Questions & Answers about

Settlements under “The Japanese Government Securities Guidelines for Real Time Gross Settlement” and “Practical Guidelines for Handling of Fails Charges”

November, 2010 Version

Japan Securities Dealers Association

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<u>Introduction</u>

With the huge expansion and globalization of financial transactions, many countries are facing the growing necessity to implement measures to reduce risks relating to settlement systems. Among others, it is becoming one of the urgent issues to address settlement risks relating to securities settlement systems. In Japan, the Bank of Japan (BOJ) launched “Real Time Gross Settlement” (“RTGS”) for the Bank of Japan Financial Network System JGB Services (the BOJ-NET JGB Services) on January 4, 2001. As a settlement system conforming to the global standards, RTGS has been enabling smooth and speedy delivery of funds and securities. Owing to RTGS, systemic risks at the time of a default in government securities settlements by the BOJ-NET JGB Services are reduced and real time (immediate) finality is realized. Furthermore, RTGS serves as infrastructures to enable market participants to manage counterparties’ settlement risks in real time and enhances the settlement system stability on the government securities market.

In the meantime, Japan Securities Dealers Association (JSDA) set up a study group concerning the introduction of RTGS for government securities composed of the members selected from securities firms, banks, trust banks, government-affiliated financial institutions, and life insurance companies, and this study group started to have discussions, with the aim of establishing the market practice and related rules and regulations to be followed by market participants to mitigate their burden of procuring funds and government securities and ensure smooth and stable settlement procedures for transactions in government securities based on the BOJ-NET JGB Services. As a result of these discussions by the study group, JSDA formulated “The Japanese Government Securities Guidelines for Real Time Gross Settlement” (the “RTGS Guidelines”) and presented them to securities firms and other related persons.

Since the global financial crisis emerging in 2008, market participants have strongly recognized the necessity to review the Fails Practice and other processes in bonds settlements. Considering this background, with the intention of preventing frequent occurrence of settlement failures and further establishing the Fails Practice, the Working Group concerning Review of Fails Practice for Bond Trading was established in May 2009, as a subordinate organization of JSDA’s Bond Committee, composed of members covering a broad range of market participants. With a view to offshore settlements in yen and other global trends, this Working Group has been reviewing the scope of DVP settlements subject to the Fails Practice and discussing how to establish the Fails Practice further. In April 2010, the final report was publicly announced by the Working Group. Based on this report, JSDA revised the RTGS Guidelines in June 2010.

While JSDA provides answers to the inquiries about the RTGS Guidelines from market participants on a case-by-case basis, JSDA has prepared the handbook of Questions and

Answers in parallel, because it is considered to be instrumental in facilitating smooth and stable settlements to provide more adequate explanations about the background of the formulation and revision of the RTGS Guidelines and the contents of applicable rules and regulations. As part of the revision of the RTGS Guidelines to launch the scheme of Fails Charges, JSDA has newly established the "Practical Guidelines for Handling of Fails Charges" (the "Fails Charges Handling Guidelines"). In addition, the provisions regarding the Cut-off time and the required conditions for the application of the Fails Practice have been modified. Based on these changes, JSDA has examined and completely modified the former Questions and Answers handbook.

All market participants are welcome to raise any comments or opinions, especially from practical standpoints, and JSDA is going to continue efforts to review and improve the market practice for RTGS from time to time.

Q1: What is the limitation on size of settlements?

A: The limitation on size of settlements is a market practice to set an upper limit on size of settlements processed through the BOJ-NET JGB Services at five billion yen in face value per settlement. Yet, this does not restrict transactions with face value exceeding five billion yen.

For the purpose of matching the contract amount with the total settlement amount after splitting the contract amount into smaller portions, market participants are required to split contract slips into such units not exceeding five billion yen in face value each.

(RTGS Guidelines II.1. “Limitation on size of settlements”)

Q2: Why is it necessary to limit the size of settlements?

A: Under the RTGS system, unlike the conventional designated-time net settlement (DNS), funds and government securities are transferred and settled on gross basis and on a transaction-to-transaction basis, and multiple continuous transactions are settled in sequence while securing necessary balances of funds and government securities in parallel. Therefore, a large-size transaction requires a longer time to arrange the necessary volume of funds and government securities, possibly leading to the delay of the settlement, and one or more large-size transactions are likely to cause a drastic accumulation of settlements outstanding during the daytime.

Limiting the size of settlements is conducive to reducing the amount of funds and government securities necessary per settlement. This is believed to be very effective in resolving the delay of settlements that may be caused by temporary shortage of funds or government securities during the daytime. In addition, the limitation of the size of settlements is helpful for facilitating the netting scheme.

In view of the convenience of market participants and other practical aspects, the limitation on size of settlements does not apply to certain types of transactions with the BOJ. However, in case of transactions in government securities that tend to be sequentially executed, it is not until a broad range of market participants conform to this market practice that the standardization and systemization of settlement procedures can be promoted.

In some cases, for example, where you want to reduce the burden of back-office operations, you might prefer to exceptionally execute a transaction with face value exceeding the specified upper limit. Even in such cases, all market participants are requested to understand the purpose of the limitation as explained above and adhere to the upper limit of the size of settlement.

Q3: What is the “Cut-off time”?

A: The Cut-off time is the deadline for government securities settlements prior to the closing time of the BOJ-NET JGB Services, as decided by market participants for the purpose of recognizing Fails, etc. and completing all settlements each day.

The RTGS Guidelines stipulate that the Cut-off time is 2:00 p.m. Market participants are required to complete all transmissions of securities transfer messages by the Cut-off time.

If the transmission of a securities transfer message has not yet been completed for any transaction at the Cut-off time, the transaction will be treated as a Fail unless otherwise agreed in advance between both parties.

On condition that both parties have agreed in advance, market participants can treat any transaction as a Fail even before the Cut-off time, insofar as the transmission of a securities transfer message has not been yet completed for such a transaction.

(RTGS Guidelines II.2. “Establishment of Cut-off time and Reversal time,”
III.6. “Applications to Fails based on Cut-off time”)

Q4: Why is the Cut-off time necessary?

A: Under the RTGS system, the status of continuation of transactions or balances remaining unsettled may constantly be varying, depending on the order of settlements for pending transactions, and some transactions may not be completed within the same day if settlements of earlier transactions are delayed, or if the volumes of funds or securities become insufficient from time to time.

Considering these situations, it is necessary to set a certain period of time before each day’s closing in order that a party can, based on the results of that day’s settlements, invest or otherwise manage surplus funds, if arising due to failure to receive government securities from the counterparty, and adjust balances of intraday credits received from BOJ and finalize end-of-day balances of government securities and funds.

Based on the foregoing, in order for all market participants to complete each day’s settlements smoothly, we came to a conclusion that a certain deadline must be established as the target time for market participants to complete settlements and for the parties to respective transactions to identify Fails. In this way, the Cut-off time has been established.

Whether each day’s Cut-off time functions effectively or not could significantly affect the progress and efficiency of that day’s settlements on the market. All market participants are therefore requested to understand and comply with the market practice using the Cut-off time.

The market practice of the Cut-off time is introduced also on the market for U.S. treasury securities where the real time gross settlement is adopted, as with Japanese government securities.

(RTGS Guidelines II.3. “Guidelines for activities of market participants on the settlement day”)

Q5: What is the “Reversal time”?

A: The Reversal time is the period during which the parties can work to complete that day’s transactions by such actions as: (i) resolving a Fail if the extension of the settlement is agreed upon by both parties before the Cut-off time, (ii) investing unused funds or government securities after the occurrence of a Fail is confirmed, or (iii) correcting errors if there are any errors in the settlement procedure. It is very important to effectively use each day’s Reversal time to smoothly complete all settlements on that day.

According to the RTGS Guidelines, the Reversal time is specified as the period from each day’s Cut-off time to the same day’s closing time of the BOJ-NET JGB Services.

However, for the purpose of smoothly completing each day’s all settlement, the period of half an hour preceding the closing time of the BOJ-NET JGB Services is used mainly for correcting errors that have occurred in the settlement procedures.

In addition, the RTGS Guidelines require both parties to respective transactions to faithfully endeavor to make good use of the Reversal time and complete all settlements within the same day.

(RTGS Guidelines II.2. “Establishment of Cut-off time and Reversal time, ”
II.3. “Guidelines for activities of market participants on the settlement day”)

Q6: Why has the Cut-off time been changed?

A: In the course of drawing up the 2010 revision of the RTGS Guidelines, how to review the Cut-off time was discussed with the aim of encouraging market participants to develop their back-office systems capable of handling Fails and further establishing the Fails Practice. In consequence, considering the fact that those who have no experience of accepting and handling Fails are unfamiliar with back-office operations and management of surplus funds to be needed after the confirmation of a Fail, the Cut-off time is now set at 2:00 p.m., which was been moved forward from 3:30 p.m. as adopted before.

This Cut-off time is fixed at 2:00 p.m., even when the closing time of the BOJ-NET JGB Services is extended. Under the former RTGS Guidelines, if the closing time of the BOJ-NET JGB Services was extended for some reasons, the Cut-off time was supposed to be extended accordingly.

However, if the closing time of the BOJ-NET JGB Services is extended in an emergency under the framework of the BCP (business continuity plan) for the bond market, it is likely to be recommended to change the market practice in such a way to extend or otherwise adjust the Cut-off time.

(Note) This closing time of the BOJ-NET JGB Services (4:30 p.m.) is based on normal operating hours.

	Reviewed RTGS Guidelines (From November 1, 2010)	Former RTGS Guidelines (Up to October 31, 2010)
2:00 p.m.	Cut-off time at 2:00 p.m.	
3:00 p.m.	Reversal time from 2:00 p.m. to 4:30 p.m. (Note)	Cut-off time at 3:30 p.m.
4:00 p.m.		Reversal time from 3:30 p.m. to 4:30 p.m.
4:30 p.m.	Closing of the BOJ-NET JGB Services	Closing of the BOJ-NET JGB Services

(As of June 2010).

(RTGS Guidelines II.2. “Establishment of Cut-off time and Reversal time“)

Q7: What are the points to be considered when using the message columns in the DVP system of the BOJ-NET JGB Services?

A: In order to ensure smooth system processing among market participants, market participants are requested to strictly adhere to the manner of using the first to 30th columns as specified in the RTGS Guidelines.

This practice has been introduced, because the standardization of how to used the message columns in the DVP system of the BOJ-NET JGB Services is believed to be effective for accurate and speedy settlements through customers' accounts of the BOJ-NET JGB Services System, etc.

At present, many market participants reportedly seem to skillfully use the 31st and subsequent columns (remarks columns). In this regard, each market participant is requested to confirm the respective counterparty's system processing scheme and mutually agree on how to use the remarks columns in advance.

(RTGS Guidelines II.4. "Guidelines for ensuring smooth settlements through customers' accounts of the BOJ-NET JGB Services System, etc.")

Q8: What is a "Fail"?

A: A Fail means a situation whereby a party supposed to receive government securities is unable to receive the relevant securities from the delivering party even after the scheduled settlement date.

(RTGS Guidelines III.1. "Definition of a Fail")

Q9: What are the required conditions to apply the Fails Practice?

A: According to the RTGS Guidelines, the required conditions to apply the Fails Practice are as follows.

(1) The transaction to be treated as a Fail is a transaction based on DVP settlement (including settlement by the delivery of government securities against the payment of funds on the same date under an agreement between the parties to the transaction in which their mutual claims and debts are explicitly preserved).(Note)

(2) The transaction to be treated as a Fail is a purchase and sale transaction or a repo transaction (a starting or closing leg of a transaction in a conditional purchase and sale transaction, and lending or returning in a lending transaction).

(3) The delivery in the purchase and sale transaction or the repo transaction is performed in accordance with the manner specified in Article 4 of the “Regulations Concerning Handling of Short Sale and Lending Transaction of Bonds,” Article 11 of the same regulations, or Article 13 of the “Regulations Concerning Handling of Conditional Sale and Purchase of Bonds, etc.”

(4) The market participant must refrain from exercising the right of cancellation on the grounds of the occurrence of a Fail.

(5) It is not acceptable that the settlement remains uncompleted on the grounds that the party supposed to receive government securities is unable to prepare necessary funds.

(6) All settlements remaining uncompleted and not falling under a Fail as defined in the RTGS Guidelines must be resolved through both parties’ mutual consultations

(Note) In the course of drawing up the 2010 revision of the RTGS Guidelines, how to define the scope of DVP settlements was discussed, with reference to global trends including offshore settlements in yen for government securities after the establishment of the 2001 RTGS Guidelines, prior cases in the United States, and other related matters. In consequence, it was decided that the Fails Charge Trading Practice should apply to all DVP settlements, including not only the conventional DVP settlements by the BOJ-NET JGB Services through the delivery of government securities against and concurrently with the payment of funds, but also settlements through the delivery of government securities against the payment of funds on the same date under an agreement between the parties in which their mutual claims and debts are explicitly preserved. In this regard, DVP transactions include overseas DVP settlements, such as those settled in Euroclear or Clearstream.

(RTGS Guidelines III.3. “Required conditions to Guidelines concerning Fails”)

Q10: Who must comply with the Fails Practice?

A: All market participants executing purchase and sale transactions and repo transactions (conditional purchase and sale transactions and lending transactions) in Japanese government securities are expected to comply with the Fails Practice specified in the RTGS Guidelines.

(RTGS Guidelines I.1. “Purpose,” III.3. “Required conditions to Guidelines concerning Fails”)

Q11: Why is the Fails Practice necessary?

A: As you are aware, the Fails Practice is a well-established practice on major overseas markets and accepted by their market participants. It is well recognized among them that it is necessary to tolerate Fails for the purpose of expanding transactions and ensuring smooth and efficient settlements under the RTGS system and that they must endeavor to prevent Fails but should not deny the occurrence of Fails.

At the times when designated-time net settlement (DNS) was primarily adopted on Japanese bond markets, the Fails Practice was not introduced in terms of systemic risks and we were not in a culture that could accept Fails. Yet, circumstances have been changing, as you are aware, since the introduction of RTGS for the BOJ-NET JGB Services on January 4, 2001.

The RTGS system for government securities settlements inevitably requires more burdensome workload for a larger number of settlements, delays some settlements because of continuous transactions, and increases the likelihood of causing loop transactions (i.e., a chain of transactions among multiple entities which begin and end with the same entity, thereby forming a loop), unavoidably leading to a certain level of Fails. After scrutinizing the economic rationality and effect of the Fails Practice, applicable global standards, and other related issues, we concluded that Japan’s government securities market should introduce the Fails Practice in order to revitalize and expand transactions in Japanese government securities and ensure their smooth and efficient settlements. Consequently, the Fails Practice has been introduced. (Note 1)

To establish the Fails Practice in Japan, the idea to accept unavoidable Fails must be shared by all market participants and the Fails Practice must be positively recognized among them.

On the other hand, we are going to continue reasonable efforts to prevent the abuse of the Fails Practice to intentionally cause Fails and the frequent occurrence of Fails, because such intentional or frequent Fails might increase settlement risks and impede smooth transactions and settlements. (Note 2)

As another approach to entrench the Fails Practice, JSDA is now preparing a proposal stating the matters to be indicated in accounting books, in recognition that it is necessary to establish the bookkeeping system and the accounting procedure to be promptly followed upon the occurrence of a Fail. JSDA is going to continue necessary follow-on activities on these issues.

(Note 1) On May 29, 2001, BOJ publicly announced the "Measures for Enhancing Liquidity in JGB Markets and Transparency in JGB-Related Money Market Operations", to clarify the rules on delivery failure in transactions for operations, etc. with BOJ.

(Note 2) JSDA has established the "Regulations Concerning Resolution of Fails in Bonds Settlements" (Uniform Practical Regulation No. 4). These regulations serve as the rules to resolve a Fail that the parties to the transaction is unable to resolve for a long term. In addition, according to the "Cabinet Office Ordinance on Securities Corporation's Capital Requirements" as revised in March 2001, the risk weight applied to the counterparty causing a Fail in DVP settlements is set at 0 percent, if the Fail period is four days or less, and raised in phases according to the Fail period if it is longer than four days. This rule is effective in motivating securities firms, etc. to seek to resolve Fails at the first available opportunity.

Q12: Why have been Fails Charges introduced?

A: When a Fail that has occurred between the parties to the transaction is resolved, the amount equal to the contract amount (the sum of the principal amount and accrued interest) is supposed to be paid and received between the parties. The economic effects arising in this case are as follows.

(1) Economic disadvantage suffered by the party failing to deliver government securities (the failing party)

As the failing party is unable to receive funds that would have been paid against the delivery of government securities, the failing party will have to incur some funding costs for holding the government securities on hand or give up profit that could be earned through investing the aforesaid funds. Moreover, accrued interest to be received by the failing party will be limited to the amount attributable to the period up to the scheduled settlement date.

(2) Economic advantage given to the party receiving government securities (the non-failing party)

To the contrary, the non-failing party will be able to receive interest accrued from the scheduled settlement date to the date of actual receipt of the government securities and will have an opportunity to use funds remaining on hand because of the delayed settlement and acquire investment gains.

As JSDA has come to the conclusion that these economic effects could motivate market participants to prevent the occurrence of Fails or resolve Fails, JSDA's rules have no provisions to penalize failing parties or impose overdue charges, etc. on Fails.

Under the circumstances of low interest rates, however, the economic rationality explained above may not work effectively, and there may be a concern about frequent occurrence of Fails.

Therefore, according to the provisional rules under the former Fails Practice to address circumstances of low interest rates, the non-failing party is entitled to demand the failing party to reimburse the costs incurred because of the Fail, including funding costs for acquiring the same type of government securities as those treated as the Fail through bond lending transactions or other means. However, the former guidelines did not stipulate any specific provisions for how to reimburse such costs.

In the course of drawing up the 2010 revision of the RTGS Guidelines, how to prevent the frequent occurrence of Fails under circumstances of low interest rates were discussed for the purpose of making the Fails Practice more acceptable for market participants. As a result, it was decided to introduce Fails Charges, not as a provisional measure, but as an established mechanism to entitle a non-failing party to demand that a failing party pay a Fails Charge (a monetary burden imposed on the failing party). The introduction of Fails Charges is expected to function so that the economic rationality to endeavor to prevent Fails could effectively work even under circumstance of low interest rates.

(RTGS Guidelines III.4. "Policy regarding costs incurred under Fails")

Q13: Why is there no market practice to address failures in non-DVP settlements?

A: There are various types of settlements of transactions in government securities: DVP settlement, FOP (free-of-payment) settlement, settlement by physical delivery of certificates, and book-entry settlement. In addition, settlement instructions may be issued either through online input by the BOJ-NET JGB Services or in paper form such as a transfer instruction. In reality, therefore, settlement failures may occur in various forms and for various reasons.

Yet, the ongoing Fails Practice prescribed by JSDA is intended to apply only to DVP settlements (including settlement by the delivery of government securities against the payment of funds on the same date under an agreement between the parties to the transaction in which their mutual claims and debts are explicitly preserved). This is because the economic rationality to prevent Fails can work well under the condition where the delivery of government securities and the corresponding payment of funds are supposed to be performed on the same day (cf. Q8, Q9, and Q12).

Looking into non-DVP settlements, the delivery of government securities and the payment of funds are not necessarily performed on the same day, in which event the economic rationality to prevent Fails may not work well. In addition, in view of the fact that situations involving failures in non-DVP settlements are much more diversified than in DVP settlements, it was determined to be more practical to have the relevant parties seek a flexible resolution for such settlement failure based on individual situations, without setting a uniformed market practice (Note).

(Note) If a financial instruments business operator addresses a failure in accordance with the Fails Practice, it must be noted whether the duty of segregated custody applies or not to customers' securities or money, etc.

Q14: Why is the netting scheme introduced even under the RTGS system?

A: The implementation of RTGS for transactions in government securities is preferable to avoid systemic risks, because securities and funds are settled in real time on a transaction-to-transaction basis under the RTGS system. On the other hand, RTGS requires a larger volume of government securities and funds for settlements than in the former settlement system.

For this reason, the netting scheme has been established as a market practice in order to curtail settlement volumes for more efficient back-office operation and reduce the burden of funding costs among market participants. Under this scheme, if there are outstanding obligations owed by both parties to the other parties respectively (delivery of government securities and payment of funds) to become due on the same date, the parties must offset respective obligations and the balance after the offset ("net settlement position") will be settled between both parties.

However, taking into due consideration that the main objective of RTGS is to reduce settlement risks, the original rights and obligations under a transaction subject to the netting will remain in existence as they are, unless and until the settlement of the net settlement position is completed ("bilateral payment netting").

In order that the netting scheme can be widely accepted by market participants including investors, netting will apply to government securities with same issue and same face value under JSDA's standard netting scheme ("pair off").

Bearing in mind the points explained above, market participants are requested to use the netting scheme, for the purpose of facilitating settlements on the market.

Until now, there is neither market practice nor legislation in relation to netting in securities settlements in Japan. Thus, JSDA has obtained the Legal Opinion on Netting issued by a law firm and communicated it to JSDA's members to entrench the netting scheme.

(RTGS Guidelines IV.1. "Standard netting scheme")

Q15: What are the points to be considered when applying payment netting for securities with different face values?

A: With active transactions in government securities, many market participant are reportedly willing to use payment netting for securities with different face values, because they quite often conduct transactions involving the right to receive, and the obligation to deliver, government securities with same issue and with different face values and thus market participants dealing with large volume of settlements are eager to enhance the netting efficiency and reduce back-office workload.

Payment netting for securities with different face values is not different from a pair off in terms of the following aspects: (a) the parties have agreed to revert their relationship based on the net settlement position to the original state before the netting, if the responsible party fails to perform its obligation to settle the net settlement position; (b) the netting is deemed to be completed when the net settlement position is finally settled between the parties; and (c) the result of the netting is confirmed by the BOJ-NET JGB Services.

However, if payment netting is made for "multiple face values" vs. "multiple face values" in order to enhance netting efficiency, how to standardize the netting method and how to design the accounting procedure applied when a net settlement position is not settled by its due date may vary on a case-to-case basis, unlike the case of a pair off. Therefore, market participants are requested to review and develop necessary in-house systems before using such irregular or advanced payment netting.

(RTGS Guidelines IV.5. "Points with regard to execution of netting other than 'pair offs in bilateral payment netting'")

Q16: While it is recommended to send a prior notice to the counterparty, is this step mandatory for introducing Fails Charges? Do we have to conclude a written agreement or obtain the counterparty's seal or signature?

A: To introduce Fails Charges and put them legally in force, the parties to the transaction must reach an agreement to that effect. As the introduction of Fails Charges constitutes a significant change in the market practice governing the parties' transactions, such a significant change must be agreed upon in advance between the parties and sending a prior notice is an important process to substantiate their mutual agreement. Each market participant is therefore recommended to give a prior notice to introduce Fails Charges to each of its counterparties.

It is not necessarily required to obtain the counterparty's seal or signature to introduce Fails Charges. It is also allowed, instead of sending a prior notice, to execute a supplementary agreement, amend the applicable agreement then in effect, or make any other equivalent arrangement. However, the standard method recommended in the Fails Charges Handling Guidelines is an approach using a prior notice, because it seems less burdensome than the workload needed for any other approach such as preparing a supplementary agreement.

Q17: In what way can we introduce Fails Charges? What are the meanings of the “Confirmation Date”, the “Reference Date”, and the “Effective Date” referred to in the model form for prior notice of introduction of Fails Charges?

A: In the model form for prior notice of introduction of Fails Charges prepared by JSDA, those terms are defined as follows.

Confirmation Date:	Deadline for the counterparty’s notification objecting to the introduction of the Fails Charges Trading Practice
Reference Date:	Date on which a new transaction is executed on and after the next day of Confirmation Date
Effective Date:	Date on which both parties start to apply the Fails Charges Trading Practice

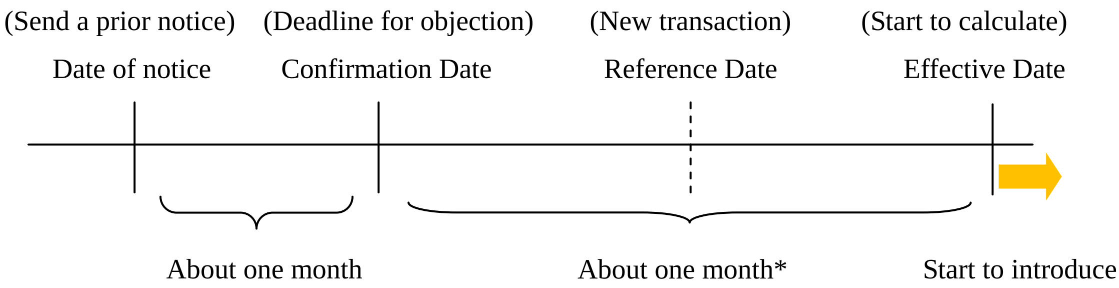
Unless an agreement to the contrary is explicitly made between the parties in connection with a specific transaction, the Fails Charges Trading Practice will apply to the Fail period after the Effective Date.

When sending a prior notice, it is also recommended to set a period of about one month each, from the date of the prior notice to the Confirmation Date, and from the Confirmation Date to the Effective Date.

In the scenario envisaged by JSDA where Fails Charges are initially introduced based on the RTGS Guidelines revised in June 2010 and a prior notice is sent for that purpose, the Effective Date is supposed to be November 1, 2010.

If you start transactions in government securities with a new counterparty after the date of your introduction of Fails Charges, both parties will generally be considered to have agreed to carry out their operations in accordance with the market practice prevailing when entering into a master agreement governing their transactions or executing an individual transaction. In this case, therefore, no other particular procedure is required to introduce Fails Charges. However, in order to avoid confusion that may arise in executing actual transactions, it may be advisable to confirm that the parties have understood and agreed on the introduction of Fails Charges and the Effective Date, by such means as sending a prior notice.

(Workflow from sending a prior notice to introducing Fails Charges)



* If there is no new transaction during the period up to the Effective Date, the Fails Charges Trading Practice will apply after the Effective Date to settlements made after the Reference Date.

Q18: While it is recommended to send a notice by a confirmation or a similar trade notification is this step mandatory for the application of a Fails Charge? Can we skip the process of sending this notice?

A: A notice by a confirmation or a similar trade notification is an instrument to reinforce the legal basis for claiming a Fails Charge by indicating that the transaction in question is subject to a Fails Charges. This notice can be used to confirm that the parties to the transaction have agreed that a Fails Charges can be claimed between the parties based on the prior notice if a Fail is caused in relation to the transaction in question.

In order to avoid confusion that may arise between the parties when a Fails Charges is claimed, it is recommended under the Fails Charges Handling Guidelines to add wording to the effect that the transaction in question is subject to a Fail Charge in a confirmation or a similar trade notification.

However, if the parties have entered into the "Agreement on Omission of Issuance of Confirmations" or any other similar agreement and agreed to omit to send a confirmation or a similar trade notification in their transactions, the parties may omit to make this notice (i.e, incorporate additional wording to indicate the application of a Fails Charge). In addition to the foregoing case, if the arrangement of such additional wording entails a considerable burden in processing in computer systems or other back-office operations, the parties to transactions are exceptionally allowed to omit to indicate additional wording on condition that both parties have properly confirmed their agreement on the introduction of Fails Charges and the scope of transactions subject to Fails Charges.

(Fails Charges Handling Guidelines II.3. "Notice in confirmations or similar trade notifications")

Q19: Please explain how to calculate a Fails Charge.

A: A Fails Charge is calculated in accordance with the following formula.

$$\sum_{\text{Fail period}} 1/365 \times \max(3\% - \text{Reference rate}, 0) \times \text{Amount of funds delivered}$$

More specifically, the amount of a Fails Charge is calculated for each applicable transaction each day, rounding down fractions less than one yen. Then, for each such transaction, the total monthly amount of daily Fails Charges is calculated and claimed against the failing party.

(Fails Charges Handling Guidelines III.1. "Calculation method")

Q20: Where can we find BOJ's policy interest rate in the conduct of monetary policy which is used as the "reference rate" mentioned in the formula for calculating a Fails Charge?

A: As of June 2010, an uncollateralized overnight call rate is adopted as BOJ's policy interest rate in the conduct of monetary policy management. When the target level of this rate is indicated in the form of a target range, the lower limit of the target range is adopted as the reference rate. When BOJ's policy interest rate is expressed in the form of "around ___%," "hovering at the level of ___%," or the like, the figure of the percentage referred to in such expression is used as the reference rate.

BOJ's policy interest rate in the conduct of monetary policy management can be found in the most recent statement on the monetary policy to be announced after each Monetary Policy Meeting ("Statement on Monetary Policy" posted at http://www.boj.or.jp/).

(Fails Charges Handling Guidelines III.1. "Calculation method" (2) Definitions and explanations of terms in the formula)

Q21: If the reference rate is changed during the Fail period, how should the Fails Charge be calculated? While the Guidelines say that BOJ's policy interest rate in the conduct of monetary policy management is used as the reference rate, what will happen if the basis of BOJ's policy interest rate is changed to another one (for example, changed to the target range for current account balances)?

A: If the reference rate is revised during the Fail period, the Fails Charge attributable to the period following the revision is calculated at the revised reference rate.

If BOJ's policy interest rate in the conduct of monetary policy is changed from the uncollateralized overnight call rate to another one, the Fails Charge is calculated at the reference rate before the change as a provisional measure. In this case, how to set the reference rate will be discussed promptly by JSDA.

(Fails Charges Handling Guidelines III.1. "Calculation method" (2) Definitions and explanations of terms in the formula)

Q22: Does the "amount of funds delivered" mentioned in the formula for calculating Fails Charges include such amounts as lending fees in bond lending transactions or interest or amounts paid and received based on margin calls?

A: In the "amount of funds delivered" in the formula for Fails Charges, lending fees and lending interest and amounts paid and received based on margin calls are included in case of bond lending transactions, and repurchase interest is included in case of conditional purchase and sale transactions. In case of a conditional purchase and sale transaction based on the unit price exclusive of accrued interest, the amounts of interest paid during the transaction period are not included in the "amount of funds delivered" as above.

This interpretation of the "amount of funds delivered" is determined in the same manner as applied by most market participants when calculating the amount to be settled at the end of a transaction (at the time of repayment in a lending transaction or at the time of an ending transaction in a conditional purchase and sale transaction) by DVP settlements.

Q23: What kind of information do we have to describe in a written claim for Fails Charges?

A: When claiming Fails Charges, it is necessary to describe the failing party, the non-failing party, the transactions involving Fails, the amounts of Fails Charges, and other identifying information. The specific elements of such information are as illustrated below.

- Company names of the failing party and the non-failing party
- Bonds or securities involving a Fail (issue, amount delivered, etc.)
- Date on which each Fail occurred, and date on which each Fail was resolved
- Reference rate prevailing on the date of the occurrence of each Fail (Note)
- Amount of the Fails Charge for each transaction (Note)
- Total amount of Fails Charges

(Note) If a Fail continues from the month preceding the billing month, or continues into the month following the billing month, the claiming party must describe the amounts of Fails Charges attributable to the billing month as calculated for respective transactions and the reference rate prevailing at the date of the occurrence of each Fail.

Q24: Who can claim a Fails Charge? Who should pay a Fails Charge?

A: A claim for a Fails Charge is made between the parties to the transaction in Japanese government securities involving the Fail. Such a claim is issued by the receiving party suffering from the Fail (the non-failing party) against the delivering party failing to deliver securities (the failing party). In this connection, a trust bank responsible for the management of securities in the trust account in case of a securities management trust, and some other persons under similar situations, shall be considered to be eligible as a party to the said transaction.

The parties to the transaction are recommended to confirm their respective contact points for communicating claims, collation, settlement, and other matters relating to Fails Charges in advance. Such confirmation is highly recommended to avoid problems in back-office operations, particularly in the case of a nonresident transaction, trust transaction, or other transaction involving multiple parties such as agents for clerical support.

(Fails Charges Handling Guidelines III.2. “Claim of Fails Charges” (1) Claimant and claimee,

(5) Confirmation of contact information)

Q25: How do Fails Charges apply in case of sequential Fails or loop transactions?

A: Even in case of sequential Fails or loop transactions, a Fails Charge applies to each transaction and a Fails Charge is claimable for each Fail. However, if so agreed by the parties to transactions, netting may be used for payments and receipts of Fails Charges.

(Fails Charges Handling Guidelines IV. (2) Netting)

Q26: The Guidelines say that the payment of Fails Charges can be omitted if the amount is less than 50,000 yen. Does this lower limit apply to the total monthly amount of Fails Charges or to the amount of a Fails Charge for each transaction?

A: Fails Charges are supposed to be claimed on a monthly basis. In order to streamline back-office operations and save efforts for payments and receipts in small amounts, the parties to transactions may agree to set the minimum amount to be actually remitted at 50,000 yen. In this case, the remittance of Fails Charges will be omitted if its amount is less than 50,000 yen. This means that the remittance can be omitted when the total monthly amount is less than 50,000 yen.

The minimum amount rule may apply either to an amount remitted by each party to the other party on a gross basis or to an amount remitted by one responsible party to the other party on a net basis, i.e., the amount of the balance after offsetting the amounts payable between both parties. From the standpoint of efficient back-office operations, the general principle is to apply the minimum amount rule to the amount payable by each party to the other party if they adopt the remittance of Fails Charges on a gross basis, and to the net amount payable by one responsible party to the other party if they adopt the remittance of Fails Charges on a net basis.

(Fails Charges Handling Guidelines III.2 “Claim of Fails Charges”, IV.
(3) Minimum amount of a Fails Charge)

Q27: How should we act if the Fails Charges claimed are not paid by the specified payment date?

A: If the amount of Fails Charges is not remitted between the parties to the transactions within the billing month, both parties negotiate on how to solve such payment failure.

If both parties agree to do so, a late charge may be imposed on the overdue portion accrued at a specified rate for the period following the payment due date.

(Fails Charges Handling Guidelines IV.(5) “Handling of delayed payment of a Fails Charge”)

Q28: If a transaction is settled by JGBCC, how should we apply the Fails Practice or Fails Charges?

A: In principle, transactions settled by JGBCC are governed by the fails practice and the rules on fails charges that are separately prescribed by JGBCC in accordance with the the market practices specified in JSDA’s RTGS Guidelines and Fails Charges Handling Guidelines.

Q29: Do Fails Charges apply to corporate bonds, etc. other than government securities?

A: The RTGS Guidelines and the Fails Charges Handling Guidelines apply to transactions in government securities only. In the meantime, JSDA has no plan to review the market practice for corporate bonds, etc. other than government securities and Fails Charges do not apply to such bonds. However, the fails practice for corporate bonds, etc. is prescribed in the Book-Entry Transfer Guidelines for Corporate Bonds and so on, and we cannot deny the possibility of reviewing such guidelines in the future, depending on the reality of settlements of such bonds or changes in market environments.

In July 2010, JSDA amended the “Regulations Concerning Handling of Short Sale and Lending Transaction of Bonds” and the “Regulations Concerning Handling of Conditional Sale and Purchase of Bonds, etc.”, and the control on short repo transaction (Note) is adopted, in addition to the preexisting control on short sale transactions. These regulations apply not only to government securities but also to corporate bonds, etc.

(Note) For more details, please see Note 2 on page 7 of “The Final Report (Framework) of the Working Group concerning Review of Fails Practice for Bond Trading” (April 20, 2010) posted on JSDA’s website.

Q30: Can we act in any manner other than what is specified in the “Practical Guidelines for Handling of Fails Charges”?

A: All market participants are expected to act in accordance with the Fails Charges Handling Guidelines, which is believed to facilitate practical operations for securities transactions and settlements. Yet, the parties to transactions are not precluded from acting in any other manner, if so agreed between both parties.

Neither the RTGS Guidelines nor the Fails Charges Handling Guidelines will in any way restrict the rights of market participants under law.

Q31: How should Fails Charges be treated in terms of tax management and accounting?

A: Given that there are various conceivable approaches for accounting and tax management for Fails Charges based on respective companies’ situations, the Fails Charges Handling Guidelines have no provision for accounting or tax management uniformly applicable to all market participants.

For the accounting procedures available for JSDA’s members, please see the documentation provisionally entitled “Model Cases of Accounting Procedures for Fails Charges.”

In principle, each market participant is requested to confirm its accounting procedures and tax management for Fails Charges on its own responsibility.