JSE COMMODITY DERIVATIVES MARKET

Explanatory Note

Date:- **10 June 2021**

Subject - **Proposed rule amendments for "Exchange for Physical" and "Exchange for Risk" transactions**

Exchange for Physical ("EFP") and Exchange for Risk ("EFR") are combinations of transactions whereby a futures transaction in the JSE commodity derivatives market is negotiated off book and reported to the exchange in conjunction with the simultaneous conclusion of a transaction in the underlying physical market or in an over the counter ("OTC") derivative instrument where the underlying asset corresponds to the commodity underlying the exchange contract.

Commodity trading businesses are often engaged in activities which include physical trading, exchange derivative trading and hedging, procurement, storage, distribution, transport and logistics, etc. These activities and functions may sometimes reside in separate legal entities within a commodities group. The legal entity in a group which is a trading member on a commodities exchange may not be the same legal entity which trades in and holds physical commodities.

An EFR or EFP currently contemplates an exchange member being the buyer or seller of the exchange futures contract and the seller or buyer respectively of the relevant OTC physical contract. However, if a trading member of the exchange were to remain as the party on the physical contract leg it would be obliged to perform and deliver on physical commodity contractual obligations which were never intended to be performed or settled by the exchange member.

In order to resolve this mismatch, the physical contract leg would need to be transferred from the trading member (i.e. JSE member firm) legal entity to that legal entity within the group that actually does the physical commodities trading for the group.

In order to avoid the unnecessary administrative burden of processing these transfers as outlined above (i.e. transferring obligations from exchange member to physical trading legal entity) we have proposed amending the rules to permit another legal entity within a group to be a party to an EFP or EFR. In other words, the exchange member will be a party to the futures contract and another legal entity within the group may be the party to the OTC or physical contract. This other legal entity will typically be that entity within a commodities group that is engaged in physical commodities trading. The proviso is that both legal entities (i.e. the exchange member and the physical trading firm) have the same beneficial ownership.

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