OTC Derivatives Regulatory Reform in Japan
: FSA Reveals More Details

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I. OTC Derivatives Regulation Review Panel releases report

On 26 December 2011, the Financial Services Agency's OTC Derivatives Regulation Review Panel released a report on the issues it discussed regarding trading in over-the-counter (OTC) derivatives, namely the mandatory use of central counterparty (CCP), the obligations to store and report trading information, and the requirement to trade using electronic trading platforms (ETPs, described below)[1].

The reform of Japan's regulation of OTC derivatives had already begun with the May 2010 Amendment to the Financial Instruments and Exchange Act (FIEA), which sets forth the requirement to clear OTC derivative trades on a CCP, as well as the requirements for storing and reporting data on those trades. This revision of the FIEA is consistent with the agreement by G20 leaders at the Pittsburgh Summit in September 2009 that "All standardised 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," and that "OTC derivative contracts should be reported to trade repositories." Nevertheless, because not much headway has been made at the global level on this requirement to trade on electronic trading platforms, and because Japan's market for such trades is not large, the writing of specific regulations was deferred.

Requirements will be put in place in the US to use swap execution facilities (SEFs) as ETPs, while in Europe it was proposed that organized trading facilities (OTFs) be used, in both cases together with exchanges[2].

In addition, the International Organization of Securities Commissions (IOSCO), a grouping of the authorities that regulate securities in each country, released a report in February 2011 spelling out the significance and purpose of requirements to trade on an ETP, noting that they could (1) possibly reduce trading costs and improve liquidity,

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1 See http://www.fsa.go.jp/news/23/syouken/20111226-3.html (in Japanese).
2 For more on reforms of OTC derivative regulations in the US, see Shogo Isobe, *Beikoku no OTC Deributibu Kiseikaikaku—Kaikaku no Zentaizou to Kadai* (OTC derivatives regulatory reform in the US—Big picture and challenges), Nomura Capital Market Review, Winter 2012 issue (in Japanese).

(2) mitigate systemic risk by diversifying market participants, and (3) achieve greater trade transparency and the oversight of unfair trades by regulators[3].

In addition to these moves internationally, within Japan, in response to the growth in the notional amounts outstanding of OTC derivative contracts to US$56.2 trillion as of end-June 2011 (up 92% from end-2008), the FSA established the OTC Derivatives Regulation Review Panel in November 2011 to create detailed OTC derivative rules as required by the amended FIEA and to look at introducing a requirement to trade on an ETP[4]. In this report, we look at the Review Panel's report with an eye on the broad direction of Japan's reform of OTC derivative regulations.

II. Overview of Japan's OTC derivative regulatory reform

Credit default swap (CDS) markets, which had grown rapidly in Europe and the US, experienced an increase in counterparty risk and extreme drop in market liquidity during the financial crisis because market participants lost trust in each other's financial soundness. Regulators were caught flat-footed because they were unable to get an accurate picture of market participants' credit exposure.

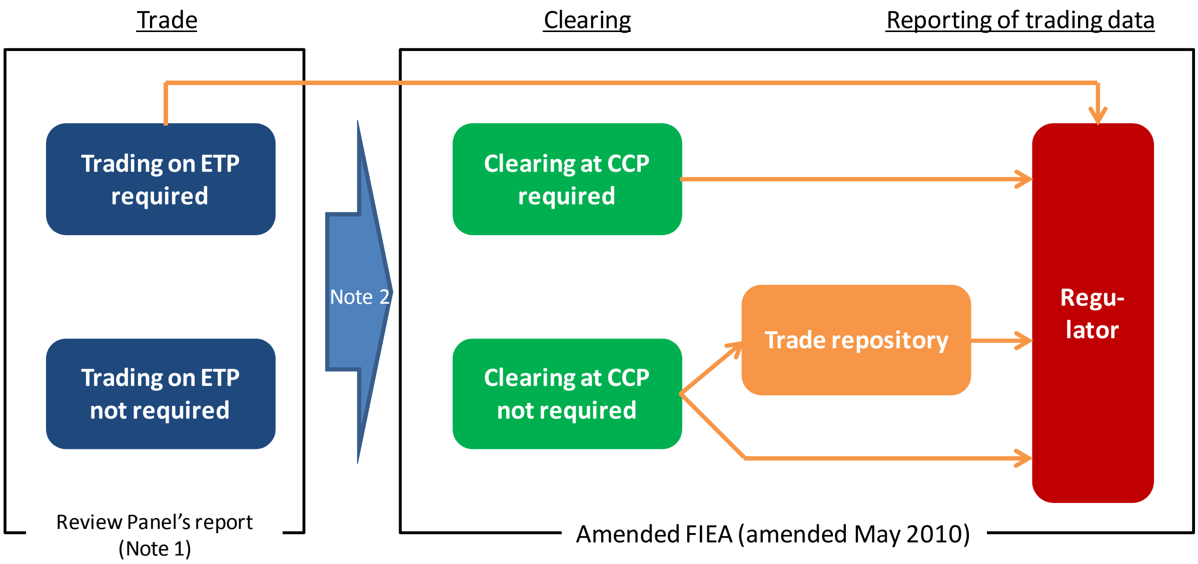
The amended FIEA attempts to mitigate the counterparty risk from CDS and other OTC derivative contracts likely to create systemic risk by requiring clearing at a CCP (Figure 1). The new law also requires CCPs to report the trading information stipulated by Cabinet Office Ordinance to regulators. On the other side, financial instruments business operators (FIBOs), etc. are required to report trading information stipulated by Cabinet Office Ordinance to trade repositories, or directly to regulators for those trades not subject to the CCP requirement. The trade repositories pass on to regulators the trading information reported to them by the FIBOs and others.

The Review Panel has indicated it plans to phase in these regulations (Figure 2). It has also indicated that it is appropriate to require ETP trading of trades between two large-volume FIBOs and the like of OTC derivatives cleared at a CCP that meet certain levels of standardization and liquidity.

Hereafter FSA plans to formulate a Cabinet Office Ordinance detailing the mandatory use of CCPs and the obligations to store and report trading information, and also to further amend the FIEA to spell out the requirement for ETP trading.

[3] IOSCO, Report on Trading of OTC Derivatives, 18 February 2011
[4] The Review Panel has 16 members, coming from financial institutions, a CCP, a settlement institution, a systems company, universities, and a law firm.

Figure 1: The trading process under Japan's OTC derivative regulations



Note: 1. The Review Panel's report also provides details on the mandatory use of CCPs and the obligations to store and report trading information.
2. We expect the relationship between the requirement to trade on an ETP and the requirement to clear at a CCP to vary depending on the financial instrument and who is trading it.
3. The obligations to store and report trading information on those trades that are not required to be cleared at a CCP applies to trades stipulated by Cabinet Office Ordinance.

Source: Nomura Institute of Capital Markets Research, based on various data sources

Figure 2: Overview of the phased-in implementation indicated by the Review Panel

	Requirement to clear at a CCP	Obligations to store and report trading information
Initial implementation of the amended Financial Instruments and Exchange Act (by November 2012)	〈Covered instruments〉 ・ Yen-denominated interest rate swaps (plain-vanilla swaps using LIBOR to index the variable rate) ・ ITraxx Japan (investment-grade index CDS from 50 Japanese firms) 〈Covered entities〉 ・ Dealers meeting the requirements for clearing at a CCP that can operate domestically, including dealing a large volume of covered instruments (phase I)	〈Covered instruments〉 ・ Covered transactions required to be cleared at CCPs noted to the left ・ Instruments for which there exists a trade repository that handles that asset class 〈Covered entities〉 ・ CCPs ・ Type 1 FIBOs, banks that are registered financial institutions, Norinchukin Bank, and Shinkin Central Bank
Subsequent expansion of coverage being considered	〈Covered instruments〉 ・ Dollar- and euro-denominated interest rate swaps (plain vanilla) ・ Yen-denominated interest rate swaps using TIBOR to index the variable rate ・ European index CDS, North American index CDS, and single-name CDS 〈Covered entities〉 ・ Assuming that client clearing has become possible, the CCP clearing requirement will be expanded to include FIBOs, etc. deemed to have a major impact in the event of the failure of a counterparty, based on the size of transactions in instruments subject to the CCP clearing requirement (phase II). ・ While keeping an eye on the direction of international regulatory reform, add transactions with an overseas financial institution as the counterparty	〈Covered instruments〉 ・ In step with the expansion of transactions required to clear at CCPs listed on the left, expand the list of instruments with a storage and reporting requirement 〈Covered entities〉 ・ Small and medium-sized FIBOs, etc.

Source: Nomura Institute of Capital Markets Research, based on the Review Panel's report

III. Mandatory use of CCPs

The amended FIEA (Article 156-62) mandates the use of CCPs when FIBOs, etc. trade OTC derivatives stipulated by Cabinet Office Ordinance. It reflects current trading volumes and the serious impact on Japan's capital markets that the default of such contracts could have.

Specifically, when the amended FIEA goes into effect in November 2012, it will initially require clearing of iTraxx Japan CDS[5] at domestic CCPs and clearing of plain-vanilla yen-denominated interest rate swaps at domestic or overseas CCPs[6]. This appears to be on account of the FSA having decided it necessary to mitigate counterparty risk, because of concerns over the systemic risk from CDS in the case of the iTraxx Japan requirement, and because of the major overall market impact owing to the large volume of transactions in Japan[7] in the case of the plain vanilla yen-denominated interest rate swap (IRS) requirement. The amended FIEA will effectively require plain vanilla yen-denominated IRS to be cleared at domestic or overseas CCPs, owing to the large volume of cross-border transactions.

The Review Panel reaffirmed all of the above and also indicated that LIBOR would be the reference index for variable rates used in plain vanilla yen-denominated IRS subject to the CCP clearing requirement. During the initial implementation (phase I) of the amended FIEA, dealers that meet the conditions, which are consistent with the requirements for clearing through CCPs authorized to operate domestically and include handling a large volume of transactions, will be subject to the CCP clearing requirements when trading in the instruments noted above (Figure 2).

During phase II, which is set to begin roughly two years after the start of phase I, and assuming that client clearing has become possible, the CCP clearing requirement will be expanded to include FIBOs, etc. deemed to have a major impact in the event of the failure of a counterparty, based on the size of their transactions in instruments subject to the CCP clearing requirement. The Review Panel is also considering, depending on the direction of international regulatory reform, requiring trades in which the counterparty is an overseas financial institution to be cleared at CCPs.

Apart from the entities subject to the CCP clearing requirement, it also plans on reviewing as needed the types of OTC derivatives subject to those requirements after the amended FIEA takes effect. It is looking at expanding the types of interest rate swaps and CDS subject to the CCP clearing requirement, taking into account the size and degree of standardization of the transaction as well as the clearing activity at CCPs.

It also indicated it is appropriate that the CCP clearing requirement not be applied to (1) trades executed prior to the requirement going into effect, (2) intra-group

5 Investment-grade index CDS from 50 Japanese firms.

6 Clearing can also be done using a link between a domestic CCP and an overseas CCP. Both the domestic and overseas CCP must be licensed, and the link between the two must be approved.

7 As of end-June 2011, approximately 70% of Japan's OTC derivative contracts outstanding were interest rate swaps.

transactions (including overseas affiliates), and (3) trades with the Japanese government, foreign governments, the Bank of Japan, overseas central banks, or multilateral institutions.

In Japan, the Japan Securities Clearing Corporation (JSCC) began clearing the iTraxx Japan index in July 2011, and it plans to consider clearing single-name CDS, as well[8]. In the area of interest rate swaps, JSCC is now looking at clearing plain vanilla yen-denominated IRS by November 2012, when the amended FIEA goes into effect, and is putting in place the CCP systems needed when those instruments become subject to CCP clearing requirement.

IV. Obligation to store and report trading information

The amended FIEA (Article 156-63) requires CCPs to report to regulators that data stipulated by Cabinet Office Ordinance on transactions that are subject to the requirement to be cleared at a CCP. It also requires FIBOs, etc. to report information on transactions stipulated by Cabinet Office Ordinance to trade repositories or directly to regulators for those trades not subject to the CCP clearing requirement (Article 156-64). The trade repositories pass on to regulators the trading information reported to them by FIBOs and others. (Article 156-65).

The Review Panel indicated that, in addition to CCPs, it was appropriate that (1) Type 1 FIBOs, (2) banks that are registered financial institutions, (3) the Norinchukin Bank, and (4) the Shinkin Central Bank all be subject to storage and reporting requirements when the amended FIEA is initially implemented (Figure 2). This is because these institutions account for the majority of Japan's OTC derivative transactions. The FSA will consider whether to subject smaller FIBOs or other entities to the CCP clearing requirement, depending on how the situation unfolds.

CCPs are required to store and report trading information on instruments subject to the CCP clearing requirement, and the four types of market participants noted above are required to store and report trading information on instruments in asset classes handled by trade repositories. The items that must be stored and reported by these four types of market participants are in principle the same reporting items required by trade repositories[9]. Because Japan currently has no domestic trade repositories, we expect the FSA to designate as trade repositories foreign trade repositories such as the Deposit Trust & Clearing Corporation (DTCC).

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8 Takeshi Hirano, Nihon ni okeru Tentou Deributibu Torihiki no Seisan Gyoumu (Clearing services for OTC derivative transactions in Japan), Kinzai Institute for Financial Affairs, 10 October 2011

9 Currently, because trade repositories do not ask for information on market value, the Review Panel has said it will not require the reporting of market value information during the initial phase of the amended FIEA's implementation. Be aware, however, that the final rules on recordkeeping and reporting requirements issued by the US Commodity Futures Trading Commission (CFTC) in December 2011 included a requirement to report market value information to trade repositories. For more on the CFTC's final rules, see http://www.cftc.gov/PressRoom/Events/ssLINK/federalregister122011b

The FSA has indicated it is appropriate that CCPs must in principle submit reports to regulators within one business day after clearing acceptance, while the four types of market participants listed above must in principle report within one business day after concluding the contract when reporting to a trade repository and report weekly when reporting directly to regulator. For ongoing transactions that were already entered by the last day of the month prior to the amended FIEA going into effect, the four types of market participants are required to report consolidated trading information.

Regulator plan to compile the information on OTC derivative transactions they receive and publish basic information, including the total number of trades and notional amounts during the period, possibly on a monthly basis.

V. Requirement to trade on ETPs

1. Overview of electronic trading platforms

Although the amended FIEA does not require trades to be executed on an ETP, the Review Panel has indicated that such a requirement should be added in light of developments in the global debate. The Review Panel argues that the requirement to trade on ETPs would be significant in that (1) regulators would have the ability to immediately monitor the actual trades made, (2) trades based on reliable rules are important for stabilizing the market, (3) greater transparency of pricing information makes the market more efficient and leads to growth in the number of market participants, and (4) the use of electronic trading will promote the use of straight-through-processing (STP)[10].

The Review Panel defines an ETP as a system that allows OTC derivative trades to be placed and executed electronically using communications lines connecting the operator with the client. It noted, however, that to ensure the flexibility of trades, it would be appropriate to allow hybrid ETPs in which orders are accepted and matched over the phone or otherwise and then separately input and recorded electronically.

It indicated that there are two different types of operating forms for ETPs that should be approved: multi-dealer types in which the ETP operator only serves as an intermediary for OTC derivative transactions and single-dealer types in which the ETP operator takes the other side of the trade. As noted below, however, initially only trades between two large-volume market participants will be subject to the trading requirements, and thus the system will primarily cover multi-dealer trades when it is first implemented.

We note that ETPs operated within Japan are required to register as Type 1 FIBOs, and must store, publish, and report to the authorities the necessary data. It indicated that it is appropriate that ETPs operated overseas that meet certain conditions, including being registered with and being subjected to the appropriate oversight from

10 All administrative procedures from placing the trade to funds settlement are automated without human intervention.

overseas regulators, should be allowed to trade without registering as Type 1 FIBOs. The number of operators in Japan capable of becoming multi-dealer ETPs is small compared to that number in the US, so it will be interesting to see how ETPs develop moving forward.

2. Traders and instruments subject to ETP trading requirements

The Review Panel indicated that it is appropriate to require that FIBOs and registered financial institutions that handle a large turnover of OTC derivative trades be subject to ETP trading requirements during the initial phase of implementation[11]. It would require such traders to use an ETP to trade OTC derivatives cleared by a CCP that meet a certain level of standardization and liquidity. The Review Panel specifically identified plain vanilla yen-denominated interest rate swaps as falling under this category.

While noting that it made sense to extend this requirement to iTraxx Japan CDS from the perspective of ensuring fair trades, it has decided to further study the idea while keeping tabs on trading activity because of the low levels of liquidity for those trades. The Panel is also considering expanding the list of market participants subject to the ETP trading requirement as needed.

It indicated that while trading data on ETPs is published in real time, block trades should be treated differently owing to the risk that the trade will be disadvantaged because of information held by other traders, which would reduce liquidity and increase trading costs. One conceivable way to handle this, assuming that the system could be set up to keep block trades from being seen except by the several companies that have requested pricing information, would be to subject block trades to ETP trading requirements, but delay announcement of the trade order.

The Panel noted that it could take as long as three years of preparation after implementing the system to require trading on an ETP. We think this time table takes account international developments in regulatory reform. Proposed US rules detailing the requirement for trading on swap execution facilities (SEF) have yet to be finalized, while the EU requirement for trading on an organized trading facility (OTF) or exchange may not be implemented until early 2015.

11 It considers it appropriate to not require the use of ETPs by nonfinancial firms or for intra-group transactions.

VI. Developments overseas bear close watching

The structure of the OTC derivatives market, which includes many cross-border transactions, could change substantially depending on regulatory moves in each country. The deadline for implementing the G20 agreement reached at the Pittsburgh summit is end-December 2012, but the US, which should be leading the world in reforming OTC derivative regulations, is finding it difficult to craft the regulations directed by Dodd-Frank[12], while the EU has yet to pass its two proposed pieces of legislation for OTC derivatives reform. In Japan, the Cabinet Office ordinances that detail the new regulations must be put together before the November 2012 deadline for implementing the amended FIEA.

Figure 3: CCPs and trade repositories for OTC derivatives in each country

Asset class	CCPs	Trade repositories
Interest rate	LCH Clearnet, SwapClear (UK) CME Clearing (US) International Derivatives Clearing Group (IDCG) (US) Eurex (Germany) AsiaClear (Singapore) Japan Securities Clearing Corporation (JSCC) (Japan, planned) HKEx (Hong Kong, planned) Korea Exchange (Korea, planned) New York Portfolio Clearing (NYPC) (US, planned) CME Clearing Europe (UK, planned) NASDAQ OMX Swap Clear Nordic (Sweden, planned) KDPW_CCP (Poland, planned)	DTCC (UK) TriOptima (Sweden) Regis-TR (Luxembourg)
Credit	ICE Clear Credit (US) ICE Clear Europe (UK) CME Clearing (US) LCH Clearnet SA (France) Japan Securities Clearing Corporation (JSCC) (Japan)	DTCC Trade Information Warehouse (TIW) (US) Regis-TR (Luxembourg, planned)
Equity	Eurex (Germany) LCH Clearnet (UK) NYSE Liffe (UK) Canadian Derivatives Clearing Corp. (CDCC) (Canada) BM&F Bovespa (Brazil) Options Clearing Corporation (OCC) (US, planned)	DTCC Equity Derivatives Reporting Repository (EDRR) (UK) Regis-TR (Luxembourg, planned)
Commodity	CME ClearPort/CME Clearing Europe (US and UK) LCH Clearnet (UK) NYSE Liffe (UK) ICE Clear Europe (UK) NASDAQ OMX Stockholm AB (Sweden) AsiaClear (Singapore)	DTCC and EFETnet (planned) ICE (planned) Regis-TR (Luxembourg, planned)
Forex	CME Clearing (US) LCH Clearnet (UK) BM&F Bovespa (Brazil) Clearing Corporation of India (India) ICE (planned) HKEx (Hong Kong, planned)	Regis-TR (Luxembourg) DTCC and SWIFT (planned)

Note: According to a 15 August 2011 article in Risk.net, "CME, Ice to launch repositories rivaling the DTCC," the CME also plans to establish a trade repository, although it has not said which asset classes it will cover.
Source: Nomura Institute of Capital Markets Research, based on various data sources

12 For more on progress in rulemaking required by the Dodd-Frank Act, see Shogo Isobe, *Nankou suru Beikoku no OTC Deribatibu Kisei Kaikaku* (Reform of OTC derivatives regulations in the US hitting turbulence), Nomura Capital Market Review (online version), Winter 2012 issue (in Japanese).

Thus with other countries having yet to establish their regulations, participants in the Japanese market must deal with the uncertainty as to which trading infrastructures (such as CCPs, trade repositories, and ETPs) inside and outside of Japan that they can use or must use. For example, there are questions as to how these CCPs, trade repositories, and ETPs connect to each other and which country's clearing requirement take precedence when counterparties from different countries in a cross-border transaction each attempt to adhere to the clearing requirements of their home country.

Meanwhile, the players involved in trading infrastructure are already making steady progress, before the details of the new regulations have been set, and plans to establish CCPs and trade repositories are already being announced in many countries (Figure 3). Depending on the timing and content of the OTC derivative regulations implemented by the regulators of each country and on when this trading infrastructure begins operating, there is also a possibility that the pecking order among global OTC derivative markets will change. Market participants must keep a close eye not only on trends both in Japan and overseas, as well as on moves toward international harmonization among regulators.