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Financial Derivatives in Japan**

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Professor, Faculty of Law, University of Tokyo

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I Introduction

Financial derivatives are instruments whose value is based on or derived from financial assets, variables, or indexes. Derivatives transactions may be used to reallocate risk between parties. These transactions can enhance the economic and social welfare of both the parties involved when the risk exposure is transferred to a party that is presumably better able to manage it or that is willing to bear it at a lower cost than the party who transferred it. Thus far, financial derivatives transactions have mainly been developed—and financial innovation has taken place—in the over-the-counter (OTC) space, as OTC derivatives can be designed under lax regulation and as they enjoy freedom of contract. Various complicated derivatives instruments are available in the marketplace to provide hedging techniques against the risk of fluctuations in exchange rates or prices. However, it should be noted that derivatives transactions never make risk go away, but only transfer and reallocate it.

OTC derivatives can threaten the stability of the global financial system. When many derivatives transactions are contracted, cleared, and settled—not on the exchange but in the OTC space—the counterparty risk of the OTC derivatives transactions could amount to huge risk. To make matters worse, exposures in OTC derivatives are often opaque and off-balance-sheet and the interconnections among financial firms are even more unclear.¹ These disadvantages of OTC derivatives may create systemic risk.² Systemic risk is the risk that a default, liquidity squeeze, or crisis in a given market, sector, or jurisdiction will spread to other markets, sectors, and jurisdictions and eventually develop into a global financial crisis.³ This risk was realized in the recent global financial crisis of 2008 and 2009,⁴ which was triggered by the collapse of Bear Stearns, Lehman Brothers, and American International Group (AIG)⁵.

¹ V. V. Acharya/ C. Brownlees/ R. Engle/ F. Farazmand/ M. P. Richardson, *Measuring Systemic Risk*, in V. Acharya/ T. Cooley/ M. P. Richardson/ I. Walter (ed.), *Regulating Wall Street – The Dodd-Frank Act and the New Architecture of Global Finance*, John Wiley & Sons, Inc., at 368 (2011).

² OTC derivative transactions are one of the ways of interconnections of financial firms in a variety networks in bilateral and multilateral relationships and contracts between financial firms. And counterparty risk of OTC derivatives might be huge and be difficult to be well controlled, because of the reasons that I mention in the text.

³ Mario Giovanoli, *The International Financial Architecture and its Reform after the Global Crisis*, in Mario Giovanoli/ Diego Devos, *International Monetary and Financial Law*, at 6, Oxford University Press, 2010.

⁴ About the background of the financial crisis of 2008 and 2009, see D. W. Arner/ J. J. Norton, *International Responses to the Global Financial Crisis*, in J. R. Labrosse/ R. Olivares-Caminal/ D. Singh (ed.), *Financial Crisis – Management and Bank Resolution*, Infroma Law, 2009, at 16-18.

⁵ AIG was rescued by the government of the United States of America, because its

Counterparty risk can be mitigated by margin or collateral calls to cover the credit exposure when the volume of the counterparty risk exceeds the threshold. Deep out-of-the-money derivatives transactions, such as the credit default swaps (CDS) sold by AIG, can lead to defaults due to margin or collateral calls even before the events being insured against materialize.⁶ Furthermore, they have a consequent effect on the markets, since parties rush to sell trades with the debtor and buy corresponding positions with new counterparties.⁷ The financial crisis of 2008 and 2009 was exacerbated by the lack of liquidity. These problems should be resolved by the reform of regulatory and supervisory architecture in terms of OTC derivatives transactions.

The characteristics of OTC derivatives raise two important questions in the field of private law: the validity of a financial derivatives contract,⁸ and investor protection, especially when the investor is a consumer or non-professional investor. In Japan, due to the complexity of newer derivatives instruments and the lack of sophistication on the part of many derivatives buyers and, sometimes, even sellers, many derivatives buyers have failed to realize the goals of the transactions. Finally, investors have suffered huge losses mainly due to the tremendous volatility of foreign exchange rates and large obligatory close-out amounts due to cancellation. Investors have often resorted—and still resort—to litigation to try to recoup these losses. In these cases, OTC derivatives transactions may not control actual risk but may produce new risk, which would not enhance social and economic welfare.

I focus my paper on OTC financial derivatives because they are practically and theoretically important, not only in Japan, but also internationally. I first provide the statistics of financial

counterparty position was too large to be allowed to fail, while Lehmann Brothers filed for Chapter 11 bankruptcy and wound up. “Too big to fail” problem causes moral hazard and excess risk-taking.

⁶ Acharya et al., *supra* note 1, at 95-96.

⁷ Stephen J. Lubben, *Bankruptcy Code Without Safe Harbors*, 84 *American Bankruptcy Law Journal*, Apr. 2010, at 130-131.

⁸ There are also legal issues, whether financial derivatives transactions shall constitute illegal gambling under the Articles 185 and 186 of Japanese Criminal Code. These legal issues are not yet clearly resolved and remain opaque. These problems will not be handled on this paper. Financial Instruments Exchange Act stipulates that to conduct a forward contract out of the exchange in terms of the quotation of financial instruments on the exchange constitutes crime (FIEA, Art. 202 (1)). Nevertheless it becomes out of the extent of the object for punishment, as long as a party is allowed to conduct the relevant transactions as financial instruments business firm or as registered financial institution in the course of business (FIEA, Art. 202 (2)). This stipulation is generally understood as special provision with respect to gambling in the Criminal Code.

derivatives transactions (**II**), before briefly explaining the comprehensive regulatory regime of derivatives in Japan, focusing on the legislative reform of OTC derivatives regulation in the aftermath of the financial crisis (**III**). There has been little change in the regulation on on-the-exchange traded derivatives, which performed well even during the crisis.⁹ When derivatives transactions are traded on an exchange and cleared through a clearinghouse, which monitors the risk of positions of participants and imposes margins and other risk-mitigating devices, they may be more transparent and better controlled than OTC derivatives transactions. Finally, I outline the well-known recent civil litigations and discussions in Japan with regard to OTC derivatives from the civil law viewpoint (**IV**).

II Statistics

A. Global

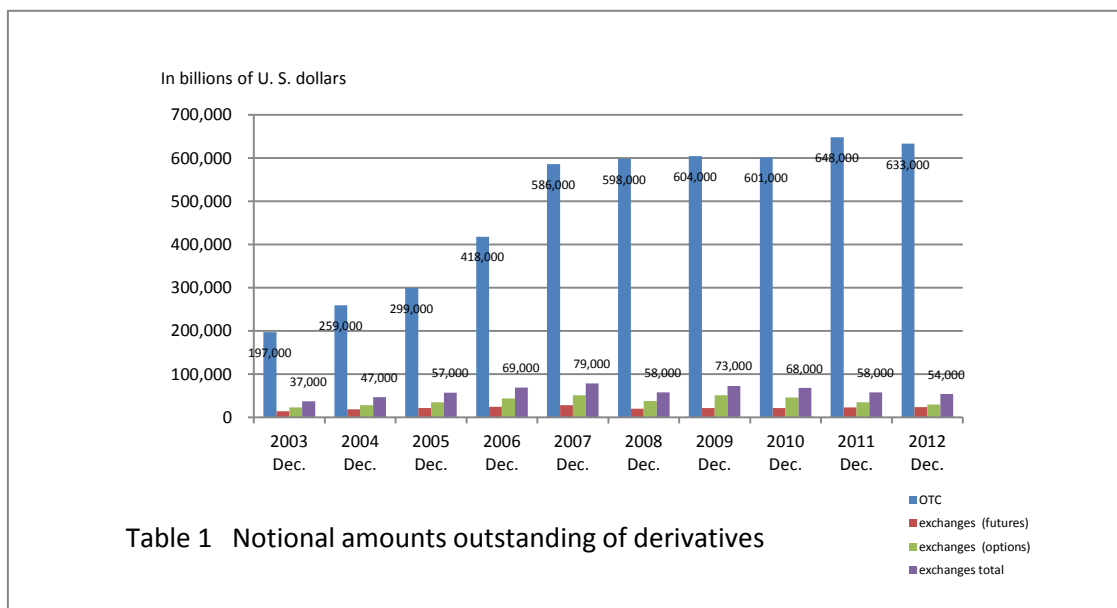
According to the Bank for International Settlements (BIS), the total notional principal of outstanding OTC derivatives contracts in December 2012 fell by 1% from the previous survey in end-July 2012, to \$633 trillion, while the gross market value amounted to \$25 trillion. OTC derivatives accounted for a significant proportion of overall banking and intermediation activity. Foreign exchange contracts amounted to \$67 trillion, interest rate contracts to \$490 trillion, equity-linked contracts to \$6 trillion, and commodity based derivatives contracts to \$3 trillion in notional principal. In the CDS market, outstanding contract volumes continued to decline, and fell by 7% to \$25 trillion—far below the end-2007 peak of \$58 trillion.¹⁰ Since 1997, when the first omens of the financial crisis appeared, the amount of outstanding notional principal stopped growing rapidly, and became steady. On the other hand, the notional principal of on-the-exchange traded derivatives has decreased consistently since 2009.

Credit exposures related to these contracts after legally enforceable netting but before collateral were steady, ending the period at 14.7% of gross market value. In the important interest rate segment of the market, offsetting changes in swaps and forward rate agreements (FRAs) that related to different aspects of central clearing did not much affect outstanding notional amounts (–1%). Swap positions fell by \$9 trillion to \$370 trillion, as compression of trades with central counterparties (CCPs) accelerated. Meanwhile, FRA positions rose by \$7 trillion to \$71 trillion, as more of these derivatives were cleared centrally, which mechanically increases contract

⁹ H. Scott/ A. Gelpert, *International Finance: Law and Regulation*, 3d. ed., Sweet & Maxwell, 14-002 at 807 (2012).

¹⁰ BIS Quarterly Review, June 2013, Table 19 A141.
<http://www.bis.org/publ/qtrpdf/r_qa1306.pdf>

volumes.

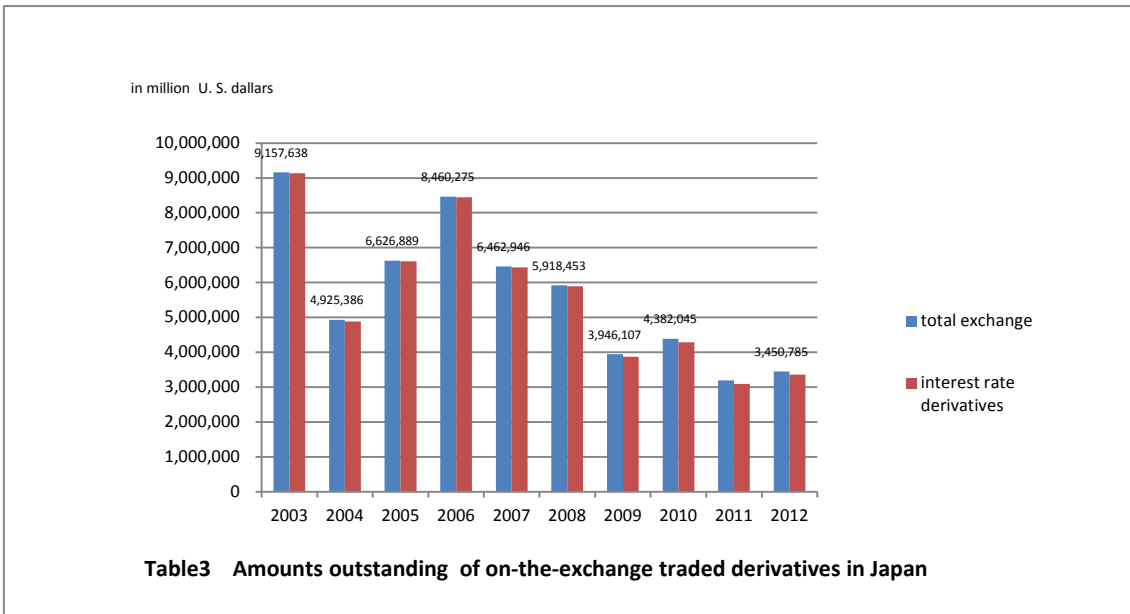
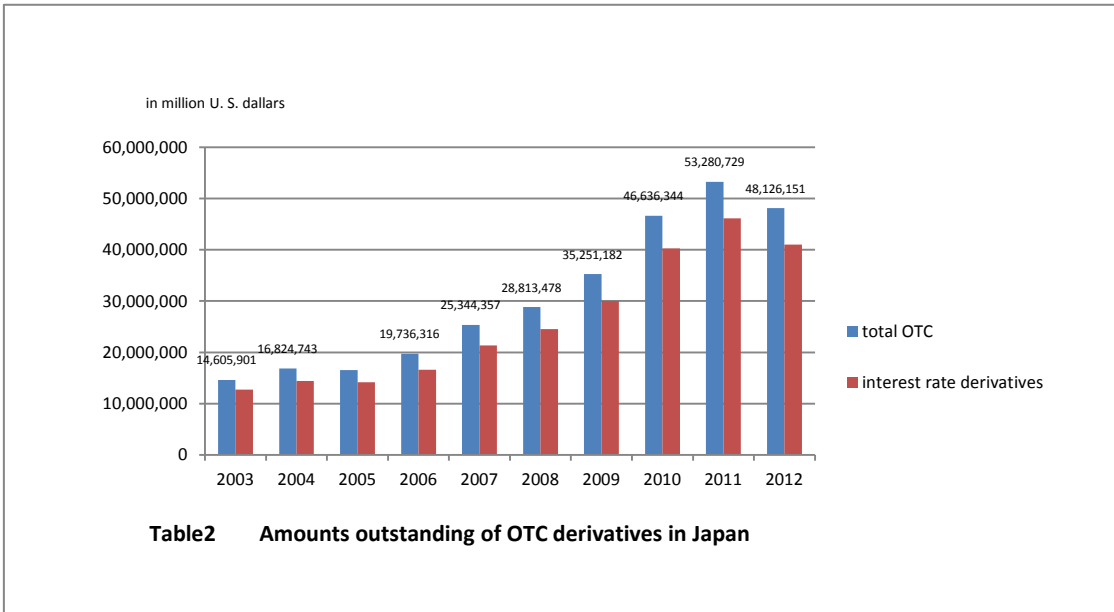


	2003 Dec.	2004 Dec.	2005 Dec.	2006 Dec.	2007 Dec.	2008 Dec.	2009 Dec.	2010 Dec.	2011 Dec.	2012 Dec.
OTC	197,000	259,000	299,000	418,000	586,000	598,000	604,000	601,000	648,000	633,000
exchanges (futures)	14,000	19,000	22,000	25,000	28,000	20,000	22,000	22,000	23,000	24,000
exchanges (options)	23,000	28,000	35,000	44,000	51,000	38,000	51,000	46,000	35,000	30,000
exchanges total	37,000	47,000	57,000	69,000	79,000	58,000	73,000	68,000	58,000	54,000

B. Japan

According to the Bank of Japan, the total notional principal of outstanding OTC derivatives contracts in December 2012 fell by 4.8% from the previous survey in end-July 2012, to \$47 trillion, while the gross market value amounted to \$0.78 trillion. Contrary to the global trend, the total notional principal of OTC derivatives transactions in Japan increased between 2007 and 2011, regardless of the financial crisis. Foreign-exchange-related derivatives contracts amounted to \$5.9 trillion, interest-rate-related contracts to \$41 trillion, and equity-linked derivatives contracts to \$0.14 trillion in notional principal basis. In the CDS market, outstanding contract volumes continued to decline. The total notional principal of outstanding contracts on-the-exchange traded derivatives contracts amounted to \$3.5 trillion, decreasing by 15.9 percent from the previous survey in end-June 2012.¹¹

¹¹ The Bank of Japan, Financial Market Department, Results of the Regular Derivatives Market Statistics in Japan (End-December 2012), March 18, 2013



III Regulation and Supervision of OTC Financial Derivatives in Japan

A. Regulatory and supervisory framework for derivatives in general

In Japan, financial derivatives are regulated by the Financial Instruments and Exchange Act

<<http://www.boj.or.jp/statistics/bis/yoshi/index.htm/>>

(FIEA), and commodity-based derivatives are regulated by the Commodity Futures Transaction Act. Formerly, the regulatory framework of derivatives in Japan consisted of three acts, namely, the Securities and Exchange Act, the Financial Futures Trading Act, and the Commodity Futures Exchange Act. The basic principle of this framework was that derivatives should be regulated and supervised according to the underlying asset from which their value was derived. Therefore, security-based derivatives were regulated by the former Securities and Exchange Act and supervised by the Financial Services Agency (FSA), and commodity-based derivatives were regulated by the former Commodity Exchange Act and supervised by the Ministry of Economy, Trade and Industry (METI) and the Ministry of Agriculture, Forestry and Fisheries (MAFF). Foreign-exchange-related and interest-rate-related derivatives involving forwards were regulated by the former Financial Futures Trading Act and supervised by the FSA.

In 2006, the former Financial Futures Trading Act of 1988 was repealed, and foreign exchange or interest-rate-related futures began to be regulated by FIEA, along with security-based derivatives. The title of the Act also changed from the Securities and Exchange Act to the Financial Instruments Exchange Act. The definition of financial derivatives by FIEA encompasses foreign exchange or interest-rate-related swaps, credit derivatives, weather derivatives, and earthquake derivatives¹²; these newer financial derivatives, which had been regulated by neither the former Securities and Exchange Act nor the former Commodity Exchange Act, became the object of regulation. The aim of FIEA is to compile comprehensive and cross-sectional rules for investor protection and to respond to the developing of newer derivatives appropriately.¹³ Newer financial derivatives such as credit default swaps were added to the list of financial derivatives regulated by FIEA. The definition of financial derivatives in FIEA will be provided in Section B.

On the other hand, the former Commodity Exchange Act continues to exist. On January 1, 2011,

¹² By the amendment of the Cabinet Order about the Financial Instrument Trading Firm of 2011 real estate based derivatives are anew regulated by FIEA.

¹³ For example under the former regulatory regime a security firm needed to be licensed to conduct the security-based OTC derivatives transactions, to be notified to conduct the foreign exchange or interest-rate-related derivatives transactions and to be approved to conduct credit derivatives transactions. Under current regulatory regime financial instrument business firm needs to be registered to conduct each of these three derivative transactions. On the other hand a bank could conduct foreign exchange or interest-rate-related derivatives transactions before the Financial Futures Trading Act of 1988 was enacted without additional approval or permission, since these derivatives transactions were thought to be essentially ancillary to banking business (Shinsaku IWAHARA, *Derivative Torihiki ni kansuru Kantoku-hô jô no Mondai* [Legal Issues regarding to the Supervisory Regulation on the Derivatives Transactions], Kinyû hô kenkyû No. 14, at 26 (1998)).

the title of the Act was changed from the Commodity Exchange Act to the Commodity Futures Trading Act, and not only on-the-exchange traded futures but also OTC commodity-based derivatives were brought under the supervision of the Act.

Why was the regulation of commodity derivatives not integrated into the FIEA, unlike foreign exchange and interest-rate-related derivatives? The lawmaker explains that commodity-based derivatives seem to be closely related to the policy in terms of the production and circulation of underlying commodities.¹⁴ However, the regulatory regime of commodity derivatives in the Commodity Futures Trading Act of 2011 was similar to that of financial derivatives, since the Commodity Futures Trading Act was modeled after the regulatory framework of the FIEA in terms of financial derivatives.¹⁵ The basic frameworks of regulation on financial derivatives and commodity derivatives in Japan are therefore almost convergent.

If both financial derivatives and commodity derivatives could be traded and cleared on the same exchange, like on the Hong Kong Exchange and the Korean Exchange, it would be convenient for investors and would improve the efficiency and liquidity of the market. On February 24, 2012, FSA, METI, and MAFF published a common statement regarding a universal exchange where financial instruments, financial derivatives, commodities, and commodity derivatives (excluding rice) can be traded. This statement includes the agenda for establishing a universal exchange and the intention to cooperation for comprehensive and effective supervision.¹⁶ Through the amendment of FIEA in 2012, the financial instruments exchange is permitted to handle commodities and commodity derivatives.¹⁷ Type-1 financial instruments business firms

¹⁴ Hidenori MITSUI/Tadakazu IKEDA (ed.), *Ichimon Ittô, Kinyû Shôhin Torihiki Hô* [One Answer to one Question: Financial Instruments and Exchange Act], at 11 and 464, Shôjihômu, 2008.

¹⁵ About the brief sketch of the history of regulation on financial derivatives transactions in Japan, see Hiroyuki KANSAKU, *Derivative Torihiki Kisei no Genjô to Kadai* [The Actual Stand and Legal Issues of Regulation on Financial Derivatives Transactions in Japan], Jurist No. 1444, at 56-58 (2012).

¹⁶ FSA, METI and MAFF, *Sôgôteki na Torihikijo Kentô Team Torimatome* [Final Report of the Working Group for the universal exchange], February 24, 2012.

¹⁷ FIEA, Article 2 (24) 3-2. A universal exchange has been realized through the extension of the definition of financial instruments and correspondingly the extension of the coverage of financial indicator and market financial derivatives transactions by the amendment of FIEA of 2012. According to the amendment financial instruments and financial indicators might encompass commodities, which are specified by a Cabinet Order as those the derivatives transactions pertaining thereto would be useful on national economy. Therefore a universal exchange is legally a financial instruments exchange, which is supervised by FSA with close cooperation of METI and MAFF. However, an exchange, where only commodities and commodity-related derivatives are traded, shall not be a financial instruments exchange (FIEA, Art.2 (14)).

are also permitted to intermediate any transaction on a universal exchange, and the clearinghouse is allowed to settle and clear any transaction on a universal exchange, regardless of the asset from which the value of the instrument is derived.¹⁸

B. Definition of over-the-counter (OTC) financial derivatives transactions in FIEA

FIEA classifies financial derivatives transactions, based on the place of the transaction, into three categories: financial market derivatives transactions,¹⁹ foreign financial market derivatives transactions, and over-the counter (OTC) financial derivatives transactions. FIEA defines over-the-counter financial derivatives transactions as the following transactions which are conducted in neither a financial instruments market nor a foreign financial instruments market.

(a) The first category is a transaction wherein the parties thereto promise to deliver or receive financial instruments or consideration for them at a fixed time in the future, and, when the resale or repurchase of the underlying financial instruments is made, settlement thereof may be made by paying or receiving the differences. Financial instruments include securities or currencies and other assets for which there are many of the same kind, which have substantial price volatility, and which are specified by a Cabinet Order as those for which it is found necessary to secure the protection of investors with regard to derivatives transactions (or other similar transactions) pertaining thereto. This definition does not include so-called standardized instruments that the financial instruments exchange has structured (FIEA, Art.2 (22) (i) and (24) (v)). Examples in this category are Forex (foreign exchange) Margin Contracts and Non-Deliverable Forwards (NDF).²⁰

(b) The second category is a transaction wherein the parties thereto promise to pay or receive

¹⁸ FIEA, Art. 28 (1) (i - ii) and Art. 156-6 (2). The definition of “financial instruments business” is also extended to encompass on-the-exchange traded commodity related derivatives transactions named “commodity-related market derivative transactions” (FIEA, Art. 2 (8) (i)). To conduct commodity-related market derivatives transactions business is under the definition of “type-1 financial instruments transactions business” (FIEA, Article 28 (1)(i - ii)). A market, where only commodity related derivatives market derivatives are traded, shall not be a “financial instruments market” (FIEA, Article 2 (14)).

¹⁹ “Market financial derivatives transactions” mean the derivatives transactions conducted in a “financial instruments market”, in accordance with requirements and by using methods prescribed by the operator of the financial instruments market.

²⁰ A non-deliverable forward (NDF) is a foreign exchange derivatives contract, which is settled by calculating the difference between the agreed upon exchange rate and the spot rate at the time of settlement.

the amount of money calculated based on the difference between the agreed figure and the actual figure of a determined financial indicator²¹ or any other similar transactions (FIEA, Art.2 (22) (ii)). Examples in this category include Forward Rate Agreement (FRA)²² and Contract for Difference (CFD).

(c) The third category is a transaction wherein the parties thereto promise that one of the parties will grant the other party an option to effect a transaction of financial instruments between the parties only by unilateral manifestation of the other party's intention. The other party pays a consideration for such option (FIEA, Art.2 (22) (iii)). Foreign Exchange Option is included in this category.

(d) The fourth category is a transaction wherein the parties thereto promise that one of the parties will grant the other party an option to, only by unilateral manifestation of his/her intention, effect a transaction wherein the parties promise to pay or receive an amount of money. This amount is calculated based on the difference between a figure that the parties have agreed in advance to use as the agreed figure of the financial indicator when such manifestation is made and the actual figure of the financial indicator at the time of such manifestation. The other party pays a consideration for such option (FIEA, Art.2 (22) (iv)).

(e) The fifth category is a transaction wherein the parties mutually promise that, using the amount the parties have agreed to as the principal, one of the parties will pay the other party an amount of money. This amount is calculated based on the rate of change in the agreed period of the interest rate, financial instruments, or a financial indicator agreed with the other party (FIEA, Art.2 (22) (v)). Examples in this category are Interest Rate Swaps (IRS) and Foreign Exchange Swaps.

(f) The sixth category is a transaction wherein one of the parties pays money, and the other party, as the consideration therefor, promises to pay money in cases where a cause agreed by the

²¹ Financial indicator is following: (i) prices of financial instruments or interest rates of financial instruments, or (ii) figures pertaining to the results of meteorological observations published by the Meteorological Agency or others or; (iii) among indicators which it is impossible or extremely difficult for a person to exert his/her influence on the fluctuation in and which may have serious influence on business activities of business firms or statistical figures pertaining to social or economic conditions, indicators or figures or; (iv) figures calculated based on those listed in the preceding three items (FIEA, Article 2 (25)).

²² A forward rate agreement (FRA) is a forward contract between parties that determines the rate of interest, or the foreign exchange rate, to be paid or received on an obligation beginning at a future start date.

parties in advance and (α) a cause pertaining to the credit status of a juridical person or other similar cause occurs or (β) a cause which it is impossible or extremely difficult for either party to exert his/her influence on the occurrence of and which may have serious influence on business activities of the parties or other business firms occurs (FIEA, Art.2 (22) (vi)). The Credit Default Swaps (CDSs) are included in subcategory (α) and Weather Derivatives, Earthquake Derivatives, and other disaster-related derivatives are included in subcategory (β).

OTC financial derivatives transactions are further classified into the abovementioned (a)~(f) categories, making it possible to regulate each category of OTC derivatives transactions in more detail, thereby ensuring appropriate investor protection and enhancing the efficiency and effectiveness of supervision.²³

Insurance contracts, guarantee contracts, and loss compensation contracts are excluded from the definition of OTC derivatives transactions²⁴ because these contracts do not aim to speculate but to compensate or cover actual damage or loss.²⁵

C. Registration requirements for OTC financial derivatives transactions

Type-1 financial instruments businesses are required to conduct OTC financial derivatives transactions or to provide intermediary, brokerage, or agency services in the course of business (FIEA, Art. 28 (1) (ii)).²⁶ Financial instruments business firms shall be registered by the Prime Minister (FIEA, Art. 29). An applicant should clearly identify the categories of financial

²³ When FIEA defines the OTC financial derivatives abstractly, there remain concerns that financial derivatives transactions might constitute illegal gambling under the Japanese Criminal Code considerably. See supra note 8.

²⁴ FIEA, Art. 2 (22), The Cabinet Order for Implementation of Financial Instruments Exchange Act, Art. 1-15.

²⁵ Miho MATSUSHITA/ Atsushi SAKAI/ Daisuke TACHI, *Kinyū Shōhin Toriki Hō no Taishō Shōhin Torihiki* (Investment Instruments and Transactions to which Financial Instruments and Exchange Act apply), in Naohiko MATSUO (ed.), *Kinyū Shōhin Torihiki Hō Kankei Seifurei no Kaisetsu* (Explanation of Financial Instruments and Exchange Act and related Cabinet Office Ordinances), Bessatsu Shōji Hōmu No. 318, at 148 (2008).

²⁶ On the other hand it is included by type-2 financial instruments business, on-the-exchange or on-the-foreign-exchange to conduct derivatives transactions, regarding financial instrument or asset which is deemed to be a security or non-security, or to provide intermediary, brokerage or agency service in the course of business (FIEA, Article 28 (2) (i) and (ii)). Type-2 financial instruments business firm shall be registered by the prime minister same as type-1 but the registration requirements such as capital requirements are laxer than the requirements for type-1 financial instruments business (FIEA, Article 29).

instruments businesses that the firm intends to conduct on the application (FIEA, Art. 29-2 (1) (v)). The law stipulates the following requirements: capital amount, capital adequacy, personnel qualification, legal form, organization, etc.

Registration to conduct OTC derivatives transactions business is not necessary in three cases, which do not technically fall within the original scope of type-1 financial instruments business. The first is when a counterparty is a type-1 financial instruments business firm, registered financial institution, qualified institutional investor, or stock company with more than 1 billion Yen capital.²⁷ This exclusion is granted because there is no need for investor protection in this case and so that the speed and efficiency of transactions with clients can be enhanced. These clients are called professionals for derivatives transactions. Nevertheless, it should be examined *de lege ferenda*, to maintain the category of professionals for derivatives transactions.²⁸ The second case is when a counterparty is a business firm that conducts sales and purchases, transport, custodian of goods or provides intermediary services of sales and purchases of goods in the course of business, and the aim of foreign exchange derivatives contract is to hedge the volatility risk of foreign exchange.²⁹ The third is when a company that submits financial reports conducts foreign exchange derivatives with its subsidiary, aiming to hedge the volatility risk of foreign exchange or to provide intermediary, brokerage, or agency services regarding the hedge transaction for its subsidiary.³⁰

On the other hand, there is a principle of separation between banking and securities businesses in the Japanese financial regime (FIEA, Art. 33 (1)). A bank must not register as a type-1 financial instruments business firm when it intends to conduct OTC financial derivatives transactions, excluding securities-related derivatives transactions (FIEA, Art. 33 (3) (ii)), insofar as it is a registered financial institution (*Tôroku Kinyû Kikan*) (FIEA, Art. 33-2 (iii)),

²⁷ FIEA, Art. 2 (8); The Cabinet Order for Implementation of Financial Instruments Exchange Act, Art. 1-8-6 (1) (ii); The Cabinet Office Ordinance Regarding the Definitions of Article 2 of FIEA, Art. 15.

²⁸ Prof. Kanda suggests that the category should be surplus and then abolished, because FIEA has already similar categories namely qualified financial institution and so-called professional investor and excluding out of financial instruments business is too excessive. Hideki, KANDA, *Derivative Torihiki no Genjô to Kadai - Wholesale Torihiki* [The Stand and Legal Issues on Financial Derivatives Transactions in Japan - Wholesale Transactions], Jurist No. 1951, at 58-59 (2012).

²⁹ FIEA, Art. 2 (8); The Cabinet Order for Implementation of Financial Instruments Exchange Act, Art. 1-8-6 (1) (iv); The Cabinet Office Ordinance Regarding the Definitions of Article 2 of FIEA, Art. 16 (1) (iii).

³⁰ FIEA, Art. 2 (8); The Cabinet Order for Implementation of Financial Instruments Exchange Act, Art. 1-8-6 (1) (ii); The Cabinet Office Ordinance Regarding the Definitions of Article 2 of FIEA, Art. 16 (1) (iv).

33-4 (1)).

Besides, any firm that has registered as a type-1 financial instruments business firm may sell and purchase currencies and other assets specified by a Cabinet Order as being related to financial derivatives transactions, excluding securities-related derivatives transactions, or it may provide intermediary, brokerage, or agency services thereof as ancillary business to type-1 financial instruments business (FIEA, Art. 35 (1) (x iii)).

D. New regulation on OTC derivatives transactions

1. Overview

In the aftermath of the financial crisis of 2008–09, the FIEA has been amended several times to prevent and control the deterioration of the financial system by regulating OTC derivatives transactions. These amendments have reflected the worldwide trend of coordination for the reform of OTC derivatives regulation and supervision.³¹ The first measure is to strengthen the development of the infrastructure of central counterparty (CCP).

The 2010 amendment of FIEA mandates the use of CCP for given OTC derivatives transactions clearing, and establishes a system for data storage and reporting of trading information. The 2012 amendment of FIEA mandates the use of electronic execution facilities for given OTC financial derivatives transactions. The 2013 amendment of the Deposit Insurance Act introduced the temporary stay of the close-out netting clause to prevent the extension of systemic risk.

2. Transparency and reporting requirements

The 2010 amendment of FIEA requires a clearinghouse, a given financial instruments trading firm, and a registered financial institution to store data regarding certain types of OTC derivatives transactions and to report this data to the Prime Minister (FIEA, Art. 156-63, 156-64).³² The information has to be provided in accordance with uniform data standards to the

³¹ Leaders' Statement: The Pittsburgh Summit (September 24 – 25, 2009), <<http://www.g20.org/images/stories/docs/eng/pittsburgh.pdf>>; Financial Stability Board, Implementing OTC Derivatives Market Reform (25 October 2010) <http://www.financialstabilityboard.org/publications/r_101025.pdf>; Technical Committee of the IOSCO, Report on Trading of OTC Derivatives (February 2011) <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD345.pdf>>

³² About the 2010 amendment of FIEA on OTC derivatives, see Akira WANI, *Derivative Kisei no Minaoshi* <Review of Derivative Regulation>, Kinyu Hômu Jijô No. 1903, at

registered Derivatives Transactions Data Repositories (DDRs: *Torihiki Jôhô Chikuseki Kikan*), which serve as secure, centralized recordkeeping facilities that are accessible by regulators and relevant authorities (FIEA Art. 156-66). DDrs have to verify and maintain data and publicly disseminate it in a timely fashion.

The structure of DDrs is designed to promote transparency and efficiency in the given OTC derivatives market and to create an infrastructure to assist regulators in performing their market oversight functions. The opacity of OTC derivatives transactions was highlighted as a cause for the financial crisis of 2008–09, since it exacerbated systemic risk.

The Cabinet Office Ordinance for the OTC Derivatives Transactions Regulation designates that the following OTC derivatives transactions shall be stored in and disseminated through DDrs: The plain vanilla interest rate swap on the Yen and iTraxx Japan,³³ which is an indicator financial product for CDS.³⁴

3. Centralized Clearing

The 2010 amendment of the FIEA required a given financial instruments trading firm and a registered financial institution to make certain types of OTC derivatives transactions centrally cleared. When OTC derivatives transactions in Japan that are standardized and liquid are defaulted on, the Japanese capital market may be significantly affected, so these transactions should be centrally cleared through either a foreign central counterparty (CCP) or a domestic CCP (FIEA Art. 156-62). The aim of a CCP is to have an entity that stands between parties with respect to the given OTC derivatives transactions between them. While the CCP bears no net market risk, which remains with the original party to each trade, it takes on the counterparty risk, which is centralized in the CCP. The parties no longer need to worry about the credit counterparty risk.³⁵

Legally, the original contract is automatically replaced by two contracts, each of which arises between one of the original parties and the CCP³⁶. The original parties do not have counterparty

55-57 (2010).

³³ The iTraxx Japan is the representative credit index in the Japanese credit market consisting of a basket of 50 CDS investment-graded Japanese entities.

³⁴ The Cabinet Order for the OTC Derivatives Transactions Regulation, Article 3 and 6 (1).

³⁵ Jon Gregory, *Counterparty Credit Risk*, John Wiley & Sons Ltd, at 369 (2010).

³⁶ It is controversial how an original contract can be automatically replaced by two contracts under Japanese civil law. In practice two alternatives are used. One is

risk to one another, and this risk is borne only by the CCP, which is expected to control the risk efficiently due to adequate evaluation and margin control. Furthermore, contracts traded through the CCP can be netted, which means that the multilateral netting benefit is provided by the CCP. On the other hand, there are some disadvantages of centralized clearing, the most famous of which is that the all risks are concentrated in the CCP, which then will be too big or too systemic to be allowed to fail.³⁷

The Cabinet Office Ordinance for the OTC Derivatives Transactions Regulation designates that the following OTC derivatives transactions shall be CCP cleared. The first is the plain vanilla interest rate swap on the Yen, for which three months or six months TIBOR is indicated as the floating rate benchmark. The second is iTraxx Japan, which is the indicator financial product for CDS.³⁸

Nevertheless, a substantial portion of OTC derivatives is not standardized or centrally cleared. Therefore, compulsory use of the CCP will not be enough to reduce systemic risk. BIS strengthened the capital requirements for OTC derivatives in Basel III.³⁹ BIS and the International Organization of Securities Commissions (IOSCO) published a consultation paper in which they proposed that appropriate margining practices should be put in place with respect to all derivatives transactions that are not cleared by CCPs. According to the consultation paper, all financial firms and systemically important non-financial entities that engage in non-centrally cleared derivatives must exchange initial and variation margins as

novation (*koukai*) and another is acceptance of the obligation (*saimu-hikiuke*) by CCP. The legal commission for the civil law (the law of obligations) reform has proposed the third alternative as a special type of novation (*sanmen-koukai*). *Minpô (Saiken Kankei) no Kaisei ni kansuru Chûkan-Shian* [Interim Proposal for the Civil Law (Law of Obligations) Reform], Article 24-6. <<http://www.moj.go.jp/content/000108853.pdf>>

³⁷ Regarding to the disadvantages of the centralized clearing system, see Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 *Stan. L. Rev.* 539, at 586-587 (2010-2011); Acharya et al., *supra* note 1, at 399-402. Mr. Wani pointed out from another aspect that especially in Japan, where there was little chaotic even during this financial crisis, the introduction to compulsory centralized clearing would not be necessary. Wani, *supra* note 32, at 58.

³⁸ The Cabinet Office Ordinance for the OTC Derivatives Transactions Regulation, Article 2 (1) and (2). The Notification of the Financial Services Agency of July 13th, 2012. In future the following OTC derivatives transactions will be added the list, those shall be centrally cleared: The plain vanilla interest rate swap on dollars or euros, plain vanilla interest rate swap on the Yen, that TIBOR is indicated as floating rate benchmark and single-named CDS.

³⁹ Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, December 2010 (rev June 2011), at 31-37. <<http://www.bis.org/publ/bcbs189.pdf>>

appropriate to the counterparty risks posed by such transactions.⁴⁰

Japan Government Bond transactions are cleared and settled in Japan Government Bond Clearing Corporation (JGBCC). On the other hand, stocks, bonds, beneficiaries interests to investment trust, and, since October 9, 2012, interest rate swap (IRS) transactions are cleared in Japan Securities Clearing Corporation (JSCC) and foreign exchange and interest-rate-related financial derivatives are cleared in the Tokyo Financial Exchange. The separation of CCP has a disadvantage, since the efficiency of central clearance could be impaired. The combination of three CCPs in Japan has not yet been realized, but the JGBCC will be merged into the JSCC on October 1, 2013. This merger will make it easy to introduce cross-margin between IRS and Japan Government Bond futures. JSCC plans to introduce a client clearing system for IRS and a default fund system in the next year in order to overcome inefficiencies and vulnerability.⁴¹

4. Trading infrastructure - Electronic derivatives transactions execution facilities

The 2012 amendment of the FIEA required a financial instruments trading firm to conduct OTC derivatives transactions in the course of business, using electronic derivatives transactions execution facilities (EDTEF) for certain types of OTC derivatives transactions (FIEA Art. 40-7).

The EDTEF is intended to play an important role in enhancing the transparency and oversight of the market for these OTC derivatives transactions. EDTEF should help further the statutory objective of greater transparency by serving as a conduit for information regarding trading interest in the selected OTC derivatives transactions.

There are two points of view on the regulation on EDTEF, in comparison to the regulation in the USA on swap execution facilities (SEF) and in the EU on multilateral trading facilities (MTF).⁴² In the first point of view, contrary to the USA and EU, the administration of EDTEF is handled in Japan not as an exchange or PTS but as a type-1 financial instruments business. That is, the

⁴⁰ Basel Committee on Banking Supervision/ Board of the International Organization of Securities Commissions, Second Consultative Document Margin requirements for non-centrally cleared derivatives, February 2013 <<http://www.bis.org/publ/bcbs242.pdf>>

⁴¹ Takahiro KANEKO, *Kinri Swap Torihiki no Client Clearing wo Kaisi he* [Introduction of Client Clearing System with Regard to Interests Rate Swap], Kinyû Hômu Jijô, August 26, 2013, at 18-23.

⁴² See more detail, Hiroyuki KANSAKU, *Derivative Torihiki no Genjô to Kadai - Kinshô-hô ni okeru Infura Seibi* [The Stand and Legal Issues on Financial Transactions in Japan - Establishment of the Infrastructure for the determined OTC Derivatives Transactions], Jurist No. 1951, at 44-55 (2012).

trading of financial derivatives, excluding security-based derivatives, is of two types: on-the-exchange traded derivatives and OTC derivatives. In the second point of view, with respect to security-based derivatives, there are three types of trading: on-the-exchange, OTC, and PTS.

The first point may be related to the second. The EDTEF in Japan must not be of the multiple-dealer type. In the USA and EU, the obligatory use of an electronic trading platform is intended to enhance a more competitive environment for the trading of the given OTC derivatives transactions by providing a venue for multiple parties to execute trades in OTC derivatives. Therefore, SEF in USA and MTF in EU must be of the multiple-dealer type and therefore be similar to exchange.

The regulator would have access to information on the trading of given OTC derivatives transactions in EDTEF and information regarding trading by their participants. Then, EDTEF would be expected to play an important role in helping to oversee the market for given OTC derivatives transactions on an ongoing basis, allowing regulators to quickly assess information regarding the potential for systemic risk across trading venues.

The scope of OTC derivatives transactions traded through EDTEF has not yet been determined, but will be a little narrower than that of the derivatives transactions that will be centrally cleared.⁴³

5. Temporary stay of close-out clause

Due to the close-out clause upon the default of one of the two counterparties, all future claims and contractual relations between the two become due, calculated, netted and then set off. The close-out amount can be a smaller fraction. In the case of insolvency, counterparty credit risk is substantially reduced to the resulting net position. This means that close-out netting, by reducing counterparty exposures, can contribute to a reduction in systemic risk. In Japan, the validity of the close-out clause is protected by Art. 58 of the Bankruptcy Act and the Act Regarding Close-Out Netting in Qualified Financial Transactions.

On the other hand, the close-out netting rights of counterparties could exacerbate a failing

⁴³ At the first stage only the plain vanilla interest rate swap on Yen will be specified. FSA, *Tentô Derivative Shijô Kisei ni kakaru Kentôkai ni okeru Giron no Torimatome* [Concluding the Discussion in the Working Group regarding Regulation on the OTC Derivatives Market], December 26, 2011, at 3-4.

bank's position to such an extent that orderly resolution by the authorities will become difficult. This might generate systemic risk. Therefore, it is claimed that a temporary stay on rights to close-out netting will be introduced in order to facilitate the orderly resolution of failing banks in a manner that does not destabilize the counterparties under netting agreements, thus increasing systemic risk.⁴⁴ Authorities should have the legal authority to temporarily stay the operations of contractual early termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution.

The 2013 amendment of the Deposit Insurance Act introduced the temporary stay of early termination clause to conduct close-out netting at an early stage, by which the Prime Minister shall make a decision not to give effect to the clause during the period when it is considered to be necessary to take measurements to avoid turbulence in the financial system (Art. 137-3(1)).⁴⁵ During the temporarily delay, the stipulations of the Bankruptcy Act Art. 58 and the Act Regarding Close-Out Netting in Qualified Financial Transactions do not apply (Art. 137-3 (5) and (6)). It is expected that, during the temporary stay of early termination clause, authorities will transfer relevant contracts, as part of a resolution measure, to another sound financial institution. This regulation is the intervention of the state in the area of private law and private autonomy. We should observe the appropriate implementation and enforcement of this temporary stay carefully.⁴⁶

E. Regulation of business conduct in financial derivatives transactions

1. Overview

Unlike regulations with regard to registration, the rules and regulations for business conduct standards are comprehensive and common to all types of financial instruments business.

A financial instruments business firm submits to the regulation of business conduct standards by FIEA and a self-regulating organization. Generally, a financial instruments business firm, as well as the officers and employees thereof, shall execute their business in good faith and fairly

⁴⁴ Basel Committee on Banking Supervision, Report and Recommendations of the Cross-border Bank Resolution Group, 2010 March, Recommendation 8 and 9.

⁴⁵ Atsushi SAWAII/ Masamichi UEAHIMA, *Kinyu-Shôhin Torihiki Hô no Ichibu wo Kaisei suru Hôritu no Gaiyô* [Outline of the Act amending a Part of the Financial Instruments and Exchange Act], Shôji Hômu No.2006, at 2- (2013).

⁴⁶ Kazuhiko YAMAMOTO, *Kinyû Kikan no Chitujô aru Shori no Wakugugumi* [Legal Framework for Orderly Resolution of Financial Institutions], Kinyû Hômu Jijô, No. 1975, at 35 (2013).

to customers (FIEA, Art. 36).

2. Delivery of a document prior to and on the contract

In the stage of solicitation prior to the concluding of OTC financial derivatives contract, a type-1 financial instruments business firm shall in advance deliver a document containing the identification of the firm, the outline of the contract, the risk that a loss would be incurred with regard to the contract due to fluctuations in the money rate, value of currencies, quotations on the financial instruments market, and so on (FIEA, Art. 37-3 (1)). The characteristics of the document with regard to OTC financial derivatives are detailed in the contents. For example, the performance of the duty, a way of settlement, procedures of the transaction, and the definition of main technical terms concerning the transaction shall be included in the document (FIEA, Art. 37-3 (1) (vii), The Cabinet Office Ordinance Regarding Financial Instruments Transactions Business, Art. 93 (1)). Upon solicitation prior to the conclusion of an OTC financial futures contract or other OTC derivatives contract with an individual customer, the document shall include matters related to the covered transaction, prohibited actions, segregation of the customers assets, and so on (FIEA, Art. 37-3 (1) (vii), The Cabinet Office Ordinance Regarding Financial Instruments Transactions Business, Art. 94 (1)).

Upon the concluding of a contract for a financial instruments transaction, a financial instruments business firm shall, without delay, prepare and deliver a document to the customer (FIEA, Art. 37-4 (1)). The matters that should be included in the document are stipulated in a Cabinet Office Ordinance, and include the type of underlying financial instruments or financial indicator, volumes of the transaction, price of one unit, the type of the derivatives transaction, etc.

3. Prohibition of solicitation without invitation

The characteristic of the regulation, with regard to solicitation of derivatives transactions, is the prohibition without invitation from the side of the customer. The object of this prohibition is limited to OTC financial futures and other types of OTC derivatives transactions, and holds only when a customer is an individual (FIEA, Art. 38, Cabinet Order for Implementation of Financial Instruments and Exchange Act, Art. 16-4 (1)). The introduction of this regulation points out that the suitability rule and the duty to explain does not work perfectly to protect individual customers.

4. Duty to explain and suitability rule

Any financial instruments business firm shall not provide a customer with conclusive evaluations on uncertain matters or with information that misleads him/her into believing the certainty of such matters, thereby soliciting him/her to conclude a contract for a financial instruments transaction.

When a financial instruments business firm or registered financial institution solicits a customer, it is prohibited to conduct business in a manner that is found to be inappropriate in light of the customer's knowledge, experience, the status of property, or the purpose of concluding a contract for financial instruments transaction that results in, or is likely to result in, insufficient protection of the investors (FIEA, Art. 40 (1) (i)). This prohibition is called the suitability rule, and it belongs to the supervisory regulation and does not have private law effect automatically. However, the Japanese Supreme Court judged that in cases where a person in charge of a customer at a securities company solicits securities transactions that deviate excessively from the suitability rule, against the intention of the customer and the circumstances, and actively solicits transactions which involve obviously excessive risk, this act should be regarded as unlawful under tort law.⁴⁷ The violation of the supervisory regulation aiming to protect the investor may lead to the liability of the financial institution to compensate for the damage that resulted from the violation.

IV Duties and responsibilities between financial firm and customer in OTC derivatives transactions

A. Overview

Lately, there have been many litigations and alternative dispute resolutions (ADR)⁴⁸ in Japan concerning OTC financial derivatives transactions. Most of these are OTC financial derivatives involving swaps contracts of foreign exchanges or interest rate. I illustrate some legal issues in the field of civil law in OTC derivatives transactions, and introduce some remarkable cases in

⁴⁷ The Japanese Supreme Court decided that the suitability rule in FIEA stipulates originally supervisory relationship between the state and a firm, but a customer can demand compensation of the loss resulted from the violation of the rule due to tort law, when the violation is material. Supreme Court, judgment of July 14, 2005, *Minshû* vol.59, No.6, at 1323.

⁴⁸ According to the reform of FIEA of 2009, financial institutions are required to use a designated dispute resolution institution. Japanese Bankers Association was appointed as a designated dispute resolution institution and operates since October 1, 2010.

Japan.

B. Validity

A customer often sues against a financial instruments business firm for damages or for restitution. A customer claims sometimes that the OTC financial derivatives transaction is not valid. The grounds for invalidity can be broken down into two groups. The first is because the transaction is against public policy. However, many judgments have dismissed plaintiffs' claims that the OTC financial derivatives transaction was invalid. For example, the judgment of April 16, 2012, of the Tokyo District Court was that a Dollar-Yen currency swap transaction was not invalid, and pay-off from the customer to the firm was calculated in inverse proportion to the current spot FX rate. The Court illustrated that a derivatives transaction is only invalid insofar as it cannot be found to have social meaning at all and is therefore outside the scope of appropriateness as an economic transaction; typically, this is when the risk of a derivatives transaction is difficult to evaluate or calculate.⁴⁹

The second reason that a derivatives transaction is invalid is because the customer is prohibited by law from engaging in that sort of transaction or, in the case of a corporation, the transaction is outside of the scope of the purpose of the corporation. The judgment of February 24, 2012, of the Osaka District Court was that to invest in a complicated structured bond or financial derivatives instrument is not out of the scope of the purpose of a private university as juridical person. Therefore, the Australian Dollar/Japanese Yen swap forwards contract between the financial institution and the private university is valid.⁵⁰

C. Duty to explain and suitability rule

Most controversial and disputable points are regarding the duty to explain and the suitability rule. A plaintiff demands damages in most cases by tort law because the financial institution

⁴⁹ The Tokyo District Court, judgment of April 16, 2012, *Kinyû Shôji Hanrei*, No. 1419, at 39. The financial instruments business firm and a customer concluded a following swap transaction. The customer pays on yen 200 thousands multiplied 42.5, when current FX rate of 1 dollar would rise over 83 Yen, or 450 thousands multiplied 83 multiplied 83/FX rate, when the current FX rate of 1 Dollar would drop under 83 Yen. The firm pays for 20 years on the yen that amounts to the notional principal multiplied the current spot rate.

⁵⁰ The Osaka District Court, judgment of February 24, 2012, *Hanrei Jihô* No. 2169, at 44. The firm pays off to the customer 200 thousands Australian dollars multiplying the current FX rate of 1 Australian dollar. The university pays off 200 thousands Australian dollars multiplying the 74 Yen as FX rate of 1 Australian dollar.

violated the duty to explain and/or the suitability rule, and damaged the plaintiff. Concretely, a plaintiff typically claims that the OTC derivatives transaction was not adequate for the aim of the transaction to hedge risk, and that the defendant failed to explain this. The duty to explain and the suitability rule are closely related in the litigation and ADR practice.

The duty to explain is not only under FIEA, but also under the Financial Instruments Sales Act (FISA). FISA stipulates the duty to explain of the financial instruments provider to its customers with private law effect. In addition, when a firm has failed to give an explanation, it shall be liable for the damages suffered by said customer as a result thereof (FISA, Art. 5). The amount of loss of principal shall be presumed to be the damage incurred by said customer due to the failure of the financial instruments provider to give an explanation on important matters (FISA, Art. 6). The causal relationship between the violation of the duty to explain and the occurrence of damage is also presumed by the stipulation of the Act.

A customer is likely to claim that he or she would not have concluded the OTC financial derivatives contract if he or she knew all the material facts about the contract, especially about the fair value. Fair value has three possible meanings: mark-to-market at the outset of the contract, evaluation of pledge or margin to be offered, and the simulation of the settlement calculation clause. The Japanese Supreme Court judged on this point this March. In the judgment of March 7, 2013, an interest rate swap contract was concluded, after which a customer is to pay a provider at the rate of 2.445 percent for six years on the notional principal 200 million Yen and to receive at the rate of the three-month Japanese Yen TIBOR. The swap is to start one year after the conclusion of the contract.⁵¹ In the judgment of March 26, 2013, an interest rate swap contract was concluded, after which a customer is to pay a provider at the rate of the three-month Japanese Yen TIBOR and to receive for six years at the rate of 2.145 on the notional principal of 400 million Yen. The swap is to start one year after the conclusion of the contract.⁵² The Fukuoka High Court decided that the defendant violated the duty to explain with regard to (1) the concrete calculation method of the settlement amount when the contract is cancelled prior to the expiration, (2) the pro and cons of the swap contract between the conclusion of the time it is in effect and one year later, and (3) the steady interest rate being adequate to hedge the risk of raising the interest rate. However, the Japanese Supreme Court quashed the judgment of the Fukuoka High Court and judged that the defendant did not violate the duty to explain. With respect to (1), the defendant had no duty to explain the method of calculating the settlement amount, because there was a clause forbidding cancellation and

⁵¹ The Supreme Court, judgment of March 7, 2013, *Kinyû Hômu Jijô*, No. 1973, at 94.

⁵² The Supreme Court, judgment of March 26, 2013, *Kinyû Hômu Jijô*, No. 1973, at 99.

paying the settlement amount in the case of prior-to-expiration cancellation. With respect to (2), the plaintiff himself chose the contract, which becomes effective one year after the conclusion of the contract, after the provider explained the pro and cons of each type. With respect to (3), the defendant had no duty to explain whether the interest rate was appropriate, as that was to be judged by the individual customer.

D. Damages or Settlement Amount Calculation

When an OTC financial derivatives contract is cancelled prior to its expiration, it might be questioned how the damage or settlement amount should be determined. If the parties make a document based upon the International Swaps and Derivatives Association (ISDA) master agreements,⁵³ there are provisions concerning settlement amount calculation and damages in case the contract is cancelled prior to its expiration. They include a number of factors that should be considered, such as market quotations for replacement transactions, supplied by third parties and market data in the form, rates, prices, yield curves, or volatilities. Unless there are such replacement provisions, the scope of the damage should be compensated, when it can be interpreted as ordinary damage from the failure to perform its terms of Art. 416 (1) of the Japanese Civil Code.

In this respect, there is a famous case in Japan regarding how the damage should be measured from the failure to perform the obligation of an interest rates swaps contract. The judgment says that gains from the interest rate swaps on the settlement date, when they come after the cancellation, must be an expected return from the performance of the contract and that ought to be ordinary damage.⁵⁴ The Court approved the plaintiff's claim that the damage should be the cost, with which one can replace the same contractual status as the original contract. Lately, there have often been clauses regarding settlement amount clauses and damage clauses that stipulate how the settlement amount should be calculated. Concretely, this is the discounted present value of the total net-out amount of each aggregation of the mutual payoff, namely the counterparty's gain or loss, which is calculated based upon the Bloomberg forward Yen/ Spanish Peseta (ESP) forwards exchange rate.

Nowadays, some of the OTC financial derivatives transactions in Japan are documented after the ISDA master agreements, under which the close-out provision is included, and holds that the

⁵³ The use of the ISDA master agreements might contribute to the more liquidity and efficiency, since market player quote on the standardized contractual provisions, those can enhance the comparability.

⁵⁴ The Tokyo High Court, judgment of May 28, 1997, *Hanrei Times* No. 982, at 166.

mutual payoff should be net-out and only the difference should be paid when the termination event in that agreement occurs. The termination amount must be theoretically equivalent to its fair value. Unlike for on-the-exchange traded derivatives, however, it is difficult to determine the fair value. The agreement list provides a number of factors to determine the fair value, such as market quotations for replacement transactions supplied by third parties and market data in the form of rates, prices, yield curves, or volatilities. There is also a general clause that stipulates that the parties must exercise good faith and use commercially reasonable procedures in calculating the termination amount or in measuring the damage.

Some cases involve a subsidiary of Lehman Brothers in Japan, where the bankruptcy trustee of Lehman Brothers Japan claimed that the paid settlement amount by Lehman Brothers Japan was higher than the true amount, and that the difference should be returned.⁵⁵ The valuation of the contract or evaluation of the damage is in contention.

E. Collateral and Closing-out Netting

A party of OTC derivatives transactions in Japan normally offers as collateral Japan Government Bonds or other securities. It is normal in Japan for these securities to be provided as collateral, not under the creation of pledges but as deposits for consumption contract. When Lehman Brothers Japan went bankrupt, its counterparty, who had provided surplus securities as collateral under deposit for consumption construction, claimed the right of segregation. The Tokyo High Court judged that the right of the plaintiff to the defendant was not claims on the estate, but normal bankruptcy claims, which have no priority.⁵⁶ However, if the plaintiff had claimed the application of the Act Regarding Close-out Netting in Qualified Financial Transactions, he would have had priority due to netting with his other obligations to the defendant, according to close-out netting.⁵⁷

Concluding Remarks

OTC derivatives have enjoyed freedom of contract and private autonomy in the borderless financial market. However, in the aftermath of the financial crisis of 2008 and 2009, OTC

⁵⁵ The Tokyo District Court, judgment of March 11, 2013 (now unpublished).

⁵⁶ The Tokyo High Court, judgment of October 27, 2010, *Kinyū Shōji Hanrei*, No. 1360, at 53.

⁵⁷ Hideki KANDA, *Derivative Torihiki ni okeru Kokusai no Tanpo Teikyō* [Provision of Japan Government Bonds as Collateral in Derivatives Transaction], *Kinyū Shōhin Torihiki Hō Hanrei Hyakusen* [100 Cases on Financial Instruments Exchange Act], at 177 (2013).

derivatives transactions have come to be strictly regulated and supervised, at both the national and international levels. OTC derivatives transactions can trigger systemic risk and destabilize the global financial system. I doubt that some types of OTC derivatives transactions can enhance the economic welfare of the parties thereto. Coordination between national and international regulation and between domestic public law and private law may become more important.