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**Legal Analysis of the Indonesian
Commodities Supervisory
Board, BAPPEBTI, and the Jakarta
Futures Exchange (JFX)**

Contract #PCE-I-801-99-00006-00
Task Order #801

Technical Assistance for Taxation
Public Macroeconomics and Commodity
Futures Trading

by Susan Ervin

For Barents Group, LLC
United States Agency for International Development
USAID/G/EGAD/EM

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Indonesia

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TABLE OF CONTENTS

Legal Analysis of the Indonesian Commodities Supervisory Board, BAPPEBTI, and the Jakarta Futures Exchange (JFX)

Attachment A: *Preliminary Outline:* Considerations relevant to commencement of Trading on the Jakarta Futures Exchange

Attachment B: Suggested plan of action for BAPPEBTI preparatory to opening of futures trading

Attachment C: Surveillance/Compliance oversight

Attachment D: Electronic trading systems – Special considerations

Legal Analysis of the Indonesian Commodities Supervisory Board, BAPPEBTI, and the Jakarta Futures Exchange (JFX)

INTRODUCTION

This report covers a one-month mission in the regulation of commodity futures trading to provide technical legal assistance to the Indonesian Commodities Supervisory Board, BAPPEBTI. The legal assistance entailed an analysis of legal materials pertinent to the operation of BAPPEBTI, the Jakarta Futures Exchange ("Exchange") and the Clearing House and on-site work in Jakarta BAPPEBTI officials provided suggestions and recommendations concerning the proposed rules of BAPPEBTI, the Exchange and the Clearing House, and to provide training to BAPPEBTI staff. Nearly contemporaneously with the inception of on-site work, practical issues relating to the planned July opening of the Exchange became a topic of urgent attention. As a result, the consultant was asked to devote priority attention to assessment of the state of development of the Exchange, Clearing House, and BAPPEBTI's oversight programs in light of the proposed date for commencement of futures trading. Following on-site work, the consultant was also requested by BAPPEBTI to suggest a plan of action for BAPPEBTI's preparation for oversight of the new Exchange and Clearing House. Reflecting the evolution of priorities for this consultancy, this report addresses first the state of progress toward the opening of futures trading, followed by a discussion of the rules of BAPPEBTI, Exchange and the Clearing House, training given to BAPPEBTI staff and further training needs, and issues relating to development of a warehouse receipts system.

I. State of Progress Toward Opening of Futures Trading by the Jakarta Futures Exchange

A. Conclusions and Recommendations

A priority issue for the consultant's consideration upon arrival in Jakarta was the extent to which the Exchange's stated goal of opening in July 2000 was workable and whether there should be continued supported through financial and technical assistance to BAPPEBTI. In the case of a new marketplace such as the Exchange, readiness for trading involves the preparedness of all related parties necessary for effective, orderly operation of an exchange and its clearing systems. This means that the Exchange, its Clearing House, its regulator, the brokers, traders, and other anticipated users of and participants in the market would need to be prepared for the opening of trading. This assessment, based on interviews with Exchange, Clearing House and BAPPEBTI officials during March 2000, was that although all relevant parties appeared to be working diligently toward the commencement of trading, it was unlikely that all of the interrelated trading, operational and settlement systems of the Exchange and the Clearing House could be established sufficiently to permit BAPPEBTI to license the Exchange and Clearing House by July 2000.

From the perspective of government regulators, the Exchange and the Clearing House both have the burden of demonstrating -- prior to July 2000, if that remains the intended timeframe for opening of trading -- that they have satisfied the requirements for licensing as an exchange and clearing house. As of March 17, 2000, neither organization had submitted a formal and complete application for licensing and it was evident that much work remained before they were ready to do so. BAPPEBTI and Exchange officials were proceeding on the basis of an understanding that the Exchange would submit to BAPPEBTI drafts of various components of the licensing application as they were developed. A trading system commissioned by the Exchange was in development but was not expected to be ready for simulated trading until May 2000, and at least some period of revision and further testing (which in many cases is quite protracted) would be expected to ensue following simulated trading. Further, rules and by-laws had not then been finalized, and staffing and implementation of Exchange and Clearing House compliance programs were in an initial phase.

In these circumstances, it is evident that preparedness for trading in July, 2000 is dependent upon meeting a highly compressed schedule of deployment and testing of a trading system and establishment of other facilities to support trading and oversight. BAPPEBTI's careful evaluation of the Exchange's preparedness to commence trading as part of its review of the Exchange's application for licensing must assure that the Exchange's natural inclination to begin business rapidly does not result in compromise of critical standards of customer protection, orderly trading and market integrity. The volatility of futures prices, highly leveraged nature of futures trading, and financial risks of futures trading have led to well-publicized problems in other markets, which experience showed to have regulatory or market weaknesses that were not obvious initially. A new market such as the Exchange will be closely scrutinized by market participants, particularly foreign brokers and traders, to assure that it has effective systems and oversight, and any developments which reflect negatively upon the Exchange's credibility may be difficult to overcome.

Consequently, it is recommended that financial and technical assistance continue to be provided to BAPPEBTI, but that a substantial portion of these resources be conditioned upon BAPPEBTI not licensing the exchange for business until it is demonstrable under appropriate international standards that the Exchange is adequately prepared to discharge its market and self-regulatory functions. The following section outlines the elements of Exchange and Clearing House facilities and programs which should be reviewed as a minimum initial matter.

However, prior to the commencement of actual trading, there could be public formalities that would recognize the significant progress which has already been made toward establishing futures trading in Jakarta. For example, opening of the trading floor for simulated trading, issuance by BAPPEBTI of its approval of the Exchange's licensing application or even announcement of an opening date for trading could all be presented as significant events marking the Exchange's progress toward full operations.

Multiple documents have been prepared to assist BAPPEBTI in assessing the development of Exchange and Clearing House programs. Two of these documents are discussed in Section III on Training. In addition, two documents specifically addressing areas which must be addressed by BAPPEBTI in establishing its own oversight programs and reviewing Exchange and Clearing House programs prior to the commencement of futures trading.

- ◆ *Considerations Relevant to Commencement of Trading on the Jakarta Futures Exchange.* This document was prepared in response to a request of Mr. Arafin Gaol, Chairman of BAPPEBTI, for the consultant's preliminary thoughts as to suggested measures by BAPPEBTI prior to her departure from Jakarta. It was provided to BAPPEBTI officials on March 17, 2000. (Attachment A).
- ◆ *Suggested Plan of Action for BAPPEBTI Preparatory to Opening of Futures Trading.* Following the conclusion of the consultant's on-site work in Jakarta, she was requested by Mr. Ridwan Kurnaen, Operations Officer and Board Secretary of BAPPEBTI, to provide an "action plan" for BAPPEBTI. Ms. Ervin provided this document by facsimile to Mr. Kurnaen on April 25, 2000. (Attachment B). The following section is based upon the latter document.

B. Progress to Date and Suggested Plan of Action for BAPPEBTI Preparatory to Opening of Futures Trading

As noted previously, opening of the Exchange for trading depends upon the Exchange and Clearing House being able to demonstrate to BAPPEBTI their compliance with regulatory standards. In addition, and indeed, as a predicate to its review and approval of the Exchange and Clearing House applications, BAPPEBTI must have both its legal structure and oversight programs in place.

1. Assure Regulatory Structure is in Place

- a. Finalize and Publish BAPPEBTI Decrees and Any Related Regulatory Provisions. BAPPEBTI decrees and any related rules and interpretations needed to guide and inform market participants should be in place well in advance of commencement of trading. Once they have been completed, they should be reviewed to assure that they address concerns raised previously by Barents consultants. As discussed in the Section II below, due to the unavailability of English transactions, a review of these documents has not been completed. BAPPEBTI's regulatory framework should be firmly established prior to licensing of commodity professionals, the Exchange, and the Clearing House, in order that all participants in the market can design their

operations to comply with the rules and so that review of license applications can be performed pursuant to clear rules and standards.

- b. Recruitment and Training of BAPPEBTI Staff. BAPPEBTI has assembled a substantial staff to date but needs more staff and more training of existing staff and training programs for new staff. For example, BAPPEBTI currently must rely upon Mr. Bachrul Chairi to head the Legal Bureau on an acting basis, as well as to serve in his permanent position as Director of the Trading Division. Most staff have little actual experience in the supervision of futures trading, and both existing and new staff should be allotted time for internal training, and on-site training in a jurisdiction with a well-developed futures market, such as Singapore or the U.S. Hiring of necessary staff should be occurring immediately, or as soon as possible, with the objective of having at least 4-8 weeks of training for new staff members prior to their actually being expected to assume oversight responsibilities. Training needs are discussed below in Section III.
- c. Establish and Implement System for the Testing and Registration of Commodity Professionals. BAPPEBTI was in the process of developing a proficiency testing program of commodity professionals in March 2000. Establishment of a testing and registration process with sufficient time for commodity professionals to undergo testing and for BAPPEBTI to review applications for registration prior to the opening of trading is clearly essential. In the U.S., it is not uncommon for the fitness screening aspect of the registration process to take one to two months. Moreover, the current U.S. system for registration processing has been through a number of evolutionary phases, including in its early stages, an extremely labor-intensive and delay-prone system of manual processing of applications. While the volume of applications initially can be expected to be relatively low in Jakarta, there should be very intense work now to create a reliable and efficient system. The registration process can easily become a bureaucratic quagmire and, if not properly managed, can be the cause of allowing unfit persons into the marketplace.
- d. Organization of Internal Oversight Programs. BAPPEBTI's staff have been working to develop plans for overseeing the Exchange. The content of regulatory oversight programs is outlined in the materials attached to this report. These programs should be planned, staffed and in operation prior to the opening of trading. One way of testing the extent of development of these programs is to do a regulatory simulation along with the trading simulation that will be undertaken as part of the Exchange's preparation for trading.
- e. Establishment of Computer Systems Capable of Providing Oversight Support. BAPPEBTI needs to have the ability to review computer-generated trading

and clearing data from the Exchange and Clearing House. Adequate hardware and software systems that are compatible with the systems used by the Exchange and Clearing House are essential for this purpose. These systems, like the Exchange and Clearing House systems with which they will work, will need a period of testing to assure reliable and effective operation.

- f. Contingency Planning. BAPPEBTI should have its own internal emergency planning for all possible events that could adversely affect the market, including so-called "physical" emergencies, such as computer breakdowns affecting the exchange, financial failures of brokers, traders, clearing banks and any other significant market participants, and events such as export restrictions or other developments affecting trading of the underlying commodity.
- g. Warehouse Receipts System. This is an area in which work is ongoing. At this point, it appears unrealistic to expect that a statutory warehouse receipts program can be established this year. However, BAPPEBTI must assure itself that the delivery mechanism to be used for the Exchange futures contracts will function effectively, from both a legal and practical perspective.

2. Complete Review of Exchange License Application.

As of March 17, 2000, the Exchange had not yet submitted its formal application for a license. Software and hardware systems were yet to be installed or tested by the Exchange or by BAPPEBTI. Proposed contracts and the Exchange's business plan had not been submitted for review. The Exchange was planning for but had not yet hired an audit staff and its surveillance/compliance program was very thinly staffed. All aspects of the Exchange's proposed contracts, trading and compliance systems, self-regulatory programs and business plans must be reviewed against BAPPEBTI's standards before the Exchange is granted a license. Some of these systems, such as the trading system, will require review and testing by technical experts, perhaps hired from outside the agency. Areas which would normally be reviewed in the U.S. as part of determining whether to license a new futures exchange include the following:

- ◆ Rules and By-Laws of the proposed Exchange.
- ◆ Governance Structure, including functions and composition of committees and board membership.
- ◆ Compliance Programs, including staffing, systems and standards for the Financial Audit Program and Market and Trade Practice Surveillance Programs.
- ◆ Trading System, including design, hardware and software; trader interfaces to trading system. Review and assessment of the trading system by an expert

independent of the Exchange should be required and BAPPEBTI should have full access to that technical assessment.

- ◆ Standards and Programs for Screening and Admission of Exchange Members.
- ◆ Member Disciplinary Program.
- ◆ Default Procedures.
- ◆ Contingency Planning for market emergencies, physical emergencies, and to address security issues.
- ◆ Exchange Security: enforcement of limitations on access to exchange floor and to terminals; protection of computer systems, exchange records, and physical facility.

3. Review of Clearing House Rules, Systems and Procedures

Prior to commencement of trading on the Exchange, BAPPEBTI will also need to determine that the Clearing House should receive a license to act as such. Review of the application of the Clearing House should address a number of areas including: governance structure, computer hardware and software systems, compliance programs, default procedures and contingency planning, security of systems, contents of the business plan, settlement bank arrangements and interfaces with Exchange systems and procedures.

4. Other

Other matters relevant to the effective functioning of the Exchange but not necessarily required prior to opening of the Exchange include:

- a. Development of Agriculture Information System. Development of a system for generating information about cash market prices would clearly facilitate futures trading. However, due to the exigencies of other aspects of development of the futures market, neither BAPPEBTI nor the Exchange appears to have had time to devote to this project.
- b. Educational Programs. As in the case of cash price information systems, educational programs apparently have had to be deferred until more pressing projects are completed.

II. Review of BAPPEBTI, Exchange and Clearing House Rules

Prior to beginning work at BAPPEBTI on March 6, 2000, the consultant was provided copies of the statutory and regulatory framework applicable to futures trading in Indonesia, as well as drafts of the rules of the Exchange and Clearing House. Upon arriving at BAPPEBTI, Ms. Ervin

learned that these drafts had been superseded and that the current versions of the BAPPEBTI rules consist of Presidential Decrees, eight which had been issued in final form and seven which were then in draft form. None of the Presidential Decrees had as of that date been translated into English. Barents Group arranged for the translation of the Presidential Decrees. Pending completion of these translations, Mr. Ridwan Kurnaen recommended that the consultant be briefed by BAPPEBTI staff on the decrees that were then still in the drafting process so that she could provide input and suggestions concerning these drafts. Ms. Ervin requested that Barents contract for translation of the draft decrees on an expedited basis and this was accomplished, with translations being produced beginning Friday, March 10. In the meantime, Ms. Ervin held extensive meetings with BAPPEBTI staff to review various aspects of the proposed drafts, a process which consumed the bulk of one week's time at BAPPEBTI.

Due to the inherent difficulty of translation of the drafts into English, orally, in the course of these discussions, only the broad outlines and little detail of the draft decrees was communicated to Ms. Ervin and her comments were provisional and general in nature. In general, however, Ms. Ervin found the decrees to be well-conceived, often reflecting provisions of U.S., Singapore or Malaysia regulations or rules on the same topics. Due to the lack of translations of the bulk of the decrees, it was impossible to determine whether concerns expressed by a previous Barents consultant, Frederick Spindel, concerning a prior version of the rules had been fully addressed.

EXCHANGE AND CLEARING HOUSE RULES

Ms. Ervin was provided with copies of English translations (prepared in September 1997) of Rules and Regulations of the Exchange and the Business Rules of the Indonesian Clearing House, prior to her arrival in Jakarta. The consultant reviewed both sets of rules and prepared questions and comments on them to discuss during on-site meetings in Jakarta. However, upon her arrival in Jakarta, Ms. Ervin learned that both sets of rules had been superseded by new draft rules that, as of March 2000, had not yet been translated into English. The consultant spent approximately two and one-half days in discussions with Exchange and Clearing House representatives to discuss the current versions of the by-laws and rules of the Exchange and Clearing House. As in the case of the BAPPEBTI decrees, these discussions generally proceeded by the means of an oral English translation overview by Exchange and Clearing House officials of their rules in a given area. Discussion of particular areas of concern to some extent was based upon review of the earlier version of those rules. For example, based upon her review of the 1997 English translations of the Exchange rules, the consultant raised issues concerning the provisions of the Exchange's rules concerning responsibility for trades, the definition of "affiliated person", for purposes of the Exchange's trading standards, the content of the Exchange's "early warning" notification system, the provision concerning decline in net equity of discretionary customer accounts, the specifications of minimum brokerage commissions and the types of margin that would be deemed acceptable to the Exchange. With respect to the rules of the Clearing House, issues were raised concerning the amount and composition of security deposits and guarantee fund, the desirability of instituting a strong

financial "early warning" notice system and audit process, and the nature of the Clearing House's intended use of sub-accounts in the clearing process.

In most cases, issues raised based upon the 1997 drafts of the Exchange and Clearing House rules had been resolved by the more recent versions of the rules. However, since drafts of these more recent versions of the rules were not available for review in English, a detailed and informed review of those rules was not possible at that time.

II. Training

Throughout the course of discussions with BAPPEBTI officials concerning the BAPPEBTI decrees, informal training was given on a variety of regulatory topics in response to specific questions or issues. These discussions were extensive and covered many aspects of BAPPEBTI's regulatory responsibilities. A more formal training program was given, lasting about two and one-half hours, at the conclusion of on-site work. This training covered two broad topics: the conduct of surveillance and compliance oversight by a futures market regulator; and regulatory issues pertaining to electronic trading systems. The first topic was intended to provide an overview of the content and operation of staff market oversight programs at a futures regulatory agency; the second focused on the minimum regulatory standards for electronic trading systems recommended in a recent report by the International Organization of Securities Commissions (IOSCO).

In connection with this training, the consultant prepared two documents which were distributed to BAPPEBTI staff and summarized major points covered in the training session:

- ◆ *Surveillance/Compliance Oversight (Attachment C)*. This document provided an outline of a futures regulator's responsibilities, oversight methods and substantive requirements with respect to financial, market and sales practice surveillance and compliance. It was provided to BAPPEBTI staff and used in connection with a training session for BAPPEBTI staff on March 17, 2000.
- ◆ *Electronic Trading Systems – Special Considerations (Attachment D)*. This document consisted of a summary of the IOSCO guidance on minimum regulatory standards for electronic trading systems. This document was provided to BAPPEBTI staff and also used in the training session for BAPPEBTI staff.

BAPPEBTI has a need for additional staff but has little ability to hire experienced staff, due to restrictions compelling hiring from within the government, therefore, the need for practical training in the oversight of markets therefore is great. Past attempts to enlist the U.S. Commodity Futures Trading Commission ("CFTC") in providing on-site training in Jakarta to BAPPEBTI staff have apparently been unsuccessful. These efforts should be renewed, if that

has not already occurred, by contacting the CFTC's Chairman, William Rainer or his staff. Alternatively, outside consultants or other technical experts might provide such assistance. Much of the needed training should be "hands-on" training that focuses on the conduct of trade practice reviews, financial audits and market surveillance and related matters known best by experienced regulators (or self-regulators). Commencing regulation of a new futures market without any significantly experienced staff is a daunting but not impossible task. However, all feasible practical training opportunities should be pursued. These would include training both in Jakarta and in the U.S. by regulators and self-regulators who have experience in futures market oversight.

III. Warehouse Receipt Issues

On Friday, March 10, Mr. Bachrul Chairi, Mr. Made Soekarwo and I met with Gary Goodpaster, PEG (Pacific Economic Growth) to discuss the status of work on a warehouse receipt system. Mr. Goodpaster reported that the project of drafting a warehouse receipt law involved a local Indonesian lawyer, Victor Purba, who was to establish a committee to work on the project. Mr. Purba had not yet moved forward; however, Mr. Goodpaster is prepared to proceed when matters have been coordinated with Purba.

We discussed several issues that arise in the context of the proposed warehouse receipts program.

- ◆ Will the project be confined only to warehouse receipts as opposed to creating a legal structure for negotiable instruments generally, as there is no such legal framework now under Indonesian law.
- ◆ Will the initial focus of the warehouse receipt program will be on rice or other commodities as well.
- ◆ The concept of negotiability may not be currently recognized by Indonesian law. Mr. Goodpaster noted that Indonesia does not have the concept of secured transfers but, instead, applies the Dutch concept of "fiduciary transfers" which require a transfer of title to goods held as security and each such transfer must be handled by processing through a notary. If there is no such concept, that would need to be addressed. Mr. Bachrul seemed to believe that the Bank of Indonesia does accept some instruments as negotiable and that they would have to incorporate warehouse receipts in their structure of recognized negotiable instruments.
- ◆ The relationship between a warehouse receipts law and the process of certification of warehouses. Mr. Goodpaster believed that while the drafting of a warehouse receipts law is relatively simple, the practical aspects of establishing a system of standards and certification for warehouses is potentially more complicated.

With respect to how the project might proceed, Mr. Bachrul noted that Mr. Arafin had expressed a preference for using the approach of Barents preparing a draft and then having the draft "Indonesianized" by others. In this case, Mr. Goodpaster would produce a draft and then Mr. Purba would make revisions needed to tailor the draft for incorporation in the Indonesia framework. Based on this approach, Mr. Goodpaster will meet with Mr. Purba to clarify how the project will proceed.

With respect to timing, Mr. Goodpaster is of the view that a warehouse receipt statute can be quite simple but that there are practical issues concerning who will certificate warehouses and which warehouses will be certificated, which require knowledge of local conditions. Mr. Bachrul discussed the steps that would have to be taken to achieve issuance of a warehouse receipts law and it appears that at least nine months would ordinarily be required to complete the legislative process for a new law. However, as this might be quite a simple law, there may be a possibility that completion could occur more expeditiously.

Prior to establishment of a warehouse receipt program, Mr. Bachrul pointed out that a Dutch consulting firm has been engaged to work on a warehouse contract system using "field warehouses" which will be used as a basis for effecting deliveries on futures contracts.

We also discussed the question of how small producers will access the futures market given that in most cases, they will not be large enough to make use of futures contracts. Mr. Bachrul noted that there is an interdepartmental team working on cooperatives to address this problem.

ATTACHMENT A

Considerations Relevant to Commencement of Trading on the Jakarta Futures Exchange

Preliminary Outline

1. Bappebti Preparation

- ◆ Finalization of Bappebti Decrees.
- ◆ Recruitment and Training of Bappebti staff. A particular difficulty exists due to the requirement to hire from within the Ministry of Trade and Industry, which does not employ auditors.
- ◆ Establishment of System for Testing and Registration of Commodity Professionals.
- ◆ The Malaysian regulatory authority will assist in training and testing, beginning in April.
- ◆ Review of Exchange Application for License. The exchange has not yet submitted its application for a license. Software and hardware systems remain to be installed, tested and reviewed by Bappebti, proposed contracts need to be reviewed, and the Exchange's business plan must be submitted and approved. Currently, the Exchange has plans to hire but has not yet hired an audit staff and its surveillance/compliance staff is extremely limited. Trading and reporting systems as well as critical self-regulatory programs will need to be reviewed by Bappebti prior to approval of the licensing application.
- ◆ Agriculture Information System.
- ◆ Warehouse Receipts System
- ◆ Contingency Planning
- ◆ Bankruptcy legal framework.

2. Jakarta Futures Exchange Preparation.

- ◆ Establishment of Governance Structure and Staff. Committees of the Board must be established and exchange compliance programs must be staffed. As noted above, compliance staffing is currently very thin; for example, the exchange has no auditors currently but intends to hire an audit staff in April. Once staff are engaged, they will need to be trained and internal procedures and programs in each area of self-regulatory responsibility will need to be developed.
- ◆ Completion, Installation and Testing of Electronic Trading System and Computer Hardware. Exchange officials advise that hardware and software systems should be ready for simulated trading in May.

- ◆ Review and Admission of Exchange Members. Under Exchange rules, the customer representatives and screen traders of brokers must be registered with the Exchange and take appropriate tests. This program must be established by the Exchange.
- ◆ Financial Audit Program. As noted above, the exchange currently lacks an audit staff.
- ◆ Market and Trade Practice Surveillance Program
- ◆ Member Disciplinary Program
- ◆ Default Procedures
- ◆ Clearing System Interfaces: Coordination of Computer Systems, Surveillance Programs, Default Procedures, Contingency Planning; Information-Sharing Protocol
- ◆ Contingency Planning: Market Emergencies, Physical Emergencies, Security Issues
- ◆ Exchange Security: enforcement of limitations on access to floor and to terminals and protection of Exchange computer systems.
- ◆ Completion of Exchange Business Plan and Application for License

3. Clearing House Preparation

- ◆ Development, Installation and Testing of Computer Software and Hardware Programs
- ◆ Establishment of Governance Structure and Compliance Staff. The Clearing House currently has one auditor on staff.
- ◆ Contingency Planning
- ◆ Member Disciplinary Program
- ◆ Clearing House Security
- ◆ Completion of Business Plan and Application for License
- ◆ Default Procedures
- ◆ Interfaces with Exchange Systems and Procedures
- ◆ Information-Sharing Protocol with Exchange

ATTACHMENT B

Suggested Plan of Action for Bappebti Preparatory to Opening of Futures Trading

The time schedule previously prepared by Bappebti for its program in 2000 sets forth 22 tasks relevant to its preparations for trading on the Jakarta Futures Exchange. This suggested plan of action is based upon the timetable and the information gathered in Jakarta in March 2000.

I. Assure Regulatory Structure in Place.

- A. Finalize and Publish Bappebti Decrees and Any Related Regulatory Provisions. Bappebti decrees and any related rules and interpretations needed to guide and inform market participants should be in place well in advance of commencement of trading. Once completed, they should be reviewed to assure that concerns raised previously by Barents consultants are addressed. This regulatory framework should be firmly established prior to licensing of commodity professionals and of the exchange, to ensure that all participants in the market can design their operations to comply with the rules and so that licensing can be done pursuant to clear rules.
- B. Recruitment and Training of Bappebti Staff. Bappebti has assembled a substantial staff to date but needs more staff and more training of staff. For example, Bappebti must currently rely upon Mr. Bachrul Chairi to head the Legal Bureau on an acting basis as well as to serve in his permanent position as Director of Trading. Most staff have little actual experience in the supervision of futures trading, and both existing and new staff should be allotted time for internal training and, ideally, on-site training in a jurisdiction with a well-developed futures market, such as Singapore or the U.S. Hiring of necessary staff should be occurring immediately, or as soon as possible, with the objective of having at least 4-8 weeks of training for new staff members prior to their actually being expected to assume oversight responsibilities.
- C. Establish and Implement System for the Testing and Registration of Commodity Professionals. Bappebti was in the process of preparing for testing of commodity professionals in March 2000. Establishing a testing and registration process with sufficient time to review applications for registration well prior to the opening of trading is clearly essential. In the U.S., it is not uncommon for the fitness screening aspect of the registration process to take one to two months.
- D. Organization of Internal Oversight Programs. Bappebti's staff have been working to develop plans for overseeing the new exchange. These programs should be planned, staffed and in operation prior to the opening of trading. One way of testing the extent of development of these programs is to do a regulatory simulation along with the trading simulation that will be undertaken as part of the Exchange's preparation for trading.

- E. Establishment of Computer Systems Capable of Providing Oversight Support. Bappebti needs to have the ability to review computer-generated trading and clearing data from the Exchange and Clearing House. Adequate hardware and software systems and their compatibility with the systems used by the Exchange and Clearing House are clearly essential for this purpose. These systems, like the exchange and clearing systems with which they will work, will need a period of testing to assure effective operation.
- F. Contingency Planning. Bappebti should have its own internal emergency planning for all possible events that could adversely affect the market, including so-called "physical" emergencies, such as computer breakdowns affecting the exchange, financial failures of brokers, traders, clearing banks, and any other significant market participants, and events such as export restrictions or other developments affecting trading of the underlying commodity.
- G. Warehouse Receipts System. This is an area in which work is on-going. At this point, it appears unrealistic to expect that a statutory warehouse receipts program can be established during the current year. However, Bappebti must assure itself that the delivery mechanism to be used for the exchange contracts, will function effectively from both a legal and practical perspective.

II. Complete Review of Exchange License Application

As of March 17, 2000, the Exchange had not yet submitted its formal application for a license. Software and hardware systems were yet to be installed or tested by the Exchange or by Bappebti. Proposed contracts and the Exchange's business plan had not yet been submitted for review. The Exchange was planning for but had not yet hired an audit staff and its surveillance/compliance program was very thinly staffed. All aspects of the Exchange's proposed contracts, trading and compliance systems, self-regulatory programs and business plans must be reviewed against Bappebti's standards before the Exchange is granted a license. Certain of these systems, such as the trading system, will require review and testing by technical experts, perhaps hired from outside the agency. Areas which would normally be reviewed in the U.S. as part of determining whether to license a new futures exchange include the following:

- ◆ Rules and By-Laws of the proposed Exchange
- ◆ Governance Structure, including functions and composition of committees and board membership
- ◆ Compliance Programs, including staffing, systems and standards for the Financial Audit Program and Market and Trade Practice Surveillance Programs
- ◆ Trading System: design, hardware and software; trader interfaces to trading system
- ◆ Screening and Admission of Exchange Members

- ◆ Member Disciplinary Program
- ◆ Default Procedures
- ◆ Contingency Planning: market emergencies, physical emergencies, security issues
- ◆ Exchange Security: enforcement of limitations on access to exchange floor and to terminals; protection of computer systems, exchange records, and physical facility

III. Review of Clearing House Rules, Systems and Procedures.

Prior to commencement of trading on the Exchange, Bappebti will also need to determine that the Clearing House should receive a license to act as such. Review of the application of the Clearing House will need to address a number of areas including: governance structure, computer hardware and software systems, compliance programs, default procedures and contingency planning, security of systems, contents of the business plan, settlement bank arrangements and interfaces with Exchange systems and procedures.

IV. Other

These are matters which are relevant to the effective functioning of the Exchange but are not necessarily required prior to opening of the Exchange.

- A. Development of Agriculture Information System
- B. Educational Programs

ATTACHMENT C

Surveillance/Compliance Oversight

I. Responsibilities

- A. Bappebti oversight of compliance by all market participants
- B. Exchange Rule Enforcement Responsibilities
- C. Broker Supervisory Duties

II. Types of Surveillance/Compliance Monitoring

- A. Financial
- B. Market/Trade Practice
- C. Sales Practice/Customer Relationships

III. Methods

- A. Financial
 - 1. Direct Audits by Exchanges/Bappebti
 - 2. Review of Financial Reports
 - 3. Review of Exchange Financial Programs (for example, audits, financial reporting, financial surveillance)
 - 4. Review of Clearing House Financial Programs
- B. Market/Trade Practice Surveillance
 - 1. Exchange Market Surveillance Program
 - 2. Review of Position Information and Market Surveillance by Bappebti
 - 3. Review of Exchange Surveillance Program
 - 4. Special Issues Relating to Electronic Trading Systems.

C. Sales Practice/Customer Relationships

1. Audits of Brokers by Exchanges, Bappebti?
2. Review of Exchange Programs

IV. Basic Substantive Requirements

A. Financial

1. Minimum Capital (including early warning requirements)
2. Segregation of Customer Funds; Margin Practices
3. Internal Controls
4. Current and Accurate Books and Records
5. Reporting to Bappebti and Exchange

B. Market/Trade Practice

1. Prohibitions Against Manipulation and Prohibited Trade Practices
2. Speculative Position Limits
3. Contract Terms and Delivery Procedures
4. Audit Trail Requirements
5. Electronic Trading System Issues – Access, Algorithm, etc.

C. Sales Practices

1. Broker Supervision and Compliance Procedures
2. Disclosure and Reporting to Customers
3. Account Opening Procedures
4. Trade authorization
5. Adequacy of Exchange Oversight Programs

ATTACHMENT D

Electronic Trading Systems – Special Considerations

IOSCO Technical Committee Report, “Screen-Based Trading Systems for Derivative Products”

Principle 1: The system sponsor should be able to demonstrate to the relevant regulatory authorities that the system meets and continues to meet applicable legal standards, regulatory policies, and/or market custom or practice where relevant.

Principle 2: The system should be designed to ensure the equitable availability of accurate and timely trade and quotation information to all system participants and the system sponsor should be able to describe to the relevant regulatory authorities the processing, prioritization, and display of quotations within the system.

Principle 3: The system sponsor should be able to describe to the relevant regulatory authorities the order execution algorithm used by the system, i.e., the set of rules governing the processing, including prioritization, and execution of orders

The algorithm refers to the set of rules governing processing, including prioritization, and execution of orders which have been entered into a screen-based trading system. The algorithm performs the same function as trading rules in a floor trading system. Regulatory authorities should apply standards to screen-based systems just as they apply standards in the assessment of rules relating to floor trading systems.

Examples of algorithm approaches:

- ◆ Matching based on price priority. Orders are executed at the best prices but the system does not grant time priority. Executions are allocated among all orders at the same price, without regard to entry-time.
- ◆ Matching based on price/time priority. Orders are executed at the best price first, and for all orders with equal prices, according to the time of entry.

Principle 4: From a technical perspective, the system should be designed to operate in a manner which is equitable to all market participants and any differences in treatment among classes of participants should be identified

Principle 5: Before implementation, and on a periodic basis thereafter, the system and system interfaces should be subject to an objective risk assessment to identify vulnerabilities (e.g., the risk of unauthorized access, internal failures, human errors, attacks, and natural catastrophes) which may exist in the system design, development, or implementation.

- ◆ System sponsors and the regulatory authorities should ensure that safeguards which protect the system against unauthorized access, internal failures, human errors, attacks and natural catastrophes that might cause improper disclosures, modification, destruction, or denial of service are reviewed.
- ◆ This review should include: the physical environment, system capacity, operating System software, data integrity, access controls, systems testing, documentation, internal controls and contingency plans and other safeguards that should be incorporated into the design of the system.
- ◆ This review should be objective and independent – parties responsible for the development or operation of the system should not be the same individuals conducting the review.

The purpose of the review is to identify vulnerabilities that may exist prior to implementation of the system.

Principle 6: Procedures should be established to ensure the competence, integrity, and authority of system users, to ensure that system users are adequately supervised, and that access to the system is not arbitrarily or discriminatorily denied.

- ◆ Brokerage firms and regulatory authorities should devote sufficient resources to adequate supervision of system access and the activities of all authorized users and other operators.
- ◆ Regulators should devote sufficient resources to monitoring and enforcement of compliance with access and use restrictions.

Principle 7: The relevant regulatory authorities and the system provider should consider any additional risk management exposures pertinent to the system, including those arising from interaction with related financial systems.

Principle 8: Mechanisms should be in place to ensure that the information necessary to conduct adequate surveillance of the system for supervisory and enforcement purposes is available to the system sponsor and the relevant regulatory authorities on a timely basis.

- ◆ Information to be collected: screen-based trading systems should have complete audit trail capability – meaning, the ability to capture and maintain, reconstruction of trading and analysis, the essential facts concerning each transaction effected in the system. These facts would include for each trade: the instrument traded, quantity, price, time, identity of executing brokers, identity of clearing parties, and an indication of type of account (e.g., principal/agent) for which the transaction is effected. For quotations or inputting of orders, essential facts include: identity of the party inputting the quote or order, identity of the party legally responsible for the quote or order, terms of the quote (price and size) or order (buy/sell, market/limit, quantity) and time.
- ◆ The system should maintain such records for all orders, including cancellations and modifications.
- ◆ Consideration should be given to what information should be maintained by the system user in respect of orders inputted into the system, and what information should be reported back to the system user from the system or clearing house.
- ◆ On-site surveillance.
- ◆ Large trader/position information.
- ◆ Monitoring of financial integrity of market participants, including: (1) initial and continuing compliance with restrictions on access designed to assure creditworthiness; (2) the financial condition of different participants; and (3) the settlement obligations of clearing members.
- ◆ Surveillance function: real-time surveillance information should be provided to the self-regulator for purposes of performing on-line as well as after-the-fact analysis. Ideally, systems should be designed to provide the self-regulator with access to audit trail information on a real-time basis, when necessary to ensure effective surveillance. The surveillance function generally will rely upon automated, computerized surveillance systems and procedures. These systems should be able to identify unusual and significant volumes of transactions and perhaps particular market participants undertaking such activity, which may suggest manipulative or other abusive trading activities.
- ◆ Information sharing. Adequate surveillance of derivative product markets requires access to trade and financial information from the underlying cash markets, as well as from related derivative product markets.

Principle 9: The relevant regulatory authorities and/or the system sponsor should ensure that system users and system customers are adequately informed of the significant risks particular to

trading through the system. The liability of the system sponsor, and/or the system providers to system users and system customers should be described, especially any agreements that seek to vary the allocation of losses that otherwise would result by operation of law.

- ◆ Example: where the system does not provide a means to execute complex trades such as spreads, straddles and boxes, customers would benefit from the knowledge that it may be considerably more difficult to implement such strategies due to the uncertainty of the time of execution of all legs of the transaction.
- ◆ There should be full disclosure of such matters as the order execution algorithms of the system, rules governing allocation of liability for losses from system malfunction or operator error.

Principle 10: Procedures should be developed to ensure that the system sponsor, system providers, and system users are aware of and will be responsive to the directives and concerns of relevant regulatory authorities.