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## **Summary of the Commodity Exchange Committee Interim Report on How Commodity Futures Markets should be in the Future in Japan**

Ministry of Agriculture, Forestry and Fisheries

Ministry of Economy, Trade and Industry

This document is an interim report compiled by the Commodity Exchange Committee (chaired by Yasuhiro Osaki, Professor of Waseda University). The Ministry of Agriculture, Forestry and Fishery and the Ministry of Economy, Trade and Industry worked as the secretariat of the Committee.

### **I. Points at issue for discussion on how commodity futures markets should be in the future**

#### **1. Present condition that surrounds commodity futures markets**

- (1) Developments in trading volumes at domestic and overseas commodity futures markets
  - (i) Futures trading worldwide has roughly tripled over the last five years while the volume of commodity futures traded in Japan's markets has fallen some 45 percent during the past three years.
  - (ii) Amid intensifying cross-border, cross-sectoral intermarket competition overseas commodity exchanges have made progress in improvement of electronic trading systems, extension of trading hours (implementation of 24-hour trading), and M&A (mergers and acquisitions) or international tie-ups between exchanges including the area of financial instruments.
  - (iii) **In the overseas markets, fusions of commodity sector and financial sector are progressing, through the expansion of investment products that bridge financial instruments and commodity such as commodity-based ETF's**, and an increase in financial institutions' alternative investment in commodities. These developments provide an important background to greater market liquidity.
- (2) Trends in the number of complaints and consultations filed or requested by general investors
  - (i) The number of complaints and consultations filed or requested on commodity futures transactions has considerably fallen. Yet it still remains at a high level.
  - (ii) Recent years have seen a sharp increase in the number of troubles related to overseas commodity futures transactions or commodity futures options transactions (the so-called bogus "Loco London" transactions).
- (3) Discussions on how Japan's commodity future markets should be
  - (i) The Council on Economic and Fiscal Policy engaged in wide-ranging discussions also related to commodity futures markets from the perspective of strengthening the competitiveness of

Japan's financial and capital markets. In its 2007 Basic Policies for Economic and Fiscal Reform (adopted by the Cabinet on June 19, 2007), the Council referred to the enhancement of Japanese exchanges' competitiveness.

## **2. Current efforts for stronger competitiveness of commodity futures markets**

In view of such severe internal and external environments surrounding Japan's commodity futures markets, efforts have been made toward markets' stronger competitiveness and solution of troubles suffered by general investors.

### (1) Efforts aimed at strengthening competitiveness

#### (i) Efforts focused on industrial futures markets (efforts made by the Tokyo Commodity Exchange (TOCOM))

- Early implementation of a world-leading new electronic trading system (in FY2008); and
- Demutualization (in 2008).

#### (ii) Efforts focused on agricultural futures markets (efforts made by the Tokyo Grain Exchange)

- Review of listed commodities; and
- Adoption of a plan to introduce a continuous session for certain products in the trading system (starting in January 2008). The single-price session (*itayose*) currently in effect was also upgraded (in this past August).

### (2) Efforts for solution of troubles suffered by general investors

#### (i) Government's efforts

- Improvement of legislation for general investor protection (revision of the Commodity Exchange Law made in 2004 and 2006), and rigorous law enforcement including on-site inspection and supervision.

#### (ii) Efforts by related associations

##### (a) Commodity Futures Association of Japan

- Formulated the action program designed to eliminate troubles related to commodity transactions (in December 2006).

##### (b) National Futures Protection Fund

- Implemented measures designed for separate custody of general investors' assets for protection, and faithfully repaid general investors' assets.

##### (c) Japan Commodity Futures Industry Association

- Worked to have each member make efforts toward disclosure and publication of its solicitation policy, announce its customer-oriented business policy, and make its complaint window fully known and available to customers.

#### (iii) Efforts made by exchanges

##### (a) TOCOM

- Implemented the “loss-cut rules” designed to prevent losses from increasing beyond certain amounts (requiring its members to establish the system and explain it to customers), and introduced reduced-risk smaller contracts.

(b) Tokyo Grain Exchange

- Implemented the “loss-cut rules” (members may adopt this system at their own discretion); and
- Implemented the TGA (Tokyo Grain Adviser) certification system.

### **3. Points at issue for the study of how commodity futures markets should be in the future**

(1) Basic concepts for the development of commodity futures market

Commodity futures trading helps form transparent and fair prices, and provides the function for hedging against price fluctuation, adjusting inventory, and managing assets. It therefore serves as an important industrial infrastructure that supports our economy. Organized and arranged below are tasks to be considered and materialized in the future in addition to current efforts toward stronger competitiveness and general investor protection.

(2) Points at issue

(i) Tasks to be addressed for greater market liquidity

- (a) Further enhancement of markets’ convenience including reduction of transaction costs;
- (b) Diversification and expansion of listed commodities;
- (c) Diversification and expansion of market participants by inviting professional market participants such as financial institutions and institutional investors; and
- (d) Promotion of linkage or fusion between financial instruments and commodities.

(ii) Tasks to be addressed for enhanced market credibility

(a) Upgrading of the clearing system

- By utilizing the transfer system, and reviewing/revising the clearing membership requirements.

(b) Improvement of transparency, fairness, and market oversight

- By reviewing current efforts taking into consideration international trends, enhancing transparency and fairness of the markets, and performing more effective market oversight including by the government.

(3) Tasks to be addressed for general investor protection (solution of troubles suffered by general investors)

(a) Diminishing of troubles suffered by general investors

- By best efforts by the government, related associations, exchanges and exchange members; and
- By promoting individual investors’ participation in the markets by means of funds, as well

as transactions over the Internet and risk-limited or risk-reduced transactions/contracts such as the “loss-cut rules” and smaller contracts.

(b) Accurate disclosure of information related to general investor protection

(c) Overseas commodity futures transactions or options transactions

- A study will be required as to how necessary measures should be designed including institutional ones.

(4) Tasks related to management of exchanges’ or exchange members’ organization and business operations

(a) Management of exchanges’ organization and business operations

- Exchanges that are currently being demutualized converted to stock companies will continue to make steady efforts toward such goal. Other exchanges will also be required to consider and materialize demutualization conversion to stock companies and implementation of an internal control system from the viewpoint of reinforcing governance.

(b) Management of exchange members’ organization and business operations

- Exchange members will be required to develop new business models, which are predicated on general investor protection, in business environments expected to be present in the future. A study must be made as to what measures will be necessary to facilitate exchange members’ change to another business category or development of new business models, which are predicated on general investor protection.

## **II. How commodity futures markets should be linked to or fused with the financial sector**

The following shall be the direction in which efforts will be made to have commodity futures markets linked to or fused with the financial sector in consideration of the discussions thus far held at the present Committee and the statements made in the “2007 Basic Policies for Economic and Fiscal Reform.” At least such discussed or stated items should be incorporated into the “Plan to Strengthen Financial and Capital Markets’ Competitiveness” (tentative naming) which is due to be drawn up.

### **1. Materialization of commodity-based ETFs**

(1) Needs have been indicated among investors for commodity-based ETFs. If such ETFs which are linked to domestic commodity futures markets are listed in financial commodity exchanges, they will provide greater liquidity to commodity futures markets in Japan. From this perspective, necessary systems must be created and implemented to materialize such commodity-based ETFs.

[Key Points]

(i) Scope of Article 3 “Specific Assets” of the enforcement ordinance of the Law concerning

Securities Investment Trust and Securities Investment Companies (“Securities Investment Trust Law”)

“Physical commodities” and “rights pertaining to commodity futures transactions” should be added.

(ii) Adjustment to provisions that overlap those under the Commodity Fund Law

It must be ensured that “those who engage in investment management” shall not be subject to the Commodity Fund Law.

(iii) Other improvement of system-related matters

Modification to the Securities Investment Trust Law that shall be necessary if the law is to permit redemption of physical commodities.

(2) At the same time commodity futures exchanges in Japan should make their utmost efforts to have ETFs listed that are based on commodities linked to their commodity futures markets for greater market liquidity through hedging or arbitrage transactions.

## **2. System improvement to promote equity partnership between exchanges and a wider commodity assortment**

(1) In order for Japan’s commodity futures markets to be more competitive and have greater potential for the future, it is an urgent task to create an environment that will prompt partnership or competition between exchanges. To this end, it is an urgent, necessary task to take into consideration international trends and study how to facilitate equity partnership between exchanges and permit commodity exchanges to handle financial instruments, naturally avoiding being too fast and sloppy in any event.

(2) Specifically, we should take into consideration increasingly active international equity partnerships between exchanges in recent years, investigate and analyze such trends, and then, review/consider the significance of and problems related to the easing or modification of the following matters provided for in the Commodity Exchange Law: (i) regulation that prohibits dual business, (ii) restrictions imposed on the ownership of voting rights, and (iii) provisions relating to holding companies. The review or consideration shall be followed by the revision of the system and application of the law (similar system modification or improvement is considered necessary also for the Financial Instruments and Exchange Law).

(3) For system improvement, the following should be taken into consideration:

(i) To support the function of commodity futures trading as an industrial infrastructure the Commodity Exchange Law has a legal purpose and a regulatory system, which are different from those contemplated in the Financial Instruments and Exchange Law. For this reason it should be appropriate for a commodity exchange to be regulated under the Financial Instruments and Exchange Law for handling financial instruments.

- (ii) On the contrary, for a financial instrument exchange or a subsidiary of its holding company to open a commodity derivative market, for a similar reason it should do so subject to the regulation under the Commodity Exchange Law.

### **3. Strengthening the competitiveness of commodity futures markets that are closely related to financial and capital markets**

- (1) For stronger competitiveness of financial and capital markets, it is also necessary to simultaneously improve the competitiveness of commodity futures markets that are closely related thereto. Hence, it becomes necessary to make this point clear in step with the strengthening of financial and capital markets' competitiveness.
- (2) Specifically, along with the strengthening of financial and capital markets' competitiveness, it is necessary to indicate the policy to enhance the competitiveness of commodity futures markets including improvement of market convenience, materialization of a wider assortment of commodities, and diversification of market participants.

### **4. Creation of a system that facilitates the inflow of assets under management in the financial sector into commodity futures markets**

- (1) For promotion of linkage or fusion between financing and commodities it is necessary to develop an environment that facilitates the inflow of assets under management in the financial sector into commodity futures markets.
- (2) Specifically, the systems should be improved as follows:
  - (i) Improve the systems to ensure that banks, insurance companies and other entities can engage in trading in commodity futures markets without being worried about legal risks involved in settlement by delivery of physical commodities.
  - (ii) Create an environment that facilitates the inflow of assets under management in the financial markets into the commodity futures markets, thereby permitting pension funds to invest funds in commodity futures.