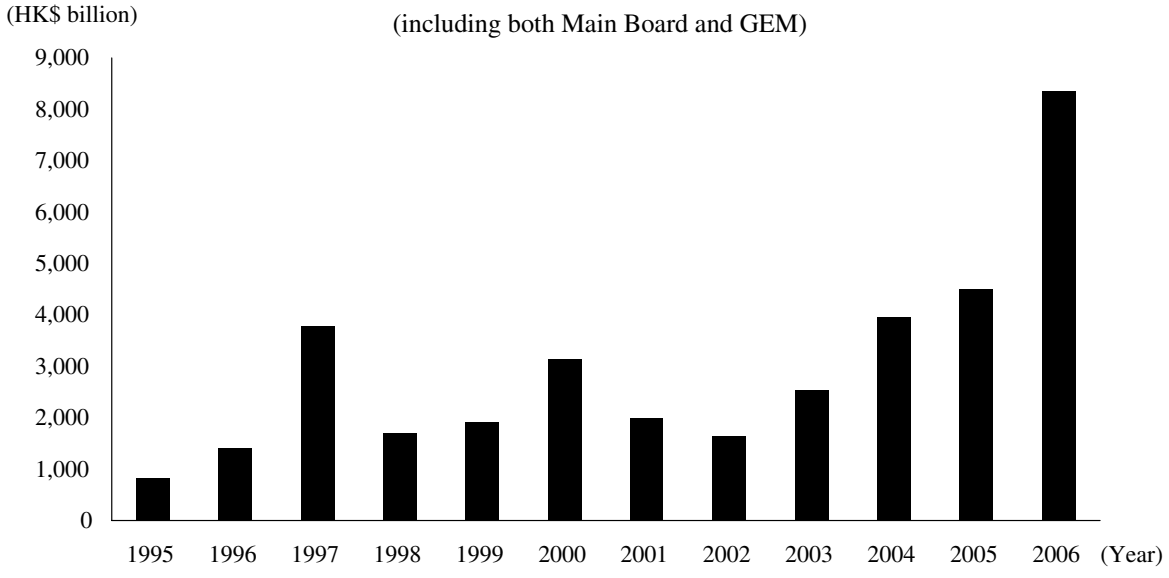
THE STOCK MARKET IN HONG KONG

Securities trading activities in Hong Kong can be traced back to 1866, while the first stock exchange began its operation in 1891. In view of the economic boom in Hong Kong, three other exchanges were established in late 1969 and the early 1970s. The four exchanges ceased to operate in 1986 and the Stock Exchange commenced trading in the same year. In the aftermath of the stock market crash in 1987, SFC was set up in May 1989. The SFC's focus was to improve the regulatory framework for the stock market. CCASS was introduced in 1992 and the Automatic Order Matching and Execution System was launched in 1993. In the same year, the first H-share company was listed in Hong Kong. GEM was set up in November 1999. On 6 March 2000, the Stock Exchange, the Futures Exchange and HKSCC were merged under the HKEC.

For 2006, Hong Kong became the second largest initial public offering centre in the World, after London and surpassing New York. Total capital raised from the Hong Kong securities market through initial public offering amounted to HK$333.9 billion in 2006, which was the second largest securities market in Asia after Tokyo, with an average daily turnover of HK$33.9 billion (including both Main Board and GEM) in 2006. At the end of 2006, the total number of companies listed on the Stock Exchange was 1,173 (including both Main Board and GEM).

Turnover
(including both Main Board and GEM)



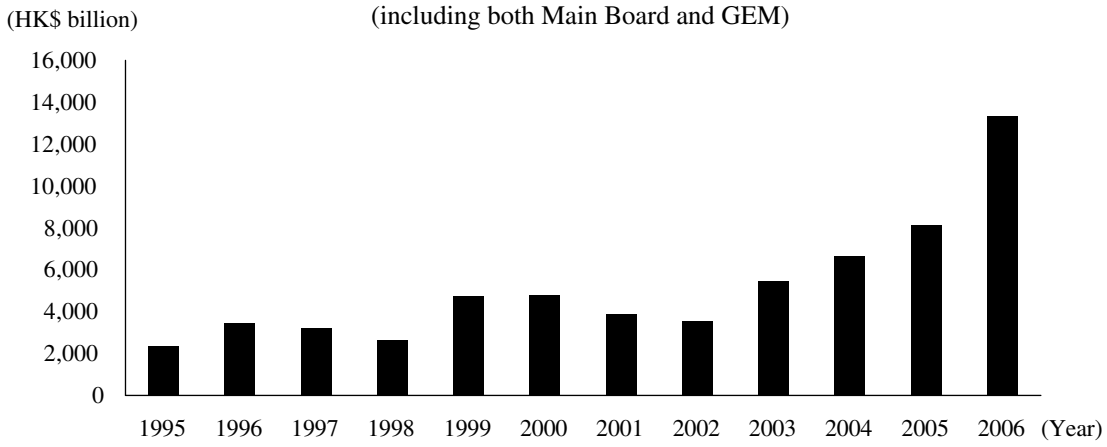
Source: HKEC

SECURITIES TRADING

The two markets operated by the Stock Exchange for securities trading in Hong Kong are the Main Board and the GEM. The Main Board is a platform for larger and more established companies with a trading record of at least three financial years. As at 31 December 2006, there were 975 companies listed on the Main Board, 95 of which were H-share companies and 86 were red chip companies. The market capitalisation of the Main Board as at 31 December 2006 was HK$13,248.8 billion. The GEM was introduced in November 1999 in order to provide opportunity for growth companies from all industries and with all sizes to get listed. As at 31 December 2006, 198 companies were listed on the GEM and among them 46 were H-share companies and 4 were red chip companies. The GEM's market capitalisation as at 31 December 2006 amounted to HK$88.9 billion.

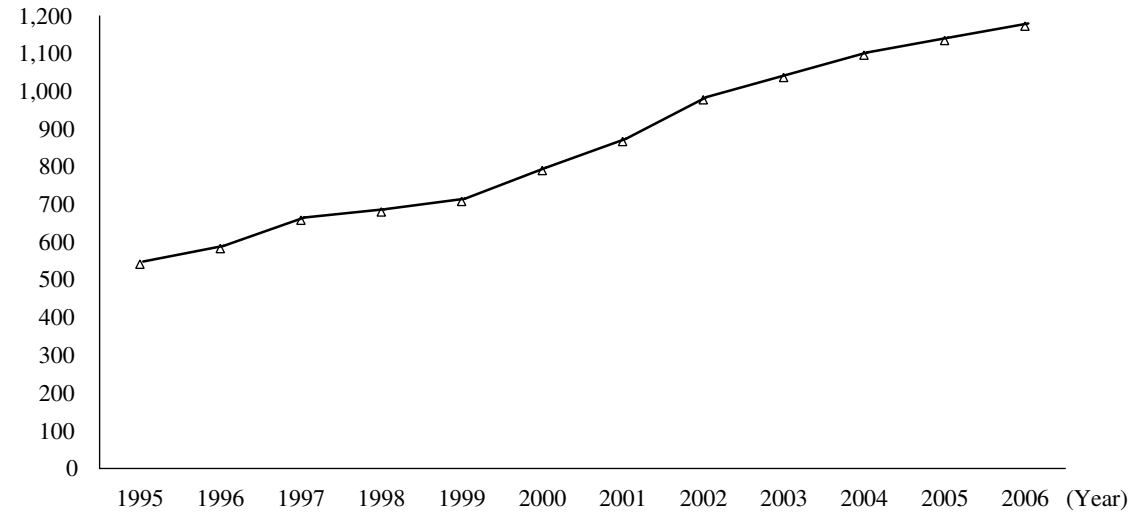
Market capitalisation

(including both Main Board and GEM)



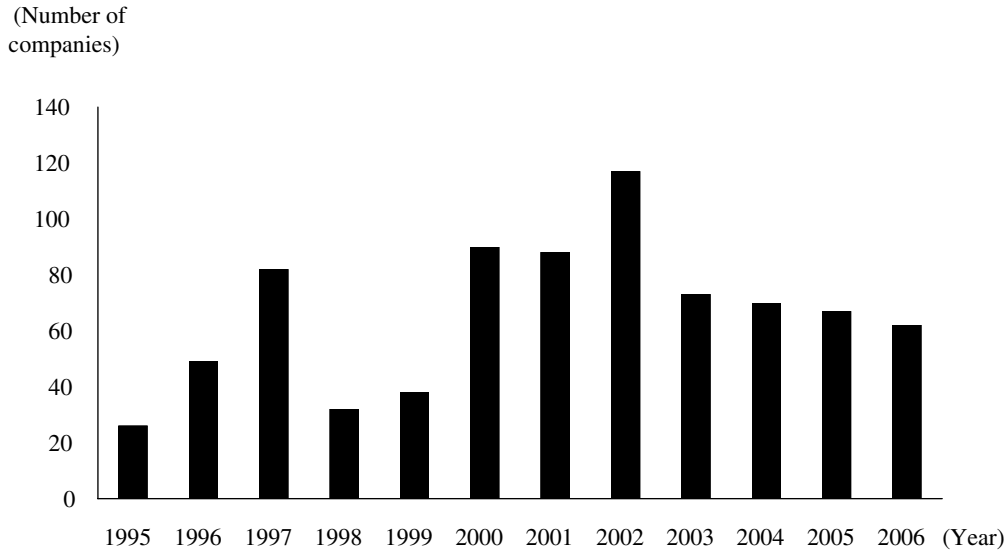
Source: HKEC

Number of listed companies
(including both Main Board and GEM)



Source: HKEC

New Listing
(including both Main Board and GEM)



Source: HKEC

Stock Exchange Participants

A person who wishes to trade listed securities on or through the facilities of the Stock Exchange is required to hold a Stock Exchange Trading Right and be a Stock Exchange Participant. A Stock Exchange Participant must be a company limited by shares incorporated in Hong Kong and be a licensed corporation under the SFO to carry on Type 1 (dealing in securities) regulated activity under the SFO. Generally speaking, Stock Exchange Participants must have a minimum paid-up share capital of HK$5 million. If the Stock Exchange Participants also provide securities margin financing, the minimum paid-up share capital requirement will increase to HK$10 million. In addition, Stock Exchange Participants are required to meet the financial resources requirements as stipulated in the SFO, the FRR, the rules of the Stock Exchange and such other financial resources requirements for Stock Exchange Participantship as the Stock Exchange may from time to time prescribe.

A Stock Exchange Participant who conducts options trading on the Stock Exchange must become admitted and registered by the Stock Exchange as an options exchange participant as either an Options Trading Exchange Participant or an options broker exchange participant.

Stockbroking industry in Hong Kong

As at 31 December 2006, there were a total of 518 Stock Exchange Trading Right holders, of which 425 were trading Stock Exchange Participants, 44 were non-trading Stock Exchange Participants and 49 were non-Stock Exchange Participants.

Trading and settlement

Trading on the Stock Exchange is conducted through an automated trading system which is known as the Automatic Order Matching and Execution System ("AMS"). The third-generation AMS ("AMS/3") was launched in October 2000. Together with other upgraded functions, such as new order types, the new feature of AMS/3 is the provision of connectivity between the AMS/3 trading host system and the systems of brokers through an open gateway. Such connectivity provides investor access channels which enable placing of trading orders via the internet or by mobile phones, in addition to the traditional method of placing orders with brokers.

The trading capacity of a Stock Exchange Participant, which is called the throttle rate, had all along been restricted by the number of Stock Exchange Trading Rights held by it. The throttle rate determines the rate at which orders can be sent through an open gateway to the AMS/3 by the Stock Exchange Participant. The standard throttle rate is one order per second. The scheme that enables Stock Exchange Participants to increase their throttle rates in integral multiples of one order per second by payment of additional fee was launched in December 2002. Such a scheme helps brokers operate more efficiently without having to acquire additional trading rights.

Trades executed on the AMS/3 are automatically transferred to CCASS, a clearing and settlement system operated by HKSCC for automatic settlement among Stock Exchange Participants on T + 2.

Formerly, share certificates were physically delivered by the selling party to the buying party against payment made by the buying party to the selling party. This process was cumbersome and the brokers and investors were subject to risks when any party failed to fully comply with the agreed settlement arrangement. The risk of counterparty failure has been reduced since the introduction of CCASS in June 1992.

CCASS is a computerized book-entry clearing and settlement system and reduces scrip circulation in the market by the immobilization of share certificates delivered by participants in HKSCC's central securities depository. Settlement is electronically recorded as increases or decreases in participant's stock account balances, without the physical movement of share certificates. Under CCASS, HKSCC becomes the central risk taker by substituting itself as the universal counter-party to Stock Exchange trades to be settled under continuous net settlement system ("CNS System"). This effectively guarantees settlement of Stock Exchange trades by broker participants.

After the launch of investor account service in May 1998, HKSCC currently has six categories of CCASS participants, namely, CCASS Broker Participants, Clearing Agency Participants, CCASS Custodian Participants, CCASS Investor Participants, Stock Lender Participants and Stock Pledgee Participants.

THE FUTURES MARKET IN HONG KONG

The Futures Exchange was established in 1976 and introduced its first financial futures product, the HSI futures, in May 1986. In 2006, derivatives market contributed 16% of the income of HKEC. Derivatives currently offered by the Futures Exchange include three main types, namely, (a) equity index derivatives such as HSI futures and options, and mini-HSI futures and options; (b) equity derivatives such as stock futures; and (c) interest rate derivatives such as one-month HIBOR futures and three-month HIBOR futures. Among these, HSI futures are the most important derivatives at the Futures Exchange today. Over 64% of the futures contracts traded in 2006 on the Stock Exchange were HSI futures. The HSI futures allow investors to participate in the performance of the underlying HSI, which is regarded as the benchmark for the Hong Kong equity market.

Futures Exchange Participants

In order to trade on or through the facilities of the Futures Exchange, a person must hold a Futures Exchange Trading Right and be a Futures Exchange Participant. A Futures Exchange Participant must be a company limited by shares incorporated in Hong Kong and be a licensed corporation licensed under the SFO to carry on Type 2 (dealing in futures contracts) regulated activity under the SFO. Futures Exchange Participants must have a minimum paid-up share capital of HK$5 million. In addition, Futures Exchange Participants are required to meet the financial resources requirements as stipulated in the SFO, the FRR, the rules of the Futures Exchange and such other financial resources requirements as may be prescribed by the Futures Exchange.

Futures trading industry in Hong Kong

As at 31 December 2006, there were a total of 194 Futures Exchange Trading Right holders, of which 135 were trading Futures Exchange Participants and 59 were non-Futures Exchange Participants.

Trading and settlement

The Futures Exchange's electronic trading system, namely the Automated Trading System, was first introduced in November 1995. The system was subsequently upgraded in April 1999 and was renamed as the Hong Kong Futures Automated Trading System ("HKATS"). Following the migration in June 2000 of the trading in HSI futures contracts and option contracts from open outcry to electronic trading system, HKATS became the trading platform for all products traded on the Futures Exchange. Trading on HKATS can be made through HKATS Click workstations or independently supplied workstations connected through Omnet Application Programming Interface located at the premises of Futures Exchange Participants. With HKATS, users can view real-time price information on a computer screen, click on a bid or ask price and execute an order.

Trading of derivatives products of HKEC are settled through the Derivatives Clearing and Settlement System ("DCASS") which is a fully electronic and automated clearing and settlement system capable of supporting many types of derivatives products. DCASS is on the same technology platform and the same operational infrastructure as HKATS and thus provides a seamless operational environment for derivatives trading and clearing.

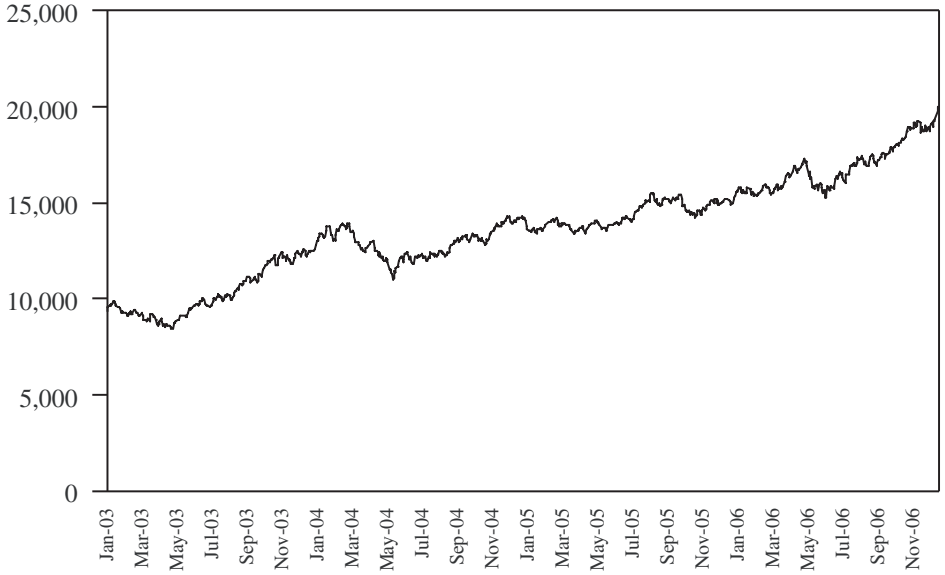
INDICES

Major indices are set out below.

The HSI

The HSI was launched on 24 November 1969 and is a barometer of the Hong Kong stock market. The current HSI comprises 38 constituent stocks and such stocks cover over 60% of the market capitalisation of all eligible stocks listed on the Main Board as at 28 February 2007. Companies with a primary listing on the Main Board are eligible for selection to become assimilated by the HSI. Mainland enterprises that have an H-share listing in Hong Kong is eligible for inclusion in the HSI if they meet the criteria as set out under the paragraph headed "Inclusion of H-share companies in the HSI" below. The list of the stock composition is reviewed on a quarterly basis by HSI Services Limited. In 1985, four sub-indices of the HSI were introduced in order to better reflect the performance of single industries at the Stock Exchange. These four indices were divided into finance, utilities, properties, commerce and industry. The HSI index was set at 100 with the base day at 31 July 1964. As at 30 March 2007, the HSI was valued at 19,800.

HSI (01/2003 – 11/2006)



Source: HKEC

On 30 June 2006, HSI Services Limited announced details of the changes to the HSI compilation methodology.

Compilation methodology

The compilation of the HSI will be switched from a full market capitalisation weighted formula to a freefloat-adjusted market capitalisation weighted formula with a cap on individual stock weightings. Details are as follows:

a) Freefloat adjustment: A Freefloat-Adjusted Factor ("FAF") will be assigned to each constituent in index calculation. The freefloat definition has been revised to exclude shareholdings with a lock-up arrangement.

b) Cap: A 15% cap on individual stock weightings will be applied.

c) Re-capping frequency: A re-capping exercise will be conducted semi-annually in the first and the third quarter to coincide with the regular update of the FAF. Additional re-capping will be performed should there be constituent changes.

The above changes are being implemented during a 12-month period from September 2006 to September 2007 to ensure a smooth transition and to minimise any impact on the market. The timetable and adjustments are as follows:

After market close on	Freefloat adjustment	Capping level
Phase 1: 8 Sep 2006 (Fri)	Nil	25%
Phase 2: 9 Mar 2007 (Fri)	Applying 2/3 Freefloat Adjustment ("FAF_1"), Where: $FAF_1 = 100\% - \frac{2}{3}(100\% - FAF_2)$ Rounded up to the nearest 5%	20%
Phase 3: 7 Sep 2007 (Fri)	Applying full Freefloat Adjustment ("FAF_2")	15%

For new constituents entering into the HSI, the FAF will be applied in full at the time of entry.

Inclusion of H-share companies in the HSI

As decided in February 2006, mainland enterprises that have an H-share listing in Hong Kong is eligible for inclusion in the HSI when they meet any one of the following conditions:

1. The H-share company has 100% of its ordinary share capital in the form of H-shares which are listed on the Stock Exchange;

2. The H-share company has completed the process of share reform, with the result that there is no unlisted share capital in the company; or

3. For new H-share initial public offering, the company has no unlisted share capital.

Eligible H-share companies entered into the stock universe for the regular HSI review since August 2006.

For any H-share companies included in the HSI, only the H-share portion of the share capital of the company will be used for index calculation, subject to freefloat adjustment.

Number of constituents with inclusion of H-share companies

In order to ensure that the HSI will remain broad-based enough to represent the Hong Kong equity market following the inclusion of eligible H-share companies, it has been decided that the number of constituents will be gradually increased.

As an interim measure, any H-share company joining the HSI will result in a net increase in the number of HSI constituents. The number of non-H-share constituents will be maintained at 33.

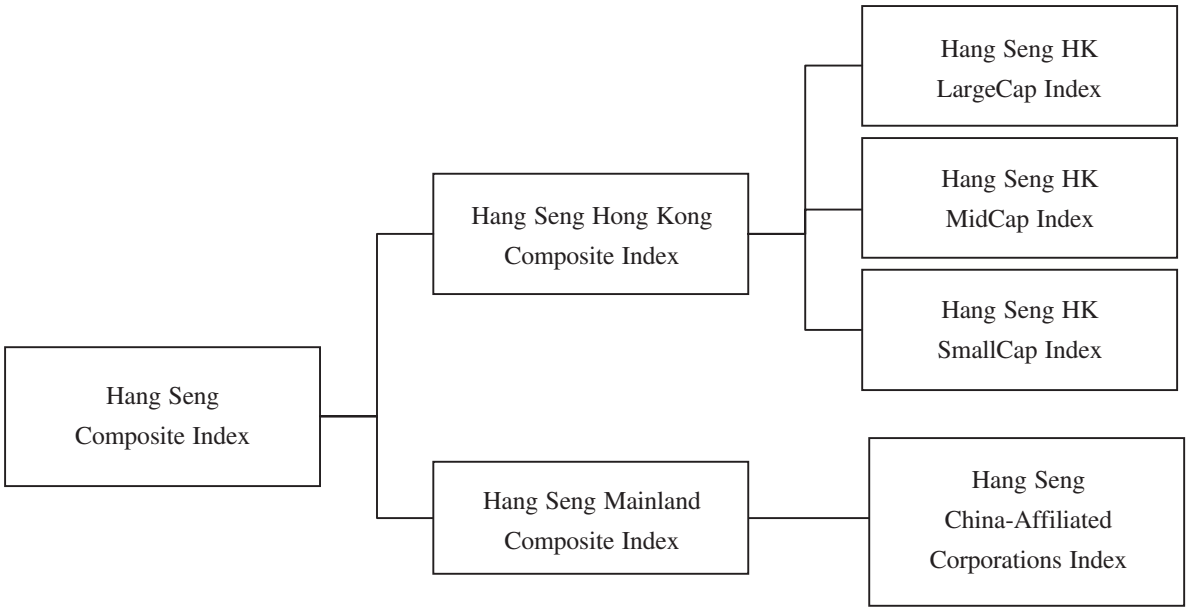
HSI Services Limited will further announce the way ahead with regard to the number of index constituents once the fifth H-share company joins the HSI, bringing the index to 38 constituents.

Hang Seng Composite Index

The Hang Seng Composite Index Series consists of the top 200 listed companies in the Hong Kong stock market. Launched on 3 October 2001, its aim is to provide a comprehensive benchmark of the Hong Kong stock market. The Hang Seng Composite Index Series covers approximately 90% of the total market capitalisation of all stocks listed on the Main Board. Eleven sub-indices according to different industries have been created which include:

- Energy
- Materials
- Industrial Goods
- Consumer Goods
- Services
- Telecommunications
- Utilities
- Financials
- Properties & Construction
- Information Technology
- Conglomerates

Contemporaneously sub-indices according to geographical composition were also created. These sub-indices indicate the respective performance of different industries or regions.



Source: HSI Services Limited

Only companies with a primary listing on the Main Board are regarded as eligible constituents of the Hang Seng Composite Index. The list of the constituents is reviewed on a half-yearly basis. The index was set at 2,000 with the base day at 3 January 2000. As at 30 March 2007, the Hang Seng Composite Index was 2772.

Standard & Poor's Indices

In March 2003, Standard & Poor's and HKEC together created the S&P/HKEx LargeCap Index and the S&P/HKEx GEM Index. The S&P/HKEx LargeCap Index and the S&P/HKEx GEM Index replaced the All Ordinaries Index and the Growth Enterprises Index to reflect the real-time performance of the Main Board and the GEM respectively. The S&P/HKEx Indices are governed by an index committee which consists of five members, three representatives from Standard & Poor's and two from HKEC.

The S&P/HKEx LargeCap Index is a large capitalisation index for Hong Kong equity markets. The 25-stock index is market-capitalisation weighted, with each company's weight reflective of shares publicly available for trading, and is balanced across 10 Global Industry Classification Standard sectors. S&P/HKEx LargeCap Index constituents are selected for inclusion using Standard & Poor's guidelines for evaluating company capitalisation, liquidity and fundamentals. The S&P/HKEx LargeCap Index will serve as the base for relative derivative products such as exchange traded funds, and index options and futures. To prevent the index being dominated by only a few companies, stocks with a relative weight in excess of 15% will be capped on a quarterly basis. The index is based at 23 February 2003 with a base value of 10,000. As at 30 March 2007, the index was valued at 23,487.

The S&P/HKEx GEM Index was introduced to represent the GEM. This index does not consist of a fixed number of companies. The index is float capitalisation weighted and, at its inception, included 46 companies. A quarterly revision process will be used to remove companies that comprise less than 0.25% of the weight of the index, and add companies whose weight, when included, will be greater than 0.5% of the index. Companies will also have to meet minimum liquidity requirements to be eligible for inclusion. The index is based at 28 February 2003 with a base value of 1,000. As at 30 March 2007, the S&P/HKEx GEM Index was 1,349.

REGULATORY FRAMEWORK

A three tier regulatory framework exists in Hong Kong. The following paragraphs will describe the roles and competences of each tier.

First Tier

The ultimate responsibility for policy and legislative matters, which is considered the first tier of regulation, rests with the Hong Kong Government. The Hong Kong Government provides an appropriate economic and legal environment for the maintenance of Hong Kong as an international financial centre. For instance, the Chief Executive of Hong Kong may, upon being satisfied that it is in the public interest to do so, give the SFC written directions as to the furtherance of any of its regulatory objectives or the performance of any of its functions. All members of the board of the SFC are also appointed by the Chief Executive of Hong Kong.

Second Tier

Established in May 1989, the SFC is the statutory body governed by the SFO which came into effect on 1 April 2003. The SFC serves as the regulator of market operators and in practice acts as the principal regulator of the securities and futures market. Furthermore, the SFC also has a role of monitoring listing applications and listed companies in Hong Kong. SFC's regulatory objectives as set out in the SFO are:

- to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- to promote understanding by the public of the operation and functioning of the securities and futures industry;
- to provide protection for members of the public investing in or holding financial products;
- to minimise crime and misconduct in the securities and futures industry;
- to reduce systemic risks in the securities and futures industry; and
- to assist the Financial Secretary of the Hong Kong Government in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

It is the task of the SFC to license any person carrying on a business of dealing in securities, or futures like securities dealers, futures dealers, etc. Furthermore, it supervises and monitors the operations of the HKEC and its subsidiaries. It also regulates listed companies by monitoring share dealings, buy backs, announcements and listing application. The SFC can also investigate listed companies suspected of prejudicial or fraudulent transactions.

Third Tier

The HKEC forms the third tier of the regulatory framework. The HKEC is an exchange controller under the SFO, which owns and operates the only stock and futures exchanges in Hong Kong, namely the Stock Exchange and the Futures Exchange, and their related clearing houses. The Stock Exchange has the following responsibilities:

(a) to establish a stock exchange and to provide, regulate, and maintain facilities for conducting the business thereof;

(b) to provide and operate a stock market and to promote and protect the interests of all members of the public having dealings on the Stock Exchange or with members thereof;

(c) to provide and promote a fair, orderly, and efficient market for the trading of securities;

(d) to establish and promulgate rules prescribing listing requirements for the quotation of securities on, and in respect of such other matters as are necessary or desirable for the proper and efficient operation and management of, the stock market;

(e) to administer the Listing Rules fairly, in accordance with the general principles set out in the respective rules, and having regard to the best interest of each market and Hong Kong's stock market as a whole and the public interest;

(f) to ensure that persons administering the Listing Rules are independent, professional, and competent; and

(g) to establish fair and appropriate procedural rules governing the manner in which it will discharge its listing-related functions and responsibilities.

The Futures Exchange has the role to operate and maintain a futures market and is the primary regulator for Futures Exchange Participants with respect to trading matters.

The role of the clearing houses of the HKEC is to perform clearing and settlement for the securities and futures markets.

FUTURES MARKET IN US AND JAPAN

The US Futures Exchanges

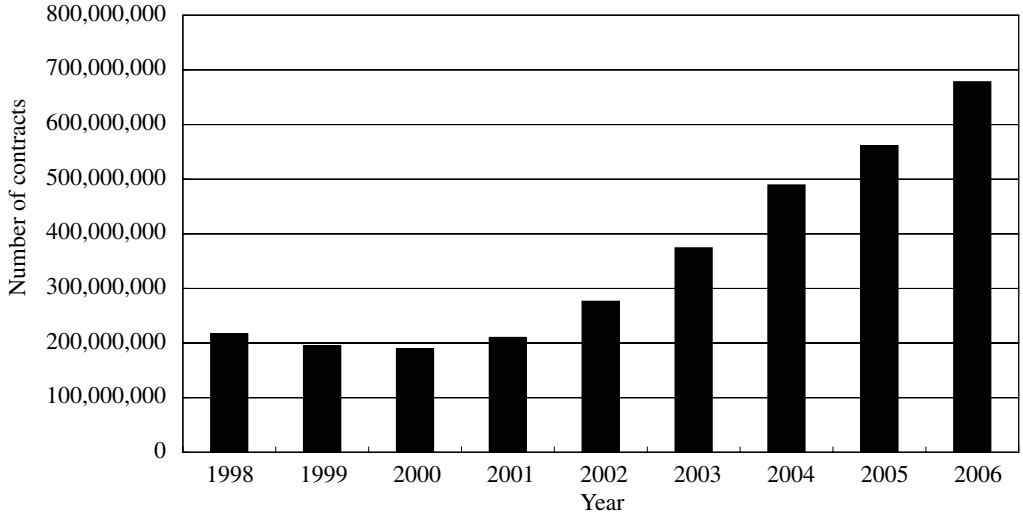
The US is considered a major futures market in the world with more than ten futures exchanges with an annual turnover of approximately 1,653 million and 2,044 million futures contracts in 2005 and 2006 respectively and accounted for approximately 41% and 39% of the global volume respectively. The four major futures exchanges are the Chicago Board of Trade, Chicago Mercantile Exchange, New York Mercantile Exchange and New York Board of Trade.

Chicago Board of Trade ("CBOT")

On 3 April 1848, the Chicago Board of Trade was officially founded and the earliest corn forward contract was recorded in 1851. But the modern form of futures contract that requires performance bonds, i.e. margin, was not formalized until 1865. In 1977, CBOT launched the US Treasury Bond futures contract, and has become the most actively traded debt futures contract in the world.

On 28 September 1998, the board of directors of CBOT established side-by-side open outcry and electronic trading for financial contracts, providing trading opportunity for those members and firms who wishes to trade on the CBOT's electronic trading system during the day. On 26 April 2006, CBOT announced that it would increase global access to its benchmark agricultural products by offering trading of CBOT full-sized, physically delivered agricultural futures contracts on its electronic trading platform during daytime trading hours. Trading began on 1 August 2006.

CBOT trading volume

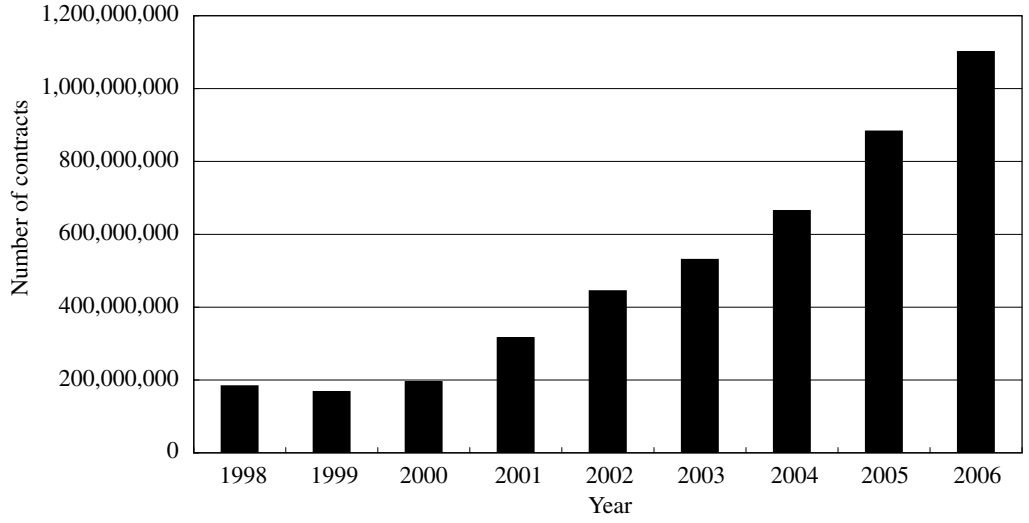


Source: Own illustration according to data from Chicago Board of Trade

Chicago Mercantile Exchange ("CME")

Founded in 1898 as a not-for-profit corporation, the Chicago Mercantile Exchange was called the Chicago Butter and Egg Board until 1919. In November 2000, CME became the first US financial exchange to demutualize and become a shareholder-owned corporation. CME is the world's third-largest exchange for futures and options on futures and is the largest in the US, which accounted for 53% and 54% of all US futures volume in 2005 and 2006 respectively. Its products are mostly futures on interest rates, currency, stock indices and a small amount on agricultural products, with Eurodollars and mini S&P futures being the flagship contracts.

CME trading volume

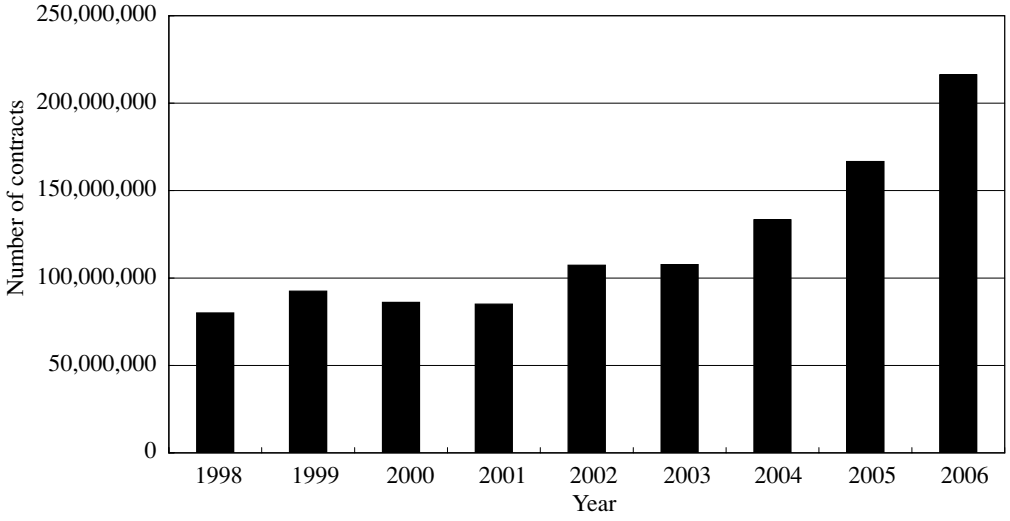


Source: Own illustration according to data from Chicago Mercantile Exchange and Futures Industry Association

New York Mercantile Exchange ("NYMEX")

New York Mercantile Exchange was originally founded by a group of dairy merchants and first called The Butter and Cheese Exchange of New York in 1872. NYMEX merged with New York Commodities Exchange ("COMEX") in 1994 and converted into a for-profit organization in 2000. It is the world's largest physical commodity futures exchange. Trading is conducted through two divisions: the NYMEX Division, which is the home of energy, platinum and palladium markets, and the COMEX Division, where metals like gold, silver and copper are traded. NYMEX uses an outcry trading system during the day and an electronic trading system CME Globex when the trading floor is closed.

NYMEX trading volume

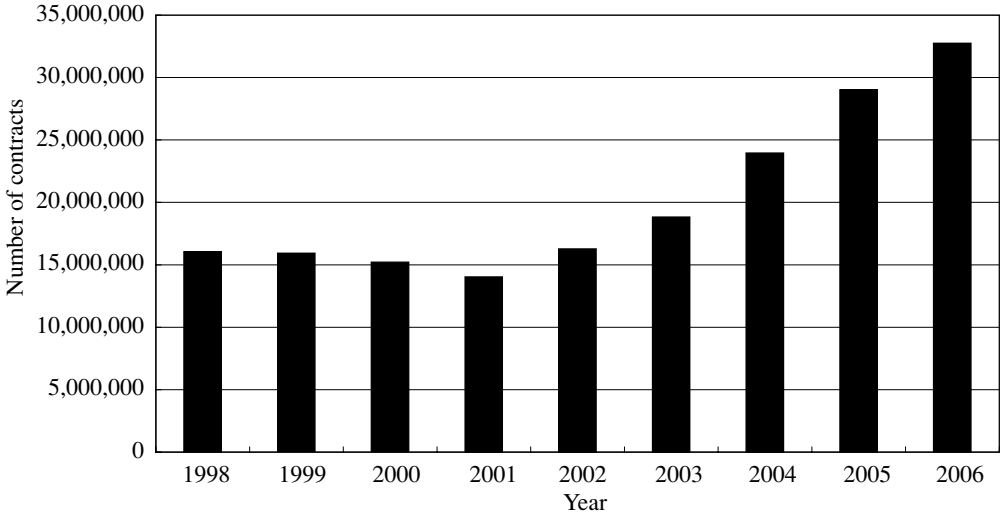


Source: Own illustration according to data from New York Mercantile Exchange

New York Board of Trade ("NYBOT")

New York Board of Trade was formed from the merger of the New York Cotton Exchange ("NYCE") and the Coffee, Sugar and Cocoa Exchange in 2004. The history began with the founding of the NYCE in 1870. NYBOT is a leading soft commodity exchange that trades futures and options on sugar, cotton, coffee, cocoa and orange juice.

NYBOT trading volume



Source: Own illustration according to data from New York Board of Trade and Futures Industry Association

Regulatory Framework in US

US futures exchanges adopted an individual self-regulation or administrative law in early years. The US Congress introduced the Grain Futures Act in 1922 which requires all futures exchanges to be licensed. The Commodity Exchange Act of 1936 was imposed to enable the government to deal directly with traders rather than only the exchanges, and established the commodity exchange authority ("Commodity Exchange Authority"), a bureau of the US Department of Agriculture, to monitor and investigate trading activities and prosecute price manipulation as a criminal offence.

Congress amended the Commodity Exchange Act in 1968 in order to increase the regulatory power of the Commodity Exchange Authority, and in 1974 Congress passed the Commodity Futures Trading Act, which created far-reaching federal oversight of US futures trading and established the Commodity Futures Trading Commission ("CFTC"), which is given broad regulatory power over all futures trading and related exchange activities throughout the US. CFTC consists of five presidential appointees who are confirmed by the US Senate. The Futures Trading Act of 1982 amended the Commodity Futures Trading Act of 1974. CFTC's mandate has been renewed and expanded several times, most recently by the Commodity Futures Modernization Act of 2000.

The Japanese Commodity Futures Market

The history of commodity futures trading in Japan can date back to the early forward contract for rice in 1730 at Dojima in Osaka. Forward contracts have evolved and have been standardized into what we know today as futures contracts.

There are five commodity exchanges in Japan which were established under the Commodity Exchange Law of Japan, including:

- The Tokyo Commodity Exchange
- The Tokyo Grain Exchange
- Kansai Commodities Exchange
- Central Japan Commodity Exchange
- Fukuoka Futures Exchange

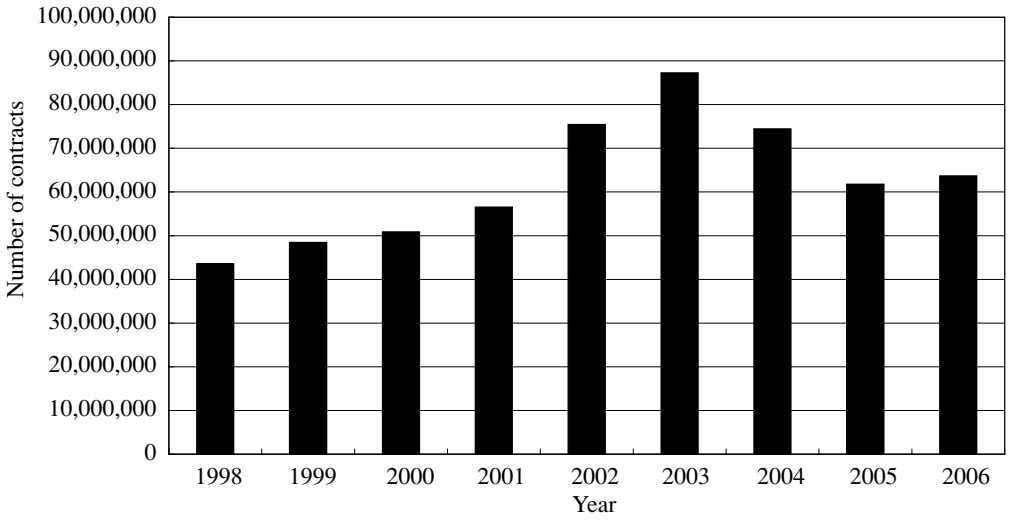
Similar to the situation of US, where most futures turnover are concentrated in CME and CBOT, the commodity futures trading in Japan mostly goes to the Tokyo Commodity Exchange and Tokyo Grain Exchange.

The Tokyo Commodity Exchange ("TOCOM")

Following the merger of Tokyo Textile Exchange, Tokyo Rubber Exchange and Tokyo Gold Exchange, the Tokyo Commodity Exchange was established in November 1984. There are nine futures contracts and one options contract trading on TOCOM , including:

- Gold futures
- Gold options
- Silver futures
- Platinum futures
- Palladium futures
- Aluminum futures
- Crude Oil futures
- Gasoline futures
- Kerosene futures
- Rubber futures

TOCOM trading volume



Source: Own illustration according to data from Tokyo Commodity Exchange

The Tokyo Grain Exchange ("TGE")

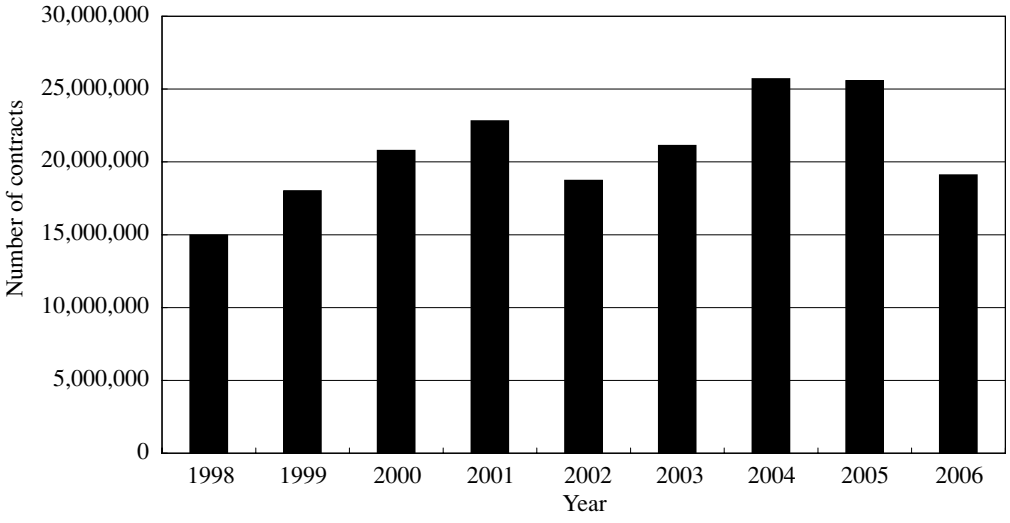
The Tokyo Grain Exchange originated from the Kakigaracho Rice Trading Exchange which was established in 1874.

TGE was closed in July 1939 due to World War II, and was re-established in 1952 as the trading facility for futures contracts covering soybean, azuki bean, and potato starch. TGE moved from floor hand trading to fully computerized trading in April 1988. TGE merged with the Tokyo Sugar Exchange in October 1993 and then merged with Hokkaido Grain Exchange in April 1995. TGE further merged with Yokohama Commodity Exchange in April 2006.

There are ten futures contracts and three options contracts trading on TGE, including:

- Corn futures
- Soybean Meal futures
- Soybeans futures
- Non-GMO Soybeans futures
- Azuki Bean futures
- Arabica Coffee futures
- Robusta Coffee futures
- Raw Sugar futures
- Raw Silk futures
- Vegetable futures
- Corn options
- Soybean options
- Raw Sugar options

TGE trading volume



Source: Own illustration according to data from Futures Industry Association

Futures Trading Methods in Japan

There are two methods of trading in the Japanese commodity futures markets. One is the traditional Japanese "*Itayose*", or session trading method. With Itayose method, a number of sessions are held per day at predetermined time, and a single execution price for a series of contract months of a specified commodity will be determined. TGE and Central Japan Commodity Exchange are using the "*Itayose*" trading method. There are morning and afternoon sessions which are further divided into either two or three sub-sessions.

The second is the "*Zaraba*" trading method, or continuous computerized trading which is used to trade precious metals, aluminum, and energy markets in TOCOM.

Regulatory Framework in Japan

The Commodity Exchange Law and Regulators

After World War II in 1950, the Commodity Exchange Law ("CEL") was constituted to supervise and regulate all commodity futures trading activities in Japan. The CEL governs the entire range of commodity trading from the organizational structure of the five domestic commodity exchanges to illegal trading practices. The securities and commodity trading were completely separated after World War II, with the Securities and Exchange Law enacted in 1948 and the CEL coming two years later. The law has been amended more than 20 times, including both comprehensive and specific revisions. A 1998 amendment, which took effect in April 1999, simplified the procedure for registering commodities on an exchange and liberalized commodity brokerage commissions. As the structural economic reform has preceded and the commodity futures market in Japan has developed so rapidly, the function of hedging price volatility risk and price formation in the commodity futures market has been regarded more and more important. The CEL was drastically amended on 12 May 2004, and the amended CEL took effect on 1 May 2005.

The Ministry of Economy, Trade and Industry ("METI") and the Ministry of Agriculture, Forestry and Fishery ("MAFF") are authorized by the CEL to ensure sound operation of the commodity futures market in Japan and the protection of consignors who undertake commodity futures transactions.

Futures Commission Merchant ("FCM") is a broker which executes a transaction. Not only are the FCMs regulated by METI and MAFF, they also need to register with the Commodity Futures Association of Japan ("CFAJ") all officers and/or employees thereof who engage in solicitation of the acceptance of consignment of any transactions, as sales representatives. The CFAJ was established as a self-regulatory organization for FCMs, in order to ensure the fair and smooth acceptance of consignment of transactions as well as customer protection.

The CFAJ has established its own regulatory rules with regard to its members' business operations of accepting consignments, monitoring and inspecting its members, and guiding, making recommendations to, and, if necessary, punishing its members that do not follow the CEL or the rules. The CFAJ ensures the resolution of complaints from customers and, if necessary, mediates in regard to disputes between its members. The CFAJ also registers, trains, guides and, if necessary, punishes sales representatives of FCMs.

The amendment of the CEL, effective on 1 May 2005, introduced an "outhouse" type of clearing house, established outside of commodity exchanges. Its establishment and operation necessitate the permission and overseeing of METI and MAFF. The outhouse clearing house namely the Japan Commodity Clearing House ("JCCH") began operation on 1 May 2005.

The Consignors' Asset Protection and Consignor Protection Fund System

It is essential that consignors' assets (specifically, trading margins and appraisal profits) be fully protected in order to assure the confidence of commodity futures markets.

Therefore, the amendment of the CEL in 2004 achieved two major advancements. First, the margin system was fundamentally revised to ensure that an investor shall, in principle, deposit all the trading margins with a commodity transaction clearing organization. In other words, in normal cases, FCMs segregate consignors' assets for one day, after they receive the assets from consignors and before they deposit the assets with commodity transaction clearing organizations. Second, the system of consignor asset protection was introduced to compensate for possible damage to consignors' assets, in the case of the FCM's insolvency. Under the system, the consignor protection fund shall compensate for damaged consignors' assets up to 10 million yen per consignor, and each FCM shall be a member of the consignor protection fund set up to ensure there are enough funds for compensation, through dues paid by its member FCMs.

The National Futures Protection Fund got the registration of its consignor protection business on 1 May 2005.

Clearing and Settlement of Commodity Futures Transactions

The CEL requires commodity exchanges to have a system to minimize the impact of a default of its member on its market(s), so as to ensure that transactions on its market shall be safely carried out.

Members of commodity exchanges shall deposit guarantee money with commodity exchanges and clearing deposits with commodity transaction clearing organizations, to compensate for losses that a default of a member of a commodity exchange would result in for consignors, other members of the commodity exchanges, and other clearing members of the commodity transaction clearing organizations (in the case that the defaulted FCM is a clearing member of a commodity transaction clearing organizations).

In practice, the JCCH requires its clearing members to mark their positions in relation to the market with it once every business day. Therefore, if a default of a clearing member happens, its damage to other clearing members will be restrained to the extent of two business days' appraisal losses.