Reference Translation

ISDA Safe, Efficient Markets

TO: Financial Markets Division,
Office of International Affairs,
General Coordination Division,
Planning & Coordination Bureau,
Financial Services Agency

FROM: ISDA Japan Regulatory Committee
OTC Derivatives Regulations Working Group

DATE: August 6, 2012

SUBJECT: Request concerning Application of Regulation on OTC Derivatives to Cross-Border Transactions

Based on the Leaders' Statement delivered at the 2009 G20 Pittsburgh Summit in September 2009, new regulations on OTC derivatives are being introduced in the world's leading states and regions. In Japan, measures were also taken to prescribe that organizations have a duty to carry out central clearing and establish a trade information preserving and reporting system, and details thereof, on the occasion of the amendment of the Financial Instruments and Exchange Act (the "FIEA") in 2010. The amended FIEA is scheduled to be enforced in November 2012.

The ISDA Japan Regulatory Committee's Working Group on Regulation of OTC Derivatives (the "Working Group") agreed with the intent of preventing systemic risk, and has expressed a great number of opinions. In particular, it has shown its opinions on amendment of the FIEA and on related rules and regulations including Cabinet Office Ordinances, with a view to facilitating proper and effective introduction of regulations that would be in keeping with the said intent.

Cross-border transactions reaching across borders to other states and regions are being actively conducted as a feature of the OTC derivatives market and efficient risk management is being performed by financial institutions and other users who use such cross-border transactions. In light of these and other things, the Working Group has been stressing the importance for each state and region to introduce regulations on OTC derivatives in a globally consistent manner.

Details of, and specific schedules for, regulation by the FIEA in Japan and by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in the United States are being worked out. In this situation, the U.S. Commodities Futures Trading Commission (the "CFTC") announced an interpretive guidance on application of derivatives regulations to cross-

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border transactions (the "CFTC Guidance").[1] The CFTC Guidance is of significance in that it was the first guidance explicitly presented by the regulatory authorities of one of the leading economic powers. And it has triggered specific arguments over how to deal with extraterritorial application and cross-border application of a certain regulation. However, we would like to point out that its individual clauses lack consistency with the regulations of the other jurisdictions, in particular, the FIEA of Japan. And there is a risk that, in reality, applying these clauses will give rise to a range of practical problems and will eventually cause Japan's market functions to deteriorate sharply.

This letter represents a summary by the Working Group, made up of members of major participants in the OTC derivatives market in Japan, of requests made from the perspectives of participants in the Japanese market concerning extraterritorial application and cross-border application of each state's regulations on OTC derivatives. While our primary focus is placed on our concerns and requests concerning the CFTC Guidance that has recently been published, we draw to your attention the fact that the European Market Infrastructure Regulation (the "EMIR") whose detailed provisions are scheduled to be established in Europe next year and thereafter potentially poses problems comparable to those posed by the CFTC Guidance. Hence we have added our concerns and requests concerning the EMIR in this document as well.

Given this awareness of problems, we strongly request that the FSA works together with the regulatory authorities of major economic powers including the United States to establish specific rules for introducing coherent regulations and takes the measures necessary therefor.

1. Specific Concerns over Cross-Border Transactions

If any relevant clause of the CFTC Guidance or the EMIR were actually applied, we are concerned that the problems described below could realistically occur:

(i) Problem associated with registration of Swap Dealers (SDs) and Major Swap Participants (MSPs)

According to the CFTC Guidance, if the aggregate amount of swap transactions of a non-U.S. person with U.S. persons exceeds $8 billion (de-minimis threshold) over a period of 12 months, the said non-U.S. person would be obligated to register as an SD and would consequently be obligated to meet relevant entity-level requirements[2]. However, for all practical purposes, it would be impossible or difficult for many Japanese market participants to deal with such obligation to register as SDs or to meet the entity-level requirements associated with the said registration. Consequently, many Japanese market participants are likely to sidestep

[1] Commodities Futures Trading Commission, "Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act; Proposed Rule", Federal Register Vol. 77, No. 134, July 12, 2012

[2] However, substituted compliance would be allowed.

transactions with U.S. market participants in order to avoid the risk of having to register as SDs.

(ii) Practical problems associated with central clearing

If the requirement for central clearing becomes effective under the regulations of both Japan and the United States, and if the CFTC Guidance is actually put into practice, the following problems associated with central clearing are likely to occur[3].

Example 1: If the Tokyo branch of a U.S. bank conducts a JPY interest rate swap transaction with a U.S. person (such as the head office of a U.S. bank or U.S. securities firm, the U.S. subsidiary of a Japanese bank or Tokyo branch of another U.S. bank), the said Tokyo branch would be obligated to centrally-clear under the Dodd-Frank Act. However, the said Tokyo branch is a Registered Financial Institution in Japan and would not be allowed to centrally-clear the said transaction through LCH or any other overseas clearing organization (which is not authorized as Foreign Financial Instruments Clearing Organizations). It is possible for the said Tokyo branch to clear through the Japan Securities Clearing Corporation ("JSCC"), which is a licensed Financial Instruments Clearing Organization, but the JSCC is not registered as a Derivatives Clearing Organization ("DCO") under the Dodd-Frank Act and is not subject to exemption. Hence, the Tokyo branch would not be able to fulfill its obligation under the Dodd-Frank Act to clear through the JSCC. As a result, for all practical purposes, the Tokyo branch would find it impossible to conduct any JPY interest rate swap transaction with any U.S. person.

Example 2: If a Japanese bank conducts a JPY interest rate swap transaction with the Tokyo branch of a U.S. bank, the said transaction would be subject to the requirement for central clearing in Japan. Meanwhile, under the Dodd-Frank Act, the said transaction is one conducted between an overseas branch of a U.S. bank and a non-U.S. person and, albeit subject to the one-year deferment measure, and would ultimately be subject to the requirement for central clearing. However, as the JSCC is not registered as a DCO under the Dodd-Frank Act or is not subject to exemption, clearing through the JSCC would not enable the said Japanese bank to fulfill its requirement for central clearing under the Dodd-Frank Act. At the same time, as LCH or any other overseas clearing organization is not licensed as a Foreign Financial Instruments Clearing Organization under the FIEA, clearing through LCH would not enable the said Japanese bank to comply with the requirement of central clearing, either. As a result, for all practical purposes, the said Japanese bank would find it impossible to conduct any such transaction.

[3] The major premises here as follows: (i) JPY interest rate swaps are included as part of those instruments subject to the requirements for centralized clearing under the Dodd-Frank Act; (ii) Overseas clearing organizations including LCH are not licensed as Foreign Financial Instruments Clearing Organizations under the FIEA; (iii) The JSCC is not registered as a DCO under the Dodd-Frank Act and is not subject to exemption; and (iv) For the purposes of CFTC's rules on extraterritorial application, neither a deferment measure nor substituted compliance is applied to transactions between an offshore branch of a U.S. bank and a U.S. person, whereas the one-year deferment measure is applied to transactions between a offshore branch of a U.S. bank and a non-U.S. person, and substituted compliance would be applied after expiration of the said deferment measure.

Meanwhile, the EMIR may also give rise to practical problems such as those described below[4]:

Example 3: The Tokyo branch of a European bank, as a Registered Financial Institution, would be obligated to clear through the JSCC with respect to its JPY interest rate swap transactions that it may conduct with Financial Instruments Business Operators ("FIBOs"). But, at the same time, it would be prohibited under Article 25(1) of the EMIR from performing central clearing through the JSCC, which is a CCP established outside of Europe. In addition, the said Tokyo branch and FIBOs as counterparties would not be allowed to clear through LCH or any other CCP which is not licensed as a Foreign Financial Instruments Clearing Organization under the FIEA. As a result, for all practical purposes, the said Tokyo branch would find it impossible to conduct any JPY interest rate swap transaction with any FIBO.

Example 4: If the head office of a Japanese bank conducts a JPY interest rate swap transaction with a European branch of another Japanese bank, the said head office would be obligated to centrally-clear under the FIEA. However, the said head office would be prohibited under Article 25(1) of the EMIR from performing central clearing through the JSCC which is a CCP established outside of Europe. In addition, as LCH or any other CCP in Europe is not licensed as a Foreign Financial Instruments Clearing Organization under the FIEA, the said head office would not be allowed to perform central clearing through LCH or any other European CCP. As a result, for all practical purposes, the said head office would find it impossible to conduct any such transaction with any European branch of another Japanese bank.

Thus, if the relevant clauses of the CFTC Guidance and/or the EMIR are applied as-is, many Japanese market participants may sidestep transactions with U.S. market participants in order to avoid the SD registration requirements. In addition, because practical problems as demonstrated in the foregoing examples would arise, many market participants, irrespective of whether they are Japanese, American or European, would, for all practical purposes, find it impossible to conduct the specified transactions. Furthermore, market participants would be forced to incur additional costs to build administrative and management structures for dealing with the dual regulatory regime, which would cause market transaction costs to rise and would eventually cause market transactions to stagnate.

If there are uncertainties about the SD registration requirements and about application of substituted compliance concerning entity-level requirements and transaction-level requirements, the abovementioned tendency may accelerate faster than expected as market participants may have a great deal of suspicion and take a risk-adverse stance. In Japan, regulations are to be introduced in November 2012 in a phased-in manner, where the initial scope of FIBOs subject to

[4] The major premises here are as follows: (i) EMIR's Article 25(1) "Prohibition against non-EU CCPs providing clearing services in the EU" is enforced, and branches outside of Europe of European banks and European branches of Japanese banks would be subject to the said provision; (ii) The JSCC is not recognized by the European Securities and Markets Authority (ESMA); and (iii) Europeans CCPs including LCH are not licensed by the FSA as Foreign Financial Instruments Clearing Organizations.

the obligation for central clearing and targeted transactions would be defined relatively narrowly. In contrast, we are concerned that exterritorial application of the regulations in the United States and Europe would cause FIBOs and transactions not initially subject to the requirement for central clearing under the FIEA to become subject to the U.S. and European regulations, thereby most probably creating huge confusion among Japanese market participants. These moves are likely to seriously impair not only the market functions in Japan but also the risk management capability of Japanese market participants.

2. Requests

Based on the abovementioned awareness of problems, we request that the FSA and overseas regulatory authorities the following issues:

2-1. CFTC Guidance and Deferment Measure

General Arguments

(1) uniform measure to defer application to cross-border transactions inG20 jurisdictions:

Each country should mutually limit the scope of application of its regulations to domestically booked transactions (the so-called “onshore-onshore transactions”), and not apply regulations to “onshore-offshore transactions” until G20 regulatory authorities agree on rules for regulating cross-border transactions. (Refer to (3) below.)

(2) Flexible operation of substituted compliance at national level:

In applying regulations to “onshore-onshore transactions” in each country for the time being, for example, Japanese and U.S. regulatory authorities should implement comprehensive measures for substituted compliance on the basis of a government-to-government agreement rather than on the basis of piecemeal applications by financial institutions, from the perspective of avoiding duplication of regulations applied to transactions conducted by the U.S. branch of a Japanese bank or the Japanese branch of a U.S. bank

(3) G20 agreement on rules for extraterritorial application:

G20 regulatory authorities should discuss and assure international consistency, prepare detailed rules for regulations on cross-border transactions by considering market environment of each country (market size and magnitude of systemic risk), and implement regulations for each country by expanding the scope of application to “onshore-offshore transactions.”

Specific Arguments

(1) Application of entity-level and transaction-level requirements outside of the United States

(i) Application to non-U.S. persons that are not registered as SDs or MSPs:

The CFTC Guidance stipulates that some of the transaction-level requirements (including central clearing and electronic trade execution) would be applied to non-U.S. persons that are not registered as SDs or MSPs if their counterparties are U.S. persons. This means that the U.S. regulations would be applied to offshore juridical persons whose businesses are not registered in the United States, which is inappropriate. Such excessive extraterritorial application should be prohibited.

(ii) Application to offshore affiliates of U.S. persons that are not registered as SDs or MSPs:

The CFTC Guidance reads as if the entity-level and transaction-level requirements of the U.S. could be applied to offshore affiliates of U.S. persons even if they are not registered as SDs or MSPs. If this interpretation is correct, then this would mean that the U.S. regulations would be applied to offshore juridical persons whose businesses are not registered in the United States, which is inappropriate. Such excessive extraterritorial application should be prohibited.

(iii) Application of entity-level and transaction-level requirements to non-U.S. SDs:

If an SD that is a non-U.S. person is a FIBO in Japan, from the perspective of avoiding duplication of regulations, the entity-level and transaction-level requirements of the United States should not be applied.

(2) Substituted Compliance

(i) Comprehensive application of substituted compliance:

Under the CFTC Guidance, each juridical person is supposed to submit an individual application for substituted compliance to the CFTC and, in the case of transaction-level requirements, the CFTC grants approval for each and every requirement. However, it would not be proper for juridical persons outside of the U.S. falling under the category of FIBOs in Japan or offshore branches of U.S. banks conducting transactions outside of the United States to perform application procedures individually. A comprehensive agreement should be reached between the Japanese and U.S. regulatory authorities, and substituted compliance should be applied uniformly to all FIBOs. In addition, the fact that applicability of substituted compliance would be determined for each and every item of transaction-level requirements is deemed to be irrational if we remember that it would only make sense if these requirements were applied in an integrated manner. With respect to the transaction-level requirements, substituted compliance should be approved comprehensively on the basis of compliance with regulations under the

FIEA.

(ii) Conclusion of MOUs between regulatory authorities:

Under the CFTC Guidance, procedures on application for substituted compliance are premised upon conclusion of MOUs (or contracts of a similar nature) with overseas regulatory authorities. We request that the FSA conclude MOUs with the U.S. regulatory authorities (CFTC and SEC) as early as possible with a view to promptly eliminating Japanese market participants' concerns about application of substituted compliance to Japan.

(iii) Order of priority in negotiating for MOUs:

We request that the FSA negotiate with CFTC on substituted compliance by placing the highest priority on the treatment of central clearing in particular and have CFTC acknowledge comparability without getting overly concerned about the difference in the scope of application of the requirement for central clearing. We would also like the FSA to prevent CFTC from refusing to approve substituted compliance on the grounds of the time lag in implementation (in or around 2015) of electronic platform-based transactions given the current state of the Japanese market, limitation of the scope to FIBOs, non-establishment of requirements for real-time reporting, and such like. With respect to margin regulations, we are aware that the Japanese regulatory authorities have not yet set a firm an implementation schedule, but request that the FSA define a direction to head in as soon as possible and create a favorable environment for the CFTC to approve substituted compliance.

(3) Mutual approval of clearing organizations

(i) Registration of the JSCC as DCO:

We request that the FSA actively urge the CFTC to allow the JSCC to be registered as a DCO as soon as possible in order to ensure that suspension of interest rate swap transactions and any other similarly undesirable situations will be avoided.

(ii) Approval of major overseas clearing organizations as "Foreign Financial Instruments Clearing Organizations":

We request that, concurrently with the foregoing efforts, the FSA actively work to grant approval of the status of "Foreign Financial Instruments Clearing Organizations" to major U.S. and European CCPs (including LCH and CME), Asian CCPs (including SGX, HKEX and KRX) and other major overseas clearing organizations.

(4) Registration of SDs and MSPs

(i) Duplication of business registration in Japan and the United States:

Notwithstanding the fact that the FIBOs whose businesses are registered under the FIEA in Japan are already fully subject to the Japanese OTC derivatives regulations, they would be simultaneously obligated to obtain registration as SDs in the United States under the CFTC Guidance if they fulfill certain specific standards. We request that the FSA negotiate with a view to preventing both the Japanese and U.S. regulatory authorities from imposing double regulations on the same entities.

(ii) Request for deferment of deadline for registration of non-U.S. persons as SDs:

Under the CFTC Guidance, the deadline for registration of both U.S. persons and non-U.S. persons is uniformly set for October 12, 2012 (or the day 60 days after the final definition of the term "swap"). However, as the rules for extraterritorial application including the particulars of substituted compliance are not yet set, it is impossible to deal with this matter within the current time frame. The deadline for registration of non-U.S. persons as Swaps Dealers should be deferred by at least one year or until such time as satisfactory coordination on cross-border regulation is reached between the Japanese and U.S. regulatory authorities.

(iii) Addition of transactions of affiliates under the control of an identical entity to the threshold value for registration of an SD:

The CFTC Guidance stipulates that for the purpose of calculating the threshold value for registration of an SD, transactions of non-U.S. affiliates under the control of an identical entity with U.S. persons, and transactions whose debt obligations are guaranteed by U.S. persons should be added up. Although the phrase "under the control of an identical entity" and the term "affiliates" are not clearly defined, the objects of the said addition should be limited to "subsidiaries" (while the so-called "fellow subsidiaries" are to be excluded). In combining the threshold value for affiliates under the control of an identical entity, the volume of transactions of affiliates registered as SDs should be excluded from the scope of addition.

(iv) Non-inclusion of transactions conducted by a Japanese subsidiary of a U.S. person through intermediation or agency into the threshold value for registration of an SD:

The CFTC Guidance stipulates that for the purpose of calculating the threshold value for registration of an SD, transactions conducted by an overseas juridical person as an affiliate of a U.S. person through intermediation to a U.S. person or agency for a U.S. person should be included. In the case of intermediation or agency form, it is not made entirely clear whether or not only transactions with U.S. persons should be included or whether or not transactions with non-U.S. persons should also be included. However, the objects of the said inclusion should be limited to the threshold value for registration of an SD for a U.S. person who has delegated as the said intermediation or agency (and should be excluded from the threshold value for registration of an SD for an overseas juridical person who has delegated the said intermediation or agency).

(v) Non-inclusion of transactions of non-U.S. persons with a Japanese branch of a U.S. SD in the threshold value for registration of an MSP:

The CFTC Guidance proposes that transactions of non-U.S. persons with an offshore branch of a U.S. SD be not included in the threshold value for registration of an SD but makes no proposal about whether or not such transactions should be not included in the threshold value for registration of an MSP[5]. If such transactions are not included in the threshold value for registration of an SD on the one hand and are included in the threshold value for registration as an MSP on the other, non-U.S. persons may consider distancing themselves from transactions with Japanese branches of U.S. SD. Hence the CFTC Guidance should propose that transactions of non-U.S. persons with offshore branches of U.S. SDs should also be not included in the threshold value for registration of an MSP.

(vi) Clarification of "Dealing Activity":

Under the CFTC Guidance, whether or not a certain transaction constitutes a "Dealing Activity" is considered to be an important point for the purpose of determining the threshold value. However, safe harbors and such like are not clearly indicated. As a result, non-U.S. persons may uniformly try to stay away from those transactions with U.S. persons which are not clearly identified as "Dealing Activity" or otherwise, or may overreact to such transactions in a similar manner. Typical transactions not subject to regulation should be clarified by indicating safe harbors therefor.

(5) U.S. person versus non-U.S. person

(i) Distinction of a U.S. person from a non-U.S. person:

Given the fact that the definition of a U.S. person given in the CFTC Guidance remains conceptualistic and vague, in practical operation in the marketplace, it is practically difficult to conduct a transaction by instantaneously distinguishing between a U.S. person and a non-U.S. person. As a result, non-U.S. persons may concurrently sidestep transactions with counterparties who are suspected of being U.S. persons for fear of their own SD registration risk or application of U.S. regulations, or may otherwise overreact in a similar manner, thereby ultimately causing a contraction of market transactions. For the purpose of regulating cross-border transactions, the relevant rules should not be made on the basis of the concept of a U.S. person versus a non-U.S. person. Instead, a framework of rules should be built in which substitutability of various countries' regulations would be broadly acknowledged and all transactions would be covered by any one of such regulations.

[5] Comments are being sought as to whether or not this should be included in Q4 of p. 31.

(ii) Clarification of treatment of a U.S. branch of a non-U.S. person:

Under the CFTC Guidance, a U.S. branch of a non-U.S. person is presumed to be treated as a non-U.S. person, but there is no clear-cut rule. It should be made clear that a U.S. branch of a non-U.S. person would be treated as a non-U.S. person.

2-2. Extraterritorial Application of European Regulations

(1) Early announcement of guideline for extraterritorial application:

No specific guideline for extraterritorial application of the European regulations has yet been announced. However, we understand that if either one of the counterparties is an EU person, EU's regulations would probably be applied to the other counterparty who is a non-EU person. Assuming that the European regulatory authorities plan to announce their own rules on extraterritorial application, we request that the FSA urge the Europeans to announce such a plan as early as possible.

(2) Mutual approval of clearing organizations:

If offshore branches of European banks are to be subject to the EMIR Article 25(1) "Prohibition against non-EU CCPs providing clearing services in the EU," the said prohibition would exert a material influence on the Japanese market. In addition, if the ESMA's approval of the JSCC is not forthcoming, European banks planning to participate in the JSCC through their head offices and branches within the EU would be unable to conduct transactions with Japanese financial institutions. Hence we request that the FSA actively urge the ESMA to approve the JSCC and the FSA approve the LCH and other overseas clearing organizations as "Foreign Financial Instruments Clearing Organizations."

End