Public Consultation Results on

"Business Outlines Related to Introduction of New Margin Calculation Method (VaR Method) for Futures/Options Contracts"

Japan Securities Clearing Corporation (hereinafter referred to as "JSCC") published the "Business Outlines Related to Introduction of New Margin Calculation Method (VaR Method) for Futures/Options Contracts" on June 20, 2022 for public consultation, and solicited public comments up to July 20.

JSCC really appreciate precious comments on this. Presented below are the summary of the comments JSCC received and JSCC's view on the comments received.

No.	Summary of Comments	JSCC's View
	1. Introduction of New Margin Calculation Method for Futures/Option Contracts	
	(1) Purpose of Introduction	
1	Current SPAN Margin Framework has No Problem ・ In the Commodity derivatives trading, current SPAN margin framework has no problem. We do not deny VaR method itself, but VaR method is more complicated and hard to understand. Even if the dealers would give sufficient explanation, customers may not be able to understand it fully, and we are anxious about great turbulence this may cause.	・ Our motivation for a migration to VaR method is a provision of safe marketplace that would promote more on-boarding, by suppressing abrupt rise/fall of margin and enhancing transparency through utilization of many historical data, as well as by enhancing the original function of margin that is to protect dealers and customers through optimization of margin by portfolio level margin calculation. ・ As to the concerns about possible great turbulence, we will continue our efforts to enhance understanding of the framework by refining the materials (contents) related to VaR margin that will be made broadly available to
2	Overseas Commodity Exchanges Adopted VaR Method are Minority ・ As a reason for introduction of VaR method, JSCC explained that "a migration to VaR method is a trend among major CCPs in Europe and U.S., and JSCC intends to respond to global trend and sophisticate its risk management." However, looking at materials prepared by JSCC, the only CCPs adopted VaR method are Eurex, Occ (U.S.) and B3 (Brazil). CME and ICE that publish global price index in the Commodity derivatives area have not introduced VaR method. Also, VaR method is not adopted at Singapore,	

	the Asian financial center.	general investors, such as posting on JSCC website. ・ As to the introduction status at global market, among major CCPs mentioned in your comment that have not introduced VaR method, some have already introduced or published their plan for introduction. We consider that a migration to VaR method is a global trend. ・ Besides this initiative, JSCC will continue our efforts in vitalization of the Commodity market in cooperation with the exchanges.
3	Please be Mindful of Existing Customers and Existing Dealers ・ The comprehensive exchange was borne under the initiative of the Japanese government for the purpose of "vitalization of Commodity market" and "expansion of Japanese financial market." JPX is trying to apply the same rules as the financial derivatives market to the traditional Commodity futures trades. However, although it has past almost 2 years since the launch of the comprehensive exchange, the Commodity derivatives trading had not been vitalized, but rather is following a course of decline. Domestic securities firms originally expected on-boarding are not showing even an air of an entry. Then, JSCC is trying to change the margin framework to VaR method to promote on-boarding of overseas investors. Would overseas investors enter the market, if JSCC changes rules? If the change of the margin framework would cause confusion among the existing customers and dealers, and the market liquidity would further decline, who would take responsibility? No one but we, the dealers, should take responsibility. Aren't there plenty of things that JSCC should do before introducing VaR method?	
4	Global Trend of VaR Margin Introduction ・ We are against the introduction of this framework. Although the Business Outlines JSCC distributed stated that this framework "has been introduced by overseas key CCPs," the global exchanges adopted VaR method are only 3, namely, Eurex, Occ and B3. CME and ICE, main players in the Commodity derivatives area, have not introduced VaR method. If, under such circumstance, VaR method is introduced to the domestic	

	Commodity derivatives market which remains sluggish, more market downdraft is concerned. In light of the above, we ask following questions: (1) Is there any background for the introduction of VaR margin, like a recommendation of IOSCO? We would like to ask JSCC what made JSCC to consider introduction of this framework. (2) The comprehensive exchange has been promoted, so to say, as "national policy" from a viewpoint of vitalization of the Commodity market. However, although it has past 2 years since the establishment, we cannot say that the Commodity market has been vitalized. We think that JPX Group should promote the measures for vitalization of the sluggish Commodity market first. How do you think about this point?	
5	・ For a number of years we have been engaged in discussions with JSCC through bilateral meetings and FIA on this important topic. We appreciate JSCC's work and enduring commitment to developing a robust margining framework. With this in mind, JPM is broadly supportive of the migration of F&O products from SPAN to VaR based margin calculation. We are encouraged that JSCC is moving to a filtered historical simulation using a quantile based Expected Shortfall risk measure which includes stress scenarios in the lookback.	・ We appreciate your understanding of this initiative. We are considering this introduction of VaR method would provide a safe market that would induce on-boarding of new participants through an enhancement of original function of margins. ・ We will continue our efforts in an enhancement of the credibility as CCP through various initiatives, including this.
	(2) Handling of Holding Period for Margin Calculation and Handling of Prepaid Margin	

6	This may Harm Customer-Oriented Operation ・ i) According to the material JSCC prepared, the amount of VaR margin per Gold futures contract will be much more than SPAN margin amount. For customers which had no problem under current margin framework, significant rise in the margin amount associated with the rule change alone would be a significant burden. Existing customer may have no choice than to withdraw from the market, and we think this is against the "Principle of Customer-Oriented Operations." At the same time, it is apparent that the market would get avoided not only by the existing customers, but also by potential investors intending new entry, and the Japanese Commodity futures market would decline further. ・ ii) As to funding plan, majority of the customers in the Commodity derivatives calculate the required funds for trading by multiplying the margin per contract by the number of contracts. Traditionally, importance has been attached between the Commodity dealers and customers to, for example, how much margin per contract would be required for trading Gold futures at a price of 8 million yen/kilogram. This concept had not changed even in an introduction of SPAN margin framework. However, in VaR method, the parties will know the exact amount of margin after the trading. Customers will not be able to perform accurate funding calculation before trading. As a business, not knowing the exact amount of funds needed for trading is unacceptable under normal social convention. ・ iii) Under SPAN margin framework, when a customer places an order of long 11 contracts and short 10 contracts, the margin is only required for long 1 contract through contract netting. However, since the introduction of SPAN margin framework, the Commodity futures market has adopted "MAX method," wherein the entire margin for the larger	・ The level of VaR margin would differ depending on Commodity, position composition and calculation timing. ・ Under the original proposal, MPOR for margin calculation, which has been set at "1 day" as a measure for mitigation of abrupt change associated with the integration of the clearing function with Japan Commodity Clearing Organization, will be set at "2 days." This was a factor of significant impact on the margin level. However, in light of the comments received, we will set MPOR for Commodity futures/option contracts (excluding Electricity futures and LNG futures; the same applies hereinafter) at "1 day" for the time being considering the attribute of existing investors. ・ Furthermore, as we understand, each firm will consider needs and method of the prepaid margin. In light of the comments related to the Commodity futures dealers' operations facing customers, we decided that VaR margin for the Commodity futures/option contracts will be calculated using the method JSCC separately prescribes (AS-VaR method) for the time being, and parameter update frequency for AS-VaR method will be

	position, i.e., long 11 contracts in this example, should be deposited. Moreover, most of the dealers ask general customers and the commercials, such as corporations, to deposit more margin than the margin amount JSCC calculates as “prepaid margin” before trading. This is a wisdom for pursuing “concept of protecting customers, in other words customer-oriented” by accepting excess margin, because the price fluctuation range is quite large in the Commodity futures market. Because the margin for the day will be fixed after EoD under VaR method, we need to rebuild the way the margin should be which has been built up between dealers and customers to date. We think this will be significant burden and trouble to the customers.	weekly in principle, which is the same as current procedures. ・ However, the Electricity futures and LNG futures are the products of new area for which the market participants and other stakeholders expect precise margin calculations and impact on existing investors is considered limited. So, JSCC will calculate VaR Margin using the same MPOR (2 days) and method (HS-VaR method) as financial derivatives for these products.
7	Unable to Notify/Explain Exact Margin Amount to Customers ・ In accordance with Article 104 of the Ordinance for Enforcement of the Commodity Derivatives Act, we specify the amount of margin in the pre-conclusion document and post the amount of margin on our website weekly. The amount of margin is notified to the customers through the sales representatives, and, at the time of new contract conclusion, we make sure to explain the margin amount and hand deliver the list of margin. In VaR method, we can only give such a notification to the customers after EoD every business day, which may cause confusion to customers. (Tokyo Financial Exchange publishes margin amount every Monday, and applies it from next Monday. The Commodity Exchange before the comprehensive exchange published margin amount twice a month, and there was a time when the margin amount publication was once a month)	

8	Customers cannot Know Exact Margin Status during Trading Session ・ Customers will be unable to grasp the exact real-time status of margin, through sales representatives or web, in the middle of the trading session. When visiting customers, sales representatives of our firm bring balance reconciliation sheets for them to reconcile margin and positions. When a customer established a new position or settled its position, the sales representative communicates current status, including margin excess or shortfall, over the phone, or sends a balance reconciliation sheet via facsimile. We will be unable to grasp exact margin status. ・ For dealers adopted loss-cut framework, because the margin amount at the time of loss-cut will be known after the close of the market, if a loss-cut applies to a customer, we will not be able to make correct judgment as to whether the loss-cut really was necessary or not.	
9	More System Entry Work, Internal Rule Change Required, and Burden of System Revision Costs ・ Under VaR method, the amount of margin differs by contract month and long/short direction. Our firm adopts MAX method, and needs to enter the amount of margin for each contract month, long and short for all instruments manually. It would require significant time/manpower, and the work may not be completed by opening of the night session. ・ We need to revise internal rules and manuals, and have to notify changes, if any, to customers as well as internally. Depending on a case, system revision would also become necessary, and its cost will be borne by each firm.	

10	Is it Legally OK? ・ Our corporate lawyer advised that we would ask JSCC and JPX (OSE, TOCOM, JPXR) to confirm if the migration to VaR method would have no legal issue not only with respect to FIEA and CDA, but also laws concerning consumer protection, such as the Basic Act on Consumer Policies, as well as in legal actions. If JSCC decides an introduction of VaR method, we, the Clearing Participants, have no choice but to follow. If this is the case, our customers also have no choice but to follow. Until now, the Financial Services Agency, the supervisory agency, and various organizations involved, including Japan Securities Dealers Association, have given us guidances on "Principle of Customer-Oriented Operations." We wonder if such a trend can be said to be Customer-Oriented. We think that this will cause significant confusion to customers since they cannot know exact amount of margin during their trading activities. ・ If VaR method is introduced, it is easily foreseeable that an allegation "we could not understand the margin framework" will be made in a legal action, and a possibility of the court supporting such position is highly likely more than ever. Even if we ask customers' submission of a letter evidencing their understanding of the margin framework, an assertion "we are forced to sign the letter without knowing what it was" will go unchallenged. We think a framework should be as simple as possible.	

11	Point that Margin Amount is Known after Market Close ・ As we understand, under the new framework, the amount of margin will be known after the close of the trading session for the day. We point out this has following issues: (1) Matters to be Included in Pre-Conclusion Document (Article 104 of the Ordinance for Enforcement of the Commodity Derivatives Act) "The type of the Clearing Margin, etc. and the amount or calculation method thereof" are required to be included in the pre-conclusion document, and are also subject to the obligation of explanation to customers (Article 218 of CDA). However, the dealers cannot include the margin amount in the document if it is not fixed. (2) Matters to be specified in conducting acts similar to advertising (Article 213-2 of CDA, Article 29, Item (ii) of the Order for Enforcement of the Commodity Derivatives Act), The Commodity Derivatives Business Operators are required to indicate "amount of Clearing Margin or calculation method" when conducting acts similar to advertising. In this regard, the dealers are unable to satisfy their obligations by the same reason as mentioned in (1) above. (3) Trade Suppression Effect As mentioned above, we would like to express our concerns about the fact that the margin amount is not known in advance would give rise to substantial trade cooling effect.	

12	Margin Amount will be Set Separately for each Contract Month and Long/Short Position ・ We recognize, as features of VaR margin framework, that i) margin requirement will change daily and ii) the amount of margin differs by contract month and long/short direction. We would like to ask some questions on these features: (1) Cost Benefit If the amount of margin changes daily and differs by contract and by long/short direction, work required for margin management at Commodity futures dealers and financial instruments dealers ("Dealers") and investors would increase significantly. For example, because the margin amount for the day is applied retroactively after the close of the day session, information concerning existence of margin shortfall and whether or not it is possible to accept orders for night session will need to be straighten up and entered within a short period of time up to the opening of the night session. Having such a situation in mind, are we correct in understanding that JSCC considers there will be trading vitalization effects exceeding these burdens? If so, what are those effects? (2) Stop Dealing with Some Products and Collect Thicker Margin Let' say, when we set margin amounts for long/short positions in an instrument with 15 contract months, Dealers need to set total of 30 types of margin amounts during a very short period of time from the close of day session to the opening of the night session as mentioned above. If Dealers are unable to accommodate this, their option might be to ask customers to deposit thicker margin, or make decision to stop dealing with some of the instruments. We are concerned that this may result in a suppression of trading.	

13	Other, Margin will Increase ・ The material JSCC distributed presented calculation results showing that VaR margin calculation method itself would cause significant increase in margin amount comparing to SPAN method. We are concerned about further decline in the Commodity market, whose liquidity low, due to introduction of the new margin framework. We would like to ask JSCC to prioritize the trading stimulation measures to avoid further cooling of the Commodity Futures trading and Commodity derivatives trading. If JSCC is currently considering some measures, please advise details of such measures.	
14	As to the Commodity derivatives market, it is said that "In order to make our commodity market have a price formation function and a risk aversion function in commodity trading ensured stably, further decline in the commodity derivative market must be averted" ("Recommendation for Realizing a Comprehensive Exchange"; Council for Promotion of Regulatory Reform Nov. 8, 2018), and an expansion of the Commodity derivatives market through a realization of a comprehensive exchange has been a national policy. In this, a realization of a comprehensive exchange is a mean, and the policy target is an expansion of the Commodity derivatives market. Through a transfer of the market, the comprehensive exchange was realized on the surface in July 2020. However, regret to say, but the current situation of the Commodity derivatives market experiencing trading volume decrease and following a course of decline is nothing but an evidence of JPX not realizing the national policy. Although an introduction of VaR method is desirable to keep up with global trend, for the Commodity derivatives market, it should be done after an expansion of the market, the national policy, is achieved (unless everyone shares the awareness that the introduction of	

	VaR method contributes to the market expansion for sure). Because an introduction of VaR method would decrease trading volume in the Commodity derivatives market and accelerate market decline (details are mentioned later as **Supplementary Comments**), if it will ever be introduced, it must be introduced after an expansion of the Commodity derivatives market through a realization of a comprehensive exchange is achieved. Specifically, it should be introduced after the trading volume stably exceeds the level at 2018 when a realization of a comprehensive exchange was adopted as national policy (i.e. trading volume of 21.3 million contracts/year which almost equals to 1.8 million contracts/month). Moreover, when introducing VaR method (i.e. the method to set margin at 99% coverage of expected loss calculated from historical data) to the Commodity derivatives market after a realization of the national policy, the margin amount obtained through a calculation needs to be applied to the positions for the next business day (trading day) rather than the current day while calculating margin based on VaR method. (Supplementary Comments) Reasons for our argument that an introduction of VaR method would decrease trading volume in the Commodity derivatives market are as follows: In the Japanese Commodity derivatives market, private investors who may supply liquidity (referring to the number of long or short orders placed to the market; the same applies hereinafter) for sure in diverse market environment are a key to a rise/fall of the market, although their shares in the total trading volume may not be large. Not only the commercials (corporations engaging in manufacturing/distribution) hedging price fluctuation risk, but funds, like props, will enter the market only because there is a liquidity generated by a core	

	group of private investors. Apparent from examples of the Rubber futures market whose market decline was accelerated, or LNG futures which failed to be listed, by an expansion of contract months without having regard to a convenience of private investors, ensuring private investors on-boarding is an important factor for the market. Private investors dealing in the Commodity derivatives have long been familiar with SPAN margin. They engage in trading by depositing relatively standardized amount of margin, same for an instrument and weekly update in principle, and without called for additional margin immediately after trading in a normal conditions (in other words, without a burden of remittance of additional margin). Dealers (referring to Financial Instruments Business Operators Engaged in Type-I Financial Instruments Business dealing in Commodity derivatives or Commodity Futures dealers; the same applies hereinafter) also need to accept deposit of margin in advance from a viewpoint of line of credit of private investors whose excess funding ability is not necessarily robust unlike corporations. Therefore, if VaR method is introduced, what Dealers (referring to Financial Instruments Business Operators Engaged in Type-I Financial Instruments Business dealing in Commodity derivatives or Commodity Futures dealers; the same applies hereinafter) having private investor customers can do is to accept margin in the amount determined based on the highest margin amount among long/ short position and by contract months under VaR margin for the same instrument and adding certain buffer (50% for example) thereto (to avoid additional margin call arising from VaR margin increase) in advance. As a result, in case of private investors who only have limited amount of excess funding ability, trading volume will decrease inversely to an increase in margin if VaR method is introduced.	

	Particularly, according to the material JSCC prepared, in the Precious Metal market, in case of a simple position of one contract (directional position), VaR margin would increase significantly comparing to SPAN margin. Taking a simple position is often a case for private investors, and, as a result, margin to be pre-deposited to Dealers would be expected to be two to four fold of SPAN margin. Significant decline in trading volume is for sure due to private investors' trade shrink and the entire market losing core of liquidity. As discussed above, although not intended by JPX, an introduction of VaR method gives further, or detrimental, I should say in this decline trend (against the national policy of market expansion), damage to the Commodity derivatives market.	
	(3) Details of VaR Margin Calculation Method	
15	・ While acknowledging work is continuing on fine tuning the model, we believe that there are key issues that should be addressed prior to migration. To that end, as detailed below, we offer some recommendations that we believe could further strengthen the VaR based margin framework. ・ JPM respectfully questions the targeted confidence level of 97.5%. JSCC argues that, under the assumption of normally distributed returns, 97.5% Expected Shortfall equates to approximately 99% VaR. We are concerned that, in reality, markets don't always behave this way and rather exhibit fatter tails. If conditional returns are not normally distributed, the computed Expected Shortfall margin will not achieve the regulatory required 99% coverage.	・ We have confirmed that 99% coverage has been achieved by the method of the current plan. However, for the status of 99% coverage, we will continue monitoring and consider revision of the method as necessary.
16	・ JPM fully supports stress scenarios in the IM lookback to prevent margin from dropping during low volatile periods. However, the number of stresses proposed by JSCC appear	・ We will use this comment as reference for future review.

	limited and hence may not cover all tail events. JSCC should ensure that the stress margin component includes an adequate number of extreme market movements for all ETD products over the past 30 years, or as long as reliable data have been available. We think stresses should be applied to all material risk factors, which could potentially lead to big-stepped changes in margin.	
17	・ We strongly believe more work is needed to strengthen the controls against procyclicality. Specifically, we recommend a Stress VaR as a more steady tail view to prevent pro-cyclical margins. The stressed period is selected dynamically by scanning all the available historical data, and choosing a 1 year window that results in the largest SVaR for each individual contract. SVaR should use a level of confidence of at least 99%, the same liquidation horizon used for baseline margin, but avoid using scaling techniques. Moreover, forward looking scenarios should be included to model the breakdown of historically stable correlations. ・ JSCC should combine the EWMA baseline margin model with the un-weighted Stress VaR (see above) by assigning 75% weight to the baseline margin and 25% weight to the stress margin. As the baseline margin approaches the stress margin during a period where calculated margin requirements are rising significantly, the CCP may temporarily increase the weight that is applied to the baseline margin and equally reduce the weight applied to the stress margin as this implied buffer gets gradually and automatically eroded.	・ We decided to adopt this method because we consider that the stress scenario introduction method JSCC is currently considering can sufficiently contribute to an enhancement of coverage and a suppression of procyclicality. We will use the comments received as reference for future review.
18	・ We agree to a large extent with JSCC to not allow margin offsets across different silos. However, within a silo, VaR allows for extensive offsets across products that may not fully reflect true closeout costs in a default event. JSCC should apply certain thresholds on the level and stability of correlation that must be met as well as minimum thresholds	・ We will continue our review of details of the off-set restrictions. However, we are planning to introduce off-set restrictions to products within the same clearing qualification as necessary to reflect situation where

	regarding the period of time over which historical correlation is measured.	correlation breaks up.
19	・ Equally important, we are calling for increased transparency into margin model calculations. We are not able to adequately assess the model as JSCC has not provided full disclosure around the parameters used to calculate initial margin. For example, the decay factor and the approach to calibrate the decay factor used to calculate EWMA volatilities are unknown. Further, JSCC should fully disclose the stress scenarios in the IM model to allow the replication of margin calculation given market moves. We further recommend additional disclosure of back testing results and margin breach information particularly at the contract level. Another critical area of transparency would be the calibration of the liquidity and concentration add-on charge so that members can better anticipate additional margin calls. Moving from SPAN to VaR based models makes it even more important for CCPs to provide more transparency into how the model generates margin requirements. For example, JSCC could share spreadsheets that replicate key aspects of the model. Furthermore, we strongly believe that the availability of tools that lets users estimate what their margin requirements would be in different volatility scenarios, would have a significant impact on the ability of market participants to anticipate large changes in margin requirement.	・ JSCC will continue our efforts in gaining investors' understanding of VaR method by making available materials (contents) related to VaR margin at the location accessible by general investors, such as JSCC website.
	2. Preliminary Margin Add-on Framework related to Holiday Trading	
20	・ Holiday trading will start from Sept. 23, 2022. There will be a margin add-on during holidays. How the margin amount that will be the basis for the add-on charge will be calculated?	・ Under SPAN method, SPAN margin not taking into account the net option value (SPAN risk amount) is calculated as Preliminary Add-on charge for holiday trading. Similarly, under VaR method, VaR margin not

		taking into consideration the net option value (VaR risk amount) will be calculated as Preliminary Add-on charge for holiday trading.

Comments submitted by: YUTAKA TRUSTY SECURITIES Co.,Ltd. (1-3, 6-10 and 20); JAPAN COMMODITY FUTURES INDUSTRY ASSOCIATION (4, 9, 11-13); Daiki Securities Co.,Ltd. (14); and JP Morgan (5, 15-19).