REPORT
The Journal on the Law of Investment & Risk Management Products
Futures & Derivatives Law
December 2010 ■ Volume 30 ■ Issue 11

Japan's Amended Commodity Derivatives Act

New Regulations Regarding Commodity Derivatives Business in Japan

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In July 2009, amendments to the Commodity Exchange Act of Japan (Act No. 239 of 1950, as amended) were enacted into law; some of these amendments are now in effect, with the remaining provisions to come into force on January 1, 2011. When such remaining provisions come into force, the Commodity Exchange Act will be renamed the Commodity Derivatives Act, and the regulatory framework for the commodity derivatives business in Japan will be drastically altered. Throughout this article, the statute prior to the amendments coming into force on January 1, 2011 will be referred to as the "Commodity Exchange Act," and the post-amendment statute will be referred to as the "Amended Act."

A number of key details with respect to the Amended Act will be covered by subordinate regulations[3] which will also take effect on January 1, 2011. This article presents some of the key aspects of the Amended Act and the subordinate regulations thereof, and provides an outline of how they are expected to affect the commodity derivatives business in Japan, particularly, offshore exchanges and over the counter ("OTC") markets.

Current regulations

Overview

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, such as commodity derivatives transactions traded on offshore commodity exchanges and OTC commodity derivatives transactions. Such disjointed approach has resulted in

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Futures & Derivatives Law Report
West LegalEdcenter
610 Opperman Drive
Eagan, MN55123

One Year Subscription ■ 11 Issues ■ $535.95
(ISSN#: 1083-8562)

differing levels of regulation based on the type of transaction conducted.

Onshore commodity derivatives transactions

The Commodity Exchange Act regulates commodity derivatives transactions[4] traded on onshore commodity exchanges, and prohibits, with limited exceptions, OTC commodity derivatives transactions that reference market prices on onshore commodity exchanges ("Onshore OTC Derivatives"). It also sets forth the licensing requirements and customer protection regulations regarding brokers and dealers that are engaged in the business of commodity derivatives transactions traded on onshore commodity exchanges.

Offshore commodity derivatives transactions

The Commodity Exchange Act does not regulate commodity derivatives transactions traded on offshore commodity exchanges or OTC commodity derivatives transactions that reference market prices on offshore commodity exchanges ("Offshore OTC Derivatives"); such transactions are subject to different legislation. Under such different legislation, (i) the scope of the codes of conduct applicable to the brokers and dealers of such offshore transactions is more limited, and not comparable to the customer protection regulations provided under the Commodity Exchange Act, and (ii) there are no licensing requirements for such transactions.[5]

New regulations

Features of the Amended Act

The regulatory framework applicable to commodity derivatives brokers and dealers under the Amended Act will to a large extent resemble that of the Financial Instruments and Exchange Act of Japan (Act No. 25 of 1948, as amended; the "FIEA"). The FIEA provides a regulatory framework regarding (i) exchange-traded derivatives transactions and OTC derivatives transactions relating to securities or other financial instruments, and (ii) brokers and dealers in securities and financial derivatives transactions. Under the FIEA, the extent of regulation applicable to a transaction differs depending on the type of customer involved (i.e., whether such customer falls into the category of a "professional" or a "non-professional").

The Amended Act intends to establish so-called "cross-sectional" and seamless regulations for the commodity derivatives sector, meaning that there should be no distinction between cross-border and domestic transactions, or between exchange-traded and OTC transactions. In other words, the Amended Act will (a) expand the level of regulation of commodity derivatives transactions traded on offshore exchanges and OTC commodity derivatives transactions to bring it in line with that already applicable to onshore exchange-traded commodity derivatives transactions, and (b) provide consistent rules for such onshore and offshore transactions, as well as 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 (i.e., a "professional" or a "non-professional").

Commodity derivatives transactions on offshore exchanges

Under the current legislation, there are no licensing requirements for engaging in the business of commodity derivatives transactions traded on offshore commodity exchanges. Under the Amended Act, by contrast, any entity seeking to engage in Japan in the business of acting as an intermediary, broker or agent for commodity derivatives transactions traded on offshore commodity exchanges will generally be required to obtain Japanese regulatory approval prior to engaging in such business.

Such approval will not be required in relation to commodity derivatives transactions traded on offshore commodity exchanges where:

- the customer is a sophisticated investor; or
- a foreign entity, which engages in the commodity derivatives business in a foreign jurisdiction, enters into, as a principal, a com-

modity derivatives transaction on an offshore commodity exchange on behalf of a customer (who is not an individual) located in Japan; provided that (i) such arrangement is made through the agency or intermediation of a commodity derivatives dealer approved under the Amended Act, and (ii) such foreign entity itself does not solicit the customer.

The scope of the term "sophisticated investor" includes commodity derivatives dealers approved under the Amended Act, qualified institutional investors, certain types of financial instruments business operators, registered financial institutions, and stock companies the amount of stated capital of which is at least JPY 1 billion.

OTC commodity derivatives transactions

Offshore OTC Derivatives are not currently subject to regulation in Japan under the Commodity Exchange Act but will be regulated under the Amended Act. As well, under the Amended Act, Onshore OTC Derivatives continue to be prohibited with limited exceptions. Furthermore, any entity seeking to engage in Japan in the business of entering into and/or performing OTC commodity derivatives transactions, and/or acting as an intermediary, a broker and/or an agent for such OTC commodity derivatives transactions, will generally be required to obtain Japanese regulatory approval prior to engaging in such business.

Such approval will not be required in relation to OTC commodity derivatives transactions where:

- the customer is a sophisticated investor (as described above);
- a foreign entity, which engages in the commodity derivatives business in a foreign jurisdiction, enters into, as a principal, an OTC commodity derivatives transaction with a customer (who is not an individual) located in Japan; provided that (i) such transaction is made through the agency or intermediation of a commodity derivatives dealer approved under the Amended Act, and (ii) such foreign entity itself does not solicit the customer;
- an entity enters into an OTC commodity derivatives transaction with, or acts as an intermediary, a broker or an agent for such transaction on behalf of, a parent company of such entity, a subsidiary company of such entity or a company which has the same parent company as such entity; or
- an entity, which engages in the business of trading commodities, enters into an OTC commodity derivatives transaction with a different entity, which also engages in the business of trading commodities, where such OTC commodity derivatives transaction (i) accompanies a sale and purchase transaction of a commodity between these entities, and (ii) intends to hedge risks borne by such other entity arising out of the price fluctuation of the relevant commodity.

Licensing/notification requirements

Licensing requirements of commodity derivatives dealers

Any entity engaging, as a business, in Japan in any or all of the following businesses is required under the Amended Act to obtain Japanese regulatory approval as a "commodity derivatives dealer,"[6] provided that such business does not fall under any exception described in either of the two preceding sections: (i) acting as an intermediary, a broker and/or an agent for commodity derivatives transactions traded on onshore/offshore exchanges; (ii) entering into and/or performing OTC commodity derivatives transactions; and/or (iii) acting as an intermediary, a broker and/or an agent for such OTC commodity derivatives transactions.[7]

In order to obtain regulatory approval as a commodity derivatives dealer, all of the following requirements must be satisfied.

- The applicant must be: (i) a stock company (*kabushiki kaisha*); (ii) a foreign entity equivalent to a *kabushiki kaisha* which has an office in Japan; or (iii) any other entity as specified by subordinate regulation.[8]
- The applicant 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 favorable. If the value of the applicant's net assets is less than JPY 100 million, the entity shall be deemed to lack sufficient financial standing.

- The applicant must have knowledge and experience sufficient to ensure the fair and appropriate performance of its commodity derivatives business, and must have sufficient social credibility. As well, the operation of such business must not be lacking in customer protection.

- The applicant 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.

Some of the above requirements are ambiguous, and the interpretation thereof is at the broad discretion of the relevant Japanese authorities; therefore, an applicant may find that the authorities have different interpretations from those which are expected regarding whether the applicant satisfies such requirements. There is also the further possibility that certain conditions may be attached to the approval or renewal[9] at the time that it is granted.

Moreover, all individuals employed by or working for a commodity derivatives dealer must also be registered as sales representatives if such individuals engage in the business of (i) acting as an intermediary, a broker and/or an agent for commodity derivatives transactions traded on onshore/offshore exchanges; (ii) entering into and/or performing OTC commodity derivatives transactions, and/or acting as an intermediary, a broker and/or an agent for such OTC commodity derivatives transactions; and/or (iii) soliciting customers for those transactions.[10]

Notification requirements of certain exempted business

Approval will not be required under the Amended Act in relation to the OTC commodity derivatives transactions conducted with sophisticated investors; however, the relevant Japanese authorities may still require the dealer to file a notification in advance of commencing the business of engaging in OTC derivatives transactions which refer to certain commodities and/or commodity indices that are (or are similar to those) listed on an onshore commodity exchange. Such OTC derivatives transactions may have an impact on the pricing on onshore commodity exchanges, and therefore the relevant Japanese authorities may monitor such market trends. This filing requirement will apply to transaction principals only; persons acting as intermediaries, brokers or agents in connection with such transactions will not be required to make these filings.

In addition, individuals employed by or working for an entity engaging in transactions of this kind are not required to register as a sales representative with respect to such transactions.

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

Customer protection regulations to which commodity derivatives dealers are subject

Commodity derivatives dealers will become subject to several detailed customer protection regulations under the Amended Act. As the Amended Act will generally be similar to the FIEA, the framework of the Amend Act regulations is very similar to that provided in the FIEA. Therefore, a "financial instruments business operator" or a "registered financial institution" (each of which is regulated under the FIEA), dealing in commodity derivatives transactions and thus becoming regulated under the Amended Act, may find it easier to establish the necessary systems and operations to comply with the regulations under the Amended Act as compared to other entities seeking approval under the Amended Act but have no experience of compliance under the FIEA.

One of the key features of the customer protection regulations is the strict requirement for the segregation of customers' assets. The Amended Act will require a commodity derivatives dealer to (i) segregate the customers' assets from its own proprietary assets, and (ii) secure the customers' assets in a specified manner.

Further, the Amended Act will also introduce new restrictions on marketing commodity derivatives transactions. One of the most notable new restrictions is that a commodity derivatives dealer is prohibited from soliciting a potential customer by visiting or telephoning to engage in certain types of commodity derivatives transactions unless the potential customer has requested such solicitation (the "Unrequested Solicitation Restriction" or "USR"). Subordinate regulations define the types of commodity derivatives transactions which are subject to the USR. They include (i) any OTC commodity derivatives transactions executed with individual customers,[11] and (ii) any commodity derivatives transactions traded on exchanges executed on behalf of individual customers.

It should be noted that subordinate regulations also provide that where the latter transactions are subject to protections that prevent the customer from incurring losses greater than the initial investment amount, those transactions will be exempt from the USR; therefore commodity derivatives dealers may be permitted to solicit individual customers for such products. There are exchange-traded transactions which adopt "loss cut rules" (rules under which the relevant transaction will be mandatorily terminated when unrealized losses attributable to a customer exceed the margin amount); however, even in such transactions, there remains the possibility that a customer could incur losses greater than the margin amount. For this reason, such transactions will not be exempt from the USR, and the relevant Japanese authority has concurred with this view. Therefore, it would be difficult to structure the transactions that satisfy the requirements of the above exemption of the USR, and accordingly, it would also be difficult to solicit to engage in commodity derivatives transactions those potential individual customers that had not previously requested to be solicited.

The Amended Act also provides for other customer protections including certain restrictions on solicitation of customers, restrictions on advertising, delivery of certain documents to customers, and obligations to provide explanations to customers.

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.

Conclusion

The regulatory framework for the commodity derivatives business in Japan will be drastically altered by the Amended Act which will come into force at the beginning of 2011. Particularly affected will be those commodity derivatives businesses relating to offshore exchanges and OTC markets.

The increase in the scope of the regulations concerning commodity derivatives transactions traded on offshore exchanges and OTC commodity derivatives transactions will mean more consistency between the rules for the onshore and offshore transactions, as well as between exchange-traded and OTC transactions. Additionally, customer protections will generally be enhanced under the Amended Act.

As a result of such regulatory changes, many aspects (e.g., licensing, notification, dealing with current customers and solicitation of potential customers) of the business of those working with commodity derivatives business will be impacted. Therefore, it is of the utmost importance that such practitioners be aware of and ensure compliance with such regulatory changes.

NOTES

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licensing procedures of companies engaging in derivatives business.

3 Such subordinate regulations are (i) a Cabinet Order, promulgated in September 2010, and (ii) an Enforcement Regulation, promulgated in October 2010.

4 The underlying assets of the transactions that the Commodity Exchange Act regulates are "commodities". "Commodities" are defined as including certain tangible assets such as agricultural, forestry, animal, and aquatic products, and metals and mineral substances. Accordingly, derivatives transactions based on intangible assets such as electric power, emissions allowances and freight rates are outside the scope of the Commodity Exchange Act and will be outside of the scope of the Amended Act as well.

5 In addition to the general regulations above, certain institutions licensed or authorized to operate banking, securities or insurance businesses are, pursuant to the regulations governing them, (i) 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 authorized business) a commodity derivatives business, and/or (ii) restricted from engaging in certain types of commodity derivatives business. Such institutions will continue to be subject to these regulations under the Amended Act.

6 An entity intending to engage in an only intermediary business relating to commodity derivatives transactions will be permitted to do so without obtaining regulatory approval as a "commodity derivatives dealer"; however, such entity must register as a "commodity derivatives intermediary" and specify the commodity derivatives dealer(s) for which it will be acting.

7 An entity may, without obtaining an approval as a commodity derivatives dealer, perform its obligations under an OTC commodity derivatives transaction or a commodity derivatives transaction traded on an offshore exchange, as long as the entity enters into the transaction before the Amended Act fully takes effect (i.e., January 1, 2011).

8 Such entities are limited to certain types of financial institutions incorporated or licensed under Japanese law.

9 Such approval must be renewed every six years.

10 Such registration must be renewed every six years.

11 However, very high net worth individuals may be exempt from such restriction.