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Applicability of Japanese Margin Rules to a Foreign Entity that is not a Registered Dealer in Japan

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This short bulletin provides information about applicability of the final Japanese margin rules for non-cleared OTC derivatives published by the Financial Services Agency of Japan ("JFSA") on March 31, 2016 (excluding the JFSA's Supervisory Guidelines stated below, the "Margin Rules") to a foreign entity not registered with JFSA as either a Financial Instrument Business Operator or a Registered Financial Institution (an "Unregistered Foreign Entity").

1. An Unregistered Foreign Entity will not be a covered entity

An Unregistered Foreign Entity will not be a covered entity because the Margin Rules[1] will directly apply only to dealers registered with JFSA as (i) Financial Instrument Business Operators which conduct Type I Financial Instruments Businesses or (ii) certain Registered Financial Institutions, including, among others, securities companies, banks, trust banks, insurance companies and certain public financial institutions (each a "Covered Dealer") whose average aggregated notional amount ("AANA") of OTC Derivatives which are subject to the mandatory clearing or trade data reporting requirement under the Financial Instruments and Exchange Act (the "FIEA") exceeds certain thresholds[2]. That being said, an Unregistered Foreign Entity may need to comply with the Margin Rules when conducting Non-cleared OTC Derivatives with a Covered Dealer, if the entity falls under the definition of Foreign Derivative Dealer as explained below.

OTC Derivative

"OTC Derivative" means an "OTC Derivative Transaction" as defined in Article 2, paragraph 22 of the FIEA which covers a broad range of OTC derivative transactions but does not include an OTC commodities derivative and physically-settled FX forward and FX swap.

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[1] To get an overview of the final margin rules, please refer to our newsletter titled "JFSA published final rules of margin requirements for OTC derivatives" (the "Newsletter"). https://www.amt-law.com/pdf/bulletins2_pdf/160420.pdf

[2] Please refer to II.5 (1) of the Newsletter for the details of AANA thresholds for a Covered Dealer.

Non-cleared OTC Derivative

"Non-cleared OTC Derivative" means an OTC Derivative that is not cleared by either: (i) a local or overseas CCP licensed in Japan; or (ii) an overseas CCP, which offers clearing services equivalent to Japanese licensed CCP relying on a relevant exemption under the FIEA.

2. Indirect application to Foreign Derivative Dealer

The Margin Rules will apply to non-cleared OTC Derivatives executed between a Covered Dealer whose AANA exceeds certain thresholds and an entity that conducts OTC Derivatives in a foreign state[3] as a business (excluding Foreign Governments, etc., a "Foreign Derivative Dealer") unless one or more exemptions are applied.

3. Exemptions for a Foreign Derivative Dealer

(1) 300 billion yen threshold for Foreign Derivative Dealer's AANA of OTC Derivatives

The Margin Rules regarding both variation and initial margins will be exempt if a Foreign Derivative Dealer's AANA of OTC Derivatives (see below), on a single entity basis, is expected, judging reasonably from the status of the transactions and other circumstances, to be less than 300 billion yen[4].

Foreign Derivative Dealer's AANA of OTC Derivatives

"Foreign Derivative Dealer's AANA of OTC Derivatives" means the yearly average of the total amount of the notional principal amounts pertaining to OTC Derivatives on the last day of each month starting from April of the year that is two years before the year in which the trade date of a Non-cleared OTC Derivative falls (if the trade date falls in December, starting from April of the year that is one year before the year in which the trade date falls). In practice, the calculation will need to be made once every year and be referenced in relation to Non-cleared OTC Derivatives whose trade date falls into the relevant one year period (i.e. from December to November).

(2) 1.1 trillion yen threshold for Foreign Derivative Dealer's AANA of Non-cleared OTC Derivatives, etc.

Any requirements regarding an initial margin will be exempt, if a Foreign Derivative Dealer's AANA of Non-cleared OTC Derivatives, etc. (see below), on a group basis, is expected, judging reasonably from the status of the transactions and other circumstances, to be not more than JPY1.1 trillion[5].

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[3] Limited to a state where it is appropriately recognized that agreements on Close-out Netting and similar agreements are valid in light of the laws and regulations of that foreign state.

[4] Subject to the applicable phase-in schedule

[5] For a period between September 1, 2016 to August 31, 2017, 420 trillion yen;
For a period between September 1, 2017 to August 31, 2018, 315 trillion yen;
For a period between September 1, 2018 to August 31, 2019, 210 trillion yen;
For a period between September 1, 2019 to August 31, 2020, 105 trillion yen;

Foreign Derivative Dealer's AANA of Non-cleared OTC Derivatives, etc.

"Foreign Derivative Dealer's AANA of Non-cleared OTC Derivatives, etc." means the average of the total amount of the notional principal amount pertaining to Non-cleared OTC Derivatives, non-cleared OTC commodity derivatives and physically-settled FX forwards and FX swaps on the last day of each month from March to May of the year prior to the year in which the trade date falls (if the trade date falls between September and December, from March to May of the year in which the trade date falls). In practice, the calculation will need to be made once every year and be referenced in relation to Non-cleared OTC Derivatives whose trade date falls into the relevant one year period (i.e. from September to August).

What constitutes a "group"?

A "group" is constituted by a Parent Company, etc., a Subsidiary, etc. or a Subsidiary, etc. of a Parent company, etc. of the Foreign Derivative Dealer.

"Parent Company, etc." means those specified by the relevant Cabinet Office Ordinance as a company, etc. which has control over the decision making body, including the shareholders meeting, which is responsible for deciding the policies for finance, operations, and business of another company, etc. (meaning a company, partnership, or any other business entity equivalent thereto (including those equivalent thereto in a foreign state)).

"Subsidiary Company, etc." means another Company, etc. whose decision making body is controlled by a Parent Company, etc.

How are intra-group transactions counted?

Any intra-group transactions are not included in the relevant calculation of Foreign Derivative Dealer's AANA of Non-cleared OTC Derivatives, etc.

(3) Representation of counterparty's regulatory status

JFSA's responses to public comments suggest that reasonable representations made by a counterparty as to whether its AANAs are above thresholds or not can be a major factor to determine the status of the counterparty, but it is not permissible to rely solely on the representations, not considering other factors which are reasonably available.

4. Foreign fund's / SPC's issues

It is not entirely clear under what circumstances a foreign fund or SPC is considered to be a Foreign Derivative Dealer. JFSA's responses to public comments suggest that OTC Derivatives conducted for the purpose of improving its own portfolio are basically not deemed to be the OTC derivatives conducted "as a business". At the same time, however, the responses suggest that whether a foreign fund or SPC is considered to be a Foreign Derivative Dealer or not should be determined each by each from the perspective of its substance.

5. JFSA's Supervisory Guideline

The JFSA Supervisory Guidelines require a financial institution etc. (including a Covered Dealer) which is subject to the J-FSA's supervision (each a "Regulated Dealer") to enter into agreements for a variation margin (e.g. ISDA Master Agreement and CSA) and to calculate current exposure and exchange variation margins on a regular basis or in response to an ad-hoc margin call, if it enters into Non-cleared OTC Derivatives with another financial institution etc. (including a Foreign Derivative Dealer) on and after March 1, 2017 regardless of its AANAs or the counterparty's AANAs. Hence, even a Foreign Derivative Dealer whose AANAs are below the thresholds explained in paragraphs 3 above may be requested to enter into such agreements if it conducts Non-cleared OTC Derivatives with a Regulated Dealer.

End

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