Report and Proposal Concerning the Creation of a Comprehensive Market in Japan

Futures Industry Association Japan

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(Note: this document is a translation and should only be used as a general reference to the original text in Japanese)

Executive Summary

The Japanese derivatives market is positioned between the U.S. and European markets, and is the market, along with Australia, that opens earliest in the world's trading day. Following the New York market, Japan is an extremely important market for indicating reactions to economic indicators and to determine the trading direction for the coming market day. Despite being in such a fortunate position, the international commodity derivatives market in Japan has not only failed to reap the benefits of participating in the rapid growth of the expanding global market, but also has fallen far behind. This was caused by Japan remaining an old-fashioned business environment compared to the rapidly changing global market environment and needs. Japan has failed to establish an environment as an international market, and has very few market participants able to promote the Japanese commodity market internationally due to the current market participant structure. As a result, the Japanese commodity market has reached a state in which its share of liquidity between international markets has been continually declining for many years and without the primary value of the commodity industry being recognized in the Japanese economy.

The Futures Industry Association Japan (FIAJ) has considered the possible structure of a Comprehensive Market considering the opinions of the FIAJ Comprehensive Market Strategy Committee, made up of representatives from various parts of the industry, and expert market participants in Japan and overseas.

We would like to express our gratitude to the following: members of the FIAJ Comprehensive Market Strategy Committee who worked and collaborated on the proposal; the industry players who provided survey responses, the Japan Commodity Futures Industry Association for their input, the FIA headquarters and other relevant persons who collaborated and supported the survey. We sincerely hope that this proposal will be of assistance in the development of the derivatives market in Japan.

Following are our proposals for the development of the derivatives market in Japan:

1. <u>Proposal for market supervision to be conducted by a single comprehensive regulatory organization, based on unified laws and regulations</u>

    (1) The current regulatory environment vertically segmented by product group (so called "silos") presents a variety of obstacles to market participants, functioning of listed products, market design, clearing transactions and global access to the market.

Eliminating this segmentation is essential to support the development of a Comprehensive Market.

(2) All derivative products should be recognized as types of financial instruments, and all market participants and exchanges should be permitted to handle all listed derivatives if they satisfy certain criteria.

2. <u>Proposal for the creation of a market structure that is a foundation for the development of an Asian core commodity derivatives market in Japan</u>

(1) Listed commodities in Japan should include international commodities and not only those specific to Japan. The market must create a foundation, serving as part of the international market, based on highly transparent and sound transactions, opening its doors as a place for secure clearing, and the participation of diverse trading participants, and be a market that can be depended upon between international markets, especially within the Asian time zones. This would lead to the creation of a market where global players gather together.

(2) The Comprehensive Market should be able to consolidate commodities traded on individual exchanges into a single market and apply the same rules as other listed derivatives and under a unified governance system in order to operate an effective and highly convenient market.

3. <u>Proposal for the creation of an integrated clearing organization for clearing all transactions in the Comprehensive Market</u>

(1) In addition to the creation of a Comprehensive Market, the creation of an integrated clearing organization that will contribute to the diversification and mitigation of market risk, and also support the orderly management and operation of the market, is recommended.

(2) Mitigating the costs of clearing participants and simplifying comprehensive and customer-specific risk management increases convenience and the security of clearing participants and lowers barriers to entry. Based on the survey we have implemented, FIAJ sees comprehensive clearing in a unified

clearing organization to be one of the greatest factors determining the success of the Comprehensive Market.

4. Proposal for a survey regarding the separation of the regulatory administration of the futures market and physical market

A commodity derivatives market regulatory organization that designs and supervises the regulatory environment for the smooth functioning of the derivatives market should be separated from the physical market regulatory organization. However, there must be sufficient cooperation and exchange of information with the physical market regulatory organization, facilitating the smooth operation of the physical commodities market. To achieve this, it is vital to establish a collaborative arrangement between relevant regulatory organizations and staff.

5. Proposal for a Strategic Approach amid Competition between International Markets

(1) Japanese International brokers are expected to participate in the commodity derivatives market and create a global service network promoting the diversification and globalization of market access.

(2) Reconsider product design and development of new listed commodities that meet the needs of commercial investors, global market participants and investors.

(3) Promotion of strategic intermarket cooperation in an international market environment.

(4) Reduction of costs for clearing participants through the realization of clearing functions in a unified clearing organization.

(5) Utilization of effective risk funds such as cross margining across a diverse range of financial derivatives.

About Futures Industry Association Japan (FIAJ)

Futures Industry Association Japan (FIA Japan) is the only organization in Japan with a membership drawn from the entire cross section of the futures industry. Members include futures and securities exchanges, FCMs, security firms, banks and other users of the markets, as well as legal, technology and other professionals that provide services to the industry. We focus on both financial and commodity markets and we stay abreast of both domestic and international development in this global industry.

FIA Japan was established in 1988 as a volunteer-based association, with participation of professionals from both the Japanese and foreign futures industry, with the encouragement of The Futures Industry Association based in Washington DC (FIA). FIA Japan was reorganized as an independent General Incorporated Association, under Japanese law, in 2010 to help it succeed with its mission.

In 2016, FIA Japan entered into an affiliation agreement with FIA creating a more formal relationship between the two organizations, in order to better coordinate policies and promote the cleared derivatives industry. FIA Japan continues as an independent organization, with its own Mission, and its Board of Directors elected by its members, including representatives from FIA, operating under its Articles of Incorporation, with a specific focus on the development of the Japanese financial markets.

FIA Japan's mission is to encourage the growth and success of the Japanese financial market-place and its development as a regional and global financial center.

https://www.fiajapan.org/

About Futures Industry Association (FIA)

FIA is a global trade association based in Washington, D.C. and organized for the development of futures, options and centrally cleared derivatives markets. It has offices in Brussels, London and Singapore, in addition to affiliated organizations, including FIA Japan. Its membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and many other professionals serving the industry.

FIA’s mission is to:

- support open, transparent and competitive markets;
- protect and enhance the integrity of the financial system; and
- promote high standards of professional conduct.
- https://fia.org/about-0

About the FIAJ Survey

In November 2018, FIAJ sought a wide range of representatives, from within Japan and overseas, to organize a Comprehensive Market Strategy Committee to consider the structure of a Comprehensive Market. The aim (of the committee) is market development in relation to the launch of a Comprehensive Market, integrating the securities and commodity derivatives markets. In December 2018 FIAJ conducted a survey of participants in the derivatives industry regarding the Comprehensive Market possible future structure.

Responses were received from 41 of the approximately 150 people surveyed. 57% of the respondents were from foreign companies and 43% of the respondents were from Japanese companies, with a generally even split. A further breakdown of the respondents showed brokers account for 44%, investors (market users) for 38% and other respondents for 18%.
For details, please see the attached "**Survey on Market Integration**".

This document is based on FIAJ's knowledge of commodities, finance (fixed income), securities futures and options markets, and related industries in Japan and overseas, accumulated over the past 30 years, and is a proposal for the development of the derivatives market in Japan using the survey results considered by the Comprehensive Market Strategy Committee.

See the survey respondents, locations and types on P2 A1 of the FIAJ survey.
See the breakdown between brokers, investors, and other entities on P3 of the FIAJ survey

1. Comprehensive Market and Its Significance

The true intention of a Comprehensive Market should not be to integrate exchanges or markets, but rather it must aim to promote the development of the financial (fixed income), securities and commodity derivatives markets in Japan. It must also aim to create a market able to provide sufficient market functions not only to market participants in Japan and overseas, but also between global markets, as the core market in Asia.

Regulatory organizations, exchanges and the industry should focus on what an ideal market would look like in the future and set the foundations for a more effective market and derivatives industry, with a high level of convenience, security and transparency that can be accessed internationally, and without the constraints of keeping a status quo on existing regulatory environments, culture, experience and various trade practices, or the history of the market and industry. As mentioned above, we are certain that regulatory authorities, exchanges and industry professionals mutually recognize that the creation of a Comprehensive Market is simply aimed to achieve market growth that will provide the basis for the success of a new derivatives market. Furthermore, it is important to recognize that the Comprehensive Market vision is the merging and integration of relevant industries including all systems, rather than simply the integration of commodities, securities and financial futures markets. Also, it is important to have a common awareness that the government and the private sector must work as one to promote their own reforms and promote the development of the market and the industry.

The rapid advancement of information technology has accelerated market globalization and competition between international markets beyond distance, borders and time zones, and there are inevitable concerns that the Japanese derivatives commodity markets and industry are unable to adequately fulfill their global role and meet the needs of market participants. In particular, in light of the diversification of credit risk and markets in an increasingly uncertain global physical market for international commodities, the commodity derivatives market within the Comprehensive Market should be designed so that it is easily accessible by the world's physical market participant/investors. Global market participants trade on global markets and conduct cross-border transactions, selecting the most effective and convenient derivatives markets.

Commodity futures markets, assuming a high level of market liquidity, function as a place for fair and appropriate price formation. Trading companies and financial institutions regard listed commodity futures and options markets as places for ensuring the stable supply and smooth circulation of commodities through risk management transactions, commodity finance and structured financial instruments, as the broad meaning of derivatives markets, while securities firms and investment managers regard commodity markets as important investment venues, for the risk management of assets and for providing stable returns. That is to say, as risk management needs are more diverse and earning opportunities are sought after by commercial players, financial institutions and investors, on-exchange derivatives markets, including commodity futures markets, are recognized as an important and paramount part of the industrial and financial market infrastructure.

See question 3 of the FIAJ survey on trading venues.

2. Competition and Cooperation between International Markets

The global derivatives market that continues to develop rapidly recorded a total of 25.2 billion lots on 79 exchange derivatives markets worldwide in 2017. Looking at the composition of global markets regionally, the U.S market accounted for 8.88 billion lots (35.3% of the world market), Asia-Pacific stood at 8.80 billion lots (35.0%), Europe at 4.93 billion lots (19.6%), South America at 1.9 billion lots (7.8%) and other markets at 590 million lots (2.4%). Around 380 million lots were traded in the Japanese market. Of these, JPX (OSE) accounted for 320 million lots (84% of the Japanese market), TFX stood at 38 million lots (10%) and TOCOM at 24 million lots (6%). The Japanese market accounts for a mere 1.5% of the entire world market, and just 4.3% of the Asian market, which greatly deviates from the country's stature based on factors such as Japan's GNP compared to other countries in the rest of the world. The size of the derivatives market in Japan is smaller than in neighboring countries and even smaller than in some emerging countries, which is due to a prolonged slump in the commodity futures market.

FIAJ has maintained its mission of developing the exchange derivatives market in Japan throughout the years, and has repeatedly proposed and supported the early creation of a Comprehensive Market since it made its first recommendations to the Council on Fiscal and Economic Policy in July 2007. During that period, the growth rates of the world's exchange derivatives markets, and particularly the Asian markets, have far outpaced the growth rate of the Japanese market, and the size of the Asian market has reached the point where it now holds one of the largest shares of the global market. In particular, the rapid development of the commodity futures market in China is outpacing the U.S. commodity market and may develop as an international benchmark market representing Asia, thanks to the internationalization of the energy, non-ferrous metals and grain markets in the near future, with the potential to expand to become a massive commodity market center in the Asian region. One example is the steady growth of trading volume in the front months of crude oil futures that began trading last March (2018) for the first time in China's history, achieving in less than one year since its launch an astounding tenfold increase in trading volume. The initial daily volume of 30,000 lots at launch increased to more than 400,000 lots recently, equivalent to approximately three times the volume of the (whole) Japanese commodity futures market. In this respect, the development of the Chinese market, which has an abundance of people within the government and industry with practical experience in European and U.S. futures markets, is the greatest threat to the Japanese market aiming to become the core market in the Asian region.

A market globalization strategy is essential for the development of the Japanese commodity market. Rather than simply monitoring and focusing on competition between international markets, beneficial cooperation between markets is believed to be important. The basic development element of the commodity futures market is the physical market. That is to say, while many hold the view that the size of a physical market as a producing and consuming country is determined by trading needs, a recent trend among market participants is to seek a market with highly efficient stable clearing functions without being limited to or to focus on more than the exchange price formation function. Precedents for this can clearly be found in the development of SGX and LME as so-called "intermediate markets" that are in neither large-scale producing nor consuming countries. The most beneficial and effective choice for a commodity futures market in Japan is to aim to be a commodity futures market established as a centrally cleared market using the synergies of the international position of Japan, which has a more stable economic environment and creditworthiness.

In order to achieve this, in addition to expanding the financial base of the exchange and clearing organization, FIAJ proposes that it is important to:
(1) create a system that expands the service network through clearing participants (members);
(2) seek flexibility and diversity in membership types (market participants), such as the separation of market (trading) members and clearing members, and having members limited to specific commodities and other comprehensive members;
(3) constructively review systems for domestic and foreign agents, particularly having a clear understanding of regulatory environments in the relevant countries of foreign commission merchants (brokers), and also create a robust communication and management system for dynamically exchanging information with foreign regulatory organizations;
(4) promote the realization of segregation of assets of Japanese clients overseas (already implemented for commodity derivatives transactions) in addition to the diversification of Japanese and foreign client transactions through Japanese commission merchants; and
(5) seek broad cooperation with international markets including the Chinese market.

See question 6 of the FIAJ survey on market membership structure.

3. Issues with Development of Derivatives Market Including Commodity Futures Market

(1) Unification of Regulatory Environment (Laws, Regulations and Regulatory Organizations)

The Japanese commodity futures market is highly dependent on foreign sources for the supply of resources essential for the lives of the Japanese people. Ordinarily, commodity futures markets aim to bring resources shared by the world closer by listing resources on each other's commodity futures markets. Based on this, the commodity market prices made public in each country and region participate in and reflect the price formation on foreign derivatives markets by communicating their respective participants' views to the world's various markets.

In order to do this, it is important to attract many investors and market participants that are international commission merchants (brokers)[1] or trading companies and commercial players, who are broadly participating in various international markets, to the Japanese commodity futures and options market so that they will not only contribute to the development of the market, but also play a very important role in reflecting the Japanese people's view of market prices on international markets. In addition to establishing the market environment required to do this, there is a pressing need to educate and recruit many human resources as well.

Despite the fact that the economic functions and objectives of derivatives markets are the same regardless of the type of listed product (commodities, securities or financial instruments), the regulatory environment in Japan has for many years been separated into product groups due to the emphasis on the physical markets (so called "silo regulations"). The establishment and design of a unified regulatory environment before the proposed creation of a Comprehensive Market is an important step toward the smooth organization and success of the Comprehensive Market. (See below 5. Monitoring between Commodity Derivatives Markets and Physical Markets).

[1] *International commission merchants (brokers): Commission merchants participating in the world's major derivatives markets, which are commission merchants with the authority to simultaneously participate in the Japanese market and international markets (global FCMs), many of whom are active in Japan as securities firms, investment banks and participants in the JPX markets. Many international commission merchants have a history of participation on commodity derivatives markets as clearing members of on-exchange derivatives markets in foreign countries.*

The Japanese commodity derivatives market has one of the longest histories in the world, and is a venerable market that was designed based on the wisdom and efforts of our predecessors. However, another aspect is the negative heritage from past errors made in efforts to improve the market, which are still impeding market development.

As indicated in the *FIAJ survey*, unification of the regulatory environment including the integration of laws, regulations and regulatory organizations is the issue that respondents have the strongest desire to address and is also mentioned as the most important matter required for the creation and success of a Comprehensive Market.

See question 1 of the FIAJ survey on products.
See question 5 of the FIAJ survey on the regulatory environment.

(2) Integration of Financial Derivatives Market and Commodity Derivatives Market

Along with a low trading volume, the number of participating business operators, including market participants and investors, such as foreign commercial players and high-speed traders, active in the Japanese commodity derivatives market is low compared to other global markets. There is therefore great theoretical potential for market growth. Under such conditions and based on an analysis of data in Japan, although foreign clients account for more than 50% of market volume and show rapid growth, there is an ongoing vicious cycle of declining trading of commodity derivatives by domestic clients due to a decline in the number of commission merchants (brokers) and sales representatives in the commodity derivatives market.

Furthermore, the number of commodity commission merchants (brokers) capable of handling transactions from foreign clients is limited, and much of the market trading volume is severely concentrated on certain market participants as a result. Ordinarily, market prices formed by a wide range of diverse market participants both in and out of Japan promotes the use of transactions as they are perceived as valuable benchmark markets. In particular, arbitrage transactions between markets function to correct disparities between markets and time differentials for commodity derivatives markets listing the same (or similar) international commodities. Arbitrage transactions are also important transactions for reflecting Japanese market prices in international markets. However, the ability of market participants in the Japanese commodity derivatives market to reflect Japanese market prices on international markets is currently very limited. A clear conclusion of the survey is that there is a very strong desire to participate and increase transactions in the commodity market assuming that the problems related to entry into the Japanese commodity derivatives market are eliminated by a Comprehensive Market, with comprehensive international commission merchants (brokers) and market participants. This is expected to promote market liquidity and lead to a globally operating market offering services to a diverse clientele through Japanese and overseas networks.

One of the main differences between on-exchange commodity derivatives markets and physical markets is that, for the latter, the goal is to provide a stable supply/demand of the commodity, whereas the commodity derivatives markets are focused on managing market risk and counter-party risk, as well as the formation of fair market prices. There are two types of settlements available for transactions in the commodity futures markets: cash settlement through offset and physical settlement by delivery (except for index futures). Offset settlements account for most of the transactions in the futures market and create highly liquid markets, hence making it possible for the futures market to fulfill its core functions. Furthermore, although commodity futures markets are not originally designed for the purpose of making delivery of physical commodities, the physical delivery settlement function not only serves to manage inventory risk, but also increases risk management functions and price formation functions in the futures market by strengthening the linkage of prices between physical and futures markets.

Putting aside the specific historical background of Japan, commodity futures markets are ordinarily thought to be financial risk management markets as shown by the functions/objectives and type of trading they offer. In Europe and the United States, which have advanced derivatives markets, there is no independent “commodity futures industry.” The industry is positioned as a part of the financial services industry in the broad sense of the term, and operations are carried out under the regulatory environment for the unified derivatives market.

4. Japanese Commodity Derivatives Market from Viewpoint of Foreign Market Participants

(1) Historical Background of Market

The Japanese grain and precious metal futures markets were world-leading markets ranked in the top five globally in terms of trading volume in the mid-1990s. They accounted for 60 to 70 percent of the Japanese futures market trading volume including financials and securities. Even now, Japanese trading companies, foreign commercial players and institutional investors engaged in global operations continue to have needs for hedging transactions. However, many of these market participants and clients have moved from the Japanese market to foreign markets such as COMEX, NYMEX, CME and LME. Also, most transactions in which orders are issued by foreign commercial players and other investors in global markets by-pass the Japanese market and are concentrated in commodity market transactions in countries outside of Japan. Major market participants have already entered the Chinese markets or have been reported to be seeking to enter these markets.

In addition, based on the recent trend of managing the risk of these transactions during the Asian time zone, there is a possibility that these transactions may move to the Chinese market if there is an increased international dependence on, and globalization of, the Chinese market in the future. The time remaining for the Japanese market to become more internationally competitive is limited.

(2) Issues in Commodity Derivatives Markets

The problem currently faced in the Japanese commodity futures market is not a market slump caused by fundamentals such as supply and demand for commodities. It can better be explained as being caused by market inefficiencies. In the European and U.S. markets, transactions made by diverse market participants, including commission merchants with access to many international markets, creates effective market liquidity that forms the basis for the market to function. The trading efficiency of market users is higher than that in the Japanese market, enjoying lower trading costs in relation to trading opportunities.

Meanwhile, the Japanese commodity derivatives market has unique regulations and product designs aimed at public investors, driven by the continued existence of a market structure that is reliant upon public investors. This historic market structure sustains a market that has difficulty meeting the trading needs of large market users, including commercial players, or in other words – it is hard for non-public investors to use the current commodity market with such high transaction costs. Under these conditions, it is difficult for an internationally recognized and utilized Asian benchmark price to exist in the Japanese commodity market today. It is thought to be difficult for trading participants to form benchmark prices other than by diversifying the commodity derivatives market from its structure today.

(3) How the Comprehensive Market Could Bring Back the Lost Commodity Derivatives Market

Case Study of TOPIX Index

Prior to making TOPIX futures available on the OM platform, participants had to connect to the TDEX system to trade TOPIX futures. At that time many participants could not justify the additional infrastructure and control costs versus the reward of trading the TOPIX index product (in addition to trading the Nikkei 225 index product), and were concerned about the need for new system investments to access TOPIX.

As a result, the number of participants in the TOPIX market was lower than the number of participants in the Nikkei 225 market. After the migration of TOPIX to the OM platform, the number of participants trading on the TOPIX market increased, and the average annual volume increased as shown in the figures below. This was because participants could avoid the economic burden to participate in additional products because they could trade various products using a single platform.

Fig.1

Year	Total contracts TOPIX	TOPIX Mini	Platform	4-year average TOPIX	TOPIX mini
2010	14,451,751	1,044,343	TDEX	16,741,619	1,742,601
2011	14,608,165	621,569			
2012	15,192,439	2,148,039			
2013	22,714,121	3,156,452			
2014	20,877,250	4,743,111	OM	22,533,630	3,909,310
2015	22,303,956	4,314,181			
2016	22,560,705	2,955,098			
2017	24,392,610	3,624,850			

Further analyzing this example, the following changes to market participation were observed:

(a) Participants who previously did not access TDEX, but had historically invested strongly in OM trading infrastructure, used their sophisticated OM set up to trade TOPIX.

(b) Participants with access to the OM platform, who had lots of experience trading arbitrage of Nikkei large versus mini, and Nikkei OSE versus SGX, immediately started trading TOPIX large versus mini arbitrage and TPX versus JGB arbitrage. After the migration of TOPIX to OM, these arbitrage players immediately became 'top rank' in the TOPIX volume statistics.

(c) The participants connected to OM with abundant experience with the Nikkei index, TOPIX index and JGB markets, became increasingly active in trading on other markets listing these products.

(d) Due to the synergies created between the distribution channels of the OSE market and the TOPIX market, there was an acceleration and increase in trading by institutional investors, proprietary traders and public investors.

Additionally, smaller Japanese brokers, who had been hesitant about the capital investment to create new infrastructure, could enjoy the benefits of increased opportunities due to the growth of the market and because TOPIX trading costs were substantially reduced. Smaller Japanese brokers benefited from these synergies proportionately more than larger brokers in this respect.

(4) Does the TOPIX Case Study Apply to Commodities?

There are 117 securities brokers who are members of JPX. Of these JPX member brokers, only eight are also members of TOCOM, and 2/3 of these eight occupy a large portion of the total volume on the TOCOM markets today. The 109 brokers, including foreign brokers, who are not currently members of TOCOM could have access to commodity derivatives markets if they were available in a Comprehensive Market. According to the results of the FIAJ survey, large foreign brokers participating in JPX (OSE) in Japan with abundant experience and enormous international networks in foreign commodity derivatives markets are (1) brokers that do not participate in the Japanese commodity derivatives market at all at present, and/or (2) brokers for whom foreign subsidiaries within the same group perform commission business for commodities listed on foreign commodity exchanges for Japanese investors. These brokers have a great desire to participate and see more active trading in a derivatives market within an internationally focused Comprehensive Market in Japan.

Furthermore, FIAJ believes that of the 19 large foreign commission merchants currently active in Japan, the 16 that do not currently participate as commission merchants on the Japanese commodity derivatives market intend to consider participation assuming integration of the market and integration of the clearing organization, and that the number of participants in the Japanese market would increase rapidly.

Considering the above situation, although the contract specifications of products traded are different (between commodity products traded in Japan and the rest of the world), the synergies and growth experienced in the TOPIX market mentioned above could serve as a reference for the development of the commodity derivatives market.

See question A1 of the FIAJ survey on products.

(5) Elements Expected to Add to Market Expansion

The activities of the previously mentioned 19 foreign brokers and the major Japanese brokers not only include various and influential buy-side clients, such as Japanese and foreign financial institutions, insurance companies and hedge funds, as well as attracting their own clients' transactions to the Japanese market, but also include conducting global wholesale clearing operations for clients that are brokers (FCMs) subject to foreign regulations through *omnibus accounts*[2].

Omnibus accounts make it possible to provide services to foreign clients, such as foreign hedge funds and commercial players, which are difficult for Japanese commission merchants to directly access. Omnibus accounts create an organized network for the further expansion of commission operations with foreign brokers who are themselves unable to participate in the Comprehensive Market as clients of a licensed broker in Japan. Omnibus accounts are an important strategic factor for expanding inbound customer operations. These omnibus accounts are essential to a market network that has become established in global derivatives operations as a bridge connecting international markets. Furthermore, it is believed that this will increase access to foreign markets for Japanese commission merchants, foreign investors and domestic investors, and also accelerate outbound

[2] *Omnibus account: a common practice whereby an account is established and carried by one broker for another broker's multiple customers' transactions. In this case, customer transactions of a foreign broker regulated by their jurisdiction or their regulator would be carried in an omnibus account by a member of the Japanese market. This can help expand a global network connecting international markets for clearing transactions on behalf of clients in the Japanese commodity markets.*

transactions, including arbitrage transactions between Japanese and foreign markets.

Many online brokers in Japan and especially overseas offer a wide range of smaller-sized ("mini") financial products to their customers, but it is currently difficult to participate in the Japanese commodity derivatives market due to their budget constraints and their consideration of returns after the investments required for additional infrastructure and connectivity. New participants in the commodity derivatives market will be able to provide market access to these online brokers in Japan and overseas through omnibus accounts, as clearing transaction participants in the Comprehensive Market.

5. Monitoring between Commodity Derivatives Markets and Physical Markets -Relationship between Futures Market Regulatory Administration and Underlying Physical Market Industry Regulatory Administration

The difference between a futures market and its corresponding physical market is that the objective of futures market is price discovery and risk management and the objective of physical markets is the smooth supply and distribution of commodities. Both of these objectives are publicly managed by the government. The derivatives markets simply utilize high market liquidity to serve as a market that facilitates the physical (spot) market price fundamentals, which is aimed at smooth distribution and supply of a commodity. This is achieved by the futures market providing a fair and reliable market price discovery function for a certain period in the future, and by reducing and mitigating the risk of market price fluctuation. Therefore, it is important that the regulatory administration related to futures markets is effectively separated from physical market regulatory administration.

The management of the relationship between intermarket prices and the physical market is very important for the futures market regulatory administration, and the *gensaki* (repo) market prices inevitably fluctuate based on fundamentals reflecting the actual state of supply and demand of common commodities that are traded inter-market. Prices in futures markets are determined for a certain period in the future based on physical/spot prices by reflecting charges such as warehousing, insurance, transportation and interest, considering that the physical delivery will take place at a certain time in the future. Additionally, supply and demand factors unique to specific commodities, including the market price of similar/substitute commodities and seasonal supply and demand, also have an influence.

As a result, the settlement price in the futures market is similar to the physical or benchmark price. Providing these market functions enables the realization of the economic functions of a sound futures market since the futures price is closely linked to the physical market price, thanks to high market liquidity that does not exist in the physical market.

Because the contract months structure of futures market provides an economic function linking prices through different time horizons, considering the cost of carry between the physical price versus each contract month price, the liquidity of market transactions between different contract months provides an important economic function for the futures market (calendar spreads). This factor uses benchmarks and indexes based on physical trading prices of the underlying products, even for cash settled futures transactions that do not involve physical delivery. However, if the trading volume (or market liquidity) in the nearby month is low in the futures market, it is also difficult to execute hedge transactions of international commodities and arbitrage transactions between international markets. It is believed that the absence of front month liquidity in the Japanese commodity markets is an important factor leading to the withdrawal of risk managers, investment management and other market participants/customers from the Japanese commodity market historically.

This situation of low liquidity in the front months is thought to be created by the market and product design present in the Japanese commodity market:
(1) where smooth physical delivery settlement is difficult for domestic and foreign market participants, despite being a physical futures market, and…
(2) where there is a tendency for commercial players or hedgers to focus their trading on either the sell side or the buy side, and…
(3) in cases where excessive regulations are introduced for nearby-month market transactions, based on policies to protect investors and market functions resulting from a heavy reliance on speculative trading by the general public.
<u>Looking at commodity futures market price fluctuation factors, although fluctuation of the physical market has a significant impact on the futures market based on the supply and demand relationship in physical price market, the impact of the futures market on the physical market is thought to be limited to internal factors (i.e: technical impact).</u>

Under the established futures market management system, abnormal fluctuations in the market price are thought to be corrected in a short period based on the principles of the market economy. Therefore, it is very important for futures market regulatory organizations to monitor the connection between physical and futures market prices in conjunction with physical market regulatory organizations. Those organizations should focus on preventing and addressing inappropriate market actions, such as price manipulation in both the physical and futures markets. They should create a system capable of maintaining smooth and orderly price formation and securing a secondary market in the physical and future markets. In addition, it is vital to design and build an adequate system of cooperation and collaboration between the supervisory organizations.

Although this document proposes the unification of regulation and supervision of the futures market in a single market regulation and management organization regardless of the type of instrument listed, we believe it is important to have sufficient information exchanges and sharing of problems with relevant regulatory authorities including the physical market management organization, and to prevent abnormal price fluctuations due to inappropriate activities in both markets.

Reference examples such as the cooperative system and operations between U.S. federal regulatory authorities are attached to this section. Please refer to the below websites for detailed information on and examples of cooperative systems

https://www.cftc.gov/sites/default/files/2018-09/aac_charter092118.pdf
https://www.cftc.gov/About/CFTCCommittees/AgriculturalAdvisory/aac_members
https://www.cftc.gov/About/CFTCCommittees/AgriculturalAdvisory/aac_meetings.html
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https://www.cftc.gov/About/CFTCCommittees/CFTC-SECJointAdvisoryCommittee/index.htm

6. Clearing Organization

A stable clearing environment guarantees the performance of transactions between market participants by having the clearing organization participate as a party to clearing transactions in-between parties who trade in the market. A clearing organization also isolates credit risk related to the claims and liabilities arising between parties, and so

guarantees the performance of transactions.
Further, in Japanese clearing organization structures, a clearing organization strengthens the preservation of client assets with a custodian function that segregates client assets from trustee assets. In addition, a clearing organization prevents the paralysis of clearing functions in excessive or unexpected market changes, ensures there are various security deposits and mechanisms for securing transactions, and provides a management system and financial base for maintaining smooth and orderly market functions.
However, there is a global trend of the financial base of clearing organizations being unable to keep pace with the rapid expansion of volume and associated risk of derivatives market transactions, and it has been indicated that the financial base of many clearing organizations needs to be further strengthened to ensure the security of the market.
For risk management as a clearing organization, the diversification of cleared commodities into a larger Comprehensive Market will regulate market price fluctuations arising from the uniqueness of commodities and synergies within the portfolios of clearing participants, effectively diversifying market risk as a clearing organization. Furthermore, clearing participants have high expectations for the application of consistent margin methodologies by a single organization, in addition to clearing transactions netting products according to portfolio risk.

In the FIAJ survey, it was found that concerns about the financial base of participants (i.e: broker members as well as exchanges and clearing houses) and the related risk management functions of exchanges and clearing organizations is a major factor in the historic limited participation of major domestic and foreign financial institutions, brokers and trading companies, etc. in the Japanese commodities market. In a Comprehensive Market, diverse clearing participants with a stronger financial base, also thanks to more participants, and a single integrated clearing organization are essential for the expansion and development of commodity derivatives in Japan.

According to survey participants from overseas, having to provide funds to multiple clearing organizations within a single country is an additional cost of funding. Many major banks operating globally are currently members of the Japan Securities Clearing Corporation and will participate in the Japanese commodity market if it is possible to settle commodities at the Japan Securities Clearing Corporation.
Furthermore, in relation to assuming final liability in the event that the clearing organization becomes insolvent (or in a financial crisis), firms are hesitant to participate in a commodity market and clearing organization with a weak financial base, and that currently has a

potential for "unlimited liability" for the member firms. This is a concern for clearing participants and also an obstacle for new entrants, and appropriate action is expected to be taken if commodities are included in the clearing organization related to the Comprehensive Market in the future.

In this survey, it was found that clearing in a single clearing organization is essential for the development of a Comprehensive Market. Diversification of market participants including major commission merchants, major commercial players, investment management firms and high-speed traders is believed to create synergies between varied market transactions and form the basis for new market development and growth.

See question 2 of the FIAJ survey on clearing house and depository.

7. Impact on Japanese and Overseas Markets

Systems and Technologies

When considering a Comprehensive Market, the impact on transactions and clearing systems must be discussed. One of the advantages of a Comprehensive Market is the simplification of a complicated environment requiring multiple system APIs to connect to multiple markets. At present, the development and maintenance costs for multiple network infrastructures, exchange systems and clearing systems, as well as high risk levels, are reflected in high transaction costs. Furthermore, the implementation of a global-standard system and the reduction of systems for connectivity has a significant effect on minimizing the number of required contact points for entry by new market participants. A simplified environment does not simply reduce maintenance expenses, but also facilitates the development of high-quality systems because it provides a harmonious development and testing environment. This leads to the reduction of risk and costs for the market as a whole. This increases responsiveness to environmental changes in the financial market and promotes further confidence in the market because it makes BCP and system restoration easier in case of system failure or when a disaster occurs.

A simplified trading and clearing system is a great convenience brought about by the concept of a Comprehensive Market. This convenience provides benefits greater than the initial cost of changing from multiple to single systems and operations related to the transition to a Comprehensive Market.

However, a simplified system also entails risk. Risk management and governance related to risks, such as a wider scope of impact of system failures and cyberattacks targeting a single system, will clearly be called into question. Design and operational procedures planned to deliver higher standards are required. It will also be necessary to secure the personnel and budget required to ensure success.

8. Organization of the Comprehensive Exchange and Listed Commodities

FIAJ has determined that it is not appropriate to make detailed comments on the integration of specific exchanges when creating the Comprehensive Market currently being considered. However, FIAJ believes it is important for the Comprehensive Market to be organized based on a clear understanding of the operations engaged in by new and existing commodity market participants and operators, and to focus on commodity products and market design that will contribute to the development of the market. Considering the enormous work, time and cost required for exchanges to apply for the listing of new contracts, it is preferable to list as many commodity products as possible on the Comprehensive Market from the start. When doing so, the relevant personnel should act with consideration to the specifications of listed commodities and their relative importance, by sufficiently taking into account past accomplishments, industry needs and potential for future expansion, but without being constrained by any low volume of some products at the present time.

The probability of a newly established futures contracts starting with a basic volume from launch is extremely low compared to the number of established contracts, and requires much time and efforts to grow the volume of such new contracts. In the history of the industry in the United States, until the CFTC was founded in 1976 whereupon a separate and independent futures trading regulatory environment was established, U.S. commodity futures exchanges were in a regulatory environment limited to agricultural commodities such as grains produced in the U.S. Since 1976, the definition of regulated commodities has been significantly expanded, and financial and securities futures have been listed. The relevance of this is that, it was not only the provision of additional market functions to financial markets and the diversification of market participants and clients that encouraged the stable growth of market liquidity. But it was also the aspect of improving the earnings of exchanges and market participants by attracting additional participants from the finance and securities industries that encouraged the stable growth of market liquidity.

In other words, the U.S. market environment limited to agricultural commodities had an unstable earnings structure in which the market conditions of limited commodities greatly affected the earnings of exchanges and market participants. It has been said that the people involved at that time worked to diversify listed commodities by adding commodities with different price volatilities than existing commodities, in order to generate stable earnings for exchanges and commission merchants. This in turn encouraged the development of exchanges and related business operators. As a result, the exchange futures market transformed into a futures market structure spanning from commodities to financial (fixed income and securities) markets. The fact that this later led to rapid development of the exchange market is clear from the examples seen in the United States, the United Kingdom and other markets. Although we live in a different time and market environment, the above example provides a point of reference for the Comprehensive Market vision. Another example within Japan that should be mentioned for reference is the Tokyo corn and soybeans futures market on the Tokyo Grain Exchange. In 1996-1997 (prior to electronic trading), with trading volume of more than 26 million lots, this market had the second largest volume of agricultural commodities in the world, only behind the Chicago Board of Trade (CBOT). It was frequently used by Japanese and foreign trading companies and commercial players, while CBOT was seeking partnerships in grain markets in the East and the West. However, trading subsequently declined sharply not simply due to regulatory problems, such as regulation of domestic market listing international commodities, but also due to market and membership structural problems and problems with product design, such as contract specifications being outdated and not updated.

<u>When listing commodities on a Comprehensive Market, it is important to perform product design and market design based on an understanding of a wide range of market participants, and also vital to provide education to participants for the development of the market domestically and overseas.</u>

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