CIRCULAR

SEBI/HO/CDMRD/DMP/CIR/P/2017/6 **January 20, 2017**

To,

The Managing Directors / Chief Executive Officers
All National Commodity Derivatives Exchanges

Dear Sir / Madam,

Sub: Criteria for Eligibility, Retention and re-introduction of derivative contracts on Commodities

1. The nature/properties of one commodity differs from another, thereby not all commodities may be suitable for the commodity derivatives trading. It is prudent that before allowing any derivatives contract on any commodity, the appropriateness / usefulness of commencing futures trading in products (not necessarily of just commodities), needs to be ascertained.

2. The Commodity Derivatives Advisory Committee (CDAC), constituted for advising SEBI on matters concerning effective regulation and development of the commodity derivatives market, on the above aspects had inter alia, recommended that:

   2.1. The commodities which are to be recommended by SEBI for notification by the Government or on which the exchange proposes to launch a contract should pass through some test based upon the objective parameters and upon satisfaction, should be allowed for trading.
   2.2. It is also important that the contracts available for trading in the commodity derivatives market are liquid enough for the contracts to trade smoothly.

3. Though it may not be practicable to keep a strict objective criteria which may be uniformly applied across all commodities for inclusion under derivatives, a broad framework can certainly be laid down. Thus, based on the recommendation of CDAC and in consultation with the stakeholders, it has been decided that the following criteria for eligibility, retention and re-introduction of derivative contracts on commodities shall be followed by all national commodity derivatives exchanges ('exchange').

   3.1. **<u>Eligibility criteria for allowing derivative contracts on commodities</u>**

a) Exchanges shall examine following basic parameters and the commodity may be permitted to be included under derivatives if such commodity satisfies these parameters.

I. Commodity Fundamentals

- Size of the market / Volume of the market**:** The total supply value of the commodity in each year is taken as a measure of the physical market size of that commodity in that year. A higher physical market size could create higher futures trading volume by attracting more hedgers and speculators into the futures market.

- Homogeneity/Standardization**:** The commodity should be either Homogeneous or should be conducive to standardization. This is required so that participants trading the commodity on exchange platform should be able to unambiguously understand exactly what they are trading as on exchange only standardized contracts can be traded.

- Durable / Storable**:** The commodity should be durable and storable for better price discovery. Durability i.e. higher shelf life makes commodity conducive for storage, which creates opportunity for cash and carry and hence would attract arbitragers thus make it more suitable for derivatives trading.

II. Trade Factors

- Global**:** Global market in a commodity could be a positive indicator as internationally linked commodity prices are influenced by various global factors and thus create multiple reference points for price discovery which may make it conducive for derivatives trading.

- Value chain**:** The term ''value chain'' describes the full range of value adding activities required to bring a product or service through the different phases of production, including procurement of raw materials and other inputs", connected along a chain of producing, transforming and bringing goods and services to end-consumers through a sequenced set of activities and a strategic network among a number of business organizations". Larger is the value chain larger would be the number of participants interested in derivatives trading of such commodity.

- Geographical coverage: The commodity should ideally have a vast distribution across the country. The coverage can be in the form of production of commodity or the distribution of the commodity across the country. Higher coverage would attract higher number of participants to the derivatives.

III. Ease-of-doing-business

- Price Control: Price controls are government mandated minimum or maximum prices that can be charged for specified goods. Government sometimes implements price controls when prices on essential items, such as food grain or oil are rising rapidly. Such goods which are prone to price control may be less conducive for derivatives markets.

- Applicability of other laws: The Food control Regulation Act, Essential commodities Act, APMC Act etc., may have an impact on the commodities to be introduced for derivatives trading. Commodities which have excessive restrictions may be less conducive for derivatives markets.

IV. Risk Management

- Correlation with International Market: Commodities which have a strong correlation with the global market have higher need for price risk management. Such commodities are conducive for derivatives trading.

- Seasonality: The Indian commodity sphere is characterized by seasonality. The prices fluctuate with the supply season and the off season. The derivatives market is necessary to even out this fluctuation and facilitate better price discovery. Thus the commodities with higher seasonality are conducive for derivatives trading.

- Price Volatility: Commodities with high volatility of prices have high need for hedging. Such commodities are conducive for Derivatives trading.

b) In order to bring in uniformity among the commodity derivatives exchanges, the indicative template as enclosed at **Annexure A** shall be adopted by the exchanges. In this regard the exchanges shall decide upon the specific numerical weightages as approved by their oversight committee for 'Product Design'.

c) The exchanges shall also analyze all the proposed commodities/ commodity derivatives contracts on the afore-said parameters comprised in the template and submit the same to SEBI while applying for the approvals along with necessary supporting documentary evidence.

3.2. **Applicability of the template on the commodities presently being traded**

a) As regards the commodities which are presently being traded on the exchange platforms, the exchanges shall apply the afore-said parameters comprised in the template on each of the commodities.

b) The results of such exercise is to be submitted to SEBI within a period of 3 months.

3.3. **Criteria for retention and reintroduction of derivative contracts on commodities**

a) For any commodity to continue to be eligible for Futures trading on Exchange, it should have annual turnover of more than ₹500 Crore across all National Commodity Derivatives Exchanges in at least one of the last three financial years. For validating this criteria, gestation period of three years is provided for commodities from the launch date/re-launch date, as may be applicable.

b) Once, a commodity becomes ineligible for derivatives trading due to not satisfying the retention criteria, the exchanges shall not reconsider such commodity for re-launching contract for a minimum period of one year.

c) Further, a commodity which is discontinued/suspended by the exchange from derivatives trading on its platform, shall not be re-considered by the concerned exchange for re-launching of derivatives contract on such commodity at least for a minimum period of one year.

4. The provisions of this circular shall come into effect from the date of the circular except for the provisions listed out at 3.3 above which will be effective from April 01, 2017.

5. This circular is issued in exercise of the powers conferred under Section 11(1) of the Securities and Exchange Board of India Act 1992 to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

6. The Exchanges are advised to:

   i. To make necessary amendments to the relevant bye-laws, rules and regulations.
   ii. Bring the provisions of this circular to the notice of the stock brokers of the Exchange and also to disseminate the same on their website.
   iii. Communicate to SEBI, the status of the implementation of the provisions of this circular.

7. This circular is available on SEBI website at www.sebi.gov.in under the category “Circulars” and “Info for Commodity Derivatives”.

Yours faithfully,

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Annexure A

Criteria for Commodity Eligibility for Derivative Products - Template

Section I

Particulars	**Weight**	**Sub-score**	**Details**
Parameter I - Commodity Fundamentals			
Size of commodity			This parameter relates to production, imports, carryover stocks etc…
Volume in cash market			The daily volumes in the underlying cash/spot/physical market may be a good indicator of the depth
Durability and Storability			Relates to the durability and duration for which the commodity can be stored
Homogeneous/ Standardization			Scope for standardization
Parameter I Score			
Parameter II - Ease of doing Business			
Particulars	**Weight**	**Sub-score**	**Details**
Prevalence of price controls			These parameters relates to the ease of doing business in commodity markets. Issues such as price controls, storage controls, Taxation etc., have a bearing on the trade. These parameters are also an indicator of what reforms should be brought in the commodity space in a regulated environment to be best in class globally.
Minimum Support Price (MSP) for the commodity			
Storage controls/ Stock Limits			
Government. Policy			
Applicability of other Laws			
Parameter II Score =			

Section II

Particulars	Weight	Sub-score	Details
Parameter III - Trade/ Business			
Global Trade - Imports or Exports			Importance in global trade and to our economy. Ability to add value to the base commodity. Commercial application, nature of buyers, Supply/demand gap etc.
Domestic market / Geographical coverage			
Presence of Value Chain participants (VCPs)			
Supply/ Demand			
Parameter III Score			
Parameter IV - Risk Management			
Particulars	**Weight**	**Sub-score**	**Details**
Correlation			The risk parameters viz., volatility, correlation with either domestic traded prices or globally traded prices, seasonality, liquidity, benefits to hedgers / farmer through direct / indirect participation and scope to hedge the price risk forms part of the Risk Management
Seasonality			
Basis Risk			
Volatility			
Hedging Incentive			
Liquidity			
Parameter IV Score			
Parameter V - Benchmark Potential			
Particulars	**Weight**	**Sub-score**	**Details**
Existence of Forward Trading in OTC markets			
Suitability for Futures/ Options Trading			
Potential to create a Domestic Benchmark			
Potential to create a Global Benchmark			
Parameter V Score			

<u>Section I Score =</u> Parameter I Score + Parameter II Score **<u>Section II Score =</u> Parameter III Score + Parameter IV Score + Parameter V Score** **Overall Score = Section I Score + Section II Score**
Note: • *Weight-ages in % and total of all weight-ages should be 100* • *Scores/Sub-scores are to be given in a range of 1 to 5* • *The following scale is to be used for scoring the parameters:* *1 : Poor* *2 : Reasonable* *3 : Good* *4 : Very Good* *5 : Excellent*