

Amended Commodity Derivatives Act

- Following promulgation of subordinate regulations

The Commodity Exchange Act of Japan (Act No. 239 of 1950, as amended; the “Commodity Exchange Act”) at present principally regulates business relating to domestic commodity exchange transactions¹; while commodity derivatives transactions traded on offshore exchanges and OTC commodity derivatives transactions that reference market prices on offshore exchanges are subject to different and limited regulations. Effective as of January 1, 2011, however, (i) the title of the Commodity Exchange Act will change to the “Commodity Derivatives Act” (*shouhin sakimono torihiki hou*) (the “Amended Act”), and (ii) the regulatory framework for commodity derivatives business in Japan will be drastically altered to impose seamless regulation for the commodity derivatives business, without distinction among cross-border and domestic transactions, or exchange and OTC transactions.

A number of key details with respect to the Amended Act will be covered by subordinate regulations² which will also take effect on January 1, 2011. This paper focuses on notable points in the Amended Act and the subordinate regulations and provides an outline of how they are expected to affect current commodity derivatives business in Japan, with particular attention to offshore exchanges and OTC markets³.

I. Features of the Amended Act

As noted, the Amended Act is intended to establish seamless regulation for the commodity derivatives sector, without distinction among cross-border and domestic transactions, or exchange and OTC transactions. Accordingly, the Amended Act will (i) expand the level of regulation of commodity derivatives transactions traded on offshore exchanges and OTC commodity derivatives transactions to bring it in line with that already applicable to onshore exchange-traded commodity derivatives transactions, and (ii) provide consistent rules for such onshore and offshore transactions, as well as exchange-traded and OTC transactions.

The Amended Act will also strengthen client protections, although there will be some differences in the applicability of these regulations depending on the type of client involved (*i.e.*, “professional” or “non-professional”).

¹ The Commodity Exchange Act also prohibits, with limited exceptions, OTC commodity derivatives transactions that reference market prices on onshore exchanges.

² Such subordinate regulations are (i) a Cabinet Order, promulgated in September 2010, and (ii) an Enforcement Regulation and related orders, promulgated in October 2010.

³ The underlying assets of all transactions regulated by the Commodity Exchange Act are “commodities”. “Commodities” are defined to include certain tangible assets such as agricultural, forestry, animal and aquatic products, and metals and mineral substances. Accordingly, derivatives transactions based on intangible assets such as electric power, emissions allowances and freight rates are outside the scope of the Commodity Exchange Act and will be outside of the scope of the Amended Act as well.

II. New Regulated Business under the Amended Act

(A) Commodity derivatives transactions on offshore exchanges

Under the current Japanese regulatory regime, no licensing requirement is imposed on engagement in the business of commodity derivatives transactions traded on offshore exchanges. Under the Amended Act, by contrast, entities wishing to engage in Japan in the business of acting as an intermediary, broker or agent for commodity derivatives transactions traded on offshore exchanges will generally be required to obtain Japanese regulatory approval prior to engaging in such business.

Such approval, however, will not be required in relation to commodity derivatives transactions traded on offshore exchanges if:

- the client is a sophisticated investor; or
- a foreign entity which engages in commodity derivatives business in a foreign jurisdiction enters as a principal into the commodity derivatives transaction traded on an offshore exchange on behalf of a client (who is not an individual) located in Japan; provided that (i) such arrangement is made through the agency or intermediation of a Commodity Derivatives Dealer (as defined below) approved under the Amended Act, and (ii) such foreign entity itself does not solicit the client.

The scope of the term “sophisticated investor” includes (i) Commodity Derivatives Dealers approved under the Amended Act, “qualified institutional investors”, certain types of “financial instruments business operators” and “registered financial institutions” (as such terms are defined in the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended)); (ii) stock companies (*kaishiki kaisha*) or foreign equivalents the stated capital of which amounts to at least JPY 1 billion; and (iii) subsidiaries of any entity described in (i) or (ii) above.

(B) OTC commodity derivatives transactions

OTC commodity derivatives transactions that reference market prices on offshore exchanges are not currently subject to regulation in Japan under the Commodity Exchange Act, but will be regulated under the Amended Act. As with the Commodity Exchange Act, OTC commodity derivatives transactions that reference market prices on onshore exchanges will continue to be prohibited, with limited exceptions. In addition, any entity seeking to engage in Japan in the business of (i) entering into and/or performing OTC commodity derivatives transactions and/or (ii) acting as an intermediary, broker and/or agent for such OTC commodity derivatives transactions will generally be required to obtain Japanese regulatory approval prior to engaging in such business.

Such approval will not be required in relation to OTC commodity derivatives transactions if:

- the client is a sophisticated investor (as described in II.(A) above);
- a foreign entity which engages in commodity derivatives business in a foreign jurisdiction enters as a principal into the OTC commodity derivatives transaction with a client (who is not an individual) located in Japan; provided that (i) such transaction is made through the agency or intermediation of a Commodity Derivatives Dealer approved under the Amended Act, and (ii) such foreign entity itself does not solicit the client;
- an entity enters into the OTC commodity derivatives transaction with, or acts as an intermediary, broker or agent for such transaction on behalf of, a parent company of such entity, a subsidiary company of such entity or a company which has the same parent company as such entity; or
- an entity which engages in the business of trading commodities enters into the OTC commodity derivatives transaction with other entity, which also engages in the business of trading commodities, where such OTC commodity derivatives transaction (i) accompanies a sale and purchase transaction of a commodity between such entities, and (ii) is intended to hedge risks borne by such other entity arising out of price fluctuation of the relevant commodity.

III. Licensing/notification requirements⁴

(A) Licensing requirements for Commodity Derivatives Dealers⁵

Any entity intending to engage as a business in Japan in any or all of the following will be required under the Amended Act to obtain Japanese regulatory approval as a “Commodity Derivatives Dealer”⁶, provided that such activity does not fall under any exception described in either II.(A) or II.(B) above:

- ✓ acting as an intermediary, broker and/or agent for commodity derivatives transactions traded on onshore/offshore exchanges; and/or

⁴ In addition to the general regulations above, as with the current regulations, certain institutions licensed or authorized to operate banking, securities or insurance businesses will be, pursuant to the regulations governing them, (i) required to submit notifications to, or obtain approval of, the relevant Japanese authorities prior to commencing operation (in addition to their licensed or authorized business) of a commodity derivatives business, and/or (ii) restricted from engaging in certain types of commodity derivatives business.

⁵ Any entity wishing to engage only in intermediary business relating to commodity derivatives transactions will be permitted to do so without obtaining regulatory approval as a “Commodity Derivatives Dealer”; however, such entity must register as a “Commodity Derivatives Intermediary” and specify the Commodity Derivatives Dealer(s) for which it will be acting.

⁶ The regulatory authorities with responsibility for Commodity Derivatives Dealers will be the Ministry of Agriculture, Forestry and Fisheries of Japan (the “MAFF”) and the Ministry of Economy, Trade and Industry of Japan (the “METI”); accordingly, such approval will be granted by the MAFF and the METI.

- ✓ entering into and/or performing OTC commodity derivatives transactions, and/or acting as an intermediary, broker and/or agent for such OTC commodity derivatives transactions.

In order to obtain regulatory approval as a Commodity Derivatives Dealer, all of the following requirements must be satisfied.

- The applicant must be: (i) a stock company (*kabushiki kaisha*); (ii) a foreign entity equivalent to a *kabushiki kaisha* which has an office in Japan; or (iii) any of certain other entities specified by subordinate regulation⁷.
- The applicant 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. If the value of the applicant's net assets is less than JPY 100 million, the entity shall be deemed to lack sufficient financial standing.
- The applicant must have knowledge and experience sufficient to ensure the fair and appropriate performance of its commodity derivatives business, and must have sufficient social credibility. In addition, the operations of such business must not be lacking in client protection.
- The applicant must not be an entity that is disqualified from operating such a business by virtue of falling under any of certain "disqualification causes" specified in the Amended Act.
- Neither the application for approval itself nor any of the documents attached thereto may contain any false statement in relation to a material matter.

Some of the above requirements are ambiguous, and interpretation thereof is at the broad discretion of the relevant Japanese authorities. Furthermore, the Amended Act specifically provides that the authorities may impose supplemental conditions upon initial approval or renewal thereof⁸.

In addition, individuals employed by or working for a Commodity Derivatives Dealer must be registered as sales representatives if they will engage in the business of (i) acting as an intermediary, broker and/or agent for commodity derivatives transactions traded on onshore/offshore exchanges; (ii) entering into and/or performing OTC commodity derivatives transactions, and/or acting as an intermediary, broker and/or agent for such transactions; and/or (iii) soliciting clients for transactions described in (i) and (ii) above⁹.

⁷ Such other entities are limited to certain types of financial institutions incorporated or licensed under Japanese law.

⁸ Such approval must be renewed every six years.

⁹ Such registration must be renewed every six years.

(B) Notification requirements for Specified OTC Commodity Derivatives Business Operators

Approval will not be required under the Amended Act in relation to OTC commodity derivatives transactions conducted with sophisticated investors (as described in II.(A) above). The Amended Act, however, will still require any person/entity wishing to engage as a business in OTC derivatives transactions which refer to certain commodities and/or commodity indices that are (or are similar to those) listed on an onshore exchange to file an advance notification with the relevant Japanese authorities¹⁰. The reasoning behind this requirement appears to be a concern that such OTC derivatives transactions may have an impact on pricing on onshore exchanges, and accordingly such authorities consider it desirable to receive notice from any persons/entities intending to engage in such business. This filing requirement will apply to transaction principals only; those acting as intermediaries, brokers or agents in connection with such transactions will not be required to make such filings. The persons/entities which are subject to this filing requirement are referred to as “Specified OTC Commodity Derivatives Business Operators” under the Amended Act.

It is worth noting that even an entity that has obtained approval as a Commodity Derivatives Dealer must submit such a notification to the relevant Japanese authorities with respect to the transactions of this kind. Individuals employed by or working for a Specified OTC Commodity Derivatives Business Operator are not required to register as sales representatives with respect to such transactions.

IV. Client protection and other regulations

(A) Commodity Derivatives Dealers

Any Commodity Derivatives Dealer will become subject to several detailed client protection and other regulations as provided in the Amended Act. One of the key features of the client protection regulations is a strict requirement for segregation of client assets. The Amended Act will require a Commodity Derivatives Dealer to (i) segregate client assets from its own proprietary assets, and (ii) secure client assets in a specified manner. In addition, the Amended Act will introduce new restrictions on marketing commodity derivatives transactions. One of the most notable new restrictions is that all Commodity Derivatives Dealers will be prohibited from soliciting potential individual clients to engage in certain types of commodity derivatives transactions, either by visit or telephone, unless they have requested such solicitation.

The Amended Act also provides for other client protection and other regulations, including certain additional restrictions on client solicitation, restrictions on

¹⁰ The regulatory authorities with responsibility for such business operators will be the MAFF and/or the METI, depending upon the underlying assets of the transactions in which such business operators engage.

advertising, requirements for delivery of certain documents to clients, obligations to provide explanations to clients, restrictions on compensation for losses, restrictions on net assets ratio¹¹ and book and record keeping.

Some of the client protection regulations will not apply to “professional” clients. The Amended Act defines two categories of “professional” clients: (i) so-called “Specified Investors” (*tokutei itakusha*), comprised of clients who are generally considered to be professional in investing in any commodity derivatives transactions (*e.g.*, qualified institutional investors and listed companies) and (ii) so-called “Specified Traders” (*tokutei tougyousha*), comprised of clients who are generally considered to be professional in investing in specific commodity derivatives transactions (*e.g.*, gas station operators with respect to oil derivatives transactions); and in either case who satisfy relevant additional requirements (if any).

(B) Specified OTC Commodity Derivatives Business Operators

Specified OTC Commodity Derivatives Business Operators will be subject to certain limited regulation, such as restrictions on compensation for losses, and book and record keeping with respect to the relevant transactions.

V. Effective Date and Interim Measures

As mentioned above, the Amended Act will come into force on January 1, 2011; however, the Amended Act provides some interim measures as well. One such interim measure provides that entities will be permitted, without obtaining approval as Commodity Derivatives Dealers, to perform their obligations under commodity derivatives transactions traded on offshore exchanges or OTC commodity derivatives transactions, as long as the relevant transaction is entered into prior to January 1, 2011.

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¹¹ Banks and other financial institutions as specified in subordinate regulation will be exempted from the restrictions on net assets ratio.

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