Amendments to Japan's FSA Guidelines for the marketing of derivative transactions

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The Financial Services Agency of Japan (FSA) has partly amended the following guidelines (the Amended Guidelines):

(a) 'Comprehensive Guidelines for Supervision of Major Banks, etc.';

(b) 'Comprehensive Guidelines for Supervision of Small/Medium and Regional Financial Institutions'; and

(c) 'Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.'.

The Amended Guidelines, which became effective on April 16, 2010, are intended to improve the regulatory environment in respect of, among other things, the duty to explain derivative transactions to customers.

Overview – amendments to FSA guidelines

As can be seen in their titles, the Amended Guidelines are respectively applicable to certain financial institutions regulated in Japan, i.e., major banks and small/medium and regional financial institutions (collectively 'Banks' and each a 'Bank') and financial instruments business operators, etc.[1] (Banks and financial instruments business operators, etc. shall collectively be referred to as 'Financial Institutions' and each a 'Financial Institution'). Although each of the Amended Guidelines provides rules applicable to a particular sector, there are certain provisions in the Amended Guidelines which apply in common to all Financial Institutions, such as the duty to explain derivative transactions to customers in executing such transactions. We set out below a summary of such main common provisions.[2]

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The Amended Guidelines require each Financial Institution to explain to its customer in a certain manner the risks regarding the relevant derivative transaction. For example:

(a) the Financial Institution should explain to the customer the 'estimate maximum loss amount' based on the worst-case scenario of the status of the underlying instruments (including the level of volatility) in relation to the relevant derivative transaction (using a reasonable basis such as data under past stressed market conditions) and the fact that the loss may increase if market conditions deviate from the assumptions;
(b) should there be a possibility that, even if the loss may not exceed the worst-case scenario mentioned above, the loss may exceed the amount of loss acceptable to the customer, such possibility should nonetheless be explained. The explanation should enable the customer to understand how market conditions in respect of the relevant underlying instruments may adversely affect the customer's business; and
(c) when the Financial Institution uses an example different from the actual derivative transaction, it should clarify that such example is different from the latter.

Further, the Amended Guidelines require each Financial Institution to explain to its customer certain matters regarding early termination and settlement of the relevant derivative transaction. To illustrate:

(a) should the relevant derivative transaction not be subject to early termination, such fact should be explained;
(b) should there be a need to pay a settlement amount in terminating the relevant derivative transaction prior to maturity, the Financial Institution should explain to the customer such fact together with the details of such settlement amount, including an estimated settlement amount assuming the worst-case scenario. Further, if there is a possibility that the actual settlement amount may exceed the estimated amount, such possibility should still be explained; and
(c) the Financial Institution should confirm with the customer what amount is acceptable as a settlement amount under the relevant derivative transaction, and should there be a possibility that, even if the loss may not exceed the worst-case scenario mentioned above, the customer would suffer a loss exceeding the acceptable amount, such possibility should also be explained.

Separately, the Amended Guidelines require each Financial Institution to confirm with its customer the following matters in respect of a derivative transaction for hedging purposes:

(a) whether the derivative transaction works as an effective hedging measure for the customer, given the business conditions of the customer and the competition in the product market where the customer operates its business;[3]
(b) whether the customer's needs for hedging will most likely last until the end of the term of the derivative transaction;[4] and
(c) whether it will not adversely affect the customer's flexibility in its future business.[5]

In addition to the above, the Amended Guidelines also require Financial Institutions to confirm with each customer, among others, the customer's intention to enter into the relevant transaction and, if the derivative transaction may have a material effect on the customer's future business, whether the customer has decided to enter into the transaction after obtaining the approval of the board of directors or other necessary corporate approvals.

In addition to the foregoing rules applicable to Financial Institutions, each Bank is required to explain to its customer the effect of the relevant derivative transaction to the customer's loan transactions with the Bank. That is, the Bank is required to ensure that the customer does not fear that any refusal to enter into the derivative transaction proposed by the Bank could affect its loan transactions. By way of example, the Amended Guidelines provide that each Bank should explain to its customer that notwithstanding the customer's refusal to enter into the

derivative transaction proposed by the Bank, such refusal will not affect future loan transactions between such customer and the Bank. In another example, the Amended Guidelines provide that each Bank should adopt a method for confirming that the customer has received an explanation that there is no abuse of the Bank's 'dominant bargaining position'.[6]

What led to the adoption of the Amended Guidelines? A number of disputes involving derivative transactions could explain why the Amended Guidelines have been adopted. Below are two cases which may shed light on the necessity of adopting the Amended Guidelines.

A case involving violation of a securities company's duty to explain

This is a court case where the Japanese court ordered a certain securities company (X) to compensate its customer (Y) due to the breach by X's employee of X's obligation to provide sufficient explanation to Y regarding interest rate swap transaction.

The material facts found by the court are as follows:

First, the court found that the approval by the internal committee of X, which analyses and pre-approves transactions, of the relevant transaction with Y was subject to, among other conditions, X providing Y with a sensitivity analysis chart (the 'sensitivity analysis chart') which contained a detailed analysis of the risks of the relevant transaction considering various probabilities. However, the court did not find any evidence to show that X's employee provided Y with such chart or with any explanation based on such chart.

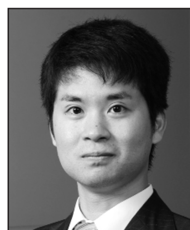
Instead, the court found that X's employee provided Y with a simulation chart to explain the transaction (the 'simulation chart') and that the contents of such chart and X's employee's explanation were too different from those of the sensitivity analysis chart. The simulation chart was insufficient compared with the sensitivity analysis chart because the simulation chart did not explicitly mention the assumptions used and the possibility that there would be a loss in market value if any such assumptions did not hold.

It should also be noted that the maximum possible loss calculated in the sensitivity analysis chart was –46.64% while the maximum amount of loss shown in the simulation chart was only –8.86%. The court found that the minutes of the board of directors of Y which approved the relevant transaction state that a chart similar to the simulation chart was presented during the meeting for their consideration.

In view of such facts, the court ruled that, since X entered into the relevant transaction with Y without providing the sensitivity analysis chart and without explaining the risks based on such chart, it can be concluded that X's omissions prevented Y from fulfilling the preconditions necessary for making its own investment judgment. For this reason, the court ruled that there was a breach of X's obligation to provide sufficient explanation to Y.

A case involving a bank's abuse of 'dominant bargaining position'

Another case is a ruling by the Japan Fair Trade Commission (JFTC) that a certain bank (Z) abused its 'dominant bargaining position' in inducing customers to enter into derivative transactions.



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The JFTC found the following facts which led to its ruling:

First, the JFTC found that Z engaged in misconduct while inducing customers to enter into derivative transactions notwithstanding their refusal. For example, in some cases, Z explicitly mentioned to its customer that, if such customer does not enter into an interest rate swap transaction with Z, Z would treat that customer in a disadvantageous manner when such customer renews its credit line. In other cases, although Z did not expressly mention to its customer that entering into an interest rate swap transaction was a condition for entering into a loan transaction with such customer, Z nonetheless implied the same. In the said cases, the JFTC found that the relevant customer consistently refused to enter into the relevant interest rate swap transaction with Z due to, among other reasons, the financial burden of payment and the customer's concern that the floating interest rate would not rise very high for a while.

Second, the JFTC found that Z has induced several of its customers to enter into interest rate swap transactions having longer terms and bigger notional amounts than those of the loan transactions to be hedged against interest fluctuation risks. This was without regard to the interest payable by each customer including the (a) type of interest rate for the customer's loan from a financial institution; (b) repayment conditions of the customer's individual loan; and (c) customer's future plans in respect of borrowing money from financial institutions.

In view of such facts, the JFTC ordered Z to, among other things, cease the abuse of dominant bargaining position and develop internal rules for marketing interest rate swap transactions which should include, (a) setting an appropriate term and notional amount when inducing any customer to enter into an interest rate swap transaction for hedging purposes; and (b) informing each customer that such interest rate swap transaction is not a condition for entering into any loan transaction and that Z will not treat any customer in a disadvantageous manner even if such customer refuses to enter into the said swap transaction.

Outlook

While the Amended Guidelines have already come into effect, it remains to be seen how the amendments will affect Financial Institutions, particularly how they will influence court rulings on the breach of explanation duties by Financial Institutions. However, it may be said that the Amended Guidelines would play an important role in interpreting the requirements with respect to marketing of derivative transactions by Financial Institutions.

Notes:

1. Under the Financial Instruments and Exchange Act (FIEA), 'financial instruments business operators, etc.', which are more commonly known as securities companies, refer to financial instruments business operators and registered financial institutions. The FSA has stated that the 'Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.' are not intended to make financial instruments business operators, etc. take necessary actions for transactions not regulated by the FIEA (such as OTC commodity derivative transactions).
2. For financial instruments business operators, etc., the requirements for marketing as stipulated in the 'Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc.' apply to transactions having the same level of risk characteristics as OTC derivative transactions (such as sale of structured products) in addition to OTC derivative transactions.
3. For example, in making a decision, what should be taken into account is the ability of the customer to negotiate the price or to decide on the price notwithstanding the fluctuation of exchange rates or interests.
4. For example, it must be noted that, even if there is no loss from the hedging measure itself, the customer's needs in hedging may alter or the result of the hedging may not effectively work until the end of the term of the derivative transaction due to a change in the customer's business conditions (for example, the narrowing of the scope of its business) and other reasons.
5. For example, the effects of hedging to the purchase price may influence the ability of the customer to compete in respect of the price of the end products.
6. This is an activity which is designated as an 'unfair trade practice' under Japanese Anti-monopoly regulations.

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