



## U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk

Ananda Radhakrishnan  
Director

CFTC Letter No. 14-87  
No-Action  
June 26, 2014  
Division of Clearing and Risk

Mr. Kyungsoo Choi  
Chairman & CEO  
Korea Exchange

Re: No-Action Relief with Regard to Section 5b(a) of the Commodity Exchange Act and  
Commission Regulations Thereunder

Dear Mr. Choi:

This letter responds to your letter dated May 29, 2014 (“Letter”) to the Division of Clearing and Risk (“Division”) of the Commodity Futures Trading Commission (“Commission”). In the Letter, you request that the Division confirm that it will not recommend that the Commission take enforcement action against Korea Exchange, Inc. (“KRX”) for failure to register as a derivatives clearing organization (“DCO”) pursuant to Section 5b(a) of the Commodity Exchange Act (“CEA”)<sup>1</sup> should KRX engage in certain clearing activities specified in the Letter.

Specifically, KRX seeks to clear Korean Won-denominated interest rate swaps (“KRW IRS”), as well as any other swaps later covered by the clearing requirements of the Republic of Korea’s (“Korea”) Financial Investment Services and Capital Markets Act (the “FSCMA”), for the proprietary trades of KRX’s clearing members that are U.S. persons. KRX requests that this relief expire on the earlier of May 31, 2015, or any date on which the Commission exempts KRX from the DCO registration requirement under Section 5b(h) of the CEA.<sup>2</sup> KRX represents that it intends to apply for an exemption from registration as a DCO once the Commission addresses the process or specific criteria and conditions necessary to obtain exemptive relief.<sup>3</sup>

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<sup>1</sup> 7 U.S.C. § 7a-1(a).

<sup>2</sup> Section 5b(h) of the CEA, 7 U.S.C. § 7a-1(h), permits the Commission to exempt a clearing organization from registration for the clearing of swaps if the Commission determines that the clearing organization is subject to comparable, comprehensive supervision and regulation by the Securities and Exchange Commission or the appropriate government authorities in the clearing organization’s home country.

<sup>3</sup> See Letter at 3 n.4 (“KRX stands ready to promptly apply for an exemption from registration as a DCO as soon as the CFTC issues guidance on the process or specific criteria and conditions necessary to obtain exemptive relief.”)

### Statement of Facts

Based on KRX's representations to the Division contained in the Letter, the Division understands the relevant facts to be as follows:

KRX, which operates as both an exchange and a clearinghouse, was established under the Securities and Futures Exchange Law of Korea, which was later replaced by the FSCMA. KRX operates three separate clearing businesses, including its Swaps Clearing Business, which was opened to KRX clearing members on March 3, 2014. KRX's Swaps Clearing Business currently offers clearing services only for plain vanilla KRW IRS, and it currently limits its swaps clearing services exclusively to clearing participants that are not U.S. persons.

The Korean Financial Services Commission ("FSC") authorizes Korean clearinghouses, and the FSCMA requires that prior to authorizing a clearinghouse, the FSC must be satisfied that a clearinghouse has: equity capital satisfying a specified regulatory minimum; a proper and sound business plan; human resources, data-processing equipment, and other physical facilities sufficient to protect investors and conduct its clearing business; articles of incorporation and regulations suitable for its clearing business; a system to prevent certain conflicts of interest; and shareholders possessing adequate financial capabilities. The FSCMA also requires that clearinghouses meet these requirements on an ongoing basis to maintain their authorization.

Authorized clearinghouses in Korea are subject to day-to-day supervision and ongoing examination and oversight by the FSC and the Financial Supervisory Service, which acts under the oversight of the FSC. The Bank of Korea also shares responsibility for oversight of clearinghouses in Korea and is responsible for developing some of the regulatory requirements applicable to clearinghouses. Korean regulatory authorities have incorporated into the Korean regulatory scheme for clearinghouses the Principles for Financial Market Infrastructure ("PFMIs") developed by the Committee on Payment and Settlement Systems of the Bank for International Settlements and the Technical Committee of the International Organization of Securities Commissions. The FSC has confirmed that the standards articulated in the PFMIs are incorporated through a combination of FSCMA provisions, enforcement decrees, FSC regulations, and by a requirement that Korean clearinghouses incorporate certain provisions directly into their rulebook.

### Discussion of Request for No-Action Relief and Applicable Legal Requirements

KRX has represented that the KRW IRS that it seeks to clear for proprietary trades of U.S. clearing members are swaps under the CEA and Commission regulations, and the Division accepts KRX's representation without independent analysis.<sup>4</sup> Section 5b(a) of the CEA provides

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<sup>4</sup> The CEA's statutory definition of "swap" includes interest rate swaps. *See* Section 1a(47)(A) of the CEA, 7 U.S.C. § 1a(47)(A) ("[T]he term 'swap' means any agreement, contract, or transaction – . . . (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates . . . including any agreement, contract, or transaction commonly known as – (I) an interest rate swap . . .")

that a DCO may not perform the functions of a DCO with respect to swaps unless it is registered with the Commission.<sup>5</sup>

The Division, however, has recently granted no-action relief permitting non-U.S. clearing organizations to clear swaps for U.S. persons prior to registering with the Commission as a DCO,<sup>6</sup> and KRX's request is generally consistent with the requests that prompted that relief. Granting the relief KRX requests pending consideration of its anticipated application for an exemption pursuant to Section 5b(h) of the CEA is appropriate in order to facilitate the centralized clearing of KRW IRS and to promote competition and enhance choice for clearing services. The Division notes, however, that the Commission has not established a regulatory framework for exempting a clearing organization from registration as a DCO pursuant to Section 5b(h) of the CEA. Accordingly, the Division's grant of no-action relief herein should not be interpreted to mean that the Commission will exempt KRX from registration as a DCO.

With respect to the scope of products covered by the requested relief, KRX seeks relief that applies to "any swaps covered by the FSCMA Clearing Requirements, including KRW IRS."<sup>7</sup> It is unclear, however, when or if the FSCMA Clearing Requirements will expand beyond KRW IRS, and the Division does not have any information regarding the nature of the products that could potentially fall within any future expansion.<sup>8</sup> As a result, the no-action relief detailed below is limited to the KRW IRS products that are specifically discussed in the Letter.<sup>9</sup>

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<sup>5</sup> Section 5b(a) of the CEA, 7 U.S.C. § 7a-1(a), states: "Except as provided in paragraph (2), it shall be unlawful for a derivatives clearing organization, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a derivatives clearing organization with respect to . . . (B) a swap. (2) EXCEPTION. – Paragraph (1) shall not apply to a derivatives clearing organization that is registered with the Commission."

<sup>6</sup> See CFTC Letter 14-68 (May 7, 2014) (granting no-action relief to OTC Clearing Hong Kong Limited and certain of its clearing members); CFTC Letter 14-27 (Mar. 20, 2014) (extending previous grant of no-action relief to Eurex Clearing AG and certain of its clearing members); CFTC Letter 14-07 (Feb. 6, 2014) (granting no-action relief to ASX Clear (Futures) Pty Limited); CFTC Letter No. 13-73 (Dec. 19, 2013) (extending previous grant of no-action relief to Japan Securities Clearing Corporation and certain of its clearing members); CFTC Letter No. 13-44 (July 11, 2013) (granting no-action relief to Eurex Clearing AG and certain of its clearing members); CFTC Letter No. 13-43 (July 11, 2013) (granting no-action relief to LCH.Clearnet SA and certain of its clearing members); CFTC Letter No. 12-63 (Dec. 21, 2012) (granting no-action relief to Singapore Exchange Derivatives Clearing Limited and certain of its clearing members); and CFTC Letter No. 12-56 (Dec. 17, 2012) (granting no-action relief to Japan Securities Clearing Corporation and certain of its clearing members).

<sup>7</sup> Letter at 4.

<sup>8</sup> See Letter at 2-3 ("The FSCMA Clearing Requirements may be expanded in the future to cover other types of swaps, although no definitive plans have yet been announced.")

<sup>9</sup> If the FSCMA Clearing Requirements expand to include additional products while the no-action relief granted herein is still in effect, KRX may request that the Division amend the relief.

### Grant of No-Action Relief

Based on the facts presented and KRX's representations to the Division, the Division will not recommend that the Commission take enforcement action against KRX for failure to register as a DCO pursuant to the requirements of Section 5b(a) of the CEA, subject to the following conditions:

1. Product Scope. The relief is limited to clearing of KRW IRS swaps.
2. Participant Scope. The relief applies to KRX's clearing of proprietary trades<sup>10</sup> of U.S. clearing members.
3. Reporting. If a clearing member clears through KRX a swap (referred to as the "alpha" swap) that has been reported to a Commission-registered swap data repository ("SDR") pursuant to Part 45 of the Commission's regulations,<sup>11</sup> then KRX must report to an SDR, pursuant to Part 45, data regarding the two swaps resulting from the novation of the alpha swap that had been submitted to KRX for clearing (referred to as "beta" and "gamma" swaps.)<sup>12</sup>
4. Limited Duration. The no-action relief shall expire at the earlier of: (i) December 31, 2014;<sup>13</sup> or (ii) the date on which the Commission either registers KRX as a DCO under

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<sup>10</sup> See 17 C.F.R. § 1.3(y) (definition of "proprietary account").

<sup>11</sup> See Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (Jan. 13, 2012) (adopting Part 45).

<sup>12</sup> Pursuant to Regulation 39.12(b)(6), 17 C.F.R. § 39.12(b)(6), during the clearing process, a swap submitted for clearing to a registered DCO (the alpha swap) is extinguished or terminated, and two new swaps (the beta and gamma swaps) are created. The registered DCO must then report the beta and gamma swaps to an SDR under Part 45 and associate the unique swap identifier of the alpha swap with the beta and gamma swaps in order for the Commission to confirm that such alpha swap was cleared. See Statement of the Commission concerning CME Rule 1001 (Mar. 6, 2013) at 6, available at: <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/statementofthecommission.pdf>; see also Regulation 45.4(a), 17 C.F.R. § 45.4(a) ("[R]eporting counterparties and [DCOs] required to report swap continuation data must do so in a manner sufficient to ensure that all data in the [SDR] concerning the swap remains current and accurate, and includes all changes to the primary economic terms of the swap occurring during the existence of the swap."); 77 Fed. Reg. at 2153 ("[T]he final rule requires registered entities and reporting counterparties to report continuation data in a manner sufficient to ensure that the information in the SDR concerning the swap is current and accurate, and includes all changes to any of the primary economic terms of the swap.").

In order to avoid duplicative reporting for such transactions, KRX should have rules that prohibit the Part 45 reporting of the beta and gamma swaps by the original counterparties to the alpha swap. These rules should make it clear to market participants that KRX is reporting the beta and gamma swaps as if it were a registered DCO under the Part 45 rules.

<sup>13</sup> KRX requested that the relief expire on the earlier of May 31, 2015, or any date on which the CFTC exempts KRX from the DCO registration requirement under Section 5b(h) of the CEA. To maintain consistency with the relief granted to other similarly situated non-U.S. clearing organizations, the date certain included in this provision is December 31, 2014, rather than the requested date.

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Section 5b(a) of the CEA or exempts KRX from registration as a DCO under Section 5b(h) of the CEA.

The position taken herein concerns enforcement action only and does not represent a legal conclusion with respect to the applicability of any provision of the CEA or the Commission's regulations. In addition, the Division's position does not necessarily reflect the views of the Commission or any other division or office of the Commission. Because this position is based on the representations contained in the Letter, any different, changed, or omitted material facts or circumstances may require a different conclusion or render this letter void. Finally, as with all no-action letters, the Division retains the authority to condition further, modify, suspend, terminate, or otherwise restrict the terms of the no-action relief provided herein, in its discretion.

Should you have any questions, please do not hesitate to contact me at (202) 418-5188 or Theodore Polley, Special Counsel, at (312) 596-0551.

Sincerely,

Ananda Radhakrishnan  
Director