of T+2 settlement cycle.
- Extend cut-off time for error correction at stock exchanges from 13:00 to 14:00. Optimization of contents and distribution timing of various related data at JSCC will also be promoted.
- On the other hand, in light of future environmental changes surrounding T+0 stock lending transactions, such as treatment of remittance upon introduction of *Zengin-net* 24 hour service and treatment of funding and investment of surplus, and paying attention to avoid system development overlap, extension of settlement cut-off times to achieve satisfactory effect will be subject to ongoing study.

Various Settlement Cut-off Times, etc.	Cut-off Time
Cut-off time for settlement matching for transactions with non-residents	12:20
Cut-off time for JSCC's DVP Settlement (for exchange traded transactions)	13:00
Cut-off time for lending DVP settlement	13:30
Cut-off time for non-exchange DVP settlement	14:00
Cut-off time for FOP settlement	15:30

II. Policies on each Task

(5) Treatment of Customer Margin and Additional Margin in Margin Transactions, Study of Operational Flow related to Stock Lending Application for Bidding

Study Items

- Study cut-off time for provision of customer margin and additional margin in margin transactions
- Study whether revision is necessary for operational flow and schedules in association with implementation of T+1 settlement cycle for stock lending excess issues at securities finance companies

Policies

1. Treatment of Customer Margin and Additional Margin in Margin Transactions

- As to customer margin, while pre-settlement deposit is considered desirable from viewpoint of its positioning as collateral and avoidance of excessive speculation arising from the possible deposit of profit from margin transaction itself as customer margin, it is also desirable to secure time for customers and securities firms for the operational process as much as possible. So, deposit cut-off time shall be noon on T+2.
- As to additional margin, from viewpoint of making the structure easy to understand, deposit cut-off time shall be the same as customer margin, i.e., noon on T+2.

2. Operational Flow related to Stock Lending Application for Bidding

- The schedule of stock lending application for bidding will remain unchanged, because decrease in bidders and rising of premium charge are expected if the bidding schedule is shortened or moved forward.
- At the end of fiscal year when handling of lending stocks tends to be delayed, and when issues failing to procure through the bidding occur, publication of data for loans for margin transactions by securities finance companies should be made by 1:00 p.m. at the latest by means of revision of operations at the securities finance company.
- Regarding operational flow for stock procurement in case of issues failing to procure through the bidding and treatment when it is difficult to procure stock lending excess issues, securities finance companies and concerned people will continue discussion.

II. Policies on each Task (6) Settlement cycle of BOJ Investment Securities for Capital Contribution and non-Exchange Traded Securities

Study Items

- BOJ investment securities for capital contribution are settled via physical delivery of securities certificates on T+3 in normal cases and exceptionally T+4 in case where traded date falls on ex-dividend date. Study treatment and settlement cycle after shortening settlement cycle.
- Study treatment of settlement of non-exchange traded securities (bonds, foreign securities and investment trusts) after implementation of T+2 settlement cycle for domestic exchange-traded stocks, etc.

Policies

1. Settlement Schedule for BOJ Investment Securities for Capital Contribution

- As to BOJ investment securities for capital contribution, while paperless operation would be desirable, it is considered that various laws and ordinances need to be revised in order to realize paperless operation. So, request competent authorities to consider revision of relevant laws and ordinances.
- Considering a situation where paperless operation would be difficult due to legal restraint and there is no other option than to continue physical delivery, settlement cycle under such assumption shall be in line with stocks, etc. in light of easiness to understand for investors and burden on participants side (T+2 in normal cases but exceptionally T+3 in case of traded date falling on ex-dividend date).

2. Treatment of Non-Exchange Traded Securities

- In light of simplicity (settlement cycles among products) and convenience (trading in different products) for customers, and scope of shortening settlement cycle at other overseas markets, try to shorten settlement cycle to T+2 for JGB retail trading, straight bonds (referring to issues covered by JASDEC's Book-Entry transfer system for Corporate Bond and Municipal Bonds) and foreign securities. For investment trusts, settlement cycles differ significantly depending on product. As there are restrictions due to settlement cycle in composite products, no uniform treatment will be adopted.
- Proceed with study in a direction of migration to T+2 at the same timing as the implementation of T+2 for domestic listed stocks, etc. and detailed implementation timing will be determined in light of necessary discussion at related conference body, such as JSDA.

II. Policies on each Task (7) Other Tasks, etc. Associated with Implementation of T+2 Settlement

Study Item

Also study the following items expected to arise due to the move to T+2

- Transactions outside stock exchanges
- Settlements related to a record date for convertible bonds and exercise/assignment of securities options
- Delivery of trade reports

Policies

1. Transactions Outside Stock Exchanges

- It is desirable to move to T+2 for transactions outside stock exchanges, but it should still be determined by the separate OTC trading parties. For PTS cleared by JSCC, arrange to move to T+2 in the same manner as exchange traded transactions.

2. Settlements related to a record date for convertible bonds and exercise/assignment of securities options

- Shorten settlement schedule by 1 business day.

3. Delivery of trade reports

- Each firm to make its utmost efforts in an enhancement of operational efficiency and continue their effort to promptly deliver written trade report to customers after implementation of T+2 settlement cycle.

Other

After implementation of T+2 settlement cycle, settlement failure ratio is presumed to rise and there remain possibility that settlement failures may not be controlled sufficiently. In order to reduce occurrence of settlement failures as much as possible and to maintain the same level of settlement failure ratio as today's level, it is desirable to take more fundamental measures. From such viewpoints, as detailed measures, it was requested to seek possibility of striving for enhancement of efficiency of clearing/settlement scheme and operations by building a structure that enables netting between DVP settlement of non-exchange stock transaction deliveries and DVP settlement of exchange traded stocks, etc. So, it was decided that parties involved will study on this point in parallel with the study on implementation of T+2 settlement cycle.

III. Target Schedule for T+2 Implementation for Stocks, etc

Target Schedule for T+2 Implementation

- In setting target schedule for implementation, process and time periods required for T+2 implementation are expected as follows:
 1. Study on tasks at WG and report study results (by June 2016)
 2. System development and establishment of internal structure on market participants side (approx. 2 years)
 3. Implementation of necessary scheme and rule revisions at market infrastructures, etc. and preparation for comprehensive running test, etc. (approx. 2 years)
 4. Implementation of comprehensive running test (approx. 6 months)
- Market is in the process of preparation for JGB T+1 settlement cycle scheduled for the first half of 2018 (excluding transactions with non-residents). From viewpoint of settlement stability of the Japanese market as a whole, smooth implementation and stable operation of JGB T+1 settlement cycle (including coupon payment and redemption process) should be confirmed in advance to the migration of Stocks, etc. settlement cycle to T+2.
- In light of the above, the target schedule for T+2 implementation is set at “as early as possible in 2019.”
 - * However, if necessary in light of the future study status/results of the tasks that require detailed study and status of preparation at market participants, revision of the target implementation schedule would be considered.

Expected T+2 Implementation Date based on Target Implementation Schedule

- As to the specific T+2 implementation date, it is required (i) to be after the confirmation of stable operation of JGB T+1 settlement cycle, and (ii) to secure time schedule with at least 3 consecutive non-business days. Possible schedule to satisfy above requirements are consecutive non-business days in April or May 2019.
- In light of the above, based on current target implementation schedule (i.e., as early as possible in 2019), expected implementation date is set at **the business day after the consecutive non-business days in April or May 2019.**

III. Target Schedule for T+2 Implementation for Stocks, etc

Illustration of Timelines

- After publication of WG final report, WG, sub-WG and operation review groups will continue their study on the items that are decided to be subject to ongoing study.
- Simultaneously with the above-mentioned detailed study, each party concerned in the market will proceed with following preparation work followed by the publication of the final report.
 - Market infrastructures and related organizations will develop system specifications to be changed and required rules and guidelines in light of the final report and the above-mentioned study results.
 - Each market participant will start preparation for building internal structure and system required.
 - Market infrastructure organizations will proceed with preparation for comprehensive running test with market participants and report test plan to WG, and WG will check the test plan.
 - Base on the test plan checked at WG, parties concerned in the market will implement the comprehensive running test. Whether or not to go live on T+2 settlement cycle will be judged based on the test results.

III. Target Schedule for T+2 Implementation for Stocks, etc

Illustration of Timelines

