

# Q&A on External Audit of Segregated Management

Established on June 8, 2017

(Note) Abbreviations used in the documents are as follows:

Regulations: Investment Trust Association, Japan Regulations for Direct Offering, etc. of Beneficiary Certificates, etc.

Bylaws: Investment Trust Association, Japan, By-laws of the Regulations for Direct Offering, etc. of Beneficiary Certificates, etc.

Practical Guidelines: The Japanese Institute of Certified Public Accountants, Practical Guidelines No. 56 by Business Committees; Practical Guidelines for Assurance Engagements for Compliance with Laws, Regulations, etc. Concerning Segregated Management of Customer Assets at Investment Trust Management Companies, etc. for Direct Offerings, etc. of Beneficiary Certificates, etc.

Question 1: What are the main points of the amendment to the Regulations dated June 8, 2017?

Answer: Major changes related to the Segregated Management Audit due to the amendment to the Regulations dated June 8, 2017, are as follows:

## (1) Unification of legal compliance for segregated management with Assurance Engagements

In the past, Full Members who have been engaged in direct offering have been subject to Segregated Management Audit by selecting either of verification services regarding compliance with the laws, regulations, etc. concerning segregated management (hereinafter referred to as “Verification Services”) or agreed procedures regarding the segregated management (hereinafter referred to as “Agreed Procedures”) with reference to the regulations of the Japan Securities Dealers Association (Regulations for Proper Implementation of Segregated Management of Customer Assets) and practical guidelines by the Japanese Institute of Certified Public Accountants<sup>1</sup> (hereinafter referred to as “Old Practical Guidelines”).

Recently, the Japan Securities Dealers Association has revised the Association’s regulations based on the results of a study conducted by the Working Group for studying the ideal external audit, etc. for the segregated management of customer assets in April 2015 and has decided to unify them as the Assurance Engagements (procedures equivalent to the conventional Verification Services of the Japan Securities Dealers Association).

The Association has decided to obligate the Certified Public Accountants, etc. to perform the “Assurance Engagements for Compliance with Laws and Regulations on Segregated Management of Customer Assets” (hereinafter referred to as “Assurance Engagement”) in addition to clarifying the

---

<sup>1</sup> The Japanese Institute of Certified Public Accountants, Practical Guidelines No. 40 by Business Committees; Handling of Verification Services for Compliance with Laws and Regulations for Segregated Management of Customer Assets by Financial Instruments Business Operators.

basis for the segregated management of beneficiary certificates of investment trusts and money as well as the Segregated Management Audit.

Furthermore, through consultation with the Japanese Institute of Certified Public Accountants, it has been decided that they will formulate the “Practical Guidelines” for the Segregated Management Audits.

## (2) Introduction of the obligation to prepare Management Reports

In the past, Full Members have prepared Management Reports with reference to the “Old Practical Guidelines” when receiving the Verification Services.

This time, in order to clarify the principle of dual responsibility in the Segregated Management Audit, it has been determined that the rules of the Japan Securities Dealers Association stipulate the obligation for the Members to prepare a Management Report.

In the direct offering of investment trusts, the act of taking custody of customers’ assets requires strict control, and in order to earn the customers’ trust, we believe that the same level of segregated management as that applicable to the Type I Financial Instruments Business Operators and audit are also required in the business.

The Association has decided to stipulate in the Regulations the obligation of Full Members to prepare the Management Report.

(Article 11, Paragraph 5 of the Regulations)

## (3) Matters to be included in Management Report

In Article 3-2, Paragraph 1 of the By-laws, the following are provided for:

- (i) The obligation to comply with the laws, regulations, etc. concerning segregated management;
- (ii) The obligation for establishing and operating an effective internal control system to ensure legal compliance with the laws, regulations, etc. concerning segregated management;
- (iii) The obligation to entrust segregated customer funds or manage customer securities separately if the member is also an account management institution as of the base date for audits (hereinafter referred to as the “Base Date”);
- (iv) The obligation to perform procedures to confirm that segregated management of customer assets has been implemented in compliance with the laws, regulations, etc.;
- (v) Whether or not segregated management for customer assets complies with the laws, regulations, etc. as of the Base Date as a result of performing the procedures set forth in the preceding item; and
- (vi) The content of any event that may have a material impact on compliance with the laws, regulations, etc. concerning segregated management, which occurred after the Base Date but before the Management Report submission date.

(Article 3-2, Paragraph 1 of the By-laws)

- (4) Introduction of an obligation to implement the procedures to confirm the establishment and operation of effective internal control for compliance with the laws, regulations, etc. concerning segregated management as well as the status of compliance with such laws, regulations, etc. (referred to as the “Confirmation Procedures” in (4) and (5) below)

With the recent amendment to the Regulations obligating the preparation of the Management Report described in (2) above in such Regulations, it has been decided to oblige the Full Members to implement the Confirmation Procedures as the basis for preparing the Management Report.

The Confirmation Procedures at the time of receiving the Segregated Management Audit are considered to have been implemented with reference to the Old Practical Guidelines in the past, but shall conform to the revised Regulations henceforth.

(Article 11, Paragraph 6 of the Regulations)

- (5) Introduction of an obligation to produce the records on the Confirmation Procedures regarding the establishment and operation of effective internal control for compliance with the laws, regulations, etc. concerning segregated management as well as for the Confirmation Procedures of the compliance status with such laws, regulations, etc.

It is decided to oblige the Full Members to record the results of implementing the Confirmation Procedures described in (4) above. In addition, it is decided to oblige to record any non-compliance event, etc. identified during the implementation of such Procedures. See Q3 for details.

(Article 11, Paragraph 7 of the Regulations)

- (6) Reporting the results of the Segregated Management Audit to the Investment Trust Association, Japan

When a Full Member receives a report on the results of Segregated Management Audit conducted by Certified Public Accountants, etc. (meaning the “Assurance report on compliance with the laws, regulations, etc. concerning segregated management” submitted by Certified Public Accountants, etc.; hereinafter referred to as the “Segregated Management Audit Report”), the Regulations oblige the Full Member to report to the Association according to the submission form as set forth in the By-laws with a copy of the Management Report attached thereto.

However, notification to this Association is no longer required only when a Full Member, which has obtained registration for both Type I financial instruments business and Type II financial instruments business, engages in taking their customers’ deposits for investment concerned with the direct offering of investment trusts as part of their securities, etc. management business (Type I business) and submits a Segregated Management Audit Report to the Japan Securities Dealers Association.

In order to conduct solicitation and sales as Type I financial instruments business, it is necessary to register securities sales representatives with the Japan Securities Dealers Association as well as to submit a notification of the Sales Officers and Representatives to the Association.

(Article 11, Paragraph 8 of the Regulations and Article 3-2, Paragraph 3 of the By-laws)

Question 2: In Article 11, Paragraph 6 of the Regulations, it is provided that the member shall implement procedures to confirm that it has established and operated an effective internal control system for compliance with the laws, regulations, etc. concerning segregated management and has conducted the segregated management of customer assets in compliance with such laws, regulations, etc. What kind of procedures are specifically required?

Answer: Full Members are obligated to conduct the segregated management in compliance with the relevant laws, regulations, etc. and to receive routine audits by Certified Public Accountants, etc. regarding the status of their segregated management at least once a year as stipulated in the Order Regarding Account Management Institutions or the Regulations. In order to receive such audit by Certified Public Accountants, etc., it is necessary to prepare a Management Report.

Management Report is for the management to express their opinion on the status of compliance with the laws, regulations, etc. regarding the segregated management of a Full Member on the Base Date for audit in order for the Full Member to receive such audit by Certified Public Accountants, etc. on a regular basis.

In other words, in order for the management to express their opinions in the Management Report, the management needs to conduct an inspection according to the procedures suited to their own circumstances (internal inspection, etc.) to ascertain, as of the Base Date for audit, whether the segregated customer fund has been entrusted and Customer Securities are managed separately as set forth in the relevant laws, regulations, etc. as well as whether an effective internal control has been established and implemented to comply with such laws, regulations, etc. concerning segregated management. Examples of such procedures include the following:

- (1) Full Members who have been subject to the Agreed Procedures in the past or who receive the Segregated Management Audit for the first time

With reference to the “Internal Control Framework for Segregated Management” and attached document thereto “Check Items and Checkpoints for Segregated Management of Customer Assets,” it may be advisable to implement procedures (such as internal inspections) to confirm that it has established and operated an effective internal control system for compliance with the laws, regulations, etc. concerning segregated management and has conducted the segregated management of customer assets in compliance with such laws, regulations, etc.

- (2) Full Members who have received Verification Services in the past

It is acceptable to basically follow the same procedures as the Confirmation Procedures pursuant to the old Practical Guidelines at the time of receiving the Verification Services in the past.

(Article 11, Paragraph 6 of the Regulations)

Question 3: What sort of records are required to be produced according to Article 11, Paragraph 7 of the Regulations?

Answer: The records to be prepared according to Article 11, Paragraph 7 of the Regulations shall include the procedures implemented pursuant to Article 11, Paragraph 6 of the Regulations (see Q2) and the summary of the results thereof.

(1) Full Members who have been subject to the Agreed Procedures in the past or who receive the Segregated Management Audit for the first time

When procedures are implemented with reference to the description of Q2(1) above, it is advisable to record the results of such procedures by using the Japan Securities Dealers Association's sample form such as the "Investigation Sheet for Segregated Management."

(2) Full Members who have received Verification Services in the past

It is acceptable to basically follow the same procedures to prepare the records pursuant to the old Practical Guidelines at the time of receiving the Verification Services in the past.

Question 4: How long should the records be kept, which is prepared according to Article 11, Paragraph 7 of the Regulations?

Answer: The storage period of records prepared under Article 11, Paragraph 7 of the Regulations is not prescribed. However, as a check item in the "Inspection Manual for Financial Instruments Business Operators, etc.," it is stipulated that "whether a person engaged in the internal audit has accurate records of the matters verified through internal audit and problems identified," and "whether a person engaged in the internal audit has prepared an internal audit report without delay which accurately reflects problems, etc. identified through such internal audit." Therefore, although we believe each member company provides for an appropriate period for their safekeeping, it is considered necessary to keep such records related to internal audit for at least three (3) years taking also into accounts necessary responses to inspections, etc. by the relevant authorities.

Question 5: What matters should be included in the Management Report?

Answer: In preparing the Management Report pursuant to Article 3-2, Paragraph 1 of the By-laws, as a result of the procedures (internal inspection, etc.; refer to Q2 above) to confirm that an effective internal control system for compliance with the laws, regulations, etc. concerning segregated management has been established and implemented, and the segregated management of the customer assets comply with the such laws, regulations, etc., if any non-compliance with the laws, regulations, etc. is detected on the Base Date for audit such as (i) shortage of segregated customer fund and (ii) non-performance of

segregated management of the securities, all of such non-compliance incidence with the relevant laws, regulations, etc. shall be described in the Management Report, in principle. It is not necessary to state in the Management Report any accounting error or clerical error that is identified on the Base Date for audit but not regarded non-compliance with the laws, regulations, etc. (e.g., calculation error or clerical mistake although the Necessary Amount of segregated customer trust fund is satisfied) or legal non-compliance incidence that had occurred prior to the Base Date for audit but addressed by such Base Date.

Please refer to Q1(3) for descriptions items in the Management Report.

(Article 3-2, Paragraph 1 of the By-laws)

Question 6: When do we need to start receiving the Assurance Engagements under this revised Regulations?
--

Answer: The Assurance Engagements under the revised Regulations shall apply to any Segregated Management Audit, which will be conducted on or after March 31, 2018, as the Base Date of audit. Specifically, the details are as follows:

(1) Full Members who have received Verification Services in the past

The Full Members who received the Verification Services before the effective date of this amendment will continue to receive the Assurance Engagements.

(2) Full Members who have received Agreed Procedures in the past

Full Members who have been subject to the Agreed Procedures prior to the effective date of this amendment will also be required to receive the Assurance Engagements. However, in consideration of the fact that preparation is required for the switchover from the Agreed Procedures to the Assurance Engagements, a grace period has been established. Specifically, with respect to the Segregated Management Audit to be conducted on or before March 31, 2018, as the Base Date of audit, it is possible to continue to receive the Agreed Procedures. (In this case, the Segregated Management Audit to be conducted on or after April 1, 2018, as the Base Date for the audit is subject to the Assurance Engagements.)