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10 Preconditions for a Successful Commodity Exchange – a Comparison between ACE and ZAMACE

Preconditions for a Successful Commodity Exchange outlines the necessary prerequisites for a viable commodity exchange in Africa. The preconditions are drawn from COMPETE's Structured Trade Specialist Ian Goggin's extensive knowledge of and hands on experience with launching African exchanges as well as COMPETE's work with the Agricultural Commodity Exchange for Africa (ACE) and the Zambian Commodity Exchange (ZAMACE). COMPETE also consulted documents such as the Michigan State University (2011) case study of ZAMACE¹.

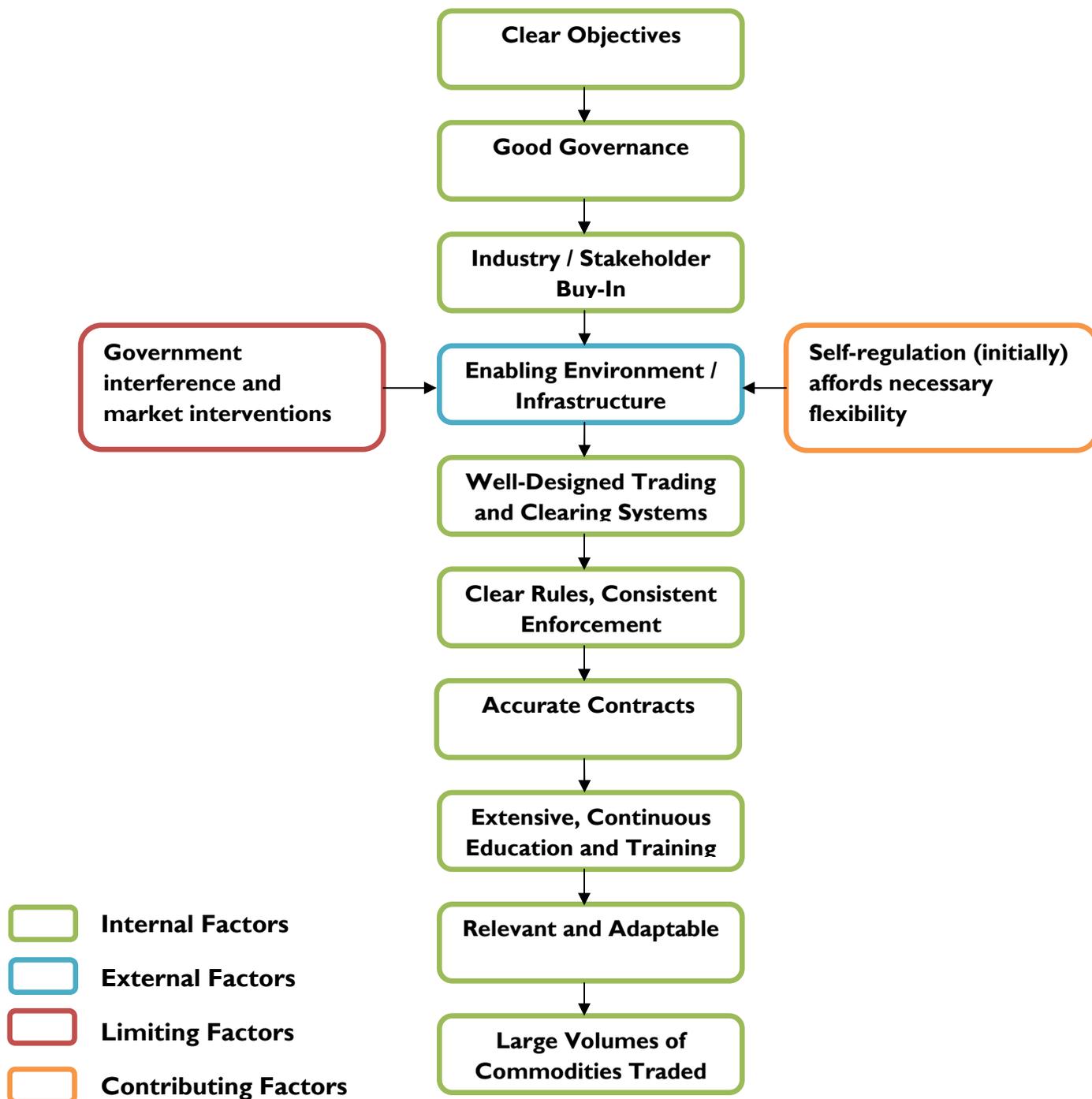
A commodity exchange is an open and organized marketplace where ownership titles to standardized quantities or volumes of specific commodities (usually agricultural) are traded by its members for their clients. Commodities are traded at a specified price with guaranteed delivery on a specified date. In its simplest form, a commodity exchange provides a venue for buyers and sellers to conduct business, normally through a group of registered brokers. A properly run exchange reduces the cost of doing business for all parties along the value chain from producers and traders to processors and consumers. In the words of ZAMACE: "Agricultural commodity exchanges bring more formality to trading methods, enhancing market transparency and increase quantity and quality of commodities traded, for the benefit of the agricultural sector and the economy as a whole." www.zamace.org

ACE is the Agricultural Commodity Exchange for Africa. It is a spot and forward market commodity exchange based in Malawi. A spot and forward exchange means that all contracts require an immediate physical delivery or specified future date. ACE was registered in July 2004 and has operated a live exchange trading platform since October 2006. The main objective of ACE is to link farmers to markets and to create price discovery in a transparent marketplace. ACE was a COMPETE grantee from January 2010 to March 2012. www.aceafrica.org

ZAMACE is the Zambian Commodity Exchange. It has undergone several iterations since its formation in May 2007, and has not operated as an exchange since January 2011. By 2013, ZAMACE hopes to provide a traditional spot-trading and trade information distribution facility that is based on warehouse receipts to guarantee quantity and quality. ZAMACE's main objective is to "provide an efficient and vibrant Zambian and regional agricultural commodity exchange, supported by a warehouse certification and receipts system to enhance market access, liquidity and credibility in the Zambian commodities market." ZAMACE was a COMPETE grantee from March 2010 to December 2011. www.zamace.org

¹ Nicholas J. , S., & T.S. , J. (2011). *Constraints to the development of commodity exchanges in Africa: A case study of ZAMACE*. Food Security Research Project, Michigan State University, Lusaka, Zambia. Retrieved from <http://www.aec.msu.edu/agecon/fs2/zambia/index.htm>

10 Preconditions for a Successful Commodity Exchange



1. Clear Objectives

A commodity exchange needs a clear plan with a well-defined scope. The exchange must have a detailed business plan, operating budget and strategy to engage productively with stakeholders.

2. Good Governance

A commodity exchange must have a well-thought-out governance structure that emphasizes and responds to membership needs while maintaining an effective board and advisory structure that upholds business standards and meets performance targets. The board should include representatives from government, banking, storage/warehousing and the agricultural sector (e.g. FBOs, traders, processors, input suppliers, etc.). The exchange employees must be committed to the exchange's mission and understand/promote the benefits of the exchange for all users and potential users.

3. Industry / Stakeholder Buy-In

Commodity exchange leadership must meet with farmers, traders, processors, banks, the Central Bank, Ministry of Agriculture, Ministry of Finance and donors/relief agencies to generate support for the exchange. It is essential that each constituency understand the function of the exchange, their role in the process and the expected benefits. Farmers must want to use it, banks must trust it, government must support it and everyone must recognize the value it adds. Workshops targeted toward increasing awareness of the exchange's value and benefits to stakeholders are essential to gaining industry-wide support.

4. Enabling Environment / Infrastructure

The host country needs to have legislation in place that consistently addresses agricultural, financial, trade and legal policies. However, legislation specific to a commodity exchange is not necessary for it to operate. Rather, policies should allow for a free market – i.e. supply and demand determines prices. The host country also needs sound infrastructure – payment structures, brokerage services, storage, and transport. Government interference in agricultural markets through export bans and other interventions will undermine the proper functioning of an exchange. While legislation governing the functioning of the exchange can evolve over time, the rigidity it imposes up front can impede the development and limit the exchange's flexibility to address changing market needs.

5. Well-Designed Trading and Clearing Systems

The exchange must develop a system that is appropriate to the environment in which it is operating. This can include open outcry (shouting and the use of hand signals to transfer information), electronic or a combination of the two. Electronic systems allow for longer trading sessions, greater flexibility and greater freedom for members. An exchange must have graded products that meet quality standards, but it should not limit what grades and type of product can be traded. It is important to note that systems can and do evolve over time and that what works well for one exchange may not be appropriate for another. An exchange needs to determine what is best for its operations and be willing to change as the market matures.

6. Clear Rules, Consistent Enforcement

A commodity exchange must have clear, consistently applied and balanced rules and regulations designed to protect the integrity of the exchange. The rules must govern all parties to the exchange: members (including their employees and clients), brokers, arbitrators, exchange employees, and other relevant parties. The rules should stipulate capital requirements for members, acceptable conduct of all parties, performance and sanctions for infractions. Trading rules need to include delivery guarantees or a means of alternative dispute resolution that ensures performance by all parties. The exchange must develop a transparent surveillance and monitoring system and act decisively when breaches in rules occur.

7. Accurate Contracts

The exchange should work with members and the industry to develop an agreed contract to facilitate trades and more detailed commodities-specific contracts that contain standard information on quality standards, analysis, delivery and weights, demurrage, force majeure and arbitration, among others. Exchange staff must ensure the accuracy of all contracts issued through the exchange.

8. Extensive, Continuous Education and Training

Training and certification of members and brokers is critical to ensuring the integrity of the exchange. The exchange should develop training and testing materials for this purpose and require certification of all parties trading through the exchange, renewable every two years. Broader education and awareness campaigns targeting potential users must be included in the annual operating budget to drive more business across the exchange.

9. Relevant and Adaptable

An exchange serves the market. It must therefore constantly re-evaluate its performance, regulations, systems and membership to ensure that it is delivering value and maintaining its integrity. Exchanges must understand that they will make mistakes but the important lesson is to learn from those mistakes and be willing to adapt and change whenever necessary.

10. Large Volumes of Commodities Traded

To stay viable, exchanges must attract large volumes of commodity across its trading floor. The commodity exchange planning phase must research trade volume potential. If the potential doesn't exist, neither should the exchange.

Preconditions for a Successful Commodity Exchange	Agricultural Commodity Exchange for Africa (ACE)	Zambian Commodity Exchange (ZAMACE)
Clear Objectives	<ul style="list-style-type: none"> 👍 Engaged stakeholders, including govt. in all planning phases to ensure endorsement 👍 Formed advisory board to guide the strategy and development of the Exchange from this multi-stakeholder group 👍 Spent significant time upfront (1 year) refining business/operating plan to ensure sustainability 	<ul style="list-style-type: none"> 👍 Engaged some stakeholders in discussion 👍 Engaged with government 👎 Business plan remained an internal document without input from industry stakeholders
Good Governance	<ul style="list-style-type: none"> 👍 Formed advisory board with broad-base representation 👍 Created two separate boards – ACE Trust to focus on farmer organizations and donor activities (5 members) and ACE Ltd to focus on commercial interests (6 members). Board members include representatives from the storage industry, smallholder farmer associations, the farmer union of Malawi, the National Association of Smallholders Farmers’ of Malawi (NASFAM), and traders. 👍 43 members (Users) representing stakeholders from across the agricultural industry 	<ul style="list-style-type: none"> 👎 Never formed an advisory board 👎 Elected board without broad-base consultation 👎 Started with 8 core members (15 at its peak, now down to 4) mainly large grain traders
Industry / Stakeholder Buy-In	<ul style="list-style-type: none"> 👍 Embraced all sectors of the agricultural industry, obtained buy-in from both public and private sectors 👍 Workshops have successfully improved understanding of 	<ul style="list-style-type: none"> 👎 Very limited membership and limited buy-in 👎 No bank support 👎 Misunderstanding of how an exchange works and benefits and users

	<p>the commodity exchange and increased participation, particularly in the farming sector through the P4P program²</p> <ul style="list-style-type: none"> 👍 Received government support 👍 Endorsed by a majority of commercial banks 👍 Broad range of commodities traded 	<ul style="list-style-type: none"> 👎 Mistrust from potential participants 👎 Mainly maize is traded with smaller volumes of soya and wheat
Enabling Environment / Infrastructure	<ul style="list-style-type: none"> 👍 Gained support of govt. for self-regulation 👍 Solid payment structures, brokerage services, storage, etc. 	<ul style="list-style-type: none"> 👎 Focused on gaining legitimacy through government legislation, which was never finalized 👎 Substantial govt. interference (trade bans, purchasing maize at above market prices) 👎 Limited brokerage services in the country 👎 Weak commercial law
Well-Designed Trading and Clearing Systems	<ul style="list-style-type: none"> 👍 Uses an internet-based trading system that is well suited to the operating environment 👍 Built an electronic warehouse receipt system and a Bid Volume Only (which caters to smallholder farmers) into its main trading platform 	<ul style="list-style-type: none"> 👍 Uses an open outcry trading system 👎 The majority of trades conducted through the Exchange are recorded off the exchange – they are not conducted openly and transparently across the Exchange floor 👎 Traders often serve as brokers creating potential conflict of interest
Clear Rules, Consistent Enforcement	<ul style="list-style-type: none"> 👍 Established regulations governing the Exchange and participants including: rules of arbitration, silo / warehouse receipt rules and 	<ul style="list-style-type: none"> 👍 Adopted ACE's rules and procedures 👎 Limited administrative capacity to ensure contract enforcement

² Purchase for Progress (P4P) is being piloted in 21 countries as part of the World Food Program's (WFP) goal to purchase staple foods in a more smallholder-friendly way. As a major buyer of staple foods for food aid programs, WFP has begun sourcing food locally, providing increased market opportunities to smallholder farmers in developing countries like Malawi. www.wfp.org/purchase-progress

	<ul style="list-style-type: none"> 👍 a contracts system 👍 Created an alternative dispute resolution system 	<ul style="list-style-type: none"> 👎 Dispute resolution is time consuming and too costly (one arbitration case lasted almost 1 year and cost both parties nearly USD \$20,000)³
Accurate Contracts	<ul style="list-style-type: none"> 👍 Developed a system with 13 commodity-specific contracts and a general contract for lesser-traded items. 👍 Contracts cover all aspects of an agreement between buyer and seller 	<ul style="list-style-type: none"> 👎 Created similar contracts to ACE but because most trades occur off the exchange, the use of official contracts remains limited
Extensive, Continuous Education and Training	<ul style="list-style-type: none"> 👍 ACE currently acts as a broker to ensure direct access to the trade platform and a wider spectrum of participation. ACE also generates income as a broker 👍 ACE continues to train future brokers (outside of ACE) for an eventual transition 👍 Continuously hosts trainings for potential participants in the private and public sectors, including smallholder farmers 👍 Maintains 28 agents to collect market prices, sensitize farmers in the rural areas and provide those rural farmers with direct access to the trading platform 	<ul style="list-style-type: none"> 👎 Suffered from a lack of trained and certified brokers 👎 Attempts at education and trainings have not yet overcome initial skepticism 👎 Implemented Grain Marketing Expansion Program (GMEP), but never gained traction. Rural farmers did not buy-in to the commodity exchange concept
Relevant and Adaptable	<ul style="list-style-type: none"> 👍 Increased and adapted services when necessary to meet market needs. 👍 Maintains relevance through upgrades like the Bid Volume Only platform and electronic 	<ul style="list-style-type: none"> 👎 High membership costs and burdensome dispute resolution procedures disincentivise participation⁴ 👎 Zero confidence from banks hinders expansion

³ MSU, 2011

⁴ MSU, 2011

	<p>warehouse receipt system</p> <ul style="list-style-type: none"> 👍 Improved security to all exchange participants with an improved performance guarantee where payments are made through the exchange, ensuring that any debts due to the depositor are reconciled before they receive payment 	<ul style="list-style-type: none"> 👎 Opaque trading breeds mistrust 👎 Over focus on legislating the Exchange neglected market needs
<p>Large Volumes of Commodities Traded</p>	<ul style="list-style-type: none"> 👍 Trade volumes continue to grow as the full range of services that ACE offers becomes more widely known (ACE trades jumped from 20,000 MT in 2010 to 41,840MT in 2011) 👍 Increased volumes improved price discovery 👍 Smallholders have won an increasing number of supply contracts through the WFP P4P program 	<ul style="list-style-type: none"> 👎 Trade volumes were initially encouraging but have not been sustained (ZAMACE trades peaked in 2009 with 20,000 MT of closed deals. Volume of trade have decreased since that time, coming to a stop in January 2011) 👎 Limited volumes reduces guarantee of transparent price discovery



Pictures: Left – A smallholder farmer bulks her grain for sale on the exchange. **Center** (photo credit: Charlie Barnwell, WFP) - ACE demonstrates the Bid Volume Only platform to Malawi smallholder farmers – Lilongwe, Malawi. **Right** – Lawrence Chikhasu, a small trader, receives the first warehouse receipt traded on ACE.