

**The Interim Report (Framework) of the Working Group  
concerning Review of Fails Practice for Bond Trading**

November 26, 2009

Japan Securities Dealers Association

**1. Purpose of establishing the working group**

Since the outbreak of the global financial crisis triggered by the bankruptcy of Lehman Brothers last September, the necessity to review the fails practice and other processes in bonds settlements has been strongly recognized in light of the drastic change of the market environment. Considering this background, with the intention of further establishing the fails practice while preventing frequent occurrence of fails, the “Working Group concerning Review of Fails Practice for Bond Trading” was established this May as a subordinate organization of the Japan Securities Dealers Association (JSDA) Bond Committee and has since started reviewing the fails practice and discussing specific measures.

**2. Meaning and role of Fails Practice\***

When starting the discussions at this working group, market participants who experienced the disruption after the bankruptcy of Lehman Brothers expressed the view that preparing a system which enabled the handling of fails was necessary because a situation where a fail could not be handled practically (or accepted) would hinder emergency market operations. Furthermore, the promotion of the understanding of fails was also cited as essential, especially at the executive level, as some arguably do not accept the Fails Practice due to a lack of understanding of fails.

Taking these opinions from market participants into consideration, this working group decided to reconfirm the meaning and the importance of the role of the Fails Practice and, while preventing frequent fails occurrence, review the Fails Practice and discuss specific measures with the intention of further establishing the Fails Practice.

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\* As real-time gross settlement (RTGS) was implemented for government securities settlements and for funds settlements through the funds transfer system of the BOJ-NET, JSDA compiled the “Japanese Government Securities Guidelines for Real Time Gross Settlement” as a market practice. This was to be observed for reducing settlement risks and securing smooth settlement in the settlement environment in place after the settlement of JGB transfers on an RTGS basis was introduced in January 2001. JSDA also specified the “Fails Practice” assuming DVP settlements, where the JGB and the funds are settled at the same time, in the “Guidelines concerning Fails” contained in the guidelines.

### **3. Specific agenda**

Among the agenda items, the group discussed measures to modify the existing Fails Practice or related categories at the meetings held before the release of the interim report.

#### **(1) “Policy regarding costs incurred under fails (introduction of Fails Charges)”**

##### **(a) Introduction of Fails Charges**

In the process of inviting opinions on the agenda items of this working group and discussing the items based on those opinions, many expressed the view that a Fails Charge is effective in preventing frequent occurrence of fails and the introduction of a Fails Charge should be discussed positively. In light of this, it was agreed that discussions shall be carried out assuming that a Fails Charge would be introduced as a consensus of not only JSDA members but also a wide range of market participants, including the representative of each business type, and then complied by them.

Additionally, it was agreed that a Fails Charge shall be discussed assuming that it would be introduced not as a rule but as a market practice, just as implemented in the United States. At the same time, it was agreed that discussions shall not make a distinction between intentional and unintentional fails, and the status of a Fails Charge, whether it should be considered to be a penalty or not, was left open.

##### **(b) Level of Fails Charges**

Regarding the calculation method for a Fails Charge, it was agreed that practical solution shall be explored, with a reference to the U.S. type “ $\alpha\%$  – policy interest rate (uncollateralized overnight call rate),” with which the effect preventing frequent occurrence of fails under low interest rate conditions are expected.

Additionally, regarding the specific level of the Fails Charge ( $\alpha\%$ ), considering that while there is a concern that a level lower than the U.S. level (3%) might not ensure enough effect of preventing frequent occurrence of fails, a high-level Fails Charge would mean the “penalty,”—it was agreed that discussions shall be carried out assuming that  $\alpha\%$  would be set at 3%.

##### **(c) Applicable scope of a Fails Charge**

Regarding the applicable scope of a Fails Charge, after the group discussed the application to overseas transactions and loop transactions (i.e., a chain of transactions among multiple entities which begin and end with the same entity, thereby forming a loop), it was agreed that a Fails Charge would be applied without exceptions.

## (2) Review of the cut-off time

Regarding the cut-off time, considering business operations after a fail is confirmed and the investment of surplus funds where fails have never been accepted, it was agreed that the time would be moved forward from the current 15:30 to 14:00. It was also agreed that the period between the new cut-off time and the closing time of the BOJ-NET JGB Services (16:30) shall be regarded as reversal time and that fails can be confirmed even before the cut-off time based on agreement between the parties concerned.

	After guideline review	Current guidelines
14:00	14:00 cut-off time	
15:00	14:00–16:30 Reversal time	15:30 cut-off time
16:00		15:30–16:30 Reversal time
16:30		Closing of BOJ-NET JGB Services

## 4. Future agenda items and discussion on practical issues

This working group is scheduled to discuss “good-faith efforts and related issues,” “information disclosure and related issues,” and “margin calls and related issues” as other measures that require development of, for example, the new practice.

Note that it was agreed that the group would ask the Bonds Gensaki Transaction Study Group to discuss the actual operations concerning the claim for and the payment of Fails Charges. Additionally, the group plans to specifically discuss the actual operations concerning the claim for and the payment of Fails Charges involving overseas transactions after establishing a sectional committee composed of a small number of relevant parties.