

## *Amendment to derivatives business regulations under the FIEA effective April 2011*

On April 1, 2011, significant amendments to subordinate regulations under the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the “**FIEA**”) will come into force. These amendments (the “**2011 Amendments**”) will have a substantial impact on the conduct of derivatives business in Japan, among others. This newsletter focuses on the notable points of the 2011 Amendments relating to derivatives business, including those relating to property derivatives business and to the marketing of derivatives transactions.<sup>1</sup>

### **I. Overview**

Derivatives transactions are classified for Japanese regulatory purposes depending on the underlying asset: (a) equity or bond derivatives, (b) interest rate or currency derivatives, credit derivatives, weather, earthquake or catastrophe derivatives, and (c) commodity derivatives, property derivatives, freight, power or other derivatives. Engagement in the business of securities-related derivatives transactions (including those referred to in (a) above) (“**Securities Derivatives Transactions**”) and certain financial derivatives transactions (including those referred to in (b) above) (“**Financial Derivatives Transactions**”) has for years been generally regulated by the FIEA, with engagement in either such business being subject to registration requirements and detailed client protection rules. Furthermore, effective as of January 1, 2011, engagement in the commodity derivatives business became generally subject to regulation under the Commodity Derivatives Act of Japan (Act No. 239 of 1950, as amended), which imposes licensing requirements and detailed client protection rules.<sup>2</sup>

By contrast, engagement in certain other types of derivatives business, including property derivatives business, currently remains free from any such licensing or registration requirements or specific client protection rules. This situation, however, is now scheduled for change under the 2011 Amendments.

### **II. New regulation of property derivatives business**

As noted, the property derivatives business in Japan has remained free to date from licensing or registration requirements or specific client protection rules under Japanese law. Japanese regulators, however, forecasting an increasing need for property derivatives as hedging

<sup>1</sup> With respect to clearing of derivatives transactions, the 2011 Amendments also clarify certain regulations applicable to central counterparties (CCPs). We will provide details of such regulations in a separate newsletter focusing on this topic.

<sup>2</sup> With respect to the outline of the Commodity Derivatives Act, please see our newsletter published on November 12, 2010 at [http://www.amt-law.com/pdf/bulletins2\\_pdf/101112.pdf](http://www.amt-law.com/pdf/bulletins2_pdf/101112.pdf).

instruments against fluctuations in the value of real-estate, and with the goal of protecting purchasers of such property derivatives, have expanded Japan's regulatory regime under the FIEA to cover the business of property derivatives with effect from April 1, 2011.

More specifically, effective as of April 1, 2011, any entity wishing to engage in Japan in the business of (i) entering into and/or performing property derivatives transactions and/or (ii) acting as an intermediary, broker and/or agent for such property derivatives transactions will generally be required to be registered as Financial Instruments Business Operator<sup>3</sup> prior to engaging in such business. Furthermore, registered Financial Instruments Business Operators with respect to property derivatives transactions will be subject to various detailed client protection regulations, including restrictions on client solicitation, suitability rules, restrictions on advertising and requirements for delivery of certain documents to clients.

For the purpose of the FIEA, "property derivatives transactions" will consist of derivatives transactions based on value or profit in real-estate (*e.g.*, prices, rents and rates of operation/vacancy) or related indices published or provided by governmental agencies or certain entities engaged in real-estate related business.

### III. Enhanced regulation of derivatives transaction marketing

The 2011 Amendments will also strengthen client protections with respect to OTC derivatives transactions. Under the FIEA, Financial Instruments Business Operators are already subject to several detailed client protection regulations. In particular, stricter than normal regulations are already applicable to Financial Instruments Business Operators with respect to certain types of OTC Financial Derivatives Transactions (*e.g.*, currency CFDs and currency options). One such regulation generally prohibits Financial Instruments Business Operators from soliciting potential clients (individuals or otherwise) to engage in those types of OTC Financial Derivatives Transactions, either by visit or telephone, unless they have requested such solicitation (the "**Unrequested Solicitation Restriction**").<sup>4</sup>

The Financial Services Agency of Japan (the "**FSA**") has observed, however, that engagement in other types of OTC derivatives transactions (*e.g.*, equity CFDs) with individual clients has spread into the Japanese market. Accordingly, the 2011 Amendments will expand the current scope of the Unrequested Solicitation Restriction to cover all OTC Securities Derivatives Transactions and OTC Financial Derivatives Transactions if the potential clients are individuals.<sup>5</sup>

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<sup>3</sup> If the relevant entity is a prescribed financial institution, registration as a Registered Financial Institution, rather than as a Financial Instruments Business Operator, will generally be required. The same regulations imposed on Financial Instruments Business Operators generally will be imposed upon Registered Financial Institutions.

<sup>4</sup> With respect to the mentioned types of OTC Financial Derivatives Transactions, the Unrequested Solicitation Restriction will not apply to certain types of clients (*i.e.*, clients with which prescribed ongoing relationships exist with respect to the same kind of transactions) or certain types of transactions (*i.e.*, transactions entered into as exchange rate hedging instruments for clients engaging in the business of foreign trade or foreign exchange transactions).

<sup>5</sup> With respect to the newly covered transactions, the Unrequested Solicitation Restriction will not apply to certain types of clients (*i.e.*, clients with which prescribed ongoing relationships exist with respect to the same

As with the Unrequested Solicitation Restriction, the scope of certain other marketing regulations will also expand to cover all OTC Securities Derivatives Transactions and OTC Financial Derivatives Transactions with individual clients. For example, under the 2011 Amendments, Financial Instruments Business Operators will generally be prohibited from soliciting individual clients to engage in any OTC Securities Derivatives Transaction or OTC Financial Derivatives Transaction (i) without first confirming whether the client wishes to be solicited or (ii) after such client has indicated that the client will not engage in such transaction or does not wish to be solicited. In addition, requirements for delivery of certain documents to individual clients with respect to all OTC Securities Derivatives Transactions and OTC Financial Derivatives Transactions will be expanded to bring them in line with the stricter than normal requirements already applicable to certain types of OTC Financial Derivatives Transactions, as mentioned above.<sup>6</sup>

The 2011 Amendments do not alter existing regulations regarding (i) OTC Securities Derivatives Transactions or OTC Financial Derivatives Transactions with non-individual clients, (ii) exchange-traded Securities Derivatives Transactions or exchange-traded Financial Derivatives Transactions, (iii) structured notes or units in investment trusts which are complex and similar to OTC derivatives transactions or (iv) structured bank-deposits embedding derivatives. The relevant self-regulatory organizations, however, are expected to implement new rules and regulations or to amend existing rules and regulations with respect to these transactions or products in order to enhance client protection. The FSA's guidelines applicable to Financial Instruments Business Operators or banks will also be amended for the same purpose.

#### **IV. Clarification of regulation on business by foreign entities relating to financial derivatives transactions traded on offshore exchanges**

Currently, the FIEA expressly permits any foreign entity to engage in the business of acting as an intermediary, broker or agent for Securities Derivatives Transactions traded on offshore exchanges under prescribed conditions, without registering as a Financial Instruments Business Operator. By contrast, the FIEA is silent as to whether a foreign entity engaging in the business of acting as an intermediary, broker or agent for Financial Derivatives Transactions traded on offshore exchanges (*e.g.*, listed interest-rate futures) must register as Financial Instruments Business Operator. As a matter of practice, however, such business by foreign entities has been permitted under certain conditions (*e.g.*, if the foreign entity acts as an intermediary, broker or agent on behalf of certain financial institutions), in light of the need for such transactions.

The 2011 Amendments clarify that any foreign entity which engages in a foreign jurisdiction in the business of Financial Derivatives Transactions traded on an offshore exchange will be permitted, without registration under the FIEA, to engage in the business of acting as an

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kind of transactions) or certain types of transactions (*e.g.*, stock call options granted by individual clients under which such stock is provided to the option holder as collateral).

<sup>6</sup> Such prohibitions or requirements will not apply to certain types of transactions (*e.g.*, stock call options granted by individual clients under which such stock is provided to the option holder as collateral).

intermediary, broker or agent for Financial Derivatives Transactions traded on offshore exchanges:

- (i) on behalf of prescribed financial institutions or other prescribed clients located in Japan; or
- (ii) (a) on behalf of certain other sophisticated clients located in Japan (*e.g.*, “qualified institutional investors”, as defined under the FIEA, and stock companies (*kabushiki kaisha*) or foreign equivalents the stated capital of which amounts to at least JPY 1 billion), (b) upon receipt of orders from such clients or upon engagement in such capacity arranged through the agency or intermediation of a qualified Financial Instruments Business Operator, and (c) provided that such foreign entity does not itself solicit such clients.

#### V. **Reclassification of local governments as non-professional clients**

As noted, Financial Instruments Business Operators are subject to several detailed client protection regulations, although there are some differences in the applicability of these regulations depending on the type of client involved (*i.e.*, “professional” or “non-professional”). Currently, Japanese local governments (*chihou koukyou dantai*) are classified as “professional” clients (so-called “Specified Investors (*tokutei tousehika*)”) under the FIEA. Accordingly, certain client protection regulations (*e.g.*, suitability rules, restrictions on advertising and requirements for delivery of certain documents to clients) do not apply to certain financial transactions (*e.g.*, Financial Derivatives Transactions) with local governments, unless the relevant local government requests to be treated as a “non-professional” client.

Recently, however, it has sometimes been the case that local governments in Japan have purchased complex financial products (including derivatives) for which highly specialized knowledge is required for appropriate investment decisions, despite not having the requisite knowledge. In light of this, and in order to ensure appropriate client protection, the 2011 Amendments will alter the classification of local governments from “professional” clients to “non-professional” clients. As a result, effective as of April 1, 2011, all client protection regulations under the FIEA (including suitability rules, restrictions on advertising and requirements for delivery of certain documents to clients) will become generally applicable to any local government; provided that, if such local government requests to be treated as a “professional” client, such local government may be treated as such under prescribed conditions.

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*February 18, 2011*

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