Compliance Case Studies

As of June 2023

Participants Examination and Inspection Department
Japan Exchange Regulation

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Introduction

In the past, the Participants Examination and Inspection Department of Japan Exchange Regulation compiled items of interest from trading participants' inquiries about the compliance issues. We published such compilation in a Q&A format in the **"Compliance Case Studies"** (binder-type) and provided it mainly to trading participants.

For this edition, we have added a large number of Q&As related to the Market Access Rule, which was introduced in January 2021. We have also revised the existing content, and in response to an increase in the number of deficiencies related to the following sections in recent inspections, we have revised and expanded the section on "Trading Supervision Systems" and added a new section related to the "Exchanges' Systems."

We hope that this handbook will be used effectively by market users as a handy reference in their daily operations.

June 2023

Japan Exchange Regulations
Participants Examination & Inspection Dept.

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Abbreviations

TSE: Tokyo Stock Exchange
OSE: Osaka Exchange
TOCOM: Tokyo Commodity Exchange
FIEA: Financial Instruments and Exchange Act
JSDA: Japan Securities Dealers Association

To readers of this document

In applying the laws and regulations as well as exchange rules to individual cases, it is essential to interpret them and make judgments on a case-by-case basis. As such, please note that differences in the underlying conditions, the content of a sequence of transactions of each case or the intent of such laws and regulations as well as exchange rules could lead to different conclusions. We hope this handbook serves as a handy reference to our readers.

I. CASES RELATING TO ORDER SLIPS

I-1 Preserving the Order Slip of an Unexecuted Order

Should we preserve an order slip even if the order was not executed? If yes, how should it be kept?

(Answer)

Just as an order slip is required to be kept when an order has been executed, so too is an order slip kept even when an order goes unexecuted.

The entry contents of order slips are prescribed in Article 158 of the Cabinet Office Order on Financial Instruments Business, stating that when an order has been unexecuted, you have to indicate on an order slip to that effect. As there is no specific requirement in the above-mentioned article as to the way of keeping order slips for unexecuted orders, these slips should be filed sequentially by date just like those for executed orders.

(Related Laws and/or Regulations)

- **Articles 157 and 158 of the Cabinet Office Order on Financial Instruments Business**

I-2 Entry of Time of Order Receipt

In our company, order slips for placing orders at TSE/OSE, regardless of whether they are on principal or agency account, are all time stamped with a time stamping machine at the time when the orders are received, in order to always make the time of order receipt clear. Would there be any problem if, instead of entering the time of receipt of orders on order slips, we enter the time when we route the orders to the financial instruments exchange?

(Answer)

Article 158 of the Cabinet Office Order on Financial Instruments Business explicitly states that the time of receipt of an order must be entered. Accordingly, you must enter in the order slip the time at which you received an order from your customers.

However, if a financial instruments business operator completes an order slip electronically for its books and record of the order by inputting the particulars of the order into its computer systems for routing it to the exchange at the same time the order is received, the time of input of the order is also the time of receipt of the order.

(Related Laws and/or Regulations)

- **II-3-3 of Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**

I-3 Entry of Time of Contract When Placing Customer's Order with Another Broker

We placed our customer's order with another financial instruments business operator for execution in the market of a foreign financial instruments exchange. In such a case, are we still required to enter the time of conclusion of the contract on the order slip?

(Answer)

The Cabinet Office Order on Financial Instruments Business requires entry of the time of conclusion of a contract on the order slip with no exceptions thereto. Accordingly, you must enter the time of conclusion of the contract on the order slip even if you entrusted your customer's order to another financial instruments business operator for execution in a foreign financial instruments exchange market. You may enter the time either in Japan Standard Time or local time in the foreign country provided you clearly indicate which you are using. It is advisable that you make sure that the time of conclusion of a contract is reported to you by the financial instruments business operator with which you placed the order, as it may be difficult for you to confirm such time on your own.

Naturally, this also holds for financial instruments business operators that entrust a customer's order to buy or sell securities listed on other financial instruments exchanges in Japan, of which it is not a member, with another financial instruments business operator that is a member.

(Related Laws and/or Regulations)

- **Article 158 of the Cabinet Office Order on Financial Instruments Business**

I-4 Entry of Time of Contract

During the course of our internal inspection, it was found that an order had been executed in several portions at different prices. While in the transaction journal the time of execution was entered for each contract at each price, on the order slip a single time had been entered as the time of execution. Is this appropriate?

(Answer)

No, it is not.

If an order was executed in more than one portion, the time of execution must be entered for each contract, even though it was a single order. This is also applicable in such cases where an order was executed at the same price but in more than one portion at different times.

I-5 Entry When Order for Transaction on Margin Consists of Trade for Initiating New Position and Trade for Covering Short Position

We received an order to buy 10,000 shares of the same stock on margin, of which 5,000 shares were for initiating a new long position and the other 5,000 were for covering the customer's short position.

In this case, would it be proper to enter the entire order on one order slip?

(Answer)

While Article 158 of the Cabinet Office Order on Financial Instruments Business does not specify the details of the order slip, it apparently is an accepted practice that in such cases separate order slips be prepared for transactions initiating a new long or short position and for transactions covering an existing long or short position—even if the two transactions are placed as one order to buy or sell the same stock.

Accordingly, it is considered appropriate in terms of internal management that a separate order slip be made out in order to distinguish between a transaction for initiating a new long/short position and one for covering an existing long/short position.

(Related Laws and/or Regulations)

- **Article 158 of the Cabinet Office Order on Financial Instruments Business**

I-6 Concerning the Necessity of Preparing an Order Slip

Should we make out an order slip in the following two cases?

(1) When, on the exercise date for a security option, an in-the-money option has become subject to an automatic exercise; and

(2) When exercising a right to convert convertible bonds.

(Answer)

No order slip needs to be made out in either case, as an order slip is required for entering the particulars of an order to buy or sell securities.

I-7 Order Slip Pertaining to an Order That Was Rejected as Erroneous

For orders subject to the short sale price regulation, TSE's trading system rejects short sell orders which do not meet the so-called up-tick rule (meaning that such orders are not registered on the order book). In practice, short sales against the regulation are rejected as errors at the time of acceptance of the order. Should we make out an order slip even if the order has been rejected in this way?

(Answer)

An order slip must be made out at the time of receiving an order. The fact that you received an order cannot be undone by the event that the order has been rejected as an error. You must make out and preserve an order slip whether or not the order is registered on the order book of the Exchange. This also holds good for a principal order.

I-8 Order Slip for Principal Trading

Should we make out an order slip for our principal transactions in each of the following cases?

(1) In cases where we routed an order to TSE but cancelled it while it remained unexecuted;

(2) In cases where we routed an order to sell short to TSE, but it was rejected because of the short sale price regulation; and

(3) In cases where an order to sell short that we were about to route to TSE was checked under our internal control, and as a result, was not routed.

(Answer)

For principal transactions, only if the order was not routed do you not have to make out an order slip. Therefore, cases (1) and (2) require you to complete an order slip, while no order slip is necessary in case (3).

I-9 Order Slip for Principal Transaction for Correcting Error in Execution of Brokerage Order

Due to an erroneous input in the order routing terminal we effected an agency transaction in excess of the number of shares instructed by a customer. To correct the error, we transferred to our own account the number of shares in excess of the instructed number. In this instance, should we make out an order slip for the principal transaction?

(Answer)

A transfer of a portion of an agency transaction to the financial instruments business operator's own account for the purpose of correcting its clerical error in executing the customer's order is an operation carried out by the firm admitting that the portion so transferred had not been a customer's order but an order for its own account.

Accordingly, you must make out an order slip for such a transfer as a transaction for your own account. On the order slip you should enter the time at which the customer's order was routed, as well as a description which identifies the transaction as the one that was conducted for the purpose of correcting an error.

I-10 Order Slip for "Good throughout the Week Order"

Yesterday we received a "good throughout the week order" from a customer, which remained unexecuted during the day. Today, we mistakenly failed to route the order to TSE, although we found that the order would not have been executable throughout the day even if we had not forgotten to route it. We will surely route the order tomorrow. In this case, should we make out a new order slip in addition to the original one?

(Answer)

The order you are going to route to TSE tomorrow is not a new order, even if you failed to do so today. Therefore, you should not make out an additional order slip in order not to create the misunderstanding that you received the same order twice.

Also, you would be advised to make a record in the original order slip of your failure to route the order today, with the explanation that the order would not have been executable even if the order had been routed.

I-11 Completing an Order Slip for a Customer's Order to Be Filled off Exchange Market for Dealer's Own Account

We received an order from a customer specifying that the order be filled by trading for our own account off the exchange market. In such a case, should we make out an order slip with an entry to the effect that, by the customer's instruction, the order is to be filled by trading for our own account off the exchange market? Or, should we prepare an additional slip for our transaction for our own account?

(Answer)

It makes no difference to the act of receiving an order from a customer whether the order is executed in or off the exchange market. In this case, it is advisable that you make out two order slips—one for the order from the customer and the other for the trade for your own account to fill the customer's order.

However, you do not have to prepare two slips if you make out one order slip from which it can be clearly understood that the order was filled by trading for your own account. Stating clearly to that effect on the order slip or preparing an order slip in a form exclusively used for an order for execution for the firm's own account are typical examples for meeting this requirement. In addition, other particulars of the order including the time and date of receipt of the order must be clearly stated in the order slip, lest any problems arise for preparation of the firm's books and records.

I-12 Order Slip for Additional Order with Same Instructions as Previous Order

We received from a customer an order to buy 10,000 shares of XYZ stock on margin. When the order was executed in its entirety, the customer placed with us another order to buy 5,000 shares of the same stock with the same instructions as the previous order. In this case, is it permissible to simply make a correction on the order slip for the first order by changing the number of shares from 10,000 shares to 15,000 shares?

(Answer)

An additional order for the same stock should be considered as a new order, unlike a reduction in the number of shares or a change of an instruction as to price, which can be reflected in the order slip by making the necessary corrections. Accordingly, a separate order slip must be made out for an additional order rather than making a correction to the number of shares on the order slip for the first order, even if the additional order is for the same stock with the same instructions.

I-13 Entering a Correction to the Stop Price for a Stop Order

We received from a customer an instruction to correct the stop price for his stop order. Should we make out an order slip by regarding the correction as a new order?

(Answer)

When you accept a stop order from a customer, you should record on the order sheet that it is a stop order and also enter the customer's instructions for the stop order, such as the stop price. If the stop price is then changed you do not have to make out a new order slip, as the change is simply a partial alteration to the conditions of the order for execution, and thus does not amount to a new order. Accordingly, you only need to make a correction in the usual way on the original order slip.

I-14 Entry in Order Slip of Order to Be Executed at VWAP off the Exchange Market

(1) Prior to the opening of the market, we received an order to buy ABC stock off the exchange market after the close of trading for the day. The customer instructed that the order be executed at a volume weighted average price ("VWAP") for that day. In this case, the customer did not mention a specific execution price. How should the price be entered on the order slip?

(2) Prior to the opening of the market, we received an order to buy XYZ stock off the exchange market after the close of trading for the day. The customer instructed that we, the financial instruments business operator, purchase the same number of shares of the same stock as in his order in the auction market of TSE, and that these shares so purchased be then sold to the customer at the volume weighted average price of such transaction after the close of the TSE market. How should the price be entered on the order slip?

(Answer)

(1) In this case, the formal time of receipt of the order should be the time when the order was placed prior to the opening of the market, although no specific execution price was mentioned.

Although a specific execution price was not determined at the time of receipt of the order prior to the opening of the market, an agreement that the order be executed at the day's VWAP has been made between you and the customer. Therefore, it should be written on the order slip that the customer gave instructions to use the day's VWAP as the execution price, and that the order is the one to be executed by you acting as a principal after the close of the auction market of TSE, thereby clearly distinguishing the order from an order that is executed at a VWAP in the TSE market under the auction principle.

(2) In the case (2) above, on the other hand, you are required to obtain the customer's approval for execution of his order at the time when an execution price was determined - after the close of TSE market - and thus that time is the time of receipt of the order.

The price determined after the close of the TSE market should be entered on the order slip.

I-15 Entry in Order Slip, etc. of Order for Margin Transaction outside Margin Transaction System without Due Date.

In the case that a negotiable margin transaction is effected without a due date (i.e., without a deadline by which the margin position must be covered), how should the "Due Date" be entered on the order slip, customer's ledger, and trade balance report?

(Answer)

An entry should be made simply to reflect a contractual agreement with the customer. An entry of “no due date” is a good example of how to indicate that there is no deadline. The same holds in the case of the “deadline for repayment/return notification” which appears on the “report on margin transaction” prescribed in the "Regulations Regarding Margin Transactions and Loans for Margin Transactions."

I-16 Entry of Agency or Principal in Trade Report

When a customer's order was matched with an order for the financial instruments business operator's own account in the Tokyo Stock Exchange Trading Network System (“ToSTNeT”), should such order be marked “principal” rather than “agency” in the trade report?

(Answer)

If you matched a customer's order with an order for your own account in the ToSTNeT it should be marked “agency”, while if you filled a customer's order by buying or selling for your own account off the exchange market, it should be marked “principal”.

I-17 Preparing an order slip for IOC order

What are the points to note in preparing an order slip for an IOC (Immediate or Cancel) order, which is a conditional order, for auction trading in the TSE cash equity market (such as stocks and convertible bonds)?

(Answer)

For an IOC order, it is necessary to show clearly on the order slip that the order shall be executed under certain conditions, just like other conditional orders available on the TSE market such as those that are only executed during the opening auction.

Where a part of an IOC order is immediately executed, the remaining quantity of such order becomes void. Such unexecuted quantity can be grasped from the figures of "order quantity" and "executed quantity" stated on the order slip. Therefore, no special procedures are required.

Other conditional orders available on the OSE derivatives market such as "IC" or "FAK" have uses similar to those of "IOC." For order slips for such conditional orders in the TSE cash market, even if you use description other than "IOC", it can be identified as one for an IOC order on the TSE cash market.

II. CASES RELATING TO MARGIN TRANSACTION

II-1. Instructions at the Time of Order Acceptance

When we accept an order from a customer to buy or sell stock on margin, are there any specific matters on which we should receive confirmation from the customer?

(Answer)

In addition to the basic 4 instructions (i.e., name of the stock, buy or sell, number of shares and limitation as to price) that you must also receive from a customer at the time of accepting an order, you must receive other relevant instructions where applicable. For example, if the customer wants to buy or sell the stock on margin, you need to check with him/her about it, and at the same time you are required to confirm whether the order for a margin transaction is for initiating a new long or short position or for covering his/her long or short position.

Also, when a financial instruments business operator acts as an agent for another financial instruments business operator which has received an order for a transaction on margin, the firm acting as an agent must receive from the other firm the instructions mentioned in the above.

(Related Laws and/or Regulations)

- **Rule 6 of the TSE Brokerage Agreement Standards**

II-2. Report on Margin transaction and Trade Balance Report

In its rules, TSE requires a financial instruments business operator to send to a customer with uncovered positions in his/her margin account a report on such positions every month. Would there be any problem if we substitute the trade balance report for the report on margin transactions?

(Answer)

Article 37-4 of FIEA prescribes that the trade balance report is a document which needs to be sent to a customer upon conclusion of a contract and must be sent without delay.

Rule 6 of the TSE Regulations Regarding Margin Transactions and Loans for Margin Transactions, on the other hand, stipulates that every month a financial instruments business operator must send to a customer with uncovered margin transaction positions a report on his/her margin transactions.

As the trade balance report covers the matters to be entered in the report on margin transaction, you may substitute the trade balance report for the report on margin transaction provided that you send the trade balance report every month to your customers who have uncovered margin transaction positions.

(Related Laws and/or Regulations)

- **Article 37-4 of FIEA**
- **Article 108 of the Cabinet Office Order on Financial Instruments Business**
- **Rule 6 of the TSE Regulations Regarding Margin Transactions and Loans for Margin Transactions**

II-3. Settlement When Covering a Position in Another Market

One of our customers initiated a new long position on margin in the Tokyo market. Later, the customer wanted to close that long position with an offsetting sale in the Nagoya market in the expectation that she would be able to do so at a better price there than in the Tokyo market. Is it possible to close a newly created position in the TSE market with a trade in the Nagoya market?

(Answer)

There is no rule that restricts initiating a new position in one market and closing it in another market by conducting an offsetting transaction.

If the financial instruments business operator has provided a customer with a loan or securities for margin transaction using its own capital or holdings, you will find little problem in closing a position initiated in one market by effecting an offsetting transaction in another market.

If your firm has borrowed funds or securities for a margin trade from a securities finance company under the margin transaction system, or should your firm find itself in a position to borrow funds or securities from a securities finance company for settlement of the offsetting transaction due to an imbalance between the amount of long positions and that of short positions within your firm (which may have been caused by such offsetting transaction), your firm can basically complete settlement of an offsetting transaction effected in the other market after January 2003, when Japan Securities Clearing Corporation commenced operation. However, in this case, it would be quite difficult to practically do so if your firm places your order with another financial instruments business operator (a participant of the other market, etc.) for execution in the other market.

II-4. Deposit of Additional Margin for Margin transaction

One of our customers has deposited margin for margin transaction, all in securities in lieu of security deposit. One day, we assessed the value of the deposited securities on the basis of the previous day's closing price of these securities and found that the customer had excess margin of JPY 600,000 in terms of the security deposit ratio. Accordingly, we allowed them to establish an additional long position of JPY 2,000,000. On the second business day following that day, on which a margin deposit or additional margin deposit must be made, the value of the excess margin declined to JPY 560,000.

In this case, should we require the customer to make an additional margin deposit of JPY 40,000 to make up for the decline?

(Answer)

In the above case, the excess in the security deposit ratio (the ratio of the security deposit amount to the market price of the subject security; the same hereinafter) satisfied the minimum margin requirement of 30% at the time of creating the additional long position (JPY 2,000,000 X 30% = JPY 600,000).

Therefore you do not have to call for additional margin, as far as the excess meets the additional deposit requirement due to such additional long position.

Any change in the value of securities deposited as margin should be reflected when calculating the gross amount of deposited margin.

(Related Laws and/or Regulations)

- **Articles 3 and 4, Article 7 (Paragraph 3), and Article 8 (Paragraph 1) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39, Rule 44 (Paragraph 3), and Rule 45 (Paragraph 1) of the TSE Brokerage Agreement Standards**

II-5. Minimum Required Margin and Additional Position

One of our customers has maintained a margin deposit of JPY 300,000 in cash for margin transaction. One day, we found that the value of his long position, which he had initiated at JPY 200,000, declined by JPY 10,000.
In this case, can we understand that there'll be no problem if he establishes an additional position of JPY 600,000 for the following reason?
After deducting 30% of his initial position value (JPY 200,000 X 30% = JPY 60,000) and the unrealized loss therein (JPY 10,000) from his margin deposit (JPY 300,000), the customer still has JPY 230,000 as margin for initiating a new position.

(Answer)

In the margin transaction system, there is a minimum margin requirement, where the amount of a customer's margin deposit must be at least JPY 300,000 even if the amount obtained by multiplying 30% to the additional position is less than JPY 300,000. Accordingly, when a customer makes a margin trade, he/she must ensure that his/her margin deposit is the prescribed minimum.

In this case, at the time when the customer wishes to establish an additional position, the amount of his margin deposit had decreased by JPY 10,000 to JPY 290,000 due to a decline in the value of his long position. If he is to establish an additional position of JPY 600,000, the required security deposit would be JPY 240,000 [(JPY 200,000 + JPY 600,000) X 30%], which falls within the amount of the existing deposit. However, in order to meet the minimum margin requirement, the customer must deposit JPY 10,000 to top up his margin deposit to JPY 300,000 by noon on the second business day following the day on which the contract for establishing the additional position is made.

(Related Laws and/or Regulations)

- **Articles 3 and 4, and Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39 and Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-6. Margin Deposit for New Position Covered on Same Day

One of our customers initiated a new long position on margin and closed it using gains on the same day. Is this customer required to deposit security deposit in such a case?

Also, supposing that a customer's margin ratio falls to 30% or less, is the customer required to make an additional margin deposit if the customer effects transactions similar to the above case?

(Answer)

When a customer initiates a new position on margin, he/she must deposit the required margin by noon on the second business day following the day of the initiation. Whenever the customer has effected a transaction to close the position, he/she can withdraw his/her margin deposit, up to the net amount after deducting realized losses and other expenses from deposited margin. This rule is applicable even before the settlement of such offsetting transaction is completed. Accordingly, the customer should deposit the required margin by noon on the second business day following the day of the position initiation, and then withdraw the available amount.

In cases where the customer already has a position, if his/her margin deposit ratio is 30% or less, since the customer will have no excess margin for establishing an additional position, he/she will be required to make an additional margin deposit.

(Related Laws and/or Regulations)

- **Article 3, Article 4, Article 7 (Paragraph 1), and Article 8 (Paragraph 1) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39, Rule 44 (Paragraph 1), and Rule 45 (Paragraph 1) of the TSE Brokerage Agreement Standards**

II-7. Margin Deposits and Day Trades

If a customer who has no margin deposit made several margin trades and closed them on the same day, how much security deposit should he/she be required to make? Is it equivalent to 30% of the largest position established by the customer on that day?

(Answer)

In this case, the required deposit of security deposit is not the largest position established by the customer on the day. Since there is no existing security deposit that can be used each time for establishing each new position, the required deposit of security deposit will be for all the positions for which margin deposit has yet to be made.

(Related Laws and/or Regulations)

- **Articles 3 and 4 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39 of the TSE Brokerage Agreement Standards**

II-8. Amount of Margin Deposit Required for Day Trades

One day, one of our customers bought, in the following order, three stocks, A, B, and C, on margin, creating long positions. The customer later sold them to close the positions on the same day. In this case, should we ask the customer to make a margin deposit of only JPY 1,260,000 for the margin purchase of A stock, the largest in value, by noon on the second business day following that day?

	Bought	Sold (Closed)
1. A	JPY 4,200,000	JPY 4,300,000
2. B	JPY 4,000,000	JPY 4,200,000
3. C	JPY 4,000,000	JPY 3,900,000

(Answer)

If a customer has established a new position when the amount of his/her margin deposit is less than 30%, or if a customer has initiated a new position, the customer must top up his/her margin deposit by noon on the second business day following the day of execution.

The margin deposit made for a previous transaction can be used for an additional position on margin, once such previous position is closed by an offsetting transaction.

However, when the customer does not have an existing margin deposit to use for new positions, the customer has to make deposits for all new positions which he/she has established.

Accordingly, in the above case, even if the customer bought A stock on margin and sold it to close the long position on the same day, since he/she has not deposited margin for the transaction, he/she will not have existing margin deposits to be used for establishing additional positions. As such, he/she must make margin deposits for margin trades of B stock and C stock. (The same holds when margin trades 1, 2, and 3 are made in a single stock.)

Hence, the customer must make a margin deposit for the total purchase value of the three stocks, A, B, and C - JPY 3,660,000 (i.e., (JPY 4,200,000+JPY 4,000,000+JPY 4,000,000) X 30%) - by noon on the second business day following that day.

However, the margin deposit could be JPY 1,260,000 (i.e., JPY 4,200,000 X 30%) if the trades in the above case are conducted in the following sequence:

(1) The customer sold A stock to close the long position.

(2) The customer made a deposit for the margin trade immediately after (1)

(3) The customer then bought B stock on margin and sold it to close the long position on the same day.

(4) The customer then bought C stock on margin on the same day.

In this case, the deposit made in (2) can be used for the margin trades in B stock and C stock as long as the deposit is properly allocated as margin deposit for each trade.
(Other costs and losses due to a decline in the value of deposited securities are disregarded in the above example.)

(Related Laws and/or Regulations)

- **Articles 3 and 4, and Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39 and Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-9. Allocation of Margin to Margin Trades on Same Day

A customer who has a margin deposit of JPY 300,000 has established an additional position of JPY 2,000,000 and closed that position on the same day. The margin deposit required for this additional transaction is JPY 600,000.

If the customer makes the same transaction twice more on the same day in the following manner, does he/she only have to make a margin deposit of JPY 300,000 (i.e., JPY 600,000 - JPY 300,000)?

1-1) Establish an additional JPY 2,000,000 position on margin

1-2) Close the position on the same day

2-1) Establish another JPY 2,000,000 position on margin

2-2) Close the position again on the same day

3-1) Establish a JPY 2,000,000 position on margin once more

3-2) Close the position for the third time on the same day

(Answer)

The margin deposit required in this case is JPY 1,500,000 (i.e., JPY 600,000 X 3 - existing deposit of JPY 300,000) for the following reason.

The customer had to add JPY 300,000 to his/her existing margin deposit of JPY 300,000 when the customer established the first position of JPY 2,000,000 because the required security deposit deposit was JPY 600,000. In other words, there was already a shortfall in his/her margin deposit (i.e., less than 30%) at that point. In such cases, the customer will not be able to use his/her existing deposit of JPY 300,000 for other subsequent additional positions. It follows that the customer must make deposits for all additional positions established on the same day. Therefore the customer is required to deposit JPY 1,500,000.

(Related Laws and/or Regulations)

- **Article 3, Article 4, and Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39 and Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-10. Excess in Margin to Be Used for Additional Position after Closing Part of Existing Position

One of our customers, who had existing positions of JPY 5,000,000 on margin in a stock, effected a transaction to close a part (JPY 1,000,000) of his positions, and on the same day, initiated a new position of JPY 1,000,000. The gross amount of his margin deposit was computed as JPY 1,400,000.

In this case, we understand that the customer is not required to make an additional margin deposit for the new position, as his two transactions are equal in value. Is our understanding correct?

(Answer)

If, after a customer's transaction for closing part of the positions in his/her margin account, the gross amount of margin deposited by the customer exceeds 30% of the amount obtained by deducting the value of his/her positions closed by an offsetting transaction or physical delivery/payment (limited to funds or securities actually delivered by customers) from the total contract value of his/her positions, the excess in his/her margin deposit can be withdrawn or used for such settlement. However, the gross amount of margin should not include unrealized losses on the remaining positions, realized losses on the offsetting transaction, brokerage commissions, interest, and other obligations payable by the customer.

In the above case, the amount of the excess that can be used as margin for initiating a new position on the same day would be JPY 200,000 (i.e., JPY 1,400,000 - (JPY 5,000,000 - JPY 1,000,000) X 30%).

The amount of required margin for the new position, on the other hand, is JPY 300,000 (i.e., JPY 1,000,000 X 30%). Accordingly, the customer must make an additional margin deposit of JPY 100,000.

(Note) Brokerage commission, interest, and the customer's other payment obligations are disregarded in the above example.

(Related Laws and/or Regulations)

- **Article 3, Article 4, and Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39 and Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-11. Making Additional Margin Deposit after Using Excess Margin for a New Position

One of our customers effected a transaction for closing part of her positions on margin, and at the same time initiated a new position. The amount of her excess margin resulting from the offsetting transaction was just half of the amount of margin required for the new position. In this case, can we arrange so that the customer can make the margin deposit by 2 steps, by using that excess to partially fill the margin deposit for the new position on the same day, and then making the deposit for the balance required for the new position by noon on T+2?

(Answer)

The use of excess margin and the deposit of additional margin can take place separately. In the above example, as there is an excess in the customer's margin as a result of an offsetting transaction, the excess can be used for the new position on the day of the transaction at the customer's instruction, with the shortfall in margin to be deposited later by noon on T+2.

However, please note the following points in using this arrangement.

(1) It should be noted that when computing the customer's gross amount of margin deposit pertaining to the margin transaction, the new position will be included from the moment the customer gives instructions on the use of the excess margin or deposit of additional margin, whether in whole or in part.

(2) Where the margin deposit for a new position is only partially filled by either the excess margin or additional deposit, the transaction is not deemed to come under the definition of Rule 44 (in the parentheses of Paragraph 1, Item 1 of the same rule) of the TSE Brokerage Agreement Standards. Therefore, when the customer effects a margin transaction to close the position without fully meeting the margin deposit requirement for that position, the customer is not allowed to withdraw or use that partial portion of the deposit for other transactions.

(Related Laws and/or Regulations)

- **Articles 3 and 4, and Article 7 (Paragraphs 1 and 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39 and Rule 44 (Paragraphs 1 and 3) of the TSE Brokerage Agreement Standards**

II-12. Closing a Margin Position by Delivery/Payment

When a customer wants to close his/her margin position by physical delivery/payment instead of an offsetting transaction, is he/her able to withdraw or use the margin deposit upon receiving notice for such arrangement?

Suppose that we received a notice from the customer on T, and he/she delivers the funds or securities on T+1, on which day do we release the deposit, T or T+1?

(Answer)

Physical delivery of funds or securities is required for releasing margin deposit. Therefore, margin deposit should not be released based on a notice from the customer.

In the above case, the margin deposit should be released on T+1, i.e., when the funds or securities are actually delivered.

However, as a general rule, the funds or securities delivered by a customer for closing a margin position by physical delivery/payment should be segregated from his/her margin deposit account. If they are kept within the margin deposit account, you are required to ensure that those funds and securities are clearly excluded from the margin deposit.

(Related Laws and/or Regulations)

- **Article 7 (Paragraphs 1 and 2) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraphs 1 and 2) of the TSE Brokerage Agreement Standards**

II-13. Decline in Value of Deposited Securities after Withdrawal of Excess Margin

One day, a customer withdrew the full amount of her excess margin. However, the value of her margin positions and securities deposited in lieu of money declined later on the same day, and as a result, her margin deposit fell below 30% at the end of trading on that day. Would this case be a violation of the restrictions on withdrawal of margin?

(Answer)

This case is not in violation of the restriction on withdrawal of margin deposit.

II-14. Withdrawal of Margin Deposit after Closing a Position

One day, our customer initiated a position on margin, and effected an offsetting transaction to close the position before making a margin deposit. In this case, can we allow our customer to draw the margin deposit immediately after making it for this particular transaction? The customer has no other positions.

(Answer)

Yes, you can allow the customer to do so. However, please note that the following costs and expenses related to the margin transaction in the above case, where applicable, must be borne by the customer and must be deducted from the margin deposit before withdrawal:

- Realized loss on the position which was closed by the offsetting transaction
- Brokerage commissions
- Interest on borrowed funds
- Fee for borrowed stock
- Other related expenses

(Related Laws and/or Regulations)

- **Article 3, Article 4, Article 7 (Paragraph 1), and Article 8 (Paragraph 1) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 39, Rule 44 (Paragraph 1) and Rule 45 (Paragraph 1) of the TSE Brokerage Agreement Standards**

II-15. Withdrawal of Margin for Covering Realized Loss

A customer's margin declined to nearly 20% of the value of her margin positions. In this situation, the customer effected a transaction to close part of her positions at a loss. If she used part of her margin deposit to settle the realized loss, would it be a violation of the restrictions on withdrawal of margin?

(Answer)

Assuming that a customer effects an offsetting transaction to close part of his/her positions resulted in a realized loss, if the gross amount of margin deposit exceeds 30% of the amount obtained by deducting the value of such closed positions and the value of other positions for which an offsetting transaction or physical delivery/payment (limited to funds or securities delivered by the customer) was conducted from the total contract value of his/her positions, the excess in his/her margin deposit can be withdrawn for settling such transaction. However, if the amount obtained by such calculation is less than JPY 300,000, the withdrawable amount should be the portion in excess of JPY 300,000.

It should be noted that since this is a case of withdrawing margin for settlement of part of his/her positions on margin, in calculations, the realized loss pertaining to the settlement of such offsetting transaction and the customer's other payment obligations (brokerage commissions, interest, etc.) should not be deducted from the gross amount of his/her margin deposit pursuant to the proviso of Article 8 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions and the proviso of Rule 45 of the TSE Brokerage Agreement Standards).

To put it simply, using the amount obtained by the following formula for settlement does not violate the restrictions on withdrawal of margin:

Gross Amount of Margin Deposit* - (Contract Value of Total Positions - Contract Value of Position Closed) X 30%

* The realized loss from settlement of the offsetting transaction and the customer's other payment obligations should not be deducted.

For instance, suppose a customer has JPY 5,000,000 in existing margin positions, and he/she effects an offsetting transaction to close JPY 1,000,000 of his/her positions at a loss of JPY 100,000. Assuming that on the settlement day, the gross amount of his/her margin deposit (before deducting the realized loss) is JPY 1,300,000, his/her excess margin deposit would be:

JPY 1,300,000 - (JPY 5,000,000 - JPY 1,000,000) X 30% = JPY 100,000

Accordingly, JPY 100,000 can be used for settling the realized loss of JPY 100,000 at the

time of settlement.

(Note) Brokerage commission, interest, and the customer's other payment obligations are disregarded in the above example.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 2, Item 1) and Article 8 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 2, Item 1) and Rule 45 of the TSE Brokerage Agreement Standards**

II-16. Withdrawal of Margin for Covering Realized Loss by Effecting Additional Offsetting Transaction on Settlement Day

Three days ago, a customer suffered a realized loss as a result of an offsetting transaction to close a part of the positions in his margin account. The settlement date for the transaction is today, but there is no amount of margin allowed to be withdrawn in the customer's margin account to cover the loss. So he wishes to effect a transaction today to close some of his remaining positions so that he can make up the loss by using the excess margin, which may be generated by such transaction. Can he really cover the realized loss in this way?

(Answer)

In the case that a customer effects an offsetting transaction to close part of his/her positions resulting in a realized loss, if the gross amount of margin deposit exceeds 30% of the amount obtained by deducting the sum of the value of such closed positions and the contract value of securities pertaining to the value of other positions for which an offsetting transaction or physical delivery/payment (limited to funds or securities delivered by the customer) was conducted from the total contract value of his/her positions, the excess in his/her margin deposit can be withdrawn for settling such transaction. However, if the amount obtained by the above calculation is less than JPY 300,000, there must be at least JPY 300,000 in excess deposit to allow withdrawal.

Please note that the "other positions for which an offsetting transaction or physical delivery/payment (limited to funds or securities delivered by the customer) was conducted" mentioned above includes other transactions and delivery/payment that are made on the settlement day of the transaction.

In this case, because the additional position that was closed on the settlement date falls under "other positions for which an offsetting transaction or physical delivery/payment (limited to funds or securities delivered by the customer) was conducted," the customer can calculate, with this, the amount withdrawable to be used for the settlement of the realized loss.

However, the customer is required to cover the realized loss by a time specified by the JSCC Business Regulations. As such, in this case, the customer must close other positions by the same deadline.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 2, Item 1) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 2, Item 1) of the TSE Brokerage Agreement Standards**

II-17. Withdrawal of Margin for Closing Position by Physical Delivery/Payment

When a customer's margin deposit ratio was 30% of the contract value of her positions, she closed a part of long positions with payment of cash that is part of her margin, and then deposited the withdrawn stocks as securities in lieu of security deposit. As a result, her margin ratio became more than 30%. Would the customer's act be a violation of the restrictions on withdrawal of margin?

(Answer)

In the case that a customer effects an offsetting transaction to close part of his/her positions, if the gross amount of margin deposit exceeds 30% of the amount obtained by deducting the sum of the value of such closed positions and the contract value of securities pertaining to the value of other positions for which an offsetting transaction or physical delivery/payment (limited to funds or securities delivered by the customer) was conducted from the total contract value of all of his/her positions, the excess in his/her margin deposit can be withdrawn for settling such transaction. However, if the amount obtained by the above calculation is less than JPY 300,000, there must be at least JPY 300,000 in excess deposit to allow withdrawal.

Similarly, when a customer closes part of his/her margin positions by paying off margin loan or returning borrowed securities, and deposits all of the securities or cash which the customer will so come to own, then the customer is allowed to withdraw the excess margin generated as a result. Such deposits should be limited to the case where the gross amount of such deposit exceeds 30% of the amount obtained by deducting the sum of the value of such closed positions and the contract value of securities pertaining to the value of other positions for which an offsetting transaction or physical delivery/payment (limited to funds or securities delivered by the customer) was applied from the total contract value of his/her positions. However, if the amount obtained by the above calculation is less than JPY 300,000, there must be at least JPY 300,000 in excess deposit to allow withdrawal.

The above case is not in violation of the restrictions on withdrawal of margin, as long as the amount obtained by the following formula is not negative:

(Gross Margin Deposit* + Collateral Value of Stocks Resulting from Closing Positions by Payment) －(Contract Value of Total Positions - Contract Value of Total Positions Closed by Payment) X 30%

*Any unrealized loss (considered as zero in cases of profit) in stocks resulting from closing position by payment, as well as the customer's other payment obligations should

not be deducted. The amount of margin withdrawn for closing position by payment is not to be included in "Gross Margin Deposit."

The amount of deposited margin is calculated based on closing prices on the day before the settlement date.

The abovementioned rule is also applicable to the case where such a customer, who may not have cash in his/her margin account, sells collateral securities in the margin account and deposits the sales proceeds as margin in order to use such margin for receiving delivery of stocks by payment.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 2, Items 2 and 4) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 2, Items 2 and 4) of the TSE Brokerage Agreement Standards**

II-18. Use of Deposited Margin for Other Margin Positions (1)

1. A customer has an existing margin position A from at least 2 days ago and has already made the margin deposit for the position. The customer then established a new position B. Assuming that the customer closed position A by offsetting the transaction by the deadline of margin deposit for position B, will the customer be allowed to use the margin deposit for position A for the margin required for position B?

2. A customer who has a margin deposit established a new position C but the new position could not be fully closed by his existing margin deposit. The customer then made an offsetting transaction to close position C without covering the shortfall in margin due to creating the position. Will the customer be allowed to use his existing margin deposit for another new position D without making the additional margin deposit that corresponds to such shortfall position C?

(Answer)

For the first case, the answer is yes. However, for the second case, the answer is no because the customer is not allowed to use the existing margin deposit for another position without covering the shortfall.

Even if the customer realized a gain by closing his/her new position A or C, the answers will be the same, i.e., yes for the first case, and no for the second case.

The same applies to cases where the customer applied for closing positions by physical delivery/payment (limited to funds or securities delivered by customers), instead of offsetting transactions.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 3) and Article 8 (Paragraphs 4 and 5) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 3) and Rule 45 (Paragraphs 4 and 5) of the TSE Brokerage Agreement Standards**

II-19. Use of Deposited Margin for Other Margin Positions (2)

1. A customer who has no margin deposit initiated a new margin position A and immediately deposited the required margin. If the customer establishes another position B and then closes position A by an offsetting transaction, can the customer use the deposit for A for the margin required for B?

2. A customer who has no margin deposit initiated a new margin position C and made an offsetting transaction on the same day. Then on the same day, he initiated a new position D.
After the sequence of transactions, the customer duly made a margin deposit for position C by the deadline. In this case, is the customer allowed to use the deposit for C as the margin deposit required for D?

(Answer)

For the first case, the answer is yes. In the second case, when the customer initiated position D, the customer had yet to deposit margin for position C. Since customers are not allowed to use margin deposits on a post hoc basis, the customer cannot use the margin that he deposits later for position C as the margin required for position D.

The same applies to cases where the customer closes positions by physical delivery/payment (limited to funds or securities delivered by customers), instead of offsetting transactions.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-20. Use of Deposited Margin for Other Margin Positions (3)

1. A customer who has no margin deposit initiated a new margin position A and then subsequently initiated a new position B on the same day.
After initiating the positions A and B, she made a margin deposit for position A and then closed position A by an offsetting transaction on the same day. Is the customer allowed to use the deposit for A for the margin deposit required for B?

2. A customer who has no margin deposit account initiated a new margin position C on day 1 (T), and closed it by an offsetting transaction on the same day. On day 2 (T+1) he subsequently initiated a new position D and closed it by an offsetting transaction on the same day. Then, on the third day (T+2), he duly made the margin deposit for position C by the deadline.
In this case, is the customer allowed to use the deposit for C for the margin deposit required for D?

(Answer)

For the first case, the answer is no because the customer had not made a margin deposit at the point of initiating position B. Since customers are not allowed to use deposits on a post hoc basis, in this case the customer is not allowed to use the margin deposit for A for the deposit required for B, which was initiated on the same day.

For the second case, the answer is yes. In the second case, when the customer initiated position D, there was no balance in the customer's margin deposit. However, the positions C and D were initiated separately on different days, i.e., on day 1 and day 2, meaning the deadline for making the respective margin deposits for C and D were different. The margin deposit for C was made on the third day and was released simultaneously because of the offsetting transaction on day 1. Therefore, the margin deposit for position C can be used for position D, which was initiated on day 2.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-21. Calculation of Total Security Deposit in Closing a Position by Delivery/Payment

In the case of using delivery/payment for settlement of a margin transaction, can the following amounts be excluded from the calculation of the total amount of margin deposit as long as there is actual delivery of the funds or securities pertaining to settlement by delivery/payment?

(1)The amount equivalent to calculated loss due to market fluctuations (valuation loss) of the margin position pertaining to such delivery/payment.

(2)Miscellaneous expenses pertaining to such delivery/payment

(Answer)

The answer for (1) is yes. The answer for (2) depends on whether the deposit corresponding to such expenses has been made. If the deposit has been made, such expenses can be excluded from the calculation. If such deposit has not been made, these expenses must be included as a negative amount when calculating the total amount of margin deposit.

(Related Laws and/or Regulations)

- **Article 8 (Paragraph 1) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 45 (Paragraph 1) of the TSE Brokerage Agreement Standards**

II-22. Calculation of Deposit

In calculating the current balance of a customer's margin deposit, supposing that there are gains resulting from an offsetting transaction, can these be included in the calculation of his/her margin deposit? Also, can we also include premium or other amounts that the customer receives, such as negative interest per diem, in the calculation? Are there any other points to consider?

(Answer)

The current balance of a customer's margin deposit is calculated as below:

[Total margin deposit] － [Calculated losses due to market fluctuation] － [Losses due to offsetting transactions] － [Other charges related to margin transaction payable by the customer]

In cases where there are gains from offsetting transactions, if there is an arrangement in which the customer deposits the amount equivalent to such gains as margin deposit at the time of settling such offsetting transactions, such amount can be added to the calculated amount of his/her margin deposit.

Here, "gains from offsetting transactions" is defined as the positive difference between the contract value pertaining to the offsetting transaction and the contract value of the unsettled position pertaining to such offsetting transaction. Please note that said difference does not include amounts receivable by the customer, such as negative interest per diem.

Therefore, receivables such as negative interest per diem can only be added to his/her margin deposit when the customer actually makes a deposit equivalent to the amount of such receivables. (They may not be included when the customer only plans to make such deposit.)

Please note that, when including gains from offsetting transactions to the customer's margin deposit, losses and gains are realized on different days (for example if the losses was occurred on day 1 (T) and the gains realized on day 2 or later (T+1 or later)), they cannot be used to offset each other in the calculation.

Moreover, the following points should be considered when performing such calculations:

(1)The purchased securities in lieu of security deposit or proceeds from sold securities in lieu of security deposit may be included in calculating the amount of margin deposit on or after the day of settlement, not on the day of trading.

(2)"Calculated losses" is the amount of unrealized losses obtained by deducting gains from the losses due to price fluctuations in the market where the customer is conducting margin transaction.

(3)"Other charges related to margin transaction payable by the customer" are expenses to be borne by the customer including brokerage commissions, interest, and premium

charges.
(4)Any advance money for the unsettled loss related to margin transactions should be subtracted from the total amount of margin deposit.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 1) and Article 8 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 1) and Rule 45 of the TSE Brokerage Agreement Standards**

II-23. Using Realized Gains for Margin Deposit

1. A customer who has no margin deposit initiated a new margin position A and then realized a gain by closing it by an offsetting transaction on the same day. Subsequently, the customer initiated a new margin position B on the same day. In this case, will the customer be allowed to use the gain from position A for the margin deposit of position B if the customer duly makes the margin deposit for position A by the deadline?

2. A customer who has no margin deposit initiated a new margin position C, and on the next day the same customer made an offsetting transaction and realized a gain before making a margin deposit. In this case, will the customer be allowed to use this gain as margin for a new margin position D?

(Answer)

The answer is no for both cases above.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 3) and Article 8 (Paragraphs 4 and 5) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 3) and Rule 45 (Paragraphs 4 and 5) of the TSE Brokerage Agreement Standards**

II-24. Stock Price Fluctuation after a Margin Call

1. In the case where a customer has to make an additional margin deposit but the market value of his/her positions and/or deposited securities in lieu of security deposit improved and his/her margin deposit ratio returned to a level above the minimum requirement before the deadline for depositing additional margin, will the customer be allowed to not make additional margin deposit?

2. A customer partially covered the amount of additional margin deposit by closing some positions and paying the amount to cover the realized loss. Later on, as the market value of his/her positions and/or deposited securities in lieu of security deposit improved and his/her margin deposit ratio returned to a level above the minimum requirement. In this case, will the customer be allowed to not deposit margin for the remaining portion of the additional margin deposit?

(Answer)

Additional margin can only be covered by additional deposit of funds, etc. or a method newly permitted by the TSE rule revision (enforced January 2013) (partial settlement of position and payment for realized loss).

Accordingly, in case 1 above, the additional margin deposit must be made in full. In case 2 above, the customer must deposit the remaining amount obtained by deducting the amount of partially deposited margin from the required amount of additional margin.

(Related Laws and/or Regulations)

- **Rule 48 (Paragraph 1) of the TSE Brokerage Agreement Standards**

II-25. Realized Gains and Calculation of Additional Margin

Based on the closing price on a certain day (T-1), a margin call was issued on the next day (T). On the next day (T), the customer realized a gain by partially closing the position by an offsetting transaction in auction trading. In this case, will the customer be allowed to deduct such gain from the required additional margin?

(Answer)

Additional margin requirement can be waived only by (1) depositing cash, etc. as additional margin, (2) partially settling existing positions, or (3) covering realized losses by cash.

Therefore, the gain realized in this case cannot be deducted from the required additional margin.

(Related Laws and/or Regulations)

- **Rule 48 (Paragraph 1) of the TSE Brokerage Agreement Standards**

II-26. Covering Additional Margin

Based on the closing price on a certain day (T-1), a margin call was issued on the next day (T).
On that day (T), the customer conducted offsetting transactions to close the positions that could cover the additional required margin.
As a result of these transactions, realized losses occurred for the customer, and the margin deposit ratio again fell below the minimum required amount as of the closing price of the day (T).
In this case, was the initial additional margin call (on T based on T-1 closing prices) really covered?

(Answer)

Additional margin occurring on T (based on T-1 closing prices) was covered by settling part of positions. However, the portion corresponding to the additional margin occurring on T+1 (based on T closing prices) is required to be covered separately by noon on T+3.

(Related Laws and/or Regulations)

- **Rule 48 (Paragraph 2) of the TSE Brokerage Agreement Standards**

II-27. Conditions for Decreasing Additional Margin

In cases where the additional margin was reduced due to payment in cash to settle realized losses, is it mandatory to freeze such cash so that it cannot be used for other transactions until the settlement day?

Is there any problem with handling such realized losses within the margin account?

(Answer)

It is mandatory to freeze it.

In principle, you will need to segregate such cash from the customer's margin account. Please note that, if such cash is accepted within a margin account, the amount of such cash corresponding to the realized losses must not be included in the total margin deposit.

In calculating a customer's total margin deposit, the amount of realized losses must be deducted until the positions related to such realized losses are settled. However, in the case where additional margin call was issued based on the closing prices on T or T+1, such amount of additional margin can be covered using funds deposited to settle each realized loss.

(Related Laws and/or Regulations)

- **Rule 48 (Paragraph 3) of the TSE Brokerage Agreement Standards**

II-28. Customers' Margin for Increased Margin Stock

A customer closed a margin position by conducting an offsetting transaction in a stock to which a higher customer's margin requirement had been applied (hereinafter called "increased margin stock").
Immediately following this transaction, the customer initiated a new margin position in another increased margin stock. In this case, will the customer be allowed to use the margin deposit released by closing the first margin position for the new position?
Also, if the higher margin requirement is lifted, how should we respond to requests from the customer to withdraw the excess in his/her margin that have resulted from deposits made to meet the higher margin requirement?

(Answer)

When the gross amount of the customer's margin deposit exceeds 30% of the contract value of his remaining positions (i.e., positions other than positions closed by offsetting transactions or physical delivery/payment (limited to funds or securities delivered by customers for settlement)), the amount in excess can be used as margin for the new position in another increased margin stock. In this case, such margin deposit made in cash under the limit on securities in lieu of security deposit can be used as cash deposits for the new position as well.

The following should answer the second question concerning withdrawal of the customer's margin if the higher margin requirement is lifted.
(1) The normal customer's margin requirement (30%) applies to a new position initiated on or after the day on which the higher margin requirement is lifted.
(2) Regarding positions initiated before the higher margin requirement is lifted and for which margin deposit has yet to be made, the customer must make such deposit by the deadline required under the higher margin requirement. After the higher margin requirement is lifted, the customer is allowed to withdraw margin as long as his/her margin deposit ratio does not fall below 30%.
(3) Regarding positions initiated before the higher margin requirement is lifted and for which margin deposit has been made, on or after the day the higher margin requirement is lifted, the customer can withdraw margin as long as the margin deposit ratio does not fall below 30%.

In addition, if there are positions related to other increased margin stocks, it is necessary to consider the amount of these positions when calculating the excess margin that can be used for other positions or withdrawn.

Regardless of whether there are margin positions in increased margin stocks, the security deposit must be maintained at 20% of the contract value of margin positions. In

the event that such ratio has fallen below 20%, additional margin deposits must be made to cover the shortfall, either in cash or securities.
Margin transaction restrictions apply to both standardized and negotiable margin transactions.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 3) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 3) of the TSE Brokerage Agreement Standards**
- **Rule 1 (Item 1) of the Rules on Regulatory Measures Concerning Securities Trading, etc. or Its Brokerage**

II-29. Replacement of Securities Deposited as Margin

When a customer's margin deposit ratio is below 30%, do the following violate restrictions on withdrawal of margin?

(1) the customer sells A stock deposited as securities in lieu of security deposit and in turn deposits as margin either the sales proceeds or B stock that the customer buys with the sales proceeds; or

(2) the customer uses cash deposited as margin to buy C stock and deposits it in lieu of money.

(Answer)

In above (1), when the sales proceeds or the value of B stock (as calculated on the basis of the market price on the day before the replacement (or settlement) day; hereinafter the same) exceed the value of A stock, this replacement does not violate restrictions on withdrawal of margin even the customer deposit ratio falls below 30%, because it means replacing A stock with the sales proceeds or B stock.

In above (2), when the value of purchased C stock exceeds the cash portion of margin deposit, this replacement also does not violate the restrictions.

However, the customer must deposit the amount equivalent to or more than additional cash or securities in lieu of security deposit to make up the resulting shortfall in margin if the sales proceeds of A stock or value of B stock are less than the value of A stock in the above (1), or if the value of C stock is less than the cash portion of margin deposit in the above (2). (When the customer buys securities with cash deposited as margin, the value of the gross amount of calculated margin always decreases in accordance with the assessment rate of collateral applied to such securities. This is a point which should be especially noted when replacing cash with securities.)

Therefore, when a customer intends to replace margin through such methods, it is recommended that the customer will be well informed on the requirements explained above. At the same time, it is desirable to pay close attention to changes in market prices of A stock, purchased B stock, and C stock and take measures such as warning the customer, as needed.

(Note)

(1) When replacing an existing margin deposit with another stock or funds obtained by trading in the market in advance of such replacement, it is essential for the financial instruments business operator to check the portion of the cash or securities deposit which is to be replaced every time before accepting such brokerage request from the customer. Especially, when such replacement is to be concluded by conducting several trades, the customer might possibly suffer huge losses and be required to make a large additional margin deposit (cash or securities) to make up for the resulting shortfall.

(2) Replacement of cash margin with cash might appear to be meaningless as an economic activity. However, there could be various cases where this could happen. One is where a customer buys securities in order to replace a deposit in cash, like in a particular case of a series of transactions:

(i) the customer successfully buying the securities for replacement,
(ii) the customer sells the securities and buys other securities in the market immediately after (i),
(iii) the customer deposits the securities he/she newly obtained in (ii).

If the customer fails to buy the securities in (ii), the customer ends up in a situation where he/she has no choice but to deposit cash (i.e., the proceeds obtained in (ii)) as margin. While cash itself is a financial asset not exposed to value fluctuation risk in a sense, a sequence of trades like the above (i) to (ii) could also result in a decrease in the sales proceeds that end up being deposited. Therefore, attention must also be paid to "cash-for-cash" replacements.

(Related Laws and/or Regulations)

- **Article 7 (Paragraph 2, Item 4) of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 44 (Paragraph 2, Item 4) of the TSE Brokerage Agreement Standards**

II-30. Execution of Customer's Order on Margin by Trading as Principal

Suppose we receive from a customer an order for a margin transaction to be executed at a VWAP (Volume Weighted Average Price) in the ToSTNeT market. In this case, if we execute the customer's order to initiate a new long position by selling for our own account, and later fill the customer's order to close the long position by trading as principal again, are the transactions considered an "execution of a customer's margin transaction by trading as principal," which is legally prohibited?

(Answer)

Regulations concerning "execution of a customer's margin transaction by trading as principal" prohibit a financial instruments business operator from, when it has executed a customer's margin transaction by trading as principal without payment of money or delivery of securities (A), effecting an offsetting transaction with the customer to settle its unsettled position (B).

A typical example of this sort is an execution of a customer's order for a margin transaction by matching the order with a transaction for the financial instruments business operator's own account, which is then followed by an offsetting principal transaction along with the customer's transaction to close his/her position.

For example, if you fill a customer's order to initiate a margin long position by matching the order with a transaction for your own account without delivery of securities, it falls under (A) above. If you keep your short position resulting from this transaction, and eventually close the position by effecting an offsetting transaction with the same customer, it is deemed to fall under (B) above, and thus is considered against the regulations.

However, even in the above example, (1) if, before filling the customer's order to initiate a margin long position, you acquired in your inventory a number of shares corresponding to the customer's order (in other words, if you hedged in advance to filling the order), or (2) if it is clear that you have closed your short position resulting from the transaction with the customer before the customer closes his/her long position, your succeeding principal transaction along with the customer's transaction to close his/her position is not considered as one for the purpose of settling your unsettled position and thus is not a violation of the regulations prohibiting "execution of a customer's margin transaction by trading as principal".

The same can be said if you fill a customer's order to initiate a margin short position by matching the order with a transaction for your own account without payment of money.

(Related Laws and/or Regulations)

- **Article 117 (Paragraph 1, Item 24) of the Cabinet Office Order on Financial Instruments Business**

II-31. Correction of Contract as Margin Transaction

We sold 10,000 shares of A stock short for our own account. While we intended to buy back the same number of shares on the same day, we failed to do so and bought back only 5,000 shares. Accordingly, we plan to apply to change our uncovered sale of 5,000 shares to a margin transaction. Is this possible?

(Answer)

In the event that the particulars of an actual contract with respect to a margin transaction differ from those reported to TSE when routing the order, you need to promptly make a correction by filing an "Application for Correcting Contract as a Short Sale/Margin Transaction/Proprietary or Brokerage." However, TSE accepts such applications only when the difference has been caused by a clerical error or a mistake in procedures that can be proved ex post facto, and not by a change in investment objective or decision after the contract was made.

Accordingly, as in the above case, you are not allowed to apply for a correction of the sale as a margin sale for the reason that you failed to buy back shares that you originally had not intended to sell on margin. This also applies to cases where your customer requests similar correction for his/her contract.

A clerical error or a mistake in procedures which can be proved ex post facto is, for example, a flagging mistake at the time of order input or miscalculation of positions, which is evidenced by the order slip or other form of proof. This holds true in cases where you received an order from another financial instruments business operator that, after conclusion of a contract, requests you to correct the order because it had made a similar clerical mistake. In this case, you need to submit evidence which explains ex post facto that the correction is due to a clerical error or a mistake in procedures at such other financial instruments business operator.

(Related Laws and/or Regulations)

- **Rule 14 of the TSE Business Regulations**
- **Rule 6 of the TSE Brokerage Agreement Standards**

III. CASES RELATING TO TRADING IN DIFFERENCES

III-1. Day Trading (1)

If a customer buys and sells the same stock during the day without payment of purchase money, would the customer's act come under the trading in differences?

(Answer)

Should a customer buy XYZ stock and sell it at a gain or a loss during a day and then settle the contracts by receipt or payment of the differences only, his/her transactions come under “a transaction not explicitly stated as margin transaction” (hereinafter called “transaction in differences”) as mentioned in Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions. This also holds when, on settlement day, a financial instruments business operator has paid out a gain to a customer before the customer makes a full payment of his/her purchase money.

(Related Laws and/or Regulations)

- **Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**

III-2 Sale and Repurchase of Stocks Owned

If a customer sells a stock he/she owns and buys it back during the day without payment of purchase money, would the customer's act come under trading in differences?

(Answer)

A customer's sale of a stock he/she holds and repurchase thereof effected during the day does not come under trading in differences, even if the purchase is not accompanied by a full payment.

It should be noted, however, that in the above case, records must be made to the registry of the account transfer log as part of in-company processing.

(Related Laws and/or Regulations)

- **Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**

III-3. Day Trading (2)

A customer effected the following transactions during a day. Would these transactions be considered trading in differences if the customer makes a payment of JPY 1,000,000 (for the first purchase)?

	Bought	Sold
ABC stock	JPY 1,000,000	JPY 1,200,000
OPQ stock	JPY 1,200,000	JPY 1,300,000
XYZ stock	JPY 1,300,000	JPY 1,350,000

(Answer)

If the customer paid JPY 1,000,000 with his/her instruction that the payment is for his/her purchase of ABC stock, the series of transactions is not considered trading in differences.

It should be noted, however, that if the above transactions had been made in the same stock, they might be considered as trading in differences unless the customer made full payment for his/her every purchase.

(Related Laws and/or Regulations)

- **Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**

III-4. Day Trading When Customer Has Payment Obligation

When a customer had a payment obligation to a financial instruments business operator, he bought and sold XYZ stock during a day and paid the full amount for the purchase by the settlement day. Would these transactions not come under trading in differences?

(Answer)

In this case, money paid by the customer for purchase of XYZ stock should first be appropriated for covering his preceding payment obligation. If part of the amount of his payment is so appropriated, the customer cannot be in a position to make full payment for purchase of XYZ stock, and accordingly his transactions would be considered trading in differences.

In practice, a financial instruments business operator should not accept an order to buy securities from a customer while he/she has a payment obligation thereto. Should the financial instruments business operator ever do so, an order should be limited only to the sale of securities for the purpose of making up the customer's payment obligation with the proceeds from the sale.

III-5. Multiple Day Trading in Same Stock

One of our customers owned 1,000 shares of XYZ stock. One day the customer sold the shares and bought them back. We understand that the customer's transactions do not come under trading in differences, provided we made necessary entries into the account transfer registry. However, as the price of XYZ stock rose following the repurchase, the customer wanted to resell it on the same day. If we permitted him to do so, would it be considered trading in differences?

(Answer)

When a customer repeats transactions in the same stock during the same day on a cash basis, you need to compare his/her transactions with what the customer owns in his/her account.

In the above case, your customer sold XYZ stock twice (i.e., 2,000 shares in total) while he bought it once (i.e., 1,000 shares). If the customer had 2,000 shares of XYZ stock for delivery, his transactions would not fall under trading in differences. Since your customer appears to own only 1,000 shares, it would be considered trading in differences should you permit him to settle these transactions as they are.

This applies also in the similar case where a customer bought 1,000 shares of XYZ stock at JPY 1,000,000, sold the same number of shares and bought them back during the same day, while the customer had only JPY 1,000,000 instead of JPY 2,000,000 in his/her account.

There are two ways to prevent the above case from falling under trading in differences: One is, needless to say, to have the customer deliver to you another 1,000 shares of XYZ stock, should he hold them outside your company. Another way is to have the customer pay JPY 1,000,000 for his purchase of XYZ stock to distinguish the original sale of XYZ stock from the succeeding purchase and resale thereof.

(Related Laws and/or Regulations)

- **Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**

III-6. Covering Margin Positions by Payment/Delivery

Suppose a customer has both long and short positions in the same stock in his margin account. If his financial instruments business operator permits him to (1) receive his long position on margin without payment, (2) then cover his short position by delivering the stock he has so come to own, and (3) finally make full payment for his (unpaid) long position with the proceeds he has received by such delivery, would these transactions fall under trading in differences?

(Answer)

The above transactions fall under improper transactions similar to trading in differences.

Since Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions refers to “a transaction not explicitly stated as margin transaction”, the above transactions are not considered trading in differences. Nonetheless, they are regarded as legally improper transactions similar to trading in differences, because the customer has received his long position on margin without payment and then has offset his short position by such unpaid long position for settlement purposes.

In addition to the above case, a financial instruments business operator should not permit its customer to effect the following transactions, as they are regarded as improper transactions:

1. To receive his long position on margin without payment, sell the stock he has so come to own, and then make full payment for his (unpaid) long position with the proceeds from the sale; and
2. To receive a stock he has purchased without payment, cover his short position on margin by delivering such stock, and then make full payment for his (unpaid) purchase of such stock.

III-7. Buy-in/Sell-out in Case of Customer's Failure to Pay/Deliver

We make it a rule to effect, with consent of the customer, an offsetting transaction for contracts in which a customer has failed to pay or deliver. Would this fall under trading in differences?

(Answer)

A buy-in or sell-out effected by a financial instruments business operator for its customer's contract for which the customer has failed to make a payment or delivery (as prescribed in Rule 53 of the TSE Brokerage Agreement Standards) does not come under trading in differences.

In the event of a customer's failure to pay or deliver, the financial instruments business operator has usually been placed in a position to complete settlement for the customer by using its own capital. While this sort of transaction appears similar to trading in differences, it would hamper assurance of a smooth settlement process if such transactions by a financial instruments business operator to cover settlement failures caused by its customer were regarded as such. Accordingly, the provisions of Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions are not considered applicable to a buy-in or sell-out effected by a financial instruments business operator for its customer's contract where the customer has failed to make payment or delivery.

(Related Laws and/or Regulations)

- **Rule 53 of the TSE Brokerage Agreement Standards**

IV. CASES RELATING TO REGULATION ON SHORT SALE

IV-1 Clarification of Short Sale in Order Placement

Under the former regulative framework on short selling, we were required to clarify whether an order was a short sale or not and whether it was subject to short selling price regulations when placing an order to TSE.

Are we required to do the same under the revised short sale regulations implemented in November 2013?

Or, are we allowed to place a short sale order without clarification about price regulations, if such price regulations are not applied at the time of order placement?

(Answer)

With regards to short sale orders placed to TSE markets, we continue to require trading participants to clarify whether the order is a short sale or not and, if it is, whether such an order falls under the statutory price regulations.

According to the definition of the TSE rules and regulations, "**a short sale order under the price regulations**" means "a short sale order that will be subject to the price regulations if such price regulations should be applied, regardless of the actual status of price regulations at the time of order placement."

Similarly, "**a short sale order that is not under the price regulations**" is defined as a "short sale order to which the price regulations cannot be applied."

Trading participants are required to follow this rule in order to prevent actions that violate short selling regulations. Namely, even when price regulations are not actually applied, market participants are strictly prohibited from placing to TSE such a short sale order, incorrectly describing it as an order of stocks they actually hold or as a short sale order not under the price regulations, regardless of whether it is a proprietary or brokerage order.

Trading participants are kindly requested to understand these rules and regulations to conduct trading management properly when placing short sale orders. In addition, please kindly correct a short sale order that is identified as placed in an inappropriate way, by submitting an "Application for Correcting Contracts as Short Sale/Margin Transaction" as soon as possible.

(Related Laws and/or Regulations)

- **Article 162 (Paragraph 1, Item 1) of the FIEA**
- **Articles 26-2, 26-3, and 26-4 of the Order for Enforcement of the FIEA**

- **Articles 11 and 15 of the Cabinet Office Order on Restrictions on Securities Transactions**
- **Rule 14 (Paragraph 1, Item 2) of the TSE Business Regulations**
- **Rule 8 of the TSE Rules on Bids and Offers**

IV-2 Sale Resulting from Erroneous Execution of a Canceled Order

We received from a customer an at-the-close market order to sell 1,000 shares of XYZ stock, and a moment later, received from another customer an at-the-close market order to buy 1,000 shares of the same stock. Before closing, both customers instructed us to cancel their orders. However, our order handler failed to cancel the orders, and as a result, both orders were executed.

We coped with the errors by transferring the contracts into our proprietary account. In this case, if our company has no XYZ stock in its inventory, would the sale be regarded as a short sale, even if there is a matching purchase contract? Also, can we file a trade correction application for such a case?

(Answer)

Since it is a sale of the stock that your company does not own, the sale is a short sale.

In this case, you are also required to submit an ”Application for Correcting Contracts as Short Sale/Margin Transaction” to TSE in accordance with the rules, because the order has already been executed as an actual sale by the customer through a dealer.

You are also required to follow the same procedure regarding the buy order which was erroneously executed.

(Related Laws and/or Regulations)

- **Articles 26-3 and 26-4 of the Order for Enforcement of the FIEA**
- **Articles 11 and 15 of the Cabinet Office Order on Restrictions on Securities Transactions**
- **Rule 14 (Paragraph 1, Item 2) of the TSE Business Regulations**
- **Rule 8 of TSE Rules on Bids and Offers**

IV-3 Sale by Customer Owning a Certain Stock But Wishing to Deliver by Borrowing the Stock

We received an order to sell a stock from a customer for an amount equal to a purchase the same customer made in the past, which is deposited with our company. However, the customer instructed that the settlement of such sale be effected by delivery of shares borrowed from a securities finance corporation, not by delivery of the deposited shares. Would the customer's sale be regarded as a short sale?

(Answer)

A sale to be settled by delivery of a borrowed stock is regarded as a short sale, even if the seller actually owns such stock at the time of the sale.
In this case, you must make a record of confirmations about the settlement, such as the customer's name, the date of confirmation, as well as the method of settlement made by delivery of shares borrowed from a securities finance corporation. In addition, such a record must be preserved for 7 years.

In contrast, if the customer delivers his deposited shares for settlement, his sale will not be regarded as a short sale.

Please also see Question IV-16 for “repeated transactions with borrowed stock” for the financial instruments business operator's own account.

(Related Laws and/or Regulations)

- **Article 162 (Paragraph 1, Item 1) of FIEA**
- **Articles 26-2 and 26-2-2 of the Order for Enforcement of the FIEA**
- **Article 157 (Paragraph 1, Item 3-2) and Article 158-2 of Cabinet Office Order on Financial Instruments Business**

IV-4 Sale to Be Settled by Delivery of Stock Obtained by Covering Long Position on Margin by Payment

A customer who had a long position in a stock in his/her margin account sold the stock on a cash basis. To settle this sale, the customer covered his/her long position by full payment and delivered the stock he/she so came to own. Would the customer's sale be regarded as a short sale?

(Answer)

If a customer with a long position in a stock sells that stock on a cash basis, covers his/her long position by payment on the same day, and settles the sale by delivery of the stock he/she so comes to own, his/her sale is not regarded as a short sale.

In the above case, at the time of accepting the customer's instructions to sell, when there has been no deposit of securities from the customer other than the shares of the long position, you must confirm the customer's intention to cover her long position by payment and use the shares received to settle such sale.

(Related Laws and/or Regulations)

- **Article 117 (Paragraph 1, Item 24-5), Article 157 (Paragraph 1, Item 3-4), and Article 158-4 of the Cabinet Office Order on Financial Instruments Business**

IV-5 Sale Order Consisting of Long and Short

We received an order to sell 1,000 shares and 5,000 shares of XYZ stock at 9:30 a.m. and 10:00 a.m., respectively. The customer owned 5,000 shares of the stock and 1,000 shares borrowed from a securities finance company. In the market, the order to sell the 5,000 shares was filled first, and then the 1,000 shares were sold. In this case, which order would be regarded as short sale?

Also, assuming that the order to sell accepted at 9:30 a.m. was not regarded as a short sale, a sale of 1,000 shares out of 5,000 shares accepted at 10:00 a.m. should naturally be regarded as short sale. In this instance, how should we mark the order "short sale" at the time of order placement?

(Answer)

Regarding the obligation to specify short selling, judgment as to whether or not a sale is a short sale should be based on whether the customer owns the security at the time of placing the order. In the above case, an order to sell 1,000 shares of XYZ stock should be regarded as "long sale", unless the Customer instructs that the sale be a short sale. Hence, 1,000 shares out of the latter order to sell 5,000 shares should be regarded as "short sale".

Like in this case, when an order to sell consists of both long and short, the best way to handle it is to divide the order into long and short for routing. If it is difficult to do so, the entire 5,000 shares have to be marked "short sale". Should you route the order to the market without marking it as short sale and apply to correct the order as having 1,000 shares sold short after the order has already been filled, your act is deemed a violation of the clarification and confirmation obligations, and the requirement of marking short sales as "short". In other words, you must not route a recognized short selling order without marking it as "short."

IV-6 Arbitrage Transaction Initiated with Sale

In effecting an arbitrage transaction in a stock between different financial instruments exchanges, if one initiates the transaction by selling the stock, would the sale be regarded as a short sale?

(Answer)

If he/she does not own the stock, the sale is regarded as a short sale, but is exempt from the restrictions on short sale price pursuant to Article 9-3 (Item 1-36) and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions. Accordingly, the order should be marked “short sale exempt from price restrictions”.

(Related Laws and/or Regulations)

- **Article 9-3 (Paragraph 1, Item 1-36) and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-7 Applicability of Short-Selling in Case of a Stock a Customer May Not Own

We have received from an overseas customer an order to sell XYZ stock. We were unable to confirm whether the customer held XYZ stock or not, due to the fact that the customer has not deposited securities related to such sale with us. If, in this situation, we fill the order, would the sale be regarded as a short sale?

(Answer)

In a case where you received a sale order from a customer and such order will be executed as an actual sale, if there has been no deposit of securities, first the method of securities management must be confirmed and recorded. In this case, if the customer's holdings are not clear, the sale will be regarded as a short sale.

In addition, you are required to confirm that the transaction is not a naked short sale before executing such an order as short selling.

(Related Laws and/or Regulations)

- **Article 26-2 and Article 26-2 (Item 2) of the Order for Enforcement of the FIEA**
- **Article 117 (Items 1 and 24-5), Article 157 (Paragraph 1, Items 3-2 through 3-4) and Articles 158-2 through 158-4 of the Cabinet Office Order on Financial Instruments Business**

IV-8 Principal Sale in Off-Auction Market for Correcting Error

We received from a customer an order to buy in the TSE market, but our order handler failed to route the order to the market. The order would have been filled, had it been routed at the time of acceptance. Accordingly, we intend to apply for correcting the error by filling the customer's buy order with our principal sale. In the event that we do not own the security, would our sale be regarded as a short sale?

(Answer)

While your sale took the form of a short sale, it is exempt from the short sale regulations under Article 10, Item 8 of the Cabinet Office Order on Restrictions on Securities Transactions which exempts from the clarification and confirmation obligations related to short sales such short sales corresponding to transactions effected outside the auction market as prescribed in the TSE Business Regulations. A purchase or sale transaction for correcting an error, as prescribed in Rule 41 of the TSE Business Regulations, is considered a transaction effected outside the auction market prescribed in such Regulations, and your sale is exempt from the clarification and confirmation obligations, accordingly.

For your information, a transaction through ToSTNeT is also considered as such a transaction.

(Related Laws and/or Regulations)

- **Article 9-3 (Item 1-8) and Article 11 (Item 1) of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-9 Sale for Reducing Risk Involved in Correction of Error

We received from a customer an at-the-opening market order to sell a stock, but our order handler failed to route the order to the TSE market. The order would have been filled at the opening had it been routed properly. While we intend to apply to correct the error by filling the customer's sell order with our principal purchase, before filing the application we intend to sell the stock for our own account in the TSE market to reduce the risk involved in correction of the error. In the event that we do not own the stock at the time of the sale, would the sale be regarded as a short sale?

(Answer)

Yes, the sale is deemed to be a short sale, because it is uncertain at the time of the sale whether your application for correction will be approved by TSE or not and therefore you are deemed not to be a holder of the stock.

In addition, please note that you must consider the possibility that the correction might not be approved and the subsequent procedures might differ depending on its result.

IV-10 Execution of Sale Order in Wrong Name

We received from Customer A an order to sell XYZ stock, but erroneously made out an order slip and filled the sell order as Customer B's order. We immediately corrected it to Customer A's contract. As Customer B did not own XYZ stock, would the sale be regarded as a short sale?

(Answer)

As the sale was not originally Customer B's order, it cannot be a short sale.

IV-11 Transfer of Erroneous Agency Sale into Own Account When the Customer Owns the Stock Sold

We received from a customer an order to sell 1,000 shares of XYZ stock, but mistakenly sold 10,000 shares due to our order handling person's mistake. To make up the error, we transferred the oversold 9,000 shares into our own account. While we did not own XYZ stock in our inventory at the time of the sale, the customer owned 20,000 shares in her account. Accordingly, we judged that the erroneous sale of 9,000 shares so transferred would not be a short sale, and thus we did not file the “Application for Correcting Contracts as Short Sale/Margin Transaction”.
Was our judgment correct?

(Answer)

When transferring an erroneous sale caused by a clerical mistake into a financial instruments business operator's own account, judgment on whether the sale is a short sale or not should be based on whether the financial instruments business operator, not the customer, owned the stock in question at the time of the sale. Therefore, in the above case, a sale of 9,000 shares for your own account resulting from the transfer is a short sale, and you must file with TSE the above application.

(Also, see IV-12: Transfer of Erroneous Agency Sale to Principal Account to Be Followed by Covering the Sale by Borrowing Stock from Securities Finance Corporation)

IV-12 Transfer of Erroneous Agency Sale to Principal Account to Be Followed by Covering the Sale by Borrowing Stock from Securities Finance Corporation

We received from a customer an order to buy a stock, but we mistakenly sold it. We tried to handle the error by transferring the sale contract into our own account and at the same time by carrying out the procedures for borrowing the stock from a securities finance corporation. In this case, we neither owned the stock at the time of the sale nor sold the stock on margin. What are the procedures we should follow in such cases where we borrow a stock from the securities finance corporation ex post facto?

(Answer)

When a financial instruments business operator effects a sale for its own account for which a stock is to be borrowed from a securities finance corporation, such a transaction is subject to the price regulation, and it must also indicate that the sale is a short sale. This requirement is satisfied by indicating at the time of order routing that the order to sell is to initiate a short position on margin.

In your case, you failed to do so, as the sale was a result of an erroneous execution. In this event, you need to file with TSE the "Application for Correcting Contract as a Short Sale/Margin Transaction".

For your information, the Financial Services Agency has published the following view on an erroneous short sale made in violation of the short sale price regulation:

Results of Public Comments to the Summary of the Cabinet Office Order (Preliminary) to Amend the Cabinet Office Order on Short Sales of Securities (September 13, 2002)

Although a sale that has been made by an error in the process of order execution and has resulted in a short sale (including a sale on margin) in violation of the short sale price regulation cannot be treated as an exemption from the regulation, such a sale does not in general seem to be a violation against the law being subject to a penalty. However, in order for such a sale to be regarded as caused by an error, the sale must be backed by a clear proof that it has been made by an error, and in addition, the error should have been corrected in a proper method.

It is no need to say that securities companies should be equipped with an appropriate control system to prevent errors from occurring in the process of order execution.

(Related Laws and/or Regulations)

- **Articles 26-3 and 26-4 of the Order for Enforcement of the FIEA**
- **Articles 11 and 15 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-13 Erroneous Principal Sale to Be Followed by Covering the Sale by Borrowing Stock from a Securities Finance Corporation

We intended to sell 5,000 shares of XYZ stock from our inventory but mistakenly sold 50,000 shares. To cover the portion we did not own, we carried out procedures for borrowing them from a securities finance corporation. Will this transaction be exempted from the short sale price regulations?

(Answer)

Your case is quite similar to the previous case in IV-12. You need to file with TSE an application for correcting the contract as mentioned above.

IV-14 Short Sale Judgment for Separate Account for Accident Recovery

We received an order to sell 1,000 shares of XYZ stock from a customer owning 10,000 shares of that stock, but our order-handler mistakenly executed 10,000 shares. To cope with the situation, we created a “separate account for accident recovery” for the customer and transferred the excess 9,000 shares into the account. We understand that the erroneous sale of 9,000 shares is not regarded as a short sale, as the customer owned 10,000 shares. Is this correct? For your information, we did not own XYZ stock for our own account at the time of the sale.

(Answer)

When transferring an erroneous sale caused by a clerical mistake (e.g., erroneous input of buy/sell, name of issue, quantity, etc.) into a financial instruments business operator's own account, judgment whether the sale is a short sale or not should be based on whether the financial instruments business operator, not the customer, owned the stock in question at the time of the sale (See case 8). This holds in cases where the sale is transferred into customer's “separate account for accident recovery,” rather than into the firm's own account.

While it is true that a sale on a separate account for accident recovery may be regarded as a customer's sale due to error, the sale in this case should not be regarded as the customer's and therefore should not be settled by delivering the customer's shares. Instead, the firm must borrow and deliver the issue. Accordingly, the sale of 9,000 shares is regarded as a short sale by the firm.

When the firm, in error, did not execute the selling order of 1,000 shares that the customer owned, and executed the trade in a separate account for accident recovery, this trade is not regarded as a short sale. This is because the trade was executed to be regarded as a customer's with the customer's consent and the customer owned the same share.

IV-15 Monitoring of Short Sales Where More than One Trader Is Engaged in Principal Trading

When there is more than one trader in a financial instruments business operator, each engaging in buying and selling for the firm's own account, would it be all right if judgment of whether or not his/her sale is a short sale is left to each trader based on the security positions under his/her management?

For instance, suppose there were two traders in a financial instruments business operator: Trader A bought 1,000 shares of XYZ stock at 9:00 a.m. and sold them at 10:00 a.m., while Trader B sold 1,000 shares of the same stock at 9:30 a.m. Assuming that the financial instruments business operator did not own XYZ stock in its inventory, which sale would be regarded as a short sale, Trader A's sale at 10:00 a.m. or Trader B's sale at 9:30 a.m.?

(Answer)

The answer to the question differs depending upon the financial instruments business operator's policy on security position management.

Under such circumstances where the firm's security positions are monitored and shared by more than one trader through close communication among traders, 1,000 shares of XYZ stock bought by Trader A can be considered to have been sold by Trader B, leaving Trader A's sale at 10:00 a.m. as a short sale. If, on the other hand, the firm has adopted a system where each trader maintains his/her own security positions separately from other traders, Trader B's sale, rather than Trader A's sale, is regarded as a short sale. It should be noted, however, that if a financial instruments business operator leaves the judgment concerning a short sale to each trader based on his/her own security positions, the firm is required to prove that traders' security positions are managed separately by each trader, by, for example, preparing and keeping a manual for traders in which such policy is clearly stated.

Also, a financial instruments business operator should maintain a consistent policy on management of security positions.

IV-16 Applicability of Short Sale Regulations to Repeated Transactions with Borrowed Stock

We sold on margin 10,000 shares of XYZ stock and bought 10,000 shares of the same stock in cash on the same day (Day 1), both for our own account. We originally intended to cover the short position by applying on the next day (Day 2) for settlement by delivery of the stock we bought in cash. However, as the price of stock declined on Day 2, we chose not to do so and instead sold the 10,000 shares of XYZ stock again by linking the sale to Day 1's purchase in cash. Would that sale (on Day 2) be regarded as a short sale?

Also, what if, on Day 2, we not only sold 10,000 shares of XYZ stock but bought and sold them again?

(Answer)

The sale of 10,000 shares on Day 2 to be settled by delivering 10,000 shares purchased on Day 1 is treated as an exemption from the clarification and confirmation obligation of short sale under Article 9-3, Item 1-6 and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions

However, for a financial instruments business operator's principal trades, a sale in the series of transactions that is not backed by a long position is regarded as a short sale. Accordingly, when Day 1's long and short positions are square (i.e., a margin sale of 10,000 shares and a cash purchase of 10,000 shares in the above case), the above sale of XYZ stock in a series of transactions on Day 2 is regarded as a short sale, except when you link the sale to Day 1's purchase in cash. This is exceptionally treated as an exemption under Article 9-3, Item 1-6 of the Cabinet Office Order on Restrictions on Securities Transactions.

In practice, in the above question, when, on Day 2, 10,000 shares are sold, then bought and sold again, the first sale is treated as an exemption if you are to cover such sale by delivering 10,000 shares purchased in cash on Day 1, while the second sale is regarded as a short sale. On the other hand, should you choose to cover the second sale by delivering 10,000 shares bought in cash on Day 1, the second sale is treated as an exemption, while the first sale is regarded as a short sale.

(Related Laws and/or Regulations)

- **Article 9-3 (Item 1-6) and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-17 Necessity of Application for Correction in Case of Principal Short Sale and Covering Thereof by Delivery Occurring on the Same Day

If, for example, we sell a stock on margin for our own account today and later in the day, cover our prior short position in the same stock of the same amount by delivery to the securities finance corporation, or if we buy back a stock that we sold on margin on the same day, the securities finance corporation will not lend us the stock for today's sale on margin.

In this case, should we correct the sale on margin to being “not on margin” by filing with TSE an “Application for Correcting Contracts as Short Sale/Margin Transaction”?

(Answer)

The securities finance corporation does not lend stock for sale on margin in cases like the above. Similarly, you are not allowed to borrow stocks to cover prior margin sale positions by delivery of stocks. However, you are not required to submit an “Application for Correcting Contracts as Short Sale/Margin Transaction” in this case.

In addition, a margin short sale that is made simply for the purpose of rolling over the existing margin short position with its settlement date approaching is treated similarly.

Please note that selling a stock on margin for own account is deemed a short sale that is subject to price regulations.

IV-18 Judgment of Settlement Measure in Selling on Margin by Own Account

If we sell a stock on margin for our own account and buy back the same stock on the same day, the securities finance corporation will not lend us the stock for today's sale on margin.

Will this transaction be free from restrictions on naked short sales, based on the assumption of borrowing the same stock from a securities finance corporation?

Or will it be deemed a case of naked short sale without measures to settle the position, a requirement of the short selling regulations?

(Answer)

This is not deemed a case of naked short sale. The measure to settle the position can be considered to be in place, on the condition that you entered into a comprehensive agreement regarding loan stocks with the securities finance corporation, regardless of whether you actually borrow stocks to close the position or not.

However, if the stocks were under suspension of application for use of stock loans by the securities finance corporation at the time of order placement, the measure to settle the position is not deemed to be in place.

IV-19 Sale of Stock on Public Offering/Distribution, for Which Customer Has Subscribed

A customer who is to receive a stock that he/she has duly subscribed for in a public offering or public distribution intends to sell the stock on the third business day preceding the day on which he/she will receive the stock. While the customer will come to own the stock on the settlement day for his/her sale, would the sale be regarded as a short sale?

(Answer)

As far as the procedures are duly completed within the subscription period and the customer will receive (and thus, deliver in time) the stock the customer is going to sell, and thus, once the number of shares that the customer shall receive in this transaction become certain, the customer's sale is exempted from the clarification and confirmation obligations of short sale, even if such sale occurs before the receipt of the stock is recorded in his/her account.

Similarly, if, judging from the fact that the customer has claimed exchange of exchangeable corporate bonds or has received allotment of new shares due to a stock split-up or a merger, the number of stock that a customer will receive is fixed, his/her sale before receipt of the stock is treated as an exemption from the clarification and confirmation obligations, even when the settlement of the sale is not effected by delivery of the very stock received by the exchange claim and others.

However, it is necessary to confirm and record the so-called management method of securities, in order to execute this transaction as an exemption from such obligations.

(Related Laws and/or Regulations)

- **Articles 9-3 (Item 1-13) and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions**
- **Article 117 (Items 1 and 24-5), Article 157 (Paragraph 1, Item 3-4), and Article 158-4 of the Cabinet Office Order on Financial Instruments Business**

IV-20 Treatment of Agency Sale When Customer Has Requested Conversion through Another Financial Instruments Business Operator

We received from a customer an order to sell a stock. He said that he had requested conversion of convertible bonds through another financial instruments business operator, but it is beyond our capacity to confirm whether he has actually requested conversion through another firm. If he says that he would come to own the stock for delivery, would it be all right if we treat the customer's sale as an exemption from the clarification and confirmation obligation for short sales?

(Answer)

If you have been informed by the customer that he has satisfied the requirements for being exempted from the clarification and confirmation obligation for short sales through another financial instruments business operator, you may treat the order as an exemption.

In this, you are required to preserve the confirmation record of “management methods for securities” related to this arrangement.

(Related Laws and/or Regulations)

- **Article 9-3 (Item 1-9) and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions**
- **Article 117 (Item 1, 24-5), Article 157 (Paragraph 1, Item 3-4), and Article 158-4 of the Cabinet Office Order on Financial Instruments Business**

IV-21 Sale to Be Settled by Delivery of Security Purchased in Overseas Market

According to Article 9-3, Item 1-6 of the Cabinet Office Order on Restrictions on Securities Transactions, "of short sale of securities which have been purchased but not yet settled, such short sale that is to be settled by delivery of the purchased securities" is exempt from the clarification and confirmation obligation for short sales, except in cases of (1) accepting consignment of short sale on a financial instrument exchange market, (2) a transaction equivalent to accepting consignment of short selling which is conducted in conspiracy with a consigner of such a transaction, (3) de-facto consignment of short sale using securities bought in own account, instead of accepting such consignment directly from a consigner.

Would the exemption be applicable to such cases where a security has been purchased in an overseas market?

(Answer)

If a sale can be settled by delivery of the purchased securities, it does not matter whether the securities have been purchased in a domestic or overseas market.

(Related Laws and/or Regulations)

- **Article 9-3 (Item 1-6) and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-22 Short Sale Judgment at Fail-affected Participant

Yesterday was the settlement date of a purchase contract of a stock made by a customer, but we suffered a fail for the transaction. Today the customer told us that he would like to sell the purchased stock, because its price exploded today. If we sell the stock, is it regarded as a short sale?

(Answer)

No. You can sell the stock because this case is deemed to be an exemption from the clarification and confirmation obligation for short sales.

Article 9-3, Item 1-6 and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions prescribes that sales of purchased stock before their settlement date are exempted from the clarification and confirmation obligation for short sales. In the above case, the customer sold the stock which he did not actually own because of suffering a fail, but it is considered as “sales of securities which have been purchased but not yet settled” prescribed in the above mentioned Item, and is exempted from the clarification and confirmation obligation for short sales.

(Related Laws and/or Regulations)

- **Article 9-3 (Item 1-6) and Article 11 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-23 Order Split of Short Sale during Auction Hours

During the continuous double auction session, we received an order from an individual customer to sell 10,000 shares (100 units) of a stock on margin. In this instance if we, in accordance with the customer's instructions, divide the order in half, each consisting of 5,000 shares (50 units), and route them one after the other, would the two orders be treated as exemptions from the short sale price regulations?

(Answer)

In order to decide whether or not this case falls under the scope of the exemption from the short sale price regulations, it is necessary to consider the actual intention of the investor in addition to the trading situation.

In this case, a retail investor, who is not a "Qualified Institutional Investor" is exempted from the short sale price regulations, provided that;

- One order is for 50 units or less each, and
- The order split is based upon an investment decision that such a retail investor makes separately for each of the split orders.

In light of the above requirements, this transaction is not eligible for an exemption to the short sale regulations, because it is deemed to be an order of "100 units" placed under a single investment decision or intention. Splitting up an order of 100 units into two orders of 50 units to circumvent the regulation is simply unacceptable.

The two orders cannot be regarded as separate orders, even if you make out two separate order slips for them. The exemption from the short sale price regulations cannot be applied to this case.

(Note 1) Similarly, when such an investor uses his or her family member's account or a corporate account of his or her company to split a larger short sale order into smaller ones that agree with the exemptions from price regulations, it could be deemed to be conduct in violation of the short sale regulations, whether such split orders are placed through the same financial instrument dealer/broker or through separate multiple dealers/brokers.

(Note 2) In addition to investors, financial instruments dealers or brokers will be imposed with penalties when they route orders that violate the short sale regulations whether orders are bilateral or non-bilateral ones. Trading participants need to establish an appropriate management system to identify and prevent the violation of the short sale regulations.

(Related Laws and/or Regulations)

- **Article 162 (Item 1-1) of FIEA**
- **Articles 26-2, 26-3, and 26-4 of the Order for Enforcement of the FIEA**
- **Article 15 (Item1-2) of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-24 Placement of Multiple Orders before Market Opening

Before the opening of the TSE market, we received from an individual customer an order to sell 5,000 shares (50 units) of a stock on margin. Following the first order, the customer again placed an order to sell 5,000 shares (50 units) of the same stock on margin, also before the opening of the market. The first and the second order were treated as simultaneous orders and executed as a single order of 10,000 shares in total. Would these two orders be treated as separate orders, each consisting of 50 units or less, and thus be exempted from the short sale price regulation?

(Answer)

While the first order and the second one were placed at separate times before the opening of the market, it is evident that participants are supposed to have agreed to the rule that these orders shall be recorded as pre-market orders that will be treated as a single order placement, as prescribed in the trading rules of TSE. As such, this case is deemed to be in violation of the regulations, and not falling under the scope of exemption from the short sale price regulations.

Therefore, the participants need to explain in advance that this client will be technically deemed to have placed these two orders intentionally to circumvent the regulations, and that it is in violation of short sale regulations, outside the scope of exemption from the short sale price regulations. At the same time, the participants must strive to identify and prevent acts that violate the short sale regulations by monitoring continuously through daily trading examinations. The participants must conduct monitoring both at the time of order placement and after the execution of contracts, in light of the past improprieties.

To identify conduct in violation of the regulations, simply checking their formalities alone is not enough. Instead, it is mandatory to examine the substantial attributes of transactions. If such conduct should be identified, the participants need to explain the short sale regulations to the client, taking proper measures such as issuance of warning in accordance with internal rules.

(Related Laws and/or Regulations)

- **Article 162 (Item 1-1) of FIEA**
- **Articles 26-2, 26-3, and 26-4 of the Order for Enforcement of the FIEA**
- **Article 15 (Item 1-2) of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-25 Agency Margin Sale Order from Another Financial Instruments Business Operator

Suppose we have newly received an agency margin sale order from an overseas financial instruments business operator or another domestic financial instruments business operator. If the order has been placed with the overseas or other such firm by an individual investor, and if the order consists of 50 units or less, would the sale be treated as an exemption from the short sale price regulations?

(Answer)

If you have been informed by the overseas or domestic financial instruments business operator that the customer is an individual, you may treat the order as an exemption. In such cases, you should preserve the record of such information to fill internal management duties.

IV-26 Time Lag between Purchase and Sale in Arbitrage Transactions

In effecting arbitrage transactions, if there was a time lag between orders to buy and sell (short) or between executions thereof, would the short sale be treated as an exemption from the short sale price regulations? Also, what if we conduct short sales in portions in consideration of market liquidity?

(Answer)

While arbitrage transactions should be effected in principle by simultaneous purchase and sale or by a purchase (sale) which is immediately followed by a sale (purchase), a time lag between purchase and sale contracts due to order input process or portion-by-portion execution of sales due to liquidity consideration does not, if it remains within a reasonable extent, prevent the short sales from being exempted from the short sale price regulations. However, as a large block being subject to portion-by-portion execution does not in general seem suitable for arbitrage, prudent judgment would be required on a case-by-case basis.

For your information, even if short sales effected in arbitrage were unable to be covered in part by purchases in the process of arbitrage activity, the uncovered short sales can be exempted from the price regulations if they are covered later.

IV-27 Applicability of Exemption to Sale in Arbitrage from Price Regulations

Are the following short sales treated as an exemption from the short sale price regulations?

(1) While holding index arbitrage positions – a long position in the stock index futures and a short position in a basket of underlying stocks – there has been replacement of some index component stocks (or the correlation of the basket with the index has lowered due to a change in the market value of the index component stocks). To minimize the tracking error, we sell short some stocks in the basket for rebalancing purposes.

(2) In the situation where XYZ Company will merge into ABC Company, we effect arbitrage by (A) selling XYZ stock short several times within the extent of the share-swap ratio while continuing to hold ABC stock, which we had owned from before (at least since yesterday), or (B) placing a limit order to buy ABC stock, and selling XYZ stock short within the extent of the share-swap ratio every time the buy order is executed (in full or in part).

(3) Short sale in an arbitrage between the selling of overvalued stocks and the buying of undervalued stocks.

(Answer)

(1) A short sale to rebalance the portfolio for the purpose of minimizing the index tracking error is considered part of an arbitrage transaction, and thus is exempted from the short sale price regulations. In this instance, however, you should preserve the record of the fact that the short sale was made for rebalancing purposes, so that you can prove it ex post facto.

(2) Under the provisions in Article 9-3, Item 1-34 and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions, short sales that are exempted from the short sale price regulations are limited to short sales of shares of a company merging into another company that are made along with purchases of shares of the other company within the amount of the purchase value. Accordingly, a short sale that is effected when you already own the absorbing company's stock, as shown in (A), is not considered arbitrage and thus is not exempted from the short sale price regulations. A short sale in (B), on the other hand, is treated as an exemption from the regulations.

(3) This type of transaction does not fall under any of the cases enumerated as exemptions to the short sale price regulations in laws and ordinances (such as Article 9-3 of the Cabinet Office Order on Restrictions on Securities Transactions). Therefore, it is subject to the short sale price regulations. The public comment on the revision to the short sale regulations in 2002 states, referring to this issue,

that this type of transaction should not be exempted from the short sale price regulations, on the grounds that there is no theory that explains the relation between different stocks and that it is impossible to identify a specific transaction that falls under this category.

(Related Laws and/or Regulations)

- **Article 9-3 (Paragraph 1) and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-28 Applicability of Exemption to Sale for Hedging Purpose from Price Regulations

Are the following short sales treated as an exemption from the short sale price regulations?

(1) A customer has subscribed for corporate bonds with new share reservation rights. In order to reduce the risk associated with a change in price of the bonds, she intends to sell the stock short up to the number of shares she can obtain through exercising the rights.

(2) A financial instruments business operator is going to fill as principal a customer's order to sell a stock index futures contract at a price targeted at the underlying index value at the close. The firm intends to sell stocks short in advance for hedging purposes.

(3) A customer holding corporate bonds with new share reservation rights has maintained a margin short position in the underlying stock for the purpose of hedging the risk associated with the bonds. With the settlement date of the short position approaching, the customer has effected an offsetting margin purchase, and then has again sold short the same number of shares of the same stock on margin.

(4) A customer owns convertible-bond type corporate bonds with new share reservation rights. One day, the conversion price of the bonds was changed from JPY 1,000 to JPY 800. The customer is going to sell short the underlying stock for hedging purposes at or below an upper limit price determined on the basis of the new conversion price. The settlement date of the short position will fall on or after the effective date of the new conversion price.

(5) A financial instruments business operator filled a customer's order to buy a non-index tracking basket of stocks by selling short for its own account outside the auction market. The firm then established a long position with a stock index futures contract to help hedge the short position in stocks. In this instance, to reduce the market risk involved in over-hedging resulting from the index long position, the firm sold different issues of stocks short to ensure closer correlation between the index and its equity short position including stocks sold short earlier.

(6) A short sale as a hedge made in advance against closing-price guaranteed transactions and closing-price targeted transactions, or a short sale for hedging OTC derivatives trading.

(Answer)

(1) As it is certain from her subscription to corporate bonds with new share reservation rights that the customer will receive such corporate bonds, under Article 9-3, Item 1-21 and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions, her short sale is exempted from the short sale price regulations even if the sale is made before she actually receives the bonds. In this instance, there is

no need to say that the sale should be made for the same stock (and up to the same number of shares) as that to be obtained by the exercise of rights.

(2) While such a short sale of stocks that is made within the extent of the balance of index futures long positions to reduce market risk is exempted from the short sale price regulations under Article 9-3, Item 1-23 and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions, a short sale that is made in advance of establishing an index futures long position, as in this example, is not treated as an exemption from the regulations.

(3) While a margin short sale that is made within the extent of the number of shares to be obtained through the exercise of rights is exempted from the short sale price regulations, a margin short sale that is made simply for the purpose of rolling over the existing margin short position with its settlement date approaching is not treated as an exemption.

(4) A sale that is made for hedging purposes within the extent of the number of shares to be obtained by conversion is treated as an exemption from the short sale price regulations. Accordingly, this sale can be made at a price determined on the basis of the new conversion price (i.e., JPY 800), if the settlement date of the short position comes on or after the effective date of the new conversion price.

(5) If the different issues of stocks to be additionally sold short have been selected to ensure closer correlation between the index and the equity short position, including stocks sold short earlier, and in addition if such short sale of stocks is made within the extent of the balance of the index futures long position, the sale is treated as an exemption from the short sale price regulations under Article 9-3, Item 1-23 and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions. In this instance, however, the financial instruments business operator should preserve the record thereof, so that the firm can prove it ex post facto.

(6) These types of transactions are subject to the short sale price regulations prescribed in the laws and ordinances that such as Article 9-3 of the Cabinet Office Order on Restrictions on Securities Transactions, not falling under the cases enumerated as an exemption to the price regulations.

The public comment on the revision to the short sale regulations in 2002 refers to the issue of closing-price-guaranteed/ closing-price-targeted transactions, pointing out that they should not be exempted from the price regulations due to the possibility of being used as an instrument to manipulate prices in the closing market. Similarly, some argued in public comments that OTC derivatives should not be exempted from the price regulation, pointing out that (1) OTC derivatives trading involves made-to-order transactions whose specifications are freely determined between customers and financial instruments dealers, and that (2) such specifications would not be disclosed to the public.

(Related Laws and/or Regulations)

- **Article 9-3 (Item 1) and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-29 Principal Sale to Reduce Risk

Before the opening of the market, we received from a customer an order to sell a stock after the close of the market through the off-auction ToSTNeT at the stock's VWAP for the day. To reduce the risk involved, we sold the stock for our own account in TSE's auction market during the day. At the time of the sale, we did not own the stock. Would this be a short sale?

Also, would this sale be a violation of law prohibiting front running?

(Answer)

Even if the sale was intended to reduce the risk associated with your principal purchase to fill a customer's sell order, the sale was a short sale as it was made for your own account without owning the stock. The sale must therefore be marked “short” at the time of routing the order. However, including a sale in this case, a sale for hedging purposes in advance of a VWAP-guaranteed transaction or a sale corresponding to a VWAP-targeted transaction is, if the transaction is to be effected at a day's VWAP, a morning-session VWAP or an afternoon session VWAP (excluding a VWAP for other specific periods), exempted from the short sale price regulations **provided the sale order is routed in accordance with a predetermined computer program** (which does not mean ruling out adjustment at a trader's discretion in accordance with the market condition). Moreover, the VWAP related transactions **must be managed in a special account**, enabling separate profit/risk management and an audit trail.

As to the second question, the above sale in the auction market does not violate the law because, when an order is to be filled at a VWAP off auction, an actual price at which the order is to be bought/sold is determined later and is, thus, not certain at the time of receipt of the order.

(Related Laws and/or Regulations)

- **Article 9-3 (Paragraph 1, Item 19) and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions**
- **Articles 117 (Paragraph 1, Item 10) of the Cabinet Office Order on Financial Instruments Business**

IV-30 Applicability for Transactions for which Short-Selling Price Restrictions Do Not Apply (Anticipatory Sales related to VWAP Ippon-ne Kaeshi* Transactions with a Non-Trading Participant)

A trading participant receives a so-called ***Ippon-ne Kaeshi*** transaction order, such as a VWAP-guarantee or VWAP-target order, from a customer to be executed via off-auction trading, etc. following the closing of the auction market. In the case where we conduct an anticipatory sale in the auction market for hedging, etc., price regulations would not apply. However, in the case where a non-trading participant securities company conducted such Ippon-ne Kaeshi transactions with the customer, would price regulations apply to anticipatory sales for hedging by the trading participant which received the order from such non-trading participant?

(Answer)

In a case where the non-trading participant securities company matches the customer's sale with a purchase from its own account for the VWAP *Ippon-ne Kaeshi* transaction, and furthermore conducts a VWAP-sale for its own account with a trading participant, price regulations will apply. In a case where a trading participant, etc. of a financial instruments exchange receives such an *Ippon-ne Kaeshi* transaction directly from a customer and conducts an anticipatory sale for its own account in the auction market, as stated in IV-29, price regulations will not apply pursuant to Article 14, Item 3 of the Cabinet Office Order on Restrictions on Securities Transactions. This non-application of price regulations is based on the perspective that short-selling from a customer's actual demand is equivalent to the customer's actual sale.

On the other hand, in the above case, the trading participant makes a matching purchase for its own account. The customer of such trading participant is a non-trading participant, and at the time such non-trading participant submitted the sale order related to the VWAP *Ippon-ne Kaeshi* transaction to such trading participant, the non-trading participant did not hold the shares related to such sale, and thus the sale cannot be said to have been made based on a customer's actual demand.

Furthermore, in a case where the trading participant's overseas affiliate company accepted the *Ippon-ne Kaeshi* transaction order from such affiliate company's customer, and conducted an anticipatory sale in the auction market for such affiliate company's account, price regulations will apply. In order to not be subject to price restrictions, it must occur directly between a customer and a trading participant, etc. of a financial instruments exchange.

*_Ippon-ne Kaeshi_ Transactions generally refer to off-auction or off-exchange transactions after auction trading between a customer and a financial instruments business operator at the VWAP

(Note) In the transactions that are similar to this case, where trading participant X executes an order in the Exchange via trading participant Y, trading participant X is always assumed to be a “non-member securities company” and trading participant Y is always assumed to be the “trading participant” (the same will apply in the Q&A below).

IV-31 Applicability of Short Sale Price Regulations to Sale Pertaining to VWAP Orders

In each of the following cases, is the sale pertaining to a VWAP order treated as an exemption from the short sale price regulations?

(1) A financial instruments business operator received a VWAP order from a customer. To reduce the risk involved, it made a principal short sale, fulfilling every requirement needed for exemption from the short sale price regulations. However, the customer cancelled the order.

(2) A financial instruments business operator received a VWAP order to sell a single stock or a basket of stocks, but the number of shares for each stock was quite small. Nonetheless, the firm made a principal short sale for hedging purposes.

(3) A financial instruments business operator agreed to fill a customer's sell order at the day's VWAP with its principal purchase, and it began to make a series of short sales for hedging purposes. The customer then instructed the firm to increase the number of shares, and the firm conducted more short selling after the instruction in order to reduce the risk involved in the increased number of shares.

(4) A financial instruments business operator agreed with a customer on a VWAP-guaranteed transaction to be effected outside the auction market, with the customer's instruction that there would be no decimal in the price. In this instance, the VWAP turned out to be 100.5 yen. To meet the customer's instructions, the firm arranges two transactions—one at 101 yen and the other at 100 yen (100.5 yen on average), and effects a short sale for hedging these transactions.

(5) A financial instruments business operator made a short sale to reduce the risk associated with a customer's VWAP sell order, the conditions of which (number of shares and/or price) depended on the market's condition (for example, excluding from the VWAP such portions executed by allotment if the price hits a daily price limit, etc.).

(6) Before a financial instruments business operator finished making a series of short sales to hedge the risk associated with the day's VWAP-guaranteed or VWAP-targeted sell order from a customer, it received from another customer an afternoon-trading-session VWAP-guaranteed buy order for the same stock. As the VWAP buy order matched the VWAP sell order, the short sale contracts that had been made by the financial instruments business operator by that time for hedging purposes became unnecessary.

(Answer)

(1) In the event that the customer cancelled his/her order, the short sale price regulations do not retrospectively apply to the short sales that had already been made by the financial instruments business operator for hedging purposes; provided that the firm has an internal management system to preserve the record of the customer's instruction to cancel the order. However, the most important thing is to raise awareness among employees so that they won't easily accept a request for cancellation without reasonable cause.

(2) As there are no specific provisions concerning the number of shares in VWAP sell orders, it is left to the judgment of the financial instruments business operator on a case-by-case basis whether the orders meet the conditions provided in Article 9-3, Item 1-19, and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions so that such orders may be treated as an exemption from the price regulations.

(3) When the customer's order is a VWAP-guaranteed sale order (as defined in Article 9-3, Item 1-19(a) of the Cabinet Office Order on Restrictions on Securities Transactions), the firm's short sale falls under an exemption from the short sale price regulations, if the total number of shares to be sold by the customer after the increase remains within the number of shares owned by the customer (excluding borrowed shares or shares for which delivery is uncertain).

On the other hand, when the customer's order is a VWAP-targeted sale order, the firm's short sales are considered to fall under an exemption from the regulations if the firm can effect hedging short sales (including those made to correct the number of shares) aimed at the VWAP; and if not, no exemption is applicable to the short sales including those made for corrective purpose. Even in this case, however, the short sale price regulations do not apply retrospectively to short sales that had already been made by the financial instruments business operator for hedging purposes; provided that the firm should manage the case properly, recording instructions to correct the number of shares.

(4) Even if the actual contract price outside the auction market cannot be exactly equivalent to the VWAP due to a customer's instruction, the firm's short sales to reduce the risk associated with filling the customer's order falls under an exemption from the short sale price regulations if the composite price derived from more than one transaction is equal to the VWAP. However, you should preserve a record of the contents of the transactions (i.e., the customer's VWAP-guaranteed order, the related hedging short sales and the actual contract executed outside the auction market), so that you can prove their particulars ex post facto.

(5) While there are no regulations that prevent a financial instruments business operator from making short sales with certain conditions to reduce the risk associated with a customer's VWAP order, the firm should see to it that the short

sales satisfy the requirements prescribed in Article 9-3, Item 1-19 of the Cabinet Office Order on Restrictions on Securities Transactions.

Meanwhile, the short sale in the example does not meet such requirements, and thus cannot be treated as an exemption from the short sale price regulations.

(6) Under the provisions of Article 9-3, Item 1-19 of the Cabinet Office Order on Restrictions on Securities Transactions, a financial instruments business operator cannot make exempted short sales for hedging purpose in excess of the number of shares to be bought by the customer. Nonetheless, the short sale price regulations do not apply retrospectively to such short sales that were made by a financial instruments business operator for hedging purpose but became unnecessary due to an unexpected matching order from another customer. In this instance, however, the firm should preserve a record of the fact that the hedging short sale became unnecessary, so that they can prove it ex post facto.

(Related Laws and/or Regulations)

- **Article 9-3 (Paragraph 1, Item 19) and Article 15 of the Cabinet Office Order on Restrictions on Securities Transactions**

IV-32 Reporting Obligations related to Short Position Balance

While one of our individual customers has been trading on margin, the balance of short position on margin exceeded 0.2% of the number of issued shares. The client doesn't have a margin transaction account with other brokers or dealers. In this case, is it necessary to report the short sale balance to the Exchange?

(Answer)

The balance of short sale in the reporting obligation is defined as figure (A) in the formula (A) = (B) – (C) below:

(A) = The balance subject to the reporting obligation

(B) = The total of all the short sale transactions conducted within or without the market

(C) = The balance of short sale transactions exempted from the price regulations, but limited to the number of securities or rights to own such securities that need to be obtained later to square the balance

As such, this transaction is subject to the reporting obligation for retail investors, if it meets both of the trading unit criteria (at least 50 units per transaction) and the criteria of the ratio of the short sale balance against the number of issued shares (at least 0.2%).

Thus, the reporting obligation is not for the entire outstanding short sale position.

(Related Laws and/or Regulations)

- **Articles 26-5 of the Order for Enforcement of the FIEA**
- **Article 15 (Items 2 and 3) of the Cabinet Office Order on Restrictions on Securities Transactions**

V. CASES RELATING TO LOW LATENCY TRADING

V-1 Definition of Low Latency Trading

How should we determine whether or not a customer's trading falls under Low Latency Trading (or High Speed Trading)?

(Answer)

Trading falls under Low Latency Trading (or High Speed Trading) if all of the following three conditions are met:

(1) Decisions on buying and selling securities or trading derivatives are made automatically by an electronic data processing system.

(2) The facility that accommodates said electronic data processing system is located in (or adjacent to/close to) a venue which accommodates the matching engine (trade execution system) of a financial instruments exchange or similar.

(3) The system has a mechanism that prevents transmissions of transaction or other data to the matching engine from competing with other transmissions.

Note that judgement on whether "Decisions… are made automatically by an electronic data processing system" is made regardless of the speed of decision-making or the degree of automation. The location of the electronic data processing system mentioned in (2) is not limited to the use of co-location services provided by the financial instruments exchange or similar. Note also that "adjacent to" and "close to" are defined based on physical distance between the electronic data processing system and the matching engine of the financial instruments exchange or similar. "A mechanism that prevents transmissions… from competing with other transmissions" can be for example, but not limited to, substantially exclusive possession of a virtual server or similar.

(Related Laws and/or Regulations)

- **Article 2 (Paragraph 41) of FIEA**
- **Article 26 of Cabinet Office Order on Definitions under Article 2 of the FIEA**

V-2 Rules that a trading participant must observe when accepting an order for Low Latency Trading

What rules must a trading participant observe when accepting an order for Low Latency Trading (or High-Speed Trading)?

(Answer)

When a trading participant accepts an order for Low Latency Trading (or High Speed Trading), said trading participant is required to confirm that the entity conducting said Low Latency Trading has filed notification of their virtual server, etc. and that they will comply with the rules of the exchange. Moreover, said trading participant is required to establish systems and frameworks to supervise order executions (i.e., to prevent unusual orders and detect such orders quickly, etc.) as well as systems and frameworks to manage communications (i.e., to prevent communications that will place excessive stress on the exchange and detect such communications quickly, etc.) It is also important to establish crisis-management systems and frameworks like a contingency plan.

The trading participant is also required to establish, among other things, management systems and frameworks that prevent acceptance of orders for Low Latency Trading from customers who are not registered as Low Latency Traders or are suspended from business operations pertaining to Low Latency Trading.

(Related Laws and/or Regulations)

- **Article 38 (Item 8) of FIEA**
- **Article 116-4 of Cabinet Office Order on Financial Instruments Business**
- **IV 3-2-3 of Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**
- **Rule 21-2 of TSE Trading Participant Regulations**
- **Rule 55 of TSE Brokerage Agreement Standards**
- **Rule 19-2 of OSE Trading Participant Regulations**
- **Rule 35 of OSE Brokerage Agreement Standards**

V-3 In the Case where a Financial Instruments Business Operator or similar Conducts Low Latency Trading on their Own Account

When a financial instruments business operator or similar conducts Low Latency Trading (or High-Speed Trading) on their own account, what actions will be required of them?

(Answer)

When a financial instruments business operator or similar conducts Low Latency Trading (or High-Speed Trading) on their own account, they are required to file, among other things, a notification to this effect (for example a business alteration notification for the addition of Low Latency Trading to business operations).

As is the case with management systems and frameworks required of Low Latency Traders (or High-Speed Traders), said financial instruments business operator must establish management systems and frameworks that prevent circumstances where it is deemed that oversight aimed at preventing hindrance of adequate fulfillment of the financial instruments market's functions is insufficient, due for example to unusual operations of an electronic data processing system. Specifically, financial instruments business operators and similar should pay attention to the focal points stipulated by III-2-1-2 of Guidelines for Supervision of High Speed Traders

(Related Laws and/or Regulations)

- **Article 2 (Paragraph 41), and Articles 29-2, 33-3, 60-2, and 66-57 of FIEA**
- **Article 40 (Paragraph 2) of FIEA**
- **Article 123 (Paragraph 1, Item 14) of Cabinet Office Order on Financial Instruments Business**
- **IV-3-2-1 (3) of Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**
- **III-2-1-2 of Guidelines for Supervision of High Speed Traders**
- **Rule 55 of TSE Brokerage Agreement Standards**
- **Rule 11 (Item 1-4) of TSE Enforcement Rules for Trading Participant Regulations**
- **Rule 35 of OSE Brokerage Agreement Standards**
- **Rule 5, (Paragraph 1, Item 1-4) of OSE Enforcement Rules of Regulations for Transaction Participants**

V-4 Obligation for Creating and Keeping Statutory Books

When a trading participant accepts orders from a Low Latency Trader (or High Speed Trader), what are the points of attention for preparing statutory books?

(Answer)

When a trading participant accepts an order for Low Latency Trading (or High Speed Trading), said trading participant is required to create an order slip and trading date ledger, etc. so that the order can be identified as that pertaining to Low Latency Trading.

Also, the order acceptance number and time stamp (the same number of digits as the time stamp that is communicated by the exchange, etc.) must be written on the order slip.

For the number of digits of the time stamp, please refer to the system interface specifications for the exchange's trading system.

(Related Laws and/or Regulations)

- **Article 158 (Paragraph 4), Article 159 (Paragraph 4), and Article 338 (Paragraphs 6 and 7) of the Cabinet Office Order on Financial Instruments Business**

V-5 Clarification of Trading Strategy

When a trading participant has accepted an order for Low Latency Trading (or High Speed Trading), what must said trading participant clarify to the Exchange when placing the order?

(Answer)

When conducting trading, a Low Latency Trader (or High Speed Trader) is required to make clear (a) whether or not such trading falls under Low Latency Trading and (b) if it is Low Latency Trading, the type of trading strategy. Trading strategies must be classified into one of the following four categories: (i) market-making, (ii) arbitrage, (iii) directional, and (iv) other.

Trading participants that accept such orders are advised to avoid reporting a Low Latency Trading strategy when it is clear that an order from a Low Latency Trader is not for Low Latency Trading. If the trading participant somehow becomes aware of a flagging error, for example by receiving a post-hoc notification from the customer, said trading participant is required to promptly file an amendment notification with the exchange.

(Related Laws and/or Regulations)

- **Rule 14 of TSE Business Regulations**
- **Rule 6 of TSE Brokerage Agreement Standards**
- **Rule 26 of OSE Business Regulations**
- **Rule 9 of OSE Brokerage Agreement Standards**

Ⅵ. CASES RELATING TO CORRECTION OF ERRORS

Ⅵ-1 Correction of Error Caused by Person Who Is Not in Charge of Order Routing

Our department specializes in accepting orders from financial instruments business operators that are not trading participants of TSE (hereinafter called "non-participant financial instruments business operator").

One day, we received from a non-participant financial instruments business operator an order to buy a stock, but the clerk in our department failed to forward it to the order-handling department. While we transmitted the order immediately after we found the mistake, the purchase order was executed at a higher price than the price instructed by the client company. We informed the client of our error as well as our willingness to make up the error by covering the difference on our account. However, the client insisted that we fill the order at the originally instructed price by filing an application for correcting the error with TSE.

Does TSE accept applications for correcting errors caused by a person who is not in charge of order routing/execution?

(Answer)

For errors that occurred at a department specializing in agency services for non-participant financial instruments business operators, TSE accepts applications for correction of errors as prescribed in Rule 41 of its Business Regulations. There are some conditions that must be met. The application must be accompanied by the relevant internal rules of the firm stating that the sole business of the department is to offer an agency service only to non-participant financial instruments business operators, or if there are no such provisions, by a document clearly stating to that effect (with the seal/signature of a person in an executive position). Also, other supporting materials, including a copy of the relevant order slip must be attached thereto.

In addition to such cases as mentioned in the above, since May 22, 2000 TSE has accepted applications for correcting errors caused by person(s) other than those in charge of order routing/execution (e.g., persons in charge of sales) due to unavoidable circumstances, on the following conditions:

(1) The application must be accompanied by (a) an application for approval of an off-auction transaction for correcting the error; (b) a document stating the reason for the transaction to correct the error; (c) a copy of the relevant order slip; (d) a document containing the reproduction of the taped conversation with the customer at the time of acceptance of the order (or the record of electronic communications with the customer, showing the customer's instructions); and (e) a document certifying that the person responsible for internal management and control*

(including an assistant to such person* or the head of the internal management and control department) has, after examination of the substance of the error, found no misconduct therein.

(2) The relevant part of the taped conversation with the customer at the time of acceptance of the order must be preserved for five years to be available at the TSE's request.

(3) The financial instruments business operator concerned is ready to obtain, upon request from TSE, a written statement from the customer concerning his/her instructions, which should be attached to the document mentioned in (1) (e) above.

Similar requirements are applicable for correction of an error caused by an erroneous notice to a customer with respect to the result of execution of his/her order. If such an erroneous notice has been made by a person in charge of reporting execution results to customers, an application for correcting the error may be made, only if the customer does not excuse the mistake, under such conditions that the application be accompanied by the reason in writing why the customer does not excuse it. Also the erroneous execution report made by the person in charge must be able to be confirmed in writing. If an erroneous execution report has been made by a salesperson, the requirements mentioned earlier must be met in addition to these conditions in applying to correct the error.

*As defined in the Rules Concerning Internal Administrators, Etc. of Association Members (No 13 of the JSDA Self-Regulatory Rules).

(Related Laws and/or Regulations)

- **Rule 41 of the TSE Business Regulations**

Ⅵ-2 Correction of Error due to Regular Client Non-Participant Financial Instruments Business Operator's Failure to Place Order

A non-participant financial instruments business operator that is our regular client for transactions in listed securities failed to place an order with us from its customer. The client requested us to cover its error by filing an Application for Correction of Error with TSE. Can we do this?

(Answer)

An Application for Correction of Error may be filed by a trading participant to correct an error caused by the trading participant, including an error made in the process of filling a customer's order. No application is accepted to correct an error committed by a customer.

In the above case, you cannot file an application since the non-participant financial instruments business operator is your client. Accordingly, you have no choice but to have the client company correct the error itself.

Ⅵ-3 Correction of Error Pertaining to Allotment of Shares of Stock Hitting Daily Price Limit

We received from a customer a market order to buy 5,000 shares of XYZ stock, and we immediately routed it to the TSE market. On that day, however, XYZ stock traded only at the closing price hitting an upper daily price limit, and the customer's order was partially filled by allotment in accordance with TSE rules*. While the customer received only 1,000 shares as a result of allotment, we mistakenly reported to him the number of shares as 2,000.

Can we correct the error by filing an Application for Correction of Error with TSE? If not, how should we correct the error?

*In the TSE market, if a price of a listed stock hits or remains on an upper or lower price limit at the close of the market with major order imbalance, the closing price may be determined by allocating to each bidding or offering trade participant at least one trading unit of the stock.

(Answer)

Including the above case, when it is obvious that an order that had been routed exactly in accordance with a customer's instructions was unable to be filled, you cannot correct an error, if any occur, with respect to the order by filing an application with TSE.

The best way to resolve this would be to explain the circumstances to the customer and persuade him to cancel the order. Should you fail to do so, you are obliged to fill the order through ToSTNeT or off the TSE market with customer's approval. In doing so, you should record a complete account of the occurrence so as not to invite suspicion of illegal compensation for losses to the customer.

Ⅵ-4 Correction of Error Caused by Erroneous Order Routing to Other Market

We received from a customer an order to buy 10,000 shares of XYZ stock at JPY 2,000 in the TSE market, but our order handler routed the order mistakenly to another financial instruments exchange. While the order was filled at JPY 2,000 as instructed, it would have been executed at JPY 1,900 if it had been routed to TSE.
How should we correct the error?

(Answer)

In this case, you can file with TSE an Application for Correction of Error, as the error was caused by your failure to route the order to the TSE market. Thus, you should make an application to TSE, and at the same time transfer the purchase contract made in the other financial instruments exchange to your own account.

Alternatively, you can transfer the purchase contract of 10,000 shares at ¥2,000 from the customer's account to a separate account for operational mistake recovery, and then execute a cross-trade for correction of the same amount of shares at ¥1,900 from the separate account to the customer's account.

* In cases where it results in a violation of the best execution obligation, an in-house operational mistake report must be filed separately with government authorities, etc.

(Related Laws and/or Regulations)

- **Articles 40-2 of FIEA**
- **Articles 16-6 of the Order for Enforcement of the FIEA**
- **Article 124 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-5 Transferability of Customer's Contract to Own Account, Which Was Made against Same Day Cash Collection Rule

We received from a customer an order to buy a newly listed stock, which was filled on the same day. Furthermore, we were aware that the stock was subject to the regulation requiring a financial instruments business operator to collect purchase money in cash from a customer placing an order to buy a stock on the day on which its initial price was to be determined. While we notified the customer to that effect in accepting the order, he failed to pay to us within the day.

In this situation, we intend to transfer the customer's contract to our own account. Would there be any problem with this?

(Answer)

A financial instruments business operator cannot undo a customer's contract, with which it made no error in the course of order acceptance/execution, by transferring the contract to its own account.

In your case, you explained to the customer the regulation under which he has to pay purchase money in cash on the same day of placing the order, and thus, you made no error. Accordingly, you cannot transfer the customer's contract to your own account under the excuse that it turned out to be a violation of the regulation.

You are advised to be careful when you receive orders to buy stock for which such regulations apply, particularly from a customer who has no cash deposit with you.

Ⅵ-6 Transfer of Customer's Contract to Own Account due to Erroneous Execution

We received from a customer a limit order to buy 500 shares of a stock at JPY 15,000 but erroneously routed it to the market as a market order. Consequently, while 300 shares were executed at the instructed price, the remaining 200 shares were filled at a price higher than JPY 15,000. We therefore intend to transfer the entire 500 shares to our own account.

Would this be all right?

(Answer)

Although you failed to route the order in accordance with the customer's instructions, 300 hundred shares turned out to be filled at JPY 15,000 as instructed. Accordingly, these 300 shares should belong to the customer, and thus should not be transferred to your own account.

As for the remaining 200 shares that were not executed in accordance with the customer's instructions, you can make up the error either by filing with TSE an Application for Correction of Error after transferring the contract to your own account or by following the procedure using the customer's separate account for accident recovery. (See IV-14)

If you choose the latter case, you may wonder whether you need to file an application for confirmation of accident. As the error has been caused by clerical mistake you do not have to file an application for confirmation of accident if (1) the amount of compensation does not exceed JPY 1,000,000, or if, (2) even in the event that the amount exceeds JPY 1,000,000, it is clear from the firm's books and records or the record of customer's instructions concerning the order that the compensation has resulted from an accident. In such cases you simply need to submit a report of the accident by the end of the following month. (See Note in bold letters in Ⅴ I-9.)

(Related Laws and/or Regulations)

- **Articles 118 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-7 Correction of Error Caused by Erroneous Report to Customer

We received from a customer an order to sell 20,000 shares of XYZ stock at JPY 1,000. As the price of XYZ stock kept declining after opening at JPY 1,000, we carelessly thought that only 10,000 shares had been filled and notified the customer to that effect. The customer then instructed us to lower the limit price to JPY 900 for the remaining 10,000 shares, and we executed in accordance therewith. When we checked after the market close, however, we found that the customer's order had been filled at JPY 1,000 in its entirety by the time of the (erroneous) report to the customer.

In this case, can we transfer the original sale contract of 10,000 shares made at JPY 1,000 to our own account?

(Answer)

No, you cannot do so, because the sale contract of 10,000 shares made at JPY 1,000 is a part of the customer's original order to sell 20,000 shares filled in accordance with his/her instructions. The contract at JPY 900 is considered to be made as a result of your misleading solicitation, because you induced and received a new order from the customer by giving him/her the wrong information, not correctly confirming the executed portion at the time of the report to him/her. Hence, it is natural to consider that routing the order to sell 10,000 shares at JPY 900 was an error.

In this case, you should give the customer full explanation of the error, transfer this erroneous contract at JPY 900 to the separate account for accident recovery, and sell the shares on the separate account. Should the amount of loss as a result of such sale exceed JPY 100,000, you must make an application for confirmation of the accident, etc.

However, should the customer ever insist for whatever reason on taking the contract made at JPY 900, you would be obliged to transfer the contract of 10,000 shares made at JPY 1,000 to the separate account for accident recovery and sell them on the account, with a complete record concerning the error and the process of correction thereof.

Ⅵ-8 Correction of Error Caused by Failure to Route Order and Application for Confirmation of Accident

We received from a customer an order to buy 1,000 shares of XYZ stock at JPY 3,000, but failed to route it to the TSE market.

While we routed the order on the next day, the XYZ stock was traded only at JPY 3,500*, the day's price limit, at which the customer's order was executed. As the order would have been filled at the instructed price if we had not failed to route it, we intend to compensate the customer for the JPY 500 difference. Are there any problems with this?

Also, should we file an application with the regulatory authority (through JSDA) for confirmation of the accident as it pertains to compensation?

*Japanese financial instruments exchanges have adopted the so-called “special quote system” to avoid sudden, sharp price changes in listed securities. In this system, in the event of a major imbalance between buy and sell orders, the financial instruments exchange posts a special bid or asked quote at a price level higher or lower than the last sale price to solicit counter orders. The level of the special quote is revised upward or downward until orders can be matched in accordance with trading rules of the financial instruments exchange.

(Answer)

There is no problem with compensating the customer for the difference in the above case, if you obtain his/her prior consent by fully explaining what you are going to do to make up your failure to route the order. You should enter a contract price as JPY 3,500 in the trade report et al., together with the amount of compensation to the customer. Were you to enter a contract price of JPY 3,000 in the trade report et al. without informing the customer of your failure and then settle the contract, the transaction is regarded as a violation of the duty of best execution.

When you make a correction of error by compensating the customer for the difference, you are required to file an application for confirmation of accident.

However, instead of compensating the customer for the difference, it is more common to use a “separate account for accident recovery” as a convenience-conscious method in tax calculation (By this, you can use the contract price as purchase money and sale money.). Firstly, you cancel the purchase contract at JPY 3,500 in the customer's principal account and re-create an order slip of the contract in the customer's separate account for accident recovery. Secondly, you make a transaction at JPY 3,000 between the separate account as bear side and the principal account as bull side. Thirdly, the financial instruments business operator bears the loss at the separate account. This method does not cause the problem mentioned above, which arises when you compensate the customer for the difference.

JSDA states in its circular to members that no application for confirmation of accident

is necessary for a correction of a clerical error made by the day immediately preceding the settlement day.

(Related Laws and/or Regulations)

- **Articles 40-2 of FIEA**
- **Articles 16-6 of the Order for Enforcement of the FIEA**
- **Article 124 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-9 Correction on Settlement Day of Error Caused by Erroneous Execution

We received from a customer an order to buy 1,000 shares of a stock but accidentally bought 2,000 shares by routing it to TSE market twice. We discovered the error on the settlement day. What procedures should we follow to correct the error?

(Answer)

If you had found the error on or before the day immediately preceding the settlement day, you would have been able to correct the error by transferring the mistakenly purchased 1,000 shares to your own account from the customer's account. Since the error was found on the settlement day, you must follow different procedures:

You need to make up the error by selling 1,000 shares, shouldering any loss resulting from the offsetting sale. All of these operations should be done on the customer's account (normally a separate account for accident recovery is used). Since the loss compensation has been caused by a clerical error, you do not have to file an application for confirmation of accident, if (1) the amount of compensation per day for each category of accident* does not exceed JPY 1,000,000, or if, (2) even in the event that the amount exceeds JPY 1,000,000, it is clear from the firm's books and records or the record of customer's instructions concerning the order that the compensation has resulted from an accident. In such cases you simply need to submit a report of the accident by the end of the following month. The application and the reporting should be made via JSDA.

***The amount of compensation to customers per day must be computed for each category of accident set forth in each Item of Article 118 of the Cabinet Office Order on Financial Instruments Business. In computation of the total of amount of compensation for customers' losses caused by clerical errors in execution of orders or erroneous execution of orders due to trouble in electronic and communications systems, the amount of compensation due to such error that can be identified clearly as an accident in the firm's books and records or the record of customer's instructions should be deducted from the total amount of compensation for each of the two categories.**

The correction procedure should be made to the following executed transaction.

(Related Laws and/or Regulations)

- **Articles 118 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-10 Correction of Error Caused by Failure to Confirm Customer's Instruction

We received from a customer a limit order to buy 1,000 shares of XYZ stock at JPY 500. Despite having been unable to hear the customer's instruction well, an error occurred due to a failure to confirm the name of the stock on the part of the person who took the call. He routed an order to buy WXY stock, the name of which sounded very similar to XYZ stock, and the order was executed at JPY 500. To correct the error, we transferred WXY stock to the customer's separate account for accident recovery, sold WXY stock on such account at JPY 490 to offset the erroneous purchase contract, and at the same time routed an order to buy 1,000 shares of XYZ stock at the market price, which was executed at JPY 550. Had the order been routed correctly at the time of the order acceptance it would have been executed at JPY 500, hence we made a transaction of XYZ stock at JPY 500 between the customer's separate account and principal account.

Accordingly, to compensate the customer, we intend to pay to him JPY 60,000, of which JPY 10,000 is the difference between the erroneous purchase and sale in WXY stock on the separate account and JPY 50,000 is the difference as a result of the transaction of XYZ stock between the separate account and the principal account. Our understanding is that in this case we do not have to make an application for confirmation of the accident, but simply submit a report of the accident by the end of the next month. Is this correct?

(Answer)

Including this case, you do not need to make an application for confirmation of accident if the total amount of compensation for customers' losses due to accidents under the same category does not exceed JPY 1,000,000. You simply are required to report these accidents to the regulatory authority through JSDA by the end of the following month. (See Note in bold letters in Question 5.)

However, if, in the above, the amount of compensation for the customer's losses was more than JPY 1,000,000, you would need to file an application for confirmation of accident.

(Related Laws and/or Regulations)

- **Articles 118 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-11 Correction of Error Caused by Inducement with Erroneous Information

We received from a customer a sell order on margin to initiate a new short position, and then filled it. While we tried to borrow the stock for the customer from the Japan Securities Finance Corporation, we found that the stock had been under suspension from lending, which we should have known about and told the customer at the time when he placed the order. When we informed him of our mistake, the customer blamed us for our failure to provide the information, and insisted that the order be cancelled.

In this case, can we transfer the customer's sale to our own account?

Also, a similar mistake took place when we gave a customer erroneous information in answering his inquiry about the number of shares he owned in our safekeeping. We told the customer that he owned 6,000 shares instead of 5,000, which was the correct number. Based on the wrong information, the customer placed an order to sell 6,000 shares, which was then filled. In this instance, can we transfer 1,000 shares to our own account?

(Answer)

When a stock has been suspended by a securities finance corporation from lending, a financial instruments business operator must notify its customers to that effect when it accepts an order to sell the stock short. In your case, you did not give the information to the customer at the time of acceptance of the order because you only became aware of the suspension when you attempted to borrow the stock from the Japan Securities Finance Corporation after you had filled the order. Regardless if you were aware of the suspension or not, such an act is considered an inducement with misleading/erroneous information—i.e., inducing a customer to trade by giving him/her misleading/erroneous information concerning terms of transactions.

Accordingly, you need to purchase the stock on the customer's account (normally a separate account for accident recovery is used) to offset his short position, and compensate the customer for any loss from these transactions. Should the amount of compensation exceed JPY 1,000,000, you must make an application for confirmation of the accident before you make compensation. If the amount is equal to or below JPY 1,000,000, you do not have to make such application, but simply submit a report on the incident by the end of the following month.

As for the second question, your actions in that case are also considered inducement with misleading/erroneous information, and thus you should follow similar procedures as in the above.

(Related Laws and/or Regulations)

- **Articles 118 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-12 Off-Exchange Transaction for Correction of Error Caused by Failure to Route Order

We received an order from a customer to buy 1,000 shares of XYZ stock at JPY 1,000, but failed to route it to the TSE market. Had we routed it to the market at the time of order acceptance, it would have been filled at the instructed price. When we discovered the mistake, however, the price of XYZ stock had risen to well above JPY 1,000, and thus we were unable to fill the order as instructed. While we know that the error can be corrected by filing an application with TSE, we would rather like to make up the error by filling the order by acting as principal outside the TSE market. Are there any problems with this?

(Answer)

If you have already prepared the Best Execution Policy which states that in cases where a customer separately gives you an instruction to execute his/her order at a specific market, such instruction has a priority over a financial instruments business operator's discretion, there is no problem in executing a customer's order based on his/her instruction. However, without a customer's instruction or consent, you cannot fill a customer's order by buying/selling for your own account outside the TSE market contrary to the Policy you delivered to the customer.

Accordingly, in the above case, it is advised that you take the following steps to avoid any violation of the law: You (1) inform the customer of the error, (2) ask him/her to cancel the order, (3) accept from him/her a new order with an instruction to execute it outside TSE on a dealer basis, and (4) fill the order as instructed.

(Related Laws and/or Regulations)

- **Articles 37-2 and 40-2 of FIEA**
- **Articles 16-6 of the Order for Enforcement of the FIEA**
- **Article 124 of the Cabinet Office Order on Financial Instruments Business**

Ⅵ-13 Correction of Error due to Erroneous Execution at Different Price (1)

We received from a customer a limit order to sell a stock at JPY 1,010, but mistakenly executed it at JPY 1,000 due to miss-input by our order-handler. We found the error after the close of the market, and informed the customer of our mistake. As the price of the stock showed an up-ward trend that day, the customer asked us to cancel the order and route it as a new order the next day. We therefore transferred the contract made at JPY 1,000 to our own account, and routed the order anew at JPY 1,010 on the next day as instructed. Fortunately, the order was filled at JPY 1,050.

While we know that we were able to correct the error by filing with TSE an Application for Correction of Error, would what we did in favor of the customer pose any problem?

(Answer)

While it is true that, as methods to correct an erroneous execution of a limit order at a price different from that instructed, you can either file with TSE an Application for Correction of Error pursuant to Rule 41 of TSE's Business Regulations or pay the customer the difference (if the action is taken by the day immediately preceding the settlement day), you cannot force either method on the customer. Because you failed to fill the order in accordance with the customer's instructions, the method of dealing with the error should be left to the customer's discretion.

In your case, while the execution price would have been JPY 1,010 had you corrected the error by filing an application, the action you took in favor of the customer does not seem to pose any problem.

Ⅵ-14 Correction of Error due to Erroneous Execution at Different Price (2)

We received an order from a customer to sell 1,000 shares of XYZ stock at JPY 455, but erroneously routed the order at JPY 445 and the order was executed at JPY 447. Next day the customer pointed out that the executed price was not correct, and we discovered the incorrect routing and execution of the order.

In such case, what procedures should we follow to correct the error?

(Answer)

In this case, such error is commonly corrected with the use of the separate account for accident recovery.

Firstly, you should cancel the sale contract at the wrong price of JPY 447 in the customer's principal account and re-create an order slip of the contract in the customer's separate account for accident recovery.

Secondly, you should make a transaction at the price at which the order would have been filled had the error not occurred between the separate account and the principal account as an execution of the customer's original order, because the order was correctly executed in name of issue, buy or sell and quantity other than price. The loss resulting from correction of the error shall be borne by the financial instruments business operator.

The cost of the loss in this case can be borne by the financial instruments business operator without the procedures of application for confirmation of accident, etc., because it is caused by a clerical error and the correction is made by the day immediately preceding the settlement day.

Ⅵ-15 Payment of Interest to Customer due to Correction of Error Caused by Erroneous Execution of Margin Purchase

We received from a customer an at-the-opening market order to purchase a stock on margin but mistakenly executed it as a sale. While we immediately re-routed the order, the purchase order was filled at a price that was JPY 100 higher than the opening price. Accordingly, we intend to transfer the erroneous sale contract to our own account and pay the difference (JPY 100) between the execution price and the opening price to the customer. In this instance, do we need to pay interest on the difference? Also, should we make an application for confirmation of accident?

(Answer)

Yes, you need to pay interest on the amount equivalent to JPY 100 X the number of shares purchased.

On the other hand, you do not have to file an application for confirmation of accident, as the purchase is considered a correction of an error that was effected before the settlement day.

Ⅵ-16 Preservation of Record of Errors

We understand that we are required to preserve a record of every error and correction thereof made in the process of filling customers' orders, with a complete account of each error and correction. What are the details that we should keep on record?

(Answer)

Correction of an error committed in the process of filling a customer's order may, if you fail to follow accurate procedures, lead to a violation of the law, including, among other things, a bucket shop operation or illegal compensation for losses. To avoid this, it is advisable that you have your compliance department fully check your correction procedures. You should also preserve in writing a complete account of each error and correction thereof in order to enable you to provide full explanation when inspected by the government and other regulators.

Details that should be kept on record differ in different cases, and thus there are no definite answers to this question. Nonetheless, it is best to preserve on record the following items: (1) the circumstances in which errors took place; (2) the cause of errors; and (3) actions taken to correct errors. Examples of these are as follows:

(1) Circumstances in which errors took place

Name (code number) of customer; name (code number) of department or section where the error occurred; name (code number) of person who handled the order; time and date when the order was accepted; time and date when the order was executed; time and date when the error was found; time and date when the error was reported to your compliance department/section; and so forth

(2) Cause of Errors

Mishearing of an order; erroneous entry on an order slip; erroneous input in order routing terminal with respect to name of issue, buy or sell, quantity, price or market; double order routing; failure to route; failure to cancel; failure to correct; error in customer's name (code number); and so forth.

(3) Actions Taken to Correct Errors

In addition to a full explanation of actions taken (e.g., transfer of transaction to own account; filing of Application for Correction of Error; off-exchange transaction; off-auction transaction; payment of difference), you should keep on record such matters as whether you filed confirmation of the accident, the amount of difference resulting from correction of error, time and date of correction of error, name of the person/department/section responsible for correction of error (e.g., stock trading department), and the name of the person/department/section responsible for authorizing correction of error (e.g., compliance department, treasury department).

Also, it is advisable that you attach to the record of errors copies of firm's books and records including the relevant order slip and transaction journal and at the same time

preserve the taped conversation you had with the customer at the time of accepting the order. This is so that you can use these items as evidences in case a dispute with the customer or regulatory inspector arises.

Ⅶ. CASES RELATING TO PREVENTION OF ERRONEOUS ORDER PLACEMENT

Ⅶ-1 Transactions, etc. Subject to Erroneous Order Prevention Rules

We believe the “Rules Concerning Order Management Systems at Trading Participants” (TSE or OSE) only apply to orders related to stocks, and do not apply to convertible bonds, derivative products, etc. Is this correct?

Additionally, we believe that these Regulations only apply to erroneous orders originating from a mistake on the side of the securities company and not erroneous orders originating from the side of the customer. Is this correct?

(Answer)

Rules such as “Rules Concerning Order Management Systems at Trading Participants” require the preparation of order management systems for all TSE-listed products for which trading participants can place orders, regardless of the frequency, etc. of orders. Particularly, there have been cases observed through compliance investigations where proper response had not been taken with regard to derivatives transactions such as stock price index futures trading and JGB futures trading, thus caution is required in these areas.

Additionally, the purpose of TSE's, OSE's, and TOCOM's rules is “to prevent the acceptance and placement of erroneous orders by trading participants” (Rule 1, Paragraph 2). However, such “erroneous orders” include mistakes on the side of the customer. In addition to verifying “details of the customer's order” and “information relating to the customer” when accepting customer orders at the trading participant (Rule 3), when placing such orders, “restrictions requiring prior approval for the placement of order in excess of a specified volume or value (soft limit)” (Rule 4, Paragraph 1, Item 2) must be applied. Thus, a management system which verifies order details, including cases where a mistake was made on the customer-side, is required.

Furthermore, these rules also apply to customer orders submitted through indirect means, such as the internet or DMA.

[Reference]

For cases in which orders are managed with only a hard limit by not implementing the soft limit, and instead setting the hard limit's conditions as the conditions for the soft limit, please refer to [VII-4].

(Related Laws and/or Regulations)

- **Rule 1 (Paragraph 2), Rule 3, and Rule 4 (Paragraph 1, Item 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 1 (Paragraph 2), Rule 3, and Rule 4 (Paragraph 1, Item 2) of OSE Rules Concerning Order Management Systems at Trading Participants**

- **Rule 1 (Paragraph 2), Rule 3, and Rule 4 (Paragraph 1, Item 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-2 Management related to Orders submitted through Indirect Means

Because orders submitted through indirect means, such as the Internet or DMA, are placed to the exchange market immediately through trading participants, what kind of management system should be set in place?

(Answer)

In rules such as “Rules Concerning Order Management Systems at Trading Participants”, implementation of a soft limit (Rule 4, Paragraph 1, Item 2 of TSE's, OSE's, and TOCOM's Rules) is required in order to enable trading participants to exclude erroneous orders. For orders placed through indirect means, such as the Internet, etc., it is assumed that the soft limit be implemented in the system through which customers place orders. However, in such a case, the display of a warning screen and proper setting of a cancellation method must be prepared, so that customers cannot easily release the soft limit and cause the placement of erroneous orders.

Additionally, in cases where this type of method is employed, customers placing orders through DMA are expected to make transactions on a large scale, which requires greater caution. Therefore, where customers place such orders, creation of a system of double checks on the customers' side by the person placing the order and another party will be required when such orders exceed the soft limit.

[Reference]

Please refer to [VII-4] for cases where the soft limit is not employed, and instead the hard limit conditions are set for the soft limit conditions, thus managing orders with only the hard limit.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1, Item 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 2) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-3 Self-Approval by Person-in-Charge of Soft-Limit Release Approval

In cases where the person responsible for approval related to the soft limit places orders exceeding the soft limit, is it acceptable for such person to conduct approval for his/her own orders?

(Answer)

In order to prevent erroneous orders, a double check must be conducted by a separate person when orders exceed the soft limit. Because of this, in this type of case, the confirmation of order details and approval must be conducted by a separate person with the authority of soft limit approval within the company, such as a person who such person-in-charge of approval has delegated with such authority.

(Related Laws and/or Regulations)

- **Rule 5 of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 5 of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 5 of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-4 Level of Ordering Restriction

What level is appropriate for the hard limit prescribed in Rule 4, Paragraph 1, Item 1 of the TSE and OSE “Rules Concerning Order Management Systems at Trading Participants” and the soft limit prescribed in Item 2 of the same rule? Can the Exchange tell us specific a level?

(Answer)

The hard limit is expected to be “set at a level where there is almost no possibility of occurrence as a regular order”, while the soft limit is expected to be “set at a level where there is sometimes, but not always, a possibility of occurrence.” Because these levels differ depending on the trading conditions of the trading participant, each trading participant must set the proper levels themselves.

Furthermore, even if the soft limit is set to the level of the hard limit and only the hard limit is used to manage orders, such setting and usage are not direct violations of such regulations. However, such limit must be properly set so that it is not excessive. Additionally, in such a case, because it is expected that orders will hit the hard limit with some frequency, careful measures are required as stated in [VII-6].

(Note)

Setting a hard limit or soft limit at a threshold level that is too permissive will be deemed to violate the rules of the Exchange, because such a limit cannot be expected to have an effect to prevent erroneous order placement on the Exchange. For example, setting a hard limit that is too wide in comparison with the past trading level, or a hard limit that is less strict than the order limit of the Exchange can be in violation the TSE rules.

(Related Laws and/or Regulations)

- **Rule 1 and Rule 4 of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 1 and Rule 4 of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 1 and Rule 4 of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-5 Alteration of Ordering Restriction

Is it acceptable to change the level of the hard limit or soft limit in response to changes in market conditions?

(Answer)

It is foreseeable that, depending market conditions, orders will begin reaching the soft limit with some frequency or will cease reaching the limit at all, and it will thus no longer properly function to prevent erroneous orders. Accordingly, it will be proper to flexibly alter the level of the soft limit in such a case.

The same will apply to the hard limit. However, it is not likely that the "**level where there is almost no possibility of occurrence as a regular order**" will frequently change. Thus, alteration of the hard limit should only be conducted with cautious deliberation.

(Related Laws and/or Regulations)

- **Rule 4 of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-6 Placement of Orders in Excess of the Hard Limit

In cases where orders are to be placed in excess of the hard limit, what areas require particular caution?

(Answer)

In cases where an order is to be placed in excess of the hard limit, it is expected that such order will be divided so that each of the divided orders do not reach the hard limit. Because particular caution is required when handling this type of large scale order, it is desirable that the method of dividing orders is confirmed with the compliance department and that such details will be recorded on the order slips, etc. in terms of proper internal management.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1, Item 1) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 1) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 1) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-7 Setting Ordering Restrictions on an Order Terminal

Are we required to set the hard limit and soft limit on every order placement terminal our company has?

(Answer)

The hard limit and soft limit must be set on every terminal which can place orders to the exchange market, including those used in case of malfunctions, and not just for terminals used to place orders during daily business.

Hard limits pertaining to orders placed on OSE and TOCOM must be set on order placement restriction systems that OSE and TOCOM provide to each trading participant.

In addition, if your company brokers orders from another securities company, and said securities company is able to change the ordering restriction settings, there is a chance that said securities company may change the settings without your company's permission. Therefore, it is necessary for your company to set the limits for the order-placement terminals that are used by any securities company that places orders through your company.

(Note)

Although the orders placed for off-auction trading are not subject to the rules of the Exchange, it is desirable to set proper limits or take other proper managerial measures for off-auction trading thinking of the impact of market trading.

(Related Laws and/or Regulations)

- **Rules 1 and 4 of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rules 1, 4, and 6 of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rules 1, 4, and 6 of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-8 Hard Limit and Advanced-Acceptance of Internet Orders

In cases where orders are accepted from customers via the Internet, we employ an Advanced-Acceptance system where orders cannot be placed in excess of the amount of cash and securities such customer has deposited with us. Can we treat this system as the hard limit?

(Answer)

The hard limit should be set based on a “level where there is almost no possibility of occurrence as a regular order”. It is possible for such level to be exceeded depending on the amount of cash and securities deposited by a customer. Thus, it cannot be said that, because an Advanced-Acceptance system is employed, a hard limit is not needed.

Furthermore, when a system is used which is not complete Advanced-Acceptance, such as a so-called “Deposited Asset Appraisal System” where an order placement restriction is set on the amount of orders possible based on the appraisal value of securities deposited by the customer, the need to separately establish a hard limit is even greater. Thus cautious deliberation is required in consideration of the actual number of orders able to be placed.

Similarly, just because a trading participant has a system in place to prevent the placement of an order to cover a position that exceeds the customer's position does not mean that it is unnecessary to set a hard limit.

(Related Laws and/or Regulations)

- **Rule 4 of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-9 Advanced-Acceptance System for Internet Orders and Confirmation of Customer Financial Resources

In cases where orders are accepted via the Internet, if a so-called Advanced-Acceptance system is employed, can it be treated as a means of confirming a customer's “financial resources” as prescribed in Rule 3, Item 1 of the “Rules Concerning Order Management Systems at Trading Participants”?

(Answer)

If a system is employed which prevents the placement of orders in excess of a customer's deposited cash, it can be thought of as confirming such customer's financial resources at the trading participant.

Furthermore, when the trading participant uses a system which is not complete Advanced-Acceptance, such as a so-called “Deposited Asset Appraisal System” where a restriction is set on the amount of orders to be placed based on the appraisal value of the customer's deposited securities, a confirmation system must be established for the customer, such as displaying the insufficient amount of purchase consideration on the order screen before a customer places an order.

(Related Laws and/or Regulations)

- **Rule 3 (Paragraph 1, Item 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 3 (Paragraph 1, Item 2) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 3 (Paragraph 1, Item 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-10 Management of Automatic Order Placement

Our company handles algorithmic trading (automatic order placement) whereby decisions on placement, alteration and cancellation of orders are made by a computer and those decisions are electronically transmitted to the exchange.

Our algorithmic trading does not run a high-frequency order placement strategy, so in terms of order placement management, what points do we have to pay attention to, other than restrictions on placement of one-shot orders?

(Answer)

In addition to the one-shot order restrictions, trading participants are required to perform the management that is necessary in order to prevent the placement of numerous suborders that result in the creation of a position or the placement of an order with an excessive quantity or amount.

When implementing such management, trading participants are not expected to comply with a uniform set of standards from each exchange. Instead, they must implement a form of order management that is appropriate to their line of business, size, customer attributes (e.g., financial resources, form of trading), and other circumstances.

When trading participants handle automatic order placement, they may consider setting restrictions on cumulative positions and on the number of orders that may be placed in a given period of time and their amounts. It is also important for trading participants to develop a system that allows them to prevent order placement or sever the connection in the event of an emergency.

In addition, it is also important for trading participants to establish a monitoring system that is in accordance with their business conditions and risks and that can promptly recognize the creation of excessive orders or positions. One way to do so is by implementing an alert function in the order placement system.

(Related Laws and/or Regulations)

- **Article 123 (Paragraph 1, Item 14) of Cabinet Office Order on Financial Instruments Business**
- **Rule 4 (Paragraph 1, Item 3) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 5-5 (Item 2) of OSE Enforcement Rules of Regulations for Transaction Participants**
- **Rule 4 (Paragraph 1, Item 3) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 3) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-11 Setting and Management of Cumulative Limits

Our company has a form of order placement that uses a simple algorithm that merely divides (slices up) the parent order into multiple smaller orders (child orders). Unlike the case of a complex algorithm, the occurrence of such things as unusual system performance is highly unlikely. Therefore, are we correct in assuming that it is unnecessary to have restrictions in place to prevent the placement of an order with an excessive quantity or amount?

(Answer)

Even a simple algorithm, such as one that slices up the parent order, may result in the placement of an order with an excessive quantity or amount if the parent order was mistakenly configured with an excessive value or if a bug or other problem resulting from a modification to the algorithm causes a series of child orders to be placed whose total quantity exceeds that of the parent order. Therefore, trading participants are required to have adequate restrictions on orders in place.

Each trading participant must examine the actual circumstances at their company and determine the appropriate methods of order management to adopt in order to prevent the placement of an order with an excessive quantity or amount. Such methods may include restrictions on such things as cumulative positions, the setting of limits on parent orders, restrictions on such things as the number of orders that may be placed in a given period of time and their amounts, or some combination thereof.

(Related Laws and/or Regulations)

- **Article 123 (Paragraph 1, Item 14) of Cabinet Office Order on Financial Instruments Business**
- **Rule 4 (Paragraph 1, Item 3) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 5-5 (Item 2) of OSE Enforcement Rules of Regulations for Transaction Participants**
- **Rule 4 (Paragraph 1, Item 3) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 3) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-12 Order Placement Prevention Function (1)

Our company has set soft and hard limits and has never experienced the placement of any unexpected or unusual orders, nor do we expect to experience any in the future. Besides the aforementioned limits, what other steps do we need to take to prevent the placement of an order to the exchange in the event of a malfunction in or other problem with the order placement system?

Also, is there any problem with manually triggering the order placement prevention function?

(Answer)

If an unexpected or unusual order occurs or is likely to occur due to the unusual performance of the system that is used by the customer or trading participant or due to some other reason, the trading participant is required to take immediate measures to prevent the placement of the order to the exchange. The measures that are required by each trading participant will vary depending on such things as customer attributes and forms of trading.

Trading participants are required to develop appropriate triggering criteria, triggering methods, and the scope for the order placement prevention function by considering such things as customer attributes and forms of trading at their company in addition to the circumstances under which unusual orders had occurred in the past.

They may also use the risk management functions that are provided by each exchange if they judge the functions to be sufficient in light of their risk management policies.

Trading participants may select a triggering method that is appropriate for their order placement prevention function according to customer attributes and forms of trading. The triggering method does not necessarily have to be automated.

Please note that even in the case of manual triggering, the triggering criteria and procedures must be developed as an in-house operation, and its effectiveness must be confirmed through periodic training.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1, Item 4) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 4) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 4) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-13 Order Placement Prevention Function (2)

We are considering adopting an order placement prevention function. We would like to use the function that is provided by the exchange's trading system because implementing it on our own system or a vendor's system would be costly. Is it safe to say that we have developed measures to prevent order placement if we use the risk management functions that are provided by each exchange, such as arrowhead's order suspension/cancellation request function (i.e., "kill switch")?

(Answer)

There is no problem in using the risk management functions that are provided by each exchange if they are judged to be sufficient in light of the trading participant's risk management approach. However, please note that the risk management functions that are provided by the exchange or third-party vendors are to be used at the trading participant's own risk.

In addition, as of November 2018 finer-tuned measures are required of trading participants who accept low-latency/high-frequency trades due to the inherent nature of that form of trading. The measures include inspections for the adequate management of low-latency/high-frequency trades.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1, Item 4) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 4) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 1, Item 4) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-14 Verifying the Adequacy of Ordering Restrictions

Each year our company regularly checks that the ordering restrictions that have been specified in our rules for order management have been configured adequately in each of our order placement systems. What other points should we take into consideration when conducting such checks?

(Answer)

Trading participants are required to ensure the effectiveness of their order management by conducting such things as regular internal inspections of the compliance of their order management systems. When conducting such things as these internal inspections, it is necessary for the ordering restrictions that have been specified in the company's internal rules to be configured correctly in each order placement system and for them to be configured effectively for all accounts that can place orders.

Because of this, it is important that any verification also takes into account the adequacy of the ordering restrictions and the comprehensiveness of their configuration.

When verifying the adequacy of the ordering restrictions, it is important to consider the level that is appropriate in light of such things as customer attributes and forms of trading in addition to past trading history and the prospective scale of trading.

(Related Laws and/or Regulations)

- **Rule 7 of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 7 of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 7 of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-15 Direct and Exclusive Control (1)

Our company has installed software on a system that our customer manages. The software has the risk-checking functions, such as ordering restrictions for order management, that we as a trading participant require. The customer signed agreements with us beforehand that it would not change any parameters without our permission, and we have put a mechanism in place to detect any changes. Does this constitute a method of direct and exclusive control?

(Answer)

The method that you have described (i.e., installing software, which has the risk-checking functions that you as a trading participant require, on a system that your customer manages and confirming that the settings and parameters have remained unchanged (including the case in which the customer has signed a contract or other agreement beforehand promising not to change the settings and parameters)) is considered one of indirect control. It is not considered one of direct and exclusive control because parameter changes cannot be detected in advance, and the appropriate risk checks may not be performed in the event of a malfunction in or other problem with the system that the customer manages.

The phrase "direct and exclusive" refers to a situation in which only the trading participant is able to control the functions (such as setting and changing risk parameters related to ordering restrictions), and the customer is not able to tamper with the settings or other controls.

For example, a trading participant may use a proprietary system that is physically independent from its customers, or it may use a risk-checking solution that has been provided by a third party (such as a vendor or the exchange), just as long as it has direct and exclusive control over said solution.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-16 Direct and Exclusive Control (2)

Our company uses a risk management function that has been provided by a vendor. What should we keep in mind when using this form of risk management?

(Answer)

When a trading participant uses a risk management function that has been provided by a third-party vendor, the vendor must be independent from the trading participant's customers, and the risk management function that the trading participant uses must be under its direct and exclusive control. Please note that independence from the customer shall be determined on a case-by-case basis by taking into account the overall ties between the customer and the vendor, including their capital and personal ties.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-17 Direct and Exclusive Control (3)

We are a trading participant, and our company accepts orders from our overseas offices. Is it necessary for us to manage their orders in a form that is physically independent from them?

(Answer)

With regard to a trading participant accepting orders from its overseas affiliates (i.e., "proprietary trading by the foreign affiliates of Japanese trading participants"), it is not necessarily required that the trading participant manage the affiliates' orders in a form that is physically independent from them, provided that a system is in place to appropriately implement the restrictions or measures that are listed in the items of Rule 4, Paragraph 1 of each exchange's Rules Concerning Order Management Systems at Trading Participants.

Please note that if the affiliate accepts orders from other customers, it is necessary that the implementation of restrictions or measures pertaining to those customers' orders is under the trading participant's direct and exclusive control.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-18 Direct and Exclusive Control (4)

In addition to the risk checks that are required by the rules of each exchange, our company has put several other risk checks, such as price limits, in place. Does "direct and exclusive control" also apply to all of the risk checks that a trading participant implements on its own?

(Answer)

"Direct and exclusive control" applies only to the risk checks that are listed in the "Rules Concerning Order Management Systems at Trading Participants" (e.g., one-shot order restrictions and restrictions to prevent the placement of numerous suborders that result in the placement of an order with an excessive quantity or amount).

Therefore, although the rules of each exchange do not mandate a direct and exclusive form of control over the risk checks that trading participants have established on their own or the risk checks (e.g., communications management) that are required by the HFT Checklist (i.e., the checklist to be submitted to each exchange when commencing low-latency/high-frequency trading activities), as a matter of course, trading participants are expected to take appropriate measures, such as using hardware that is physically independent from their customers to manage their own risk checks based on the risks that an indirect form of order management could pose.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 2) of TSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of OSE Rules Concerning Order Management Systems at Trading Participants**
- **Rule 4 (Paragraph 2) of TOCOM Detailed Rules Concerning Order Management Systems at Trading Participants**

Ⅶ-19 Prohibition of Forms of Order Management That Are Based on Such Things as Intentionally Erroneous Orders

Is a case that results in an erroneous order, such as a case that violates the short sale price restrictions, also considered an example of an inadequate form of order management?

(Answer)

Examples of inadequate forms of management are limited to those that are clearly intentional, such as the incorporation of a program that generates erroneous orders in the trading participant's system. Therefore, cases which result in an erroneous order, such as those that violate the short sale price restrictions or those of trading immediately after the initial price is determined for newly listed stocks, are excluded.

Forms of order management that are based on such things as intentionally erroneous orders have been prohibited in order to relieve the burden that is placed on the exchange's trading system by the placement of such orders and thus avoid the resulting impact on market stability. In light of this, each trading participant is required to develop a system for the effective management and control of orders that violate the ordering restriction thresholds or that contain invalid packets, such as by automatically refusing such orders or disconnecting as soon as they are received.

For instance, the following forms of management are considered to be inadequate methods of restricting order placement: a form that is based on a method in which an order is placed with an intentionally modified condition (e.g., setting the order quantity to zero or setting an order price that is beyond the price limit) that would obviously result in an error in the exchange's trading system and cause the order to be rejected (i.e., a "malformed order"), or a form that is based on a method in which a packet is rewritten in an invalid format that would cause the order to be invalidated (i.e., a "malformed packet").

Ⅷ. CASES RELATING TO TRADING SUPERVISION SYSTEMS

VIII-1 **Notes on Identification**

We use a market surveillance system to identify transactions that are subject to market surveillance. What should we look out for in order to make sure we don't miss any relevant transactions, and that our market surveillance is effective and based on realistic transaction data?

(Answer)

When identifying transactions subject to market surveillance, the market surveillance system must be sufficient to process all the relevant transaction data without fail. For example, if trading volume surges suddenly, the system may take more time than usual to process transaction data, so if trading participants finish processing the data without taking this into account, part of the transaction data may be omitted. Participants also must ensure that when data is incorporated from multiple order placement systems, a situation does not arise where data from one or more of those systems is omitted.

Identification logic and setting values also must be fully examined to ensure that transactions are adequately identified. For example, the partial cancellation of unexecuted orders (i.e., "corrections to reduce the quantities of orders") need to be identified as a form of spoofing, so please be aware of this when doing such things as using the market surveillance system to identify transactions that are subject to market surveillance.

All settings for market surveillance systems identifying transactions need to fit with the trading conditions of each trading participant. For instance, if a trading participant accepts orders for a type of trading in which orders are repeatedly placed within a short time frame, but identifies matching transactions by using a minute or second time stamp, a large number of unrelated transactions which were carried out in the same minute or second will be erroneously identified as matching. Also, when a trading participant accepts orders from many originating customers via foreign affiliate companies and identifies customers by each foreign affiliate company, some unrelated originating customers will be identified as related. By configuring identification settings that fit your own customer attributes and trading conditions, you can enable more in-depth market surveillance.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1, Item 1) of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-2 Changing Identification Criteria and Narrowing Down after Identification

When identifying transactions subject to market surveillance of the stock and other cash markets according to the criteria specified by the Exchange, the number of transactions identified is too large to result in effective market surveillance. In this case, is it possible to change the identification criteria and/or narrow down the number?

(Answer)

The Exchange's "Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading" provide minimum standards, but if your own identification criteria are reasonable enough to be able to obtain similar results as those obtained through customer surveillance using criteria based on the Exchange rules, you are permitted to change them and narrow down the number of identified transactions.

Whether or not the criteria are reasonable is dependent on various factors such as customer attributes and forms of order placement. As such, it is impossible to set unified standards. However, for example, if a large number of similar transactions from one customer are identified by the same identification key, it would be considered reasonable for a surveillance system to for example survey only a small sample of those similar transactions on a daily basis, as long as the trading participant has verified the transactions of said customer in detail and can confirm that the trading strategy said customer's trading is based on raises no issues.

Narrowing down the number after identification will require criteria that enable comprehensive analysis on each identification item. Therefore, using single criterion such as involvement ratio or price changes to narrow down the identification number is not considered reasonable.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1) of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-3 Market Manipulation and Artificial Price Formation

When carrying out order management for price formation, we conduct market surveillance to prevent market manipulation. What should we pay attention to?

(Answer)

Financial instruments business operators, etc. must take steps to ensure they do not fall into a situation in which their trading supervision is judged to be insufficient to prevent acceptance of orders such as those that may result in formation of a manipulative quotation not reflecting actual market status. As such, trading participants need to conduct sufficient market surveillance to prevent not only market manipulation but also artificial price formation.

Artificial price formation refers to trading objectively deemed to be artificially created and not reflect actual market status judging by trading conditions, even if the trade was not intended to solicit trading by other investors. It also includes trading that attempts to raise a stock price to increase the value of a held security.

For more information, refer to Japan Exchange Regulation (JPX-R) website: Guidelines Concerning the Prevention of Unfair Trading.

(Related Laws and/or Regulations)

- **Article 123 (Paragraph 1, Item 12) of the Cabinet Office Order on Financial Instruments Business**

VIII-4 Trading Supervision Systems for Derivatives Trading

We handle derivatives trading such as Nikkei 225 futures. What should we pay attention to when carrying out market surveillance?

(Answer)

In April 2020, rules were put into effect stipulating that trading participants must establish trading supervision systems for derivatives trading, but no clear numerical standards for identifying transactions had been provided. Therefore, trading participants are required to use OSE's "Guidelines for Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading (enacted on April 1, 2020)" and TOCOM's "Guidelines for Detailed Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading (enacted on January 1, 2023)" as a reference to establish such things as identification criteria to prevent unfair trading and conduct the necessary supervision according to such things as their customer attributes and forms of trading.

In addition, it is necessary for trading participants to pay attention to such things as the characteristics of derivatives trading, such as the fact that there may be incentives to manipulate not only the price of the derivatives themselves but also such things as their final settlement price (SQ price) and the fact that there may be incentives to manipulate the price of the underlying asset near an option's exercise price.

(Related Laws and/or Regulations)

- **Article 123 (Paragraph 1, Item 12) of the Cabinet Office Order on Financial Instruments Business**
- **OSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **TOCOM Detailed Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-5 Trading Supervision Systems for Proprietary Trading

We operate a dealing business. Should our market surveillance for our own proprietary trading use the same criteria as for brokerage trading?

(Answer)

Trading participants are required to make efforts to ensure fair price formation and smooth trading in the exchange market, so that the function of the Exchange as a financial instruments exchange market can be maintained and enhanced. They are expected to play the role of gatekeepers for the exchange market. As such, considering their role as gatekeepers, it is crucial to manage proprietary trading to ensure that trading participants do not hinder fair price formation, etc. through their own activities. Also, given the possible administrative disciplinary actions and reputational risks to proprietary traders from unfair trading such as market manipulation, it goes without saying that such traders need to develop adequate trading supervision systems to prevent unfair trading.

Accordingly, it is not sufficient for proprietary trading participants just to conduct market surveillance based on the same criteria as brokerage trading. They are expected to improve their compliance levels further, using various measures to improve identification criteria, categories for analysis, and trading supervision systems overall according to their own situations, in order to categorically prevent unfair trading .

(Related Laws and/or Regulations)

- **Rule 7 of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 7 of OSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 7 of TOCOM Detailed Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-6 When Receiving Explanation from Self-regulatory Organizations

We sometimes receive cautions from self-regulatory organizations concerning the possibility of illegal trading. How should we respond?

(Answer)

In the process of market surveillance at JPX-R, when trading by a certain customer constitutes a pattern of orders and executions that JPX-R judges may lead to a legal violation such as market manipulation in the future, JPX-R may caution the trading participant accepting such trades as an early warning.

When a trading participant receives such information, they should follow their own internal rules, etc. which should include re-verifying the transactions of said customers. Trading participants can also use this as an opportunity to confirm whether their own identification criteria, categories for analysis, and other trading supervision systems are effective.

VIII-7 Market Surveillance for Prevention of Insider Trading

What kind of market surveillance should we set up to prevent insider trading?

(Answer)

Identification criteria specified by the Exchange requires trading participants to conduct market surveillance by identifying customers who have carried out transactions before material facts or other information is published, and using trading patterns etc. to identify who among them can be suspected of having engaged in insider trading.

Trading participants are also required, when a customer has registered as an insider, to not only request an application form but also verify whether said customer conducted any trades around the time of publication of material information about their company. In addition, to prevent insider trading, it is useful to conduct market surveillance on trading conducted by customers whose trades coincide with publication of material facts or other information.

When trading participants find a possible example of insider trading as a result of conducting market surveillance, they need to submit their findings to the regulator and the self-regulatory organization.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 3) of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **TOCOM Detailed Rules on Insider Regulations for Electricity**

VIII-8 Market Surveillance Using AI

Is it acceptable to use Artificial Intelligence (AI) to conduct market surveillance?

(Answer)

Yes, it is acceptable to apply AI to market surveillance.

However, it is not the case that application of AI will simply reduce the necessary number of market surveillance staff. Failing to find an appropriate balance between humans and technology, leading to excessive dependence on that technology, may prevent you carrying out sufficient market surveillance. As such, in order to appropriately use technology without placing too much confidence in it, employees with in-depth knowledge of surveillance operations are indispensable.

Adopting AI also requires trading participants to implement cautionary measures such as confirming whether surveillance results obtained from AI are similar to the ones obtained from market surveillance based on Exchange criteria, not only at the time of AI adoption but also regularly afterwards.

Furthermore, when adopting AI, trading participants are required to operate the new system concurrently with the existing one, and after adoption, implement measures for business continuity planning so that market surveillance can continue in the event of an AI failure.

The market surveillance divisions of trading participants using AI still have a duty to explain their results, so for example, if they have to give a warning to a customer, they must be able to explain why the transactions in question were flagged.

VIII-9 Measures against Customers

Market surveillance has revealed a form of trading that may infringe laws and regulations. We want to issue a cautionary notice to the customer, but what kind of information should it include?

(Answer)

It needs to be sufficient so that the customer fully understands the specific problem with that form of trading. Accordingly, in order for the customer to share your understanding, it may be useful to provide information such as the issue name, time of trading and the type of trade, and explain in real terms how the market was affected, how the trade may violate laws or regulations, and what measures will be taken if no appropriate improvements are made, or if the same problem reoccurs. Having done this, you can take measures according to your internal rules. In the event of malicious transactions, or if no appropriate improvements are made after a cautionary notice was issued, you must take appropriate measures such as suspending order acceptance.

It is also important that measures such as issuance of cautionary notices should be consistent to all customers and among all market surveillance staff.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 2) of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 4 (Paragraph 2) of OSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 4 (Paragraph 2) of TOCOM Detailed Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-10 Preparing and Preserving Records

In terms of recording market surveillance and disciplinary measures, should we record anything other than whether or not there was a problem and the time when a measure was implemented?

(Answer)

All surveillance records are required to be kept unless the case clearly falls outside unfair trading. It is critical to record all information that can be used for verification later, allowing for consistency with internal and other rules. For market surveillance you need to record, for example, the date of market surveillance, attributes of the identified customer, the applicable timeframe, the issue name and identification criteria, the applicable market surveillance category, the results of surveillance and reason for selection, the name and title of the person in charge, and in the case that you have asked the customer for their explanation, their reply. For disciplinary measures, you need to record the date that measures were implemented, attributes of the customer subject to said measures, the applicable timeframe, the issue name, the reason for applying measures, the type of measures applied, the name and title of the person in charge, and so on.

Records of market surveillance and disciplinary measures need to be kept for five years. If you accept orders from online customers, their IP addresses need to be kept for three years.

(Related Laws and/or Regulations)

- **Rule 5 of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 5 of OSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 5 of TOCOM Detailed Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-11 Principles-Based Market Surveillance

Our company is finding it difficult to conduct appropriate market surveillance of the stock and other cash markets due to the large number of matches that would be identified if we applied the existing rules-based identification criteria. Is it possible to conduct market surveillance by changing the identification criteria and methods of analysis to ones that are not rules-based?

(Answer)

The fundamentals of conducting market surveillance consist of using the rules-based identification criteria to identify transactions of the customer that are subject to market surveillance and the rules-based categories for analysis to analyze said transactions. However, a trading participant may change the identification criteria and categories for analysis to ones that are more flexible if it takes such factors as its line of business and customer attributes into consideration and finds that it can obtain adequate market surveillance results by developing a trading supervision system that can respond to the risk of unfair trading occurring at the company and that can guarantee a certain level of effectiveness.

In order to conduct such principles-based market surveillance, it is necessary to have an adequately constructed and managed system in place for the constant refinement of such market surveillance.

In addition, in order to conduct such principles-based market surveillance, the market surveillance must be functioning effectively with regard to actual market transactions. Specifically, it is required that the person in charge of market surveillance understands both the circumstances behind the adoption of the identification criteria and methods of analysis as well as their contents, and that the identification criteria and methods of analysis can adequately identify and analyze the necessary forms of trading in the market where the market surveillance is actually conducted.

For details on the adoption of principle-based market surveillance, please refer to the "Guidelines for Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading (enacted on April 4, 2022)" that TSE has established, and if you have any questions, please contact our Market Surveillance & Compliance Department or Participants Examination & Inspection Department.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1) of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

VIII-12 Checking the Status of Data Linkage

We have decided to add a new order placement system in addition to our existing order placement system. What should we keep in mind in terms of market surveillance?

(Answer)

When adding an order placement system, please confirm that the order and execution data that is generated by the new order placement system is correctly linked to the system that performs market surveillance.

When changing the market surveillance system to a new system, please also carefully check that the same transaction data is correctly linked to both the old system and the new system and that the new system properly performs identification and other tasks.

Please also check the aforementioned data linkage and identification criteria when your company starts to carry a new product.

In addition, it is important to periodically check that the data is properly linked for both stock and derivatives transactions.

(Related Laws and/or Regulations)

- **Rule 4 (Paragraph 1) of TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**
- **Rule 4 (Paragraph 1) of OSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

Ⅸ. CASES RELATING TO TRADING REGULATIONS

Ⅸ-1 Regulations on Transactions in Newly Listed Stocks (1)

Could you specify the regulations that may be applied by TSE to transactions in a newly listed stock?

(Answer)

Regulations that TSE may apply to transactions in a newly listed stock include:

(1) Requirement for a trading participant to collect purchase money in cash on the day of purchase from customers who buy a newly listed stock on the day on which the initial price is determined for the stock; and

(2) Prohibition of trading participants' principal purchase of the newly listed stock at the time, or before, the initial price for the stock is determined.

The purchase-day collection requirement mentioned in (1) is applicable throughout the day on which the initial price of the newly listed stock is determined. Thus, for instance, even if an initial price is determined at 10:00 a.m. on the listing day, trading participants are required to collect purchase money on the same day from every customer who has bought the newly listed stock that day.

The prohibition of trading participants' purchase for their own account, on the other hand, is applied only to transactions for determining the initial price of a newly listed stock. Accordingly, trading participants may make principal purchases after the initial price is determined.

(Related Laws and/or Regulations)

- **Rule 1 (Items 7 and 8) of the Rules on Regulatory Measures Concerning Securities Trading, etc. or Its Brokerage**

Ⅸ-2 Regulations on Transactions in Newly Listed Stocks (2)

TSE, through its regulations on transactions in a newly listed stock, requires that a trading participant collect purchase money in cash on the day of purchase from a customer who buys a newly listed stock on the day on which the initial price is determined for the stock. In this case, is a bank check regarded as cash?

(Answer)

Under the regulations of TSE, the following are regarded as cash:

(1) Cash;

(2) Bank check;

(3) Money in the customer's account that can be appropriated for the purchase; and

(4) Money in the Money Reserve Fund that can be appropriated for the purchase.

It should be noted that cash so collected must be retained in the financial instruments business operator until the settlement day for payment for purchase of the newly listed stock, and thus cannot be withdrawn or appropriated for purchasing other securities

(Related Laws and/or Regulations)

- **Rule 1 (Item 7) of the Rules on Regulatory Measures Concerning Securities Trading, etc. or Its Brokerage**

Ⅸ-3 Collection of Cash from Non-Participant Financial Instruments Business Operator on Day of Purchase

TSE, through its regulations on transactions in a newly listed stock, requires that a trading participant collect purchase money in cash on the day of purchase from a customer who buys a newly-listed stock on the day on which the initial price is determined for the stock. In this case, suppose a customer is a non-participant financial instruments business operator that has placed its customer's order with us. Should we collect purchase money from the non-participant firm in accordance with the regulations even if we have confirmed that the non-participant firm has collected purchase money in cash from its customer?

(Answer)

Yes, you must collect purchase money in cash from the non-participant financial instruments business operator in accordance with the regulation, as the firm is a customer of your company.

(Related Laws and/or Regulations)

- **Rule 1 (Item 7) of the Rules on Regulatory Measures Concerning Securities Trading, etc. or Its Brokerage**

Ⅸ-4 Applicability of Purchase-day Collection Requirement for Margin transaction

TSE requires that a trading participant collect purchase money in cash on the day of purchase from a customer who buys a newly listed stock on the day on which the initial price is determined for the stock. Does this requirement apply also to a customer who buys a newly listed stock on margin? If yes, how should we handle it?

(Answer)

The purchase-day collection requirement is applicable with no exception to every customer who buys a newly listed stock on the day on which the initial price is determined for the stock. Accordingly, you should collect money in cash equivalent to the purchase value from the customer on the day of purchase aside from the margin deposit, even if he/she buys a newly listed stock on margin. Needless to say, you must tie up the cash collected on the day of purchase until the customer's delivery deadline (9:00 a.m. on the settlement date) to prevent him/her from appropriating it to other purposes (including margin deposit).

(Related Laws and/or Regulations)

- **Rule 1 (Item 7) of the Rules on Regulatory Measures Concerning Securities Trading, etc. or Its Brokerage**

Ⅸ-5 Day Trading of Stocks subject to Regulatory Measure

A customer used part of the cash he had deposited to buy a stock subject to a regulatory measure which required the purchase consideration to be delivered within the trading day. The stock price rose and he sold it on the same day. Can he go on to use the sales proceeds to buy other stocks?

(Answer)

The answer is yes. However, please note that cash used to buy a stock subject to the requirement for the purchase consideration to be delivered within the trading day cannot be used until the settlement date, and that since this is a case of day trading, if the purchase consideration for the initial trade is not allocated for settlement, it will be deemed a net settlement transaction, which is prohibited.

(Related Laws and/or Regulations)

- **Article 10 of the Cabinet Office Order on Transactions Prescribed in Article 161-2 of the FIEA and Security Deposits for the Transactions**
- **Rule 1 (Item 7) of the Rules on Regulatory Measures Concerning Securities Trading, etc. or Its Brokerage**

Ⅹ. CASES RELATING TO THE EXCHANGES' SYSTEMS

Ⅹ-1 Configuring and Modifying Such Things as Virtual Servers

We have outsourced the business of actually configuring and modifying our virtual servers and user IDs to a system vendor, and the only thing we do ourselves is handle the application to the exchange. Is this arrangement acceptable?

(Answer)

Trading participants are responsible for handling the applications for configuring and modifying such things as virtual servers. Therefore, they should take an active role in checking whether the application details (e.g., the IP address, port number, and other settings) that have been prepared by the system vendor are correct.

As we have advised you in the past after a failure of the exchange's trading system, please confirm that you are able to switch between multiple communication pathways in the event of a server or other failure in the exchange's trading system.

Ⅹ-2 Communications Management

What details should we be aware of when the order placement system communicates with the exchange's trading system?

(Answer)

In order to ensure the stable operation of the exchange's trading system and maintain the market's soundness, trading participants are required to adequately manage their communications so that it only consists of business-related messages and does not place an excessive load on the exchange's trading system.

Specifically, user-side applications are required to set restrictions on the number of retries in order to mitigate the communications load related to retry processing (e.g., login processing) when an error occurs.

In addition, in the event that an unauthorized communication (including one from the exchange) is detected, measures such as the immediate severing of the connection must be taken.

For more details on such things as items to observe when making a connection, please refer to each trading system's system interface requirements or specifications.

(Related Laws and/or Regulations)

- **Rule 77 (Paragraph 2) of TSE Business Regulations**
- **Rule 51 (Paragraph 2) of OSE Business Regulations**
- **III-2-8-(1)-(xi) of the Financial Services Agency (FSA) Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**

Ⅹ-3 Response to a System Failure in the Exchange's Trading System

As a trading participant, what should we keep in mind in the event of a system failure in the exchange's trading system?

(Answer)

As a general rule, brokerage orders are still valid even when bids and offers have been canceled due to a system failure in the exchange's trading system. Because of this, it is important to arrange a policy for responding to such an event beforehand and decide first and foremost whether you will make any bids and offers again after such an event has occurred. Please note that if you decide not to place such orders again, you are required to inform your customers of this in advance.

It is also important to have an effective contingency plan and work procedures in place, to clarify and prepare the system-related responses that you as a trading participant will take, and to participate in the training that is conducted by the exchange and system vendors and verify the measures that your company has in place.

(Related Laws and/or Regulations)

- **Rules 8 and 9 of TSE Brokerage Agreement Standards**
- **Rules 11 and 11-2 of OSE Brokerage Agreement Standards**
- **III-2-8-(1)-(ix)-C of the Financial Services Agency (FSA) Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**

Ⅹ-4 Management of the Customers' Order Placement Systems

In addition to the systems that our company develops and manages ourselves and the order placement systems that we outsource to system vendors, we also have systems whose software (e.g., algorithms) is managed by our customers directly. In a case like this, what should we keep in mind?

(Answer)

Systems that trading participants develop and manage themselves, order placement systems that are outsourced to system vendors, and systems that have customer-managed software are all systems that trading participants use to place orders with the exchange. Therefore, trading participants are required to do such things as conduct checks and provide guidance with due consideration to system risk management, including cybersecurity management and system development/operation management.

Specifically, trading participants should check the status of their customers' system risk management, such as their cybersecurity management, and conduct risk assessments by questionnaire or some other method. At the same time, they should develop a system to enable the identification of such things as changes in the management status and encourage customers to take actions as needed.

(Related Laws and/or Regulations)

- **III-2-8-(1)-(v) of the Financial Services Agency (FSA) Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**

Ⅹ-5 Computer System Failure Report

When are we required to submit a computer system failure report?

(Answer)

After you have become aware of a system failure in connection with the system that you use to trade on the TSE, OSE, or TOCOM markets and have submitted a "Report on Problem Occurrence, etc." to the authorities (i.e., when the system failure falls under "Computer System Trouble Subject to Reporting to the Authorities" as defined in Financial Services Agency (FSA) Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.), you must submit a computer system failure report to the relevant exchange. In addition, please submit a computer system failure report if a cyberattack has been announced or detected, and it would affect or would be likely to affect customers and business operations, even when no actual failure has occurred.

However, you do not need to submit a computer system failure report when the system failure is unrelated to trading or other activities on the TSE, OSE, or TOCOM markets.

(Related Laws and/or Regulations)

- **Rule 18 of TSE Trading Participant Regulations**
- **Rule 11 (Item 26-3) of TSE Enforcement Rules for Trading Participant Regulations**
- **Rule 16 (Paragraph 1) of OSE Trading Participant Regulations**
- **Rule 5 (Paragraph 1, Item 25) of OSE Enforcement Rules of Regulations for Transaction Participants**
- **Rule 141 (Item 20) of TOCOM Market Rules**
- **III-2-8-(1)-(xi)-E and G of the Financial Services Agency (FSA) Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**
- **III-2-8-(3)-(i) of the Financial Services Agency (FSA) Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**

Ⅺ. OTHER CASES

Ⅺ-1 Employment of Information Technology in Maintenance of Customer Information

Our company is considering computerization of the existing paper-based maintenance of customer information, which we find not only inefficient in correcting or revising customer information but also an obstacle to centralization of customer information at our headquarters. Is there anything we should be aware of in employing information technology for maintenance of customer information?

(Answer)

Preparing and storing customer information by means of electromagnetic method is allowed by Article 5, Paragraph 3 of the Regulations Concerning Solicitation for Investments and Management of Customers by Association Members of JSDA. According to JSDA's notice, it is considered that such method has to meet the following requirements:

(1) All customer information set forth in the Regulation must be preserved in the electronic system and retrievable on the screen at any time.

(2) Data must be stored in duplication.

(3) The system must be capable of reproducing customer data in a printed form when requested by the Securities and Exchange Surveillance Commission for inspection.

***Article 5 (Maintenance, etc. of Customer Cards) of the Regulations Concerning Solicitation for Investments and Management of Customers by Association Members requires that a customer card contain the following items:**

(1) Name
(2) Address or location and place of contact;
(3) Date of birth (limited to the case where a customer is an individual. The same shall apply to the next item.);
(4) Occupation;
(5) Purpose of investment;
(6) Financial position
(7) Experience in making investments in securities;
(8) Type of transaction;
(9) Motive behind becoming a customer of an Association member; and
(10) Other matters deemed necessary by each Association member.

Ⅺ-2 Confirmation of Customer's Identity

Our company has no office in the Kansai area but happens to have a customer residing there. He opened an account with us decades ago. Since then, his customer information has not been rechecked.

Originally, the customer followed a long-term investment policy, and thus rarely participated in short term trading. During the most recent six months, however, he has increased his stock trading activity, repeatedly buying today and selling tomorrow, and as a result, a substantial amount of money has frequently been paid in to and out of his account.

Should we confirm the customer's identity in such circumstance? If yes, how should we do so?

(Answer)

You need to meet with the customer and recheck the customer's identity as soon as possible in order to confirm whether the recent trading activities originated from the customer himself, given that you have found a dramatic change in his investment policy and trading activity without personally meeting the customer or reconfirming the customer's information for an extended period of time.

The manager and person in charge of the customer should visit the customer together to renew the customer card by rechecking information (investment policy etc.) about him. At the same time, you should show him his trading record for the recent year to confirm whether orders on the record actually originated with him.

Furthermore, you should have taken adequate actions, such as meeting with the customer, in a timely and appropriate manner before this situation developed, in order to correctly grasp the trading activities of the customer.

(Related Laws and/or Regulations)

- **Article 4 of Act on Prevention of Transfer of Criminal Proceeds**

Ⅺ-3 Personal Investment by Officer/Employee of Financial Instruments Business Operator

What should we, a financial instruments business operator, pay attention to when we allow our officers/employees to conduct personal investments by opening accounts at other financial instruments business operators?

(Answer)

When allowing officers/employees of financial instruments business operators to trade by opening accounts at other financial instruments business operators, in order to prevent unfair trading such as insider trading and transactions exclusively aimed at speculative profits, you need to put in place effective procedures according to your line of business, organization structure, and staff allocation, and to appropriately manage the matter without relying on the procedures of the other operators.

Please note that the revised rules of JSDA and each exchange (as of August 1, 2017) prohibit employees of securities firms from placing orders with other brokers.

(Related Laws and/or Regulations)

- **Article 4 (Item 2) of Rules Concerning Sale and Purchase, etc. of Specified Securities, etc. of Listed Companies, etc. by Employees of Association Members of JSDA**
- **The view stated in Article 4 of Rules Concerning Sale and Purchase, etc. of Specified Securities, etc. of Listed Companies, etc. by Employees of Association Members of JSDA.**

Ⅺ-4 Settlement of When-issued Transaction

How can we handle a situation where a customer holding a short position in a when-issued transaction is unable to deliver new shares on the settlement day?

In accordance with our policy related to when-issued transactions, we inform customers of their settlement schedules and check which settlement method they intend to take, offsetting transaction or actual delivery of new shares.

(Answer)

For settlement of a when-issued transaction, you cannot deliver old shares or fail to deliver. Therefore, you have no choice but to have the customer somehow obtain the new shares or, if the customer is unable to do so, you must borrow new shares on his/her behalf by the settlement day. Therefore, you should be careful about a customer's short position in a when-issued transaction.

Please also note that a customer can opt to close his/her short position pertaining to when-issued transactions by an offsetting transaction until the day before the settlement day.

(Related Laws and/or Regulations)

- **Rule 64 of the JSCC Business Regulations**

Ⅺ-5 Margin Pertaining to When-issued Transaction

A customer bought XYZ stock in a when-issued transaction. Unfortunately, the price of the stock declined thereafter, and as a result, his margin deposit rate fell below 20%. In this case, should we request the customer to make an additional margin deposit to bring the rate back to 20%?

(Answer)

Security deposit requirements for when-issued transactions are slightly different from those for margin transactions, and the above case is a typical example of this - bringing the deposit rate (hereafter "margin maintenance rate") back to 20%.

For margin transactions, when the customer's margin maintenance rate falls below the minimum requirement of 20%, the customer must make an additional margin deposit to bring the rate back to 20% by the second business day after the margin deficiency occurred. In contrast, for when-issued transactions, the customer must make an additional margin deposit to bring the rate up to 30% by the same deadline. If the customer fails to do so, it is deemed to be a violation of the margin requirements for when-issued transactions.

The following are other security deposit requirements for when-issued transactions that are different from those for margin transactions:

(1) A margin deposit is required for a net long or short position held by the same customer in the same issue (i.e., no margin is required for a number of shares in a customer's long position in a certain issue that can be matched by an equal number of shares in his/her short position of the same issue, and vice versa.).

(2) If a customer requests the return of margin for his/her long and short positions that match each other as described above, margin for the matched long and short positions shall be returned after deducting therefrom any unrealized loss on such long and short positions.

(Related Laws and/or Regulations)

- **Rules 31, 37, and 38 of the TSE Brokerage Agreement Standards**

XI-6 Principal Purchase during Stabilizing Transaction Period

We mistakenly executed a customer's order to buy a stock twice and responded by transferring the erroneous extra contract to our own account on the same day. However, immediately after this, we realized that the stock was in a stabilization transaction period. Is there any exceptional treatment for the purchase transaction for our own account in such circumstances?

(Answer)

The trading participant in the above case is eligible for Rule 67 of TSE's Business Regulations which is applied to "purchases made by the trading participant to correct an internal error committed in the course of executing a customer's order that the Exchange deems to be for a truly unavoidable reason," as an exception from the restrictions on purchases of such stock during the stabilization transaction period.

Such trading participant must seek approval of TSE by filing an "Application for Approval on Principal Purchase Pursuant to Rule 67, Item 2 of the Business Regulations," attaching with it a form "Reason for Principal Purchase" which states necessary items.

TSE decides whether to grant approval after examining each case based on the "Application" and the "Reason".

(Related Laws and/or Regulations)

- **Article 117 (Paragraph 1, Item 22) of the Cabinet Office Order on Financial Instruments Business**
- **Rule 67 (Item 2) of the TSE Business Regulations**

Ⅺ-7 Display Obligation in Cases where a Stabilizing Transaction was Conducted

A stabilizing transaction notice has been issued by TSE, and we believe there is a high probability that stabilizing transactions will be conducted for the issues which entered the stabilizing transaction period. Because we already communicate such facts to customers as part of our operations, we think that no further action is required. Is this understanding correct?

(Answer)

What TSE's regulations ask is not that trading participants indicate that issues have entered into a stabilizing transaction period, but to display to customers who will place buy orders that stabilizing transactions have been conducted for such issue. In cases where stabilizing transactions have been conducted at TSE, trading participants will be notified simultaneously via such means as fax of an “Acceptance of Stabilizing Transaction Notification (Copy)” and TSE's TARGET. After confirming the details of such notification, your company must notify relevant customers and employees of such details with no exceptions. From the perspective of investor protection, all relevant customers must be informed that stabilizing transactions are being conducted, thus this is not limited to face-to-face transactions but also applies to non-face-to-face transactions such as those conducted through the Internet, DMA, etc.

(Related Laws and/or Regulations)

- **Rule 7 (Item 2) of TSE Rules Regarding Just and Equitable Principles of Trade**

Ⅺ-8 Use of Customer's Purchase Money for Other Purpose Until Settlement Day

A customer paid his purchase money to us on the day of contract. Would it cause any problem if we used the money for margin for his trading in equity options until the settlement day?

(Answer)

Unless the customer instructs you to do so, you cannot use his purchase money for margin for his trading in equity options.

Also, if your company's internal rules require prior collection of purchase money or securities to be sold, it would be a violation of those rules, even if your customer instructs you to use the money that way.

Ⅺ-9 Entry in Transaction Journal

Is there any difference in entry in a transaction journal between off-exchange transactions and exchange transactions?

(Answer)

You do not have to make an entry of the name and address of your counter party for an exchange transaction, while you must do so for an off-exchange transaction. In addition, in the case of an off-exchange transaction, you are required to make an entry of the date on which delivery has actually been made.

(Related Laws and/or Regulations)

- **Article 159 of the Cabinet Office Order on Financial Instruments Business**

Ⅺ-10 Off-Exchange VWAP Order Executed at Better Price than Closing Price

We received an order from an institutional customer to buy XYZ stock off exchange after the close of the TSE auction market for the day. We agreed with the customer that the order be executed in the TSE auction market during the day, and that the actual contract price be the volume weighted average of the execution prices (VWAP), to be confirmed after the close of the auction market.

We filled the order in the auction market accordingly, and as a result, our VWAP happened to be far better than the day's closing price of XYZ stock. In a case such as this, would it be perceived that we have delivered tangible benefits to a customer, which is prohibited by law?

(Answer)

In the above case, you filled the customer's order at your VWAP (although you likely tried to replicate the day's VWAP) in accordance with a prior agreement with the customer. There seems to be no room for you to choose a better price for him/her between your VWAP and the closing price of XYZ stock after the close of the TSE auction market. Accordingly, there would be no problem with your trade with regard to delivering tangible benefits to a customer.

(Related Laws and/or Regulations)

- **Article 39 of FIEA**

Ⅺ-11 Internal Allocation of Shares of Stock Hitting Daily Price Limit

We received orders from some customers to buy XYZ stock. On that day XYZ stock traded only at the closing price, its upper daily price limit, and their orders in total were partially filled by stop allotment in accordance with TSE rules. As a result, we were unable to satisfy each customer's order in full. In this case, how should we allocate the limited number of shares to each customer?

Also, is there anything we should be aware of in allocation, particularly in cases where the partially filled orders include an order for our own account in addition to those on the accounts of the customers?

(Answer)

Each financial instruments business operator needs to adopt rules governing internal allocation of shares to customers in cases where the firm's orders in total have been partially filled in the TSE market at the daily price fluctuation limit. The internal rules must be enforced to ensure fair and equitable allocation without room for arbitrariness. Moreover, in light of this, it is necessary to establish rules in advance for cases where agency and principal orders compete for allocation.

Ⅺ-12 Front Running

We received from a customer an order to buy a listed stock in off-auction trading. Since we did not hold such stock on hand, we bought the stock in auction trading for our own account. Then we sold the same to the customer in the off-auction market after the close of the auction market at a price on which we had agreed. In this case, would our purchase in the auction market be a violation of the prohibition on front running?

(Answer)

No, your principal purchase in the above case is not considered a violation of the regulation to prohibit front running. The reason is that the price at which the customer's order was to be filled was not decided at the time when you received the order.

Had the price been decided then, however, your principal purchase might well be considered a violation of the regulation.

(Related Laws and/or Regulations)

- **Article 117 (Paragraph 1, Item 10) of the Cabinet Office Order on Financial Instruments Business**

Ⅺ-13 Acceptance of CD Order (1)

On condition that it has developed adequate internal control systems, the law permits a financial instruments business operator to accept both an order to sell XYZ stock at the market and, at the same time, an order to buy as many shares of ABC stock, also at the market, that the proceeds from the sale of XYZ stock allow. If we accept both an order to buy 5,000 shares of XYZ stock at JPY 2,000 and, at the same time, an order to sell a sufficient number of ABC stock at as high a price as possible to cover the purchase price of XYZ stock, would it also be exempted from the restriction?

(Answer)

If a financial instruments business operator obtains prior consent through an agreement with its customer that allows the firm to determine, at its own discretion, either the quantity of securities in or the price for a transaction, in addition to the distinction of whether to sell or buy, the issue of security and the total amount of sales proceeds to be obtained from the sale (or the total amount of money to be put into the purchase), such a situation would be covered under Article 123, Item 3 (c) of the Cabinet Office Order on Financial Instruments Business, and thus is allowed for financial instruments business operators to accept, on condition that the firm has developed adequate internal control systems to prevent neglect of investor protection and prejudice of fair trading, etc..

Therefore, under Article 123, Item 3 (c) of the Cabinet Office Order on Financial Instruments Business, you can accept the order to sell a sufficient number of ABC stock at as high a price as possible to cover the purchase price of XYZ stock, as you have received from the customer not only instructions that the amount of proceeds obtained from the sale should correspond to the amount of money used to purchase a set number of XYZ shares at a set price, but also instructions that the execution price be “as high as possible” (what is called a “CD order”).

In addition, you need to explain the customer that your acceptance of the order does not assure him of its execution and he may get low on purchase money to buy sufficient shares.

(Related Laws and/or Regulations)

- **Article 123 (Paragraph 1, Item 13) of the Cabinet Office Order on Financial Instruments Business**
- **IV 3-1-3 of Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.**

Ⅺ-14 Acceptance of CD Order (2)

On Monday, we received from a customer a limit order to "buy, within the week, up to JPY 500 million as many shares of XYZ stock as possible at JPY 1,000."

Would accepting such an order be considered a violation of the restrictions on discretionary trade accounts?

(Answer)

You can accept from a customer such instruction as "buy as many shares at JPY 1,000 of XYZ stock as possible, up to JPY 500 million (leaving the actual number of shares to be bought to your discretion)" on condition that the financial instruments business operator has developed adequate internal control systems to prevent neglect of investor protection and prejudice of fair trading, etc., under the provision of Article 123, Item 13(c) of the Cabinet Office Order on Financial Instruments Business. Also, you have received clear instructions from the customer that the order remain good throughout the week. This satisfies the requirement concerning instructions as to the effective period of order, as stipulated in Rule 6, Paragraph 1, Item (7) of the TSE Brokerage Agreement Standards. Accordingly, there is no problem in accepting the above order, on the premise that your internal control systems have already been prepared. In such cases, it is advised that you do not forget to clearly enter the effective period of the order on the order slip.

(Related Laws and/or Regulations)

- **Article 123 (Paragraph 1, Item 13) of the Cabinet Office Order on Financial Instruments Business**
- **Rule 6 (Paragraph 1, Item 7) of the TSE Brokerage Agreement Standards**

Ⅺ-15 Fill or Kill Order

One of our customers placed an order with us to buy 100,000 shares of A stock in the auction market of TSE, with the condition that if the order is not executed in full amount, it should be cancelled completely (a fill or kill order). Can we accept such an order?

(Answer)

Acceptance of a fill or kill order often entails a substantial risk for the financial instruments business operator; should the order not be executed in full, the financial instruments business operator is compelled to transfer the executed portion to its own account, leaving the financial instruments business operator to assume the trading risk that should be shouldered by the customer. This is not appropriate when considering the fairness of trades. Accordingly, financial instruments business operators should not accept such orders.

(Related Laws and/or Regulations)

- **Rule 3 (Item 5) of the TSE Rules Regarding Just and Equitable Principles of Trade**

Ⅺ-16 Execution of a Cross Order

When a customer places cross orders (simultaneously place an order to close and another to initiate a margin position in the same stock) with us to roll his existing standardized margin position in a certain issue, what should be considered?

(Answer)

This is a typical case of executing opposing transactions of sales and purchases for a single account. The execution of this kind of transaction during a continuous auction session requires proper attention to check whether it is unfair trading in terms of its impact on aspects including price formation in the market. You should avoid readily accepting such orders, and respond carefully after considering various options such as using ToSTNeT, and placing and executing both market buy and sell orders at the opening auction, in order to avoid unnecessary impact on pricing in the market. At the same time, please appropriately manage and monitor the transactions of such customers in the course of your daily surveillance operations.

(Related Laws and/or Regulations)

- **Article 117 (Paragraph 1, Item 20) and Article 123 (Paragraph 1, Item 12) of the Cabinet Office Order on Financial Instruments Business**
- **Rules 2 through 5 of the TSE Rules Concerning Trading Supervision Systems at Trading Participants to Prevent Unfair Trading**

Ⅺ-17 Deposit of Margin for Futures/Options Contracts

Customer A has deposited securities equivalent to JPY 1.5 million as margin for futures and options contracts (substituted for price of JPY 1.05 million, actual required margin is JPY 0.8 million) with us.

We will deposit substitute margin with JSCC, but how much do we need to deposit? (*Without reference to the amount of cash the customer is supposed to receive or pay.)

(1) The required amount of margin: JPY 0.8 million

(2) The substituted price of securities that the customer deposited: JPY 1.05 million

(3) The market value of securities deposited by the customer: JPY 1.5 million

(Answer)

(3) The market value of securities deposited by the customer: JPY 1.5 million.

You need to deposit clearing margin with JSCC in your own cash or securities at a market value of JPY 1.5 million or more.

Even if you are not a clearing participant of JSCC, you need to deposit margin through a trading participant with the same value as (3).

In the event that the amount submitted as clearing margin or deposited as brokerage margin etc. by customer A is less than the required amount of margin of said customer, you will need to deposit the deficit or more with JSCC.

(Related Laws and/or Regulations)

- **Articles 11 and 18 of JSCC Rules on Margins, etc. for Futures and Option Contracts**