REGULATIONS GOVERNING INDEX OPTION CONTRACTS

[GAZETTE NOTIFICATION OF MAY 02, 2012]

REGULATIONS GOVERNING INDEX OPTION CONTRACTS OF THE KARACHI STOCK EXCHANGE (GUARANTEE) LIMITED

1. **PREAMBLE**

WHEREAS in order to introduce Index Option Contracts at the Karachi Stock Exchange it is desirable that necessary Regulations be framed to regulate Index Option Contracts.

In exercise of the powers conferred under Sub-Section (1) of Section 34 of the Securities & Exchange Ordinance, 1969, the Karachi Stock Exchange (Guarantee) Limited, with the prior approval of Securities & Exchange Commission of Pakistan, hereby makes the Regulations Governing Index Option Contracts, as mentioned below:

2. **SHORT TITLE AND COMMENCEMENT**

(i) These Regulations shall be called "The Regulations Governing Index Option Contracts".

(ii) These Regulations shall come into force with immediate effect.

3. **DEFINITIONS**

In these regulations, unless the subject or context otherwise requires:

(i) **At the money** means when the Exercise Price of the Option Contract is at the same level as the Exercise Settlement Index Level. All At the money Option Contracts shall, for the purpose of exercise be considered the same as Out of the money Option Contracts and expire without getting exercised at the end of the Option Contract.

(ii) **Board** means, Board of Directors of the Karachi Stock Exchange (Guarantee) Limited.

(iii) **Broker** means, any member of the Exchange engaged in the business of executing transactions in securities for the account of others and for his own account and is registered with the Commission under the Brokers and Agents Registration Rules, 2001.

(iv) **Call Option** means, the Option Contract which gives the buyer/holder a right to buy the Underlying Index at the Exercise Price at the end of a specified period as per the terms of these Regulations.

(v) **Clearing Company** means, the National Clearing Company of Pakistan Limited

(vi) **Commission** means, the Securities and Exchange Commission of Pakistan

(vii) **Contract Multiplier** means, the numeric value of Rs. 5.00 or any other amount as may be prescribed by the Exchange from time to time with the prior approval of the Commission.

(viii) **Contract Value** means, the value of Option Contract arrived at by multiplying the Exercise Price with the Contract Multiplier.

(ix) **Daily Settlement Price** means, the Weighted Average of the index levels of the Underlying Index during the last hour of trading, multiplied by the Contract Multiplier and expressed in Pakistani Rupees.

(x) **European Style Option Contract** means, an Option Contract, which shall only be exercised on the Expiration Day.

(xi) **Exchange** means, the Karachi Stock Exchange (Guarantee) Limited.

(xii) **Exercise Price Interval** means, the gap to be maintained between any two successive Exercise Prices as specified in the contract specifications of each Option Contract which the Exchange may prescribe with the approval of the Commission from time to time.

(xiii) **Exercise Price** means, a fixed index level of the Underlying Index which the buyer/holder of Option Contract can buy (in case of Call Option), or sell (in case of Put Option) as per these Regulations.

(xiv) **Exercise Settlement Index Level** means, the index level calculated based on a set of 121 readings of 15 second intervals (price points) of the underlying index levels taken between the last half an hour of trading. The highest and lowest 20 price points will be ignored and the closing price computed as an average of the remaining 81 price points will be the Exercise Settlement Price for the settlement of the Option Contract.

(xv) **Exercise Settlement Value** means, the difference between the Contract Value and the Exercise Settlement Index Level multiplied by the Contract Multiplier and its absolute value expressed in Pakistani Rupees on the Expiration Day.

(xvi) **Expiration Day** means, the day on which the final settlement obligations are determined in the Option Contract.

(xvii) **Exposure** means the amount determined in accordance with the Risk Management Regulations as amended from time to time.

(xviii) **In the money** in case of Call Option means, when the Exercise Price of the Option Contract is less than the Exercise Settlement Index Level and in case of Put Option means, when the Exercise Price of the Option Contract is greater than the Exercise Settlement Index Level. All in the money Option Contracts shall be automatically exercised at the end of the Option Contract.

(xix) **Index Options Market** means, a Market made available by the Exchange for trading in Option Contracts subject to these Regulations.

(xx) **Mark-to-Market Loss** shall have the same meaning as defined under the Regulations governing Risk Management of the Exchange, as amended from time to time.

(xxi) **Mark-to-Market Profit** shall have the same meaning as defined under the Regulations governing Risk Management of the Exchange as amended from time to time.

(xxii) **Open Interest** means, the total value and number of Option Contracts of a broker and his clients in a particular Underlying Index which have not been subject of offsetting transactions nor reached Expiration Day. For calculation of open interest only one side of the Option Contract is counted.

(xxiii) **Option Contract** means, a standardized Option Contract which gives the buyer/holder of the Option Contract the right (but not the obligation) to buy and/or sell the Underlying Index at the Exercise Price at the end of the Option Contract. The Option Contract shall be subject to these Regulations and as per the contract specifications provided in Annexure-A.

(xxiv) **Option Seller** means a buyer/ holder who squares off an earlier open purchase position in an option contract by selling an option contract in the same Option Series and Option Type.

(xxv) **Option Series** means, all Option Contracts of a particular Underlying Index having same Exercise Price and Expiration Day.

(xxvi) **Option Type** means, the classification of an option as either a Put or a Call.

(xxvii) **Option Writer** means, a broker or any other institution permitted by the Exchange to write Option Contracts based on the eligibility criteria devised by the Exchange with prior approval of the Commission.

(xxviii) **Out of the money** means in case of Call Option, when Exercise Price of the Option Contract is greater than the Exercise Settlement Index Level and in case of Put Option, when Exercise Price of the Option Contract is less than Exercise Settlement Index Level. All Out of the money Option Contracts shall expire without getting exercised at the end of the Option Contracts.

(xxix) **Premium** means, the price obtained by the product of index points and the Contract Multiplier which the buyer of the Option Contract pays to the Option Writer and/or Seller of the Option Contract for the rights conveyed by the Option Contract. Premium shall be quoted in index points.

(xxx) **Put Option** means, the Option Contract which gives the buyer/holder a right to sell the Underlying Index at an Exercise Price at the end of a specified period as per the terms of these Regulations.

(xxxi) **Underlying Index** means, the Index as may be defined by the Board for the purpose of trading in Index Options Market based on the criteria devised by the Exchange with prior approval of the Commission.

4. **TRADING**

(i) Trading in Option Contracts shall take place only through the Karachi Automated Trading System (KATS).

(ii) Any broker of the Exchange can enter into Option Contracts under these Regulations subject to prior notification in writing and payment of Rs.25,000/- in cash to the Exchange, as basic deposit. This deposit along with any return earned on it is to be kept separate by the Exchange and cannot be used for purposes other than to meet any obligations of the broker to the Exchange arising from the Index Options Market.

Provided that only a broker who meets the eligibility criteria, as prescribed by the Exchange with prior approval of the Commission, may write Option contract either for his proprietary position or on behalf of its institutional clients which also meet the eligibility criteria mentioned above.

Provided that the basic deposit paid by a broker under these Regulations may be utilized against exposure margin of such broker in the Index Options Market during the trading hours. However, the basic deposit, so utilized, shall be replenished by the broker at the end of each trading day.

Provided further that in case of broker’s default, this deposit shall be utilized in accordance with the Members’ Default Management Regulations of the Exchange.

(iii) The Contract Specifications as determined by the Board and approved by the Commission and attached hereto as Annexure-A, shall form part of these Regulations.

(iv) The Option Contract as specified in these Regulations shall be deemed to have taken place when a buyer/seller accepts a bid/offer in the Index Options Market.

(v) All offers/bids made may be accepted for or up to the limit of the offer/bid as prescribed by the Exchange from time to time and the broker making an offer/bid shall be bound by the Option Contract.

(vi) Upon Opening of any Option Contract, the Exchange shall notify the name of the Option Contract and the date of opening and closing of such Contract, the date of settlement of the said Contract and other relevant details governing such Contract as per Annexure-A.

(vii) There shall be a minimum of fourteen standardized 90 days Option Contracts which shall be issued each month on the first trading day following last Friday of each month for each Underlying Index. The Exchange shall ensure that three In the money, three Out of the money and one At the money Option Contracts in each Option Type shall remain available for trading at all times.

(viii) The Expiration Day for the 90 days Option Contracts shall be the last Friday of the third month of the Option Contract. If the last Friday is a trading holiday the Option Contract shall expire on the previous trading day. No overlapping period is allowed in options contracts.

(ix) The Exchange shall issue Option Contracts of same Expiration Day at new Exercise Prices on real-time basis using 50 points Exercise Price Interval based on the level of the Underlying Index.

(x) Trading shall be permitted only in available Option Series and opening of new Option Series shall not affect other Option Series opened previously.

(xi) Only an eligible Option Writer shall be allowed to write an Option Contract without any open purchase position in such Option Series. Provided that a buyer/ holder of an Option Contract may sell an option contract in the same Option Series only to the extent of squaring up an earlier open purchase position in the same Option Series.

(xii) There will be no adjustment for cash Dividends, Bonus and Right issue in the Index Option Contracts.

5. <u>CLEARING, SETTLEMENT AND RISK MANAGEMENT</u>

(i) Deposit against exposure shall be payable by the Option Writer as per VaR margins on the total exposure in Index Options Market as prescribed in the Regulations Governing Risk Management from time to time.

(ii) Exposure shall be calculated in accordance with the netting regime prescribed in the Regulations Governing Risk Management as amended from time to time.

(iii) The Option Writer would be subject to all applicable margins and mark-to-market losses as prescribed in the Regulations governing Risk Management as amended from time to time.

(iv) No margins shall be applicable on the buyer of the Option Contract other than pre-trade and VaR margins on exposure, calculated in accordance with the Regulations Governing Risk Management, which shall be levied on real-time basis, till the completion of pay-in towards Premium settlement.

(v) The Premium shall be payable by buyer/holder of the Option Contract in cash on T+0 basis and distributed onwards by the Exchange to the Option Writer and/or Option Seller on a T+1 basis.

(vi) Mark-to-Market losses determined by the Exchange at the end of a trading day based on the Daily Settlement Price shall be collected only from the Option Writer as per Schedule 2 of the Regulations Governing Risk Management of the Exchange by the Clearing Company on T+0 settlement basis (by day-end on trade day).

(vii) The Exchange shall withhold Mark to Market profits, if any, of a Broker on his proprietary or client account in an option contract until the settlement of such contract.

(viii) Exercise Settlement shall take place on the next trading day after expiry of the Options Contract and the resulting profits or losses, calculated on the basis of "Exercise Settlement Index Level" shall be settled in cash. The collection and payment of profits or losses on Exercise Settlement to/from brokers shall be done by the Clearing Company within the stipulated time and in the prescribed manner as per its Regulations and Procedures.

(ix) In case any broker fails to make any payment to the Exchange and/or Clearing Company within the stipulated time, the Exchange and Clearing Company shall initiate necessary action against such broker as per their respective default management regulations.

(x) For the purpose of calculating the position limits in the Index Options Market the open interest in all Option Contracts of a particular Underlying Index on UIN basis would be taken into account.

(xi) For the purpose of determining broker-level and client level open interest for calculation of Position Limits, no netting shall be allowed across offsetting position in Option Contracts of a particular Underlying Index having different Expiration Day.

6. **GENERAL**

(i) It shall be obligatory upon the brokers transacting in Index Options Market under these regulations to take such margins from their clients which shall not be less than the margins as prescribed in these regulations and under the Regulations governing Risk Management of the Exchange and the same margin shall be deposited to the Exchange against the respective exposure of the clients. The Exchange shall ensure compliance of this requirement.

(ii) In addition to the regulations mentioned in Clause 5 above, the Exchange may, with the prior written approval of the Commission, impose any further risk mitigating conditions and risk management measures to protect the interest of Exchange and to provide comfort to investors both local and international.

(iii) A broker shall not directly or indirectly enter into any arrangement or adopt any procedure for the purpose of evading or assisting in the evasion of the requirements prescribed under these Regulations. The Exchange shall have the powers to investigate and/or take appropriate action in case any contravention of these Regulations and/or malpractice by a Broker or his client is detected.

(iv) The Board may, with the prior approval of the Commission, make changes in these Regulations after giving reasonable notice.

(v) The KSE Management shall place on its website necessary and relevant information with respect to Open Interest and other ancillary information on daily basis.

(vi) Further provisions relating to risk management including Open Interest, Mark-to-Market Losses, Exposure Margins, etc. shall be applicable as provided under the Regulations Governing Risk Management of the Exchange.

ANNEXURE-A

CONTRACT SPECIFICATION FOR INDEX OPTION CONTRACTS

Contract/Index Multiplier	Rs. 5.00 per index point or any other amount as may be determined by the Exchange from time to time with the prior approval of the Commission.
Contract Description	European Style, Index Calls and Puts
Minimum Fluctuation (Tick Size)	One Index Point
Exercise Style	European
Currency	Pakistan Rupee
Exercise Price Interval	50 Index Points (3-1-3) (3 OTM, 1 ATM, 3 ITM)
Period of Contract	90 days
Opening of Contract	First Trading day of the next week following the close of the Option Contract.
Expiration Day/ Last Trading day	Last Friday of the calendar month in which the Option Contract is to expire.
Trading Hours	As may be notified by the Exchange from time to time.
Margin Requirements	Exposure Margin shall be in accordance with Underlying Index VaR as provided in the Regulations Governing Risk Management.