

Amendment to the Financial Instruments and Exchange Act with Respect to the OTC Derivatives

The bill for amendment of the Financial Instruments and Exchange Act (Act No. 25 of 1948) passed the Diet as of May 12, 2010 and was promulgated on May 19, 2010 (the “Amendment”). The Amendment consists mainly of (i) provisions to improve the stability and transparency of settlement of over-the-counter (“OTC”) derivative transactions and other transactions, (ii) provisions to strengthen the group-wide regulation and supervision of the securities companies, and (iii) other investor protection measures. This newsletter focuses on the provisions to improve the stability and transparency of settlement of OTC derivative transactions, including the mandatory use of a central counterparty (“CCP”) with respect to clearing of the OTC derivatives.

At the G20 Pittsburgh summit (September 2009), the G20 members agreed in their leaders’ statement that “all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories”. After this statement, the Financial Services Agency (the “FSA”) published the paper titled “Development of Institutional Frameworks Pertaining to Financial and Capital Markets” on November 13, 2009, in which the FSA indicated that it commenced a detailed examination of the issues including the regulations over the OTC derivative transactions in preparation for the 2010 ordinary session of the Diet. Further, on December 17, 2009, the FSA outlined its proposed regulations in the “Draft Blueprint for the Development of Institutional Frameworks Pertaining to Financial and Capital Markets” and invited members of the general public to provide their opinions and held two meetings to exchange opinions with markets participants and others.

On January 21, 2010, drawing upon these opinions, the FSA presented its proposed regulatory framework in the final version of the “Development of Institutional Frameworks Pertaining to Financial and Capital Markets”¹. After discussions at the meetings of the FSA policy council (*kinyu cho seisaku kaigi*), the Amendment was prepared in order to legislate the regulations.

A number of the details would be left to subordinate regulations which should be published by the FSA in due course. Accordingly, the substance of those regulations will not be known until the relevant cabinet orders/cabinet office ordinances are published. We will by further newsletters inform you as to developments as they occur on this matter.

1. Systems for the Development of the Infrastructure for Clearing

(1) Strengthening the infrastructure for domestic CCPs

(i) Amendment of the definition of the “Financial Instruments Obligation Assumption Service”

Under the current Financial Instruments and Exchange Act (the “Current Act”), the Financial Instruments Obligation Assumption Service (*kinyu shohin saimu hikiuke gyo*) is defined as the “provision of service, which is comprised of the assumption of an obligation (*saimu hikiuke*)”

¹ English version is available on the FSA’s website (<http://www.fsa.go.jp/en/news/2010/20100122-3.html>).

arisen from a Subject Transaction (*taisho torihiki*) conducted by a Financial Instruments Business Operator (*kinyu shohin torihiki gyosha*), a Registered Financial Institution (*toroku kinyu kikan*) or a Securities Finance Company (*shoken kinyu kaisha*), in the course of trade, to Business Operators Covered by Financial Instruments Obligation Assumption Service (*kinyu shohin saimu hikiuke gyo taisho gyosha*)” (Article 2, Paragraph 28 of the Current Act). This definition assumes that the clearing of the Subject Transaction is conducted through the assumption of an obligation. A Subject Transaction (*taisho torihiki*) means a sale and purchase of Securities (*yuka shoken*), Derivative Transactions (*deribatyibu torihiki*) or other transactions designated by a cabinet order. The Financial Instruments and Exchange Act to be amended by the Amendment (the “Amended Act”) will expand the definition from “the assumption of an obligation” to “the assumption of an obligation, or novation (*kokai*) or other method to come to owe an obligation”, so that the Subject Transactions may be cleared by legal structures other than the assumption of an obligation.

The Payment Services Act (Act No. 59 of 2009) was recently promulgated and contains regulations on “Fund Clearing Service” (*shikin seisan gyo*) with respect to clearing services of currency exchange transactions (including the domestic fund transfers and remittances system (*zenkoku ginko naikoku kawase seido*) which is currently operated by the Tokyo Bankers Association (*Tokyo Ginko Kyokai*)). The term “Fund Clearing Service” is defined as the “service of assuming obligation under money remittance transactions arising among the Banks, etc. (*ginko tou*) by way of the assumption of an obligation, novation or otherwise for the purpose of settlement of debts and credits relating to the money remittance transactions” (Article 2, Paragraph 5 of the Payment Services Act). The definition of the Financial Instruments Obligation Assumption Service in the Amendment is in line with the definition of the Fund Clearing Service, which allows the clearing to be conducted by methods other than the assumption of an obligation.

Under the Amendment, certain types of transactions shall be exempted from the definition of the Financial Instruments Obligation Assumption Service if they are not harmful to the investor’s protection or the interest of the public from the viewpoint of the impact on Japanese market, the status of the transactions and others.

The Amendment authorizes the cabinet order to define exempted transactions. According to the explanatory material provided by the FSA, a CDS transaction will be exempted if, for example, the reference entity is a U.S. company and the transaction is subject to the mandatory use of U.S. CCPs. The Amendment apparently allows the possibility of the Japanese regulator deferring to the regulations of other jurisdiction in case of conflict of dual regulations.

(ii) Amendment of the criteria for license examination of Financial Instruments Clearing Organization

An entity which operates the Financial Instruments Obligation Assumption Service is defined as a “Financial Instruments Clearing Organization” (*kinyu shohin torihiki seisan kikan*) (Article 2, Paragraph 29 of the Current Act) and subject to the licensing requirement (Article 156-2 or 156-19 of the Current Act). Under the Amendment, the criteria for license examination of Financial Instruments Clearing Organization (Article 156-4, Paragraph 1 of the Current Act) will be tightened such that a Financial Instruments Clearing Organization will be required to establish a sufficient system and organizational structure for ensuring appropriate and secure clearing of unsettled obligations, including receiving collateral for unsettled obligations and

establishing operation by stable equipment for ensuring a smooth settlement. The Current Act does not explicitly require receiving collateral in connection with clearing of the OTC derivatives transactions. However, the Current Act requires a Financial Instruments Clearing Organization to describe in its business rules the “matters concerning securing performance of obligations owed by a Clearing Participant²” (Article 156-7, Paragraph 2, Item 5 of the Current Act). In addition, a Financial Instruments Clearing Organization shall stipulate in its business rules the obligations of Clearing Participants to bear all the loss incurred in connection with the Financial Instruments Obligation Assumption Services, and/or take other measures for securing the appropriate provision of such services (Article 156-10 of the Current Act).

The Financial Instruments Clearing Organizations’ current market practices already include taking from market participants certain collateral and clearing margins. In this regard, the Amendment should not materially alter the current practice.

(iii) Regulation of the capital amount

The Amendment introduces certain capital requirements applicable to the Financial Instruments Clearing Organizations (Article 156-5-2 of the Amended Act). The minimum capital amount is not currently known since it will be determined by the cabinet order. The amendment of capital amount is also regulated. The decrease of the capital amount shall require the authorization of the Prime Minister and the increase shall be notified to the Prime Minister (Article 156-12-3 of the Amended Act).

(iv) Regulation of the major shareholders

The Amendment introduces certain regulation on major shareholders of the Financial Instruments Clearing Organizations. A holder of more than 5% of the voting rights of a Financial Instruments Clearing Organization shall notify to that effect to the Prime Minister, and a person who intends to hold or acquire 20% or more of the voting rights shall obtain the authorization of the Prime Minister before completing such transaction (Article 156-5-3, Articles 156-5-5 to 156-5-7 of the Amended Act). In addition, the major shareholders of the Financial Instruments Clearing Organizations will be subject to certain regulations of the Prime Minister including reporting obligations, on-site inspections and rescission of the authorization (Articles 156-5-8 to 156-5-10 of the Amended Act).

(2) Establishment of a system for foreign CCPs

Foreign CCPs, mainly those that are U.S.- or U.K.- based, have commenced clearing services of OTC derivatives. When a foreign CCP carries out clearing services in Japan, however, such clearing services might fall into the definition of “Financial Instruments Obligation Assumption Service” under the Current Act, which would require the foreign CCP to obtain an authorization of the Prime Minister. As one of the requirements for such authorization, however, an applicant shall be a corporation by shares (*kabushiki kaisha*) incorporated under Japanese law (Article 156-4, Paragraph 2, Item 1 of the Current Act), and thus, such requirement would prevent foreign CCPs from obtaining such authorization.

² The term “Clearing Participant” (*seisan sankasha*) is defined under Article 156-7, Paragraph 2, Item 3 of the Current Act, as a person who is a counter party of Financial Instruments Obligation Assumption Service.

The Amendment allows foreign entities, which provide a service similar to the Financial Instruments Obligation Assumption Service in a foreign jurisdiction, to carry out the Financial Instruments Obligation Assumption Service in Japan by obtaining a license (such entities shall be referred as the “Foreign Financial Instruments Clearing Organizations”). The requirements for a license are similar to those for domestic Financial Instruments Clearing Organizations, except that an applicant shall be required to have a representative in Japan and shall be required to have operated in a foreign jurisdiction for not less than a certain period designated by the cabinet order a service similar to the Financial Instruments Obligation Assumption Service in accordance with the laws of such foreign jurisdiction (Articles 156-20-2 to 156-20-5 of the Amended Act).

In addition, Foreign Financial Instruments Clearing Organizations will be subject to certain regulations similar to those for domestic Financial Instruments Clearing Organizations, including establishing business rules, confidentiality obligation of officers and employees (Articles 156-20-6 to 156-20-11 of the Amended Act), save the major shareholders and minimum capital amount will not be regulated. Further, similarly with a domestic Financial Instruments Clearing Organization, certain supervisory provisions, such as reporting obligations, on-site inspections, orders to improve business operations and suspensions of business or rescissions of license, will be equally applicable to Foreign Financial Instruments Clearing Organizations (Articles 156-20-12 to 156-20-15 of the Amended Act).

(3) Development of a system for links between domestic CCPs and foreign CCPs

Financial Instruments Clearing Organizations may, upon an authorization of the Prime Minister, carry out Financial Instruments Obligation Assumption Services, by executing a contract with another CCP (i.e., a Financial Instruments Clearing Organization, a Foreign Financial Instruments Clearing Organization or an entity which is established under a foreign law and provide in a foreign jurisdiction a service similar to the Financial Instruments Obligation Assumption Service) (Article 156-20-16 of the Amended Act).

This is called “link method”, allowing two CCPs in concert to carry out a clearing service (such service shall be referred as the “Aligned Financial Instruments Obligation Assumption Service” (*renkei kinyu shohin saimu hikiuke gyomu*)). The followings are the different methods of linking two CCPs;

- (i) an alliance between a domestic Financial Instruments Clearing Organization and another domestic Financial Instruments Clearing Organization,
- (ii) an alliance between a domestic Financial Instruments Clearing Organization and a Foreign Financial Instruments Clearing Organization, or
- (iii) an alliance between a domestic Financial Instruments Clearing Organization and an entity which is established under a foreign law and provides in a foreign country a service similar to the Financial Instruments Obligation Assumption Service (i.e., a foreign CCP which has no license under Article 156-20-2 of the Amended Act).

The requirements of an authorization for an Aligned Financial Instruments Obligation Assumption Service include the establishment of a system and organizational structure to ensure appropriate and secure clearing of unsettled obligations (Articles 156-20-17 and 156-20-18 of the Amended Act). In case of a linking method (iii) above, the relevant foreign CCP would need to satisfy the same or similar level of requirements applicable to Foreign Financial

Instruments Clearing Organization (Article 156-20-18, Paragraphs 1 and 2 of the Amended Act).

A foreign CCP which is considering clearing services in Japan would have an option of either (a) obtaining a license as a Foreign Financial Instruments Clearing Organization or (b) entering into an alliance with a domestic Financial Instruments Clearing Organization (link method). The link method (b) is different from (a) in that under (b), a foreign CCP would not be required to obtain a license in Japan. However because such a foreign CCP would need to satisfy the requirements set forth above in the immediately preceding paragraph, the regulatory requirements for the market entry should not be materially different between two methods (a) and (b).

Certain supervisory provisions, such as suspension of business and rescissions of authorization, shall be imposed for the Aligned Financial Instruments Obligation Assumption Service (Article 156-20-22 of the Amended Act).

(4) Hearing from BOJ

The Prime Minister may hear an opinion from the Bank of Japan if it finds necessary to take a disciplinary action against the Financial Instruments Clearing Organizations, etc.³ (Article 156-20-23 of the Amended Act).

2. Mandatory Use of CCPs for Clearing OTC Derivatives Transactions

(1) Requiring certain OTC derivatives transactions to be cleared at domestic CCPs (Article 156-62, Item 1 of the Amended Act)

Certain OTC derivatives transactions, which will be designated by the cabinet office ordinance, must be cleared through domestic CCPs. The Amendment authorizes the cabinet office ordinance to determine the scope of the OTC derivatives transactions that are subject to this mandatory use of the domestic CCPs. According to the explanatory material provided by the FSA, the FSA envisages to designate CDS transactions referring to an index of iTraxx Japan.

(2) Requiring certain OTC derivatives transactions to be cleared at domestic CCPs, link method or foreign CCPs (Article 156-62, Item 2 of the Amended Act)

Certain OTC derivatives transactions, which will be designated by the cabinet office ordinance, must be cleared either (i) through a domestic Financial Instruments Clearing Organization, (ii) by a link method or (iii) through a Foreign Financial Instruments Clearing Organization. The Amendment authorizes the cabinet office ordinance to determine the scope of the OTC derivatives transactions that are subject to this mandatory use. According to the explanatory material of the FSA, the FSA envisages to designate “plain vanilla type” yen interest rate swap transactions. Further, one of the participants of the seventh meeting of the FSA policy council held on February 25, 2010 said that if there are other transactions, including a foreign currency swap transaction, of which volume in Japan becomes larger, it is necessary to monitor such transactions so that it may include them into the transactions subject to the mandatory use of

³ The term “Financial Instruments Clearing Organizations, etc.” (*kinyu shohin torihiki seisan kikan tou*) is defined under Article 156-63, Paragraph 1 of the Amended Act, as the Financial Instruments Clearing Organizations or the Foreign Financial Instruments Clearing Organizations.

CCPs.

The Japan Securities Clearing Corporation and Tokyo Financial Exchange Inc. are now considering clearing services with respect to interest rate swap transactions and CDS transactions (according to the outline of a subcommittee of the FSA policy council held on February 18, 2010).

(3) Determination of the Credit Event

A protection buyer of CDS transactions pays a certain sum to a protection buyer as indemnity (protection), upon a Credit Event including a change in the credit standing or bankruptcy of the reference entity. The determination of whether or not a Credit Event has occurred is important to ensure the fairness of the transactions and the stability of the settlement. Currently, an increasing number of contract documentations provide that whether or not a Credit Event has occurred shall be determined by the Determinations Committee, which is organized by ISDA.

There is no provision on the Amendment with respect to the determination of a Credit Event for CDS transactions. The FSA mentioned in its explanatory material that the Amendment introduces a mandatory use of domestic CCPs so that they may be appropriately involved in the determination of whether or not a “bankruptcy” has occurred, while the international protocol which is typically employed by the market participants should be respected, and they need to maintain the right to assert their views concerning the determination as a party to CDS transactions. CCPs are known to determine whether or not a Credit Event has occurred in certain foreign jurisdictions in case the market participants are not able to make the determination. It is likely that under the relevant cabinet order/cabinet office ordinance the domestic CCPs would be required to be involved in the determination of a Credit Event to certain extent, while taking into account the internationally accepted practice.

(4) Scope of the dealers subject to the mandatory use of CCPs

The FSA policy paper entitled the “Development of Institutional Frameworks Pertaining to Financial and Capital Markets” provides that parties subject to the mandatory use of CCPs should be limited to Financial Instruments Business Operators, etc.⁴ with a high trading volume, because in the case of the bankruptcy of such a party, it may be enormously costly to transfer its positions to others (restructuring costs). The Amendment has no provision with respect to the limitation of parties which are subject to the mandatory use of CCPs. However, it is likely that the relevant cabinet order/cabinet office ordinance would limit the scope of such parties in line with the “Development of Institutional Frameworks Pertaining to Financial and Capital Markets”.

3. Establishment of a System for Data Storage and Reporting of Trading Information

(1) Establishment of a system for Trade Repositories

As we mention below, the Amendment provides that information of certain OTC derivatives

⁴ The term “Financial Instruments Business Operators, etc.” (*kinyu shohin torihiki gyosha tou*) is defined under Article 34 of the Current Act, as the Financial Instruments Business Operators (*kinyu shohin torihiki gyosha*) or the Registered Financial Institutions (*toroku kinyu kikan*).

transactions shall be stored and reported to the Prime Minister through the Trade Repositories (*torihiki joho chikuseki kikan*) or the Designated Foreign Trade Repositories (*shitei gaikoku torihiki Joho chikuseki kikan*). In connection therewith, a system for Trade Repositories will be established.

An applicant may be a Trade Repository upon the designation of the Prime Minister. The Amendment provides, among other things, the requirements for the designation, authorization of concurrent holding of positions by officers, confidentiality duty of the officers and employees (Articles 156-67 to 156-70 of the Amended Act).

In addition, the operations of Trade Repositories shall be subject to certain regulations, such as the approval of ancillary business and authorization of the business rules (Articles 156-71 to 156-79 of the Amended Act). Certain supervisory provisions, such as reporting obligations, on-site inspections, orders to improve business operations and rescissions of license, will be imposed for the trade repositories (Articles 156-80 to 156-84 of the Amended Act).

(2) Data storage and reporting of trading information

The Financial Instruments Clearing Organizations, etc. shall store information with respect to transactions which are subject to the mandatory use of CCPs, and report the same to the Prime Minister (Article 156-63 of the Amended Act).

The Financial Instruments Business Operators, etc. are required to store information with respect to certain OTC derivatives transactions which are not subject to the mandatory use of CCPs, and report the same to the Prime Minister. Such obligations shall be waived for those who provide information to the Trade Repositories or the Designated Foreign Trade Repositories (Article 156-64 of the Amended Act). The Amendment does not indicate what OTC derivatives transactions shall be subject to the storage and reporting obligations in addition to transactions which are subject to the mandatory use of the CCPs. The Amendment authorizes the cabinet office ordinance to define “Trading Data” (*torihiki joho*) (Article 156-64, Paragraph 1 of the Amended Act) as information which shall be subject to the storage and reporting obligations.

Domestic Trade Repositories are required to record, store and report to the Prime Minister certain trading information reported by the Financial Instruments Business Operators, etc. The scope of information subject to repositories services shall be defined in the cabinet office ordinance (Article 156-65 of the Amended Act). However, the Designated Foreign Trade Repositories are not required to report information to the Prime Minister. The FSA stated in the explanatory material that it is now establishing a system to exchange information internationally with the supervisory agencies of each trade repository.

Designated Foreign Trade Repositories are organizations which carry out in one or more foreign jurisdictions a business similar to a trade repository business (a business engaging in collection and storage of information) and which the Prime Minister designates as organizations from which it expects to obtain information (Article 156-64, Paragraph 3 of the Amended Act). There is no provision for the requirements and procedure of such designation. The reference material of the FSA contains a list of trade repositories in foreign countries, such as Warehouse Trust (for CDS, located in the U.S.), TriOptima (for interest rate derivatives, located in Sweden) and MarkitSERV (for equity derivatives, located in the U.S.). These organizations are expected to be designated.

The Prime Minister may disclose to the public certain information that is necessary to clarify the outline of the transactions so that transparency and predictability of the market is enhanced. Further, in case that the Prime Minister finds it necessary, it may direct Financial Instruments Clearing Organizations, etc. or the Trade Repositories to disclose such information to public (Article 156-66 of the Amended Act) (please note that the Designated Foreign Trade Repositories are not subject to this disclosure obligation).

4. Effective Date

Among the matters set forth in Section 1. (Systems for the development of the infrastructure for clearing) above, the exemption from the Financial Instruments Obligation Assumption Service set forth in Section 1. (1)(i) was effective as of the date of promulgation (i.e., May 19, 2010). However, as of May 20, 2010, the FSA does not publish a relevant cabinet order to define the transactions which shall be exempted from the definition of the Financial Instruments Obligation Assumption Service. Other matters set forth in Section 1. (Systems for the development of the infrastructure for clearing) above will be effective as of a certain date to be designated by the cabinet order within one year after promulgation. The matters set forth in Section 2. (Mandatory use of CCPs for clearing OTC derivatives transactions) and Section 3. (Establishment of a system for data storage and reporting of trading information) above will be effective as of a certain date to be designated by the cabinet order within two and a half years after promulgation.

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