

Amendments to JSDA Rules - New Selection Criteria for Foreign Funds: Restrictions on Derivatives Trading and Management of Credit Risks

1. Introduction

On September 24, 2014, the Japan Securities Dealers Association (the “**JSDA**”) released for public comment a draft amendment to the Rules Concerning Foreign Securities Transactions (the “**Rules**”), introducing new regulations concerning derivatives trading and credit risk in the context of asset management by foreign funds. With respect to domestic funds, new regulations focusing on the same subject matter will generally become effective on December 1, 2014 under the Financial Instruments and Exchange Act of Japan (the “**FIEA**”) pursuant to an amendment to the Cabinet Office Ordinance on Financial Instruments Business (the “**Cabinet Office Ordinance**”) and new and amended rules and guidelines of the Investment Trusts Association (the “**ITA**”). The planned amendment to the Rules is intended to impose similar regulations on foreign funds.

It is important to note that the amendment to the Rules, as currently drafted, will apply to foreign funds which are publicly offered in Japan through JSDA member dealers (i.e., securities companies and banks), while foreign funds privately placed in Japan will not be affected. In addition, it is worth noting that the new regulations will take the form of additional selection criteria applicable to foreign funds, which means that neither foreign funds nor foreign fund managers will be directly obligated to comply with the Rules. Rather, JSDA member dealers regulated under the Rules will be prohibited from offering foreign funds in Japan if they do not satisfy the selection criteria. In order to implement this regulation, JSDA member dealers will be required to confirm with foreign fund managers whether the foreign funds currently offered in Japan meet the selection criteria.

The amended Rules will generally become effective as of December 1, 2014. However, the amendment regarding credit risk (discussed in further detail below) will not become applicable with respect to foreign funds already offered in Japan as of such date for a transitional period of five years.

2. Restriction on Derivatives Trading

In the case of domestic funds, commencing from December 1, 2014, fund managers will be required under the FIEA, pursuant to the amended Cabinet Office Ordinance, to restrict Derivatives Trading (as defined under Article 2, Paragraph 20 of the FIEA) to manage risks arising therefrom through the application of a “rational method”. For this purpose, the amended rules and guidelines of the ITA¹ (collectively, the “**ITA Derivatives Trading**”

¹ The amended Rules Concerning Management of Investment Trusts, the amended Detailed Regulations Governing the Rules Concerning Management of Investment Trusts and the amended Guidelines Concerning Investment Restrictions on Derivatives Trading.

Regulations”) expressly identify the simplified method, the standard method and the VaR method as permissible; provided, however, that for domestic funds engaging in Derivatives Trading only for hedging purposes, all those three methods are permissible, while for domestic funds engaging in Derivatives Trading for purposes other than hedging only the latter two methods are permissible.

Under the amended Rules, foreign funds wishing to meet the selection criteria will also be subject to the same restriction mentioned above (i.e., restricting their Derivatives Trading to manage risks arising therefrom through the application of a “rational method”); however, the amended Rules do not identify what methods are “rational”. No determination has yet been made regarding permissible methods for foreign funds, but we anticipate that the above risk management methods applicable to domestic funds would be deemed “rational” to foreign funds as well and some other methods including those stipulated under overseas laws and practices applicable to foreign investment funds, such as the European Union directive concerning undertakings for collective investment in transferable securities and the Investment Company Act of 1940 of the United States of America.

Please be advised that a foreign fund which does not engage in Derivative Trading is not subject to this restriction on Derivative Trading, but has to confirm to the relevant JSDA member dealer that it does not engage in Derivative Trading. Whether a foreign fund engages in Derivative Trading or not is determined at the applicable fund level (i.e., not at the master fund level in case of a master-feeder structure or at an underlying fund level in case of a fund of funds structure).

3. Management of Credit Risks

In the case of domestic funds, commencing from December 1, 2014 (but subject to a transitional period of five years for funds already offered as of such date), fund managers will be required under the FIEA, pursuant to the amended Cabinet Office Ordinance, to manage credit risks through the application of a “rational method”. For this purpose, the new and amended rules and guidelines of the ITA² (the “**ITA Credit Risk Regulations**”) set forth the applicable restrictions on investment. More specifically, under the ITA Credit Risk Regulations, investment by domestic funds is categorized into equity, debt and derivatives exposure. In principle, exposure to a single counterparty within a particular exposure category may not exceed 10% of the relevant fund’s net asset value amount attributable to such exposure category, and also may not exceed 20% of the fund’s total net asset value, provided that (i) exposure to certain types of government bonds and certain other investments is disregarded and (ii) in the case of investment by one fund in another fund with identifiable exposure, such exposure will be imputed to the investing fund in proportion to its investment.

Under the amended Rules, foreign funds wishing to meet the selection criteria will also be required to manage credit risks by applying a “rational method”. The details, however, remain undetermined at this time. We anticipate that the above risk management method

² The amended Rules Concerning Management of Investment Trusts, the amended Detailed Regulations Governing the Rules Concerning Management of Investment Trusts and the new Guidelines Concerning Investment Restrictions to Prevent Excessive Concentration of Credit Risk.

applicable to domestic funds would be deemed “rational” to foreign funds as well and some other methods would be also permissible taking in to account overseas laws and practices applicable to foreign investment funds.

4. Filing with JSDA

The prohibition on sale by JSDA member dealers of foreign funds which fail to meet the selection criteria will require such dealers to confirm with relevant fund managers how foreign funds manage their derivatives trading and credit risks, and to make filings with the JSDA regarding compliance with the selection criteria. These filings will be required to include documentary evidence showing the results of JSDA member dealers’ inquiries.

5. Disclosure

Under the ITA Derivatives Trading Regulations, in the case of any domestic fund which is permitted to engage in Derivatives Trading under its investment trust contract, the relevant underlying investment trust contract will be required to prescribe the method to be used to manage risks arising therefrom. Under the amended rules of the ITA³, the fund manager will be required to disclose a summary of such method on its website. In line with this disclosure requirement for domestic funds, foreign funds engaging in Derivatives Trading also will be required to disclose their methods used to manage risk arising from Derivatives Trading after the amendment to the Rules comes into effect.

Domestic funds that change their existing credit risk management methods or employ new ones in order to comply with the new regulations may need to change their investment trust contracts and disclose such changed or new credit risk management methods. Similarly, foreign funds that change their existing credit risk management methods or employ new ones will be required to disclose such changed or new methods.

6. Further Details

The current draft amended Rules provide only a general outline of the new restrictions. We anticipate that further details will be revealed in the course of the public comment process. Should you have any questions or require assistance in connection with these amendments, please do not hesitate to contact us.

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³ The amended Rules Concerning Investment Reports of Investment Trusts and Investment Corporations.

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