Japan's Bankruptcy Safe Harbour Provisions and Repurchase Agreements:

A commentary and annotated translation of the "Act Concerning Close-out Netting of Specified Financial Transactions Undertaken by Financial Institutions etc."

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A. COMMENTARY

I. INTRODUCTION – THE IMPORTANCE OF TRANSLATION AND NETTING

In this article I provide an annotated English translation of the Japanese "Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc" ("Close-out Netting Act").[1] I also consider the drivers behind the introduction of the Close-out Netting Act in 1998, as well as its implementation and operation in light of the safe harbour provisions in other Japanese insolvency-related legislation. Finally,

* I am indebted to Mr Akihiro WANI and Ms Reiko OMACHI (Linklaters LLP, Tokyo) for their indispensible comments and guidance during the preparation of this article. They are experts in this field. Mr Wani was a member of the working committee organized under the auspices of the Financial Systems Council (*Kin'yū Shingi-kai*) to submit an advisory report regarding the enactment of the Close-out Netting Act.

1 金融機関等が行う特定金融取引の一括清算に関する法律 [Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc], Act No. 108, 15 June Heisei Year 10 [1998], last amended by Act No. 66, 14 June Heisei Year 18 [2006].

I provide an example of the application of the Close-out Netting Act from a practical perspective by analysing how the Close-out Netting Act might work in relation to commonly used repurchase agreements if a counterparty were to become insolvent in Japan in certain circumstances, and analyse its effect in light of the global financial crisis.

Annotated translations promote transparency and market understanding.[2] The legal framework surrounding transactions involving the transfer of collateral and netting in insolvency is particularly complex and has the potential to involve many jurisdictions, making it important for an English translation of the Close-out Netting Act to be available for parties dealing with Japanese counterparties who may become subject to Japanese insolvency proceedings.[3] Although the Japanese government has embarked on an aggressive schedule to promote translations of Japanese commercial law as part of its transparency of law project,[4] I am not aware of an existing publicly available translation of the Close-out Netting Act from Japanese into English.

The analysis of repurchase agreements in the context of the global financial crisis in the final section of this article provides clues as to the impact of the Close-out Netting Act on Japanese market practice. The collapse of Lehman Brothers has heightened global market interest in collateral transfers and payment settlement systems. Further, the application of bankruptcy safe harbour provisions to repurchase agreements leading to the effective netting of financial obligations has come under intense scrutiny as a result of the financial crisis in the United States.[5] I am not aware, however, of any judicial precedents applying the Japanese Close-out Netting Act. I conclude that any disputes or delays arising from the liquidity crisis in global financial markets in 2008-09 in Japan were dealt with by way of private workout in the shadow of the clear provisions set out in the Close-out Netting Act, related insolvency legislation and applicable contractual arrangements.

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2 On the importance of "good" translation generally, *see*, C. LAWSON, Found in Translation: The 'Transparency of Japanese Law Project' in Context, in: ZJapanR/J.Japan.L 24 (2007) 187.

3 For an overview of this area of law generally *see*, P.R. WOOD, Set-off and netting, derivatives, clearing systems (2nd ed., London, 2007).

4 LAWSON, *supra* note 2. LAWSON provides an academic and freelance translator's perspective on the "Transparency and Enrichment of Japanese Laws concerning International Transactions in the 21st Century – Doing Cross-Border Business with/in Japan Project".

5 *See*, *e.g.*, M. BRIDGE, Security financial collateral transfers and prime broker insolvency, in: Law and Financial Markets Review, March (2010) 180. BRIDGE is commenting on the treatment of financial collateral arrangements in the case of *Re Lehman Brothers International (Europe), Lomas v RAB Market Cycles (master) Fund Ltd* [2009] EWHC 2545 (Ch). In relation to the global financial crisis and derivatives generally, *see*, *e.g.*, C. BROWN / T. CLEARY, Impact of the global financial crisis on OTC derivatives in structured debt transactions, in: Capital Markets Law Journal 5(2) (2010) 218. Organisations such as the Bank for International Settlements gave serious consideration to the credit, financial and liquidity risks posed by netting structures as early as the 1980s. *See*, BANK FOR INTERNATIONAL SETTLEMENT, Report on Netting Schemes (February 1989), at *http://riskinstitute.ch/138820.htm*, at 19 April 2010. The Report was drafted by the Group of Experts on Payment systems and included a representative from the Bank of Japan.

II. Treatment of Derivative Transactions when a Counterparty enters into Insolvency Proceedings

1. Development of safe harbour provisions

The filing of a petition under insolvency legislation or the commencement of a proceeding may result in moratoriums or stays on the ability of counterparties to exercise otherwise enforceable contractual and commercial law rights in relation to derivative transactions. The uncertainty created by the application of a moratorium to contracts which may vary greatly from day to day depending on pricing has the potential to undermine confidence in a financial system. Accordingly, some jurisdictions provide for qualifying agreements to be exempt from any moratorium under the relevant insolvency proceedings, and for the contract to be terminated and any collateral liquidated. Accordingly, these types of provisions are known as "safe harbours" from the moratorium for those contracts. The most recent judicial examples of the application of safe harbour provisions have occurred in relation to derivative transactions and the Chapter 11 proceedings relating to the American investment bank, Lehman Brothers.[6]

Safe harbour provisions were included in the new United States Bankruptcy Code to exempt commodity and forward contracts from the powerful automatic stay and preference provisions when it was initially established in 1978.[7] The protections were expanded in 1982,[8] 1984, 1990 and, most recently, in 2005. According to Krimminger, a Federal Deposit Insurance Corporation official in 2006,[9] the American government expanded the exemption to the automatic stay to deal with financial market developments, and was comfortable making exceptions to the important automatic stay concept on the basis that "protection of these contractual rights is viewed as crucial to protect the viability, not only of individual counterparties, but of the marketplace as a whole"; the extensions followed a theme of limiting the exemption to contracts which are "actively traded in the financial markets and [are] subject to the risks of fluctuating values inherent in those markets".[10] Supporters of safe harbour provisions argue from an economic policy perspective that contracts such as repurchase agreements are fundamentally important to

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6 *See*, *e.g.*, Lehman Brothers Holdings Inc., *et al.* (Chapter 11 Case No. 08-013555 (JMP) (Jointly Administered), Debtors' Motion pursuant to sections 105(a), 362 and 365 of the Bankruptcy Code to Compel Performance of Metavante Corporation's Obligations under an Executory Contract and to Enforce the Automatic Stay.

7 G. Walters, Note: Repurchase Agreements and the Bankruptcy Code, in: Fordham Law Rev. 52 (1983-4) 828, 845.

8 *Id.*

9 M. Krimminger, The evolution of US insolvency law for financial market contracts (2006), at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=916345*, at 29 April 2010. At the time of writing his article, Krimminger was "Senior Policy Advisor to the Director of the Federal Deposit Insurance Corporation's Division of Resolutions and Receiverships". *See*, *id.*, note 1.

10 *Id.*, 5. Krimminger is referring to title IX of the Bankruptcy Abuse Prevention and Consumer Protection Act, 2005 (United States). *See*, *esp.*, at 2 and 5-7.

the functioning of a stable economy and deserve protection.[11] Positive endorsements of the development of safe harbour exemptions, however, was (and is) not given by everyone.

Safe harbour provisions highlight the tension between bankruptcy and economic policy. The safe harbour provisions in the United States Bankruptcy Code were criticised before, and subsequent to, the global financial crisis and the collapse of Lehman Brothers, for placing certain counterparties in a privileged position in insolvencies involving financial entities.[12] According to this line of argument, safe harbour provisions are contrary to the fundamental bankruptcy policy aim of treating all creditors equally (the pari passu principle).[13] Lubben, an American academic, argues that the concept of preventing the debtor from "cherry picking" contracts drives the support for the United State's Bankruptcy Code's "special treatment of derivative contracts, which are not subject to the automatic stay". He is critical of the exemptions, in part based on the assumption that the majority of contracts which benefit from the safe harbour provisions are hedging contracts forming an "integral part of the going concern value of the business";[14] this is not the case for many repurchase agreements, as discussed below.

Despite the provisions in the United States Bankruptcy Code which were previously understood to provide safe harbors, however, anecdotal evidence suggests that investors with collateralized investment exposure under certain agreements with Lehman Brothers in the United States have encountered difficulties in, for example, obtaining the return of collateral.[15] It would appear, however, that Lehman's Chapter 11 counsel in the United States is aggressively seeking to manage settlement outcomes under contracts such as repurchase agreements to achieve favorable outcomes for Lehman's unsecured creditors. It is difficult to know exactly what occurred in 2008, however, because the parties to

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11 Walters, *supra* note 7, 848. On the arguments in favour of maintaining the automatic stay in relation to repurchase agreements, *see*, WALTERS at 847-8. For a recent summary of the arguments for close-out netting, *see*, D. MENGLE, Close-Out Netting and Risk Management in Over-the-Counter Derivatives, in: International Swaps and Derivatives Association and Fordham University (1 June 2010), at *http://ssrn.com/abstract=1619480*, at 6 September 2010. MENGLE works for the International Swaps and Derivatives Association.

12 *See*, *e.g.*, F. EDWARDS / E. MORRISON, Derivatives and the Bankruptcy Code: Why the Special Treatment? Columbia Law and Economics Paper no. 258 (2004), at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=589261,* at 29 April 2010. EDWARDS and MORRISON'S focus is derivative contracts and the collapse of Long Term Capital Management in 1998. *See*, also, K. KETTERING, Securitization and its discontents, in: Cardozo Law Review (2008) 1651.

13 In relation to the aims of insolvency law and the pari passu principle, *see*, *e.g.*, M. MURRAY, Keay's Insolvency: Personal and Corporate Law and Practice (6th ed., Sydney, 2008) 11.

14 S.J. LUBBEN, Derivatives and Bankruptcy: The flawed case for special treatment, in: U.Pa.J.Bus.L. 12 (2009) 61, 62.

15 *See* also the comments by BRIDGE on the case of *Re Lehman Brothers International (Europe)*, *supra* note 5, and the United State's Bankruptcy Court's decision in Lehman Brothers Holdings Inc., *et al*., *supra* note 6.

agreements with entities in the Lehman Brothers group generally contracted privately without the use of a public settlement or clearing system.

2. *Model netting legislation and the role of ISDA*

In addition to providing for protections for derivative transactions in general insolvency legislation, another way of protecting these financial contracts is to enact specific close-out netting legislation. The International Swaps and Derivatives Association (ISDA), a leading global trade organisation which sponsors standardized contracts used for the vast majority of derivative contracts, has long recognised the importance of close-out netting.[16] It developed a Model Netting Law which was published in 1996, revised in 2002,[17] and further revised and updated in 2006.[18] ISDA has consistently encouraged various jurisdictions to adopt close-out netting provisions.[19] According to ISDA, close-out netting is "central" to its "primary purpose", which "is to encourage and assist in the establishment of sound legal documentation and financial risk management systems and to ensure the prudent and efficient development of the derivative markets".[20]

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16 According to ISDA, it has promoted netting legislation in various jurisdictions since 1987. *See*, R. PICKEL (Executive Director and Chief Executive Officer) and K. DARRAS (General Counsel, Americas, ISDA), Introduction to ISDA and its Documentation Architecture (2008), presentation available on ISDA's website, at *http://www.isda.org*, at 6 September 2010. For a recent explanation of ISDA's policy, *see*, D. MENGLE, The Importance of Close-Out Netting, ISDA Research Notes (Number 1, 2010), at *http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf,* at 6 September 2010.

17 For a copy of the 2002 Model Netting Act, *see*, International Swaps & Derivatives Association, Inc., 2002 Model Netting Act, at *http://www.isda.org/docproj/netact.pdf*, at 6 September 2010. For a practitioner's view of the 2002 Model Netting Act *see*, T.J. WERLEN / S.M. FLANAGAN, The 2002 Model Netting Act: A solution for insolvency uncertainty, in: Butterworths Journal of International Banking and Financial Law (April 2002) 154. The article concludes with a copy of the 2002 Act. WERLEN and FLANAGAN worked for Allen & Overy, global counsel for ISDA (at 160).

18 For a copy of the 2006 Model Netting Act, *see*, International Swaps & Derivatives Association, Inc., 2006 Model Netting Act, at *http://www.isda.org/docproj/pdf/Model-Netting-Act101007.pdf*, at 6 September 2010. Slight revisions were made to the version published in March 2006 and were published in October 2007. PICKEL / DARRAS, *supra* note 16, 7.

19 *See*, *e.g.*, the letter dated 26 November 2003 published in English and Korean on the ISDA website from ISDA to The National Assembly of the Republic of Korea, Legislation and Judiciary Committee, urging the Committee to continue its support of the close-out netting provision in the then draft Debtor Rehabilitation and Bankruptcy Law of Korea. *See*, also, ISDA's list of countries which have adopted netting legislation. ISDA, Netting Legislation – Status, at *http://www.isda.org/docproj/stat_of_net_leg.html*, at 30 August 2010. For a summary of the close-out netting situation in some other Asian jurisdictions, *see*, C. LEIW, J. GU / K. NOYES, The Derivatives Safety Net, in: AsiaRisk (July 2010), at *http://www.isda.org/uploadfiles/-docs/AsiaRisk15AnniversaryIssue_legal%20certainty.pdf,* at 6 September 2010.

20 *Id*, 1.

Highlighting its success in fulfilling these goals, ISDA has taken credit for provisions in legislation which reflect its Model Netting Act.[21] Further, ISDA published a Memorandum on the implementation of netting legislation in March 2006[22] with a view to providing "practical advice and guidance to governmental officials and other policy-makers in countries that are currently considering implementing netting legislation".[23] The Memorandum attempts to take into account concerns raised by countries with a civil law tradition, such as Japan.[24] ISDA noted that "in many countries it will not necessarily be feasible, as a matter of theory or practice, to implement the 2006 MNA [Model Netting Act] substantially in the form in which [ISDA] have published it".[25] The analysis in the Memorandum, however, provides a useful global benchmark for analysing the Japanese Close-Out Netting Act.

According to ISDA, laws dealing with close-out netting should facilitate close-out netting of transactions in the case of default, whether in or outside the context of insolvency, without stay or delay, free form avoidance, claw-back or "cherry-pick" risk.[26] Cherry picking refers to the practice of debtors seeking to continue existing profitable unperformed contracts, but terminate unprofitable contracts potentially to the detriment of the non-bankrupt counterparty. According to ISDA, close-out netting legislation should also permit single and cross-product netting, whether pursuant to a single master agreement or multiple master agreements where the agreement(s) permit default to become a close-out event for all transactions and agreements.[27] ISDA cites statistics that suggest the use of close-out netting arrangements and the certainty provided by supporting legislation can substantially decrease the monetary risk involved in outstanding over-the-counter derivative transactions.[28]

In Japan, although the 1996 ISDA Model Law was often referred to by the Japanese drafters of the Close-out Netting Act, it was not adopted verbatim.[29] There were concerns by legislators that the 1996 ISDA Model Law did not meet the needs of countries such as Japan with a civil law tradition.[30] The 2002 ISDA Model Law was designed to

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21 *Id*, 2.

22 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., Memorandum on the implementation of netting legislation: A guide for legislators and other policy-makers (March 2006), at *http://www.isda.org/docproj/pdf/Memo-Model-Netting-Act.pdf,* at 6 September 2010.

23 *Id*., 1.

24 *Id*., 2. I use the term "civil law tradition" in the broadest sense of the term, and without an intention to narrowly classify or categorise the Japanese legal system, including, for example, in a family of legal systems. For a critique of attempts to narrowly classify legal systems in Asia, *see*, A. MARFORDING, The Fallacy of Classification of Legal Systems: Japan Examined, in: V. Taylor (ed.), Asian Laws Through Australian Eyes (Sydney, 1997) 65.

25 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., *supra* note 22.

26 PICKEL / DARRAS, *supra* note 16, 8.

27 PICKEL / DARRAS, *id*., 9.

28 *Id*., 10.

29 Correspondence between Linklaters and author, 8 July 2010.

30 WERLEN / FLANAGAN, *supra* note 17, 158.

better facilitate the Model Law's use in these jurisdictions.[31] By 2002, however, Japan had already adopted the Close-out Netting Act.

III. CLOSE-OUT NETTING AND DERIVATIVE TRANSACTIONS IN JAPAN

1. Drivers for the enactment of the Close-out Netting Act in Japan

The Close-out Netting Act was enacted by the Japanese government in 1998. The provisions are designed to ensure the validity and enforceability of close-out netting agreements (Art. 1). Prior to the introduction to the Close-out Netting Act, the validity of close-out netting had been debated. Similarly to the debates in the United States, it was argued that its effectiveness was questionable in light of the aims of Japanese insolvency law.[32] If a creditor was allowed to close out and net its position on the insolvency of a debtor, that creditor's claim could be fully or partly paid and the creditor could be placed in a privileged position despite the legal priority among creditors provided for under insolvency legislation.

The timing of the introduction of the Close-out Netting Act was also driven by far reaching reforms[33] of the Japanese financial system.[34] The reforms were designed to significantly liberalise the Japanese financial system, including new rules relating to the licensing and registration of banks, securities companies and insurance businesses, and the types of services that they may provide. Because derivatives became available to general investors, the government, bureaucracy and market participants considered it important to clarify the position of close-out netting to encourage and ensure the credibility of new derivative markets by minimizing the impact of an insolvent party.[35]

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31 *Id.*

32 Correspondence between Linklaters and author, 8 July 2010.

33 Also known as the "Japanese Big Bang". For a brief government-sponsored overview, *see*, Financial Services Agency, Japanese Big Bang (January 2000), at *http://www.fsa.go.jp/p_mof/english/big-bang/ebb37.htm,* at 23 August 2010. For a more detailed academic analysis in English, *see*, C. WELLS, Financial Services and Regulation, in: G. MCALINN (ed.), Japanese Business Law (Alphen aan den Rijn, 2007).

34 For commentaries on the Close-out Netting Act, *see*, N. YAMANA, *Kin'yū kikan nado ga okonau tokutei kin'yū torihiki no ikkatsu seisan ni kansuru hōritsu no kaisetsu* [Commentary on the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc], in: NBL 645 (1998) 20, and H. KANDA, *Ikkatsu seisan hō no seiritsu* [The Close-Out Netting Act becomes effective], in: Kinhō 1517 (1998) 18.

35 *See*, *e.g.*, YAMANA, *id*, 20-1. *See*, also, ŌKURA-SHŌ [Office of the Minister of Finance], *Kin'yū shisutemu kaikaku no puran – kaiku no sōki jitsugen ni mukete* [Plan for the reform of the financial system: towards the early realisation of the reforms] (13 June 1997), at Financial Services Agency, *http://www.fsa.go.jp/p_mof/big-bang/bb32.htm*, at 23 August 2010. The introduction of close-out netting legislation to the Diet "in the next sitting" is listed as one of the measures to be taken to reduce increased payment system risk. Other measures taken as part of the Big Bank reforms designed to support the market included the establishment of a bank deposit guarantee by the Japanese government. Financial Services Agency, *id*.

International trends and financial institutions also created conditions favourable to the introduction of close-out netting legislation in Japan. Japan was the last of the G7 nations to adopt close-out netting legislation, which was recommended by the Bank for International Settlements.[36]

The Close-out Netting Act was amended in Japan in 1999 (twice), 2000, 2002, 2004 and 2006, but Japanese legislators did not make significant amendments to its operation. The most recent amendments in 2006 simply updated references to the Securities Exchange Act[37] which was significantly amended and became the Financial Instruments and Exchange Act[38] in the same year.[39] The most significant amendment to the operation of the Close-out Netting Act was as a result of an amendment to the Ordinance (translated below) in 2001. By this amendment, repo and gensaki transactions were specifically included as eligible transactions.[40]

2. *Protection for eligible derivative contracts under the Close-Out Netting Act*

The Close-out Netting Act itself is made up of only three provisions and involves four key concepts which are essential to understanding its parameters. This section deals with the key concepts of "specified financial transaction", "bankruptcy proceeding etc" and "financial institution etc". The fourth concept of "close-out netting event" is dealt with in the next section as part of the discussion of the Bankruptcy Act.

In essence, if an eligible counterparty in Japan were to enter into "bankruptcy proceedings etc", an eligible agreement would be automatically closed-out and any applicable collateral liquidated despite any moratorium under the relevant insolvency proceedings. More specifically, the safe harbour provisions provide that where a ruling to commence a bankruptcy, corporate reorganisation or civil rehabilitation proceeding in Japan (Art. 3) is made in respect of a "financial institution etc" (*kin'yū kikan nado*) or its counterparty, and they have entered into a "specified financial transaction" (*tokutei*

36 *See*, YAMANA, *id*, 21 and 23.

37 Act No. 25, Shôwa Year 23 [1948].

38 *Financial Instruments and Exchange Act* (Act No. 25, Shôwa Year 23 [1948]), MINISTRY OF JUSTICE (JAPAN) (trans.) (16 June 2009), at *http://www.japaneselawtranslation.go.jp/*, at 12 July 2010.

39 Correspondence between Linklaters and author, 8 July 2010. The Financial Services Agency recently proposed a new amendment to the Ordinance. *See* FINANCIAL SERVICES AGENCY, *Kin'yū shōhin torihiki seisan kikan nado ni kansuru naikaku-fu-rei no ichibu o kaisei suru naikaku-fu-rei an nado no kōhyō ni tsuite* [Concerning the publication of the draft Order of the Cabinet Office for the partial amendment of the Ordinance for Financial Instruments Clearing Organization etc.] (27 August 2010), at *http://www.fsa.go.jp/news/22/syouken/20100827-1.html*, at 20 September 2010. Over-the-counter commodity derivative transactions (店頭商品デリバティブ取引) may be included as eligible transactions; note that these are different to over-the-counter derivative transactions (店頭デリバティブ取引) which are already included in the definition (see art. 2(1) of the Close-out Netting Act and translator's notes below.

40 *See* discussion of repurchase agreements below.

kin'yū torihiki) under an agreement providing for close-out netting on the occurrence of certain events, the claims held by each party against each other will be replaced by a single net claim pursuant to the relevant close-out netting arrangement. The Bank for International Settlement describes this type of netting as "netting by close-out".[41] Further, payments or transfers of collateral in relation to eligible transactions will not be subject to the otherwise relevant preference laws and thus will not be avoided.[42]

The term "specified financial transaction" (*tokutei kin'yū torihiki*)[43] is defined in the Close-Out Netting Act (see Art. 2(1)). ISDA argues that it is "clearly important" to "clarify in some way or other the types of financial transaction that benefit from the netting regime", but to do so in a way which allows for future market innovations.[44] The Close-Out Netting Act does this by providing for regulations to be ordered by Cabinet to keep up with market innovations (see Art. 2(1)). It also gave consideration to ISDA's general recommendation that the definition be broad enough to encompass transactions other than derivative transactions, such as repurchase transactions and securities lending transactions.[45] The transaction must also take placed under a "master agreement" (see Art. 2(6)), which is defined in Art. 2(5). Examples of the types of master agreements to which the Close-out Netting Act was designed to apply were given by the drafters of the legislation at the time of its enactment, including: standard ISDA Master Agreements 1992/2002; International Foreign Exchange Master Agreements; and International Currency Options Market's Master Agreements.[46]

The reference to "bankruptcy proceeding etc" in the Close-out Netting Act includes bankruptcy, corporate reorganisation and civil rehabilitation proceedings in Japan. Accordingly, it encompasses the major insolvency procedures, but the legislation might have gone further.[47] Benchmarked against ISDA's guide for implementing its Model

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41 The Bank for International Settlement defines "netting by close-out" as "[A]n arrangement to settle all contracted but not yet due liabilities to and claims on a bank by one single payment, immediately upon the occurrence of one of a list of defined events (such as the appointment of a liquidator to that bank)". To be contrasted with "netting by novation" which means "[T]he replacement of two existing contracts between two parties for delivery of a specified currency on the same date by one single net contract for that date, such that the original contracts are satisfied and discharged. (Also referred to as obligation netting.)". *See*, BANK FOR INTERNATIONAL SETTLEMENT, Report on Netting Schemes, Glossary of Terms, at *http://riskinstitute.ch/141860,* at 19 April 2010.

42 *See* Article 1 of the Ordinance for the enforcement of the Act (translated below) which includes "collateralisation transactions" as eligible transactions.

43 Section 1 of the ISDA Model Netting Law refers to a similar concept of "qualified financial contract".

44 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., *supra* note 22, 4.

45 *Id*., 5.

46 YAMANA, *supra* note 34, 24-5.

47 The original Close-out Netting Act only provided for proceedings under the Bankruptcy Act and Corporate Reorganisation Act. The Civil Rehabilitation Act only replaced the Composition Act (Act No. 72, Taishō Year 11 [1922]) in 1999. The Composition Act did not have a mechanism whereby a trustee could adopt or terminate contracts, as discussed below.

Netting Law, the Japanese Close-Out Netting Act might also have referenced "all types of insolvency proceedings", including, for example, "voluntary arrangements with creditors or the inability of the debtor to pay its debts as they become due".[48] ISDA's comments on the breadth of close-out netting legislation's application to insolvency proceedings are particularly relevant in light of developments surrounding the Act on Promotion of Use of Alternative Dispute Resolution ("ADR Act") in Japan,[49] which has been used in conjunction with insolvency legislation to promote turnarounds. A catch all provision relating to "all similar proceedings" would have extended the scope of the Japanese Close-out Netting Act to "new types of proceedings" such as the ADR Act.[50] At this stage, I am not aware of any legislative intention to amend Art. 3 of the Close-out Netting Act to include the new ADR Act.[51]

The definition of "financial institution etc" (*kin'yū kikan nado*) in the Close-out Netting Act (Art. 2(2)) limits the application of the legislation to entities such as licensed banks, stock brokers and prescribed quasi-government central banks.[52] The drafters of the legislation were primarily concerned with cross-border and inter-bank transactions which could lead to systemic risk, thus partly justifying the limitation.[53] ISDA's Model Law, however, does not limit the scope of potential contracts to those with entities such as banks. ISDA argues that limiting close-out netting to "certain categories of market participant" does not "necessarily make sense from a system risk point of view".[54] ISDA is concerned that limitations "potentially lead to difficult issues of characterization in relation to certain market participants", and this may create "legal uncertainty, and require periodic updating to reflect the continuing evolution of dynamic market".[55] Recent reform to Japan's Bankruptcy Act help to mitigate the risk that the limitations placed on the application of the Close-out Netting Act will cause the type of problems highlighted by ISDA.[56]

Accordingly, it was not deemed necessary to include the Composition Act in the original definition of "bankruptcy proceeding etc". *See*, YAMANA, *supra* note 34, 24.

48 *Id*., 11.

49 Act No. 151, 1 December Heisei Year 16 [2004], MINISTRY OF JUSTICE (JAPAN) (trans.) (1 April 2009), at *http://www.japaneselawtranslation.go.jp/*, at 6 September 2010 .

50 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., *supra* note 22, 11. Act No. 151 of December 1, 2004

51 Correspondence between Linklaters and author, 8 July 2010.

52 *See*, *e.g.*, Cabinet Order for enforcement of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc translated below. The list of prescribed financial institutions includes central banks such as The Norinchukin Bank, which is the central bank for Japan's agricultural, forestry and fisher co-operatives. The Norinchukin Bank, at *http://www.nochubank.or.jp/annual/index.shtml*, at 23 August 2010.

53 YAMANA, *supra* note 34, 24. He notes that the major players in the derivative contracts involving close-out netting (not payment netting) also tend to be financial institutions.

54 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., *supra* note 22, 4.

55 *Id*.

56 The Bankruptcy Act provides for a larger application of the close-out netting concept because Article 58 is not limited to "financial institutions etc", as discussed in the next section.

3. Safe harbour provisions in Japan's Bankruptcy Act and other insolvency-related proceedings

Article 58(5) of the new Bankruptcy Act enacted in 2004[57] clarifies the effectiveness of netting[58] on the commencement of bankruptcy proceedings in relation to exchange traded products or, more specifically, "a contract for a transaction of goods with a quotation on an exchange or any other market quotation". Concurrently with the occurrence of the effect of any eligible netting, such contracts between a bankrupt and any other counterparty will be cancelled (Art. 58(1)). If the non-bankrupt party is owed money, s/he becomes a bankruptcy creditor.[59]

Unlike the Close-out Netting Act, the Bankruptcy Act is not limited to contracts involving a "financial institution etc" (*kin'yū kikan nado*) or its counterparty[60]. According to the explanatory commentary produced by members of the Ministry of Justice who drafted the bill on which the Bankruptcy Act was based, the definition of contract in the Bankruptcy Act should not be limited to a certain type of contract or list;[61] also potentially broadening its application beyond that of the Close-out Netting Act.[62] According to the authors, they were particularly concerned that the Close-out Netting Act would not apply to contracts between a Japanese trading corporation which entered into bankruptcy proceedings in Japan and a non-Japanese financial institution.[63] Article 58 of the Bankruptcy Act also applies mutatis mutandis to netting in a civil rehabilitation proceeding[64] and corporate reorganisation proceeding,[65] thus covering the vast majority of

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57 Bankruptcy Act (Act No. 75, Heisei Year 16 [2004]), MINISTRY OF JUSTICE (JAPAN) (trans.) (20 October 2009), at *http://www.japaneselawtranslation.go.jp/*), at 23 August 2010.

58 Previously, the treatment of these types of contracts was dealt with in Article 61 of the old Bankruptcy Act (Act No. 71, Taishō Year 11 [1922]).

59 Bankruptcy Act, *supra* note 57, Article 58(2) and (3).

60 H. OGAWA (ed.), Ministry of Justice, *Ichimon ittō atarashii hasan-hō* [Question and Answer: New Bankruptcy Act], in: Shōji hōmu 2004, 97-8. This book is typical of the commentary produced by members of the Ministry of Justice who have worked on drafting bills. The commentary provides transparency and insight into each provision in the legislation. They also form influential guides for the future interpretation of the relevant legislation. A similar book was not published in relation to the Close-Out Netting Act, probably because of its limited and technical application. These commentaries became more common from 2000, after the enactment of the Close-out Netting Act. Explanatory commentary was published by the drafters of the bill on which the Close-out Netting Act was based in the form of a short article in a leading financial law journal in 1998 when the legislation was enacted. *See*, YAMANA , *supra* note 34.

61 *Id*.

62 *Id*, 99.

63 *Id*, 97-8.

64 Article 51 of Civil Rehabilitation Act (Act No. 225, Heisei Year 11 [1999]), MINISTRY OF JUSTICE (JAPAN) (trans.) (1 April 2009), at *http://www.japaneselawtranslation.go.jp/*), at 30 August 2010.

65 Article 63 of Corporate Reorganisation Act (Act No. 154, Heisei Year 14 [2002]). As at 30 August 2010, there was no translation available at MINISTRY OF JUSTICE (JAPAN) (trans.), at *http://www.japaneselawtranslation.go.jp/*).

formal insolvency proceedings in Japan. The Close-out Netting Act will apply to the extent a derivative contract falls within the Close-out Netting Act's application. It survives as a special law which can be used to keep up with new types of derivative transactions. Accordingly, legislators may avoid frequently amending the Bankruptcy Act which is viewed as a general and basic law of Japan.[66] The drafters of the new Bankruptcy Act expect that the validity of the Close-out Netting Act would become more stable by setting forth the Article 58 (5) of the Bankruptcy Act and they imply that any judicial interpretation of the Close-out Netting Act will be influential to the interpretation of Article 58.

Article 58 is part of subsection 2 of the Bankruptcy Act, which deals with the effect of the commencement of a bankruptcy proceeding on different types of contracts and transactions. At first glance, a financial contract such as a swap or other derivative contract between two entities one of which was not a financial institutions etc as defined in Article 2 of the Close-out Netting Act would fall within Article 53 of subsection 2 of the Bankruptcy Act.[67] If that were the case, Article 53 gives the trustee power to decide what to do with bilateral contracts under which performance has not been completed at the time of the commencement of bankruptcy, and potentially gives the trustee to cherry pick.[68] A trustee may cancel the contract or perform the bankrupt's obligation and request the counterparty to perform his/her obligation; any provision in a contract to the contrary would ordinarily be invalid.[69] In this case, however, Article 58 stipulates that if the contract is a transaction with a quotation on an exchange or any other market quotation[70] the due date for the transaction will fall after the commencement of the bankruptcy proceeding, the contract will be cancelled. Article 58(5) also overrides the prohibition on set-off where a claim arises on or after the commencement of the relevant proceeding (Arts. 71 and 72 of the Bankruptcy Act), such that a netting provision in a qualifying contract will be valid.[71] Accordingly, the validity of a provision providing for a close-out netting event on the commencement of an insolvency proceeding in respect of a counterparty is confirmed by the provision.

The Bankruptcy Act provides that contracts may be closed out when a ruling for the commencement of a bankruptcy proceeding is made if that is the "close-out netting

66 The drafters believed that a general law such as the Bankruptcy Act should include a definition of eligible contracts which was based on the substance of the contract given the high degree of innovation when it comes to financial products. OGAWA (ed.), *supra* note 50, 97-8.

67 M. ITOH, *Hasan-hō minji saisei-hō* [Bankruptcy Act and Civil Rehabilitation Act] (Tokyo, 2007), 285. The Close-out Netting Act would apply if one of the parties to the contract was a financial institution etc.

68 OGAWA (ed.), *supra* note 50, 98.

69 M. ITOH, *supra* note 57, 285.

70 The claim must be able to be determined according to a fair and objective method, otherwise the value of the bankruptcy estate may be decreased by admitting the subjective claims of netting creditors. Correspondence between Linklaters and author, 18 September 2010.

71 OGAWA (ed.), *supra* note 50, 98.

event" on which the parties agreed. The drafters of Article 58 believe it should also be effective to confirm the validity of netting where the relevant netting event leading to the cancellation of the contract occurs during the time between filing and a ruling for the commencement of a bankruptcy proceeding.[72] In practice, this is an important distinction because of the time difference between filing and a ruling for commencement. Depending on the relevant District Court in which the insolvency filing occurs, commencement might take one week from filing (e.g., Tokyo District Court), but it could be much longer.[73] The definition of "close-out netting event" in the Close-out Netting Act refers to the filing of a petition for the commencement of formal insolvency proceedings. The drafters of the bill suggested that this timing made sense, because derivative creditors are likely to be involved in preparing documentation for the filing, or would at least be aware of an imminent filing.[74] Finally, in Japan, it is generally thought that multi-branch netting is valid on the basis that an entity is made up of its headquarters and branches.[75]

IV. REPURCHASE AGREEMENTS AND FINANCIAL MARKETS

From a market perspective, one of the most important derivative transactions to which close-out netting legislation should apply are transactions effected under repurchase agreements.[76] Repurchase agreements involving the transfer of financial collateral are commonly used to document transactions which will potentially involve the need for close-out netting if one party becomes insolvent. The importance of repurchase agreements to the United States' economy was recognised by commentators and market participants in the early 1980s. As one academic noted, "[T]he Federal Reserve uses repos to implement monetary policy. Government securities dealers finance their portfolios with repos. Mutual funds, state and local governments, corporations and other institutions find repos an attractive investment for idle cash balances".[77] Amendments to the United

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72 *Id*. *See* also, M. ITOH, *supra* note 57, 285. Professor Itoh is one of Japan's leading authorities on insolvency law. He also suggests that Article 58 is sufficient to protect netting on the basis of a provision which provides for the cancellation of the contract on the event of a filing for formal insolvency proceedings, as well as the later event of commencement.

73 *See*, generally, K. ANDERSON / S. STEELE, Insolvency Law, in: Japanese Business Law Guide (CCH Loose-leaf, 2003).

74 YAMANA, *supra* note 34, 24.

75 Correspondence between Linklaters and author, 8 July 2010.

76 On repurchase agreements generally, *see*, K. TYSON-QUAH (ed.), Cross-Border Securities: Repo, Lending and Collateralisation (London, 1997), and F. FABOZZI / S. MANN, Repurchase and Reverse Repurchase Agreements, in: F. Fabozzi/S. Mann (eds.), Securities Finance – Securities Lending and Repurchase Agreements (Hoboken, New Jersey, 2005).

77 WALTERS, *supra* note 7, 831. WALTERS provides an early commentary on repurchase agreements in the United States and whether they should be characterized as a sale or secured loan. *See* also his more detailed comments on the use of repurchase agreements in the United States and the risk of "'ripple' bankruptcies" which "could lead to a market crash" if

States Bankruptcy Code in 1984 clearly brought repurchase agreements within the safe harbour exemptions, reflecting uncertainty created by the *Lombard-Wall* decision,[78] the possibility that they may be characterised as secured loans and thus subject to the automatic stay, and their importance to financial markets.[79] Carew also deals with the importance of repurchase agreements in Australia, my home jurisdiction, and other markets in the most recent version of her seminal treatise, *Fast Money 4*.[80] She notes that repurchase agreements are used: (1) as a means of funding bond portfolios (cash repo) where the owner of bonds uses them as collateral for cash because it is cheaper than an outright loan as the bonds form security; (2) by bond-dealers to bridge gaps in bond portfolio (cash repo or bond-for-bond switch); (3) to cover a short-term liquidity requirement, and thus avoid the need to sell bonds which might involve capital loss; and (4) by an entity with a temporary cash surplus which they can use to invest in repo.[81] According to Carew, repurchase activity in Australia increased in the mid-to-late 1990s, but can be traced back to the 1950s.[82]

By the end of the 1990s, "repo business" was also thriving in Japan.[83] Repurchase agreements in Japan are usually either: (1) repo transactions (*tanpo tsuki saiken taishaku torihiki*); or (2) gensaki transactions (*saiken no jōken tsuki baibai torihiki*). Economically, they have the same effect; that is, assets are transferred by a counterparty in favour of another party in return for that party paying a purchase price, and transferred back to the counterparty when it makes a demand and pays the repurchase price which is either the original purchase price plus interest or a fixed higher price. Legally, (1) repo transactions are contracts of loan for consumption generally with cash collateral, and (2) *gensaki* transactions are contracts of sale with repurchase agreements.

Although it was clear from the enactment of the Close-out Netting Act in 1996 that a "master agreement", as defined in Article 2(5), was intended to include the standard ISDA Master Agreements 1992/2002, the list of "specified financial transactions" (see Art. 2(1)) to which the Close-out Netting Act applied was specifically updated in 2001[84]

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relief is not given to repurchase agreements under the powerful Chapter 11 automatic stay (at 842-845)

78 *See*, KRIMMINGER reflecting on these historical developments, *supra* note 9, and WALTERS' earlier commentary on the case, *id*.

79 KRIMMINGER, *id*., 6.

80 E. CAREW, Chapter 9: Repurchase Agreements", in: E. Carew (ed.), Fast Money 4 (St Leonards, NSW, 1998) 174.

81 *Id*., 174-5.

82 *Id*.

83 E. BETTELHEIM, The International Regulation of Repos, in: K. Tyson-Quah (ed.), Cross-Border Securities: Repo, Lending and Collateralisation (London, 1997) 136-42, 105, deals with the regulatory and legal framework in the United Kingdom, the United States, France, Germany and Japan; jurisdictions which "account for significant volumes of repo business, both domestic and cross-border" (at 105).

84 FINANCIAL SERVICES AGENCY, *Kin'yū kikan nado ga okonau tokutei kin'yū torihiki no ikkatsu seisan ni kansuru hōritsu sekō kisoku no ichibu o kaisei suru naikaku-fu-rei an no*

to include repurchase agreements involving repo and gensaki transactions.[85] Accordingly, the repurchase transactions described above would fall within the definition of "specified financial transaction" (see also Art. 2(1)) involving close-out netting (*ikkatsu seisan*) under the Close-out Netting Act[86]. Provided that at least one of the parties to the transaction is a "financial institution etc" as defined under the Close-out Netting Act, the Close-out Netting Act should apply to those transactions such that a counterparty would be entitled to benefit from the safe harbour provisions under the Close-out Netting Act. Article 2(2) defines "financial institution etc" to mean a juridical person such as a bank or long-term trust bank, a financial instruments business operator (for example, a juridical person conducting a securities underwriting business) or some other registered financial institution.

The existing market-based understanding that a counterparty may validly close out and/or liquidate collateral even if a counterparty filed for insolvency has not been judicially tested; the validity and enforceability of the legal arrangements surrounding repurchase transactions have never been tested in court in Japan. However, the existence of the Close-out Netting Act and the Bankruptcy Act clearly confirms the enforceability of a repurchase transaction involving a close-out netting event on the commencement of an insolvency proceeding by placing it out of danger of being recharacterized as a transaction to which Articles 53, 71 or 72 of the Bankruptcy Act may apply.

The Bank of Japan investigated the market turmoil after Lehman Brothers filed for civil rehabilitation proceedings in Japan on 16 September 2008, and has acknowledged that market participants reported "problems regarding repo markets".[87] Its comments are based on public clearing house data, interviews with major market participants and surveys. Importantly, however, most trades in Japan are still completed privately. Ac-

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kōhyō ni tsuite [Concerning the publication of the draft Order of the Cabinet Office for the partial amendment of the Ordinance for enforcement of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc.] (11 December 2001), at *http://www.fsa.go.jp/news/newsj/13/f-20011211-1.html#betu1,* at 23 August 2010. On the legislative and regulatory position in Japan prior to the Close-out Netting Act becoming effective, *see*, generally, BETTELHEIM, *id*.

85 *See*, Arts. 1(3)-(5) of *Kin'yū kikan nado ga okonau tokutei kin'yū torihiki no ikkatsu seisan ni kansuru hōritsu sekō kisoku* [Ordinance for Enforcement of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc], Order of the Office of the Prime Minster and Office of the Minister of Finance No. 48, 27 November Heisei Year 10 [1998], last amended by Cabinet Office Ordinance No. 60, 8 August Heisei Year 19 [2007]. *See* below for a translation.

86 This interpretation is generally accepted in Japan. *See*, *e.g.*, its use by the Bank of Japan in: BANK OF JAPAN, Assessment of the Settlement System for Japanese Government Securities against the CPSS/IOSCO Recommendations for Securities Settlement Systems (20 November 2009), at *http://www.boj.or.jp/en/type/release/zuiji07/data/set0711.pdf,* at 6 August 2009 (at 19); BANK OF JAPAN, Payment Systems in Japan, at *http://www.boj.or.jp/en/type/release/zuiji/kako03/set0207a.pdf,* at 19 August 2009 (at 1.1.4, 180).

87 BANK OF JAPAN, Financial Markets Report (March 2009), at *http://www.boj.or.jp/en/type/ronbun/mkr/data/mkr0903.pdf,* at 29 April 2010 (at 91-2).

cordingly, it is difficult for even the Bank of Japan to be comprehensive in its findings on what happened in the repo markets during the last few months of 2008. A recent report by the Bank for International Settlements suggests that there were increased settlement failures and intraday settlement delays after the Lehman Brother's default until the end of September 2008, but the Bank of Japan took steps to support the market through the turmoil.[88] The Bank of Japan states that it is encouraging parties to use its JGBCC (Japan Government Bond Clearing Corporation) system which has minimum qualification requirements, including solvency tests, but only a small percentage of parties have joined to date.[89] Similarly to the United States, not much information is available on how much counterparties were affected by the Lehman Brother's failure.

The Bank of Japan, however, has also publicly stated that: "the filing for bankruptcy by LBJ [Lehman Brothers Japan] caused a chain of settlement fails and resulted in intraday delays that lasted for several business days in a number of securities settlement systems, but closing of LBJ's outstanding positions and rebuilding of positions by LBJ's counterparties were executed without significant delays in accordance with the rules of individual central counterparties and agreements between market participants … [for] JGB [Japanese Government Bond] transactions settled directly between market participants and LBJ …, repo transactions with LBJ were liquidated as stipulated in contracts by terminating transactions or executing close-out netting on grounds of default … funds settlements were executed on schedule and long-term delays in securities settlements were avoided".[90] Accordingly, generally speaking, it appears that the repo markets continued to operate efficiently in Japan.

Anecdotally, it would also seem that the lack of public disputes suggests that even transactions between entities in the Lehman Brothers' group were closed out without the need for judicial involvement as a result of the clarity provided by the Close-out Netting Act and underlying contractual documentation drafted in light of the Close-out Netting Act. Other commentators might also, for example, assert that the lack of litigation relates to a certain Japanese cultural reluctance to litigate, or cite institutional obstacles to bringing litigation relating to repurchase agreements to a satisfactory, reasonably priced and timely conclusion in Japan. These alternative theories, however, ignore the fact that by making netting in Japan automatic, the Close-out Netting Act and the Bankruptcy Act have avoided some of the pitfalls created by the United State's Bankruptcy Code's approach of exempting certain contracts from the application of the automatic stay for a certain period of time. The Close-out Netting Act may have helped regulators

88 *See*, COMMITTEE ON PAYMENT AND SETTLEMENT SYSTEMS, BANK FOR INTERNATIONAL SETTLEMENTS, Strengthening repo clearing and settlement arrangements (September 2010), at *www.bis.org,* at 20 September 2010, 55.

89 *Id*.

90 BANK OF JAPAN, Payment and Settlement Systems Report 2007-08 (trans.), at *http://www.boj.or.jp/en/type/ronbun/psr/data/psr2007.pdf,* at 6 August 2009 (Introduction and at 19-23).

achieve its objective of contributing to increasing external and internal confidence in the financial system of Japan, based on the certainty of treatment of financial transactions such as repurchase agreements.

V. CONCLUSION – PERCEPTION AND OPERATION OF THE CLOSE-OUT NETTING ACT IN JAPAN AFTER THE GLOBAL FINANCIAL CRISIS

The criticisms of safe harbour provisions in the United States arising before and after the Global Financial Crisis[91] were not as readily apparent in Japan. The accepted view appears to support the systemic certainty created by close-out netting legislation, over the perspective that an insolvent company be given the opportunity to continue or terminate a transaction depending on what is best for its rehabilitation.[92] In fact, commentators argue that the combination of Section 2(a)(iii) of the ISDA Master Agreement (Automatic Early Termination) and the Close-Out Netting Act provide a high level of market certainty in Japan.[93] Certainly, there is no wide-spread call for amendment to the Close-Out Netting Act to reduce its coverage in the wake of the Global Financial Crisis.[94]

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91 D. MENGLE, *supra* note 16, 5. He also sets out ISDA's response. On recent legislative efforts in the United States, *see*, M. PENGELLY, Harbouring doubts on close-out netting, Risk Magazine (7 June 2010), at *http://www.risk.net/risk-magazine/feature/1652761/harbouring-doubts-close-netting,* at 6 September 2010.

92 Correspondence between Linklaters and author, 8 July 2010. *See*, also, YAMANA, *supra* note 34. Note the comments by KANDA, a professor at the University of Tokyo, however, who issued a warning that selling derivatives on a retail basis needs special consideration when the Close-out Netting Act was introduced in 1998. His article also addresses what he saw as some of the outstanding technical issues surrounding the legislation at the time. *See*, KANDA, *supra* note 34, 19-20.

93 *Id.*

94 *Id.*

金融機関等が行う特定金融取引の一括清算に関する法律

ACT CONCERNING CLOSE-OUT NETTING OF SPECIFIED FINANCIAL TRANSACTIONS UNDERTAKEN BY FINANCIAL ENSTITUTIONS ETC.[i]

（平成十年六月十五日法律第百八号
(Act No. 108, 15 June Heisei Year 10 [1998])

最終改正年月日:平成一八年六月一四日法律第六六号
Last amended by Act No. 66, 14 June Heisei Year 18 [2006]

（目的）
(OBJECTIVE)

第一条
Article 1

この法律は、金融機関等が行う特定金融取引の一括清算についての破産手続等における取扱いを確定することにより、金融機関等が行う特定金融取引の決済の安定性の確保とこれによる特定金融取引の活性化を図り、もって我が国の金融の機能に対する内外の信頼の向上と国民経済の健全な発展に資することを目的とする。

The objective of this Act is to contribute to increasing external and internal confidence in the financial system of Japan and the sound development of our national economy, by determining the treatment of close-out netting in bankruptcy proceedings etc of specified financial transactions undertaken by financial institutions etc, and providing for the maintenance of secure settlement of specified financial transactions undertaken by financial institutions etc and thus encouraging such specified financial transactions.

（定義）
(DEFINITIONS)

第二条
Article 2

この法律において「特定金融取引」とは、金利、通貨の価格、金融商品市場（金融商品取引法（昭和二十三年法律第二十五号）第二条第十四項に規定する金融商品市場をいう。）における相場その他の指標に係る変動、市場間の格差等（以下この項において「金利変動等」という。）に基づいて算出される金銭

の授受を約する取引その他の金利変動等を利用して行われる取引のうち、同条第二十二項に規定する店頭デリバティブ取引その他の内閣府令で定めるものをいう。

In this Act, the term “specified financial transaction” means a transaction where the amount of payments under an agreement is determined based on fluctuations in interest rates, currency prices, quotations on a financial instruments market (a “financial instruments market” as prescribed under article 2(14) of the Financial Instruments and Exchange Act, Act No. 25, Shôwa Year 23 [1948]), other market indices, or spreads between markets etc (hereafter in this paragraph, collectively “fluctuations in interest rates etc.”), or any transaction referring fluctuations in interest rates etc, which falls within those prescribed as an over-the-counter derivative transaction under article 2(22) of the Financial Instruments and Exchange Act or some other transactions prescribed by any other Cabinet Office Ordinances.[ii]

２　この法律において「金融機関等」とは、次に掲げる法人をいう。

(2) In this Act, the term “financial institution etc” means any of the following juridical persons:

一　銀行法（昭和五十六年法律第五十九号）第二条第一項に規定する銀行又は長期信用銀行法（昭和二十七年法律第百八十七号）第二条に規定する長期信用銀行

(i) A bank as prescribed under article 2(1) of the Banking Act (Act No. 59, Shôwa Year 56), or a long-term credit bank as prescribed under article 2 of the Long-term Credit Bank Act (Act No. 187, Shôwa Year 27)

二　金融商品取引法第二条第九項に規定する金融商品取引業者（同法第二十八条第一項に規定する第一種金融商品取引業を行う者に限る。）

(ii) A financial instruments business operator as prescribed under article 2(9) of the Financial Instruments and Exchange Act[iii] (but limited to persons involved in type 1 financial instruments business prescribed under article 28(1) of that Act.[iv])

三　その他我が国の法令により営業若しくは事業の免許、登録等を受けている法人又は特別の法律により設立された法人であって、自己又は顧客の計算において特定金融取引を相当の規模で行うものとして政令で定めるもの

(iii) In addition [to items 1 and 2], a juridical person prescribed in the Cabinet Order that has obtained a licence or registration in respect of its business or enterprise under a national law or regulation, or that has been incorporated under special legislation, which undertakes a substantial amount of specified financial transactions for its own account or on behalf of clients.[v]

3　この法律において「破産手続等」とは、破産手続、再生手続又は更生手続をいう。

(3) In this Act, the term “bankruptcy proceeding etc” means a bankruptcy proceeding, civil rehabilitation proceeding or a corporate reorganisation proceeding.

4　この法律において「一括清算事由」とは、破産手続開始、再生手続開始又は更生手続開始の申立てをいう。

(4) In this Act, the term “close-out netting event” means the filing of a petition for the commencement of a bankruptcy proceeding, civil rehabilitation proceeding or reorganisation proceeding.

5　この法律において「基本契約書」とは、特定金融取引を行おうとする金融機関等とその相手方との間において二以上の特定金融取引を継続して行うために作成される契約書で、契約の当事者間において行われる特定金融取引に係る債務についてその履行の方法その他当該特定金融取引に関する基本的事項を定めるものをいう。

(5) In this Act, “master agreement” means an agreement that is entered into by a financial institution etc. which is undertaking specified financial transactions and its counterparty in order to undertake two or more specified financial transactions on a continuing basis, and stipulates the method of performance of the obligations associated with such specified financial transactions as well as other fundamental matters regarding those specified financial transactions undertaken as between the parties concerned.

6　この法律において「一括清算」とは、基本契約書に基づき特定金融取引を行っている当事者の一方に一括清算事由が生じた場合には、当該当事者の双方の意思にかかわらず、当該一括清算事由が生じた時において、当該基本契約書に基づいて行われているすべての特定金融取引についてその時における当該特定金融取引のそれぞれにつき内閣府令で定めるところにより算出した評価額を合算して得られる純合計額が、当該当事者間における一の債権又は一の債務となることをいう。

(6) In this Act, “close-out netting” means, in the event that a close-out netting event occurs in respect of either of the relevant parties undertaking specified financial transactions under a master agreement, the net total balance of all the specified financial transactions undertaken under that master agreement as at the time the close-out netting event occurred, which is obtained by adding up the evaluation value, as calculated in accordance with the Cabinet Office Ordinances, of each transaction at that time, which shall then become a single debt or claim as between the relevant parties, regardless of the parties’ intention.

（一括清算と破産手続等との関係）
(RELATIONSHIP BETWEEN CLOSE-OUT NETTING AND BANKRUPTCY PROCEEDINGS ETC)

第三条
Article 3

破産手続開始の決定、再生手続開始の決定又は更生手続開始の決定（以下この条において「破産手続開始決定等」という。）がなされた者が、一括清算の約定をした基本契約書に基づき特定金融取引を行っていた金融機関等又はその相手方である場合には、当該基本契約書に基づいて行われていたすべての特定金融取引についてこれらの者が有する次の各号に掲げる法律に規定する当該各号に定める財産又は債権は、当該破産手続開始決定等に係る一括清算事由が生じたことにより、それぞれ、当該破産手続開始決定等がなされた者が当該約定に基づき有することとなった一の債権又はその相手方が当該約定に基づき有することとなった一の債権とする。

In the event that a ruling to commence a bankruptcy proceeding, a ruling to commence a civil rehabilitation proceeding or a ruling to commence a corporate reorganization proceeding (hereafter in this article, "ruling to commence a bankruptcy proceeding etc") occurs in relation to a person that is a financial institution etc or a counterparty of a financial institution etc undertaking a specified financial transaction based on a master agreement which includes a close-out netting provision, an asset or claim, as the case may be, provided for in the relevant item[s] prescribed in the laws listed in the following items which is held by that person in relation to all of the specified transactions undertaken under that master agreement, shall become a single claim held by the person to which the ruling to commence a bankruptcy proceeding etc relates in accordance with the relevant [close-out netting] provision, or a single claim held by their counterparty in accordance with the relevant [close-out netting] provision, as a result of the occurrence of the close-out netting event to which the ruling to commence a bankruptcy proceeding etc. applies.

一　破産法（平成十六年法律第七十五号　破産財団に属する財産又は破産債権

(i) Bankruptcy Act (Act No. 75, Heisei Year 16 [2004]) Asset belonging to the bankruptcy estate, or bankruptcy claim

二　民事再生法（平成十一年法律第二百二十五号）　再生手続開始の時に再生債務者に属する財産又は再生債権

(ii) Civil Rehabilitation Act (Act No. 225, Heisei Year 11 [1999]) Asset belonging to the rehabilitation debtor at the time of commencement of the rehabilitation proceeding, or rehabilitation claim

三　会社更生法（平成十四年法律第百五十四号）又は金融機関等の更生手続の特例等に関する法律（平成八年法律第九十五号）　更生手続開始の時に株式会社若しくは同法第二条第二項に規定する協同組織金融機関若しくは同条第六項に規定する相互会社に属する財産又は会社更生法第二条第十二項本文若しくは金融機関等の更生手続の特例等に関する法律第四条第十二項本文若しくは第百六十九条第十二項本文に規定する更生債権等

(iii) Corporate Reorganisation Act (Act No. 154, Heisei Year 14 [2002]) or Act on Special Provisions etc concerning reorganisation proceedings for financial institutions etc (Act No. 95, Heisei 8 [1996]) Asset belonging to the joint-stock company (kabushiki kaisha), or the co-operative financial institution as prescribed under article 2(2) of Act on Special Provisions etc concerning reorganisation proceedings for financial institutions etc or the mutual company as prescribed under article 2(6) of Act on Special Provisions etc concerning reorganisation proceedings for financial institutions etc, at the time of commencement of the corporate reorganisation proceeding, or reorganisation claim as prescribed under the main clause of article 2(12) of the Corporate Reorganisation Act, or under the main clause of article 4(12) or under the main clause of article 169(12) of the Act on Special Provisions etc concerning reorganisation proceedings for financial institutions etc

附則

SUPPLEMENTARY PROVISIONS

Translator's note. The supplementary provisions not translated here set out: the dates on which certain provisions become effective; transitional measures relating to parts of the Civil Code etc.; and transitional measures in relation to the application of penal provisions.

Notes:

[i] The Japanese version of this Act may be found at *e-Gov*, Ministry of Internal Affairs and Communications (Japan), at *http://law.e-gov.go.jp/cgi-bin/strsearch.cgi*, at 4 June 2009.

This English translation of this law has been translated (through the revisions of Law No. 66 of 2006) in compliance with the Standard Bilingual Dictionary (March 2006 edition) ("SBD"). This is an unofficial translation. Only the original Japanese texts of laws and regulations have legal effect, and the translations are to be used solely as reference material to aid in the understanding of Japanese laws and regulations. Neither the Government of Japan nor Standard & Poor's shall be responsible for the accuracy, reliability or currency of the legislative material provided in the SBD Website, or for any consequence resulting from use of the information in the SBD Website. For all purposes of interpreting and applying law to any legal issue or dispute, users should consult the original Japanese texts published in the Official Gazette.

この法令の翻訳は，平成 18 年法律第 66 号までの改正について，「法令用語日英標準対訳辞書」（平成１８年３月版）に準拠して作成したものです。なお，この法令の翻訳は公定訳ではありません。法的効力を有するのは日本語の法令自体であり，翻訳はあくまでその理解を助けるための参考資料です。この翻訳の利用に伴って発生した問題について，一切の責任を負いかねますので，法律上の問題に関しては，官報に掲載された日本語の法令を参照してください。

The translator thanks the following people for their indispensible comments on the final draft of this translation: Judge Toshiyuki ABE (Yokohama District Court) and Mr Akihiro WANI and Ms Reiko OMACHI (Linklaters LLP, Tokyo).

[ii] *Translator's note.* The Cabinet Office Ordinance relating to this Act is called "Ordinance for enforcement of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc." For convenience, the relevant provisions of the Ordinance are reproduced below. The Japanese version of the Ordinance may be found at *e-Gov*, Ministry of Internal Affairs and Communications (Japan), at *http://law.e-gov.go.jp/cgi-bin/strsearch.cgi*, at 21 April 2010.

金融機関等が行う特定金融取引の一括清算に関する法律 施行規則

ORDINANCE FOR ENFORCEMENT OF THE ACT CONCERNING CLOSE-OUT NETTING OF SPECIFIED FINANCIAL TRANSACTIONS UNDERTAKEN BY FINANCIAL INSTITUTIONS ETC.

（平成十年十一月二十七日総理府・大蔵省令第四十八号）

(Order of the Office of the Prime Minster [reorganised as the 内閣府 the Cabinet Office in 2001] and Office of the Minister of Finance [known in Japanese as 財務省 since 2000] No. 48, 27 November Heisei Year 10 [1998])

最終改正年月日:平成一九年八月八日内閣府令第六〇号

Last amended by Cabinet Office Ordinance No. 60, 8 August Heisei Year 19 [2007]

（特定金融取引）
SPECIFIED FINANCIAL TRANSACTIONS

第一条
Article 1

金融機関等が行う特定金融取引の一括清算に関する法律（以下「法」という。）第二条第一項に規定する内閣府令で定めるものは、次に掲げるものとする。

The transactions to be prescribed in a Cabinet Office Ordinance as provided for in article 2(1) of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc (hereafter "the Act") are as follows:

一 金融商品取引法（昭和二十三年法律第二十五号）第二条第二十二項に規定する店頭デリバティブ取引及びその担保の目的で行う金銭又は有価証券の貸借又は寄託（以下「担保取引」という。）

1. Over-the-Counter Transactions of Derivatives as prescribed in article 2(22) of the Financial Instruments and Exchange Act (Act No. 25, Shôwa Year 23 [1948]) and financial or securities loans or deposits for consumption undertaken with the objective of collateralisation related thereto (hereafter "collateralisation transactions")

二 銀行法（昭和五十六年法律第五十九号）第十条第二項第十四号に規定する金融等デリバティブ取引及びその担保取引

2. Financial etc derivative transactions prescribed in article 10(2)(xiv) of the Banking Act (Act No. 59, Shôwa Year 56 [1981]) and related collateralisation transactions

三 有価証券の買戻又は売戻条件付売買及びその担保取引

3. Gensaki transactions with provisions for resale or repurchase of securities and related collateralisation transactions

四　有価証券の貸借及びその担保取引

4. Loan for consumption of securities and related collateralised transactions

Translator's note: This means loan transactions and does not include sale and purchase transactions.

五 当事者の一方が受渡日を指定できる権利を有する債券売買であって、一定の期間内に当該権利が行使されない場合には、当該売買契約が解除される取引及びその担保取引

5. Sale and purchase of bonds involving a cancellation provision whereby the contract may be cancelled in the case where one party has a right to designate a delivery date but that party does not exercise the right within a certain period of time, and related collateralisation transactions

六 先物外国為替取引及びその担保取引

6. Forward foreign exchange transactions and related collateralisation transactions

（評価額の算出）
CALCULATING THE EVALUATION VALUE

第二条
Article 2

法第二条第六項に規定する内閣府令で定めるところにより算出した評価額は、金利、通貨の価格、金融商品市場（金融商品取引法第二条第十四項に規定する金融商品市場をいう。）における相場その他の指標の実勢条件に基づき、公正な方法により算出した額とする。
The "evaluation value as calculated in accordance with the Cabinet Office Ordinance" as prescribed in article 2 (6) of the Act shall be an amount fairly calculated in accordance with a publicly available methodology based on the market conditions such as interest rates, currency prices, quotations on financial instruments market (a "financial instruments market" as prescribed under article 2(14) of the Financial Instruments and Exchange Act) and other indices.

[iii] *Translator's note.* Article 2(9) of the Financial Instruments and Exchange Act states: "The term "Financial Instruments Business Operators" as used in this Act means a person registered by the Prime Minister under Article 29. *Financial Instruments and Exchange Act* (Act No. 25, Shôwa Year 23 [1948]), Ministry of Justice (Japan) (trans.) (16 June 2009), at *http://www.japaneselawtranslation.go.jp/*, at 12 July 2010. The governing agency responsible for the Financial Instruments and Exchange Act is the Financial Services Agency, but the Ministry of Justice has provided a tentative translation as part of its "Transparency of Japanese Law Project". On the Project generally, see, C. LAWSON, Found in Translation: The 'Transparency of Japanese Law Project' in Context, in: ZJapanR / J.Japan.L 24 (2007) 187.

[iv] Article 28(1) of the Financial Instruments and Exchange Act states: "The term "Type 1 Financial Instruments Business" as used in this Chapter means, among Financial Instruments Businesses, conducting any of the following acts in the course of trade:
(i) acts listed in Article 2(8)(i) to (iii), (v), (viii), or (ix) with regard to Securities (excluding rights listed in the items of Article 2(2) that are deemed to be Securities pursuant to the provisions of said paragraph);
(ii) acts listed in Article 2(8)(iv), or acts listed in Article 2(8)(v) with regard to over-the-counter derivatives;
(iii) acts falling under any of the following (a) to (c)
  a. wholesale Underwriting of Securities that are specified by a Cabinet Order as those for which management of risks of loss is highly necessary;
  b. underwriting of Securities other than those listed in (a);
  c. acts listed in Article 2(8)(vi) that are other than Wholesale Underwriting of Securities;
(iv) acts listed in Article 2(8)(x);
(v) acts listed in Article 2(8)(xvi) or (xvii)".

Financial Instruments and Exchange Act (Act No. 25, Shôwa Year 23 [1948]), Ministry of Justice (Japan) (trans.) (16 June 2009), at *http://www.japaneselawtranslation.go.jp/*, at 12 July 2010.

Translator's note. Article 28(1)(ii) of the Financial Instruments and Exchange Act has been updated by inserting "or acts listed in Article 2(8)(v) with regard to over-the-counter derivatives" since the version that was translated into English for the Ministry of Justice referred to above. The Japanese version of the Act up to and including the last amendment (Law No. 32, 19 May Heisei Year 22 [2010]) may be found at *e-Gov*, Ministry of Internal Affairs and Communications (Japan), at *http://law.e-gov.go.jp/cgi-bin/strsearch.cgi*, at 12 July 2010.

[v] *Translator's note.* The Cabinet Order relating to this Act is called "Cabinet Order for enforcement of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc." For convenience, the relevant provisions of the Cabinet Order are translated below. The Japanese version of the Ordinance may be found at *e-Gov*, Ministry of Internal Affairs and Communications (Japan), at *http://law.e-gov.go.jp/cgi-bin/strsearch.cgi*, at 21 April 2010.

金融機関等が行う特定金融取引の一括清算に関する法律 施行令
CABINET ORDER FOR ENFORCEMENT OF THE ACT CONCERNING CLOSE-OUT NETTING OF SPECIFIED FINANCIAL TRANSACTIONS UNDERTAKEN BY FINANCIAL INSTITUTIONS ETC

（平成十年十一月二十日政令第三百七十一号）
(Order No. 371, 20 November Heisei Year 10 [1998])

最終改正年月日:平成二〇年七月二五日政令第二三七号
Last amended by order No. 237, 25 July Heisei Year 20 [2008]

金融機関等が行う特定金融取引の一括清算に関する法律 第二条第二項第三号に規定する政令で定めるものは、次に掲げるものとする。
The "judicial persons prescribed in the Cabinet Order" as provided for in article 2(2)(iii) of the Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc are as follows:

一 保険会社又は保険業法（平成七年法律第百五号）第二条第七項に規定する外国保険会社等
1. Insurance company or foreign insurance company etc as specified in article 2(7) of the Insurance Business Act (Act No. 105, Heisei Year 7 [1995])

二 信用金庫連合会
2. Shinkin Central Bank

三 農林中央金庫
3. The Norinchukin Bank

四 株式会社商工組合中央金庫
4. The Shoko Chukin Bank, Ltd.

五 株式会社日本政策投資銀行
5. Development Bank of Japan Inc.

六 金融商品取引法（昭和二十三年法律第二十五号）第二条第三十項に規定する証券金融会社
6. A securities finance company as specified in article 2(30) of the *Financial Instruments and Exchange Act* (Act No. 25, Shôwa Year 23 [1948])

Translator's note. Article 2(30) of the Financial Instruments and Exchange Act states: "The term "Securities Finance Company" as used in this Act means a person who has been granted the license by the Prime Minister under Article 156-24". See *Financial Instruments and Exchange Act* (Act No. 25, Shôwa Year 23 [1948]), Ministry of Justice (Japan) (trans.) (16 June 2009), at *http://www.japaneselawtranslation.go.jp*, at 12 July 2010.

七 貸金業法施行令（昭和五十八年政令第百八十一号）第一条の二第三号に掲げる者
7. Persons listed in article 1-2(iii) of the Cabinet order for enforcement of the Money Lending Business Act (Order No. 181, Shôwa Year 58 [1983])

ABSTRACT

In this article I provide an annotated English translation of the Japanese Act concerning close-out netting of specified financial transactions undertaken by financial institutions etc ("Act"). The Act forms part of Japan' response to the debate about bankruptcy safe harbour provisions, which save transactions which may otherwise be void in a formal insolvency proceeding. The Act was part of the Big Bang financial reforms introduced in Japan at the end of the 1990s. As part of my commentary on the Act I discuss the drivers for its introduction, which included harmonization and international trends, and concerns about financial regulation of new financial products aimed at a wider audience in the post-Bang, deregulated environment. I also consider the interaction of the Act with Japan's formal insolvency proceedings. Finally, I analyse the potential market implications of the Act in light of repurchase agreements and the global financial crisis, which focused attention on bankruptcy safe harbour provisions

ZUSAMMENFASSUNG

In ihrem Beitrag stellt die Verfasserin eine von ihr gefertigte annotierte Übersetzung des Gesetzes betreffend das „close-out netting" bei Finanztransaktionen zwischen Finanzinstituten vor. Das Gesetz ist Teil der japanischen Antwort auf die internationale Diskussion über „safe harbour"-Regelungen in Insolvenzen, welche die Abwicklung von finanziellen Transaktionen sichern, die andernfalls im Rahmen eines förmlichen Insolvenzverfahrens nichtig wären. Das Gesetz war Teil der sog. „Big Bang"-Finanzreform, die Ende der 1990er Jahre in Japan durchgeführt wurde. In ihrer Kommentierung analysiert die Verfasserin unter anderem die Ursachen, die zur Verabschiedung des Gesetzes führten, wozu sie neben einem internationalen Trend und einer generellen Harmonisierung der Finanzmärkte auch die Sorge der japanischen Regierung zählt, die im Zuge der Deregulierung des japanischen Finanzmarktes erwarteten neuen Finanzprodukte für den breiten Markt regulatorisch in den Griff zu bekommen. Ferner werden das Zusammenspiel zwischen diesem Gesetz und den allgemeinen Insolvenzgesetzen beleuchtet und schließlich die potentiellen Auswirkungen der Regelung auf den Markt mit Blick auf repurchase agreements *(Repo-Geschäfte) und die globale Finanzkrise diskutiert, welche die Aufmerksamkeit auf „safe harbour"-Regelungen gelenkt hat.*