

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

In Japan, new regulations requiring the mandatory clearing and reporting of OTC derivatives become effective from 1 November 2012 (subject to limited transitional measures). These new regulations may have some extraterritorial effect. This briefing note provides a summary of the scope of the new regulations.

At the September 2009 Pittsburgh Summit, the G20 agreed that, by the end of 2012 at the latest (i) standardised derivatives transactions should be traded on exchanges or electronic trading platforms, (ii) standardised 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 order for Japan to comply with its G20 commitments, the Financial Instruments and Exchange Act (the "**FIEA**", Act No. 25 of 1948, as amended) was amended in 2010 to require (1) clearing of certain standardised OTC derivatives transactions through a CCP and (2) reporting of certain data in relation to certain OTC derivatives transactions to the Financial Services Agency of Japan (the "**JFSA**"). In addition, a bill to amend the FIEA approved at the Diet on 6 September 2012 requires firms to use electronic trading platforms in relation to certain OTC derivatives transactions to be specified in a cabinet office ordinance (such OTC derivatives transactions are expected to include JPY plain-vanilla interest rate swaps and/or other OTC derivatives transactions which are to be cleared through CCPs)¹.

On 11 July 2012, the JFSA released the final version of the Cabinet Office Ordinance concerning Regulations on OTC Derivatives Transactions, etc. (the "**COO**") together with its responses to comments received through a public consultation procedure for the COO (the "**JFSA's Response**"). The COO sets out the details and scope of the mandatory clearing and reporting requirements in Japan. This briefing note explains the new mandatory clearing and reporting requirements laid down by the COO, its related notices and the JFSA's Response.

Key issues

- Central Clearing Obligations
- Trade Information Storage and Reporting Requirements
- Date of Implementation and Grace Period

¹ The cabinet office ordinance has not yet been published.

Central Clearing Obligation

Scope of OTC derivatives transactions which must be cleared through a CCP

All types of Financial Instruments Business Operators² ("FIBOs") and Registered Financial Institutions³ ("RFIs") registered under the FIEA are required to clear certain OTC derivatives transactions at a CCP⁴ licensed under the FIEA as follows:

Type of Product	Available CCPs under the FIEA
<p>CDS transactions on the iTraxx Japan index of which reference entities are 50 or less domestic corporations and which are designated to be cleared centrally by the Japan Securities Clearing Corporation ("JSCC")</p> <ul style="list-style-type: none"> Currently, iTraxx Japan 50 is included in this type of product. For further details, please see Article 10 of the Handling Procedures of CDS Business Rules of JSCC (http://www.jscs.co.jp/en/rule/PDF(CDS)/02Handling%20Procedures%20of%20CDS%20Business%20Rules_20120301.pdf) 	<p>Can only be cleared through a licensed Japanese CCP</p> <ul style="list-style-type: none"> currently only JSCC meets this requirement
<p>Yen-denominated interest swaps on 3-month or 6-month JPY-LIBOR which are designated to be cleared centrally by JSCC</p> <ul style="list-style-type: none"> For further details, please see Article 9 of the Handling Procedures of Interest Rate Swap Business Rules of JSCC (http://www.jscs.co.jp/en/rule/PDF(IRS)/02HandlingProceduresofIRSBusinessRules.pdf) 	<p>Can be cleared through a licensed Japanese CCP, a licensed foreign CCP or a linked foreign CCP</p> <ul style="list-style-type: none"> currently only JSCC meets this requirement

In this briefing note we refer to an OTC derivatives transactions which must be cleared through a CCP (as set out in the table above) as a "**Regulated Transaction**"⁵. The clearing requirement will not apply to other OTC derivatives transactions (even where entered into between FIBOs and RFIs). However, the scope of OTC derivatives transactions subject to the clearing requirement is expected to be expanded over time.

Exemptions

Even if a Regulated Transaction is conducted by a FIBO or RFI, the central clearing requirement will not apply where:

- (i) the counterparty to the Regulated Transaction is not a FIBO or RFI;
- (ii) the Regulated Transaction is booked in a trust account;
- (iii) the Regulated Transaction falls within certain intra-group transactions;
- (iv) the parties to the Regulated Transaction (or their parent's or subsidiary's) are not a clearing member of the same CCP (but only if there are reasonable grounds for one or both of the parties (or their parent's or subsidiary's) not being a clearing member of the CCP); or
- (v) the OTC derivatives transaction is made under special circumstances designated as exempt by the JFSA (there has been no such designation as of September 2012).

² Financial Instruments Business Operators include securities firms, investment advisors and investment managers registered in Japan under the FIEA. A foreign securities firm, investment advisor or investment manager are not included unless it is registered in Japan.

³ Registered Financial Institutions include banks, insurance companies and certain other financial institutions which are licensed as such in Japan and registered in Japan to operate certain securities business or derivatives business under the FIEA. Foreign banks or other financial institutions not licensed in Japan are not included.

⁴ In order to conduct business as a CCP in Japan, the CCP needs to obtain a licence to operate as a CCP or a foreign CCP, as appropriate, from the Japanese regulator. There are several CCPs licensed in Japan, however, currently only Japan Securities Clearing Corporation is licensed to clear certain OCT derivatives transactions.

⁵ We use the concept of Regulated Transaction for convenience. It is not a term or concept which is used in the FIEA or COO.

While there is no explanation in the COO as to what would constitute "reasonable grounds" referred to in (iv) above, the JFSA's Response states, that, in general, where a FIBO or RFI does not have major difficulties in satisfying the membership requirements of the CCP but does not become a participant of the CCP, such FIBO or RFI does not have a reasonable ground.

There is some uncertainty around the application of these exemptions in the context of cross-border OTC derivatives transactions. Consequently, it is necessary to consider whether a proposed cross-border Regulated Transaction may trigger the central clearing requirement under the FIEA on a case-by-case basis. Some examples extracted from the JFSA's Response are set out below:

- Regulated Transactions between the offices of a FIBO or RFI in Japan and the overseas branches of that FIBO or RFI are likely to be outside of the scope of the clearing obligation. For example, a transaction between X Tokyo Co Ltd (FIBO) and X London branch.
- If a FIBO or RFI acts as an intermediary, broker or agent in respect of the execution of a Regulated Transaction by an overseas branch which is within the same legal entity as that FIBO or RFI, this falls into a grey area that may trigger the central clearing obligation for the FIBO or RFI. The JFSA may determine the applicability of the clearing requirement under the FIEA on a case-by-case basis, taking into account the location where the OTC derivatives transaction is conducted and the purpose of the central clearing obligation.
- If a FIBO or RFI acts as an intermediary, broker or agent in respect of the execution of a Regulated Transaction by its parent company located outside Japan (i.e., a different legal entity from the FIBO or RFI), this also falls in the grey area. However, so long as the Regulated Transaction is not booked in the FIBO or RFI's own account, such transaction is likely to be outside of the scope of the central clearing obligation.
- If an overseas branch of a domestic RFI and a Japanese head office of another domestic RFI enter into a Regulated Transaction, both RFIs are likely to be subject to the central clearing obligation.⁶

As the Japanese rules have potential extraterritorial application, a further complication to be resolved in the context of cross-border transactions is the potential for a transaction to be subject to a clearing obligation under a foreign law as well as under Japanese law.⁷ There is no clear rule under Japanese law that indicates how to deal with overlapping regulations. The extent to which regulatory overlap will become a problem will depend largely on the extent to which a CCP authorised to provide clearing services under the foreign law becomes licensed as a foreign CCP in Japan and/or a relevant Japanese CCP is registered or is authorised or recognised under the foreign law to provide clearing services in the foreign jurisdiction (or is otherwise exempt from such registration requirements).⁸

Trade Information Storage and Reporting Requirements

The scope of the trade reporting requirement is broader in terms of its application than that of the mandatory clearing requirement. There are two tests for determining application of the reporting requirements, namely, the nature of transaction parties and the type of transaction. The reporting requirements will apply in respect of an OTC derivatives transaction (a "Reporting Transaction") which:

- (i) is conducted by one or both parties as a Type 1 FIBO or RFI (limited to licensed commercial banks, the Shoko Chukin Bank Ltd., the Development Bank of Japan Inc., the Federation of Shinkin Banks, or the Norinchukin Bank) other than where a counterparty to the OTC derivatives transaction is a parent company, subsidiary, or sister company of such Type 1 FIBO or RFI; and
- (ii) relates to the price of a financial product, an interest rate, or financial indicators based on the price of a financial product, or an interest rate including:

⁶ The JFSA's Response does not refer to the case of a FIBO. However, the analyse for a FIBO is likely to be the same as that for a RFI referred to in the main text.

⁷ The relevant transaction would need to be a Regulated Transaction in Japan and it would also need to be one which is subject to the mandatory clearing requirement in the foreign jurisdiction.

⁸ There is also the potential issue that entities which are regulated under a foreign law may be effectively prohibited under that foreign law from using the clearing services of a Japanese CCP unless the Japanese CCP is authorized or recognised under that foreign law.

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- forward transactions or index forward transactions where the period from the trade date to the delivery date is three business days or more;
- option transactions or index option transactions where the rights exercise period is three business days or more;
- swap transactions; or
- credit derivatives transactions where the relevant event is in relation to credit conditions.

There are three types of obligor who must keep and report trade information to the JFSA in relation to Reporting Transactions, namely:

- (i) CCPs licensed by the JFSA;
- (ii) trade repositories designated by the JFSA; or
- (iii) Type 1 FIBOs or RFIs.

In respect of any Reporting Transaction cleared through a CCP (including a licensed Japanese CCP and a licensed foreign CCP), the CCP is required to keep the trade information and report it to the JFSA.

The table below summarises the circumstances in which each of these types of obligor is required to keep and report trade information.

Type of the Reporting Transactions; Use of the CCPs	Obligor to keep and report the trade information to the JFSA
Reporting Transactions which are subject to the mandatory central clearing obligation	CCP
Reporting Transactions which are not subject to the mandatory central clearing obligation but are voluntarily cleared centrally	CCP
Reporting Transactions which are not subject to the mandatory central clearing obligation and which are not cleared centrally	Trade Repository (where the Trade Repository is used)
	Type 1 FIBOs and RFIs (where the Trade Repository is not used)

If a Type 1 FIBO or RFI keep and report trade information to the JFSA by themselves:

- The trade information must be kept for five years from the date on which the record is processed; and
- In principle, each week's information on trades executed during that week must be submitted to the JFSA within three business days from the first business day of the following week.

Date of Implementation and Grace Period

Date of Implementation

The FIEA and COO will be enforced from 1 November 2012.

Grace Period

- (a) Central Clearing Obligation

No grace period or transitional measures are stipulated in the COO. OTC derivatives transactions which are booked by 31 October 2012 would fall outside of the scope of the central clearing obligation⁹.

⁹ However, if an OTC derivatives transaction which is booked by 31 October 2012 is amended after 1 November 2012, it would then become subject to the central clearing obligation.

(b) Information Keeping and Reporting Requirements

Reporting Transactions which expire by 31 October would fall outside of the scope of the storage and reporting obligation.

The following interim or transitional measures apply to Reporting Transactions entered into during the period from 1 November 2012 to 31 March 2013:

- Reporting Transactions expiring by 31 March 2013: Remain outside of the scope of the storage and reporting requirements; and
- Reporting Transactions expiring after 31 March 2013: The transaction balance (i.e., the notional amount of each Reporting Transaction) as of 31 March 2013 must be reported by the first reporting deadline falling on or after 1 April 2013.

Don't Relax Just Yet!

Market participants who are not subject to the Japanese central clearing obligation as of 1 November 2012 should continue to pay attention to developments in this area as future amendments to the FIEA are expected to expand both the scope of the types of OTC derivatives transactions which are subject to the central clearing obligation and/or the types of counterparties which are subject to the central clearing obligation.

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.

Contacts

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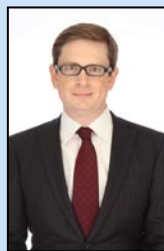
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