

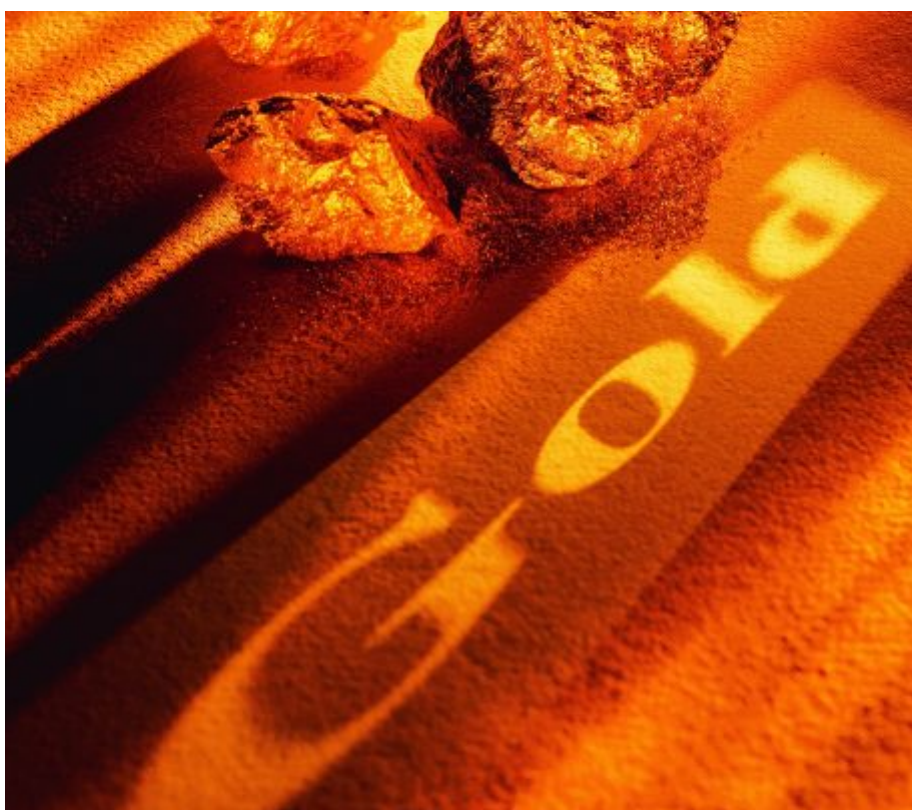


## GUIDE ON EXCHANGE OF FUTURES FOR PHYSICALS (EFP)

## CONTENT

---

A. DEFINITION.....	03
B. MEANING .....	03
C. HOW DOES IT WORK.....	04
D. EFP COMMODITIES .....	06
E. ADVANTAGES OF EFP .....	06
F. EFP EXAMPLES .....	07
G. EFP APPLICATION PROCESS .....	10
H. EFP RESTRICTIONS .....	11
I. EFP REVIEW PROCESS .....	12
J. THINGS TO REMEMBER.....	12



## **A. DEFINITION**

An EFP transaction is a simultaneous exchange of a futures position for a physical position between two market participants. Here, one party buys a commodity in the physical market and sells the futures contract of the same commodity while the opposite party sells the commodity in the physical market and buys the futures contract of the same commodity.

The EFP transaction may involve an agreement between two parties for delivery of a commodity in the physical market whose grade/quality, delivery location & timing is different from that specified in the futures contract of the same commodity from one party to another. Further, the parties, simultaneously, take equal and opposite futures market positions in the same commodity at the time of the physical agreement. Thus in EFP the trading parties are free to choose their trading partners, delivery location, grade/quality of the commodity to be delivered and timing of delivery.

## **B. MEANING**

Exchange of Futures for Physicals (EFP) is a way to use the futures market to reduce price risk on physical sales and purchases. It is an exchange of a futures contract for a position in the physical market.

For example, with an EFP, participants can negotiate the delivery of the commodity bilaterally. The physical commodity is delivered from a seller to a buyer, and in exchange, the exchange clearing house transfers a long futures position of the same commodity from the buyer to the seller.

EFPs can be utilized wherein the futures are used for hedging purposes and the users are not interested in making or taking delivery at the specified locations or in delivering the underlying grades of the futures contract or in delivering in the time schedule prescribed in the futures contract. In many cases, they are not interested in being matched to an unknown trading partner for delivery by the Exchange. More often than not, a hedger using futures finds it economically desirable to make or take delivery elsewhere, under terms that differ from those of the futures contract.

EFPs allow both buyers and sellers the flexibility of determining the final price of their commodities at their own convenience while securing physical delivery on their preferred terms with the preferred counterparty.

An EFP transaction is a non-competitive transaction where the transaction price is mutually negotiated.

**EFPs provide a mechanism to:**

- swap from a futures to a physical position or vice versa
- offer better market and price certainty for large, hedged physical transactions
- fulfil delivery commitments.

In an EFP, a genuine physical agreement has to be executed and actual physical delivery has to have occurred (or committed to). The physical and futures components must be 'substantially similar' and equal in terms of either:

- value (i.e. the value of the physical being similar to the value of the futures); or in terms of
- quantity (the quantity of the physical being similar to the quantity of the futures).

EFPs do not affect open /high /low /close information in the futures market as the EFP price is not included in the settlement price calculation.

EFPs are a standard feature in futures contract specifications in international markets. Many more futures positions are closed out through EFPs than through standard delivery procedures. As they provide much greater ease of use than traditional delivery modalities, they tend to attract producers, processors and traders to the exchange by effectively making it easier to deliver against futures market positions.

## C. HOW DOES IT WORK

EFPs can be effected between two futures market participants - a long and a short hedger - provided there is a physical market transaction between the parties. For example, a futures market long (a buyer) can take delivery of a commodity from a futures market short (the seller) with whom an EFP is conducted. In this transaction, the buyer's hedge is liquidated, as is the seller's, and the actual transfer of the commodity occurs between the parties.

There are several ways in which EFPs can be useful for market participants, where they can be used to initiate futures positions, close futures positions and to directly swap a futures position for a similar physical position.

There are, in effect, three ways of using EFPs:

### 1. Closing Existing Futures Positions

A holder of a short position on the futures market and a holder of an

equivalent long position decide to enter into a physical transaction. In payment for the physical commodity, the buyer's long position is transferred to the seller; thus, both buyer and seller have closed out their futures position. As the actual physical commodity that is being sold, or its delivery location and other contract characteristics, may imply a market premium or discount compared to the futures market reference price, the buyer or seller may also make an additional payment but that should be commercially reasonable.

## **2. Opening Fresh Futures Positions**

Two parties that are in a regular commercial relationship may decide to use the futures market as the explicit determinant of the pricing of their transactions. EFPs are one way of doing this. In this case, for each relevant physical transaction entered into by the two parties, the exchange clearing house is informed; and the clearing house will then allocate an equivalent long position to the seller, and the same short position to the buyer. Both parties will close their futures positions at their convenience.

## **3. Swapping Existing Futures Positions**

The EFP is used to transfer a futures position from one party to another. For example, at planting time, a producer has hedged its crop, and now that it has been harvested, is ready for a physical sale. Rather than selling its crop in the traditional manner and simultaneously closing out its futures position, it decides to enter into an EFP. It signs an EFP with a trader, and informs the exchange clearing house accordingly; the clearing house will then transfer the producer's short position to the trader. Thus, the producer has closed out its position, and the trader can close out his futures position at his convenience but prior to contract maturity by buying futures.

Note that the same types of trade could have taken place by the two parties in the foregoing examples by taking independent futures market positions, but at higher costs and risk. In other words, one important advantage of conducting an EFP with known counterparty instead of operating independently on the exchange and in the physical market is that the costs of an EFP are much lower than the transaction costs involved in buying and selling separate futures & physical contracts. Moreover, the risk of slippage (realized prices being worse than expected prices because of fast market movements) is eliminated; and until the moment that their futures positions are closed out, the EFP-participants benefit from the "counterpart guarantees" provided by the clearing house. An additional advantage is that EFP's can also be used as a marketing tool to identify new clients.

## D. EFP COMMODITIES

At present the following commodities are permitted to have EFP transaction facility.

- Gold and Gold mini
- Silver and Silver mini
- Copper
- Zinc
- Aluminium
- Nickel
- Lead
- Chana
- Wheat
- Mentha Oil

Other commodities may be allowed for EFP transaction facility in a phased manner subject to regulatory approvals.

## E. ADVANTAGES OF EFP

- EFPs allow individuals/companies to choose their trading partners, delivery site, the grade of product to be delivered, and the timing of delivery and at the same time eliminate price risk through futures market
- For physical market players, EFP is the preferred method of delivery of physicals because it provides greater flexibility than the traditional exchange-set delivery modalities. Thus eliminates substantial sales and/ or supply risk
- EFP guarantees quality management as there is no receipt of commodities from unknown sources
- EFP can be effectively used to take positions in less liquid far month contracts
- Because there is no risk of price “slippage”, the participants have maximum flexibility to bring large orders to market without worrying of market depth and basis risk
- EFP aids negotiation of physical contracts during differing price ideas by separating price determination and sale of goods
- EFP improves market quality of the Exchange, by increasing total volume, increasing liquidity, lowering transactional risk, and lowering hedging costs.

## F. EFP EXAMPLES

### Scenario 1: Swap Bullish Position

#### Before EFP

##### **Producer**

Price View: Bullish

Physical Position: Wants to sell 100 tons of Chana

##### **Processor**

Price View: Bullish

Futures Position: Long 10 Chana January 2010 futures contract at 2300

They know each other and have done business earlier. On 31st Nov they agree to do an EFP at that day's futures market price as follows:

#### After EFP

##### **Producer**

Physical Position: Sell's/deliver's 100 tons of Chana at 2350 to the processor

Futures Position: Long 10 Chana January 2010 futures contract at 2350

**Sale price not fixed till futures position is closed**

##### **Processor**

Futures Position: Short 10 Chana January 2010 futures contract at 2350

Physical Position: Acquire's 100 tons of Chana at 2350

**Gets assured delivery of Chana at 2300 [2350 – (2350-2300)]**

**Net futures position is zero**

### Scenario 2: Swap Bearish Position

#### Before EFP

##### **Producer**

Price View: Bearish

Futures Position: Short 10 Chana January 2010 futures contract at 2300

##### **Processor**

Price View: Bearish

Physical Position: Wants to buy 100 tons of Chana

They know each other and have done business earlier. On 31st Nov they agree to do an EFP at that day's futures market price as follows:

### **After EFP**

#### **Producer**

Futures Position: Long 10 Chana January 2010 futures contract at 2250

Physical Position: Sells 100 tons of Chana at 2250 to the processor

**Gets assured payment of Chana at 2300 [2250 + (2300-2250)]**

**Net futures position is zero**

#### **Processor**

Physical Position: acquires/take delivery of 100 tons of Chana at 2250 Futures

Position: Short 10 Chana January 2010 futures contract at 2250

Purchase price not fixed till futures position is closed

### **Scenario 3: Opening Fresh Position**

#### **Before EFP**

##### **Producer**

Price View: Bullish

Physical Position: Wants to sell 100 tons of Chana

##### **Processor**

Price View: Bearish

Physical Position: Wants to buy 100 tons of Chana

They know each other and have done business earlier. On 31st Nov they agree

to do an EFP at that day's futures market price as follows:

#### **After EFP**

##### **Producer**

Physical Position: Sell's/deliver's 100 tons of Chana at 2350 to the processor

Futures Position: Long 10 Chana January 2010 futures contract at 2350

**Sale price not fixed till futures position is closed**

##### **Processor**

Physical Position: Acquires 100 tons of Chana at 2350

Futures Position: Short 10 Chana January 2010 futures contract at 2350

**Purchase price not fixed till futures position is closed**

## Scenario 4: Closing Existing Position

### Before EFP

#### **Producer**

Price View: Bearish

Futures Position: Short 10 Chana January 2010 futures contract at 2350, to hedge his stocks.

#### **Processor**

Price View: Bullish

Futures Position: Long 10 Chana January 2010 futures contract at 2250, to hedge his physical requirements.

They know each other and have done business earlier. On 31st Nov they agree to do an EFP at that day's futures market price as follows:

### After EFP

#### **Producer**

Physical Position: Sells/deliver's 100 tons of Chana at 2300 to the processor

Futures Position: Long 10 Chana January 2010 futures contract at 2300

**Gets assured payment of Chana at 2350 [2300 + (2350-2300)]**

**Net futures position is zero**

#### **Processor**

Physical Position: Acquires 100 tons of Chana at 2300

Futures Position: Short 10 Chana January 2010 futures contract at 2300

**Gets assured delivery of Chana at 2250 [2300 - (2300-2250)]**

**Net futures position is zero**

**Note:** In all the above four scenarios the **"negotiated price of physical transaction"** may differ in relation to the futures transaction of the EFP, based on the quality/grade delivered, delivery location and timing of delivery in the physical market in relation to the futures contract specification.

## G. EFP APPLICATION PROCESS

The parties who wish to enter into an EFP transaction should first negotiate the terms of the physical transaction, such as price, quantity, quality, delivery location and delivery timing. They also agree upon the price at which their futures market trades in the same contract should be opened or closed, subject to it is within the specified period's High & Low prices & conforming to the standard minimum tick increment of the given commodity contract. EFP transactions are permitted during the tenure of a futures contract with some exceptions as follows.

1. EFP for closure or to swap future positions is applicable only in respect of historical futures positions of the relevant contract listed on the Exchange, meaning the futures positions to be closed or swapped is not applicable to new positions opened on the day of application for EFP.
2. During the tender & delivery period of the futures contract no EFP will be permitted.

Next, both the parties should approach their respective Member and inform them about the EFP transaction, with the negotiated terms and conditions of the physical and futures transaction of EFP. The Clearing Members in turn should process their request after confirming the authenticity of the EFP transaction within 1 hour of closing of the specified period. An EFP is also possible between two parties through a same clearing member.

The Clearing Members must subsequently approve the terms of the transaction, including the price, quantity, grade and delivery date prior to submitting the EFP request to the Exchange. Clearing Members are responsible for exercising due diligence as to the bona fide nature of EFP transactions submitted on behalf of their customers.

The EFP transaction is reported to the Exchange through respective Clearing Members in the specified format.

The Exchange offers standardized forms for applying for EFP, including but not limited to:

- A statement that an EFP is transacted
- A statement of changing ownership of a certain commodity
- The date of transaction
- The quantity & grade/quality of the physical commodity involved
- The delivery place
- The price of physical transaction
- The price at which the futures transaction is to be cleared on a particular futures contract

- The names of the Clearing Members involved

Members to any EFP transaction must maintain all documents relevant to the futures and the physical transaction.

The documents maintained by the Members to the transaction must include:

1. All documents relevant to the futures side of the trade (e.g., orders, trades and customer account statements);

Cash confirmations, invoices, bills of sale, or other documents evidencing all of the terms of the cash side of the transaction, including evidence of payment/settlement of the cash transaction.

The documentation evidencing the physical transaction consist of those documents customarily generated in accordance with physical market practices that demonstrate the existence and nature of the physical transactions, including, but not limited to, contracts, confirmation statements, telex printouts, invoices, warehouse receipts or other documents of title reflecting payment and transfer of title.

Any such documents must be provided to the Exchange along with submission of EFP transaction details and it shall be the responsibility of the Clearing Member to provide the requested documentation on a timely basis.

Members should not square off outstanding futures positions for which closure request of futures positions towards EFP transaction is submitted to the Exchange.

## H. EFP RESTRICTIONS

- EFP can be executed between two parties which are separate legal entities with different beneficial ownership
- The party that is the seller of the physical or "spot" commodity must have the cash commodity in his possession at the time of the EFP transaction or produce evidence of his capability to supply the commodity in its normal course of business.
- The buyer of the cash commodity must retain ownership of the transferred product for personal use or resale to customers and may not resell the product either directly or indirectly to the original seller.
- No EFPs will be accepted after 1 hours of the close of the specified period for a given commodity on that day.
- No EFPs will be permitted which will lead to breach of prescribed position limits for a given commodity.

## I. EFP REVIEW PROCESS

The buyer's and seller's Clearing Members must satisfy the Exchange that the transaction is a legitimate EFP. Evidence of a change in ownership of the physical commodity involved in the EFP (or a commitment for such a change), as well as payment received by the firm selling the product, must be made available to the Exchange and secured by the Clearing Members representing the parties to the EFP upon the specific request from the Exchange Clearing House.

The Clearing House will review the transaction information for completeness and conformity to EFP guidelines and on that basis either approve or reject the transaction and accordingly inform the parties to the transaction. Only after approval will the EFP be considered as executed. On approval the Exchange will open / close corresponding futures positions in the same contract on behalf of the two parties after the end of that trading day i.e. after 11.30/ 11.55 pm on weekdays and 2.00 pm on Saturdays.

EFP trades will be approved by Exchange as long as they occur in prescribed contracts and do not contravene the Business Rules/ Guidelines of the Exchange concerning EFP.

## J. THINGS TO REMEMBER

- When an EFP is registered with the Exchange, the EFP volume will be attributed to that trading day for respective Clients & Members but the price will not be disclosed to the market. However, EFP transaction details will not be reflected in bhavcopy of that trading day.
- Once a futures contract is created through an EFP, it will be considered as a normal futures position and shall be margined accordingly.
- The Exchange's role in respect of the physical transaction between the counterparties shall restrict only to approval of the EFP. The responsibilities, risks and enforcement of settlement of the physical transaction will lie with the respective counterparties.

---

The logo for Multi Commodity Exchange of India Ltd. (MCX) features the letters 'MCX' in a bold, sans-serif font. The 'M' and 'X' are dark blue, while the 'C' is red.

India's No.1 Commodity Exchange

**Multi Commodity Exchange of India Ltd.**

Exchange Square, Suren Road, Andheri (East), Mumbai 400 093, India. Tel: 91-22-6731 8888. Fax: 91-22-6649 4151. [www.mcxindia.com](http://www.mcxindia.com)