New Regulatory Framework for Commodity Derivatives Business - Amended Commodity Futures and Exchange Act

On July 3, 2009, the bill of amendments to the Commodity Exchange Act of Japan (Act No. 239 of 1950, as amended; the "Commodity Exchange Act") was enacted. The amendments will come into effect in three stages, and in the final stage (which will occur within a year and a half of July 10, 2009), the title of the Commodity Exchange Act will change to "Commodity Futures and Exchange Act" (the "Amended Commodity Futures and Exchange Act" or the "Amended Act"), at which point, the regulatory framework for the commodity derivatives business in Japan will also change drastically. This paper will focus on the amendments in the final stage and will provide an outline of how they affect current commodity derivatives business, in particular, how offshore and OTC markets are affected[1].

1. Current Regulatory Framework

Under the current Commodity Exchange Act, only commodity derivatives business that is domestic in nature is regulated[2]. More specifically, the Commodity Exchange Act mainly regulates business relating to domestic commodity exchange transactions, and also provides some regulations on OTC commodity derivative transactions referring to market prices in domestic commodity exchanges. It stipulates the licensing and reporting requirements of entities which intend to engage in such business, together with client protection schemes and other regulations relating to such business.

By contrast, business in Japan relating to certain offshore commodity exchange transactions and certain OTC commodity derivative transactions (not referring to market prices in domestic commodity exchanges) is regulated by other laws as well. However, there are no licensing or reporting requirements of such business[3]. Moreover, it had been indicated by some non-dealer parties that the client protection regulations regarding such business were incomplete when compared to such regulations for the business relating to domestic commodity exchange transactions under the Commodity Exchange Act.

To date, the regulations on the commodity derivatives business have been established on a step by step basis reacting to the newly established business, thus resulting in the above differing levels of regulation.

[1] The amendments in the first and second stages principally relate to regulations on domestic commodity exchanges and domestic commodity exchange transactions including development in regulations on market manipulation.
[2] The "Commodities", that is, the underlying assets of the derivatives regulated under the Commodity Exchange Act, include certain agricultural products, forest products, animal products and aquatic products, and certain metals and other mineral substances. Note that the "Commodities" do not include emission allowances.
[3] Note that, for certain financial institutions licensed under Japanese law, submission of the reports to or the approvals of the Japanese authority (which governs their principal business) may be required when commencing such business by side-business regulations under the laws governing their principal business.

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2. New Regulatory Framework - Cross-sectional and Flexible Regulations

What will occur under the Amended Commodity Futures and Exchange Act appears to have some similarity to what has occurred to the financial derivatives business under the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the "FIEA") whereby the former Securities and Exchange Act was transformed by bringing "cross-sectional" and "flexible" regulations to the new regulatory framework for financial derivatives business. It could be said that the enactment of the Amended Act follows the same trends as the enactment of the FIEA that came into effect in September 2007.

The Amended Act intends to set cross-sectional and seamless regulations for commodity derivatives business, without regard to cross-border and domestic transactions, exchanges and OTC transactions. That is, the Amended Act will (i) expand the regulations regarding business in Japan relating to offshore commodity exchange transactions and OTC commodity derivative transactions in addition to the current coverage of business relating to domestic commodity exchange transactions; and (ii) set consistent rules for such business ("cross-sectional" regulations).

Reacting to the increase of unscrupulous dealer cases, the Amended Act will also strengthen client protection regulations, while adding some flexibility in the applicability of certain client protection regulations, depending on whether the clients are in the category of professionals or amateurs ("flexible" regulations).

3. New Regulations for Commodity Derivatives Business relating to Offshore and OTC Markets

The following are notable points in the new regulations for commodity derivatives business relating to offshore and OTC markets provided under the Amended Commodity Futures and Exchange Act.

(1) Licensing Requirements

Under the Amended Act, an entity that intends to engage in business in Japan regarding one or more of the following will be required to obtain the approval of the Japanese authority to conduct such business:

(a) acting as an intermediary, a broker or an agent for offshore commodity exchange transactions; and/or

(b) entering into and/or performing OTC commodity derivative transactions, or acting as an intermediary, a broker or an agent for such OTC commodity derivative transactions.

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Typically speaking and by way of an example, if an entity intends to engage in business in Japan by entering into and/or performing OTC oil swap transactions using an index of WTI prices in New York Mercantile Exchange (NYMEX), or by acting as an intermediary, a broker or an agent for such oil swap transactions, such business would fall within the category of (b) above.

Note that, for certain financial institutions licensed under Japanese law, the scope of commodity derivatives business that they are permitted to engage in may be restricted by side-business regulations under the laws governing their principal business.

In order to obtain approval, all of the following requirements must be satisfied. Even if approval is obtained, it must be renewed every six years in order to maintain its effectiveness (an entity which has obtained the effective approval is a "Commodity Futures Trader").

(i) the applicant for the approval must be one of the following:

- ✓ a stock company (*Kabushiki Kaisha* or "KK");
- ✓ a foreign entity equivalent to a KK having its office(s) in Japan; or
- ✓ any other entity as specified by the cabinet order;

(ii) it must have sufficient financial standing to ensure the sound performance of its commodity derivatives business and the outlook for income and expenditures relating to such business must be favorable;

(iii) it must have knowledge and experience for the fair and appropriate performance of its commodity derivatives business and have sufficient social credibility, and the operation of such business should not be lacking in client protection;

(iv) it must not be an entity which falls under any of the disqualification causes specified in the Amended Act; and

(v) there must be no false statement relating to any material matter in the application for the approval or documents attached thereto.

As to the requirements in (ii) above, if the amount of the entity's net assets is less than the amount specified by the ministerial ordinance, such entity shall be deemed to lack sufficient financial standing.

The requirements set out in (i) to (v) above are those provided by the Amended Act, however, in practice, there may be a possibility that the Japanese authority would require the applicant to satisfy supplemental or elevated requirements. Also, certain conditions for approval may be attached at the time the approval or renewal is granted.

Moreover, all individuals employed by or working for a Commodity Futures Trader and engaging in any of the previously mentioned conduct in 3 (1) (a) or (b) or of solicitation of

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clients for the transactions will also be required to be registered as sales staff. The registration must be renewed every six years in order to maintain its effectiveness.

(2) Client Protection and Other Regulations

A Commodity Futures Trader will become subject to several detailed client protection schemes and other regulations as provided in the Amended Act, including:

- ✓ segregation of the clients' assets;
- ✓ prohibition of bucketing;
- ✓ restrictions on advertisement;
- ✓ restrictions on the solicitation of clients;
- ✓ delivery of certain documents to clients;
- ✓ obligation to provide explanations to clients;
- ✓ restrictions on compensation for losses;
- ✓ restrictions on net assets ratio[4]; and
- ✓ book and record keeping.

Some of the client protection regulations will not apply if the clients are certain professional clients, or certain quasi-professional clients which have completed requisite procedures.

(3) Exempted Business

As to the business relating to OTC commodity derivative transactions with certain high-level professional clients, the approvals mentioned in (1) above will not be required. However, submission of the reports to the Japanese authority may still be required prior to the commencement of such business[5]. In such cases, such entities will be subject to certain limited regulations such as restrictions on compensation for losses, and book and record keeping.

(4) Commodity Futures Intermediary

The Amended Act also provides a new regulatory framework for business of acting as an intermediary for Commodity Futures Trader(s) relating to domestic commodity exchange transactions as well as offshore commodity exchange transactions and OTC commodity derivative transactions.

Under such framework, if an entity which has not obtained the approval mentioned in (1) above intends to engage in the intermediary business relating to offshore commodity exchange transactions and/or OTC commodity derivative transactions, it must register with

[4] Certain entities such as banks to be specified by the cabinet order are likely to be exempted from the restrictions on net assets ratio under the Amended Act.
[5] By way of clarification, even an entity that has obtained the approval mentioned in (1) above may be required to submit this report to the Japanese authority prior to the commencement of such exempted business.

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the Japanese authority and stipulate the Commodity Futures Trader(s) which it will be acting for (an entity which has completed such registration is a "Commodity Futures Intermediary"). The registration must be renewed every six years in order to maintain its effectiveness. A Commodity Futures Intermediary will be subject to certain regulations including prohibition on holding the clients' assets, registration of its sales staff, restrictions on advertisement, restrictions on the solicitation of clients, obligation to provide explanations to clients, restrictions on compensation for losses, and book and record keeping.

4. Further Steps and Effective Date

Although the Amended Commodity Futures and Exchange Act provides the outline of the new regulations on the commodity derivatives business, the details will be stipulated in the cabinet order and ministerial ordinance and drafts of such are expected to be published before the effective date of the Amended Act.

The Amended Act will come into effect on a date to be specified by the cabinet order but within a year and a half of July 10, 2009.

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