

Commodity derivatives changed forever

Tatsu Katayama and Ayako Kuyama of Anderson Mori & Tomotsune explain how the commodity derivatives business in Japan has been drastically altered

In July 2009, a bill to amend the Commodity Exchange Act of Japan (Act No. 239 of 1950, as amended) was passed. Once in force, the Commodity Exchange Act will be renamed the Commodity Futures and Exchange Act. It will drastically alter the regulatory framework for the commodity derivatives business. As of May 2010, the amendments are not yet in effect. Although no implementation date has been announced, the amendments should come into force no later than January 9 2011. This article presents some of the key aspects of the new regulations and provides an outline of how they are expected to affect the commodity derivatives business; in particular, offshore exchanges and OTC markets.

The Commodity Exchange Act regulates commodity derivative transactions traded on the onshore commodity exchanges as well as OTC commodity derivative transactions that reference market prices on the same exchanges (the latter are prohibited with limited exceptions). It also sets out the licensing requirements of brokers and dealers engaged in the business of commodity derivative transactions traded on the onshore commodity exchanges, and provides detailed customer protection schemes and other regulations relating to this business.

Commodity derivative transactions traded on offshore commodity exchanges and OTC commodity derivative transactions that do not reference market

prices on onshore commodity exchanges are subject to other legislation. There are no licensing requirements for such businesses. The scope of the codes of conduct applicable to the brokers and dealers of such transactions is more limited, and not comparable to the customer protection schemes provided for under the Commodity Exchange Act.

To date, regulation of the commodity derivatives business sector has developed on a piecemeal basis, in reaction to the emergence of each new type of business, including, amongst others, commodity derivative transactions traded on offshore commodity exchanges and OTC commodity derivative transactions. This helps to account for the differing levels of regulation.

In addition to the general regulations above, certain institutions licensed or authorised to operate banking, securities or insurance businesses, pursuant to the regulations governing them, are required to submit notifications to, or obtain the approval of, the relevant Japanese authorities when they begin to operate (in addition to their licensed or authorised business) a commodity derivatives business; and/or restricted from engaging in certain types of commodity derivatives business.

The Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the FIEA) provides a regulatory framework for both exchange-traded derivative transactions and OTC derivative transactions relating to securities or other financial instruments. This regulatory framework includes the regulation of brokers and dealers in securities and financial derivative transactions. The extent of regulation applicable to a transaction differs depending on the type of customer involved (professional/non-professional). The regulatory framework applicable to commodity derivatives brokers and dealers under the Amended Act will resemble that of the FIEA to a large extent.

The Amended Act intends to establish so-called cross-sectional and seamless regulations for the commodity derivatives sector. The intention is for there to be no distinction between cross-border and domestic transactions or exchange-traded and OTC transactions. In other words, the Amended Act will expand the level of regulation of commodity derivative transactions traded on offshore exchanges and OTC commodity derivative transactions, to bring it in line with that already applicable to onshore exchange-traded commodity derivative transactions and financial derivative transactions. It will

Current regulations		
	Exchange-traded derivatives	OTC derivatives
Onshore*	Licensing requirements Detailed customer protection schemes	Prohibited with limited exceptions
Offshore*	No licensing requirements Limited customer protection schemes	No licensing requirements Very limited customer protection schemes

* Onshore OTC Derivatives mean OTC commodity derivative transactions that reference market prices on the onshore commodity exchanges, while Offshore OTC Derivatives mean OTC commodity derivative transactions that reference market prices on offshore commodity exchanges.

New regulations		
	Exchange-traded derivatives	OTC derivatives
Onshore*	Licensing requirements Detailed customer protection schemes	Prohibited with limited exceptions
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“It will provide consistent rules for such onshore and offshore, and exchange-traded and OTC transactions”

provide consistent rules for such onshore and offshore, and exchange-traded and OTC transactions. The Amended Act will also strengthen customer protections, although there will be some differences in the applicability of these regulations depending on the type of customer involved (professional/non-professional). OTC commodity derivative transactions that reference market prices on onshore commodity exchanges continue to be prohibited with limited exceptions.

The current Commodity Exchange Act regulates derivative transactions traded on the onshore exchanges where the underlying assets are commodities. Commodities are defined as including certain tangible assets such as agricultural, forest, animal, and aquatic products, metals and mineral substances. The definition of commodities under the Commodity Exchange Act does not necessarily match that envisioned by such standardised market documentation as the 2005 Isda Commodity Definitions published by the International Swaps and Derivatives Association Inc. For example, derivative transactions based on electric power, emissions allowances and freight rates may be the subject of such commodity derivatives documentation, despite being intangible and therefore not subject to the Commodity Exchange Act.

The Amended Act does not define the scope of the commodities subject to it, leaving this to be clarified in subordinate regulations. It is not expected that the definition of commodities under the Commodity Exchange Act will change upon enforcement of the Amended Act. Intangible assets such as electric power, emission allowances and freight rates will continue to be outside the scope of the Amended Act.

As stated above, the FIEA regulates financial derivative transactions. Hybrid products may contain elements of both

Author biographies



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Tatsu Katayama is a partner at Anderson Mori & Tomotsune, whose areas of expertise are international banking, finance and securities matters with particular emphasis on structured finance, financial derivatives and other complex financial transactions.

He has been instrumental in structuring innovative transaction schemes and regularly advises investment banks, asset managers and investment vehicles such as TMKs (special purpose companies) and J-Reits (real estate investment trusts)

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Mr. Katayama was appointed by the Japan Financial Supervisory Agency as the administrator for a failed credit union (2001 to 2002). He counseled a number of restructurings of financial, securities and insurance companies and has collaborated with the firm's litigation group in advising financial institutions in relation to disputes involving complicated financial transactions. Since 2008, Mr. Katayama has served as the Director of International Affairs of the Japan Federation of Bar Associations (Nichibenren).

Mr. Katayama is a graduate of the University of Tokyo (LLB, 1985) and the University of Pennsylvania (LLM, 1991). Mr. Katayama is admitted to practice law in Japan (1987) and New York (1992).

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Ayako Kuyama is an associate at Anderson Mori & Tomotsune. Ms Kuyama works primarily in the field of financial regulatory issues, derivatives, structured finance such as synthetic CDOs and securitisations, and various issues relating to trust laws and other financial transactions.

With respect to her work in derivatives, she advises on a variety of issues relating to financial products and structured finance products that incorporate derivatives. She also provides

advice on regulation and other issues relating to structuring, documentation, and handling of defaults and disputes relating to such derivatives. She also advised on establishing and licensing procedures of companies engaging in derivatives and on the investor protection regulations relating to marketing derivatives.

Ms. Kuyama received an LLB degree (2001) and an LLM degree (2003) from The University of Tokyo and served as a lecturer at The University of Tokyo School of Law from 2005 to 2006. Ms. Kuyama is admitted to practice law in Japan (2004).

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financial and commodity derivatives. As a result, businesses that deal in hybrid products may be regulated by the FIEA as well as by the Amended Act. Any brokers and dealers in such products may be required to comply with both the regulations under the FIEA and the Amended Act.

Offshore exchanges and OTC markets

We will now set out the main points of note in relation to the new regulations applicable to commodity derivative transactions traded on offshore exchanges and OTC markets.

Under the Amended Act, an entity that

intends to engage in Japan and in the business of acting as an intermediary, a broker and/or an agent for commodity derivative transactions traded on offshore exchanges; and/or 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 from the relevant Japanese authorities to conduct this business.

Institutions licensed or authorised to conduct banking, securities or insurance businesses, continue to be required to submit notifications to, or obtain the

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approval of, the relevant Japanese authorities when they begin to operate a commodity derivatives business (in addition to their licensed or authorised business). They continue to be restricted from engaging in certain types of commodity derivatives businesses.

In order to obtain approval, all of the following requirements must be satisfied. The approval should be renewed every six years. An entity that has obtained such approval is referred to as a commodity derivatives dealer.

- The applicant must be a stock company (*kabushiki kaisha*); a foreign entity equivalent to a *kabushiki kaisha* which has an office in Japan; or any other entity as specified by subordinate regulation.
- It must have sufficient financial standing to ensure the sound performance of its commodity derivatives business, and its income forecast should exceed expected expenditure. If the value of the applicant's net assets is less than that specified by subordinate regulation, the entity shall be deemed to lack sufficient financial standing.
- The applicant must have sufficient knowledge and experience for the fair and appropriate performance of its commodity derivatives business. It must have sufficient social credibility and proper customer protection measures in place.
- It must not be an entity that is disqualified from operating such a business, by virtue of falling under any of the disqualification causes specified in the Amended Act.
- There must be no false statement in relation to any material matter, either in the application for approval itself or in any of the documents attached thereto.

The above requirements are set out in the Amended Act. However, in practice, it is

possible that the relevant Japanese authorities may require the applicant to satisfy additional or stricter requirements. There is also the further possibility that certain conditions may be attached to the approval or renewal at the time it is granted.

Moreover, all individuals employed by or working for a commodity derivatives dealer and engaging in the business of acting as an intermediary, a broker and/or an agent for commodity derivative transactions traded on offshore exchanges; 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 soliciting customers for those transactions, must also be registered as sales representatives. This registration must be renewed every six years.

Commodity derivatives dealers will also become subject to several detailed customer protection schemes under the Amended Act. As the Amended Act follows the same trends as the FIEA, the outline of these schemes is very similar to those provided in the FIEA. Therefore, if a financial instruments business operator or a registered financial institution, (both are regulated under the FIEA) deals in commodity derivative transactions, it may find it easier to establish the necessary systems and operations to comply with the regulations under the Amended Act, than entities which have no experience of compliance under the FIEA.

A key feature of the customer protection schemes is the strict requirement for segregation of customers' assets. The Amended Act will require a commodity derivatives dealer to segregate customers' assets from its proprietary assets and to secure them in a specified manner. Further details of the assets to be segregated and how they should be secured will be provided in subordinate regulations under the Amended Act. It may be, that the subordinate regulations will permit the value of a customer's assets to be secured by the dealer, to be reduced by the value of the customer's assets posted under any collateral agreement with that same dealer and under which the dealer may sell, transfer or otherwise dispose of such assets. For example, the assets posted by way of a transfer or loan under the relevant Isda Credit Support Annex. However, the more likely possibility appears to be that such a reduction in the value of the customer's assets to be secured will not be permitted. This will mean that, notwithstanding the

terms of any collateral agreement, the dealer will not be permitted to sell, transfer or otherwise dispose of such assets. Instead the dealer will have to secure them in the manner specified by the Amended Act. One possible result of this situation is that current collateral practice will be altered.

The Amended Act will also introduce new restrictions on marketing commodity derivative transactions. A commodity derivatives dealer is prohibited from soliciting a potential customer to engage in certain types of commodity derivative transactions unless the potential customer has requested such solicitation. Subordinate regulations will be made under the Amended Act to define the types of commodity derivative transactions which are subject to such marketing regulations. They are expected to include any OTC commodity derivative transaction executed with individual customers¹, and any commodity derivative transactions traded on exchanges executed on behalf of individual customers. However, it should be noted that where the latter transactions are covered by a scheme to prevent the customer from incurring losses greater than the initial investment amount, those transactions will not be subject to such stringent marketing regulations, and commodity derivatives dealers may be permitted to solicit individual customers for such products.

The Amended Act also provides for additional customer protections including other restrictions on solicitation of customers; restrictions on advertising; delivery of certain documents to customers; restrictions on compensation for losses; restrictions on net asset ratios (although certain entities such as banks are likely to be exempted from this restriction); and record and book-keeping.

Some of the customer protection regulations will not apply to certain professional customers, or to certain quasi-professional customers who have completed the requisite procedures.

The approvals mentioned above will not be required in relation to businesses dealing in certain types of commodity derivative transactions traded on offshore exchanges and OTC commodity derivative transactions. Subordinate regulations made under the Amended Act will define precisely what type of businesses will be exempt from approval. We anticipate that:

- Dealers will be exempt from approval for entering into and/or performing OTC commodity derivative transactions with, or acting as an intermediary, broker or agent for, such OTC

commodity derivative transactions or commodity derivative transactions traded on offshore exchanges, with particularly sophisticated professional customers; and

- Foreign entities which engage in the commodity derivatives business in a foreign jurisdiction, in accordance with the laws of that jurisdiction, may act as a broker for commodity derivative transactions traded on offshore exchanges for, or enter into and/or perform OTC commodity derivative transactions with, a customer (who is not an individual) in Japan without obtaining approval as a commodity derivatives dealer, if such transactions are made through the agency or intermediation of a commodity derivatives dealer approved under the Amended Act, and to the extent that the foreign entity itself does not solicit customers.

Where an entity is exempt from approval under the criteria above, the relevant Japanese authorities may still require the dealer to report in advance of commencing business in OTC derivatives which refer to certain commodities and/or commodity

indices that are (or are similar to those) listed on an onshore commodity exchange. Such OTC derivative transactions may have an impact on pricing on the onshore commodity exchanges, and thus the relevant Japanese authorities need to follow market trends. As a result, these entities will be subject to certain limited regulation, including restrictions on compensation for losses and record and book-keeping. However, these requirements are not applicable to entities that only act as an intermediary broker and/or agent for such transactions and do not themselves enter into and/or perform such transactions.

It is worth noting that even an entity that has obtained approval as a commodity derivatives dealer must submit such reports to the relevant Japanese authorities with respect to its OTC derivatives business.

The Amended Act also provides new regulations in relation to acting as an intermediary for commodity derivatives dealer(s) in exchange-traded commodity derivative transactions and OTC commodity derivative transactions.

Under these regulations, if an entity that has not obtained the approvals mentioned above intends to engage in an intermediary

business relating to commodity derivative transactions traded on offshore exchanges and/or OTC commodity derivative transactions, it must register with the relevant Japanese authorities and specify the commodity derivatives dealer(s) for which it will be acting. An entity that has completed such registration is known as a commodity derivatives intermediary. The registration must be renewed every six years. A commodity derivatives intermediary will be subject to certain regulations, including prohibition on holding the customers' assets; registration of its sales representative; restrictions on advertisement and manner of marketing; restrictions on compensation for losses; and record and book-keeping.

This article has outlined the regulatory framework of the commodity derivatives business under the Amended Act. The details of these regulations will be provided in the related subordinate regulations, the drafts of which are currently under consideration. Given that such details may have a material impact on market practices, market participants must pay close attention to these drafts, which will be open to public comment.

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