11th Annual Conference
of the
Association of Futures Markets AFM

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The 11th Annual Conference of the Association of Futures Markets (http://www.afmorg.net/) was held in the city of Bangkok, Thailand.

Pre-Conference Workshop: Setting Up a Derivatives Exchange

This year's Conference was preceded by a workshop intended to provide participants with a focus on the most important points and information to take into consideration when setting up a derivatives exchange. The one day workshop was divided into three parts: "The HOW Factor", "The WHAT Factor" and "The WHY Factor".

With workshop moderation in the expert hands of AFM Board Member, Rod Gravelet-Blondin, it was underlined that the sharing of information was the primary aim of AFM. This had been the reason it had been decided to run a pre-conference workshop at the 2008 Annual Conference.

After a warm welcome to the Workshop by Clive Furness, whose organisation Contango Markets was sponsoring the day, Rod started the ball rolling by suggesting that, when it came to The WHY Factor, important was that a derivatives exchange had to bring economic added value. It was not valid to setup a derivatives exchange as a political "nice to have".

Pre-Conference Workshop: The HOW Factor

In a wide ranging but concise summary, panel participant Patrick Catania of NCDEX agreed with Rod that a derivatives exchange was not to be set up to "look good on the resumé of a country's economy". It had to be considered if the local economy of the country in question could support an exchange.

When it came to technology, in Pat's view: "you don't get a second chance" and markets had to be designed from the outset to accommodate growth. Market participants needed access to capital markets to permit the building up of positions in other markets.

Drawing on his experience working for many years as a professional in the exchange industry, Pat explained that relationships between exchanges and their regulators had changed in the 1980s. Prior to that exchanges and regulators had often taken conflicting positions and battled with each other. Relationships had become cooperative – exchanges mostly working together with their regulators – in the 1980s.

To Pat, the ownership structure of an exchange was of lesser importance than the products the exchange listed and the structure of the exchange.

To round off, Pat directed participants to a Web URL: http://www.world-exchanges.org/publications/Focus208.pdf which provided very useful information from the World Federation of Exchanges concerning recent developments in the exchange business.

Panel member Gary Clarke of JSE Limited thought that regulation was key in setting up a successful exchange. In addition to celebrating his 9th wedding anniversary on the day of the Workshop, Gary went on to point out that there had been a crackdown on price manipulation in markets over the last 15 to 20 years. It was "integrity, integrity, integrity".

The exchange industry relied more heavily upon rules than most other industries. However it was essential to strike the right balance Gary continued. When it came to publicly listed exchanges it was required to "walk the talk": listed exchanges should at least comply with their own listing requirements.

Magnus Haglind of OMX drew attention to the fact that many of the regulatory aspects in the exchange industry had direct implications for the technology used by exchanges.

Technology was necessary in the first phase, but it became an area of competitive advantage in later phases. Reliability was the focus in the 1st, 2nd and 3rd phases of development. Now speed, latency and performance were becoming the main focus. Magnus suggested that there may have been a play-off to consider when setting up a new exchange between initial quick time to market [via, e.g, sourcing an "off the shelf product"] and longer implementation times for changes at later stages.

Jahja Sudomo of the Jakarta Futures Exchange (JFX) asked a characteristically perceptive and fundamental question: what defines an exchange? What was on-exchange and what was off-exchange? Jahja suggested that in an on-exchange transaction one did not know who the counterparty was. In off-exchange transactions it was essential to know who the counterparty was in order to be able to assess the counterparty's credit risk.

JSE's Allan Thomson followed on from this by suggesting that there had been a convergence between on-exchange and off-exchange (OTC) markets. CFDs (contracts for difference) were an example of a product space where this was taking place. Important was the co-existence of on-exchange and OTC markets.

Pre-Conference Workshop: The WHAT Factor

Speaking in an area of remarkable personal achievement and with the benefit of a wealth of unique professional experience, panel member Otto E Nägeli of the Options Industry Council (OIC) joked that "back office people" were not often regarded as being that interesting.

Margins in the clearing house (CH) should not be open to competition as they were insurance premiums. The CH was an insurance company offering risk reduction, scalability but, above all, cost reduction for its members. Not for profit, member owned CHs were the way to set things up, but Otto was open for debate on this point.

In Otto's experience it was often difficult to convince members of the necessity of contributing to a clearing fund. Reasonable capital adequacy requirements – 25 million Euro for DCMs and 250 million Euro for GCMs, say – was also essential. CH access to central securities depositories (CSDs) was necessary, CH access to central bank money desirable. 10 million Euro, as for banks, was suggested as being sufficient for a CH's own capital, and when it came to setting up new exchanges Otto's main advice was "don't re-invent the wheel".

Sergey Mayorov of MICEX asked why in the exchange world people did not approach insurance companies to provide clearing services? Why was providing specialist CHs concentrated upon?

In his day at SOFFEX and Eurex, Otto said that he *had* approached insurance companies concerning the provision of clearing services. He had found though that insurance companies often did not properly understand the requirements of securities transactions. The clearing member's (CM's) contribution to the collective clearing fund could, for example, be replaced by an insurance premium. Otto had asked insurance companies to provide a proposal for offering such a service but had never received a price.

MCX' Lamon Rutten added that insurance companies were now around with insurance products which could be used at 2^{nd} and 3^{rd} levels of defence in the CH. The products were usually reasonably priced.

Lamon went on to describe the situation where, as an exchange or CH operator, one might know that one had legacy IT systems or infrastructure, be in the position to be able to (and to want to) upgrade it, but not be able to do so because the users of the infrastructure were not able to upgrade their interfacing systems.

John Mathias from Merrill Lynch emphasised that when it came to "The WHAT Factor" in setting up exchanges it was important first to talk to the exchange's customers and potential customers that products were aimed at. All too often exchange R&D talked to a small choice of their market participants, feedback concerning a new product launch was always selectively positive – product launch then became a self-fulfilling prophecy – but then the product didn't work. It was imperative to avoid self delusion.

Do not focus on a narrow segment of clients when it came to product development John continued. Work with market participants and take feedback seriously. Keep products simple. Referring to errors made for example by European exchanges: do not clone [products]. Instead aim for building liquidity on regional exchanges. Application of tried and tested standards was also very important.

The taxation regime was also of great importance in John's eyes. There were intricate interdependencies between exchanges, governments, regulators and taxation regimes. John spoke of an extreme [bad] example where the taxation regime in one country had forced a benchmark product into OTC space, this not being in anyone's interests in the end.

Acknowledging that it was an unusual position for a representative of the broker community, John concluded that it was not only about cutting fees. Exchanges also needed to invest in R&D and infrastructure.

Panel member Clive Furness suggested that product was key in the exchange business. Clive cited the London Metal Exchange (LME) plastics contract as an example of a contract aimed at a market whose participants were not conversant with futures.

It was important to try to estimate the underlying base value of a contract. Was a minimum underlying base value of, say, 2 billion Euro prerequisite for a contract to be successful Clive asked? Global coco, as an example of one of the smaller markets, was estimated to have a base value of 6 billion Euro.

Clive agreed with John Mathias' recommendation not to rush things when setting up new exchanges and contracts. Listen to the market and in this, not only the strong players should be listened to. More often than not the stronger players were only out to protect their own interests.

Fees were an important factor. Clive invited Conference delegates to ask themselves the question: can a day trader come in and get out and still make a profit, net of fees, on a one tick upward movement?

Exchanges often did not understand physical delivery, this causing them to opt for cash settlement in contracts. In turn, such contracts were then sometimes pitched at industries that did not understand cash settlement! Delivery was key Clive concluded.

Pre-Conference Workshop: The WHY Factor

Speaking from the panel, MCX' Lamon Rutten suggested that the first thing to create when setting up a new derivatives exchange was an information system that gathered prices from regional exchanges, thus enabling hedging.

Road shows, free training, offering longer training sessions to those interested – and even longer ones to those really interested – was also important. It was crucial to identify (road shows being a good method of doing this) people who would really make markets work. News letters and operation of an exchange training department were also very important for promoting the markets and business of an exchange. All these measures were often not seen as necessary or good from a short sighted business development perspective as there was no immediate return but they were essential in Lamon's view.

As part of training activities MCX had developed simulation software to allow market participants and potential market participants to familiarise with working in the markets.

Referring to discussion during the WHAT Factor session concerning the CH, Lamon related that MCX had developed their own margining systems but that these were not currently used as international brokers [interfaced to MCX markets] mostly had less sophisticated systems.

MCX had trained university professors so that they, in turn, would be able to train students to be able to work in the markets. It was estimated that MCX markets had created approximately 300 thousand jobs, so this was of great importance.

MCX had specific training courses for market professionals, professors and education sector professionals, politicians, journalists, etc. "Think long term" appealed Lamon. If students were trained now then you would benefit in the future.

Employees of the exchange also often left. It was important that they were well trained during their time working at the exchange as this would help to ensure that they kept using the exchange after they left.

MCX had engaged in an advertising campaign in India, to promote their markets, which involved things like adverts in aeroplanes, newspaper adverts, etc. At an early stage the focus of this had been that MCX was India's No. 1 exchange and positive aspects like that. This had attracted negative attention. People had started to ask such things as what exactly had MCX done for India? As a result, MCX' advertising strategy had been switched to being more informative with less of what might be interpreted by some as bragging.

Finishing on a light note, Lamon joked that it was certainly not hard to generate interest in a road show in India.

In panel member Eurex' Simona Simon's opinion it was essential to focus on the customer base when establishing new exchanges and markets. In the case of Eurex this was mostly banks and brokers with head offices in London.

Liquidity was obviously key, but good product design did not guarantee liquidity. Product development had to interact with many different entities: customers, sales, IT departments, etc. Agreeing with John Mathias' earlier comments, Simona said yes, absolutely, do not clone when it came to product development. Also, do not launch a product if one market maker and five investment banks have said they wanted the product. This was not sufficient ground to decide to launch a product.

The customer had to be respected. There were often maybe 6 or 7 interest groups that needed to be satisfied when launching a new product. It was usually near impossible to satisfy all of these.

Simona concluded that misunderstanding could easily arise between exchanges and their clients as to what was thought to be required when it came to product design. Advertising, working committees and other such measures were essential to try to avoid this.

Alan van Griethuysen from NYSE Euronext started by pointing out that there were big advantages for derivatives exchanges which were independent and not just departments of stock exchanges.

The European Options Exchange, EOX (founded in Amsterdam), had at first suffered much bad publicity. Newspaper headlines had been around at the time, Alan recounted, such as "I became a member of this exchange to close it down as soon as possible."

EOX had decided back then that if the big banks did not want to work with their products then they, EOX, would sell their products themselves. Strong education initiatives had been embarked upon with retail investors. EOX had also had a very active president who had seemed to be in the press almost every day and had branded the exchange "Optiebeurs". A 5 year option had been launched for example and it had

been noticed that retail investors were making the market and building up open interest.

Alan concluded that concerning the relationship with stock exchanges, cash market operators should be aware that 30% or more of their volumes were generated as a consequence of derivatives market transactions.

11th Annual Conference: Day 1

Welcoming Remarks

Representing out-going AFM President Ricardo Marra, MATba's Guillermo Desiervi welcomed participants to the first day of the AFM 11th Annual Conference. Guillermo was sure that we were on the right track towards the development and growth of our markets.

Sarit Vorapanya of the Agricultural Futures Exchange of Thailand (AFET) extended delegates' welcome to the Conference and to Thailand. Thailand was a "newcomer in the futures industry" with two exchanges having been recently formed: AFET and the Thailand Futures Exchange (TFEX), the two being for agricultural and financial products respectively. AFET in particular was formed to help stabilise prices of agricultural products.

Access to Thai futures markets was new for investors and hedgers. Hedging instruments were indispensable in Sarit's view as they could be used by investors to protect against price fluctuations.

Thai capital markets were also developing to the next phase with TFEX offering financial hedging instruments. The OSET50 contract (option on the Thai SET 50 benchmark index) was completely new to investors, its futures counterparty, the FSET50 contract, had been around longer and was also very useful for hedging purposes.

Keynote Address

The Honourable Banyin Tangpakorn, Deputy Minister of Commerce, Thailand delivered a very interesting and thorough overview of the Thai economy, financial system and the role that the country's two, relatively new futures exchanges, AFET and TFEX, had to play in these.

The concept of futures trading was relatively new in the Thai economy. Thai investors were more familiar with financial and capital markets than with commodities markets. Agricultural futures were crucial to the Thai economy none the less as Thailand had a large agricultural sector in its economy, and agricultural price risk could impact the country's economy greatly therefore. Hedging with agricultural futures was thus essential and these were the main reasons that AFET had been established.

Turning to the markets of TFEX Banyin drew attention to the major role played by the capital markets in the Thai financial system and in the long term prosperity of the country. Thai securities were well recognised among both domestic and foreign investors, and capital market developments were now reported in almost all media.

Using contemporary events to illustrate the necessity of Thai derivatives markets, Banyin noted that the FSET50 contract had proved a very valuable instrument with which Thai capital market investors could protect their portfolios against the effects on the domestic [Thai] economy of the international sub-prime crisis. Interestingly, the crisis had first influenced those who had thought that the derivatives market was irrelevant to them and their business. Those that had hedged and *used* derivatives had faired much better Banyin observed.

Banyin rounded off by stressing the importance of education in the use of derivatives markets and products. Hosting the AFM 11th Annual Conference in Bangkok was of great benefit towards this goal and was also very important for the newly established derivatives exchanges, AFET and TFEX, of Thailand.

Roundtable 1: Derivatives – Challenges to the Thai Markets

Introducing the larger than life moderator of the first roundtable discussion, Simon Rostron of Rostron Parry, session chairperson, Roderick Gravelet-Blondin, informed Conference that ever since he had known Simon he had always looked up to him!

Simon got the ball rolling by recounting that 20 to 25 years ago the Thai economy had won the reputation in the City of London of being an Asian Tiger. Thailand had lived up to this reputation. The country had excellent infrastructure and an economy composed of 10.8% agriculture, the rest being industry and services (Simon noted that the strong agricultural component should be to the benefit of AFET).

Nitus Patrayotin from AFET provided Conference with an overview of the progress made by his organisation since its formation 3 to 4 years ago. There had been a large increase in liquidity. However players in the agricultural economy had been doing business in Thailand for centuries before AFET's advent. There was therefore a certain amount of uncertainty about using the futures exchange. AFET were in the process of building up trust and persuading farmers to use the exchange.

In previous times the Thai governments had supported agricultural prices during harvest seasons. Now investors needed new products for their portfolios. Financial futures were relatively widely used and accepted, but investors were still somewhat apprehensive when it came to the use of agricultural products.

In terms of future AFET prospects, Nitus continued that Thailand had the great advantage in the agricultural sector of being a relatively large producer of agricultural products. This meant that changes in prices of Thai agricultural products could influence world market prices quite substantially in some agricultural sectors. Hedging in AFET futures markets in such sectors would be of interest therefore to international investors. Tapioca was an example of a market where Thailand was a large producer. Tapioca was also being used as an alternative energy source in the current times of high oil prices, this making the product all the more significant.

AFET's Napaporn Kurupasutachai asked how to get liquidity? Most important was education and persuading people to come into the market. Properly trained personnel were in shortage in Thailand. Many people viewed exchanges as "casinos", this being the result of former times when bogus operations had been set up and people had lost money.

The Thai Government had started to intervene less with the rice price since 2007. This had led to a pick up in AFET volumes. Napaporn hoped that the Government would continue in this vain. But education was the key to success and they were still suffering a shortage of funds for education and of trained personnel. Support was also lacking in some areas of Government which should have been supportive of AFET and their activities.

Kesara Manchusree of TFEX explained that his organisation was a subsidiary of the Thai Stock Exchange, the latter operating a classical cash market, i.e. stocks, bonds, etc.

April 2006 had seen the launch by TFEX of the FSET50 contract. OSET50 had been launched in October 2007. The FSET50 contract had undergone 4 fold (400%) growth in annual traded contracts from 2006 to 2007.

Kesara explained the importance in the exchange industry of education, expansion of the customer base and product development. It was good to bring in traders, financial professionals and people [from outside Thailand] but that alone was not enough. Experts who had local knowledge and who could speak Thai were also needed.

The number of investors in equities in Thailand remained low. Mutual funds had started at the end of 2007 but only two were active on TFEX at present. TFEX were using OMX technology, but most local brokers were using software from local ISVs. Concerning liquidity, TFEX were going to invite market makers from outside Thailand to participate in their [TFEX] markets.

MFC Asset Management Plc's Pichit Akrathit pointed out that the need to use derivatives for hedging increased as capital markets became more volatile. Investors seeking more alpha from other asset classes were a second effect which led to derivatives becoming more popular. Thirdly, the separation of alpha and beta would have been impossible without derivatives. Derivatives could be used to make "alpha portable". Pichit was looking forward to equity and stock sector futures and options contracts, fixed income futures, CFDs and commodity contracts such as palm oil futures in Thailand.

Pichit's own organisation offered clients local investment knowledge in Thailand. Clients were institutions and high net worth individuals. Pichit spoke very positively about investment conditions in Thailand, saying that the country currently had an "ideal investment environment". Concerning liquidity and turnover, a daily equity market turnover of 50 billion Baht was cited. That figure in fixed income and agricultural markets was 100 billion and 10 billion respectively. In terms of financial infrastructure, a common CH, to enable clearing across markets and asset classes, was needed.

Wiboon Perm-Arayawong from ACL Securities, Thailand, praised TFEX for being one of the most successful young derivatives markets, and that having been achieved in only 2 years. The FSET50 and OSET50 contracts were excellent and already highly successful. About 20.000 FSET50 contracts were being traded per day. The OSET50 contract had only been very recently launched and still appeared too sophisticated for retail investors. Future challenges for the Thai exchange industry were FX futures and options.

There was less foreign participation in TFEX markets than in Thai equity markets. TFEX participants were made up of 54% retail investors, 25 to 27% Thai institutions and the remaining approximately 20% foreign institutions.

Wiboon echoed Napaporn Kurupasutachi's concerns that the shortfall in human capital – well trained professionals – was problematic for development of the Thai financial and exchange industry.

Providing animated and eloquent input to the discussion, roundtable member Chanon Phucharoenyos of JSP Futures Ltd, Thailand, explained that his company had built a 25% market share in futures broking in Thailand.

JSP Futures saw investors and speculators (long and short term) active in the market. Challenge 1, according to Chanon, was to encourage more of the former.

Challenge 2 was to encourage market participants to short sell. Thai investors knew only one dimension until now: buy low, sell high. With illuminating simplicity, Chanon explained that there were at least two dimensions in futures trading and 3, 4 or many more in options trading. As futures brokers JSP Futures wanted to encourage this all.

To develop futures trading it was also necessary to concentrate on macro economic analysis. On a light humoured note Chanon likened this to swimming. Was it possible to swim without jumping into the water? Chanon's theory was that Thai investment funds needed a little push!

Chanon went on to point out that asset managers were increasingly being trained to make more and more return with minimised volatility. This bode well for AFET markets as the exchange's products were designed exactly to make this possible. Chanon and others of his market professional colleagues in Thailand were broadcasting this around, loud and clear within the community, but asset managers were still not yet coming to exchange markets. The perception that futures trading was gambling remained pervasive. The two were quite different: in horse racing one betted on a horse not knowing if it would win or not. In futures trading no one stops you taking your profit if you are ahead.

Returning to his earlier comment concerning the wariness of short selling in the Thai investment community, Chanon related one client who had had the hunch that rubber prices would go down. The possibility of shorting futures contracts had been suggested, the reaction to which had been, "no, buy when it hits the bottom!"

As a broker one can offer the advice to bet the price of a market down. Exchange operators cannot do that. They put markets for products in place but can only tell market participants what they can do with the products, not advise market participants to do one thing or other.

Chanon concluded a scintillating overview of investment in Thailand by subscribing to Napaporn Kurupasutachi and Wiboon Perm-Arayawong concerns about lack of trained financial professionals in adequate numbers in Thailand, adding that the focus for the future of Thai markets was liquidity, liquidity, liquidity.

Speaking from the audience, futures markets were all about improving transparency and price efficiency to David Rutledge of DMCC. Economies were full of people who made big money out of market inefficiency. David asked if it was the case in the Thai

economy, as it was in many other economies, that there were people who, although they completely understood futures markets, continued to resist futures markets as they were a threat to their margins (vested interests).

Moderator Simon Rostron responded to this point by suggesting that a solution was to open up markets to international investors. If the practices described by David were present in a market, then international hedge funds would step in and "sort it out" pretty quickly at great profit to themselves and their investors and at the annoyance of local market participants.

<u>Roundtable 2: Developing Derivatives Markets in Asia</u>

Moderator Pat Catania recounted episodes in US agricultural markets where large price movements had made it necessary for the US Government to intervene and support farmers. Illustrating the efficiency and reliability introduced by futures markets, this had been done by the Government using tax dollars to buy put options contracts for farmers.

Elena Sng of the Singapore Exchange informed Conference that her organisation was engaged in trading and clearing of commodity products. Singapore Exchange was witnessing rising popularity of commodities as an asset class as investment funds moved into commodities and equities became more volatile.

David Rutledge advised that when talking about financial markets, these should be thought of as extensions of capital markets. It was hence important to look at how developed capital markets were in a region when it came to setting up financial derivatives markets.

Even in jurisdictions where Sharia law was not formally in force, David continued, derivatives markets that were wrongly perceived as being speculative may not fit in as the culture may remain "Sharia" in nature.

The Thai economy had a very strong agricultural sector. The mainstay in Dubai was oil. When establishing new exchange markets it was essential to look at what commodities were being imported and exported and that were easily standardised. Steel rebar imports were an example of this in Dubai.

Dubai was at the centre of trade flows from the East to Europe, Africa to China and South East Asia to Europe and Africa. The greatest challenges in Dubai were, i) the structure of domestic capital markets and local economic culture and ii) the interaction with the wider economies that Dubai sat within.

Raghbir Singh Bahrt of Bursa Malaysia suggested that the most significant difference between the West and Asia was history. Western derivatives markets went back 200 years. CME Group introduced option contracts after almost 200 years futures trading.

Derivatives trading had started in Malaysia in the 1980s. There had been 20 years' futures trading in Malaysia but the first options contracts had not worked because investors did not yet understand them. Raghbir's conclusion: education was the essential element.

US universities had courses as standard on futures. Their Asian counterparties did not. Additionally, there was a family business culture in Asia. Businesses were handed down from father to son with prevailing attitudes such as, "if my grandfather and father did not use futures then why should I?"

The older generation was still mainly in the driving seat, but they were being phased out and replaced by younger people in Malaysian companies.

In anecdotal evidence of the importance of education, Pat Catania explained to Conference a time when cattle producers had demonstrated at CBOT because of low cattle futures prices. Pat, who worked at the exchange in those days, had been called down to try to sort things out. It had transpired that the cattle producers had been long cattle futures contracts when their yards had already been full of cattle!

UBS' Christopher Chong explained that his clients wanted to trade globally. But markets were restrictive in Taiwan, China and Korea concerning lot sizes and post and pre margins. China and India were removing restrictions.

Explaining some of the background to his exchange, Steve Wang of TAIFEX informed Conference that a lot of underground trading had sprung up in Taiwan. The Government had stepped in, ratcheted up regulation and the result of this was that the organised futures market, TAIFEX, had come into existence.

Equity markets had a 50 year history in Taiwan. There were 10 million accounts to trade equities in Taiwan, the country having very sophisticated retail investors. At the launch of TAIFEX and as a result of this sophistication, retail investors had been very fast to learn about futures markets and realise that these were good, high leverage markets.

Internet usage was well developed and widespread in Taiwan. A home, internet based trading solutions from Korea (originally for trading KOSPI options) had been adopted. The take up had been greatly successful.

The cash market in Taiwan was operated with T+2 settlement. There were lots of problems with defaults however and this had led to pre-trade margins being imposed in TAIFEX markets. This was proving too restrictive for institutional investors. The CME SPAN margining system had been adopted at TAIFEX.

Jahja Sudomo described how he had started setting up the Jakarta Futures Exchange (JFX) in 1999. It had taken 2 years to get a license for the exchange. They had started with 1 million US Dollars capital. This had diminished to 300 thousand US Dollars by the time they had obtained the license. Of the 25 employees of the exchange, only one understood futures properly.

Referring to the discussion in preceding panels concerning education, Jahja agreed with the importance of education. In the case of JFX however it had not been possible for them to invest all their money in education. Jahja joked that, on the contrary, his own ignorance in the initial stages of setting up JFX had proved to be an advantage. Had he known then how much trouble, difficulty and work would be involved in setting up the exchange he would most likely not have started!

JFX was not for profit but also not government subsidised. People had predicted that the exchange would last 3 months. JFX had now been running for 9 years and had a 5 million US Dollar capitalisation.

Jahja had introduced a “rolling gold” contract at JFX. Gold was classed as a commodity, not as a financial product, and hence JFX was allowed to list it (JFX was not allowed to list financial products). Jahja took the precaution of asking if the rolling gold contract was legal. It took the Government 2 months to answer yes. The contract had substantially helped JFX to survive.

Looking to the future Steve Wang said that TAIFEX were working hard with their regulator. They were informing the regulator about TAIFEX markets and hoped to get pre-margining requirements lifted. The next steps were to introduce direct market access, extend distribution of SPAN information from [currently only] CMs to all market participants and to diversify their product scope (16 of their products were equity based so it was thought necessary to broaden this).

Answering a question from the floor as to the importance of charging or not charging fees for market data when it came to establishing new exchanges, Raghbir Singh Bhart responded on a humorous note that a friend of his had recently made all his exchange’s market data available free of charge. The market had then crashed and Raghbir had asked, “what happened to all the data you gave out for free!”

In David Rutledge’s mind a good strategy might be to provide market data free initially to get people interested.

Jahja Sudomo joked that his exchange’s data was almost worthless.

On a more serious note, Steve Wang reported that data vending accounted for less than 1% of TAIFEX revenues.

Chris Chong rounded up by pointing out that he and his fellow brokers always wanted free data.

<u>Roundtable 3: Exchanges – Public Monopoly or Private for Profit Enterprise; Ownership of Data and Value</u>

Responding first to the panel title, Otto E Nägeli of OIC pointed out that when it came to setting up a new exchange the most important things were to open it and start doing business on it. Ownership was not important at first but became important at later stages.

Panel member Sergey Mayorov from MICEX informed Conference of the apt example of how the relationship between MICEX and its owners had changed of its own accord.

MICEX had begun in the early 1990s with FX contracts. In the early stages it had been like a club with a member structure typical for exchanges in those days. Some of the initial members left the exchange and some 15 remained as shareholders. More recently MICEX had moved its focus more towards bond and cash markets, this being of far less interest to the original members (who were mostly interested in FX) and thus the shareholders and owners now had a relationship with MICEX which was more like that of investors [in the exchange].

Sergey rounded off his initial panel contribution by adding that the merits and pit falls of horizontal or vertical silos or for profit (shareholders) versus not for profit (membership) were often discussed, but in his opinion the world was more complicated than that. There was more to the discussion than one or other of these alternatives being absolutely right or wrong.

With reference to so-called "shareholder activism", Lidia Adamska of Warsaw Stock Exchange (WSE) proposed that the difficulty was how to combine long-term interests of an exchange with the often seemingly more short-term interests of shareholders.

Bankon Management's Michael Jesch thought that it was important to take account of history. Was it the case that organisations being "for profit" led to increased efficiency or was state owned better he asked?

Moderator John Mathias from Merrill Lynch took up this point by asking panel members if perhaps not fully state owned but "state'ist" in nature was a better ownership structure in the initial phases of exchanges being established in emerging markets?

Speaking from experience at SOFFEX and Eurex Otto Nägeli explained that when one was running an exchange you wanted the owners to cooperate with you and not to work against you. The change from members being members to members being customers had been undertaken by Werner Seifert at the Deutsche Börse for example. Not long after IPO, Deutsche Börse's then stakeholders had sold out during a downturn, as they needed cash, to hedge funds.

John Mathias queried if it was not then "for profit" that triggered and drove competition? Was it not, John asked, that if exchanges were for profit, and it was thought that prices were too high, that competing exchanges could then be started?

Otto replied that he believed it was not quite like this in the exchange world as exchanges were pieces of infrastructure.

Concerning competition in the Russian exchange industry Sergey explained that there were two exchanges in Russia that were symmetric in products, but which remained separate.

Lidia described the planned privatisation of WSE. It was thought that WSE was a relatively small exchange which was cheap and easy for large investors to buy up in the very competitive exchange sector. Privatisation would improve competitiveness however and it had been decided to sell 49% of the exchange to institutional investors. The [Polish] State would control the remaining 51%.

John Mathias probed further by asking about ownership structure of exchanges in a different way. Did mergers between big exchanges create synergies (e.g. in the technology area)?

Michael Jesch thought that exchange mergers did create synergies as otherwise they would not take place.

John's next question concerned what additional safeguards were required to be introduced with the shift to private ownership. There was a gulf between member ownership, where any member could stand up and say their piece about the running of

the exchange they were member of, and private ownership where there was a board, elected by prominent shareholders, which ruled the day. Were additional safeguards required with private ownership in the area of, for example, fees?

Otto Nägeli took the discussion further by drawing attention to the fact that genuine cross-border consolidation had yet to take place in his view. There was Eurex, but there were still two parent exchanges behind Eurex (Deutsche Börse and SWX). The same [there were now two exchanges between the organisation] was essentially true of NYSE Euronext. Regional markets remained split, this amounting to “make believe globalisation”.

John Mathias interjected at this point to inform Conference of the fact that his organisation, Merrill Lynch, was actually a confederation.

Sergey Mayorov pointed out that with property prices as they were in Moscow if competition and short-term economic interest were the only priorities then MICEX would probably be closed down and its offices used as office space lets or for residential accommodation.

Lidia Adamska reported that WSE had a relatively stable staff compared to other financial services organisations. Consolidation in the form of mergers, etc, between exchanges was obviously taking place. It was important though to point out that integration of markets was also ongoing, but that this was something different to consolidation.

In reference to the debate surrounding privatisation and for-profit, Pat Catania raised a laugh by recalling, with typical wit, the words of a colleague. The colleague had told Pat that you could “milk the cow every day, but barbeque it only once!” In the aftermath of the tussle between DTB and LIFFE to win the German Government Bund futures contract (a tussle in which DTB was ultimately successful, this leading to the near bankrupting of LIFFE) the same colleague came back to Pat and added, “well you know Pat, I didn’t realise the cow could die too!”

Continuing the humorous note and rounding up the panel, Otto Nägeli added that there was one example of a for profit monopole that everyone unfortunately knew: the tax office!

11th Annual Conference: Day 2

Roundtable 4: Exchanges and the Media: How the Media Can Help to Create Liquidity

The second and final day of the 11th Annual Conference got off to a start with roundtable discussion 4.

Adam Maciiejewski provided a description of the state of the Polish economy and how his organisation, WSE, was developing. WSE had established trading surveillance and business networks connecting members, ISVs, investment funds, trading participants and market data takers.

Poland was witnessing 6% annual GDP growth, 6 to 7% growth in private consumption and unemployment had fallen rapidly from 20 to 10%.

WSE were operating markets in equities, derivatives and, more recently, in structured products. The very successful WSE WIG20 futures contract traded 10 million contracts in 2007.

Turning to the roundtable discussion topic Adam explained that WSE had a Media and Marketing Department and a foundation for capital market education. WSE held regular meetings with investors, a General Assembly and various meetings with companies to promote their [WSE's] markets, services and business.

The exchange had decided not to have a spokesman as it was thought that the executive management should be their own spokespersons.

Dealing with the media, it was proposed, could be carried out well by for example setting up a "council for information order" at an exchange that would be in charge of media communication.

Internet websites were also an indispensable tool for media communication Adam continued. WSE had established a full set of specialised websites including a main website and specific websites for derivatives and structured products, "WSE Info Space" (that had been created with the Polish Press Agency), "WSE International", a corporate governance website and a network connections website.

Darius Cipariu informed Conference of the relationship his exchange, the Sibiu Exchange, Romania, had with the media. Darius interestingly explained that he saw it the role of conventional television to attract new investors. Specialised (financial) press was there to assist in dissemination of prices and other market data, but it was the role of the mainstream media to attract retail investors.

Darius explained that there had been price increases in Romanian markets. These had been reported in mainstream press and this had resulted in many new investors entering markets and turnover increasing substantially. Prices had then decreased again, but many of the new investors had remained in the markets and liquidity had increased as a result. This was an excellent example, in direct response to the roundtable title, were media influence had helped to create additional liquidity.

Darius summarised these points by emphasising that it was of course necessary to build and maintain a good relationship with the specialised, industry press. But also not to be neglected was maintaining a good relation with mainstream press.

The first task in MATba Guillermo Desiervi's eyes was to educate potential investors as to what futures contracts were and how they should be used. MATba viewed it as important to try to teach journalists how they can explain the benefits of hedging in futures markets to farmers. Talk of speculation in Argentina was somewhat risky Guillermo warned. It was thus imperative to work well with the press and to try to ensure that journalists were well informed to reduce misunderstanding.

Contango Markets' David Setters recalled his days working for FOW Global Derivatives Magazine. Illuminatingly, David explained that press and media organizations could be categorized:

i) the “mass media”, so the Sun, Bild Zeitung, etc
ii) “serious press”, so the FT, etc
iii) “the wires”, Bloomberg, Reuters, etc
iv) “business magazines” e.g. Pension Funds International, etc
v) highly specialized industry publications covering our own *exchange industry*, so FOW itself, Profit and Loss, etc.

Typical headlines in i) might have been “exchange executive marries lap dance girl”, articles about traders driving fast cars, prices going *up*, not down, the price of bread, things like that.

David recalled when Nick Leeson was arrested at Frankfurt Airport. Having been working at the FOW Frankfurt event at the time, David had also happened to be in Frankfurt. Suddenly David, his colleagues and FOW had been overrun by Sun journalists looking for exclusive information on Nick Leeson!

Describing his relationship, as press representative, with the exchange industry David continued, partly on personal terms, that he had always felt *part* of the exchange industry and not external to it.

Exchanges had positive stories to tell. But exchanges had to be pro-active in promoting these David advised. Newspaper articles about price manipulation had to be avoided, articles about positive things actively promoted.

It caused amusement to David that many markets oriented articles and press continued to carry images of pit traders in brightly coloured jackets although these had all but ceased to exist.

Information from the wires had the trait that it often “trickled down” into other media forms. The specialised press, sort of Pension Funds International, etc, was also not to be overlooked. Such publications were very powerful as the information got down to end users of exchange products and services.

It was also important to make distinctions within the specialist industry publications. There were good ones, but there were bad ones which were too strongly driven by advertising revenues. These publications were specialised and so could not draw on mainstream advertising revenue sources. FOW had once received a complaint from Rolfe and Nolan. The next week they received a complaint from Sungard. FOW must have been reasonably fair therefore, David joked!

In summary, “look after your specialised media” was David’s main recommendation.

Adam Maciejewski invested a lot of effort to establish trust between the media and WSE. The relationship of an exchange to the media was less dependent upon region or country. More significant was the stage of development that the exchange was at.

WSE focused on applying simple methods when it came to interacting with the media. For example, it was thought very important to personify the capital markets by ensuring that WSE representatives were often present in television interviews, etc. Making many public appearances was tough work for exchange employees but, Adam thought, well worth it.

Panel moderator Simona Simon from Eurex posed a question concerning location to Darius Cipariu. Having been brought up in Romania herself – and so having first hand knowledge of the country – Simona asked how it was for Darius' exchange being located in a city outside the capital and being geographically displaced from the main client base, this being a situation that many exchanges in emerging and established economies were in. Did this create additional work for the exchange and how did this effect the exchange's relationship with the media? Eurex was headquartered in Frankfurt when the exchange's main customer base was in London.

Darius responded that it was correct that the main customer base, brokerage community, etc, of his exchange were located in the Romanian capital Bucharest, approximately 300km from the Sibiu headquarters of his exchange. Sibiu Exchange had thus decided to open a representative office in Bucharest. This was used mainly for hosting educational activities such as training courses, etc, but press release events were also held there.

The media liked sensational stories such as "50% price gains in 3 trading sessions" or "sellers make 3 million US Dollars in one trading session". The great advantage of the media, Darius pointed out, was that they published articles and ran stories without asking to be paid in return.

There was a special forum for retail investors that had been established in Romania. Sibiu Exchange associated closely with the forum. They had put up banner adverts in the forum's website with slogans such as, "Did you know you could speculate on stock prices more cheaply?" and "Did you know you can make money on falling prices?" these being linked to the Sibiu Exchange website.

Guillermo Desiervi related to Conference that MATba was a frequent and active participant in the many farm shows that took place in Argentina. These were very important forums where promotion of MATba products and services was taken directly to farmers, the end users of MATba products and services.

MATba had used many advertising slogans such as: "Did you know the dream price of beans was attained on MATba yesterday?"

Rounding up the discussion, Guillermo explained, as an example of the huge effect media coverage and information could have on exchange prices, how, some days before Conference, the Argentinean yellow press had rumoured that the Government was going to increase export tax. MATba prices had slumped as a result.

Roundtable 5: "How to Keep Markets Efficient and Honest… Ensuring Ongoing Positive Recognition of Derivatives Markets" – Product Design, Physical Delivery, Speculation Limits, Lessons Learned from Established Exchanges

Arman Falsafi provided Conference with details about the vertical business model implemented and run by her organisation, CME Group. 10 million contracts had been traded per day on the CME platform in 2007. The figure in 2008 so far was 13.5 million. Arman highlighted the importance of recognition of the use of derivatives. There was a winner in the derivatives market for every looser.

Roundtable moderator, Paul Meier, Chairman of SFOA, thanked Arman for the PR and asked what was necessary though to keep markets efficient and honest.

DMCC's David Rutledge explained that markets were there to serve a purpose to economies. This was the reason markets existed and why they were supported by governments.

Lamon Rutten from MCX suggested that there were 3 spheres in the exchange landscape where honesty was relevant. There were i) the internal operations of the exchange itself, ii) the exchange's relationship with its brokers and clients and, iii) the exchange's relationship with the outside world.

In terms of i), the exchange was well placed to be able to tackle honesty in its internal operations. The exchange knew who were taking big positions in its markets and knew who were responsible for large price movements if this caused problems. Delivery systems were a problematic area as delivery was easily open to manipulation.

Lamon's advice when it came to issues concerning ii) was that the exchange had to be hard headed. In many emerging market environments semi-illegal structures had existed before the advent of the exchange. Brokers often complained about capital requirements being too high. Such pressure was to be resisted. Brokers had to be fired if necessary. Be strict with your clients and brokers for all of these reasons appealed Lamon.

Taking the third area, the outside world always blamed exchanges for price increases, e.g. for food price increases. Lamon recommended that it was important to open up markets to international investors and players, as had happened in the US wheat market. A contract may initially be designed with domestic interests in mind. The market may become so important that international players start to use the contract to hedge their interests. This would lead to a mix of international and domestic interests in the market.

JSE's Chris Sturgess informed Conference about an interesting development where non-South African (e.g. German) wheat was being delivered at South African delivery points.

Speaking from the audience, independent consultant Chip Dempsey explained that in the US wheat and grain markets the delivery mechanisms had got out of step with the requirements of the spot markets at one stage.

Contango Markets' Clive Furness raised the illuminating point that "the roll" feature in contracts was perhaps to blame for some market difficulties. According to Clive some contracts specified that positions had to be rolled on one particular day. This led to the market "knowing you were coming" if you were to roll a position in one of such contracts. This was a fundamental contract design fault in many cases thought Clive. Problems at roll were exacerbated by also not being able to trade [time] spreads in advance of the roll in many cases.

Pat Catania lent his vast experience to the discussion by adding to this that exchanges often removed price limits in delivery months whilst leaving them in place in back months. This accentuated problems at the roll.

Lamon Rutten explained that price limits were mostly requested by clients and regulators, clients because they often could not afford to pay (intra-day) margins.

Arman Falsafi explained that in her opinion cash settlement *did* work well when indisputable, fair settlement processes were in place.

Lamon expanded upon this by pointing out that it should be differentiated between 2 types of cash settlement. MCX listed international contracts where the underlying was an international instrument. These were cash settled in Rupees, based upon prices obtained from the international exchanges in question.

The second form of cash settled contracts at MCX were those in products were physical delivery was horribly unreliable or simply not possible. Settlement and processing of positions in these contracts was difficult and very labour intensive. MCX had a department of people who had to phone round market participants to obtain spot prices. This often unfortunately led to less accuracy in settlement prices but it was thought that cash settled contracts, processed in this way, was the least bad solution for products where physical delivery was so very problematic.

Lamon's recommendation for achieving reliable, fair and efficient physical delivery was for the exchange to set up its own network of warehouses.

Speaking from the floor Jahja Sudomo of JFX pointed out that this was all very well, but asked what should be done if one owned a warehouse and the warehouse defaulted.

Chris Sturgess followed on from this by adding that former South African governments had invested heavily in delivery infrastructure. There was a pretty well developed network of warehouses and delivery points in place in South Africa which JSE Agricultural Division markets simply piggy backed on to and used. The JSE were very fortunate in South Africa in this respect.

Chris was also a fan of "sausage bags" (the use of which he was pleased to see was becoming more commonplace) as these were a more flexible form of storage.

Arman Falsafi suggested that whilst it was important to have good, reliable delivery infrastructure in place for physically settled contracts it was also important to be careful. Product "innovations of tomorrow" might not fit into the standard model Arman warned.

The discussion turning to position limits, Lamon Rutten described how MCX' markets had position limits imposed upon them by the regulator which made no sense. Hedgers were exempt from these limits, but the definition of "hedger" was so narrow that it was almost impossible for a market participant to obtain classification as a hedger. The regulator appeared to think that position limits were a tool to keep inflation down.

Jahja Sudomo again interjected from the floor. Persistence was necessary when it came to negotiating with regulators. Jahja explained that his philosophy was to never ever give up!

John Mathias of Merrill Lynch spoke up in favour of position limits. John's point was that position limits were not necessarily wrong in principle. More problematic was how position limits were applied. Market participants often traded under multiple identities in order to avoid position limits, this making a mockery of the limits.

Roundtable 6: Review and Outlook

Opening the Review and Outlook roundtable, expert moderator Rod Gravelet-Blondin asked roundtable members what they would identify as particularly provocative statements that had come up during the Conference.

John Mathias thought “annihilating bad practice” that Chris Sturgess had come up with in the preceding roundtable discussion was good. John suggested that “the best is the end of the good” was also an interesting conclusion.

On a more serious note John continued that “the devil was in the detail” when it came to keeping markets efficient and honest. A rule book and legal code needed to be developed, but flexibility in the interpretation of the rule book was then needed.

Standing in for her colleague, Robert Ray, CME Group’s Arman Falsafi was convinced that rules should be set and then adhered to. 120 km per hour *was* 120 km per hour and not 185 km per hour Arman light heartedly pointed out.

An important point was added by Alan van Griethuysen from NYSE Euronext. Alan thought it key to set precedents. As an exchange one could not be lenient with one market participant and strict with another. It was consistency that was the significant point when it came to the rule book.

Alan added to this that the situation was particularly challenging in emerging markets as the regulatory, legal, governmental and economic framework could change very rapidly. Governments could change dramatically; new laws could be drafted and come in fast, etc.

Roundtable member Adam Gross from MCX Africa homed in on Jahja Sudomo’s comment the preceding day that his own “ignorance had been a blessing” (if he had known how much work and difficulty it would be to set up JFX he would never have started, Jahja had joked). Referring to his recently taken up role at newly established MCX Africa, Adam accorded with Jahja Sudomo in how much work was involved in setting up a new exchange.

Adam drew parallels between cooking spaghetti and setting up new exchanges. Like throwing spaghetti against the wall, the trick when it came to setting up new exchanges was to throw up whatever products you can think of and see which stick!

John Mathias picked up this point by adding that it was valid to try out plenty of new products but that the buy in and participation of brokers, amongst others, was necessary to make a product work. Brokers were of the inundated with failure products though, so some caution was necessary.

Clive Furness also picked up on a comment from Jahja Sudomo the preceding day that his (JFX’) market data was “almost worthless anyway”. This brought attention to a very serious issue in Clive’s opinion. There was value in allowing the market more say in how market data was used. The 4 or 5 large global exchanges had a monopoly on fundamental economic data such as entire yield curves, oil prices, Clive reminded Conference.

Otto Nägeli queried whether there were any plans from exchanges to launch educational vehicles on mutual bases. It was highly advisable to operate educational vehicles and initiatives on a mutual basis Otto thought. The US options exchanges' response to this was Otto's organisation, the OIC. The institutions behind OIC were all competing in the same industry but they were united in the mutual aim of education through OIC.

In conclusion, moderator Rod Gravelet-Blondin asked roundtable participants for a short sum up of what developments they thought would be coming through in the near future.

Clive Furness suggested that an extension of CCPs into OTC space would take place.

Arman Falsafi agreed with this, but thought that extension of CCPs into OTC space would be more of a hot topic in emerging markets. Further consolidation would be the trend in developed markets.

John Mathias thought that we would see ISVs providing far greater and improved access to emerging markets, this being an important step for emerging markets – if international brokers and liquidity providers could not process the trades then they would not enter the markets.

Jahja Sudomo thought that clearing would be come more and more significant. In characteristically original and thought provoking style, Jahja proposed that this would not, however, be in the form of exchanges owning clearing houses but of clearing houses owning exchanges!

Abbreviations

AFET – Agricultural Futures Exchange of Thailand
AFM – Association of Futures Markets
CBOT – Chicago Board of Trade
CCP – central counter party
CH – clearing house
CFD – contract for difference
CM – clearing member
CME – Chicago Mercantile Exchange Group
CSD – central securities depository
DCM – direct clearing member
DMCC – Dubai Multi Commodities Centre
DTB – Deutsche Termin Börse (predecessor of Eurex)
EOX – European Options Exchange (founded in Amsterdam in 1978)
FSET50 – futures contract on the SET 50 index
FX – foreign exchange
GCM – general clearing member
ISV – independent software vendor
IT – information technology
JFX – Jakarta Futures Exchange, Indonesia
JSE – Johannesburg Securities Exchange Ltd
KOSPI – Korean Composite Stock Price Index
LIFFE – London International Financial Futures (and Options) Exchange
LME – London Metal Exchange
MATba – Mercado a Termino de Buenos Aires
MCX – Multi Commodity Exchange (India)
MICEX – Moscow Inter-bank Currency Exchange
NCDEX – National Commodities Exchange (India)
OIC – Options Industry Council
OSET50 – option contract on the SET 50 index
OTC – over the counter (market)
PR – public relations
R&D – research and development
SET 50 – Thai benchmark index
SOFFEX – Swiss Options and Financial Futures Exchange (merged with DTB to create Eurex)
SPAN – Standard Portfolio Analysis of Risk
TAIFEX – Taiwan Futures Exchange
TFEX – Thailand Futures Exchange
WIG20 – Polish 20 equity benchmark index
WSE – Warsaw Stock Exchange

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