

JSE COMMODITY DERIVATIVES MARKET

Date:- April 2021

Subject:- Explanatory Note - draft rules and directives for Delta Option Trades & Structured Option Trades

Delta Option Trades (“DOT”) and Structured Option Trades (“SOT”) have been a feature of the JSE Commodity Derivatives Market (“CDM”) for a number of years. The attached draft rules and directives on off book transactions include draft new provisions which provide an improved and clearer framework within which a DOT or SOT may be negotiated off the order book and then reported to the trading system by members.

The reason for off book DOT trades in the CDM is to enable the negotiation and the subsequent reporting of option trades by members in circumstances where the underlying futures price may move significantly after the parties have agreed on the terms of the transaction but before the option writer has secured all of the necessary deltas. Subsequent to a DOT being negotiated between the parties, a change in the price of the underlying futures could result in the option premiums being traded in the naked options central order book at levels which are materially different to those premium levels which existed at the time the transaction was negotiated. This in turn could make it difficult for the members to execute and book the trade through the naked option central order book, at the agreed upon levels, without a third party matching with one of the legs.

It is imperative that the rules provide a framework to ensure that members abide by their fiduciary obligations and carry out appropriate due diligence to obtain the best outcome for clients in circumstances where a deal is being negotiated between members or between a member and a counterparty off order book and where competitive orders may simultaneously be displayed by other market participants in the naked option central order book.

In this regard the JSE has prepared draft new rule 7.115.6 (per the attached) which promotes the best execution requirement by imposing an obligation on a trading member (acting on behalf of a client) to take cognisance of orders being displayed in the naked options central order book before negotiating and concluding a DOT with another member or counterparty and to satisfy those orders where this is in the best interests of the client.

It is important that DOT and SOT trades which are reported to the exchange comply with all of the requirements which have been specified in these draft rules and directives. In this regard the following requirements are extremely important:-

A. In respect of both DOT and SOT transactions:-

1. Definitions for both DOT and SOT transactions have been included with the list of transactions that do not have to be executed through the central order book and which may be validly reported to the JSE trading system.
2. DOT and SOT transactions must be reported to the trading system without delay after the parties have agreed on the terms of the transaction and all conditions precedent have been fulfilled.
3. DOT and SOT transactions which are reported to the trading system must comply with the minimum number of contracts as set out in the directives.

B. In respect of DOT transactions:-

1. The trading member must take into account the factors as specified in the draft rule 7.115.5 when determining the best option volatility level at which to trade on behalf of a client.
2. Draft rule 7.115.6 also promotes the best execution requirement by imposing an obligation on a trading member to ensure that there are no unfilled orders in that option contract in the naked options central order book which are at least equal in aggregate volume to the number of contracts being traded on behalf of the client and at a better price for the client than the price for the DOT being negotiated by the trading member with the counterparty.
3. The trading member must, on request, provide the Director: Market Regulation with details of the underlying futures trades executed by that trading member for its own account or on behalf of a client which comprise the delta hedge in respect of a DOT transaction.