

# New regulatory framework for commodity derivatives business in Japan

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**In July 2009, the bill of amendments to the Commodity Exchange Act of Japan (Act No. 239 of 1950, as amended; the “Commodity Exchange Act”) was enacted. These amendments will change the title of the Commodity Exchange Act to the “Commodity Futures and Exchange Act” (the “Amended Commodity Futures and Exchange Act”) and will drastically alter the regulatory framework for commodity derivatives business. This article presents some of the fundamental aspects of the new regulations and provides an outline of how they affect current commodity derivatives business, in particular, how they affect offshore and OTC markets.**



## Current regulatory framework

### General framework

Under the current Commodity Exchange Act, only commodity derivatives business that is domestic in nature is regulated. More specifically, the Commodity Exchange Act principally regulates business relating to domestic commodity exchange transactions and also provides some regulations on OTC commodity derivative transactions referring to market prices in domestic commodity exchanges. It stipulates the licensing and reporting requirements of entities which intend to engage in such business, together with client protection schemes and other regulations relating to such business.

By contrast, business in Japan relating to certain offshore commodity exchange transactions and certain OTC commodity derivative transactions (not referring to market prices in domestic commodity exchanges) is regulated by other laws as well. However, there are no licensing or reporting requirements for such business.

Moreover, it has been indicated by some non-dealer parties that the client protection regulations regarding such business were incomplete when compared to such regulations for the business relating to domestic commodity exchange transactions under the Commodity Exchange Act.

To date, the regulations on the commodity derivatives business have been established on a step by step basis reacting to the newly established business, thus resulting in the above differing levels of regulation.

### Side-business regulations for financial institutions

Aside from the general regulations above, certain financial institutions licensed under Japanese law may be required to submit reports to or obtain approvals of the Japanese authority (which governs their principal business) when commencing such business pursuant to

the side-business regulations under the laws governing their principal business.

## New regulatory framework

### Cross-sectional and flexible regulations

What will occur under the Amended Commodity Futures and Exchange Act appears to have some similarity to what has occurred to the financial derivatives business under the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the “FIEA”) whereby the former Securities and Exchange Act was transformed by bringing “cross-sectional” and “flexible” regulations to the new regulatory framework for financial derivatives business. It could be said that the enactment of the Amended Commodity Futures and Exchange Act follows the same trends as the enactment of the FIEA that came into effect in September 2007.

The Amended Commodity Futures and Exchange Act intends to set cross-sectional and seamless regulations for commodity derivatives business, without regard to cross-border and domestic transactions, exchanges and OTC transactions. That is, the Amended Commodity Futures and Exchange Act will (i) expand the regulations regarding business in Japan relating to offshore commodity exchange transactions and OTC commodity derivative transactions in addition to the current coverage of business relating to domestic commodity exchange transactions; and (ii) set consistent rules for such business (“cross-sectional” regulations).

Reacting to the increase of unscrupulous dealer cases, the Amended Commodity Futures and Exchange Act will also strengthen client protection regulations, while adding some flexibility in the applicability of certain client protection regulations, depending on whether the clients are in the category of professionals or amateurs (“flexible” regulations).

## Commodity derivatives business relating to offshore and OTC markets

The following are points to note with regard to the new regulations for commodity derivatives business relating to offshore and OTC markets provided under the Amended Commodity Futures and Exchange Act.

**Licensing requirements.** Under the Amended Commodity Futures and Exchange Act, an entity that intends to engage, in Japan, in the business of (i) acting as an intermediary, a broker and/or an agent for offshore commodity exchange transactions; and/or (ii) entering into and/or performing OTC commodity derivative transactions, and/or acting as an intermediary, a broker and/or an agent for such OTC commodity derivative transactions, will be required to obtain approval to conduct such business from the Ministry of Economy, Trade and Industry of Japan (METI) or any other relevant authority.

Generally speaking and by way of an example, if an entity intends to engage in business in Japan by entering into and/or performing OTC oil swap transactions using an index of WTI prices in New York Mercantile Exchange (NYMEX), or by acting as an intermediary, a broker or an agent for such oil swap transactions, such business would fall within the category of (ii) above.

Please note that, for certain financial institutions licensed under Japanese law, the scope of commodity derivatives business that they are permitted to engage in may be restricted by side-business regulations under the laws governing their principal business.

In order to obtain approval, all of the following requirements must be satisfied. Even if approval is obtained, it must be renewed every six years in order to maintain its effectiveness (an entity which has obtained the effective approval is a "commodity futures trader").

- The applicant for the approval must be: (i) a stock company (*kabushiki kaisha*); (ii) a foreign entity equivalent to a *kabushiki kaisha* having its office(s) in Japan; or (iii) any other entity as specified by the cabinet order (a draft of such has not yet published).
- It must have sufficient financial standing to ensure the sound performance of its commodity derivatives business and the outlook for income and expenditures relating to such business must be favourable. If the amount of the entity's net assets is less than the amount specified by the ministerial ordinance (a draft of such has not yet published), such entity shall be deemed to lack sufficient financial standing.
- It must have knowledge and experience for the fair and appropriate performance of its commodity derivatives business and have sufficient social credibility, and the operation of such business

should not be lacking in client protection.

- It must not be an entity which falls under any of the disqualification causes specified in the Amended Commodity Futures and Exchange Act.
- There must be no false statement relating to any material matter in the application for the approval or documents attached thereto.

The requirements set out in the above are those provided by the Amended Commodity Futures and Exchange Act, however, in practice, there may be a possibility that the Japanese authority would require the applicant to satisfy supplemental or elevated requirements. Also, certain conditions for approval may be attached at the time the approval or renewal is granted.

Moreover, all individuals employed by or working for a commodity futures trader and engaging in the business of (i) acting as an intermediary, a broker and/or an agent for offshore commodity exchange transactions; (ii) entering into and/or performing OTC commodity derivative transactions, and/or acting as an intermediary, a broker and/or an agent for such OTC commodity derivative transactions; and/or (iii) soliciting clients for those transactions, will also be required to be registered as sales staff. This registration must be renewed every six years in order to maintain its effectiveness.

**Client protection and other regulations.** A commodity futures trader will become subject to several detailed client protection schemes and other regulations as provided in the Amended Commodity Futures and Exchange Act, including segregation of the clients' assets; prohibition of bucketing; restrictions on advertisement; restrictions on the solicitation of clients; delivery of certain documents to clients; obligation to provide explanations to clients; restrictions on compensation for losses; restrictions on net assets ratio (provided, certain entities such as banks to be specified by the cabinet order (a draft of such has not yet published) are likely to be exempted from the restrictions on net assets ratio); and book and record keeping.

Some of the client protection regulations will not apply if the clients are certain professional clients, or certain quasi-professional clients who have completed the requisite procedures.

**Exempted business.** As to the business relating to OTC commodity derivative transactions with certain high-level professional clients, the approvals mentioned in the above will not be required. However, if such OTC derivative transactions refer to certain commodities and/or commodity indices that are (or that are similar to those) listed in a domestic commodity exchange, submission of the reports to the Japanese authority will still be required prior to

the commencement of such business, in order for the Japanese authority to identify market trends as such transactions may have practical impact on price formation in domestic commodity exchanges.

In such cases, these entities will be subject to certain limited regulations such as restrictions on compensation for losses and book and record keeping. Please note that, such report and related requirements are not applicable to those entities that only engage in the business of acting as an intermediary, a broker and/or an agent for such transactions and do not engage in the business of entering into and/or performing such transactions.

By way of clarification, even an entity that has obtained the approval mentioned in the above may be required to submit this report to the Japanese authority prior to the commencement of such exempted business.

**Commodity futures intermediary.** The Amended Commodity Futures and Exchange Act also provides a new regulatory framework with respect to the business of acting as an intermediary for commodity futures trader(s) relating to domestic commodity

exchange transactions as well as offshore commodity exchange transactions and OTC commodity derivative transactions.

Under such framework, if an entity, which has not obtained the approval mentioned in the above, intends to engage in the intermediary business relating to offshore commodity exchange transactions and/or OTC commodity derivative transactions, it must register with the Japanese authority and stipulate the commodity futures trader(s) which it will be acting for (an entity which has completed such registration is a "commodity futures intermediary"). The registration must be renewed every six years in order to maintain its effectiveness.

A commodity futures intermediary will be subject to certain regulations, including prohibition on holding the clients' assets; registration of its sales staff; restrictions on advertisement; restrictions on the solicitation of clients; obligation to provide explanations to clients; restrictions on compensation for losses; and book and record keeping.

#### **Scope of regulated transactions**

**Definition of "commodities".** Traditionally, the



Commodity Exchange Act has mainly regulated business relating to domestic exchange transactions whose underliers are certain “goods”. Such “goods” are defined as “commodities” to include certain agricultural products, forest products, animal products, aquatic products, and certain metals and other mineral substances. However, unlike the scope of the underliers of the commodity derivatives which are envisioned by the market standardised documentation (e.g., “2005 ISDA Commodity Definitions” published by the International Swaps and Derivatives Association, Inc. (ISDA)), the definition of “commodities” does not include certain underliers such as electric power, emission allowances and freight rates.

As the new Commodity Futures and Exchange Act only provides an outline of the new regulations, with the details to be provided in the cabinet order and ministerial ordinance (drafts of such have not yet published), there are certain ambiguities regarding the applicability of the new regulations. In particular, at this stage the definitions of “commodities” are not sufficiently clear, as the details thereof are to be provided in the cabinet order (a draft of such has not yet published). Therefore, currently we are not in a position to reach a definite conclusion as to whether the derivative transactions with certain underliers that do not fall under the current definition of the “commodities” (e.g., electric power, emission allowances and freight rates) will be regulated under the Amended Commodity Futures and Exchange Act.

However, under both the Commodity Exchange Act and the Amended Commodity Futures and Exchange Act, “commodities” are defined as being certain “goods”; whereas electric power, emission allowances and freight rates are not “goods” themselves; therefore they may not fall within the above definition of “commodities”.

On April 13, 2009, the ISDA Japan Regulatory Committee invited METI to attend its meeting in order for METI to hold its briefing session to explain the outline of the new regulations to the ISDA members. At that time, in response to inquiries from the ISDA members, METI stated that it does not plan to change the scope of the “commodities” from that set out in the Commodity Exchange Act. Since then, we have not obtained any information indicating that METI has changed the above policy so as to regulate derivative transactions based on certain underliers that do not fall under the current definition of “commodities”.

**Hybrid products.** The business relating to certain financial derivatives are regulated by the FIEA. Certain business relating to hybrid products that contain such financial derivatives as well as other transactions may also be regulated by the FIEA. Presuming that there are certain hybrid products that contain financial derivatives as well as commodity derivatives (i.e., the products referring prices and/or indices of financial instruments and commodities) that have already been regulated by the FIEA, aside from such regulations, there is a possibility that the Amended Commodity Futures and Exchange Act will also regulate the business relating to such products. In such case, both the regulations under the FIEA and the Amended Commodity Futures and Exchange Act need to be complied with.

## Conclusion

The Amended Commodity Futures and Exchange Act will come into effect on a date to be specified by the cabinet order but no later than January 9, 2011. Although the Amended Commodity Futures and Exchange Act provides the outline of the new regulations on the commodity derivatives business and there is certain ambiguity on the law’s position over the applicability of the new regulations, the details will be stipulated in the cabinet order and ministerial ordinance and drafts of such are expected to be published before the effective date of the Amended Commodity Futures and Exchange Act. Practitioners and market participants must pay close attention to the further developments of the new regulations by reviewing the forthcoming relevant cabinet order and the ministerial ordinance which will complete the outline of the regulations provided in the Amended Commodity Futures and Exchange Act.

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