

## Memorandum

**Date:** 24 April 2023

**Subject:** Proposed amendments to the JSE Equities Directives - Directive BI 2 (Suspense accounts), Directive BI 5 (Account type and identification codes) and Directive BI 8 (Stock accounts for matched principal trading) – and guidance on the use of client suspense accounts and matched principal trades

Dear Member

### Impact of derivative transactions on the use of client suspense accounts

It has come to the JSE's attention that member firms sometimes transact in a listed derivative instrument (such as a single stock future) or an unlisted derivative instrument (such as an OTC swap or CFD) with a client, or facilitate a transaction in a listed or unlisted derivative instrument by the client with another member firm, in respect of a quantity of shares originally bought or sold by the member for the client's account on the client's instruction. In these circumstances, the member would typically have bought or sold the relevant quantity of shares on behalf of the client on a client suspense account, but once the member has concluded or facilitated the transaction in a derivative instrument with the client, hedged by the relevant quantity of shares, the member has to transfer the relevant quantity of shares from the client suspense account to a stock account. The shares are then either held by the member on the stock account as a hedge against the derivative trade with the client, or the member reports a delta trade with another member on the stock account in order to transfer the shares to the other member, who will in turn transact in a derivative instrument with the client.

JSE Directive BI 2.3 states that a member may not allocate trades from suspense accounts to the accounts of interested parties (which would include stock accounts) unless the member can demonstrate that no client has been prejudiced. Directive BI 2.4 then lists certain controls that members must implement to prevent prejudice to clients when utilizing suspense accounts. The allocation of trades from a client suspense account to a stock account in the circumstances described above, where a derivative instrument is to be traded, is not specifically addressed in Directive BI 2.4. The JSE Market Regulation Division believes that it would be appropriate to make specific mention of these particular circumstances when listing the controls that are required to manage the risks associated with the use of suspense accounts in Directive BI 2.4, particularly as the circumstances result in trades being allocated from an account specified as being used for client trades (a client suspense account) to a proprietary stock account belonging to the member.

The Market Regulation Division is therefore proposing to amend Directive BI 2.4 by inserting a new section BI 2.4.5 that requires members to appropriately manage allocations from a client suspense account to a stock account as a result of the circumstances described above, to ensure that this process does not result in any prejudice to affected clients. The Market Regulation Division's expectation is that a member would implement the necessary measures to ensure that trades are only allocated from a client suspense account to a stock account in instances where the member has transacted in a derivative instrument with the client, or has facilitated a transaction in a derivative instrument with the client by another member, through a delta trade, subsequent to the trades being executed for the client's account, and where the relevant quantity of shares is required by the member or by another member to hedge the derivative trade. The Market Regulation Division also expects that allocations from client suspense accounts to stock accounts are subject to appropriate compliance monitoring to ensure that they only occur in the aforementioned circumstances and with no prejudice to affected clients.

Members should note that in instances where a client advises, when placing an order, that the entire order is for a derivative instrument and not for an equity security, the member should execute the relevant cash equity transactions on a stock account and not on a client suspense account, as the member knows at the outset that the cash equity transactions are for the member's own account and not for the client's account.

The Market Regulation Division is, however, aware that there are instances where a client may advise, when placing an order, that once the order is filled a portion of the executed cash equity trades may be substituted by a derivative trade, with the other portion of the executed trades remaining as cash equity trades on the client's account. In these instances, the member usually does not know when executing the cash equity trades which specific portion of those trades may be substituted by a derivative trade, nor does the member know with any certainty whether the derivative trade is definitely going to be concluded. Given this uncertainty at the time of receiving the order from the client and executing the relevant trades, the member is entitled, in these circumstances, to treat all of the cash equity trades as client trades, and therefore execute all of the trades on a client suspense account. It is usually only once the terms of the derivative trade have been concluded that the member has certainty that a specific portion of the cash equity trades has been substituted by a derivative trade, and it is usually only at that time that the member would allocate the relevant portion of the trades from the client suspense account to a stock account.

#### **Impact of derivative transactions on matched principal trades**

The JSE has also become aware that common members of the JSE and A2X may be requested by clients to transact in a derivative instrument with the client, or to facilitate a transaction in a derivative instrument with the client by another member through a delta trade, in relation to all or part of a quantity of shares that has been traded on A2X and subsequently booked to a client suspense account on the BDA system via a matched principal trade.

Members will be aware that the matched principal trade was introduced by the JSE in 2022 to facilitate the issuing of a single contract note to institutional clients in relation to cross market trades on the JSE and A2X. In a situation where an institutional client requests a member to transact in a derivative instrument with the client, or to facilitate a transaction in a derivative instrument with the client by another member through a delta trade, in respect of all or part of a quantity of shares booked to a client suspense account through a matched principal trade, the member will not be issuing a single contract note in respect of the quantity of shares that originates from the matched principal trade and that will be allocated to one of the member's stock accounts to facilitate the derivative trade instead of being allocated to the underlying client accounts. This would be contrary to the original purpose of introducing the matched principal trade. However, the JSE will deem it to be an acceptable practice provided it only occurs where the member executes trades on A2X with the intention of those trades being cash equity trades for the client's account, and reports the matched principal trade on the JSE to the client suspense account with that intention in mind. If the member subsequently concludes the terms of a derivative trade with the client, or subsequently concludes the terms of a delta trade with another member, the portion of the matched principal trade that needs to be used to facilitate the derivative trade may legitimately be allocated from the client suspense account to a stock account for this purpose. This would not be deemed to be in conflict with the purpose of introducing the matched principal trade or result in a breach of the matched principal trade rule.

If a member were to report a matched principal trade in respect of a quantity of shares that the member knows at the time of trade reporting is to be used to facilitate a derivative trade instead of being allocated to underlying clients, because the terms of the derivative trade have already been concluded, it would result in a breach of rule 6.40.8 (Matched Principal Trade) and therefore not be an acceptable practice. The breach would occur because a matched principal trade is defined as a principal trade with a client, and the member can therefore only report a matched principal trade if the member has the

intention, at the time of trade reporting, for the trade to be with a client, and not that the affected quantity of shares is to be booked to a stock account to facilitate a derivative trade.

Members should note that the JSE equity market rules do not regulate transactions in listed or unlisted derivative instruments, and therefore a trade booked to a stock account to facilitate a derivative trade cannot be regarded as trade with a 'client' in terms of the equity market rules, despite the client indirectly receiving the economic benefits of the trade through the derivative instrument. In terms of the equity market rules, all trades or allocations to stock accounts are proprietary trades for the member's benefit. A 'client' trade in terms of the equity market rules can only be a trade for a client's account in a JSE listed equity security.

### **The use of matched principal trades for full executions on A2X**

The matched principal trade was introduced to facilitate the issuing of a single contract note for cross market trades, where an institutional client's order is partly filled on the JSE and partly filled on A2X. If a member firm knowingly seeks to fill a client's order entirely on A2X, the member should not be reporting a matched principal trade on the JSE in respect of the quantity of shares traded on A2X, as the trade is intended to be an A2X trade from the outset and should be treated as such from a post trade point of view, which will include the issuing of a contract note.

However, the JSE is aware that, in almost every case, when using smart order routers, the member will not know at the outset which portion of an order will be filled on the JSE and which portion on A2X. There is a possibility that when using smart order routing, an order could be filled entirely on A2X. If this were the case, and the member then decided to report a matched principal trade on the JSE, this would not be in accordance with the original intention of the matched principal trade, being to issue a single contract note for cross market trades, where an order is filled across both markets. Nevertheless, the JSE will permit common members to report a matched principal trade on the JSE in a situation where a client's order is filled entirely on A2X, provided the member's intention at the outset is to trade cross market at the best available price in seeking to achieve best execution for the client, and not to trade entirely on A2X. In these instances, the member is expecting to need to issue a single contract note in respect of trades on both exchanges, and would have set up the relevant accounts in the JSE's systems and in A2X's systems to achieve this. We recognize that there will be material operational challenges for a member if they were expecting to issue a single contract note to consolidate cross market trades using the JSE's BDA system, but they have filled the client's order entirely on A2X and are not permitted to report a matched principal trade on the JSE in respect of the A2X trades. It is for this reason that we deem it appropriate to permit common members to report matched principal trades on the JSE under these circumstances.

### **The use of Matched Principal stock accounts**

At the time that the rules and directives were drafted to facilitate the introduction of the matched principal trade, the JSE did not know whether it had sufficient time before the new trade type was to be implemented to introduce a new Account ID on the BDA system for stock accounts that would be used for matched principal trades. For regulatory purposes it was important for the JSE to be able to identify all matched principal trades, and, therefore, in the absence of a specific Account ID for matched principal stock accounts, Directive BI 8 was introduced requiring members to use the words "Matched Principal" in the name of any stock account to be used for cross-market matched principal trading. The JSE has since introduced a new Account ID for matched principal stock accounts on the BDA system, both for regulatory purposes and to ensure that such accounts attract the correct fees, and therefore we are proposing to amend Directive BI 8 to require members to use the designated Matched Principal stock accounts on the BDA system for their matched principal trading, rather than merely referring to matched principal trading in the name of the relevant accounts.

Members should note that if they are reporting matched principal trades between a Matched Principal stock account and a client suspense account, they do not need to use separate Matched Principal stock accounts for each client. Members may use a single Matched Principal stock account for all matched principal trades if they elect to do so.

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