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Recent developments in OTC derivatives regulations in Japan

The Financial Services Agency of Japan (the "FSA") has recently published a wide range of amendments and proposed amendments to OTC derivatives regulations as regards mandatory clearing, trade reporting and margin requirements, among other things. This note provides a brief summary of these amendments and proposed amendments.

Background

At the September 2009 Pittsburgh Summit, the G20 agreed that, by the end of 2012 at the latest (i) standardised OTC derivatives transactions should be traded on exchanges or electronic trading platforms, (ii) standardised OTC derivatives transactions should be cleared through central clearing parties ("**CCPs**") and (iii) data relating to OTC derivatives transactions should be reported to trade repositories. In addition, in 2011, the G20 agreed to add margin requirements for non-centrally cleared derivatives transactions to the reform programme at the Cannes Summit.

In order to comply with its G20 commitments, the Financial Instruments and Exchange Act of Japan (the "**FIEA**") was amended in 2010 to require (1) the clearing of certain standardised OTC derivatives transactions through a CCP and (2) the reporting of certain data in relation to certain OTC derivatives transactions to the FSA. In addition, a bill to amend the FIEA approved at the Diet in 2012 requires firms to use electronic trading platforms in relation to certain OTC derivatives transactions to be specified by the FSA.

Mandatory clearing requirements and trade reporting requirements came into force in November 2012 with certain transitional measures, but the scope of their application was limited in terms of products and counterparties. Rules relating to margin requirements and the mandatory use of electronic trading platforms were not published at that time. By July 2014, further amendments to the rules were made broadening the scope of the mandatory clearing and reporting requirements and draft regulations were published by the FSA in relation to margin requirements and mandatory trading.

The current note is intended to provide an overview of developments since November 2012. For a summary of the requirements which took effect in November 2012, please refer to our separate note published in October 2012[1].

Mandatory clearing requirements

Mandatory clearing requirements for OTC derivatives transactions were introduced in Japan on 1 November 2012, pursuant to which all types of Financial Instruments Business Operators (i.e. securities houses, investment managers and investment advisors, "**FIBOs**") and Registered Financial Institutions (i.e. banks and other financial institutions registered under the FIEA, "**RFIs**") were required to clear certain (a) interest rate swap ("**IRS**") transactions in JPY-LIBOR and (b) CDS transactions, through a CCP[2], with some broad exemptions ("Phase I" implementation). Below are the most recent steps taken towards implementing "Phase II" of the mandatory clearing requirements:

- On 1 July 2014, amendments to the relevant administrative notice (*kokuji*) came into effect, which added certain IRS transactions in Euro-yen TIBOR to those transactions subject to the clearing requirements; and
- As for IRS transactions, amendment ordinances to narrow the scope of exemptions from the mandatory clearing requirements have been proposed.

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1 New Japanese Regulations on Central Clearing, Trade Information Storage and Reporting in relation to OTC Derivatives Transactions

2 Japan Securities Clearing Corporation ("**JSCC**") is a licensed CCP which clears OTC derivatives transactions.

The following table provides a summary of the current mandatory clearing requirements and expected amendments:

Covered transactions	Transactions which fall into any of the following categories and are clearable through JSCC: (a) CDS transactions on the iTraxx Japan index (b) IRS transactions in 3-month or 6-month JPY-LIBOR (c) IRS transactions in 3-month or 6-month Euro-yen TIBOR (with maximum 5 or 10 year duration, respectively) * (c) transactions were added with effect from 1 July 2014.
Exemptions	The mandatory clearing requirements do not apply where: (i) one of the parties to the transaction is not a FIBO or RFI; (ii) the transaction is booked in a trust account; (iii) the transaction falls within certain intra-group transactions; (iv) the parties to the transaction (or their parents or subsidiaries) are not clearing members of the same CCP (but only if there are reasonable grounds for one or both of the parties (or their parents or subsidiaries) not to be a clearing member of the CCP); or (v) the transaction is made under special circumstances to be designated by the Japanese regulator.
Expected amendments	On 20 June 2014, the FSA finalised an amendment ordinance. As such, from 1 December 2014, as regards IRS transactions, exemption (iv) above will be replaced by a new exemption whereby transactions which meet either of the following conditions will be excluded from the mandatory clearing requirements: • one party is not: (a) Type I FIBO (i.e. securities house); (b) bank which is an RFI; (c) Shoko Chukin Bank; (d) Development Bank of Japan; (e) Shinkin Central Bank; or (f) Norinchukin Bank ((a) to (f) above are referred to as the "**Obligated Operators**")[3]; or • the average outstanding notional amount[4] of OTC derivatives transactions held by one party is: (i) from 1 December 2014, less than JPY1 trillion; and (ii) from 1 December 2015, less than JPY300 billion.
	On 3 July 2014 the FSA published a draft amendment to the relevant ordinance to narrow the scope of the exemptions above with respect to IRS transactions as follows: • Insurance companies which are RFIs ("**Insurance RFIs**") will be added to the list of Obligated Operators; and • the scope of the exemption for trust accounts (item (ii) above) will be narrowed (i.e. it will not cover transactions executed through a trust account in respect of which the average outstanding notional amount[5] of OTC derivatives transactions is JPY300 billion or more). The proposed implementation date of the above amendments is 1 December 2016.

[3] JSCC introduced client clearing for IRS transactions on 24 February 2014 and therefore non-members (i.e. non-direct participants) of JSCC can now clear their IRS transactions through JSCC, via a member of JSCC.

[4] More precisely, the average of the outstanding notional amounts (limited to OTC derivatives transactions that are subject to mandatory clearing or reporting and excluding transactions booked in trust accounts) as of the end of each of the following months:

- from April of the second preceding year, to March of the first preceding year, of the year when the IRS transactions are entered into, if the IRS transactions are entered into from January to November; or
- from April of the first preceding year, to March of the year when the IRS transactions are entered into, if the IRS transactions are entered into in December.

[5] More precisely, the average of the outstanding notional amounts (limited to OTC derivatives transactions that are subject to mandatory clearing or reporting) as of the end of each of the following months:

- from April of the second preceding year, to March of the first proceeding year, of the year when the IRS transactions are entered into, if the IRS transactions are entered into from January to November; or
- from April of the first preceding year, to March, of the year when the IRS transactions are entered into, if the IRS transactions are entered into in December.

Notification requirements

Pursuant to an amendment ordinance which came into effect on 20 June 2014, the mandatory reporting rules were amended to introduce notification requirements whereby Obligated Operators which hold an average outstanding notional amount[6] of OTC derivatives transactions that exceeds or has ceased to exceed the following threshold must report the same to the FSA between 1 April and 31 May each year:

(i) from 1 April 2015, JPY1 trillion or more; and

(ii) from 1 April 2016, JPY300 billion or more.

The first notification was due by 19 August 2014 for Obligated Operators who had exceeded the JPY1 trillion threshold. Further, a draft ordinance amendment was published on 3 July 2014 whereby Insurance RFIs and trust accounts will be subject to the above-mentioned notification requirements from 1 April 2015.

On 30 September 2014, the FSA published a list of those Obligated Operators whose notional amounts are above the threshold.

Trade information storage and reporting requirements

Mandatory information storage and trade reporting requirements were introduced in Japan on 1 November 2012 with certain transitional measures. The requirements cover all types of FIBOs and RFIs, CCPs licensed by the FSA and a trade repository designated by the FSA[7], with respect to certain OTC derivatives transactions.

The following table provides a summary of the current trade reporting requirements applicable to FIBOs and RFIs and expected amendments[8]:

Covered transactions	Any OTC derivatives transaction which is not cleared by a CCP and: (i) is entered into between parties where one or both parties are Obligated Operators; and (ii) relates to the price or interest rate of certain financial products, or financial indicators based on the price or interest rate of certain financial products, including certain forward transactions or index forward transactions, option transactions or index option transactions, swap transactions and credit derivatives.
Expected amendments	On 3 July 2014, the FSA published a draft amendment to the relevant ordinance to add Insurance RFIs to the list of Obligated Operators. This amendment is expected to be effective from 1 April 2015.
Exemptions	A party which is not an Obligated Operator is not subject to the trade reporting requirements. Any OTC derivatives transaction which is entered into with a parent company, subsidiary or sister company, or certain public sector organisations (including Japanese/foreign national/local governments and central banks) is not subject to the trade reporting requirements.

[6] More precisely, the average of the outstanding notional amounts (limited to OTC derivatives transactions that are subject to mandatory clearing or reporting and excluding transactions booked in trust accounts) as of the end of each of the months from April of the first preceding year, to March of the year when the notification is made.

[7] DTCC Data Repository (Japan) KK commenced work on 1 April 2013 as that trade repository.

[8] On 3 July 2014 the FSA published its view on issues related to trade information storage and reporting requirements (e.g. FIBOs and RFIs are not to report transactions cleared through a CCP, since such transactions are reported by the CCP).

Margin requirements

In response to the BCBS-IOSCO proposal "Margin requirements for non-centrally cleared derivatives" published on 2 September 2013, the FSA published draft regulations on margin requirements for non-centrally cleared OTC derivatives on 3 July 2014. Once finalised, the new regulations will generally take effect on 1 December 2015, with phase in of the initial margin requirement.

The margin requirements will apply to OTC derivatives that are not cleared by a CCP licensed under the FIEA, however, the initial margin requirement will not apply to the exchange of principal portion of certain cross-currency swaps. The drafts regulations require FIBOs and RFIs to calculate and exchange variation margin and initial margin as follows:

(1) Variation margin

- to be calculated with respect to each counterparty every day; and
- parties to collect variation margin as soon as possible unless the amount to be transferred does not exceed JPY 70 million or a lesser amount to be agreed between the parties.

(2) Initial margin

- to be calculated using the parties' own quantitative initial margin models (which are consistent with the standards to be set by the FSA and submitted to the FSA in advance) or an initial margin schedule set out in the draft regulations;
- parties to collect initial margin as soon as possible unless the amount to be transferred does not exceed JPY 70 million or a lesser amount to be agreed between the parties;
- parties may agree on an initial margin threshold not exceeding JPY 7 billion;
- FIBOs and RFIs must appropriately manage the initial margin received from their counterparties – e.g. create a trust account to hold initial margin;
- assets collected as initial margin may not be re-hypothecated, re-pledged or re-used.

There are some exemptions from the margin requirements including the following:

(i) if the counterparty is not a FIBO or RFI, the margin requirements will not apply; however, if the counterparty is a foreign derivatives house and its outstanding notional amount of OTC derivatives transactions is likely to be JPY300 billion or more (as regards the initial margin requirement, there is an additional threshold of JPY1.1 trillion which should be calculated on a group basis and to include a wider range of uncleared OTC derivatives), the margin requirements will apply;

(ii) where both of the parties are FIBOs or RFIs, the margin requirements will not apply if:

- one party is not: (a) an Obligated Operator; or (b) an Insurance RFI; or
- the average outstanding notional amount[9] of OTC derivatives transactions held by one party is less than JPY300 billion (as regards the initial margin requirement, there is an additional threshold of JPY1.1 trillion which should be calculated on a group basis and to include a wider range of uncleared OTC derivatives); and

(iii) the margin requirements will not apply to certain intra-group transactions.

For financial institutions that are exempted, the draft amendment to the supervisory guidelines published on 3 July 2014 contains proposals to encourage them to adopt certain appropriate systems to collect variation margin.

[9] More precisely, the average of the outstanding notional amounts (limited to OTC derivatives transactions that are subject to mandatory clearing or reporting and excluding transactions booked in trust accounts) as of the end of each of the following months:

- from April of the second preceding year to March of the first preceding year if the calculation is required from January to November; or
- from April of the first preceding year to March of the year if the calculation is required in December.

Mandatory use of electronic trading facilities

On 1 July 2014, the FSA published draft regulations regarding OTC derivatives electronic trading facilities and the mandatory use of electronic trading facilities. The draft regulations are intended to implement amendments to the FIEA that were passed by the Diet on 6 September 2012, which introduced and outlined a new regime for OTC derivatives electronic trading facilities and the mandatory use of electronic trading facilities. It is proposed that the new regulations will become effective on 1 September 2015, although provisions in relation to licensing of foreign electronic trading facilities are expected to become effective as early as possible.

Electronic trading facilities

The draft regulations set out requirements which an operator of an electronic trading facility needs to satisfy, including minimum capital (JPY300 million), internal rules, books and records and the publication of information on transactions. The draft regulations also provide for procedures for applying to the FSA for a licence (permission), which must be obtained before an operator of a foreign electronic trading facility can engage in business in Japan[10].

Mandatory use of electronic trading facilities

In general, FIBOs and RFIs will be required to use electronic trading facilities when they enter into certain OTC derivatives transactions. According to the draft regulations, such transactions will be limited to certain types of IRSs (yet to be specified by the FSA) that are denominated in JPY.

Under the draft regulations, FIBOs and RFIs may be exempt from the mandatory use of electronic trading facilities if any of the following can be met:

- the transaction is booked in a trust account;
- the transaction is an intra-group transaction satisfying conditions;
- one party is not an Obligated Operator;
- the average outstanding notional amount[11] of OTC derivatives transactions held by one party is less than JPY6 trillion; or
- there is a disruption to the electronic trading facility systems or any other special circumstances to be designated by the FSA.

Conclusion

The amendments recently published broaden the scope of the various regulations relating to OTC derivatives transactions in accordance with Japan's international commitments. Companies which are not registered/licensed in Japan are generally not subject to these regulations, but they may indirectly be affected by the regulations. For example, under the draft regulation for margin requirements, a registered/licensed company in Japan must require its foreign counterparties which are not registered/licensed in Japan to post initial and variation margin if certain conditions are met. Furthermore, foreign electronic trading facilities may not engage in business in Japan without a licence from the FSA.

Further, some of the proposed regulations have not been finalised and are subject to further changes. Market participants should understand the regulations thoroughly and continue to pay attention to developments in this area.

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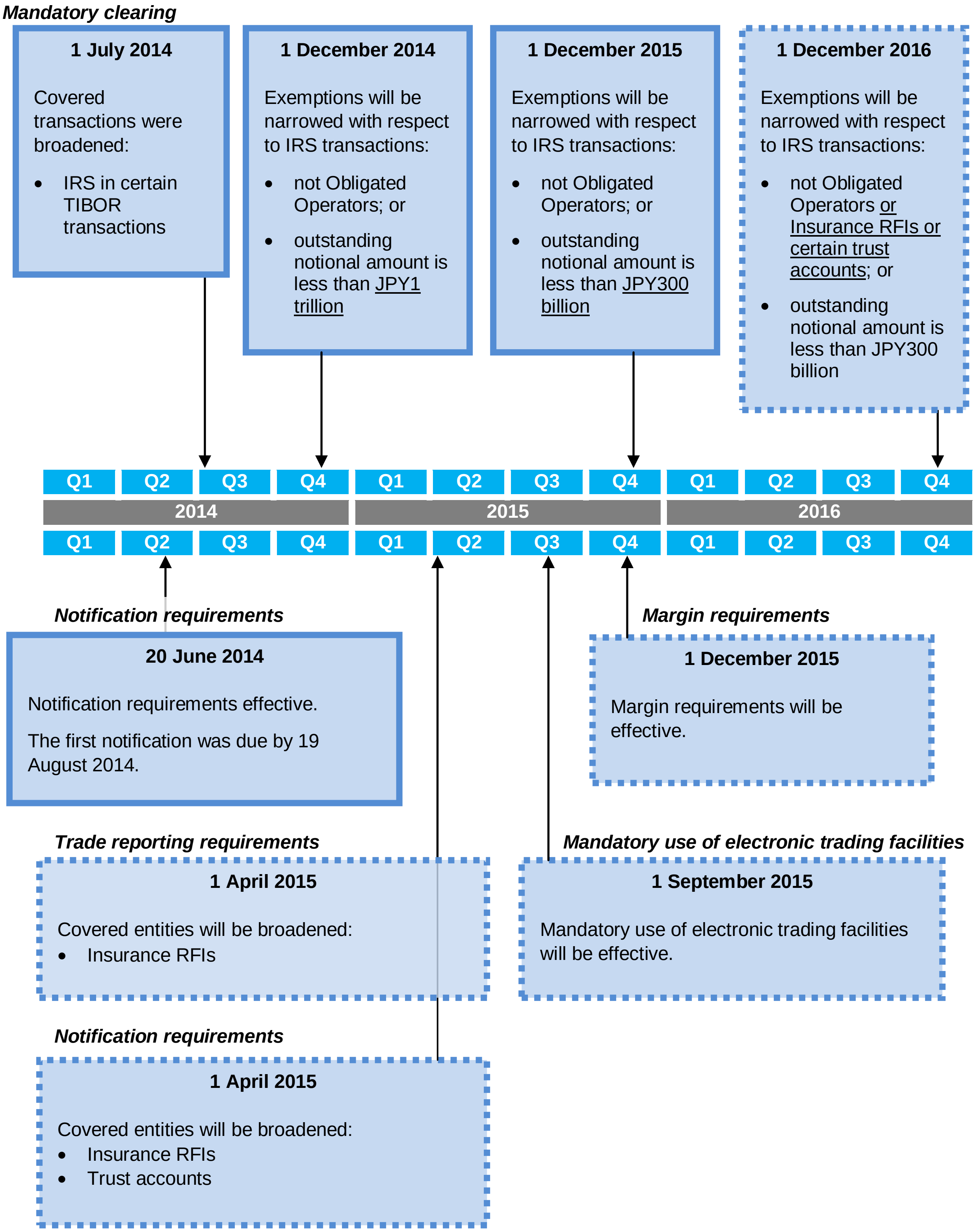
[10] A foreign person who has not been licensed as a FIBO or certain other financial institutions in Japan may only carry out the business of a foreign electronic trading facility with Japanese securities companies and certain other institutional investors if they obtain licenses (permission) from the FSA.

[11] More precisely, the average of the outstanding notional amounts (limited to OTC derivatives transactions that are subject to mandatory clearing or reporting and excluding transactions booked in trust accounts) as of the end of each of the following months:

- from April of the second preceding year, to March of the first preceding year, of the year when the IRS transactions are entered into, if the IRS transactions are entered into from January to November; or
- from April of the first preceding year, to March of the year when the IRS transactions are entered into, if the IRS transactions are entered into in December.

Implementation timeline
(Dotted boxes represent amendments which have not yet been finalised.)



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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