REPORT

The current legislative framework governing commodity futures markets

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Contents

I. Overview:

This report reviews the current legislative framework governing commodity futures markets in Vietnam and formulates recommendations for its improvement.It is drafted with reference to the European Trade Policy and Investment Support Project: Revision of the Commercial Law of Viet Nam (Code ICB-15), which has the specific objective (ii) *to support the legal Department of MOIT in revising the text of the Commercial law in Viet Nam, focusing specifically on commodity exchange markets*. The report builds upon a previous report:*Commodity Exchanges in the Socialist Republic of Viet Nam*[1]which provides extensive background information, including a commodity markets overview,current legislative measures and authorities operating in Vietnam and other countries' regulatory frameworks. This report also draws upon the recommendations formulated by the local PMU expert, as presented at conference in HCMC (24 December,2014). Finally, the report includes insights and observations gained by the DMI experts who have been involved in commodities futures markets and their regulation for several decades. The report finds that an improved regulatory framework can be achieved for Vietnam by 1)making specific modifications to the current governing legislation and by 2) focusing on core principles and building legislation upon the standard components of markets' regulation.

II. Current legislation:

The main legal normative documents governing the transactions of goods through commodity exchanges are:

1. The Commercial Law
2. Decree No. 158/2006/ND-CP
3. Circular No. 03/2009/TT-BCT
4. Decision No. 4361/2010/QD-BCT
5. Circular No. 38/2013/TT-BCT

Overall, these specify the conditions, structure and operations of commodity exchanges. These are summarized as follows:

Conditions for establishing a Commodity Exchange

- Joint stock company or limited liability corporation
- Charter in compliance with Decree No. 158/2006/ND-CP
- Articles of Incorporation in compliance with the Law on Enterprises
- Director/President: bachelor'sdegree + experience

[1]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, (May 2014), European Trade And Investment Support Project (EU - MUTRAP) Eduard C. de Bouter, DMI expert 2

- Corporate statement: mission, progress, locations, technical solutions

Members of Commodity Exchanges

- Business: legal capital of 75 billion VND
- Broker: enterprise with legal capital of 5 billion VND

Clearing House

- Division of exchange or entrusted to a credit institution
- Functions: deposits; clearing and settlement
- Regulated entirely by State Bank

Delivery Centers

- Storing, maintaining quality, delivering goods as specified by exchange regulations
- Exchange controlled entity or authorizes other entities to carry out functions

Items permitted for trading

- Three commodities to date authorized to be transacted for delivery on commodity exchanges: rubber, steel, coffee
- Sensitive commodities, e.g. gold, rice, not permitted

Transaction limit

- Total transaction amount (notional volume of trade) not to exceed 50% of total volume of goods produced in Vietnam the previous year
- Transaction limit per member not to exceed 10% of total transaction limit
- [Comments by PMU expert – this limitation is without economic basis and inconsistent with international best practices – most exchanges operate with position limits [ownership, not transaction quantities] or position limit guidance. DMI experts strongly agree with the PMU expert.]

Margins

- Initial margins not to be less than 5% of transactionalvalue; leverage 20:1
- [comments by PMU expert – greater leverage would be desirable]
- [DMI experts note that current agricultural initial margins on agricultural products at CME are about 5% of transactional value although these percentage levels can change in accordance withStandardized PortfolioAnalysis of Risk (SPAN), the system employed by CME. The 5% margin level therefore seems reasonable for commodities trading. During Jan 2015, several foreign currency brokers and exchanges, which had been offering leverage as high as 100:1 filed for bankruptcy following a dramatic move in the Swiss Franc.]

Order Matching Method and Principle

- Centralized order system
- Principle of price and time priority
- Exchange does not offer market making function

Entrusted trading

- Business members only can make transactions
- Other organizations/individuals must transact through business members

Establishment procedures

- Guidelines on documents, orders, and procedures for issuing a Certificate of Commodity Exchange Establishment are made pursuant to Circular No. 03/2009/TT-BCT
- Certificate issued by the Ministry of Industry and Trade
- MOIT will establish an Inspection Board if necessary

Within the framework outlined above, two exchanges have received certificates to transact in commodity futures contracts - VNX and INFO COMEX of Ocean Group – but are slow to proceed. Their lack of traction is in part attributable to the existing normative legal documents which are insufficient in scope and fall short of international best practices.

Recommendations for improving the legislative framework are listed below in 2 separate Sections. Section I is a set of specific recommendations formulated by the PMU expert. Section II is a set of broader principles and components needed for a comprehensive regulatory regime formulated by the DMI experts.

III. PMU recommendations:

Define and align membership categories with global standards.

These include the categories of traders – enterprises, individuals and brokers; clearing members and non-clearing members.

Remove the transaction limit.

No viable exchange limits total transactions. Position limits –which limit total long or short contract exposure of any single entity, are the standard safeguards to guard against "excessive speculation."

Expand the number of commodities authorized for futures trading.

Precious metals and oils should be considered for product authorization. Gold in particular is gaining “currency” as a store of value in Vietnam.

Regime of taxes, charges, fees, invoices and documents needs clarification and alignment with the transactional behavior and needs of traders such as hedgers or investors.

Tax obligation of individuals which transact in exchange traded futures is not specified. In addition, since the clearinghouse performs a novation (becomes the buyer to the seller and the seller to the buyer) on all purchases and sales, the standard regime requiring documentation between buyer and seller (bilateral transactions) is not applicable.

1. VAT

Currently not clearly defined VAT in commodity transactions via exchange, especially with the physical transfer of goods. For example, if the seller is an individual, then the law is unclear whether or not that individual must have separate purchase invoices.

2. The tax liability of individual investors

The tax liability of individual investors (domestic) participating in transactions via VNX is defined like stock investors for personal income tax’s obligation. Specifically, Document No. 10706 / BTC-TCT dated 09/8/2012 states detailed guidance on accounting, withholding and tax settlement procedures for investors to participate in commodity transactions.

But noting that the temporary withholding of personal income tax of 0.1% on revenue per sell short (open position) of individuals may take place before the repurchase (close position), differs from the current transaction practices on stock exchanges where investors are required to own stock in order to sell. The purchase and sale of financial investors takes place 2 times, if there is open position (purchase or sale in advance), there would have close position (sale or purchase later).

Another difference between the current stock exchange and commodity exchange is that the funds of stock investors are held in a designated bank account. For each sale, the securities company temporarily deducts 0.1% in advance, and tranfers the remaining funds into the deposit account of investors at the bank. The obligation to declare and pay tax and issue receipts to investors is implemented by secturtities companies. For commodity trading, in order to guarantee the safety of investor funds and make fast payment to investors, funds will be transferred to VNX to manage and clear the daily payment status (profit and loss). This method of funds clearing and payment by a commodities exchange raises questions concerning the declaration, tax payment and receipts issuance if VNX is not involved directly in the management of investors.

3. The tax liability of individuals who purchase physical goods via exchange

The tax liability of individuals who purchase goods via exchange has not been specified yet. The purchase and sale of physical goods only occurs 1 time (sale or purchase), and when selling or buying, there are provisions relating to invoices and each revenue (consignment) or presumptive tax,...

4. Certificates/documents during transport of physical goods when purchasing via exchange

In general goods transations involving transport and delivery of those goods, the buyer and seller will sign a contract directly with each other. The contract will include the terms of the transaction and the seller will give the buyer the necessary documents for transport (transport to the warehouse of the buyer or per the buyer's request).

However, when the transaction of physical goods occurs via exchange, the buyer and seller will not know each other, but just know exchange (or an authorized member). So the state agency must specify the documents/certificates required for transports, number of copies, and issuing agent, among other procedural measures.

Allow Vietnamese exchanges to link with foreign exchanges.

Linkages can occur directly between two exchanges and increase liquidity by providing an alternate time window. Linkages can occur indirectly between two exchanges via a single clearinghouse. A single clearinghouse for two exchanges can create market confidence in the smaller exchange and help engender trade.

Thanks to goods' interoperability between countries, allowing Vietnamese traders to trade goods via a foreign Commodity Exchange is, would be beneficial in promoting trade and avoiding price pressure as well as forecasting the consumption demand. However, the limitation to allow only Vietnamese businesses (local institutions) to trade, does not fully meet the needs of the parties participating in other production & consumption markets like producers (mostly individual farmers and households), commodity exchanges and members of local commodity exchanges as a market maker, ... Hence, it is necessary to expand the types of participants trading goods via commodity exchanges abroad.

It is necessary to pay attention to the payment of goods transactions via foreign commodity exchanges such as the procedures for making deposits and the amount of funds needed to establish a trading account. The reason is that before the transaction, the customer has to deposit a certain amount, at a level normally higher than the minimum regulated rate to avoid compulsory liquidation of contracts when price negatively fluctuates.

5.Strengthening State Apparatus:

Establish a division within the MOIT that will be responsible for rulemaking and for exchange supervision. Such division needs adequate human resources and funding. It should be noted that warehouse receipts in Vietnam, although issued by large private companies to holders of commodities, are yet to be legally recognized as negotiable instruments. Legal recognition of warehouse receipts is critical to developing domestic commodities futures trade. This initiative can be possibly proposed by the MOIT.

IV. DMI recommendations:

In addition to the specific recommendations by the PMU expert, DMI experts recommend that the GoVN broaden its regulatory framework to reflect international best practices. This process,underscored by the myriad of regulatory frameworks presented in the previous report,[2] can appear overly complex. The DMI experts recommend a fairly simple and straightforward approach: using core principles of regulation for guidance and then dividing the regulatory tasks into their essential components.

Core principles refer to those issued by the International Organization of Securities Commissions for the regulation of commodities derivatives markets.[3] These were compiled following a request by the G-20 during 2010, when major commodities futures markets were experiencing heightened volumes of trade.[4] They comprise the following:

1. Contract Design Principles
2. Principles for Surveillance of Commodity Derivatives Markets
3. Principles to Address Disorderly Commodity Derivatives Markets
4. Principles for Enforcement and Information Sharing

These four principals (included in their entirety in the Annex) underscore how commodity futures markets are distinct from securities markets. In particular, in the area of contract design, many aspects of surveillance and the concept of disorderly markets are unique to commodity futures markets. To function properly, regulation has to ensure that commodity contracts have economic utility- i.e. that the futures prices and cash market converge to the same price at expiration and that they are resistant to manipulation. Also exchanges must have proper infrastructure to monitor all futures activity in real time and devise safeguards against abusive trade practices in both the futures markets and underlying goods, notably supply hoarding. There must be rules for addressing disorderly markets which can occur when a severe supply/demand imbalance arises from either an ownership concentration or supply-disrupting climatic event. Finally, enforcement procedures must be I place to deal with rule violations. (Please refer to Annex for the detailed description of each of the four principles.)

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[2] Ibid.

[3] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf

[4] Vietnam became a full signatory to the IOSCO MMOU in September, 2013

Components of regulation can be divided into three categories:

1. Licensing/Approving
2. Surveillance/Monitoring
3. Enforcement

1. *Licensing:* Regulators can ensure the financial integrity of market participants by establishing minimal requirements or thresholds for all would-be participants. These include capital adequacy, education/certification (upon entry to the market and an on-going basis)/good standing of personnel, including exchange officials, and mandatory reporting.

   It should be noted that the normative legal documents aforementioned contain several licensing provisions and, with recommendations included in Section I, can be easily made more comprehensive.

   The concept of licensing can be broadened to include approval of exchange products[5], trade matching systems, audit procedures and the rulebook governing trade practices. It can also include the approval of the clearinghouse operational procedures to ensure its capability in dealing with default.
2. *Surveillance/Monitoring:* Regulators must ensure that all licensed market participants maintain compliance with capital requirements, regulations and recordkeeping. Monitoring should take the form of mandatory periodic reporting by market participants and pro-active investigation on the part of the regulator. Monitoring should also include surveillance of physical market activity and real time futures pricing as provided by the exchange. For example, the US Commodity Futures Trading Commission (CFTC) requires the Chicago Board of Trade [part of CME Group] to furnish a weekly grain stocks report of the quantity of grain in delivery silos as well as daily delivery totals. In other markets, such as the London cocoa market and London coffee market, the exchange publishes these stocks figures and delivery quantities on a voluntary basis. All futures exchanges disseminate instantaneous price quotations,daily volumes and open interest.
3. *Enforcement:* Regulator must ensure that violations of rules and reporting requirements are subject to sanctions, which may include fines, license suspension or ultimately expulsion from the industry. Since wrongdoing often gives rise to

[5]Regulators can and do examine futures contracts for their economic utility. China, for example, reformed the exchange product offerings [among other issues] via two rectifications during the 1990's; India decided to suspend trading in wheat, tur and dal, during the 2007/2008 "food crisis" [deferring the matter to an expert commission until 2010]; and South Africa commissioned an extensive economic review of its wheat contract in 2009. For an overview of government policy in several agricultural countries – see: http://www.amis-outlook.org/fileadmin/user_upload/amis/docs/reports/International_Commody_Benchmarks.pdf

disputes, the regulator should also establish a dispute settlement mechanism, although electronic records now retained by the exchange or brokers have greatly reduced exchange related disputes. While most regulators, such as the US CFTC, China Securities Regulatory Commission (CSRC), and the India Forward Markets Commission(FMC) have an enforcement division, the UK has recently separated the Financial Service Authority into two bodies. The Prudential Regulatory Authority is responsible for regulatory and banking supervisory matters and the Financial Conduct Authorityis responsible for enforcement matters. It should be noted that this structural division occurred primarily because of the size and scope of the UK banking sector and not because of its concern for commodity futures markets.

Vietnam is experiencing rapid economic growth and a spurt in exports. Agricultural exports are projected to total $31 billion for 2014. Owing to the stability of the Vietnamese Dong, the prospects of continued export growth appear positive. However,Vietnamese producers and warehouses lack domestic risk management tools, specifically futures and options contracts, leaving them vulnerable to the price risks inherent in commodity markets. These price risks tend to be passed along the supply chain in the form of higher margins – diminishing the price received by producers. In countries where futures and options are well established and integrated into the financial system - such as the US or South Africa - this asymmetrical pricing system dissipates and producers enjoy a high levelof pricing power.[6]

In conclusion, as part of its efforts to promote growth and income realization, Vietnam can and should establish a regulatory framework for commodity futures markets. It can achieve this by adhering to the principles espoused by IOSCO and by focusing on the basic components of regulation which include licensing, surveillance and enforcement, as outlined in this report. Given that the global regulatory landscape demonstrates much diversity, no single model can be selected as the "right one" for Vietnam. Indeed the history of regulation shows that every regulatory regime evolves continually, responding to ever changing economic patterns and technological innovation. Therefore, Vietnam will have to devise elements of regulation that can be merged with existing law, custom and institutions.

[6]: http://www.amis-outlook.org/fileadmin/user_upload/amis/docs/reports/International_Commody_Benchmarks.pdf

ANNEX

International Organization of Securities Commissions (IOSCO)

Principles for the Regulation and Supervision of Commodity Derivatives Markets – Oct 2012

1. Contract Design

- **Principle: Accountability –** Market Authorities should establish a clear framework as to design and review criteria or procedures for commodity derivatives contracts.
- **Principle: Economic Utility -** Contracts should meet the risk management needs of potential users and promote price discovery of the underlying commodity.
- **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.
- **Principle: Promotion of Price Convergence through Settlement Reliability -** Settlement and delivery procedures should reflect the underlying physical market and promote reliable pricing relationships and price convergence and should be regularly evaluated to ensure that they meet this standard.
- **Principle: Responsiveness -** The views of potential contract users should be taken into account in designing commodity contracts.
- **Principle: Transparency -** Information concerning a physical commodity derivatives contract's terms and conditions, as well as other relevant information concerning delivery and pricing, should be readily available to Market Authorities with respect to all derivatives transactions within its jurisdiction and to market participants in organized derivatives markets.

2. Surveillance

- **Principle: Framework for Undertaking Market Surveillance -** Market Authorities should have a clear and robust framework for conducting market surveillance, compliance and enforcement activities and there should be oversight of these activities
- **Principle: Monitoring, Collecting and Analyzing Information –** Market Authorities should develop, employ and maintain methods for monitoring of trading activity on the markets they supervise, collecting needed information and analyzing the information they collect that are efficient and suitable for the type of market being supervised.
- **Principle: Authority to Access information -** Market Authorities should have the authority to access information on a routine and non-routine basis for regulated commodity derivatives markets as well as the power to obtain information on a market participant’s positions in related over-the-counter (OTC) commodity derivatives and the underlying physical commodity markets.

- **Principle: Collection of Information on On-Exchange Transactions –** In respect to on-exchange commodity derivatives transactions, a Market Authority should collect information on a routine and regular basis on:
- **Principle: Collection of OTC Information** – In respect of OTC commodity derivatives transactions and positions, a Market Authority should consider what information it should collect on a routine basis and what it should collect on an ”as needed” basis. A Market Authority that has access to a relevant Trade Repository's (TR) data should take such broader access into account, as well as its statutory obligations with respect to the TR, in constructing its data collection policies.
- **Principle: Large Positions** – Market Authorities should require the reporting of large trader positions for the relevant on-exchange commodity derivatives contracts.

3. Disorderly Markets

- **Principle: Intervention Powers in the Market -** Market Authorities should have, and use, effective powers to intervene in commodity derivatives markets to prevent or address disorderly markets and to ensure the efficiency of the markets. These powers should include the following:
- **1) Position Management Powers, Including the Power to Set Position Limits -** Market Authorities should have and use formal position management powers, including the power to set ex-ante position limits, particularly in the delivery month,.

2) Other Discretionary Powers - Market Authorities should also have the powers to employ any of the following measures, as appropriate to address market disruption or the perceived threat of such disruption or to assist market surveillance efforts:

  - a) the imposition of price movement limits;
  - b) calling for additional margin, either from customers or from clearing members on behalf of their clients;
  - c) ordering the liquidation or transfer of open positions;
  - d) suspending or curtailing trading on the market (e.g., trading halts and circuit breakers);
  - e) altering the delivery terms or conditions;
  - f) cancelling trades;
  - g) requiring owners of positions to specify delivery intentions; and
  - h) requiring traders to disclose related OTC derivatives or large physical market positions.
- **Principle: Review of Evolving Practices -** Market Authorities should have, or contribute to, a process to review the perimeter of regulation to ensure that they have the power to address evolving trading practices that might result in a disorderly market. Exchanges and self-regulatory organizations play a critical and complementary role with governmental regulators in identifying such practices.

4. Enforcement

- **Principle: Rules and Compliance Programs -** Market Authorities should have rules, compliance programs, sanctioning policies and powers to prohibit, detect, prevent and deter abusive practices on their markets, including manipulation or attempted manipulation of the market.
- **Principle: Framework for Addressing Multi-Market Abusive Trading -** The overall framework for market surveillance and enforcement within a jurisdiction should be structured to provide for active and coordinated detection and enforcement action against manipulative or abusive schemes that might affect trading on multiple exchange and OTC markets, as well as the underlying physical commodity markets.
- **Principle: Powers and Capacity to Respond to Market Abuse -** Market Authorities should have adequate powers and capacity to investigate and prosecute actual or suspected market abuse, including attempted manipulation. IOSCO members that are responsible for the oversight of commodity derivatives markets should have all of the powers required by the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMOU).
- **Principle: Disciplinary Sanctions Against Market Members -** The relevant Market Authority should have and use effective powers to discipline its members or other authorized market participants if an abusive practice has occurred in the market. There should be clarity as to the types of disciplinary actions which can be taken.
- **Principle: Disciplinary Sanctions Against Non-Members of the Market -** The relevant Market Authority should have power to take action against non-members of regulated commodity derivatives markets or other market participants if they have engaged in abusive or manipulative practices, or are suspected of doing so.
- **Principle: Information Sharing -** Market Authorities should cooperate with one another, both domestically and outside the jurisdiction, to share information for surveillance and disciplinary purposes.