

FUTURES INDUSTRY ASSOCIATION – JAPAN CHAPTER

FIA-Japan

Clearinghouse Task Force

Follow-Up Report

June 30, 2008

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Commodity Clearinghouse Task Force

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Background and Overall Comments

Background

Several months ago, FIA-Japan formed a Task Force to study and make recommendations leading to improving the clearinghouse function for the Japan commodity industry. On April 7, 2008 our Task Force issued its Interim Report summarizing our views and recommendations, including the identification of several Strategic Business Considerations. The Interim Report was distributed to industry members and the regulators. Subsequently, a regulators' study group issued its own report on changes that they believe should be made to the clearinghouse function. We have reviewed the report issued by the regulators' study group and we have considered several areas where we believe further attention needs to be focused. Our comments and suggestions are included in this "Follow-Up Report".

Overall Comments

Current Status of Commodity Industry in Japan – Market Liquidity Issues

The volume of transactions conducted on the Japan commodity exchanges has declined in recent times while the global markets have enjoyed explosive growth. Although this is due to a variety of reasons, some observers in the Japan community have been criticizing the actions taken by the Regulators in recent years to revise the regulations and to modernize the market. Concerns about the liquidity of the market and the declining customer business and the inability to attract new business are being voiced.

As we have noted in the past, we believe that the actions taken by the Regulators, and recently, by several Exchanges were essential for the future success of the commodity industry in Japan. The short term impact has been painful but we believe it was required to provide the foundation for a viable commodity market in Japan. We further believe that the project to implement a

new trading system by TOCOM, and subsequently by the other commodity exchanges, will create an interest for use of these markets by both international and domestic industrial and commercial firms as well as proprietary trading firms and market makers. But it must be recognized that it is *imperative* that a satisfactory clearinghouse function be established in order to attract this new business to the markets. The new modern trading system being installed at Tocom is only part of the requirements which must be put into place. The clearing function and guarantee system must also meet the global standards. A modern clearinghouse system, with an adequate capital base and a strong risk management control system, is part of the criteria major users of the market consider essential and demand before entering the market. However, once established, there will be significant growth of trading business coming from professional and commercial users both overseas and from within Japan.

We strongly believe that forming an adequate clearinghouse structure, together with the actions underway to install the new trading platform, will lead to the required liquidity and the success of the commodity futures market. But timing for the implementation of such a clearinghouse system is critical. Our comments and recommendations below are made with this critical issue in mind.

Expand the Scope of Clearinghouse Project

We understand that the discussions held to date among regulators and industry study groups have focused around the existing JCCH clearinghouse. The plans now being considered would try to improve the existing organization. However, we believe it would be useful to expand the scope of study to include the possibility of creating an entirely new clearinghouse organization. As a part of this, the possibility of “joint venturing” with other clearinghouses in Japan should be considered. For example a “Japan-wide Derivatives Clearinghouse” could be considered. This kind of structure would be very attractive to market users. The efficiency and cost reduction to the clearinghouse and to all clearing members is obvious. There are aspects including cross margining, support of a larger guarantee fund and development of an adequate capital base which could be considered in such a study. This could also be important for the stability and growth of the clearinghouse through more diversified products and membership which can attract more financially sound investors.

We believe that an initial step, in any case, would be to establish a “Roundtable” for discussion about common interests among derivatives clearing organizations/exchanges in Japan. There are issues related to technology, risk management, collateral, and others that are common to all of these organizations. Further, we believe that discussions with other international global clearinghouses on these issues would provide valuable insight and direction for the Japan Clearinghouse initiative.

Detailed Recommendations

Our detailed recommendations in this Report are categorized as follows:

- I. Financial Considerations***
- II. Corporate Governance and Management Requirements***
- III. Operations Planning – Revenue and Expenses***
- IV. Clearing Member Minimum “Net Capital” Requirements***
- V. Position Transfers, Give-Ups and DMA***

I. Financial Considerations

1. Adequate Clearinghouse Capital Is Needed Now

The regulators' study group has recommended accumulating additional capital in the clearinghouse by retaining earnings from clearing fees over the next five years. It was suggested that 5 billion yen could be accumulated under this method. We believe this approach is inadequate as to timing, approach and amount.

Clearinghouse capital is needed now, and it will not be adequate to correct the current deficiency over a five year period. Future growth in volume of business starting next year, when the new trading platform is installed, has the potential to be significantly large and must be considered and planned in determining the capital requirements for the clearinghouse. However, the absence of adequate capital will impede the attraction of major players to the futures market and will slow the development of new business. Financial credibility for counterparty guarantee is dependent upon this.

There are significant capital requirements for investment in systems and technology that cannot wait for the accumulation of earnings. Operating capital is needed now for investment in a risk management system, development of real-time information reporting, etc.

Further, there are significant tax issues in attempting to fund the clearinghouse capital requirement entirely through retained earnings. A major part of the earnings will be paid out in income tax rather than being retained as capital or otherwise invested in capital assets. Currently, a major source of income to the clearinghouse is derived from interest income on member deposits which are invested by the clearinghouse for its own account.

However, no interest is paid out to members on their deposits. We believe that the payment of interest to members based on their deposits is a basic requirement. This is discussed further later in this report.

As to the determination of the amount of required capital, it is clear that amounts greater than 5 billion yen are needed when considering the capital required for investment in systems and technology and the relationship to the operations and exposure of a rapidly growing clearinghouse function. Although we are not prepared to firmly advise on the specific amount of capital that is required, we believe that thinking in terms of targeting for 10 billion yen would be more reasonable than the current discussion of seeking 5 billion.

2. Expand Sources of Capital

Since it will be inadequate to accumulate capital for the clearinghouse over a number of years from earnings, the source of immediate capital must come from investors. We believe that the categories of investors that should be considered could include the following:

- Exchanges
- Members
- Other domestic investors
- International strategic partner

Of course, financial investors require a financial return on their investment. Returns can be measured in terms of dividends and/or capital appreciation. In any case it must be recognized that the clearinghouse is a “for-profit” business. There needs to be an appropriate business environment established and the adoption of a business model which is based on a “for-profit” organization. It should be recognized that it is internationally accepted that the clearing function can be the major value proposition for investors and exchanges if it is run on a basis of an appropriate business model. If appropriate capital is allocated and if there is an appropriate business plan, there will be strong interest by potential investors in the clearinghouse.

We also suggest that involvement with an international strategic partner be considered. The globalization of markets and the development of cross border business relationships make this alternative worth considering. Developing such cross border relationship relates not only to the raising of capital, but can add value through many aspects including the transfer of technical and business expertise.

II. Corporate Governance and Management Requirements

1. Key Management Position Requirements

In developing the business plan for a clearinghouse, there are key management positions that must be filled with appropriate level of expertise. Recruiting experienced management in these important areas is critical. The cost of attracting appropriate experienced management must be part of the business plan. The key management positions will include the following senior management and directors:

- CEO, CFO
- Chief Risk Officer (CRO)
- Chief Information Officer (CIO)
- Director of Internal Audit
- Director of Member Examination and Compliance
- Qualified Independent Outside Directors

It must be recognized that these positions are for professionally trained and experienced management people. The compensation cost must be part of the business plan.

We note the importance of the “Chief Risk Officer” (CRO) and the Chief Information Officer (CIO). These key positions are critical to the management of the clearinghouse and to risk control aspects of the business. Similarly, the Director of Internal Audit and the Director of Member Examination and Compliance are critical and require management level expertise.

2. Conflicts of Interests Issues – Adopt Global Model

There has been much attention internationally to the issue of conflict of interests in both exchange and clearinghouse organizations. Clearly, the clearinghouse plays a fiduciary role as a custodian of customer money and securities as well as serving as a “self regulatory organization” (SRO). On one hand, we can look at models in the banking industry where special conflicts of interests rules are put in place. In many respects the clearinghouse serves in a role similar to a bank or trust operation with respect to its function. The various reports of international committees such as IOSCO and the CCP12 have published studies and recommendations in this regard which should be used as a reference to structuring the corporate governance with respect to conflicts of interests.

These considerations define the criteria for selecting who can serve as a member of the

Board of Directors and on Board Committees, as well as Operating and Surveillance Committees. The role of qualified outside independent Board members is fundamental to the principles of governance in this clearinghouse environment.

In developing appropriate rules and procedures, there should be clear definitions and rules related to conflicts of interests. Currently this area is vague and perhaps not well understood.

III. Operations Planning – Revenue and Expenses

1. Preparation of Short Term and Long Term Business Plan

Careful planning and the development of short term and longer term business plans are required. This is necessary in determining the capital requirements and in attracting both capital investments as well as attracting professional management. In preparing this plan, strategic issues including the payment of interest on deposits and the development of additional sources of revenues need to be addressed. Potential diverse business expansion including clearing of OTC futures business, custodian services, etc. should be considered in this process.

2. Interest on Deposits

The payment of interest on deposits to members is required for the clearinghouse to be self sustaining. In general, interest on funds should be paid to members who directly bear the customer risk. Global practices in this area should be reviewed for guidance.

3. Significantly Higher Operating Expenses Must Be Planned

We understand that the study group's report assumes that operating expenses of 4 billion yen will be required for the clearinghouse. This is inadequate considering the basic requirements of the clearinghouse. The technology requirements for risk management responsibilities, and real time information for monitoring and for meeting member requirements will require systems and staffing that are considerable. Further, the management and corporate governance structure discussed above will have significant compensation requirements. We have not attempted to prepare a definitive estimate of operating expenses required, but it is clear that the amount could be double the 4 billion assumption. (Of course the payment of interest on deposits would be above and separate from operating expenses.)

IV. Clearing Member Minimum “Net Capital” Requirements

1. Calculation Methodology – Adopt Global Standards of Calculation

The current methodology used for calculating “net capital” for commodity firms is not consistent with international standards, nor with standards used in Japan in the securities industry. There are several parts of the calculation of minimum net capital required by exchanges and the clearinghouse which should be revised:

- a) Capital requirements should be based on “liquid capital” - exclude non-liquid assets**
- b) “Haircuts” on securities and other investments owned should be required**
- c) Contingency Liabilities, including those related to customers’ disputes, should be recognized**

a) Liquid Capital Focus –

The focus of capital rules and minimum requirements should be to determine the amount of “liquid capital funds” required. Considering the risk of volatility of markets and the need to convert assets into cash quickly, the net capital requirement for clearinghouse members should be based entirely upon liquid net capital rather than book value net capital. Non-liquid assets held by the clearing members should not be considered a part of the assets available for this purpose. For example, real estate, long-term receivables, and other investments not easily convertible into cash should be excluded from net assets in this calculation.

b) “Haircuts” on Securities –

The volatility of market value of securities and other investments should be recognized by applying “haircuts” as a part of the capital requirements. Such “haircuts” would be deducted from “net capital” in the calculation.

c) Contingent liabilities Accrual -

Contingent liabilities, including those related to customers’ disputes, should be assessed and reviewed by the independent professionals and accrued as a liability of the clearing firm and deducted from “net capital” in the calculation.

There are existing examples of “best practices” in determining capital requirements for members of trading markets and exchanges. In Japan, the securities industry has adopted many of these methods. They should be reviewed as having application for the Japan commodities markets.

2. Net Capital Requirements for “General Clearing Members” and “Self Clearing Members” – Should be “Risk Based”

The regulators’ study group recommends that clearing members should be required to have a higher amount of minimum net capital than the amount required for non-clearing members of the exchanges. The distinction between clearing and non-clearing members of exchanges is essential. We firmly agree in principle with this important fundamental conclusion.

“General Clearing Member”

The Study Group recommends that minimum capital requirements varying between 2 billion and 20 billion would be required for clearing members depending on whether they serve as a “General Clearing Member” offering clearing services for other “non-clearing members”. This recommendation acknowledges the more significant risk involved in serving the clearing function. However, we understand that in determining the amount of required capital, the Study Group would not require a greater amount of capital for those general clearing members offering to clear for “non-exchange members” compared to clearing for members of the exchange. We believe that the requirement for minimum net capital for General Clearing Members should not be based on whether they clear for a member versus non-member of an exchange, but rather, they should be treated in the same way in terms of requiring additional capital.

Further, the Study Group recommendation would require minimum capital that would be based on the “number of such clearing arrangements”. We believe that this approach to determining the required capital is not consistent with a risk based approach. We believe that the required net capital should not be based on the “number of such clearing arrangements”; rather, it should be based on the risk magnitude associated with the volume of positions carried for other non-clearing FCMs.

Generally, we believe it is necessary to provide friendly markets and clearing accessibility for the non-clearing participants, including those institutions newly participating in our markets. We suggest that this area be simplified by having just two categories of clearing memberships which are (1) “Self Clearing Member” (自社精算会員) (providing clearing services limited to their direct customers) with capital requirements as recommended by the Study Group and (2) “General Clearing Member” (他社精算会員) (providing clearing services for other FCMs) with capital requirements of a greater amount (perhaps Yen 5 billion). This 2nd category would include clearing for both member and non-member FCMs, including foreign FCMs having an omnibus account with the clearing member.

Discretionary Powers of the Clearinghouse –

As we noted in our prior Interim Report, we want to re-emphasize the need for systems to be able to monitor and assess member risk profiles based upon real-time information as to positions, volatility, concentrations, etc., and the clearinghouse must have the power to require clearing members to increase their amounts of deposits/margin on a discretionary basis when the situation calls for such action based on market exposures.

V. Position Transfers, Give-Ups and DMA

1. Position Transfers

Position transfers under the instructions of customers and market participants are fundamental for the protection and interests of customers and members of the industry, including the exchanges and the clearinghouse. Efficient procedures should be established by the clearinghouse for such position transfers.

In addition to requests made by customers and/or clearing members we believe that the clearinghouse should be empowered to act to transfer positions in certain emergency situations where the financial condition of the clearing member warrants such action.

2. Give-Up Trades and Direct Market Access (DMA) Accounts

As discussed above, in permitting General Clearing Members to perform clearing for non-clearing members, Give-up transactions become a part of the process. The ability for non-clearing members to trade on the markets and to give up these transactions to clearing members represents an important system for both market and clearing activities.

However, in these environments, it is important for the clearing member to be able to monitor and manage the positions being created and carried by these transactions.

It should be also be understood that there is a greater risk associated with handling trades for other firms who are using "Direct Market Access (DMA) rather than running the trades through the clearing broker's system. It is much more difficult for the clearing firm to monitor the transactions on a real time basis when the non-clearing firm is using DMA. Indeed, there may be some customer accounts (in addition to non-clearing brokers) using DMA that will also require special monitoring by the clearing broker. These situations represent greater risk from a control point of view.

While it is possible for the exchanges to provide systems to monitor these positions in real time, these will not be able to monitor the consolidated risk of a clearing member's position across all the exchanges, or the possible risk to the clearing house from such systems.

We would therefore recommend that the clearing house invests in systems to monitor the positions and the risks in real time, and that they focus on how they can support the clearing members with such systems.

Following are selected examples to illustrate situations where give ups are commonly used in the industry:

- A customer uses an FCM who has a high level of execution ability but the FCM is not a clearing member

- A remote member physically located overseas trades remotely with direct trading connectivity to the market. They give up the trades to local clearing members.
- An FCM is an exchange member (but not clearing member) acts as omnibus broker to the clearing FCM. It may be able to execute their customers' orders by themselves and gives up the positions to the clearing member carrying their omnibus account.
- An Introducing Broker (IB) as a member of the exchange introduces the customer account to the clearing FCM and executes the customer's transaction and gives up the position to the customer's account with the clearing FCM
- A customer using 2 or more clearing FCMs (due to their internal risk management policy) uses one clearing FCM for execution of the trades, some of which are given up to another designated clearing FCM.
- A fund manager using a specialized broker for each product but using one clearing firm.
- The clearing member gives up the position to the other clearing members when their customers' position exceeds the limit self-imposed by the firm.

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FIA-Japan Board members representing the futures Exchanges and other industry participants have provided input and advice to the Task Force during its deliberations.