

COMMITTEE ON CAPITAL MARKETS REGULATION

December 12, 2024

The Honorable Rostin Behnam
Chairman
U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Re.: US Customer Access to Japanese Yen Interest Rate Swaps Cleared by the Japan Securities Clearing Corporation

Dear Chair Behnam:

The Committee on Capital Markets Regulation (the “Committee”) is writing to recommend that the Commodity Futures Trading Commission (“CFTC”) grant the petition of the Japan Securities Clearing Corporation (“JSCC”) to clear Japanese yen interest rate swaps for US customers. Doing so will reduce transaction costs and risks for US customers at a time when economic conditions make the ability to enter into such swaps increasingly important and is consistent with US regulatory policy with respect to US investment in other Japanese financial instruments. The JSCC’s petition is also consistent with the CFTC’s 2019 proposal to permit customer access to foreign swap clearing. Although the CFTC has thus far not formally adopted this proposal, it has indicated its openness to continued consideration of the merits of customer access. The Committee believes that the JSCC’s petition exemplifies the factors that support customer access. It is also within the CFTC’s legal discretion to grant the JSCC’s petition whether or not the CFTC formally adopts a rule codifying this exemption, which will allow the benefits of customer access with respect to Japanese yen interest rate swaps to more immediately accrue to US market participants.

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of US capital markets and ensuring the stability of the US financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in four parts. Part I reviews the history of the exclusion of customers from clearing of swaps through exempt DCOs and the CFTC’s legal authority to modify this exclusion.

Part II summarizes how the CFTC’s current order granting JSCC an exemption from registration as a derivatives clearing organization permits JSCC to clear swaps only for the proprietary accounts of JSCC clearing members and prevents JSCC from clearing Japanese yen interest rate swaps for US customers of those clearing members. Part III identifies the significant costs and risks that stem from this limitation and explains why allowing JSCC to clear yen interest rate swaps for US customers is consistent with sound regulatory policy and does not result in undue risk. It also describes how the importance of the Japanese yen and recent changes in Japanese economic conditions justify modifying the conditions of the JSCC’s current registration exemption to permit this access. Part IV calls on the CFTC to grant the JSCC’s petition for a modification of its exemptive order and reaffirms the CFTC’s legal authority to do so.

I. The Clearing of Swaps by Exempt DCOs

An interest rate swap is a financial derivative contract between two parties where one party promises to make payments at a fixed interest rate in exchange for the other party’s promise to make payments at a floating interest rate. The Commodities Exchange Act (“CEA”) and CFTC implementing regulations require that the vast majority of interest rate swaps in the United States be centrally cleared, meaning that a central counterparty (“CCP”) is interposed between the two swap counterparties and guarantees performance of the contract.¹

To clear derivatives for US market participants, a CCP must generally register with the CFTC as a derivatives clearing organization (“registered DCO”).² Registered DCOs must comply with a comprehensive regulatory framework under the CEA and CFTC rules that cover, for example, governance, minimum capital requirements, and operational standards. In 2010, Congress amended the CEA to allow the CFTC to conditionally or unconditionally exempt a foreign CCP from the registration requirement, provided the CCP is subject to “comparable, comprehensive supervision and regulation” in its home jurisdiction (“exempt DCO”).³ Permitting these exemptions allows US market participants to access a wider range of foreign financial products and markets while empowering the CFTC to ensure that US investors who access these markets and the broader US financial system are adequately protected.

i. Exempt DCOs Are Currently Not Permitted to Clear Customer Swaps

Under its CEA authority, the CFTC exempted four foreign swap-clearing CCPs from the requirement to register as DCOs. However, as a condition of each exemption, the CFTC limited the exempt DCO to clearing proprietary swap positions of its members and their affiliates.⁴ Most swap market participants cannot become members of a DCO and must therefore clear their swap

¹ BANK FOR INT’L SETTLEMENTS, *CRE: Calculation of RWA for Credit Risk*, 50.2 (Dec. 15, 2019), https://www.bis.org/basel_framework/chapter/CRE/50.htm.

² 7 U.S.C. § 7a–1(a), (h).

³ 7 USC § 7a–1 (h); CFTC, *Exemption from Derivatives Clearing Organization Registration*, 83 FED. REG. 39923, 39,925 (Aug. 13, 2018), <https://www.govinfo.gov/content/pkg/FR-2018-08-13/pdf/2018-17335.pdf> [the “2018 Proposal”].

⁴ *Id.*

positions through an intermediary that is a member of the DCO and acts on the customer’s behalf. The effect of this limitation is therefore to exclude the majority of US swap market participants from clearing swaps through exempt DCOs. This means that US investors cannot access significant risk-management instruments and pools of liquidity in the non-US swap market.

This limitation arose as a result of the manner in which the US Bankruptcy Code may apply to customer swaps and property at an exempt DCO.⁵ The CEA provides that any intermediary that facilitates clearing of swaps for customers at a registered DCO must register with the CFTC as a futures commission merchant (“FCM”).⁶ The US Bankruptcy Code provides that if an FCM becomes insolvent, “customer property” that the FCM holds on deposit with a *registered* DCO is protected from creditors of the FCM and is returned to the FCM’s customers.⁷ However, the US Bankruptcy Code does not expressly clarify that customer property cleared through an *exempt* DCO is protected from creditors in the event the swaps clearing intermediary fails.

In 2018, the CFTC proposed a rule to establish a formal framework to exempt non-U.S. DCOs from CFTC registration requirements (the “2018 Proposal”).⁸ Because of the uncertainty regarding the protection of customer property under the US Bankruptcy Code at an exempt DCO, the 2018 Proposal only permitted the clearing of swaps at an exempt DCO by an FCM clearing member for itself and its non-customer positions – in effect prohibiting the clearing of FCM customer positions at an exempt DCO.⁹

ii. The CFTC Revisited this Limitation and Proposed to Permit Customer Clearing Pursuant to its Discretion under the CEA

In 2019 the CFTC revisited the exclusion of swap customers from exempt DCO clearing in light of public comments responding to the 2018 Proposal and a white paper by then-CFTC Chairman Giancarlo.¹⁰ Based on these further analyses the CFTC issued a supplemental notice of proposed rulemaking to permit DCOs that are exempt from registration to clear swaps for US customers under certain circumstances (the “2019 Proposal”).¹¹

In the 2019 Proposal the CFTC proposed to permit an exempt DCO to clear US customer swaps through a non-US intermediary that is not an FCM pursuant to the CFTC’s authority under the CEA to provide exemptions from certain CEA requirements if doing promotes “responsible

⁵ *Id.* at 39,923.

⁶ 7 U.S.C. § 6d(f).

⁷ 11 U.S.C. § 766; 11 U.S.C. § 761(2), (4) & (10).

⁸ CFTC, *supra* note 3.

⁹ 2018 Proposal, 83 Fed. Reg. at 39,926.

¹⁰ See, e.g., FIA, SIFMA, *Comment Letter Re. Notice of Proposed Rulemaking on the Exemption from Derivatives Clearing Organization Registration* (Oct. 12, 2018), <https://www.sifma.org/wp-content/uploads/2019/08/SIFMA-FIA-Comment-on-CFTC-Proposed-Exemption-from-DCO-Registration-Oct-18-2018.pdf>; J. Christopher Giancarlo, *Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation* (Oct. 1, 2018), https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf.

¹¹ CFTC, *Exemption from Derivatives Clearing Organization Registration*, 84 FED. REG. 35456, 35457 (July 23, 2019), <https://www.govinfo.gov/content/pkg/FR-2019-07-23/pdf/2019-15258.pdf> [“2019 Proposal”].

financial innovation and fair competition” and is “consistent with the public interest and the purposes of [the CEA]” (a “public interest exemption”).¹² Each such intermediary would be required to disclose to the customer that the intermediary is not a registered FCM, that the exempt DCO is not registered with the CFTC, and that the customer’s property is subject to the provisions of a foreign bankruptcy law. The notice also must compare the protections available to the US customer under US law and the laws of the exempt DCO’s home jurisdiction.¹³ The 2019 Proposal highlighted the benefits of allowing customer access to exempt DCOs, including that it would reduce current the concentration of customer funds at registered FCMs, allow customers to more effectively hedge, and provide access to deeper pools of liquidity as more swaps moved to cleared markets.¹⁴ Overall, the CFTC preliminarily concluded that the proposed exemption “promotes responsible financial innovation and fair competition, while also being consistent with the public interest and purposes of the CEA” and was thus authorized as a public interest exemption.¹⁵

The CFTC explained that it was proposing to allow US customer access to exempt DCOs through unregistered foreign intermediaries rather than registered FCMs because it continued to be uncertain whether customer property held by FCMs would be protected under US bankruptcy law. However, the 2019 Proposal noted that the CFTC would continue to consider the issue and acknowledged that there may be other ways to deal with these uncertainties.¹⁶ In particular, the definition of “customer property” also refers to “any other contract, option, agreement, or transaction that is similar to a contract, option, agreement, or transaction” as those cleared through registered DCOs.¹⁷ This language could be interpreted to cover swaps cleared through an exempt DCO.¹⁸

iii. The CFTC Did Not Finalize the 2019 Proposal and Customer Clearing at Exempt DCOs is Still Prohibited

In 2020, the CFTC voted unanimously to finalize the 2018 Proposal in a final rule, which, in line with the proposal, did not permit US customer participation in swaps clearing through exempt DCOs.¹⁹

Then-CFTC Chair Tarbert and then-Commissioner Quintenz noted that while they voted in favor of the 2018 Rule as a “modest first step” toward improving the foreign swaps clearing regime, they stated the CFTC should work to address the issues that had been raised with the 2019 Proposal in

¹² 7 U.S.C. § 6(c).

¹³ 2019 Proposal at 35,459.

¹⁴ *Id.* at 35,458-59.

¹⁵ *Id.* at 35,458.

¹⁶ 2019 Proposal at 35,457 & n.13.

¹⁷ 11 U.S.C. § 761(4)(F).

¹⁸ 2019 Rule at 35,461-62.

¹⁹ CFTC, *Exemption from Derivatives Clearing Organization Registration* 86 FED. REG. 949 (Jan. 7, 2021), <https://www.federalregister.gov/documents/2021/01/07/2020-26527/exemption-from-derivatives-clearing-organization-registration>.

order to permit customer access.²⁰ They urged the CFTC to continue to consider the issue of customer access in light of the benefits of this access to US swaps customers.²¹ The CFTC has yet to finalize the 2019 Proposal. As a result, absent an exemptive order from the CFTC, US customers do not have access to cleared swaps at an exempt DCO.

II. JSCC is Currently Prevented from Clearing JPY IRS for US Customers

The Japanese yen interest rate swap (“JPY IRS”) is a type of interest rate swap where one party makes interest payments in Japanese yen at a fixed rate in exchange for interest payments in Japanese yen at a floating rate by the other party. JPY IRS are a vital tool for US investors and companies with investment or operational exposure to Japanese markets because they allow these parties to hedge interest rate risk, and in some circumstances also to hedge foreign exchange risk. The Tokyo-based Japan Securities Clearing Corporation (“JSCC”) clears approximately 70% of global volume in cleared JPY IRS. The remaining 30% is cleared by the UK-based LCH Group.²²

In 2015, the CFTC granted the JSCC status as an exempt DCO.²³ In granting the Order of Exemption to JSCC, the CFTC found that JSCC “is subject to comparable, comprehensive supervision and regulation by the appropriate government authorities in the home country of the DCO.”²⁴ However, despite this finding, as in the case of the other three exempt DCOs, JSCC’s exemption is currently limited to clearing swap positions of dealers who are direct clearing members of the DCO. Under the current Order of Exemption, JSCC is thus not permitted to clear JPY IRS swaps for the vast majority of US market participants who are not direct clearing members (“US customers”).²⁵ As a result, US customers seeking to enter into cleared JPY IRS are excluded from participating in the largest liquidity pool for cleared JPY IRS. They can only transact in JPY IRS swaps that are cleared at LCH Group, which is a registered DCO.

In December 2023 the JSCC petitioned the CFTC to modify its exemptive order to allow JSCC to clear JPY IRS for US customers through non-US clearing members that are not FCMs, consistent with the objective of the 2019 Proposal. To date the CFTC has not acted on the petition in light of concerns regarding the treatment of customer collateral under Japanese law. In particular, US law

²⁰ See, e.g., Comment Letter of FIA, SIFMA, Re: Notice of Proposed Rulemaking on the Exemption from Derivatives Clearing Organization Registration (RIN No. 3038-AE65) (Oct. 12, 2018), <https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=61884&SearchText=>.

²¹ Statement of Chairman Heath P. Tarbert in Support of Foreign Clearinghouse Registration Exemption Framework (Nov. 17, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/tarbertstatement111820>; CFTC, Supporting Statement of Commissioner Brian D. Quintenz Regarding Exemption from Derivatives Clearing Organization Registration Final Rule (Nov. 18, 2020), <https://www.cftc.gov/PressRoom/SpeechesTestimony/quintenzstatement111820b>.

²² Chris Davis, *JSCC Presses for US Client Clearing Exemption* RISK.NET (May 28, 2024), <https://www.risk.net/markets/7959465/jsc-presses-for-us-client-clearing-exemption>.

²³ THE COMMODITY FUTURES TRADING COMMISSION, In the Matter of the Petition of Japan Securities Clearing Corporation for Exemption from Registration as a Derivatives Clearing Organization (Oct. 26, 2015), <https://www.cftc.gov/sites/default/files/idc/groups/public/@otherif/documents/ifdocs/jscddcoexemptorder10-26-15.pdf>.

²⁴ *Id.*

²⁵ *Id.*

requires that a CCP segregate customer collateral from the CCP's property at all times. Under Japanese law, when a customer posts collateral to JSCC, the JSCC is required to initially deposit the collateral in an account at the Bank of Japan ("BoJ") where it is held for one hour before it is then transferred to a trust account. CFTC staff have expressed concern that if JSCC were to become insolvent during the one hour that the customer's collateral is held in the BoJ account, the collateral would be part of JSCC's bankruptcy estate and thus be subject to the claims of JSCC's creditors. However, as we explain in Part III, in light of the benefits to US market participants and limited risk to US customers an exemptive order for customer clearing of JPY IRS by JSCC is warranted.

III. Barring US Customers from JSCC Clearing of JPY IRS Is Costly and Unnecessary

Part III (1) identifies several significant costs and risks to US customers that result from not allowing them to clear JPY IRS at JSCC, (2) shows that permitting US customer access to JSCC clearing is consistent with existing CFTC policies and does not pose unreasonable risks to US customers, and (3) explains how the significance of the Japanese yen to the global economy and recent changes in economic conditions in Japan justify a specific exemption for JPY IRS.

1. The inability to access JSCC clearing increases costs and risks.

The inability to access JPY IRS clearing at JSCC increases costs and risks for US customers. We highlight four important examples:

- US customers receive worse pricing: US customers lose direct access to 70% of the volume in the JPY IRS market and are thus confined to a significantly smaller and less liquid portion of the market where trading costs are higher. US customers therefore incur greater costs for their trades of JPY IRS. These costs are amplified in times of market stress, when firms' preferences for more liquid markets increase, and the difference between spreads in the most liquid portion of the market cleared by JSCC and the rest of the JPY IRS market grows greater.
- US customers are subject to greater risks: Confining US customers to a smaller and less liquid portion of the JPY IRS market increases the time it takes for them to enter and exit their JPY IRS positions. This increases the likelihood that a US customer will be unable to hedge their risks on a timely basis or to capitalize on a favorable price movement by entering into or exiting a JPY IRS position.
- US customers have reduced access to Japanese investment markets: US customers use JPY IRS to hedge purchases of other yen-denominated investment instruments, including

Japanese government bonds. Constraining the ability of US customers to efficiently trade JPY IRS thus also impedes their ability to access other sectors of the Japanese market.²⁶

- US customers are at a competitive disadvantage: The United States is an outlier among major jurisdictions in disallowing customer access to the JSCC-cleared JPY IRS market. Regulators in the EU, UK, and other jurisdictions permit JSCC to clear JPY IRS for domestic market participants.²⁷ US market participants are thus at a competitive disadvantage, because their non-US peers are not subject to the same costs and risks outlined above.
2. **Allowing JSCC to clear customer JPY IRS is consistent with US regulatory policy and does not entail undue risk.**

The CFTC has cited a purported risk to US customer property under Japanese law as a basis for refusing to permit the JSCC to clear JPY IRS for US customers. However, in consideration of the significant benefits to US customers from full access to the cleared JPY IRS market and the minimal risks to customer collateral, US customers should be permitted to access JPY IRS clearing through JSCC:

- The risk to customer collateral under Japanese law is minimal and speculative: The risk to collateral under Japanese law only arises in the unlikely event that JSCC – a CCP with extensive risk management procedures and capital requirements – becomes insolvent during the same hour that the customer’s collateral is held in the BoJ account, *and* a court rules that the collateral held in the account is part of JSCC’s bankruptcy estate. But there is in fact no provision of US or Japanese law that provides that property held in the BoJ account would become part of JSCC’s bankruptcy estate in this scenario. The minimal and speculative risk associated with permitting JSCC clearing of JPY IRS is thus disproportionate to the immediate and substantial costs and risks associated with the refusal to allow JSCC to clear JPY IRS for customers.
- Disallowing US customer clearing of JPY IRS is inconsistent with US customer access to other Japanese derivatives and financial instruments: US customers – including both institutional and retail investors – have long been able to access JSCC-cleared futures contracts even though a similar small risk exists with respect to customer collateral posted for these positions. And although both retail and institutional customers may trade futures contracts, US law limits swap trading to market participants with at least \$5 million in total assets and is not open to retail investors. The CFTC’s refusal to permit the JSCC to clear JPY IRS thus applies a more restrictive standard to derivatives instruments open only to

²⁶ Chris Davis, *Yen Swaps Users Stuck in Clearing Catch-22* RISK.NET (May 10, 2021) <https://www.risk.net/derivatives/7830421/yen-swaps-users-stuck-in-clearing-catch-22>

²⁷ JSCC, Regulatory Status <https://www.jpx.co.jp/jscc/en/company/regulatory-status.html> (last visited Aug. 20, 2024).

institutional investors than it applies to derivatives instruments that are open to retail investors. Furthermore, US institutional and retail investors already invest extensively in Japanese financial markets via other instruments including equities and government debt and are thereby subject to Japanese bankruptcy laws without undue impairment to the interest of US customers.

3. The global significance of the Japanese yen and major changes in economic conditions justify a specific exemption for JPY IRS.

The ability to trade Japanese yen-denominated assets is of critical relevance for US market participants due to the importance of the Japanese yen and the Japanese economy in global markets. Recent changes in Japanese interest rate policies have only increased this importance. Along with the US dollar, Euro, and UK pound, the Japanese yen is one of the four G4 currencies, and is one of the most traded currencies in the world.²⁸ Exchanges of US dollar and Japanese yen constitute around 13% of global volume in foreign exchange markets and are the second most commonly traded pair in foreign exchange markets after the US dollar and Euro.²⁹ Furthermore, Japan is also the fourth largest economy in the world³⁰ and the fourth-largest trading partner of the United States, accounting for about 14% of the value of US foreign trade.³¹

The importance of the JPY IRS has increased further over the past two years as a result of major shifts in the Japanese economy and Japanese government’s monetary policy. Since December 2022, Japanese interest rates have become increasingly volatile, thus increasing the importance of being able to efficiently manage yen interest rate risk. In March 2024, the Bank of Japan abandoned its longstanding negative interest policy, which increased interest rate volatility further and opened additional investment opportunities for US investment in Japanese government debt.³² Trading volume in the cleared JPY IRS market in Japan has therefore grown substantially, from approximately \$400 billion in monthly volume for January 2020 to a record high of \$2.7 trillion in August 2024. The importance of allowing US customers to access the largest portion of the JPY IRS market has therefore increased significantly.

²⁸ BANK FOR INT’L SETTLEMENTS, Reserve Management and Motivations for FX Interventions (2019), <https://www.bis.org/publ/bppdf/bispap104v.pdf>.

²⁹ BANK FOR INT’L SETTLEMENTS, Triennial Central Bank Survey, OTC Foreign Exchange Turnover in April 2022 (2022), https://www.bis.org/statistics/rpfx22_fx.htm.

³⁰ INT’L MONETARY FUND, GDP, Current Prices (2024), <https://www.imf.org/external/datamapper/NGDPD@WEO/OEMDC/ADVEC/WEOWORLD>

³¹ UNITED STATES CENSUS, Top Trading Partners, <https://www.census.gov/foreign-trade/statistics/highlights/toppartners.html>.

³² Dave Sebastian, *What the End of Negative Rates Means for Japan* WALL STREET JOURNAL (Apr. 25, 2024), <https://www.wsj.com/world/asia/what-the-end-of-negative-rates-means-for-japan-aa0c0669>.

IV. Conclusion

In December 2023, JSCC filed a petition with the CFTC to modify JSCC’s exemptive order to allow the JSCC to clear JPY IRS for US customers.³³ As detailed in this letter, the current exclusion of US customers from the JSCC-cleared portion of the JPY IRS market results in significant costs and risks and places US customers at a competitive disadvantage relative to their non-US peers. Moreover, the exclusion is based on a highly theoretical difference between Japanese and US law and is inconsistent with US regulatory approaches to investment by US customers in other portions of Japanese financial markets that present the same risks. Recent macro developments in the Japanese economy have only increased the importance to US market participants of addressing these issues.

Furthermore, modifying JSCC’s exemptive order is within the CFTC’s legal authority and would be entirely consistent with the legal and policy rationales the CFTC set forth in the 2019 Proposal, detailed in Part I above.

The Committee therefore calls on the CFTC to grant the JSCC’s petition.

³³ Davis, *supra* note 22.

COMMITTEE ON CAPITAL MARKETS REGULATION

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Thank you for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmksreg.org), at your convenience.

Respectfully submitted,



John L. Thornton
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