October 7th, 2019

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

Re: Registration With Alternative Compliance for Non-U.S. Derivatives Clearing Organizations (RIN 3038-AE87)

Dear Mr. Kirkpatrick:

I. Introduction

Japan Securities Clearing Corporation ("**JSCC**") appreciates the opportunity to provide the Commodity Futures Trading Commission ("**Commission**" or "**CFTC**") with comments on its notice of proposed rulemaking ("**NPR**") regarding registration with alternative compliance for non-U.S. derivatives clearing organizations.[1]

While JSCC supports the CFTC's efforts to codify a regulatory and supervisory approach based on the recognition of, and the deference to, the home country regulators of non-U.S. clearinghouses advocated in the NPR, as discussed below, JSCC, which is currently exempted from registration with the CFTC as a derivatives clearing organization ("**DCO**"), would not be able to utilize the proposed alternative compliance framework. Indeed, we believe the NPR would not address the current challenges many U.S. customers face in accessing non-U.S. swap markets. Therefore, regardless of any action the CFTC may take concerning the NPR, we strongly request that the Commission finalize its supplemental notice of proposed rulemaking ("**SNPR**") regarding exemptions from DCO registration,[2] which was proposed separately.

[1] Registration With Alternative Compliance for Non-U.S. Derivatives Clearing Organizations, 84 Fed. Reg. 34819 (Jul. 19, 2019).

[2] Exemption From Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456 (Jul. 23, 2019); JSCC's comments on the SNPR dated October 7, 2019 are available at:

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II. Access to foreign clearinghouses for U.S. customers continues to be very problematic

As the CFTC is aware, the swaps market is global in nature, with cross-border trading constituting a significant portion of market activity. U.S. customers that trade cross-border need access to a wider range of clearinghouses in order to clear swaps in jurisdictions other than the U.S. Given the impending adoption of mandatory clearing requirements in non-U.S. jurisdictions, the next implementation phase of initial margin requirements for uncleared swaps, and the obvious benefits of netting, there will be a significant demand for clearing, including at non-U.S. clearinghouses.

Clearing is also attractive to swaps market participants due to the reduced capital requirements for central counterparty exposures under the Basel III framework, as evidenced in recent research[3] by the Financial Stability Board. Therefore, any restriction on access to clearing for U.S. customers will be increasingly problematic. This situation is further exacerbated for U.S. customers that trade swaps denominated in foreign currencies and subject to the CFTC's clearing mandate.[4] For example, for interest rate swaps denominated in non-U.S. dollar currencies such as Japanese Yen ("**JPY**"), U.S. customers may not be able to access the non-U.S. swap markets in the home country of the currency, where the highest liquidity and the best prices would be available and where the safest clearing arrangements for that transaction may be offered.

III. Maintaining sufficient FCM members would not be feasible for non-U.S. clearinghouses

https://comments.cftc.gov/PublicComments/CommentList.aspx?id=3009.

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

[4] The CFTC's clearing mandate includes interest rate swaps denominated in Australian Dollar, Canadian Dollar, Euro, Hong Kong Dollar, Mexican Peso, Norwegian Krone, Polish Zloty, Singapore Dollar, Swedish Krona, Swiss Franc, Sterling, U.S. Dollar, and Yen. A list of the classes of swaps subject to the CFTC's clearing mandate is available at:

https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/clearingrequirementcharts9-16.pdf.

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We understand that there are ongoing concerns within the Commission regarding futures commission merchant ("**FCM**") competition issues, should clearing members that are not FCMs be allowed to clear for U.S. customers. However, the entities active in swap customer clearing are global banking groups, including several U.S. banking groups, that support the complex business needs of the eligible contract participants that dominate this market. Many of these banking groups serve customers for swap clearing generally through separate subsidiaries in the non-U.S. markets, including Japan.

Today very few non-U.S. entities are registered as FCMs with the CFTC, and the overall number of FCMs has been decreasing.[5] Where an FCM has a non-U.S. affiliate that is a member of a non-U.S. DCO, the cost of onboarding an additional FCM affiliate, solely to provide swap clearing services to U.S. customers, would be prohibitively expensive.[6] To achieve customer portability in the event of an FCM clearing member's default, which is expected of central counterparties globally as one of the fundamental requirements of the Principles for Financial Market Infrastructure ("PFMIs") and implemented in the CFTC regulatory framework for DCOs under the CFTC Regulation 39.15,[7] a non-U.S. DCO would need to have multiple FCM clearing members. This would be an elusive goal for most non-U.S. DCOs given the lack of interest by entities to register as FCMs to clear at non-U.S. DCOs.

Therefore, we believe that under the NPR, U.S. customers may not be able to access a wide range of non-U.S. swap markets and diversify their swap clearing risks. Rather, U.S. customers may be forced to concentrate their clearing in a limited number of DCOs and FCM clearing members, as is currently the case.

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[5] *See* "Incentives to centrally clear over-the-counter (OTC) derivatives, A post-implementation evaluation of the effects of the G20 financial regulatory reforms" (Nov. 19, 2018), Figure C.10 Historical count of Futures Commission Merchants (FCMs), available at: https://www.fsb.org/wp-content/uploads/R191118-1-1.pdf.

[6] *See* Statement of Commissioner Dawn D. Stump, Registration with Alternative Compliance for Non-U.S. Derivatives Clearing Organizations, 84 Fed. Reg. 34819, 34836 (Jul. 19, 2019).

[7] 17 C.F.R. § 39.15.

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IV. Non-U.S. clearinghouses may not be able to comply with the CFTC's customer protection requirements

The alternative compliance framework would require non-U.S. DCOs to comply with the customer protection requirements under the CFTC regulations and would maintain the U.S. Bankruptcy Code treatment for U.S. customer funds by requiring such funds to be held by CFTC-registered FCMs.[8] While some of the six non-U.S. clearinghouses that are currently registered as DCOs may seek to register pursuant to this alternative compliance framework, we do not believe that most of the non-U.S. clearinghouses that are currently exempt from DCO registration will be able to register under the alternative compliance framework due to the application of the CFTC's customer protection requirements.

From our ongoing discussions with the CFTC staff, we understand that JSCC's existing arrangements are problematic for the CFTC because when a clearing member of JSCC, acting as agent of a customer, deposits customer collateral with JSCC, there is a period of a few hours when JSCC holds the customer collateral in its account with the Bank of Japan, a settlement bank used for the swap clearing operation, before it is transferred to the trust bank, which holds the collateral in a trust that is legally segregated from the trustee's own assets and is bankruptcy remote from the clearing member acting as a clearing broker, JSCC, and the trust bank. To ensure that title of the customer collateral is transferred to JSCC, under Japanese law and JSCC's rulebook, in order to protect against the potential claim by the third party creditors of the clearing member, the customer collateral must be delivered, not directly into the trust, but through a settlement account in the name of JSCC. We understand that as a result of this settlement process, which includes a few hours during which the customer's funds are not held in the trust, JSCC is deemed as not strictly complying with Section 4d(f) of the Commodity Exchange Act, which requires that customer funds must be subject to the U.S. Bankruptcy Code at all times, and would therefore be prohibited from relying on the alternative compliance regime.

[8] *See* Registration With Alternative Compliance for Non-U.S. Derivatives Clearing Organizations, 84 Fed. Reg. 34819, 34823 (Jul. 19, 2019).

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Since registration under the alternative compliance framework is limited to those DCOs that do not pose a substantial risk to the U.S. financial system, we do not believe that the CFTC should impose its own unique requirements, including its customer protection requirements, on non-U.S. DCOs. Rather, the CFTC should defer to the regulation and the supervision of non-U.S. DCOs' home country regulators, as long as these regulators have implemented a regulatory framework for central counterparties that is consistent with the PFMIs. As the CFTC is well aware, significant progress has been made in addressing systemic risk and customer protection issues through the broad adoption by global regulators of internationally recognized standards, such as the PFMIs. It is imperative that supervisory authorities recognize the broad comparability of standards and provide approaches to regulation that avoid unnecessary cost and duplication, while ensuring protections to customers and the wider financial system. In fact, in the adopting release to the NPR, the Commission explicitly recognizes the need to minimize duplicative regulatory regimes when non-U.S. clearinghouses do not pose a significant risk to the U.S. financial system.[9] The direct application of the U.S. Bankruptcy Code framework to non-U.S. DCOs in relation to the customer funds protection, when these DCOs and their home country regulators have implemented their own customer protection framework in compliance with the PFMIs, creates little benefit while imposing significant burden on non-U.S. DCOs because compliance with both the home country regime and the U.S. regime could be impractical when those regimes are incompatible with each other. Exporting U.S. regulatory models to non-U.S. clearinghouses is unnecessary, particularly in instances where non-U.S. jurisdictions have developed substantially equivalent regimes for customer protection.

In JSCC's customer protection scheme, all swap customers would be well protected under the regulations and supervision in the Japanese swap market because JSCC's rules require that clearing members identify the beneficial owner of all swap customer funds when these are deposited with JSCC as collateral for swap clearing, so that JSCC can manage these funds in an individually segregated account maintained at JSCC for each customer. JSCC does not permit its clearing members to hold swap customer funds, and clearing members are required to transfer swap customer funds without delay to JSCC upon receipt from the customer. All swap customer

[9] Registration With Alternative Compliance for Non-U.S. Derivatives Clearing Organizations, 84 Fed. Reg. 34819, 34820 (Jul. 19, 2019).

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funds are then placed into a trust under Japanese law,[10] where these funds are held bankruptcy remote from the clearing member acting as a clearing broker, JSCC, and the trust bank. In the event of a clearing broker's default, swap customer funds would be returned by JSCC directly to each beneficial swap customer, after deducting outstanding obligations that arise from the customer's own swap positions. In the event of JSCC's bankruptcy, swap customer funds would be returned by the pre-assigned customer agent (an independent lawyer) directly to each beneficial swap customer, after first deducting outstanding obligations that arise from the customer's own swap positions. In both scenarios, no permission by the Japanese court is required to return the funds to each beneficial swap customer, and so U.S. customers will be able to receive their funds swiftly, which is very important for U.S. customers in times of market stress. And in any default case of a clearing member, JSCC, or the relevant trust bank, no deductions are permitted from customer funds for any bankruptcy administration costs.

JSCC's customer protection system fully conforms with the relevant PFMI principles and provides sufficient safety for customers in all of the jurisdictions where JSCC operates. We would also like to highlight that no other jurisdiction[11] in which JSCC holds a license to provide swap clearing requires the extraterritorial application of the foreign jurisdiction's bankruptcy code to customer funds.

V. Proposed test for "substantial risk to the U.S. financial system"[12]

Under the NPR, a DCO would only be able to rely on the alternative compliance framework if the DCO does not pose "substantial risk to the U.S. financial system." Under the NPR, a DCO organized outside of the U.S. poses a "substantial risk to the U.S. financial system" if (1) the DCO holds 20%

[10] Due to the administration of the trust and the impact of a negative interest rate on cash collateral, JSCC charges the relevant fees to each clearing member. Alternatively, clearing members and their customers may elect to use the custody of JPY cash collateral at the Bank of Japan, which is not subject to these fees.

[11] JSCC maintains a license for swap clearing services in the EU, Australia, Hong Kong, and Switzerland, in addition to the U.S. and Japan.

[12] In addition to the comments contained in this section, our comment letter on the SNPR also comments on the definition of "U.S. clearing member" as it relates to the substantial risk to the U.S. financial system test.

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or more of the required initial margin of U.S. clearing members for swaps across all registered and exempt DCOs; and (2) 20% or more of the initial margin requirements for swaps at the DCO is attributable to U.S. clearing members; *provided, however,* where one or both of these thresholds are close to 20%, the Commission may exercise discretion in determining whether the DCO poses substantial risk to the U.S. financial system.[13]

Due to the large global presence of non-U.S. affiliated entities of U.S. banking groups, we believe that the second threshold, i.e., "20% or more of the initial margin requirements for swaps at the DCO is attributable to U.S. clearing members," may be breached even by small-sized DCOs. This is due to the inclusion of non-U.S. subsidiaries whose parent company is organized in the U.S. in the definition of "U.S. clearing member" and therefore in the calculation of the initial margin exposure, for which the ultimate risks to the U.S. financial system would be negligible.

If a DCO is deemed to be a "substantial risk to the U.S. financial system" under the NPR, the DCO must fully register as a DCO with the CFTC and cannot rely on the alternative compliance framework, irrespective of the real level of their risk to the U.S. financial system.

We strongly request that the Commission reconsider the criteria for the assessment of "substantial risk to the U.S. financial system" as defined in the proposed CFTC Regulation 39.2, such that the test should permit the Commission to exercise its discretion only if both of the two thresholds are close to 20%. This would more accurately capture the risks to the U.S. financial system.

We believe that the status of each DCO subject to the alternative compliance framework should be reassessed every two years. This should be sufficient from the CFTC's perspective, as it would allow a regular review of each DCO. We also suggest that the reassessment of each test look at the averages over the previous 12 months, to ensure that the test results are not overly influenced by any specific event, such as quarter-end or year-end.

[13] Registration With Alternative Compliance for Non-U.S. Derivatives Clearing Organizations, 84 Fed. Reg. 34819, 34821–22 (Jul. 19, 2019).

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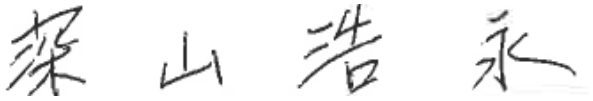
VI. Conclusion

We believe it is imperative that the CFTC finalize the SNPR, regardless of any action taken with respect to the NPR. Finalizing the NPR without finalizing the SNPR would leave the swap markets as fragmented for U.S. customers as they are today because U.S. customers would still be required to access non-U.S. swap markets only through registered FCMs, thereby limiting the available clearinghouse options.

We appreciate the opportunity to provide these comments, and we look forward to a discussion with the Commission on our opinions. Should you have any questions about this letter, please do not hesitate to contact Mr. Tetsuo Otashiro, Head of Clearing Planning, at +81-50-3361-0928 or by email to t-otashiro@jpx.co.jp.

Yours sincerely,



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