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

April 20,2010
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 in September 2008, the necessity to review the Fails Practice and other processes in bonds settlements has been strongly recognized in light of the drastic change in 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 the Fails Practice for Bond Trading” was established in May 2009 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 the Fails Practice[1]

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 important, 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.

[1] 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 in January 2001, JSDA compiled the “Japanese Government Securities Guidelines for Real Time Gross Settlement” as a market practice, which should be followed to reduce settlement risks and secure smooth settlement of JGB transfers on an RTGS basis. JSDA specified the “Fails Practice” in the “Guidelines concerning Fails” contained in the guidelines.

3. Items reviewed concerning measures for modifications of the existing Fails Practice

Among the agenda items, the group discussed the issues of "Policy regarding costs incurred under fails (introduction of Fails Charges)," "Review of Cut-off time," and "Review of buy-in system" as possible measures to make modifications to the existing Fails Practice.

Review of the practice concerning claiming, paying, and receiving a Fails Charge was assigned to the Bonds Gensaki Transaction Study Group. Additionally, review of the practice concerning claiming, paying, and receiving a Fails Charge in connection with overseas transactions was assigned to the sectional committee composed of members related to nonresident transactions.

(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.

Later, it was agreed that a Fails Charge should 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 no distinction should be made between intentional and unintentional fails, and the nature 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 to adopt the U.S. scheme "α% – policy interest rate (uncollateralized overnight call rate)," which is expected to have the effect of preventing frequent occurrence of fails under low interest rate conditions.

Additionally, regarding the specific level of the Fails Charge (α percent), considering that while there was a concern that a level lower than the U.S. level (3 percent) might not ensure enough effect of preventing frequent occurrence of fails, a higher-level Fails Charge would mean the "penalty,"—it was agreed to set α percent at 3 percent.

(c) Applicable scope of a Fails Charge

Regarding the applicable scope of the Fails Practice (a Fails Charge), it was agreed that a Fails Charge would also apply 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) without exceptions. Based on the reports provided from the sectional committee, discussion was made regarding specific scope of applying the Fails Practice, with reference to global trends, including offshore settlements in yen for government securities after the establishment of “The Japanese Government Securities Guidelines for Real Time Gross Settlement (RTGS Guidelines)” in 2001 and prior cases in the United States.

As a result, it was agreed that a Fails Charge would apply to all delivery-versus-payment (DVP) settlements of the transactions in government securities (purchase and sale transactions, lending transactions, and transactions under repurchase agreement), including not only DVP settlements thorough_the BOJ-NET JGB Services, but also settlements of government securities against the payments of funds on the same date. Further, it was agreed that offshore settlements in yen, including transactions settled in Euroclear or Clearstream should also be subject to a Fails Charge.

(2) Review of the Cut-off time

Regarding the Cut-off time in the RTGS Guidelines, 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 any transactions can be treated as fails even before the Cut-off time, if an agreement to that effect has been made 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 15:30-16:30 Reversal time
16:00		
16:30	Closing of BOJ-NET JGB Services	Closing of BOJ-NET JGB Services

(3) Review of the buy-in system

It was agreed not to review the buy-in system at present because many members expressed prudent opinions on this issue in view of a rather short time necessary to resolve a fail in Japan, operational costs, and other issues involved.

4. Agenda items and discussion on other measures that require establishment of new practice

In addition to the measures for reviewing the existing Fails Practice, the working group discussed "good-faith efforts" (regulations on short lending and repurchase transactions, accountability for the situation leading to the fail, and loop resolution process), "disclosure" (expanding disclosure of fail-related information) and "margin calls" (margin calls after fails in the closing leg of the transactions) as other measures that would require development of, for example, the new practice.

(1) "Regulations on short lending and repurchase transactions" [2]

Transactions subject to the current regulations on short sale imposed by JSDA are limited to the purchase and sale transactions (outright transactions) and starting legs of sale transactions under repurchase agreement. With reference to such situation, from the standpoint of preventing easy and intentional fails on the market, and ensuring the compliance with the obligation of good-faith efforts to resolve fails, it was agreed that the similar regulations (regulations on short repo transactions) should be introduced for the repo transactions in general, including the closing leg of purchase transactions under repurchase agreement, and lending and returning in lending transactions. Hence, the delivery of securities should be required in these transactions through a short covering or other means pursuant to the provisions of both the JSDA regulations and the RTGS Guidelines.

- Transactions subject to the JSDA regulations and the RTGS Guidelines -

	Current short sale regulations	Proposed amendment to JSDA regulations	Proposed amendment to RTGS Guidelines

[2] JSDA's current version of "Regulations concerning Handling of Short Sale and Lending Transaction of Bonds" requires that an association member of JSDA conducting a short sale of bonds (sale of bonds without owning the subject bonds on the contract date) should conduct a short covering to procure the bonds required to be delivered. In this Report, "short repo transactions" are assumed to be in "the situation where no bonds to be delivered on the delivery date are secured by the party in the case of conducting the starting leg of the transaction as seller (the party selling bonds to the purchaser at the starting leg of the transaction) or conducting a transaction in the closing leg as purchaser (the party purchasing bonds from the seller at the starting transaction), or in the case of lending or returning in the bonds lending transactions. The "regulations on short repo transactions" requires the parties to the transaction to secure subject bonds through an exchange cover or other means, as in the case of current "regulations on short sale."

Purchase and sale transactions (Outright transactions)	Applicable	Applicable	Applicable
Starting legs of sale transactions under repurchase agreement	Applicable	Applicable	Applicable
Closing legs of purchase transactions under repurchase agreement	Not applicable	Applicable	Applicable
Lending of securities in lending transactions	Not applicable	Applicable	Applicable
Returning of securities in lending transactions	Not applicable	Applicable	Applicable

(2) “Expanding disclosure of fail-related information (statistical basis)”

It was agreed not to disclose the name of securities for which settlement fails have occurred because collecting and reporting fails-related information in such frequency as to secure usefulness of the information would require substantial workload to the reporting and collecting parties. For the time being, the working group will monitor the effects of preventing fails by the introduction of Fails Charges and regulations on short lending and repurchase, and if these measures are found insufficient to prevent fails, necessity of the additional disclosure will be considered anew as one of preventive measures.

It was also agreed not to disclose the name of the company involved in a fail in light of feasibility of disclosure and a concern about unexpected impacts of the disclosure such as malicious rumor.

(3) “Accountability for the situation leading to the fail”

It was agreed that accountability for a detailed explanation of the situation leading to a settlement fail should not be imposed uniformly in view of the practical workload, and instead, it was agreed to incorporate a statement in the section of “good-faith effort to resolve fails” of the RTGS Guidelines to the effect that the delivering party who caused the fail should sincerely give the receiving party who suffered from the fail explanations of the situation leading to the fail, if so requested by the receiving party.

(4) “Margin calls after fails in the closing leg of transactions”

It was agreed that margin calls after fails in the closing leg of the transactions should not be implemented as a market practice because many members expressed their views that this issue should be considered carefully in the light of a burden for system developments to cope with such margin calls. However, since the implementation of margin calls after fails in the closing leg of the transactions is desirable for risk management, it was agreed alternatively to recommend market participants to take necessary measures to be prepared for such margin calls, including system adjustments, and to claim additional margins pursuant to an agreement between the parties concerned.

(5) “Loop resolution process”

It was agreed not to make specific discussion for implementing a loop resolution process, considering the fact that with so various cases of loops involved, it would be technically difficult to determine the resolution process in detail.

It was agreed that the working group would not discuss to admit a partial delivery as a market practice because some members expressed a concern about heavy burden for system developments and operations to cope with the partial delivery. However, in view of the usefulness of the partial delivery in preventing fails, it was confirmed that the partial delivery can be adopted if so agreed between the parties concerned. For the time being, the working group will monitor the effects of preventing fails by the introduction of Fails Charges and the regulations on short repo transactions, and if these measures are found insufficient to prevent fails, necessity of the loop resolution process will be considered anew as one of preventive measures.

5. Agenda items and discussion by Bonds Gensaki Transaction Study Group concerning the practice of claiming, paying, and receiving Fails Charges

With respect to the practice of claiming, paying, and receiving Fails Charges, based on the results of discussion by Bond Gensaki Transaction Study Group, the “Practical Guidelines for Handling of Fails Charges” were prepared, which provide for preparations before the introduction of Fails Charges, and the practice regarding calculation, claim, payment, and receipt of Fails Charges which is to be introduced as a market practice by the RTGS Guidelines. The Guidelines were approved by the working group.

6. Agenda items and discussion by the Sectional Committee concerning Practice of Claiming, Paying and Receiving Fails Charges in Overseas Transactions[3]

The "Sectional Committee concerning Practice of Claiming, Paying and Receiving Fails Charges in Overseas Transactions" was established by market participants conducting transactions involving nonresidents in connection with the practice of claiming, paying, and receiving Fails Charges in these transactions. In order to realize the smooth introduction of the Fails Charge practice for transactions involving nonresidents, the sectional committee categorized the transactions anticipated in nonresident trades according to their types and examined each transaction. As a result, the committee reported to the working group that in introducing Fails Charges for transactions involving nonresidents, Fails Charges should be handled pursuant to the "Practical Guidelines for Handling of Fails Charges," and that there is no need for any additional provisions to be incorporated in the Guidelines for transactions involving nonresidents or other similar rules.

Together with the above-mentioned report, the sectional committee gave a report on the scope of Fails Charges and other relevant items, taking into consideration global trends including offshore settlements in yen for government securities after the establishment of the RTGS Guidelines in 2001, as well as prior cases in the United States. The working group gave its approval for the scope of Fails Charges and other relevant items to be formulated according to the sectional committee's recommendation.

7. Schedule for the future developments

Discussions will be made until June 2010 with respect to the formats of the prior notice about introduction of Fails Charges and of the confirmations or similar trade notifications, and the Frequently Asked Questions assumed to be practically required for the introduction of Fails Charges, and the results of review will be published afterwards. As to the time to introduce the reviewed Fails Practice (such as Fails Charges), it was agreed that the working group shall confirm the introduction date with market participants in June 2010, when the review relating to the formats of the prior notice about introduction of Fails Charges, other formats, and the relevant questions and answers will be completed, and that, though the introduction date can be postponed until the end of 2010 or so depending on the circumstances involved, for the time being, the working group will make further study assuming the reviewed Fails Charges to be introduced in October 2010.

---

[3] Discussions were made among the following committee members who are handling a lot of transactions and settlements with nonresidents as market participants: Bank of Tokyo-Mitsubishi UFJ (leader), Credit Suisse Securities, Goldman Sachs Securities, JP Morgan Securities, Citibank Japan, Daiwa Securities Capital Markets, Deutsche Securities, Nomura Securities, Mizuho Corporate Bank, Sumitomo Mitsui Banking Corporation, and Hong Kong and Shanghai Banking Corporation.

8. Conclusion

This final report summarizes the specific measures and the purposes of review for establishing of the Fails Practice further.

Unlike the cases in the United States where the Fails Practice is widely established among the market participants, occurrence of settlement fails still remains at a low level in Japan in ordinary times. In the background of this situation lie market participants' efforts to prevent fails, while the Fails Practice has not been well established. In an emergency, such as the period after the bankruptcy of Lehman Brothers in 2008, fails can occur frequently. Therefore, awareness is growing about the importance of further establishing the Fails Practice so that a wide range of market participants can be prepared to cope with settlement fails.

On the other hand, although efforts should be made to attain further recognition of the Fails Practice, frequent occurrence of fails under low-interest environments would not be desirable from the standpoint of smooth settlement of transactions or reduction of unsettled positions. Therefore, it is also necessary to enhance a mechanism to prevent frequent occurrence of fails, including the introduction of Fails Charges.

Market participants are expected to exert efforts for further establishing the Fails Practice, which efforts include but not limited to, taking actions to deepen understanding and knowledge among widespread parties concerned about the importance of establishing the Fails Practice in Japan while preventing their frequent occurrence as well as the purposes of the review this time, and establishing operational scheme and systems that can practicably cope with fails, such as giving prior notice to the parties concerned when introducing Fails Charges, executing a "Memorandum concerning Fails" for bond lending transactions with cash collateral, and developing related systems, pursuant to the provisions of the "Practical Guidelines for Handling of Fails Charges."

Members of the Working Group concerning Review of Fails Practice for Bond Trading

Members of the Working Group

Central Tanshi Co., Ltd.	Mitsubishi UFJ Trust and Banking Corporation
Citigroup Global Markets Japan Inc.	Mizuho Securities Co., Ltd.
Daiwa Asset Management Co.Ltd.	Nippon Life Insurance Company
Daiwa Securities Capital Markets Co. Ltd.	Nomura Securities Co.,Ltd.
Goldman Sachs Japan Co., Ltd.	Sumitomo Mitsui Banking Corporation
Japan Bond Trading Co.,Ltd.	The Bank of Fukuoka , Ltd.
Japan Government Bond Clearing Corporation	The Bank of Tokyo-Mitsubishi UFJ, Ltd .
Japan Post Bank Co., Ltd.	The Master Trust Bank of Japan ,Ltd.
JPMorgan Securities Japan Co., Ltd.	The Norinchukin Bank
Mitsubishi UFJ Morgan Stanley Securities Co., Ltd.	Tokai Tokyo Securities Co., Ltd.

Observer Members

Bank of Japan	Government Pension Investment Fund
Financial Services Agency	Ministry of Finance