

*Recent updates on the regulatory regime  
for OTC derivatives in Japan*

**Recent Updates**

- Mandatory clearing requirements through CCPs and information storage and reporting requirements for OTC derivatives took effect as of November 1, 2012, however, broad exemptions are available.
- A bill for amendments to the FIEA to introduce the mandatory use of the ETP for OTC derivatives was passed and promulgated as of September 12, 2012. It is scheduled to take effect within three (3) years from the promulgation (i.e., by September 12, 2015).

At the G-20 Pittsburgh Summit in September 2009, the G-20 members agreed in their leaders' statement that all standardized over-the-counter (OTC) derivative contracts should be traded on exchanges or electronic trading platforms ("ETPs"), where appropriate, and cleared through central counterparties ("CCPs") and OTC derivative contracts should be reported to trade repositories ("TRs").

In response to this statement, the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the "FIEA") was amended in May 2010 (the "2010 Amendment"). The 2010 Amendment provides for, among other things, (i) the mandatory use of a CCP with respect to the clearing of certain OTC derivatives transactions; and (ii) data storage and reporting requirements regarding certain OTC derivatives transactions. The 2010 Amendment came into force on November 1, 2012.

In addition, a bill to further amend the FIEA was passed and promulgated on September 12, 2012 (the "2012 Amendment"). The 2012 Amendment introduces provisions regarding the mandatory use of ETPs. It is scheduled to take effect within three (3) years from the promulgation (i.e., by September 12, 2015) and most of the details of the relevant provisions under the 2012 Amendment are still unknown and are to be substantiated by subordinate regulations by its effective date.

This news letter provides an overview of the regulatory regime for (i) the mandatory use of a CCP, (ii) the data storage and reporting requirements for trade information under the 2010 Amendment and (iii) an outline of the 2012 Amendment with respect to the mandatory use of ETPs in connection with OTC derivatives, to which each participant in the Japanese OTC derivatives market should pay close attention.

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## **Mandatory use of CCPs for clearing OTC derivatives transactions**

The 2010 Amendment provides that certain types of OTC derivatives transactions must be cleared at a CCP.

### Transactions subject to the mandatory use of CCPs

Under the 2010 Amendment, the mandatory central clearing requirement applies only to certain limited categories of OTC derivatives transactions as follows;

- (i) credit default swap (“CDS”) transactions which refer to an index of iTraxx Japan and for which Japan Securities Clearing Corporation (“JSCC”) provides clearing services must be cleared through a local CCP licensed by the Japanese government, and
- (ii) interest rate swap (“IRS”) transactions which refer to the three (3) month or six (6) month Japanese yen LIBOR interest rate and for which JSCC provides clearing services must be cleared either through (a) a local CCP licensed by the Japanese government, (b) a foreign CCP licensed by the Japanese government or (c) certain arrangement with authorization from the Prime Minister of Japan<sup>1</sup>, under which local licensed CCP and foreign (licensed or non-licensed) CCP carry out a clearing service in concert (linked method).

JSCC provides, as a local CCP licensed under the FIEA, clearing services to financial institutions with respect to certain CDS transactions referring to an index of iTraxx Japan since July 2011. In October 2012, JSCC also commenced clearing services for interest rate swap transactions which refer to three (3) month or six (6) month Japanese yen LIBOR interest rate. As of the date of this news letter, only JSCC provides clearing services for OTC derivatives transactions, and no foreign CCPs have been licensed and no linked method has been authorized by the Prime Minister of Japan. Thus, every OTC derivatives transaction subject to the mandatory clearing requirements under (i) and (ii) above must be cleared by JSCC at this time.

### Exemptions

The 2010 Amendment allows broad exemptions to the above mandatory clearing requirements, in order to apply such requirements rather narrowly as an initial step in the OTC derivatives regulations in Japan. These exemptions include (i) transactions already existing at the time of the implementation of these requirements (November 1, 2012); (ii) transactions where any of the parties are not a certain type of broker/dealer registered under the FIEA (Financial Instrument Business Operator, “FIBO”) or other financial institution registered under the FIEA (Registered Financial Institution, “RFI”); (iii)

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<sup>1</sup> The powers and authorities granted to the Prime Minister of Japan under the 2010 Amendment and the 2012 Amendment have in general been delegated to the Commissioner of the FSA.

transactions for trust accounts; (iv) intra-group transactions; and (v) transactions where either of the parties (or any of their group companies), with reasonable grounds, is not a clearing member of a CCP.

In essence, the 2010 Amendment narrowly applies the mandatory use of CCPs to a limited category both of parties and transactions. For example, in accordance with exemption (ii) above, the mandatory clearing requirements may apply only if both parties to the OTC derivatives transactions are FIBOs/RFIs. With respect to exemption (v) above, we should note that a certain amount of uncertainty exists regarding what is a “reasonable ground” for not being a clearing member of CCPs. The Financial Services Agency of Japan (the “FSA”) published in its responses to the public comments in July 2012 (the “FSA’s Responses”) its view on this point. According to the FSA’s Responses, the FSA generally understands that a party does not have a “reasonable ground” when it does not become a member of a CCP even though it could satisfy without any major difficulty the qualifications designated by a relevant CCP to become its clearing member, such as financial criteria and its trade volume. Relevant market participants should carefully consider whether there is any “reasonable ground” for not being a clearing member of a CCP if exemption (v) is planned to be used.

Transactions	Clearing methods	Eligible CCP
CDS for iTraxx Japan	Must be cleared at a local licensed CCP	JSCC
IRS for 3 or 6 month yen LIBOR	Must be cleared; (i) at a local licensed CCP, (ii) at foreign licensed CCP, or (iii) by linked method.	JSCC
<u>Exemptions</u>		
(a) existing transactions		
(b) transactions by non-FIBO or non-RFI		
(c) transactions for trust accounts		
(d) intra-group transactions		
(e) transactions with non-clearing members of a CCP		

#### Future expansion of mandatory clearing requirements through CCPs

In connection with the regulatory reforms for OTC derivatives, the FSA held a regulation review attended by major market participants and academics on 2011, to discuss relevant issues for OTC derivatives regulations. The FSA published in December 2011 a paper (the “2011 Paper”) summarizing the discussions held during the review and expressed its intention to substantiate the regulations by taking into account those discussions.

The FSA states in the 2011 Paper that it takes a step-by-step approach to the regulation of OTC derivatives, to the effect that initially the scope of the regulations, in general, should

not be too broad, as it may shrink the OTC derivatives market. The FSA will review and revise the regulations as required in the future. As to the mandatory use of CCPs, the FSA applies it very narrowly by allowing broad exemptions and will consider in the future whether it will expand these central clearing requirements to include:

- i. plain vanilla IRS transactions referring to US Dollars or the Euro;
- ii. IRS transactions referring to the Japanese yen TIBOR;
- iii. CDS transactions referring to a single-named Japanese entity; and
- iv. CDS transactions referring to a single-named European or North American entity, or an index regarding European or North American entities.

When considering whether to expand the mandatory use of CCPs to a particular type of transaction, the FSA will take into account the trade volume, level of standardization of that type of transaction, and the number of CCPs acting in Japan. The 2011 Paper states that the FSA should consider harmonization with regulations of other jurisdictions. This should be done to avoid a substantial discrepancy between the regulations of Japan and other jurisdictions, which could create opportunities for 'regulatory arbitrage'. The FSA will also consider expanding the mandatory use of CCPs to transactions between FIBO/RFI and (i) foreign dealer acting outside Japan (i.e., cross border transactions with foreign dealer); or (ii) non-financial entity.

Therefore, market participants should pay close attention to any future expansion of the scope of mandatory clearing requirements and any other relevant regulatory reforms.

### **Storage and reporting requirements for trade information**

The 2010 Amendment provides that information for certain OTC derivatives transactions must be stored and reported to the Prime Minister through local TRs (*torihiki joho chikuseki kikan*) or foreign TRs (*shitei gaikoku torihiki joho chikuseki kikan*) designated by the Prime Minister of Japan.

#### Transactions subject to the mandatory storage and reporting requirements for trade information on OTC derivatives

The 2010 Amendment entails storage and reporting requirement for trade information which is broader for every type of OTC derivatives transaction which is currently regulated under the FIEA (except for weather derivatives transactions or earthquake derivatives transactions, which are specifically excluded under the relevant subordinate regulations), including:

- (i) forward transactions and index forward transactions where the settlement date comes three (3) business days or more after its trade date;
- (ii) option transactions and index option transactions where the settlement date comes three (3) business days or more after its trade date;

- (iii) swap transactions (e.g., interest rate swap and currency swap); and
- (iv) credit derivatives transactions where settlement is triggered by the occurrence of credit changes to a reference entity.

These information storage and reporting requirements applies only if at least one of the parties to the above OTC derivative transaction is a “Type 1 FIBO” or certain RFI (banks licensed under the Japanese Banking Act, the Shoko Chukin Bank, Ltd., Development Bank of Japan Inc., Shinkin Central Bank and the Norinchukin Bank). A Type 1 FIBO is a registered broker/dealer (FIBO) which conducts securities and/or OTC derivatives businesses and is subject to stricter regulations under the FIEA than other FIBOs.

#### Parties subject to mandatory storage and reporting requirements for trade information on OTC derivatives

With respect to transactions which are cleared by CCPs (regardless of whether it is subject to the mandatory central clearing requirements through CCPs), local CCPs or foreign licensed CCPs are required to store information and report the same to the Prime Minister and a party to such OTC derivatives transactions does not need to store or report the data by itself.

With respect to the OTC derivatives transactions which are not cleared by CCPs, a party to the transactions, who is a Type 1 FIBO or RFI, is required to (i) store information and report the same directly to the Prime Minister of Japan by itself or (ii) provide information to a local TR or a foreign TR designated by the Prime Minister of Japan. In the case of (ii) above, a local TR shall instead store and report the trade information to the Prime Minister. On the other hand, the FIEA does not impose such storage and reporting obligations on a foreign TR. The FSA explained that it is now establishing a system to exchange information internationally with the supervisory agencies of the jurisdictions of foreign TRs and expects to collect via such system the trade data which is provided to foreign TRs.

#### Exemptions

2010 Amendment (and its subordinate regulations) provides that the following transactions will be exempt from the information storage and reporting requirements:

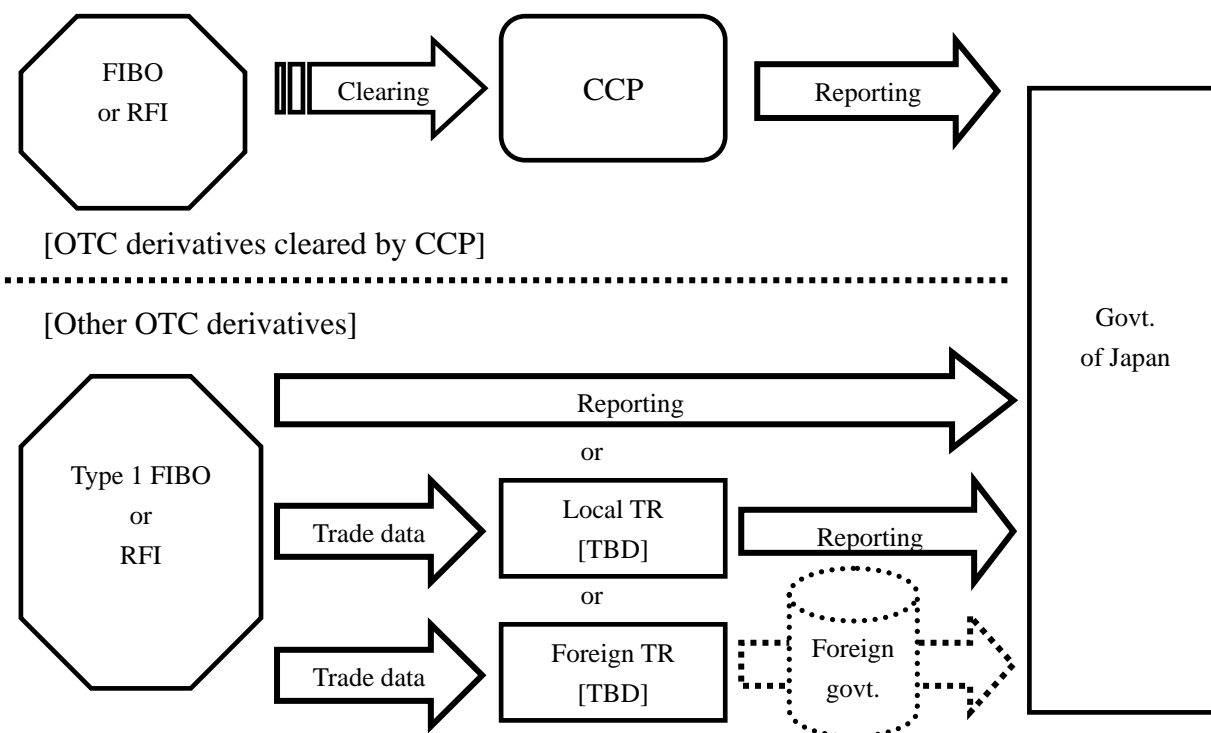
- (i) transactions already existing at the time of the implementation of this requirement (November 1, 2012);
- (ii) transactions with governments, central banks or other international authorities specified by the FSA; and
- (iii) certain intra-group transactions (i.e., transactions with parent companies, subsidiaries, or subsidiaries of a parent company).

In addition, certain transitional exemptions are available for transactions which are traded

between the effective date of this requirement (November 1, 2012) and March 31, 2013 as follows:

- (i) if a transaction will be settled or expire by March 31, 2013, the data storage and reporting requirements do not apply to such transaction; and
- (ii) if a transaction will be still outstanding as of March 31, 2013, the data of such transaction at that moment shall be stored and reported by the first reporting date after March 31, 2013.

In sum, although the 2010 Amendment has already taken effect in connection with the mandatory data storage and reporting requirements, it has not been operating due to the transitional exemptions above. Although the FSA has not designated a local TR or foreign TR yet, we believe that the FSA will make such designations by March 2013.



## Mandatory use of ETPs

### Transactions and parties

According to the 2012 Amendment, certain FIBOs and RFIs will be required to use ETPs when they enter into certain OTC derivatives transactions. The types of OTC derivatives transactions subject to this requirement will be specified in the subordinate regulations.

According to the 2011 Paper, initially ‘plain vanilla’ interest rate swap transactions referring to Japanese yen (entered into between certain FIBOs or RFIs with a high trading

volume) will be subject to this requirement, and the FSA will consider expanding this requirement to CDS transactions referring to an index of iTraxx Japan at a later stage after considering the market liquidity of these transactions.

#### ETP Operator

According to the 2011 Paper, ETP operators will be required to register under the FIEA as 'Type 1 FIBOs'. Considering that OTC derivatives transactions are made globally, the 2012 Amendment allows a non-Japanese ETP operator to operate in Japan without registering as a 'Type 1 FIBO', subject to certain requirements (including regulatory approval from the Prime Minister). ETP operators will be required to disclose the relevant trade data to the public.

#### Effective date

The above reform is expected to come into force within three (3) years of the 2012 Amendment being promulgated (i.e., by September 12, 2015).

#### **Conclusion**

As the mandatory clearing requirements and information storage and reporting requirements take effect, relevant market participants and potential participants should check and review whether these requirements may have an impact on their OTC derivatives business. The regulations with respect to the use of ETPs are to be detailed by the subordinate regulations, which will be published by the FSA before their effective date. In addition, the FSA has stated that it will review and revise the OTC derivatives regulations on an on-going basis. Market participants should pay close attention to further developments in this area.

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