

# Internal Control Framework for Segregated Management

Established on June 8, 2017

## 1. Introduction

In order to secure the proper implementation of the segregated management of customer assets by members of investment trust management companies, etc. (hereinafter referred to as “members”), as provided for in Article 2, Item 1 of the Order Regarding Account Management Institutions and Articles 11 and 12 of the Regulations for Direct Offerings, etc. of Beneficiary Certificates, etc. (hereinafter collectively referred to as the “laws and regulations”), the internal control framework for segregated management has been established as guidelines for smooth preparation and operation of policies and procedures for the members to comply with the laws and regulations, etc. regarding segregated management of customer assets when they receive audit by certified public accountants or auditing firms (hereinafter referred to as “certified public accountants, etc.”) on a regular basis at least once a year on the status of segregated management of customer assets under the provisions of Article 43-2, Paragraph 3 of the Financial Instruments and Exchange Act (hereinafter referred to as the “Financial Instruments and Exchange Act”) in accordance with the provisions of Article 43-2, Paragraphs 1 and 2 of the same article.

The Internal Control Framework for Segregated Management is considered to function as a guideline for the establishment and operation of a system for compliance with the laws and regulations, etc. pertinent to the segregated management by our members, and also as a certain standard established for performing the Assurance Engagements for compliance with the relevant laws and regulations, etc. concerned with the segregated management by certified public accountants, etc. (hereinafter referred to as the “Assurance Engagements”) pursuant to No. 56 of Practical Guidelines by the Business Committee of the Japanese Institute of Certified Public Accountants; “Practical Guidelines for Assurance Engagements for Compliance with Laws and Regulations, etc. for Segregated Management of Customer Assets at Investment Trust Management Companies, etc. for Direct Offerings of Beneficiary Certificates, etc.” (June 23, 2017).

The Attachment 2 “Check items and checkpoints for segregated management of customer assets” is publicly available as the reference for each member to check the degree of achievement in relation to the internal control objectives and for the certified public accountants, etc. to apply as reference materials when performing the Assurance Engagements.

As described later, internal control should be developed and operated in accordance with the environment, characteristics, and size of the business, etc. relevant to each member. Therefore, it is not required for all members to conform to the examples as shown in Attachments 1 and 2. Rather, it is advisable for each member to establish an organizational structure according to its own circumstances, and to selectively use the relevant examples.

## 2. General Framework for Internal Control

Generally, internal control is established within a company for the purpose of enhancing the effectiveness and efficiency of business management, securing the reliability of financial reporting of the company, promoting compliance with the laws and regulations concerning business management, and protecting the assets. Internal control is considered to be performed by all persons who constitute the company.

Internal control is considered to consist of the following six elements: (i) control environment comprising of management philosophy and basic management policy, functions of the Board of Directors and Audit Committee, corporate culture, and general business practices; (ii) risk assessment function to recognize all management risks affecting the corporate objectives, to classify the nature of such risks and to evaluate the frequency and impact of their occurrence; (iii) various control activities including granting of authorities and duties, and division of duties; (iv) information and communication function to ensure that necessary information is properly communicated to the relevant departments and responsible persons as appropriate in a timely manner; (v) monitoring activities to ensure these functions to be properly monitored, evaluated, and corrected if necessary at all times; and (vi) appropriate response to internal and external IT requirements for conducting business operations based on the appropriate policies and procedures predetermined to achieve the corporate objectives.

These six elements of internal control are all necessary to achieve the objectives of internal control discussed above. Since these six elements interact with each other and function as an integral part of the management structure, they are relevant to the entire organization. Furthermore, they can be seen to be concerned with each division of an organization, each business operation, and each transaction cycle. Therefore, in order for the internal control of a division to be effective, all six elements related to the internal control objectives described above must be present.

Since internal control is established by the management themselves within an organization for the purpose of achieving the corporate objectives, the final responsibility for developing and maintaining the internal control rests with the management.

Although an internal control system is established and operated to achieve the corporate objectives, it is necessary to keep in mind the inherent limitations of internal controls as follows:

- Possible deviation in the internal control due to the error of judgment or carelessness of the person in charge of internal control,
- Inability to deal with a transaction that was not contemplated at the time of establishing the relevant internal control,
- Possible invalidation of the internal control functions through conspiracy by the person in charge of internal control and others, or
- Possible invalidation of the internal control functions as result of neglect by the internal control manager themselves.

Regarding more detailed explanation of the general framework of internal control, please refer to the “Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting” in the “Revisions concerned with the Standards for Management Assessment and Audit concerning Internal Control over Financial Reporting and Practical Standards for Management Assessment and Audit

concerning Internal Control over Financial Reporting (opinion paper)” issued by the Business Accounting Council on March 30, 2011, and the “Report No. 315 of the Audit Standards Committee; Identification and Evaluation of Material Misrepresentation Risk through Understanding Companies and the Corporate Environment” issued by the Japanese Institute of Certified Public Accountants on May 29, 2015. These standards demonstrate the concept of materiality with respect to the misrepresentation of the financial statements. Meanwhile, Financial Instruments Business Operators have the obligation to properly manage the assets of all customers by segregated management in accordance with the laws and regulations, etc. concerning the segregated management, and the concept of materiality does not apply to their performing such obligations.

### 3. Internal Control Framework for Segregated Management

The general framework for internal control is as described above, and internal control for segregated management is a mechanism developed within a company and operated by all constituent members of such company for the purpose of complying with the laws and regulations specific to the segregated management among the laws and regulations concerned with business management.

The purpose of internal control for segregated management is to comply with the laws and regulations regarding such segregated management. More specifically, it is considered to be a scheme designed and maintained in order to achieve the following control objectives.

As to how to establish and operate an internal control structure for segregated management, in order to achieve these control objectives, it is considered that the management of each member themselves should devise ways to effectively fulfill the functions and roles of internal control described herein, taking into account the environment, the nature, and scale, etc. of the business pertinent to each member.

In Attachment 1, key control points in establishing and operating the internal control for segregated management by each member are presented as “1. General Matters,” “2. Segregated Management of Securities,” and “3. Segregated Management of Money, etc.” for each control objective. Furthermore, among these key control points, the matters related specially to accounting and book keeping are summarized as “4. Accounting and Book Keeping.”

The key control points may be regarded as specific guidelines for establishing and operating the internal controls to achieve respective control objectives. They are summarized only for demonstrative purposes, and may be supplemented, deleted, or corrected for their application as appropriate in accordance with the circumstances pertinent to individual members.

#### <Control Objectives in Internal Control for Segregated Management>

##### 1. General Matters

- (1) Directors shall recognize the importance of compliance with the laws and regulations, etc. concerning the segregated management and shall be aware of the status of the organization’s compliance with the relevant laws and regulations as appropriate.
- (2) Organizational structure, etc. for compliance with the laws and regulations, etc. concerning the segregated management has been established with each employee carrying out one’s daily duties

based on full understanding of the relevant laws, regulations, internal rules, and other matters regarding the segregated management

(3) Independent department to properly monitor the status of segregated management in an appropriate manner.

## 2. Segregated Management of Securities

### 2-1. General Matters

The officers and employees concerned shall comprehensively and accurately identify the scope of customers' securities subject to the segregated management as required by the laws and regulations, etc. concerned with such segregated management in line with the types of business and products handled by the Financial Instruments Business Operator.

### 2-2. Third-Party Custody

- (1) Customer's consent shall be obtained for having a third party safekeep the relevant securities.
- (2) The selection of a third-party organization to safekeep customers' securities shall be appropriate from the viewpoint of protecting the customers' assets.
- (3) Outstanding balance of the customers' securities subject to the segregated management shall be comprehensively grasped, and such securities are kept in a manner stipulated in the laws and regulations for segregated management (commingled custody, non-commingled custody).
- (4) Among all securities in possession of a Financial Instruments Business Operator, the substantiality of book balance and status of the segregated management concerned with the securities under custody of a third-party organization (separately for simple custody, commingled custody or joint custody) shall be verified.

### 2-3. Account Management

- (1) Among customers' securities subject to the segregated management, balance of those that are recorded in the transfer account book as prescribed in the Act on Transfer of Corporate Bonds, Shares, etc. (hereinafter referred to as the "Transfer Act") shall be comprehensively grasped, and such securities are kept in a manner stipulated in the laws and regulations for segregated management.
- (2) Among all securities in possession of a Financial Instruments Business Operator, the substantiality of book balance and status of the segregated management concerned with the securities recorded in the transfer account book pursuant to the Transfer Act shall be verified.

## 3. Segregated Management of Money, etc.

### 3-1. General Matters

- (1) The officers and employees concerned shall comprehensively and accurately identify the scope of customers' securities subject to the segregated management as required by the laws and regulations, etc. concerned with such segregated management in line with the types of business and products handled by the Financial Instruments Business Operator.
- (2) The selection of a trust bank in which a segregated customer trust account is to be established shall

be appropriate from the viewpoint of protecting customer assets.

- (3) The contract with the trust bank for establishing a segregated customer trust account shall include all the provisions required by the laws and regulations relevant to the segregated management.

### 3-2. Segregated Management System of Customer Funds

- (1) The method and object for calculation of segregated funds shall be specified, and the accuracy and completeness of the recorded data to be used as the basis of calculation, as well as the consistency with accounting book records, shall be ensured.
- (2) The necessary amount of segregated customer funds as the sum of segregated customer funds shall be calculated comprehensively and accurately in compliance with the laws and regulations, etc. concerning the segregated managements.
- (3) The necessary amount as stipulated in the laws and regulations, etc. concerning the segregated management shall be deposited in the trust account for segregated customers fund.
- (4) Any deposit and withdrawal in the trust account for the segregated customers fund shall be made in compliance with the laws and regulations, etc. concerning the segregated management following the appropriate procedures.
- (5) Procedures to periodically check the balance of account books for segregated customers fund against the balance at such trust bank account exist.

## 4. Accounting and Book Keeping

### 4-1. Account Opening, Orders Receipt, and Contract with Customers

- (1) Appropriateness of the transaction (i.e., that all customer transactions initiated are with a real counterparty and have been properly authorized) shall be ensured.
- (2) All transactions shall be entered, processed, and reported.
- (3) Any contract for the transactions shall be accurately entered, processed, and reported with respect to major trading information, such as the principal transaction or customer transaction, customer name, account number, dates and times of the orders received and contracted, product name, quantity, price, currency, amount, buy or sell, and others.

### 4-2. Settlement of Transaction with Customer

- (1) To ensure that any transfer of the customers' securities or money is made solely in connection with a valid transaction or under the proper instruction from the relevant customer with proper authorization.
- (2) To ensure that the authorized transfer of securities or money has been comprehensively accounted for the purpose of accounting and accurately recorded in the appropriate accounting item with respect to major trade information, such as the amount, quantity, product name, currency, customer name, dates, delivery information, and others.

### 4-3. Master Data and Cumulative Data

- (1) To ensure that any change to the master data (customer data such as customer name, account number, address, settlement account, product data, etc.) has been approved and completely and accurately entered into.

- (2) To ensure that any input data regarding trading transactions, receipts, and payments of securities and money are accurately recorded in the database including the customer's account ledger, the securities register under custody, the securities register per location of custody (register on securities held by the Financial Instruments Business Operator for each location of custody), etc.
- (3) To ensure that any accumulated data on trading, transfer of securities and money, and any modification thereof are consistent with the relevant items of securities register per location of custody and other related accounting books.

#### 4-4. Restrictions on Access to Assets and Records

- (1) To ensure that only authorized employees shall have access to assets and accounting book records, including master data and settlement data for money and securities.

End.

#### Supplementary Provisions

1. The Framework shall come into effect on March 31, 2018.
2. Members who have received an audit of segregated management in connection with the agreed procedural services with reference to the pre-revised version of Article 2, Paragraph 1 of the "Regulations for Proper Implementation of Segregated Management of Customer Assets" by the Japan Securities Dealers Association prior to the effective date of this Framework may conduct an audit of the segregated management on or before March 31, 2018 pursuant to the provisions then in force.