IBA JAPAN | INTERNATIONAL BANKERS ASSOCIATION OF JAPAN | JFMC Japan Financial Markets Council

November 12, 2019

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St, NW
Washington, DC 20581

Re: Exemption from Derivatives Clearing Organization Registration (RIN 3038-AE65); Supplemental Notice of Proposed Rulemaking

Dear Mr. Kirkpatrick:

I. Introduction

The International Bankers Association of Japan ("IBA Japan")[1] and Japan Financial Markets Council ("JFMC")[2] are grateful for the opportunity to provide our comments to the supplemental notice of proposed rulemaking on the Exemption from Derivatives Clearing Organization Registration ("Proposal") released by the Commodity Futures Trading Commission ("Commission" or "CFTC").[3] In Japan, the Japan Securities Clearing Corporation ("JSCC") is licensed under Japanese law by the Financial Services Agency of Japan ("JFSA") for the clearing of OTC derivatives including interest rate swaps ("IRS") and credit default swaps ("CDS"). JSCC is currently exempted by the Commission from derivatives clearing organization ("DCO") registration [4] for the clearing of proprietary

[1] IBA Japan is an association for foreign banks, securities companies and associate members based in Japan. It carries out a range of services and activities to promote a strong and efficient financial sector and support members' business interests. http://www.ibajapan.org/

[2] JFMC is an association which includes representatives from five Japan-based institutions and five international firms active in Japanese capital markets. Its aim is to ensure that authorities deciding on regulatory initiatives that have a global impact are aware of and take into account the effect of new regulations on Japanese capital markets. http://www.japanfmc.org/

[3] *Exemption From Derivatives Clearing Organization Registration*; *Proposed Rule*, 84 Fed. Reg. 35,456 (July 23, 2019), *available at* https://www.cftc.gov/sites/default/files/2019/07/2019-15258a.pdf

[4] Japan Securities Clearing Corporation Order of Exemption from Registration (Oct. 26, 2015), available at

swaps for U.S. Persons and FCMs. Our comments in this letter are primarily from the perspective of the Japanese market, in particular, the impact of the commission's proposal on JSCC and Japanese market participants.

We support the CFTC's efforts to codify the existing regulatory framework for exempting clearing houses from the DCO registration requirements. Such codification will enhance transparency and legal certainty on the status of exempt clearing houses ("exempt DCOs"). We also support the Commission's proposal to exempt foreign intermediaries from the CFTC regulations applicable to future commission merchants ("FCMs") and commodity trading advisors ("CTAs").

II. U.S. Customer Clearing

More importantly, the IBA Japan and JFMC strongly support the expansion of the Commission's exemptive authority to exempt non-U.S. clearinghouses from the DCO registration requirements, when such clearing organizations do not pose substantial risk to the U.S. financial system, thereby permitting such clearing organizations and their non-FCM clearing members to provide swap clearing services to U.S. customers. The IBA Japan and JFMC believe the expansion is critically important for Japanese market because this can lead to higher liquidity by taking in trading interest of U.S. customers. US customers will also benefit from this expansion as clearing mandates globally have shifted liquidity into central clearing and more entities are incentivized to clear OTC derivatives due to (i) the global margin rules applying to uncleared OTC derivatives, (ii) netting benefits and (iii) the capital treatment for CCP exposures under the Basel III framework, as evidenced in recent research by the Financial Stability Board.[5]

We believe it would be highly beneficial for U.S. customers to gain access to exempt DCOs as this would allow U.S. customers to diversify their clearing activity across a wide range of clearing members and CCPs, as opposed to concentrating their clearing activity in a limited number of DCOs and FCM clearing members. Moreover, U.S. customers will gain access to the market with deep liquidity and competitive prices associated with safe clearing arrangements for non-U.S. products. In most cases, that would be the home country of the relevant product, *i.e.*, the Japanese market for trading and clearing of JPY IRS. One notable merit is that the expansion will significantly alleviate the hedging

---

http://www.cftc.gov/idc/groups/public/@otherif/documents/ifdocs/jsccdcoexemptorder10-26-15.pdf

[5] "Incentives to centrally clear over-the-counter (OTC) derivatives, A post-implementation evaluation of the effects of the G20 financial regulatory reforms" (19 November 2018), Part A Executive summary: https://www.fsb.org/wp-content/uploads/R191118-1-1.pdf

difficulties in Asian currencies during Asia business hours, which has been a material issue that U.S. customers have been grappling with in recent years due to lack of access to the deep liquidity of the exempt DCOs in Asia.

III. CPMI-IOSCO Principles for Financial Market Infrastructures

The IBA Japan and JFMC support the Commission's approach of using the CPMI-IOSCO Principles for Financial Market Infrastructures ("PFMI") as a baseline in determining whether a foreign supervisory or regulatory framework is as comparable to, and comprehensive as, the supervisory and regulatory framework applicable to registered DCOs.[6] We agree with the Commission's recognition that while the supervisory and regulatory framework of a foreign jurisdiction may not be identical to the CFTC's framework, the foreign framework should still be recognized as comparable and comprehensive if the foreign framework achieves the same underlying objectives as the CFTC's framework. Given the global nature of the swaps market, we agree with the Commission that such an outcomes-based approach strikes the right balance between addressing risk to the United States and promoting cross-border harmonization.

IV. Substantial Risk to the U.S. Financial System

To continue to be eligible for a DCO exemption the Proposal requires, among other things, that a non-U.S. clearing organization must not pose "substantial risk to the U.S. financial system"[7]. For this purpose, "substantial risk to the U.S. financial system" is proposed to mean that (1) the DCO holds 20 percent or more of the required initial margin of U.S. clearing members for swaps across all registered or exempt DCOs; and (2) 20 percent or more of the initial margin requirements for swaps at that DCO is attributable to U.S. clearing members. We conceptually agree with the Commission's intent under the two-prong test of striking the right balance between addressing the systemic risk-related concern of the U.S. swaps market and respecting international comity. However, we are concerned that this test may have unintended consequence of exacerbating market fragmentation and negatively impacting market liquidity.

1. Two-Prong Test for "Substantial Risk" Determination

The Commission states that the term "substantial" under the two-prong test would

[6] CPMI-IOSCO, Principles for financial market infrastructures (Apr. 2012) http://www.iosco.org/library/pubdocs/pdf/IOSCOPD377-PFMI.pdf

[7] 84 FR 35472

reasonably apply to proportions of approximately 20 percent or greater. In this context, the Commission stresses that this is not a bright-line test and by offering this figure the Commission does not intend to suggest that, for example, a DCO that holds 20.1 percent of the required initial margin of U.S. clearing members would potentially pose substantial risk to the U.S. financial system, while a DCO that holds 19.9 percent would not. We conceptually agree with the Commission's flexible approach as we believe no single factor or quantitative metric should be determinative in measuring substantial risk and the Commission should consider all relevant factors under a holistic approach. We also agree with the Commission's approach of retaining discretion in determining whether an exempt DCO poses substantial risk to the U.S. financial system, particularly where the DCO is close to 20 percent on both prongs of the test.

However, we strongly request the Commission to amend the proposed definition of "Substantial risk to the U.S. financial system" to remove the second prong or clarify that the Commission will exercise its discretion only if both thresholds under the two-prong test are close to 20 percent. More specifically, we request the proviso in the proposed definition be amended to "*provided, however, where ~~one or~~ both of these thresholds are close to 20 percent, the Commission may exercise discretion in determining whether the DCO poses substantial risk to the U.S. financial system.*" As further stated below, our proposed amendment will mitigate legal uncertainty, which should help alleviate concerns about potential market fragmentation and negative impacts to market liquidity, while more appropriately capturing circumstances that pose substantial risks to the U.S. financial system.

a. Lack of Substantial Risk

With respect to the local CCPs in Asia including Japan, we can easily conceive of a situation where an exempt DCO will be in the lower single digits under the first prong, while coming close to, or exceeding, the 20 percent threshold under the second prong. This is due to the Asian CCPs being of small scale compared to the global CCPs in the U.S. and EU.

By virtue of their small scale, the exempt DCOs could easily come close to, or exceed, the 20 percent threshold under the second prong to the extent the exempt DCO clears a certain volume of swaps for U.S. clearing members, which under the proposed definition include non-U.S. subsidiaries of U.S. headquartered institutions. However, given the small scale of the exempt DCO on a global level, the exempt DCO may still

be in the lower single digits under the first prong.

As stated above, the proposed definition allows the Commission to exercise discretion even where only one of the two thresholds is close to 20 percent. However, we do not believe an exempt DCO of such risk profile would pose any substantial risk to the U.S. financial system. The market participants in Japan would greatly benefit from legal certainty that the CFTC will not exercise discretion where only one of the two thresholds is close to 20 percent.

b. Impact to the Asian Markets

If an exempt DCO is determined to pose "substantial risk to the US financial system" the exempt DCO must fully register as a DCO in order to continue clearing for U.S. Persons otherwise the CFTC may terminate the DCO exemption permitting swaps clearing for U.S. Persons. Due to conflicting legal requirements of laws and regulations between the U.S. and the exempt DCO's home country, an exempt DCO may find it extremely difficult or practically impossible to register as a DCO. As a result, if the DCO exemption is terminated by the CFTC, such non-U.S. CCP will be prohibited from clearing swaps for all U.S. Persons, including proprietary positions of clearing members and affiliates, for which the exempt DCO has been clearing swaps under the DCO exemption. In such case, the exempt DCO may potentially terminate outstanding cleared swaps of such U.S. Persons. We believe this would create significant systemic risks in the Japanese swap markets, as well as imposing a detrimental effect to U.S. Persons currently clearing swaps at an exempt DCO.

For example, in Japan, the Japan branches of a few U.S. banks are subject to the Japanese clearing obligation for certain JPY IRS. If JSCC loses the current DCO exemption, it will be prohibited from clearing swaps for the Japan branches of U.S. banks and, as a result, the Japan branches of U.S. banks will lose access to JSCC. The Japanese branches of the U.S. banks are generally registered with the JFSA as a registered financial institution and licensed to engage in financial instruments business, which includes trading of swaps, in the Japanese market. If the Japan branches of U.S. banks lost access to clear swaps at JSCC that could severely impair the Japan branches' ability to trade swaps, negatively affecting liquidity of the JPY IRS market in Japan and further exacerbate market fragmentation. Also, this could potentially lead to significant loss of

business opportunities and may severely undermine one of the key business objectives of the registered financial institution. Our proposed amendment will help alleviate concerns of these potential negative impacts to the market liquidity and market fragmentation.

c. Systemic Risk

Section 803(9) of the Dodd-Frank Act[8] defines "systemically important" to mean a situation where the failure of or a disruption to the functioning of a financial market utility . . . could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States. The report of the IMF, BIS and FSB for the G20 defined "systemic risk" as a risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and has the potential to have serious negative consequences for the real economy.[9]

It is important to note that the U.S. Financial Stability Oversight Council ("FSOC") has only designated U.S. CCPs as "systemically important financial market utilities" ("SIFMU)" and has not designated a non-U.S. CCP to date.[10] We believe the limitation of the designation to U.S. CCPs is based on important policy considerations including the supervisory difficulties in addressing and managing market stress and liquidity constraints involving a CCP that has supervisors from different jurisdictions.

While the legal concepts of "systemically important" or "systemic risk" and "substantial risk" may be subtly different, we believe the concepts are analogous and the determinations should generally be aligned. Considering the U.S. and international standards on systemic risk and international comity considerations, we believe that the Commission should limit the designation of an exempt DCO as posing "substantial risk to the U.S. financial system" only in situations where such designation is truly and strictly necessary. Our proposed amendment will more appropriately capture the substantial risks to the U.S. financial system.

2. Definition of "U.S. Clearing Member"

---

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")

[9] "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations" (October 2009); available at https://www.imf.org/external/np/g20/pdf/100109.pdf.

[10] https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx

Under the Proposal, the Commission is proposing to define "U.S. clearing member" to mean a clearing member organized in the United States, a clearing member whose parent company is organized in the United States, or an FCM. We strongly request the Commission to redefine "U.S. clearing member" to mean a clearing member that is a U.S. Person[11] or an FCM based on the following reasons.

a. Impact to the Asian Markets

As stated above, with respect to the local CCPs in Asia including Japan, we can easily conceive of a situation where an exempt DCO is in the lower single digits under the first prong, however coming close to, or exceeding, the 20 percent threshold under the second prong. Such imbalance between the two prongs will become more acute if the initial margin of, or attributable to, the non-U.S. subsidiaries of U.S. headquartered institutions is included in the threshold calculation under the two-prong test.

The proposed definition allows the Commission to exercise discretion even where only one of the two thresholds is close to 20 percent. If an exempt DCO is determined to pose "substantial risk to the US financial system" the exempt DCO must fully register as a DCO in order to continue clearing for U.S. Persons otherwise the CFTC may terminate the DCO exemption permitting to clear swaps for U.S. Persons. As previously stated, an exempt DCO may find it extremely difficult to register as a DCO and the termination of the DCO exemption may have a detrimental impact to the Asian markets where swaps are primarily cleared by the exempt DCO. In such case, the exempt DCO could significantly cap the clearing volume for swaps by the non-U.S. affiliates of U.S. headquartered institutions with an aim to reduce and maintain the initial margin posted by such non-U.S. affiliates below the 20 percent threshold under the second prong. Such cap will severely restrict access of the non-U.S. affiliates to clear swaps at exempt DCO and will result in a material decrease of market liquidity and further exacerbate market fragmentation.

For example in Japan, there are currently five non-U.S. affiliates of U.S. headquartered institutions registered as a clearing member of JSCC for JPY IRS.[12] These non-U.S. affiliates are registered as a Type 1 financial instruments business operator

---

[11] "U.S. Person" as set forth in the Commission's Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 FR 45292, 45316—45317 (July 26, 2013)

[12] The five non-U.S. affiliates of U.S. headquartered institutions are Citigroup Global Markets Japan Inc., Goldman Sachs Japan Co., Ltd., JPMorgan Securities Japan Co., Ltd., Merrill Lynch Japan Securities Co., Ltd. and Morgan Stanley MUFG Securities Co., Ltd., available at https://www.jpx.co.jp/jscc/en/participant/irs/irs2.html

("Type 1 FIBO") with the JFSA thus licensed to engage in financial instruments business, which includes trading of swaps, in the Japanese market. If the JSCC imposed a cap on the clearing volume for non-U.S. affiliates, such cap will severely impair the non-U.S. affiliates' ability to trade swaps, which could potentially lead to significant loss of business opportunities and may severely undermine one of the key business objectives of the Type 1 FIBO. Our proposed definition of "U.S. clearing member" should help alleviate these concerns regarding trading ability and clearinghouse access and mitigate any negative impacts to the market liquidity and market fragmentation.

b. Alignment with Current DCO Regime

We believe our proposed definition of "U.S. clearing member" is better aligned with the current DCO registration and exemption regime and in line with the Commission's approach in measuring systemic risk.

Pursuant to section 2(i) of the Commodity Exchange Act ("CEA"),[13] the DCO registration requirement under section 5b(a)[14] extends to any clearing organization whose clearing activities outside of the United States have a direct and significant connection with activities in, or effect on, commerce of the United States; except for clearing organizations exempt from DCO registration in cases where the Commission has determined that the clearing organization is subject to "comparable, comprehensive supervision and regulation" by its home country regulator. The Commission's current DCO regime is based on the U.S. Person concept where essentially a DCO registration or exemption is required in order to clear swaps for a U.S. Person.[15] Our view is that the CFTC's current DCO regime based on the U.S. Person concept is the right approach in measuring the "direct and significant" connection under section 2(i) of the CEA. While there may be subtle differences between the legal concepts of "direct and significant connection with activities in, or effect on, commerce of the United States" and "substantial risks to the U.S. financial system," we believe the two concepts are analogous in respect of measuring systemic risk to the United States. On this basis, we believe the approach in measuring "substantial risk to the U.S. financial system" should

[13] Section 2(i) of the CEA provides that activities outside of the United States are not subject to the swap provisions of the CEA, including any rules prescribed or regulations promulgated thereunder, unless those activities either have a direct and significant connection with activities in, or effect on, commerce of the United States.

[14] Section 5b(a) of the CEA provides that a clearing organization may not perform the functions of a registered DCO with respect to swaps unless the clearing organization is registered with the Commission.

[15] The Commission's current exempt DCO framework permits U.S. Persons to clear proprietary swap transactions at an exempt DCO, provided that the U.S. Person is a direct clearing member, or an affiliate of a direct clearing member, of the exempt DCO.

be aligned with the approach under the CFTC's current DCO regime based on the U.S. Person concept.

Under the current DCO regime, a non-U.S. CCP is allowed to clear swaps for a non-U.S. Person, including a non-U.S. affiliate of U.S. headquartered institution, without a DCO registration or exemption. We see no notable changes in the risk profile of the non-U.S. affiliates that would now trigger the CFTC's jurisdictional interest. Our view is that the non-U.S. Person's cleared swaps positions will not pose substantial risk to the U.S. financial system.

While we recognize that non-U.S. entities which form part of an U.S. headquartered group present a higher level of interconnectedness with the United States compared to non-U.S. entities which form part of a non-U.S. headquartered group, we believe the former non-U.S. entities should not be treated as indistinguishable with U.S. entities since they are independent separate legal entities from the U.S. parent. Therefore, the two non-U.S. entities should be similarly treated from a systemic risk perspective. On this basis, we believe our proposed definition is better aligned with the current DCO regime and in line with the Commission's approach in measuring systemic risk.

3. Initial Margin of Non-U.S. Customers

Under the Proposal, the Commission is proposing to include the "initial margin of U.S. clearing member" and "initial margin...attributable to U.S. clearing members" under the two-prong test. We strongly request clarification from the Commission that initial margin from non-U.S. Person customers posted through a U.S. clearing member is not required to be counted toward the 20 percent threshold under both prongs based on the following reasons.

a. Impact to the Asian Markets

Similar to the clearing for non-U.S. affiliates, the clearing of swaps for non-U.S. Person customers has been allowed without a DCO registration or exemption. We believe this is consistent with the Commission's approach that the non-U.S. Person's cleared swaps positions will not have a direct and significant connection with activities in, or effect on, commerce of the United States. We see no notable changes in the risk profile of non-U.S. Person customers that would now trigger the CFTC's jurisdictional interest. Our view is that the non-U.S. Person's cleared swaps positions will not pose substantial risk to the U.S. financial system.

With respect to JSCC, our view can be supported and corroborated by the robust

customer asset protection regime of JSCC where customer assets are individually segregated and held in individual trust accounts at a trust bank, which are bankruptcy remote from the insolvency of JSCC, clearing members, other clearing customers and trust bank.

If the initial margin of non-U.S. Person customers of U.S. clearing members is required to be counted toward the 20 percent threshold, an exempt DCO could significantly cap the clearing volume for swaps by non-U.S. Person customers of U.S. clearing members with an aim to reduce and maintain the initial margin posted by non-U.S. Person customers below the 20 percent threshold under the second prong. Such cap will severely restrict access of non-U.S. Person customers to clear swaps at an exempt DCO, severely constraining the ability of U.S. clearing members to provide liquidity in the Asian swaps markets, and will result in a material decrease of market liquidity and further exacerbate market fragmentation. In light of the above, we believe initial margin of non-U.S. Person customers should not be required to be counted toward the 20 percent threshold under both prongs.

b. Purpose of Reporting Requirements

Under the Proposal, the Commission will introduce changes to the reporting requirement for the purpose of evaluating whether an exempt DCO's cleared swaps activity for U.S. persons reaches a level such that the exempt DCO would pose substantial risk to the U.S. financial system. More specifically, (I) proposed §39.6(c)(2)(i) will provide the Commission with information on the margin associated with U.S. Persons clearing swaps through exempt DCOs in order to analyze the risks presented by such U.S. Persons and to assess the extent to which U.S. business is being cleared by each exempt DCO; (II) proposed §39.6(c)(2)(ii)[16] is intended to enable the Commission, in conducting risk surveillance of U.S. Persons and swaps markets more broadly, to better understand and evaluate the nature and extent of the cleared swaps activity of U.S. Persons; and (III) the supplement for proposed §39.6(c)(2)(vii) is based on the recognition that the default of any clearing member may impact U.S. clearing members and U.S. Persons clearing at the exempt DCO.

The purpose of the proposed reporting requirements is mainly focused on U.S. Person customers insofar as customers are concerned. We believe this is the right focus because

[16] Proposed §39.6(c)(2)(ii) would require an exempt DCO to compile a report as of the last day of each fiscal quarter, and submit the report to the Commission no later than 17 business days after the end of the fiscal quarter, containing a list of U.S. Persons and FCMs that are either clearing members or affiliates of any clearing member, with respect to the clearing of swaps, as of the last day of the fiscal quarter.

the non-U.S. Person's cleared swaps positions will not pose substantial risk to the U.S. financial system. Therefore, we believe initial margin of non-U.S. Person customers should not be required to be counted toward the 20 percent threshold under both prongs.

4. Metrics for "Substantial Risk" Measurement

a. Initial Margin

Under the Proposal, the Commission is intending to use initial margin as the primary metric to measure substantial risk. We agree with the Commission's use of initial margin as a primary metric. We commend the Commission for proposing to develop an objective quantitative metric that would provide clarity and legal certainty that a CCP with only a small volume of clearing business with U.S. clearing members or U.S. clients would not be determined to pose substantial risk to the U.S. financial system.

We further agree with the Commission that the use of initial margin is a better risk-based metric to assess the exposure to an exempt DCO compared to a metric such as notional, which may not be a clear indication of risk and in some cases can lead to an over-estimation of the underlying risk managed by the exempt DCO.

We also share the view that a test based solely on initial margin requirements may not fully capture the risk of a given exempt DCO. As previously stated, we believe no single factor or quantitative metric should be determinative to measure substantial risk to the U.S. financial system and the Commission should consider all relevant factors under a holistic approach. Below are a few additional metrics that we encourage the Commission to consider in the analysis of whether an exempt DCO poses substantial risk to the U.S. financial system to ensure a fair, suitable, and consistent determination.

b. Customer Protection

We encourage the Commission to consider the robustness of the customer asset protection regime of an exempt DCO. If the customer asset protection regime is structured with robust customer asset segregation compliant with its home country regulations and conforming to the PFMI principles, the exempt DCO likely will pose less risk to the U.S. financial system.

c. Resilience and Recovery

We encourage the Commission to consider the resilience and the recovery arrangements of the exempt DCO, in particular the financial risk management framework including governance, stress testing, margin, and an exempt DCO's contribution of its financial resources to losses. We believe the resilience and the

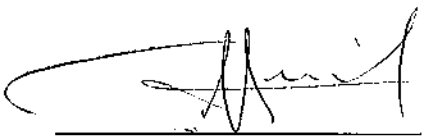
recovery arrangements of the exempt DCO will affect the impact of an exempt DCO's failure to U.S. clearing members and U.S. customers. The level of such impact may be an important element in assessing an exempt DCO's relevance to the systemic importance of the U.S. financial system.

The PFMIs specifically address the resilience and the recovery arrangements of CCPs and whether the exempt DCO adheres to the PFMIs should be considered in the determination of the systemic importance of an exempt DCO to the U.S. financial system.

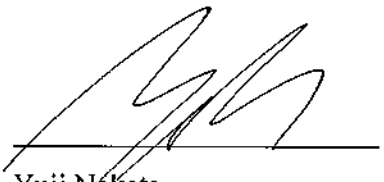
V. Conclusion

Thank you for the opportunity to share our views on the CFTC's Proposal. We strongly support the CFTC's objective of expanding the Commission's exemptive authority to permit exempt DCO and its non-FCM clearing members to provide swap clearing services to U.S. customers. We are committed to working collaboratively with the CFTC to establish rules better calibrated to mitigate systemic risk while avoiding fragmentation, fostering innovation, competition and international cooperation. We are available to discuss these comments in further detail with you if required.

Yours faithfully,



Philippe Avril
Chairman of the IBA Japan
Co-Chairman of JFMC
Date: 12 Nov 2019



Yuji Nakata
Co-Chairman of JFMC
Date: 12, Nov. 2019