

Re: Tax Treatment of Co-Location Service

November 5, 2009

1. Subject of Inquiry

We would like to inquire whether it will be affirmed that a Foreign Investor will not be treated as having a permanent establishment in Japan solely because of the following transaction: pursuant to the “Co-Location Service” provided by Tokyo Stock Exchange, Inc. (hereinafter “TSE”), a Trading Participant (a so-called securities company authorized to place an order and the like on TSE markets by acquiring the trading qualifications of TSE) has installed equipment such as servers in Japan for the execution of placing orders, and a Foreign Investor enjoys the service of provision of environment for high-speed placement of orders by using the equipment owned or leased by the Trading Participant.

2. Facts and Preliminary Matters

(1) Outline of the Co-Location Service

The Co-Location Service is a service intended to enable the execution of purchase and sale of securities at a high speed, and are made possible by TSE approving the Trading Participant’s installation of equipment such as servers to be used for placement of orders, within the Primary Site where TSE’s Trading Systems and Market Information System are installed, or within the Access Points on the network operated by TSE, with a view to shortening the circuit path from those servers to TSE’s Trading Systems and Market Information System and thereby reducing latency within the network.

For an outline of the Co-Location Service, please refer to the Attachments (1) and (2).

(2) Background and Purpose of the Co-Location Service

In the past, securities trading by Trading Participants (principally so-called securities companies) at TSE was carried out principally in a manner that “floor clerks,” or personnel of the Trading Participants in charge of purchase/sale of securities, carried out the trading on TSE’s trading floor. Later, in 1999, the trading process was completely computerized and trading through floor clerks on the trading floor was discontinued. Further, the form of trading changed to that of order transmission and quote information transmission through connecting the computer systems of Trading Participants and TSE’s Trading Systems and Market Information System through the network. Once the computerization was complete, Trading Participants placed orders through the personnel of the Trading Participants in charge of placing orders, by acquiring quote information via the network from TSE’s Market Information System, making decisions on

individual orders based upon the quote information, and transmitting the orders to TSE's Trading Systems.

With the development of information technology in recent years, Trading Participants are increasingly adopting the method of automatic placement of orders via computers in which certain programs have been installed. In such automatic trading, when a computer that is configured to process automatic placement of orders acquires certain quote information from TSE's Market Information System, the computer calculates the terms of the orders, and the orders are then automatically placed to TSE's Trading Systems by operation of the program for automatic placement of orders installed in the computer in advance, without going through the individual decisions of the Trading Participant.

The purpose of such trading is to conduct execution of purchase/sale in a manner that is responsive, on a real-time basis, to the quote information of the market as well as its constant fluctuations during trading hours, to the extent possible and with certainty. Consequently, the most significant issue in this type of trading is how fast the computer in which the program has been installed will acquire the quote information from TSE's Market Information System, and how fast the orders will be entered into TSE's Trading Systems. The demand to accelerate the speed of transmission of information from TSE's Trading Systems and Market Information System to the system of Trading Participants through the network is increasing. However, so long as the computer to place orders (or the server) is physically located within the premise of Trading Participants, there will be some physical distance with the TSE's network, and this will limit the acceleration of the transmission speed.

The purpose of the Co-Location Service is to respond to the demand of further accelerating the transmission speed within the network. By physically installing the computers for order placement (or the servers) within the Primary Site where TSE's Trading Systems and Market Information System are installed or within the Access Points on the network operated by TSE, the distance within the network between TSE's Trading Systems and Market Information System and the servers can be minimized. As a result, while orders placed not through the Co-Location Service required a few milliseconds in each direction for transmission of quote information and orders, this can be reduced to less than one millisecond in each direction in the case of orders placed through the Co-Location Service. The purpose of the Co-Location Service is to reduce, to the extent possible, the latency within the network connecting TSE's Trading Systems and Market Information System and the servers of Trading Participants. As a result, Trading Participants will be able to execute purchase/sale at a high speed, and investors will be able to enjoy this benefit.

In the U.S., services similar to the Co-Location Service have been carried out for about the last 10 years. The demand to provide the Co-Location Service in Japan is increasing as well.

(3) How the Co-Location Service works

The details of how the Co-Location Service pertaining to this inquiry works are set out

below. Please also refer to the Attachment (3)-1.

(i) TSE leases to the Trading Participant a certain space (hereinafter the “Space”) for installation of network-connecting equipment and computers (or servers) for receiving quote information from TSE’s Market Information System and placing orders (hereinafter collectively referred to as the “Server”), within the Primary Site where TSE’s Trading Systems and Market Information System are installed or within the Access Points on the network operated by TSE. The Space is located in Japan.

(ii) A Trading Participant is a Type 1 Financial Instruments Business Operator (a so-called securities company) duly registered as such under the Financial Instruments and Exchange Act, and is authorized to place orders with TSE by acquiring TSE’s trading qualifications. It is a joint stock company that is a Japanese corporation or a Japanese branch of a foreign corporation. An investor is a non-resident individual or a foreign corporation (i.e., a judicial person) and does not have any permanent establishment¹ in Japan (hereinafter, such investors shall be referred to as “Foreign Investor(s)”). A Foreign Investor is a person who conducts investments, including the purchase/sale of securities, as a business. Foreign Investors include hedge funds in the form of a foreign corporation.

(iii) The Trading Participant executes purchase/sale of securities based upon entrustment by a Foreign Investor of such purchase/sale of securities (which may include certain trading of listed derivatives; hereinafter the same shall apply). A Foreign Investor entrusts the purchase/sale of securities to the Trading Participants as a client of the Trading Participants. The terms of the entrustment of purchase/sale of such securities follow the Brokerage Agreement Standards of TSE. In the same manner as entrustment of purchase/sale of securities in ordinary cases, a Trading Participant acts as a commissionaire (*toiya*) in relation to the Foreign Investor; and the purchase/sale contract of securities will be concluded in the name of the Trading Participant as a party to the contract (and for the account of the Foreign Investor) (that is; the contract will not be concluded in the name of a Foreign Investor on behalf of the Foreign Investor). A purchase/sale agreement will be legally formed only when a sale order or a purchase order of a Trading Participant in the market matches a purchase order or a sale order of another Trading Participant. The settlement and clearing are made in the same manner as entrustment of purchase/sale of securities in ordinary cases.

(iv) A Foreign Investor and the Trading Participant enter into an agreement under which the Trading Participant agrees to provide services of offering environment for high-speed placement of orders using the Server of the Trading Participant, to the Foreign Investor (hereinafter the “Services”). TSE is not a party to the Services. According to some Trading Participants, however, the following specific details of the Services are contemplated. The Services are still under discussion and a draft of the relevant contract is not yet prepared. The following are the principal terms presently being planned:

¹ Needless to say, the subject matter of this inquiry should be separately decided.

(a) A Server will be owned or leased from a third party by the Trading Participant, and will be installed in the Space leased from TSE. The Trading Participant will place orders with TSE via the Server it owns or leases from another party, as orders placed by the Trading Participant pursuant to the entrustment of orders received from the Foreign Investor.

(b) Once the Server is installed in the Space, the Foreign Investor will neither own nor lease the Server, nor will it receive delivery of the Server (nor acquire any right of possession). The contract on the Services is not a lease agreement or a rental agreement, with or without charge, but is a service agreement (provision of services) of offering environment for high-speed placement of orders. As the Server is to be owned or leased by the Trading Participant, as is natural, the Foreign Investor will not be permitted to dispose of the Server (or sell, provide as collateral, destroy, etc.) at its discretion or utilize the Server (or rent or provide services similar to the Services to any third party) at its discretion. Further, the Foreign Investor will in principle be prohibited from entering the Space.

(c) The following fact patterns are contemplated with respect to the procurement and installation of the Server by the Trading Participant:

x. “One-to-One-Installation Type”

In this pattern, the Server procured by the Trading Participant is used only for the provision of the Services to a particular Foreign Investor (that is, not for the provision of the Services to any other Foreign Investors, but for the provision of the Services on an exclusive basis).

There are two reasons for employing this pattern: (1) if one server is shared among multiple Foreign Investors and the program of any one of the Foreign Investors fails, there is a risk that the other Foreign Investors will be adversely impacted by the failure as well (i.e., environment for high-speed placement of orders will not be available). If the Foreign Investor is a so-called high-end investor, it tends to avoid this risk to the extent possible; and (2) on the side of the Trading Participant, the operational management may become complicated if a server is shared.

As for the procurement of the Server by the Trading Participant, it is contemplated that the Foreign Investor will designate the specifications and performance of the Server (CPU, RAM, OS, etc.) in advance and the Trading Participant will procure a Server that satisfies the designation (or, if the Trading Participant has not been informed of any specific designation, the Trading Participant will decide at the outset to procure a Server that will satisfy the specifications and performance that the Foreign Investor would likely request), taking into consideration various factors such as the volume of trading to be made by such particular Foreign Investor. The reason for such procurement is that it will most appropriately reflect the requirements for the specifications and performance (CPU, RAM, OS, etc.) of a particular Foreign Investor.

However, in circumstances where procurement at a less expensive cost is possible if the particular Foreign Investor procures the Server by itself, or where the Trading Participant wants to avoid the burden of installing and checking the operation of the program and other data to be used by the particular Foreign Investor, it is also possible that the particular Foreign Investor will purchase the Server that satisfies the

specifications and performance that it requires (CPU, RAM, OS, etc.) beforehand, taking into consideration various factors such as the volume of trading to be made by the particular Foreign Investor, complete the installation and checking of the operation of the program and other data that it uses, bring that Server into Japan, and sell and deliver it to the Trading Participant for an appropriate consideration.

y. “Shared-Use-among-Multiple-Investors Type”

This is a pattern where the Server of the Trading Participant is shared for the Services for multiple Foreign Investors. This pattern is used when the “One-to-One-Installation Type” is not required and there are no particular problems. In this case, the decision for the procurement of the Server is expected to be made independently by the Trading Participant without taking into account the requirements of the Foreign Investors.

(d) In either of the aforesaid patterns of the “One-to-One-Installation Type” and the “Shared-Use-among-Multiple-Investors Type,” a mass-produced product generally available in the market as a computer server is expected to be used as the Server. In the case of the “One-to-One-Installation Type,” a server that satisfies the specifications and performance (CPU, RAM, OS, etc.) required by the Foreign Investor will be selected from among numerous mass-produced servers available. In the case of a “Shared-Use-among-Multiple-Investors Type,” the Trading Participant will select a server with specifications that satisfy the intended purpose. In other words, the Server is only a mass-produced product that is generally and readily available in the market, even if it is to be deployed on an exclusive basis for a particular Foreign Investor.

(e) Even in the case of the “One-to-One-Installation Type,” the particular Foreign Investor has no rights whatsoever with regard to the Server such as any right or option to purchase the Server or to repurchase it from the Trading Participant. There are no circumstances where it is agreed upon in advance that the ownership of the Server will eventually belong to the particular Foreign Investor.

(f) Maintenance work necessary for the Server will be conducted by the maintenance operator contracted with the Trading Participant. All maintenance expenses payable to the maintenance operator will be borne by the Trading Participant. Under no circumstances will the Foreign Investor be involved in the maintenance work.

(g) The Foreign Investor may, in accordance with the manner instructed by the Trading Participant, enjoy the Services and may upload, install, and store on the Server the computer program (hereinafter the “Program”) and various parameters and other data it uses for entrusting orders, through remote access. The Foreign Investor will then be able to receive and enjoy “environment for high-speed placement of orders” by starting up and operating the Program of its own on the Server. In either of the two patterns, the “One-to-One-Installation Type” or the “Shared-Use-among-Multiple-Investors Type,” the activities of the Foreign Investor that can be performed on the Server will be limited to the above. As stated above, a Foreign Investor will not be able to dispose of or utilize the Server at its discretion; and it is not contemplated that the Foreign Investor will use the Server for any purpose other than to receive and enjoy the “environment for high-speed placement of orders” in accordance

with the Services (as well as for incidental matters, such as exchanging, with the Trading Participants, various information on securities trading pertaining to its entrustment of orders).

(h) As the Server will be owned or leased by the Trading Participant, the Trading Participant will be able to dispose of (or sell, provide as collateral, divert to another use, destroy, etc.) the Server (if owned) at its discretion, or to utilize (or divert to another use, etc.) the Server (if leased) at its discretion. However, such disposition or utilization of the Server may intervene stable provision of the Services, if, for example, discretionary disposition occurs in the midst of providing the Services (i.e., in the midst of performance of high-speed order placement), and this will contravene the contractual obligation of the Trading Participant to provide the Services in a stable manner to the Foreign Investor; therefore, such events are expected not to happen. Further, because the Program and various parameters and other data stored on the Server are extremely valuable and confidential information of the Foreign Investor, these materials are expected to be completely destroyed and erased when the Server is to be disposed of. There are no restrictions on disposition of the Server by virtue of the ownership right, or on utilization of the Server by virtue of the leasehold right, of the Trading Participant, other than such inevitable contractual restrictions.

(i) The type of consideration to be received from the Foreign Investor by the Trading Participant as a consideration for the provision of the Services, or the method for the payment, have not yet been determined. However, in no event will the Trading Participant provide the Services substantially without any economic consideration. One example would be to recover consideration in the form of an amount based on the trading volume of the Foreign Investor, by adding a small amount onto the securities trading commissions. In such arrangement, it is contemplated an amount that can be considered objectively appropriate as consideration for the Services will be recovered in total (i.e., the Trading Participant would assume the risk when the trading volume drops, while a greater amount of commission is expected when the trading volume increases).

(v) The Program and various parameters mentioned above are prepared and set up outside of Japan by the Foreign Investor and are owned exclusively by the Foreign Investor. The same applies even after these have been uploaded on the Server under the Services. When the Program is prepared and various parameters pertaining to the Program are set up, investment decisions, including decisions on the formulation of certain investment policies, are to be made in advance; and all such investment decisions are to be made by the Foreign Investor outside of Japan. The Foreign Investor may change various parameters at any time through remote access from outside of Japan, in response to the fluctuations of market conditions.

(vi) The Server will, by operation of the Program and various parameters prepared and set up in advance by the Foreign Investor outside of Japan, acquire quote information provided on a realtime basis from the Market Information System of TSE, carry out information processing (or electronic calculation), and automatically transmit the calculated results as orders entrusted from the Foreign Investor (this series of process is referred to as “automatic placement of orders” in this document). (Excluding the

exceptional cases stated in (viii) hereunder), there is no room that arbitrary decisions of the Trading Participant, maintenance companies, or other persons located in Japan will intervene in the placement of orders. As stated in (iii) above, no purchase/sale agreement will be legally formed in the market by the mere fact that the orders were automatically transmitted by the Server.

(vii) The following is an illustration of items (v) and (vi) above in the chronological order based on a hypothetical example (Please refer to the Attachment (4)).

(a) The Foreign Investor determines the investment policies and makes investment decisions as follows (“(1) Investment Decisions” in the Attachment (4)).

(A) The Foreign Investor decides on a certain investment policy; for example, the following: “Execute an arbitrage transaction between the two stocks **X** and **Y**. Specifically, if the stock price of **X** ($\text{¥}x$) relative to the stock price of **Y** ($\text{¥}y$) becomes (1) higher than $(100 + \textbf{Z})\%$, sell **a** shares of **X** at $\text{¥}x$ and buy **b** shares of **Y** at $\text{¥}y$; and (2) if the stock price of **X** ($\text{¥}x$) becomes less than $(100 - \textbf{Z})\%$, buy **a** shares of **X** at $\text{¥}x$ and sell **b** shares of **Y** at $\text{¥}y$.”

(B) The Foreign Investor prepares the Program to implement the above investment policy on the Server. The variables mentioned in (A) above, **X**, **x**, **Y**, **y**, **Z**, **a** and **b**, will be the parameters that the Foreign Investor establishes pursuant to its investment decisions, as in (C) below.

(C) The Foreign Investor makes investment decisions, such as the selection of stocks it plans to invest in and the establishment of numbers and indexes. For example, the Foreign Investor selects “XXX Co., Ltd.” as **X** stock and “YYY Co., Ltd.” as **Y** stock (therefore, **x** is the stock price of XXX Co., Ltd. and **y** is the stock price of YYY Co., Ltd.), selects “20” as the variable **Z** representing the difference of the stock prices, and selects “100” for both variables **a** and **b** representing the numbers of shares in the buy and sell orders. At this point, the Foreign Investor would have made the investment decision (1) to entrust the sale of 100 shares of XXX Co., Ltd. at $\text{¥}x$ and the purchase of 100 shares of YYY Co., Ltd. at $\text{¥}y$, if the stock price of XXX Co., Ltd. ($\text{¥}x$) becomes 120% of the stock price of YYY Co., Ltd. ($\text{¥}y$) or higher, and (2) to entrust the purchase of 100 shares of XXX Co., Ltd. at $\text{¥}x$ and the sale of 100 shares of YYY Co., Ltd. at $\text{¥}y$, if the stock price of XXX Co., Ltd. ($\text{¥}x$) becomes 80% of the stock price of YYY Co., Ltd. ($\text{¥}y$) or lower.

(b) The Foreign Investor uploads and sets up the Program on the Server of the Trading Participant pursuant to the Services (“(2) Upload the program” in the Attachment (4)). This may be remotely operated from outside of Japan.

(c) The Foreign Investor enters the parameters, “**X**=XXX Co., Ltd.” (**x** = stock price of XXX Co., Ltd.), “**Y**=YYY Co., Ltd.” (**y** = stock price of YYY Co., Ltd.), “**Z**=20,” “**a** = 100,” and “**b** = 100,” as mentioned above, pursuant to the Services, onto the Server of the Trading Participant (“(3) Input parameters” in Attachment (4)). This may be remotely operated from outside of Japan.

(d) The Server of the Trading Participant receives the market price information that

the stock price of XXX is “¥200” and the stock price of YYY is “¥150” from the Market Information System of TSE (“(4) Receive quote information” in Attachment (4)).

(e) As ¥200 is greater than 120% of ¥150, the Program uploaded and set up on the Server of the Trading Participant automatically calculates, pursuant to the market price information received in (d) above, the order to “sell 100 shares of XXX Co., Ltd. at ¥200 and purchase 100 shares of YYY Co., Ltd. at ¥150” because it is met that “the stock price of XXX Co., Ltd. (¥200) becomes 120% or higher than the stock price of YYY Co., Ltd. (¥150)” (“(5) Automatic calculation” in Attachment (4)).

(f) Pursuant to the results of automatic calculation in (e) above, the Server of the Trading Participant automatically transmits to the Trading System of TSE an order “to sell 100 shares of XXX Co., Ltd. at ¥200 and purchase 100 shares of YYY Co., Ltd. at ¥150” (“(6) Automatic ordering” in Attachment (4)).

(g) The Foreign Investor will assess the performance of the trades referred to in (a) through (f) above (“(7) Ex-post valuation” in Attachment (4)). As a result of this, additional investment decisions may be made to change or modify the above-mentioned investment policies, the Program, or parameters, etc. The processes indicated in (a) above and thereafter will be repeated.

(viii) As the orders placed from the Server are in any event orders of the Trading Participant entrusted by the Foreign Investor, these orders will always be screened by risk-management tools² of the Trading Participant such as restriction filters. However, all orders placed from the Server will be made solely in accordance with the Program and various parameters prepared and set up by the Foreign Investor outside of Japan, unless the orders are blocked due to violations of the criteria set by the risk management tools.

(4) Supplementary notes on the use of the Co-Location Service for the “Remote Participants System”

TSE has already introduced a system where Foreign Investors who are participants in local stock exchanges overseas (excluding non-resident individuals) acquire trading qualifications of TSE as Authorized Transaction-at-Exchange Operators (Financial Instruments and Exchange Act, Article 60-4, Paragraph 1) (hereinafter the “Remote Participants System”). The Co-Location Service explained above is expected to be used by Foreign Investors in this category who have acquired trading qualifications of TSE as Authorized Transaction-at-Exchange Operators (hereinafter the “Remote Participant(s)”) in conducting trades at TSE.

Remote Participants may directly participate in market trading by themselves at TSE without intermediary of the Trading Participants (so-called securities companies) (without having to entrust purchase/sale to securities companies). The Remote

² For example, tools to prevent the erroneous placement of orders caused by erroneous order entry.

Participants, on the other hand, are participants of local stock exchanges overseas (Article 60-3, Paragraph 1, Item 1 (d) of the said Act), yet do not have clearing qualifications as Financial-Instruments-Clearing Organizations (Article 2, Paragraph 29 of the said Act) under the Remote Participants System. Therefore, the Remote Participants are required to entrust broking for the clearing of securities, etc. (Article 27 of the said Act) to the “Clearing Participants” (those who possess clearing qualifications as Financial-Instruments-Clearing Organizations among the Trading Participants). In other words, the Remote Participants are not required to entrust purchase/sale to the Trading Participants, but are required to entrust trade settlement (clearing) to the Clearing Participants. In order to enable this arrangement, the said Act stipulates provisions under which the Remote Participants will execute, for and on behalf of the Clearing Participants, contracts on the purchase/sale of securities (Item 1 of the said Paragraph). Therefore, settlement will be effected in the name of the Clearing Participants.

As a Remote Participant is required to be registered as a foreign company under the Company Act, it will have a representative in Japan (Company Act Article 817). This representative in Japan is expected to function virtually only as a contact person with TSE. Therefore, the representative will under no circumstances maintain places for conducting business, such as offices, for the Remote Participants in Japan, or habitually exercise authorities to conclude agreements for the Remote Participants in Japan. All purchase/sale agreements for securities and any other agreements to be concluded by the Remote Participant under the Remote Participant System will be concluded outside of Japan without any involvement of the representative in Japan. Therefore, a representative in Japan will in no way constitute a permanent establishment of the Remote Participant (so-called Type 1 PE or Agent PE, Corporation Tax Act, Article 141, Item 1 or Item 3).

When a Remote Participant uses the Co-Location Service under the Remote Participants System, the Clearing Participant (who has been entrusted with broking of clearing of securities by the Remote Participant) will rent the Space from TSE and install the Server owned or leased by the Clearing Participant in the Space, and the Remote Participant will enjoy the Services from the Clearing Participant using the Server. Please also refer to Attachment (3)-2 regarding this matter.

The explanation on the facts and preliminary matters pertaining to the Co-Location Service explained under “(3) How the Co-Location Service Works” above will also apply as an explanation for the case where Remote Participants use the Co-Location Service under the Remote Participants System, except for the difference mentioned above. That is, there are no differences in the background and purpose of the Co-Location Service. Further, there are no differences in the functions performed by the Server, or on the point that a Server owned or leased from a third party by the Clearing Participant is installed in the Space in Japan and the Remote Participant enjoys the Services using the Server. Consequently, please treat “1. Subject of Inquiry” above as the inquiry with respect to the case where the Remote Participants use the Co-Location Service under the Remote Participant System.

3. Analysis

(1) Issues involved

Under the Co-Location Service referred to above, the Foreign Investor does not own or lease the Server in Japan (or in the Space), but the Foreign Investor will be able to receive and enjoy environment for high-speed placement of orders using the Server pursuant to the Services. Then the issue is whether or not the Foreign Investor is found to have a permanent establishment in Japan under Japanese tax law. More specifically, the foremost issue is whether or not the Foreign Investor is found to have a Type 1 PE, i.e., “an establishment similar to the place prescribed in the two preceding paragraphs as a fixed place of business” (Corporation Tax Act, Article 141 Paragraph 1, Item 1, Cabinet Order for Enforcement of Corporation Tax Act, Article 185, Paragraph 1, Item 3).

(2) Interpretation of Laws

(i) Guidelines on interpretation of domestic tax laws

Regarding the interpretation of “an establishment similar to the place prescribed in the two preceding paragraphs as a fixed place of business” (Cabinet Order for Enforcement of Corporation Tax Act, Article 185, Paragraph 1, Item 3), the interpretative circular (Corporation Tax Basic Interpretative Circular 20-2-1) only prescribes that this includes “a room in a hotel, place for exhibition sale” serving as a center of business activities of a non-resident or foreign corporation. To our knowledge, there is no official interpretation of the tax authority that clarifies the application of the above rule in relation to transactions using computer servers.

On the other hand, the question of whether a server or a website constitutes a permanent establishment is one of the most significant tax issues related to electronic commercial transactions. In this regard, the results of the discussion of the OECD Committee of Fiscal Affairs are summarized in the form of a Commentary on the permanent establishment provisions of OECD Model Tax Convention (Article 5). The Commentary on the OECD Model Tax Convention itself is not a direct statement on the interpretation of domestic laws of Japan, but there are views of a commentator regarding the relationship between the two, especially in the context of electronic commercial transactions, as follows: “when there is no clear criteria for determination in domestic tax laws or the related provisions, one of the solutions would be to interpret the scope of permanent establishment under domestic tax laws by referring to the opinion of the OECD Committee of Fiscal Affairs.”³ In addition, with respect to the old U.S.-Japan Tax Treaty, one commentator states that “provisions related to permanent establishment under the Income Tax Act and the Corporation Tax Act in Japan and those under the U.S.-Japan Tax Treaty could be said as generally similar to each other, while there are some differences. This would be because both the Tax Treaty and the domestic

³ The Japanese Institute of Certified Public Accountants, Tax Treatment of Electronic Commercial Transactions (October 7, 2002), 3.

tax laws conform to the OECD Model Tax Convention.”⁴ Further, as far as the provisions of the above domestic tax laws are concerned, the wording is largely similar to that of the corresponding provisions in Article 5 of the OECD Model Tax Convention, (Article 5, Paragraphs 1 and 2, or Article 5, Paragraph 4, Item e), and no substantial differences would be found. Consequently, the Commentary on Article 5 of the OECD Model Tax Convention may be referred to as a guideline on interpretation of the above provisions of the domestic tax laws as well.

(ii) Discussions on Commentary on OECD Model Tax Convention

The Commentary on Article 5 of the OECD Model Tax Convention mainly provides interpretation of the concept of permanent establishment as it relates to the operation of electronic commercial transactions, in Paragraph 42.1 to 42.10. Specifically, the concept as to whether or not servers and web sites constitute a permanent establishment is outlined below⁵.

a. “[A]n Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property.” “It therefore does not have a location that can constitute a ‘place of business’ as there is no ‘facility such as premises or, in certain instances, machinery or equipment’ (see paragraph 2 above) as far as the software and data constituting that web site is concerned. “On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute ‘a fixed place of business’ of the enterprise that operates that server.” (Paragraph 42.2).

b. “[T]hese contracts typically do not result in the server and its location being at the disposal of the enterprise, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location.” “In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement.” “However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met. (Paragraph 42.3).

(3) Application to this case

⁴ Yoshiaki Komatsu, Clause-by-Clause Commentary - Japan-U.S. Tax Treaty (3rd ed.), 107. The Financial Services Agency and tax authorities also worked on the interpretation by referring to the OECD Model Tax Convention with regard to the provisions to exclude independent agents from the so-called agent PE provided by the 2008 Tax Reform (Cabinet Order for Enforcement of Income Tax Act, Article 290 proviso clause, Cabinet Order for Enforcement of Corporation Tax Act, Article 186, proviso clause). (Refer to “Reference Cases” and “Q&A” regarding permanent establishment (PE) (dated June 27, 2008)).

⁵ The Japanese translation hereinafter is from Yasuyuki Kawabata (as translation supervisor), OECD Model Tax Convention 2003 version (2003).

Application of the above interpretation of laws to the facts pertaining to the Co-Location Service at issue will be as follows:

As set out in fact (iv) above, as indicated in “2. Facts and Preliminary Matters - (3) How the Co-Location Service Works,” a Foreign Investor will not own or lease the Server when receiving the Services. Disposal rights such as ownership rights to the Server are exclusively owned by the Trading Participant, and the Server cannot be disposed of by the Foreign Investor at its discretion. The contract pertaining to the Services is not a lease agreement or a rental agreement, with or without charge, but is a service agreement, and the Foreign Investor does not receive delivery (or acquire right of possession) of the Server once the Server has been installed at the Space, and the Foreign Investor may not utilize the Server at its discretion for any purposes other than receiving and enjoying environment for high-speed placement of orders constituting the content of the Services. Maintenance work required for the Server will be done by the maintenance operator contracted with the Trading Participant, and all maintenance expenses will be paid by the Trading Participant to the maintenance operator. Under no circumstances will the Foreign Investor be involved in the maintenance work. Further, the Foreign Investor is in principle prohibited from entering the Space where the Server is installed. From the foregoing factors, the Foreign Investor would not be considered to own disposal rights to or virtual control over the Server, beyond receiving and enjoying environment for high-speed placement of orders.

In the case of the “One-to-One-Installation Type” pattern of the Services, one separate and independent server will be furnished to each Foreign Investor. Yet even in this case, the above facts will not change in any way. The “One-to-One-Installation Type” is provided for the purpose of preventing adverse effects to other Foreign Investors when the server is shared among multiple investors; and in no sense disposal rights to or virtual control over the Server will be granted to any Foreign Investor beyond receiving and enjoying environment for high-speed placement of orders. That is, even in the case of the “One-to-One-Installation Type,” the activities that the Foreign Investor is authorized to conduct on the Server are exactly the same as those in the case of the “Shared-Use-among-Multiple-Investors Type.” Further, even in the case of the “One-to-One-Installation Type,” the Foreign Investor has no such rights whatsoever as rights or options to purchase the Server or to repurchase it from the Trading Participant. There are no circumstances where it is agreed upon in advance that the ownership of the Server will eventually belong to a particular Foreign Investor. In this point too, the situation is exactly the same as that in the case of the “Shared-Use-among-Multiple-Investors Type.”

In addition, in the case of the “One-to-One-Installation Type,” the Foreign Investor will be involved, or the Foreign Investor’s opinion will be reflected, in the stage of procurement of the Server by the Trading Participant. However, this factor is a different question from whether or not the Foreign Investor owns free disposal rights to or virtual control over the Server at the stage where the Foreign Investor conducts securities trading, and, as stated above, the Foreign Investor owns no such disposal rights or control at the stage where the Foreign Investor conducts securities trading. In other words, the “One-to-One-Installation Type” and the “Shared-Use-among-Multiple-Investors Type” are identical in the aspect that the

Foreign Investor does not own any disposal rights to or virtual control over the Server at the stage of conducting securities trading.

In both the “One-to-One-Installation Type” and the “Shared-Use-among-Multiple-Investors Type,” mass-produced products generally and readily available in the market as a server are expected to be used as the Server. That is, there is no special connection between the Foreign Investor or its Program and the Server such that the Program of the Foreign Investor can be operated only on a particular server. The Program, much like any computer software sold commercially, can be operated on any server available as a mass-produced product, as long as it meets certain specifications.

Further, as the Server is to be owned or leased by the Trading Participant under the Services, it is the basic premise and principle that the Trading Participant may dispose of (or sell, provide as collateral, divert to another use, destroy, etc.) (in the case of ownership) the Server at its discretion, or utilize (or divert to another use, etc.) the Server at its discretion (in the case of lease). As a minimum restriction inevitable and necessary to ensure stable provision of the Services and protection of the Program and various parameters and other data, only the restriction agreed upon under the contract pertaining to the Services is imposed. There are no restrictions on disposition of the Server by virtue of the ownership right or on utilization of the Server by virtue of the leasehold right of the Trading Participant, other than such minimum restriction inevitable and necessary for the purpose of the contract. The existence of this restriction does not mean that the Foreign Investor will be granted disposal rights to or virtual control over the Server beyond receiving and enjoying environment for high-speed placement of orders (or, to enable the Foreign Investor to dispose of the Server at its discretion regardless of the intention of the Trading Participant).

After all, in either of the cases of the “One-to-One-Installation Type” or the “Shared-Use-among-Multiple-Investors Type,” the Foreign Investor’s activities that can be conducted under the Services are limited to uploading, installing and storing on the Server the Program and various parameters and other data it uses for the entrustment of orders in accordance with the manner instructed by the Trading Participant, and operating the Program on the Server for the purpose of entrusting the orders (as well as incidental matters such as exchanging, with the Trading Participants, various information related to the securities trading pertaining to its entrustment). The Program and various parameters and other data will be owned by the Foreign Investor. It would be natural to find that such a fact pattern is substantially the same as a fact pattern where a foreign enterprise owns the software and electronic data constituting a website and uses a disk space on a server owned by the Internet Service Provider (ISP), in order to host and store the software and electronic data, as indicated in the example in the OECD Commentary above. The Program and various parameters and other data definitely correspond to software and electronic data, and under the Services, the Trading Participant allows the Foreign Investor to use the disk space on the Server owned by the Trading Participant. A Trading Participant is not an ISP, but it would be natural to find that the Trading Participant fulfills a function substantially the same as an ISP in the Services.

In the case at issue, the Foreign Investor would only possess the Program and various parameters and other data (as stored in the disk space on the Server) in Japan. In this regard, it is interpreted that: “[W]ebsite... does not have a location that can constitute a ‘place of business’ as there is no ‘facility such as premises or, in certain instances, machinery or equipment’ as far as the software and data ... is concerned” (Paragraph 42.2). “[T]he enterprise does not even have a physical presence at that location since the web site [TSE Note: software and electronic data] is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement.” (Paragraph 42.3). We should therefore conclude that a Foreign Investor will not be found to have a “fixed place of business” in Japan.

In the case of the “One-to-One-Installation Type,” a separate and independent server will be provided for each Foreign Investor and the Foreign Investor will be able to upload the Program and various parameters and other data in accordance with the manner instructed by the Trading Participant. However, (1) it is interpreted that “these contracts typically do not result in the server and its location being at the disposal of the enterprise, even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location.” (Paragraph 42.3). In addition, (2) it is interpreted that, if “it owns (or leases) and operates the server on which the web site is stored and used,” the Foreign Investor may be considered to be in possession of a permanent establishment (Paragraph 42.2), and, given the word “and” in the original sentence, it can be assumed that, unless both “owns (or leases)” and “operates” are satisfied, the Foreign Investor will not be considered to have a permanent establishment. On that basis, we must conclude that, even in the case of the “One-to-One-Installation Type,” the conclusion that a Foreign Investor does not have any “fixed place of business” will not be affected. Given that the preparation of the Program and various parameters and other data and all relevant investment decisions will be made outside of Japan, it is needless to say that these points do not affect the conclusion.

As stated above, in either of the cases of the “One-to-One-Installation Type” or the “Shared-Use-among-Multiple-Investors Type,” even if a Foreign Investor receives and enjoys the service of provision of environment for high-speed placement of orders pursuant to the Services, we should conclude that a Foreign Investor will not be found to have “any other fixed places for conducting a business equivalent to the places listed in the preceding two items” (Corporation Tax Act, Article 141, Paragraph 1, Item 1, Cabinet Order for Enforcement of Corporation Tax Act, Article 185, Paragraph 1, Item 3) in Japan, solely because of these transactions.

We would like to add that, as the Server itself does not constitute a “Person” as used in Japanese statutes, the Server itself does not constitute a so-called “Agent PE” (Corporation Tax Act, Article 141, Paragraph 1, Item 3). In addition, as a Trading Participant is, apart from providing the Services, only conducting regular securities trading business (or purchase and sale of securities by way of entrustment) under the facts of the case, a Trading Participant does not fall under any of a “person who is authorized to conclude...a contract regarding its business...and regularly exercises such authority...” (Cabinet Order for Enforcement of Corporation Tax Act, Article 186, Item 1), a “person who retains...a certain amount of assets for responding to ordinary

requests from customers” (Item 2 of the said Article), and a “person who regularly performs...an essential part of the receipt of an order (Item 3 of the said Article). Therefore, we should conclude that it is not an issue whether the Trading Participant constitutes a so-called Agent PE.

4. Conclusion

For the foregoing reasons, even if the Trading Participant provides to a Foreign Investor, and a Foreign Investor receives from the Trading Participant and enjoys, the service of providing environment for high-speed placement of orders pursuant to the Co-Location Service provided by TSE to the Trading Participant, it should be affirmed that the Foreign Investor will not be treated as having a permanent establishment in Japan solely because of these transactions.

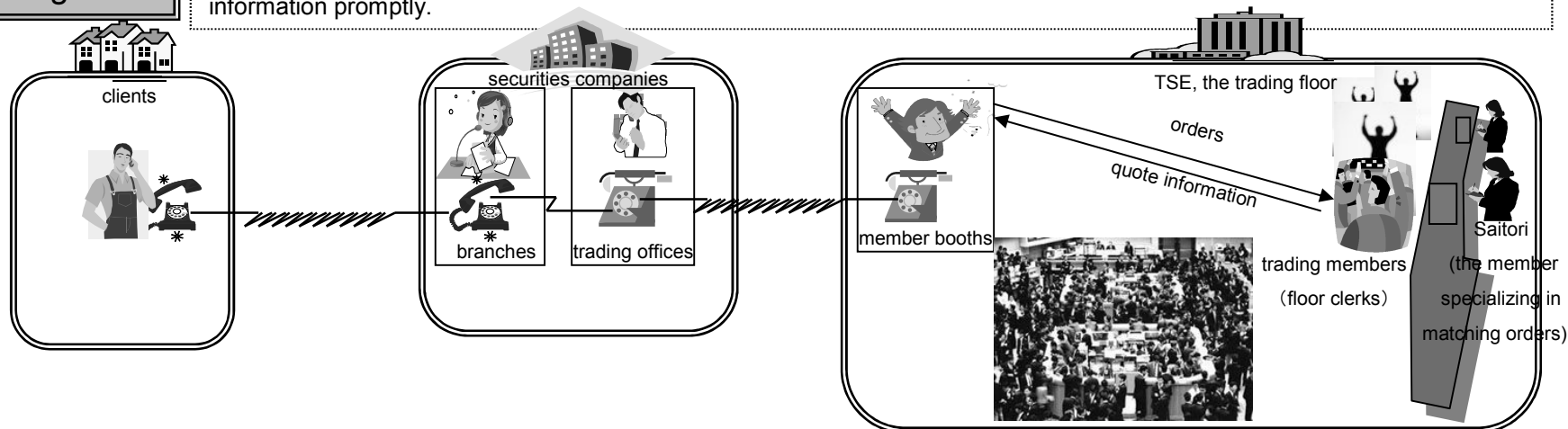
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From the trading floor to the ultrafast computerized trading system

~ Evolution from floor clerks to co-location ~

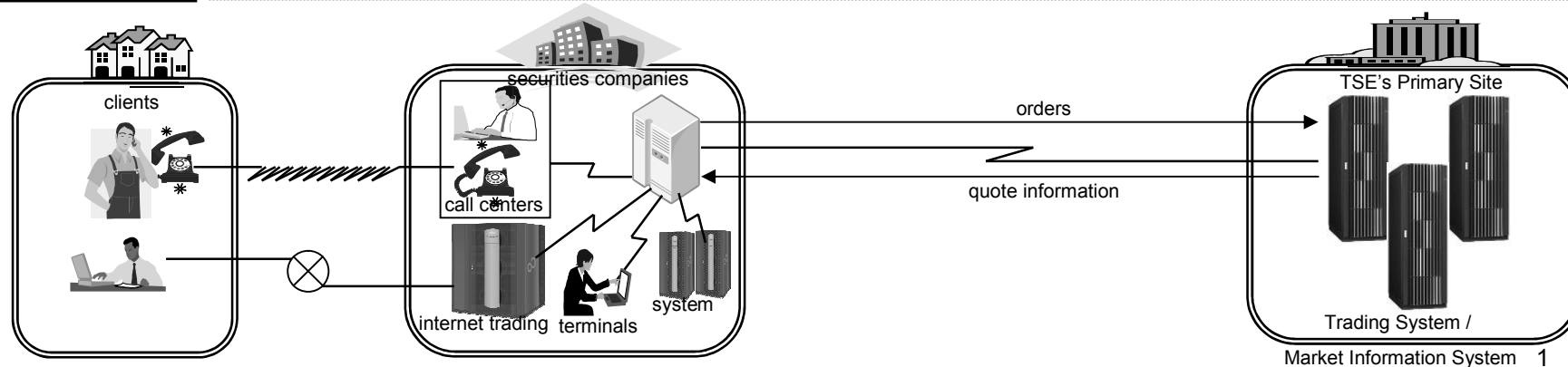
the trading floor

Clerks in member booths communicated with floor clerks through hand gestures in order to convey orders and quote information promptly.



computerization (1999)

With the development of IT, the trading system, rather than Saitori, has come to automatically perform matching of orders. The number of securities companies near Kabuto-cho where TSE is located is decreased. This led to distance between TSE's Primary Site and data centers of securities companies.

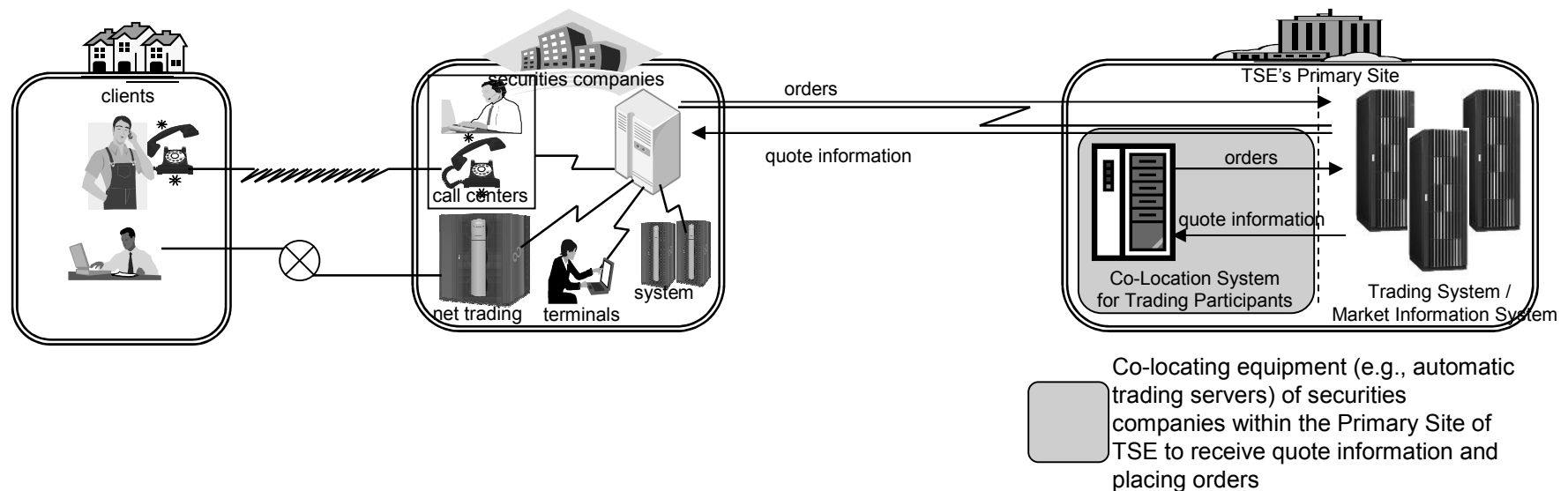


Emergence of algorithmic trading

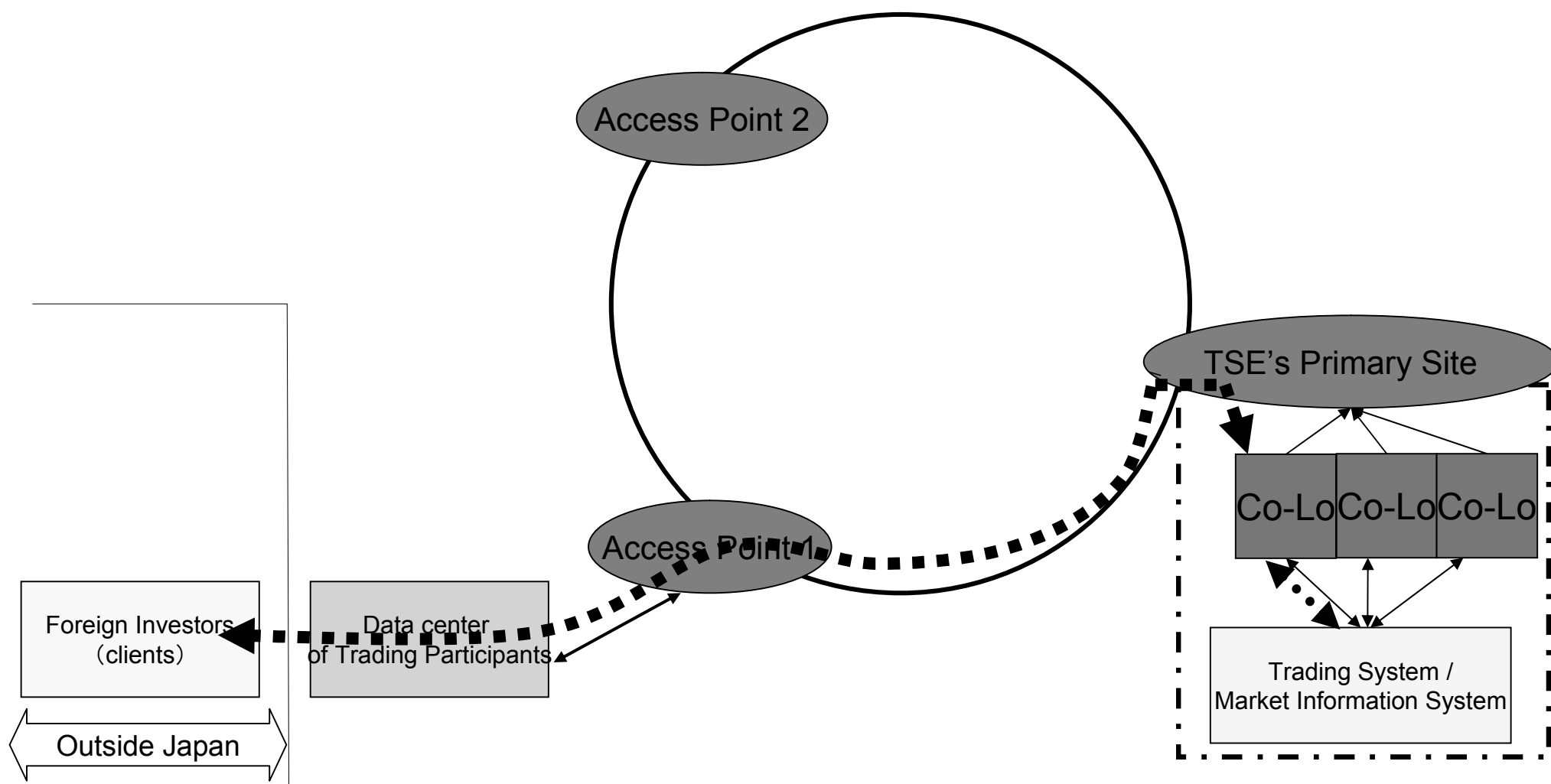
In automatic algorithmic trading, it became crucial how fast market users can get the quote information, and there arose increasing demands for making faster the transmission from the TSE Primary Site to the data centers of securities companies.

Co-Location

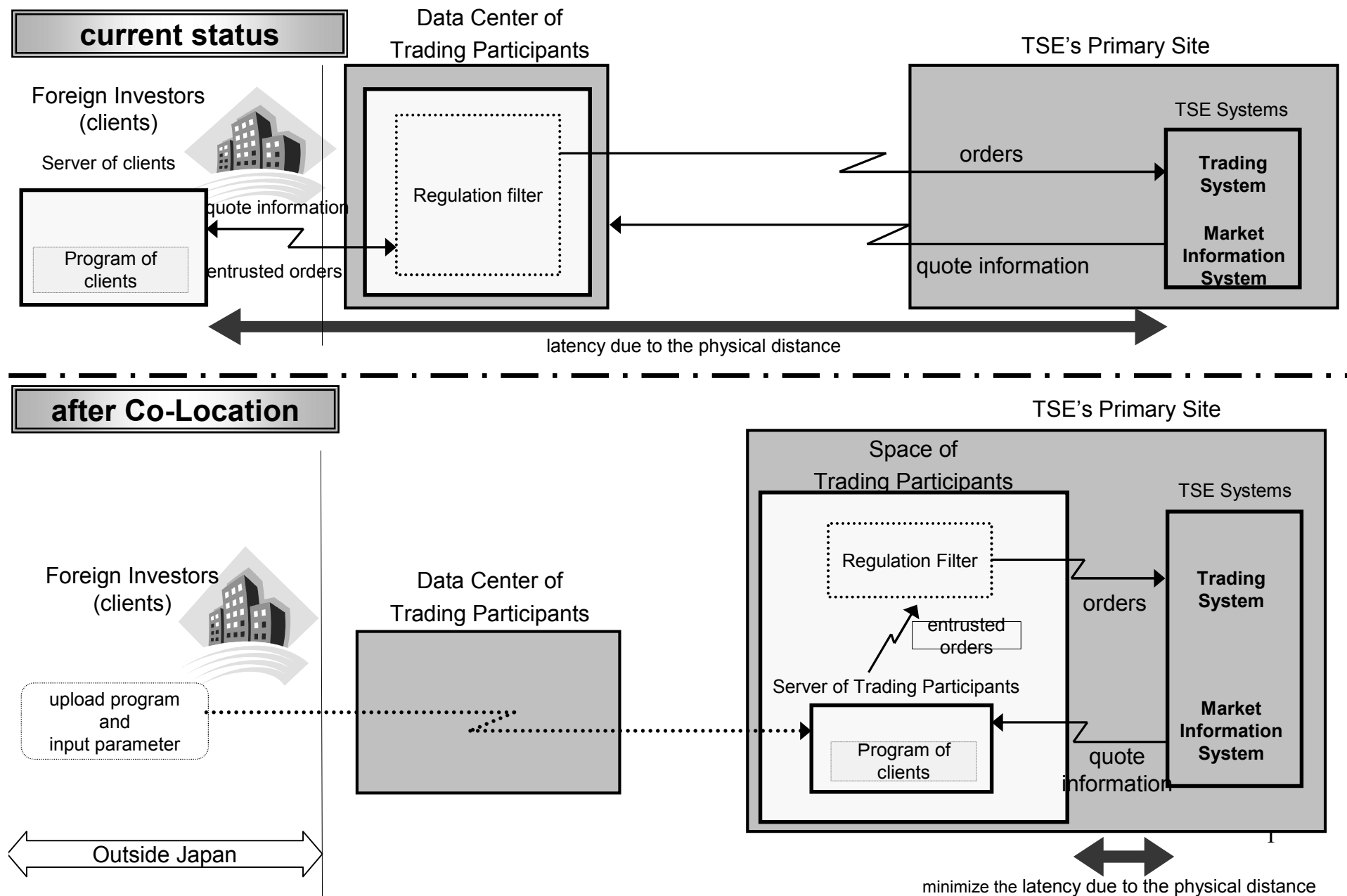
With the Trading System operating at an ultrafast speed (less than 10 milliseconds), there are increasing demands for co-locating the equipment (e.g., automatic trading servers) of securities companies within the data center of TSE, with a view to receiving the quote information as fast as possible (one millisecond or less) and placing orders. The “co-location” structure, or an electronic “floor clerk,” has received rapidly increasing demands in overseas stock markets specially in the U.S.



Network Diagram for Co-Location Service

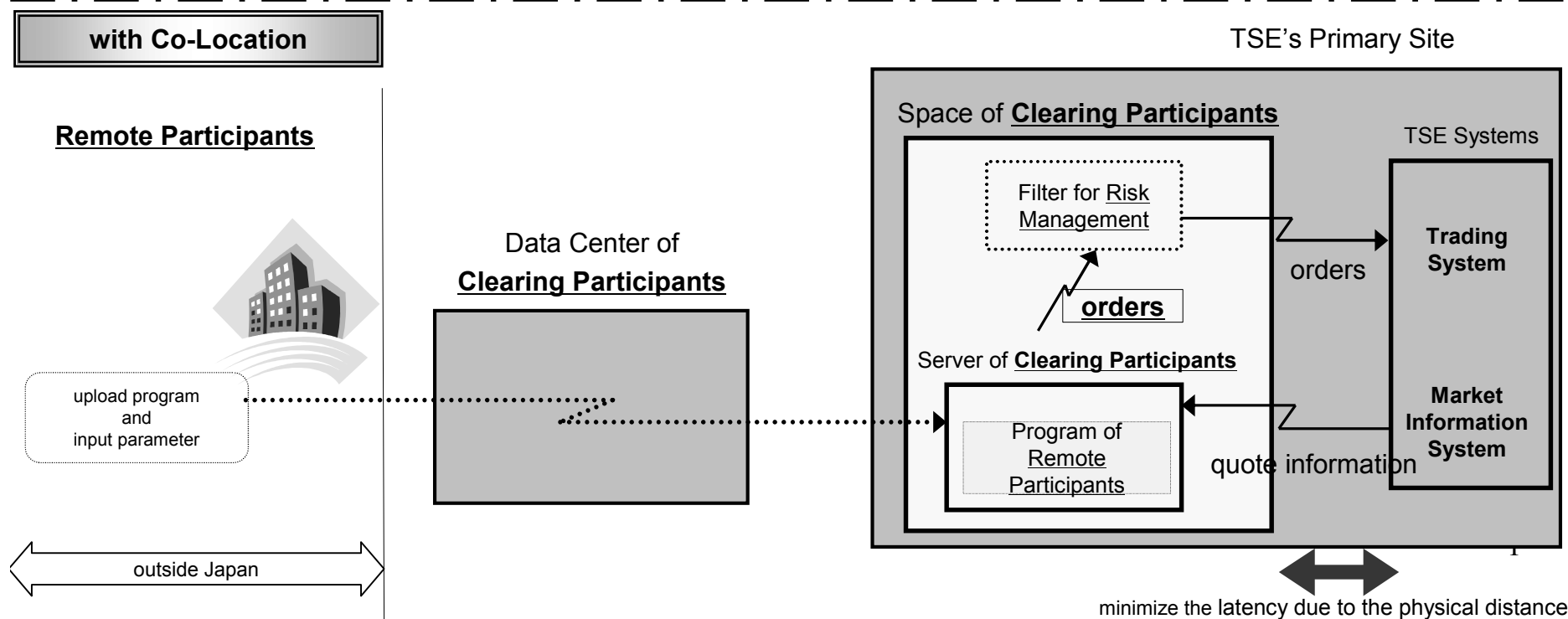
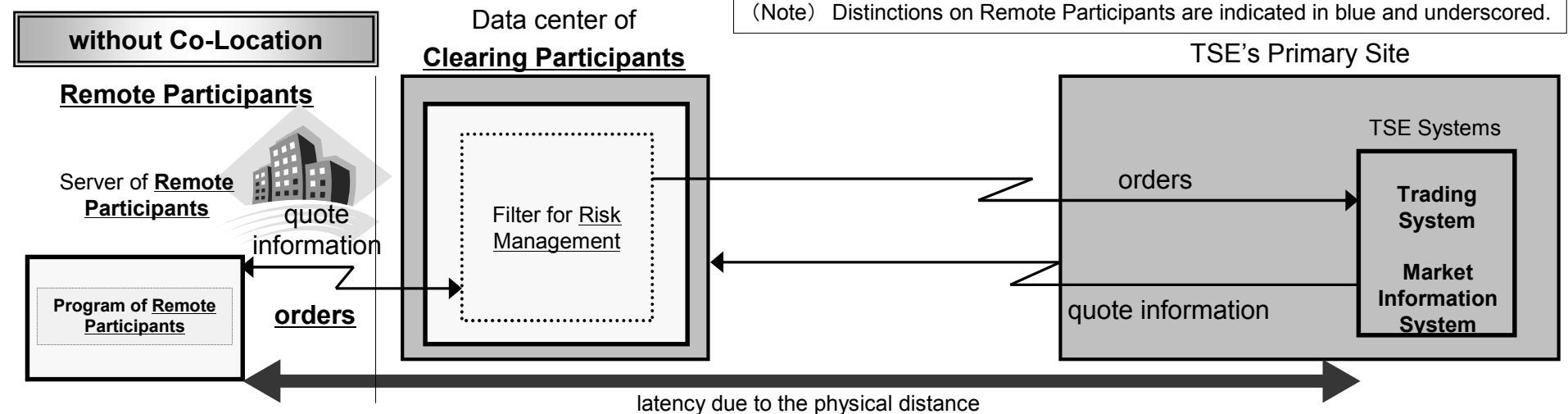


Co-Location Service



Co-Location Service (for Remote Participants)

(Note) Distinctions on Remote Participants are indicated in blue and underscored.



Setting of Automatic Trading Program and Parameters ~ the Process of Automatic Trading

Attachment (4)

TSE's Primary Site

Foreign Investors
(Clients or Remote Participants)



① investment decisions

- decide an investing policy
"arbitrage between 2 issues"
- create a program
- select stocks and set other necessary parameters

② upload the program

③ input parameters

- ## ⑦ ex-post valuation / investment decisions
- the investing policy, the ordering program and/or modification of parameters, etc.

Space of Trading Participants or Clearing Participants

Server of Trading Participants or Clearing Participants

Program of foreign investors (clients or Remote Participants)

"When X's stock price(x) becomes $(100+Z)\%$ or more than Y's stock price(y), sell X ($\text{¥ } x \times \text{"a"}$ stocks) and buy Y ($\text{¥ } y \times \text{"b"}$ stocks). When x becomes $(100-Z)\%$ or less than y, buy X ($\text{¥ } x \times \text{"a"}$ stocks) and sell Y ($\text{¥ } y \times \text{"b"}$ stocks)"

parameters

X="XXX", Y="YYY", Z="20", a=b="100"

④ receive quote information

The server receives the quote information, "XXX ¥200" "YYY ¥150"

⑤ automatic calculation

The program automatically calculates "sell XXX ($\text{¥ } 200 \times 100$ stocks) and buy YYY ($\text{¥ } 150 \times 100$ stocks)" on the basis of received quote information.

⑥ automatic ordering

The server automatically orders "sell XXX ($\text{¥ } 200 \times 100$ stocks) and buy YYY ($\text{¥ } 150 \times 100$ stocks)" on the basis of calculation result.

TSE's Systems

..., XXX ¥200,
.....,
....YYY ¥150,
.....

quote
information

Market
Information
System

Trading
System

orders