

## **Study Group Report on the Enhancement of Competitiveness of the Non-Agricultural Commodity Futures Markets**

- Establishment of more attractive markets for participants -

A study group, at which members are attached, discussed measures to improve non-agricultural commodity exchanges, where commodities such as metals, energy reserves and rubber are traded. The Ministry of Economy, Trade and Industry worked as the secretariat of the group. This document is the translation of specific measures and future plans discussed and agreed in June 2007.

### **Specific Measures and Objectives**

#### **1. Professionally Oriented Markets with Greater Convenience for Participants**

The Tokyo Commodity Exchange (“TOCOM”) is to swiftly work to implement the following measures in coordination with all related parties. The Central Japan Commodity Exchange (“C-COM”) is to take all necessary measures based on the following strategies with a special focus on promoting the participation of hedgers.

##### **(1) The Early Introduction of the Most Advanced Electronic System**

- The current electronic trading system operating at TOCOM, although cutting edge technology at the time of its introduction, has since become increasingly obsolete and insufficient when compared to other systems in terms of performance, functionality, and the requirements sought by customers including overseas institutional investors.

- Thus, necessary procedures are to be followed in accordance with the schedule set forth separately in preparation for the introduction of a new trading system that is equipped to perform at the world's highest levels, as well as to function in line with the global standards. This system is to be operational by the end of FY2008 (March 2009). As part of the specific measures to be taken for the purpose of the new system, discussions are to be held with the members on the basic principle of adopting a packaged software with minimal customization, by changing the current trading practices, rules, and regulations to be in line with international standards as much as possible, while maintaining the original functions of the overseas packaged software. Furthermore, from the perspective of reducing costs for the market participants, alliance and/or system integration among the

exchanges is to be placed on the forthcoming agenda.

(2) **Extension of Trading Hours as Asia's Primary Market**

- In contrast with the worldwide initiatives to establish 24-hour trading sessions on exchanges in response to global competition, the current trading hours of TOCOM are limited from 9:00 to 11:00 and 12:30 to 15:30.

- To resolve this issue, necessary measures are to be taken to extend the trading hours up to 24 hours per day along with the introduction of the new electronic system discussed above. Prior to fully extending trading hours to 24 hours per day, the closing time of the afternoon trading session is to be extended from the current 15:30 to 17:30, which is the maximum extension possible under the existing system, placing possible care on the potential impact upon the relevant administrative and operational tasks of the market participants that may arise from extending trading hours up to 17:30.

(3) **Establishment of Market Operating Rules of the Global Standards**

(a) **Extension of Price Limits**

- In contrast with the common global practice of entirely or in effect abolishing price limits by using such alternatives as the Circuit Breakers System<sup>2</sup>, trading on TOCOM is still subject to price limits that are not wide enough. Since the price volatility of commodities has recently increased, TOCOM prices sometimes reach the limits, in which cases the TOCOM prices can not keep up with the price movements in the overseas markets and it may also be difficult to exit the market due to lack of opportunities to liquidate existing positions. These issues prevent TOCOM from fully functioning as a global exchange.

- To cope with this issue, measures are to be taken to extend price limits, but at the same time still pay the utmost attention to customer protection by encouraging all the futures commission merchants to introduce stop orders (the so-called "Loss-cut Trading" system<sup>3</sup>) for the benefits of non-professional investors. As the first step, the current gold price limits are to be extended sometime this summer under the present electronic system in order to reduce the probability of reaching the price limits to near zero.

- The current crude oil price limits are also to be extended as early as possible, in keeping with the introduction of the "Loss-cut Trading" system applicable to all the listed commodities. Subsequently, similar measures are to be taken to extend the price limits of other commodities, taking into consideration the characteristics of each commodity.

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<sup>2</sup> A system aimed to ease market overheating in the event of price fluctuations beyond limits by suspending trading for a prescribed period, then followed by an extension of the price limits before trading resumes.

<sup>3</sup> See (2) (4) (a) below.

- Furthermore, abolishing price limits is also to be discussed in connection with the introduction of the new electronic system that will provide compatibility with the Circuit Breakers System, while taking into account the transformation of the market towards greater participation by professionals and customer protection.

(b) **Extending Position Limits**

- Under the current TOCOM rules, the position limits of the members<sup>4</sup> are set in accordance with the volume of net assets held by each member, whereas the customers' position limits are subject to a uniform amount that is applied equally to all customers. Some of the relevant trading parties and the institutional investors point out that the current position limits are too small for substantial trading as compared to global levels.

- Thus, the current position limits are to be extended to their maximum in order to cope with demands from the professionals such as hedgers, funds and institutional investors, from the perspective of transforming the market towards greater participation by professionals, taking into consideration related factors such as the size of the spot market and market management. More specifically, the customers are to be divided into two categories, "commercial" traders and "non-commercial" traders; the former is to be subject to significantly wider position limits than the latter<sup>5</sup>. The members are to be subject to the same position limits, without the different position limits corresponding to the net assets of each member, provided that a new additional margin system<sup>6</sup> be introduced in accordance with the net assets held by each member in order to prevent excessive speculative trading by a member with low net assets.

- The measures discussed above are scheduled for implementation in summer 2007 for gold futures trading, followed by crude oil as early as possible in the fall 2007. Subsequently, similar measures are to be taken for other commodities based on the characteristics of each commodity.

(4) **Information Disclosure**

- A common international practice regarding information disclosure is to disseminate price and market trading volume information while maintaining each market player's trades

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<sup>4</sup> A market principle that restricts the volume of open interest limits (outstanding positions) held by each market player to staying below a certain level.

<sup>5</sup> Separate studies and discussions shall be conducted on the position limits applicable to institutional investors and the funds with regard to their actual trading situation.

<sup>6</sup> The new additional margin system shall comply with regulations governing the trading of one's own position equivalent to the consigned commodity trading (Article 214 (9) of the Commodity Exchange Act & Article 103 (2) of the Ordinance for Enforcement the Commodity Exchange Act).

confidential. Despite this global practice, TOCOM has been disclosing information about market players, which most institutional investors find to be inappropriate when conducting transactions in a fair and orderly manner. Separately, inequity exists between the members and non-members in terms of information disclosure on the order book screen, etc.<sup>7</sup>

- To remedy this issue, large order information, as well as order book screen information prior to the opening of the trading session<sup>8</sup>, is now to be kept undisclosed while order book screen information is to be displayed during the continuous trading session from opening till closing<sup>9</sup> without making the distinction between members and non-members. In addition, trading volumes by members, as well as open interest by members, are to be undisclosed<sup>10</sup>. Alternative information is to be made available after the preparation period of the forthcoming six-month to one-year (limited to information on volume having been traded by top 10 to 20 members, in terms of their total trading volume over all contract months, as well as open interest by category). During the preparation period, information about the list of trading volume by member and the list of open interest held by members is to be concurrently disclosed (monthly).

(5) **Other Measures for Greater Convenience and Higher Liquidity**

Further steps are necessary and to be discussed and launched in phases as feasible, including those listed below, to establish greater market convenience and higher liquidity in order to satisfy market participants' needs:

- Greater accessibility to the market via the Independent Software Vendors ("ISV")<sup>11</sup>
- Listing of new products including the "TOCOM Index"<sup>12</sup>, which has already been developed and published
- Development of funds linked to the "TOCOM Index"
- Introduction of the Market Maker system<sup>13</sup>
- Adoption of a uniform English documentation format for market participation, as well as

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<sup>7</sup> A screen displaying each order from the members will be divided into categories of "buy" and "sell," as well as listing prices based upon each commodity type and month of delivery.

<sup>8</sup> A timeframe from the beginning of order acceptance to the opening of trading sessions.

<sup>9</sup> A timeframe during which trading will be closed based upon the contract method of matching each bid and offer with the same trading terms from the opening to the closing of trading sessions.

<sup>10</sup> Any inquiry as provided for in Article 23 (2) of the Legal Profession Act shall be subject to conventional arrangements. Certain information acknowledged to contribute to public interest shall be disclosed upon the lapse of a certain period if and when required.

<sup>11</sup> A software vendor providing electronic trading software that enables access to several exchanges worldwide.

<sup>12</sup> A comprehensive commodity index representing the average commodity price of the market calculated on all the commodities listed on the Tokyo Commodity Exchange.

<sup>13</sup> A system under which the market maker must execute a mandatory contract at a constantly offered bid/offer price with respect to the newly-listed commodities or commodities with poor liquidity for the purpose of providing liquidity in the market. In consideration of this obligation, the market maker is entitled to preferential measures, such as lower commission fees and similar benefits.

building infrastructure for smooth English communications

- Introduction of a flexible exchange fee system, such as volume discount system<sup>14</sup>
- Review on the margin requirement system, such as the adoption of a margin system in accordance with risk levels
- Verification and change of relevant systems for smoother delivery of physical commodities
- Introduction of a non-competitive trading facility for large transactions

## 2. **Ensuring Market Reliability such as the Protection of General Investors**

The administrative and self-regulatory authorities, the exchanges and the relevant trading parties, each with its own role, are to make utmost efforts to meet the following main objectives to maintain and improve market reliability,.

### (1) **Stringent Enforcement of the Law to Eliminate Illegal Acts and Implementation of the Necessary Measures by the Self-Regulatory Organization**

- (a) Protection of the customers should be given high priority when reforming the markets to enhance competitiveness, with the social awareness of the social needs for consumer protection. Among other things, it is imperative to uphold the principle of suitability and other relevant rules in implementing the measures to enhance competitiveness. Also, if implementation of the previously discussed measures lead to any incident on customer protection, responses must be swift and adequate.
- (b) The administration is to strictly and swiftly enforce the Commodity Exchange Act, which was strengthened by the amendments of 2004 and 2006, through measures such as on-site inspections, administrative actions and other supervisions for the purpose of eliminating illicit acts in commodity futures trading. As for overseas commodity futures trading, the Act on the Consignment and Other Matters Relating to Futures Transaction in Foreign Commodity is to be strictly enforced in order to eliminate and crack down on any illicit conducts. Also, increasing troubles in overseas futures option trading and fraudulent so-called “Loco London-like Trading” have been reported, and any conducts in such trading against the Act on Specified Commercial Transactions are now strictly regulated and stringent enforcement of the law is to be taken by the authority. All such policies and measures are to be implemented in accordance with the supplementary resolution adopted at the Diet discussion on the amendments of the Commodity Exchange Act in 2004 and

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<sup>14</sup> A commission fee system under which a lower fee rate is applicable for contracts exceeding a certain volume during a prescribed period of time.

2006. The administration is also to monitor the efforts of the self-regulatory organization and provide guidance for further improvements when needed.

- (c) The Commodity Futures Association of Japan, a self-regulatory organization, is to ensure strict compliance with the “Action Plan on Settling Commodity Trading Disputes” as enacted in December 2006, and intensify efforts for reliable dispute settlements and improve each member’s compliance. Furthermore, a wider range of instructive programs is to be implemented, including the special retraining of mid-level sales personnel, the opening of a special telephone counseling hotline, and adoption of stricter disciplinary actions regarding the misconduct of sales personnel.

(2) **Better Environment for Online Trading**

Online trading has been type of trading form that poses fewer customer troubles, and is viewed as a suitable way for general investors to participate in the markets. In order to facilitate online trading, necessary measures are to be taken, including revising the current liability reserve system<sup>15</sup>.

(3) **Promotion of Participation by General Investors by Measures Such as Sound Development of Commodity Funds**

Commodity funds offer indirect market participation that allow investors to keep risks of their investment loss within the amount of their investment, unlike direct market participation, which at times requires additional margin. Therefore commodity funds play a pivotal role for general investors to take part in the commodity futures market. To this end, the necessary measures are to be discussed and taken for the sound development of commodity funds, such as relaxing the capital requirements for commodity trading advisors. Studies and discussions are to continue regarding other adequate methods of enhancing market liquidity via indirect forms of market participation through the commodity funds by general investors, taking into account customer protection.

(4) **Measures to Limit or Drastically Reduce General Investors’ Risks**

(a) **Stop Orders**

Stop order (the so-called “Loss-cut Trading” system) aims to limit losses and the investors’ risk exposure within a certain range if adopted by a customer. It is an effective measure for protecting those general investors taking part in commodity futures market directly.

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<sup>15</sup> A mandatory reserve requirement in accordance with the trading volume applicable to FCMs for possible damage claims from an illegal act or administrative misconduct (Article 221 (1) of The Commodity Exchange Act & Article 111 of the Rules on The Commodity Exchange Act).

Therefore, it is appropriate to introduce a structure that provides customers with a choice of Stop order. This structure is to be introduced in phases beginning with an implementation in mini contracts with lower risk exposure, followed by a comprehensive implementation for all the commodities by January 2008, after the scheduled preparation period for system integration and other necessary tasks.

(b) **Mini Contracts**

It would be an important endeavor from the view point of customer protection to introduce mini contracts, with considerably lower trading unit and margin requirements, and invite non-professional investors in commodity futures to such trading. In order to ensure sufficient customer protection, the exchanges are to introduce the Stop order to such trading, constantly monitor and assess the level of compliance in terms of customer protection, and discuss any potential change(s) in the design of the commodity trading if and when required.

3. **The Operations System**

(1) **The Exchanges**

(a) **The Demutualization of Exchanges**

- TOCOM is to prepare for demutualization in accordance with the attached schedule to become a stock company by the end of 2008 to ensure greater governance and financing for the new electronic system. The C-COM is to continue to prepare for its conversion into a stock company while continuing to discuss relevant matters pursuant to the initiative of the committee that was formed in July 2005.

- It is essential for the management of the exchanges to respond swiftly to the changes in the market environment such as globalization and the trends of other markets in the world. To that end, the scheduled stock company is to proactively invite not only representatives of the business but also knowledgeable experts from outside the company to serve as the board members. The board is to consist of a small number of directors who are well versed in matters both in and outside Japan and provide a forum for active discussions contributing to speedy and flexible decision makings. A committee in charge of market management is also to proactively invite not only representatives of the industry but also knowledgeable experts from outside the company and provide a forum for discussions and decision makings from objective viewpoints. The existing membership organization is also to be reviewed based upon the same perspectives as discussed above.

- In addition to setting a clear-cut outlook for business operations upon completing the demutualization and introducing the next electronic system, it is imperative to list the stock

company's shares to have funding participation from investors.

(b) **Other Issues**

- Drastic reform is needed in the sales and marketing area such as establishing marketing teams which understand the needs of professional investors within and outside of Japan, such as large market players including institutional investors and hedgers, and promote their participation in the markets, and recruiting suitable human resources with sufficient expertise and knowledge in the relevant fields.

- Further discussions are to be held on building up the relationship with other exchanges both in and outside Japan, including deliberation on future international alliances with overseas exchanges in order to respond effectively to growing competitions among the exchanges.

(2) **Management of FCMs**

Futures Commission Merchants ("FCM") are facing increasing difficulties in their management, with increased needs on consumer protection, more strict regulation, and decline in trading turnover in domestic exchanges. Thus, the FCMs must develop themselves into strong operational bodies by upgrading the conventional business models, taking into consideration possible future competition beyond the present legal structure and market areas. To this end, it is imperative to continuously discuss concrete measures on the needed new management styles, such as the diversification of existing operations and management structures based upon the principles of customer protection and transformation into management to substantially increase customer satisfaction.

4. **Other Measures**

(1) The administration is to make utmost efforts to simplify and facilitate all procedures required to grant approvals and licenses to the exchanges (e.g., the introduction of a shorter examination period) so as not to hinder the speedy efforts of those concerned including the exchanges.

(2) TOCOM is to take all necessary measures without delay in accordance with the proposed schedule discussed in this report. Also, it is to reinforce the management and planning functions of the exchange and raise the members awareness to avoid provoking any confusion in the market caused by careless studies or actions, and spare no effort in performing these tasks as promptly as possible, preferably ahead of the scheduled deadlines.

### **Plans for Implementation and Discussion**

1. Concrete actions are to be taken immediately on the matters which have been clarified in this report in terms of specific measures and a detailed schedule. Progress of such works are to be closely monitored and the outcomes are to be discussed at this Study Group around this fall. Especially, the exchanges need to be prepared to survive in this harsh competing environment which transcends national boundaries, areas, or existing legal frameworks. To this end, the exchanges are to immediately put into practice all measures, including those set forth in this report.
2. Matters listed in this report that require further deliberations are to remain on the agenda at meetings including this Study Group will be deliberated in accordance with the opinions expressed by the Group. A comprehensive study on the Japan Commodity Clearing House (“JCCH”), which has not yet been deliberated by the Study Group, is also necessary, including its clearing system, reinforcing its financial condition, reviewing its qualification requirement and raising its financial requirements for clearing members.