Commission Implementing Decision (EU) 2019/684 of 25 April 2019 on the recognition of the legal, supervisory and enforcement arrangements of Japan for derivatives transactions supervised by the Japan Financial Services Agency as equivalent to the valuation, dispute resolution and margin requirements of Article 11 of Regulation (EU) No 648/2012 of the European Parliament and Council on OTC derivatives, central counterparties and trade repositories (Text with EEA relevance)

COMMISSION IMPLEMENTING DECISION (EU) 2019/684

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THE EUROPEAN COMMISSION,

Having regard to Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories[(1)], and in particular Article 13(2) thereof,

After consulting the European Securities Committee,

Whereas:

(1) Article 13 of Regulation (EU) No 648/2012 provides for a mechanism to ensure consistency between the legal, supervisory and enforcement arrangements established by the Union and those of third countries in the areas within the scope of that Regulation. The Commission is empowered to adopt equivalence decisions whereby the legal, supervisory and enforcement arrangements of a third country are declared equivalent to the requirements laid down in Articles 4, 9, 10 and 11 of Regulation (EU) No 648/2012 so that counterparties which enter into a transaction within the scope of that Regulation, where at least one of the counterparties is established in that third country, should be deemed to have fulfilled those requirements by complying with the requirements set out in that third country's legal regime. The declaration of equivalence avoids the application of duplicative or conflicting rules. Furthermore, the declaration of equivalence contributes to the achievement of the overarching aim of Regulation (EU) No 648/2012 namely to reduce systemic risk and increase the transparency of derivatives markets by ensuring an internationally consistent application of the principles agreed with third countries and laid down in that Regulation.

(2) Paragraphs 1, 2 and 3 of Article 11 of Regulation (EU) No 648/2012 which is supplemented by Commission Delegated Regulation (EU) No 149/2013[(2)] and Commission Delegated Regulation (EU) 2016/2251[(3)], establish the Union's legal requirements concerning the timely confirmation of the terms of an OTC derivative

contract, the conduct of a portfolio compression exercise and the arrangements under which portfolios are reconciled in relation to OTC derivative contracts not cleared by a central counterparty ('CCP'). In addition, those paragraphs lay down the valuation and dispute resolution obligations applicable to those contracts ('operational risk mitigation techniques') as well as the obligations on the exchange of collateral ('margins') between counterparties.

(3) In order for a third country's legal, supervisory and enforcement regime to be considered equivalent to the regime of the Union in respect of operational risk mitigation techniques and margins requirements, the substantive outcome of the applicable legal, supervisory and enforcement arrangements should be equivalent to Union requirements under Article 11 of Regulation (EU) No 648/2012, ensure protection of professional secrecy that is equivalent to that set out in this Regulation; and the legal, supervisory and enforcement arrangements should be effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that third country. The purpose of this equivalence assessment is therefore to verify that the legal, supervisory and enforcement arrangements of Japan ensure that OTC derivative contracts not cleared by a CCP and entered into by at least one counterparty established in that third country do not expose financial markets in the Union to a higher level of risk and consequently do not pose unacceptable levels of systemic risk in the Union.

(4) On 1 September 2013, the Commission received the technical advice of the European Markets Supervisory Authority ('ESMA') on the legal, supervisory and enforcement arrangements in Japan[(4)] including, inter alia, the operational risk mitigation techniques applicable to OTC derivative contracts not cleared by a CCP. In its technical advice, ESMA found that there were no legally binding requirements on timely confirmation of the terms of an OTC derivative contract, the arrangements for carrying out portfolio reconciliation, the conduct of a portfolio compression, the valuation of a portfolio and the obligation for dispute resolution or for the exchange of collateral between counterparties to OTC derivative contracts in Japan. ESMA also observed that the equivalence between regimes for bilateral margins could not be assessed at the time, as the technical standards specifying the rules on bilateral margins in the Union had not yet been developed.

(5) The Commission has considered ESMA's technical advice in carrying out its assessment, and has taken into account the regulatory developments that have taken place since then. This Decision is not only based on a comparative analysis of the legal, supervisory and enforcement requirements applicable in Japan, but also on an assessment of the outcome of those requirements and their adequacy in order to mitigate the risks arising from OTC derivative contracts not cleared by a CCP in a manner considered equivalent to the outcome of the requirements laid down in Regulation (EU) No 648/2012.

(6) The legal, supervisory and enforcement arrangements applicable in Japan for OTC derivative contracts are laid out in the Financial Instruments and Exchange Act, No 25 of 1948 ('FIEA'), and apply to Financial Instrument Business Operators ('FIBOs') and Registered Financial Institutions ('RFIs'), which include regulated banks, cooperatives,

insurance companies, pension funds and investment funds. The Financial Services Agency of Japan ('JFSA') has broad powers to implement the FIEA and has the Cabinet Office Ordinance, Supervisory Guidelines, and Public Notifications (together 'the OTC derivatives rules of Japan'). The JFSA has jurisdiction over OTC derivatives within the meaning of Article 2(7) of Regulation (EU) No 648/2012, with the exception of OTC commodity derivatives, which are under the jurisdiction of the Japanese Ministry of Economy, Trade and Industry ('METI') and the Japanese Ministry of Agriculture, Forestry and Fisheries ('MAFF').

(7) The operational risk mitigation techniques for OTC derivative contracts not cleared by a CCP, as laid down in the OTC derivatives rules of Japan, continue to be insufficient when compared with the obligations provided for in paragraphs 1 and 2 of Article 11 of Regulation (EU) No 648/2012 and Delegated Regulation (EU) No 149/2013 with regard to timely confirmation of the terms of an OTC derivative contract, the conduct of a portfolio compression exercise and the arrangements under which portfolios are reconciled. This Decision should therefore only cover the legal, supervisory and enforcement arrangements concerning the valuation and dispute resolution obligations as provided for in paragraphs 1 and 2 of Article 11 of Regulation (EU) No 648/2012 and Delegated Regulation (EU) No 149/2013 as well as those concerning margin requirements as provided for in paragraph 3 of Article 11 of Regulation (EU) No 648/2012 and Delegated Regulation (EU) 2016/2251.

(8) With regard to the requirements for the valuation of transactions and for the resolution of disputes applicable to OTC derivatives not cleared by a CCP, the OTC derivatives rules of Japan contain similar obligations to those provided for in paragraphs 1 and 2 of Article 11 of Regulation (EU) No 648/2012. In particular, Section IV-2-4 of the Supervisory Guidelines contains specific requirements regarding dispute resolution applicable to OTC derivative contracts not cleared by a CCP and Article 123 of the Cabinet Office Ordinance lays out the requirements for carrying out daily valuations for the purpose of margin exchanges.

(9) Concerning the margins for OTC derivative contracts not cleared by a CCP, the legally binding requirements of Japan consist of a set of final regulations adopted by the JFSA, published on 31 March 2016 which entered into force on 1 September 2016. Those regulations comprise the Cabinet Office Ordinance on Financial Instrument Businesses No 52 of 6 August 2007 including the Supplementary Provisions, the Financial Services Agency Public Notices No 15, 16 and 17 of 31 March 2016 and No 33 of 25 August 2017, the revised Comprehensive Guidelines for Supervision of Major Banks, etc., the revised Comprehensive Guidelines for Supervision of Small- and Medium-Sized and Regional Financial Institutions, the revised Comprehensive Guidelines for Supervision of Cooperative Banks, the revised Comprehensive Guidelines for Supervision of Financial Instruments Business Operators, etc., the revised Comprehensive Guidelines for Supervision of Insurance Companies and the revised Comprehensive Guidelines for Supervision with respect to Trust Companies, etc. The rules applicable to OTC Commodity derivatives under the jurisdiction of METI and MAFF replicate the set of final regulations adopted by the JFSA, (together 'the margin rules of Japan').

(10) As laid down in the margin rules of Japan, financial institutions which have an average total amount of notional principal of OTC derivatives for a certain period of time equal to or above JPY 300 billion must exchange variation margin on a daily basis under the FIEA, while financial institutions below that threshold must exchange variation margin with 'a sufficient frequency'. Because Regulation (EU) No 648/2012 requires all counterparties to an OTC derivative transaction not cleared by a CCP to exchange variation margin on a daily basis, this Decision should therefore be conditional on the daily exchange of variation margin for transactions conducted with FIBOs and RFIs whose average total amount of the notional principal of OTC derivatives for a one-year period, from April two years before the year in which calculation is required (or one year if calculated in December) falls below JPY 300 billion.

(11) Similar to the requirements laid down in Delegated Regulation (EU) 2016/2251, under the margin rules of Japan, all financial institutions which aggregate notional amounts of non-cleared OTC derivatives, non-cleared OTC Commodity derivatives, physically-settled foreign exchange ('FX') forwards and FX swaps of a consolidated group, excluding intragroup transactions, for the months March, April and May one year before the year in which the calculation exceeds JPY 1,1 trillion must exchange details of the initial margin. The margin rules of Japan also provide for a combined minimum transfer amount of initial and variation margins of JPY 70 million, whereas the threshold in Article 25 of Delegated Regulation (EU) 2016/2251 is EUR 500 000. Taking into account the marginal difference in the value of those currencies, those amounts should be considered equivalent.

(12) The margin rules of Japan apply to almost all OTC derivatives contracts as defined in point (7) of Article 2 of Regulation (EU) No 648/2012, with the exception of physically settled FX forwards and FX swaps, for which the margin rules of Japan set no requirements. FX transactions associated with the exchange of principal by means of cross-currency swaps are exempted from initial margin requirements. In addition, the margin rules of Japan do not contain any specific treatment for structured products, including covered bonds and securitisations. Under the terms of Regulation (EU) No 648/2012, only FX swaps and FX forwards are exempted from the initial margins requirements and only derivatives, associated with covered bonds for hedging purposes, are exempted from all margin requirements. This Decision should therefore only apply to OTC derivatives contracts that are subject to margin requirements under Regulation (EU) No 648/2012 and the margin rules of Japan.

(13) The requirements in the margin rules of Japan for the calculation of initial margin are equivalent to the requirements set out in Regulation (EU) No 648/2012. In a similar manner to the standardised method for the calculation of the initial margin set out in Annex IV to Delegated Regulation (EU) 2016/2251, the margin rules of Japan allow for the use of a standardised model equivalent to the one laid out in the aforementioned annex. Alternatively, internal or third party models may be used to calculate the initial margin where those models contain certain specific parameters, including minimum confidence intervals and margin periods of risk and certain historical data, including stressed periods. Counterparties must notify the JFSA, METI or MAFF, as appropriate,