



U.S. COMMODITY FUTURES TRADING COMMISSION

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Division of Clearing and Risk

CFTC Letter No. 12-56
No-Action
December 17, 2012
Division of Clearing and Risk

Mr. Yasuo Tobiyama
President and CEO
Japan Securities Clearing Corporation
2-1 Nihombashi-Kabuto-cho
Chuo-Ku
Tokyo 103-0026, Japan

Re: No-Action Relief with Regard to Section 5b(a) of the Commodity Exchange Act and Section 2(h)(1)(A) of the Commodity Exchange Act and Implementing Regulations Thereunder

Dear Mr. Tobiyama:

This is in response to your letter dated December 11, 2012 (“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 (1) Japan Securities Clearing Corporation (“JSCC”) for failing to register as a derivatives clearing organization (“DCO”) under section 5b(a) of the Commodity Exchange Act (“CEA”),¹ and (2) JSCC qualified clearing participants, and a parent or affiliate of a JSCC qualified clearing participant, for failing to clear yen-denominated interest rate swaps subject to required clearing, under section 2(h)(1)(A) of the CEA² and Commission regulations³ thereunder, through a registered DCO.

Under this proposed relief, JSCC would be permitted to clear certain credit default swap (“CDS”) transactions based on an iTraxx Japan index and certain yen-denominated interest rate swaps referencing either the London Interbank Offered Rate (“LIBOR”) or the Tokyo Interbank Offered Rate (“TIBOR”). In addition, under the proposed relief, JSCC’s qualified clearing participants, and a parent or affiliate of a JSCC qualified clearing participant, would be permitted to clear interest rate swaps required to be cleared under section 2(h)(1)(A) and Commission

¹ 7 U.S.C. 7a-1(a).

² 7 U.S.C. 2(h)(1)(A).

³ Commission rules referred to herein are found at 17 CFR Ch. I (2012).

regulations through a DCO that is not registered with the Commission. You have requested that such relief be effective until the earlier of December 31, 2013, or the date upon which JSCC registers as a DCO with respect to its interest rate swap clearing business.

Statement of Facts

On November 19, 2012, JSCC filed a draft application to be registered as a DCO. Based upon the representations made in the Letter, we understand the relevant facts to be as follows:

JSCC was established in 2002 by Japanese securities exchanges as a cross-market, central clearing organization for the Japanese securities market. JSCC is organized under the Companies Act of Japan as a *kabushiki kaisha* (i.e., a joint-stock corporation). In 2003, JSCC obtained a license from the Prime Minister of Japan as a Financial Instruments Clearing Organization (“FICO”) under the Financial Instruments and Exchange Act (“FIEA”) and started its clearing business. Since receiving a license, JSCC has been subject to the supervision of the Japanese Financial Services Agency (“JFSA”) to whom the Prime Minister delegates the authority of supervision.

JSCC operates three separate clearing businesses. JSCC clears transactions listed on financial instruments exchanges in its Listed Products Clearing Business. It also clears an iTraxx Japan index in its CDS Clearing Business and it clears yen-denominated interest rate swaps referencing LIBOR⁴ in its IRS Clearing Business. JSCC’s FICO registration applies to all three of its clearing businesses. The rules of each of JSCC’s clearing businesses require that all qualified clearing participants must be registered with the Prime Minister of Japan as either a financial instrument business operator (“FIBO”) or a registered financial institution (“RFI”).

None of JSCC’s three Clearing Businesses are currently registered with the CFTC as a DCO, nor have they received an exemption from the DCO registration requirements. JSCC management intends to register as a DCO with respect to its IRS Clearing Business with the CFTC as promptly as possible. JSCC is in the process of amending its IRS Clearing Business rules and making operational changes in order to meet the regulatory requirements associated with DCO status in the United States.

In 2010, the Japanese government amended the FIEA to require the phased implementation of mandatory clearing of certain derivative transactions (the “FIEA Clearing Requirements”). Under the first phase of the FIEA Clearing Requirements, which became effective on November 1, 2012, subject to certain exemptions,⁵ FIBOs and RFIs that enter into

⁴ JSCC currently clears yen-denominated interest rate swaps referencing LIBOR and plans to start offering yen-denominated interest rate swaps referencing TIBOR in the first quarter of 2013.

⁵ The following exemptions apply to the FIEA Clearing Requirements: (1) transactions in which one counterparty is not a FIBO or RFI; (2) transactions which are booked in a trust account; (3) transactions between affiliated counterparties; (4) transactions in which both counterparties are not clearing members (or parents or subsidiaries of a clearing member) of the same clearing organization or are not clearing members of the clearing organizations involved in a Foreign Linkage Arrangement; and (5) transactions that the JFSA has otherwise designated as exempt

CDS transactions based on an iTraxx Japan index that references 50 or fewer domestic Japanese corporations (“covered iTraxx Japan CDS”) must clear such transactions through a FICO. In addition, subject to the same exemptions, FIBOs and RFIs that enter into yen-denominated interest rate swaps referencing LIBOR and designated by the FIEA (“covered yen-denominated interest rate swaps referencing LIBOR”) must clear such transactions through either: (1) a FICO, (2) a non-Japanese clearing organization which has obtained a license from the Prime Minister in accordance with the FIEA as a Foreign Financial Instruments Clearing Organization (“FFICO”) or (3) a clearing organization that has entered into a linkage arrangement with a FICO (the linked clearing organization is a “Linkage Clearing Organization” and the arrangement itself is a “Foreign Linkage Arrangement”). On or after 2013, the FIEA Clearing Requirements may also be expanded to covered yen-denominated interest rate swaps referencing TIBOR.

As a result, as of November 1, 2012, qualified clearing participants of JSCC that are FIBOs and RFIs and potentially their parent entities and affiliates, absent an exemption, must clear covered iTraxx Japan CDS and covered yen-denominated interest rate swaps referencing LIBOR in accordance with FIEA Clearing Requirements, with yen-denominated interest rate swaps referencing TIBOR expected to become subject to the FIEA Clearing Requirements in the future.

JSCC is currently the only swaps clearing organization licensed as a FICO. Furthermore, there are currently no clearing organizations that have obtained a license from the Prime Minister of Japan as FFICOs or engaged in a Foreign Linkage Arrangement that satisfy the FIEA Clearing Requirement. As a result, JSCC is the sole clearing organization available to FIBOs and RFIs to comply with the FIEA Clearing Requirements in Japan.

On November 29, 2012, the Commission finalized its first clearing requirement determination, which requires market participants to clear certain classes of CDS based on North American and European corporate entities and certain classes of interest rate swaps, including yen-denominated interest rate swaps referencing LIBOR (“CEA Clearing Requirements”). The Commission has not considered whether iTraxx Japan indices or yen-denominated interest rate swaps referencing TIBOR should be required to be cleared.

As a result, certain participants in the market for products such as yen-denominated interest rate swaps referencing LIBOR will find themselves subject to potentially conflicting mandates – requirements to clear transactions in compliance with both the FIEA Clearing Requirements as well as the CEA Clearing Requirements. Unless JSCC and JSCC’s qualified clearing participants (along with the parent or affiliate of each JSCC qualified clearing participant for whom a JSCC qualified clearing participant is clearing) are granted temporary relief while JSCC’s DCO registration is pending, it will be impossible for these market participants to satisfy both the Japanese and U.S. requirements simultaneously.

from the FIEA Clearing Requirements. *See* Cabinet Ordinance No. 48 of July 11th 2012, “Cabinet Ordinance on Regulation of Over-the-Counter Transactions of Derivatives, Etc.,” Article 2-3.

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

The Division accepts, without independent analysis, JSCC's representation that the three contracts subject to its request, CDS based on an iTraxx Japan index, covered yen-denominated interest rate swaps referencing LIBOR, and yen-denominated interest rate swaps referencing TIBOR, are swaps under the CEA and Commission regulations. It also accepts, without further inquiry, that some of JSCC's qualified clearing participants registered as FIBOs and RFIs under Japanese law (a) may be U.S. persons or (b) may be non-U.S. persons, but enter into covered swaps with counterparties that are U.S. persons.

Section 5b(a) of the CEA provides that a DCO may not perform the functions of a DCO with respect to swaps unless the DCO is registered.⁶ Section 2(h)(1)(A) of the CEA goes on to state that swaps that are required to be cleared must be submitted to a registered DCO or a DCO that is exempt from registration.⁷ Accordingly, DCOs may apply to be registered DCOs or exempt DCOs, subject to certain conditions. At this time, there are no DCOs that are exempt from registration and through which market participants may satisfy their CEA Clearing Requirement obligations. JSCC has expressed its intent to register with the Commission as a DCO and has submitted a draft application for registration. As a condition of its no-action request, JSCC has represented that its qualified clearing participants will not clear any swaps subject to this relief on behalf of U.S. customers.⁸

As noted above, the Commission recently adopted CEA Clearing Requirements as part its review under section 2(h) of the CEA. In the absence of this no-action relief, certain market participants may find themselves subject to conflicting requirements under (1) the Japan's FIEA Clearing Requirements, which require clearing of covered yen-denominated interest rate swaps at one of three clearing organizations recognized by Japanese authorities, and (2) the Commission's CEA Clearing Requirements, which require clearing of certain yen-denominated interest rate swaps at a DCO or a DCO that is exempt from registration.

Division staff recognizes that the clearing requirement established by the Dodd-Frank Act and codified within the CEA, arose out of commitments made, and affirmed by, the leaders of the Group of 20 ("G-20"). As other members of the G-20, such as Japan, move forward with

⁶ Section 5b(a) of the CEA 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."

⁷ 7 U.S.C. § 2(h)(1)(A). *See also* section 5b(h) (permitting the Commission to exempt, conditionally or unconditionally, a DCO from registration for the clearing of swaps if the Commission determines that the DCO is subject to comparable, comprehensive supervision by the Securities and Exchange Commission or the appropriate government authorities in the home country of the DCO).

⁸ The term "customer" is defined in § 1.3(k) to include "any person who uses a futures commission merchant, introducing broker, commodity trading advisor, or commodity pool operator as an agent in connection with trading in any commodity interest." *See* Adaptation of Regulations to Incorporate Swaps, 77 FR 66288, 66316 (Nov. 2, 2012).

provisions designed to implement mandatory clearing of swaps through central counterparties, staff believes it is important to ensure that the interplay of differing regulatory regimes does not discourage clearing generally. Similarly, in this interim period during the implementation of new regulatory regimes, it is critical to address potential disruptions to the market and its participants caused by conflicting requirements and/or existing market infrastructure.

Recognizing that global migration to a cleared environment will take time, staff believes that the time-limited relief sought in this instance is appropriate, especially in light of JSCC's commitment to apply for registered-DCO status with the Commission.

Grant of No-Action Relief

Based on the facts presented and the representations you have made, the Division will not recommend that the Commission take enforcement action against (i) JSCC for failure to register as a DCO pursuant to the requirements of section 5b(a) of the CEA, or (ii) a qualified clearing participant of JSCC, or a parent or affiliate of a JSCC qualified clearing participant, subject to the FIEA Clearing Requirements, for failure to clear a swap that is required to be cleared under section 2(h)(1) of the CEA and Commission regulations, through a registered DCO, subject to the following conditions:

- (1) Product Scope. This relief is limited to the swaps designated in this paragraph. JSCC may clear (i) any swaps covered by the FIEA Clearing Requirements, including covered iTraxx Japan CDS and covered yen-denominated interest rate swaps referencing LIBOR, and (ii) yen-denominated interest rate swaps referencing TIBOR; provided that JSCC will not accept, and no JSCC qualified clearing participant will offer for clearing in JSCC, the swaps referenced in (i) and (ii) of this paragraph on behalf of a U.S. customer.
- (2) Participant Scope. The no-action relief applies to swaps in which one or more counterparties to the swap is a JSCC qualified clearing participant or a parent or affiliate of a JSCC qualified clearing participant subject to the FIEA Clearing Requirements. For purposes of complying with its obligations under section 2(h)(1) of the CEA and Commission Regulations thereunder, a JSCC qualified clearing participant or a parent or affiliate of a JSCC qualified clearing participant, subject to the FIEA Clearing Requirements, may clear their proprietary, yen-denominated interest rate swaps that reference LIBOR through JSCC.
- (3) Limited Duration. The no-action relief shall expire at the earlier of: (i) December 31, 2013 or (ii) the date upon which JSCC registers as a DCO with respect to its IRS Clearing Business.

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 upon the representations contained in the Letter, it should be noted that 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

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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 Brian O'Keefe, Associate Director, at (202)-418-5658.

Sincerely,

Ananda Radhakrishnan
Director