

IN SHORT **The Situation:** The Financial Services Agency of Japan has introduced an amending ordinance regarding margin requirements for over-the-counter derivatives transactions.

The Solution: Certain financial entities not based in Japan and entering into over-the-counter derivatives transactions with Japanese financial institutions may be subject to new collateral requirements.

Looking Ahead: Similar collateral requirements have been introduced in other jurisdictions. Participants in these transactions should remain alert for new mandates that could affect them.

Following the Basel Committee on Banking Supervision and the International Organization of Securities Commissions' March 18, 2015, release of revisions to the framework for margin requirements for non-centrally cleared derivatives, the Financial Services Agency of Japan ("FSA") issued an amending ordinance regarding the margin requirements for derivatives transactions on March 31, 2016 ("Amending Ordinance"). Beginning on March 1, 2017, non-Japanese entities that entered into over-the-counter ("OTC") derivatives transactions with Japanese financial institutions may be required to provide collateral to cover their marked-to-market exposure in certain transactions. Although the Amending Ordinance also sets out other requirements, including those for initial margin, this Commentary focuses on the variation margin requirements for non-Japanese entities.

Background

The Japanese margin regulations applicable to OTC derivative transactions are mainly prescribed in the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended, "FIEA") and its ordinances. The FIEA sets out licensing requirements for securities-related and/or derivative-related businesses conducted in Japan or for the benefit of any resident of Japan by Japanese and non-Japanese firms. The FIEA also regulates the conduct of financial service providers who hold such license. Under the FIEA, there are two defined types of provider—a financial service provider ("FSP") and a registered financial institution ("RFI"). The Japanese margin regulations primarily target FSPs and RFIs only.

Margin Regulations

Certain FSPs and RFIs are subject to margin requirements under the FIEA and the Cabinet Office Ordinance on Financial Instruments Business, etc. ("Business Ordinance"). Those margin requirements are applicable only to OTC derivative transactions not cleared through a Japanese licensed clearing organization, a non-Japanese clearing organization holding a Japanese license, or a non-Japanese clearing organization designated by the Japanese regulator. As shown below, certain non-Japanese entities would be indirectly affected by these regulations.

Applicability to Non-Japanese Entities

The Japanese variation margin regulations apply only to transactions between a Japanese entity and a non-Japanese entity if the following three conditions are met:

- 1. An average aggregate notional amount of OTC derivative transactions (including centrally cleared transactions) entered into by a non-Japanese entity is not less than 300 billion Japanese yen;
- 2. The Japanese counterparty is either: (i) an FSP that has a license for Type I Financial Instruments Business or (ii) one of the banks—Shoko Chukin Bank, Development Bank of Japan, Shinkin Central Bank, Norin Chukin Bank—or insurance companies that are RFIs ("Covered FSP"); and
- 3. An average aggregate notional amount of OTC derivative transactions entered into by the Japanese counterparty (limited to OTC derivative transactions subject to mandatory clearing or reporting obligations, but excluding those made in trust accounts) is not less than 300 billion Japanese yen.

The average aggregate notional amount referred in conditions (1) and (3) above is:



FSP

a financial service provider licensed to conduct financial instruments business as defined in the FIEA.

RFI

a bank or cooperative financial institution with a license to conduct certain financial instruments business.

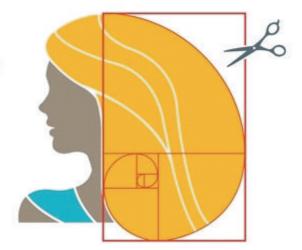
- In December, an average of the amount at the end of each month from April of the immediately preceding year to March of that year, or
- In January to November, an average of the amount at the end of each month from April of the second preceding year to March of the immediately preceding year.

In this case, the Covered FSP is obliged by the FIEA and the Business Ordinance to request the non-Japanese entity to post or collect collateral for the applicable variation margin. Therefore, the non-Japanese entity may be required to follow the Japanese variation margin requirements to the extent necessary for the Japanese counterparty's compliance with the regulations.

Where the Japanese variation margin requirements are applicable, the Japanese counterparty must: (i) calculate its exposure against the non-Japanese entity on daily basis; (ii) request the non-Japanese entity to post or collect applicable margin collateral subject to the minimum transfer amount (70 million Japanese yen or less); (iii) receive such collaterals without delay; and (iv) accept similar requests made by the non-Japanese entity. The Japanese counterparty, at its discretion, may include certain other types of derivative or other transactions into the calculation of variation margin to the extent that such inclusion will be maintained on a continuous basis.

What is a haircut ratio?

A ratio to determine the percentage of an asset's value considered acceptable as collateral.



Eligible Collateral

The Business Ordinance and relevant public notices listed a number of eligible collateral, including cash, governmental bonds, bonds issued by certain international institutions, certain corporate bonds with high ratings, certain equities, and certain investment trusts. Each category of collateral is subject to a haircut ratio that varies based upon its maturity and issuer.

Government Guideline on Margin Requirements

Notwithstanding the above regulations, according to the government guideline issued by FSA, FSPs and RFIs may be required by FSA, on a discretionary basis, to request their financial institution counterparty to post and collect appropriate margin collateral, even if the relevant transactions do not meet the conditions mentioned above. Consequently, although this guideline is not applicable to a non-Japanese entity, a non-Japanese entity may be required to post or collect margin collateral by the Japanese counterparty in order that the Japanese counterparty can comply with this government guideline.

Documentation

ISDA has identified various credit support documents to address the variation margin requirement (including regulatory margin self-disclosure letters). Each participant should carefully consider which form is best suited for its document management.

Looking Forward

From this March, similar variation margin requirements have been introduced globally, including the European Market Infrastructure Regulations (see "EMIR Variation Margin Rules Effective March 1, 2017," Jones Day Commentary, February 2017). Entities entered into OTC derivatives transactions are encouraged to pay attention if they are subject to any of the variation margin requirements.

FOUR KEY TAKEAWAYS

- 1. This *Commentary* addresses only the variation margin requirements for entities not based in Japan.
- 2. The margin regulations and collateral requirements apply only where certain conditions are met.
- Eligible collateral includes cash, governmental bonds, bonds issued by certain international institutions, certain corporate bonds with high ratings, certain equities, and certain investment trusts.
- ISDA has identified a number of support documents to substantiate that variation margin requirements are met.

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