MARKET NOTICE

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NOTICE NO.	**151/2015**
RELATES TO	

	Equity Market
	Equity Derivatives Market
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DATE:	**5 March 2015**
SUBJECT:	**PROPOSAL FOR THE INTRODUCTION OF BASIS FUTURES CONTRACTS AS AN EXTENSION TO THE DELIVERABLE GRAIN FUTURES CONTRACTS**
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Dear Stakeholder,

The JSE, endeavoring to improve transparency and provide a platform to secure basis premiums for grain in registered delivery points, has consulted a number of market participants in preparing the following proposal. A number of independent reports undertaken over the years suggested establishing a platform to secure basis premiums and whilst the JSE's spot basis platform has assisted market participants to a degree, the evolution of this was to provide a platform where premiums could be transacted with a future dated delivery obligation, hence the introduction of Basis Futures.

We would like to extend our sincere gratitude to all participants that have provided inputs in preparing this proposal and we look forward to your feedback. Please feel free to share this proposal with any interested clients and provide input by **Friday 20th March 2015**. Please could you also confirm the level of interest from your client base for the proposed Basis Futures contract as this will assist us as we present the product for final signoff. All comments can be emailed to commodities@jse.co.za and will be discussed at the next Agricultural Advisory meeting on the 25th March.

The proposed contract design for a Basis Futures contract is that this will form an extension of the current deliverable grain futures contracts and included in the detailed agricultural contract specifications as an additional appendix. We propose the following contract design for your consideration:

- Basis Futures – defined as the location premium or discount that buyer and seller agree on, for a future dated obligation to either make or take physical delivery at the specified registered delivery point.
- Futures contracts will be available for all major grain products, namely WMAZ, YMAZ, WEAT, SOYA, SUNS, and SORG.
- Only 5 main hedging month expiries will be available where basis futures can be secured, namely March, May, July, September and December. Listing of expiries per registered delivery point will be demand driven and subject to an initial interest to either bid or offer 50 contracts or more.
- The Basis Futures will price at a premium or discount to the reference deliverable grain futures contract and will not include any location differential component. In other words should the basis futures contract, referencing WMAZ as the underlying product, trade at +10 and assuming the WMAZ contract is trading at R2600/ton, then this represents R10 over and above R2600 for the white maize delivery at the specific delivery point. **NO REFERENCE TO A LOCATION DIFFERENTIAL WILL BE INCLUDED IN ANY OF THE BASIS FUTURES PRICING**. Should the Basis Future trade at -50 and assuming WMAZ is trading at R2600, then this represents delivery of white maize at the specific delivery point R50 under the R2600 level or R2550 should the client lock in both the underlying WMAZ hedge as well as Basis Future.
- The underlying contract specifications in terms of contract size and deliverable qualities will align with the listed grain futures contract e.g. Basis Futures listed on white maize will see 1 contract represent 100 tons of WM1 grade maize.
- The JSE reserves the right to introduce price limits for Basis Futures contract and although we had considered referencing a percentage, this becomes more difficult where the Basis Future is small in value, we propose taking on the same price limit as the referenced grain contract e.g for white maize contracts a price limit of R80 will apply. The same model for extended price limits will be implemented with price limits removed two days prior to last trading day.
- The Basis Futures contract will be quoted anonymously in a similar fashion to the spot basis contracts so as not to disclose the participants actively quoting and encouraging bids and offer to come through the central order book.
- The Basis futures contract, introduced in the trading system as a separate futures contract, will be margined and subject to a daily mtm relying on the existing JSE methodologies applicable to the grains market.
- Clients can trade the Basis Futures contract independently of the underlying deliverable grain futures contract, in other words lock in the basis premium or discount and then at a later date hedge the overall price risk for the underlying commodity. At expiration only then will a position in the deliverable grain futures contract be required, but if this is not available an equal and opposite futures positions will be opened similar to the spot basis market today.
- Since the Basis Futures contract ultimately is an extension of the deliverable grains contract, whereby at expiration physical delivery is required and matched with a futures position in the deliverable grain contract, the Basis Futures contract last trading day will be first position day as defined for the deliverable grains contract, with physical delivery processed for 5 business days following last trading day.
- Therefore all short position holders who have a Basis Futures position following last trading day, will be obligated to tender a JSE silo receipt in the registered delivery point as per the listed Basis Futures contract for the defined underlying product, with last notice day described as 5 business days following last trading day. Should the short position holder not have a corresponding short futures position on the deliverable grain contract e.g. WMAZ, then the position holder will receive both a short and long futures in WMAZ in order to process the physical delivery – this is similar to the process in the spot basis contract.

- The long position holders whom have a Basis Futures position following last trading day, will be obligated to take delivery and make full payment for product represented by a JSE silo receipt in a specific registered delivery point referencing the underlying deliverable grain contract, with delivery triggered by the short position holder. The long position holder can therefore expect notice of delivery any day following last trading day within a 5 business day period. Since a long position is required in the deliverable grain futures contract e.g. WMAZ to process the delivery, if this is not available a corresponding long and short futures position will be created to accommodate the physical delivery – this is similar to the process in the spot basis contract.
- Settlement invoicing and processing transfer of payment of the Basis Futures contract is therefore done in a similar manner to the current invoicing process except there will be no inclusion of the location differential where applicable. The final Basis Futures mtm will be referenced as at last trading day against the deliverable futures mtm on the notice day of delivery in order to calculate the final invoice value.
- The requirements to introduce registered delivery points as a Basis Future will be as follows:
    - We appreciate the JSE currently has over 250 registered delivery points, and while we had considered consolidating delivery points to link to a specific Basis Future, our ultimate proposal to allow for the most efficient pricing is to allow for each registered delivery point to trade at its own basis premium or discount.
    - The introduction of a specific delivery point will be subject to the firm commitment to <u>either bid or offer 50 futures contracts</u> (this then translates into either 5000 tons or 2500 tons depending on the underlying product); the idea behind this is to ensure focus around specific delivery points where there is increased demand for the contract. Once there is open interest, the initial requirement to bid or offer a total of 50 contracts per registered delivery point will no longer be required and clients can transact in single contracts. Should quantities match with the bid or offer of 50 contracts be in smaller volumes, the client who originally requested the Basis Future is require to continue quoting with the intention that a minimum 50 contracts ultimately form part of the open interest.
    - The introduction of the Basis Future on an existing registered delivery point remains subject to the storage operators approval should the expiry month requested for trading go further out than 6 months, otherwise the JSE will include the registered delivery point as soon as we receive confirmation of the demand. For any additional Basis Futures contract to be added, the JSE must be informed before 14h00 on the day, the contract will then be loaded into the JSE systems and available for trading the next business day and will be available <u>between 9h00 and 12h00.</u> The JSE can extend this trading period if there is demand for this.
    - The existing storage operator commitments will remain, ensuring that once a JSE silo receipt is issued; all commitments are honoured by the registered operator. Short position holders will be required to negotiate directly with storage operators to secure storage capacity in order to meet any of their Basis Futures delivery obligations.
- The current JSE trading and clearing systems will accommodate the initial design as proposed however additional improvements are underway to accommodate the proposed Basis Future. The implementation of the requested changes is expected later in the year and so it is proposed to introduce the Basis Futures contracts on the existing code base. The proposed technical design is as follows:
    - Basis Futures will be introduced as a separate instrument with futures contracts enabled – no options will be available to start with. The JSE will assign a unique reference code to each registered delivery point and aligned this to the product code- all will be display as the instrument code. For

example white maize will be allocated a W whilst Kroonstad as a registered delivery point will reference KRO, the complete code for a July 15 expiry will display as WKRO 29 Jun15 (29 June is equivalent to first position day). The JSE is working on providing an easy lookup table with all the possible contract code combinations. Once the improved technology is implemented later in the year, the full name of the delivery point will be available for easy reference under the instrument code.

- It is proposed the unique codes for each product be as follows: W = white maize, Y=yellow maize, T= wheat, S= soya, N= sunflower seed and G=sorghum (SORG).
- A detailed list of all registered delivery point codes will be provided in due course.
- The Basis Futures contracts will be loaded under the current can-do trading windows, separated from the existing grain futures windows and will allow for bids or offers to be entered as a positive or negative value. Remember the value quoted is per ton and will be referenced back to the deliverable grain futures standard nominal, e.g. white maize = 100 tons whilst wheat = 50 tons.
- Notice of delivery will be processed in a similar way using the trading front end functionality, however initially all clients must process these via the EFP functionality to ensure the deliveries are allocated to the Basis Future long position holders. All deliveries applicable to the Basis Future will be randomly allocated should more than one long position holder have exposure at the specific delivery point.
- JSE will generate all the necessary invoicing as per the current delivery process and include any discount calculation like outstanding storage or grade discounts on the same basis of physical delivery today. PLEASE NOTE NO LOCATION DIFFERENTIALS WILL BE INCLUDED IN THE BASIS FUTURES FINAL SETTLEMENT VALUE.
- For all ISV's the Basis Future will simply be another futures instrument for download and that can trade either positive or negative in value.
- Based on this current proposal, the JSE will load a selection of instruments in the test environment should clients want to test their systems. Please feel free to contact us if you require access to this environment.

The above proposal was crafted after considering a number of meetings with various market participants. We appreciate some clients may still prefer trading a cluster of registered delivery points as a Basis Future, however our initial view is that lets allow the market to price each registered point to its full potential to allow buyers certainty of delivery at a specific delivery point. The other more innovative way of pricing by excluding any reference to location differentials, may appear more complex however the end calculation is simplified as clients then simply have to add or subtract the basis value from the deliverable grain contract price. On both these scenarios the JSE would prefer to continue as suggested and only consider making changes to the Basis Futures contract design following an initial trial period.

We appreciate the above is described in detail, to explain the concept using a simple example:

Assume a farmer who aims to deliver at Kroonstad is interested in securing a Basis Future contract for July 2015 white maize (WMAZ) at a level of R-60 on the 4th March 2015. There is a willing buyer who agrees to trade 50 contracts at this level of R -60 and therefore expects delivery can commence from either 1 Jul2015 through until 6 July 2015 (5 business days from last trading day which will be 29 June 2015). The Basis Future contract code would be displayed as WKRO 29 Jun15 [W=white maize, KRO=code for Kroonstad, 29 Jun15 is last trading day for the contract].

On the 9th April the same farmer hedges his overall price risk on a WMAZ contract at R2700.

On 29 June 2015, last trading day the WKRO contract the final mtm is R-50 implying that the farmer would have paid in R10 variation margin to the buyer. On the 1 July 2015 the farmer tenders notice of physical delivery via a JSE silo receipt and this is then linked back to the short WMAZ position held, the Jul15 WMAZ mtm is now R2600, this implies the farmer would have received R100 variation margin as the WMAZ futures hedge fell from R2700 to R2600. The invoice price for the farmer is then calculated as follows assuming no outstanding storage = R2600-R50 = R2550 is paid for the stock delivered in Kroonstad. If we consider the original hedge value of R2700-60=R2640 and compare this with the final invoice price, do not forget the farmer received R100 (from the WMAZ contract) and paid out R10 (from the WKRO contract) therefore resulting in a net amount of R90 received. This R90 added to the R2550 invoiced value results in R2640 – back to the original hedged value!

Please take note that nowhere in the above example any reference to the published location differential is included when hedging the basis value of the product.

I trust the above detailed description and example clarifies the proposed Basis Futures contract and how it is integrated into the deliverable grain futures contract. The Basis Futures contract will provide a number of advantages for market participants of which some are:

- Sellers can secure a premium for delivery in a specified delivery point way in advance and no longer has to wait until they have access to the physical product.
- Buyers can secure product in preferred delivery points and therefore no longer subject to random allocation when taking physical delivery.
- Although Basis Futures contracts require initial and variation margin, they can be unwound depending on the liquidity of the contract, providing more flexibility than traditional OTC contracts.
- Basis Futures positions can be combined with a hedge price to secure additional financing as participants will be able to provide both hedge positions to financiers, therefore the overall value for financing increases and clients are no longer limited to only finance a hedge price less location differential.
- The Basis Futures contract at delivery is integrated into a deliverable grain futures contract, therefore existing positions where the price risk is hedged will be offset, this is provided physical delivery for long position holders is not received prior to last notice day of the Basis Futures contract.

Thank you for your time and for considering this enhancement to the existing deliverable grain contracts. We look forward to your feedback and conformation of clients interested in this product. Based on the feedback received and confirmation from interested parties, we will be happy to hold a workshop to discuss this enhancement in more detail as well as any suggestions to improve the proposed product. Thank you again for your support!

Should you have any queries please contact Chris Sturgess on 011 520 7299 or use the group e-mail

commodities@jse.co.za

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