भारतीय प्रतिभूति और विनिमय बोर्ड
Securities and Exchange Board of India

Consultation paper on design of commodity indices and product design for futures on commodity indices

1. Objective

1.1. The objective of this consultation paper is to seek comments / views from the public on commodity index design and product design for futures on commodity indices.

2. Background

2.1. In the Union Budget Speech for the year 2016-17, the Hon'ble Finance Minister had announced that "new derivatives products will be developed by SEBI in the Commodity Derivatives Market". Introduction of new commodity derivatives products has been a subject of deliberation as it is considered to be conducive for the overall development of the commodity derivatives market, attracting broad based participation, enhancing liquidity, facilitating hedging and bringing in more depth to the commodity derivatives market.

2.2. The matter was discussed in the Commodity Derivatives Advisory Committee (CDAC) of SEBI and it had inter-alia recommended introduction of options, derivatives products on commodity indices and in later stage introduction of products such as weather derivatives, freight derivatives etc., in the Indian commodity derivatives markets to deepen as well as broaden them. Accordingly, SEBI vide circular dated September 28, 2016 allowed introduction of options in Commodity Derivatives Market. Further, vide circular dated June 13, 2017, SEBI issued Product Design and Risk Management Framework for options on commodity futures.

2.3. Index allows stakeholders to trade in an entire segment or basket, e.g. the entire base metal segment, through a single product. This facility is of immense use to SMEs and other small users who are exposed to the volatility in prices of the entire segment. Index trading allows funds to track commodity basket prices, rather than a single commodity price. Retail investors can participate in these funds and get the benefits of trading in commodity basket.

2.4. It was envisaged that Index-based products will also encourage the participation of institutions such as mutual funds, insurance companies etc., in the commodity derivatives market. Further, trading in derivatives products on commodity indices may also increase liquidity in underlying commodity derivatives products (futures and options) as entities would like to carry out arbitrage trades across index products and constituents or may use one product to hedge their positions in other.

2.5. The CDAC recommended that to begin with, futures contracts on commodity indices may be launched by exchanges.

2.6. Accordingly, draft norms for design of commodity indices and draft product design for futures on commodity indices have been prepared as given in subsequent paragraphs.

A. Design of Index

A.1. **Underlying**: Indices {composite i.e., comprising of commodities from more than one sector and sectoral} meeting the eligibility criteria prescribed herein are permitted. Exchanges shall ensure that such indices are compliant with IOSCO Principles for Financial Benchmarks for being eligible to launch derivatives upon and make necessary disclosures in this regard on their websites. Further the exchanges shall also ensure that an index is not susceptible to manipulation and exchanges shall make mandatory disclosure with respect to the Index design parameters on their website.

A.2. **Name:** The name of index should include the name of the exchange on which the constituents of index are traded.

A.3. **Eligibility criteria:** The constituent futures contracts of an index shall meet the following eligibility criteria at the time of inclusion/re-balancing-

a. Futures contracts should be in existence on the respective exchange for **at least previous twelve months/previous calendar year/previous financial year.**

b. The contracts shall be traded for at least 90% of trading days during the **previous twelve months/previous calendar year/previous financial year.**

c. The average daily turnover of the constituent futures contracts during the **previous twelve months/previous calendar year/previous financial year** is at least :

- INR 75 Crore for agricultural and agri-processed commodities
- INR 500 Crore for all other commodities.

However, the above turnover requirements may not be applicable for sectoral indices subject to exchanges ensuring that constituent futures have adequate liquidity.

A.4. **Re-balancing:**

a. The index constituents and their weightage will be periodically (say half-yearly or annually) selected and rebalanced.

b. However, in case of extraordinary event such as ban / suspension of trading of an index constituent, following action will be taken by exchange-
   - Reselection of commodities (excluding banned/suspended commodities)
   - Recalculation of weightage

The index changes shall be implemented only after market hours.

c. If any of the commodity futures constituent of an index fails to meet the eligibility criteria, it shall cease to be a constituent of the index, when index is re-balanced.

A.5. **Weight of constituents:**

a. Index constituents will be assigned weightage based on their production value and liquidity value with appropriate weightages pre-decided by exchange for production value and liquidity value (provided that weightage of either shall not be less than 25%). The liquidity value will be total traded value of the index constituent on the exchange platform in the preceding twelve months prior to the construction / re-balancing of the index. The production value will be average of the value of deliverable supply of underlying commodity for past five financial years prior to the construction / re-balancing of the index.

b. Maximum weightage for any index constituent in a composite index will be at most 20% and minimum weightage will be at least 1%. However, these weightage caps may not be applicable for sectoral indices subject to exchanges ensuring that a single constituent does not get heavily weighted in an index.

c. In case of index having multiple commodity groups, exchanges may put in place maximum and minimum weightages for a commodity group.

A.6. **Computation and roll over**

a. The index value will be computed using the nearest expiry futures prices of the index constituents.

b. Exchange shall put in place a transparent methodology for gradual roll over of all index constituents from nearest expiry month to next month taking into account the liquidity in the underlying nearest expiry/next contracts.

A.7. **Real time dissemination:** The index value shall be updated on real time continuous basis and shall be displayed on the Exchange website.

A.8. **Dissemination of methodology:** Exchange shall ensure a transparent methodology of index construction, calculation, roll over, periodic rebalancing etc. and disseminate the same on its website.

B. Product Design of Futures on Index

B.1. **Trading Hours:** The trading hours will be in line with the trading hours for underlying futures. In case trading hours vary for constituents, trading hours for index derivatives shall be kept such that it is available for trading whenever any of the constituent futures contract is available for trading.

B.2. **Size of the Contract:** At least INR 5 lakh at the time of introduction in the market.

B.3. **Tenor of the Contract:** To begin with maximum tenor of contracts shall be 6 months.

B.4. **Available Contracts:** Stock Exchanges shall decide the number of contracts, duration of contracts and launch calendar based on market requirements.

B.5. **Position Limits:**

a. **Client level:** Client level position limits shall be higher of:
5% of the total open interest in the market in commodity index futures
Or
1000 lots

b. **Trading Member level:** Trading member level position limits shall be higher of:
15% of the total open interest in the market in commodity index futures
Or
3000 lots

B.6. **Daily Price Limit:** Stock Exchanges shall decide appropriate daily price limits for commodity index futures.

B.7. **Settlement Mechanism:** Final Settlement for futures on commodity index shall be done in cash.

B.8. **Final Settlement Price:** The final settlement price shall be the closing price of the underlying index on the day of expiry. The closing price of the underlying index shall be based on last half an hour VWAP (Volume Weighted Average Price) of the constituents of the underlying index.

B.9. **Expiry:** The stock exchanges shall have the flexibility to set the expiry date for contracts. However, the expiry date may not coincide with the roll-over period of the constituents of the underlying index.

B.10. **Application:** Before launching any futures contract on an index, a Recognised Stock Exchange with commodity derivative segment shall submit its proposal with contract specifications and risk management framework to SEBI, for approval.

C. Risk Management Framework: Exchanges shall adopt risk management framework compliant with the CPMI-IOSCO Principles for Financial Market Infrastructures, including the following:

C.1. **Margining model and quantum of initial margins**: Exchanges shall adopt initial margin models and parameters that are risk-based and generate margin requirements sufficient to cover potential future exposure to participants/clients in the interval between the last margin collection and the close out of positions following a participant/client default. The model should:

a) use a conservative estimate of the time horizons for close out of the positions (including in stressed market conditions),

b) have an appropriate method for measuring credit exposure that accounts for relevant risk factors and portfolio effects, and

c) to the extent practicable and prudent, limit the need for destabilising, pro-cyclical changes.

Initial margin requirement shall be adequate to cover at least 99% VaR (Value at Risk) and Margin Period of Risk (MPOR) shall be at least two days. In case of portfolio based margining, this requirement applies to each portfolio's distribution of future exposure.

Accordingly, exchanges shall fix prudent price scan range, and/or plausible changes in any other parameters impacting futures price.

C.2. **Margining at client level**: Exchanges shall impose initial margins at the level of portfolio of individual client.

C.3. **Real time computation**: Though the margining models may update various scenarios of parameter changes (underlying price, volatility etc.) at discrete time points each day (at least every two hours), the latest available scenarios shall be applied to client portfolios on a real time basis.

D. Disclosure: Exchange shall make necessary disclosures such as the open interest of top 10 largest participants/group of participants in index derivatives (both long and short) and the details of their combined open interest in underlying constituents etc., to the public.

E. Surveillance: The Exchanges shall augment their monitoring and surveillance capacity.

3. Public comments: Public comments are invited on the proposal contained in this consultation paper. Comments/suggestions may kindly be provided in the format given below:

Name of Entity/Person intermediary/ Organization			
Sr. No.	***Para No. of Paper***	***Suggestions ****	***Rationale***
** Any other suggestions on the subject, including on issues not covered in this paper, may also be given*			

The comments may be sent by email to cdmrd_dmp@sebi.gov.in or alternatively may be sent to following address latest by one month from the date of issue of the consultation paper i.e. **January 16, 2019.**

Shri Vikas Sukhwal,

Deputy General Manager,

Division of New Products and Market Policy,

Commodity Derivatives Market Regulation Department

Securities and Exchange Board of India

SEBI Bhavan, Plot C4-A, G-Block,

Bandra Kurla Complex,

Mumbai – 400051