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Amendments to the Netting Act of Japan

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Amendments to the Act on Close-Out Netting of Specified Financial Transactions Conducted by Financial Institutions (Act No. 108 of 1998, as amended; the “**Netting Act**”) were enacted by the Diet on May 31, 2019. Further thereto, on April 3, 2020, the relevant amended subordinate legislation were published by the Financial Services Agency of Japan (the “**JFSA**”). These amendments (the “**Amendments**”) were put in place to protect the validity and enforceability of close-out netting arrangements under corporate reorganization proceedings in Japan, in cases where security interest has been created over eligible financial assets in connection with an eligible financial transaction.

I. Background

Before the Amendments, the Netting Act did not encompass the validity and enforceability of close-out netting arrangements in respect of collateral assets that have been posted through the creation of pledges or other security interests. This is because collateral transactions eligible for protection under the Netting Act were limited to loans or deposits for consumption (i.e., title transfer collateral arrangements).

In line with this, the margin rules in Japan for uncleared OTC derivatives introduced in 2016 required the posting or collection of collateral assets as variation and initial margin to be made by way of either loans for consumption or deposits for consumption. In response to public comments dated March 31, 2016, the JFSA stated that posting of initial margins in accordance with English law IM CSDs or NY law IM CSAs would be eligible for purposes of the Japanese margin rules, if the equivalence determination thereof has been conducted by the JFSA Commissioner. On July 25, 2016, in light of the prevailing initial margin posting structure, the JFSA introduced measures provisionally permitting the posting or collection

of collateral assets in a manner similar to loans or deposits for consumption.¹ This provisional measure was generally understood to render typical overseas initial margin custody schemes eligible for purposes of Japanese margin rules even without the conduct of any equivalence determination by the JFSA Commissioner.

However, concerns remained that the Netting Act would not apply to collateral transactions where security interest had been used. In particular, there were concerns that the counterparty would be restricted from foreclosing on the security interest under Japanese law corporate reorganization proceedings, and that even receivables may be mandatorily reduced.

II. The Amendments

1. Close-out netting of pledged collateral assets

Under the Amendments, where a collateral taker has positive exposure (i.e., a close-out amount) against a collateral provider in respect of which corporate reorganization proceedings have commenced, the collateral assets over which security interests (e.g., pledges) have been created in favor of the collateral taker would be treated in the manner outlined below.

(a) Settlement by acquisition of collateral assets

Where a collateral contract provides that the collateral taker may cause the collateral assets to belong to the collateral taker upon the filing of a petition for commencement of corporate reorganization proceedings with respect to the collateral provider, the collateral assets will belong to the collateral taker upon the filing of such petition. In such a case, the fair market value of the collateral assets will be deducted from the collateral taker's claim against the collateral provider (i.e., the close-out amount), or if applicable, the excess amount will be returned to the collateral provider.

Such fair market value will be calculated after the elapse of a duration typically needed for the relevant calculation process, if so agreed upon in the collateral contract. In the absence of such agreement, the fair market value will be calculated as at the time the petition is filed for commencement of the corporate reorganization proceedings.

(b) Settlement by disposal of collateral assets

Where the collateral contract permits the collateral taker to dispose of the collateral assets upon the filing of a petition for a corporate reorganization proceedings with respect to the collateral provider, the

¹ The JFSA also amended the Cabinet Office Order on Financial Instruments Business, etc. (Cabinet Office Order No. 52 of 2007, as amended) to enable this provisional measure to be formally incorporated into Japanese margin rules effective as at May 1, 2020.

collateral assets will belong to the third party who has purchased the collateral assets from the collateral taker before commencement of the corporate reorganization proceedings. In such a case, the purchase price (or the fair market value as at the time of the purchase, if the purchase price is unduly low) of the collateral assets will be deducted from the collateral taker's claim against the collateral provider (i.e., the close-out amount) or, if applicable, the excess amount will be returned to the collateral provider.

2. Eligible collateral assets

Collateral assets that are eligible for close-out netting protection under the Amendments are limited to those that meet the same eligibility criteria applicable to the eligible collateral assets specified in the Japanese margin rules for uncleared OTC derivatives (such as cash, bonds issued by an eligible issuer, certain listed shares and interests in eligible funds).

Collateral assets over which multiple security interests have been created (in favor of not only the collateral taker but also a third party) are ineligible. According to the JFSA's response to public comments dated April 3, 2020, security interests that are routinely held by a global custodian and do not prevent timely usage of the collateral assets would not be deemed multiple securities interests for this purpose.

3. Eligibility of transactions secured by security interests

The protection of close-out netting in respect of collateral assets over which security interests have been created is available on the condition that the transactions secured by such security interests meet all the original eligibility criteria under the Netting Act before the Amendments (e.g., at least one of the parties must be a financial institution, and the parties have entered into specified financial transactions, such as OTC derivatives, repos and security lending transactions, under an eligible master agreement). Such original criteria have not been revised under the Amendments. In other words, where transactions secured by security interests are ineligible under the Netting Act, the close-out netting between such transactions and the collateral assets will not be protected under the Amendments.

III. Date of entry into force

The Amendments will come into force on May 1, 2020. Accordingly, the Amendments will apply to security interests created over eligible collateral assets by a person in respect of which a petition has been filed on or after May 1, 2020 for commencement of corporate reorganization proceedings.

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