SUMMARY DESCRIPTION OF TEMPORARY STAY UNDER JAPANESE LAW AND JAPANESE JURISDICTIONAL MODULE

1 Background

Upon the endorsement at the G20 Summit in Cannes in November 2011 of the document titled “Key Attributes of Effective Resolution Regimes for Financial Institutions” (the “Key Attributes”) and published by the Financial Stability Board (FSB), major countries including the United States, major European countries and Japan have been making great efforts to develop a new comprehensive framework for the effective resolution of the failure of financial institutions. As is the case with “Dodd–Frank Wall Street Reform and Consumer Protection Act” in the United States and “European Commission Proposal for a Directive on the Recovery and Resolution of Credit Institutions and Investment firms” in the EU, Japan implemented new special resolution regimes in accordance with the revisions made to the Deposit Insurance Act of Japan (Act No. 34 of 1971, as amended) (the “DIA”) and the subordinate statutes for the DIA that were effected in March 2014.

2 Temporary Stay under the DIA and the requirements under the Key Attributes

In the discussions regarding the orderly resolution of financial institutions, there were concerns that an exercise by counterparties of the early termination rights may impede the orderly reorganization/resolution of failed financial institutions or may pose a threat to the stability of the markets. To address such concerns, the Key Attributes provided that “the resolution authority should have the power to stay temporarily (contractual acceleration or early termination) rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers”. The DIA, like similar legislations overseas, also adopts the “temporary stay”, which is designed to meet the requirements under the Key Attributes.

2.1 Requirements under the Key Attributes

Below are the key elements required under the Key Attributes in respect of the “temporary stay”:

The stay should (i) be strictly limited in time (for example, for a period not exceeding two business days) (the “Element (i)”), (ii) be subject to adequate safeguards that protect
the integrity of financial contracts and provide certainty to counterparties (see Annex IV on Conditions for a temporary stay) (the “Element (ii)”), and (iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, deliver or return collateral on a due date) (the “Element (iii)”).

Annex IV of the Key Attributes further requires a temporary stay to satisfy the following conditions (the “Further Conditions”) in respect of the exercise of early termination rights:

(i) The stay only applies to early termination rights that arise for reasons only of entry into resolution or in connection with the use of resolution powers (including, for example, a change in control of the relevant firm or its business arising from such proceedings).

(ii) The stay is strictly limited in time (for example, for a period not exceeding two business days).

(iii) The resolution authority would only be permitted to transfer all of the eligible contracts with a particular counterparty to a new entity and would not be permitted to select for transfer individual contracts with the same counterparty and subject to the same netting agreement (“no cherry-picking” rule).

(iv) For contracts that are transferred to a third party or bridge institution, the acquiring entity would assume all the rights and obligations of the firm from which the contracts were transferred.

(v) The early termination rights of the counterparty are preserved against the firm in resolution in the case of any default occurring before, during or after the period of the stay that is not related to entry into resolution or the exercise of a resolution power (for example, a failure to make a payment or the failure to deliver or return collateral on a due date).

(vi) Following a transfer of financial contracts the early termination rights of the counterparty are preserved against the acquiring entity in the case of any subsequent independent default by the acquiring entity.

(vii) The counterparty can exercise the right to close out immediately against the firm in resolution on expiry of the stay or earlier if the authorities inform the firm that the relevant contracts will not be transferred.

(viii) After the period of the stay, early termination rights could be exercised for those financial contracts that are not transferred to a sound firm, bridge institution or other public entity.

2.2 DIA and the Requirements under the Key Attributes

The “temporary stay” under the DIA meets the requirements required with respect to the stay under the Key Attributes as follows:¹

¹ (iii) and (iv) of the Further Conditions are not covered by the “temporary stay” regime under the DIA and therefore they are not considered here.
(a) Authority and Period of “temporary stay” – Element (i) under the Key Attributes and (ii), (vii) and (viii) of the Further Conditions

The Prime Minister is given the authority under the DIA to make a decision on a “temporary stay” based on deliberations held by the Financial System Management Council (the “FSMC”), which is a standing committee and comprises, among others, the Prime Minister, the Minister in charge of Financial Affairs, the Commissioner of the Japanese Financial Services Agency and the Governor of the Bank of Japan.

Under the DIA, it is stated that the period of “temporary stay” (the “Stay Period”) is designated by the Prime Minister and that such Stay Period should be limited to a period that is required to take measures necessary for avoiding the risk of serious disorder in the Japanese financial system. It is also stated that the effect of the “temporary stay” only lasts during the Stay Period.

While no specific number is granted under the DIA or its subordinate statutes with respect to the Stay Period, the Prime Minister is required to designate a definitive number of days as the Stay Period and the length of the Stay Period is subject to the qualitative limitation where it should be a period that is required to take measures necessary for avoiding the risk of serious disorder in the Japanese financial system.

In practice, it is thought that the length of the Stay Period should not substantially exceed two business days. This is mainly because the Japanese Financial Services Agency (the “JFSA”) expressed its view that the length of the Stay Period needs to be duly determined based on the actual situation where orderly resolution measures are taken for a financial institution in resolution so that the JFSA can effectively achieve recovery and resolution (including the transfer of business and assets and the associated financial assistance) of such troubled financial institution by taking into consideration the view of the Key Attributes, referring to the following wording of Annex IV 2.1 (ii) of the Key Attributes: “The stay is strictly limited in time (for example, for a period not exceeding two business days)”.

In the context of the Stay Period, since the determination of the “temporary stay” by the Prime Minister must be made based on deliberations held by the FSMC, opinions of the Commissioner of the JFSA and the Minister of Financial Affairs would be solicited and respected.

Therefore, it is thought that the Element (i) under the Key Attributes and (ii), (vii) and (viii) of the Further Conditions are satisfied. In order to further address possible concerns as to the Stay Period exceeding two business days, the Japanese Jurisdictional Module sets out a condition precedent that the effect of the Japanese Jurisdictional Module becomes effective only when the Stay Period will not exceed two business days in Japan.

(b) Transactions subject to “temporary stay” and Scope of defaults overridden by “temporary stay” – Element (iii) under the Key Attributes and (i), (v), (vi), (vii) and (viii) of the Further Conditions

The types of transactions that can be subject to “temporary stay” under the DIA are transactions that have a price quoted on an exchange or otherwise have a price in the market and have been entered into by certain types of financial institutions (Article 35-
18 of the DIA Enforcement Ordinance\(^2\)). These transactions include, without limitation, OTC derivative transactions, repurchase transactions, securities lending transactions and foreign exchange transactions.

A Related Measure (kanren sochi) as defined in Article 137-3, Paragraph 1 of the DIA outlines the scope of defaults overridden. The Related Measure is generally interpreted, and confirmed by the JFSA, to include (in addition to resolution action taken by the JFSA) measures under insolvency proceedings related to the resolution action. Accordingly, Events of Default under an ISDA Master Agreement that are related to insolvency proceedings and also JFSA’s resolution action (e.g. a Bankruptcy Event of Default) would be overridden but other types of Event of Default (e.g. a Failure to Pay/Deliver Event of Default) would not. Further, the “temporary stay” does not override any subsequent default. A new Event of Default or Termination Event occurs with respect to a financial institution in resolution after the expiry of the Stay Period, or with respect to a bridge financial institution, the exercise by the counterparty of its termination rights under the contract will not be overridden.

Therefore, it is thought that the Element (iii) under the Key Attributes and (i), (v), (vi), (vii) and (viii) of the Further Conditions are satisfied.

2.3 New Japanese Stay Regulations and Japanese Jurisdictional Module

2.3.1 New Japanese Stay Regulations

In line with international movements to ensure enforceability of “temporary stays” on early termination rights on contracts governed by foreign laws to avoid any cross-border legal issues, the JFSA published the new Japanese Stay Regulations\(^3\) specifically related to the treatment of non-Japanese law contracts. The new Japanese Stay Regulations requires that all financial institutions that are subject to the DIA should (i) adhere to an internationally common protocol for the purpose of applying the stay decision under the DIA to contracts governed by laws other than Japanese law, and confirm that the counterparties have also adhered to such protocol or (ii) clearly indicate in each contract governed by laws other than Japanese law that the stay decision under the DIA applies to the contract. Such requirement will be effective on 1 April 2017. Of particular note is that these new Japanese Stay Regulations are applicable on a consolidated basis (similar to equivalent regulations in a country such as the United Kingdom, for example). It results in the application of the requirements under the new Japanese Stay Regulations not only to Japan-incorporated companies but also to their overseas subsidiaries.

2.3.2 Covered Agreement

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\(^2\) The Order for Enforcement of the Deposit Insurance Act (Cabinet Order No. 111 of 1971, as amended).

\(^3\) Consisting of the “Comprehensive Guidelines for the Supervision of Major Banks, etc.” (shuyoko to muke no sogoteki na kantoku shishin), the “Comprehensive Guidelines for the Supervision of Small and Medium-Sized Enterprises and Regional Financial Institutions” (chusho chiiki kinyukikan muke no sogoteki na kantoku shishin), the “Comprehensive Guidelines for the Supervision of Insurance Companies” (hoken gaisha muke no sogoteki na kantoku shishin) and the “Comprehensive Guidelines for the Supervision of Financial Instruments Business Operators, etc.” (kinyu shohin tonhiki gyosha to muke no sogoteki na kantoku shishin), and such regulations become effective 1 April 2017.
Under the new Japanese Stay Regulations, the contracts that need to be amended are substantially the same as the contracts that could be subject to the “temporary stay” under the DIA but are governed by laws other than Japanese law.

2.3.3 Required Amendment

Under the Japanese Stay Regulations, it is expected that the counterparty to the subject financial institution under the Covered Agreement acknowledge that, in the case where the subject financial institution is in resolution, the effect of the “Stay Decision” [sutei no kettei] with respect to such institution and the “special provisions for procedures of creditor protection” [saikensha hogo tetsuzuki no tokurei to] prescribed in Article 131 of the DIA (meaning the effect of the decision of “temporary stay” made by the Prime Minister and the relevant procedures of creditor protection under the DIA) applies to each Covered Agreement.

2.4 Japanese Jurisdictional Module

As you may be aware, ISDA published the ISDA Resolution Stay Jurisdictional Modular Protocol (the “ISDA JMP”) that is composed of boilerplate provisions and jurisdictional modules with respect to particular stay regulations in particular jurisdictions. The ISDA JMP, together with the relevant jurisdictional modules, enable parties to amend the terms of Protocol Covered Agreements to aid compliance with certain regulatory requirements in various jurisdictions which, in general, require entities subject to those regulatory requirements to obtain from their counterparties a contractual recognition of the application of stays on or overrides of certain termination rights under the home-country special resolution regime of such regulated entity. The ISDA UK (PRA Rule) Jurisdictional Module was published on 3 May 2016 and the ISDA German Jurisdictional Module was published on 28 June 2016. ISDA has been working on some further Jurisdictional Modules and it is expected that the US Jurisdictional Module, the Swiss Jurisdictional Module and the French Jurisdictional Module are to be published in due course.

In the series of these Jurisdictional Modules, ISDA published the Japanese Jurisdictional Module on 5 January 2017 (ISDA Resolution Stay Jurisdictional Modular Protocol) to assist financial institutions to comply with the requirements under the Japanese Stay Regulations. The Japanese Jurisdictional Module is designed only to the extent necessary to comply with the Japanese Stay Regulations and the effect of the Japanese Jurisdictional Module is subject to the condition precedents that the JFSA, Prime Minister or Minister of State for Financial Services issues a public statement announcing either that (a) the subject agreements (and any collateral arrangements) will be transferred to a successor of the financial institution or (b) the duration of the relevant “temporary stay” will not exceed two business days in Japan.

The Japanese Jurisdictional Module has been prepared based on a discussion with the JFSA, and the JFSA confirmed that it effectively satisfies the requirements under the Japanese Stay Regulations.

ISDA has also published a list of frequently asked questions with respect to the Japanese Jurisdictional Module for the counterparties’ consideration.

3 Addressee

3.1 This memorandum is given solely for the benefit of ISDA and its members.
3.2 A copy of this memorandum, for the purpose of information only, may be provided to or referred to with counterparties, professional advisers, auditors and regulators (including the competent banking supervisors) of ISDA or its members, but only on the basis that no such person may provide a copy of this memorandum to any other person or refer to this memorandum with any other person.

3.3 Except as provided in paragraphs 3.1 and 3.2 above or where required by any relevant law or regulation, this memorandum is not to be transmitted to anyone nor is it to be relied upon by anyone or for any other purpose or quoted or referred to in any public document or filed with anyone without our prior written consent. We accept no responsibility or legal liability to any party other than ISDA in relation to the contents of this memorandum.

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