

Interim Report of the Committee for Reform of the Securities Clearing and Settlement System (Memorandum)

Note: This is a tentative translation of the "Memorandum of the Interim Report of the Committee for Reform of the Securities Clearing and Settlement System" and has not been formally approved by the issuer of the report. The translation, prepared by the secretariat of the JSDA, is intended to facilitate understanding of the reform by the international audience.

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I. Introduction

A securities clearing and settlement system superior in security, productivity, and efficiency is a basic infrastructure for securities markets. It is one of the most important issues yet to be tackled in Japan's efforts to establish an internationally competitive financial center.

In light of the globalization of securities transactions and worldwide competition among markets, major Western countries have already adopted "DVP" (Clearing versus Payment) for a wide range of securities, and begun work on "T+1" (settlements on the next day of transactions). These efforts to reform securities clearing and settlement systems are being made as markets strive to offer better services to meet users' various needs.

In contrast, Japan's securities clearing and settlement system is segmented by product type. It is therefore imperative to overhaul the system and adopt "STP" (Straight Through Processing), "T+1" and "DVP", in order to meet international standards.

Recognizing the above issues, an across-the-board committee was set up in July 1999, hosted by Japan Securities Dealers Association, to look into fundamental issues for developing a new clearing and settlement system. With regard to reducing settlement time to T+1 in equities, JGBs and non-JGB bonds, we have investigated the issues with the understanding that:

- (a) Consistency of the entire settlement system should be achieved, and security, productivity, and efficiency should be enhanced,

- (b) Market rules and practices compatible with global standards should be developed, by making the best use of practitioners' expertise, to keep Japanese securities markets internationally competitive, and
- (c) The reform should benefit each user of the system (investors, custodians, brokers and issuers).

With respect to achieving DVP settlement, we have investigated the issues appreciating that:

- (a) DVP should be adopted at the time of implementing a new settlement system and reduced settlement cycles,
- (b) A new DVP settlement scheme should be compatible with global standards to maintain and enhance the international competitiveness of the Japanese securities market,
- (c) Settlement risk should be kept at a minimum, although this involves costs, by developing safeguards, and
- (d) Measures should be taken to streamline the entire settlement system, to minimize the cost associated with the introduction of DVP settlement.

I. Reducing Settlement Time

1. Issues to cope with in achieving T+1

These issues are: those that commonly apply to all types of securities trading; those specific to each type of trading, and those specific to equities.

2. Direction for developing T+1

We have investigated various aspects of Japan's settlement system, including legal and regulatory issues, technical matters and market rules and practices, and concluded that the following measures should promptly be taken:

(1) Legal issues

Dematerialization of securities (paperless, immobilization, or denominating in a large unit)

- (a) To ensure STP for securities settlements, dematerialization of securities is essential. It should rather be done independently wherever possible than to wait for comprehensive legislation enabling dematerialization for all types of

securities.

A. New legislation to facilitate immobilization

For the near future, a new legislative initiative is needed to facilitate immobilization of securities. Specifically, the coverage by the existing central depository and transfer system, which currently handles equities, should be expanded. In addition, it is necessary to revise the bond recording system and promote the bundling of bond certificates into a larger unit.

B. Amending the Depository and Book-Entry Transfer of Securities Law, etc.

A) Expanding the scope of eligible securities to be handled by central securities depositories (CSDs)

In major Western countries, CSDs commonly handle various types of securities, including equities, bonds, commercial papers (CPs) and beneficiary certificates of investment trusts. In view of this, CSDs in Japan should be allowed to handle a wider range of securities to enhance security, productivity and efficiency. In doing so, each product's specific characteristics need to be taken into account. In addition to provisions for equities, the Law defines, in Article 39, that such provisions are also applicable to other types of securities. Yet there are still various types of securities that are not explicitly designated as eligible. Therefore, it should be clarified whether CSDs can actually handle them and, if necessary, the law itself should be amended.

B) Promoting deposit of stock certificates with CSDs

To make settlement procedures more efficient as well as to achieve DVP, it is necessary to boost deposits of stock certificates at CSDs, thereby effectively eliminating physical deliveries. A new regulation or legal certainty is needed to enable the following:

- More extensive use of the "deemed-to-be-deposited" system
Allowing securities to be deposited with CSDs at the time of issuance should stimulate the use of CSDs, as the costs associated with printing and then dematerializing can be eliminated.
- Treatment of those issuers yet to agree to CSD handling
In view of the objective of the Law, it is desirable that publicly traded

equities can be automatically deposited with CSDs even in the absence of the issuers' consent.

- Removing restrictions on shareholder rights
Minority shareholders who deposit shares with CSDs should be able to exercise their rights as soon as they are on the list of beneficial shareholders, which is updated every six months.
- Treatment of odd-lot shares
Odd-lot shares, for which certificates are not issued, should be eligible for CSD handling.
- Treatment of those shares with restrictions on holding by foreigners
For such securities other than NTT shares, clear interpretations of the applicable laws or legislative modification are needed regarding the treatment of those shares held by foreigner in excess of the restrictions.
- Efficient operation of CSDs
It may be necessary, depending on further discussion by the committee, to consider how to run CSDs more efficiently.

C. Revising the corporate bond recording system

A) Revising the system

- Abolishing the serial number-based management and abolishing/easing the rule for processing registration applications
Doing so will pave the way for the management of balances on a creditor-by-creditor basis, currently employed for the settlement of registered JGBs, as it will no longer be necessary to record the trading history of individual bonds. This would enable thorough online processing of registration applications, thereby making the administrative procedures more efficient.
- Delegation of registration business among registration agencies
To keep administration costs low, it is desirable to consider legislation allowing registration agencies to delegate the whole or primary portion of registration business to other well-equipped agencies.

- Introducing a method of registration under depositories' names
For efficient settlement, it is very useful to introduce a system in which depositories' names are registered in lieu of those of beneficiary creditors. Adopting such a multi-layered structure of bond holding would also boost the growth of bond lending and other settlement-related businesses. In doing so, it is necessary to accommodate those bondholders already registered under their names. In addition, arrangements should be made for transfers across/within depositories, and protection must be provided for good-faith acquirers. There are a couple of ways to introduce such a system. Under a "multi-depository" method, various institutions such as banks, securities companies and CSDs function as depositories, whereas a "single depository" method designates a CSD as the sole depository as in the case of the JGB book-entry settlement system.

B) Adopting book-entry for settlements of Non-JGB bonds

As in the JGB book-entry settlement system, book-entry should be introduced for settlements of municipal and corporate bonds (bar private placement ones held to maturity), because it would significantly lower administrative costs. It would also effectively eliminate one of the major obstacles in the bond market, namely the three-week suspension of registration prior to the interest/principal payment. One possibility of introducing a new book-entry system is to designate a CSD as the sole depository of registered bonds, whereby all transfers are made at the CSD on a book-entry basis. Another is to issue a single certificate for each bond, which a CSD then holds on behalf of all beneficiary bondholders.

A. Dematerialization of CPs

New legislation should be introduced for dematerialization of CPs, as well as a corresponding settlement system. Also, the possibility of dematerializing CPs ahead of other products needs to be explored.

B. Dematerialization of beneficiary certificates of investment trusts

It is desirable that beneficiary certificates of investment trusts be dematerialized to streamline the administrative procedures.

(a) Electronic processing of trading reports

To reduce settlement time, particularly with regard to transactions with institutional investors, online delivery of trading reports should be allowed. In addition, investment trust managers should be allowed to give instructions electronically.

(b) Revising the interest tax regime for bonds

- A. Under the current tax regime, foreign-owned bonds deposited with global custodians are subject to a withholding tax. As this inhibits a shift to book-entry JGBs from directly-registered JGBs, as well as the growth of the JGB market itself, certain tax arrangements should be made.
- B. As different interest tax regimes apply to financial institutions' holdings and corporate customers' holdings of registered bonds, the bond market has effectively been divided. To promote the growth of the bond market, taxation should be coherent regardless of the category of investors. In addition, book-entry Non-JGB bonds should be exempted from a withholding tax if such bonds are to be introduced.

(2) Improving the system architecture

(a) The need for a confirmation system to facilitate STP

A. A trade/settlement confirmation system linking all parties involved

It is essential to have a confirmation system that facilitates quick processing of trade/settlement information. To reduce settlement time, such a system should be efficient and cover a wide range of securities.

B. Developing an industry-wide trade/settlement confirmation system

Market intermediaries, such as trust banks, securities companies, investment advisors and managers, should reorganize their post-trade administrative procedures to enable online information flow among them as well as electronic data processing. We are divided as to what kind of a confirmation system is preferable. Some argue that for greater productivity and efficiency, a standardized, comprehensive confirmation system should be developed so that it covers a wide range of products. Others insist that a single system should not be forced upon the market, because such a move discourages competition as well as neglects the difference in the nature of individual products and market participants.

C. Real-time data processing

Participants, in particular those involved in "Tokkin" transactions, such as trust banks, investment trust management firms, investment advisory firms, and settlement banks, should be capable of real-time data processing.

(b) Standardizing protocols to enable STP

To enable STP, a standardized system protocol is needed whereby data are processed by all participants in a coherent, compatible manner, and inter-operability between the buy side and the sell side is ensured. In addition, it is important to set a time limit for each stage of data processing, as well as to have codes of practice.

(3) Improving market rules and practices

(a) An infrastructure to facilitate efficient transactions and settlements

A. Swift confirmation of the amount of funds/stocks which securities firms borrow from securities finance companies in loan transactions

It is necessary to review the administrative procedures at securities finance companies, namely their handling of securities firms' applications for loans of funds and stocks.

B. Developing a stock borrowing/lending market

On the trading day, T+0 stocks should be available, after the clearance of the day's transactions, in a stock borrowing/lending market for next-day settlements. With T+1, the settlement period, specifically at CSDs, should be kept as long as possible.

C. Developing a T+0 bond repo market

To facilitate T+1 settlements of bond transactions, it is essential to develop a T+0 repo market with sufficient liquidity.

D. Rules for failed settlements

Rules for failed settlements must be in place to allow deferred deliveries, at appropriate costs, for technical/temporary settlement failures, rather than automatically treating any settlement failure as a default.

E. Revising the procedures of correcting executed orders

In a T+1 settlement environment, it is difficult to handle requests for correction of executed exchange orders because of time constraints. Thus, a new set of procedures must be developed to accommodate legitimate requests to the greatest extent possible.

F. Extending operating hours of settlement systems

Operating hours of securities/fund settlement systems, such as the BOJ Net, the Zengin system, the JB Net and those at CSDs, should be extended.

(b) Developing rules and practices for non-resident transactions

A. Developing a global electronic confirmation system

Market intermediaries should have electronic, seamless procedures for handling non-resident transactions.

B. A round-the-clock confirmation system

It is necessary to develop an electronic, 24-hours-a-day settlement confirmation system so that confirmation can be done anytime with global custodians from various time zones.

C. Payments in foreign currencies

Arrangement should be made for payments in foreign currencies to be converted to yen on the same day.

(c) Promoting the use of CSDs

A. Incentives to promote deposits with CSDs

Custody/transfer costs and deposit fees need to be lowered so that deposits with CSDs can be further promoted.

B. Collateral transactions through CSD accounts

Some banks have recently begun to use CSD transfer for collateral transactions, instead of physically taking certificates from borrowers. Such use of CSD transfer should be further encouraged.

C. Advance deposit

Deposits of funds/securities prior to making buy/sell orders should be mandatory.

D. Physical deliveries of certificates

As physical deliveries are incompatible with T+1, they must be ruled out in a T+1 settlement regime.

E. Lottery-based redemption of bonds

Current administrative procedures of such redemption of bonds should be reviewed, as it is in part treated manually.

III. Achieving DVP

1. Current Analysis and Approaches to Achieving DVP

(1) Current Analysis by Product

(a) JGBs

Currently, both funds and securities are settled on a net basis through the BOJ Net, and virtually all settlements occur at 3:00 p.m. By the end of 2000, an RTGS-based DVP model will be introduced. In our discussions, the following views were presented by our participants:

- A. It is hoped that a clearance institution will provide a netting and guarantee function. Also, the legal status of such an institution should be clarified.
- B. To secure enough intra-day funds, participants of the BOJ-Net might be obliged to use the "SPDC" (simultaneous processing of DVP and collateralization) function for non-proprietary transactions. Consequently, the existing collateral law should be amended so that participants of the BOJ-Net can use customers' JGBs as collateral.

(b) Non-JGB bonds

Currently, a quasi-DVP scheme is adopted, where securities are transferred on a gross basis, while funds are settled on a net basis (designated-time settlements at 3:00 pm). In our discussion, following views were presented:

- A. With appropriate safeguards, a DVP model of gross settlements for securities and net settlement for funds should be adopted for non-JGB bonds that is compatible with settlement schemes for other types of products. (Some of our members insist that instead of seeking compatibility in designing DVP models, attention should be paid to the difference in the nature of individual products and market participants.)
- B. It is hoped that a clearance institution will provide a netting and guarantee function. In addition, further study is needed regarding the range of products that such an institution covers (i.e., only corporate bonds, or other products as well.)

(c)Equities

<Settlements of exchange transactions>

Currently, settlements are not on a DVP basis. Instead, stock exchanges (the Tokyo and Osaka stock exchanges only) guarantee the completion of settlements as the central counterparties. The two exchanges have decided to adopt a DVP scheme, where both securities and funds are settled on a net basis, in the first half of 2001. In our discussions, following comments were made: 1) in addition to netting at each exchange, re-netting should be done for multi-listed stocks, and 2) funds for both exchange- and Jasdaq transactions should be jointly settled on a net basis.

<Settlement of Jasdaq market transactions>

Currently, settlements are not on a DVP basis. Study is now in progress with regard to developing a clearance function and establishing a contingency fund. A DVP scheme, where both securities and funds are settled on a net basis, should be introduced.

<Settlement of other transactions (general, or non-exchange, transfers)>

Currently, settlements are not on a DVP basis. A new settlement scheme is being studied, where securities are settled on a gross basis

and funds are settled on a net basis. In our discussions, the following comments were made:

- A. The Depository and Book-Entry Transfer of Securities Law should be amended so that settlements of funds can be done at CSDs.
- B. For efficient transfers, securities held in non-resident customers' accounts should be available for use as collateral.
- C. The administrative procedures for handling two types of book-entry transfers at a CSD, namely market transfers and general transfers, should be streamlined, as both deal with the same types of exchange-listed securities.

d) Investment Trust beneficiary securities

Currently, settlements are not on a DVP basis. In our discussions, the following views were presented:

- A. A DVP model should be adopted, where securities are settled on a gross basis and funds on a net basis. In addition, a clearance function should be provided.
- B. We are divided as to who should handle the settlements. Some argue that all settlements should be done at a single CSD, while others insist that it would be better to use the existing settlement institutions.

e) Commercial Paper (CP)

Currently, settlements are not on a DVP basis. In our discussions, following views were presented:

- A. Dematerialization of CPs should take place ahead of other products, instead of waiting for comprehensive legislation that enables dematerialization of all types of securities certificates.
- B. We are divided on the model for settlements. Some argue that both

securities and funds should be settled on a gross basis, as the average size of CP transactions is very large. Others insist that a model of gross settlements for securities and net settlement for funds is preferable, and that a clearance function should be introduced.

C. CP settlements should be handled by a single CSD.

(2) Common prerequisites for introducing DVP

Common prerequisites for introducing DVP are:

- (a) Development of a comprehensive settlement confirmation system
- (b) Legislative incentives to promote a shift to dematerialization and book-entry transfers

2 . General Issues Regarding the Introduction of DVP

(1) Measures against risks that arise from netting

As netting accompanies systemic risks, it is necessary to minimize the risks by employing the following safeguards:

- (a) Collateralization: Further study is needed regarding the compatibility between collateralization in net settlement models and the existing collateral law.
- (b) Cross-products use of collateral: The use of collateral should be coordinated across settlement systems (some of our members, however, insist that attention should be paid to the difference in the nature of each product).
- (c) Reserve fund: Adequate sources of liquidity are needed so that no transfer need be unwound even in the event of a participant's failure to complete settlements.
- (d) Net debit position: It is important to set a limit on a participant's net debit position.
- (e) Membership criteria: Criteria for admission to a netting system should be carefully developed.
- (f) Safeguards for each settlement system: In implementing safeguards, attention should be paid to the difference in the nature of each product, etc.

(2) Settlement Times

- (a) Settlement times should be coordinated across systems. It should be noted, however, that doing so might augment systemic risks.
- (b) To facilitate an uninterrupted sequence of securities deliveries across settlement regimes, arrangements should be made for those settlement systems that use the same DVP model of gross settlements for securities and net settlement for funds.

(3) Rules for Failed Settlements

Standard industry rules should be developed for the treatment of failed settlements.

(4) Securities Borrowing/Lending

Securities borrowing and lending should be further utilized.

(5) Extensive Payment Netting

(a) A common DVP model and netting method

A. A DVP model of gross settlements for securities and net settlement for funds should be implemented for trade settlements of all products other than exchange- and Nasdaq traded equities and JGBs. In doing so, it is essential to make sure in advance that proper safeguards are in place. We are divided on the applicability of such a DVP model to CP transactions, as some participants insist that both securities and funds should be settled on a gross basis, noting that the average size of CP transactions is large.

B. We are divided on the range of payment netting arrangements. Some argue that payment netting should be coordinated as extensively as possible. Others remain skeptical of such arrangements, given the difference in the nature of each product/market, and insist that a cost/benefit analysis of such arrangements is needed.

C. We are yet to decide who will perform netting (i.e., any existing clearance/settlement institutions, or a new institution to be established specifically for that purpose). In addition, we will need

to look into the possibility of mergers/alliances of the existing clearance institutions.

D. For efficient use of funds and collateral, a single settlement system should handle as many types of securities as possible, as long as these securities' trades are settled under the same DVP model of gross settlements for securities and net settlement of funds. (Some of our members argue, in contrast, that such an arrangement is disadvantageous, because of the difficulty in dealing with various types of risks that arise from the different characteristics of each product/market.) Before making such an arrangement, it is essential to make sure that proper safeguards are in place.

(b) Mergers/alliances of the existing clearance institutions

To enable extensive payment netting, it is necessary to encourage mergers/alliances of the existing clearance institutions, and the legal status of such institutions should be clarified. (It should be noted, as some members insist, that methods of managing risks vary from one product to another.)

(c) Safeguards against systemic risks

Proper safeguards should be employed to prevent systemic risks.

3. Other Issues for DVP

(1) Non-participant issues

For the benefit of those institutional investors who use banks (BOJ-Net participants) to settle payments, it is important, in an RTGS settlement environment, to give them an opportunity to confirm their intent of buying securities, and the ability to control timing of payment/receipt of funds.

(2) The need for case studies

It is useful to study how settlement times are coordinated in other countries, and how participants in these markets manage funds for settlement.

IV. Remaining Issues in the Reform of the Securities Clearing/Settlement System

In our discussions, the following issues were pointed out as important and needing further study.

1. Non-JGB bonds

As noted previously, there are a couple of ways to implement a new bond recording system in which depositories' names are registered in lieu of those of beneficiary creditors. They are, namely, a "multi-depository" method and a "single depository" method.

Further discussion is needed to reach a consensus on this issue. In making a decision, we should consider the following: the increasing number of market participants; the increasing trading volume; globalization of transactions; possible alliances with foreign CSDs; depositories' qualifications; costs of running a new system; duration for developing a new system; and protection for good-faith acquirers. In addition, we will need to pay attention to the discussion at the "Working Group on Reform of the Securities Settlement System" under the First Committee of the Financial System Council.

2. Developing a Confirmation System to Facilitate STP

To facilitate STP in a new securities settlement/clearing system, it is essential to develop a confirmation system which electronically links market intermediaries. In doing so, a system protocol must be standardized and inter-operability be ensured as in other countries where multiple providers compete to offer better STP services. Furthermore, a timetable for each stage of data processing should be formulated, which users of a new STP system must follow.

3. Clearance and Clearance Institutions

A clearance system should have a well-founded legal basis, specifically with regard to netting and collateralization. In addition, it should ensure adequate sources of liquidity and set a cap on a participant's net debit position. As for a securities settlement system without clearance, it is imperative to set up a clearance institution. We should, as previously discussed, look into the possibility of mergers/alliances of

the existing clearance institutions and extensive payment netting. In doing so, a cost/benefit analysis must be performed, and attention should be paid to the difference in the nature of individual products and market participants. Regarding settlements of JGB transactions, new market practices such as bilateral netting are being developed to facilitate efficient settlements in an RTGS settlement regime, scheduled by the end of 2000. However, in light of an expected jump in JGB issues in the future, we will also need to consider establishing a clearance institution.