

**Reply to “Interpretation of Regulation of Segregation of Customers Assets  
pertaining to Foreign Commodity Futures Transactions”**

February 7, 2013

To: Futures Industry Association Japan

Representative Director: Mr. Mitch Fulscher, Chairman

Representative Director: Mr. Yasuo Mogi, Vice President

To: Japan Commodity Futures Industry Association

Mr. Kazumichi Okachi, Chairman

Director, Commodity Trade Division,  
Food Industry Affairs Bureau  
Ministry of Agriculture, Forestry and Fisheries

Director, Commerce and Consumer Affairs Policy Division  
Commerce, Distribution and Industrial Safety Policy Group  
Ministry of Economy, Trade and Industry

We reply as follows regarding the matter of your written request dated February 5, 2013.

When a Commodity Futures Commission Merchant licensed in Japan (hereinafter a “Japanese Commodity FCM”) intermediates as a broker accepting and transmitting a customer order for a transaction on a commodity exchange in the United States of America to a United States Futures Commission Merchant (hereinafter “US FCM”) who is a trading participant in that commodity exchange, as far as the segregation measures to be taken by the US FCM are concerned, we interpret that if the following measures are taken, the margin that the Japanese Commodity FCM receives in deposit from the customer falls under “that which is comparable” to the customer margins that are exempt from the application of the segregation measures in Japan (Ordinance for Enforcement of the Commodity Futures Act, Article 98-2(1)(i), Article 97(1)(iii)(d)). In such circumstances, there is no need for the Japanese Commodity FCM to take segregation measures.\*

- (1) The Japanese Commodity FCM shall be informed of the US FCM's segregated amount:

The Japanese Commodity FCM shall receive daily notification from the US FCM of the segregated amount, and the Japanese Commodity FCM shall respond so as to provide confirmation of the customer's segregated amount upon the customer's request.

- (2) The Japanese Commodity FCM shall take actions if the US FCM's segregated amount is insufficient:

A special agreement shall be entered into between the customer and the Japanese Commodity FCM to the effect that in circumstances where the US FCM's segregated amount becomes insufficient for return of the customer's assets, the customer may demand the Japanese Commodity FCM the return of the entire amount.

- (3) Remittances from the US FCM shall be made to an exclusively designated bank account of the Japanese Commodity FCM:

For the purpose of remittances of the customer assets from the US FCM to the Japanese Commodity FCM, the Japanese Commodity FCM shall open an account that is to be used for accepting such remittances (meaning an account that is other than the Japanese Commodity FCM's business account and which is clear to be used for accepting the customer assets from that name) and the customer assets shall be remitted to that account.

\*The reasons for this are provided in the Exhibit "Approach to the Reply."

(Exhibit)

## Approach to the Reply

### Request Presented

Article 210 (ii) of the Commodity Futures Act (*shouhin sakimono torihiki hou*) (hereinafter the “Act”) provides that a Commodity Futures Commission Merchant licensed in Japan (hereinafter a “Japanese Commodity FCM”) shall, in connection with foreign commodity market transactions, segregate assets that are equivalent to the value of the money, etc. that has been deposited by a customer, etc. from the Japanese Commodity FCM’s own assets, and deposit such assets with a trust company, etc. (hereinafter “Segregation Measures”). However, that same subparagraph provides that of the money, etc. that has been deposited by a customer, etc., that is specified by an ordinance of the competent ministry is exempted from the application of the Segregation Measures.

Thus, Article 98-2(1)(i) of the Ordinance for Enforcement of the Commodity Futures Act (hereinafter the “Ordinance”) provides that in transactions in foreign commodity markets, [cash, securities, and other assets] that are “comparable” to an item designated as exempted from the application of the Segregation Measures for transactions on domestic exchanges (each subparagraph of Article 97(1) of the Ordinance) is exempted from the application of the Segregation Measures.

It is our understanding that behind the present request [provided by FIAJ] is the existence of a situation in which Japanese Commodity FCMs are unable to appropriately respond to the needs of customers who are seeking access to trade in both domestic and foreign markets, including arbitrage transactions between international markets, because the interpretation of what is “comparable” is not clear.

### Fundamental Approach

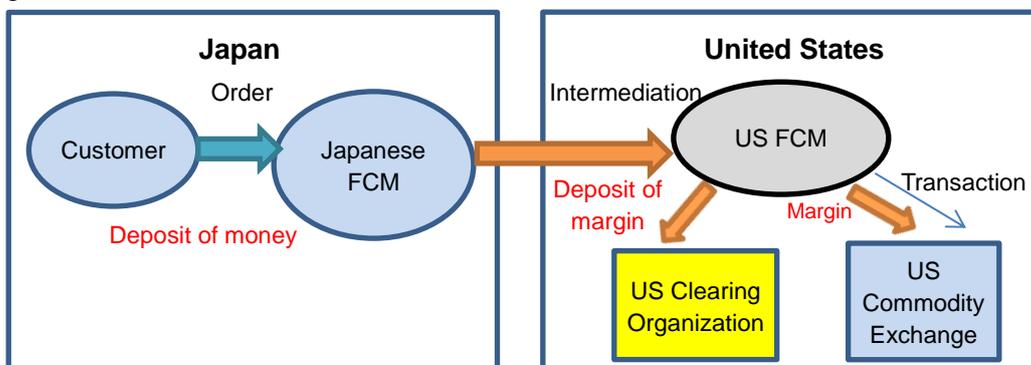
The purpose of Article 210(ii) of the Act imposing Segregation Measures obligations in foreign commodity market transactions is in preserving the customer assets. Thus, the exemption from application in Article 98-2(1)(i) of the Ordinance should be recognized where in foreign countries measures similar to those in Japan are taken for the preservation of customer assets.

Accordingly, it is understood that the question of whether a transaction relationship involving a foreign commodity market transaction is “comparable” to the items listed in the subparagraphs of Article 97(1) of the Ordinance, which pertains to domestic exchange transactions, should be assessed by giving consideration not only from the formal perspective concerning the form of the transaction but also from the substantive perspective of whether regulations are provided in the foreign country for the preservation of customer assets in a similar manner to transactions in the domestic market.

### Foreign Commodities Market Transactions on US Exchanges

Because the investor protection laws and bankruptcy laws in foreign countries relating to derivatives transaction are many and varied, and the specific transaction forms contemplated are also many and varied, whether something qualifies as “comparable” needs to be assessed case by case based on specifics. Therefore, first, we consider whether something can be found to be “comparable” in the example that is, we think, behind the request provided.

Specifically, we consider a case where a customer orders a foreign commodity market transaction on a US commodity exchange to a Japanese Commodity FCM (hereinafter the “Japanese FCM”) and the Japanese FCM intermediates as a broker by accepting and transmitting the said customer’s order to a trading participant in the commodity market in the United States (hereinafter an “US FCM”) and also deposits with the US FCM money that the Japanese FCM received in deposit from this customer for the margin for the foreign commodity market transaction (hereinafter the “Example Case”). See diagram below.



According to the provisions of the laws and orders as currently in force, in principle, under Article 210(ii) of the Act, the Japanese FCM must take Segregation Measures

with respect to the money it received in deposit from the customer such as placing it in trust with a trust company. However, if the margin that the Japanese FCM has deposited with the US FCM is “comparable” to the items listed in the subparagraphs on Article 97(1) of the Ordinance regarding transactions on domestic exchanges then this means there will be an exemption from the application of the Segregation Measures that are prescribed in Article 98-2(1)(i) and there will be no need to take Segregation Measures such as depositing in trust with a trust company for the money that was received in deposit from the customer.

Below we consider, from a formal perspective and a substantive perspective, whether the deposit of the margin with the US FCM is “comparable” to the Segregation Measures pertaining to transactions on domestic exchanges.

### **Formal Perspective**

In form, the Example Case appears to be “comparable” to Article 97(1)(iii)(d) of the Ordinance. In other words, it can be regarded that the customer in the above diagram is the “intermediary customer” (*toritsugi itakusha*), the Japanese FCM is the “intermediary” (*toritsugisha*), the US FCM is the “member, etc.” and the money that the Japanese FCM deposited with the US FCM is the “customer margin.” (*itaku shoukokin*)<sup>1</sup>

### **Substantive Perspective**

However, in view of the purpose of the segregation system, which is to preserve customer assets, in the Example Case, in order to be able to view that the money that Japanese FCM deposited with the US FCM is “comparable” to the “customer margin,” one needs also to consider from a substantive perspective whether the customer assets are sufficiently preserved in the United States.

Considering the matter based on the situation in Japan, it is prescribed by law that

---

<sup>1</sup>This means that the Japanese FCM who received the deposit of money from the customer (the brokerage margin in Article 179(3) of the Act) deposits the money with the foreign FCM to whom the Japanese FCM transmits the customer order (however, now we suppose that this is a Japanese one) (Article 179(2) and (1)(i)(a)(latter part of paragraph) of the Act). In this case, the Japanese FCM in principle incurs an obligation to keep the money that it received in deposit from the customer segregated (Article 210(i) of the Act) but by operation of Article 97(1)(iii)(d) of the Ordinance, the customer margin (limited to the extent of the amount of the brokerage margin only) is exempted from the application of the Segregation Obligations.

margins are ultimately deposited in whole with a commodity clearing organization as clearing margins (Act, Article 179) and custody is with that organization.

In contrast, in the United States, margins that are deposited with a US FCM are deposited in whole or in part with US clearing organizations as clearing margins but a portion can be held in a bank account that is separate from the business account and that is designated for the purpose of segregation. However, the customer assets that are held in the US FCM's segregated bank account are beyond the reach of liquidation procedures under the US Federal Bankruptcy Code and the customer has the right to priority payment of the amount in the account. Accordingly, if such segregation is done appropriately, even if the US FCM were to become bankrupt, the assets would be returned to the customer (in the Example Case, initially to the Japanese FCM) in their full amount but it is conceivable that if the assets are not kept appropriately segregated, there is the risk of the customer assets being lost.

Therefore, the risks concerning the customer assets that can be envisaged in the United States' segregation system arise in circumstances where assets are not kept appropriately segregated (risk of insufficiency). Also, in the Example Case, because remittances are made from outside Japan into Japan, one can conceive of the risk of commingling with the Japanese FCM's own funds when remittances are made from outside Japan (risk of commingling).

Comparing Japan and the United States in a table, the situation is as follows.

	Japan	United States		Risks of Concern
Final Destination of Deposit	Japanese Clearing Organization	Foreign Clearing Organization	Bank Account for Segregation	
Certainty of Preservation	Certain	Certain	Under the US Federal Bankruptcy Code, priority rights are granted over the amount in the account.	<b><u>Risk of Insufficiency</u></b> Risk that the amount in the account is not sufficient
Return Procedures When Trading Participant Bankrupt	The customer directly requests return.	The Japanese Commodity FCM makes a request to the US FCM's administrator for return and the US FCM's administrator returns the assets.		<b><u>Risk of Commingling</u></b> The risk of commingling with the Japanese Commodity FCMs' own funds when remittances are made from the US to Japan <sup>2</sup>

<sup>2</sup> If, at the point in time when the Japanese FCM receives the remittance, the Japanese FCM is also

In the United States, there are also systems in place that secure appropriate segregation such as the duty of the US FCM to report the segregated amount to National Futures Association (NFA) daily and penalties prescribed for having an insufficient segregation amount (a fine of up to one million dollars or imprisonment for up to ten years).

However, from the perspective of preservation of the customer assets, in order to be able to view that the deposit of the margin with the US FCM is “comparable,” from a substantive perspective, to what is designated as exempted from the application of the Segregation Measures for transactions on domestic exchanges, the following steps need to be taken in the Example Case. By virtue of (1) and (2), the risk of insufficiency, and by virtue of (3), the risk of commingling can be avoided.

<b>Steps Required in Example Case</b>	
Avoiding risk of insufficiency	(1) The US FCM shall notify the Japanese Commodity FCM of the segregated amount day to day and the Japanese Commodity FCM shall respond so as to provide confirmation of the customer’s segregated amount upon the customer’s request.
	(2) A special agreement shall be entered into between the customer and the Japanese Commodity FCM to the effect that in circumstances where the US FCM’s segregated amount becomes insufficient for return of the customer’s assets, the customer may demand the Japanese Commodity FCM the return of the entire amount.
Avoiding risk of commingling	(3) For the purpose of remittances of the customer assets from the US FCM to the Japanese Commodity FCM, the Japanese Commodity FCM shall open an account that is to be used for accepting such remittances (meaning an account that is other than the Japanese Commodity FCM’s business account and which is clear to be used for accepting the customer assets from that name) and the customer assets shall be remitted to that account.

In the Example Case, we believe that if the measures described above in (1) through (3) are secured, protection of customer assets can be sufficiently afforded and it can be viewed that deposits of margins with the US FCM is “comparable” to what is designated as exempted from the application of the Segregation Measures for

---

bankrupt, this risk becomes evident.

transactions on domestic exchanges.

In circumstances where the segregation amount in the United States is not as much as the segregation amount that would have been required in Japan (the amount required for segregation under Article 210(ii) of the Act in case the exemption from the application under Article 98-2(1)(i) of the Ordinance is not made), then the shortfall will not be covered by the exemption from application and therefore the Japanese Commodity FCM will need to take Segregation Measures.

### **Conclusion**

For foreign commodity market transactions on commodity exchanges in the United States, in the circumstances of the Example Case where the Japanese FCM deposits the customer's margin with the US FCM, if the steps described above are taken, this money will be regarded as falling under the exemption from the Segregation Measures. In these circumstances, the Japanese FCM will not need to take Segregation Measures for this money by way of depositing it in Japan with a trust company, etc.

### **Other Examples and Jurisdictions**

As stated above, the question of whether something falls under “comparable” needs to be assessed case by case based on specifics as assessments need to be made for each transaction form.

Also, because the investor protection laws and bankruptcy laws relating to derivatives transactions in foreign countries, as well as the business practices in those foreign countries, vary widely, if a Japanese Commodity FCM deposits a margin with a participant in that foreign commodity exchange, determining whether that money will be exempted from the Segregation Measures requires a substantive assessment of that country's legal system based on individual cases. Having said that, from the perspective of preservation of customer assets, in circumstances essentially the same as the Example Case, it would likely be viewed that there is an exemption from application of the Segregation Measures.

End.

*Notes: This letter is a translated version into English of the original letter written in Japanese language by Ministry of Economy, Trade and Industry and Ministry of Agriculture, Forestry and Fisheries.*

*Any contradictions with the original letter will be subject to interpretation of the original letter written in Japanese.*