

Answers to *Recommendations for Central Counterparties*

(Report by BIS/Committee on Payment and Settlement Systems and Technical Committee of the International Organization of Securities Commissions)

March 26, 2007
JASDEC DVP Clearing Corporation

Answers to the key questions of *Recommendations for Central Counterparties*(CCPs)¹

- Responding institution : JASDEC DVP Clearing Corporation (the Securities Transaction Clearing Organization pursuant to Article 156-2 of the Securities and Exchange Law)
- Name of the entity assessed : JASDEC DVP Clearing Corporation
- The information provided in the answers is accurate as of March 26, 2007.
- This response can be viewed on the homepage of Japan Securities Depository Center, Inc. (www.jasdec.com).
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1. Brief introduction to JASDEC DVP Clearing Corporation (JDCC)

Scope of business	<ul style="list-style-type: none">▪ JDCC is engaged in the Securities Obligation Assumption Business as the Securities Transaction Clearing Organization for non-exchange transaction deliveries (NETD; book entry deliveries of securities excluding those carried out in connection with clearing of trades on domestic stock exchanges).▪ Securities subject to the assumption of obligation are Certificates of stock, Certificates of corporate bonds with subscription warrant to new shares, Beneficiary certificates of real estate investment trust (REIT), Certificates of preferred equity securities, and Beneficiary certificates of exchange-traded funds (ETF) that are eligible for the Depository and Book-entry Transfer Business of Japan Securities Depository Center, Inc.
Ownership	Wholly-owned subsidiary of Japan Securities Depository Center, Inc.
Date of Incorporation	June 6, 2003
Transaction	FY2004: No. of DVP Transfers 59,825

¹ For the meaning of capitalized terms, see “Business Rules, etc. of JASDEC DVP Clearing Corporation”.

Data	Total Payments	909.5 billion yen
	FY2005 No. of DVP Transfers	80,308
	Total Payments	1,431.7 billion yen
	❖ Average figures per trading day	
	❖ No. of DVP Transfers is the number in relation to Execution of DVP Book-Entry (transfer from Transferring Party to JDCC).	
	❖ Total Payments is the amount in relation to Execution of DVP Book-Entry.	
	❖ FY2004 is from May 17 to March 31.	
Participants	62 companies (45 securities companies and 17 banks)	

(As of March 26, 2007)

2 . Answers to the key questions of the recommendations

Recommendation 1: Legal risk.

A CCP should have a well-founded, transparent and enforceable legal framework for each aspect of its activities in all relevant jurisdictions.

Key questions

1. Are the laws and regulations governing the operation of a CCP and the rules, procedures, and contractual provisions for its participants clearly stated, internally coherent, and readily accessible to participants and the public?

[Answer]

JASDEC DVP Clearing Corporation (“JDCC”) is a joint-stock corporation incorporated in accordance with the Companies Act.

The legal basis for CCP in relation to securities transactions is provided in the Securities and Exchange Law.

JDCC has obtained a license for the Securities Obligation Assumption Business in accordance with the Securities and Exchange Law, and provides a DVP settlement service for Non-exchange transactions deliveries (“NETD”) as the Securities Transaction Clearing Organization, and the scope of its business is clearly stated in the Business Rules of JDCC prepared in accordance with the Securities and Exchange Law, and the Treatment of Business Rules and the DVP Participant Agreement have set forth detailed regulations, etc.

The Companies Act, the Securities and Exchange Law and other laws and ordinances can be viewed on the e-Government portal (e-Gov) homepage². The Business Rules and other regulations are issued directly to users of JDCC’s DVP Settlement Service for NETD

²e-Government portal (e-Gov) URL: <http://www.e-gov.go.jp>

(“DVP Participant”) and can also be viewed on the JDCC’s homepage as part of JASDEC’s homepage³.

2. Does the legal framework demonstrate a high degree of assurance that there is a clear and effective legal basis for:

- (1) The CCP to act as counterparty, including the legal basis for novation or open offer.
- (2) The timing of assumption of liability as CCP.
- (3) Netting arrangements.
- (4) The CCP’s interest in collateral (including margin) that a participant pledges or transfers to the CCP.
- (5) Default procedures
- (6) Finality of transfers of funds and financial instruments.
- (7) Other significant aspects of the CCP’s operations, risk management procedures and related rules.

[Answer]

- (1) The Securities and Exchange Law defines the Securities Obligation Assumption Business conducted by a Securities Transaction Clearing Organization as the business of assuming the obligation resulting from securities transactions between securities companies, etc. (“Transaction Subject to Clearing”). The law provides the legal basis for the Securities Transaction Clearing Organization to interpose itself between the Transferring Party and the Receiving Party in a securities transaction and assume the obligation.
- (2) In the case where JDCC has received a request to assume the obligation based on a Transaction Subject to Clearing from a Transferring Party and a Receiving Party who are DVP Participants, at the point when the terms and conditions⁴ set forth in the Business Rules have been satisfied, JDCC assumes the securities transfer obligation from the Transferring Party and assumes the payment obligation from the Receiving Party.
- (3) The DVP System for NETD applies the Gross=Net-type DVP model, and the Business Rules stipulate that each time JDCC assumes an obligation, it should perform netting of Settlement Amount Payment Obligations. The legal validity of netting performed in accordance with the Business Rules is provided for in the Securities and Exchange Law.
- (4) With the DVP System for NETD, to ensure the performance of obligations by the DVP Participant, under the Business Rules, DVP participants are required to deposit collateral (“Clearing Deposit”) in the form of the Participants Fund and the Pledged Securities.
Deposits of the Pledged Securities that are JASDEC Eligible Securities (Securities eligible for the Japan Securities Depository Center or “JASDEC”) such as Certificates of stock and Certificates of corporate bonds with subscription warrant

³ JDCC URL: <http://www.jasdec.com/dvp/index.html>

⁴ The regulations set forth terms and conditions regarding the balance of subject securities, the Margin Value, and the Net Debit Cap .

- to new shares (CBs) are made by book-entry transfer at JASDEC, and deposits of Japanese government bond securities (JGBs) are made by book-entry transfer under the JGB book-entry system using the Bank of Japan's BOJ-NET JGB Services. JDCC has perfection requirements in relation to participants and third parties in accordance with the provisions of the Law Concerning Central Securities Depository and Book-Entry Transfer of Stock Certificates and Other Securities ("the CSD Law") and the Law Concerning Book-Entry Transfer of Corporate Bonds, Stocks and Other Securities ("the CB Transfer Law").
- (5) Default procedures are provided for in the Business Rules (See Recommendation 6 for details).
- (6) Once the assumption of an obligation by JDCC has taken place, under the Business Rules, the DVP Participant may not insist on the invalidation, cancellation or rescission of such Transaction Subject to Clearing or such assumption of obligation, nor in any way protest.
- i) Finality of settlement of funds
Settlement of funds is made by account transfer using the Bank of Japan's current account, and the finality of settlement of funds is assured.
- ii) Finality of securities settlement
Securities settlement is made by account transfer between JASDEC participant accounts, and the finality of securities settlement is assured in accordance with the CSD Law.
- (7) Under the Securities and Exchange Law, the Securities Transaction Clearing Organization is required to set forth as matters that must be stated in its Business Rules matters that serve as fundamental rules when executing the Securities Obligation Assumption Business, such as scope of business and risk management (matters related to performance of obligations by clearing participants). In addition, JDCC's business conduct, etc. is subject to the supervision of the competent minister (the Prime Minister).

3. Are the rules, procedures and contracts of the CCP enforceable when a CCP participant defaults or becomes insolvent? Is there a high degree of assurance that actions taken under such rules and procedures may not later be stayed, avoided or reversed?

[Answer]

The Securities and Exchange Law states that in the case where the Securities Transactions Clearing Organization has stipulated in its Business Rules a method for the netting of unsettled obligations, etc.⁵, a method for the application of collateral, or other settlement methods, if special liquidation proceedings, bankruptcy proceedings, reorganization proceedings or rehabilitation proceedings ("bankruptcy proceedings, etc.") are commenced in relation to a clearing participant, the appraisal of the value of unsettled obligations, etc. and other settlement methods in connection with such proceedings shall be in accordance with the provisions of the Business Rules.

⁵ Obligations, claims and collateral associated with the assumption of obligations.

4. Is there a significant level of cross-border participation in the CCP? Has the CCP determined whether there are other jurisdictions relevant for determining the adequacy of the legal framework? Has the legal framework been evaluated for the other relevant jurisdictions? Do laws and rules support the design of any cross-border arrangement and provide adequate protection to both CCPs in the operation of the arrangement? Are there conflicts of laws issued and, if so, have they been addressed? Have cross-border collateral arrangements been evaluated?

[Answer]

Not applicable as, at present, in the case of the DVP System for NETD, cross-border DVP participants are not envisaged.

Recommendation 2. Participation requirements

A CCP should require participants to have sufficient financial resources and robust operational capacity to meet obligations arising from participation in the CCP. A CCP should have procedures in place to monitor that participation requirements are met on an ongoing basis. A CCP's participation requirements should be objective, publicly disclosed, and permit fair and open access.

Key questions

1. Does the CCP establish requirements for participants' financial resources and creditworthiness? If so, how? What factors are considered (for example, size, clearing for indirect participants, products cleared)? Does the CCP assess participants' operational capability? If so, how? What factors are considered (for example, arrangements to meet payment obligations, risk management policies, staffing, internal audit of risk controls and IT systems)?

[Answer]

JDCC's Business Rules set forth criteria relating to financial basis as criteria for approval of the Clearing Qualification. The Rules also set forth criteria relating to aspects such as internal system for management and internal system for business operation .

Out of these criteria, those relating to financial basis stipulate capital amounts, values of net assets, capital adequacy ratio, etc. for each type of industry, and assign levels particularly in relation to capital adequacy ratio, etc., with reference to the regulatory criteria used in supervision by the supervisory authorities for each industry type. Regarding the internal system for business operation, besides the inspection of documents, before the Clearing Qualification is obtained, it is necessary to conduct an operation test of the systems involved in the DVP System for NETD to check if there is any obstacle to conducting business using the DVP System for NETD.

2. Does the CCP monitor that participation requirements are met on an ongoing basis? If so, how? Through access to regulatory reports or directly? Are reports sufficiently timely to be useful for monitoring purposes? Under what conditions can the CCP suspend and

terminate participants' membership? What arrangements does the system have in place to facilitate the suspension and orderly exit of participants that no longer meet the participation requirements?

[Answer]

Even after approval of the Clearing Qualification, JDCC monitors DVP Participants on an ongoing basis by establishing criteria relating to their internal system for management, financial basis, the internal system for business operation, etc.

The Business Rules make it obligatory for DVP Participants to give immediate or advance notification of any specific matter that has occurred or been resolved in relation to their internal system for management, financial basis, the internal system for business operation, etc., and make it obligatory for them to submit to JDCC immediately the same items they submit regularly to the supervisory authorities regarding their financial position, etc.

JDCC may, in accordance with the Business Rules, revoke the Clearing Qualification or suspend assumption of obligations if a DVP Participant has become insolvent or failed to perform payment obligations of their Participant Settlement Amount, etc. JDCC may also suspend the assumption of obligations if a DVP Participant no longer meets the criteria relating to the internal system for management or financial basis, etc. or may recommend that the Participant take appropriate measures if its operational or financial status is inappropriate.

3. Do participation requirements limit access on grounds other than risks? Are they objective and do they permit fair and open access? Are participation requirements, including arrangements for orderly exit of participants, clearly stated and publicly disclosed?

[Answer]

With the exception of the requirement that parties eligible for the Clearing Qualification under the DVP System for NETD must be participants of JASDEC's Securities Depository and Book-entry Transfer System for stock certificates, etc. and must be a user of the Pre-settlement Matching System provided by JASDEC, participation requirements do not limit the Clearing Qualification on grounds other than the risk-related approval criteria relating to the internal system for management, financial basis and the internal system for business operation.

The participation requirements are clearly stated in the Business Rules and can be viewed on the JDCC's homepage.

Recommendation 3. Measurement and management of credit exposure

A CCP should measure its credit exposures to its participants at least once a day. Through margin requirements, other risk control mechanisms or a combination of both, a CCP

should limit its exposures to potential losses from defaults by its participants in normal market conditions so that the operations of the CCP would not be disrupted and non-defaulting participants would not be exposed to losses that they cannot anticipate or control.

Key questions

1. How frequently does the CCP measure its exposures to its participants? Does the CCP have the capacity to measure exposures intraday? How timely is the information on prices and positions used in these calculations?

[Answer]

JDCC measures its exposures to DVP Participants whenever it assumes an obligation, and has a real-time awareness of its exposures.

2. How does the CCP limit its exposures to potential losses from defaults by its participants? If margin requirements are used, does the CCP observe Recommendation 4? If not, how does the CCP ensure that closing out any participant's positions in normal market conditions would not disrupt the operations of the CCP or expose non-defaulting participants to losses that they cannot anticipate or control?

[Answer]

JDCC controls its intraday exposures to each DVP Participant by making it a rule to limit its exposure i.e. maximum balance of the Net Debit⁶ (“the Maximum Net Debit Cap”) per DVP Participant to 30 billion yen, and by setting the Net Debit Cap for each DVP Participant each trading day depending on DVP Participants' trading results.

Also when JDCC assumes an obligation, it makes it a rule to assume the obligation only if the Net Debit is within the Total Assurance Assets Value⁷, thereby fully collateralizing the obligation.

JDCC observes Recommendation 4 regarding margin requirements.

Recommendation 4. Margin requirements

If a CCP relies on margin requirements to limit its credit exposures to participants, those requirements should be sufficient to cover potential exposures in normal market conditions. The models and parameters used in setting margin requirements should be risk-based and reviewed regularly.

⁶ Amount obtained after DVP Participant's claims receivable and Settlement Facilitation Payment are deducted from DVP Participant's obligations payable.

⁷ Composed of the Participants Fund, Securities-to-be-Received and Pledged Securities. See Recommendation 4.

Key questions

1. What is the intended coverage of margin requirements? What is the time interval over which potential price movements are measured? Is the interval consistent with a reasonable assumption about how quickly a defaulting participant's positions could be closed out? How does the CCP validate the models and parameters used to determine the margin levels consistent with the intended coverage? How frequently does it review and validate the models?

[Answer]

Under the DVP System for NETD, DVP Participants are required to deposit the Assurance Assets exceeding the Net Debit as a margin to ensure their performance of obligation to pay the Net Debit associated with the assumption of obligations by JDCC. The securities to be settled as a result of assumption of obligation (the Securities-to-be-Received) will be retained as collateral by JDCC, but since their appraisal value as collateral is taken as the value obtained by multiplying their market value on the previous trading day by the appraisal rate⁸, the DVP Participant must deposit with JDCC the Pledged Securities and the Participants Fund⁹ as collateral to secure the shortfall in relation to the Net Debit.

Under the DVP System for NETD, since the process from the assumption of obligation to settlement is usually effected on the same day, there is no need to accommodate day-to-day price movements after the date of assumption of obligation. The period during which potential price movements is envisaged is from the time a default occurs until JDCC sells the Pledged Securities and the Securities-to-be-Received. More specifically, since JDCC makes it a rule to complete the sale of collateral within three days after the occurrence of the default, JDCC will be exposed to price movements risk during this period. Taking this into consideration, JDCC ensures that the appraisal rate by which it multiplies the market value of the Securities-to-be-Received and the Pledged Securities is of an adequate level.

JDCC has entered into commitment line agreements with banks (Commitment Line Banks) to assure the liquidity sufficient to complete payment to DVP Participants on the settlement date even in the case where the Maximum Net Debit Cap per DVP Participant under the system is 30 billion yen and two DVP participants with Net Debit equal to the Maximum Net Debit Cap have simultaneously defaulted¹⁰.

JDCC receives the Participants Fund Deposit of a certain amount from DVP Participants, and regularly verifies whether the level of the Participants Fund is adequate to cover the credit exposures of the DVP Participant.

⁸ This collateral assessment method is also applied to the Pledged Securities.

⁹ Under the system, DVP Participant are obliged to deposit a Participants Fund exceeding a certain amount, the equivalent of this Participants Fund is included in the Assurance Assets from the outset.

¹⁰ JDCC has attained the Lamfalussy-Plus-One Standards, which are international standards for net settlement systems.

2. Does the CCP have the authority and operational capacity to demand margin intraday to maintain the desired coverage? Under what circumstances?

[Answer]

JDCC is able to maintain desirable coverage intraday by making special changes to the appraisal rate used in the appraisal value of the Securities-to-be-Received and the Pledged Securities and asking DVP Participants with inadequate collateral to increase their Assurance Assets, etc. if considered particularly necessary, for example, if a major fluctuation has occurred in the value of the Securities-to-be-Received or the Pledged Securities

3. What types of assets does the CCP accept as margin? What types are actually held? How frequently are the assets revalued? Are haircuts applied that adequately reflect the potential for declines in asset values between the last revaluation and liquidation?

[Answer]

Assurance Assets accepted as margin consist of a) cash, b) JASDEC Eligible Securities (as a general rule, listed securities), and c) JGBs.

JDCC sets the appraisal value of JASDEC Eligible Securities and JGBs to be the amount obtained by multiplying the market value of each security on a day before each settlement date by the appraisal rate that takes price movements risk into account, and it revalues the assets daily.

Recommendation 5. Financial resources

A CCP should maintain sufficient financial resources to withstand, at a minimum, a default by the participant to which it has the largest exposure in extreme but plausible market conditions.

Key questions

1. Has the CCP established procedures to stress test its exposures in extreme but plausible market conditions? What scenarios are evaluated? Do the scenarios include the most volatile periods that have been experienced by the markets for which the CCP provides services? Does the CCP have sufficient resources in the event of a default by the participant with the largest exposure? Has the potential for multiple simultaneous defaults been evaluated? Are stress tests performed at least monthly, with a comprehensive reconsideration of models, parameters and scenarios occurring at least annually? Does the CCP have a clear policy on actions to be taken in the event that stress testing results indicate resources are not likely to be adequate to meet its obligations resulting from a default? Has it adhered to that policy? Is the policy made available to participants and authorities?

[Answer]

In the case of the DVP System for NETD, JDCC does not see the need for a stress test because JDCC receives the securities to be delivered from the Transferring Party at the same time as it assumes the obligation, and holds them as the Securities-to-be-Received until the Receiving Party performs settlement of funds, and because, on the other hand, settlement of funds is effected on the same day as assumption of the obligation, and even if a DVP Participant defaulted, JDCC holds the Assurance Assets as collateral which undergo collateral appraisal commensurate with price movements risk.

In addition, JDCC assures the liquidity (totaling 60 billion yen) to be able to make same-day settlement of funds even if two DVP Participants with Net Debit equaling the Maximum Net Debit Cap (30 billion yen) default simultaneously.

Furthermore, in the event of the default of a DVP Participant, in addition to disposing of the Assurance Assets and recovering the default amount, in the case where an unperformed obligation still remains and JDCC incurs a loss, JDCC has put in place a Default Compensation Charge System under which DVP Participants bear such loss.

2. What are the types and values of resources that the CCP has available to cover losses from participants' defaults? Is there a high degree of assurance that the CCP will be able to draw on those resources for the anticipated value in the event of a participant's default? Do the CCP's rules prohibit them from being used to cover operating losses or losses from other CCP activities?

[Answer]

In the case where a DVP Participant has defaulted, after performing same-day settlement of funds using the Participants Fund and funds borrowed in accordance with commitment line agreements, JDCC disposes of the Assurance Assets of such DVP Participants and applies them to repayments to the Commitment Line Banks from which it borrowed the funds and to recovery of the Participants Fund.

JDCC conducts collateral appraisal based on the appraisal rate of the Pledged Securities and the Securities-to-be-Received that form part of the Assurance Assets. Moreover, since JDCC will use the Default Compensation Charge System in the case where it cannot cover losses simply through disposal of the Assurance Assets, there is a high level of assurance that JDCC can draw on resources to offset/cover the losses.

In accordance with the provisions of the Business Rules, the disposal of the Pledged Securities and the Securities-to-be-Received can only be achieved if the DVP Participant in question has defaulted, and cannot be achieved on any other grounds.

3. Are any of the resources that the CCP is relying upon to cover losses from defaults not immediately available to meet the CCP's obligations? If so, has the CCP obtained committed credit lines subject only to presentment that allow it to borrow against those assets? If so, can those lines be drawn upon sufficiently quickly to ensure that the CCP can meet its obligations when due?

[Answer]

Since the Pledged Securities and Securities-to-be-Received that form part of the Assurance Assets used to cover losses must be either JASDEC Eligible Securities or JGBs, although they are highly liquid, they cannot be converted into funds immediately. Therefore, JDCC has entered into commitment line agreements with Commitment Line Banks and, together with the Participants Fund, it prepares with funds (60 billion yen) to ensure same-day settlement of funds even if two DVP Participants with Net Debit equaling the Maximum Net Debit Cap (30 billion yen) default simultaneously.

Recommendation 6. Default procedures

A CCP's default procedures should be clearly stated, and they should ensure that the CCP can take timely action to contain losses and liquidity pressures and to continue meeting its obligations. Key aspects of the default procedures should be publicly available.

Key questions

1. Do the CCP's default procedures state clearly what constitutes a default? If a default occurs, do the CCP's default procedures provide it with authority to promptly close out or manage the positions of a defaulting participant and to apply the defaulting participant's collateral or other resources? Do the CCP's procedures, or mechanisms other than those of the CCP, permit the transfer or (as an alternative) liquidation of the positions and margin of customers of the defaulting participant? Do the procedures empower the CCP to draw promptly on any financial resources?

[Answer]

The Business Rules state clearly JDCC's default procedures and what constitutes a default. In the event of default by a DVP Participant, JDCC immediately suspends assumption of the obligations of such DVP Participant, obligations become immediately due and payable, and JDCC collects claims by offsetting them against its obligations.

2. Does the legal framework provide a high degree of assurance that the decisions to liquidate or transfer a position, to apply margin or to draw down liquidity resources in the event of the insolvency of a participant would not be stayed or reversed? Does national insolvency law permit identification and separate treatment of customer and proprietary assets?

[Answer]

The Securities and Exchange Law states that in the case where the Securities Transaction Clearing Organization has set forth in its Business Rules a method for the netting of unsettled obligations, etc., a method for the application of collateral, or other methods of settlement, if bankruptcy proceedings, etc, are commenced against a clearing participant, appraisal of the amount of unsettled obligations, etc. and other methods of settlement in connection with such proceedings shall be in accordance with the provisions of such Business Rules, and it provides the basis for the settlement methods provided for in

JDCC's Business Rules to be valid even in the event of bankruptcy proceedings, etc, against a DVP Participant.

Moreover, Japan's Bankruptcy Law permits identification and separate treatment of assets deposited by the customer (customer assets) and proprietary assets.

3. Does the CCP's management have internal plans for implementing its default procedures? Does the plan maintain a measure of flexibility for the CCP in deciding how best to implement its default procedures? Does the plan address the need for coordination in cases where more than one CCP, authority or a separate market operator is involved? How frequently is the plan reviewed?

[Answer]

Default procedures are stated in the Business Rules, and JDCC's management will execute the default procedures in compliance with the provisions of the Business Rules and by adopting measures appropriate and suitable to the circumstances of the default that has occurred, but discretion is afforded to them on the method of return or the method of sale of the Pledged Securities, etc.

Since the DVP System for NETD is a settlement system provided for non-exchange transactions and is not linked with other CCPs, in principle other CCPs and market operators are not directly involved in default procedures.

Besides making the necessary revisions to default procedures in the event of a change in the law, etc., JDCC also examines whether or not there is a need for revision at any time.

4. Are the key aspects of the default procedures publicly available?

[Answer]

The key aspects of the default procedures are stated in the Business Rules and can be viewed on the JDCC's homepage.

Recommendation 7. Custody and investment risks

A CCP should hold assets in a manner whereby risk of loss or of delay in its access to them is minimized. Assets invested by a CCP should be held in instruments with minimal credit, market and liquidity risks.

Key questions

1. At what types of entities is collateral held? Does the CCP verify that these entities' procedures and practices conform to Recommendation 12 of the RISS? If so, how? Does the CCP confirm that its interest in the securities can be enforced and that it can have prompt access to the securities in the event of a participant's default, even if these securities are held in another time zone or jurisdiction? Does it monitor the financial condition of its custodians on an ongoing basis?

[Answer]

The Pledged Securities used under the DVP System for NETD are recorded and managed in an account in JDCC's name at JASDEC's or the BOJ's books.

JASDEC is supervised by the competent minister (the Prime Minister etc.) as a Central Securities Depository and Book-entry Transfer Organization under the CSD law, and the BOJ is supervised by the competent minister (the Prime Minister etc.) as a Book-entry Transfer Organization under the CB Transfer Law, and the protection of customers' securities (Recommendation 12 of the Recommendations for Securities Settlement Systems) is assured.

The Pledged Securities under the DVP System for NETD are not held in other time zones or jurisdiction.

2. How is cash invested? Are investments secured? What standard does the CCP use to ensure that obligors are highly creditworthy? What standard does the CCP use to ensure that investments have minimal market and liquidity risks?

[Answer]

Most of the cash held by JDCC is deposited by DVP Participants as a Participants Fund.

JDCC entrusts the Participants Fund to a trust bank in the form of specified money in trust, with the emphasis on security, and the Participants Fund can be quickly converted into cash, as investments that give top priority to security and liquidity are chosen. JDCC selects the trust bank that will be the trustee of the Participants Fund based on criteria such as capital adequacy ratio and financial position, and even after selection, it checks the financial position and other conditions at such trust bank on an ongoing basis.

3. Does the CCP consider its overall exposure to an obligor in choosing investments? Are investments limited to avoid a concentration of credit risk exposures? If so, how?

[Answer]

Based on emergency response considerations, JDCC chooses only one trust bank to be the trustee of the Participants Fund, but since JDCC deposits the fund in the form of a trust, the Participants Fund is highly secure, and JDCC chooses the trust bank based on criteria such as financial position, and even after selection, it checks the financial position and other conditions at such trust bank on an ongoing basis.

Recommendation 8. Operational risk

A CCP should identify sources of operational risk and minimize them through the development of appropriate systems, controls and procedures. Systems should be reliable and secure, and have adequate, scalable capacity. Business continuity plans should allow for timely recovery of operations and fulfillment of a CCP's obligations.

Key questions

1. Does the CCP have a process for actively identifying, analyzing and addressing its operational risk, including risks arising from its outsourced operations and its other activities?

[Answer]

JDCC aims to achieve complete STP covering the entire process from the acceptance of obligation to its settlement, and does not intend any human involvement in operation or administration. Therefore, JDCC assumes system failure to be a critical operational risk.

JDCC entrusts system processing in relation to the DVP System for NETD to JASDEC, and in its response to operational risk, including such system risk and other risks, JDCC complies with the Basic Risk Management Policy formulated by parent company JASDEC for the entire group including JDCC, and also exercises risk management by, for example, attending the Risk Management Committee established by its parent company as a body to coordinate risk management.

2. Does the CCP have a business continuity plan that addresses events posing a significant risk of disrupting operations? Do plans ensure that critical information can be recovered in timely manner? Do plans provide, at a minimum, for the recovery of all transactions at the time of the disruption to allow systems to continue to operate with certainty? Is the business continuity plan regularly reviewed and tested with participants? Have appropriate adjustments to operations been made based on the results of such exercises?

[Answer]

In collaboration with JASDEC, JDCC has prepared countermeasures in the event of system failure, and distributes a system failure operations manual to DVP Participants, and it also regularly holds disaster drills. JDCC revises the content of the system failure operations manual as appropriate.

Moreover, for its BCP (Business Continuity Plan), assuming the case where it has become difficult to continue business due to a large earthquake or other natural disaster or terrorist attack, JDCC complies with the basic policy formulated by parent company JASDEC for the entire group including JDCC, and is also preparing and improving its business continuity structure by, for example, attending JASDEC's Risk Management Committee.

The main countermeasures against system failure assumed to be most critical for business continuity are listed below:

1. Risk reduction measures

The following measures are taken from the viewpoint of preventing the loss of data or suspension of operations because hardware functions have been damaged.

(1) Fully duplicated hardware

All hardware is duplicated, and disks saving data that cannot afford to be lost for operational reasons are duplicated again within the duplicate hardware.

(2) Hot standby

In the case where one of the hardware functions has been seriously damaged, within a short space of time a switchover to spare hardware is automatically effected.

2. Long-duration failure countermeasures

In the case where a long-duration failure has occurred, as a general rule, after the failed operation has been recovered at the main center, and the handover of request and notification, etc. has been confirmed, ordinary recovery or special recovery described below is effected. However, in the case where it is difficult to recover the failed operation at the main center and recovery of operations at a back-up center is judged possible, a switchover to the back-up center is effected, and ordinary recovery is performed.

(1) Ordinary recovery

As a general rule, the failed operation is recovered at the main center and that day's operations are continued.

In the case where a long-duration failure has occurred in one of the interfaces with DVP Participants (CPU direct connection, file transmission, integrated web terminal), operations are continued on another alternative interface.

(2) Special recovery

Depending on when the failure occurs, that day's online operations are not resumed, DVP book-entry transfer processing is completed in batch mode for DVP book-entry transfer requests executed before the failure occurred, and settlements of funds are processed in manual mode (external media, fax and BOJ network terminals).

3. Disaster countermeasures

In the case where the main center has failed due to disaster, etc., a switchover to the back-up center is effected.

3. Are there adequate management controls and sufficient (and sufficiently well-qualified) personnel to ensure that procedures are implemented appropriately? Are operational reliability issues reviewed regularly by senior management, including review by persons not responsible for the relevant operations? Is there an internal audit function and does it review operational risk controls?

[Answer]

The boards of JDCC and its parent company JASDEC have both formulated a basic internal control policy (basic policy on the establishment of a structure to assure the proper operations), and in response to this the President & Representative Director has established and convenes as appropriate a Risk Management Committee made up of executive members and key managerial staff, which strives for compliance, risk management, and appropriate, efficient execution of operations across the entire group including JDCC.

Besides establishing a Compliance Office responsible for internal audits and regularly conducting internal audits, JDCC also undergoes operational audits of its administrative structure and business activities, etc. as part of subsidiary management by its parent company JASDEC.

JASDEC, to whom JDCC entrusts system operations, has also introduced system audits by an auditing corporation.

4. How many times during the last year has a key system failed? What is the most common cause of failures? How long did it take to resume processing? How much transaction data, if any, were lost? How does the CCP ensure the integrity of messages? Does the CCP have capacity plans for key systems and are key systems tested periodically to determine if they can handle stress volume?

[Answer]

Since the launch of the DVP System for NETD in May 2004, there have been no instances in which a problematic system failure has occurred.

To ensure the integrity of messages, dedicated lines, etc. are used for communications between the JASDEC system and the systems of DVP Participants, and matching is performed with respect to the number of data items processed to check if any data has been lost. All hardware is duplicated, and discs saving data that cannot afford to be lost are also duplicated within the duplicated hardware.

As regards system processing capacity, JASDEC, to whom JDCC entrusts system operations, has plenty of spare processing capacity. JASDEC is planning to expand each server's processing capacity and upgrade systems because it is going to expand its product line-up in the future, and frequently conducts performance tests; for example, in the case where specifications are altered, functions are added, or in the case where existing operations have expanded.

Recommendation 9. Money settlement matters

A CCP should employ money settlement arrangements that eliminate or strictly limit its settlement bank risks, that is, its credit and liquidity risks from the use of banks to effect money settlements with its participants. Funds transfers to a CCP should be final when effected.

Key questions

1. Does the CCP use the central bank model or the private settlement bank model?

[Answer]

The DVP System for NETD applies the central bank model.

2. Do the CCP's legal agreements with its settlement bank or banks provide that funds transfers to its accounts are final when effected? Do the laws of the relevant jurisdictions support these provisions? Do the payment systems for the currencies used support intraday finality? Does the CCP routinely confirm that funds transfers have been effected as and when required by those agreements?

[Answer]

According to the provision of the Bank of Japan's rules, funds transfers between the current accounts of DVP Participants and JDCC are final when effected.

This provision is legally valid as an agreement between the Bank of Japan, JDCC and other users of BOJ-NET Funds Transfer System. Funds transfer business using the Bank of Japan's settlement system and the provision of the BOJ-NET services have legal basis in the Bank of Japan Law.

The only settlement currency used under the DVP System for NETD is yen, and the system supports intraday finality because settlement must be effected on the same day.

JDCC routinely confirms that funds transfers to JDCC's current account from DVP Participants and funds transfers to DVP Participants' current accounts from JDCC have been effected in accordance with the provisions of the Business Rules.

3. If the private settlement bank model is used, does the CCP establish and monitor strict criteria for the banks used that address their creditworthiness, access to liquidity, and operational reliability?

[Answer]

Not applicable as the private settlement bank model is not used.

4. If the private settlement bank model is used, does the CCP actively monitor the concentration of exposures among the settlement banks, and routinely assess its potential losses and liquidity pressures from a settlement bank's failure?

[Answer]

Not applicable as the private settlement bank model is not used.

Recommendation 10. Physical deliveries

A CCP should clearly state its obligations with respect to physical deliveries. The risks from these obligations should be identified and managed.

Key questions

1. Does the CCP have rules that clearly state its obligations with respect to deliveries of physical instruments?

[Answer]

Under the DVP System for NETD, the transfer of securities is effected using JASDEC's account transfer system. The obligations of DVP Participants and JDCC in relation to the book-entry transfer of securities are clearly stated in the Business Rules.

2. Does the CCP have obligations to make or receive deliveries of physical instruments? If yes, does the CCP use DVP mechanisms that eliminate principal risk? If no DVP mechanism is available, does the CCP take other steps to mitigate principal risk?

[Answer]

With the assumption of obligation, JDCC assumes from the Transferring Participant the obligation to deliver the Subject Securities and takes on the obligation to deliver such securities to the Receiving Participant.

Under the DVP System for NETD, as one of the conditions for assuming the obligation of DVP participants, JDCC requires the Transferring Participant to hold the Subject Securities in its JASDEC account, and the Transferring Participant must transfer such securities to JDCC's account at the point when JDCC assumes the obligation to deliver the securities. On the other hand, in order to receive such securities from JDCC by transfer, the Receiving Participant must perform the payment obligation or deposit the Assurance Assets commensurate with such payment obligation with JDCC.

3. Has the CCP identified the liquidity, storage and delivery (other than principal) risks to which it is exposed because of the delivery obligations that it assumes? Does the CCP take steps to mitigate these risks? What steps does it take?

[Answer]

Under the DVP System for NETD, at the point when JDCC assumes the obligation to deliver the securities, it receives the Subject Securities from the Transferring Participant by transfer, and there are no liquidity risks in relation to the securities.

Since JASDEC's account transfer system is always used for the custody and delivery of securities, custody and delivery risks are extremely small. The mitigation of custody and delivery risks is left to JASDEC, but JASDEC conducts Central Securities Depository and Book-entry Transfer operations in accordance with the CSD Law, and is supported by a legal framework (See Recommendation 7).

Recommendation 11. Risks in links between CCPs

CCPs that establish links either cross-border or domestically to clear trades should evaluate the potential sources of risks that can arise, and ensure that the risks are managed prudently on an ongoing basis. There should be a framework for cooperation and coordination between the relevant regulators and overseers.

Key questions

1. What kinds of links are in operation? Has the CCP carried out a risk analysis of the potential sources of risks arising from the link? Are the resultant risk management arrangements designed to minimize or contain these risks such that the CCP remains able to observe the other recommendations contained in this report?

[Answer]

Not applicable as JDCC has not established any links with other CCPs, either cross-border or domestically.

2. Which laws and contractual rules govern the link? What steps have the CCPs taken to satisfy themselves that these laws and rules support the design of the link and provide adequate protection to both CCPs in the operation of the link?

[Answer]

Not applicable as JDCC has not established any links with other CCPs, either cross-border or domestically.

3. What are the potential sources of operational, credit and liquidity risks arising from the link? Are effective mechanisms in place, including arrangements between the linked CCPs, to monitor and manage the risks identified?

[Answer]

Not applicable as JDCC has not established any links with other CCPs, either cross-border or domestically.

4. For the purposes of regulation and oversight of the link, is there a framework for cooperation and coordination between the relevant regulatory and oversight authorities, including provisions on information sharing and the division of responsibilities in the event of any need for coordinated regulatory action?

[Answer]

Not applicable as JDCC has not established any links with other CCPs, either cross-border or domestically.

Recommendation 12. Efficiency

While maintaining safe and secure operations, CCPs should be cost-effective in meeting the requirements of participants.

Key questions

1. Does the CCP have in place procedures to control costs (for example, by benchmarking its costs and charges against other CCPs that provide a similar service and by analyzing the reasons for significant differences)? Does the CCP have in place procedures to regularly review its pricing levels against its costs of operation?

[Answer]

To fulfill its social responsibility in the settlement of financial instruments, that is, to effect secure and efficient administration of the DVP System for NETD, JDCC considers medium-term income-expenditure equilibrium as its basic financial administration policy, and, while formulating its medium-term business plan each fiscal year, it endeavors to reduce costs and also considers revising DVP Settlement Fee by, for example, forecasting future administration costs and volume.

Also, because JDCC sees medium-term income-expenditure equilibrium as its basic financial administration policy, if results greatly exceed forecasts, JDCC makes rebates of DVP Settlement Fee by a resolution of the Board of Directors.

JDCC compiles an annual budget in line with the medium-term business plan, and exercises budgetary control based on this.

2. Does the CCP regularly review its service levels (for example, by surveying its participants)? Does the CCP have in place procedures to regularly review operational reliability, including its capacity levels against projected demand?

[Answer]

To appropriately reflect the views of DVP Participants in the administration of the DVP System for NETD, JDCC has established a DVP Operations Committee made up mainly of key DVP Participants, and also conducts surveys, etc. of DVP Participants as appropriate to identify aspects to be improved in respect to the DVP System for NETD.

Together with JASDEC, to whom JDCC entrusts system operations, JDCC reviews its operational reliability, including the level of processing capacity, based on volume, etc. forecast during formulation of the medium-term business plan.

Recommendation 13. Governance

Governance arrangements for a CCP should be clear and transparent to fulfil public interest requirements and to support the objectives of owners and participants. In particular, they should promote the effectiveness of a CCP's risk management procedures.

Key questions

1. What are the governance arrangements for the CCP? What information is publicly available about the CCP, its ownership and its board management structure?

[Answer]

JDCC is a joint stock corporation incorporated in accordance with the Companies Act, and is subject to legal regulation in relation to governance under the Companies Act, etc. Also, in its capacity as the Securities Transactions Clearing Organization licensed in

accordance with the Securities and Exchange Law, JDCC is subject to legal regulation in relation to governance under the Securities and Exchange Law, etc.

Moreover, JDCC is JASDEC's wholly owned subsidiary, and is administered in accordance with the Corporate Philosophy and Basic Management Policy, etc., governing JASDEC and its subsidiary JDCC, as determined by JASDEC's Board of Directors.

Information on these points, the positions and names of directors and auditors, and the notice regarding the establishment of the DVP Operations Committee which examines important matters related to operations, are made publicly available on the JDCC's homepage.

2. Is there a clear separation in the reporting lines between risk management and other operations of the CCP? How is this separation achieved? Is there an independent risk management committee?

[Answer]

At JDCC, the operations for which managing directors are responsible are determined by the Board of Directors, and, under the respective managing directors, operations related to the DVP System for NETD and other operations are executed, and relevant matters are reported to the managing director concerned.

As for risk management, since JDCC also complies with the Basic Risk Management Policy formulated by parent company JASDEC, JDCC does not have its own Risk Management Committee, but JDCC does, for example, directly participate in the Risk Management Committee established by JASDEC's President as a body to coordinate basic risk management policy, and directly reports risk information and other information to the committee. JASDEC's Risk Management Committee is an organization under the direct jurisdiction of JASDEC's President, and is clearly separated from JASDEC's operational reporting line.

3. What steps are taken to ensure that management and the board have adequate skills and incentives to achieve the CCP's objectives of delivering sound and effective services to meet related public interest requirements? What are the mechanisms the board has in place to ensure that the objectives include delivering sound risk management and meeting related public interest requirements? How are management and the board made accountable for their performance? How is the composition of the board determined? Are there mechanisms to ensure that the board contains suitable expertise and takes account of all relevant interests? Are reporting lines between management and the board clear and direct? Is the board responsible for selecting, evaluating and if necessary removing senior management?

[Answer]

JDCC has created a united governance structure with parent company JASDEC. JDCC's board is composed entirely of JASDEC managing directors, and JDCC's directors are all managing directors. JASDEC's board supervises the execution of duties by the managing

directors of JASDEC and JDCC. To make JASDEC's board a balanced structure that, for instance, assures user-orientation, business neutrality and fairness, besides appointing participants as directors (10 directors), JASDEC appoints one director from among issuing company officials, one from academic circles and one from judicial circles, making a total of 13 externally appointed directors (out of a total of 18 directors). By doing so, JSDEC creates a structure that adequately reflects the views of participants and at the same time enables deliberation cognizant of JASDEC's public nature. Therefore, the board has appropriate specialist knowledge and is structured to foster an atmosphere of mutual restraint on JDCC's governance and to assure sound risk management and promotion of public interest.

In its board of directors, to better reflect user requirements in the conduct of business, JASDEC has established an Operations Committee as a consultative committee and, under the Operations Committee, has also established subcommittees composed of those actually involved for each theme. JDCC has established the DVP Operations Committee from the same viewpoint. Furthermore, JASDEC has established an Advisory Committee as a forum where a wide range of advice from a broader perspective can be obtained from those experts who are well-informed and familiar with financial instrument systems.

As a joint stock corporation incorporated in accordance with the Companies Act, it is JDCC that makes it a rule for managing directors to report and disclose to the board information on their achievements and the status of execution of their duties and to regularly report details thereof at JASDEC's board of directors meetings, which, as a general rule, are held every month.

Given that JASDEC and JDCC are joint stock companies established in accordance with the Companies Act, their managing directors are appointed and assessed by the board. Also, when JDCC filed its license application to launch the DVP System for NETD, one of the requirements examined was that it must have a personnel structure whereby executive members have the knowledge and experience to be able to conduct operations appropriately, and JDCC's managing directors do have the appropriate specialist knowledge.

4. Are the CCP's objectives, those responsible for meeting them and the extent to which they have been met disclosed to owners, participants and public authorities? If so what/who are they?

[Answer]

JDCC's objective is to engage in the Securities Obligation Assumption Business, and as a joint stock corporation established in accordance with the Companies Act, JDCC is responsible for meeting this objective.

To its shareholder JASDEC, JDCC reports its objectives and the status of their execution in accordance with the Companies Act, and also makes its annual returns publicly available on its JDCC's homepage.

To the supervisory authorities that licensed JDCC to engage in the Securities Obligation Assumption Business in accordance with the Securities and Exchange Law, JDCC reports its Business Rules stating its objectives, etc. and its financial statements, etc., in accordance with the Securities and Exchange Law.

To DVP Participants, JDCC reports measures implemented as appropriate, the minutes of the DVP Operations Committee, and data on the usage of the DVP System for NETD.

In addition, JDCC makes publicly available on its homepage information such as an outline of the DVP System for NETD including JDCC's objectives, the Business Rules and other regulations, a corporate profile, annual returns, and usage of the DVP System for NETD.

Also, the financial report and annual report prepared and published by parent company JASDEC also give JDCC's corporate profile and a summary of its operations, etc.

Recommendation 14. Transparency

A CCP should provide market participants with sufficient information for them to identify and evaluate accurately the risks and costs associated with using its services.

Key questions

1. Does the CCP disclose to market participants its rules and regulations, relevant laws, governance procedures, risks, steps taken to mitigate risks, the rights and obligations of participants and the costs of using the CCP services? Does the CCP make clear when and in what circumstances it assumes counterparty exposure and any restriction or limitations on its fulfillment of its obligations? Does the CCP disclose appropriate quantitative information on its clearing, netting and settlement activities? Does the CCP provide market participants with sufficient information on default procedures and stress testing?

[Answer]

JDCC makes publicly available on its homepage and discloses to DVP Participants and the general public its Business Rules clearly stating matters such as risk management, procedures for the assumption and performance of obligations, default procedures, the rights and obligations of DVP Participants and costs associated with the use of JDCC, other regulations, statistical data on the use of JDCC, etc., and information outlining the DVP System for NETD, etc.

JDCC does not conduct stress tests because it conducts a collateral assessment commensurate with price movements risk on the Assurance Assets it holds as collateral (See Recommendation 5).

2. How is information made available? In what language or languages? In what form?

[Answer]

Information on JDCC is available in Japanese and partly in English on its homepage.

3. Has the CCP completed and disclosed key questions set out in this report? Are there regular reviews to ensure that the information contained in the disclosures remains current, complete and accurate?

[Answer]

JDCC has completed and disclosed its answers to all key questions in this report (as of March 26, 2007).

Recommendation 15. Regulation and oversight

A CCP should be subject to transparent and effective regulation and oversight. In both a domestic and an international context, central banks and securities regulators should cooperate with each other and with other relevant authorities.

Key questions

1. How is the CCP regulated/overseen? Describe the laws that authorize and govern the CCP's operation, the applicable regulatory bodies and their respective authority for the CCP's operation. Do the securities regulator and central bank have sufficient legal capacity and resources (including experienced staff and funding) to carry out effective regulation and oversight?

[Answer]

The Securities and Exchange Law states that the Securities Obligation Assumption Business shall be carried out by a corporation that has a license [from the Prime Minister], and the supervisory authority that licensed JDCC is the Financial Services Agency ("FSA").

In accordance with the Securities and Exchange Law, JDCC needs to obtain approval of the FSA to change its Articles of Incorporation or Business Rules. To carry out the Securities Obligation Assumption Business appropriately and tangibly, the FSA may, if considered necessary, order the licensed Securities Transactions Clearing Organizations to submit a report or materials, or conduct an on-site inspection, etc. FSA is also authorized to issue business improvement orders and to revoke licenses. Moreover, the Securities Transactions Clearing Organizations are obliged to submit to the FSA balance sheets, profit and loss statements and other financial statements at the end of each business year.

In addition, since JDCC holds current account with the Bank of Japan and the JGB accounts in the JGB book-entry system, JDCC has entered into agreement concerning information provision with the Bank of Japan, and provides the Bank of Japan with information required under this agreement.

2. Are the objectives, responsibilities and main policies of the securities regulator, central bank, and, where relevant, banking supervisor clearly defined and publicly disclosed? Are the regulations, roles and policies written in plain language so that they may be fully understood by CCPs and their participants?

[Answer]

The objectives, responsibilities, etc. of the supervisory authority i.e. the FSA in relation to the Securities Transactions Clearing Organizations are clearly stated in the Securities and Exchange Law and the Cabinet Office Ordinance Concerning Securities Transaction Clearing Organizations, and are publicly disclosed on the e-government portal (e-Gov) homepage. Main policies are publicly disclosed on the FSA's homepage¹¹.

The responsibilities of the central bank are clearly stated in the Bank of Japan Law and relevant laws and ordinances and internal regulations, etc. and are publicly disclosed on the BOJ's homepage¹².

3. What information is the CCP required to provide, including information on operations that have been outsourced? How frequently is this information provided? Are there specific information requirements for participants' defaults and CCPs' financial difficulties? Is the CCP required to report significant events, such as rule changes, outages, and changes in risk management procedures?

[Answer]

The Securities Transactions Clearing Organizations are obliged under the Securities and Exchange Law and the Cabinet Office Ordinance Concerning Securities Transactions Clearing Organizations to submit documents and report regularly and as necessary on the following matters to the FSA:

- Submission of applications for approval of changes to Articles of Incorporation and/or Business Rules
- Notification of changes in capital amount, etc.
- Submission of balance sheets, profit and loss statements and other financial statements (each business year)
- Submission of reports on complete or partial suspension of obligation assumption business due to system trouble or other accident and documents stating details and improvement measures, etc.

JDCC provides information on changes in settlement arrangements, etc. and submits financial statements, etc, to the Bank of Japan in accordance with an information provision agreement.

4. Is there a framework for cooperation between relevant authorities of the CCP, including domestic and non-domestic authorities? If so, describe the principles underlying this (these) framework(s) and their main contents, including any information sharing arrangements and decision-making procedures.

¹¹ <http://www.fsa.go.jp/>

¹² <http://www.boj.or.jp/>

[Answer]
Not applicable.

Self-Assessment in Relation to Recommendations for Central Counterparties

Recommendation		Assessment Criteria			
		Observed	Broadly observed	Partially observed	Non-observed
1	Legal risk				
2	Participation requirements				
3	Measurement and management of credit exposures				
4	Margin requirements				
5	Financial resources				
6	Default procedures				
7	Custody and investment risks				
8	Operational risk				
9	Money settlements				
10	Physical deliveries				
11	Risks in links between CCPs	N/A			
12	Efficiency				
13	Governance				
14	Transparency				
15	Regulation and oversight	N/A			