

Development of CCP in Japan – Interest Rate Swap Clearing

With respect to certain types of OTC derivative transactions, the mandatory clearing of obligations at a central counterparty ("CCP") are to be imposed by November 2012. Japan Securities Clearing Corporation ("JSCC") has already commenced its operation as a CCP with regard to CDS transactions in Japan. In March 2012, JSCC released the draft outline of interest rate swap clearing with a view to commencing its clearing operations for interest rate swaps by November 2012. This note briefly discusses the mandatory clearing obligations and the draft outline.

2010 Amendments and Mandatory Clearing Obligations

At the September 2009 Pittsburgh Summit, it was agreed by the G20 group of nations that certain OTC derivatives transactions should be cleared through CCPs by the end of 2012 at the latest.

In line with its commitment, the Japanese government made amendments to the Financial Instrument and Exchange Act (the "FIEA") on 12 May 2010 (the "2010 Amendments"). The 2010 Amendments include a requirement for the mandatory clearing of obligations at a CCP with respect to certain types of over-the-counter ("OTC") derivative transactions. Those parts of the 2010 Amendments relating to mandatory clearing are to be effective by November 2012. For more details on the 2010 Amendments, please see our client briefing titled "OTC Derivatives in Japan – Clearing and Related Developments" issued in April 2011.

It is understood that the mandatory clearing obligations would apply to the following OTC derivative transactions between certain Financial Instrument Business Operators ("FIBO") and the Registered Financial Institutions¹:

- Credit default swap ("CDS") transactions referencing certain series of the iTraxx Japan index; and
- "Plain vanilla" type Japanese Yen LIBOR interest rate swaps ("IRS") transactions.

The clearing obligations do not apply to all FIBOs and Registered Financial Institutions but to those institutions which meet certain criteria such as large volume of the relevant OTC derivative transactions.

The details of the OTC derivative transactions which will be subject to the mandatory clearing obligation will be set out in the amended Cabinet Office Ordinances. The draft amendments are expected to be released by the Japanese Financial Services Agency ("FSA") soon.

Key issues

- 2010 Amendments and Mandatory Clearing Obligations
- IRS Clearing
- Going Forward

1. The FIBO (*kinyu torihiki gyosha*) and the Registered Financial Institutions (*toroku kinyukikan*) are the defined terms under the FIEA. The FIBOs are brokers and dealers licensed in Japan and the Registered Financial Institutions are certain registered banks which operate certain securities business permitted under the Banking Act.

With respect to clearing of CDS transactions, JSCC commenced operation as a CCP in July 2011 for CDS transactions referencing iTraxx Japan between the participating clearing institutions who agree and are approved to clear CDS transactions at JSCC².

With respect to IRS transactions, JSCC released the draft outline of IRS clearing (the "**Draft Outline**") and commenced a public comment period on 1 March 2012³.

IRS Clearing

JSCC has been preparing for the commencement of its clearing business for IRS transactions with a view to commencing operations by November 2012. According to the Draft Outline, the key features of IRS transactions to be cleared at JSCC are as follows:

Contract:	Transactions based on the ISDA Master Agreement and 2000 or 2006 ISDA Definitions
Eligible Participants:	Participating clearing institutions who agree and are approved to clear IRS transactions at JSCC
Swap Type:	Fixed - Floating or Floating – Floating interest rate swaps
Eligible Floating Rate:	BBA LIBOR JPY 3 months or 6 months
Contract Term:	No less than 28 days
Contract Residual Term:	3 days to 14,623 days (both inclusive)
Notional Amount:	JPY1 to JPY10 trillion (both inclusive)
Day Count:	Floating: Actual/360 Fixed: a method stipulated by the ISDA Definitions
Business Day Conversion:	Following, Modified Following or Preceding
Financial Centre:	Tokyo (London, New York and/or TARGET can be added)

2. For more details on the CDS clearing rules of JSCC, please see http://www.jsc.co.jp/en/rule/rule_cds.html.

3. The public comments procedure ended on 31 March 2012. The result and response to the comments have not yet been released by JSCC. The Draft Outline is available at <http://www.jsc.co.jp/en/news/2012/2.html>.

Eligible Floating Rate

BBA LIBOR JPY 3 months or 6 months will be the eligible floating rate when JSCC commences its IRS clearing operation.

However, in addition to those floating rates, JSCC is considering to add other floating rates such as TIBOR released by Japanese Bankers' Association, BBA LIBOR JPY 1 month and 12 months, and BBA LIBOR USD and BBA LIBOR EUR after it commences its operation.

Requirements for Clearing Qualifications

In order to become an approved clearing participant, an applicant must be either a FIBO or Registered Financial Institution who satisfies certain financial criteria and operational criteria. The financial criteria will be examined by reference to factors such as level of net capital (not less than JPY100 billion), satisfaction of a net capital ratio (in case of the Registered Financial Institutions, capital adequacy ratio) and credit worthiness⁴. JSCC may impose more stringent financial criteria (i.e. increasing the prescribed threshold by 25%) depending on credit worthiness of the applicant. For more details on the financial and operational criteria, please see the Draft Outline.

Margin and Clearing Fund

The Participant is required to provide an Initial Margin, Variation Margin and Intra-day Margin to the JSCC in order to cover the risks arising from its portfolio. The amount of such margin will be calculated by the JSCC based on its prescribed formula.

In addition, in order to cover the risk which is not secured by the margin, the Participant is required to contribute a Clearing Fund. Together with the JSCC's equity, such margin and Clearing Fund will support the clearing system in case of the Participants' default. The Draft Outline provides for a method as to how to deal with the defaulting Participant's transactions and how to cover the loss resulting from such default. For more details, please see the Draft Outline.

Going Forward

The precise details of which OTC derivative transactions and which counterparties will be subject to the mandatory clearing obligations will be set out in the amended Cabinet Office Ordinances. The release from the FSA of the draft amendments which is due in the near future, is being anticipated by the market. These draft amendments to the Cabinet Office ordinance will provide greater clarity on the scope of the Japanese mandatory clearing obligation.

Additionally, the JSCC draft rules relating to IRS clearing are in the process of being developed and discussed between the JSCC and other interested parties. We will also have to watch this space to see how these rules unfold.

Finally, the rule making process relating to mandatory clearing and other OTC derivatives regulation continues in the United States, Europe and in other parts of Asia. We continue to keep a close watch on these developments which will no doubt have further implications for institutions in Japan, particularly those with international operations as they seek to comply with what could potentially be a myriad of overlapping and conflicting set of regulations.

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.

4. Credit rating is one of the key factors (in principle, no less than "A" or its equivalent).

Contacts

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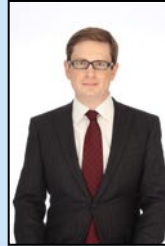
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