



*FUTURES INDUSTRY ASSOCIATION  
JAPAN CHAPTER*

**FIA-Japan**

**Report on  
Commodity Clearinghouse:  
Urgent Action**

February 9, 2009

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## *FIA-Japan*

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### **Background**

During the past year, FIA-Japan issued a series of reports with our specific recommendations for improving the clearinghouse function for the Japan commodity industry. As stated in these reports, it is critical to the success or failure of the Japan commodities industry to immediately address the need for a financially sound and reliable clearinghouse function for market users. We have urged the Regulators to address the financial, the management and the risk control inadequacies with an action plan, and to seriously consider joint venture or outsourcing alternatives.

During our meetings with Regulators and others, we have stated our view that the current plans to deal with the clearinghouse issue are “*inadequate*”. Following these discussions, we were asked by METI to recommend an *Action Plan* on how to proceed to deal with this critical issue, giving consideration to the current financial crisis among members of the industry, including the exchanges. We have prepared this Report in response to that request.

Recent global financial turmoil has reconfirmed the essential need for the Clearinghouse and its vital economic function providing transparency and counter party risk management. Although action was announced this past year to improve the clearinghouse, it is not enough to cope with the current situation. We believe that the regulators and industry leaders should act now. It is highly unlikely to see the successful development of the exchange traded markets without significant redevelopment of the clearinghouse function in Japan. Bold action is needed now.

### **Issues Are Interrelated**

In our prior reports we set forth the most important issues in the following categories:

- Financial – Clearinghouse Capital and Guarantee Fund

[1]

- Risk Management
- IT Requirements
- Management Experience and Corporate Governance
- Business Plan

In fact, these issues are all interrelated. It is not possible to deal with any one issue without dealing with the other issues. For example, the IT requirements cannot be met without addressing the financial requirements. There is a fundamental need for capital to provide the required financial guarantee to market users, but also, it is impossible to obtain the IT systems without capital. Similarly, capital is required to develop the risk management system and to attract an appropriate management team. It is well recognized that the members of the commodity futures industry are struggling with their own financial problems and cannot provide the required capital. Therefore, it is necessary to seek capital from other investors, but no one will invest money without there being a sound and reasonable business plan and an appropriate management team to execute the plan. Investors would also demand that there be an adequate risk management structure to protect the clearinghouse as well as its members.

It would be very difficult to expect the existing clearinghouse to deal with the changes that we believe are required, due to its existing structure and the current financial status of the commodities futures industry in Japan.

### **“Silo” Structure in Japan**

It must be recognized that the current “silo” structure in the financial and futures industry in Japan represents a serious problem in attempting to expand the industry from within Japan as well as to attract international users. Users demand a structure that is efficient and practical for doing business or they chose other international markets for their needs and use. That is clearly the current situation. The separation between securities and commodities businesses has disappeared in other major international markets.

In the European and North American futures exchanges, the majority of clearing members are financial institutions. In Japan, financial institutions are directly involved in the financial exchanges but are not involved in our commodity markets. Finding a way involve them would help to increase liquidity and safety of our commodity markets. This would be an important and fundamental value for users of the markets, including industrial users.

Currently, in Japan we have separate clearinghouses for securities, financials and commodities with each major exchange providing a separate clearing function. However, internationally, it is recognized that users need and demand a way to better manage their clearing funds and margin money, as well as to have transparency and to be able to measure the risk between each clearing participant as well as its offsetting positions and arbitrage. This cannot be done in the current Japan market structure. We believe that action to develop a solution to the clearinghouse problem in the commodities industry should include consideration of ways in breaking down the existing “silos”. This is what the market users need and want. This is discussed further in the latter part of this report.

We need to have a “user driven” solution to creation of a successful clearinghouse as well as a successful commodity market in Japan. This means we must not only consider, but to directly involve users in developing the action plan. They need to be part of the solution.

### **Action and Solution**

The following Action Steps must be implemented immediately. Tocom’s new system will be in place in a few months. Its major investment of capital and resources will be wasted if the absence of a secure and adequate clearinghouse keeps potential new members from using Tocom’s market. Time is critical to fulfill the promise of Tocom’s success. It will of course take substantial time to fully establish a global class clearinghouse, thus the project must be planned and an organization in place and underway to demonstrate credibility. The Japan commodity industry is at risk!

#### **I. Establish the Clearinghouse Under TOCOM**

Tocom is the largest commodity exchange in Japan. It is now implementing action to become a global exchange and to attract not only major domestic commercial users but also the international players. It is the only institution in this industry with a substantial amount of capital. We should use the capital base of Tocom as a foundation for the commodity clearinghouse in Japan. This can be done either as a subsidiary or as a division within the exchange. The existing clearinghouse has virtually no capital, and an inability to raise capital in the current circumstances, particularly as it is structurally unable to become profitable in the near term.

We recognize that if TOCOM were to take on the burden of creating and operating the clearinghouse, it will put its own capital at risk. This will be an important consideration for TOCOM to consider before they could agree to this action.

JCCH currently provides clearing services not only for TOCOM but for all of the commodity markets in Japan. Certainly any clearing solution will need to assure that the other commodity markets are provided with a continuity of common clearing services. This is contemplated in the Action Steps outlined below.

## II. Identify Outside Expert Consultant

It is generally accepted that it is necessary to bring in outside systems and consulting in developing an institution or major function like a clearinghouse. This is universally done by exchanges around the world. For example it was done by Tocom in implementing its new trading system. Even if another international exchange is engaged to help or participate in some way as discussed below, a consultant should be identified to work with the exchange in providing advice and expertise and knowledge of international standards and best practices. The consultant's expertise and experience should include systems, risk management, structure, financial and the expectations of global players. FIA-Japan could help to recommend such consultants if you wish.

In addition, discussions with outside international clearinghouses should be held in the initial stages and considerations given to alternative development or outsourcing or joint venture. Joint venture does not necessarily mean financial ownership for example. The expert consultant should assist in this step.

## III. Establish "Working Party" to Execute Action Required

A Working Party should be appointed under Tocom to support the decision making and to provide leadership in establishing the clearinghouse. This is not meant to be a "study group". This is an "action group". The Working Party should consist of a small group of senior experienced managers and we would expect that half of the members of the Working Party would be "market users". A suggested model for the Working Party participants is as follows:

### Working Party Members

Chairman –	Japanese strong leader
Tocom –	Senior operating/international management
User –	International FCM
User –	Trading firm
User –	End user of commodity (i.e. Energy company)
User –	Japanese FCM
Financial Exchange reps.	Financial/Securities Exchanges in Japan

Advisory:

Outside Consultant  
International Clearinghouse

The role of the Chairman is important for the success of the project. He should be someone with international experience who can operate independently from political industry pressures.

Regarding the representation from the Financial/Securities Exchange “silo”, as discussed above, this represents the opportunity to explore cooperation between the financial sector and the commodity sector. Efforts should be made to eliminate these artificial barriers in order to enhance the overall financial marketplace. The financial exchanges have existing clearinghouses within their exchange organizations. These clearinghouses are more advanced than the commodity industry although it is recognized that they are not at the level of clearinghouse global best practices. Nevertheless, working together to help meet user requirement will benefit the entire Japan financial marketplace. This can become the start of a “common clearing” initiative through any one of alternative models in use in the global markets today.

#### **IV. Working Party Action Steps**

The Working Party will be given a mandate with a timetable for completing the various action steps as outlined below. There should be a stated completion date for each step and objective. The Working Party will need to be supported by legal and operational assistants for each of the steps.

Following is the Working Party Action Program:

- ✚ As an initial step - search, coordinate and arrange outside professional advisers, including a foreign clearinghouse, to provide assistance as consultants to the Working Party.
- ✚ Define detailed corporate structure of the clearinghouse as a part of Tocom. In setting up the structure, there should be consideration of the requirements for having (1) adequate capital, (2) appropriate corporate governance and, if possible, (3) financial exchange involvement and “common clearing” aspects.
- ✚ Outline the Risk Control functionality for the system requirements and IT.
- ✚ Determine margining methodology
- ✚ Identify an IT system to acquire or outsource
- ✚ Consider and conclude on Risk Control Outsourcing or in-house

- ✚ Determine Corporate Capital requirements  
This determination should indicate a schedule of capital requirements based on expected volumes and growth of business and anticipated outsourcing strategies. Requirements for short-term - first two years, mid-term - next three years and following two years should be estimated.
- ✚ Determine Guarantee Fund Requirements and methodology for measuring the growth of required amount.
- ✚ Determine source and form of capital – outside investors  
This must be coordinated with the structure of the clearinghouse – inside of Tocom or as a separate subsidiary. It must also be coordinated with plan for involvement of other exchanges or clearinghouses as noted above.
- ✚ Determine Clearing member capital requirements and methodology for measuring capital requirements.
- ✚ Develop Outline of Business Plan – “For-Profit” model  
This is to be based on assumptions of volumes and international use the markets.
- ✚ Corporate Governance Model  
Using best practices internationally, define the corporate governance structure including the independence requirement over compliance and fiduciary obligations and examination.
- ✚ Define senior management requirements with specific criteria for experience and expertise.
- ✚ Determine legal and regulatory change requirements.
- ✚ Review opportunities for OTC clearing and build into plans for operations, capital, and the other steps indicated above.
- ✚ Prepare a proposed plan for continuation of the clearing services for the other Japanese commodity exchanges on a common clearing basis.
- ✚ Establish a work plan covering the above and the timetable and publish this in the form of a report for use in marketing the Japan commodity industry.

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We look forward to meeting and discussing this Report on Urgent Action with interested parties.

February 9, 2009

Respectfully yours,

Mitch Fulscher, Chairman  
FIA-Japan