

September 2011

To: Financial Services Agency, Financial Markets Division

**Proposals Pertaining to the Applicable Scope of the Mandatory Central Clearing for
Over-the-Counter Derivatives**

ISDA Japan Regulatory Committee
OTC Derivatives Regulations Working Group

International Swaps and Derivatives Association, Inc.
Otemachi Nomura Building, 21st Floor
2-1-1 Otemachi
Chiyoda-ku, Tokyo 100-0004
P 03 5200 3301 F 03 5200 3302
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

In accordance with the agreement at the G20 Pittsburgh Summit in September 2009, various major countries and regions are currently planning to introduce new regulations for OTC derivatives. As part of such initiatives, Japan also took steps such as making it mandatory to use financial instruments clearing organizations, etc. (mandatory central clearing) and establishing a system for maintaining and reporting transaction data for OTC derivatives through the 2010 revisions to the Financial Instruments and Exchange Act, and is at the stage of waiting to confirm their designs in detail in cabinet ordinances, etc., ahead of the enforcement by November 2012.

In this environment we as a participant in the OTC derivatives market strongly hope that new regulations in various countries and regions including Japan will be introduced in a consistent manner globally. For OTC derivative transactions, cross border transactions which span across countries or regions have been accounting for a material share. In addition, global financial institutions which are key players with regard to OTC derivative transactions have global operational systems in place for such transactions, by which they have local subsidiaries and branches in respective countries and regions taking the responsibility for booking, sales, risk management and other functions, and performing the risk management activities and capital allocation in an efficient way. Should the regulations in each country or region be introduced without consistency with each other in this situation, global financial institutions will be prevented from engaging in cross border transactions and maintaining their global management systems efficiently, which could potentially induce the segmentation of the global markets and regulatory arbitrage, resulting in a hindrance to the efficiency of a market in each country and increased systemic risk.

The market of OTC derivative transactions in Japan has been growing in close tandem with overseas markets and their market participants, too. Major financial institutions in Europe and the United States as well as domestic financial institutions are dealing actively as a market maker or user in derivative transactions denominated in JPY, which is a major currency, CDS transactions referring to Japanese companies, and other transactions. Such dealing takes place not only in Japan but also across the border of the country (a transaction between a domestic financial institution and an overseas investor, for example), or outside Japan (for instance, a transaction between a financial institution in Europe or the United States and an overseas investor), and it takes the form of extremely wide variety and of cross-border nature, with many of the major financial institutions in Europe and the United States frequently engaging in transactions for which they act as an agent or intermediary in Japan and those which make use of their capabilities for overseas booking.

With this backdrop, it is critically important for the development of the Japanese market to achieve mutual consistency between the forthcoming regulations in Japan and overseas in relation to OTC derivatives. Should a dealer engaging in an OTC derivative transaction be subject to dual regulation of Japan and a

foreign country as a result of the introduction of the regulations without the consistency achieved, it may well end up with causing a significant impact on the development of the domestic market. For example, it is possible that a European or U.S. financial institution will have an incentive to avoid dealing in the Japanese markets and deal in JPY-denominated transactions, CDS trades referencing to Japanese companies and others offshore, and there is a concern that Japanese financial institutions will get their international competitiveness reduced significantly because they would effectively become unable to trade with foreign customers. We believe such a situation should be avoided at all costs for the development of Japanese financial institutions and financial markets.

This document summarizes the proposals on the scope of central clearing obligations by a working group which consists of volunteers from the major participants of the Japanese OTC derivative market, and focuses on the applicable scope of mandatory central clearing for a cross border transaction conducted between market participants in Japan and overseas in particular. Among the new OTC derivatives regulations, so-called mandatory central clearing is of the utmost concern in that it is practically impossible to respond should a market participant be made subject to dual regulation in Japan and overseas, and we consider the scope of the application is critically important particularly in relation to overseas regulations.

Specific proposals are described in the ‘1. Proposals’ in the below, and key thought processes are as follows:

- (1) For the time being after the enforcement date, interest rate swaps which will become subject to mandatory central clearing in Japan(*) shall be those ‘denominated in JPY’;
- (2) The criteria for determining whether a party to a contract is ‘Japanese or not’ for the purpose of mandatory central clearing will be a function of ‘who a party to a contract (booking entity) is’;
- (3) In the case of parties to trade spanning across the borders (a cross border transaction), in consideration of the case that one of the party to a contract may be required to assume mandatory central clearing outside Japan (*), and accordingly the other party in Japan is obliged to clear a transaction through a foreign clearing organization, either statutory treatment or international coordination between regulators should be made in order that such action shall not be an issue in light of the Financial Instruments and Exchange Act (referred to as the “FIEA” hereinafter); and
- (4) In the case of parties to trade being both located outside Japan, they shall not be subject to mandatory central clearing in Japan.

* For the purpose of this document ‘mandatory central clearing in Japan’ and ‘mandatory central clearing outside Japan’ mean ‘central clearing at a financial instruments clearing organization or foreign financial instruments clearing organization as per the FIEA’ and ‘central clearing at clearing organizations other than

financial instruments clearing organizations and foreign financial instruments clearing organizations' (referred to as the "foreign clearing organization" hereinafter), respectively.

We strongly request that cabinet ordinances and others relating to mandatory central clearing be provided in order to clarify those points, and that coordination with the regulators overseas be carried out to ensure that Japanese financial markets and financial institutions will not be put at a competitive disadvantage.

1. Proposals

In relation to the forthcoming formulation and revisions to the cabinet ordinances, we would like to request the following in respect of the applicable scope¹ of the mandatory central clearing for OTC derivatives. This clearing is scheduled to become effective before November 19, 2012²:

Matters to Be Provided in the Cabinet Ordinances

1) For the purpose of Article 156-62, chapeau, of the FIEA, it shall be made clear that **“when a Financial Instruments Business Operator, etc.”** which will be subject to the mandatory central clearing **engages in a transaction listed in each of the following**³:

a. refers³ to an act of “being a party to a contract⁴” (so called “booking a transaction”) rather than an act of “soliciting and executing a transaction (including such an act via intermediation or by acting as an agent)”;

b. will not be retroactively applied to any past transactions with trade dates being prior to the enforcement of the law up to November 19, 2012.

2) With regard to the **“own and counterparty’s obligation under a relevant transaction”** under Article 156-62, chapeau, of the FIEA, it shall be made clear that:

a. it refers to cases where both “own” and its “counterparty” would satisfy the condition of being juridical persons incorporated in Japan, a branch in Japan of a foreign bank, or overseas branch⁵ of a Japanese branch (a “domestic institution”) which falls under the category of a **“Financial Instruments Business Operator, etc.” (referred to as “FIBO”)**⁶; further, in the case that the “counterparty” only does not meet this criteria (for the reason that it is not a domestic institution) (referred to as a ‘cross border transaction’

¹ The scope of the “Financial Instruments Business Operators, etc.” which will be subject to the central clearing requirement is not part of this document.

² This document presupposes that “JPY interest rate swaps” will be specified in the cabinet ordinance of Article 156-62 item ii of Financial Instruments and Exchange Act and that no “foreign financial instruments clearing organization” as defined in Article 2-29 of the FIEA exists as at the enforcement date (by November 19, 2012).

³ If it is legally clear that “engages in a transaction” does not include an act of intermediation or acting as an agent”, we propose to confirm it in the responses to the public comments.

⁴ A party which assumes economic and legal risks inherent in or arising from a transaction to a counterparty of a relevant contract.

⁵ Please refer to the footnote 8 in page 7 for the treatment of an overseas branch of a Japanese bank.

⁶ We request the cabinet ordinance to clarify that it will not be subject to mandatory central clearing where a ‘counterparty’ does not fall under the category of the ‘FIBO’ (in other others, it is a ‘customer’).

hereinafter), that an FIBO which acts as ‘own’ may clear a cross border transaction through either a foreign or a Japanese clearing organization⁷, and that if neither “own” nor the “counterparty” meet the criteria, it would be outside the applicable scope of mandatory central clearing in Japan; and that

b. any cases where a “counterparty” to “own” is a head office or branch of the same financial group⁸, or an affiliate, etc., which is subject to consolidation for the purpose of financial statements shall be excluded.

- 3) For the purpose of Article 156-62, item ii, of the FIEA, it shall be made clear that **“transactions, as provided by the cabinet ordinances in light of trade volume and other factors, for which the default give rise to a risk of causing a material impact on the capital markets in Japan”:**

include such transactions whose obligations can be assumed and are appropriate to be cleared by a “financial instruments clearing organization” or “foreign financial instruments clearing organization” among the “JPY interest rate swaps.”

Matters to Be Provided by the Notices

- 4) With regard to **“those for which the default would cause a negligible impact on the capital markets in Japan, as specified by the Financial Services Agency Commissioner”** under the Order for Enforcement of FIEA, Article 1-18-ii

For a “cross border transaction” in the above 2) a., it shall be announced and specified in an appropriate manner that an FIBO to is allowed to use a clearing organization outside Japan.⁹

⁷ Please refer to the proposal 5)..

⁸ The consolidation criteria in this regards will be separately addressed in light of discussions on the scope of FIBO which is subject to mandatory clearing obligations.

⁹ While the scope of the application of the FIEA in the case that a foreign clearing organization (which is not a foreign financial instruments clearing organization) offers clearing services to FIBOs outside Japan needs to be clarified, we request that it be addressed through public comments, etc., instead of providing clarification via express provisions. In any case we request it to be clarified without resorting to the provisions of the application outside Japan in the FIEA.

Other Matters

- 5) With regards to the proposal 2) which requests the implementation option that that an FIBO which acts as 'own' may clear a cross boarder transaction through either a foreign or a Japanese clearing organization. we would like to request the following treatments.
- a. Conduct examining and approving procedures of the license for Foreign Financial Instruments Obligation Assumption Service under Article 156-20-3 of the FIEA without any delay if a clearing organization which is approved by the regulator of the jurisdiction in which a counterparty is required to assume the clearing obligations.
 - b. If the a. above is not secured, take measures i.e. by the Notices in the above 4) or any appropriate ways, in order that a party (a FIBO) of a relevant transaction is able to continue trading with the counterparty via a clearing organization which does not obtain the license under Article 156-20-3 of the FIEA, but approved in the jurisdiction where the counterparty book the transaction.¹⁰

Further, in order to ensure that Japanese financial institutions' trading in overseas markets and with foreign customers, as well as foreign financial institutions' dealing in domestic markets and with domestic customers, will not be inhibited unnecessarily, we request that the framework of international regulations be coordinated with overseas regulators in relation to the grant to a foreign financial instruments clearing organization of a license for underwriting financial instruments and obligations and the mandatory central clearing for transactions to which parties are located in more than one country, such as in a 'cross border transaction,' and thus utmost care be given to avoid Japanese institutions or financial markets being put at a competitive disadvantage.

¹⁰ Specifically, an implementation option may be to exclude a 'transaction being cleared at an overseas clearing organization' from the applicable scope of mandatory central clearing by the cabinet ordinance. It would be also necessary to coordinate with international regulators towards standardization of clearing organizations that can be used for mandatory central clearing.

2. Applicable Scope of the Mandatory Central Clearing under the FIEA (Concrete Examples)

In consideration of the proposals in the above 1, the applicable scope of the mandatory central clearing of transactions whose obligations can be assumed by a “financial instruments clearing organization” out of the “JPY interest rate swaps” as at the effective date by November 19, 2012 shall be as below:

“Counterparty”	Head office & branches in Japan of a Japanese bank/securities company	Overseas branches of a Japanese bank	Overseas subsidiaries of a Japanese bank/securities company	Local subsidiary in Japan of a foreign financial institution	Tokyo branch of a foreign bank	Head office, branches and subsidiaries outside Japan of a foreign financial institution
“Own”						
Head office & branches in Japan of a Japanese bank/securities company	○ (both)	— (both)	△ (own)	○ (both)	○ (both)	△ (own)
Overseas branches of a Japanese bank	— (both)	— (both)	— (own)	— (both)	— (both)	— (own)
Overseas subsidiaries of a Japanese bank/securities company	△ (c/p)	— (c/p)	×	△ (c/p)	△ (c/p)	×
Local subsidiary in Japan of a foreign financial institution	○ (both)	— (both)	△ (own)	○ (both)	○ (both)	△ (own)
Tokyo branch of a foreign bank	○ (both)	— (both)	△ (own)	○ (both)	○ (both)	△ (own)
Head office, branches and subsidiaries outside Japan of a foreign financial institution	△ (c/p)	— (c/p)	×	△ (c/p)	△ (c/p)	×

(A party with the obligation is shown in parenthesis.)

- Comply with the clearing obligations in Japan
- △ An FIBO may clear a cross border transaction through either a Japanese or a foreign clearing organization
- ×
- Application of the regulations will be determined based on the agreement between international regulators¹¹

A survey (conducted in June 2011) by the OTC Derivatives Regulation Working Group (the “WG” hereinafter) estimates that those corresponding to the above “△” category account for 19% (10% by those

¹¹ With a presumption of an agreement among international authorities, an overseas branch of a Japanese bank shall, in principle, comply with the mandatory central clearing in Japan for JPY interest rate swaps (central clearing at a clearing organization or a foreign financial instruments clearing organization in partnership shall of course be permitted, too). However, where there is no such agreement and an overseas branch of a Japanese bank is required to comply with the mandatory central clearing outside Japan, we request it to be exempt from the obligation in Japan.

between Japanese financial institutions and 9% by those by a Japanese financial institution and a foreign financial institution's Tokyo book), those corresponding to the “Δ” or “—” category (between a Japanese financial institution and a foreigner's overseas book) make up for 43%, and those represented by “×” (between foreign institutions' overseas books) consist of 40%, on a transaction flow basis during the fiscal year 2010 (notional amount basis; transactions executed in Japan only) (the total does not add up to 100% partly because the survey did not differentiate between local subsidiaries and branches). In other words, approximately 58%¹² of the total (by “○”, “Δ” and “—”) may potentially be subject to mandatory central clearing in Japan.

3. Reasons

1) **“When an FIBO which will be subject to the mandatory central clearing engages in a transaction listed in each of the following”** under Article 156-62, chapeau, of the FIEA

a. Reasons why it should refer to an act of “being a party to a contract” (so called “booking a transaction”) rather than an act of “soliciting and executing a transaction” (including such an act via intermediation or by acting as an agent)

- The purpose of the mandatory central clearing originated from the Post-Trade regulations in the first place.
- Regulating the subjects that will assume the economic risks of a transaction is consistent with the objective of the mandatory central clearing of preventing systemic risks due to a default of a market participant.
- With regard to a transaction for which the location of solicitation and execution differs from that of a party to the contract of the booking location, the risk of default due to a “failure to pay” will materialize at the location of the party to the contract. Therefore, whether ‘the default on an obligation under a transaction gives rise to a risk of causing a material impact on the domestic capital markets’ or not should be judged based on where a book which acts as a party to the contract is located, rather than the location of solicitation and execution.
- It is practically difficult to capture at the stage of Post-Trade the information around the principal of solicitation, decision-making, execution, and whether an intermediary or agent plays a role, and so on for both “own” and particularly the “counterparty”.

¹² Including TIBOR-based transactions. Please note that central clearing facilities at a financial instruments clearing organization in Japan may not be available for TIBOR-based transactions yet at the time of the enforcement on November 19, 2012.

- Where an office outside Japan acts as a “party to a trade contract,” it will be subject to mandatory central clearing overseas separately. Therefore excluding it from mandatory central clearing in Japan would circumvent overlapping with the domestic regulations.
 - In the case of conducting the solicitation and execution of a transaction in Japan in the form of an intermediary or agency and acting as a “party to trade contract” at an overseas office, as mainly seen among foreign financial institutions, such a transaction is already being cleared centrally by a financial instruments clearing organization outside Japan and will continue to be subject to the local central clearing obligation overseas. With that and combined with the objective of mandatory central clearing being to prevent systemic risks in the domestic capital markets, we do not see a need of transferring such a transaction to a financial instruments clearing organization in Japan and would like to circumvent the burden from unnecessary transfer administration.
- b. Reasons why it should not be retroactively applied to any past transactions executed prior to the enforcement of the law on November 19, 2012
- In terms of the timeline it is very difficult to get a financial instruments clearing organization for interest rate swaps up and running before November 2012, and the central clearing of past transactions retroactively would pose a high operational risk.
 - Alignment with the regulators of each of G20 countries.
- 2) **The “own and counterparty’s obligation under a relevant transaction”** under Article 156-62, chapeau, of the FIEA
- a. Reasons why it should be made clear that both “own” and its “counterparty” would need to satisfy the condition of being juridical persons incorporated in Japan, a branch in Japan of a foreign bank, or overseas branch of a Japanese branch which falls under the category of “FIBO.” Further, in the case of a “cross border transaction,” that an FIBO may clear a cross boarder transaction through either a foreign or a Japanese clearing organization, and that if neither “own” nor “counterparty” meet the criteria, it would be outside the applicable scope of the mandatory central clearing in Japan.
- In the case that the booking entities of “own” and the “counterparty” to a contract are juridical persons incorporated outside Japan, it cannot necessarily be argued that the “default” gives rise to a risk of causing a material impact on the domestic capital markets.”
 - In order to perform central clearing, “own” and the “counterparty” need to be clearing members of the same central clearing organization. At the same time, you may not become a clearing member of a

financial instruments clearing organization unless you are not only a juridical person or an office in Japan but also an FIBO, as is observed in the case of JSCC's central clearing organization for CDS.¹³

- If the “own” does not fall under the category of “FIBO,” it is not subject to mandatory central clearing in Japan to start with.
 - If a “counterparty” is subject to mandatory central clearing by the regulator outside Japan, it will not work operationally due to dual regulation unless the rules around the applicability in Japan and overseas are perfectly congruent with each other.
- b. Reason why a case where a “counterparty” to “own” is the head office or a branch of the same financial group, or an affiliate, etc., which is subject to consolidation for the purpose of financial statements should be exempt from the obligation
- The reduction of systemic risk cannot be expected by including intra-group transactions of a global financial institution in the applicable scope of mandatory central clearing.
- 3) **“Transactions, as provided by the cabinet ordinances in light of trade volume and other factors, for which the default give rise to a risk of causing a material impact on the capital markets in Japan”** under Article 156-62, item ii of the FIEA

Reasons why transactions whose obligations can be assumed and appropriate to be cleared by a “financial instruments clearing organization” or “foreign financial instruments clearing organization” out of the “JPY interest rate swaps” fall under this category

- Taking into consideration that the central clearing of interest rate swaps by JSCC is expected to start at the last minute in November 2012, for the time being after the enforcement date, we should not only limit the scope to JPY interest rates but also exclude the swaps against TIBOR which would require an additional curve to be constructed for valuation. (However, it will be made subject to mandatory central clearing as soon as the clearing of TIBOR-based swaps becomes available at JSCC.)
- In addition, interest rate swaps in U.S. dollars and the euro should be out of the scope given the timeline. Trade volume of those in other currencies than JPY interest rates, according to a survey by the WG, is very limited at 2% of the total (when excluding transactions between overseas books) on a transaction flow basis during fiscal 2010. Therefore, it cannot be argued that the “default gives rise to a risk of

¹³ So called “customers” will not be clearing members of a clearing organization, requiring the use of so-called client clearing to perform central clearing. However, in light of the timeline of November 2012, it is not practically possible to start client clearing before that. Therefore, as mentioned in the earlier section, it is also necessary from the practical point of view to exclude so called “customers” from the applicable scope of mandatory central clearing.

causing a material impact on the capital markets in Japan,” and thus we believe they should be announced and specified as the “transactions for which the default would cause a negligible impact on the capital markets in Japan” under Article 1-18-ii of the Order for Enforcement of FIEA.

- If illiquid transactions that are difficult to obtain market prices are also required to be centrally cleared, clearing organizations and clearing members are not able to manage default risk properly, and consequently it would lead to an increase in systemic risk. Therefore, the scope of mandatory central clearing should be limited to certain types of transactions in consideration of market liquidity and systemic risk.
- 4) **“Transactions for which the default would cause a negligible impact on the capital markets in Japan, as specified by the Financial Services Agency Commissioner”** under Article 1-18-ii of the Order for Enforcement of FIEA

Reason why we request that it will be announced and specified in an appropriate manner that an FIBO can use a foreign clearing organization “in the case that the ‘counterparty’ only does not satisfy the criteria” as in the above 2) a.

- In case of the absence of an announcement and specification, overseas clearing would only be permitted at a central clearing organization which is licensed as a “foreign financial instruments clearing organization.” Thus we would like to avoid a situation where transactions shall virtually be disallowed from the perspective of avoiding any violation with laws until such clearing organization receives a license.
- 5) With regards to the proposal 2) a. in which we request for an option to allow an FIBO acting as ‘own’ to clear a cross boarder transaction through either a foreign or a Japanese clearing organization, set out below are reasons why we particularly request a. to conduct examining and approving procedures of the license for Foreign Financial Instruments Obligation Assumption Service under Article 156-20-3 of the FIEA without any delay if a clearing organization which is approved by the regulator of the jurisdiction in which a counterparty is required to assume the clearing obligations, and b. if the a. is not secured, to take measures i.e. by the Notices in the above 4) or any appropriate ways, in order that a party (a FIBO) of a relevant transaction is able to continue trading with the counterparty via a clearing organization which does not obtain the license under Article 156-20-3 of the FIEA, but approved in the jurisdiction where the counterparty book the transaction.

- There is no “foreign financial instruments clearing organization” that obtained the license under the FIEA as of today, and it is unclear whether major foreign clearing organizations will apply for the license in future.
- It is not realistic for Japanese “financial instruments clearing organization” to cover other types of transactions such as non-JPY interest rate swap that are subject to a cross boarder transaction.
- It is uncertain whether all of overseas regulators involved in a cross boarder transaction give a relevant license to Japanese “financial instruments clearing organization”, or to exempt from licensing requirements (if it is equivalent to a domestic clearing organization).
- Considering the G20 countries and major jurisdictions such as Singapore and Hong Kong will mandate central clearing at the same time, if there remain the issues stated above, a party in such countries will stop trading with Japanese counterparty because they are not able to comply with their local regulations.