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BEFORE THE SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND RISK MANAGEMENT
COMMITTEE ON AGRICULTURE
U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, DC
DECEMBER 13, 2012

Introduction

Mr. Chairman and Members of the Subcommittee on General Farm Commodities and Risk Management. It is my great honor and pleasure to be invited to today's hearing to speak to you about issues concerning cross-border regulation of OTC derivatives markets. My name is Masamichi Kono, Vice Commissioner for International Affairs at the Financial Services Agency of Japan. In my capacity, I represent my Agency in various international organizations of financial regulators and supervisors. I am also currently the Chairman of the Board of IOSCO, i.e. the International Organization of Securities Commissions. I must mention that any views I express today are not necessarily identical to the official views of the organizations that I represent.

In response to the financial crisis that started in 2007-2008, G20 Leaders agreed at the Pittsburgh Summit in September 2009 that all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest, and OTC derivative contracts should be reported to trade repositories.

A number of jurisdictions, including Japan and the United States, have been making significant progress in implementing the G20 commitments in an internationally consistent and coordinated manner towards the agreed deadline of end-2012. The regulations which Japan implemented from November this

year are not identical to the US regulations, but are fully consistent with the objectives of the G20 commitments to improve transparency in the derivatives markets, mitigate systemic risk and protect against market abuse. In this respect, our laws and regulations which we have implemented from November this year share the same goals as the Dodd-Frank Act.

As to the cross-border application of national laws to OTC derivatives, we can understand the CFTC's concern that risks emanating from an overseas commercial presence of a US financial group could directly flow back to the US and cause significant systemic disruptions, and this should be avoided. The same would apply if a non-US financial group had significant commercial presence in US territory. We believe, however, that such risks need not be addressed by extraterritorial application of US laws and regulations.

If the overseas commercial presence of the US financial group or the non-US financial group is appropriately regulated by foreign regulators, the US authorities could rely on the foreign regulators upon establishing that the foreign regulators have the required authority and competence to exercise appropriate regulation and oversight over those entities and activities abroad. This is what we consider as proper treatment in line with the principles of international comity between sovereign jurisdictions.

Such reliance on foreign regulators ensures that there is no conflict or overlap of applicable rules to entities operating cross-border, and to transactions that take place across borders. It not only enables an efficient and effective use of the limited supervisory resources of the regulator, but also, even more importantly, removes legal uncertainty and significantly reduces the compliance costs of market participants and infrastructure operators in all jurisdictions. This will ultimately lead to significant cost-savings for the investor, and for the taxpayer. In some cases, certain activities or transactions could be prevented from taking place because of conflicting regulation, and this can be avoided through enhanced coordination and cooperation between regulators. Needless to say, such reliance can only be possible when mutual trust is established between regulators, and appropriate supervisory arrangements exist between them.

In recognition of the above, there are now growing calls internationally for taking

steps to avoid conflicting or overlapping regulation, and for demonstrating much greater coordination and cooperation among regulators. Regulators around the world will have to respond to those calls. It is very much in this spirit that a group of regulators including ourselves issued on December 4 a joint press statement entitled “Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market”. I will come back to explain the background of this important press statement later.

OTC Derivatives Market Reforms in Japan

Since September 2009, Japan has exerted its utmost efforts to put in place legislative and regulatory measures to reform the OTC derivatives markets, for the purpose of fulfilling the G20 commitments. Our Financial Instruments and Exchange Act (FIEA) has been amended in two stages.

The first stage of legislation dates back to May 2010, when mandatory clearing requirements and requirements to report transactions to trade repositories were introduced. Those amendments took effect from 1 November this year, with phase-in arrangements for product designation and reporting requirements.

As to the second stage, our Diet passed this September legislation introducing requirements for usage of electronic trading platform (ETP) and for enhancing price transparency. In consideration of the need to provide sufficient time for preparation on the part of market participants, and to address the potential impact on market liquidity that those measures could have, the implementation of this second stage of legislation will be phased in for a period of up to three years.

With respect to the mandatory clearing requirement that entered into force last month, only Japanese index-based CDSs (i.e. the iTraxx Japan Index Series) and plain-vanilla Japanese Yen-denominated Interest Rate Swaps (IRS) with reference to LIBOR are subject to mandatory clearing. The scope of products subject to mandatory clearing will be expanded to the products, such as JPY-denominated IRSs with reference to TIBOR, foreign currency (USD and EURO) denominated IRSs, and single-name CDSs referencing Japanese

companies, taking into consideration such factors as the volume of transactions and the degree of standardization.

Also, at the outset, the application of mandatory central clearing requirements is limited to transactions between large domestic financial institutions registered under the FIEA, who are members of licensed clearing organizations. In this regard, it should be noted that currently in Japan there is only one licensed CCP under the amended FIEA. Foreign CCPs are invited to be licensed in Japan, with less onerous requirements applicable in light of their foreign status. Going forward, the clearing requirements could be expanded to transactions between the above financial institutions and foreign financial institutions (not registered under FIEA), taking into account international coordination efforts currently underway on cross-border regulation.

On reporting requirements, financial institutions registered under the FIEA are required to report their OTC derivatives transactions to trade repositories (TRs) for products such as (i) credit derivatives, and (ii) forward, option and swap transactions in relation to interest rates, foreign exchanges, and equities.

Need to avoid conflicting or overlapping cross-border regulations

In recent months, foreign regulators have expressed their concerns with regard to the CFTC's proposed reforms primarily because they find potential conflicts or overlaps with their own rules that are or will be implemented soon. Certainly the concerns described below are particularly relevant with regard to US regulations, but it should be noted that many of them are, by nature, pertinent to any set of national or regional rules applied to entities operating cross-border and to cross-border transactions. In this regard, we appreciate very much the ongoing efforts by the CFTC in dealing with those issues raised by foreign regulators.

First, it is important that the details of the applicable laws and regulations are made clear as much as possible before their implementation, in order to minimize regulatory uncertainty.

Regarding the need for this transparency up front, more clarity on the detailed

elements of the applicable rules is urgently requested in the case of the US. The examples of such elements are: the definition of a US person, the terms and conditions for applying substituted compliance to foreign entities and cross-border transactions, and the method to be employed for aggregating transaction volumes of group firms worldwide in relation to the *de-minimis* threshold for registration of swap dealers.

Second, once the details are made available, regulators should work together to avoid outright conflicts and minimize overlaps as much as possible, ideally *before* the rules are applied in their jurisdictions. Reliance on foreign regulators can be arranged through approaches of mutual recognition, substituted compliance, and exemptions, or a combination of those approaches.

Starting the implementation of US regulations under the current circumstances has already created uncertainty in the markets. If not managed properly, significant reductions in market liquidity and/or shifts in transaction venues or counterparties could occur as a result.

Thirdly, a sufficient transition period and adequate relief measures for non-US entities and infrastructure operators are needed to address the difficulties that they face in complying with US regulations. A certain amount of time is also required to work to avoid regulatory conflicts and inconsistencies arising from differences in the content and the timing of implementation of national or regional regulations. Foreign market participants and regulators would require some additional time to fully prepare for the new US requirements. In Japan, as described above, we are taking a two-stage approach in introducing new rules, and providing sufficient time for their phased implementation.

Fourth, when adopting an approach of reliance on foreign regulators, it should be based on a clear recognition of the foreign regulators' primary authority and competence in exercising effective regulation of entities and infrastructures based in its jurisdiction.

In the US, to the extent that the CFTC's proposed regulations have revealed, the scope of application of substituted compliance can be further extended to a broader set of regulated entities and transaction-level requirements. As a

national regulator, we would like to be recognized as the primary regulator of the entities established in Japan, and the CFTC is invited to rely on our supervisory authority and competence as much as possible. Whether a swap dealer qualifies for substituted compliance should be determined on recognition of equivalent regulation on a country-by-country basis, not on an entity-by-entity or rule-by-rule basis. In Japan, with respect to foreign CCPs and trade repositories, they are subject to less onerous requirements compared to CCPs and trade repositories established in Japan, if they are properly supervised by foreign regulators under supervisory cooperation arrangements with FSA Japan.

Fifth, cross-border transactions, by their nature, will be subject to regulations of two or more jurisdictions, if no arrangements are made between the relevant regulators to avoid duplication. If those duplicative requirements are not entirely conflicting or inconsistent, market participants could still cope, although there may still be additional costs involved in ensuring compliance with several different rules, such as in the case of duplicative data reporting requirements. But, if those rules clash with each other, arrangements are needed between regulators to enable the transaction to take place legally. Such cases can arise in the context of central clearing requirements.

In Japan, we have so far deliberately refrained from applying our rules to cross-border transactions in anticipation of an international coordination arrangement on regulation of cross-border transactions which we strongly hope to be developed soon.

When the US and Japan require central clearing for transactions of the same product, such as JPY-denominated IRSs with reference to LIBOR, market participants will not be able to enter into transactions without breaching the regulations of either the US or Japan, unless there is a CCP licensed or registered both in the US and Japan In this regard, a Japanese clearing organization licensed under FIEA (Japan Securities Clearing Corporation (JSCC)) is currently seeking CFTC registration as a derivatives clearing organization (DCO). The challenge for JSCC, however, is that it would need more time than its US counterparts to fully comply with US regulation, and a request is being made to grant some additional time for it to be fully compliant.

Need for better international coordination and the initiatives underway

As noted above, there are a number of important issues we need to address with respect to cross-border application of OTC derivatives regulations. To address these issues, there is a much greater need for international coordination and cooperation among regulators.

The G20 Ministers of Finance and Central Bank Governors agreed in Mexico City this November to put in place the legislation and regulation for OTC derivatives reforms promptly and act by end-2012 to identify and address conflicts, inconsistencies and gaps in their respective national frameworks, including in the cross-border application of rules. The Financial Stability Board, in its latest report on OTC derivatives market reforms, urged key, high-level OTC derivatives market regulators from G20 jurisdictions to pursue further discussions before the end-2012 deadline to (i) identify the cross-border application of rules to infrastructure, market participants, and products; (ii) identify concrete examples of any overlaps, inconsistencies and conflicts; and (iii) develop options for addressing these issues.

In response to the growing calls, leaders of regulators of major OTC derivatives jurisdictions, including regulators from the US, EU and Japan, met in New York City at the end of November, and agreed to a set of high-level operating principles and identified areas for further exploration in the regulation of the cross-border OTC derivatives market. This effort culminated in the joint press statement published last week which I referred to earlier. In pursuing this work, we have appreciated very much the leadership taken by the CFTC and the SEC. Regulators have agreed to regularly meet and consult with one another, going forward. The next meeting is scheduled to be in Brussels early next year.

The joint press statement was intended to address important issues requiring international coordination and cooperation, and to present a useful way forward. This includes (i) an understanding on clearing determinations (prior-consultation when making clearing determinations), (ii) an understanding on sharing of information and supervisory and enforcement cooperation (relevant supervisory authorities enter into supervisory and enforcement cooperation arrangements),

(iii) an understanding on timing (an orderly implementation process and a reasonable limited transition period) and (iv) areas of exploration regarding the scope of regulation and recognition or substituted compliance for cross-border compliance (possible approaches to prevent the application of conflicting rules and the desire to minimize the application of inconsistent and duplicative rules).

We found the outcome of this discussion extremely useful in further promoting coordination and cooperation among ourselves, and will continue to meet and consult regularly to coordinate in order to address any outstanding issues.

Last but not least, with the deadline of G20 commitment coming near, we will continue to need to push ahead aggressively to put in place the legislation and regulation for OTC derivatives reforms promptly and act to identify and address conflicts, inconsistencies and gaps in our respective national frameworks, including in the cross-border application of rules, so that we can achieve the G20's goals of improving transparency in the derivatives markets, mitigating systemic risk, and protecting against market abuse. We should make use of the opportunity that international forums such as IOSCO and the FSB could provide in supporting the work of OTC derivatives market regulators.

Thank you very much for providing this opportunity to share my views with you today. Let me emphasize once again that, as agreed by international regulators last month, regulators intend to cooperate and coordinate with each other much more closely and address the important issues related to cross-border regulation. It is a huge challenge, but one that has to be pursued, if we are to have globally interconnected financial markets that serve well to help growth in the real economies worldwide. Finding sensible, pragmatic cross-border solutions for global OTC derivatives trading is a test case for the global financial reform process. And it is urgent. We would be most grateful if you could provide your insights or suggestions in this regard. Now I will be delighted to respond to any questions you may have.