

Practical Guidelines for Handling of Fails Charges

I. Purpose

The purpose of these Guidelines is to provide for practical handlings of “Fails Charges” stipulated in Section “III. Guidelines concerning Fails” of “The Japanese Government Securities Guidelines for Real Time Gross Settlement” issued by Japan Securities Dealers Association (“JSDA”), in particular, preparations prior to the introduction of Fails Charges, and the practice regarding calculation, claim, payment, and receipt of Fails Charges. Transactions covered by these Guidelines are purchase and sale transactions and repo transactions (conditional purchase and sale transactions and lending transactions, hereinafter meaning the same).

II. Preparations before introduction of Fails Charges

1. Regarding contractual terms

With respect to conditional purchase and sale transactions and lending transactions, we find the provision, which stipulates, “matters not specifically stated in this master agreement shall be handled according to ... and the regulations and practices established by Japan Securities Dealers Association” in Article 20 of “Master Agreement concerning Gensaki Transactions in Bonds, etc.” (JSDA’s reference format) with respect to conditional purchase and sale transactions, and in Article 22 of “Master Agreement concerning Bond Lending transactions” with respect to lending transactions. Based on the above-mentioned provisions, it is understood that no additional contract or amendment to an existing contract will be required for introducing Fails Charges in any conditional purchase and sale transactions or lending transactions because the rules concerning the handling of Fails Charges are already provided in Section “III. Guidelines concerning Fails” of “The Japanese Government Securities Guidelines for Real Time Gross Settlement” issued by JSDA.

However, with respect to bond lending transactions with cash collateral, it is recommended to exchange a “Memorandum concerning Fails” to clearly specify the handling of a settlement fail if the parties to the transaction have not yet exchanged one.

As in the case of repo transactions, it should be understood that Fails Charges in purchase and sale transactions shall be handled according to the provisions of the “The Japanese Government Securities Guidelines for Real Time Gross Settlement” and these Guidelines.

2. Prior notice

- (a) Since the scheduled introduction of Fails Charges will be a material change in the market practice which is the prerequisite for trading, it is recommended that market participants should give a written notice to that effect to their counterparties prior to the introduction of Fails Charges. If the counterparty raises no objection in response to the written notice and a new transaction is executed after the date specified in the notice (“Confirmation Date” specified in Annex 1) as the date for introduction of Fails Charges, an agreement for the introduction of Fails Charges shall be deemed to have been made.
- (b) The written notice shall be sent at least from one party to the transaction to the other party.
- (c) The written notice shall be prepared with reference to Annex 1 and contain information concerning the date to introduce the Fails Charge, the Fails Charge to be imposed on the receiving party upon occurrence of a fail on and after the introduction date (“Effective Date” specified in Annex 1), types of transactions subject to Fails Charges, and the method of calculating Fails Charges.
- (d) The written notice can be delivered by hand, post, facsimile transmission, or e-mail. It is recommended that after the delivery of the notice, market participants who have sent the notice should confirm by any means that the notice has reached their counterparty.

3. Notice in confirmations or similar trade notifications

- (a) It is recommended that market participants should incorporate a notice to that effect in the confirmation or a similar trade notification to indicate that the relevant transaction shall be subject to Fails Charges and to use as an evidence for claiming the Fails Charge. Parties to the transaction shall confirm by such notice that an agreement has been established between the parties pursuant to the prior notice that the transaction shall be subject to Fails Charges.
- (b) The notice to be incorporated in the confirmation or a similar trade notification shall be prepared with reference to Annex 2 and indicate that the transaction specified in the notice shall be subject to Fails Charges.
- (c) Unless the confirmation or similar trade notification has been sent in connection with transactions between the parties, the parties can omit giving the notice.

III. Calculation and claim of Fails Charges

1. Calculation method

(1) Applicable formula

Fails Charges shall be calculated according to the following formula:

$$\sum_{\text{fail period}} 1/365 \times \max(3\% - \text{Reference Rate}, 0) \times \text{Amount of Funds to be Delivered}$$

(2) Definitions and explanations of terms in the formula

- (a) The “Reference Rate” shall be set at zero percent (0%) so long as the Bank of Japan is pursuing a strategy of controlling the monetary base as the operating target in its money market operations.
- (b) When the Reference Rate is changed during the fail period, the Fails Charge for the fail period after the effective date of the change shall be calculated by applying the Reference Rate after the change.

If the Bank of Japan changes the operating target in its money market operations from the monetary base to the uncollateralized overnight call rate, the Reference Rate shall be changed to the target level (or if it is indicated by target band, the lower limit of the target band). If the said operating target is changed from the monetary base to any indicator other than the uncollateralized overnight call rate, the Fails Charges shall be calculated by using tentatively the Reference Rate before the change. In this case, the Reference Rate shall be reviewed promptly.

In addition, even during the time the monetary base is the Bank of Japan’s operating target in its money market operations, if it becomes inappropriate to keep the Reference Rate at zero percent (0%) because of change in money market conditions (e.g., the actual uncollateralized overnight call rate remaining far from zero percent for a certain period of time), the Reference Rate shall be reviewed promptly.

- (c) The “Amount of Funds to be Delivered” in conditional purchase and sale transactions or in lending transactions shall mean the amount of funds to be delivered for the starting leg of the transaction, or the amount of funds to be delivered at the time of lending in the case where a fail is confirmed in the starting leg of the transaction, while in the case where a fail is confirmed in the closing leg of the transaction, it shall mean the amount of funds to be delivered

for the closing leg of transaction or the amount of funds to be delivered at the time of returning.

2. Claim of Fails Charges

(1) Claimant and claimee

Claims for a Fails Charge shall be made by the receiving party suffering from the Fail against the delivering party failing the delivery.

(2) Interval of claims

Fails charges shall be claimed monthly for the total amount of Fails Charges accrued in the relevant period for the Fails Charges calculation, which shall start on the first day and end on the last day of a month (on a calendar-day basis).

(3) Due date to claim

The claimant shall claim Fails Charges to the claimee by delivering a bill on or before the tenth (10th) business day of the month following the month for which the Fails Charges calculation is made. If the claimant fails to claim Fails Charges with respect to any calculation period, the claimant can not carry over the unclaimed amount of Fails Charges to two (2) or more months after such calculation period.

(4) Method of claiming and matching

In view of the fact that a claim for Fails Charges involves payment of money, it is recommended to make claims in writing. In addition, it is recommended that the amount of Fails Charges claimed shall be matched without delay between the parties to the transactions after the claims.

(5) Confirmation of contact information

It is recommended to confirm in advance between the parties to the transaction about their respective contact information regarding the claim, matching, settlement and other matters relating to Fails Charges. Especially, in the case of transactions where two or more counterparties are involved, such as nonresident transactions or transactions through trust banks, contact information shall be confirmed thoroughly to prevent operational troubles.

IV. Payment and Receipt of Fails Charges

(1) Date for payment and receipt

Payment and receipt of Fails Charges shall be completed within the month in which the Fails Charges are claimed. Considering the cases where substantially large amount of Fails Charges may be paid and received, it is recommended to make payments and receipts promptly after completing the claim and matching procedures between the parties to the transaction. In this case, the parties to the transaction are required to confirm the settlement date before processing the payments and receipts.

(2) Netting

If agreed between the parties to the transaction, the amount of Fails Charges can be netted. In this case, parties to the transaction shall carefully confirm as to whether or not the Fails Charges claimed by each other will be netted.

(3) Minimum amount of a Fails Charge

(a) In order to ensure efficient handling of operational processing and to avoid payments or receipts in a small amount, if agreed by the parties to the transaction, the minimum amount of payments and receipts can be set to fifty thousand yen (¥50,000), and payment and receipt of Fails Charges less than fifty thousand yen (¥50,000) can be omitted.

(b) The minimum amount can apply either to an amount of payment and receipt of the parties calculated on a gross basis or such an amount calculated on a net basis, that is, the amount remaining after deducting payments and receipts between the parties. However, basically, from the standpoint of facilitating efficient operational processing, if Fails Charges are paid and received on a gross basis, the minimum amount shall apply to the gross amount, while if the parties to the transaction have agreed to pay or receive Fails Charges by netting method according to the provisions of Section IV, (2) above, the minimum amount shall apply to the net amount. The parties to the transaction shall thoroughly confirm between the parties before payment and receipt as to which basis should be applied to the payment and receipt of Fails Charges.

(4) Method for payments and receipts

Settlement through a BOJ current account is recommended as a means for payment and receipt of Fails Charges. However, if some parties, who do not have a BOJ current account, settle through bank transfer or other means, the parties to the transaction shall thoroughly confirm between the parties as to payment methods before payment and receipt of Fails Charges.

(5) Handling of delayed payment of a Fails Charge

If payments and receipts of Fails Charges are not conducted within the month they are claimed, the parties to the transaction shall consult about the handling of the delayed payments with each other, and if so agreed, a certain overdue interest can be imposed from the day following the due date.

(Model form for prior notice of introduction of Fails Charges)

[Month] [Date], [Year]

[Counterparty name]

[Company name]

Notice of Significant Change concerning Transactions in Japanese Government Securities

We (the “Company”) would like to announce a significant change concerning transactions with you (the “Trade Counterparty”) in Japanese government securities.

Recently, Japan Securities Dealers Association (“JSDA”) has publicly announced that “The Japanese Government Securities Guidelines for Real Time Gross Settlement” will be partially amended and that the “Practical Guidelines for Handling of Fails Charges” will be newly established (the latest edition of these guidelines and other detailed information are published on JSDA’s website(http://www.jsda.or.jp/html/eigo/failwg_final_e.html)). The reviewed market practice for settlement failures is scheduled to begin on November 1, 2010.^(Note 1)

Under the reviewed market practice, if a fail occurs in any transaction in Japanese government securities based on delivery-versus-payment (DVP) settlements, the party receiving the securities will be entitled to demand the party failing to deliver the securities to pay a Fails

(Note 1) With the aim of preventing frequent occurrence of settlement failures and further establishing the Fails Practice, JSDA has reviewed and improved the market practice for settlement failures and partially amended JSDA’s regulations (the “Regulations Concerning Handling of Short Sale and Lending Transaction of Bonds” and the “Regulations Concerning Handling of Conditional Sale and Purchase of Bonds, etc”). As part of such efforts, JSDA has established the market practice for Fails Charges for the purpose of preventing frequent occurrence of settlement failures under conditions where interest rates are low. In “The Japanese Government Securities Guidelines for Real Time Gross Settlement” to be amended this time, the provisions for how to handle Fails Charges are newly stipulated in Part III “Guidelines concerning Fails.” In addition, the “Practical Guidelines for Handling of Fails Charges” will be newly established to stipulate how to introduce Fails Charges and the standard procedures for calculating, claiming, and paying/receiving Fails Charges. In the said new guidelines, the procedures relating to Fails Charges are specified, and it is recommended, with respect to bond lending transactions with cash collateral, to execute a “Memorandum concerning Fails” to clearly specify the handling of a settlement failure if it has not yet been executed by the parties to the transaction.

Charge (a monetary burden imposed on the failing party pursuant to the procedures specified in the “Practical Guidelines for Handling of Fails Charges”). This new market practice is hereinafter referred to as the “Fails Charge Handling Practice.”

As the Company has decided to adopt the Fails Charge Handling Practice to transactions with the Counterparty, the Company hereby informs the Counterparty that any DVP transactions in Japanese government securities between the Counterparty and the Company will be subject to the following conditions, unless explicitly agreed otherwise with respect to a specific transaction.

Between the Trade Counterparty and the Company, with respect to any DVP settlements of Japanese government securities transactions between the parties (including settlement by the delivery of government securities against the payment of funds on the same date in the case where an agreement to that effect is made between the parties to the transaction under which their mutual claims and debts are preserved explicitly), the Trade Counterparty is requested to notify the Company not later than [Month] [Date], [Year] (the “Confirmation Date”) if the Trade Counterparty is unable to agree on the application of the Fails Charge Handling Practice. In this connection, the term “any DVP settlements of Japanese government securities transactions” referred to in the foregoing sentence includes purchase and sale transactions and repurchase transactions which mean starting and closing legs of transactions in conditional purchase and sale transactions and lending and returning in lending transactions.

In the absence of the Trade Counterparty’s notification as aforesaid by the Confirmation Date, the Trade Counterparty will be deemed to have agreed that the Fails Charge Handling Practice shall apply to all settlements made on or after [Month] [Date], [Year]^(Note 2) (the “Effective Date”) in relation to new transactions executed between the parties after the Confirmation Date (the date for executing any such new transaction being hereinafter referred to as the “Reference Date”), unless otherwise explicitly agreed upon in connection with any specific transaction. Likewise, the Company will be deemed to have agreed that the Fails Charge Handling Practice shall apply to all settlements made on or after the Effective Date, unless otherwise explicitly agreed upon in connection with any specific transaction. Notwithstanding the foregoing, if the

Reference Date falls on the Effective Date or later, the Fails Charge Handling Practice shall apply to settlements made on or after the Reference Date.

Even in the case where either party fails to claim Fails Charges with respect to one or more transactions to which the Fails Charge Handling Practice applies, the party shall not be deemed to waive its right to claim Fails Charges in relation to any other applicable transactions. In addition, either party's claim of a Fails Charge shall not preclude the party from exercising any other right available under the agreement for the transaction in question or any applicable law, and none of the Trade Counterparty, the Company, or any third party shall in any way be deemed to have waived any such right.

We would highly appreciate your kind understanding and cooperation for smooth operations under the Fails Charge Handling Practice. If you have any questions about the change explained in this notice, please contact [each market participant to insert].

(Note 2) JSDA reviewed the Fails Practice and is planning to introduce the Fails Charge Trading Practice on November 1, 2010, as a new market practice.

(Sample wording to be described in confirmations or similar trade notifications, etc. when introducing Fails Charges)

When a market participant decides to introduce the Fails Charge Trading Practice, it is recommended, in their confirmations or similar trade notifications to add wording to indicate that the market participant will comply with the Fails Charge Trading Practice. The following sentence is a sample statement for declaring such compliance. Each market participant is requested to examine this sample statement and consider whether to rewrite it to fit in with their own circumstances.

This transaction is subject to a Fails Charge to be imposed pursuant to “The Japanese Government Securities Guidelines for Real Time Gross Settlement” issued by Japan Securities Dealers Association.