

# Checkpoints related to Trading Participant Internal Management Systems

Japan Exchange Regulation

Trading Participants Examination & Inspection Department

Revised October 2022



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## Regarding the Revised Edition

The fundamental functions of the Trading Participants Examination & Inspection Department of Japan Exchange Regulation (hereinafter "JPX-R") is to ensure the fairness and credibility of financial instruments exchange markets, contribute to the public good and shareholder protection through investigations of trading participants' (brokers/dealers qualified to trade directly on Tokyo Stock Exchange or Osaka Exchange) compliance with laws and regulations as well as rules of financial instruments exchanges (hereinafter "laws and regulations"), as the entity entrusted with self-regulatory operations by the exchanges.

In particular, in order that the exchanges may appropriately execute their functions of the markets, JPX-R's most important mission is to eliminate all inappropriate actions from the exchange markets, as well as requiring the enrichment of internal management systems of trading participants to prevent such actions from occurring.

Additionally, JPX-R does not only detect violations of laws and regulations in its inspections but also places emphasis on offering support to trading participants for the establishment of desirable internal control systems.

Based on past inspection operations, JPX-R prepared key points for internal control systems in relation to exchange compliance matters, which it published in the "Checkpoints related to Trading Participant Internal Management Systems" in 2009. After the initial release, JPX-R has revised these points where necessary to reflect amendments to laws, regulations, and rules. This latest revision has been released in light of revisions to laws and regulations pertaining to the best execution obligation and clarification of requirements for principle-based market surveillance.

The matters provided in these checkpoints are examined in JPX-R inspections and are included in inspection manuals as points of consideration for identifying causes of insufficiencies and requiring trading participants to rectify such insufficiencies in cases where a violation of laws and regulations or the likelihood of such is acknowledged or where trading participants' operations or financial positions are deemed to be, or likely to be, inappropriate. As such, these matters are reflected in the daily operations of our inspection personnel.

Amidst the large changes occurring in the business environment of the markets, it goes without saying that the pursuit of internal management systems based on the diverse risks of each trading participant is of importance. Moreover, in addition to compliance with rules, implementation of internal management with responsibility as a financial instruments business operator is extremely important.

These checkpoints are provided as matters of consideration when formulating the proper internal management system. We hope they will contribute to the implementation of proactive measures on the part of trading participants.

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★ Based on laws, rules, and regulations as of the end of September 2022.

### Abbreviations

- TSE: Tokyo Stock Exchange
- OSE: Osaka Exchange
- JSCC: Japan Securities Clearing Corporation
- FSA: Financial Services Agency
- FIEA: Financial Instruments and Exchange Act
- FIB Cabinet Order: Cabinet Office Order on Financial Instruments Business, etc.
- Securities Transaction Restrictions Cabinet Office Order: Cabinet Office Order on Restrictions on Securities Transactions
- Guideline for Supervision: Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.

## 1. Short Sale Management

### 1. Relevant Laws and Regulations

- FIEA: Article 162.1.(1)
- Order for Enforcement of the FIEA: Article 26-2 and Article 26-2-2 (Settlement Confirmation), Article 26-3 (Specification and Confirmation Obligations), Article 26-4 (Price Limit), Article 26-5 (Provision of Balance Information), Article 26-6 (Regulations on Short Sales at the Time of Capital Increase through Public Offerings), others
- FIB Cabinet Order: Article 117.1.(24)-2 through (24)-5, Article 123.1.(26), others
- Securities Transaction Restrictions Cabinet Order: Article 9-2 through Article 15-8
- TSE Business Regulations: Rule 14.1.(2), and Rule 16
- TSE Rules on Bids and Offers, Rule 8, others

**Reference:** "Chapter IV. Cases Relating to Regulation on Short Sale" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

Short sales of securities are said to play an effective role in stabilizing price fluctuations in securities markets. On the other hand, however, there are also concerns that they can unduly exaggerate price declines and be used to intentionally collapse the price of an issue. Short sales, therefore, are regulated to prevent these negative aspects of this investment approach.

"Short sale" refers to: 1) the sale of a security that is not held; 2) the sale of a security that has been borrowed; and, 3) the sale of a security when it is not clear the security will be transferred immediately after selling holdings of the same security (excludes securities borrowed). When engaging in short sales, no person should carry out such sales while in violation of provisions of laws and regulations.

Regulations are largely divided into those that address the obligation to specify and confirm and those that address price limits.

The obligation to specify and confirm refers to the need to inform the exchange of whether or not a sale is a short sale. When accepting sale orders, therefore, trading participants must confirm with their customers whether sales will be short sales (Note: The same applies to entrustment.) and customers must clearly indicate whether or not sales are short sales.

The current regulations prohibit short sales "below the most recently published price", excluding short sales at the most recently published price when that price is higher than the previously published price. In practice, this rule is applied under the "trigger-based" price regulation framework that was introduced following the comprehensive revision of short selling regulations enforced from November 5, 2013. In this framework, the price restriction is to be applied to an execution at a price at least 10% below the base price calculated using the preceding day's closing price of such stock.

It should be noted that there are exceptions to both the obligation to specify and confirm and price limit regulations. These exceptions are provided in the Cabinet Office Order (Securities Transaction Restrictions Cabinet Order).

In addition to the above, between October and December 2008, Cabinet Orders and other regulations were established with regard to the prohibition of naked short selling (short sales for which no arrangements have been made to secure the issues being sold) and enforcement of obligations of those holding short positions in excess of certain limits (more than 0.25% of issued and outstanding shares and more than 50 trading units) to provide balanced information to exchanges. Formerly, these regulatory revisions consisted of temporary measures (1. confirmation of settlement measures, 2. provision of balance information) and permanent measures (3. confirmation of regular sales without prior receipt of securities). However, following the comprehensive revision, these short selling regulations were positioned as permanent measures.

Also, "Regulations on Short Sales at the Time of Capital Increase through Public Offerings" were introduced in December 2011. These new regulations prohibit transactions to close short positions, which are created by short sales conducted during the period from the announcement of a capital increase through public offering or secondary distribution until the issuance price of the new securities is determined, using new shares obtained by

subscribing to a capital increase through public offering or secondary distribution. Financial Instruments Business Operators also have the obligation to ensure that customers and others involved are adequately aware of the contents of this regulation.

### **3. Key Regulatory Checkpoints**

- (1) Specification that a short sale is being undertaken must be made when the order is placed. For a sale that is being undertaken to correct a mistake in executing a customer order, and in essence will be a short sale on the trading participant's account, the trading participant must judge at the time of execution whether the sale is a short sale. Therefore, if a short sale is not specified as such beforehand, the trading participant must immediately file a "Corrected Declaration" to the exchange.

When filing a Corrected Declaration, if it is necessary to report a regulatory violation, that report must be made promptly.

- (2) Transactions that are exceptions to which the obligations to specify and confirm with regard to short sale regulations do not apply and transactions that are exceptions to the price limit regulations are covered to a limited extent by various Cabinet Office Orders. (\*For more details, please refer to the articles that prescribe exceptions to the obligations related to securities borrowed.) Therefore, short sales that are not included among these exceptions are subject to the obligations to specify and confirm and to price limit regulations.
- (3) When a trading participant undertakes a short sale on its own account to hedge ahead of time a purchase contract it will enter into for shares held by a customer, as part of a VWAP guarantee transaction or VWAP target transaction, the short sale is considered a sale order that is part of a predetermined program, and the order is managed in a special account. Furthermore, price limit regulations are not applied (Note: The short sale specification obligation does apply.) to all day, morning session, and afternoon session VWAPs; however, hourly VWAP is subject to such regulations.
- (4) In cases of short-selling for the purpose of hedging in advance of a transaction in which a proprietary purchase will be conducted outside the market at the closing price in the auction market (Closing Price Guarantee Transaction), price limit restrictions will apply due to "not being exempt from price limit regulations".

(5) Assuming that (i) a stock hit a trigger price (i.e. the price restriction is applied), and that (ii) the price at which one intends to sell the stock short is equal to the most recently published price (the latest quote), if the most recently published price is higher than the second most recently published price (i.e. uptick), then a short sale below the most recently published price is prohibited.

Assuming the same (i) and (ii), if the most recently published price is lower than the second most recently published price (i.e. downtick), then a short sale at or below the most recently published price is prohibited.

(6) Regarding the question of whether a transaction is considered an exception to price limit regulations, margin transaction sale orders from retail investors (Note: Investors not considered qualified institutional investors\*.) are exempt from these regulations if individual order volumes are less than 50 trading units, as a general rule. However, if a customer has intentionally split a single order into multiple orders for at most 50 trading units each to evade price limit regulations, such orders are deemed not to be separate orders eligible for exemption from price regulations.

\*FSA puts information on qualified institutional investors on the website.

(7) Even if a price limit is not triggered yet when a trading participant is placing a short sale order, it is mandatory to clarify whether such short sale order is "subject to price regulation" (Flag: 5) or "not subject to price regulation" (Flag: 7), as prescribed in Rule 8 of TSE Rules on Bids and Offers.

(8) When a trading participant receives a sale order involving securities for which a deposit request has not been received, the trading participant must confirm the approach for managing the securities to be sold (matters such as the trust bank where the securities are being held) and whether the sale qualifies as an exception to the short sale specification and confirmation obligations. In addition, the trading participant must prepare and hold (for seven years) a record of its findings, in a manner that meets legal requirements.

(9) When handling a public offering or secondary distribution, there is a need to inform customers of the regulations on short sales at the time of public offerings. In addition, all trading participants must be vigilant toward whether or not there are acts to circumvent this regulation from trade surveillance perspectives. (While there are no

obligations to proactively conduct checks, from the viewpoint of the soundness and propriety of operations, if a violation by a customer, which should have been easily detected in routine procedures, was undetected, there may be questions raised about inadequacies in the internal management system.)

#### **4. Key Management Checkpoints**

- (1) Are organizational measures being properly implemented for compliance with short sale regulations? In addition, have appropriate internal rules (internal regulations and operational rules on the types of short sales the firm handles; methods for confirming information, keeping records; and other relevant matters) been established?
- (2) Has information on the laws and regulations related to short selling, notices from self-regulatory organizations, and other such information related to short selling been properly organized and stored in administrative, sales, and other units in a manner that permits use at any time? Is such information organized in a manner that is easy to find, and permits proper management in accordance with the firm's business activities?
- (3) Has the firm achieved, and does it work to maintain, an appropriate level of knowledge regarding the implementation and revision of short sale regulations and prohibitions against naked short selling?
- (4) Are prior short sale regulation violations used to identify problems, and have operations been revised in light of the frequencies and causes of these problems?
- (5) Does the firm conduct ongoing internal training on short sale regulations, and does it appropriately provide explanations and information to relevant units when there are revisions to laws and regulations?
- (6) Have measures to prevent orders in excess of shares on hand, measures for automatically flagging short sales in excess of holdings, and other concrete, systematic steps been properly taken to prevent short sale regulation violations?



- (7) How does the firm confirm management methods for securities involved in an actual sale when no request to deposit securities has been received (meaning there is no balance of the relevant securities in an account under the seller's name) and for securities involved in orders exempt from short sale specification and confirmation obligations? In addition, does the firm properly prepare and retain records of these securities?
- (8) Are checks appropriately performed either before or after the fact to determine whether margin transaction sales orders by retail investors (Note: Investors not considered qualified institutional investors.) may have been deliberately divided to keep sales volumes at or below 50 units and avoid price limit regulations? Furthermore, are suspicious transactions properly investigated?
- (9) With amendments to order executions, when Corrected Declarations are submitted after the fact to the exchange to change the short sale categorization (Note: Submission of the Corrected Declaration for Short Sales, Margin Transactions, and Own/Entrusted Categorization), are checks properly performed to prevent omissions?
- (10) From the perspective of preventing naked short selling, is the need to apply settlement measures related to the receipt of short sale orders, and exemption from these measures, confirmed, and are records of these confirmations properly kept (Note: must be kept for seven years)?
- (11) In cases where a customer has failed delivery ("fails"; including in-house fails) multiple times, in light of compliance with short selling regulations, has the firm implemented appropriate management in ways such as re-checking the appropriateness of its management methods for securities and confirmation of settlement measures? (Such re-checking includes confirmation of where to deposit securities and where to procure securities from, the terms and conditions of the contract, and operations.) In addition, how does the firm deal with the customer and related persons?
- (12) From the perspective of compliance with requirements to provide information on short sale balances (Report on Investors with Short Positions in Excess of 0.2% of the Issued and Outstanding Shares and 50 Trading Units), does the firm take

appropriate actions (regarding customers) and perform internal checks?

- (13) From the perspective of preventing acts that hinder fair price formation, is there proper trade management or monitoring on whether or not there is circumvention of regulations?

## 2. Management of Corporate Information

### 1. Relevant Laws and Regulations

- FIEA: Article 38.(9) and Article 40.(2)
- FIB Cabinet Order: Article 1.4.(14), Article 117.1.(12) through (16), and Article 123.1.(5)
- TSE Trading Participant Regulations: Rule 22-5
- Japan Securities Dealers Association:
  - Rules Concerning Establishment of Confidential Corporate Information Management System by Association Members
  - Guideline for "Rules Concerning Establishment of Confidential Corporate Information Management System by Association Members"
  - Guidelines concerning Association Member Analysts' Interviews, etc. with Issuers and Communication of Information
  - Rules Concerning Solicitation for Investments and Management of Customers, etc., by Association Members: mainly Article 15, Article 15-2, and Article 25

### 2. Regulatory Intent

"Corporate information" means important management, operational, and financial information on listed and other companies that could be acknowledged as impacting customers' investment decisions and information on decisions to implement or suspend takeover bids or tender offers. Corporate information, as it is referred to here, is nonpublic and represents a concept broader than that used for insider trading regulations.

More specifically, under the provisions of FIB Cabinet Order Article 117.1.(12) through (16), which seek to prevent unfair trading and promote investor protection, corporate information cannot be used by executives and employees of financial instruments business operators for their personal trading, by financial instruments business operators for trading on their own accounts, or in brokerage operations.

FIB Cabinet Order Article 123.1.(5) requires that financial instruments business operators

manage their operations in such a manner as to avoid the possibility that they may be cited for management of corporate information or management conditions of customers' securities trading that lack measures necessary and appropriate for preventing unfair trading involving corporate information.

Furthermore, with FIEA and related laws and regulations amended and implemented in April 2014, J-REITs were included under the scope of insider trading regulations, and information transmission and trading recommendations by corporate insiders were newly subject to regulation. In light of the tighter regulations, TSE amended its rules to request trading participants to develop necessary and appropriate systems and frameworks for managing corporate information.

Moreover, FSA fined several trading participants in 2016, as analysts of these participants communicated with customers about information that was obtained through meetings with issuers. Though there was a possibility that the non-public information might include corporate information, these participants did not check adequately whether the information analysts provided to the customers included corporate information. In light of such situations etc., Japan Securities Dealers Association (hereinafter "JSDA") published Guidelines concerning Association Member Analysts' Interviews, etc. with Issuers and Communication of Information.

In addition, partial revisions to the FIB Cabinet Order and Guideline for Supervision (effective from June 2022), made in connection to the revision of the regulation on firewalls between banking and securities operations, have indicated the need for development of management systems for customer and other information based on the "need to know principle." In light of this, JSDA has made partial revisions to its Guideline for "Rules Concerning Establishment of Confidential Corporate Information Management System by Association Members".

### **3. Key Regulatory Checkpoints**

- (1) Corporate information is defined in FIB Cabinet Order Article 1.4.(14) (as noted above). However, whether information financial instruments business operators acquire and hold amounts to "corporate information" should be determined essentially by making judgments on a case-by-case basis. In addition, whereas

violations of insider trading regulations are subject to criminal punishment and fines, corporate information management regulations apply to corporations—not individuals—and violations are subject to administrative disciplinary actions. Specifics of managing corporate information are set forth by the framework of JSDA regulations, which demand comprehensive and thorough management through the establishment of internal rules, the clear statement of management scope and procedures, and regular reviews.

- (2) Each company is required to establish an appropriate management system for corporate information, including information that is not classified as corporate information at present but has a high possibility of becoming corporate information in the future, or for information (suggestive information) that is not corporate information in itself but can constitute a part of corporate information when combined with other corporate information obtained in advance.
- (3) Corporate information should be properly identified or recognized within companies from substantial perspectives and should be put under proper management. Typically, corporate information, in addition to material facts that are subject to insider trading regulations, is thought to include information that could impact investment decisions (for example, matters that are not material facts pertaining to a listed company but would be included in an exchange's timely disclosures or ad hoc reports) and information on facts chronologically preceding the emergence of material facts (for example, in the case of a decision to be made by the executive organ of a listed company, information on facts indicating that the decision, which would amount to a material fact, is likely to be made in the near future).
- (4) "Unfair trading involving corporate information" includes insider trading. Therefore, if measures for preventing insider trading are found to be inadequate (for example, as evidenced by the failure to register insiders for multiple transactions), it is possible that FIB Cabinet Order Article 123.1.5 will also be found to have been violated.
- (5) Corporate insiders pertaining to J-REITs include related persons of a listed investment corporation (i.e., the J-REIT issuer), its asset management company, a parent company of such asset management company, and a specified related corporation (i.e., sponsor).

- (6) Transactions based on discretionary trading agreements are transactions undertaken for customer accounts; but, if they are undertaken by a financial instruments business operator engaged in Type 1 financial instruments business, then they are included in the prohibitions on using corporate information for trading by a firm for its own account.
- (7) In the case of a financial instruments business operator engaged in Type 1 financial instruments business that is a listed company or the subsidiary of a listed company, the firm's own information is also considered corporate information and must be managed based on the same concepts applying to the corporate information of other listed companies.

#### **4. Key Management Checkpoints**

- (1) Have personnel been properly assigned and organizational measures taken to, for example: 1) manage acquired corporate information; 2) prevent unfair trading involving corporate information; 3) accurately perform insider registration procedures; and 4) supervise trading related to transactions by insiders?
- (2) Has the firm properly established internal rules (internal regulations or operating rules) to manage corporate information?
- (3) Are internal rules and points of attention regarding corporate information appropriately disseminated internally? Are operations conducted thoroughly in accordance with the internal rules on a companywide basis? (For example, even outlets which normally handle small amounts of corporate information are required to establish systems so that corporate information is managed appropriately if and when it is acquired.
- (4) Are procedures for internally reporting when corporate information has been acquired by executives or employees in the course of their business activities being properly carried out? Also, in cases where management of such corporate information is conducted based on the ranking of its importance, is the ranking being conducted appropriately?

- (5) Is communication prohibited both internally and externally, excluding cases where it is necessary for business operations and a predetermined procedure (such as obtaining approval from the administrative department) is followed? Also, is the easy communication of information from which corporate information can be inferred, or inquiries for corporate information or related information, prohibited?
- (6) Are documents and other media that contain corporate information and the related documentation for transactions in cases where the firm is involved in an important transaction by an issuer (merger, acquisition, tender offer, new share or other issuance, management change, or important matter involving the issuer) being appropriately managed (for example, whether individual organizational units manage documentation by physically isolating it from other organizational units)?
- (7) Are electronic files that include corporate information properly managed to prevent their being seen by units, departments, or divisions that do not need them for business operations, through access restrictions, for example? Also, in cases of granting IDs with special privileges, such as access to all servers and folders for the purpose of system maintenance, is management appropriately conducted to prevent information leaks, such as password setting or access log monitoring?
- (8) When investment material is to be prepared and distributed internally, is such information inspected (including whether there is leakage or communication of corporate information through the investment material) by a controlling unit, department, or division responsible for managing corporate information? In addition, is internal information disclosure performed all at the same time?
- (9) Is there a proper structure to check if information an analyst obtained through a meeting with an issuer includes corporate information?
- (10) Are proper checks conducted in a timely manner when an analyst provides information to customers through means other than an analyst report (for example, via phone or e-mail)?
- (11) Is trading supervision (addressing, for example: 1. trading on the firm's own account; 2. use of corporate information for brokerage operations; 3. trading by the firm's executives and employees; and, 4. measures for preventing the communication of

corporate information to other parties) to prevent unfair trading involving corporate information being properly performed in accordance with internal rules?

- (12) In the event of a release based on published information, are proper checks made by means such as TSE's disclosure information browsing service (TDnet)?
- (13) Is work related to the registration of insiders being properly performed in accordance with internal rules? In addition, are regular inspections of the registration details for insiders (including checks using J-IRISS) being properly performed?
- (14) Is there a requirement that customers must immediately notify the trading participant when there are changes regarding whether or not they must be registered as insiders? How is the fulfillment of the relevant obligations ensured? (Is this issue addressed in written agreements, through the use of confirmations, or from website entries? How is this issue handled in the case of Internet-based trading, in particular?) In addition, how are cases in which notification to a customer was overlooked handled?
- (15) How are transactions by customers registered as insiders handled?
- (16) How are cases in which there was a failure to secure a copy of the Customer Order handled?  
Also, how does the firm handle ex-post investigations involving issues for which corporate information has been publicly released?
- (17) Does the firm properly monitor for, and perform investigations to determine whether it has accepted, trading orders in which it is clear that an executive or employee of an issuer can profit from a trading order that involves the issuer's specified securities and is either a sell order falling within six months of a buy order or a buy order falling within six months of a sell order?
- (18) Is monitoring, such as regular inspections, conducted to determine whether management irregularities are occurring in relation to the management of corporate information or if appropriate management is being conducted?



### 3. Management of Net Settlement Transactions

#### 1. Relevant Laws and Regulations

- FIEA: Article 161-2
- Cabinet Office Order on Security Deposits and Transactions Provided in Article 161-2 of the Financial Instruments and Exchange Act: Article 10.1.

Reference: "Chapter III. Cases Relating to Trading in Differences" of "Compliance Case Study Handbook" published by JPX-R

#### 2. Regulatory Intent

"Net settlement transactions", which, under the law, are transactions not specified as margin transactions, are prohibited. If a financial instruments business operator undertakes a cash transaction to buy or sell securities based on a customer order, and then undertakes a closing transaction for the same issue, settlement cannot be made by omitting actual delivery of the securities and simply offsetting the transactions.

In other words, orders that are not specified as margin transactions when made should be settled through the actual exchange of funds and securities. Unwholesome transactions that include no delivery of securities and no margin trading deposits, despite being essentially margin transactions, are prohibited.

Net settlement transactions may undermine wholesome investment behavior by skirting margin trading deposit regulations and promoting speculative trading and, therefore, are illegal.

#### 3. Key Regulatory Checkpoints

- (1) If purchase funds are required to be deposited in a money reserved fund (MRF) or other such account, deposits of the necessary amounts must be made into these cash accounts by settlement time.

- (2) Whether multiple trades of the same issue on the same day (intraday trading) amount to net settlement transactions must be determined during that day. For example, if intraday trading involves a sale of 1,000 shares, a purchase of 1,000 shares, and another sale of 1,000 shares, a total of 2,000 shares are being sold while 1,000 shares are being purchased, and net settlement transactions will not have taken place if the sales of 2,000 shares are settled with 2,000 shares that were already on hand. However, if only 1,000 shares were on hand, net settlement transactions will have occurred. A similar analysis would apply in the case of intraday trading involving a purchase of 1,000 shares, sale of 1,000 shares, and another purchase of 1,000 shares.
- (3) For cases in which a customer sells shares already on hand, and then repurchases them on the same day (including cross trades), the movement of shares on hand must be properly recorded in the account transfer ledger and other accounting documentation when there is no deposit of funds for the purchase.
- (4) If a customer fails to make settlement (an advance is recorded) and a sale to effect a closing transaction was properly executed on the customer's account pursuant to Rule 53 of the TSE Brokerage Agreement Standards, then no net settlement transactions will have taken place.
- (5) In exchange trading, netting settlements between customers who are participants of Japan Securities Depository Center's "DVP settlement scheme for NETDs (non-exchange transaction deliveries)" based on said scheme, are not viewed as illegal. (Note: September 12, 2003 JSDA Business Rules Referral System response)

#### **4. Key Management Checkpoints**

- (1) Have appropriate organizational measures been taken to prevent net settlement transactions?
- (2) Have internal rules been properly established (internal regulations or operating rules) to prevent net settlement transactions?

- (3) How is intraday trading handled? If a firm-specific management approach is used, is it appropriate?
- (4) Are advances to customers (including situations in which advances may be made) and sales to effect closing transactions properly handled in accordance with TSE Brokerage Agreement Standards?
- (5) Are fund deposits and payments properly handled and managed to avoid net settlement transactions?
- (6) How is the identification of net settlement transactions (checks to determine whether required funds have been deposited before settlement) performed?
- (7) Are 1) margin transactions in which shares are actually received and sold, 2) cash purchases and actual deliveries, and 3) the actual receipt and actual delivery of the same shares, all of which resemble net settlements, appropriately performed and managed?
- (8) When a net settlement transaction occurs, is it properly handled within the firm?
- (9) Are appropriate internal communications (among different units) and other internal systems and measures in place to handle cases in which it is difficult to judge whether net settlement transactions have occurred?
- (10) Is internal training conducted, are specific cautions issued for individual cases, and are other steps being properly taken to prevent net settlement transactions?
- (11) How are cautions issued to customers (for example, via a website) to prevent net settlement transactions?
- (12) Are internal inspections conducted in regard to net settlement transactions? If they are, what do they focus on and with what frequency are they being performed?

## **4. Front Running Prevention**

### **1. Relevant Laws and Regulations, etc.**

- FIEA: Article 38.(9)
- FIB Cabinet Order: Article 117.1.(10)
- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. IV-3-1-3 Discretionary Trading Agreements, etc. (1)

### **2. Regulatory Intent**

To prevent conflicts of interest between financial instruments business operators pursuing brokerage and trading operations and their customers, the Cabinet Office Order prohibits financial instruments business operators from placing trades for their own accounts ahead of trading for customer orders. This order was put in place to protect customers from higher execution costs that would result if a financial instruments business operator, after receiving a customer's order, abuses the order information and places an order for the same sale or purchase for its own account ahead of the customer's order, but at similar or more advantageous terms.

It should be noted that trading orders based on the discretionary trading agreements (all discretionary trading agreements with related foreign financial instruments business operators) addressed in Article 16.1.(8).b of the Cabinet Office Order regarding Definitions Provided in Article 2 of FIEA are regarded as equivalent to orders for a financial instruments business operator's own account and are subject to front running regulations.

### **3. Key Regulatory Checkpoints**

- (1) Regulations cover not only securities purchases and sales but also derivatives market transactions and foreign derivatives market transactions.
- (2) Prevention of front running requires the establishment of separate units for handling

customer orders and handling orders for a firm's own account, as well as proper management of customer order information. At a minimum, this requires the separation of operations for handling the two types of orders and an information firewall (physical and system-based).

- (3) If a financial instruments business operator that has received a stop order uses information related to that order to trade for its own account before or after the trigger price (the market price specified by a customer as the "trigger" for immediate execution of the customer's buy or sell instructions) is reached, and before executing the customer's stop order, it may be found to have engaged in front running.
- (4) If an accommodative transaction undertaken to accommodate a trade with single price execution (Note A) is executed ahead of the entrusted CD order (Note B) or VWAP order for the same issue and in the same direction, the accommodative transaction for the firm's own account and the entrusted CD order or VWAP order must not be handled by the same person.

(Note A) This refers to a customer's request for an off-auction transaction or off-exchange transaction after a trading session at the average price for accommodative transaction completed by the financial instruments business operator. The financial instruments business operator, in order to cover the order, must undertake an accommodative transaction for its own account on the exchange.

(Note B) This refers to an order that a financial instruments business operator has been requested to handle with best execution, and its own discretion on pricing, within a day's trading.

**Remarks:** TSE and OSE have separate rules (TSE/OSE Rules Concerning Just and Equitable Principles of Trade) addressing front running involving price-linked products (for example, derivatives and listed stocks) in two markets.

#### **4. Key Management Checkpoints**

- (1) Whether the information firewall measures (Note A) in the form of physical locations of units for handling customer orders and handling orders for the firm's own account (Note B) and the seating locations of employees are adequate for compliance with front running regulations.

(Note A) Separation and independence of offices or floors, assignments of dedicated supervisors and employees, and controls preventing unauthorized employees from entering offices or floors

(Note B) Examples of units handling trades for a firm's own account include: 1) dealing units; 2) units that execute trades based on discretionary trading agreements with related foreign financial instruments business operators; 3) units that handle prior accommodative transactions for the firm's own account in connection with orders for which the firm is on the other end of a transaction for which the ToSTNeT (off-auction trading) price is predetermined; 4) units that handle prior accommodative transactions for the firm's own account in connection with orders for trades with single price execution; and 5) units handling trades for the firm's own account in connection with execution corrections (trades that rectify an incorrectly executed customer order by transferring the error to the firm's own account).

- (2) Do units that handle trades for the firm's own account also handle customer trades as an emergency measure when computer systems handling customer orders malfunction? In such cases, what types of rules govern the handling of customer orders in relation to that of orders for the firm's own account?
- (3) Have internal rules (rules on the management of order information to prevent leaks and abuse of order information, and penalties for violation) and procedure manuals been properly prepared for the prevention of front running?
- (4) Is there prompt action to ensure that employees thoroughly understand revisions of relevant rules?
- (5) Are internal checks to identify possible front running activity performed, and how are discovered cases addressed?

## 5. Management of Best Execution Duties

### 1. Relevant Laws and Regulations

- FIEA: Article 40-2
- Order for Enforcement of the FIEA: Article 16-6
- FIB Cabinet Order: Article 70-2
- FIB Cabinet Order: Article 124
- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.: IV-3-1-2 Control Environment for Customer Solicitation and Explanations

Reference: Report of the "Task Force to Discuss Optimal Ways to Ensure Best Execution," part of the Working Group on Capital Market Regulations of the Financial System Council, dated June 2, 2021 (Japanese only)

### 2. Regulatory Intent

"Best execution duty" refers to the obligation of financial instruments business operators to exercise all reasonable care to execute customer trades of securities at the terms most advantageous for customers.

Financial instruments business operators, as agents for securities transactions, are required to act prudently on behalf of customers. As stated in Civil Code Article 644, agents are obligated to exercise the care of a prudent manager in performing the duties entrusted to them in accordance with the objectives of the entrusting party. The best execution duty is borne by financial instruments business operators in that connection.

The FIEA sets forth five specific obligations of financial instruments business operators. These are: 1) establish policies and methods (hereinafter "best execution policies") for executing orders at the best terms available; 2) disclose best execution policies; 3) provide customers with documentation including best execution policies before receiving orders from them; 4) execute orders in accordance with best execution policies; and 5) once an order has been executed, provide requesting customers with a written explanation of how their orders were executed in accordance with best execution policies.

Based on the recommendations of the Report of the "Task Force to Discuss Optimal Ways to Ensure Best Execution," part of the Working Group on Capital Market Regulations of the Financial System Council, which was published in June 2021, a cabinet ordinance, an FIB Cabinet Order, and Guideline for Supervision were published in May 2022, and best execution policies will now be revised with those revisions coming into effect in January 2023 (there will be a one-year grace period for the existing best execution policies).

### **3. Key Regulatory Checkpoints**

Formulation of Best Execution Policies:

- (1) Best execution policies must address orders for trading of listed stocks, OTC securities, and securities handled (excluding futures, etc.). Orders for trading of bonds and market derivatives are excluded by laws and regulations.
- (2) Under Article 124, Paragraph 2 of the revised FIB Cabinet Order to be effective from January 2023, matters to be included in best execution policies when using a smart-order routing (SOR) system or executing orders from retail customers are as follows:
  - If an SOR is used, include this fact, the markets (exchanges, PTSs, dark pools) whose prices are compared, the method and order (Limited to when cases are included where the most favorable prices are the same in multiple markets) of market selection and any fluctuations related to market quotations caused by differences in the time required to execute orders, and the policy regarding as well as an outline of measures taken to deal with trading strategies that take advantage of disparities among markets or other situations.
  - When executing an order from a retail customer, if the order is executed using a dark pool (an internal trading system) or the best conditions for the execution are not at the best price available, include this information.
- (3) Best execution policies are called for by Cabinet Orders, which require that methods for executing orders at the best terms available for individual issues, and the reasons for selecting these particular methods, be established and documented. The purpose of this requirement is to let customers know ahead of time how their orders will be executed. Therefore, even if individual issues are not listed together



with best execution policies for each, presenting information that allows customers to know what markets and by what methods their orders for individual issues will be executed is sufficient. If policies to be followed for individual issues are not stipulated, customers who want that information must be provided with a way (including posting on the website) to obtain it.

- (4) It is not considered appropriate to have differences between a disclosed best execution policy and actual operations for execution. For example, there should be appropriate descriptions on differences in the best execution policy for face-to-face transactions and transactions via the Internet.

#### Disclosure of Best Execution Policies:

- (5) Best execution policies must be disclosed with potential customers in mind. They need to be disclosed in a way that is also accessible to people other than your customers. Informing all customers of best execution policies in writing is not considered disclosure. Furthermore, if orders are received via the Internet, these policies need to be provided via the Internet, or by postal mail or fax at the request of the customer.

#### Provision of Best Execution Policies:

- (6) For presenting customers with best execution policies in written form, it is sufficient to use some reasonable method for sending the policies to customers at their registered addresses. However, policies cannot be said to have been presented to customers when documents sent are returned, and in other cases in which it is clear that policy documents have not been delivered to customers.

It should be noted that rules for presenting best execution policies to customers do not apply in the case of specified investors (professionals) (FIEA Article 45.(2)).

#### Execution of Orders in Accordance with Best Execution Policies:

- (7) Regarding trades involving issues listed on multiple markets, it is inappropriate to not inform customers of the markets selected pursuant to best execution policies and to refuse orders if customers do not specify markets for execution.
- (8) In cases where corrective action is taken, because negligence has caused data entry mistakes, mistaken solicitation, or unconfirmed trading, resulting in a market discrepancy and the execution of orders on a market other than the ones on which

they should have been executed, the initially mistaken orders are considered violations of the best execution duty.

#### **4. Key Management Checkpoints**

##### Formulation of Best Execution Policies:

- (1) What organizational unit performs final checks to assess the appropriateness of best execution policies recorded in written form? Are rules and notifications regarding the best execution duty archived, and properly and thoroughly understood in relevant units?
- (2) Have best execution policies been revised based on matters regarding best execution policies as set out in the Guideline for Supervision IV-3-1-2 (11) to be revised in January 2023?

##### Disclosure of Best Execution Policies:

- (3) Are best execution policies properly disclosed in the head office, branches, sales offices, and other locations?

##### Provision of Best Execution Policies:

- (4) Have customers been properly provided with written copies of best execution policies? (Caution is also required when changing policies.)
- (5) For cases in which customers have not been presented with best execution policies in writing due to reasons such as neglect or inaccurate address information, are management measures for preventing the receipt of orders properly functioning?

##### Execution of Orders in Accordance with Best Execution Policies:

- (6) What internal organizational measures have been taken to properly execute (including checks) orders in accordance with best execution policies?
- (7) How is the execution market for an order determined when the order is for an initial listing that will occur simultaneously on multiple exchanges?
- (8) Are cases in which orders are executed in accordance with customer instructions

properly documented and managed?

- (9) How are cases in which system malfunctions make it impossible to execute customer orders in accordance with best execution policies managed? And, how are customers' original orders processed?

Provision of Document to Explain Best Execution:

- (10) For cases in which customers request written explanations of how their orders were executed in accordance with best execution policies, are there management measures permitting an appropriate response?

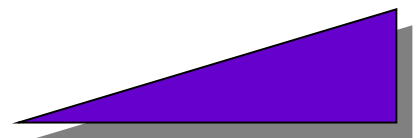
In light of the FIB Cabinet Order to be revised in January 2023, if an SOR is used, does the document to explain best execution include the execution price and the most advantageous execution price on the other financial instruments exchange markets or venues that you compared?

Regulations on Dark Pools (Internal Trading Systems)

In recent years, retail investors have been provided with services for executing orders, etc. which prioritize stock prices, and the use of trading in dark pools has increased. In response to such movements, the Working Group on Financial Markets of the Financial System Council discussed the current state of dark pool trading and how to protect investors. In September 2020, amendments were made to the FIB Cabinet Order and Guidelines for Supervision, so trading participants who conduct dark pool trading are now required to develop a framework as shown in the table below.

#	Item	Details
1.	Introduction of a dark pool flag	The trading participant must clearly indicate (flag) to the Exchange if a bid or offer is routed from a dark pool when making a bid or offer for single stock trading or basket trading in the ToSTNeT market, or for trading in the J-NET market.
2.	Clarification of the conditions of routing orders to dark pools and operational information	Financial instrument business operators, etc. that route customer orders to dark pools (entities routing orders to dark pools) will be required do the following: <ul style="list-style-type: none"><li>- Understand the operation status of dark pools to which customer orders are routed</li><li>- Provide an adequate explanation regarding the conditions for routing orders to dark pools and operation information (including dark pool operator and participant information) in consideration of the customer's knowledge, experience, etc.</li></ul>
3.	Record and store information to ensure effectiveness of price	To allow entities routing orders to dark pools to check the status of price improvement after the fact when customers or authorities request such information,

	improvement	trading participants will be required to do the following; provided that the same shall not apply to cases where customers prioritize other matters over price improvements. <ul style="list-style-type: none"> <li>- Record and store the price and time of a transaction matched in a dark pool</li> <li>- Record and store the price of an instrument at the financial instruments exchange, a proprietary trading system (PTS) and a dark pool and the time when orders have been determined to be routed to dark pools</li> </ul>
4.	Explanation to customers about price improvement effect	Provide a clear explanation on the price improvement effect for each transaction to customers for whom transactions were conducted in dark pools mainly for the purpose of price improvement



## 6. Management of Low Latency Trading

### 1. Relevant Laws and Regulations

- FIEA: Article 2.(41) through (42), Article 38.(8), Article 40.(2), Article 158.4, and Article 338.6 through 7
- FIB Cabinet Order: Article 116-4, and Article 123.1.(14)
- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. IV-3-2 Appropriate Exercise of Market Intermediary Function of Securities Companies, etc.
- Guidelines for Supervision of High Speed Traders
- TSE Business Regulations: Rule 14.1.(7), OSE Business Regulations: Rule 26.1.(2)
- TSE Trading Participant Regulations: Rule 21-2, OSE Regulations for Transaction Participants Rule 19-2

Reference: "Chapter V. Low Latency Trading" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

The impact of low latency trading of stocks, etc. has become more significant in recent years amid the advances in trading systems. However, there was no framework for regulatory authorities or exchanges to directly collect information from low latency traders, rendering a situation where it was not possible to ascertain the actual state of low latency trading. The issue was discussed by the Working Group on Financial Markets under the Financial Systems Council. The results of the discussion were summarized in a report, which pointed to a need for regulatory measures and lead to the partial revision of FIEA.

Thereafter, in April 2018, a registration regime for low latency traders was introduced, which requires entities who fit the definition of persons conducting low latency trading stipulated in laws and regulation to register as such with the regulatory authorities.

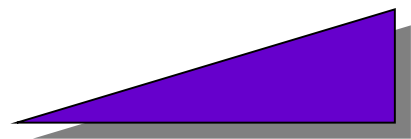
### **3. Key Regulatory Checkpoints**

- (1) Accepting orders for low latency trading from non-registered firms or from registered firms who have been issued a business suspension order or whose systems have yet to be verified is prohibited. When accepting orders from persons conducting low latency trading, a timestamp (the time at which an order is accepted by a financial instruments exchange, etc.) must be included in the statutory books or records (i.e., order forms).
- (2) When a trading participant accepts an order of low latency trading from a low latency trader, it must indicate if the trading strategy for such order falls under: Market Making, Arbitrage, Directional, or Other.
- (3) Trading participants must take appropriate action such that persons conducting low latency trading can respond to requirements made by the exchange, etc.

### **4. Key Management Checkpoints**

- (1) When starting to accept, etc. orders for low latency trading from persons who will conduct trading that constitutes low latency trading, does the trading participant confirm whether said persons are not entities other than persons conducting low latency trading as stipulated in FIEA Article 38. (8) or those defined as persons conducting low latency trading in FIB Cabinet Order, Article 116-4 (1) and (2) (hereinafter "non-registered traders, etc.")? The following are examples of the situation prescribed in Article 116-4 (2) where it is not possible to verify whether appropriate measures are being implemented to sufficiently manage electronic information processing systems and other systems for low latency trading:
  - Where it is not possible to verify in writing, etc. whether said person takes measures to sufficiently manage the trading system it specified at the start of trading as a system for managing low latency trading
  - Where it is not possible to obtain an appropriate report or explanation in writing, etc. when said person's trading system malfunctions after the start of trading
- (2) If after having accepted, etc. orders for low latency trading from persons conducting

low latency trading said persons are found to meet the criteria for unregistered traders, etc., does the trading participant take measures to immediately suspend accepting, etc. orders from said persons (by, for instance, including a clause in the contract or other documents with persons conducting low latency trading that requires a person conducting low latency trading who has met the criteria for unregistered traders, etc. to agree to immediately inform the securities company, etc. of such matter)?



## 7. System Risk Management Structure

### 1. Relevant Laws and Regulations, etc.

- FIEA: Article 40.(2)
- FIB Cabinet Order: Article 123.1.(14)
- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. III-2-8 System Risk Management Measures, others
- Policy of Approach to Strengthen the Cyber Security in the Financial Industries (published on July 2, 2015 by FSA)
- JSDA: Guidelines to Prevent Unauthorized Access and Other Incidents in Online Trading

### 2. Regulatory Intent

The order receipt and execution services that financial instruments business operators offer to customers are the most basic, yet important services, and in recent years the dependence on systems in the financial instruments business has been increasing. Under these circumstances, financial instruments business operators are required to establish risk management systems to prevent system malfunctions or other erroneous operations.

Additionally, with the recent increase of algorithmic and high-frequency trading, the risks involved with system errors has increased. Trading participants are requested to appropriately conduct management so as not to obstruct exchange trading systems or price formation, to ensure stable market operations.

Moreover, cyber security is incredibly important; incidents of large-scale cyber-attacks and unauthorized access, etc. cannot be ignored in terms of the reliability of the financial system.

### 3. Key Regulatory Checkpoints

- (1) Conditions under which management of electronic data processing systems is deemed to be inadequate under the relevant laws and regulations include, for example, situations in which appropriate electronic data processing systems have



not been established in light of the points enumerated in the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. (Note: Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. IV-3-2-1-(3))

- (2) In cases where Internet trading services are being provided, it is also necessary to consider the JSDA's "Guidelines to Prevent Unauthorized Access and Other Incidents in Online Trading".
- (3) Regarding management of cyber security, it is also necessary to consider materials such as "Policy of Approach to Strengthen the Cyber Security in the Financial Industries" published by FSA.
- (4) When a system malfunction occurs, it is necessary to submit a "Malfunction Report" to government authorities. In doing so, it is also necessary to submit a "Computer System Malfunction Report" to the exchange (TSE).

#### **4. Key Management Checkpoints**

\*For details, refer to Guideline for Supervision, III-2-8 Control Environment for Managing Information Technology Risk, (1) Major Supervisory Viewpoints.

##### 1. Sufficient Recognition of System Risk

- (A) Has the board of directors formulated a basic policy for company-wide risk management based on a full recognition of system risk? In addition, has the board of directors established a management system that recognizes the prevention of and quick recovery from system malfunctions and cyber security incidents as significant management tasks?

(Note) Cybersecurity incidents mean threats to cyber security by "cyber-attacks" through abuse of information and communications networks and systems. Such threats include unauthorized access, stealing information, unauthorized edits, and destroying websites, as well as halting and causing malfunctions in information systems, executing malicious computer programs, and launching DDoS attacks.

Furthermore, is the board of directors, etc. fully aware of the seriousness of the system risks involved and have they appointed as an executive someone who supervises and manages systems, a person who can properly execute his/her duties with sufficient systems knowledge and experience? Has the board of directors, etc. also specified in

detail the responsibilities and measures to be taken during a crisis such as a system failure? Have they trained themselves to take charge if necessary, guaranteeing this would be effective?

(Note) Cause analysis identified that recent incidents of unauthorized access by malicious third parties were caused not only by insufficient technical measures to prevent unauthorized access, etc. but also due to insufficient involvement by management.

## 2. Establishment of Risk Management System

(A) Is the basic policy for system risk management defined and has a management system been established? Does the basic policy for system risk management include a security policy (a basic policy to properly protect information assets in the organization) and a policy regarding outsourcees?

(B) Has a system risk management framework been developed based on contents that can be judged objectively? Also, is this framework consistently reviewed in response to the identification and analysis of system malfunctions, implementation of risk management, and improved technology, among other things?

## 3. System Risk Assessment

(A) Does the system risk management division understand and assess risk in a regular or timely manner as risks diversify with changes in the external environment (including large amounts of transactions arising from diversification of customer channels, and broader and more complicated impact of system malfunctions due to network expansion)? In addition, are there sufficient measures for recognized risk?

(Note) When system risk is assessed, all systems including those that are outsourced need to be comprehensively checked, and systems (including EUC) that handle important information in terms of cyber security and that will have a critical influence in the case of a system failure need to be included in the assessment as appropriate.

## 4. Information Security Management

(A) For appropriate management of information assets, are there policies, organizational structures, internal rules, and internal management systems? In addition, are the information security management systems improved regularly through PDCA cycles with reference to improprieties or incidents at other companies?

- (B) Is internal information managed by assigning persons in charge of managing information security and clarifying roles and responsibilities to maintain confidentiality, integrity, and availability of information? In addition, do said persons conduct overall supervision of systems, data, and network security?
- (C) Are there any measures to prevent unauthorized use of computer systems, unauthorized access, and intrusion by malicious software (including computer viruses)?
- (D) Does the financial instruments business operator comprehensively identify, grasp, and manage important customer information, for which the financial instruments business operator is responsible? In addition, does the financial instruments business operator conduct prioritization and risk assessment of important customer information that has been identified? Moreover, is there a structure to check, prevent, and control unauthorized access, unauthorized obtainment, and information leakage regarding important customer information?
- (E) Are there management rules for confidential information (encryption or masking)? In addition, are there management rules for encryption programs, encryption keys, and design documents for encryption or other security programs? Moreover, is there tighter management on storage and disposal, access restrictions, and bringing confidential information outside the company that sufficiently considers operational necessity?

(Note) With respect to ensuring security, please refer to the "FISC Security Guidelines on Computer Systems for Financial Institutions" (published by The Center for Financial Industry Information Systems).

- (F) Are information assets monitored regularly with regard to whether they are appropriately managed based on management rules, and is the management system reviewed continuously? In addition, are education programs on information security held for all employees (including education for outsourcees) to raise awareness about security?

## 5. Cyber Security Management

- (A) Does the board of directors recognize the importance of cyber security and establish

appropriate management systems in consideration of the increasingly complex and elaborate nature of cyber-attacks?

(Note) Recently, multiple instances have been confirmed of unauthorized access (login) to trading participants' systems by malicious third parties which have caused damage to customers and/or that have affected the business operations of trading participants, such as the unauthorized withdrawal of customer funds or a suspension of the trading system.

(B) Is there a management system for cyber security (including establishing internal rules and organizational management systems) and do countermeasures take a multi-level approach from entry point, internal, and exit phases? Moreover, are there measures to prevent the spread of the impact of a cyber-attack?

(C) Are necessary measures (OS updates or security patches) taken in a timely manner for system vulnerabilities? In addition, to improve the security measures regarding cyber security, is regular assessment of security levels conducted by use of checks on network intrusion or vulnerability assessment?

(D) Has an appropriate authentication method been implemented in line with such trading risks, and have measures to prevent unfair trading been taken in accordance with business operations if the financial instruments business operator has a non-face-to-face trading channel, such as Internet trading?

(Note) In addition to unauthorized access, multiple trading participants have confirmed instances of unauthorized withdrawals along with the unauthorized opening of bank accounts where securities were sold and money was sent.

When conducting non-face-to-face transactions, financial instruments business operators must establish a management system (including, for instance, implementing multifactor authentication or configuring user account lockout when someone enters the wrong withdrawal password multiple times) to prevent not only unauthorized access but also unauthorized withdrawals based on the "Guidelines to Prevent Unauthorized Access and Other Incidents in Online Trading" formulated by JSDA.

(E) Is there a contingency plan that addresses cyber-attacks, and are there drills or reviews of the plan? In addition, does the financial instruments business operator participate in cross-industry drills as needed? Moreover, has a policy to develop and

enhance human resources for cyber security been established and implemented?

#### 6. Systems Planning / Development / Operation and Management

- (A) Has a medium- to long-term development plan been formulated with clarification that the system strategy policy is part of management strategy, and has the plan been approved by the board of directors? In addition, has there been strategic investment to identify inherent risks in existing systems and maintain or improve measures?
- (B) Are there clear rules on approval for planning, development, and migration of development projects, and is project progress being monitored based on the development plan with persons responsible for each project? In addition, have tests been conducted adequately and appropriately (including making test plans and involving user divisions in tests) at the time of system development?
- (C) Is there a specific plan to cultivate human resources to ensure continuity and specialized knowledge of existing system structures and development skills?

#### 7. Systems Audit

- (A) Are there periodic audits of computer systems conducted by an internal audit section that is independent from the systems division? In addition, is there internal audit by staff adept at IT systems or external audit by systems auditors? Moreover, are all operations related to system risk covered in the audits? Additionally, are results from the systems audit appropriately reported to the board of directors etc.?

#### 8. Management of Outsourcing of Business Operations

- (A) Are outsourcees (including subsidiary companies and outsourcees through the use of cloud services) determined with evaluation and consideration based on criteria for selection?
- (B) Does the financial instruments business operator specify the division of roles and responsibilities, audit authority, sub-contracting process, and level of service provision regarding an outsourcing contract? In addition, does the financial instruments business operator present to the outsourcee the rules or security requirements that officers and employees of the outsourcee should comply with and include the contents in the contract or other documents?

- (C) Is risk management regarding outsourced operations (including subcontracted operations) related to IT systems implemented appropriately?

When there are multiple outsourcing firms in particular, management operations tend to be more complicated. Is the system capable of more sophisticated risk management? If operations related to IT systems are outsourced, is risk management also implemented appropriately?

- (D) Does the financial instruments business operator, as the outsourcer, regularly monitor whether the outsourced operations (including subcontracted operations) are appropriately conducted? In addition, is there an internal management system that allows the outsourcer to monitor and trace the operational status of customer data in the outsourcee?

(Note) With respect to a recent incident of an unauthorized withdrawal by an employee of an outsourcee, the unauthorized use of the authority granted to the employee at the outsourcee was disclosed. The financial instruments operator needs to manage outsourcing of business operations by combining the ID management and access restrictions at outsourcees and monitoring of outsourcees, etc.

#### 9. Contingency Plan

- (A) Is there a contingency plan and a framework for emergency response? In addition, is the plan based on objective levels and does it assume both emergency situations caused by disasters and system malfunctions at the financial instruments business operator that may occur due to internal or external factors? Moreover, have various risk scenarios (including significant delay in batch processing) been considered sufficiently?
- (B) Are the assumed scenarios of the contingency plan reviewed appropriately based on cases of system malfunctions at other companies or decisions of the Central Disaster Prevention Council? Are there regular drills based on the contingency plan on a company-wide basis and with outsourcees?
- (C) Regarding core systems that are critical for business, is there a management system in place with an off-site backup system, which is prepared in advance to quickly continue business should a disaster or system malfunction occur?

## 10. System Integration Risk

- (A) Do officers and employees of the financial instruments business operator fully recognize the risk of system integration, and is there a system to manage such risk? In addition, does the management system allow the financial instruments business operator to be involved objectively even if the operation is outsourced?
  
- (B) Has the financial instruments business operator established arrangements and procedures for conducting tests, and is the test plan suited to the nature of the system development necessitated by the system integration? In addition, does the financial instruments business operator make use of third-party assessments, such as by a systems auditor, when making judgment regarding important matters related to system integration?
  
- (C) Has the financial instruments business operator developed a contingency plan for dealing with unforeseen circumstances?

(Note) For points of focus with respect to the verification of project management for system integration risks, please refer to the appendix: Approach and Focus Points on System Integration Risk Management Structure (details) in the “Discussion Paper on Dialogues and Practices Regarding Financial Institutions' IT Governance” (published in June 2019).

## 11. Response to System Malfunctions

- (A) Can appropriate measures be taken to prevent unneeded customer confusion when a malfunction occurs, and are there operations for system recovery or alternative procedures ready for quick implementation? In addition, is there a management system ready to take necessary action, assuming the worst-case scenario in a system malfunction?
  
- (B) In preparing for system malfunctions, etc., is there a clear reporting route or chain of command that includes the outsourcees?
  
- (C) Does the financial instruments business operator immediately report a system failure that has a serious impact on management to the board members including a representative director(s)? Is there a management system to report the maximum risk in the worst-case scenario? (For example, if there is a possibility that a system failure will have serious impact on customers, the reporter shall be required to report

the maximum risk, and not underreport risk based on personal judgment.) In addition, is there a system that makes it possible for the company to establish an emergency headquarters where the representative director and other directors/executive officers can issue instructions to quickly resolve problems?

- (D) In the event of a system malfunction etc., has the financial instruments business operator made an announcement with details of the malfunction, its cause, and the expected timing of recovery as well as promptly set up a call center or other department to respond to inquiries from customers as necessary? Moreover, in preparing for system malfunctions etc., have means of providing information to related divisions and information to be provided been clarified?
- (E) Has the financial instruments business operator appropriately implemented measures for a system malfunction such as identification of the cause, investigation on the impact until recovery, improvement measures, and measures to prevent a recurrence? In addition, is there regular analysis of trends related to causes for system malfunctions and are there measures to address such trends?
- (F) Is there a systematic mechanism such as a failover to minimize the impact of system malfunctions?
- (G) Is there a system and framework for prompt reporting to the regulatory authorities when a malfunction occurs?

(Note) System malfunctions, etc. that should be reported (regardless of cause): any malfunction of a system or device (hardware or software) currently in use by a financial instruments business operator, an entity entrusted with operations from a financial instruments business operator, etc., which has or may have impact on financial instruments trading, clearing/settlement, deposit/withdrawal of funds, financing, grasping of financial conditions, or other matters such as customer convenience.

However, this excludes cases where no substantial impact occurs due to prompt switching to other systems/devices even in the event of such impact in some systems/devices (for example, cases where an error in order acceptance systems occurs outside auction trading hours, and prompt switching to alternative systems is completed in time to allow order acceptance during auction trading hours).

Furthermore, even when a malfunction has not occurred, reports are required in cases where there is a warning of a cyber-attack or the detection of a cyber-attack, and the possibility of a malfunction like those above is deemed to be high.

(Note) Reference materials on system risk are available, such as "FISC Security Guidelines on Computer Systems for Financial Institutions" (published by The Center for Financial Industry Information Systems).



## 8. Management of Margin Transaction Security Deposit, etc.

### 1. Relevant Laws and Regulations

- FIEA: Article 161-2
- Cabinet Office Order on Security Deposits and Transactions Provided in Article 161-2 of the FIEA
- TSE Business Regulations: Rule 14, Item 1, (3) through (6)
- TSE Margin/Loan Trading Regulations
- TSE Brokerage Agreement Standards: Rule 5, Rule 6, Rules 31 through 40, and Rules 43 through 48

Reference: "Chapter II. Cases Relating to Margin Trading" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

Margin trading is a form of securities brokerage in which a financial instruments business operator enters into an agreement ahead of time to loan a customer funds or securities to settle a transaction. In performing a margin transaction, laws and regulations require that the financial instruments firm receive from the customer a security deposit in excess of the amount determined by multiplying the market price of the subject security by a percentage determined by the Prime Minister as necessary for ensuring fairness in transactions.

A "when-issued transaction" is a transaction for a security that has yet to be issued. On the settlement day, a certain amount of time after the issue date, the subject security is delivered and, as with margin trading, it is necessary to receive a security deposit from the customer.

Regarding the customer margin rate, the Prime Minister may, for example, when securities markets are overheating or in danger of overheating, raise the rate by issuing a revised Cabinet Order. The rate can also be raised based on the judgment of the exchange through

autonomous, expeditious regulatory action to prevent excessive speculation.

When a sale or purchase is made through a margin transaction, the customer margin mentioned above – equal to 30% of the execution price (and no less than JPY 300,000) – must be deposited by the customer by a date and time specified by the trading participant by noon of the second day following the execution date (T+2).

Cash or securities may be withdrawn from those deposited as customer margin equivalent to the amount equal to "30% of the contract price of all securities pertaining to margin transactions (excluding those used for settlement)" subtracted from the "total amount of such customer margin".

An amendment, effective January 1, 2013, was made to change calculation and valuation of customer margin pertaining to margin transactions from the delivery date to the contract date. Prior to this, 30% of customer margin for unsettled positions was not to be withdrawn until the delivery date. Following this amendment, it is possible to release withholding from customer margin pertaining to positions for which settlement has been declared. Additionally, before the amendment, the amount available for immediate allocation was limited to once per day for only offsetting transactions. With the amendment, such immediate allocation as customer margin for other margin transactions is possible multiple times, regardless of method of settlement.

Additionally, prior to the amendment, withdrawal and allocation of fixed profits was only possible on or after the delivery date of such offsetting transaction. However, after the amendment, such profits can be included in the total amount of customer margin immediately after offsetting transactions.

Furthermore, the amendment was also made to additional margin. Previously, when additional margin was required, the deposit of cash or securities in lieu of cash was required. Following the amendment, (1) in cases of partial settlement of a position, deduction of 20% of such from the additional margin, and (2) in cases where advanced deposit of fixed losses was conducted, deduction of such deposit from the additional margin is permitted.

Please note that effective from January 10, 2023, the Brokerage Agreement Standards will be revised, and the security deposit rate for margin transactions of ETFs and ETNs tracking

leveraged and inverse products will be that obtained by multiplying 30% by the leverage factor of the relevant product. (If the leverage factor is negative, the rate will be obtained by multiplying 30% by the value obtained by deducting the leverage factor of the relevant product from zero.)

### **3. Key Regulatory Checkpoints**

- (1) It is important to note that, if new positions/settlements are repeatedly conducted (day trading) without the deposit of customer margin (including cases of insufficient customer margin), the deposit of customer margin for all transactions is required. In cases where the calculation and valuation of customer margin is changed to be based on the contract date, and the withholding of security deposit pertaining to a position for which settlement has been reported is released, the management of security deposit at the time of order placement is assumed.
- (2) In cases of actual receipt/delivery, advance deposit of the cash or securities for such settlement is required. Additionally, the cash or securities required for such actual receipt/delivery are required to be withheld until the settlement date to prevent their use in allocation, withdrawal, etc., and not included in the margin's valuated amount.
- (3) Including fixed profit in the total amount of security deposit immediately after conducting the offsetting transaction requires the deposit of such fixed profit as security deposit. Additionally, the scope of withdrawal shall be limited to the current deposited amount of security deposit.
- (4) Fixed profits in cases of offsetting transactions for "positions for which security deposits are not deposited" and "positions for which security deposit is insufficient" cannot be allocated to security deposit pertaining to other new positions.
- (5) In cases where additional margin has been released by advance deposit regarding fixed losses, the fixed losses deposited by the customer are required to be withheld until the settlement date to prevent other uses. Furthermore, fixed profits may not be deducted from additional margin.
- (6) When a trading participant, on its own, has imposed margin terms and conditions (for example, a higher minimum margin, tighter deadline for deposit of security

deposit, higher credit limit, regulations on *nikai-date* transactions (a transaction in which an issue purchased on margin is the same as an issue being used in lieu of money as the margin deposit, etc.) for margin transactions and when-issued transactions that are stricter than those required by laws and regulations, it must explain said terms and conditions to the customer ahead of time and gain its sufficient acceptance.

- (7) At Internet securities firms using margin accounts to centrally manage funds for customers' margin transactions, there have been an unduly large number of violations of net settlement transaction and same-day cash collection regulations for cash transactions funded with margin funds. A trading participant taking this approach, therefore, must be sure to comply with not only margin transaction regulations but all net settlement transaction and all other closely related regulations, as well.

#### **4. Key Management Checkpoints**

- (1) Have appropriate organizational measures been taken to manage security deposit and other matters related to margin and when-issued transactions?
- (2) Have internal rules (internal regulations or operating rules) been properly established to manage security deposit (including measures addressing regulations for increasing margin and regulations concerning cash) related to margin and when-issued transactions?
- (3) In cases of response to the deregulation that was enforced on January 1, 2013, has an appropriate internal management system, including post factum inspection, been established?
- (4) Are accounts, etc. that have, or are likely to have, 30% or 20% margin shortfall appropriately identified respectively by the compliance divisions of the head office or individual outlets?
- (5) Have approaches (integrated internal processing flow or penalties) for dealing with additional margin calls and improper withdrawal of margin funds been established within the firm and are they being uniformly applied?

- (6) Have operational measures (internal communications, customer notification, or compliance checks) been taken that would allow actions pursuant to margin-increase and cash regulations concerning margin transactions?
- (7) Have internal systems been established to check and archive the Agreement for Setting up Margin Transaction Account and the Agreement on Entrustment of When-Issued Transactions? Have internal systems been also established to deal with revisions to these agreements?
- (8) As a precaution, are measures for forcibly locking customer accounts in place and implementable if they are required?
- (9) For accounts nearing the settlement deadline, are management measures for issuing notifications in place? In addition, are measures in place that would allow responsible employees to take proper actions for dealing with customers and other purposes, as well?
- (10) Regarding responses to individual customer attempts to withdraw margin funds, are measures (ways to involve the branch or head office compliance division) in place to handle cases beyond the decision-making capability of an individual employee?
- (11) Have decision criteria for the correction of margin trading classification information (for example, correction to new margin purchase from cash purchase) reported to TSE been properly established and are they being applied under uniform internal procedural flow?
- (12) Has training for managing margin and when-issued transactions been developed?
- (13) How (by posting on the website or individual contact) are customers provided with notifications on compliance with margin withdrawal and other margin transaction and when-issued transaction rules (laws and regulations, as well as company rules)?

## 9. Error Correction Management

*(Distinguishing own-account and customer orders, and error correction)*

### 1. Relevant Laws and Regulations

- FIEA: Article 39.3 through 5
- FIB Cabinet Order: Articles 118 through 122
- TSE Business Regulations: Rule 14.1.(1) and Rule 41
- OSE Business Regulations: Rule 26.1. and Rule 34
- JSDA Regulations Concerning Application for Confirmation and Examination, etc. of Incidents, others

**Reference:** "Chapter VI. Cases Relating to Correction of Errors" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

While it would be best if securities transaction errors or incidents (hereinafter "incidents") were simply not committed, it is, in reality, impossible to completely eliminate them. Execution corrections are used as one way to protect customers from losses resulting from a wide range of incidents, including simple administrative mistakes in order execution. However, because of the ample possibility of loss compensation, provision of undo gains, and other illegal activity under the guise of execution correction, the FIEA requires that a confirmation be provided to the Prime Minister before any losses are borne in connection with the correction of a customer order and that a report be filed after losses are borne.

FIB Cabinet Order Article 118 enumerates five types of incidents. These are: 1) an unconfirmed trade; 2) mistaken solicitation; 3) an error in executing a customer order caused by an administrative mistake resulting from negligence; 4) an error in executing a customer order caused by an abnormality in an electronic information processing system; and 5) activity that violates other laws and regulations.

Execution correction is said to directly reflect compliance awareness and internal

management readiness to act at financial instruments business operators, but, depending on how corrections are handled, may also serve as a breeding ground for improper or illegal activity. That makes it an extremely important area for compliance. Among the wide variety of execution correction approaches, JPX-R inspections, noting the close relationship with exchange trading, focus in particular on corrections made to the own-account/customer-account categorization (Note 1) and error correction (Note 2) in examining the propriety of correction details and management of correction procedures.

(Note 1) When placing an order on TSE or OSE, a trading participant must specify whether the order is for its own account or for that of a customer and, if later correcting that specification, must provide a Corrected Declaration to TSE or OSE.

(Note 2) With the approval of TSE or OSE, a trading participant can execute an order intended to correct an error in a customer order outside of a trading session.

### **3. Key Regulatory Checkpoints**

- (1) The FIB Cabinet Order provisions on negligence-caused administrative errors in customer order execution apply to administrative mistakes between the receipt of an order and order execution. Not included are improprieties at the time an order is received (for example, an unconfirmed trade or mistaken solicitation) and administrative errors after execution ("execution notification mistakes").
- (2) Correction of administrative errors that occur up through the day preceding delivery do not require confirmation of an incident as the customer is not considered to have actually suffered a loss due to a mistake. (Note: Reissuance of the order and other corrective actions, however, are required.) It is important to note that, with respect to unconfirmed trades or mistaken solicitation, changing to its own account is prohibited, even before delivery.
- (3) To prevent a trading participant from assigning to a customer account, after the fact, a transaction undertaken for its own account, or compensating a customer for loss on its account by reassigning the transaction to the participant's account, both TSE and OSE require that orders be categorized by trading participants as for their own accounts or for customer accounts when they are placed. Changing the categorization after the fact is permitted only when correcting an administrative error.

- (4) Business Regulations of TSE and OSE prescribe that a trading participant may execute a sale or a purchase of a security without carrying out a trade during a trading session (a transaction for correcting errors) with the trading participant as a counterparty, when the trading participant has placed the erroneous order due to an error, etc. for a truly unavoidable reason or due to a computer system malfunction. Similarly, subject to certain conditions, a trading participant may apply for error correction when a trading participant is unable to execute an order of its customer in accordance with the purpose of entrustment in the TSE or OSE market in accordance with the purport of the entrustment due to an unavoidable error caused by the staff other than traders of the trading participant (such as sales staff).

#### **4. Key Management Checkpoints**

##### 1. Execution Correction in General

- (A) Have internal rules (internal regulations or operating rules) been properly established for correcting incidents?
- (B) Has a unit and a person-in-charge been designated for rendering final judgment on the adequacy of an execution correction application? (Have there been cases in which action was taken in contradiction to the decision of said person?)
- (C) Have procedures spanning the period from incident emergence through correction application been developed, and is it possible to implement them smoothly and uniformly?
- (D) Have supervising units taken steps, like keeping ledgers, using voice recorders, and arranging for direct confirmations with customers, which permit the confirmation of facts for error reports (internal correction rationale documentation) and other purposes, should an incident arise?
- (E) Has it been determined what units and personnel will prepare corrected declarations to the exchange and perform overall checks, and has a system allowing all of the parties to contact one another been established?
- (F) Are reports on execution correction results regularly provided to those in charge of



internal management? For particularly important cases, are reports made promptly after the incident takes place?

- (G) When there are concerns regarding the processing of an execution correction or for particularly significant incidents, is there a system in place for consulting with a self-regulatory organization and other parties before going through with correction procedures?
- (H) Have proper measures (including retraining) been taken with regard to personnel who have frequently made errors?
- (I) Does the error report (internal correction rationale documentation) include information such as supporting documentation on circumstances surrounding errors, causes, specifics of correction steps, and proof of facts that would permit checks to be performed? In addition, are error reports and related documentation properly filed by supervising or other units?

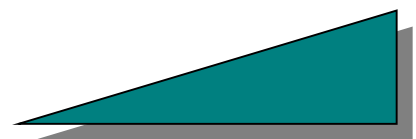
## 2. Own-Account/Customer Account Correction

- (1) Have systems been programmed to automatically (based on the terminal used or code entered) make the own-account/customer-account distinction?  
If not, are checks properly performed to manually determine whether the distinction has been correctly made?
- (2) Are supervising units appropriately examining correction rationale to determine whether gains have been transferred to customers by re-categorizing a transaction from own-account to customer-account and whether losses have been transferred to the firm by re-categorizing a transaction from customer-account to own-account?
- (3) Were the documents submitted for correction to TSE or OSE double checked both in formality and content by those in charge of or involved in the transaction?
- (4) Have criteria been clarified for determining whether it is possible to recategorize a transaction as for the firm's own account in the case of an execution correction after the settlement date?
- (5) For the processing of extremely large orders, are consistent, rational rules applied in

recategorizing orders as for the firm's own account?

### 3. Error Correction

- (A) Are internal rules, notifications from exchanges, and other documentation related to error correction all retained?
- (B) When an Application for Correction is to be submitted to TSE or OSE, are double checks of the submitted documents performed in formality and content by those in charge of and involved in the transaction?
- (C) How do the internal control units check that they are applying for correction for a "truly unavoidable reason" prescribed in the rules of TSE or OSE? For example, do they use records taken with voice recorders, or do they use other measures?
- (D) Are measures in place to properly perform checks to determine the authenticity of documentation such as order slips attached to Corrected Declarations?



## 10. Compliance with Same-Day Cash Collection Rules

### 1. Relevant Rules and Regulations

- TSE Business Regulations: Rule 65
- TSE Rules on Regulatory Measures Concerning Securities Trading or Its Brokerage: Rule 1. (7), and (8), among others

**Reference:** "Chapter IX. Cases Relating to Trading Regulations" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

When TSE determines that the state of securities trading on the exchange has become abnormal or is likely to become so, it will take the necessary measures provided in TSE's rules. Regarding the determination of initial prices for initial listings, these rules include regulations for requiring payment of purchase money prior to settlement—in other words, the same-day collection of cash for transactions.

In addition, when these regulations are applied, TSE may also apply regulations prohibiting trading participants involved in trading for the purpose of determining initial price from making purchases for their own account (including purchases pursuant to discretionary trading agreements) and market bids related to trading up through the day the initial price is determined.

Same-day cash collection regulations, it should be noted, can also be implemented with regard to trading in issues already listed.

### 3. Key Regulatory Checkpoints

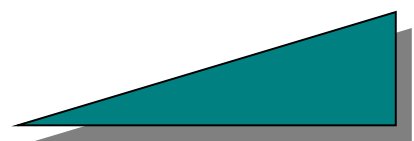
- (1) Same-day cash collection regulations apply not only to the exact time when an initial price is determined but through the end of that day.

- (2) "Cash" includes:
  - (a) Cash
  - (b) Drafts
  - (c) Customer deposit account funds used as purchase money
  - (d) MRF (Money Reserve Fund) exceeding amounts necessary as purchase money for other transactions and that is applied as purchase money for the transaction to which same-day collection regulations are being applied
- (3) Once purchase money is deposited (including MRF balances secured for application as purchase money), it cannot be used for any other purpose and must be tied up until the settlement date.
- (4) Same-day collection of purchase money must also be applied for orders from financial instruments business operators that are not trading participants, but customers in this case.
- (5) Margin transactions are not exceptions to same-day collection regulations, so, for margin transactions involving the same issue, same-day collection of cash equivalent to the purchase money amount is required in addition to the deposit of security deposit.

#### **4. Key Management Checkpoints**

- (1) Have manuals on securities trading regulatory measures been prepared? In addition, have notifications from exchanges (including self-regulatory organizations) and other such information been properly organized and archived?
- (2) When regulatory measures are announced by TSE, do relevant personnel review details and properly inform personnel involved in operations?
- (3) Are measures appropriately taken to provide information on newly announced regulatory measures to customers from whom orders were received prior to the announcement, Internet customers, other financial instruments business operators from whom orders can be received online, and other customers?

- (4) To ensure the same-day collection of purchase money, are appropriate management, including systems-based, steps (to ensure prior receipt of all purchase money) taken when an order is received from a customer for an issue subject to regulatory measures?
- (5) Are management procedures (including checks by sales offices and the head office to determine whether purchase money has been received) for execution days for issues subject to regulatory measures properly performed?
- (6) Are management procedures properly performed on a daily basis until the delivery date to ensure that purchase money that is supposed to be locked up is not used for other purposes or withdrawn?
- (7) Are internal inspections and examinations performed to ensure compliance with the subject regulatory measures? If they are, what do they focus on and with what frequency are they being performed?



## 11. Measures to Prevent Erroneous Orders

### 1. Relevant Laws and Regulations

- FIEA: Article 40.(2)
- FIB Cabinet Order: Article 123.1.(14)
- TSE Trading Participant Regulations: Rule 22-3 and Rule 42
- OSE Regulations for Transaction Participants Rule 21-2 and Rule 51
- TSE Regulations for Order Management Systems at Trading Participants
- OSE Regulations Concerning Order Control Systems at Transaction Participants
- TSE/OSE/JPX-R Order Management Guidelines

**Reference:** "Chapter VII. Cases Related to Prevention of Erroneous Order Placement" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

Placement of an erroneous order is a prime example of administrative risk, so prevention is a key compliance issue for financial instruments business operators. Individual trading participants, therefore, have long worked to prevent the placement of erroneous orders by employing limit controls in their systems and taking management measures to ensure employees are as accurate as possible in entering orders. Even so, however, it has been impossible to root out the placement of erroneous orders, which has a considerable impact on exchanges.

In December 2005, placement of a massive erroneous order resulted in a transaction for shares significantly beyond the total number of issued outstanding shares for the issue, and the impossibility of ordinary settlement by delivery and payment procedures necessitated an extremely serious situation in which settlement had to be made in cash. In such cases, where the placement of a large erroneous order has a tremendous impact on the market, the negative consequences are not limited to the immediate loss incurred but extend to administrative disciplinary action and disciplinary action by self-regulatory organizations.

Learning from this experience, TSE and OSE established its "Regulations for Order Management Systems at Trading Participants" in 2006 and now require all trading participants to have appropriate systems in place to prevent the placement of erroneous orders.

In recent years, the market has experienced the ever-growing prevalence of trading through electronic data processing systems that automatically place orders. Given concerns over the impact on the markets caused by malfunctions in electronic data processing systems, it is increasingly important for trading participants to develop an effective system for order management. As such, in April 2018, exchanges clarified certain aspects surrounding order management in the rules. These include, in addition to limitation on one-shot order placement, order management that is deemed to be appropriate for preventing the misplacement of an excessive quantity of or monetary amount for many small orders.

Furthermore, in accordance with the introduction of the Market Access Rules in January 2021, trading participants are required to implement direct and exclusive risk controls, restrict the placement of subsequent orders after an erroneous order has been placed, and clearly prohibited deliberate erroneous orders from the standpoint of enhancing risk check functions by trading participants, among other things.

### **3. Key Regulatory Checkpoints**

- (1) The Regulations for Order Management Systems at Trading Participants (hereinafter "Erroneous Order Management Regulations") require the establishment of order management systems for all the products listed on TSE and OSE, for which trading participants can place orders, regardless of their order placement frequency. Therefore, for example, even if a trading participant rarely handles orders for certain listed products, it will be in violation of the Erroneous Order Management Regulations if it fails to act in accordance with the Erroneous Order Management Regulations.
- (2) The purpose of the Erroneous Order Management Regulations is to prevent the receipt and issuance of erroneous orders by trading participants. "Erroneous orders" here includes orders that are erroneous because of customer mistakes. Consequently, proper management based on the same regulations is required for customer orders received via the Internet or Direct Market Access (DMA)

(hereinafter collectively referred to as "orders received via the Internet")

- (3) The Erroneous Order Management Regulations require the establishment of soft limits to allow trading participants to eliminate erroneous orders. For orders received via the Internet, it is conceivable that soft limits could be applied in the order issuance systems used by customers. Doing so would require the display of a warning screen and proper use of the limit release method to avoid the placement of erroneous orders arising from the customer's release of the limit without adequate understanding.
- (4) It is necessary to avoid allowing the person responsible for approvals related to soft limits (hereinafter "soft limit approver") to grant approvals for his or her own orders when they exceed a soft limit. For an order exceeding the soft limit, a double check by a person other than the person making the order is necessary to avoid placement of an erroneous order. In other words, a person to whom authority has been delegated by the soft limit approver or another internal person with soft limit approval authority must check the order details and determine whether to grant approval.
- (5) A "hard limit" must be set at a level at which there is essentially no possibility of a legitimate order being made, while a "soft limit" must be set at a level at which legitimate orders are not usually made but at which they may occasionally be made. These levels differ depending on the transaction circumstances of individual trading participants, so it is necessary for individual trading participants to consider carefully where to set these levels and then set them at levels appropriate for their operations. Particularly, hard limits need to be set within the order size limits specified by TSE and OSE.
- (6) For example, let us assume that (i) an order significantly exceeds the trading participant's past order activity, or (ii) the hard limit does not function for a trade, because it was set for off-auction trading at TSE/OSE, and an order exceeds the order size limits set by TSE and OSE for auction trading. In such cases, where no effective limits are set from an objective viewpoint, the trading participant will be deemed to have not set appropriate order limits and have failed to comply with the Erroneous Order Management Regulations. Therefore, trading participants are required to pay attention to the following matters, among others: (i) whether concrete limits are set at levels that are comparable with past order activity, (ii) whether the



limits are set at all terminals that have order placement functions, and (iii) whether limits set by the trading participants are within the order size limits that TSE and OSE have specified by product and by market division.

It should be noted that, while it would be difficult to say that setting a hard limit at a level appropriate for a soft limit and managing orders with only a hard limit violates the Erroneous Order Management Regulations, hard limits must be appropriately (conservatively) set in a manner that is not excessive.

- (7) Regarding a soft limit, it can be said that what constitutes an appropriate level can change depending on market conditions. The effectiveness of a soft limit, therefore, can be seen as dependent on changing its level appropriately. In the case of a hard limit, on the other hand, the level at which there is essentially no possibility of legitimate orders is not expected to change frequently in response to market conditions, so more care must be applied in changing the level of a hard limit.
- (8) Hard limits and soft limits must be set for all terminals from which it is possible to place an order on the TSE and OSE market. This includes, for example, TSE terminals ("exchange terminals") that could be used at the time of a system malfunction, and not just those normally used in daily operations.
- (9) For orders received from customers via the Internet, creating a system that does not permit orders exceeding certain levels for funds and securities deposited by customers (hereinafter "advance receipt system") and using this system as a hard limit leaves open the possibility that the limit levels will not rule out market impacts and that the hard limit ideal of a level at which there is essentially no possibility of legitimate orders will be exceeded. Consequently, the establishment of an advance receipt system is not reliably safe and establishment of a separate hard limit is still necessary.

Furthermore, for systems in which orders are limited based on the assessed values of securities deposited by customers (hereinafter "deposited assets valuation system") and other systems in which a full-scale advance receipt system is not being used, it is even more necessary to establish a separate hard limit, and to carefully consider the sizes of the orders that customers could actually place.

- (10) "Automated order placement trading" is a high risk form of trading where an accumulation of unintentional small, sliced orders across a short time span, for

example, caused by a malfunction in order placement systems, may result in placement of an excessive quantity of or monetary amount for orders. As such, appropriate management is necessary such as by setting certain limits to prevent placement of orders, etc. where the total quantity of or monetary amount of orders for a certain time span exceeds a certain quantity of or monetary amount for placed orders.

- (11) Where a trading participant restricts order placement by deliberately changing the conditions of an order to those which will obviously become an error (e.g., setting the order quantity to zero, setting the order price outside the daily price limits, setting the order price to one that does not match the tick size specified by the exchanges) for the exchange systems and have said order rejected by the exchange (e.g., Malformed Order), such method of restriction is inappropriate for order management.
- (12) Regardless of whether a trading participant accepts orders for low latency trading, in the event that an unexpected irregular order was placed due to a malfunction, etc. of the order placement system (including customer systems), the trading participant is required to immediately implement measures to deter placement of new orders to the exchanges.
- \* Securities companies that accept orders for low latency trading continue to be required to implement measures based on checklists requested by the TSE Equity Strategic Planning No. 300 notice dated Nov. 26, 2018 and the OSE Market Planning No. 19 notice dated Mar. 29, 2019.
- (13) Trading participants are required to have direct and exclusive management control over restrictions or measures related to order management of customers. "Direct and exclusive management control" means a situation where only the trading participant can manage restrictions or measures related to order management of customers (for example, setting, change, etc., of risk parameters) and where the customers cannot modify such parameters, etc.

**Remarks:** Regulations of TSE and OSE apply specifically to auction trading, but it goes without saying that using these regulations as a guide for setting hard limits for off-auction trading (ToSTNeT trading and J-NET trading) and taking other appropriate internal management steps is desirable.

- (14) Does the trading participant also restrict order placement entrusted by customers from other financial instruments business operators?

#### **4. Key Management Checkpoints**

- (1) Have internal rules (internal regulations or operating rules) been properly established in conformance with TSE/OSE regulations to prevent the placement of erroneous orders?
- (2) Regarding the conditions for setting order limit values (individual hard limit and soft limit values) for the internal order system, has an organization (designation of units in charge and a supervising manager) been put in place to comprehensively grasp necessary information?
- (3) Are checks properly performed to determine whether order limits established for terminals have been set as required in rules, whether such order limits are set at appropriate levels, and whether the hard limits for orders placed via such terminals are set within the order size limits that TSE and OSE have specified by product and by market division?
- (4) Have internal procedures for changing order limits been clearly established, and have they been properly put into practice?
- (5) When an order is received from a customer, how are order details and financial means confirmed to prevent placement of an erroneous order? Are these steps properly taken for wholesale, retail, Internet, call, DMA, and other transaction routes (order systems)?
- (6) Particularly with respect to conducting trades involving automatic order placement using algorithms, etc. (including proprietary trading), has a proper management system (cumulative position limits, etc.) been established to address the inherent risks to this transaction type, such as the risk of placing large amounts of irregular orders due to a trading system failure, etc., which may lead to immense losses directly connected to the bankruptcy of clients, etc., as well as the likelihood of significantly impacting the operations of exchange markets?

- (7) Does the system deliberately change an order that has breached order restrictions specified by the trading participant to that with conditions that it will clearly be an error and be rejected by the exchange systems (i.e., malformed orders)?
- (8) Have system settings and management structures been established so that, when an irregular order is placed, no further orders can be placed to the exchanges?
- (9) Does the trading participant have direct and exclusive control over setting and modifying order restrictions and order suppression when an irregular order has been placed, etc.
- (10) Have concrete procedures for releasing soft limits been established, and are they consistently followed? In particular, in the case of order placement by someone with release authority, is release of such limits or order entry subject to checks by another person?
- (11) Are soft limit levels revised at appropriate times and in appropriate ways given transaction circumstances? Have high soft limit levels, set when market conditions warranted them, ever been left in place even though lower levels were called for?
- (12) Do personnel in charge of placing orders correctly understand and implement operations and procedures to prevent placement of erroneous orders?
- (13) Have units responsible for placing orders deployed personnel appropriately and do they properly conduct training to prevent placement of erroneous orders?
- (14) Does training incorporate how to address warning notices and perform cancellation procedures?
- (15) Have proper measures (including retraining) been taken with regard to personnel who have frequently made entry mistakes?
- (16) Have basic response policies and an internal reporting system been put in place to handle the placement of large erroneous orders? In addition, has a specific contingency plan been developed to permit appropriate responses?

(17) Have information disclosure policies and specific disclosure methods been properly established to deal with the placement of large erroneous orders?

## 12. Trading Supervision Systems

### 1. Relevant Laws and Regulations

- FIEA: Article 40.(2)
- FIB Cabinet Order: Article 123.1.(12), others
- TSE Trading Participant Regulations: Rule 22-2
- TSE Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading
- OSE Trading Participant Regulations: Rule 21
- OSE Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading
- OSE Guidelines for Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading

Reference: "Chapter VIII. Trading Supervision Systems" of "Compliance Case Study Handbook" published by JPX-R

### 2. Regulatory Intent

In light of developments like the increasing volume of non-face-to-face trading, TSE requires trading participants to establish trading supervision systems, the ultimate goals of which are to prevent unfair trading, secure confidence in the TSE market and trading participants, and protect the public interest and investors. Specific requirements for systems to monitor securities (including equity, CB, and ETF) trading on the TSE market are provided in TSE's regulations.

Among other things, these regulations require: 1) the establishment of internal rules addressing matters concerning the accurate identification of trends in customers' trading behavior; 2) implementation of market surveillance based on monitoring of certain issues and customers; 3) preparation and retention of internal records; and 4) compliance with other requirements.

These regulations (implemented in June 2006) originally targeted unfair trading by customers but were later amended (amendments implemented in December 2007) to

require the establishment of trading supervision systems covering trading participants' trading for their own accounts. More recently, amendments requiring the enhancement of after-the-fact market surveillance targeting insider trading (implemented in April 2009) and those related to the storage of information pertaining to online trading (implemented in January 2012) were added to bolster TSE's transparency and fairness.

Moreover, unfair trading such as price manipulation may occur not only in cash equities market trading but also in derivatives trading in the exchange market. The laws and regulations require trading participants to take into account the nature of the instrument and properly develop trading management systems pertaining to derivatives trading.

In addition, in April 2020, OSE's Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading were implemented to specify the trading supervision systems required for derivatives market transactions. In April 2022, TSE's Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading were revised to more flexibly allow trading participants to modify identification criteria and matters concerning analysis, and requirements for trading participants conducting principle-based market surveillance were clarified in the guidelines for these Rules.

### **3. Key Regulatory Checkpoints**

- (1) TSE and OSE regulations set forth the minimum standard for appropriate transaction-monitoring systems required of trading participants by FIB Cabinet Order Article 123.1.(12). Individual trading participants, therefore, should go beyond compliance with these minimum requirements (\*for both face-to-face and non-face-to-face, and wholesale and retail trading) to take additional steps appropriate for their own circumstances to achieve even higher compliance levels. If a trading participant can obtain surveillance results equivalent to those that would be obtained using the identification criteria in accordance with TSE rules and the examination based on the analysis items for trading activities, the trading participant may change the identification criteria or narrow down the identification results among others.
- (2) Except in cases that clearly do not constitute unfair trading, trading participants must issue cautions and take other appropriate measures based on the results of market surveillance performed as required by rules and regulations. Trading participants must also prepare internal records, which they must retain for five

years.

- (3) Trading participants must ensure the effectiveness of the internal rules that comprise the operational standards for their trading supervision systems by promoting thorough understanding of the rules among executives and employees and continuously updating the rules to adjust to changes in trading circumstances. Trading participants must provide the designated reports to TSE (Market Participants Relations Office) every time internal rules are changed.

#### **4. Key Management Checkpoints**

- (1) Does the content of the internal rules (on trading supervision to prevent unfair trading) fulfill the requirements of the exchange regulations? In addition, have operating manuals been properly prepared, so that market surveillance can be smoothly carried out on a daily basis?
- (2) Are internal rules and the performance of market surveillance activities appropriately examined and revised in light of actual trading circumstances?
- (3) Have communications and reporting systems been properly established between trading supervision units and branch offices? In addition, are trading supervision units properly providing instructions and advice?
- (4) In daily market surveillance operations, are customers being appropriately identified for surveillance based on criteria provided in the exchange regulations? Particularly in cases where the market surveillance system used by the trading participant does not incorporate some information pertaining to trades, is the trading participant identifying trades that are subject to market surveillance without realizing the situation? Are transactions that should be identified not identified due to reasons such as an error in the identification logic in the market surveillance system?  
\* For derivatives market transactions, appropriate surveillance is necessary in consideration of factors such as the form of trading employed by the customer. However, depending on the trading volume and other matters at the trading participant, other than system-based identification, methods such as market surveillance based on trading data or order slips can also be considered.



\* While it is necessary to address situations where transactions that should be identified are not identified, it is also desirable to address the situation where transactions that should not be identified are identified in terms of the efficiency of market surveillance. For example, in the case of a trading participant that accepts orders from many originating customers via overseas affiliates, if the unit of identification is based on such affiliates, then the transactions of multiple irrelevant originating customers will be identified. If the identification settings are set at the trading participant based on customer attributes and trading activity, only the relevant transactions will be identified, and that will enable more in-depth market surveillance.

(5) Is market surveillance appropriately conducted on the transactions and customers identified based on criteria set in accordance with the exchange rules? Particularly, if a large number of cases are identified every day, is there a single criterion (involvement ratio, price change, etc.) used to reduce the number of surveillance targets?

\* For derivatives market transactions, is appropriate market surveillance implemented according to the forms of trading adopted by the customers (characteristics of the products handled, customer attributes, customer trading volume, and order placement methods used by customers, etc.)? (In light of past cases subject to administrative monetary penalties, etc., particular attention should be paid to fictitious orders and cross transactions.)

\* TSE will not object to any changes to the identification criteria (changing the identification criteria or narrowing-down after identification), etc. if the criteria is reasonably effectively for obtaining almost the same level of surveillance results as those applied to customers who are identified by the criteria based on TSE rules. As an example of a reasonable narrowing-down method, if a customer who conducts many similar transactions everyday and these transactions are identified based on the same identification items, and the trading participant understands the details and strategies behind the transactions and has sufficiently conducted the necessary market surveillance and, as a result, it is determined that there is very low risk of unfair trading in the customer's transactions, thereafter, market surveillance on such customer's transactions can be moved to sample-based surveillance. (If the identification criteria have been changed, JPX-R verifies during the participant inspection whether the changed criteria will achieve the same level of results, giving consideration to matters

such as the forms of trading adopted by customers, as those obtained in surveillance according to the identification criteria based on the TSE rules.)

\*If principle-based market surveillance as prescribed in Rule 4, Paragraph 1, Item 1, Sub-item c. of the Rules concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading is conducted, trading participants must verify whether they have established a transaction-monitoring system in accordance with the possible risks of possible unfair trading at their company as well as properly developed and are operating systems to secure a certain level of effectiveness of said trading supervision system, while considering their own business conditions, customer attributes, and other aspects.

- (6) Are the "Guidelines Concerning the Trading of Issues Subject to Additional Financing" published by JPX-R being properly applied in supervising the trading of issues subject to additional financing?
- (7) Are operations related to the acquisition of own shares by listed companies properly complying with laws and regulations, including those addressing information management and transaction execution (receipt of purchase orders) and "Guidelines Concerning the Acquisition of Own Shares" published by JPX-R?
- (8) Is trading surveillance related to information disclosed by listed companies being performed properly with regard to trading by registered insiders?
- (9) Are trading supervision and related investigations being properly performed with regard to non-trading participants and DMA trading customers?
- (10) Have appropriate measures for the issuance of cautions to customers and other actions been properly established based on market surveillance results? In particular, are effective measures being taken toward customers based on careful examinations of trading activities, and not simply as mechanical, administrative responses?
- (11) Have appropriate measures (re-examination, etc.) been taken after being cautioned by JPX-R Market Surveillance and Compliance Department regarding the possibility of illegal trading?

(12) Is a system in place for immediately reporting to TSE (JPX-R Market Surveillance and Compliance Department) and other authorities of possible insider trading indicated by market surveillance results?

(13) Are market surveillance records being properly prepared and retained in accordance with internal rules? In addition, have the contents of the records become effective in terms of subsequent market surveillance or measures to customers?

(14) Regarding trading for the firm's own account and in the derivatives market, is trading supervision being properly performed in light of actual trading circumstances?

(15) Regarding internal rules and other relevant matters, is training performed at times and in ways that promote the establishment of trading supervision systems for preventing unfair trading?

(Note) Notification for distribution of Trade Surveillance Handbook for Beginners was via Target in Jan. 2021.

## 13. Management of Margins for Futures Trading, etc.

### 1. Relevant Laws and Regulations

- FIEA: Article 119
- Cabinet Office Order on Financial Instruments Exchanges, etc.: Article 64, others
- OSE Rules on Margin and Transfer of Unsettled Contracts Pertaining to Futures/Options Contracts
- JSCC Rules on Margins, etc. for Futures and Options Contracts

### 2. Regulatory Intent

For futures and options trading, gains and losses are determined by the future prices of the underlying assets, and margins are required to secure settlement and ensure the safety of transactions, even if they eventually produce losses. When engaging in futures or options trading in the exchange market, customers must make a margin deposit with the trading participant by the day following the day of the transaction. (Note: Non-residents must make margin deposits by the second day following a transaction; hereinafter the same.)

Margins deposited with trading participants are deposited with JSCC as clearing margin (via JSCC clearing participants).

Where a customer deposits customer margin with a trading participant, the trading participant may substitute its own funds or securities, etc. with margins deposited by the customer to make deposits (replacement deposits) at JSCC.

In the case where a trading participant trades commodity futures and options at OSE, the trading participant is required to establish a system for managing such trades, taking into account matters required to be addressed, such as security deposit receipts and delivery clearing margin.

This section describes handling by OSE. Some rules differ with respect to handling by Tokyo Commodity Exchange (TOCOM), so other terms should be read accordingly.

**Remarks:** The minimum required margin amount is equal to the amount calculated based on SPAN® (Note: SPAN® is a margin calculation method developed by the Chicago

Mercantile Exchange) minus the total net options value.

### **3. Key Regulatory Checkpoints**

- (1) Securities, etc. can be used as margin. However, it is necessary for there to be on deposit a cash margin in excess of the cash payment due as indicated by the calculation of the required margin. Consequently, if a cash shortage develops, the customer must make an additional deposit by the following day.
- (2) A trading participant must not permit withdrawal of money or securities, etc. submitted or deposited by a customer as margin. However, this shall not apply to the smaller of excess amounts of a customer's margin deposit in securities or cash in cases where the aggregate amount of the customer's margin deposit at the time of withdrawal exceeds the required margin and the securities, etc. equivalent to the amount obtained by dividing such excess by the rate\* or the amount of cash equivalent.  
\* Described in the Appendix of the JSCC Futures/Options Clearing Margin Rules
- (3) When the total amount of deposited margin exceeds the required margin, calculated gains can be paid to the customer up to the amount of the excess.
- (4) Where a customer has submitted clearing margin in excess of the required amount of margin, the trading participant must deposit the entire amount of such clearing margin with JSCC (in cases where the trading participant is not a clearing participant, via a clearing participant).
- (5) When market quotations during the afternoon trading session (government bond futures) or during an intraday session (index futures, precious metals futures, and petroleum futures) fluctuate beyond a predetermined range, or when determined to be necessary by JSCC (clearing institution), JSCC will recalculate the required clearing margin. If it is determined that the deposit amount is less than the required amount, the participant will be required to immediately make an additional deposit. However, if the amount obtained by subtracting its own amount of required clearing margin applied when such required amount is calculated from the intraday margin requirement is JPY 10 million or less, the participant will not be obliged to make an additional deposit.

The required amount for the "intraday margin" is the amount obtained by adding/subtracting the amount equivalent to differences on futures transactions for the participant's own account, customer accounts, and transactions by non-clearing participants, and for amounts paid in connection with options transactions to/from the amount obtained by subtracting the total net options value for open positions for the participant's own options trading account from the amount calculated based on the SPAN® approach applied to open futures and options positions for the participant's own account as of 1:00 p.m., and then adding the result to the total amount of excess risk based on each account by classification. (Note: Deposit of intraday margin with JSCC is required only for clearing participants. Customers and non-clearing participants are not required to make these deposits.)

#### **4. Key Management Checkpoints**

- (1) Regarding margin management, are internal rules (internal regulations or operating rules) and administrative processes (including management of agreements for setting up trading accounts and security deposit receipts related to commodity futures and options) being properly implemented?
- (2) Are allocations or positions properly reported (close-out report or position by customer report)?
- (3) Have open position limits been properly established for customers, and is compliance with these limits being properly checked?
- (4) Is there proper management of receipt of margin deposits for customers' futures transactions, etc. or when a customer's margin deposits become or are likely to become inadequate? In addition, it should be noted that if there is a customer who uses cross margining (\*1), the effect of cross margining must be considered when calculating the required margin of the customer. In addition, if a trading participant settles commodity futures by delivery, the trading participant is required to deposit delivery clearing margin (\*2).

\*1. Cross margining enables offsetting of risks related to JGB futures and IRS transactions. The purpose of this rule is to reduce the burden of collateral obligations on clearing participants that handle such transactions.

\*2. The amount of delivery clearing margin calculated, based on Appendix 3 "Table for Calculating Required Amount of Delivery Clearing Margin" of JSCC Margin Rules, as the amount of margin required when settling commodity futures by delivery.

- (5) Where the amount of margin submitted by a customer exceeds the required amount of margin, has the full amount been deposited with JSCC? (Has only the required amount been deposited with JSCC?)
- (6) Are operations related to the receipt of intraday margins, etc. properly functioning? Are these operations capable of functioning swiftly and efficiently?
- (7) Are internal inspections and examinations performed to examine the management status of margins for futures and other transactions? If they are, what do they focus on and with what frequency are they being performed?

## **14. Credit Management for Margin Trading etc.**

### **1. Relevant Laws and Regulations, etc.**

- FIEA: Article 56-2.1
- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. IV-2-4 Control Environment for Managing Counterparty Risk, others

**Remarks:** Overview of Securities Firm Examination Results for OHT Inc. issued by the Securities and Exchange Surveillance Commission on February 8, 2008

### **2. Regulatory Intent**

There is a broad range of risks inherent to the operations of financial instruments business operators, and accurately identifying and properly managing them is critical for the protection of investors and, by extension, stability of the financial system. JPX-R inspections of risk management systems, therefore, are performed with attention focused on particular types of risk and are based on considerations of both the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. and the connection between firms and exchange trading. Regarding systems for managing credit risks related to margin trading, in particular, JPX-R, given TSE's past experience in this area, requests trading participants to perform internal inspections and, in its own inspections, examines how each company addresses and manages these risks.

More specifically, JPX-R looks at the types of customers handled by each trading participant, and examines whether management of customer margin maintenance rate, credit limit management, and after-the-fact handling of additional margin and advances are being properly addressed in light of risk management and other considerations.

### **3. Key Management Checkpoints**



- (1) From the perspectives of factors like customer financial wherewithal and investment experience, have appropriate standards been established for opening accounts of margin trading (including when-issued transactions; the same hereinafter) and trading of options on futures? Are inspections performed based on these standards? If when-issued transactions are handled, are they being handled with the same approaches used for margin trading (same applies below)?
- (2) Have internal rules for establishing account-opening standards and conducting inspections of account-opening operations been provided?  
In addition, is the enforcement status of these rules being properly checked with appropriate timing?
- (3) Have open position limits and other credit limits been established for individual customers? In addition, are an alarm system and other measures used to properly monitor the activities of customers who trade stocks, etc. on margin or options on futures?
- (4) Have internal rules for enhancing position limits (per customer or issue) standards been provided? In addition, when enhancing position limits of certain customers, are proper checks made in terms of counterparty risk?
- (5) Does the firm use a designated unit and designated personnel to monitor the direction of margin transactions or options on futures trading? In addition, how does the firm determine whether it has customers that are unusual in terms of outstanding margin transactions or margin trading conditions, and how does it monitor their activities in particular?
- (6) Are proper measures or responses taken to customers whose trading balance or activities are considered to be unnatural, such as imposition of a ban on new positions?
- (7) When an issue is designated as "issues subject to daily disclosure" or "issues under observance", or other regulatory actions pertaining to margin trading are taken, is that information properly communicated within the firm, and are relevant personnel properly informed?

- (8) With regard to issues subject to daily disclosure and issues under observance, how does the firm determine whether it has customers who are engaged in related trading or have unusual activity, and how does it continuously follow up on their activities?
- (9) For issues under observance, in particular, are transaction and customer management being properly performed in light of liquidity risk and other factors?
- (10) Are proper measures established against the practice of *nikai-date* margin positions in which securities purchased on margin are used as collateral for further margin purchases?
- (11) Have customer margin maintenance rate, collateral/deposit check, and other alarm points been established to prevent the development of advances for margin transactions or trading of options on futures?
- (12) Have measures been taken to prevent the expansion of advances for margin transactions or options on futures trading? Is additional open interest not permitted, when the maintenance ratio is still below requirements?
- (13) In terms of credit management, how does firm handle cases where the self-regulatory organization has made inquiries about a specific customer? (For example, are internal examinations of matters, such as customer backgrounds and trading motives, immediately performed?)
- (14) What kinds of management measures have been taken with regard to customers in Internet, call center, and other types of non-face-to-face transactions, which involve risks different from those associated with face-to-face transactions?
- (15) Regarding the status of credit management (including management measures addressed above) for margin transaction or options on futures trading, how are inspections (scheduled and unscheduled) of risk management effectiveness checked?

## 15. Internal Audit System

### 1. Relevant Laws and Regulations, etc.

- FIEA: Article 56-2.1
- Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc. III-1-(1)-(iv) Internal Audit Section, others

**Remarks:** Matters concerning internal audit systems are included among the items inspected for application for the registration of Type 1 Financial Instruments Business.

### 2. Regulatory Intent

According to FSA's "Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.", "internal audit" should be aimed at contributing to achieving the management goals of financial instrument business operators by examining and evaluating the appropriateness, effectiveness, reasonability, etc. of business execution and internal management/internal control from a position independent of the divisions subject to audit, and making suggestions and recommendations, etc. to the management based on the results of such examination and evaluation.

In addition, the internal audit function is expected to: 1) examine and evaluate the appropriateness and effectiveness of operational execution and internal management; 2) make recommendations to management on how to rectify management deficiencies identified; and 3) act, via examinations and recommendations for improvements from an independent position, as an internal check on audited divisions. Given the importance of internal audit functions, JPX-R inspections examine the condition of the internal audit system in companies subject to inspection and seek to determine whether they are being performed effectively.

More specifically, inspections and confirmation focus on matters like conditions with regard to internal rules and the firm's organization related to internal audits, status with regard to the performance of internal audits, and the rectification of deficiencies.

On the other hand, even if there is no dedicated internal audit division, inspections and confirmation focus on how the internal audit functions are being carried out. These include 1) examining and evaluating the appropriateness and effectiveness of operational execution and internal management; 2) making recommendations to management on how to effect improvements; and 3) acting as an internal management on audited divisions.

### **3. Key Regulatory Checkpoints**

- (1) In addition to the rules forming the basis of internal audits (hereinafter "internal audit rules"), have detailed rules and manuals been prepared? If they have, what are the purposes and what do they require?
- (2) Do internal rules provide that the division in charge of internal audits (hereinafter "internal audit division") is to audit not only sales divisions but also internal management divisions and all other divisions? Furthermore, has the internal audit division been given the authority to obtain all information required for it to perform its duties and the authority to interview and ask questions of all executives and employees?
- (3) What is the status of the internal audit division's organization? If the internal audit division is actually comprised of multiple units, what duties are performed by each of the units, and what is the status of conditions with regard to a communication system linking all of the units?
- (4) Has the internal audit division secured enough independence from sales divisions and other audited divisions to sufficiently perform its internal management function? In addition, if independence is lacking, what steps are being taken to ensure the effectiveness of internal audits?
- (5) Does management sufficiently recognize the importance of the role performed by the internal audit division, and has it assigned to the internal audit division personnel in appropriate numbers and with appropriate backgrounds to provide it with knowledge of operations of each audited division and ensure it is capable of performing its role?

- (6) What are the key drivers underlying annual internal audit planning by the internal audit division? For example, are the basic elements of internal audit plans—the direction to be taken with audits, audit schedule, and key audit concerns—determined based on the types and degrees of risks and on the status of internal management in audited divisions?
- (7) Do internal audit plans receive prior approval by not only the head of the internal audit division but also the firm's management? Also, does management direct the head of the internal audit division to change the internal audit plans when warranted by the emergence of a significant management problem or changes in the business environment?
- (8) What is the workflow used for internal audits? In particular, if internal management problems or illegal activity are identified through an internal audit, what specific actions are taken in response?
- (9) If part of the operations of an audited division has been delegated to another unit, is the management of that other unit subjected to internal audit procedures?
- (10) Do conditions permit the internal audit division to swiftly gain access to the results of internal inspections performed by audited divisions? In addition, what does the internal audit division do with these results when it performs an internal audit?
- (11) Do audited divisions reliably implement improvements based on internal audit findings? Furthermore, does the internal audit division properly determine whether audited divisions have made improvements in response to audit findings, and how does the internal audit division reflect improvements or the failure to make improvements in future internal audit plans?
- (12) If the firm is subject to inspections, does it, in addition to performing internal audits, also make use of external audits (as mainly operational audits) tailored to the unique characteristics of its operations? Or, is it considering doing so?
- (13) Are the key findings of external audits reported to management and the Board of Statutory Auditors without delay? In addition, do audited divisions make

improvements in response to external audit findings within a certain timeframe, and does the internal audit division properly identify and examine these improvements?

- (14) Does the internal audit division have policies, such as ones for improving the expertise of auditors by having them participate regularly in internal and external training that is aimed at improving internal audit functions?

**Note:** The checkpoints given above assume the presence of a dedicated internal audit division. For trading participants in which there is no dedicated internal audit division and internal audit work is performed by a unit also performing other tasks, it is necessary to determine whether functions equivalent to internal audit functions are being performed as described and indicated above.

## 16. Miscellaneous (1–4)

### 1. Regarding the submission of the Report on Activities Violating Laws, Regulations, and Rules and the Report on Computer System Malfunctions

In May 2007, TSE and OSE implemented revisions to its Trading Participant Regulations and some of its other rules, changing provisions regarding the reports trading participants submit to TSE or OSE. Among these changes are requirements to submit two new reports: the Report on Activities Violating Laws, Regulations, and Rules (hereinafter the "Regulatory Violation Report") and the Report on Computer System Malfunctions (hereinafter the "Computer System Malfunction Report"). TSE is requiring the submission of these reports, so that it can have clear information on the status of regulatory violations and system malfunctions among trading participants.

Regulatory Violation Reports incorporate two key aspects. One is offsite monitoring of regulatory violations at individual trading participants. The other is the ability to confirm each trading participant's ability to clean up its own operations. Regarding the latter, in particular, the discovery of illegal activities by trading participants themselves, through internal inspections, and other developments showing the effectiveness of trading participant's self-discipline and governance to sustain compliance have demonstrated that Regulatory Violation Reports have also been useful for confirming the status of internal management at the trading participants that submit them.

The Computer System Malfunction Report, on the other hand, gives TSE and OSE a better picture of the status of malfunctions in trading participant computer systems and allows it to respond more swiftly in analyzing the causes of problems and identifying system risks impacting TSE or OSE.

Both reports must be submitted to TSE or OSE (TSE/OSE Market Participants Relations Office) together with notifications and reports submitted to regulatory

authorities when violations or malfunctions occur. Reports on violations of TSE/OSE regulations may be submitted on a monthly basis.

**Reference Notice:**

- TSE Notice regarding the submission of "Report on Activities Violating Laws, Regulations, and Rules", etc. (dated May 25, 2007)
- TSE Notice regarding the revision of "Appendix: Items to be Submitted Regarding Violation of Rules and Regulations" (dated July 3, 2020)



## 2. Regarding internal inspection requests from JPX-R Participants Examination and Inspection Department

Based on violations discovered in past inspections, the JPX-R Participants Examination and Inspection Department asks trading participants to perform internal inspections as a preventive measure and encourages them to voluntarily comply with its requests. These requests, which began in fiscal year 2005, are made in regard to the following items.

<i>Request Date</i>	<i>Inspection Items</i>	
April 2005	Same-day cash collection regulations	Inspection to determine the status of efforts to inform personnel on the details of regulatory measures and the status of efforts to prevent evasion of these regulations
April 2005	Front running prevention management	Inspection of firewall measures taken to separate units executing customer orders from units executing orders for the firm's own account
April 2005, April 2007	Margin trading deposit calculation (1, 2)	Inspection to determine whether there have been any offsets of undelivered settlement losses against settlement gains, and inspection regarding the calculation methods used for actual-receipt/actual-delivery transactions and other matters
May 2006	Best execution duty	Inspection of the status of efforts to prevent the receipt of orders without prior provision of best execution policies in written form and other matters
May 2006, April 2007	Measures to prevent erroneous order placement (1, 2)	Inspections to determine the status of limit settings on all order terminals for all products, the appropriateness of limit levels, and other matters
April 2007	Net settlement transactions	Inspection of the management methods used to secure purchase money from Internet transaction customers
April 2008	Credit risk management	Inspection of specific management checkpoints for credit risk related to margin trading (in light of the OHT, Inc. incident)
May 2009	Stabilization trading regulations (Reporting obligation)	Inspection of measures to provide customers with information on all communications from TSE on stabilization trading
June 2010	Measures to prevent erroneous order placement (3)	Inspection to determine the status of limit management measures following the startup of TSE's arrowhead and Tdex+ systems, inspection to ensure terminals

		with low usage frequencies have not been overlooked in setting limits, and other matters
February 2012	Dummy order placement and other acts during live operation hours of exchange trading systems	Inspection of whether or not there is any order placement or other data transmission that is not in accordance with actual demand for test purposes such as specification or operational checks was carried out during live operation hours of TSE trading systems
June 2013	Trading limits to prevent erroneous orders	Inspection of trading limits following the cash market integration between TSE and OSE
December 2013	Trading limits to prevent erroneous orders	Inspection of trading limits following the derivatives market integration between TSE and OSE
March 2015	Trading limits to prevent erroneous order placement	Inspection of trading limits following the renewal of arrowhead
February 2016	Management of Corporate Information	Inspection of whether there is an appropriate management system to thoroughly check whether information acquired by an analyst or other company employee is corporate information and to prevent solicitation using corporate information
June 2018	Data Linkage with Market Surveillance System	Inspection of whether information pertaining to trading (own-account/customer account) dealt by the firm is appropriately incorporated into the market surveillance system and transactions under the market surveillance are adequately identified.

### 3. Order Management Guidelines

In recent years, trading based on automated order placement using data processing systems has continued to grow in the market. Given concerns over the impact on the market caused by a situation such as a malfunction in data processing systems, it is increasingly important for trading participants to establish effective order management systems.

With the April 2018 introduction of the registration regime, etc. for entities that conduct Low Latency Trading, TSE and OSE have revised their rules to clarify that trading participants should implement certain restrictions on orders that they deem appropriate in addition to existing one-shot limits. This revision aims to prevent the placement of many small sliced orders that result in an excessively large combined quantity or monetary amount.

Moreover, with the increasing complexity and sophistication of trading using data processing systems, trading participants are called upon to further enhance risk assessment functions to ensure their effectiveness. As such, the exchanges require trading participants to implement measures such that, when the trading participant unexpectedly receives an irregular order due to a situation such as a system malfunction, such measures are immediately taken to prevent order placement to the exchanges. At the same time, the exchanges have determined to clarify in their rules that trading participants should have direct and exclusive risk management control over such restrictions and measures, including existing one-shot limits.

Trading participants are required to appropriately manage orders, regardless of whether or not they accept orders for Low Latency Trading, according to their business conditions, size, customer attributes, etc.

These guidelines lay out points of attention particularly for order management and examples of order management methods that are deemed to be appropriate for trading participants to prevent the placement or creation of excessively large orders or positions. These examples should not, however, hamper the adoption of other management methods that are sufficient for conducting appropriate order management suitable for the purpose of these guidelines. For other matters related to order management not specified in these guidelines, trading participants are expected to establish appropriate management systems based on the intent of these guidelines.

#### 4. Regarding the development of management systems related to connections to exchange systems

For "compliance with interface specifications, etc.", TSE and OSE prescribe that "trading participants must comply with interface specifications and other matters specified by the exchanges for system connections between trading participant terminals and trading systems" in Rule 77, Paragraph 2 of TSE Business Regulations and Rule 51, Paragraph 2 of OSE Business Regulations. Specifically, these rules stipulate that "during production operation of the trading systems, trading participants must not place orders and transmit other data for testing purposes without "actual demand".

These compliance matters related to the interface specifications, etc. refer to prohibition of transmissions that cause excessive burden to the exchange trading systems, etc. Due to recent developments in ICT and trading immediacy, there is increasing risk involving the transmission of various data not limited to order data. Under these circumstances, management of data transmission and inter-system connections are becoming increasingly important. Accordingly, trading participants are called upon to establish monitoring systems to detect spikes in irregular transmission, system-based restrictions, and systems to respond to the occurrence of irregular transmissions.

Even in the case where trading participants implement adequate systems by appropriately managing transmissions, etc., there may be times when external events impact transmissions with the exchange systems. As such, trading participants are required to consider establishing business continuity systems as needed.

Persons responsible for compliance at trading participants are required to carry out proper operational management in the company in compliance with such compliance matters in cooperation with their own system divisions and outsourcee system vendors.

