

OTC Derivatives in Japan – Clearing and Related Developments

Introduction

The bill to amend the Financial Instruments and Exchange Law (Law) passed the Diet as of 12 May 2010 and was promulgated on 19 May 2010 (Amendment Act). The Amendment Act, the related Cabinet Order (Amendment Cabinet Order) and the Cabinet Office Ordinance regarding Financial Instruments Clearing Organisations (Amendment Clearing Organisation Ordinance) came into force on 1 April 2011. The Amendment Act includes provisions to improve the stability and transparency of clearing and settlement of over-the-counter (OTC) derivatives transactions by requiring clearing organisations to be used, and stipulating different possible clearing organisations depending on the characteristics of the transactions:

- Clearing by a domestic clearing organisation;
- Clearing by aligned domestic and foreign clearing organisations; or
- Clearing by a foreign clearing organisation.

Additionally, existing restrictions on cold calling with respect to OTC derivatives trades have been amended and the target scope (i.e., regulated type of trades) has been expanded.

Finally, the existing scope of the licensing regime and code of conduct for derivatives has been expanded by the Amendment Cabinet Order and the cabinet ordinance regarding definitions (Amendment Definition Cabinet Ordinance) to cover real estate derivatives trades.

Mandatory Use of Clearing Organisations in the case of OTC Derivatives Transactions

1. Target Transactions for the Mandatory Use of CCPs

The types of OTC derivatives transactions which must be cleared by clearing organisations are those that "in light of the condition of the transactions, are regarded as having a material impact on the capital market of Japan in case of default of the transactions". Detail will be set out in Cabinet Office Ordinances (Ordinances) (Please see paragraph 2 below).

Key Issues

Introduction

Mandatory Use of Clearing Organisations in the case of OTC Derivatives Transactions

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Storing and Reporting of Trading Data

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2. Clearing Organisations to be Used

Which Clearing Organisations are to be used will differ depending on the characteristics of the transactions.

(a) Clearing by a licensed Japanese clearing organisation (Japanese CCP)¹

The type of OTC derivative transactions which must be cleared by a Japanese CCP will be specified in the Ordinances. For instance, clearing requirements apply to transactions that are directly related to corporate bankruptcy in Japan. The Financial Services Agency of Japan (FSA) contemplates these as CDS transactions, in particular, those referencing iTraxx Japan, with financial institutions with a high trade volume.

(b) Clearing by either a Japanese CCP, the Linked Method (as defined below) or a licensed foreign clearing organisation (Foreign CCP)²

The type of OTC derivative transactions which must be cleared by either a Japanese CCP, the Linked Method or a Foreign CCP will be specified in the Ordinances. The FSA contemplates these as "plain vanilla" Yen interest rate swaps with financial institutions with a high trade volume.

The "Linked Method" means clearing by aligned Clearing Organisations, which consist of:

- (i) Alliance between a Japanese CCP and another Japanese CCP;
- (ii) Alliance between a Japanese CCP and a Foreign CCP; or
- (iii) Alliance between a Japanese CCP and an entity which is established in accordance with a foreign law and provides in a foreign jurisdiction a business similar to the Financial Instruments Obligation Assumption Business but which is not licensed in Japan (Aligned Foreign CCP).

3. Firms subject to Clearing Obligations

Financial Instruments Trade Business Operators or Registered Financial Institutions are subject to the clearing obligations.

4. Date of Enforcement

To be designated, but no later than November 2012.

Establishment of Clearing Organisations System

1. Japanese CCP

Under the Amendment Act, a Japanese CCP may conduct the Financial Instruments Obligation Assumption Business (FIOAB) in Japan, upon obtaining a license from the Prime Minister.

(a) Definition of FIOAB

The previous definition of FIOAB involves the "assumption of an obligation" under certain transactions. The Amendment Act expands this to the "assumption, novation or other method, by which an obligation is owed". The FIOAB excludes transactions designated by the

¹ Article 156-62, item 1 of the Amendment Act

² Article 156-62, item 2 of the Amendment Act

Commissioner of the FSA as having minor effect on the Japanese capital market out of the transactions cleared by foreign clearing organisations.³

(b) License

In addition to the standard application procedures for the licence of a business under the Law, adequate systems and organisational structure for ensuring appropriate and secure clearing of unsettled obligations must be established, including receiving collateral for unsettled obligations and establishing an operation with stable practices to ensure a smooth settlement.

(c) Additional regulations under the Amendment Act

The following new regulations apply to a Japanese CCP:

(i) Regulation of capital amount

The minimum capital amount of a Japanese CCP is one billion yen (1,000,000,000 yen)⁴.

(ii) Authorisation for Major Shareholders

(1) Any shareholder who holds more than 5% of the voting rights in a Japanese CCP is required to submit a notification of its holding of voting rights to the Prime Minister; and

(2) Any shareholder who intends to hold or acquire 20% or more of the voting rights is required to obtain authorisation from the Prime Minister prior to such transaction.

2. Foreign CCP⁵

Under the Amendment Act, an entity established in accordance with foreign laws in a foreign jurisdiction which conducts a similar business to the FIOAB in Japan, may conduct the FIOAB in Japan, upon obtaining license from the Prime Minister. This enables foreign clearing organisations to provide clearing services directly to Japanese customers in Japan.

(a) License

Criteria for determining if the license will be granted are similar to those set out in paragraph 1 (b) above.

(b) Additional Regulations

(i) It is necessary to appoint a representative in Japan.⁶

(ii) An applicant should be an entity established in accordance with foreign law that has conducted a similar business in the relevant foreign jurisdiction for three years.⁷

³ Articles 1-18-2 and 1-19 of the Amendment Cabinet Order

⁴ Article 19-4-2 of the Amendment Cabinet Order

⁵ Articles 156-20-2 through 15 of the Amendment Act

⁶ Article 156-20-3, Paragraph 1, Item 6

⁷ Articles 19-4-4 and 19-4-5 of the Amendment Cabinet Order

- (iii) An applicant must have a license similar to that for conducting the FIOAB in the relevant foreign jurisdiction.⁸
 - (iv) A balance sheet and profit and loss statement must be submitted to the Commissioner of the FSA within three months after the end of each business year.⁹
- (c) Other Provisions

Please note that regulation of the capital amount or major shareholders would not be applicable to a Foreign CCP. However, in applying for a licence, it is necessary to attach a document stating the name of the holders of voting rights of 10% or more of the voting rights of the total shareholders of the applicant, their addresses, number of voting rights held, an outline of the parent corporation holding a majority of the voting rights of the applicant and an outline of each subsidiary a majority of voting rights of which is held by the applicant¹⁰. In the case of any amendment, a filing is required.¹¹

3. Link Method¹²

Under the Amendment Act, a Japanese CCP may enter into an alliance agreement with either another Japanese CCP, a Foreign CCP or an Aligned Foreign CCP and conduct the FIOAB in Japan, allied with such CCP, upon obtaining authorisation from the Prime Minister. This enables foreign clearing organisations to provide clearing services in Japan without obtaining the license from the Prime Minister.

(a) Structure of the Linked Method

The Link Method is designed to cover the situation where a Japanese CCP interacts with a third party clearing organisation – either a domestic or foreign. Various permutations of possible transactions are covered in the legislation, including the following¹³. Note that all of these presume that a transaction is initially agreed between a participant in either the Japanese CCP or a third party clearing organisation and that participant's counterparty.

The following four types of business are set out¹⁴ (under each type of business, claims between a participant and that participant's counterparty will be changed into those against a Japanese CCP and TP (as defined below)):

⁸ Article 156-20-4, Paragraph 1, Item 1 of the Amendment Act

⁹ Article 188 of the Amendment Act and Article 49, Paragraph 1 of the Amendment Clearing Organisation Ordinance

¹⁰ Article 30, Paragraph 1, Items (i) and (ii) of the Amendment Clearing Organisation Ordinance

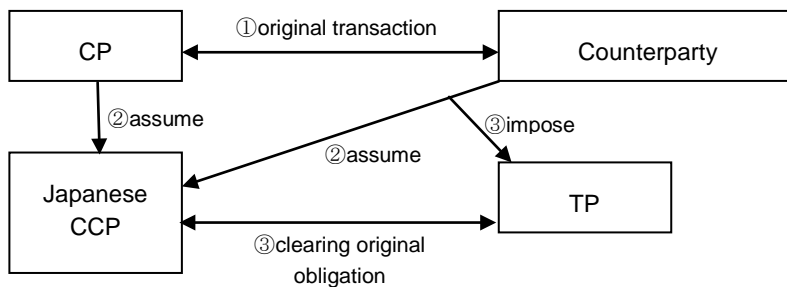
¹¹ Article 156-20-11 of the Amendment Act

¹² Article 156-20-16 to 18 of the Amendment Act

¹³ Article 38 of the Amendment Clearing Organisation Ordinance

¹⁴ Article 38 of the Amendment Clearing Organisation Ordinance

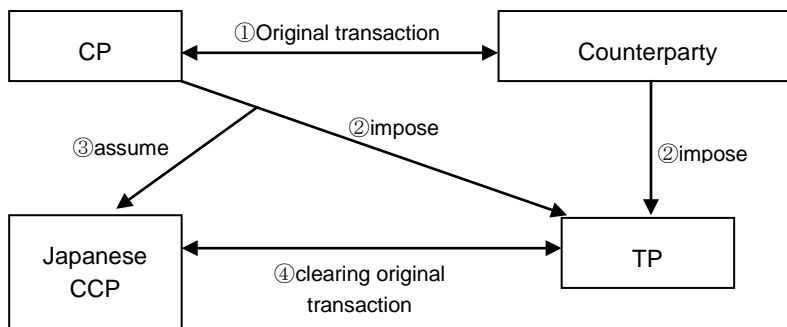
- (i) assuming the obligations of a clearing participant and the obligations of the counterparty of the clearing participant and imposing on a third party the obligations of the relevant clearing participant so assumed¹⁵;



CP = Clearing Participant

TP = Third party Japanese CCP, Foreign CCP or Aligned Foreign CCP

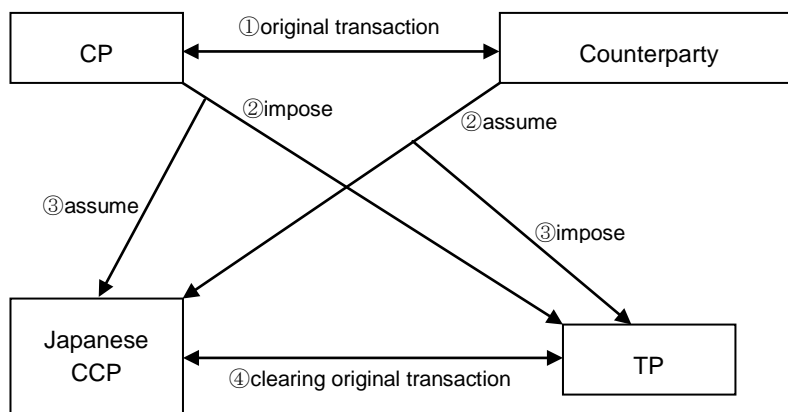
- (ii) imposing on a third party the obligations of a clearing participant and the obligations of a counterparty of a clearing participant and of assuming the obligations of the counterparty of the relevant clearing participant so imposed¹⁶;



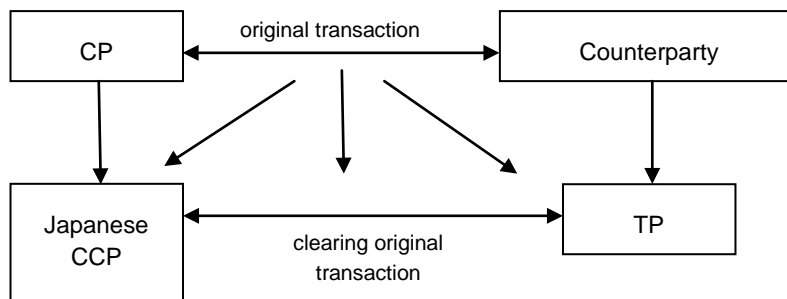
¹⁵ Article 38, Item (i) of the Amendment Clearing Organisation Ordinance

¹⁶ Article 38 Item (ii) of the Amendment Clearing Organisation Ordinance

- (iii) assuming the obligations of a clearing participant, of imposing on a third party the obligations of the relevant clearing participant so borne and the obligations of the counterparty of the relevant clearing participant, and of assuming the obligations of the counterparty of the relevant clearing participant so imposed¹⁷; and



- (iv) there is a basket-clause to catch all target transactions for the purpose of the clearing obligations¹⁸.



- (b) Authorisation
 - (i) Authorisation should be obtained for each entity which is to execute the alliance agreement.
 - (ii) Criteria for determining if the authorisation will be granted are similar to those set out in paragraph 1 (b) above. If an aligned CCP is an Aligned Foreign CCP, the requirements as described in 2 (b)(ii) and (iii) above are also applicable to such Aligned Foreign CCP.

A summary of the various requirements relating to each of a Japanese CCP, a Foreign CCP and the Linked Method is set out in the Appendix.

¹⁷ Article 38 Item (iii) of the Amendment Clearing Organisation Ordinance

¹⁸ Article 38 Item (iv) of the Amendment Clearing Organisation Ordinance

Storing and Reporting of Trading Data¹⁹

As regulators or investors need to obtain information specifying risk factors in OTC derivatives transactions, the following system will be set up to obtain information on transactions in order for the authorities to secure such information.

1. Financial Instruments Trade Business Operators and Registered Financial Institutions

Financial Instruments Trade Business Operators and Registered Financial Institutions must store and report transaction information (Trading Data) to the Prime Minister, except for

- (i) the Trading Data relating to transactions cleared by a Japanese CCP or a Foreign CCP;
- (ii) the Trading Data provided by them to Japanese Trade Repositories or Designated Foreign Trade Repositories (which conduct business similar to a trade repository business or transacting information storage business abroad).

Details on Trading Data will be set out in the Ordinances.

2. Japanese CCP and Foreign CCP

Japanese CCPs and Foreign CCPs must store and report to the Prime Minister the Trading Data relating to transactions cleared by such CCP.

3. Japanese Trade Repositories

Japanese Trade Repositories must store and report to the Prime Minister the Trading Data stored by them.

4. Date of Enforcement

To be designated, but no later than November 2012.

Strengthening of Cold Calling Regulation on OTC Derivative Trade

In view of the social situation that requires greater investor protection, Financial Instruments Trade Business Operators will be totally prohibited from cold calling individual customers on OTC derivative trade.

1. Prohibited Acts

The Amendment Cabinet Order provides that any cold calling to individual customers to solicit OTC derivative trade is prohibited²⁰. In accordance with the expansion of the cold calling restriction, the scope of prohibition of re-solicitation (an act continuing to solicit a customer to conclude a contract for OTC derivative trade despite that the customer has, after receiving solicitation, manifested the intention not to conclude the contract (including the intention to refuse to continue to receive solicitation)) and solicitation without confirmation on acceptance of solicitation with respect to OTC derivative trade will be also expanded²¹.

¹⁹ Article 156-63 to 84 of the Amendment Act

²⁰ Article 16-4, Paragraph 1, Item 2 of the Amendment Cabinet Order

²¹ Article 16-4, Paragraph 2 of the Amendment Cabinet Order

2. Permissible Acts

It is permissible for Financial Instruments Trade Business Operators to make cold calls (i) to individual customers with whom they are in a continuous trading relationship (which is determined by each type of trade (i.e., OTC financial futures or OTC securities derivative trade, etc.))²² or (ii) with respect to conditional stock-lending trade (such as a covered call (which is to sell a call option holding of shares))²³.

3. Date of Enforcement

1 April 2011

Introduction of Restriction on Real Estate Derivative Trade

Given the fact of increasing demand for real estate derivatives as an offset measure against variation in the price of real estate, to protect investors the FSA has decided to expand the existing derivatives licensing regime, related regulations and code of conduct to cover real estate index/price derivatives.

The relevant amendment provision appends (i) real estate indices / real estate prices²⁴ and (ii) rents²⁵ that are published by authorities or associations dealing with real estate related business to a reference index of derivative trade.

Clarification of Foreign Market Derivative Trade

The Amendment Cabinet Order clarifies that the "Financial Instruments Trade Business" as defined in the Law excludes a foreign dealer (i) from outside Japan, receiving orders (including brokerage) from financial instruments business operators and other specified entities in Japan or (ii) from outside Japan, receiving orders from sophisticated customers (such as financial instrument business operators, qualified institutional investors, or a joint stock company holding JPY 1 billion or more share capital, etc.) in Japan without any solicitation²⁶.

²² Article 116, Paragraph 1, Item 4 and 5 of the Amendment Business Cabinet Ordinance

²³ Article 116, Paragraph 1, Item 3 of the Amendment Business Cabinet Ordinance

²⁴ Article 1-18, Item 4 of the Amendment Cabinet Order

²⁵ Article 21-2 of the Amendment Definition Cabinet Ordinance

²⁶ Article 16, Paragraph 1, Item 1-2 of the Amendment Definition Cabinet Order

Appendix

	Japanese CCP	Foreign CCP	Link Method			
			Japanese CCP	Another Japanese CCP	Foreign CCP	Aligned Foreign CCP
Licence / Authorisation requirement	Licence (Art 156-2)	Licence (Art 156-20-2)	Authorisation (Art 156-20-16)	n/a	n/a	n/a
Licensing system /structure	a sufficient system and organisational structure for ensuring appropriate and secure clearing of unsettled obligations must be established (Art 156-4)	Same as left column (Art 156-20-4)	Same as left column (Art 156-20-18)	Same as left column	Same as left column	Same as left column
Licensing experience	n/a	3 years in foreign country (Art 19-4-4 of Cabinet Order)	n/a	n/a	3 years in foreign country (Art 19-4-4 of Cabinet Order)	3 years in foreign country (Art 19-4-5 of Cabinet Order)
Licensing minimum share capital amount	JPY 10 billion (Art 19-4-2 of Cabinet Order)	n/a	No additional requirement	n/a	n/a	n/a
Licensing major shareholder regulation	5% (submit shareholding report) (Art 156-5-3) 20% (prior approval of major shareholder) (Art 156-5-5)	n/a	No additional requirement	n/a	n/a	n/a
Code of conduct Supervision by the FSA	report, inspection, order to improve business operation, or rescind licence (Art 156-15 ~ 156-17)	report, inspection, order to improve business operation, or rescind licence (Art 156-20-12 ~ 156-20-15)	Modify, prohibit, suspend all or part of business, rescind approval (Art 156-20-22)	Same as left column.	Same as left column.	Same as left column.

Where Japanese legal concepts have been expressed in the English language, the concepts concerned may not be identical to the concepts described by the equivalent English terminology as they may be interpreted under the laws of other jurisdictions.

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