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JFSA published final rules of margin requirements for OTC derivatives

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The Financial Services Agency of Japan ("JFSA") published the final margin rules for non-centrally cleared OTC derivatives on March 31, 2016, which implement the BCBS/IOSCO framework. In line with the internationally-agreed phase-in schedule, major derivative dealers regulated in Japan will be required to collect and post initial and variation margins in relation to certain non-centrally cleared OTC derivatives including those entered into with certain overseas derivative dealers.

The JFSA also finalized amendments to its Supervisory Guidelines which would require a wider range of derivative dealers regulated in Japan to establish risk management procedures for non-centrally cleared OTC derivatives.

This law bulletin provides an overview of the final rules.

I. Amendment to the Cabinet Office Ordinance

The JFSA published the final Japanese margin rules[1] by way of amendments to the Cabinet Office Ordinance concerning Financial Instruments Business, etc. ("Cabinet Office Ordinance") as one of the subordinate regulations of the Financial Instruments and Exchange Act ("FIEA"), which will come into force in accordance with the phase-in schedule stated in III below.

[1] The JFSA's first proposal was published on July 3, 2014 and second proposal was published on December 11, 2015.

II. Details of Amendments

1. Scope of covered entities

The Japanese margin rules will apply to dealers registered with the JFSA as (i) Financial Instrument Dealers[2] which conduct Type I Financial Instruments Businesses or (ii) Registered Financial Institutions,[3] including, among others, securities companies, banks, trust banks (acting on its proprietary account or on behalf of trust assets), insurance companies and certain public financial institutions (“Covered Dealers”).

2. Scope of covered products

The Japanese margin requirements cover OTC Derivatives[4] not cleared by either: (i) a local or overseas CCP licensed in Japan; or (ii) an overseas CCP, which offers clearing services relying on exemptions from licensing requirements in Japan (“Non-cleared OTC Derivatives”).

The definition of “OTC Derivatives” covers a broad range of OTC derivatives but does not include physically-settled FX forward and FX swap transactions and OTC commodities derivatives. Further, in the case of an initial margin, principal amounts exchanged under currency swaps may be excluded from the calculation.

Covered Dealers may, but are not obliged to, include (a) physically-settled FX forward and FX swap transactions, (b) non-cleared OTC commodities derivatives, (c) principal amounts exchanged under currency swaps and (d) certain other exempt transactions in the calculation of variation and initial margins, on the condition that such transactions are continuously included in the calculation.

3. Margin requirements

Both variation and initial margins must be posted or collected by way of a loan or deposit. Differently from a variation margin, an initial margin must be segregated by way of trust or other similar methods so that the receiving party will be able to use the initial margin without delay if the posting party fails to perform its obligation or the initial margin will be returned to the posting party if an event which triggers close-out netting has occurred. Re-hypothecation of an initial margin would be generally prohibited, but re-hypothecation of the cash collateral may be permitted under certain conditions.

(1) Variation margin

Covered Dealers will be required to:

(i) calculate the amount of the current exposure on a daily basis;

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[2] *Kinnyu shohin torihiki gyosha*, a dealer registered in accordance with Article 29 of the FIEA.

[3] *Toroku kinnyu kikan*, a financial institution registered in accordance with Article 33-2 of the FIEA.

[4] As defined in Article 2, Paragraph 22 of the FIEA.

(ii) collect collateral[5] as a variation margin from the counterparty without delay; and

(iii) post collateral as a variation margin to the counterparty upon counterparty's request.

(2) Initial margin

Covered Dealers will be required to:

(i) calculate the amount of the potential future exposure at least once a month and on an ad-hoc basis (e.g. when there is a change in the portfolio);

(ii) collect collateral[6] as an initial margin from the counterparty without delay; and

(iii) post collateral as an initial margin to the counterparty upon the counterparty's request.

4. Eligible collateral assets

Eligible collateral assets include, among others, cash (0% haircut), highly rated government bonds and multinational banks bonds (0.5% to 15% haircut, depending on the credit risk category and maturity), highly rated corporate bonds (1% to 12% haircut, depending on the credit risk category and maturity), shares or convertible bonds of companies constituting a major stock index (15% haircut) and securities of certain eligible investment funds (the highest of the ratios applicable to the investment targets). An additional 8% haircut will apply if the type of currency pertaining to collateral assets is different from the currency agreed upon in advance by the parties.

5. Major Exemptions

(1) Exempted counterparties

The Japanese margin requirements will not apply if one of the parties is:

(i) a person who is neither a Covered Dealer nor a Foreign Derivative Dealer;

(ii) a Covered Dealer whose average aggregated notional amount of OTC Derivatives (limited to those subject to the mandatory clearing or trade reporting requirement of Japan) on a single entity basis (in the case of trust property, on a single trust account basis) is less than JPY300 billion; or

(iii) For an initial margin, a Covered Dealer whose average aggregated notional amount of non-cleared OTC Derivatives (plus physically-settled FX forward and FX swap transactions and non-cleared OTC commodities derivatives) on a group basis (in the case of trust property, on a single trust account basis)(excluding (a) transactions entered into by and between group companies and (b) transactions

[5] A Covered Dealer is not required to collect collateral if the required amount of collateral transfer is within the pre-agreed minimum transfer amount. The minimum transfer amount of the variation margin and that of the initial margin may not exceed JPY70 million in total.

[6] A Covered Dealer is not required to collect an initial margin up to an initial margin threshold, which may not exceed JPY7 billion across the Covered Dealer's consolidated group.

entered into with certain non-dealers which are neither Covered Dealers nor Foreign Derivative Dealers) does not exceed JPY1.1 trillion.

A “Foreign Derivative Dealer” stated above refers to a person (other than foreign governments etc.) (a) who enters into OTC Derivatives “as a business” in a foreign jurisdiction where the legal validity of close-out netting provisions is appropriately confirmed and (b) whose average aggregated notional amount[7] is expected, judging reasonably from the status of the transactions and other circumstances, to be not less than the thresholds similar to those stated in (ii) and (iii) above.

(2) Intragroup exemption

Transactions entered into by and between group companies will be exempted.

(3) Equivalence

Covered Dealers will be exempted if they comply with an equivalent overseas regime which may be designated by the JFSA Commissioner in the future.[8]

6. Grandfathering provision

Legacy transactions entered into before the enforcement date will be grandfathered, but parties may voluntarily include them in the calculation of variation and initial margins.

III. Phase-in schedule

Enforcement Date	Variation Margin	Initial Margin
	Average Aggregated Notional Amount	
September 1, 2016	More than JPY 420 trillion	More than JPY 420 trillion
March 1, 2017	Not more than JPY 420 trillion	—
September 1, 2017	—	More than JPY 315 trillion
September 1, 2018	—	More than JPY 210 trillion
September 1, 2019	—	More than JPY 105 trillion
September 1, 2020	—	More than JPY 1.1 trillion

[7] The scope of transactions included in the calculation of the average aggregated notional amount is not exactly the same as in the case of Covered Dealers (e.g. whether transactions subject to neither the mandatory clearing nor trade reporting requirement of Japan will count toward the threshold of JPY300 billion or not).

[8] According to the JFSA’s response (No. 58) to the public comment dated March 31, 2016, the English law IM CSD and the NY law IM CSA which set forth security interests arrangements for initial margin may be used for the purpose of compliance with the Japanese margin requirements if the JFSA Commissioner designates the equivalence of the relevant overseas regimes.

IV. Amendment to the JFSA Supervisory Guidelines

The JFSA Supervisory Guidelines[9] require (i) Covered Dealers or other dealers regulated in Japan (including those whose average aggregated notional amount is less than JPY 300 billion or otherwise exempted from margin rules under the Cabinet Office Ordinance ("Exempt Regulated Dealers")) to make efforts to enter into contracts for a variation margin (e.g. ISDA Master Agreement and CSA) and (ii) Exempt Regulated Dealers to make efforts to calculate the current exposure and exchange variation margins on a regular basis or in response to an ad-hoc margin call. These amendments to the Guidelines on the variation margins will become applicable to Exempt Regulated Dealers from March 1, 2017.

[9] The Supervisory Guidelines also include high-level requirements related to diversification of collateral, measures for dispute resolution and risk management concerning transactions with counterparties in non-netting friendly jurisdictions.

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