



CIRCULAR

SEBI/HO/CDMRD/DMP/CIR/P/2017/55

June 13, 2017

To,

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

Dear Sir / Madam,

**Sub: Options on Commodity Futures- Product Design and Risk Management Framework**

1. In consultation with Commodity Derivatives Advisory Committee (CDAC), SEBI vide Circular SEBI/HO/CDMRD/DMP/CIR/P/104 dated September 28, 2016 decided that Commodity Derivatives Exchanges shall be permitted to introduce trading in options. This circular is hereby being issued to stipulate necessary guidelines with regard to the product design and risk management framework to be adopted for trading in options on commodity futures.
2. The product design and risk management framework would be in conformity with the guidelines prescribed in **Annexure 1** enclosed with this circular.
3. **Eligibility criteria for selection of underlying Commodity Futures for Options:** Options would be permitted for trading on a commodity derivatives exchange only on those commodity futures as underlying, which are traded on its platform and satisfy both the criteria specified below on the respective exchange:
  - a. The underlying 'Futures contracts' on the corresponding commodity shall be amongst the top five futures contracts in terms of total trading turnover value of previous twelve months;
  - b. The average daily turnover of underlying futures contracts of the corresponding commodity during the previous twelve months, shall be at least :
    - I. INR 200 crore for agricultural and agri-processed commodities
    - II. INR 1000 crore for other commodities.



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4. It is decided that initially, on a pilot basis each exchange shall be allowed to launch options on futures of only one commodity that meets the criteria prescribed above.
5. The Commodity derivatives exchanges willing to start trading in options contracts shall take prior approval of SEBI for launching such contracts.
6. The circular shall be effective from the date of this circular.
7. The Exchanges are advised to:
  - i. take steps to make necessary amendments to the relevant bye-laws, rules and regulations for the implementation of the same,
  - ii. bring the provisions of this circular to the notice of the members 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.
8. This circular is issued in exercise of 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.
9. This circular is available on SEBI website [www.sebi.gov.in](http://www.sebi.gov.in) under the category “Circulars” and “Info for Commodity Derivatives”.

Yours faithfully,

Vikas Sukhwal  
Deputy General Manager  
Division of Market Policy  
Commodity Derivatives Market Regulation Department  
Email: [vikass@sebi.gov.in](mailto:vikass@sebi.gov.in)



Annexure 1

**A. Product Design for Options on Commodity Futures:**

1. **Underlying:** Commodity futures contract (of a specified month) traded on the corresponding exchange.
2. **Settlement Method:** On exercise, option position shall devolve into underlying futures position as follows:-
  - long call position shall devolve into long position in the underlying futures contract
  - long put position shall devolve into short position in the underlying futures contract
  - short call position shall devolve into short position in the underlying futures contract
  - short put position shall devolve into long position in the underlying futures contract

All such devolved futures positions shall be opened at the strike price of the exercised options.

3. **Exercise Style:** To begin with European Style options are permitted.
4. **Minimum Strikes:** Each option expiry shall have minimum three strikes available viz., one each for In the Money (ITM), Out of the Money (OTM) and At the Money (ATM).
5. **Exercise Mechanism:**

On expiry, following mechanism shall be adopted by Exchanges for exercise of the options contracts:

- 5.1. Option series having strike price closest to the Daily Settlement Price (DSP) of Futures shall be termed as At the Money (ATM) option series.

This ATM option series and two option series having strike prices immediately above this ATM strike and two option series having strike prices immediately below this ATM strike shall be referred as 'Close to the money' (CTM) option series.



In case the DSP is exactly midway between two strike prices, then immediate two option series having strike prices just above DSP and immediate two option series having strike prices just below DSP shall be referred as 'Close to the money' (CTM) option series.

- 5.2. All option contracts belonging to 'CTM' option series shall be exercised only on 'explicit instruction' for exercise by the long position holders of such contracts.
- 5.3. All In the money (ITM) option contracts, except those belonging to 'CTM' option series, shall be exercised automatically, unless 'contrary instruction' has been given by long position holders of such contracts for not doing so.
- 5.4. All Out of the money (OTM) option contracts, except those belonging to 'CTM' option series, shall expire worthless.
- 5.5. All exercised contracts within an option series shall be assigned to short positions in that series in a fair and non-preferential manner.
6. **Trading Hours:** Trading hours shall be same as those of corresponding futures contract.
7. **Expiry Day:** Expiry day of options contracts shall be decided by Exchange based upon period of high liquidity of underlying futures contract and shall be part of option contract specifications.
8. **Position Limits:**
  - 8.1. SEBI vide Circular [SEBI/HO/CDMRD/DMP/CIR/P/2016/96](#) dated September 27, 2016 prescribed norms for position limits for commodity futures. Position limits for options shall follow the same norms as provided in the said circular for futures.
  - 8.2. Position limits of options would be separate from position limits of futures contracts and numerical value for client level/member level limits shall be twice of corresponding numbers applicable for futures contracts provided in Annexure- A of the SEBI circular dated September 27, 2016.
  - 8.3. Due to separate position limits for options, there is a possibility that post exercise of options i.e. after devolvement of options into corresponding futures positions open positions for clients/members may exceed their



permissible position limits for future contracts. For such clients/members Exchanges may permit maximum up to two trading days post option expiry day to reduce their futures positions to bring them within the permissible position limits.

**B. Risk Management Framework:**

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

9.1. **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 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, volatility scan range and/or plausible changes in any other parameters impacting options price. Exchange shall impose appropriate short option minimum margin, calendar spread charge and extreme loss margin for option contracts.

9.2. **Margining at client level:** Exchanges shall impose initial margins at the level of portfolio of individual client comprising of his positions in futures and options contracts on each commodity.

9.3. **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.

9.4. **Mark to market:** Exchanges shall mark to market the options positions by deducting/adding the current market value of options (positive for long options and negative for short options) times the number of long/short options in the portfolio from/to the margin requirement. Thus, mark to market gains and losses would not be settled in cash for options positions.

9.5. **Risks pertaining to options that devolve into futures on expiry:**

- a) For handling increase in margins on expiry when options devolve into futures position, specifically for long option positions which are probable to be exercised, exchanges shall start sensitizing the option holders of the impending increase in margins (along with the estimated increase) at least few days in advance, and/or, based on their risk perception, may also consider gradually collecting increased margins during the last few days so as to have adequate margins to cover the risk of futures position that will be created on devolvement of options into futures.
- b) As per the provisions of SEBI circular [SEBI/HO/CDMRD/ DRMP/ CIR/P /2016/80](#) dated September 07, 2016, penalty is levied on members for short-collection/non-collection of the initial margins. Penalty for such short-collection/non-collection due to increase in initial margins resulting from devolvement of options into futures may not be levied by Exchanges for the first day.

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