

[ENGLISH TRANSLATION OF THE ORIGINAL JAPANESE TEXT]

From:

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To:

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CC :

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Director Tobe

Re: **Request for Fee Exemption for Non-beneficiaries**

December 1, 2016

Futures Industry Association Japan (FIA Japan or FIAJ) was established in 1988 as the Japan chapter of Futures Industry Association (FIA) based in Washington DC, and was reorganized as an Ippan Shadan Hojin or an independent General Incorporated Association in 2010. FIAJ has about 60 members that include domestic and foreign exchanges and clearinghouses, financial institutions, futures commission merchants, proprietary trading houses, international law firms, information and software vendor firms. In October 2016, FIAJ signed a formal affiliation agreement with FIA, which was reorganized in January this year in order to promote the development of global markets through the expansion of derivatives markets with central counterparty clearing, while FIAJ's stated mission is to help grow the Japanese markets into a core marketplace in Asia. FIA, established in 1955 in the US, regroups members from 48 countries and 15,000 professionals representing the cleared derivatives industry. Its members are estimated to manage 85% of customers' trades in the US, and represent a significant share of the major markets in the world.

#### **About the Membership Fees of the National Futures Protection Fund**

FIAJ wishes to raise the following issues in regards to the transaction fees paid to the National Futures Protection Fund (hereinafter 'Fund'). Customers' assets, such as margins, are deposited with the Japan Commodity Clearing House (JCCH) by the commodity futures commission merchants. This is in compliance with segregation measures imposed by the Fund. In addition, the Fund mandates that a transaction fee is paid to the Fund (collected by the exchange on all trades) which is used to create a retail customer protection scheme, where by up to 10 million yen per retail customer assets are protected in case of an FCM failure. This is the so-called "payoff system" in case JCCH is unable to pay off the obligation to the customer.

This payoff system is however limited to retail customers who are qualified to receive the payment (Hereinafter referred to as 'beneficial customers'), but FCMs must pay the Fund's contract fee on each lot for all transactions, including their own proprietary transactions, or transactions from foreign FCMs, commodity trading advisors, domestic and foreign institutions, commercials, and other institutional investors (Hereinafter referred to as 'non-beneficial persons') that are not qualified to receive the compensation.

Foreign participants and institutional investors feel that the fee charged to them is unfair. Under these circumstances, FIAJ suggests that the Fund exempts the contract fee for transactions made by non-beneficial persons including prop traders of FCMs and non-beneficial customers in consideration of the fairness of the compensation scheme.

### **Recent Trends of Trade Participants in Domestic Commodity Markets**

Internationally-traded commodities including precious metals and energy became actively traded in early 2016, but the TOCOM volume trend has been decreasing in the second half of the year when compared with the same period last year. On the other hand, due to the easing of monetary policy by the Bank of Japan, some investment funds shifted into commodities, helping the Dubai Crude Oil and Tokyo Spot Gold contracts to increase in terms of open interest in the markets. Institutional investors and commercial hedgers in Japan, however, rely heavily on overseas markets and are likely to trade there in the future.

Under such market environment, the market share from foreign customers continues to increase on TOCOM, trading more than half of the volume in 2016 (based on figures from January to August), and their participation is essential to contributing to market liquidity. Foreign FCMs and prop trading houses in particular, who are expected to diversify their businesses into Asia and implement arbitrage trades with international markets, could potentially increase their business interests in local markets. That said, they seek better market environments in terms of reliability and liquidity along with transparency, so the competition has intensified among international exchanges that list identical commodity contracts. In particular, market users carefully evaluate trading costs based on “cost-plus” transparent pricing models so global exchanges face further competition.

Non-beneficial persons, i.e. domestic institutions and the prop trading of member firms as well as foreign customers, represent 70 percent of the volume in the commodity markets in Japan. On the other hand, volume from domestic retail investors has slowly been reducing to represent less than 30 percent. While it is necessary to grow the retail business interests, it is more important to provide an efficient and transparent market environment for potential foreign customers, commercials and financial institutions in order to gain competitiveness in the global markets, which should be an important theme to be shared by both the public and private sectors.

### **Beneficial Customers Qualified for Payment of Claimable Assets**

Beneficial customers who are qualified for payoff (i.e: the payment of claimable assets in the limit of 10 million yen per customer) are 'general (retail) customers' as prescribed in the Commodity Derivatives Act (Hereinafter referred to as 'the Act'), Article 269, Section 1. Non-beneficial persons (including prop trading by the FCMs, qualified institutional investors as stipulated in Article 2, Paragraph 3, Item 1 of the Financial Instruments and Exchange Act, Commodity Trading Advisors as stipulated in Article 2, Paragraph 4 of the Financial Instruments and Exchange Act with regards to the Regulation of Business concerning Commodities Investment, and any person equivalent to the items mentioned above under foreign legislations) or so-called professional investors, who represent 70 percent of TOCOM volume, are not qualified to receive the payments for claimable assets (Act, Article 306).

FCMs, who are required to join as members of the Fund, pay a contract fee per lot for all transactions regardless of who trades in addition to a fixed annual fee to the Fund. The contract fee per lot is charged back to customers as a transaction cost. Non-beneficial persons including foreign customers expressed their views that it is not fair for the contract fee to be charged to them, as it is to retail customers, because they are not qualified to receive the payment for compensation.

### **Comparison of Segregation Systems of Customers' Assets in Japan and Overseas**

In Japan, even though all margin money received from customers is deposited with JCCH through FCMs, customers' assets may not be returned in the event that an FCM goes bankrupt or into financial difficulties during that short period before the FCM transfer the funds to JCCH. This is why the Fund implements segregation agreements with FCMs in order to be able to reimburse the customer in such cases. The compensation amount claimed by the customers comes from money reserved separately for the purpose of customer protection. The Fund payoff compensation is an additional measure taken for customers' protection apart from when customers' margin money is deposited with JCCH and segregated. However, a payoff has never been triggered since 2005 when the Fund was established.

In the US and other foreign markets, FCMs can only deposit or withdraw customers'

money through Regulated Customer's Segregated Accounts within a bank regulated similarly than under the CFTC rules. The customer's assets are then deposited by the FCM with a clearinghouse and are maintained as segregated funds. The transfers of customer money from receipt to return are all undertaken through Regulated Customer Segregated Accounts so that customers have the right to receive the money of the segregated account prior to other creditors. Therefore, as long as the FCM is in compliance with the segregation requirements, the segregated customer assets are protected even if the FCM goes bankrupt. Financial institutions and professional investors control counterparty risk with FCMs by setting limits on the amount of money or on the number of open positions for each FCM. Customers' funds and market functions are secured in principle through the functions of the clearing organization and the segregation of customers' funds by FCM. In Japan, there is no need to have such segregation agreement thanks to the similar measures implemented by the Fund.

### **Corresponding Japan Investor Protection Fund**

In the security industry, the Japan Investor Protection Fund (Hereinafter referred to as 'JIPF') was established under the Financial Instruments and Exchange Act for the purpose of protection of investors. Under this law, security companies are required to control customers' money, shares, bond separately from their own assets. JIPF reimburses customers and compensates them up to 10 million yen per customer in the event that customers' money and assets cannot be returned because of the bankruptcy or financial difficulties of a securities company. The compensation is made for customers' money and other assets deposited for the purpose of trading securities, bonds, mutual funds, and derivatives listed on domestic markets.

JIPF (252 members at the end of March in 2016) set the amount of funds for investors' protection at 50 billion yen under the provisions of its Regulations of Business. When the balance of the fund is less than 50 billion yen, the member companies are required to pay for a part of the "basic calculation amount" of 5 billion yen per year, to be shared between the members based on the computations (A), (B), and (C) listed below. (Note: as of the end of fiscal year 2015, the fund amounted to 56.8 billion yen. Since the fund has been kept over 50 billion yen since 2003, no further payments have been required since then)

(A) The amount derived by dividing a sum equal to 20% of the basic calculation amount by the number of members,

- (B) The amount derived by multiplying a sum equal to 40% of the basic calculation amount by the ratio of each member's operating revenue to the total of all members,
- (C) The amount derived by multiplying a sum equal to 40% of the basic calculation amount by the ratio that is obtained by dividing the amount of customer assets eligible for compensation of each member by the total amount of the customer assets eligible for compensation of all members.

In (C), customer assets eligible for compensation exclude the assets of professional investors such as banks, securities, insurance companies, country, local public offices, and qualified institutional investors, and for transactions made by such investors as they are not required to pay for JIPF fees.

### **Conclusions**

- We hereby submit for consideration that non-beneficial persons' transactions should be exempted from the contract fee of the National Futures Protection Fund due to the unfairness of the payoff compensation system, since it is only available to general (retail) customers.
- In consideration of the actual situation of TOCOM market participants, we believe that there is a need for continuous discussion and consideration of the customers' fund segregation system in Japan and the functions of the Fund, for the purpose of promoting market growth in Japan.