Press Release

SECP approves regulations for index option contracts at KSE

ISLAMABAD, April 25: In line with its efforts to strengthen the capital market in Pakistan by further developing the derivatives market segment and providing investors with more diversified range of investment/hedging alternatives, the SECP has approved the Regulations Governing Index Option Contracts of the Karachi Stock Exchange (KSE). These regulations have been framed in line with best international practices to provide a framework for the launch of trading in cash-settled index option contracts.

An option contract essentially gives its holder a right, but not the obligation to buy or sell an underlying asset on a future date at a predetermined price. Based on his expectations and prevailing market conditions, the option holder can either exercise this right and book profits from buying/selling the underlying at a favorable price than the market price or let the right lapse if he thinks the same will not benefit him. Like other derivative instruments, options are also tradable and the option holder can sell them to exit the market earlier than maturity.

Options are broadly classified into two types, “call” and “put”. Option contracts that give the buyer the right to buy an underlying asset are called “call options”, whereas contracts which give the buyer the right to sell the underlying asset are called “put options”. The buyer of the option contract must pay a nominal price called “premium” to the option writer to become entitled to the rights conveyed by such contracts. The options market operates on the principle that risk of the holder of the option contract is limited to the extent of premium, thus promising limited downside losses and unlimited upside gains.

All over the world underlying assets for which option contracts are offered include single stocks, commodities and renowned market indices. More developed derivatives markets offer options on commodity, stock and index futures contracts as well. The concept of options is not new to the Pakistani market, as market participants have historically been known to trade on the market sentiment on the indices and listed securities termed as *Tezi, Mandi*. However, such trades were being executed bilaterally between members, outside the centralized trading platforms of the stock exchanges. The regulations approved by the SECP regularize such trading activity and would ensure that trading of standardized index based option contracts now takes place on the Karachi Automated Trading System (KATS). These contracts having indices as the underlying assets would give the buyer a right to buy or sell a specific level of the underlying index.

The SECP approved regulations prescribe that while any investor can buy/sell option contracts, option writing will be limited to brokers and financial institutions that fulfill the criteria to be approved by the KSE and SECP. A criterion would also be devised for determining eligibility of the underlying indices on which option contracts would be offered by the exchange.

Today options have become an indispensable tool for the securities industry globally and provide various benefits such as helping create orderly, efficient, and liquid markets, and giving flexibility, leverage and risk minimization to investors. Because of their unique risk/reward structure, options can be used in many combinations with other option contracts and financial instruments to create a hedged or speculative position.

Introduction of options in the Pakistani capital market would not only improve its outlook, but would also further diversify the existing product portfolio for investors and allow them to leverage positions for large diversified portfolios. The avenues for the launch of options contracts on single stocks would also be assessed once the index-based options are launched after requisite system developments at the KSE.

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