



## **REPORT**

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**“Revision of the Commercial Law of the Socialist Republic of  
Viet Nam”**

**May 2014**

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**COMMODITY EXCHANGES**  
**IN**  
**THE SOCIALIST REPUBLIC OF VIET NAM**

**A REVIEW OF ARTICLES 63 - 73 OF THE COMMERCIAL LAW  
AND OF APPLICABLE REGULATIONS IN Viet Nam  
AND A DISCUSSION OF THE REGULATION AND FUNCTIONING  
OF COMMODITY EXCHANGES IN SELECTED COUNTRIES**

**EUROPEAN TRADE AND INVESTMENT SUPPORT PROJECT  
(EU - MUTRAP)**

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# **Regulation of Commodity Exchanges in the Socialist Republic of Viet nam**

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## **I Main Outputs required by Terms of Reference**

### **1. Relevant outputs according to the ToR, para 4**

- a) Report/research on the regulations of commodity exchange in Viet Nam, focused in particular on i) the mechanism to settling disputes through the commodity exchange, ii) the type of transactions which can be carried out through the commodity exchange. The research will provide the best international practices of the above mentioned topics (including organization and management of exchange commodities in foreign countries). Recommendations on how to reform the system in Viet Nam will also be provided
- b) A report on the present legislation in Viet Nam on commodity exchange. The report will provide an overview of the best practices in selected countries (e.g. Canada, Thailand, Singapore, India). The report will also illustrate the present situation of commodity exchange members in Viet Nam, the analysis of the conditions to become member of a commodity exchange and a comparative analysis with the legislation of selected countries.

### **2. Tasks of PMU expert 5 (in cooperation with PMU expert 6 and DMI expert 2)**

- a) Review the legal system governing transactions through commodity exchange in Viet Nam. In particular the expert shall analyse the following topics:
  - Current regulation in Viet Nam, assessment of conformity with the practice;
  - Analysis of the basic content of the laws of some countries regulate on transaction through commodity exchange (Canada, Singapore, Thailand, India)

Compare regulation with some countries.

- b) Comparative analysis of the statistics in Viet Nam regarding transactions through commodity exchanges compared to selected other countries

### **3. Tasks of PMU expert 6 (in cooperation with PMU expert 5 and DMI expert 2)**

Research focused on identifying the different type of members of commodity exchange, membership conditions, the tasks and obligations of Viet Nam members of commodity exchanges and best practices of selected foreign commodity exchange. In particular the analysis shall be focused on the commodity exchange in Viet Nam and in Malaysia, Thailand, India, the UK and the USA.

### **4. The task of DMI expert 2 according to the ToR, para 4**

Report/research on the regulation of commodity exchange in Viet Nam, focused on the following topics:

- a) Dispute resolution mechanism on transaction through commodity exchange
  - Responsibilities of the commodity exchange on dispute resolution

- Different types of dispute that may arise on transaction through commodity exchange;
  - Presence and features of dispute settlement body;
  - The role and the responsibility of the commodity exchange in settling disputes
- b)** Main subjects involved and main regulations of foreign commodity exchange, with a particular focus on
- The function of foreign commodity exchange for Vietnamese subjects
  - Will a foreign commodity exchange in Viet Nam be useful?
  - Problems, costs, and methods of implementation;
  - Relevant regulations and agency management
  - Best international practices in terms of eligible subjects and trading condition transaction

During the kick-off meeting of 25 February 2014, Mr Pham Dinh Thuong, Deputy Director-General of the legal department of the Ministry of Industry and Trade (MOIT) said that dispute settlement was not the most important issue.

During a meeting held on 10 March 2014, the deputy-general of the legal department of MOIT mentioned that only futures with commodities as underlying asset are the subject of this study, and futures with securities as underlying assets are not. Accordingly the latter will not be discussed in the report.

## II Executive Summary

5. The Report starts in Chapter III with a description of the history and characteristics of commodity forward and futures transactions. Following basic forward transactions with physical delivery to avoid price and delivery risks in the 19<sup>th</sup> century, markets for forward transactions started to develop. Further growth of markets required liquidity (a sufficient number of transactions) and standardisation of contracts. A further step was that parties did not enter into forward transactions to achieve physical delivery but to benefit from a difference between the agreed forward price and the market price at the time of delivery or the price of another forward contract. The parties to the transactions came to include hedgers and speculators. In addition to standardised futures contracts, options were traded as well. Also the scope of the underlying commodities of the contracts expanded, from agricultural commodities and livestock to metals (including gold and silver), minerals, and to currencies and securities.

The organised exchanges require margin from their members, and the members require margin from their clients. Exchanges also provide for clearing and settlement to ensure payment (and delivery, if applicable). Following a short description of the parties to commodity transactions (traders, dealers, brokers, clearing members), international markets, trade finance and dispute settlement, paragraph 18 of the Report describes conditions for viable commodity trade and exchanges, including legal matters (such as clear rules regarding ownership, transfer of obligations, security rights, warehouse receipts and dispute settlement) and practical matters (such as the choice of commodities, size of standard contracts, liquidity, infrastructure, IT, risk management system, separate clearing house, warehousing and quality control). In separate blocs, detailed comments are added on warehouse receipts (see also **Annex 1**) and the choice of commodities underlying successful derivatives.

Chapter IV describes the relevant authorities and legislation in Viet Nam regarding forward and futures trade.

The relevant authority for commodity based forward and futures trades and exchanges is the Ministry of Industry and Trade (MOIT). Rules governing commodity based derivatives and commodity exchanges are found in the Commercial Law 2005 articles 63-73, Decree 158/2001 MOIT and Circular 03/2009 MOIT. Comments on these documents are included in **Annex 2** to this Report.

A different regime applies to futures with securities (shares, bonds etc.) as underlying assets: the relevant authorities are the Ministry of Finance and the State Securities Commission and the governing rules are found in the Securities Law and regulations issued thereunder. As securities based and financial derivatives were specifically excluded from the scope of this Report, this category of transactions is not described in the Report but a summary is included in **Annex 3**.

If in the future rules regarding commodity based derivatives are developed, it should be discussed how the supervisory/regulatory authority and the applicable rules of commodity and financially based derivatives will relate to each other.

The third relevant authority is the State Bank of Viet Nam which bases its authority to regulate certain crossborder transactions on Article 107 of the Law on credit institutions. Through Official Letter 1229, the State Bank has set out rules that commercial banks must comply with when they act as middlemen in commodity swap transactions between domestic clients and foreign banks.

It is important to note that the State Bank and the rules promulgated by it play a significant role whenever a transaction has a crossborder aspect. Comments on rules of two other countries (Malaysia and the Netherlands) applicable to participation by national institutions in foreign commodity exchanges and the operation of foreign exchanges in the home country are made in paragraph 21.

Chapter V discusses several commodities that are grown in Viet Nam and may be used for derivatives transactions: coffee, rice, cashews, pepper, rubber and tea. The relevant commodities exchanges seem the Viet Nam Commodity Exchange (VNX) and Info Comex of Ocean Group. Reference is made to the summary and conclusions of paragraph 26.

The history, relevant authorities and applicable laws and regulations of seven countries are described in Chapter VI.

An interesting feature of Canada is that some provinces have enacted comprehensive Securities Acts governing exchanges for and trade in securities and in commodity- and securities-based derivatives while other provinces have specific Commodity Futures Acts governing commodity futures only.

The Ethiopia Commodity Exchange (ECX), even though in principle a spot exchange, is an interesting example of how necessary elements of a commodity market, including law and regulations, IT and physical infrastructure can be developed in a relatively short time. ECX warrants further attention.

India offers a large number of commodity exchanges, all subject to one Forward Contracts Regulation Act and one Forward Markets Commission. While it could be said that these features are similar to the current situation in Viet Nam (one set of rules for commodity futures transactions and several exchanges), the sheer size of India, the history of commodity transactions and the number and trading volume of relevant commodities make it difficult to use India as an example.

Malaysia and Thailand show contrasting approaches.

Malaysia moved from a rather fragmented approach (with separate Acts for, e.g. securities and derivatives) to one comprehensive Act covering the whole financial sector, and from two regulators to one Securities Commission. Moreover, following the Asian crisis the four existing exchanges were consolidated into one exchange holding company which operates several exchanges, including Bursa Malaysia Derivatives and a dedicated clearing house. Hereby brokers and other parties no longer had to have (costly) memberships of several exchanges and were no longer subject to different (audit and other) requirements of different regulators and to too many reporting lines. It is interesting to note that the Bursa Malaysia Derivatives has entered into a joint venture with CME.

Thailand offers a different picture: derivatives based on agricultural commodities have their own regulation, the Agricultural Futures Trading Act and rules issued thereunder, a separate Agricultural Futures Trading Commission and Agricultural Futures Exchange (AFET). Non-agricultural derivatives are traded on the Thailand Futures Exchange (TFEX), a subsidiary of the Stock Exchange of Thailand, governed by the Derivatives Act and supervised by the Securities and Exchange Commission. This structure seems similar to the current situation in Viet Nam. However, the reason why agricultural commodities are treated differently and separately have not become clear to DMI expert 2.

In the United Kingdom, the Financial Services and Markets Act 2000 provides for the “twin peak” supervision model (as is the case in some other European countries), whereby the Financial Conduct Authority supervises conduct of business and market integrity while the Prudential Regulation Authority focuses on prudential (including financial) risks of banks and other parties. The basic rules apply both to (trade in ) securities and in derivatives. For derivatives trade London is a global center, and the relevant exchanges are the London



Metals Exchange (LME) and the London International Financial Futures and Options Exchange (LIFFE). For more details reference is made to paragraph 32 of this Report.

The United States has separate legislation and regulation of commodity trade and exchanges in the form of the Commodity Exchange Act and the Commodity Futures Trading Commission (CFTC) (see paragraph 33 of this Report), separate from the Securities Act, the Securities Exchange Act and the Securities and Exchange Commission (SEC). It is interesting to note that the development of hybrid financial instruments that fall between, or within both of, the traditional definitions of securities and derivatives has led to an increasing need of consultation and collaboration between the CFTC and the SEC to avoid that (the trade in) certain instruments is/are left unregulated or that market parties look for the regulation most beneficial to them (“arbitrage”). With respect to the futures exchanges in the US, New York and Chicago have clearly been global centers for many years. Most of these exchanges have merged into two groups with worldwide operations: Intercontinental Exchange (ICE) and CME Group.

In the last paragraph before the conclusions, international developments are described such as the regulation of the financial markets within the European Union and the emergence of global organisations and trading platforms.

### **III Basic Introduction to Commodity Exchanges, Forward and Futures Transactions**

#### **6. Forward Transactions; Physical Delivery**

Forward transactions may be defined as sale/purchase contracts by which the parties agree to buy and sell a certain good (commodity) or a certain quantity of a commodity at a price agreed upon when the contract is entered into for delivery at an agreed date in the future. In its most simple form these contracts provide for physical delivery of the commodity at the agreed time. By such contract the parties usually intend to cover uncertainties and risks for the future: the seller (usually the supplier or producer) of the commodity wants to avoid the risk that there will be no purchaser of his commodity in the future or that the price will be lower than he wants; the buyer wants to avoid the risk that there will be no supply of the commodity when he needs it or that the price will be higher than he wants. Parties avoid the risk of price fluctuations and “lock the price”.

Example: during the growing season the (cooperative of) coffee grower(s) wants to be sure that it can sell the coming harvest of coffee beans at a price that is sufficiently high for it and it finds a company that processes (roasts) the beans and that is willing to buy the beans at this early date at the agreed price - so that it is certain that it will have adequate supply and it does not pay more than the agreed price if the market price rises. At the same time (so: before physical delivery of the coffee beans), the roasting company wants to be sure that it will be able to sell the beans that it has bought but not received, at an agreed price to a supermarket or to wholesale company.

Other examples are the steel company that wants to ensure that it will have sufficient supply of iron ore and coal at a certain price so that it can meet its obligations to its clients during the coming year or the airline that wants to be certain that it will have sufficient kerosene during a defined period and at a set price. The steel company and the airline have to find sellers (a mining company, an oil refinery) that is willing to sell and deliver (the quantity of) the good that meets all the specifications and at the time and price required by the buyer.

#### **7. Developments**

Typically, this simple form of forward contract may undergo several developments:

- a) The number of sellers and buyers and the number of transactions of the good for delivery in the future becomes so big that a market starts to exist.
- For a market to function, several conditions must be satisfied:
  - ◆ There must be liquidity, meaning that there must be a sufficient number of transactions so that sellers are confident that if they want or need to sell, there will be buyers willing to buy
  - ◆ the risk of non-performance of buyers and sellers (counter-party risks) must be eliminated. This means that

- Buyers want to be and can be certain that their sellers will deliver the agreed goods at the agreed price and time.
- Sellers want to be and can be certain that they will receive the agreed purchase prices.

b) The foregoing means that contracts often become standardised: quantities, quality and other characteristics (“specifications”) and time of delivery become standardised (prices don’t).

- ◆ Example: using standard contracts, coffee growers sell in January coffee beans of a certain guaranteed quality for delivery in June.
- ◆ If parties want to enter into transactions for which no standardised contracts exist, they may enter into a bilateral transaction over-the-counter (“OTC”) which is customised to their specific needs.

## 8. No Physical Delivery; Futures

Buyers and sellers do not only enter into contracts for physical delivery of the commodity but will try to benefit from a difference between the agreed forward price and the price they are able to obtain either in the market at the time of delivery or by entering into another forward contract at a different price.

- Example: the steel company (party A) that has bought iron ore of a certain quality and other characteristics in January from a mining company (party B) for delivery in June at a certain price, sells the same quantity and quality of iron ore to another company (party C) for delivery in June as well but at a slightly higher price. At settlement date, party A pays the original purchase price to party B and delivers the ore to party C who pays the higher price to party A. Party A makes a profit equal to the difference between the second and first purchase price.
- (Financial) parties come to the market who have no interest in actual delivery of the good. While the (standardised) contracts still refer to the delivery of a certain quantity and quality of a good at a certain date, these parties may continuously buy and sell these contracts in order to make a profit from the price differences. In other words, most contracts are cancelled out by purchasing a covering position - that is, buying a contract to cancel out an earlier sale (covering a short), or selling a contract to liquidate an earlier purchase (covering a long). Nevertheless, eventually the goods will be delivered by the seller to the buyer at beginning and end of the chain of contracts (minus transaction costs - commissions and fees).
- These financial contracts may be called futures as opposed to forward contracts that intend to provide for actual delivery of goods. Futures contracts are standardized according to the quality, quantity and delivery time and location for each commodity. The only variable is price. However, the terms “forwards” and “futures” do not always have the same meaning.

## 9. Other Goods

Contracts are (and have been) developed for many goods - originally for agricultural commodities, followed by metals and minerals; later for financial products such as shares, bonds, stock indices, foreign currencies (forex) and other. As mentioned, futures contracts for financial products are not discussed in this report.

## 10. Hedgers and Speculators

Some parties enter into forward and futures contracts to protect (hedge) themselves against unwanted price fluctuations; other parties use these contracts mainly or only to profit from price differences and speculate.

Hedgers are individuals and firms that make purchases and sales in the futures market for the purpose of establishing a known price level, weeks or months in advance, for something they intend to buy or sell later in the cash market. In this way they attempt to protect themselves against the risk of an unfavorable price change in the interim. Whatever the hedging strategy, hedgers willingly give up the opportunity to benefit from favorable price changes in order to achieve protection against unfavorable price changes.

Speculators are individuals and firms who seek to profit from anticipated increases or decreases in futures prices. Someone who expects a futures price to increase will purchase futures contracts in the hope of later being able to sell them at a higher price. This is known as "going long". Someone who expects a futures price to decline will sell futures contracts in the hope of later being able to buy back identical and offsetting contracts at a lower price. The practice of selling futures contracts in anticipation of lower prices is known as "going short".

One of the unique features of futures trading is that one can initiate a transaction with a sale as well as with a purchase.

## 11. Aspects of the Price

- Futures prices increase and decrease largely because of the many factors that influence the views of buyers and sellers about what a particular commodity will be worth at a given time in the future (anywhere from less than a month to more than two years). As new supply and demand developments occur and as new and more current information becomes available, these judgments change, and the price of a particular futures contract may go up or down.  
Thus, in January, the price of a July futures contract would reflect the views of buyers and sellers at that time as to what the value of a commodity will be when the contract expires in July. On any given day, with the arrival of new or more accurate information, the price of the July futures contract might increase or decrease.
- Sometimes, exchanges establish the minimum amount with which the price can fluctuate upward or downward.  
They may also establish the maximum amount by which the price may fluctuate from the closing price on the previous trading day (the daily price limit). Once the upper or lower daily price limit has been reached, trading at a yet higher or lower price is not permitted on that trading day.

## 12. Margin

Exchanges set a margin, that is an amount that its members have to deposit for their trades with the exchange and that the person or company that buys futures has to deposit with his broker. From the deposit the exchange or the broker can draw to cover losses caused by price increases (for the buyer) or price decreases (for the seller) of the futures. Based on market developments and perceived risks, the exchange may require additional margin. The broker may require that his client pays more margin than the exchange requires.

There are two types of margin: initial margin and maintenance margin. Initial margin (sometimes called original margin) is the sum of money that the customer must deposit with the brokerage firm for each futures contract to be bought or sold. On any day that profits accrue on the open positions of the customer, the profits will be added to the balance in the margin account. On any day losses accrue, the losses will be deducted from the balance in the margin account.

When the funds remaining available in the margin account of the customer are reduced by losses to below a certain level - known as the maintenance margin requirement - the broker will require that the customer deposit additional funds to bring the account back to the level of the initial margin. The customer may also be asked for additional margin if the exchange or the brokerage firm raises its margin requirements. Requests for additional margin are known as margin calls.

## 13. Options

An option on a futures contract gives the option-buyer the right - but not the obligation - to buy or sell a particular futures contract at a stated price at any time prior to a specified date, or at a certain date.

There are two types of options: calls and puts. A call option gives the option buyer the right to purchase a particular futures contract at a stated price at any time during the life of the option. A put option gives the option buyer the right to sell a particular futures contract at a stated price at any time during the life of the option.

The buyer of the option pays the seller a purchase price, the premium.

Options on futures are not further discussed in this introduction.

## 14. Clearing and Settlement

In order to minimise or exclude the counterparty risk, many exchanges create a separate entity, the clearing house or institute, that by way of novation of the contracts or transfer of obligations becomes the only counterparty of each party that enters into a transaction of a futures contract on the exchange instead of the initial counterparty. Therefore, the seller of each buyer and the buyer of each seller is replaced by the clearing house. To this end, each trading day all members must report all buys and sells to the clearing institute (in some exchanges through clearing members).

The clearing institute then ensures that settlement (either financially or by delivery) is made from all buyers and sellers to the clearing institute. The clearing institute guarantees all contracts and is able to do so because it has the cash deposits, i.e. the margin discussed before, paid by all market participants, available.

Usually, over-the-counter (OTC) transactions are not traded on the exchange and not guaranteed by the clearing institute; therefore the counterparty risk will exist. Usually, physical delivery and payment under these transactions are settled bilaterally between the parties to the contract. However, the price of such transactions is often based on the prices on the exchange. As additional service, exchanges may create the possibility that physical delivery and financial settlement take place through the exchange.

If the parties have the intention that physical delivery of the commodity will take place, the clearing institute accepts warehouse receipts (instead of the commodity) from the seller and transfers these receipts to the buyer. Warehouse receipts are issued by the warehouse company where the commodity is stored and the holder of the warehouse receipts is recognised as owner of the quantity and quality of the commodity described in the receipt. Following transfer of the warehouse receipt, the buyer can claim delivery from the warehouse company.

However, as mentioned before, most futures contracts are cancelled out by purchasing a covering (i.e. counter-) position - that is, buying a contract to cancel out an earlier sale (covering a short), or selling a contract to liquidate an earlier purchase (covering a long). If the parties intend cash settlement, settlement will be based on the underlying spot price. The parties settle by paying/receiving the loss/gain related to the contract in cash when the contract expires.

## **15. Parties in Commodities Transactions, Members of Commodity Exchanges**

Definitions vary from country to country and from exchange to exchange but in general the following parties are members of commodity exchanges and involved in commodities transactions:

- a) A commodity trader or dealer is a firm or individual who trades for his own account. Dealers make a profit by buying low and selling high. They trade with their clients (traders) taking the reverse side and they do not execute their clients' orders. (See Articles 17 and 21-23 of Decree 158/2006/ND-CP).
- b) A commodity broker is a firm or individual who acts as intermediary and executes orders to buy or sell commodities for its clients and puts the two counterparties together in a trade, and charges them a commission. (See Articles 17 and 19-20 of Decree 158/2006/ND-CP).
- c) A clearing member is a broker or dealer which is admitted as member of a clearing house. In order to be admitted a clearing member must satisfy capital and other requirements of the clearing house. Usually only financial parties and large trading houses can become clearing members.

## **16. Transactions and Parties in International Markets; Trade Finance**

In international markets, market parties are usually major trading houses<sup>1</sup> or financial parties such as banks with sizable financial resources. The reason is that

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<sup>1</sup> Examples are Archer Daniel Midland, Cargill, Glencore, Louis Dreyfus, Trafigura and Vitol.

international exchanges (such as LIFFE in London, the largest market for robusta coffee and ICE in New York, the largest market for arabica coffee), require their members, in particular the clearing members, to have a large capital.

Banks often have an additional role: providing trade finance to their customers/borrowers on the basis of collateral in the form of a temporary purchase of a stock of commodity from the customer followed by the sale of the same commodity to the customer/borrower when the loan is repaid. When the bank makes a loan, it will make the amount of the loan available by purchasing a certain quantity of a commodity and paying the purchase price to the customer with the agreement to sell the same commodity back to the same customer at a later date (repo transaction). The purchase price that the customer will pay to the bank constitutes repayment of the loan. In such transactions, the bank acquires temporary ownership of the commodity to secure the loan, and not to take physical delivery of the commodity.

Other parties, such as roasters and intermediate traders, may want to have physical delivery and enter into a bilateral OTC transaction. In such case the price is usually based on the settlement price on an international exchange (such as LIFFE in London for robusta coffee). As mentioned before, actual delivery and payment may take place bilaterally between the parties to the contract or through an exchange. It is noted that traders do not make profit so much on differences between purchase and sales prices but on fees and other payments for additional services in the supply chain, such as transportation, storage, quality control, processing, etc.

## **17. Dispute Settlement**

Different types of disputes may arise:

- i. Disputes between the exchange and one or more of its members or between members (e.g. a broker and a trader) and
- ii. Disputes between a member and its customer.

For the first type of dispute, the rules of some exchanges provide for proceedings within the exchange itself to settle the dispute; other exchanges have a full set of arbitration-like rules for settling these disputes.

With respect to the second type of disputes (between a member of the exchange and one or more of its customers), investors simply expect that any exchange have a transparent system for the settlement of such disputes by an independent and impartial institution applying generally accepted procedures.

The rules of several exchanges provide that complaints shall first be submitted to and be reviewed by a conciliation or mediation panel organised by the exchange itself<sup>2</sup>. If this process does not settle the dispute within a certain time (for example one month), either party may refer the matter to arbitration, where plaintiff and defendant each appoint one arbitrator and the two arbitrators jointly appoint the chair of the panel. Obviously, the arbitrators must be impartial and independent from the

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<sup>2</sup> Reserved

exchange, from the parties to the dispute and from all government institutions. In addition, there must be rules for the enforcement of the arbitral award in the country itself and abroad.

## 18. Conditions for Viable Commodity Trade / Commodity Exchange

Both forward and futures transactions with and without physical delivery and trade finance will only be successful if certain conditions are satisfied. These include:

### a) Legal matters

- a transparent, enforceable legal system with clear rules regarding:
  - ownership and transfer of title
  - transfer of obligations / novation of the contract (to make clearing and settlement possible)
  - security rights
  - warehouse receipts
  - a transparent system for independent and impartial settlement of disputes.

### b) Practical matters<sup>3</sup>

- good choice of commodities - there must be sufficient supply of or demand for the commodity in the country of the exchange (for example: Malaysia: palm oil; Thailand: rice; Viet Nam: robusta coffee)
- good size of each standard contract - in accordance with trade practices for the relevant product
- liquidity of the market with a large number of transactions - this may require the engagement of a market maker, for example a major international trading company or financial party that is willing and able to go to the market to give confidence to sellers
- good infrastructure, particularly of IT systems - note: developing one's own IT system may be very expensive and take much time and it may be better to obtain a licence from another party<sup>4</sup>
- control / risk management system - to protect the financial stability of the exchange and its members. Risk management maintains prudential safeguards, performs due diligence and sets margin requirements
- clearing house as a separate legal entity - to exclude default risk and to ensure that suppliers will deliver the agreed quantity and quality, just in

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<sup>3</sup> The matters referred to below were mentioned during a meeting of DMI expert 2 with representatives of Bursa Malaysia Derivative in Kuala Lumpur, 2 May 2014.

<sup>4</sup> For this purpose Bursa Malaysia Derivative has entered into a licence agreement with CME Group.



time, and that buyers will pay the purchase price<sup>5</sup>

- a reliable system of storage, warehouses
- quality control services (standards and specifications)
- insurance..

International exchanges and their clearing houses often offer solutions for the last mentioned “practical matters” in the form of additional services. For example, if the commodities are traded via the exchange, physical delivery may only take place from warehouses that are approved by the exchange. Moreover, quality controllers of the exchange will take samples in the warehouse where the commodity is stored and for robusta coffee tests will be performed in London (where LIFFE is established).

A complication for Viet Nam is that many warehouses in Viet Nam are not approved by international exchanges so that internationally traded commodities are often not stored in Viet Nam (the country of origin) but in Europe or North America. This is redressed to some extent if international storage companies lease and manage warehouses in Viet Nam on an annual basis and ensure that international standards are maintained<sup>6</sup>.

Another complication for Viet Nam is that there is no law for warehouse receipts. Warehouse receipts are issued by the company that holds goods in storage to the owner of the commodity described in detail (quantity, quality, specifications). The holder of the warehouse receipt is recognised by the issuer as the owner of the described commodity and can request physical delivery - or create a security right over the commodity. The lack of a legal system of warehouse receipts in Viet Nam is one of the impediments for viable commodity trade to develop in Viet Nam<sup>7</sup>.

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<sup>5</sup> Bursa Malaysia Derivative recently installed a new, fully automated electronic system developed by Korean Exchange (KRX). It includes collecting of margins and maintaining cash balances.

<sup>6</sup> Examples of these companies are: Steinweg, Unicontract, Katoennatie, Molenburgnatie, CWT Sitos, Pacorini. These companies may prefer ownership or long term leases of the warehouses but the law of Viet Nam does not permit this so that they rent the facilities on an annual basis.

<sup>7</sup> DMI expert 2 has been informed that sometimes this impediment is solved when the entity that belongs to an international trading group and that rents warehouse facilities in Viet Nam, issues a certificate or warrant confirming that the warehouse holds certain goods as described for the owner. When guaranteed by the parent company or by a substantial other entity of the same group, the stock in the warehouse in Viet Nam will be generally recognised and used as warehouse receipt for trading and as collateral.

**Note on Warehouse Receipts:**

The law of many countries have warehouse receipts, in civil law countries as part of, for example, "safe custody agreements", "storage agreements" or another type of service contract. As example, below follow Articles 7:600 -7:609 of the Civil Code of the Netherlands; see Article 7:607 for the warehouse receipt. This could possibly be combined with the contracts referred to in Sections 518 or 559 of the Civil Code of Viet Nam.

**Dutch Civil Code Book 7 Particular agreements, Title 7.9 Safe custody agreement****Article 7:600 Definition of 'safe custody agreement'**

A safe custody agreement is the agreement under which one of the parties ('the safekeeper') engages himself towards the opposite party ('the depositor') to keep and return a property which the depositor has entrusted or will entrust to him.

**Article 7:601 Custody charges, expenses and damage**

- 1. If the safekeeper has entered into the safe custody agreement in the course of his professional practice or business, then the depositor has to pay him a remuneration (custody charges) for his services.

- 2. If a remuneration is due, yet its amount has not been determined by parties, then the depositor has to pay the usual custody charges, to be calculated in the common way or, if such charges are not available, reasonable custody charges.

- 3. The depositor must compensate the safekeeper for the expenditures made with regard to the safekeeping of the property as far as these are not included already in the custody charges and he has to compensate the damage which the safekeeper has suffered as a result of the safekeeping of the property.

**Article 7:602 Caring duty**

In the performance of the safe custody agreement the safekeeper has to observe the care of a prudent keeper.

**Article 7:603 Use of the property and sub-depository**

- 1. The safekeeper may only use the property himself as far as the depositor has given his consent to do so or such use is necessary to keep or restore the property in good condition.

- 2. Without the consent of the depositor the safekeeper may not hand over the property to a sub-depository for safekeeping, unless this is necessary in the best interest of the depositor.

- 3. The safekeeper is liable for actions of a sub-depository with regard to the property in the same way as for his own actions, unless the safe custody agreement is not for remuneration (gratuitous) and the safekeeper was forced to deposit the property for safekeeping at a sub-depository as a result of circumstances not attributable to him.

**Article 7:604 Handing over of fruits (benefits)**

The fruits (benefits) produced by the property during the period between its reception and return must be handed over by the safekeeper to the depositor.

**Article 7:605 Return of the kept property**

- 1. The depositor may claim the return of the property without delay and the safekeeper may claim that the property is taken back without delay.

- 2. Upon the request of one of the parties, the Subdistrict Court of the territory where the property is located may, for compelling reasons, set another moment for the return or taking back of the property than the moment meant in the previous paragraph or than stipulated in the safe custody agreement. This paragraph does not apply in the event of a judicial deposit.

- 3. The property must be returned at the place where it is kept according to the safe custody

agreement, unless this agreement points out another place for its return.

- 4. The safekeeper must return the property in the condition in which he has received it.

#### Article 7:606 Two or more safekeepers

If two or more persons have jointly taken delivery of a property to keep it in safe custody for someone else, then they are both joint and several responsible (liable) for its return and for damages resulting from a failure in the compliance with an obligation imposed by the safe custody agreement, unless this failure is attributable to neither of them.

#### Article 7:607 Negotiable warehouse receipt

- 1. If a warrant or another document to order or to bearer has been issued in relation to a safe custody agreement, then its delivery prior to the delivery of the goods, is considered as the delivery of these goods.

- 2. Paragraph 1 does not apply to registered property.

#### Article 7:608 Effect of the safe custody agreement on liability towards third persons

- 1. If a sub-depository is held liable by the safekeeper on a non-contractual basis for damage related to the property, then he will not be liable towards the safekeeper to a further degree than he would have been as counterparty of the depositor under the safe custody agreement between the safekeeper and the depositor.

- 2. If a safekeeper is held liable by a third person, not being the depositor, on a non-contractual basis for damage related to the property, then he will not be liable, in his relation to the safekeeper and the depositor, to a further degree than he would have been as counterparty of the depositor under the safe custody agreement between the depositor and the safekeeper.

- 3. If a sub-depository is held liable by such a third person, then he will not be liable, in his relation to the safekeeper and the depositor, to a further degree than he would have been as safekeeper pursuant to the previous paragraph.

- 4. The previous paragraphs cannot be invoked by a safekeeper or sub-depository who, when he entered into the agreement under which he received the property, knew or ought to have known that his counterparty to that agreement was not authorised to give the property to him in safe custody under the legal relationship of that counterparty with the person by whom he is held liable.

#### Article 7:609 Liability of a hotelkeeper

- 1. The hotelkeeper is liable in the same way as a safekeeper for damage to or loss of property that is brought to the hotel by a guest who has settled in there.

- 2. The hotelkeeper is not liable for the behaviour of persons brought to or invited in the hotel by the guest himself, nor for damage caused by property that the guest has brought to the hotel.

- 3. The hotelkeeper has a right of retention over the property referred to in paragraph 1 for all his claims against the guest to the point of accommodation, food, drinks and services performed as hotelkeeper.

See also the following explanation from Wikipedia([http://en.wikipedia.org/wiki/Warehouse\\_receipt](http://en.wikipedia.org/wiki/Warehouse_receipt)):

A **warehouse receipt** is a document that provides proof of ownership of commodities (e.g., bars of copper) that are stored in a warehouse, vault, or depository for safekeeping.

Warehouse receipts may be negotiable or non-negotiable. Negotiable warehouse receipts allow transfer of ownership of that commodity without having to deliver the physical commodity. Most warehouse receipts are issued in negotiable form, making them eligible as collateral for loans. Non-negotiable receipts must be endorsed upon transfer. In the USA warehouse receipts are regulated by the [Uniform Commercial Code](#) article 7.

Warehouse receipts also guarantee existence and availability of a commodity of a particular quantity, type, and quality in a named storage facility. It may also show transfer of ownership for immediate delivery or for delivery at a future date. Rather than delivering the actual commodity, negotiable warehouse receipts are used to settle expiring futures contracts.

An example of an American warehouse receipt is attached as **Annex 1**.

**With respect to the conditions for viable commodity trade commodity exchanges, see the following text taken from a report of the International Organisation of Securities Commissions<sup>8</sup>.**

No proven set of terms and conditions has been established that will ensure that a commodity derivatives contract on an underlying physical commodity will be commercially successful. A review of successful and properly functioning commodity futures contracts indicates certain physical market conditions that, if present, enhance the possibility that a particular physical market may support a properly functioning commodity derivative contract. These physical market conditions are as follows.

- An active physical market should exist prior to the development of commodity derivative contracts. Active physical commodity markets provide commodity derivatives markets with a large pool of potential commercial participants and transparent, reliable pricing.
- Production and consumption of the commodity should be widely distributed among a large number of producers, merchants, and consumers. The wide dispersal of production and consumption of the underlying commodity reduces the ability of any individual, or group acting in concert, to control the supply or demand for the commodity. For example, a large vertically integrated industry, which owns facilities for the mining of or drilling for a needed physical commodity, would have less need for a commodity contract.
- An adequate supply of the commodity should be economically available (i.e., at an economically viable price) in the physical market to meet commodity market delivery needs at contract expiration. Limitations on economically available supply of the commodity or commodities permitted to be delivered under the contract may result in market congestion, squeezes, corners or other disruptions if holders of short commodity contract positions cannot obtain the underlying commodity to satisfy their delivery obligations.
- Price risk must be associated with the commodity in order to attract hedgers and speculators to a commodity market. Commercial market participants (e.g., producers, merchants and consumers/users of a commodity) would have limited incentive to hedge against potential physical market price changes if such commodity prices were stable or could be reliably predicted. Commercial market participants are more likely to use commodity contracts to hedge against physical market price movements when such price movements can be material and unpredictable. The extent to which the supply, demand or price of a physical market commodity is stabilized by government or cartel regulation would be a significant factor in determining whether a commodity derivatives market is needed.

It is difficult to establish trading interest in a new commodity derivatives contract when producers, merchants, and consumers of a commodity already have access to alternative liquid hedging instruments traded elsewhere (e.g., off-exchange). Hedgers and speculators

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<sup>8</sup> "Principles for the Regulation and Supervision of Commodity Derivatives Markets, Final Report", Technical Committee of the International Organization of Securities Commissions, September 2011, p. 16-18.

may prefer an established hedging instrument because the existing liquidity, and the consequential smaller bid/ask spread, among other things, result in lower costs to transact as compared to a newly-established market. However, a new exchange-traded commodity contract whose standardized design conforms to physical market practices could attract trading volume from established hedging instruments by offering enhanced price transparency and minimizing counterparty risk.

In order to facilitate commercial use of the market for hedging or pricing, consideration should be given to providing for alternate settlement mechanisms, such as properly structured and monitored exchange-for-physical transactions that permit settlement to be effected or delivery to be made with a different grade or quality or at a different location. Any such alternatives should be specified.

Principle: Correlation with Physical Market - Contract terms and conditions generally should, to the extent possible, reflect the operation of (i.e., the trading in) the underlying physical market and avoid impediments to delivery.

The purpose of designing a commodity derivatives contract to reflect the operation of the underlying physical commodity market is to avoid or minimize the possibility of manipulation or price distortion in the commodity derivatives contract.

For example, the price of a commodity futures contract at expiration should reflect the value of the underlying physical commodity as specified in the terms of the commodity futures contract, plus or minus the costs associated with making or taking delivery, as well as any other clearly defined and known divergence between the futures contract's specifications and the contract's delivery basket. For physical delivery contracts, the possibility of delivery is the market force that usually causes convergence of physical and futures markets at expiration. However, there are instances where futures markets are susceptible to non-convergence of cash and commodity prices, price distortion or manipulation when there are impediments to making or taking delivery.

A high correlation between physical market prices and commodity futures market prices may be achieved by designing the futures contract with terms and conditions which conform to the prevailing physical market commercial practices of the commodity underlying the futures contract. A well-designed contract therefore provides surveillance staff with visible physical market metrics e.g., commercial practices in the physical market) that can be the subject of surveillance monitoring, as needed.

Accordingly, exchange-traded commodity derivatives contracts such as futures contracts should, to the extent possible, be designed to conform to prevailing physical market commercial practices, including commodity grade and quality specifications, to avoid impediments to delivery and reduce the likelihood of non-convergence of physical and commodity derivatives prices, manipulation or a disorderly market. The terms and conditions should result in a deliverable supply that reasonably can be expected to be available to short traders and saleable by long traders at its market value in normal cash marketing channels. In this regard, delivery locations should be selected to ensure adequate and sufficient supply of the deliverable commodity.

## **IV Relevant Authorities and Legislation in Viet Nam**

### **19. Ministry of Industry and Trade**

The Ministry of Industry and Trade (“MOIT”) is in charge of commodity exchanges and forward transactions. The relevant laws, rules and regulations are:

- i. Commercial Law 2005, articles 63 - 73 (Purchase and Sale of Goods through the Goods Exchange)
  - ii. Decree 158/2006 MOIT, detailing the implementation of the commercial law regarding goods purchase and sale through the goods exchange
  - iii. Circular 03/2009 MOIT
- *Note: Articles 63 and 64 of the Commercial Law refer only to forward and option contracts for physical delivery of the underlying goods. However, Article 65 (Rights and obligations of parties to forward contracts) refer to the situation that the buyer makes cash payment and rejects the goods or the seller refuses to deliver. This suggests that the Commercial Law does not only apply to forward contracts with physical delivery but also to futures (cash settled contracts), but this not entirely clear. Decree 158/2006/ND-CP does not clarify the issue but seems to have been written for physical trades and not for financially settled contracts.*

Note: DMI expert 2 has written a memorandum dated 8 May 2014 with comments on the English translation of Commercial Law Articles 63 - 73 and Decree 158/2006. This memorandum is attached to this report as **Annex 2**.

### **20. Ministry of Finance, the State Securities Commission and the Securities Law Separate regulation of derivatives with different underlying assets?**

The Ministry of Finance is in charge of the securities market and the insurance market.

Although several definitions in Article 6 (Interpretation of Terms) of the Securities Law suggest that the Securities Law is relevant for futures and option contracts<sup>9</sup>, both the

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<sup>9</sup> Article 6 of the Securities Act defines the term “Securities” in paragraph 1. to include “(b) Share purchase rights, securities rights, purchase options, sale options, future contracts, groups of securities and securities indices”.

Paragraph 7 of Article 6 states: “Purchase option or sale option means a right stipulated in a contract which entitles a purchaser to choose the right to purchase or to sell a pre-determined volume of securities at a pre-determined price during a specified period.

Paragraph 8 of Article 6 states: “Future contract means an undertaking to purchase or sell a specified type of securities, group of securities or securities index at a pre-determined volume and pre-determined price and on a pre- determined date in the future”.

deputy-director general of the legal department of MOIT and PMU expert 6 have stated that the term futures in articles 6 and 7 of the Securities Law refers to futures with securities (shares, bonds, etc.) as underlying assets. As futures with securities as underlying asset are not subject of this report, the Ministry of Finance and the Securities Law are not discussed. See however the summary of permitted and restricted transactions in **Annex 3**.

Nevertheless, when plans for commodity markets and the regulation thereof are considered and developed, it is advisable to study the Securities Law, the regulations and institutions created thereby, particularly the State Securities Commission, the operation of the Stock Exchange and the various market parties, to learn from the experience therewith and to analyse whether a comprehensive approach of the several securities and derivatives exchanges, of their participants and the types of transactions is possible.

In this connection it needs to be analysed whether there is a difference between (i) derivatives (e.g. futures and options) with agricultural or non-agricultural commodities as underlying assets and (ii) derivatives with securities (shares, bonds) as underlying assets and whether this difference is so important that different laws, regulations and supervisory authorities should apply to them.

A report of the International Organisation of Securities Commissions refers to an earlier study focused specifically on physical commodity futures markets “because contracts that are based on an underlying tangible commodity, whether settled in cash or by delivery of a physical commodity, may have characteristics different from futures based on underlying financial instruments. This is particularly the case where supply is limited”<sup>10</sup>.

With respect to the question whether a separate organisation of agricultural commodity markets is to be preferred, the same report refers to the impact of commodity transactions on international food markets and food prices, and to an international commitment to share reliable data on agricultural markets in order to increase market information and transparency; they asked for an enhanced collaboration between physical and financial regulators<sup>11</sup>.

DMI expert 2 does not express a view on these matters and leaves this for further study. In the second part of this report on exchanges in foreign countries, experience and practice with separate or comprehensive regulation and operation of exchanges will be discussed.

## **21. State Bank of Viet Nam**

The State Bank of Viet Nam (the “SBV”) is in charge of the money market and the foreign exchange market. It is fair to assume that the role of the SVB regarding the foreign exchange market is prompted by the fact that the Vietnamese dong is not convertible in other currencies.

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<sup>10</sup> See previous footnote, p. 7, 26.

<sup>11</sup> “Principles for the Regulation and Supervision of Commodity Derivatives Markets, Final Report”, Technical Committee of the International Organization of Securities Commissions, September 2011, p. 6-7.

The basic legal instrument is the Law on Credit Institutions 2010.<sup>12</sup> This Law does not mention commodity based derivative (futures) transactions. Article 4.23 of the Law defines derivatives as financial instruments where the underlying asset is an exchange rate, interest rate, foreign exchange, currency or other principal assets. Nevertheless, the State Bank regulates certain crossborder derivatives transactions by commercial banks on the basis of Article 107 of the Law on credit institutions<sup>13</sup>. Thus, the SBV has issued Official Letter 1229<sup>14</sup> regarding commercial banks that participate in commodity price swap transactions with overseas parties.

### **Indirect participation by Vietnamese parties in foreign commodity exchanges**

Typically commercial banks “sit in the middle” when a customer wants to enter into a commodity based derivative transaction with an overseas party.

The rules as described in OL 1229 for commodity price swap transactions are:

- Commercial banks that carry out commodity price swaps with enterprises in Vietnam must meet the following conditions:
  - They must have procedures for commodity price swaps in accordance with the law of Viet Nam and international practices
  - They must have own capital of 200 billion VND or its foreign currency equivalent
  - They are allowed to operate foreign exchange
  - They are registered with SBV to carry out commodity price swaps
  - At the end of each work day the total net result of swap transactions must be positive; if the result is negative, it may not be more than 5% of the equity capital of the bank
  - The banks may only conclude commodity swap transactions for the quantity for which the Vietnamese enterprises enter into swap transactions with the banks
  
- The commercial banks must register with the SBV to carry out the commodity price swap transactions

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<sup>12</sup> The information in this paragraph is based on information given by Ms. Ms Bui Hang of State Bank of Viet Nam during a meeting on 10 March 2014.

<sup>13</sup> Art. 107 states: “Other business activities of commercial banks

1. Provision of such services as cash management, banking and financial consultancy, asset management and preservation, and safe keeping.
2. Consultancy of corporate finance, business acquisition, sale, consolidation and merger and investment.
3. Trading in government bonds and corporate bonds.
4. Monetary brokerage services.
5. Securities depository, gold trading and other business activities related to banking operations after obtaining the State Bank’s written approval.”

<sup>14</sup> OL 1229/NHHH-CSIT of 21 October 2003 (OL 1229) to regulate commodity price swap transactions between a Vietnamese enterprise and a commercial bank in Viet Nam.



- After contracting the commodity price swap with Vietnamese enterprises, the commercial banks are allowed to implement corresponding transactions with banks in foreign countries.

The SBV issues similar rules as described above on a case-by-case basis for interest and futures derivatives whereby the following applies:

- The type of commodities must be specified
- If granted, the approval applies not for each single transaction but for a certain type of transactions generally
- The commercial bank may enter into transactions with domestic customers generally in dong on the one hand and with overseas parties in USD on the other hand (so the bank enters into 2 identical contracts, back to back, and legally it is party to both contracts, so that it has no market risk - but it will have counterparty risk)
- The transactions must be for financial settlement, not for physical delivery
- The domestic customer may use the derivative only for hedging purposes
- The domestic customer must have physical stock equal to the value of the derivative (so that there can be no short positions)
- The maximum amount of possible loss must be no more than 5% of the own capital of the commercial bank.

Transactions in options and futures with overseas parties as described above are unusual and not standardised, and are traded only OTC with high value.

### **Direct participation by Vietnamese parties in foreign commodity exchanges**

DMI expert 2 has been informed orally that the Ministry of Industry and Trade and the State Bank are drafting a “Roadmap” for the participation by Vietnamese parties in foreign commodity exchanges but has not seen the text thereof.

DMI expert 2 has also been informed that at the time of writing of this report no rules exist regarding the participation by foreign parties in Vietnamese commodity exchanges. In the event that such rules are drafted, DMI expert 2 observes that rules exist regarding the participation of foreign parties in Vietnamese stock exchanges<sup>15</sup>. However, DMI expert 2 has not been able to study those documents and expresses no view whether they can serve as example for possible rules regarding foreign participation in Vietnamese commodity exchanges.

Moreover, to any sale and purchase transaction between a Vietnamese party and a party located outside Viet Nam, general rules of the State Bank apply to protect the Vietnamese Dong.

If a domestic trader exports commodities, it must receive the purchase price in a bank account in Viet Nam. .

If a domestic trader imports commodities, either spot or forward, and needs to pay

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<sup>15</sup> Decision No. 238/2005/QĐ-TTG dated 29 September 2005 about the rate of foreign participation on Vietnamese securities market and Circular No.: 90/2005/TT-BTC Hanoi, October 17, 2005 guiding the implementation of the Decision no. 238/2005/qd-ttg of Prime Minister dated 29 September 2005 on the percentage of participation of foreign parties in Viet Nam securities market

foreign exchange abroad, it needs approval from SBV. The commercial bank that will perform the payment will apply for approval.

For domestic commodities (forward and futures) trade, the SBV has not issued rules. Banks do not seem active in the domestic commodities market.

### **Rules for foreign participation in exchanges - the Malaysian and Dutch examples**

The Bursa Malaysia Derivative (“BMD”) has the following rules for foreign participation:

- A non-Malaysian applicant who intends to become a Trading Participant of BMD (a futures broker for agency trades or a trading participant for own account) needs to first establish a locally incorporated company in Malaysia. Currently, BMD has six (6) foreign brokers who have been admitted as Trading Participants and all these foreign brokers have a local presence in Malaysia via their respective locally incorporated companies. Further information with respect to, among other, financial requirements, can be found in the Rules of BMD, application forms and at <http://www.bursamalaysia.com/market/derivatives/brokers/becoming-a-participant-corporate/>.  
No distinction is made between financial parties and commercial parties.
- If a Malaysian party (who is not a Trading Participant of BMD) wants to become a broker or trader (or clearing member) of a foreign derivatives market, such party may do so subject to the requirements imposed by the foreign jurisdiction. The Malaysian party is not required to seek approval from BMD on this matter. If a Malaysian party (who is an existing Trading Participant of BMD) would like to become a broker or clearing member in a foreign derivatives market, the said party is required to seek approval from BMD. If it is a Malaysian financial institution or a licensed intermediary, information should be obtained from the Central Bank of Malaysia and the Securities Commission of Malaysia respectively, regarding the requirements applicable.

As an example from Europe, for the Netherlands the following applies:

- The law of the Netherlands has no rules or requirements for Dutch institutions that want to become members or participants of a commodity exchange outside the European Union. It is for the foreign exchange (or its legislator or supervisor) to decide whether it wants to impose rules or restrictions.
- Non-EU trading platforms that approach Dutch brokers or traders actively and offer them “connectivity”, need to obtain an exemption from the Dutch Minister of Finance. The conditions to obtain such exemptions are:
  - Being a “solid” trading platform (verified on the basis of answers to a questionnaire and confirmation by the home supervisor of the platform), and
  - There must be a basis for exchange of information between the Dutch supervisor and the domestic supervisor of the trading platform regarding the market conduct of Dutch parties. (IOSCO has a standard memorandum of understanding for multilateral exchange of information).

## 22. Conclusions regarding Authorities and Legislation in Viet Nam

- **Ministry of Industry and Trade, Commercial Law, Decree 158/2006**

The rules, particularly of Decree 158/2006 need to be revised, see **Annex 2**.

- **Ministry of Finance, Securities Law, Securities Commission**

It needs to be considered whether the Securities Law and the rules issued thereunder and by the Securities Commission, as well as the operation of the Stock Exchange can be used as example for the development of a commodity exchange and the regulatory framework. A comprehensive approach may be useful.

- **State Bank of Viet Nam**

Clearly, the non-convertibility of the Vietnamese dong and the rules that the State Bank has promulgated as a consequence thereof are a big impediment to cross-border financial transactions such as the participation by Vietnamese parties in foreign futures markets and by foreign parties in Vietnamese exchanges. If the intention is that Vietnamese parties can actively participate in foreign exchanges, not only need the rules of the State Bank applicable to futures and option transactions to be clear and confirmed in writing. Also the general foreign exchange rules that apply to any cross-border payment need to be reviewed, simplified and made as flexible as is possible under a regime of non-convertibility.

## **V Commodity Exchanges in Viet Nam**

### **23. General; Important Commodities**

Vietnam's most import agricultural products and exports are: aquatic products (fish, shrimp etc) with total annual production of more than USD 5 billion/yr. Second is rice, followed by robusta coffee, cashews and rubber and vegetables/fruits, each with total annual production of more than USD 1 billion.

One international trader has mentioned to DMI expert 2 as strong and weak points of the production of agricultural commodities in Viet Nam:

- Strong: fertility, high productivity, high yields
- Weak: infrastructure; high use of irrigation and fertiliser (adding to costs) and of pesticides (less accepted in western markets) and weak record with respect to sustainability criteria.

In 2010 MOIT authorised 8 commodities, all related to coffee, rubber or steel for trading through the Commodity Trading Agency<sup>16</sup>. Gold and Silver, being the most anticipated commodities by local investors, were not on the list of commodities authorized for trading on the commodity trading floor. Since the issuance of this list, the interest in steel as a tradable commodity seems to have subsided.

The abovementioned commodities are traded in Viet Nam partly spot, partly forward (bilateral, OTC) with (except for coffee, see below) agreed fixed prices but usually for short to medium term (3 or 6 months) only. With these short terms, buyers and sellers seek protection from unforeseeable price fluctuations instead of entering into hedging transactions.

Certain characteristics of some of the commodities are summarised below.

- Coffee<sup>17</sup>
  - Vietnam is the world's largest producer and exporter of robusta coffee with an export volume of approximately 1.5 million tons, approximately 90% of annual

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<sup>16</sup> On 18 Aug 2010, the Minister of the Ministry of Industry and Trade passed the Decision dated 18 August 2010, No. 4361/ QD-BCT to announce the list of commodities authorized for trading through the Commodities Trading Agency. The commodities are: - Non-roasted, non decaffeinated coffee beans (Industrial code H.S 0901.11); - Non/pre-rubberized natural rubber (Industrial code H.S 4001.10); - Natural rubber in the form of baked rubber sheet (Industrial code H.S 4001.21); - Treated natural rubber (Industrial code H.S 4001.22); - Rolled non-alloy steel products of 600mm and above in width, heat rolled, pre-coated, pre-plated, or pre-laminated (Industrial code H.S 7208); - Rolled non-alloy steel products of 600mm and above in width, cold rolled (cold pressed), pre-coated, pre-plated, or pre-laminated (Industrial code H.S 7209); - Rolled non-alloy steel products of 600mm and above in width, coated, plated, or laminated (Industrial code H.S 7210); - Non-alloyed steel products in bar and rod forms, that have only been forged, heat rolled, heat stretched, or heat squeezed, including post-rolling twisting (Industrial code H.S 7214). The Decision takes effect on 18 Aug 2010.

<sup>17</sup> Information provided by Mr. Đoàn Hồng Quân of Ocean Group during meeting on 5 March 2014.

production

- Exports consist of raw, unprocessed beans and processing (roasting) takes place abroad)
  - Coffee is a special case: it is a standard product with only three varieties and this makes it easy to trade on exchanges with standard contracts
  - Approximately 80% of (bilateral OTC) forward contracts between Vietnamese traders/exporters and foreign purchasers follows the London robusta market price (LIFFE benchmark) and consequently has a fluctuating price. Approximately 20% of coffee forward contracts has a fixed price, only for short term delivery (3 months). In this case, buyers and sellers don't protect themselves with hedge transactions but by using a short horizon
  - Producers of coffee in Viet Nam are small individual farmers with only 1 - 2 hectares who produce 2,000 - 3,000 tons of coffee per hectare per year, one crop per year
  - Farmers sell to local traders (family enterprises); local traders sell to bigger traders in the villages and towns, mainly private enterprises; the town traders sell to larger provincial traders and to export traders. These are private and state. Export traders sell to foreign traders
  - The general coffee organisation of farmers and traders in Viet Nam is weak (compared with rice and aquatics).
- Rice
    - Rice has a very high production with many small farmers
    - Key is that for the Government of Viet Nam there is a strong link of rice with food security so that there is more government control. 50% of rice export is based on government with government contracts. This leaves less volume for the free market, including commodity exchanges. This may be a reason why rice is not included in the list of commodities that is eligible for trading on commodity exchanges in Viet Nam.  
For other commodities there is less government control.
- Cashews and pepper
    - Main markets/auctions are in India
    - Forward contracts in Viet Nam have fixed prices with short terms, usually 3, 4 or 5 months.
- Rubber
    - Rubber is mainly produced on plantations, approximately 40% by big companies and 60% individual farmers
    - The price is mainly determined by demand from China.
- Tea
    - Tea is a difficult, fragmented market because there are many different varieties and tastes, so that it is difficult to organise standard contracts as are necessary

for a futures market

- Moreover, tea is small in value with approximately USD 300 million export value, being around 70% of total annual production. (However, tea production is big for employment: about 1.2 million farmers compared with 1.6 million farmers for rice)
- The small farmers supply green leaves to processing companies and those companies enter into spot and forward contracts with domestic and foreign buyers.

## 24. Experience with Domestic Commodity Exchanges

The publications that DMI expert 2 has studied and interviews that he has conducted lead to the conclusion that commodity markets and forward and futures transactions are not yet fully developed in Viet Nam.

Currently, the MOIT has issued licenses to two institutions to establish a commodity exchange in Viet Nam:

### a) Vietnam Commodity Exchange (VNX)

In 2010 the Ministry of Industry and Trade has issued a licence to Viet Nam Commodity Exchange (VNX) for three products: coffee, rubber and steel<sup>18</sup>. VNX opened in Ho Chi Minh City in January 2011. VNX offered a trading platform for futures, swaps and brokerage, a payment center and a commodity transaction and appraisal center (including settlement).

A report of VNX shows that in the first quarter of 2012, the total contracted transaction volume was 12,000 lots only with a trading value of 530 billion dong. The figures were 93,000 lots and 7300 billion dong in the whole year 2011. Most of the transactions were in the coffee sector, while there were few rubber transactions and nearly no steel transactions.

By March 2012, the trading floor's members had opened 1981 accounts at the trading floors. Most of the transactions have been made among individual investors, while the trading floor has not attracted institutional investors<sup>19</sup>.

Due to internal problems, VNX suspended activities in 2013 but it will be re-launched in the spring of 2014<sup>20</sup>. Although VNX will in principle be open for trade in any commodity, initially only coffee will be traded.

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<sup>18</sup> Decision of Ministry of Industry and Commerce No.4596/GP-BCT dated 1 September 2010, corrected by Decision No. 0106/QD-BCT dated 10 January 2011

<sup>19</sup> The information above is derived from several articles published in Talkvietnam, <http://talkvietnam.com/tag/vnx/>, read on 4, 5 and 6 March 2014.

<sup>20</sup> This and the following information has been obtained during an interview with mr. Nguyen Duy Phuong of Viet Nam Commodity Exchange VNX on 13 March 2014.

VNX will use the product / model contract of LIFFE (look alike). An American member of CME will enter into a joint venture with VNX, and it will do clearing and settlement, act as clearing member (to solve problem of insufficient liquidity), and can advise regarding contracts and rules. There will be a clearing house, a separate company with clearing members.

Members of the exchange will be

- Traders who buy and sell for their own account
- Brokers who open accounts for farmers etc.
- Clearing members who clear and settle<sup>21</sup>.

The target members of the exchange will be mainly commercial banks and big domestic traders. Farmers cannot become members; they will sell their produce through members of VNX.

Initially there will be no warehouses for storage of coffee stock; in the future there may be approved warehouses of third parties, but VNX will not have its own warehouses.

VNX will start with futures contracts, later options, thereafter maybe OTC contracts.

According to the website of VNX, [www.vnex.vn](http://www.vnex.vn), two regulations have been issued (Trading Regulation VNX, Decision No. 18-2011<sup>22</sup> and Member Regulation VNX, Decision No. 19-2011<sup>23</sup>).

Based on oral information and publications received from VNX, DMI expert 2 believes that following a re-launch, the major activity of VNX will be to enable Vietnamese traders and financial institutions to enter into hedging transactions for financial settlement on international exchanges like LIFFE and ICE.

## **b) Ocean Group, Info Comex**

In April 2013 the Ministry of Industry and Trade issued a licence for a second commodity exchange, Info Comex, organised by Ocean Group<sup>24</sup>. The approved products are again coffee, rubber and steel but the exchange will start with coffee trades and with standardised forward contracts with physical delivery before extending its operation to

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<sup>21</sup> Information material that was given to DMI expert 2 during his meeting with VNX of 13 March 2014 distinguishes Clients, Brokerage Members and Proprietary Members of VNX.

<sup>22</sup> SỞ GIAO DỊCH HÀNG HÓA VIỆT NAM SỐ: 18/2011/QĐ-VNX, CỘNG HÒA XÃ HỘI CHỦ NGHĨA VIỆT NAM, Độc lập – Tự do – Hạnh phúc, -TP.HCM, ngày 14 tháng 06 năm 2011.

<sup>23</sup> SỞ GIAO DỊCH HÀNG HÓA VIỆT NAM, SỐ: 19/2011/QĐ-VNX, CỘNG HÒA XÃ HỘI CHỦ NGHĨA VIỆT NAM, Độc lập – Tự do – Hạnh phúc, TP.HCM, ngày 14 tháng 06 năm 2011.

<sup>24</sup> Confirmed by Mr. Phạm Đình Thuong, MOIT, on 10 March 2014. See also “Second commodity exchange opens in Viet Nam”, published in Viet Nam Breaking News, May 4, 2013, <http://www.vietnambreakingnews.com/2013/05/second-commodity-exchange-opens-in-vietnam/>, read on 4 March 2014.

futures contracts.

Info Comex' intention is that each party to a forward transaction will pay a deposit to the exchange and that in case of non-performance the non-performing party will lose the deposit to the counterparty. This seems the beginning of a margin and clearing/settlement system. Forward contracts will be standardised with respect to quantity and quality.

Trading members of the exchange will be (not small scale farmers and village-based traders but) intermediate traders (often town-based) who sell mainly to domestic export traders, and exporters. The exchange will have an electronic trading platform, warehouses in major production centers - Dak Lak, Dak Nong, Gia Lai, Kon Tum, Lam Dong - plus Ho Chi Minh City, the center for export of coffee and head office in Hanoi.

As major hurdles have been mentioned:

- i. development of the software for the trading platform, but at the time of writing this report, an IT system had been acquired
- ii. The Commercial Law permits only forward contracts and options contracts to be traded in commodity exchange but their legal definition is not clear with respect to contracts traded on international exchanges.  
The Commercial Law does not seem to allow spot contracts to be traded on commodity exchanges is a hurdle to the development of domestic exchanges because spot transactions are the daily basic needs of coffee traders in Viet Nam, and
- iii. the lack of a law on warehouse receipts. (As discussed before, warehouse receipts and the stock of commodities for which they are issued can be used by traders as collateral to obtain loans from the banks. This can only be effective if there is a reliable legal system in place).

Based on oral information and publications received from Info Comex, DMI expert 2 believes that the major activity of Info Comex will be the organisation of an exchange for initially forward and later futures transactions for domestic suppliers and traders. Operation of the exchange is going to start June, 2014.

According to publications on internet, there are two more futures exchanges but according to the deputy director general of the legal department of MOIT these are not licensed exchanges:

### **c) Buon Ma Thuot Coffee Exchange Centre (BCEC)**

In 2007 the government has approved the establishment of a coffee transaction floor in Ban Me Thuot city, Dak Lak province. The construction was scheduled to be carried out by the host province of Dak Lak and the Viet Nam Coffee and Cacao Association (Vicofa). The transaction floor is a merging place for coffee producers and businesses to introduce their products as well as processing data and prices. Via direct and public transactions, the floor will provide information concerning consumption markets and price tendency to facilitate the production of the producers<sup>25</sup>.

In March 2011, Buon Ma Thuot Coffee Exchange Centre (BCEC) received Prime

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<sup>25</sup> See <http://www.intellasia.net/coffee-transaction-floor-for-central-highlands-49666>, read on 1 April 2014.



Ministerial approval to pilot coffee future transactions<sup>26</sup>.

BCEC was allowed by the government to carry out coffee forward transactions on a trial basis for one year, commencing from March 2011. A report of BCEC showed that from March 2011 to December 2011, the total trading volume of the trading floor was 7000 lots only, valued at 600 billion dong.

The government has allowed BCEC to extend the trial operation period until the end of 2012. However, the center is facing big difficulties, when domestic enterprises do not intend to make transactions here, while coffee growers do have confidence on the floor.

However, future transactions at these Exchanges have failed to yield positive results witness low rates of matched transactions. For example, BCEC, despite its continual efforts in 2012, registered 2,722 lots of coffee on matched future transactions, equivalent to 5,444 tonnes of coffee.

#### **d) Son Tin Merchandise Trading Floor STE**

The Son Tin Merchandise Trading Floor STE belonging to Sacombank has also been gloomy. According to reports, 250,000 tons of steel was traded on STE in 2010, 180,000 tons in 2011. Especially, the trading floor was very gloomy in the first four months of the year with only 80,000 tons traded. Meanwhile, the fertilizer trading volume was inconsiderable<sup>27</sup>.

## **25. Trading on International Commodity Markets**

In 2004, several Vietnamese banks began to act as secondary broker for domestic businesses to participate in *international* commodity exchanges, especially in futures transactions of Robusta coffee. According to the State Bank of Viet Nam's statistics, during the 2004-2012 period, all nine involved banks registered futures transactions worth of US\$23.136 million<sup>28</sup>.

The reason for this international activity may be that some Vietnamese parties (and the Vietnamese banks that act as their secondary brokers) seek the large markets with a high degree of liquidity to hedge their positions - in the case of coffee, the NYSE LIFFE Exchange which holds the primary robusta futures contract; the main global derivative contract for arabica (of which Brazil is the largest producer and exporter) is the ICE futures contract and for pepper the Kochi Commodity Exchange in India is the most important market.

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<sup>26</sup> See [http://www.vietnambreakingnews.com/2013/08/commodity-exchanges-need-enhanced-legal-framework/#.Uzgalfi\\_uCo](http://www.vietnambreakingnews.com/2013/08/commodity-exchanges-need-enhanced-legal-framework/#.Uzgalfi_uCo), read on 1 April 2014.

<sup>27</sup> See <http://english.vietnamnet.vn/fms/business/23256/merchandise-trading-floors-flutter.html>, read on 1 April 2014.

<sup>28</sup> [http://www.vietnambreakingnews.com/2013/08/commodity-exchanges-need-enhanced-legal-framework/#.Uzgalfi\\_uCo](http://www.vietnambreakingnews.com/2013/08/commodity-exchanges-need-enhanced-legal-framework/#.Uzgalfi_uCo), read on 1 April 2014. The article mentions a total amount of US\$23.136 billion but US\$23.136 seems more likely.

The rules that apply to the (indirect) participation of Vietnamese customers and banks in foreign commodity exchanges have been described in Section [21] above.

International exchanges where commodities are traded of which Viet Nam is a big producer and exporter are also important for pricing purposes and without participation by Vietnamese parties in those exchanges. As discussed in Section [23] above, it appears that traders who enter into (bilateral OTC) forward contracts for these commodities often do not agree on a fixed price for future delivery but follow the fluctuating prices on the leading markets. "Vietnamese pepper farmers use information at India's Kochi Commodity Exchange to regulate their prices because there is no domestic commodity exchange for them"<sup>29</sup>.

## **26. Summary and Conclusions regarding Commodity Markets in Viet Nam**

### **a) Domestic Commodity Exchanges**

Commodity markets are not yet a big success in Viet Nam. According to the chairman of the Viet Nam Pepper Association, the country is a leading agricultural exporter but it faces too many problems in developing trade. He said the commodity exchange for these items was vitally necessary<sup>30</sup>.

The causes of this failure are manifold. Based on interviews with several parties (including domestic and foreign traders, financial institutions and one foreign commodity exchange) the following possible causes are mentioned

#### **1. Lack of know how leading to lack of liquidity**

Many of the agricultural commodities (rice, coffee, cashews, pepper, tea) are produced and supplied by numerous small farmers. Often the first level of traders to whom the farmers sell, are small merchants. These individuals don't have the knowledge to be interested in organised and regulated commodity exchanges.

Even mid-level and higher level traders who enter into spot and forward transactions with foreign parties see little or no use in organised commodity exchanges, hedging transactions or purely financially settled futures. Only a few major exporting companies and financial parties seem to be interested in conducting derivatives transactions.

In order to make commodity markets viable, and create the required liquidity, many more persons and companies need to be interested and willing to participate. This will require training and education - therefore time.

#### **2. Lack of technical know how, need of training**

Even among people who are involved in developing commodity exchanges there may be a lack of technical know how regarding the conditions of a viable

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<sup>29</sup> Statement by the chairman of the Viet Nam Pepper Association. See <http://vietnamnews.vn/economy/224891/commodities-trade-may-expand.html>, read on 4 March 2014.

<sup>30</sup> See <http://vietnamnews.vn/economy/224891/commodities-trade-may-expand.html>

commodity exchange described in Section [18] above. They may need training and guidance, possibly from foreign market parties or institutions, with respect to, for example, IT systems, risk management, clearing and settlement, writing the rulebook, etc.

3. **Lack of interest**

The few traders that DMI expert 2 has interviewed do engage to a limited extent in practical forward contracts to hedge their positions (protection against short supply, price fluctuations etc.) but did not show interest in engaging in more complicated transactions and certainly not in transactions that envisage pure financial settlement. This was of course different for the banker who was interviewed: he expressed great interest in financially settled transactions.

4. **Approved commodities**

The list of approved commodities that may be traded on licensed exchanges could be broadened from coffee and rubber to include, for example, aquatic products, rice, cashews, pepper and tea, provided that the market parties involved (producers, domestic and foreign traders) show interest.

5. **One or more exchanges? Role of Government**

The approach of the legal system and of the Ministry of Industry and Trade has been to issue licenses to set a commodity exchange up and to leave development and implementation to the market. The result has been that three organisations have attempted or are attempting to develop an exchange but each of them without success.

The question is whether Viet Nam, with a relatively small economy and a small number of potential parties, can offer the conditions for several exchanges to exist successfully. Another question is whether the Government can leave the creation of exchanges to the market. If Viet Nam really wants to develop a commodity exchange, the Government may have to take the initiative and participate initially in setting up an exchange.

6. **Legal infrastructure**

The legal infrastructure needs to be improved. Certainly Decree 158/2006 needs to be revised but also other issues, such as warehouse receipts, need attention. This should be worked on before concrete steps toward the creation of commodity exchange are taken.

**b) Participation in Foreign Exchanges; Transactions with Foreign Parties**

Direct participation by Vietnamese parties (banks, major traders) as members of international exchanges is probably hindered by the capital requirements of membership of those exchanges and the control and restrictions exercised by the State Bank of Viet Nam.

Indirect participation, whereby Vietnamese banks act as secondary brokers between domestic customers on the one hand and member-brokers of international exchanges on the other hand are subject to restrictions and licenses of the State Bank as well. The non-convertibility of the dong is a major cause of these

impediments. Adjustment of the restrictions of the State Bank should be a priority<sup>31</sup>.

**c) Deciding on the priority: which market, which parties?**

Before taking concrete steps thought should be given to the type of products and the type of participants seems to deserve preference.

- i. If the priority is to stimulate financial instruments such as financially settled futures, the focus could be on the participation by major Vietnamese traders (exporting companies) and banks in foreign exchanges. In this case, review of the rules and policies of the State Bank should be high on the agenda and the development of a domestic market will be less relevant.
- ii. If the priority is to stimulate interests of and transactions among domestic traders, processing companies and suppliers, a domestic commodity exchange, mainly for bilateral forward contracts and maybe even spot transactions seems useful, possibly with facilities for financially settled futures for hedging purposes. In this case, participation in foreign exchanges could be given less priority.

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<sup>31</sup> According to one report, the failure by Vietnamese commodity exchanges to develop is in part due to the restrictions on both the demand and supply sides of the hedging market. On the supply side, the State Bank of Viet Nam keeps a tight grip on the commodity derivatives markets and to date only a handful of banks, including Techcombank, BIDV and Standard Chartered, have licences to offer commodity derivative products onshore. And even though the banks have been growing their businesses, actual market penetration remains consigned mostly to large players and non-state owned enterprises. The same report states that on the demand side the key remains educating market players about the ways that hedging can protect producers/suppliers and buyers (like traders, processing companies and wholesalers) from price fluctuations. See "Supply glut heats up Viet Nam coffee derivatives market", Author: Alex Davis, Source: Asia Risk | 16 Dec 2013, published in <http://www.risk.net/asia-risk/feature/2318428/supply-glut-heats-up-vietnam-coffee-derivatives-market>

## **VI Laws, Rules and Regulations in Selected Countries**

### **27. Canada**

Canadian legislation is interesting because its provincial laws offer two possible approaches of the regulation of commodity futures: either through specific Commodity Futures Acts or through more general Securities Acts that apply also to the trade of (other) securities such as shares and bonds and that consider derivatives (including futures) as securities.

#### **Structure of Provincial Derivative Legislation**

In Canada, the trade in derivatives (which term includes futures) is regulated not by the federal government but by the provinces. Each province enacts legislation under which the securities and the futures industries operate. Provincial and territorial securities commissions coordinate their activities through a national organization, the Canadian Securities Administrators.

There are two common approaches in Canada regarding the regulation of derivatives – one used by Manitoba and Ontario; the other used by British Columbia and Alberta. A third approach is followed by Quebec.

The Ontario/Manitoba approach involves the regulation of exchange-traded derivatives through separate commodity futures legislation. Unlike British Columbia and Alberta, who regulate derivatives via their respective securities legislation, Ontario/Manitoba each have a Commodity Futures Act that applies to commodity futures contracts and options. The Commodity Futures Acts regulate exchange-traded derivatives by imposing registration and recognition requirements on exchanges operating in each province. Further, the Commodity Futures Acts impose dealer and advisor registration requirements with respect to trading or advising on commodity futures contracts that are traded on recognized exchanges.

A commodity futures contract that is not traded on a recognized exchange will be regulated by the respective Securities Act, as it falls under the definition of a “security”. In regards to over-the-counter derivatives (“OTC”), the regulation depends on the nature of the trade. In Ontario, OTCs may fall under the Commodities Futures Act, the Securities Act or may not fall under either. The regulation of OTCs is extremely fact specific, causing confusion of applicable registration and prospectus requirements. In Manitoba, OTCs are more likely to fall under its Securities Act, as its definition of a “security” is more inclusive.

As indicated above, the British Columbia/Alberta approach involves regulation directly through securities legislation. In both Securities Acts, exchange-traded derivatives are regulated based on the concept of “exchange contracts”. Exchange contracts are regulated by the imposition of registration requirements for dealers and advisors and through the regulation of those exchanges on which exchange contracts are traded. With respect to OTC derivatives, they generally fall within the definition of “security” under their respective Securities Acts, however they are excluded from most aspects of the Securities Acts through the use of blanket exemptions.

With respect to Quebec, it recently passed the Derivatives Act that imposes recognition and registration requirements on intermediaries, dealers and advisors for both exchange-traded and OTC derivatives.

## **Commodity Exchanges in Canada**

There are two exchanges in Canada that trade derivatives/commodities (including futures). The larger of the two is ICE Futures Canada, which specializes in agriculture and is based in Winnipeg, Manitoba.

In Toronto, the market for futures is the Montreal Exchange (“MX”). Before 1999, these trades were the responsibility of the Toronto Futures Exchange (TFE) but it no longer exists.

The MX futures market information can be found at [http://www.m-x.ca/marc\\_termes\\_en.php](http://www.m-x.ca/marc_termes_en.php). The website provides “Rules” for trading, some of which pertain to futures and derivatives. These can be found at: [http://www.m-x.ca/publi\\_regles\\_en.php](http://www.m-x.ca/publi_regles_en.php).

ICE Clear Canada serves the agricultural markets of ICE Futures Canada which is part of ICE or Intercontinental Exchange This is an international network of regulated exchanges and clearing houses for financial and commodity markets (which recently acquired NYSE Euronext).

ICE provides counterparty risk management and post-trade services. It clears futures and options contracts for a number of commodity futures contracts<sup>32</sup>.

ICE Futures Canada and ICE Clear Canada are regulated by the Manitoba Securities Commission (MSC) pursuant to the provisions of the Commodity Futures Act (Manitoba). As part of the Canadian securities and futures industry, ICE Clear Canada operates under the jurisdiction of various regulators. All ICE Clear Canada's Rules, Operational Manual and By-law amendments are submitted to the Manitoba Securities Commission. Futures Commission Merchant Participants are regulated by both recognized Self Regulatory Organisations, including the Exchange, the Investment Industry Regulatory Organization of Canada and the Canadian Investor Protection Fund, and by provincial securities commissions.

The Canadian Investor Protection Fund (CIPF) has an important role in the oversight of the self-regulatory system with respect to firms active in futures commodity markets. The Canadian Investor Protection Fund and the Self Regulatory Organisations, under the supervision of the provincial securities commissions, establish and continually review national standards for capital adequacy and liquidity, financial reporting, accounting records, internal control, segregation of customers' fully- and partly-paid securities, insurance and matters relating to the financial condition of participants operating in Canada<sup>33</sup>.

## **Conclusion for Canada**

Canada is an interesting case because its provincial legislation offers an example of on the one hand an “integrated approach” where derivatives, including commodity based futures, are governed by general Securities Acts, together with shares and bonds, and on the other hand a specific approach where commodity futures are governed by specific Commodity Futures Acts.

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<sup>32</sup> Canola, Milling Wheat, Durum Wheat and Barley.

<sup>33</sup> Source: [https://www.theice.com/clear\\_canada.jhtml](https://www.theice.com/clear_canada.jhtml) and [https://www.theice.com/clear\\_canada\\_regulation.jhtml](https://www.theice.com/clear_canada_regulation.jhtml).

## **28. ETHIOPIA**

Although the Ethiopia Commodity Exchange (“ECX”) is a spot exchange, its features are innovative and could be used as example for commodity exchanges<sup>34</sup>.

The ECX was established in 2008 with the active participation of the Government of Ethiopia<sup>35</sup>. Before the ECX was established, Ethiopia’s market for agricultural commodities was characterised by high costs and high risk of transacting. Sellers were struggling to find buyers and vice versa. Commodity buyers and sellers traded only with those they knew, to avoid the risk of being cheated. Enforcing contracts was also a challenge. Only one third of output reached the market. Trade was done on the basis of visual inspection because there was no assurance of product quality or quantity, which drove up market costs, leading to high consumer prices. For their part, small-scale farmers, who produce 95% of Ethiopia’s output, came to market with little information and were at the mercy of middlemen, unable to negotiate better prices for their crops.

According to its website, the idea behind the ECX was to bring buyers and sellers of agricultural commodities, such as coffee and sesame, together in an open and transparent way. These days Ethiopian farmers can receive the latest crop prices on their mobile phones, or from electronic boards situated across the country. This information explosion is said to have allowed 15 million coffee farmers to increase their share of the final price from 38% to 65%, as the margins to middlemen have narrowed.

The main reason for the success of the ECX is that it was tailored specifically for the Ethiopian market, catering for small farmers and traders. In addition to just providing a trading platform, the ECX built an entire system of services that includes the warehousing and quality grading of commodities.

ECX is currently sponsored by Morgan Stanley and the International Finance Corporation. Similar exchanges are or have been developed in other countries in Africa<sup>36</sup>.

The commodities traded on ECX are: coffee, sesame , haricot beans, maize and wheat.

Main features of ECX are:

- **Warehouses**

ECX offers an integrated warehouse system from the receipt of commodities on the basis of industry accepted grades and standards for each traded commodity by type to the ultimate delivery. Commodities are deposited in warehouses operated by ECX in major surplus regions of the country. At the ECX warehouse, commodities are sampled, weighed and graded. ECX warehouses issue an Electronic Goods Received Note and provide the depositor or his/her representative with a signed print copy. The Electronic Goods Received Notes are not negotiable or transferable and do not represent legal title

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<sup>34</sup> Source, and for further information see: <http://www.ecx.com.et/CompanyProfile.aspx#AU> and <http://eleniexchanges.com/an-african-success#sthash.cfBmoGVt.dpuf>.

<sup>35</sup> ECX’s establishment is founded on Proclamation No. 550/2007. This proclamation mandates ECX to develop its own rules for the governance of its various operations.

<sup>36</sup> Mentioned are Cameroun and Ghana. See the aforementioned websites.

to the deposited commodity. The depositor has to obtain an Electronic Warehouse Receipt issued by the ECX Central Depository in order to establish legal title to the deposited commodity. The deposited commodities are stored using global standards of inventory management which rely on First-In-First-Out principles, rotation, and careful environmental control. ECX Inventory Management system guarantees the quality and quantity of the commodity throughout the pre-determined period of storage. Further, ECX warehouses are insured at maximum coverage to protect against loss and damage of deposits.

There are 16 warehouses.

- **Services**

ECX warehouses provide the following services:

- Sampling, grading, weighing and certifying of the grain and coffee coming to each warehouse using equipment provided by ECX according to ECX established standards
- Weighing, receiving and issuing Electronic Goods Received Note which matches ECX automated system
- Recording system for incoming and outgoing grain and daily stock position reports  
Proper handling of the commodity at the warehouse (store layout stacking, bin no., inventory management)
- Reporting system and formats for up-to-date information exchange between ECX and the area warehouses
- Maintain the quality of received products.

- **Central depository, Electronic Warehouse Receipts**

ECX maintains a Central Depository or Registry of warehouse receipts which guarantee product integrity. The Electronic Goods Received Note issued at an ECX warehouse is a precondition for issuance of Electronic Warehouse Receipt by the ECX Central Depository. The ECX Central Depository is the sole entity authorized to and responsible for issuing Electronic Warehouse Receipts, printing copies of receipts, transferring legal title, and canceling receipts. The Electronic Warehouse Receipt issued by the ECX Central Depository represents legal title to the deposited commodity. The Electronic Warehouse Receipt is transferable and negotiable on ECX through the function of the ECX Central Depository. The Central Depository maintains separate accounts for every depositor. ECX is currently working towards introducing the use of Electronic Warehouse Receipts for the purposes of securing collateral finance or also known as inventory financing in the near future.

In summary, the Exchange Central Depository provides the following services:

- ◆ Create Electronic Warehouse Receipts;
- ◆ Maintain and edit required electronic warehouse receipt data;
- ◆ Maintain a register of Depositors;
- ◆ Effect settlement of contracts traded on the Exchange by transferring Electronic Warehouse Receipts between holders;
- ◆ Issue Delivery Notices after transfer of Electronic Warehouse Receipt;
- ◆ Void or cancel Electronic Warehouse Receipts;
- ◆ Reconcile records daily.



- **Trading system**  
Transaction orders for sales and purchases in standard lot sizes of standardized commodity grades (referred to as contracts) are recorded on Order Tickets. The ECX automated back office system ensures the existence and validity of the Warehouse Receipt backing the sale, the availability of buyer funds in a deposit account, and where applicable the validity of the Member-Client agreement.
- **Trading sessions - Clearing & Settlement**  
ECX's Clearing and Settlement department assumes Central Counter Party (CCP) risk for all members trades. It establishes the net obligations of each member, informs the members of their daily net obligations and transfers cash funds and commodity ownership among members.
- **Communication, Market Information**  
The ECX Market Information System intends to enable all market actors, including smallholder farmers, dealers, processors, exporters and importers, to access markets more efficiently and profitably. The components of the ECX market information system are:
  - Electronic Tickers: electronic displays transmit real time prices of all commodities traded in market places in the entire country
  - Mobile Phone Short Messaging Service (SMS) will allow anyone from anywhere in the country where the mobile phone network exists to access market prices, commodity related news headlines, weather forecasts, and other relevant market information
  - Interactive Voice Response (IVR) service may be accessed using mobile / wireless / fixed line telephone networks which makes critical market price information within the reach of stakeholders located in all parts of the country
  - Bulletins – Market Commentary
  - Mass media: ECX disseminates market information daily via radio, television and newspaper
  - The ECX website ([www.ecx.com.et](http://www.ecx.com.et)) provides real time market data on all commodities traded. It also provides historical data, research, news, graphs, contract specifications and other key information.

Among the other activities and features of ECX<sup>37</sup>, two are mentioned here:

- **Discipline and Enforcement Unit:** The Discipline and Enforcement Unit (“DEU”) is responsible for enforcing the Rules of Exchange and other pertinent laws through a disciplinary rules enforcement mechanism. The DEU works closely with the Authority and relevant law enforcement agencies to protect the integrity of the Exchange.
- **Arbitration Tribunal:** The Arbitration Unit (“ABU”) is responsible for facilitating the resolution of disputes between Members or between Members and the Exchange during the course of trading at the Exchange. The Exchange has two types of alternative dispute resolution: (1) Expert Determination: grade dispute resolution for Quality disputes

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<sup>37</sup> The website mentions corporate entity and governance, membership, know your client procedure, risk management, surveillance operations, compliance, monitoring.

between the Exchange and its members, and (2) Trade disputes between members inter se, and between members and their clients.

### **Ethiopia Commodity Exchange Authority (ECEA)**

The Ethiopia Commodity Exchange Authority (ECEA), the regulatory body of the ECX, was established in 2007<sup>38</sup>. The ECEA has the powers and duties to extend recognition and oversight of Exchange Actors (Members and their representatives), recognition and oversight of Clearing Institutions (domestic banks or other financial institutions engaged in clearing and settlement of payments), oversight of the Rules of the Exchange and regulation of Exchange-traded contracts, as well as regulation of the conduct of investment advisors, consulting companies, law practices, accounting and audit professionals, as this conduct relates to ECX business. In addition, the ECEA has the power to investigate wrongdoing and adjudicate cases falling under its jurisdiction or to refer criminal cases to the appropriate court. As part of its oversight, the Authority issues Directives regarding the various key areas.

The ECEA is accountable to the Prime Minister. ECEA is governed by a Board comprised of a Chairman, and a member from each of the Ministry of Finance and Economic Development, Ministry of Trade and Industry, Ministry of Agriculture and Rural Development, and the National Bank of Ethiopia. The operations of the ECEA are executed by a Director General, who is also an ex-officio member of the Board.

### **Conclusion for Ethiopia**

Even though the Ethiopia Commodity Exchange is a spot exchange and not a futures exchange, it is interesting because it shows how an exchange can be developed from scratch in a difficult environment provided that all aspects of the necessary environment, including legislation and regulations, IT and physical infrastructure such as warehouses with additional services, are put in place. A number of those aspects, described in this section, deserve further study.

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<sup>38</sup> Proclamation 551/2007.

## **29. INDIA**

### **History of the Commodity Futures Markets in India**

Commodity futures markets in India date back to more than a century. The first organized futures market was established in 1875 under the name of 'Bombay Cotton Trade Association' to trade in cotton derivative contracts. This was followed by institutions for futures trading in oilseeds, food grains, etc. The futures market in India underwent rapid growth between the First and Second World Wars. As a result, before the outbreak of the Second World War, a large number of commodity exchanges trading futures contracts in several commodities like cotton, groundnut, groundnut oil, raw jute, jute goods, castor seed, wheat, rice, sugar, precious metals like gold and silver were flourishing throughout the country.

In view of the delicate supply situation of major commodities connected with the war efforts mobilization, futures trading came to be prohibited during the Second World War under the Defence of India Act.

After Independence, especially in the second half of the 1950s and first half of 1960s, commodity futures trading again picked up and there were thriving commodity markets. The futures trade in pepper was first organised by the India Pepper and Spices Trade Association (IPSA) in Cochin in 1957.

However, in mid-1960s, commodity futures trading in most of the commodities was banned and futures trading continued only in two minor commodities, viz, pepper and turmeric.

In 1980, a special committee recommended re-introduction of futures trading in most of the major commodities, including cotton, kapas, raw jute and jute goods and suggested that steps may be taken for introducing futures trading in commodities like potatoes, onions, etc. at an appropriate time. The government accordingly initiated futures trading in potatoes during the latter half of 1980 in a few markets in Punjab and Uttar Pradesh. Futures trading was also resumed in castor seed, and gur (jaggery), and in 1992 extended to Hessian (Jute).

After the introduction of economic reforms in June 1991 and the consequent trade and industry liberalization in both the domestic and external sectors, a Government appointed Committee on Forward Markets submitted its report in September 1994. The majority view of the Committee was that futures trading be introduced in basmati rice, cotton and kapas, raw jute and jute goods, groundnut, rapeseed/mustard seed, cottonseed, sesame seed, sunflower seed, safflower seed, copra and soybean oilseeds, oils and their oil cakes, rice bran oil, castor oil and its oilcake, linseed, silver and onion. The Committee also recommended that some of the existing commodity exchanges, particularly those with futures trading in pepper and castor seed, may be upgraded to the level of international futures markets. In April 1999, futures trading was permitted in various edible oilseed complexes.

The National Agriculture Policy announced in July 2000 and the announcements of the Finance Minister in the Budget Speech for 2002-2003 indicated the Government's resolve to put in place a mechanism of futures trade/market. Futures trading in sugar was permitted in May 2001 and the Government issued notifications on 1 April 2003 permitting futures trading in all commodities. With the issue of these notifications, futures trading is not prohibited in any commodity.

Options trading in commodities is, however, prohibited at the present time.

## **The Forward Contracts (Regulation) Act, 1952; Forward Markets Commission**

The basic law and regulations of India regulating commodity exchanges and transactions are the Forward Contracts (Regulation) Act, 1952 and the Forward Contracts (Regulation) Rules, 1954.

Section 3 of the Forward Contracts Act provides that the Central Government of India may establish a Forward Markets Commission consisting of not less than two members and not exceeding four members who are appointed (and may be re-appointed) by the Central Government for three year periods.

The Commission is situated in Mumbai and is overseen by the Minister of Finance, Department of Economic Affairs, of the Central Government.

The powers of the Commission include<sup>39</sup>:

(a) to advise the Central Government in respect of the recognition of, or the withdrawal of recognition from, any association as forward market

(b) to keep forward markets under observation and to take such action in relation to them as it may consider necessary

(c) to collect and publish information regarding the trading conditions in respect of goods to which this Act applies, including information regarding supply, demand and prices, and to submit to the Central Government periodical reports on the operation of the Forward Markets Act and on the working of forward markets relating to such goods

(d) to make recommendations generally with a view to improving the organisation and working of forward markets

(e) to undertake the inspection of the accounts and other documents of any recognised association or registered association or any member of such association whenever it considers it necessary

(f) to have the powers of a civil court, while trying a suit<sup>40</sup>

(g) to suspend member of a recognised association or to prohibit him from trading<sup>41</sup>.

Several powers of the Central Government have been delegated to the Commission, including the following:

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<sup>39</sup> Section 4 of the Forward Markets Act.

<sup>40</sup> Section 4A of the Forward Markets Act mentions specifically: (a) Summoning and enforcing the attendance of any person and examining him on oath; (b) requiring the discovery and production of any document; (c) receiving evidence on affidavits; (d) requisitioning any public record or copy thereof from any office; (e) any other matters which may be prescribed.

<sup>41</sup> Section 12(B) of the Forward Markets Act.

(h) power to direct that there shall be no limitation on the number of members of the association or that there shall be such limitation on the number of members as may be specified<sup>42</sup>

(i) power to approve of the amendment of the rules of a recognised association<sup>43</sup>

(j) power to call for periodical returns or direct inquiries to be made with respect to the affairs of a recognised association or a member thereof or to appoint one or more persons to make an enquiry in relation to the affairs of such association or the affairs or any of its members and submit a report of the result of such inquiry<sup>44</sup>

(k) power to direct a recognised association to make or amend rules<sup>45</sup>

(l) power to make or amend bye-laws of a recognised association<sup>46</sup>.

Any association concerned with the regulation and control of forward contracts may apply to the Central Government to be recognised for the purposes of the Act. The Central Government may grant recognition to the association in such form and subject to such conditions as may be described, and it shall specify the goods or classes of goods with respect to which forward contracts may be entered into between members of such association or through or with any such member. The Central Government may withdraw the recognition<sup>47</sup>.

Moreover, any association concerned with the regulation and control of business relating to forward contracts shall apply for and obtain a certificate of registration granted by the Forward Markets Commission<sup>48</sup>.

The Central Government may supercede the governing body of a recognised association for a period of up to six months and suspend the business of such association for up to seven days<sup>49</sup>.

The Central Government may declare that every forward contract for the sale or purchase of any goods specified which is entered into in the area specified, otherwise than between members of a recognised association or through or with any such member, shall be illegal. The Central Government may also declare that no person shall, without the permission of the

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<sup>42</sup> Section 6(2)(a) of the Forward Markets Act.

<sup>43</sup> Section 6(3) of the Forward Markets Act.

<sup>44</sup> Section 8 of the Commodity Forwards Act.

<sup>45</sup> Section 10(1) of the Forward Markets Act.

<sup>46</sup> Section 12(1) of the Forward Markets Act.

<sup>47</sup> Sections 5(1), 6(1) and 7(1) of the Forward Markets Act.

<sup>48</sup> Section 14(A) of the Forward Markets Act.

<sup>49</sup> Sections 13 and 14 of Forward Markets Act.

Central Government, enter into any forward contract for the sale or purchase of any goods specified and to which the foregoing does not apply<sup>50</sup>.

### Use of Regulatory Tools by the Forward Markets Commission

The Commission has used its regulatory tools and prescribed the following measures:

- Limit on open position of an individual member as well as a client to prevent over-trading
- Limit on price fluctuation (daily/weekly) to prevent abrupt upswing or downswing in prices
- Special margin deposits to be collected on outstanding purchases or sales to curb excessive speculative activity through financial restraints
- During shortages, extreme steps like skipping trading in certain deliveries of the contract, closing the markets for a specified period and even closing out the contract to overcome emergency situations are taken
- The Commission calls for daily reports from the Exchanges and takes other pro-active steps to ensure that there is no misuse of the market and that the prices reflected on the Exchange platform are governed by the demand and supply factors in the physical markets.

### Important Commodities Exchanges, Current Situation

A total of 21 recognised commodities exchanges operate in India. The recognised national commodities exchanges of India are listed below, with their symbols and the commodities traded.

Multi Commodity Exchange of India, Ltd., Mumbai	MCX	Precious Metals, Base Metals, Energy, Agricultural
National Commodity and Derivatives Exchange, Ltd., Mumbai	NCDEX	Precious Metals, Base Metals, Energy, Agricultural
National Multi-Commodity Exchange of India Ltd., Ahmedabad	NMCE	Precious Metals, Base Metals, Agricultural
Ace Derivatives & Commodity Exchange Ltd.	ACE	Agricultural
Universal Commodity Exchange, Ltd.	UCX	Agricultural, Energy, Precious Metals
Indian Commodity Exchange, Ltd., Mumbai	ICEX	

Currently 5 of these exchanges, viz. the Multi Commodity Exchange, the National Commodity and Derivatives Exchange, the National Multi Commodity Exchange, the Indian Commodity Exchange and the ACE Derivatives and Commodity Exchange, regulate forward trading in

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<sup>50</sup> Sections 15(1) and 17(1) of the Forward Markets Act.

113 commodities.

Besides, there are 16 commodity specific exchanges recognized for regulating trading in various commodities approved by the Forward Markets Commission.

The commodities traded at these exchanges comprise the following:

- Edible oilseeds complexes like Groundnut, Mustardseed, Cottonseed, Sunflower, Rice bran oil, Soy oil etc.
- Food grains – Wheat, Gram, Dals, Bajra, Maize etc.
- Metals – Gold, Silver, Copper, Zinc etc.
- Spices – Turmeric, Pepper, Jeera etc.
- Fibres – Cotton, Jute etc.
- Others – Gur, Rubber, Natural Gas, Crude Oil etc.

Out of the 113 commodities, regulated by the Forward Markets Commission, in terms of value of trade, Gold, Silver, Copper, Zinc, Guarseed, Soy Oil, Jeera, Pepper and Chana are the prominently traded commodities.

Out of the 21 recognized exchanges, the Multi Commodity Exchange, National Commodity and Derivatives Exchange, National Board of Trade (NBOT), Indore, National Multi Commodities Exchange, and the ACE Derivatives & Commodity Exchange Ltd. contributed 99% of the total value of the commodities traded during the year 2011-12.

The total volume of trade across all Exchanges in 2011-12 was 14,025.74 lakh MT at a value of Rs.181,26,103.78 Crores. The total of deliveries of all commodities on Commodity Exchange platform was 8,88,250 MT during the year 2010-11<sup>51</sup>.

The different intermediaries and clients registered at the recognized national exchanges are:

- Members - 4081
- Other intermediaries - 234
- Warehouse service providers / warehouses - 35, and
- Clients - 33,75,123 as on 31.1.2012.

### **Multi Commodity Exchange of India Ltd (MCX)**

The Multi Commodity Exchange is the most important commodity exchange and is discussed below.

#### **MCX - General**

The Multi Commodity Exchange of India Limited (MCX), India's first listed exchange, started operations in November 2003 and is based in Mumbai. It operates within the regulatory framework of the Forward Contracts (Regulation) Act, 1952 and is regulated by the Forward Markets Commission of India.

MCX offers trading in several commodity futures contracts, including bullion, ferrous and

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<sup>51</sup> Source for the information on history and current situation of commodity exchanges in India: <http://www.fmc.gov.in/index3.aspx?sslid=27&subsublinkid=13&langid=2> , read on 15 April 2014. See also: <http://www.slideshare.net/akeebsiddiqui/introduction-of-commodity-market-in-india>, read on 15 April 2014.

non-ferrous metals, energy, agri-based and agricultural commodities. MCX has an extensive national reach, with over 2100 members, operations through more than 400,000 trading terminals (including CTCL), spanning over 1900 cities and towns across India. MCX is India's leading commodity futures exchange with a market share of about 86 per cent in terms of the value of commodity futures contracts traded in 9 months of the financial year 2013-14.

The commodities and contracts traded on MCX are:

<b>METAL</b>	<b>CEREALS</b>
Aluminium, Copper, Lead, Nickel, Steel Long (Bhavnagar), Steel Long (Govindgarh), Steel Flat, Tin, Zinc	Maize, Barley, Rice, Sharbati Rice, Basmati Rice, Wheat
<b>FIBER</b>	<b>BULLION</b>
Cotton L Staple, Cotton M Staple, Cotton S Staple, Cotton Yarn, Kapas, Jute	Gold, Gold HNI, Gold M, i-gold, Silver, Silver HNI, Silver M, Silver Micro
<b>SPICES</b>	<b>ENERGY</b>
Cardamom, Jeera, Pepper, Red Chilli, Turmeric, Cumin Seed, Coriander	Brent Crude Oil, Crude Oil, Furnace Oil, Natural Gas, M. E. Sour Crude Oil, ATF, Electricity(Now delisted), Carbon Credit
<b>PULSES</b>	<b>PETROCHEMICALS</b>
Chana, Masur, Yellow Peas, Tur, Urad	HDPE, Polypropylene(PP), PVC
<b>PLANTATIONS</b>	<b>OTHERS</b>
Arecanut, Cashew Kernel, Coffee (Robusta), Rubber	Guargum, Guar Seed, Gurchaku, Mentha Oil, Potato (Agra), Potato (Tarkeshwar)
<b>OIL &amp; OIL SEEDS</b>	
Castor Oil, Castor Seeds, Coconut Cake, Coconut Oil, Cotton Seed, Crude Palm Oil, Groundnut Oil, Kapasia Khalli, Mustard Oil, Mustard Seed (Jaipur), Mustard Seed (Sirsa), RBD Palmolein, Refined Soy Oil, Refined Sunflower Oil, Rice Bran DOC, Rice Bran Refined Oil, Sesame Seed, Soymeal, Soy Bean, Soy Seeds	

In 2012, MCX ranked third among the global commodity exchanges in terms of the number of futures contracts traded.

- Globally, MCX ranks no. 1 in silver, no. 2 in natural gas, and no. 3 in crude oil and gold in futures trading. (But actual volume is far behind CME group volume as Silver is traded in 30 kg lots on MCX whereas CME traded in approximately 155 kg lot size; same in Gold 1 kg : 3 kg approximately; and Crude 100 Barrels : 1000 Barrels on CME)
- The highest traded item is gold
- As of early 2010, the normal daily turnover of MCX was about US\$ 6 to 8 billion.<sup>52</sup>

To ease participation, MCX offers facilities such as calendar-spread facility, and EFP (Exchange of Futures for Physical) transactions which enables participants to swap their positions in the futures/ physical markets. MCX's flagship index, the MCXCOMDEX, is a real-time composite commodity futures price index which gives information on market movements in key commodities. Other commodity indices developed by MCX include MCXAgri, MCXEnergy, and MCXMetal.

With an aim to integrate with the global commodities trading system, MCX has entered into

<sup>52</sup> See [http://en.wikipedia.org/wiki/Multi\\_Commodity\\_Exchange](http://en.wikipedia.org/wiki/Multi_Commodity_Exchange), read on 14 April 2014.



strategic alliances with leading international exchanges such as CME Group, London Metal Exchange (LME), The Baltic Exchange, Dalian Commodity Exchange (DCE) and Taiwan Futures Exchange (TAIFEX)<sup>53, 54</sup>.

MCX has also set up in joint venture the MCX Stock Exchange. Earlier spin-offs from the company include the National Spot Exchange, an electronic spot exchange for bullion and agricultural commodities, and National Bulk Handling Corporation (NBHC) India's largest collateral management company which provides bulk storage and handling of agricultural products.

In February 2012, MCX has come out with a public offering of shares to raise around \$134 million. It is the first ever public offering by an Indian exchange.

### **MCX - Rules, Bylaws and Business Rules**

The Rules, Bylaws and Business Rules of MCX are found in <http://www.mcxindia.com/aboutus/legal/legal.htm>.

The Rules deal mainly with management and membership of MCX. The Rules distinguish five categories of members: Trading-Cum-Clearing Members, Institutional Clearing Members, Institutional Trading cum Clearing Members, Commodity/Complex Specific Trading-cum-Clearing Members, and Trading Members<sup>55</sup>.

The Bylaws of MCX deal with such matters as contracts, trading on the exchange, trading system, clearing house of the exchange, margins, clearing and settlement, delivery, reports, settlement guarantee fund, investor (client) protection fund, clearing limits, code of conduct, arbitration, emergencies and powers to handle emergencies and confidentiality of information.

The Business Rules of MCX have regulations regarding membership, market operations, trading system, inspection and disciplinary actions and arbitration.

Of these rules and regulations, the rules regarding clearing and dispute settlement are briefly discussed.

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<sup>53</sup> Source: <http://www.mcxindia.com/aboutus/AboutUs.htm>, read on 14 April 2014.

<sup>54</sup> <http://www.mcxindia.com/aboutus/corporatemilestones.htm> mentions among milestones in MCX's existence:

- Incorporated in April 2002
- Commenced operations in November 2003
- First in India to initiate evening trading session to coincide trading timing with international markets
- In June 2006, forged an alliance with the India Post to extend benefits of the exchange to farmers through Gramin Suvidha Kendra, its social inclusion programme
- In June 2006, became India's largest commodity exchange
- Entered into several strategic alliances with global exchanges such as LME and NYMEX
- Euronext, NV., Alexandra GLG, Passport Capital, Merrill Lynch holdings, ICICI, Kotak Mahindra, New Vermon, ILFS and Citigroup acquired stakes in MCX
- World's 3rd largest commodity futures exchange in terms of the numbers of contracts traded in CY2012\*
- Became India's first listed exchange on March 9, 2012
- Highest daily turnover of INR 1,19,941 crore achieved on April 15, 2013 (since inception).

<sup>55</sup> These categories of members are defined in Section 19 of the Rules of MCX.

## **MCX - Clearing, Settlement, Margin**

MCX has an in house clearing house which monitors and performs all activities relating to delivery, fund settlement, margining and managing the settlement guarantee funds.

MCX has appointed 16 clearing banks for settlement of funds between clearing member and MCX. Every Clearing Member is required to maintain and operate a settlement account and a client account with any one of the appointed clearing banks. The clearing account is to be used exclusively for settling funds and other obligations to MCX, including payments of margins and other charges.

Clearing Members are required to authorise the Clearing Bank to access their settlement account for debiting and crediting their accounts, and reporting of balances and other information as may be required by MCX from time to time. The Clearing Bank will debit/ credit the settlement account of clearing members as per instructions received from MCX.

The members of MCX are required to pay interest free security deposit as prescribed by MCX at the time of admission, which will be used as margin deposit against exposure of the members. At least 50% thereof shall be given in the form of cash and the balance in the form of fixed deposit receipts and/or bank guarantee.

To increase the exposure limits for trading, the members may remit additional security deposit in the following forms: cash, bank guarantee, fixed deposit receipt, pledge of warehouse receipt, pledge of securities<sup>56</sup>.

### **MCX - Dispute Settlement**

MCX bye-laws prescribe that all claims, differences or disputes between members or between a member and a client in relation to trades, contracts and transactions executed on MCX shall be resolved by way of conciliation proceedings. Investors can approach MCX at the Investors Grievance Division of the Legal Department for the redressal of their grievance/s. On receipt of a complaint, MCX initially tries to resolve the complaint by following up with the member and the complainant. MCX even accords appropriate counseling to the parties in dispute for the redressal of the complaint through a mutual settlement process. Complaints are ordinarily resolved within a period of sixty (60) days.

If the complaint remains unresolved, it is referred to arbitration by arbitrators selected from an arbitration panel of the MCX. The arbitral tribunal shall make the arbitral award within three months from the date of entering upon the reference. The time to make the award may, however, be extended by the Managing Director or relevant authority on application by either of the parties or the arbitral tribunal.

On receipt of an arbitral award against an MCX member, MCX shall follow such procedure as may be provided in its Rules and Regulations.

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<sup>56</sup> The clearing rules and rules for dispute settlement are included in the Bylaws and Business Rules of MCX and have been summarised in <http://www.mcxindia.com/marketoperation/clearingsettlement/clearing.htm> and in <http://www.mcxindia.com/investorrelations/grievances/dos.htm>.

### **MCX and Social Responsibility - Gramin Suvidha Kendra, an example?<sup>57</sup>**

According to the website of MCX, its social inclusion project, Gramin Suvidha Kendra ("GSK"), uses MCX' expertise and India Post's infrastructure, to make farmers a part of the modern commodity market infrastructure.

To ensure that the benefits of commodity exchanges reach the recesses of rural India, GSK, an inclusive business model, has been designed as a single-window service for all pre-harvest and post-harvest requirements of farmers. Thanks to India Post's ubiquitous network of over 155,000 post offices across the country, MCX's potential to reach out to farmers through GSK has grown exponentially, enabling it to cater to the marketing, warehousing and advisory needs of farmers across India.

GSK drives inclusive growth by providing the following services to address certain deficiencies in the rural economy:

- Spot and Futures price information of agricultural commodities
- Query redressal
- Spot trading
- Quality agri inputs
- Weather insurance
- Warehousing receipt and credit lending
- Non agri products like rural water purifiers, educational booklets
- Adult literacy
- SMS based service.

### **Conclusion for India**

India is an interesting case but can probably not serve as an example for Viet Nam. The sheer size of India, the number of available commodities and the long tradition of specialised commodity markets may make it possible for more than twenty commodity markets to exist but cannot be compared with the Vietnamese situation.

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<sup>57</sup> For general information regarding Gramin Suvidha Kendra, see <http://gsk.mcxindia.com/AboutGSK.htm>; for information on the mentioned project, see <http://www.johnson.cornell.edu/Portals/0/images/Center%20for%20Sustainable%20Global%20Enterprise/Ce%20nter%20at%20large/Honorable%20Mention%20-%20GSK.pdf>

### **30. MALAYSIA**

The regulation of the commodities market Malaysia is an interesting case because it offers an example of a comprehensive system regulating almost the entire financial industry, including derivatives (such as forwards and futures), securities markets, trade and issues, public offers, pension systems etc.

#### **Capital Markets and Services Act 2007 ("CMSA")**

The Capital Markets and Services Act 2007 of Malaysia<sup>58</sup> (hereafter the "CMSA") is a good example of a comprehensive approach regulation of derivatives, including futures, and "other securities" like shares, bonds, etc. The CMSA has consolidated and replaced the Securities Industry Act 1983 and Futures Industry Act 1993<sup>59</sup>, to regulate and to provide for "matters relating to the activities, markets and intermediaries in the capital markets, and for matters consequential and incidental thereto". It has approximately 400 articles and 11 schedules and it covers many areas<sup>60</sup>, including securities markets, derivatives markets, clearing houses, licence requirements for market parties and rules for conduct of business on either market. Often, the rules that apply to stock exchanges, derivatives exchanges and to exchange holding companies (that hold shares in an approved stock exchange, derivatives exchange or clearing house<sup>61</sup>) are similar.

It is noted that the same rules apply to commodity based derivatives (including futures) and to financial derivatives (including securities and currency based futures). This has been a choice, in conjunction with the combination of the several exchanges that existed before 1998. However, when amendments are proposed to the rules of an exchange regarding commodity based derivatives the Securities Commission whose approval is required, must consult the Minister responsible for that commodity<sup>62</sup>.

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<sup>58</sup> For the text, see

[http://www.sc.com.my/wp-content/uploads/eng/html/cmsa/cmsa2013/2013\\_cmsa\\_full\\_121228.pdf](http://www.sc.com.my/wp-content/uploads/eng/html/cmsa/cmsa2013/2013_cmsa_full_121228.pdf)

<sup>59</sup> See Introductory paragraph of the CMSA.

<sup>60</sup> The Act consists of the following Chapters:

- Part II – Securities and Derivatives Markets, including markets and market institutions;
- Part III – Capital Markets Services, including licensing and regulation and business conduct
- Part III - Private Retirement Scheme Industry
- Part IV – Capital Market Compensation Fund
- Part V – Market Misconduct and other Prohibited Conduct
- Part VI – Issues of Securities and Take-over and Mergers
- Part VII – Provisions applicable to Listed Corporations
- Part VIII – Self-regulatory Organizations
- Part IX – Capital Market Development Fund
- Part IXa – Management of Systemic Risk in the Capital Market
- Part X – Disclosure of Information
- Part XI – Administrative and Civil Actions
- Part XII – General
- Part XIII – Repeal, Savings and Transitional Provisions

<sup>61</sup> CMSA Section 2.

<sup>62</sup> Section 9(4) of the CMSA.

Below only rules applicable to derivatives exchanges, derivatives (including forward and futures<sup>63</sup>) and clearing houses are discussed.

- Establishing, operation and maintaining a derivatives exchange are subject to approval by the Minister of Finance<sup>64</sup>. Similar approval is required for a stock exchange, an exchange holding company and a clearing house<sup>65</sup>.

Among the licence requirements is the requirement that the exchange is a legal entity and that its rules make satisfactory provision:

- (i) for an orderly and fair market in relation to the securities or derivatives that are traded through its facilities;
- (ii) for the proper regulation and supervision of its participating organizations or affiliates;
- (iii) for the exclusion of persons who are not of good character and high business integrity from being recognized as participating organizations or affiliates;
- (iv) for the expulsion, suspension or disciplining of its participating organizations or affiliates and any person acting on behalf of such participating organization or affiliates, for conduct that is inconsistent with just and equitable principles in the transaction of business or for a contravention of or failure to comply with the rules of the stock exchange or derivatives exchange;
- (v) with respect to the conditions under which securities may be listed for trading in the market proposed to be conducted by the body corporate or under which derivatives may be traded on the market through its facilities;
- (vi) with respect to the conditions governing dealings in securities or dealing in derivatives by its participating organizations or affiliates;
- (vii) with respect to the class of securities or derivatives that may be dealt in or traded on its facilities; and
- (viii) generally for the carrying on of the business of the proposed stock exchange or derivatives exchange with due regard to the need for the protection of investors and public interest.

The Minister of Finance may, on recommendation of the Securities Commission, withdraw the approval under certain circumstances, for example if the exchange has

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<sup>63</sup> Section 2 of the CMSA states that “derivatives” means any contract, either for the purposes of creating an obligation or a right or any combination of both, of which its market value, delivery or payment obligations are derived from, referenced to or based on, but not limited to, underlying securities or commodities, assets, rates, indices or any of its combination, whether or not a standardized derivative or an over-the-counter derivative, but does not include (a) securities; (b) any derivative to which Bank Negara or the Government of Malaysia is a party; (c) any over-the-counter derivatives whose market price, value, delivery or payment obligations are solely derived from, referenced to or based on, exchange rates; or (d) any agreement, when entered into, is in a class of agreements prescribed not to be derivatives; and “securities” means (a) debentures, stocks or bonds issued or proposed to be issued by any government; (b) shares in or debentures of, a body corporate or an unincorporated body; or (c) units in a unit trust scheme or prescribed investments, and includes any right, option or interest in respect thereof.

<sup>64</sup> CMSA Sections 7, 8.

<sup>65</sup> CMSA Sections 14, 15.

stopped to operate a derivatives market<sup>66</sup>.

- The rules of any derivatives exchange and of an approved clearing house, and the amendment thereof, are subject to prior approval by the Securities Commission. The Securities Commission may require a derivatives exchange and a clearing house to amend its constitution or its rules<sup>67</sup>.
- One third of the directors of a derivatives exchange will be appointed as public interest director by the Minister of Finance in consultation with the Securities Commission<sup>68</sup>.
- The approved derivatives exchange must submit annually a regulatory report to the Securities Commission regarding the extent of its compliance with certain ongoing legal requirements; the Commission may also conduct a regulatory audit. The Commission shall submit copies of the annual report and of the audit report to the Minister of Finance<sup>69</sup>.
- The Minister of Finance may order the closure or the suspension of certain functions of a derivatives exchange<sup>70</sup>.
- Establishing and operating a clearing house is subject to approval by the Securities Commission; such approval may be withdrawn<sup>71</sup>.
- The CMSA has several articles if a participant fails or is unable to meet its obligations under unsettled contracts and about the relation of such default rules to normal insolvency rules<sup>72</sup>.
- No person shall carry on a business in any regulated activity unless he is the holder of a Capital Markets Services Licence or is a registered person. Such licence may be granted by the Securities Commission and the CMSA describes the requirements and conditions for the issuance, refusal, revocation and suspension of the licence<sup>73</sup>.  
The appointment of directors and chief executive of a licensed business is subject to

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<sup>66</sup> CMSA Section 11.

<sup>67</sup> CMSA Section 9.

<sup>68</sup> However, if a derivatives exchange is the subsidiary of an exchange holding company, all of its directors will be appointed with the concurrence of the Securities Commission and one third of the directors of the exchange holding will be appointed by the Minister of Finance. CMSA Section 10.

<sup>69</sup> CMSA Section 16.

<sup>70</sup> CMSA Sections 27, 30.

<sup>71</sup> CMSA Sections 38, 39.

<sup>72</sup> CMSA Section 41 and following.

<sup>73</sup> CMSA Sections 58 and following. Section 76 deals with "registered persons".

scrutiny, respectively approval by the Securities Commission<sup>74</sup>.

- There are elaborate rules for the conduct of business of holders of Capital Market Services Licences<sup>75</sup>.
  - With respect to trading in standardised derivatives, the CMSA provides that the Securities Commission or a derivatives exchange with the approval of the Commission may, by notice in writing from time to time, specify such limits as it considers necessary on the amount of trading which may be done or positions which may be assumed by any person under a standardized derivative<sup>76</sup>.
  - This is followed by elaborate rules for licence holders who deal in derivatives with respect to the sequence of sending and carrying out of orders in order to protect the interests of (different) clients and to avoid conflict of interests with trades for own account<sup>77</sup>.
  - Licence holders may only trade in standardised derivatives on a derivatives exchange outside Malaysia if the exchange is recognised as a “specified exchange” or the derivatives have been approved in the rules of the Malaysian exchange<sup>78</sup>.
  - With respect to over-the-counter derivatives, the CMSA provides that the Securities Commission may grant approval to any body corporate to act as “trade repository” (which is defined as a body corporate that collects and maintains information or records with respect to over-the-counter derivatives transactions or positions entered by any person, including any terms and conditions thereof, for the purpose of providing a centralized record keeping facility for over-the-counter derivatives), applicable rules and conditions, withdrawal of the approval, appointment of directors and duty of secrecy<sup>79</sup>.
- Holders of capital markets services licences must keep proper books, keep assets and monies segregated and meet audit requirements<sup>80</sup>.
- With respect to market misconduct and other prohibited conduct regarding derivatives, the CMSA deals with such issues as false trading, bucketing, dissemination of information about false trading, manipulation of price of derivatives and cornering, employment of devices to defraud, false or misleading statements, prohibition of abuse of information obtained in official capacity, penalties and civil remedies<sup>81</sup>.

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<sup>74</sup> CMSA Section 75.

<sup>75</sup> CMSA Section 89 and following.

<sup>76</sup> CMSA Section 101.

<sup>77</sup> CMSA Section 104

<sup>78</sup> CMSA Section 105.

<sup>79</sup> CMSA Sections 107B and following.

<sup>80</sup> CMSA Sections 108 - 137.

<sup>81</sup> CMSA Sections 202 - 211.

- The CMSA has rules regarding other issues, including a Capital Markets Compensation Fund, Management of Systemic Risks, a Capital Market Development Fund and Administrative and Civil Sanctions in case of violation of rules.

## The Securities Commission

The Securities Commission, which has an important role under the CMSA, has been established by the Securities Act 1993. Its Board has nine members who are all appointed by the Minister of Finance of Malaysia, i.e. a Chairman (with the function of CEO), a Deputy Chief Executive, four members representing the Government; and three other persons. The Securities Commission has a broad range of functions and all power to perform those functions<sup>82</sup>. The Securities Commission may be given directions by the Minister of Finance and shall report to him<sup>83</sup>.

The Commission has broad powers to examine the documents, accounts and transactions of exchanges, licence holders and registered persons under the securities acts. For the purposes of those examinations, the Securities Commission may appoint investigating officers. These officers have power to inspect and make copies of any book, account, register

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<sup>82</sup> According to Section 15 of the Securities Act, the Commission shall have the following functions:

- (a) to advise the Minister on all matters relating to securities and derivatives industries;
- (b) to regulate all matters relating to securities and derivatives;
- (c) to ensure that the provisions of the securities laws are complied with;
- (d) to regulate the take-overs and mergers of companies;
- (e) to promote and regulate all matters relating to fund management, including unit trust schemes;
- (f) to be responsible for supervising and monitoring the activities of any exchange holding company, exchange, clearing house and central depository;
- (g) to take all reasonable measures to maintain the confidence of investors in the securities and derivatives markets by ensuring adequate protection for such investors;
- (h) to promote and encourage proper conduct amongst participating organisations, participants, affiliates, depository participants and all licensed or registered persons of an exchange, clearing house and central depository, as the case may be;
- (i) to suppress illegal, dishonourable and improper practices in dealings in securities and dealing in derivatives, and the provision of investment advice or other services relating to securities or derivatives;
- (j) to consider and make recommendations for the reform of the law relating to securities and derivatives;
- (k) to encourage and promote the development of securities and derivatives markets in Malaysia including research and training in connection thereto;
- (l) to encourage and promote self-regulation by professional associations or market bodies in the securities and derivatives industries;
- (m) to license, register, authorise and supervise all persons engaging in regulated activities or providing capital market services as may be provided for under any securities law;
- (n) to promote and maintain the integrity of all licensed persons in the securities and derivatives industries;
- (o) to register or recognise all auditors of public interest entities for the purposes of this Act, and to promote and develop an effective audit oversight framework in Malaysia;
- (p) to take all reasonable measures to monitor, mitigate and manage systemic risks arising from the securities and derivatives markets;
- (q) to promote and regulate corporate governance and approved accounting standards of listed corporations; and (r) to set and approve standards for professional qualification for the securities and derivatives markets; [Ins. Act A1403:s.3]

...

(3) The Commission shall have the functions and powers conferred upon it by or under the securities laws. The powers of the Securities Commission are described in Section 16 of the Securities Act.

<sup>83</sup> Securities Act Section 17.



or document; search and seize any object which may be used as evidence; search and detain persons and remove them into custody, and call persons for oral examination. Prosecution may only take place with the consent of the public prosecutor<sup>84</sup>.

With respect to supervision, the Minister of Finance appoints the Securities Commission but takes a distance from actual control and supervision; the Securities Commission exercises more control and day to day control is exercised by the Bursa Malaysia itself<sup>85</sup>.

### **Bursa Malaysia, History**

The Government started (and owned) the commodity exchange in 1980 as the first commodity exchange in the Asean countries, mainly for palm oil and a few other commodities. In 1995 private parties with political support started a financial exchange and, in addition, in 1996 the Malaysian Monetary Exchange was started.

Therefore, at that time (1996) three exchanges, two regulators and two clearing houses existed - in addition to the Kuala Lumpur Stock Exchange. For brokers and other parties this was not satisfactory: they had to have several memberships, which was too costly, there were too many regulators each with its own requirements (audits etc.) and there were too many reporting lines for the market parties. Given the size of the market, there simply were too many exchanges<sup>86</sup>.

Following the Asian crisis in 1998, all exchanges were consolidated and in 2005 the one consolidated exchange was renamed to Bursa Malaysia Berhad with one regulator.

Directly and indirectly, the Government of Malaysia owns 40% of Bursa Malaysia. Bursa Malaysia is an exchange holding company<sup>87</sup> and subsidiaries own and operate a securities market, a derivatives market, Islamic offerings and other markets or products. The following are relevant for the derivatives market:

- 1 Bursa Malaysia Derivatives Bhd (“BMD”), which operates a futures and options exchange, and
- 2 Bursa Malaysia Derivatives Clearing Bhd which operates a clearing house for the futures and options exchange.

While all other subsidiaries are wholly owned by Bursa Malaysia, BMD is 75% owned by Bursa Malaysia and 25% by CME Group (see below). Bursa Malaysia Derivatives Clearing is a wholly owned subsidiary of BMD.

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<sup>84</sup> Securities Act Section 125 - 136.

<sup>85</sup> This was confirmed during a meeting of several representatives of Bursa Malaysia Derivatives with DMI expert 2 on 2 May 2014.

<sup>86</sup> Information given orally by several representatives of BMD during a meeting with DMI expert 2 on 2 May 2014.

<sup>87</sup> Bursa Malaysia Berhad is a public company limited by shares under the Companies Act 1965 and is an approved exchange holding company under Section 15 of the CMSA.

The Rules of Bursa Malaysia Derivatives Bhd are comprehensive<sup>88</sup>.

### **BMD - Its Products**

The derivatives market has eleven derivatives products, in the categories commodity futures, equity futures, equity options and financial futures. The following commodity derivative products are currently available on BMD:

- Gold Futures (FGLD)
- Crude Palm Oil Futures (FCPO)
- USD Crude Palm Oil Futures (FUPO)
- Crude Palm Kernel Oil Futures (FPKO)
- Options on Crude Palm Oil Futures (OCPO)

BMD sees no reason to treat gold and silver different from other commodities.

The main product is the Crude Palm Oil Futures contract (FCPO) which is the global price benchmark for the palm oil industry.

Of the five derivative contracts traded on BMD, almost all trades are financially settled. Only less than 2% of crude palm oil futures and very little of crude palm kernel futures is physically delivered<sup>89</sup>.

For physical delivery three warehouses have been licensed by Bursa Malaysia. There is a system of electronic warehouse receipts.

Bilateral forward contracts are currently contracted, performed and settled by the parties themselves, without involvement of BMD. In the future this will change and bilateral forwards may be settled through BMD.

### **BMD - Supervision**

As mentioned above, day to day supervision of the market and of market participants is exercised by Bursa Malaysia itself. According to its website, Bursa Malaysia has the duty to maintain a fair and orderly market in the securities and derivatives that are traded through its facilities, and to ensure orderly dealings in the securities deposited with it, and orderly, clear and efficient clearing and settlement arrangements for transactions cleared and settled through its facilities. Bursa Malaysia has put in place a regulatory and supervisory framework to regulate the market and its participants, including the listed issuers and their directors and

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<sup>88</sup> These rules have not been analysed.

The Rules are found in

<http://bursa-vid5.shareinvestor.com/market/regulation/rules/bursa-malaysia-rules/derivatives/rules-of-bursa-malaysia-derivatives>.

Also the Rules of Bursa Malaysia Derivatives Clearing Bhd are comprehensive; they can be found in <http://bursa-vid5.shareinvestor.com/market/regulation/rules/bursa-malaysia-rules/derivatives/rules-of-bursa-malaysia-derivatives-clearing/>

<sup>89</sup> During a meeting on 2 May 2014, BMD representatives said that this shows that the main function of BMD is “price discovery” by financial parties.

advisers, Participating Organisations, Trading Participants, Clearing Participants, Authorised Depository Agents and Authorised Direct Members. Bursa Malaysia has issued various sets of rules that set out the requirements that need to be met by the regulated entities either upon admission and/or on a continuing basis. It administers and monitors compliance with these rules and takes enforcement action for breaches of these rules.

Bursa Malaysia supervises the listed issuers and the brokers. It also undertakes surveillance over the trading activities in the marketplace.<sup>90</sup>

Bursa Malaysia regulates and supervises two groups of brokers:

- stock brokers (stockbroking companies) i.e. Participating Organisations
- futures brokers (futures broking companies) i.e. Trading Participants.

Supervision of brokers is carried out in the following manner:

Inspection - conduct scheduled and/or ad-hoc inspection visits to the office premises of brokers with the focus to assess their degree of compliance, level of market conduct and adequacy of clients' assets protection

Compliance Monitoring – ensure timely reporting by brokers, conduct analytical review on their periodic submissions and raise alert when the needs arise

Financial Monitoring - monitor the brokers' financial condition and ensure their compliance with minimum financial requirements from various aspects

Registration – ensure all licensed brokers, their key staff and licensed personnel are duly registered with Bursa Malaysia for monitoring purpose

Others - Evaluate and process applications received from brokers that require prior consent of Bursa Malaysia before implementation, which among other things, include applications for new business activity and establishment of new office premises.

Bursa Malaysia states that it employs a risk-based approach (RBA) in conducting supervisory activities. This approach adopts a framework that assesses the risk profiles of brokers using elements associated with risk information. This in turn will be used to develop supervision plans that prioritise the scope and frequency of the assignments as well as the types of exercise to be conducted on these brokers. The assessment and risk profiles are developed and updated on a regular basis. The implementation of RBA not only enhances the effectiveness and efficiency of Bursa Malaysia's monitoring, but assists the brokers in allowing them to take the necessary rectification/improvement measures through identification of risk areas using the RBA.

As part of the continuous obligations in contributing towards a fair and orderly market, all brokers are required to report their activities and status of various areas of concern to Bursa Malaysia on a periodic basis. For example, brokers are required to declare through regular submissions whether monies received from investors are properly safeguarded by being deposited in designated trust/segregated accounts. Verification thereof will be conducted by Bursa Malaysia either during the inspection visit or off-site compliance monitoring.

Enforcement / disciplinary actions have been taken against brokers for breaches of Bursa Malaysia Rules, directives and circulars. Cases of non-compliance with the Capital Markets &

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<sup>90</sup> See <http://www.bursamalaysia.com/market/regulation/structure/overview/>.

Services Act and the Securities Industry (Central Depositories) Act by brokers and their representatives are forwarded to the Securities Commission for further action.

### **BMD - Dispute Resolution**

Based on Section 379 Capital Markets and Services Act, the Rules of Bursa Malaysia provide for a system of settlement of disputes between members and between members and the Exchange<sup>91</sup>. For customer complaints, the Securities Industry Dispute Resolution Center (SIREC) provides for alternative dispute settlement<sup>92</sup>.

### **BMD - International Activities - CME**

In September 2010 BMD migrated all its derivatives products to CME Globex, the electronic trading platform of CME Group. The intention was that this would enable global traders to access BMD's products electronically, particularly the global benchmark crude palm oil futures (FCPO) contract, and create broader exposure for BMD's products. It was believed that greater accessibility for both local and international traders would be facilitated by multiple access points through nine international telecommunications hubs, one of which is located in Kuala Lumpur<sup>93</sup>.

BMD itself believes that it - and the palm oil contract - have benefited from the link with CME. Before the CME link, foreign traders (who may be established anywhere) constituted 32% of all traders, and at the time of writing it is 50%. CME Group has acquired a 25% stake in BMD (which is said to have increased international confidence in BMD) and appoints one of the four members of its Board<sup>94</sup>.

### **Conclusions for Malaysia**

Based on the above description it seems that the following conclusions may be drawn:

- The existence in the past of several derivatives exchanges, regulators and rulebooks was found to be cost increasing and inefficient. Consequently, the various exchanges

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<sup>91</sup> Section 379 of the CMSA and Rule 513 of the BMD.

<sup>92</sup> See <http://www.sc.com.my/securities-industry-dispute-resolution-center-sidrec/> and <http://www.sidrec.com.my/flyersidrecfinalENGLISH.pdf>.

<sup>93</sup> See news release of 20 September 2010 published in: <http://www.prnewswire.com/news-releases/bursa-malaysia-derivatives-products-migrate-successfully-to-cme-groups-electronic-trading-platform-103286884.html> read on 10 April 2014. The news release added: "Bursa Malaysia Derivatives will continue to operate and regulate its market as well as have control over trading hours, products and its specifications, spread definitions and pricing, within the parameters supported by CME Globex. The trading hours for the Malaysian derivatives market will remain unchanged. All BMD contracts traded on the CME Globex electronic trading platform will continue to be cleared by Bursa Malaysia Derivatives Clearing Berhad. There are changes to the rules to reflect the trading features and functionalities on CME Globex." See also <http://www.cmegroup.com/international/partnership-resources/bursa-resources.html>.

<sup>94</sup> Statement made during meeting between five representatives of BMD and DMI expert, 2 May 2014.

and their regulators have been combined and today one derivatives exchange remains in Malaysia.

- The derivatives exchange and the clearing of transactions in Malaysia are governed by a comprehensive legal and regulatory system that is part of a coordinated framework for the capital market industry, including regulation of the securities exchange, derivatives exchange, market parties, transactions, clearing, and the appointment, composition and functioning of the over-all regulator, the Securities Commission
- The law does not make a distinction between commodity based and securities or currency based derivatives. Gold and silver are treated as other commodities
- Five commodity based futures are traded but coffee and rubber are not among them. The Crude Palm Oil Futures contract (FCPO) is the global price benchmark for the palm oil industry
- Almost all futures contracts are financially settled. Less than 2% of all trades is physically delivered.
- The derivatives exchange has entered into a joint venture with CME so that all its derivatives products are traded on the electronic trading platform of CME Group. This has increased the visibility of the Crude Palm Oil Futures Contract and the participation of foreign traders in BMD
- The Government of Malaysia has had an essential role in organising and developing Bursa Malaysia but has a limited role in its current operation. The Minister of Finance has a supervisory role, but at a distance, for example through the appointment of the members of the Securities Commission and approval for certain activities and rules. Most supervision has been entrusted to the Securities Commission and the Bursa itself.

## **31. THAILAND**

Other than Malaysia, Thailand has a specific exchange for derivatives based on agricultural commodities and specific legislation and regulation thereof, separate from the regulation of derivatives based on non-agricultural commodities and on securities.

### **The Agricultural Futures Exchange of Thailand (AFET)<sup>95</sup>**

#### **History, Introduction**

Thailand is a major exporter of several agricultural products, such as rice, rubber, tapioca, etc. - but not coffee. Thailand has been the leading exporter of rice for several decades. Domestic price fluctuations in the aforementioned agricultural products caused risks to all parties concerned in the agricultural sector, such as farmers, processors and exporters. The existing agricultural market was unable to solve this problem.

#### **Agricultural Futures Trading Act**

The idea to establish an agricultural futures exchange in Thailand had been brought up since 1979. The Internal Trade Department under the Ministry of Commerce realized the importance of an agricultural futures exchange as a mechanism in futures price discovery and as a tool to manage and hedge risks from price volatility<sup>96</sup>. This was also expected to lessen the Government's burden and save Government's budget in providing assistance to farmers. The Draft Agricultural Futures Trading Act B.E. 2542 was submitted for approval to the National Assembly and was enacted and promulgated on April 12, 2000. Two organizations were established under this Act: the Office of the Agricultural Futures Trading Commission (the Office of AFTC) which was set up on May 1, 2001 and the Agricultural Futures Exchange of Thailand (AFET) which was set up on September 20, 2001.<sup>97</sup> The Act has been amended in 2007<sup>98</sup>.

The Act has eight Chapters and 165 Articles which are summarised below.

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<sup>95</sup> Unless mentioned differently the information in this chapter on Thailand is based on <http://www.afet.or.th/2013/en/home/> (read on 2 April 2014) with respect to Agricultural Futures Trading Exchange of Thailand and on [http://www.aftc.or.th/begin\\_business\\_en.php#1](http://www.aftc.or.th/begin_business_en.php#1) (read on 2 April 2014) with respect to the Agricultural Futures Trading Commission.

<sup>96</sup> At the end of the Act (as enacted) the following "Remarks" are added: The reasons for the promulgation of this Act are: because of the instability of agricultural commodity prices causing risks to farmers, operators of agricultural commodity processing plants, and exporters; because of the inability of the present agricultural commodity market to solve the foregoing problems; as a long-term solution to the instability of agricultural commodity prices and for the development of more efficient agricultural commodity futures trading in Thailand, it is deemed fit to establish an agricultural futures exchange to provide opportunity for farmers, operators of agricultural commodity processing plants, and exporters to conduct agricultural commodity futures trading on an exchange having definite futures trading rules, regulations, and measures conducive to fairness and protection of the public, customers and economic stability, which will lessen risk of volatility of agricultural commodity prices in the future and enable production and trading plans consistent with the market demand and thus a futures trading law is expedient; this Act was enacted. AFET's own website adds that, as Thailand is a major producer and exporter in agricultural products in the world and if AFET price will be the internationally accepted benchmark for global agricultural price, this will be of great benefit to the sustainable growth in Thailand's economy and agriculture as a whole.

<sup>97</sup> See: Introducing AFTC, published by the Office of the Agricultural Futures Trading Commission, p.3.

<sup>98</sup> Agricultural Futures Trading Act (No. 2) B.E. 2550.

## **The Regulator: The Agricultural Futures Trading Commission**

Chapter 1 of the Act (Supervision of the Agricultural Futures Trading, Sections 5 - 25) establishes the Agricultural Futures Trading Commission (the “AFTC”) and the Office of the Agricultural Futures Trading Commission.

The AFTC comprises four members of the Government, including the Minister of Commerce<sup>99</sup>; the Governor of the Bank of Thailand; and five qualified persons having experience in the business of trading in agricultural commodities and appointed by the Cabinet of Ministers, as members. Of these five members, there shall be at least one qualified person from each area of law, commerce, finance, and agriculture. The AFTC also has a Secretary-General (functioning as CEO of the Office) as a member, and a secretary.

The AFTC conducts several regulatory and supervisory functions to ensure fairness, competitiveness, and efficiency of the marketplace<sup>100</sup>. The regulatory functions include issuance of regulations governing futures businesses, approval of the Agricultural Futures Exchange of Thailand (AFET) Trading Rules, and the licensing and supervision of futures businesses. Its market supervision function is to be accomplished through comprehensive market oversight programs aimed at prompt detection and prevention of manipulation and abusive trade practices and punctual initiation of appropriate action where necessary. As regards its market development mission, the AFTC uses public relation and educational programs to keep the public informed of the benefit and functions of the agricultural futures trading and to encourage the participation of all related parties. It also promotes new products for trading on the AFET<sup>101</sup>.

The functions of the AFTC can be described in more detail as follows<sup>102</sup>:

1. Regulation: rules and regulations concerning futures trading business will be submitted for the AFTC’s approval prior to being issued, such as principles or criteria for the consideration of applications for business licenses, for AFET members, members of the Clearing House, and for the election of AFET directors, rules for maintaining financial status to ensure financial reliability of futures trading operators, rules for temporary suspension of trading, etc.
2. Licensing: as part of the decision to issue a business licence, the AFTC will examine, for example, whether the directors of the business license’s applicant are not disqualified, and the applicant has employees in the number specified by the AFTC who have completed a futures trading training from an institution certified by the AFTC. The applicant must have good systems to prevent risk and conflict of interest or internal control procedures.
3. Supervision: to ensure financial stability and compliance with rules and regulations, AFET

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<sup>99</sup> The Minister of the Ministry of Commerce as chairman, the Permanent Secretary of the Ministry of Finance, the Permanent Secretary of the Ministry of Agriculture and Co-operatives, the Permanent Secretary of the Ministry of Commerce, see Section 5 of the Agricultural Futures Trading Act.

<sup>100</sup> Agricultural Futures Trading Act Section 7.

<sup>101</sup> See “Introducing AFTC”, published by the Office of the Agricultural Futures Trading Commission.

<sup>102</sup> For a further description of the powers and duties of the AFTC, see the document Protection of Investors under the Agricultural Futures Trading Act B.E. 2542 and Relevant Notifications and Principles, published at [http://www.aftc.or.th/investor\\_en.php](http://www.aftc.or.th/investor_en.php).

will supervise in accordance with international standards, such as maintaining financial status, avoidance of market manipulation, etc.

Regarding the supervision of futures trading operators, the AFTC examines whether they have fulfilled qualifications and act in accordance with the principles and criteria as specified by the AFTC to ensure that they do not take advantage of their customers; for example, with respect to executing trades for a customer and money received from a customer, the futures broker must segregate the account of each customer from the account of the broker or agent.

4. Surveillance: To prevent market manipulation and unfairness, the surveillance unit examines and monitors the market situation, especially the significant trading accounts of major traders, etc.

5. Enforcement: the AFTC has the authority to supervise futures trading operators. If it is found out that they lack qualifications for the conduct of business, or fail to comply with principles or rules, to maintain their financial status or fail to properly prepare accounts or financial statements and to complete them within the stipulated times, the Secretary-General will have power to order such operators to rectify or comply with the stipulated principles or suspend or revoke their license.

### **The Office of the Agricultural Futures Trading Commission**

The Office of the Agricultural Futures Trading Commission has the power and duties to act in accordance with the resolutions of the AFTC<sup>103</sup>.

### **The Market Participants**

The Act specifies five categories of futures trading business operators who have the following roles and duties<sup>104</sup>:

- |                             |  |
|-----------------------------|--|
| 1. Futures Trader:          | conducts futures trading for his own account, is entitled to apply for membership of the Exchange.   |
| 2. Futures Broker:          | solicits buy or sell orders from customers, conducts futures trading for his own account, is entitled to apply for membership of the Exchange. |
| 3. Futures Trading Advisor: | engages in advising in respect of futures trading those who want to trade futures on the Exchange.   |
| 4. Futures Agent            | is an agent of a futures broker in soliciting buy or sell orders from customers.   |

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<sup>103</sup> Agricultural Futures Trading Act Section 17 describes these duties as follows: (1) to perform the administrative duties of the AFTC and the sub-committee; (2) to hold ownership or possessory rights or have in possession any properties, construct, buy, procure, sell, dispose of, rent, let, hire- purchase, lease on hire-purchase terms, borrow, lend, accept pledges, take mortgages, exchange, transfer, accept transfers, do any acts concerning properties inside or outside the Kingdom, as well as receive donated properties; (3) to borrow money, lend money, and invest for profit; (4) to fix service fees for operations of the Office; (5) to receive fees as the AFTC shall require; (6) to do other acts as stipulated by law to be within the power and duties of the Office or as the AFTC shall designate.

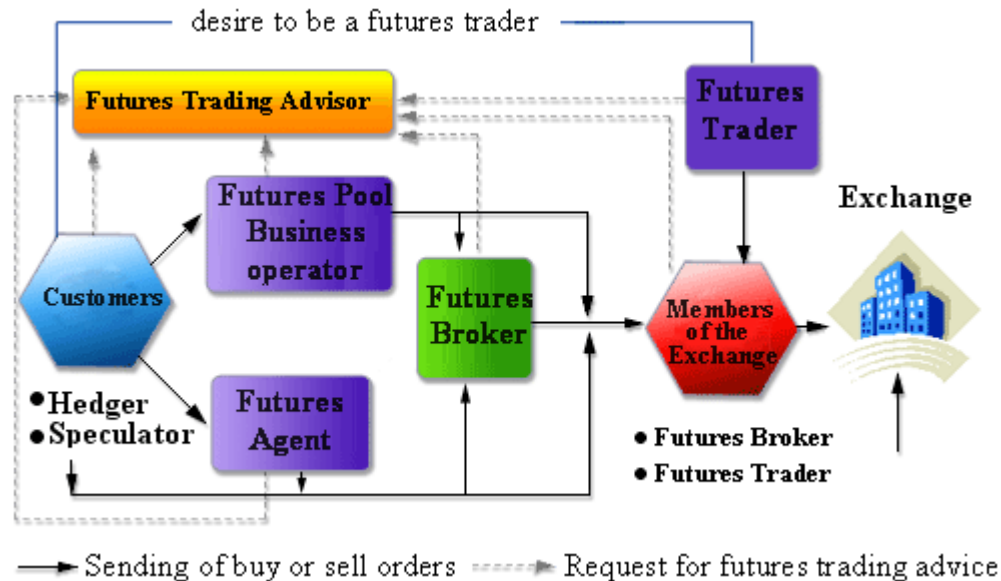
<sup>104</sup> Agricultural Futures Trading Act Chapter 2 (Futures Trading Business) Part 1 Sections 26 - 43.



5. Futures Pool Business Operator administers and manages futures pool business.

There are two kinds of futures pool business: management of private capital and management of an agricultural futures fund.

### Chart of Roles and Duties of Futures Trading Business Operators



The Act provides the application procedures, licence requirements and (ongoing) obligations for these operators; the futures pool businesses<sup>105</sup>; and suspension and revocation of license and dissolution of futures trading business<sup>106</sup>.

### The Agricultural Futures Exchange of Thailand (AFET)

The AFET has been created in the Agricultural Futures Trading Act itself as an independent legal entity established under the provisions of the Act<sup>107</sup> to run the exclusive agricultural futures exchange in Thailand regulated by the Agricultural Futures Trading Commission. The AFET is the marketplace to trade agricultural futures with established rules and regulations. Chapter 3 of the Act provides for institutional aspects of the AFET, Chapter 4 describes the operational aspects<sup>108</sup>.

On September 20, 2001, the first Board of Directors of the AFET was appointed.

<sup>105</sup> Agricultural Futures Trading Act Chapter 2 Sections 44 - 56.

<sup>106</sup> Agricultural Futures Trading Act Chapter 2 Sections 57 - 71.

<sup>107</sup> Chapter 3 (Agricultural Futures Exchange) of the Act consists of: Part 1 (Establishment) Sections 72 - 76; Part 2 (Board of Directors of the Agricultural Futures Exchange) Sections 77 - 88; Part 3 (Clearinghouse) Sections 89 - 93; Part 4 (Exchange Development Fund) Sections 94 - 98.

<sup>108</sup> Chapter 4 (Operation of the Exchange) of the Act consists of: Part 1 (Futures Trading of Members and Operation) Sections 99 - 107; Part 2 (Preparation and Audit of Accounts) Sections 108 - 113; Part 3 (Determination of Dispute) Sections 114 - 117.

AFET's stated mission is:

- 1 To serve as a price risk management mechanism for all stakeholders
- 2 To serve as a price reference source for both domestic and international trades
- 3 To serve as an alternative investment for both domestic and overseas investors
- 4 To assure that market and financial integrity be in place.

The AFET launched its first futures trading with natural rubber, ribbed smoked sheet no.3 (RSS3) on May 28, 2004. The second futures contract, white rice 5% broken, was listed on August 26, 2004 and tapioca starch premium grade on March 25, 2005.

The futures that are currently traded on AFET are:

- Ribbed Smoked Rubber Sheet no. 3
- Block Rubber STR20
- White Rice 5% both options
- Thai Hom Mali Rice 100% Grade B Both Options
- White Rice 5% FOB
- Tapioca Chip Both Options
- Canned Pineapple Pieces in Light Syrup

### **AFET - Clearing House**

AFET's Clearing House is an in-house unit in the Exchange with the function of ensuring the financial integrity of each trade for investors and hedgers. The Clearing House takes on the role to oversee that all counter-parties abide by the terms and conditions once they enter into a futures contract. In practice, orders are 'cleared' by means of the Clearing House acting as the buyer to all sellers and the seller to all buyers.

AFET's Clearing House is divided into 3 divisions which are the Clearing Division (clearing transactions between AFET and broker members), Risk Management Division, and Delivery Division.

### **Operational Aspects**

The operational provisions of the Act deal with such matters as determination (usually by the Board of Directors of the AFET, see Section 78) of the commodities that are eligible for futures trading<sup>109</sup>; certification of warehouses<sup>110</sup>; margin to be posted with the Clearing House and the daily adjustment of margin in accordance with the market conditions<sup>111</sup>; trading days<sup>112</sup>; daily price limits in the daily futures trading of agricultural commodity; trading volume of each Agricultural Commodity of the Members or the Customers<sup>113</sup>; suspension of trading in a certain commodity future; the prohibition for a member of the AFET to buy or sell an

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<sup>109</sup> Section 100.

<sup>110</sup> Section 78.

<sup>111</sup> Section 101-102.

<sup>112</sup> Section 103.

<sup>113</sup> Section 78.

agricultural commodity on the exchange; or disposal or cancellation of futures contracts<sup>114</sup>; the issuance by the AFTC of orders<sup>115</sup>; and in case of bankruptcy of a member, assignment of its contracts and margin accounts to other members<sup>116</sup>.

### **Dispute Settlement**

The Act also provides for a mechanism to settle disputes<sup>117</sup>. If a dispute arises from or in connection with futures trading between Members or between a Member and a Customer, the disputing parties may file an application to the Office of the AFTC or to the AFET for determination of the dispute by the Secretary-General or arbitration, as the case may be. The determination of the Secretary-General or the arbitration shall be final.

If the disputing parties request the determination of the dispute by arbitration, the tribunal shall comprise a person appointed by the Board of Directors of the AFET as chairman and other persons each of whom shall be appointed by each disputing party from the list of arbitrators registered with the Board of Directors of the AFET.

### **Supervision**

Chapter 5 of the Act imposes ongoing obligations for the trading operators referred to above, such as the rule that a futures trading business operator shall not conduct a futures purchase or sale off the Exchange, or act as a broker or agent for a futures purchase or sale off the Exchange, unless permitted by the AFTC; and that it shall not buy or sell an Agricultural Commodity for a Customer without a buy or sell order from the Customer<sup>118</sup>.

### **Appeal Committee**

A Futures Trading Business operator, Member, or person affected by an order issued under the Act who does not agree with the order of the Secretary-General under certain Sections or certain determinations or orders of the Board of Directors of the AFET may appeal to the Appeal Committee; this Committee consists of at least 5 and no more than 7 members<sup>119</sup>.

### **Enforcement**

The last two chapters of the Act deal with enforcement. A person appointed by the Minister of Commerce may enter the office of the AFET or of any holder of a business licence to examine the business, assets, and liabilities of such persons and collect relevant documents, evidence, or information. For the purpose of examination or taking legal action, s/he may search any place if there are reasonable grounds for suspecting that an offense under the Act

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<sup>114</sup> Section 104.

<sup>115</sup> Section 105.

<sup>116</sup> Section 106.

<sup>117</sup> Sections 114-117.

<sup>118</sup> Section 118.

<sup>119</sup> Section 129.

is committed and seize documents involved in the commission of the offense under the Act<sup>120</sup>. This is followed by a large number of penal provisions<sup>121</sup>.

### **Market Surveillance**

AFET has recognized that good governance is the key success factor since it enhances the reliability, accuracy, fairness and transparency of the exchange. To ensure the exchange's integrity, the market surveillance function was established to monitor the trading activities during all the trading hours to avoid violations, such as price distortion and price manipulation, which may cause damage to investors or other stakeholders. Moreover, AFET oversees members' activities to ensure that they comply with applicable rules and regulations. The electronic exchange trading system is one of the key areas of concern so that AFET monitors it closely to ensure efficiency and reliability of the system and that it meets generally accepted standards.

### **AFET - Rules and Regulations**

AFET's rules and regulations<sup>122</sup> deal with the following subject matters:

- Chapter 1 Membership
  - 1.1 Exchange Members, i.e. futures traders and futures brokers, with rules for both categories (including capital requirements) and the maximum number of brokers
  - 1.2 Clearing members, with rules setting out requirements (including capital requirements) and duties and obligations for general, corporate and associate clearing members, form and material details of clearing agreements and opening of bank deposit accounts with settlement banks
  - 1.3 Cash or Securities for the Stability of the Clearing Members with rules for deposits by clearing members with the clearing house
  - 1.4 Payment of Contributions, Management and Use of Money or Properties of the Exchange Development Fund
  - 1.5 Penalties and Termination of Membership
  - 1.6 Associate Trader
  - 1.7 Transaction Volumes prescribing transaction volumes generated by members, with sanctions as mentioned
  
- Chapter 2 Futures Trading
  - 2.1 Trading in Agricultural Commodities with rules regarding trading through an electronic platform, entry of bids and offers into the platform priorities

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<sup>120</sup> Section 130.

<sup>121</sup> Sections 135-160. In this connection, according to a report published in [http://www.aftc.or.th/pdf/2013-10-29\\_news.pdf](http://www.aftc.or.th/pdf/2013-10-29_news.pdf), the Settlement Committee appointed by the Commerce Minister will have power to make a determination for a case settlement as regards any offense under the Act which is punishable by a fine only, a fine or imprisonment for not more than one year, or a fine and imprisonment for not more than one year.

<sup>122</sup> The rules have not been analysed. They can be found at <http://translate.google.nl/translate?hl=nl&sl=th&tl=en&u=http%3A%2F%2Fwww.afet.or.th%2F>.

and matching of bids and offers in the platform and liquidation of positions of futures contracts

- 2.2 Exchange of Futures for Physicals setting out Rules, Procedures and Conditions Concerning the Exchange of Futures for Physicals (“EFP”) meaning the exchange of the seller or buyer position under a cash contract for the same products for an opposite futures position to be held by the selling member and the buying member against the Clearing House, i.e. exchanging the seller position under a cash contract for the same product for a long futures position, or exchanging the buyer position under a cash contract for the same product for a short futures position
- 2.3 Internet Futures Trading
- 2.4 Extension of Position Limit, stating that any person may not hold a number of contracts which is more than the limit prescribed by the rules and regulations concerning the contract specifications, unless permission to extend the position limit is granted by the Exchange under this Regulation
- 2.5 Trading Platform Officers
- 2.6 Spread Position, meaning holding a long position in a futures contract and a short position in another futures contract for the same type of agricultural commodity but with different delivery months
- 2.7 Market Maker, meaning a person approved by the Exchange to operate as a market maker to ensure liquidity in futures trading on the Exchange; the most important duty of the Market Maker is to make futures bids and offers on the Exchange under the conditions described in the Regulation
- 2.8 Negotiated Large Trades
  
- Chapter 3 Margin
  - 3.1 Margin Rates, setting out rules for initial margin and maintenance margin
  - 3.2 Deposit, Maintenance or Withdrawal of Margins and Mark to Market of Margins Accounts
  
- Chapter 4 Fees
  - 4.1 Futures Trading and Clearing Service Fee Rate
  - 4.2 Cash Settlement Fee Rate
  - 4.3 Exchange of Futures for Physicals
  - 4.4 Historical Data Service Fee Rate
  - 4.5 Futures Contract Transfer Fee Rate
  
- Chapter 5 Product
  - Rules Concerning the Designation of Agricultural Commodities for Trading on the Agricultural Futures
    - Rubber
    - Rice
    - Tapioca
    - Pineapple
  
- Chapter 6 Members Trading
  - 6.1 Futures Trading by Futures Brokers
  - 6.2 Futures Trading by Futures Traders

- Chapter 7 Settlement of Disputes  
Arbitration Procedure; this chapter provides that prior to referring a dispute to arbitration, the Secretariat of the AFTC shall hold a meeting for the parties to negotiate and settle the dispute. Following this meeting, if the parties find it

appropriate to enter into arbitration proceedings or if the mediation process terminates and the parties fail to reach an agreement, the Exchange shall give notice to the parties to appoint arbitrators. The regulation has rules for the appointment of arbitrators, the conduct of the procedure and the issuance of the arbitral award.

## Other Derivatives

Non-agricultural derivatives are traded on the Thailand Futures Exchange (TFEX), a subsidiary of the Stock Exchange of Thailand, established on May 17, 2004. TFEX is governed by the Derivatives Act B.E. 2546 (2003) and is under the supervision of the Securities and Exchange Commission. The Derivatives Act defines "goods" as securities, gold, crude oil, or any other property as specified in a notification of the Securities and Exchange Commission with the approval of the Cabinet, excluding currencies. TFEX received a license to trade futures, options and options on futures where the permitted underlying assets are:

- Equities: Index and Stocks
- Debt: Bonds and Interest Rate
- Commodities: Gold, Silver and Crude Oil
- Others: Exchange Rate and other as may be announced by the Securities and Exchange Commission.

Derivatives in Thailand started long before the Thailand Futures Exchange came into existence. Contracts usually took the form of an OTC between two counter-parties such as a retail bank and a client wishing to hedge away a risk such as exchange rate and interest rate risk. Before the establishment of TFEX, derivatives products were only available to those directly involved and not to public investors. As the market became more developed, new products were introduced and two laws were promulgated to support continuing development of instruments and transactions, namely the Derivatives Act B.E. 2546 (2003) and the Trust for Transactions in Capital Market B.E. 2550 (2007).

It is interesting that the Thailand Futures Exchange is subject to the authority of the Securities and Exchange Commission, as are the stock exchange and securities trade. As in Malaysia before 1992, several authorities (Ministry of Finance, Bank of Thailand, Stock Exchange of Thailand and Ministry of Commerce) were responsible for various aspects of securities trade. The dispersion of authority and supervision among several agencies and under several laws caused duplication of work and a lack of coherence and continuity. Besides, the highly active market in 1987 drew in short-term speculation that led to unfair market practice amidst inefficient investor protection. To address these issues, the Securities and Exchange Act B.E. 2535 (1992) was promulgated, and the Securities and Exchange Commission was established as independent regulator with centralized roles for supervision and development of the securities markets and later the derivatives market.

Other than in Malaysia, however, the organisation and regulation of derivatives with agricultural commodities as underlying asset are excluded from this comprehensive approach and, as discussed above, have their own regulation.

## Conclusions for Thailand

Based on the above description it seems that the following conclusions may be drawn:

- Thailand has a distinct regulatory regime for derivatives based on agricultural commodities with separate legislation, supervisory authority and market. The regulation and supervision of other derivatives are more in line with the regulation and supervision of the securities market and transactions in shares and bonds
- The trade in agricultural derivatives in Thailand has been initiated and continues to be managed to a considerable extent by the Government, as for example the composition of the Agricultural Futures Trading Commission shows<sup>123</sup>
- There is one agricultural futures exchange established by the Agricultural Futures Trading Act itself
- Seven agricultural commodities are traded, but coffee is not included
- It is not clear whether the Clearing House is a separate entity; it is referred to as an in-house unit of the AFET.

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<sup>123</sup> Government intervention may also be inferred from the following publication found in [http://www.aftc.or.th/pdf/2013-10-29\\_news.pdf](http://www.aftc.or.th/pdf/2013-10-29_news.pdf) (read March 2014) "The National Rice Policy Committee has approved to release 500,000-1,000,000 tonnes of rice from government stock through the Agricultural Futures Exchange of Thailand (AFET). In order to promote fairness and transparency among domestic and foreign rice purchasers, the auction will be conducted on a "basis auction method", which had been successful in the years 2007 and 2009. With this method, the bidders will bid for basis at Public Warehouse Organization, whereby AFET rice futures prices would be used as the reference prices to be delivered at a specified time in the future.

## **32. United Kingdom**

### **The UK regulatory framework<sup>124</sup>, Financial Services and Markets Act 2000 (FSMA)**

The basic regulatory legislation in the United Kingdom is the Financial Services and Markets Act 2000 (FSMA) which replaced the Financial Services Act 1986. Both Acts were and are heavily influenced by legislation of the European Union.

Since 2013, the Financial Services and Markets Act provides for a division of regulatory responsibilities between the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). The Financial Services and Markets Act has entrusted to the Financial Conduct Authority a more coordinated approach to promoting market integrity across market and firm supervision. The Prudential Regulation Authority should focus on the prudential risks to banks arising from their commodities activities.

Subject to some subtleties, the Financial Services and Markets Act applies to, and the Financial Conduct Authority regulates, commodity derivatives markets, but not the underlying physical markets. In general one could say that the Financial Services and Markets Act applies to:

- futures (which, for these purposes, includes some physical forwards and does not relate exclusively to exchange-traded products)
- contracts for difference, and
- options on financial instruments (as well as currencies and precious metals).

As for futures, the applicability of the Financial Services and Markets Act is subject to an exception intended to exclude contracts entered into for commercial purposes, based on a number of indicators. Most important is that instruments are subject to the Act and subject to regulation by the Financial Conduct Authority if they are traded on a Recognised Investment Exchange (RIE) and that they are not subject to the Financial Services and Markets Act if they are traded for spot physical delivery.

The Financial Services and Markets Act 2000 requires a Recognised Investment Exchange to ensure, inter alia, that its Rules and practices will allow for business to be conducted in an orderly manner on its market, and so as to afford proper protection to investors.

The Financial Services and Markets Act did not materially change the scope of instruments covered by the preceding Financial Services Act<sup>125</sup>.

### **Recognised Bodies**

Although the Financial Conduct Authority has a direct interest in, and powers over, the OTC market, a principal focus of its interaction with the commodity markets remains the three Recognised Investment Exchanges (RIEs) that offer trading in commodity derivatives:

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<sup>124</sup> The following paragraphs are based on the report "Regulating the commodity markets: a guide to the role of the FCA", published by the UK Financial Conduct Authority and found in <http://www.fca.org.uk/static/documents/guide-to-commodity-markets-regulation.pdf>.

<sup>125</sup> However, it affected firms in the energy market principally through abolishing the previous Permitted Persons regime, which had applied under the FS Act and which set nominal obligations upon firms.



- ICE Futures Europe
- LIFFE
- London Metal Exchange (LME).

Global consolidation amongst exchange operation and ownership is increasingly relevant for these UK Recognised Investment Exchanges: the LME is now owned by Hong Kong Exchange & Clearing Group while ICE has taken over NYSE Euronext, which includes LIFFE. Additionally, all three exchanges have made, or are instigating, changes to their clearing service provider, with a tendency to bring these in-house.

Under the new regulatory framework, Recognised Clearing Houses are from April 2013 supervised directly by the Bank of England.

The structure that Recognised Bodies operate under is essentially unchanged since the Financial Services Act: they are exempt from the requirement to obtain authorisation provided that they remain within the boundaries of their exemption<sup>126</sup>.

### **Enhanced Oversight**

Recognised Investment Exchanges are considered front-line regulators of the markets they operate and have each taken steps to enhance market oversight since 2007. ICE Futures Europe and LIFFE have initiated end-user position reporting, which is used internally for market monitoring and externally to improve market transparency by the publication of Commitment of Trader reports for certain contracts. The LME has a form of position reporting in place to support its Lending Guidance regime.

### **Warehousing**

The operation of warehouses licensed by Recognised Investment Exchanges is not a regulated activity. However, the Financial Conduct Authority has a formal interest in warehousing in relation to commodity markets because of the role it plays in ensuring that those RIE derivatives contracts which incorporate warehouse arrangements are anchored to the price of the underlying product and have effective settlement arrangements. Recognised Investment Exchanges have a contractual relationship with the warehouses and have terms and conditions by which the warehouses must abide.

### **FCA Firm supervision**

For all UK regulated commodities firms, the Financial Conduct Authority adopts the same approach as for other firms: making an assessment of impact to decide whether they should be relationship managed, thematically managed, or event-driven supervised from the FCA's firm contact centre. Relationship managed firms are subject to regular risk assessments using FCA's risk assessment framework.

Commodity market participants that are banks are prudentially regulated by the Prudential

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<sup>126</sup> RIEs are subject to the Recognition Requirements set out in secondary legislation and on which the FCA provides guidance within the FCA Handbook in the REC sourcebook.

Regulation Authority, with the FCA responsible for their conduct regulation only.

## **The London Metals Exchange (LME)**

One of the most important international commodity markets of the world is the London Metals Exchange (“LME”). On LME derivatives contracts are traded for non-ferrous metals and a few other commodities: aluminium, aluminium alloy, cobalt, copper, lead, NASAAC, molybdenum, nickel, steel billet, tin, zinc. It provides certain services regarding precious metals (gold and silver)<sup>127</sup>.

### **LME - History**

The London Metal Market and Exchange Company (London Metal Exchange) was founded in 1877, but the market traces its origins back to 1571 and the opening of the Royal Exchange, London. Before the exchange was created, business was conducted by traders in London coffee houses using a makeshift ring drawn in chalk on the floor. At first only copper was traded. Lead and zinc were soon added but only gained official trading status in 1920. The exchange was closed during World War II and did not re-open until 1952. The range of metals traded was extended to include aluminium (1978), nickel (1979), tin (1989), aluminium alloy (1992), steel (2008), and minor metals cobalt and molybdenum(2010). The exchange ceased trading plastics in 2011. The total value of the trade is around \$US 11.6 trillion annually.

### **LME - Regulatory**

The LME has been approved as a Recognised Investment Exchange (RIE). As an RIE, the Exchange comes under the direct jurisdiction of the Financial Conduct Authority. Regulation of the market is largely carried out by the LME itself, while the Financial Conduct Authority is responsible for regulating the financial soundness and conduct of LME members' business.

Moreover, both the LME and its members are subject to regulatory controls and input from various UK bodies and government offices, as well as EU directives. In international trading, rules applied by overseas regulatory bodies such as the US Commodity Futures Trading Commission (CFTC) also have to be taken into account.

To ensure the observance of these regulations, the LME has a compliance department under the supervision of the Executive Director of Regulation & Compliance.

### **LME - Rules and Regulations<sup>128</sup>**

The rules and regulations of the LME have 11 Parts, including Part 2 Membership, Enforcement and Discipline; Part 3 Trading Regulations; Part 4 Contract Regulations; Part 5 Options Regulations; Part 6 Special Contract Rules; Part 7 Requirements for the listing of brands; Part 8 Arbitration Regulations; and Part 9 Default Regulations.

As is the case with other exchanges, LME's Arbitration Regulations constitute a fully fledged

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<sup>127</sup> <http://www.lme.com/metals/>

<sup>128</sup> This paragraph is taken from <http://www.lme.com/~media/Files/Regulation/Rulebook/Full%20Rulebook.pdf>

set of rules for arbitration of disputes, witness the table of contents below:

- Section 1 Definitions and Interpretations
- Section 2 Commencement
- Section 3 Appointment of Tribunal
- Section 4 Procedure
- Section 5 Notices and Communications
- Section 6 Submission and Documents
- Section 7 Hearings and Seat of Arbitration
- Section 8 Party Representatives
- Section 9 Witnesses
- Section 10 Powers of Tribunal
- Section 11 Consolidation
- Section 12 Awards
- Section 13 Costs and Deposit
- Section 14 The Secretary and the Panel Committee
- Section 15 Exclusion of Liability
- Section 16 Governing Law

The LME website adds the following explanatory note:

#### **How arbitration works**

LME arbitration is a private dispute resolution system, designed to settle disputes fairly, expertly and economically, without having to resort to action in the UK or other courts. Designed to lead to a final enforceable award and is distinct from mediation or conciliation. The parties will have agreed that an independent decision on their dispute will be made by a third party, in the form of one, two, or even three arbitrators under the LME arbitration rules. The LME's arbitration service is generally recognised as the best available for the metals industry, which includes physical as well as market trading. Indeed, so well regarded is the LME's arbitration facility that the service is used by a growing number of enterprises who have no direct involvement in metals. The arbitration rules have been drawn under the framework of English law. Any awards are enforceable by the High Court and there is the possibility of appeals on points of law to that Court, although the parties may exclude such appeals by agreement after the arbitration has commenced. Awards are also enforceable in virtually all overseas countries under the New York Convention of 1958, for the Recognition and Enforcement of Foreign Arbitral Awards.

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#### **Selection of the arbitration panel**

Members of the LME arbitration panel are carefully selected. Panelists do not have to be members of the LME, or even associated with the Exchange, but they are generally only admitted to the panel if they can show a broad knowledge based on the practical experience of trading in metals. A legal or arbitration background is now an added requirement but is not the sole requirement. Appointments to the panel are made by the Arbitration Panel Committee.

The arbitrators, whether appointed by parties to a dispute or by the company, remain totally impartial and do not represent any party or act as advocates.

**London International Financial Futures and Options Exchange (LIFFE)**

The London International Financial Futures and Options Exchange (LIFFE) is a futures exchange based in London.

The London International Financial Futures Exchange (LIFFE) started life in 1982, to take advantage of the removal of currency controls in the UK in 1979. The exchange modelled itself after the Chicago Board of Trade and the Chicago Mercantile Exchange. It initially offered futures contracts and options linked to short term interest rates. In 1993 LIFFE merged with the London Traded Options Market (LTOM), adding equity options to its product range. This is when it changed its name to the London International Financial Futures and Options Exchange. In 1996 it merged with the London Commodity Exchange (LCE), and, as a result, a range of soft and agricultural commodity contracts was added to its products offering. By the end of 1996, LIFFE was by far the biggest futures exchange in Europe, followed by the MATIF in Paris and the Deutsche Terminbörse (DTB) in Frankfurt<sup>129</sup>.

LIFFE is now part of IntercontinentalExchange group following a series of takeovers. Euronext (itself the product of a merger between the exchanges of Amsterdam, Brussels, Paris and Lisbon) acquired LIFFE in 2002, and was then in turn taken over by the New York Stock Exchange in 2007, to form NYSE Euronext. The main rationale for this transaction was to gain ownership of LIFFE. In the same manner, IntercontinentalExchange purchased NYSE Euronext in 2013, principally to acquire LIFFE. Although no longer under independent ownership, these series of takeovers have underlined the continuing value and importance of the LIFFE business among listed derivatives exchanges.

LIFFE's robusta futures contract is the world's benchmark for robusta coffee and therefore important for Vietnamese coffee growers and traders.

### **Conclusions for the United Kingdom**

- London is one of the, if not the most important financial center of the world. Developments, such as innovative products, the behavior of market parties and regulatory response thereto may set examples for markets, parties and authorities elsewhere
- Legislation and the regulatory framework in the United Kingdom are strongly influenced by the rules and regulations that continue to be developed in the European Union. The approach is characterised not so much by a distinction between types of products (like, for example, securities and several types of derivatives) but by the type of regulation: on the one hand regulation of conduct of the market parties by the Financial Conduct Authority and on the other hand supervision of the financial position and strength of the parties
- While some of the developments and experience of the financial markets in London may be useful for Viet Nam, the reality of the attempts to create one or more commodity exchanges in Viet Nam is far removed from the London markets. Therefore Viet Nam should not just copy London.

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<sup>129</sup> See [http://en.wikipedia.org/wiki/London\\_International\\_Futures\\_and\\_Options\\_Exchange](http://en.wikipedia.org/wiki/London_International_Futures_and_Options_Exchange).

### **33. United States of America**

The section on the United States deals with

- **The Commodity Exchange Act**
- **The Commodity Futures Trading Commission**
- **The National Futures Association**
- **Futures Exchanges in the USA**

#### **The Commodity Exchange Act**

The Commodity Exchange Act is a federal act passed in 1936 by the U.S. Government. It replaced the Grain Futures Act of 1922 and has been amended several times<sup>130</sup>. The Act provides federal regulation of all commodities and futures trading activities and requires all futures and commodity options to be traded on organized exchanges. The Commodities Exchange Act prohibits fraudulent conduct in the trading of futures contracts.

In 1974, the Commodity Futures Trading Commission Act made extensive changes in the Commodity Exchange Act. It created the U.S. Commodity Futures Trading Commission (the "CFTC")<sup>131</sup> to replace the U.S. Department of Agriculture's Commodity Exchange Authority as the independent federal agency responsible for regulating the futures trading industry. The amended Commodities Exchange Act establishes the statutory framework under which the CFTC operates and gives the CFTC the authority to establish regulations.

#### **Commodity Futures Trading Commission (CFTC)**

The stated mission of the CFTC is to protect market users and the public from fraud, manipulation, abusive practices and systemic risk related to derivatives, including the sale of commodity and financial futures and options swaps, and to foster open, competitive, and financially sound futures and option markets<sup>132</sup>.

The Commission historically has been charged by the Commodity Exchange Act with regulatory authority over the commodity futures markets such as wheat, corn and cotton. Over time, the markets regulated by the Commission have grown to include contracts on energy and metals commodities, such as crude oil, heating oil, gasoline, copper, gold and

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<sup>130</sup> Source for the information on the Commodity Exchange Act:  
[http://en.wikipedia.org/wiki/Commodity\\_Exchange-Act](http://en.wikipedia.org/wiki/Commodity_Exchange-Act)

<sup>131</sup> Sources for the information of the CFTC:  
[http://en.wikipedia.org/wiki/Commodity\\_Futures\\_Trading\\_Commission](http://en.wikipedia.org/wiki/Commodity_Futures_Trading_Commission) and Barry Solomon, last updated January 10, 2012, <http://www.ask.com/explore/what-commodity-exchange-act>, read of 24 April 2014.

<sup>132</sup> The agency's mandate has been renewed and expanded several times. The Commodity Futures Modernization Act of 2000 instructs the Securities and Exchange Commission (SEC) and the CFTC to develop a joint regulatory regime for single-stock futures, the products of which began trading in November 2002. The Dodd-Frank Act of 2010 expanded CFTC's authority to the swaps markets, where the CFTC reach was extended to prohibit the reckless use of manipulative schemes without -as in the past- having to prove the specific intent of the accused to affect prices and the existence of an artificial price.

silver, and contracts on financial products, such as interest rates, stock indexes and foreign currency. In the aftermath of the 2008 financial crisis the CFTC has been charged with regulatory oversight of the swaps market, which is about a dozen times the size of the futures market.

Therefore, the Commodity Exchange Act gives the CFTC exclusive jurisdiction over all commodities futures and options trades. However when securities-based options and futures are traded, those transactions are under the authority of the Securities and Exchange Commission (the "SEC").

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As of 2014 the CFTC oversees 'designated contract markets' (DCMs) or exchanges, swap execution facilities (SEFs), derivatives clearing organizations, swap data repository, swap dealers, futures commission merchants, commodity pool operators and other intermediaries.

The law requires that all brokers and agents engaged in option and futures trading of commodities be properly registered with the CFTC and that they shall only broker transactions from people who are eligible to be a contract participant in such a trade. The CFTC, in concert with the Securities and Exchange Commission, is authorized under the Act to enact rules and to enforce those rules to protect American investors in futures and commodities trades with foreign entities on foreign exchanges.

The Commodity Exchange Act holds agents and brokers responsible for their own actions instead of passing blame on to the client.

When any Board of Trade applies for registration, the Commission is required to forward the application to the Department of the Treasury and to the Board of Governors of the Federal Reserve System to get their notes before approval can be granted.

The Commission has the right to promulgate any rules that are necessary for the execution of its responsibilities to regulate the commodities and future market trades. Additionally it has the right under the Commodity Exchange Act to evaluate any trading facility or specific market event and the investigative power to make sure that it is in complete compliance. The CFTC can rescind the authority of any entity to engage in commodities or futures exchanges if it finds irregularities.

Since other agencies have an interest in the content of commodity trading, the Commission is required to coordinate all of its activities with the Department of the Treasury, the Department of Agriculture, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission for the purpose of keeping such agencies fully informed of its activities.

Based in Washington, D.C., the CFTC maintains regional offices in Chicago, New York and Kansas City, Missouri. The Commission consists of five Commissioners appointed by the President to serve staggered five-year terms. The President, with the consent of the US Senate, designates one of the Commissioners to serve as Chairman. No more than three Commissioners at any one time may be from the same political party.

### **The National Futures Association (NFA)**

Under Section 17 of the Commodity Exchange Act, the CFTC has designated the National Futures Association (NFA) in 1982 as an independent self-regulatory association of futures professionals. As such it is a watchdog of the commodities and futures industry in the USA. The NFA oversees and protects investors from fraudulent commodities and futures activities.

The NFA also provides mediation and arbitration for resolving consumer complaints. NFA is headquartered in Chicago and also maintains an office in New York City.

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### **NFA - Principal Features**

NFA performs several regulatory activities:

- Auditing and surveillance of Members to enforce compliance with NFA financial requirements;
- establishing and enforcing rules and standards for customer protection;
- providing an arbitration forum for futures and forex-related disputes;
- screening to determine fitness to become or remain an NFA Member.

NFA's programs are operational for Futures Commission Merchants, Introducing Brokers, Commodity Trading Advisors, Commodity Pool Operators, and Retail Foreign Exchange Dealers.

NFA Membership is open to any person registered (or exempt from registration) with the CFTC and all futures exchanges provided that the applicant meets NFA's membership qualification standards.

The CFTC has authorized NFA to process CFTC registration applications by screening applicants, and where appropriate, granting or denying registration applications in all categories.

### **NFA - Mandatory Membership**

In 1978, Congress amended the Commodity Exchange Act expressly to permit NFA to have rules requiring mandatory membership. Accordingly, NFA prohibits a Member of NFA from accepting futures orders from another person (except a direct customer) unless that other person is a member of either NFA or another registered futures association. The requirement focuses on the flow of customer orders and, in effect, interrupts that flow if an ineligible person becomes involved<sup>133</sup>.

Foreign entities that transact business directly with U.S. customers solely in futures contracts and commodity options traded on foreign exchanges are exempt from registration if:

- it is an Futures Commission Merchant subject to a comparable regulatory structure by a foreign regulator which has been granted an exemption by the CFTC or an Introducing Broker, Commodity Trading Advisor or Commodity Pool Operator without a U.S. office; and
- it has filed a request for exemptive relief and an agreement with NFA appointing an authorized U.S. agent for service of process for communications in connection with activities that would otherwise require registration.<sup>134</sup>

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<sup>133</sup> One exception to the requirement is the handling of orders by floor brokers. Floor brokers and floor traders are regulated by the exchange where they conduct business, not by NFA. Thus, floor brokers and floor traders are not compelled to join NFA in order to accept futures orders for execution. However, from the point of order origination (i.e., the first FCM, IB, CTA or CPO) until the order reaches a floor broker for execution, only eligible persons may participate in that order flow.

<sup>134</sup> See <https://www.nfa.futures.org/NFA-registration/index.HTML>

With certain exceptions, members must have passed the National Commodity Futures Examination within the two years preceding their application.

### **NFA - Financial Requirements**

One of the principal functions of NFA is to establish, audit and enforce minimum financial requirements for several of its member categories<sup>135</sup>. Certain financially related matters, such as the setting of margin levels, remain exclusively with the exchanges (although NFA retains authority to require Member FCMs to collect margins in accordance with exchange requirements).

### **NFA - Ethical Standards**

The ethical standards adopted by NFA include those specifically required by Section 17 of the Commodity Exchange Act, such as prohibitions against fraud, manipulative and deceptive acts and practices, and unjust and inequitable dealings. In addition, bucketing is prohibited, and there are required procedures for the supervision of employees and the handling of discretionary accounts that are similar to CFTC and exchange requirements.

NFA has also adopted an advertising rule which contains specific provisions concerning communications with the public and promotional material and a "know your customer" rule which requires Members to obtain information about new customers and provide disclosure about the risks of futures trading before the customers open futures or forex accounts and to verify the information annually and determine whether additional disclosure is required.

### **NFA - Membership Screening**

An important first step in regulating NFA Members is screening the applicants for membership. NFA staff conducts the initial screening process. Based on the screening process, NFA's President may determine that the applicant does not meet the membership qualifications or that the application is intentionally incomplete, inaccurate or false. NFA's President must notify the applicant in writing of this determination and provide the Membership Committee with a copy. The Membership Committee makes the final determination on membership eligibility, after providing the applicant with an opportunity for a hearing.

### **NFA - Disciplinary Proceedings**

NFA's Compliance Department is responsible for monitoring NFA Members for compliance with NFA's financial and business conduct requirements. If the Compliance Department determines that a Member has committed a possible violation of an NFA Rule, the Compliance Department prepares a written report and submits it to NFA's Business Conduct Committee for review. This Committee determines whether to close the matter or serve a Complaint outlining the alleged violation(s) on the Member. If a Complaint is issued, the Member must file an Answer and may request a hearing before an NFA's Hearing Panel. If the matter is not settled, and the Hearing Panel issues a decision finding that the Member committed the alleged violations, the Member may appeal the decision to NFA's Appeals Committee. The Appeals Committee's decision is final, subject to review by the CFTC.

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<sup>135</sup> This applies to Futures Commission Merchants, Introducing Brokers and FDM Members. No such requirements currently are established for other Members of NFA, such as Commodity Trading Advisors and Commodity Pool Operators. The futures exchanges are responsible for financial compliance for exchange-member FCMs, although at the request of an exchange NFA may perform those functions for such FCMs.



NFA has authority to discipline any of its Members that are required to be registered with the CFTC.

The penalties that may be assessed include expulsion or suspension for a specified period from NFA membership, censure, reprimand, an order to cease and desist, a fine not to exceed \$250,000 per violation, or any other appropriate penalty or remedial action. A summary action may be taken by the President with the concurrence of the Executive Committee when necessary to protect the markets, customers or other Members.

### **NFA - Arbitration Proceedings, Mediation**

According to its website, another principal function of NFA is to provide a fair, equitable and expeditious procedure for settling customer claims and grievances as required by the Commodity Exchange Act. NFA offers two separate arbitration programs:

- Customer Arbitration is designed for disputes involving customers and NFA Members and their employees. This includes disputes NFA Members initiate against current or former customers.

- Member Arbitration is designed for disputes between and among NFA Members.

Subject to certain exceptions, NFA arbitration is mandatory when a Demand for Arbitration is filed by a customer against a Member or its employees. Arbitration between and among NFA Members is also mandatory in most cases. Counterclaims, cross-claims and third-party claims involving the same acts or transactions that form the basis of the customer's or Member's claim also will be heard.

Arbitration claims are decided by panels of one or three arbitrators appointed by NFA's Secretary. Customers generally have the right to request a non-Member panel consisting of a majority of arbitrators not connected with an NFA Member or NFA to decide their claim. Smaller claims are generally resolved by a single arbitrator through written submissions. Proceedings are informal; however, parties may be represented by counsel. No appeal to NFA is permitted. Awards may be enforced in any court of competent jurisdiction.

To encourage settlements, NFA incorporated mediation into the early stages of the arbitration process.

## **Futures Exchanges in the USA**

### **History**

In the USA, commodity exchanges began in the middle of the 19th century, when businessmen began organizing market forums to make buying and selling of commodities easier. These marketplaces provided a place for buyers and sellers to set the quality, standards, and establish rules of business. By the late 19th century about 1,600 marketplaces had sprung up at ports and railroad stations. For most exchanges, forward contracts were standard at the time. However, most forward contracts were not honored by both the buyer and the seller. For instance, if the buyer of a corn forward contract made an agreement to buy corn, and at the time of delivery the price of corn differed dramatically from the original contract price, either the buyer or the seller would back out. Additionally, the forward contracts market was very illiquid and an exchange was needed that would bring together a market to find potential buyers and sellers of a commodity instead of making people bear the burden of finding a buyer or seller.

As centralized warehouses were built into principal market centers such as New York and Chicago in the early 20th century, exchanges in smaller cities began to disappear giving more business to the major centers. During the 19<sup>th</sup> and 20<sup>th</sup> centuries these exchanges reorganised into four major exchanges: the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Mercantile Exchange and the Commodity Exchange.

### **The Chicago Board of Trade (CBOT)<sup>136</sup>**

Chicago is located at the base of the Great Lakes, close to the farmlands and cattle country of the Midwest, making it a natural center for transportation, distribution, and trading of agricultural produce. Gluts and shortages of these products caused chaotic fluctuations in price, and this led to the development of a market enabling grain merchants, processors, and agriculture companies to trade in "to arrive" or "cash forward" contracts to insulate them from the risk of adverse price change and enable them to hedge.

In 1848 the Chicago Board of Trade (CBOT), the world's oldest futures and options exchange, was formed to provide a centralized location where buyers and sellers can meet to negotiate and formalize forward contracts. Trading was originally in forward contracts; the first contract (on corn) was written on March 13, 1851. In 1865 standardized futures contracts were introduced.

### **The Chicago Mercantile Exchange (CME)<sup>137</sup>**

The Chicago Produce Exchange was established in 1874, renamed the Chicago Butter and Egg Board in 1898. In 1919 it reorganised to enable member traders to allow future trading, and its name was changed into the Chicago Mercantile Exchange (CME).

Following the end of the postwar international gold standard, in 1972 the CME formed a division called the International Monetary Market (IMM) to offer futures contracts in foreign currencies. The 1970s saw the development of the financial futures contracts, which allowed trading in the future value of interest rates. These had an enormous impact on the development of the interest rate swap market.

Agricultural commodities traded on CME include: Live Cattle, Lean Hogs, Feeder Cattle, Class IV Milk, Class III Milk, Frozen Pork Bellies, International Skimmed Milk Powder (ISM), Nonfat Dry Milk, Deliverable Nonfat Dry Milk, Dry Whey, Cash-Settled Butter, Butter, Random Length Lumber, Softwood Pulp, Hardwood Pulp.

### **The New York Mercantile Exchange (NYMEX) and the Commodity Exchange (COMEX)<sup>138</sup>**

In 1872, a group of Manhattan dairy merchants got together and created the Butter and Cheese Exchange of New York. Soon, egg trade became part of the business conducted on

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<sup>136</sup> [http://en.wikipedia.org/wiki/Chicago\\_Board\\_of\\_Trade](http://en.wikipedia.org/wiki/Chicago_Board_of_Trade)

<sup>137</sup> [http://en.wikipedia.org/wiki/Chicago\\_Mercantile\\_Exchange](http://en.wikipedia.org/wiki/Chicago_Mercantile_Exchange)

<sup>138</sup> From [http://en.wikipedia.org/wiki/New\\_York\\_Mercantile\\_Exchange](http://en.wikipedia.org/wiki/New_York_Mercantile_Exchange)

the exchange and the name was modified to the Butter, Cheese, and Egg Exchange. In 1882, the name changed to the New York Mercantile Exchange when opening trade to dried fruits, canned goods, and poultry.

The New York Mercantile Exchange handles billions of dollars' worth of energy products, metals, and other commodities being bought and sold on the trading floor and the overnight electronic trading computer systems for future delivery. NYMEX is headquartered in New York City and has additional offices in Boston, Washington, D.C., Atlanta, San Francisco, Dubai, London, and Tokyo.

In 1933, the COMEX was established through the merger of four smaller exchanges; the National Metal Exchange, the Rubber Exchange of New York, the National Raw Silk Exchange, and the New York Hide Exchange. In the 1970s, COMEX, NYMEX, and other exchanges shared a single trading floor in the World Trade Center. In 1994, the NYMEX and COMEX merged under the NYMEX name.

### **CME Group<sup>139</sup>**

In 2007 the Chicago Mercantile Exchange merged with the Chicago Board of Trade to form the CME Group. In 2008, the CME Group acquired NYMEX Holdings, Inc., the parent company of the New York Mercantile Exchange and Commodity Exchange.

CBOT, CME, NYMEX, and COMEX now operate as designated contract markets (DCM) of the CME Group. On October 17, 2012, CME announced it was acquiring the Kansas City Board of Trade<sup>140</sup>. KCBOT is (was) the dominant venue for the sale of hard red winter wheat. The Chicago Board of Trade is the leading trade platform for soft red winter wheat.

Today, the financial futures markets have far outgrown their agricultural origins of CME. The CME Group is now one of the largest options and futures exchanges. It owns and operates not only the derivatives and futures exchanges in Chicago and New York City, but also online trading platforms, the Dow Jones stock and financial indexes, and CME Clearing Services, which provides settlement and clearing of exchange trades. The exchange-traded derivative contracts include futures and options based on interest rates, equity indexes, foreign exchange, energy, agricultural commodities, rare and precious metals, weather, and real estate. Most trades take place through CME's electronic "Globex" trading platform; NYMEX' open outcry trading was relegated for the most part to a small number of people trading options.

### **CME Rules**

Although CME, CBOT, NYMEX and COMEX have been merged to form CME Group, each exchange remains a separate self-regulatory organization and each maintains its own set of rules. In order to provide a common regulatory framework for market users, the rulebooks

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<sup>139</sup> [http://en.wikipedia.org/wiki/CME\\_Group](http://en.wikipedia.org/wiki/CME_Group) and <http://www.cmegroup.com/>

<sup>140</sup> Effective 15 December (trade date Monday, 16 December), Kansas City Board of Trade (KCBT) products migrated from a KCBT Designated Contract Market (DCM) to the Chicago Board of Trade (CBOT) DCM. It has since been announced that the trading floor would be consolidated with the Chicago operations in June 2013.

have been substantially harmonized, making the rules parallel in structure, numbering and language where possible<sup>141</sup>.

The Rulebooks include the following chapters: Certificate of Incorporation and Bylaws, Membership, Government, Exchange Committees, Enforcement of Rules, Trading Qualifications and Practices, Arbitration, Delivery Facilities and Procedures, Clearing House and Performance Bonds, Clearing Members, following by specific rules for each product or contract traded.

Chapter 6 (Arbitration) of the CME Rulebook has a complete set of rules similar to those of a commercial arbitration center (even including appeal provisions) and has the following sections, each consisting of several articles (most of which have been omitted below):

- Jurisdiction
  - 600. Disputes subject to CME arbitration
  - 600.a. Disputes among members
  - 600.b. Disputes between members and certain non-member employees
  - 600.c. Claims against the exchange
  - 601. Customer claims against members
- Filing procedures
- Pre-hearing procedures
- Hearings
  - 614. Arbitration panel
  - 615. Hearing procedures
- Decisions
  - 616. Awards
  - 617. Correction of award
  - 618. Satisfaction of award
- Appeals
- Additional claims
  - 622. Claims relating to trade cancellations or price adjustments
- Miscellaneous
  - 623. Right to counsel
  - 624. Computation of time
  - 625. Submissions to or communications with the panel
  - 626. Arbitration fees
- Arbitration committee

The CME website offers the following practical guideline for dispute resolution and arbitration<sup>142</sup>:

<sup>141</sup> The rules in the NYMEX Rulebook are applicable to both NYMEX and COMEX. See <http://www.cmegroup.com/market-regulation/rulebook/>

<sup>142</sup> <http://www.cmegroup.com/market-regulation/dispute-resolution/>.

It's possible that at some point in your trading life a problem, misunderstanding or disagreement will occur. If so, you can often resolve such problems by:

**Acting quickly**

Immediately discuss any problem with your firm. As days pass, losses can mount, recollections can fade and information can be lost.

**Talking to your brokerage firm**

When you have a question about your account or a trade, first ask your account representative or your firm's compliance officer what happened and why. Give the firm an opportunity to look into the matter and clear it up for you, or fix a mistake if one has been made. Most differences can be resolved in this way. You can find a list of CME Group's clearing firms in the [CME Group Clearing Firm Directory](#)

**Participating in a dispute resolution program at CME Group, the National Futures Association (NFA) or the Commodity Futures Trading Commission (CFTC)**

Contact one of these entities if you can't resolve your situation with or through your firm or you believe your problem is the result of a violation of CME, CBOT, NYMEX/COMEX, NFA or CFTC rules or regulations.

**If You Are Seeking Restitution**

If you make a complaint about a possible rule violation, the ensuing investigation will be conducted with complete confidentiality. [Read More](#)

**Customer Arbitration Guide**

CME Group, through the Market Regulation department, offers a forum for resolving certain disputes concerning its exchanges. [Read More](#)

**Conclusions for the United States**

- New York and Chicago are among the most important and most developed commodity markets of the world and some of the conclusions for the United States are similar to those for the United Kingdom
- However, other than in the United Kingdom, the commodities markets and the securities markets are regulated separately in the US by the Commodity Futures Trading Commission and the Securities and Exchange Commission although exchange of information and joint approaches are necessary and exist
- The United States is the center of the two largest organisations of the world that provide for derivatives markets, securities markets, trading mechanisms, clearing houses and related services: CME Group and InterContinental Exchange
- As has been observed with respect to the United Kingdom, the examples from the United States should not just be copied to Viet Nam.

### **34. International Developments - The International Regulatory Framework**

In recent years, efforts have been made to strengthen international cooperation between regulators and supervisors and to agree on principles underlying national legislation. The G20 has driven heightened standards for commodities markets with a number of initiatives, aiming to “improve the regulation, functioning, and transparency of financial and commodity markets to address excessive commodity price volatility”. These initiatives complement developments for derivatives markets to merge, move towards central clearing and to enter into joint ventures or collaborative arrangements with other parties, and will bring these markets more comprehensively within the scope of mainstream regulation.

As a key step, the International Organisation of Securities Commissions (IOSCO) published in 2011 its Principles for the Regulation and Supervision of Commodity Derivatives Markets, giving guidance on expected regulatory standards for members and reviewing implementation the following year.

#### **EU Regulation**

In the past couple of decades, the European Union has increasingly taken steps to develop one single market for financial services in the entire EU. The main mechanism to achieve this has been a sequence of “Directives” which are negotiated among the EU member states and then issued by the EU, and which set the goals that the member states have to achieve and leaving them free how to implement this through their national legislation. The result is that underlying principles are the same in all EU member states and that all countries often recognise licences and permits granted in any one member state (referred to as the “European passport”) so that a financial institution may do business in the entire EU. However, in the details national legislation differs per country.

Under the Investment Services Directive (ISD) 1993, commodity derivatives remained outside the scope of EU financial services legislation. This meant that firms were subject only to national capital requirements (where they existed) and were unable to passport commodities business across EU borders (where commodity derivatives were subject to national domestic requirements).

MiFID is the Markets in Financial Instruments Directive (Directive 2004/39/EC). It replaced the Investment Services Directive and has been in force since 2008. It is a cornerstone of the EU's regulation of financial markets and includes commodity derivatives within the definition of financial instruments. It seeks to improve the competitiveness of EU financial markets by creating a single market for investment services and activities, and ensuring a high degree of harmonised protection for investors in financial instruments, such as shares, bonds, derivatives and various structured products.

#### **EU Regulation - New Developments**

While it is said that MiFID has contributed to a more competitive and integrated EU financial market, past years' events and market developments have demonstrated weaknesses in some of the underlying principles of MiFID, and highlighted areas needing reinforcement or revision<sup>143</sup>. The revised MiFID II and accompanying regulation (MIFIR) has received

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<sup>143</sup> See [http://europa.eu/rapid/press-release\\_MEMO-14-305\\_en.htm](http://europa.eu/rapid/press-release_MEMO-14-305_en.htm).

provisional political agreement. It will introduce a requirement for position limits, supported by a position reporting regime across Regulated Markets and other types of markets<sup>144</sup>. It will also enhance the requirement for transaction reporting for commodities.

There are three other pieces of European legislation that will have particular impact on the regulatory framework for commodities. In each case, the legislation has a wide market scope and the treatment of commodities is not central. At the time of writing, each measure is at a different stage in the European legislative process.

- **EMIR:** The European Markets Infrastructure Regulation is being implemented over the next few years. It brings greater transparency to regulators through reporting to trade repositories (which started on 12 February 2014) and reducing systemic bilateral risk through mandatory clearing obligations and risk mitigation requirements for un-cleared OTC trades (expected to start in 2014 or 2015 although the obligation to confirm trades within defined time periods is already in force)<sup>145</sup>.
- **MAR:** The Market Abuse Regulation has also received provisional political agreement. Its provisions will significantly advance the scope of the current regime through increased scope to include behaviour on different categories of markets. It will extend to manipulative behaviour in physical commodity markets. It will also capture attempted market abuse and manipulation that affects benchmarks<sup>146</sup>.  
The changes introduced by MAR will significantly increase the regulatory grip over conduct on commodities markets.
- **Benchmarks:** The European Commission published in September 2013 its proposal for a Regulation on indices and benchmarks. This proposal is wide ranging, applying to benchmarks used in financial markets, but encompassing also those benchmarks relating to commodity markets<sup>147</sup>. IOSCO is also taking forward work on benchmarks and, specific to commodity markets, on oil Price Reporting Agencies (PRAs).

## International Developments - The Markets

Previous chapters mention several mergers between securities and commodity exchanges, the most prominent of which seem

- the acquisition in 2013 by IntercontinentalExchange (ICE) of the New York Stock Exchange - Euronext - LIFFE, the major commodities exchange based in London, and
- The mergers of the Chicago Mercantile Exchange, the Chicago Board of Trade, the New York Mercantile Exchange and the Commodity Exchange.

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<sup>144</sup> Trading platforms called Multilateral Trading Facilities and Organised Trading Facilities.

<sup>145</sup> For further information, see [http://ec.europa.eu/internal\\_market/financial-markets/derivatives/index\\_en.htm](http://ec.europa.eu/internal_market/financial-markets/derivatives/index_en.htm).

<sup>146</sup> For further information, see [http://ec.europa.eu/internal\\_market/securities/abuse/index\\_en.htm](http://ec.europa.eu/internal_market/securities/abuse/index_en.htm).

<sup>147</sup> For further information, see [http://ec.europa.eu/internal\\_market/securities/benchmarks/index\\_en.htm](http://ec.europa.eu/internal_market/securities/benchmarks/index_en.htm).

Hereby two global networks have been created, the CME Group and the Intercontinental Exchange (ICE).

The Intercontinental Exchange now encompasses 17 exchanges, 6 central clearing houses and around 9,700 traded contracts and securities, including many commodity based derivatives<sup>148</sup>.

According to the website, NYSE LIFFE's commodity futures contracts have long been relied upon as global and European benchmarks for Cocoa, Robusta Coffee, White Sugar, Feed Wheat, Milling Wheat, Rapeseed, Corn and Malting Barley. "Our Robusta Coffee futures contract is relied upon as the global benchmark for the pricing of physical Robusta Coffee. It is actively traded by producers, exporters, trade houses, importers and roasters as well as by managed funds and both institutional and short-term investors<sup>149</sup>."

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<sup>148</sup> See <https://www.theice.com/about.jhtml>

<sup>149</sup> [https://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/coffee\\_futures\\_130730.pdf](https://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/coffee_futures_130730.pdf). According the ICE's website, the Coffee C contract is the world benchmark for Arabica coffee. The contract prices physical delivery of exchange-graded green beans, from one of 19 countries of origin in a licensed warehouse to one of several ports in the U. S. and Europe, with stated premiums/discounts for ports and growths. See <https://www.theice.com/productguide/ProductSpec.shtml?specId=15#>.



## VII Conclusions

It is suggested that as a beginning a first round of practical consultations should take place with market parties (such as the existing commodity exchanges and buyers, sellers and traders of a few major commodities) to find out what their immediate, practical concerns and needs are that can be addressed within a relatively short period. During his interviews with several market parties, DMI expert 2 has got the impression that traders who are active in real commodity transactions don't feel the need yet of transactions that go beyond very basic forward transactions and certainly not of financially inspired transactions. A practical step that has been mentioned and should be addressed is the development and enforcement of a reliable warehousing system with emphasis on the enforcement of anti-fraud measures and the introduction of warehouse receipts in the law.

As a second step, a working group should be established to study the most important issues that need to be solved before the basic rules governing commodity exchanges and participation in foreign exchanges in Vietnam are amended.

The working group should consist of, for example, representatives of the Ministry of Industry and Trade, the Ministry of Finance, the State Securities Commission, the Stock Exchange, the State Bank of Vietnam, organisations of suppliers of relevant commodities, trading companies, the existing commodity exchanges and of commercial banks.

This working group should investigate and make decisions on important choices regarding, for example:

- Comprehensive legislation for the financial sector?  
Should there be one comprehensive system of legislation and regulation of the financial sector (including banking, securities trade and exchanges and commodities trade and exchanges, see Malaysia and several European countries) or should there be separate legislation and regulation of on the one hand derivatives trade and exchanges and on the other hand securities trade and exchanges (see for example the USA)?  
*DMI expert 2 is inclined to advise in favour of the former alternative (comprehensive system for financial sector) in view of the development of hybrid instruments and to avoid "arbitrage" by market parties who look for the most beneficial rules by, for example, creating hybrid products that fall under the easiest or no supervision.*
- Separate legislation for commodity based derivatives?  
If a choice is made for separate legislation for derivatives, should there be separate legislation and regulation of commodity based derivatives on the one hand and financial derivatives (based on securities and currencies, FX) on the other hand?  
*DMI expert 2 advises in favour of one framework for all derivatives - the basic rules can and should be the same but detailed rules such as the standard contracts can of course be different and tailor made. Separate legislation would imply separate exchanges and therefore separate registrations and separate supervisors. This should be avoided because it will add to costs and bureaucracy (separate fees, audits and reporting lines, etc.) and create opportunities for "arbitrage" (see previous comment).*
- Separate legislation for agricultural commodities?  
Should there be separate legislation and a separate regulator for derivatives based on agricultural commodities while mineral based and financial derivatives would be subject to different but comprehensive legislation and regulation (see Thailand)? Or should the

same legislation and regulation to all (commodity based and financial) derivatives with one supervisor/regulator?

*DMI expert 2 sees no reason for separate legislation and a separate exchange and supervisor for agricultural commodities. Reason: see previous bullet.*

- One or more commodity exchanges?  
Should there be one commodity exchange, possibly affiliated with the securities exchange (see, e.g., Malaysia) or should there be more commodity exchanges, separate from the securities exchange (see, e.g., India), that can compete in the market (as is currently envisaged for Viet Nam)?  
*DMI expert 2 advises in favour of one commodity market for all selected derivatives, closely affiliated with the existing Stock Exchange. This will increase efficiency, save costs, manpower and know how for the institutions and make matters simpler for market parties (e.g. Fewer audit obligations and reporting lines). See also the comments above.*
- Twin peak model for supervision?  
Should the supervisor(s) have full authority over all aspects of market parties and trade, (see the approach in the USA) or is there a preference for the “twin peak model” (as in several European countries, including the UK) whereby one supervisor has authority for conduct of business and integrity of the markets and another supervisor exercises prudential control (with a focus on the financial, IT and structural soundness of the institutions)?  
*DMI expert 2: this question deserves further study.*
- Role of Government  
What should be the role of the government in stimulating and creating commodity exchanges?  
What should be the role of the Government after the exchange(s) has/ve been created? Should regulatory and supervisory authority be delegated to a Securities Commission or a Commodities Commission, consisting of technical experts who are beyond political influence?  
*DMI expert 2 advises that the Government should take a leading role in the creation and design of (the legislation and regulation of) commodities trade and an exchange, however in cooperation and consultation with all relevant market parties (see the suggested composition of the working group mentioned earlier in this summary). After the structure has been designed and set up, the Government should step back and abstain. The structure should provide for regulation and supervision by a separate and professional Securities and Commodities Commission, independent from the Government and Ministries and without any political interference.*
- Foreign exchange restrictions, role of State Bank of Viet Nam  
What should be the rules (mainly foreign exchange rules of the State Bank) governing the direct and indirect participation of Vietnamese parties in foreign exchanges and the participation by foreign parties in Vietnamese exchanges?  
*DMI expert 2: the State Bank of Viet Nam plays an important role and the question is whether the convertibility status of the dong will change in the future. Reference is made to the comments in paragraph 21 of this Report.*
- Physical delivery and financial settlement  
Is there a preference for derivatives with physical delivery or for financially settled derivatives?  
*DMI expert 2: financial settlement seems more relevant for the financial sector (banks etc.), physical delivery seems more important for suppliers, purchasers and traders of the*

*commodities (the “real economy”).*

- Organisation of spot transactions  
Can and should a commodity exchange also be suitable for spot transactions?  
*DMI expert 2: this question deserves further study. The Ethiopian Commodity Exchange (ECX) (which serves as an example for other countries) should be given a close look.*
- Conditions to be satisfied  
Which of the conditions that must be satisfied for a viable commodity exchange, seem particularly hard to meet in Vietnam and how can these conditions be satisfied?  
*DMI expert 2: see paragraph 18 of this Report.*
- Selection of commodities  
Which commodities may be used as basis for exchange traded derivatives?  
*DMI expert 2: see the box on pages 19-20 and paragraph 23 of this Report.*
- Training  
What are training needs of the various stakeholders and how can such training be provided?

Members of the working group could visit existing exchanges in, for example, Ethiopia, Thailand and Malaysia to get a clear picture of the alternatives. Thereafter, decisions with respect to the issues referred to above and other issues that may come up, should be taken.

A decision must then also be taken how these decisions shall be moved forward, and by whom. It seems clear that a team of domestic and international experts should be appointed to create a viable commodity exchange.

**Annexes:**

**Annex 1 Form of warehouse receipt (separate document)**

**Annex 2 Comments on Commercial Law Articles 63 - 73 and Decree 158/2006**

**Annex 3 Financial Futures**

**Annex 4 Questions for Phase II of the Project Review of Articles 63 - 73 of the Commercial Law and of applicable regulations in Viet Nam**

**Annex 2 to the Report “Commodity Exchanges in the Socialist Republic of Vietnam”, European Trade and Investment Support Project (EU - MUTRAP), May 2014**

**Comments on Commercial Law Articles 63 - 73 and Decree 158/2006**

Below follow comments and questions regarding Articles 63 - 73 of the Commercial Law and Decree 158/2006. No comments are made on Circular 03/2009/TT-BCT because no English translation is available.

Note: some of the comments and questions may be caused by the English translation and may be solved when the Vietnamese text is translated properly.

**Commercial Law Articles 63 - 73**

1. Article 63: it is assumed that parties are free to enter into a forward contract outside an exchange (OTC) and that in such case the provisions of the Civil Law or Commercial Law, or of the foreign law chosen by the parties, regarding contracts will apply. Correct?
2. Article 64.4, first line: after “purchaser” insert “of the option”.
3. Article 65.3, first line: “purchaser” must be changed to “seller”.
4. Article 73: Mr Thuong has confirmed that MOIT has not issued regulations regarding the conduct of purchase and sale of goods through overseas commodity exchanges.

**Decree 158/2006/ND-CP**

5. Articles 4.2.e, 4.3, 4.4, 4.5, 4.6 and 5: Mr Thuong has confirmed that MOIT, the State Bank, the Finance Ministry, the Planning and Investment Ministry and other Government entities have not issued roadmaps or regulations as referred to in these provisions.
6. Articles 26 - 28: these Articles should make clear whether the Payment Center will function as a Clearing House as is the case for most foreign exchanges. Typically, by way of novation of contracts (or transfer of obligations) Clearing Houses become the counterparty of each party to all forward or future contracts concluded through the Exchange on a daily basis. Hereby, the contracts can be cleared and settled by remittance of the resulting net amounts.
7. Article 26.2-4: one of these paragraphs should make clear whether the Payment Center is a separate legal entity, as is usually the case with Clearing Houses.
8. Article 27.1: the words “to request parties involved ... to perform the payment security obligations” are not clear. If the meaning is “to request trading members ... to perform (or deposit) their trading collaterals (margin)”, Article 27.1 should say so and could refer to Article 15.4 and Article 22.2.  
Also if Article 27.1 has a different meaning, it should be expressed clearly.
9. Article 27.2: if the meaning of this paragraph is the collection of charges *from trading members*, the Article should say so. Reference could be made to Article 15.5 and Article 22.3 (unless the fees mentioned in these Articles are different from the fees mentioned in Article 27.2).

10. Article 27.3: the words “may retain all collateral amounts and documents ... and other assets, regardless of whether those assets are owned by that member or its customers” seem too broad. In the first place, the assets of an insolvent member should be available not only for the Payment Center but for all its creditors (in accordance with their ranking). In the second place, assets owned by customers or others should be returned to the legal owners.
11. Article 28.1: add that the Payment Center should keep the collateral amounts deposited by members in separate/segregated bank accounts.
12. Article 29: most foreign exchanges do not own the warehouses but approve or license warehouses of third parties.
13. Articles 30.2 and 31.3: “valid documents” should include warehouse receipts as exist under the law of many countries. Warehouse receipts identify the goods stored and held by the warehouse company for the owner of those goods and are issued by the warehouse to the owner. Warehouse receipts represent title or ownership of the goods described therein and the holder of the receipt is considered owner of the goods. Therefore, the holder can transfer and pledge the goods by transfer or pledge of the receipt without physical transfer or pledge of the goods themselves. Thus, the goods can be used in a simple way as collateral to secure a bank loan (trade finance). It is strongly advised to introduce the concept of warehouse receipt in Vietnamese law (Civil Law or Commercial Law).
14. Article 31: to be added as obligation of the Goods Forwarding Center: to keep the goods insured for all damage.
15. Article 34.1, first line: it should be clarified whether the word “a year” means calendar year or a “moving period” of 12 months.  
Article 34.2: the words, calendar year or moving period of 12 months, should be added.
16. Article 41: this Article is not clear because of the terminology (in English)
  - a) Article 41.1: the words “term-contract trading parties” are not clear and not used elsewhere in the Decree. If these words mean “parties to forward contracts” (see Article 65 of the Commercial Law), these words should be used.
  - b) Article 41.2: the words “contractual trading parties” are not clear and not used elsewhere in the Decree. If these words mean “parties to option contracts” (see Article 66 of the Commercial Law), these words should be used.
  - c) Article 41.4, second sentence, the word “option” is confusing and should be replaced by “decision”.
  - d) Article 41.5, first line: “by mode of goods forwarding” should be replaced by “by delivery and receipt of goods”.
  - e) Article 41.5.a: after “account” the words “with the Payment Center” should be inserted.
17. Article 47: add a paragraph stipulating how and where trading members should keep the collaterals deposited by customers - in any event in separate/segregated bank accounts.

18. Article 48.4: add at the end “in accordance with Articles 50 - 51 of this Decree”.
19. Articles 50 - 53 regarding dispute settlement are unclear and should be rewritten.
  - a) Articles 50 and 51: what is the difference between “settlement of disputes” and “settlement of complaints and denunciations”? Usually, when parties have a dispute, one of them may submit a complaint to the court or arbitration center. If the meaning of disputes and complaints and denunciations is the same, Articles 50 and 51 should be combined. If the meaning of these words is different, their meanings should be clarified.
  - b) Articles 51 and 52-53: what is the difference between “complaints and denunciations” and “administrative violations”? Often a complaint or denunciation will be submitted if an administrative violation has taken place. Again, clarification is recommended.
  - c) Article 50: are the words “the provisions of the Commercial Law and relevant laws on settlement of commercial disputes” clear and do they refer to a particular institution for dispute settlement, for example a court or an arbitration center that is fully independent and impartial with internationally accepted procedures?
  - d) Article 51: are the words “the current provisions of law on settlement of complaints and denunciations” clear and do they refer to a particular institution for dispute settlement? See paragraph c) above.
  - e) Articles 52 - 53: are these Articles only applicable in case of disputes between an Exchange and a member, between a staff member and a member, and between members, therefore not in case of a dispute between a customer and a member or the Exchange?
  - f) Article 53: are the words “the provisions of law on handling administrative violations” clear? Is there an independent court or tribunal for administrative violations, and is it part of a criminal court? Who submits the complaint, a prosecutor? Who are parties to the proceedings?

**Annex 3 to the Report “Commodity Exchanges in the Socialist Republic of Vietnam”  
European Trade and Investment Support Project (EU - MUTRAP), May 2014**

**Financial Futures**<sup>150</sup>

Prior to describing financial futures, the characteristics of financial products and markets in Vietnam are briefly described.

● **General**

The market in Vietnam currently is mainly a money market with repos<sup>151</sup> for Vietnamese government bonds and some bonds by upper tier corporates - only domestic. Most important is that the Vietnamese dong is non-convertible and that the State Bank of Vietnam restricts and regulates financial transactions, particularly foreign exchange transactions, heavily.

● **Bonds (physical, not derivatives)**

Characteristics / impediments of the market:

- The bond market is completely institutional with a limited number of participants. Participants are banks, not corporates. Main participants are domestic banks, participation by foreign banks and (hedge) funds is limited. Those foreign entities that participate have a (representative or branch) office in Vietnam.
- There are (too) many different government bonds, mostly with 2 or 3 year maturity, less with a maturity of 5 and yet less for 10 years.
- Government bonds are usually traded OTC (over the counter) but must be settled through a securities firm, stock exchange and depository which means: high transaction costs (but limited services).
- Participants are not allowed to go short in securities (i.e., shares and bonds), so that there is a one way market.
- Foreign participants who invest in dong (to buy bonds) are not allowed by law to hedge their foreign exchange (FX) position.

The last three items are considered the major impediments.

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<sup>150</sup> The description of the financial markets and instruments is based on information provided orally by a banker during an interview with DMI expert 2 on 6 March 2014

<sup>151</sup> A **repurchase agreement**, also known as a **repo**, **RP**, or **sale and repurchase agreement**, is the sale of securities together with an agreement for the seller to buy back the securities at a later date. The repurchase price should be greater than the original sale price, the difference effectively representing interest, sometimes called the *repo rate*. The party that originally buys the securities effectively acts as a lender. The original seller is effectively acting as a borrower, using their security as collateral for a secured cash loan at a fixed rate of interest. A repo is equivalent to a spot sale combined with a forward contract. The spot sale results in transfer of money to the borrower in exchange for legal transfer of the security to the lender, while the forward contract ensures repayment of the loan to the lender and return of the collateral of the borrower. The difference between the forward price and the spot price is effectively the interest on the loan, while the settlement date of the forward contract is the maturity date of the loan. Source: Wikipedia, read on 7 March 2014



- **Foreign Exchange, Currency Market**

Characteristics / impediments of the market

- The foreign exchange (Forex) market is totally regulated and traded on a very narrow basis. The dong is allowed to fluctuate against the US dollar within a 1% margin up and down but the Central Bank usually intervenes by buying and selling to keep an even narrower band.

One of the interviewees expressed the view that a broader margin is necessary<sup>152</sup>.

- Participants in the foreign exchange markets are only domestic investors. Offshore investors cannot hedge because they are not allowed to go into derivative transactions (including forwards and swaps).

Note: offshore entities are allowed into the spot currency market but only to invest in securities (shares and bonds), not in deposits.

- **Money market**

Money market and repos is a domestic market. International/foreign institutions cannot participate.

However, Vietnamese banks are permitted to participate in foreign money markets.

### **Financial futures in Vietnam can be characterised as follows:**

1. **Options**

Options are not permitted by the State Bank of Vietnam.

2. **Interest swap market**

The interest swap market hardly exists and has only very few participants. As reasons are mentioned<sup>153</sup>:

- a) Interest rates are very volatile in Vietnam. Therefore nobody wants to be a fixed rate receiver (i.e. purchase a bond) because it is impossible to hedge - it is impossible to sell the position (too risky?)
- b) It is not allowed to go short on bonds, and
- c) There are too few participants in the market.

3. **Cross currency and FX swaps**

Characteristics:

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<sup>152</sup>

<sup>153</sup> Interview of 6 March 2014.

- a) This market is more developed than the interest swap market
- b) Usually the instruments have up to 1 year tenor, a longer maturity is tough
- c) The market could have developed further if foreign investors had been allowed.

#### 4. **Futures**

- a) Futures exist only for commodities, not for financial instruments (equity, bonds, currency)
- b) In the past some banks have tried to organise futures for domestic commodities - actually only for coffee - but these instruments seem to have disappeared
- c) Some banks participate in international futures exchanges (such as the LME, London Metals Exchange). This activity shows the following aspects:
  - i. Domestic banks act through foreign banks who trade on international markets
  - ii. The domestic banks trade for domestic clients (indirect participants), and the products are not purely financial but serve to cover “real positions” in commodities like coffee, certain metals (copper), soy, etc., and always back-to-back
  - iii. The domestic banks need a licence from the State Bank - which in practice is not hard to get.

#### **Summary and conclusions regarding Financial Futures**

- a) For foreign exchange futures, there is a forward OTC market with privately negotiated, customised transactions. Options are not allowed
- b) For shares (equities) and bonds (fixed income), there are only spot transactions, no forwards and futures

If regulation by the State Bank of Vietnam were more flexible (i.e. allowing more offshore participants and (ii) allowing short positions), and if there were a legal framework for futures, more derivatives for bonds, shares, foreign exchange options and interest derivatives would be possible.

**Annex 4 to the Report “Commodity Exchanges in the Socialist Republic of Vietnam”  
European Trade and Investment Support Project (EU - MUTRAP), May 2014**

**Questions for Phase II of MUTRAP Project Review of the provisions of the Commercial Code of Vietnam regarding commodity markets**

- **Regarding Report paragraph 19 (Ministry of Industry and Trade, MOIT):**
  - Has the intention of the authors of the Commercial Law Articles 63-73 and of Decree 158/2006 been that these documents relate only to forward contracts with physical delivery or also to financially settled futures?
  - How do the authorities, particularly the MOIT, interpret these articles and do they apply the Commercial Law and Decree 158/2006 both to forward contracts (with physical delivery in the future) and to futures contracts (financial settlement, no physical delivery)?
  - Can a commodity exchange that is subject to Commercial Law Articles 63-73 and Decree 158/2006 also organise spot transactions, in addition to forward/futures contracts?
- **Regarding Report paragraph 21 (State Bank of Vietnam, SBV):**
  - Can the information in this entire paragraph (particularly all the bullets) be double-checked with the State Bank (Ms Bui Hang, Manager of SBV Monetary Policy Department. phone: 091 5085568m, email address: [Hangbui78@yahoo.com.au](mailto:Hangbui78@yahoo.com.au))?
  - Is the payment of the purchase price by a Vietnamese party for goods purchased spot or forward from a foreign party subject to approval by SBV? Are the purchase and the payment of the purchase price subject to the Ordinance on Foreign Exchange No. 28/2005/PL-UBTVQH11 of 13 December 2005 and/or to Decree No. 160/2006/ND-CP of 28 December 2006?
  - What are the rules regarding the sale of a commodity (spot, forward or future) by a Vietnamese party to a foreign party and the receipt by the Vietnamese party of the price (in dong or in foreign currency)? Does the Vietnamese seller have to receive the money in a bank account in Viet Nam and convert the USD receipt in VNDong? Is this subject to the Ordinance on Foreign Exchange No. 28/2005/PL-UBTVQH11 of 13 December 2005 and/or to Decree No. 160/2006/ND-CP of 28 December 2006?
  - Are there draft rules (of MOIT, MoF, SBV or other government institution) regarding the participation by foreign/international parties in Vietnamese commodity markets?
  - Are there draft rules (of MOIT, MoF, SBV or other government institution) regarding the participation by Vietnamese parties, in particular banks, in foreign/international markets? See particularly draft Circular of MOIT 38/2013/TT-BCT of 30 December 2013 (Technical requirements for commodity sale in commodity exchange) and Roadmap for participation by Vietnamese parties in foreign commodity exchanges.

- **Regarding Report paragraph 23 (Important Commodities):**
  - Is there (English translation) of the Decision of the Minister of the Ministry of Industry and Trade dated 18 August 2010, No. 4361/ QD-BCT to announce the list of commodities authorized for trading through the Commodities Trading Agency and any amendment thereof?
  - Can anything be added for other commodities, e.g. for fish, shrimp or fruits?
- **Regarding Report paragraph 24 (Domestic Commodity Exchanges):**
  - Can the information regarding VNX and Info Comex/Oceangroup be completed and updated?
  - Can the description of BCEC, STE and possibly other organised markets be completed and updated? Are they commodity exchanges for forwards and futures?
- **Regarding paragraph 26 Summary and Conclusions for Commodity Exchanges in Viet Nam**
  - Are there comments on the analysis why commodity exchanges are not a success in Viet Nam?
  - Are there comments on the advantages and disadvantages that commodity exchanges and futures transactions may have for Vietnamese parties (farmers, suppliers and traders)?