

OTC Derivatives Regulation in Japan

Improving the Stability and Transparency of
OTC Derivatives Markets

17 October 2011

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Government of Japan**

Policy Background and Regulatory Framework

LEADERS' STATEMENT AT THE PITTSBURGH SUMMIT (24–25 September 2009)

Strengthening the International Financial Regulatory System

*“Improving over-the-counter derivatives markets: **All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories.** Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse.”*

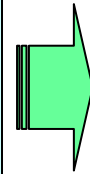
AMENDMENT TO THE FINANCIAL INSTRUMENTS AND EXCHANGE ACT (Approved by the Diet on 12 May 2010; Promulgated on 19 May 2010)

To improve the stability and transparency of OTC derivative transactions:

- **Mandatory CCP clearing for high trade volume products**
- **Mandatory clearing by domestic CCPs for derivative trades that are closely linked with Japan's bankruptcy regime**
- **Storing and reporting of trade information**

Mandatory CCP Clearing

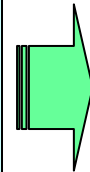
For actively traded OTC derivatives, where the reduction of clearing and settlement risk through use of CCP would contribute to the stability of Japanese market
(e.g., “plain vanilla” type interest rate swaps)



Due to extensive cross-border trade relationships, mandatory CCP clearing may be undertaken by:

- Domestic CCP
- Foreign CCP
- Domestic CCP and foreign CCP under an interoperability arrangement

For OTC derivatives where the clearing criteria relates closely to the corporate bankruptcy criteria under the domestic law
(e.g., “iTraxx Japan” CDS index)

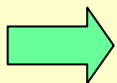


Mandatory clearing by a domestic CCP

CDS

In determining whether a credit event has occurred, local commercial and legal practices, including court decisions made under the Japanese bankruptcy law, need to be taken into account.

Whilst respecting an internationally adopted protocol among contractual parties concerning the determination of a credit event, domestic CCPs should also be appropriately involved, and to be able to reflect their views concerning the determination.



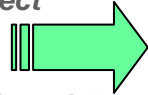
Centrally cleared by domestic CCPs

Strengthening the CCP Infrastructure

Improving the financial strength of domestic CCPs

[Previous regulation]
No restrictions on major shareholders and no minimum capital requirements for CCPs

Considering the importance of CCP as an infrastructure to protect



against risk spreading within the financial system

[Revised regulation]

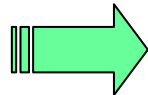
- **Authorization requirement for shareholders intending to hold more than 20% by voting rights of the CCP**
- **Minimum capital requirement**

Enabling foreign CCPs to enter the Japanese market

[Previous regulation]
Central clearing of financial instruments trades were permitted only by domestic CCPs

* *Provision of central clearing services by foreign CCPs to domestic financial institutions were prohibited*

In consideration of the fact that, among financial institutions in Japan,



trade relationships exist across nations

[Revised regulation] Introduction of new regimes

■ **LINK BETWEEN INTEROPERABLE CCPS**

Subject to authorisation regime

Requirements:

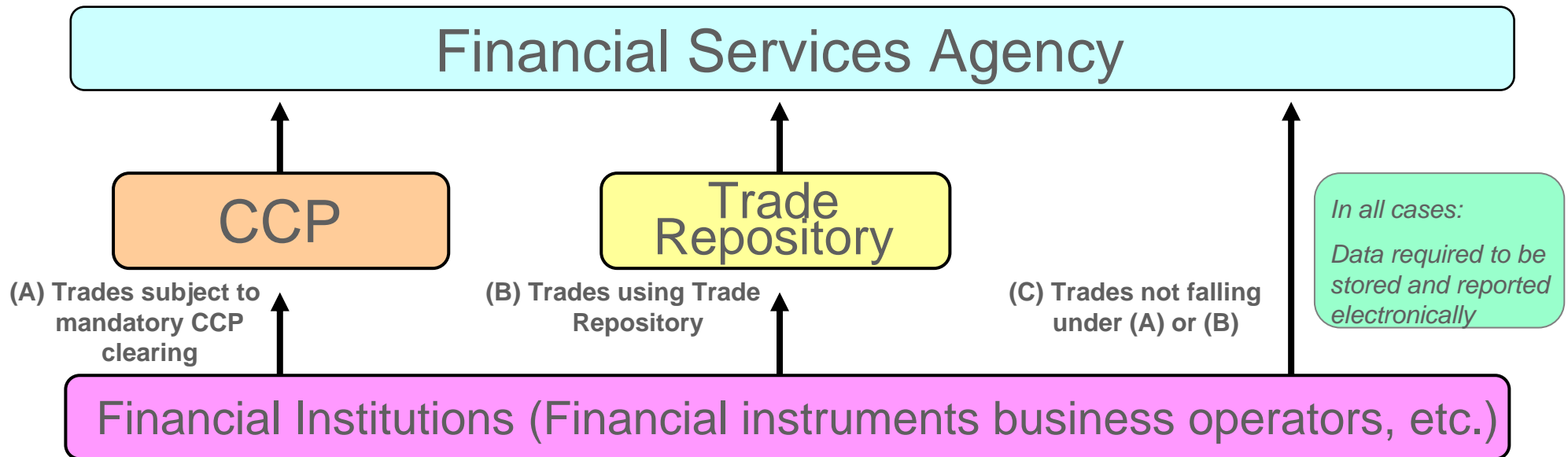
- *Need to maintain an adequate infrastructure to operate appropriately and reliably during Japanese market hours*
- *Linked foreign CCP is subject to full supervision by its primary regulator*

■ **DIRECT ENTRY**

Subject to licencing regime

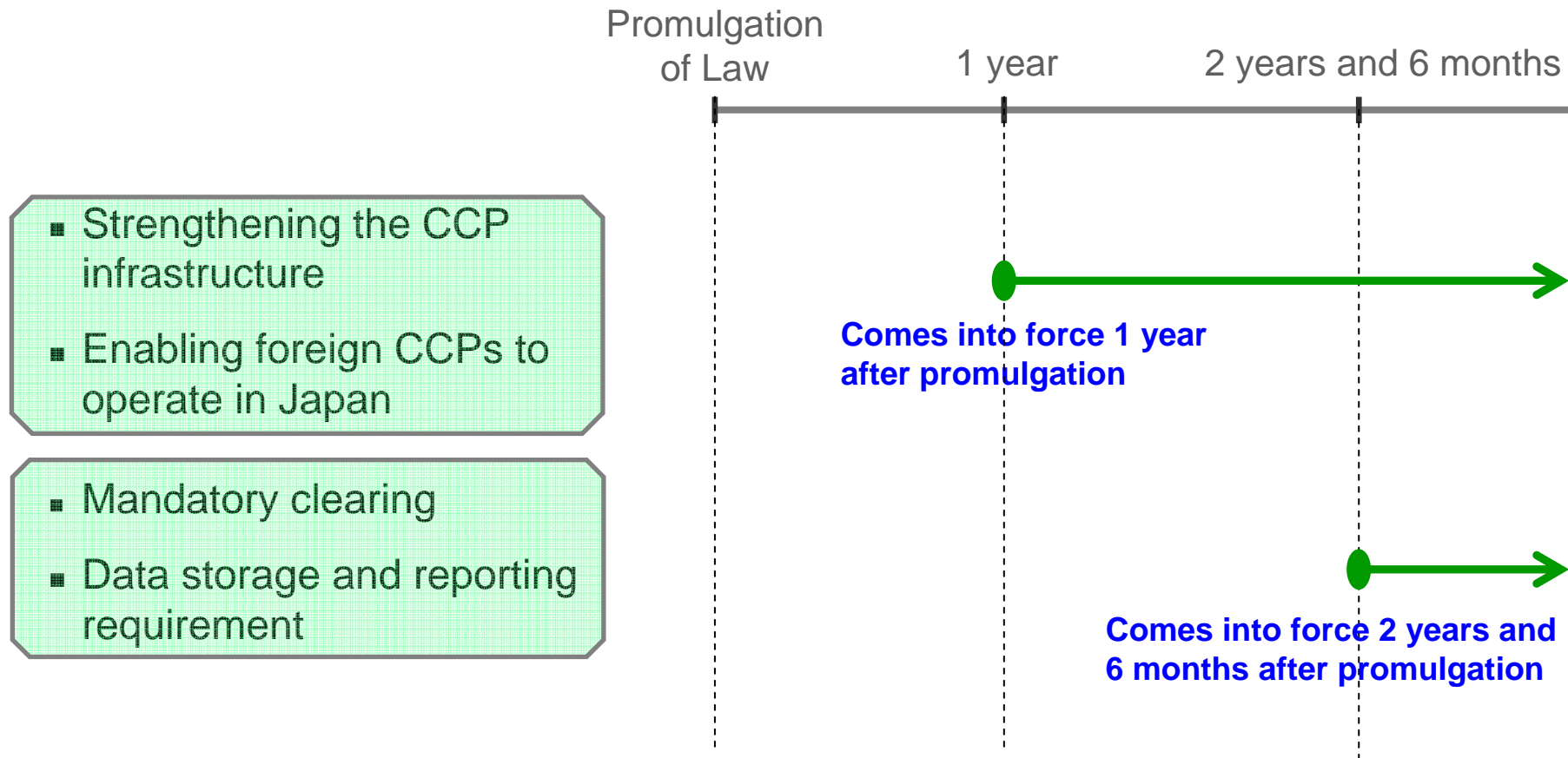
Need to satisfy the above requirements; same regime as for domestic CCPs is applied to foreign CCPs

Storing & Reporting of OTC Derivatives Trade Information



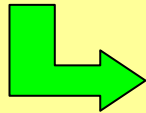
- I. For trades that are subject to mandatory CCP clearing, CCP stores the trade information and reports them to the regulator
- II. Designation of trade repositories (TR) by public notice
Designated Domestic TR: Designated upon an application by the TR
Designated Foreign TR: Designated if an international cooperative supervisory framework is established and is compliant with the domestic reporting regime
- III. Financial institutions can report trade information through TRs or directly to the regulator
- IV. Domestic TRs are required to store and to submit trade information to the regulator

Schedule for Implementation

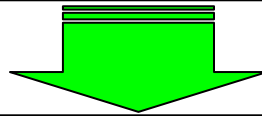


Current Regulatory Issues

- OTC derivative products are frequently traded across different jurisdictions
- Regulatory arbitrage may occur and therefore there is a need to limit these activities to maintain the stability of the financial system



Need for international coordination / cooperation



A Participating in multilateral policy discussions

- G20 / FSB
- IOSCO Task Force on OTC Derivatives Regulation: international standards setting
- CPSS-IOSCO: "Principles for Financial Market Infrastructures"
- Others (on matters regarding CCP access, links and non-CCP cleared contracts)

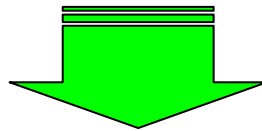
B Promoting cooperation between authorities

- Seeking consistencies with Dodd Frank Act, EMIR and MiFID, etc.
- International supervisory cooperation on foreign TRs

Current Regulatory Issues in Japan

OTC Derivative Regulation in Japan – Current Issues

- (1) Take into account the characteristics of Japanese market (e.g., large proportion of the trades are cross-border with a limited number of global counterparties)
- (2) Create a robust market infrastructure
- (3) Envisage future development of the Japanese OTC derivatives market



A Multi-stage application of regulations

- Scope of central clearing
- Storing and reporting of trade data
- Electronic trading platform

B Practical matters – current status

- Commencement of CCP clearing for CDS by JSCC (July 2011)
- Preparing for the establishment of interest rate swap CCP by JSCC (Nov 2012)
- Encouraging financial institutions in Japan to report to TRs

For Further Information

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