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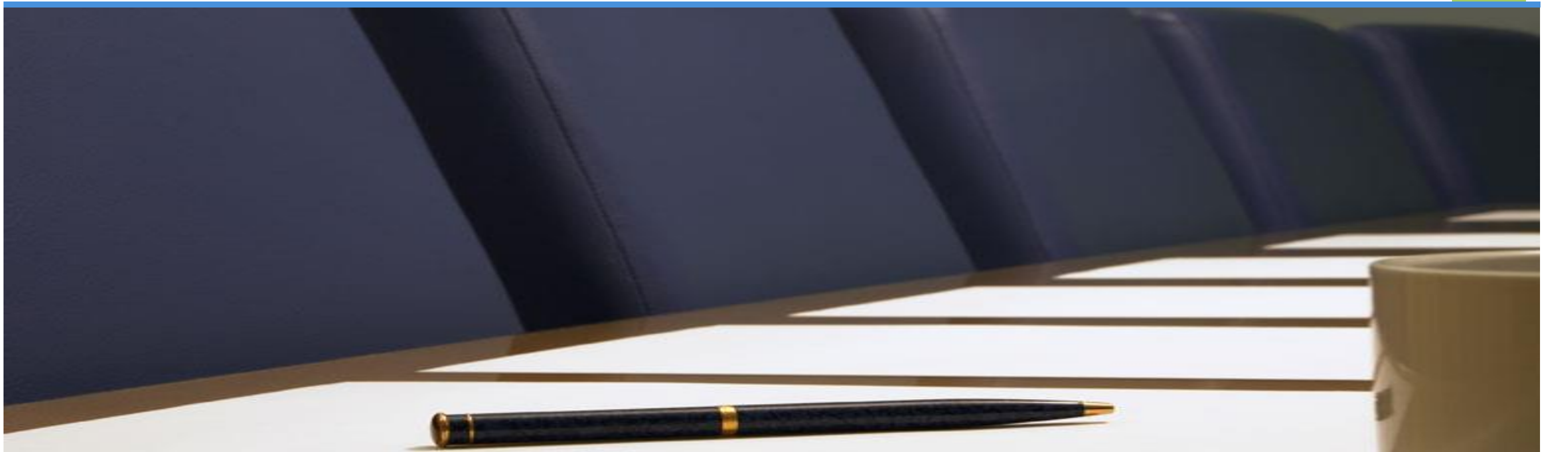

Corporate & Securities/Global – Asia Practice | Alert

October 2016

New Regulations in Japan Concerning Margin Requirements on Uncleared OTC Derivatives

Following the publication of the final report by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commission (IOSCO) in September 2013,[1] which sets forth key principles for margin requirements for uncleared derivatives, the Financial Services Agency of Japan (the JFSA) amended the Cabinet Office Ordinance on Financial Instruments Business, etc. (the Amendment), which is subordinate to the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended; the FIEA). The Amendment went into effect on Sept. 1, 2016, and provides requirements and procedures for collecting and posting initial and variation margin for uncleared OTC derivatives conducted by Japanese broker-dealers and financial institutions.

Background

The JFSA released the initial draft of the Amendment in July 2014. Upon various comments from the market participants, the second draft was issued in December 2015 and, after another round of public comments, the final version was issued in March 2016. The requirements set out in the final version of the Amendment (Margin Requirements) follow the key principles set by the BCBS-IOSCO final report with some tweaks in order to fit the practices of Japanese market participants, which were communicated with the JFSA through the public comment process and other occasions. The Margin Requirements are implemented in phases after Sept. 1, 2016 as discussed below.

[1] The latest version (March 2015) is available at http://www.bis.org/bcbs/publ/d317.htm.

Key Features of the Amendment

Parties Subject to the Margin Requirements

The Margin Requirements are applicable to Type 1 Financial Instruments Business Operators, *i.e.*, broker-dealers and certain financial institutions[2] that have a specified amount[3] of OTC derivatives (Covered Entities). Foreign derivatives firms (FDFs)[4] are not directly regulated, but are indirectly subject to the Margin Requirements to the extent that such FDFs are the counterparty to a Covered Entity in a subject transaction.

Subject Transaction

The Margin Requirements are applicable to uncleared OTC derivatives[5] regulated under the FIEA, which include most of the derivatives, but does not include forward contracts that cannot be cash-settled or commodity derivatives.[6] The Margin Requirements also exclude the fixed, physically settled exchange of principal of cross currency swaps from initial margin requirement.

The following transactions are exempted from the Margin Requirements:

> A transaction to which at least one of the parties is a non-Covered Entity other than a FDF;
> A transaction executed between Covered Entities or a Covered Entity and a FDF, where the aggregate month-end average notional amount of OTC derivatives of such Covered Entity or FDF in a specified period[7] is less than JPY 300 billion (approximately USD 3 billion);
> A transaction conducted on a trust account, where the average monthly principal amount of OTC derivatives transactions in a specified period of such trust account is less than JPY 300 billion (approximately USD 3 billion);
> A transaction with a parent company, subsidiaries, or other affiliates;
> A transaction conducted in accordance with the margin rules of a foreign jurisdiction that is equivalent to the Margin Requirements.[8]

Such exempted derivatives are not subject to the Margin Requirements. However, parties may (but are not required to)[9] take into account such derivatives in calculating initial and variation margin amount only if such treatment is consistent over time.[10]

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[2] Banks that are registered under the FIEA, the Shoko Chukin Bank, Ltd., Development Bank of Japan Inc., Shinkin Central Bank, the Norinchukin Bank and insurance companies.

[3] See "Phase-in Schedule" section below for the threshold amount of OTC derivatives.

[4] A FDF is a foreign firm that is engaged in OTC derivatives transactions in a jurisdiction where it is confirmed that a netting agreement is legally enforceable. FDFs do not include sovereigns, central banks, multilateral development banks or the Bank for International Settlements.

[5] "Uncleared OTC derivatives" means the derivatives other than those cleared by a clearinghouse licensed under the FIEA as well as cases designated by Commissioner of the JFSA prescribed in Article 1–18–2 of the Order for Enforcement of the FIEA. For example, Chicago Mercantile Exchange Inc. and LCH.Clearnet Ltd. are licensed under the FIEA. Credit default swaps cleared at a clearing house in the U.S. and European Union are also exempt from uncleared OTC derivatives.

[6] Commodity derivatives are generally regulated under the Commodity Derivatives Act (Act No. 239 of 1950, as amended, the CDA).

[7] One-year period from April 1 of the second preceding year to March 31 of the immediately preceding year (if the transaction is executed in December, such period shall be from April 1 of the immediately preceding year to March 31 of the given year).

[8] The JFSA released a draft rules on the framework for substituted compliance for public comment in August 2016. The JFSA explains in the release that it still continues reviewing the equivalence of the rules in foreign jurisdictions and it will complete the review as the equivalence reviews by the foreign regulators progress.

[9] Please note, however, that a Covered Entity that is also regulated as a Specified OTC Commodity Derivatives Operator under the CDA must include uncleared OTC commodity derivatives in the margin calculation as required by the CDA.

[10] For example, forward contracts that cannot be cash-settled such as physically settled foreign exchange forwards or swaps are not subject to Margin Requirements, but can be included in the margin calculation.

Variation Margin

A Covered Entity must calculate the mark-to-market value of uncleared OTC derivatives and that of collateral exchanged with each counterparty, applying the haircut by the type of eligible collateral, every day. A Covered Entity must request its counterparty as promptly as practically possible to post additionally required variation margin or to return excess in posted variation margin unless the calculated amount of variation margin to be posted or returned is lower than a minimum transfer amount agreed between the parties. The minimum transfer amount may not exceed JPY 70 million (approximately USD 700,000) in total with the required initial margin. The additional or excess variation margin must be collected from the counterparty without delay after making the request, but not necessarily on a T+1 basis.

When a Covered Entity is requested by the counterparty to post or return variation margin, it must post or return the required amount of variation margin without delay.

If a dispute arises between a Covered Entity and its counterparty, such dispute must be resolved by calculating the variation margin amount in an agreed-upon method between the parties such as using the largest undisputed amount or the average of the amounts calculated by both parties.

For derivatives conducted for trust accounts, variation margin must be posted and collected for each trust account.

Initial Margin

A Covered Entity must calculate the potential future exposure of uncleared OTC derivatives and the mark-to-market value of initial margin that is posted by or to the counterparty with necessary haircut when: (i) an uncleared OTC derivative transaction is executed or terminated, or any right related to an uncleared OTC derivative changes; (ii) a month passes after the last calculation of the potential future exposure; and (iii) in cases where additional initial margin should be posted for volatile market condition or other grounds.

The potential future exposure may be calculated by a quantitative model method or by applying the standardized schedule. The quantitative method, whether it is an internal or third-party model, must be notified to the JFSA in advance. The initial margin may be calculated on a portfolio basis for the derivatives that are subject to a single legally enforceable netting agreement.

A Covered Entity must request the counter party and collect the required initial margin without delay, unless the required amount is less than the minimum transfer amount agreed upon by the parties. As discussed above, the minimum transfer amount may not exceed JPY 70 million (approximately USD 700,000) in total with the required variation margin. In addition, parties may agree to a threshold amount up to JPY 7 billion (approximately USD 70 million) on a consolidated group basis that is subtracted from the potential future exposure in the calculation of required initial margin amount. When the counterparty requests posting or returning initial margin, a Covered Entity must post or return the required amount of initial margin to the counterparty without delay. Initial margin must be deposited on a gross basis without netting the amounts to each other.

If a dispute arises on the required amount of initial margin, it must be resolved by exchanging the amount calculated by an agreed-upon way and taking dispute resolution procedures between the parties to settle the balance.

Initial margin must be segregated in a trust account or other way[11] so that a Covered Entity can liquidate the collateral deposited by a counterparty without delay when such counterparty is defaulted, or the counterparty may take back the collateral deposited with a Covered Entity entirely at the default by the Covered Entity.

[11] The JFSA revised the Amendment in July 2016 to temporarily permit holding posted initial margin at a third-party custodian as a method similar to using a trust account in order to deal with delay in implementation of margin rules in some jurisdictions such as the European Union.

Rehypothecation of initial margin is prohibited. For derivatives conducted through trust accounts, initial margin must be posted and collected for each trust account.

Phase-in Schedule

The Margin Requirements apply in phases to the Covered Entities with more than the threshold amount of OTC derivatives. The phase-in schedule is set out in summary below:

Effective Date	Variation Margin	Initial Margin
	Phase-in Threshold[12,13]	
Sept. 1, 2016	More than JPY 420 trillion	More than JPY 420 trillion
March 1, 2017	JPY 420 trillion or less	-
Sept. 1, 2017	-	More than JPY 315 trillion
Sept. 1, 2018	-	More than JPY 210 trillion
Sept. 1, 2019	-	More than JPY 105 trillion
Sept. 1, 2020	-	More than JPY 1.1 trillion

CFTC's Comparability Determination

The U.S. Commodity Futures Trading Commission (CFTC) has recently recognized the JFSA's Margin Requirements as equivalent to its "Final Margin Rule"[14] with one exception in inter-affiliate trades.

The CFTC published the result of its equivalence review as set out in its "Cross-Border Margin Rule"[15] concerning Japanese Margin Requirements on Sept. 15, 2016.[16] The CFTC made a thorough comparison between its Final Margin Rule and the JFSA's Margin Requirements, and concluded that although the CFTC noted several differences,[17] the only difference that is not comparable to the Final Margin Rule is that the JFSA's Margin Requirements do not require posting or collecting margin for trades between consolidated affiliates.

Consequently, a Covered Swap Entity (CSE), as defined under the Final Margin Rule, that is subject to both the CFTC's Final Margin Rule and the JFSA's Margin Requirements may rely on the JFSA's Margin Requirements in conducting uncleared OTC derivatives with Japanese Covered Entities except that such CSE must comply with the inter-affiliate margin requirements of the Final Margin Rule in which case the CSE shall post margin in compliance with the CFTC's Final Margin Rule where JFSA's Margin Requirements does not require posting margin.

[12] Aggregate month-end average notional amount on a consolidated group basis during the three-month period from March 1 to May 31 of the preceding year (if the transaction is executed from September to December, such period shall be from March 1 to May 31 of the given year).

[13] The threshold amounts in Japanese Yen correspond to those in Euro published in the final report by the BCBS and IOSCO, using the conversion rate of JPY140 per Euro.

[14] "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," 81 FR 636 (Jan. 6, 2016). See http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2015-32320a.pdf.

[15] "Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements," 81 FR 34818 (May 31, 2016). See http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-12612a.pdf.

[16] "Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants," which is available at http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2016-22045a.pdf.

[17] For example, the definitions of products that are subject to the margin rule, i.e. "uncleared swap" under the CFTC's Final Margin Rule and "uncleared OTC derivatives" under the JFSA's Margin Requirements, mostly cover the same products, but not identical.

The purpose of this memorandum is to provide a general overview of the Margin Requirements in Japan. It is not intended as a comprehensive and detailed analysis on all of the provisions of the Amendment that may apply to each uncleared OTC derivative. Also, it is important to keep in mind that margin rules are still pending in some jurisdictions and, thus, the recognition of equivalence of foreign rules by the JFSA are yet to be finalized, which will impact the cross-border OTC derivative transactions with a Japanese broker-dealer or registered financial institution. Therefore, if you would like additional information on the Margin Requirements that may affect your derivative transaction with a Japanese entity, please feel free to contact your Greenberg Traurig attorney.

This *GT Alert* was prepared by **Koichiro Ohashi** and **Makoto Koinuma** (Main Editor of this *Alert*)**.** Questions about this information can be directed to:

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