

Consultation Paper on 'Phased Introduction of Physical Settlement in Select Agricultural Commodity Derivatives Contracts'

1. Objective:

1.1 This consultation paper seeks stakeholder views on a proposal to permit exchanges, on a pilot basis, to introduce delivery-based agricultural commodity derivatives contracts that commence trading as financially-settled contracts and mandatorily transition into physically settled contracts upon the occurrence of predefined objective thresholds.

2. Background:

2.1 Commodity derivatives markets play a vital role in the efficient functioning of agricultural value chains by facilitating price discovery, risk management, and market transparency. In India, agricultural commodity derivatives have historically been envisaged as instruments closely linked to the physical market, with physical settlement viewed as a key mechanism for ensuring convergence between futures and spot prices.

2.2 Over the years, the regulatory framework governing commodity derivatives has progressively strengthened delivery-based settlement norms, particularly for agricultural commodities. The emphasis on physical settlement has been guided by the objectives of promoting hedging by genuine participants, discouraging excessive speculation, and ensuring that futures prices reflect underlying physical demand and supply conditions.

2.3 At the same time, market experience suggests that the imposition of compulsory physical settlement from the inception of a contract may, in certain cases, inhibit liquidity formation and broader participation, especially during the early stages of contract development. In this context, there is a need to examine whether a calibrated and phased approach to physical settlement could help balance market development objectives with the overarching regulatory goal of maintaining strong linkage with the physical market.

3. Regulatory Context and Evolution of Settlement Framework in Agricultural Commodities

3.1 Agricultural commodity derivatives in India have undergone significant regulatory evolution over the past two decades. Initially, many contracts were designed with cash settlement or optional delivery mechanisms. Over time,

concerns regarding excessive speculation, weak convergence, and limited participation of genuine hedgers led to a policy shift in favour of compulsory physical settlement.

3.2 Following the integration of commodity derivatives regulation with SEBI, greater emphasis was placed on aligning futures markets with the physical ecosystem. Physical settlement was viewed as a means to strengthen the credibility of futures prices, promote participation by farmers, traders, processors, and other commercial users, and discourage purely speculative activity disconnected from physical fundamentals.

3.3 Section 11.9 of Chapter 11 of the SEBI's Master Circular for Commodity Derivatives Segment, dated August 04, 2023, prescribes the criteria for Settlement Mode of Commodity Derivative Contracts.

11.9.1. The first preference of settlement type for commodity derivatives contracts shall always be by the way of physical delivery.

11.9.2. Any exemption from the above i.e. cash settlement of commodity derivatives contract, may be considered only in following scenarios with a proper justification –

i. Physical delivery is difficult to implement due to any reason, which may inter-alia include the following:

a. commodity is intangible; or

b. commodity is difficult to store may be due to low shelf life or inadequate storage infrastructure; or

c. it is difficult to physically handle and transport the commodity due to inadequate logistics and transport infrastructure.

ii. There is availability of reliable benchmark price of the commodity which can be used as reference for settlement price. Stock Exchanges shall satisfy themselves that the reference spot price is robust – fair indicator of prevailing prices and not susceptible to any distortion/manipulation.

3.4 While this framework has improved market discipline in several commodities, it has also highlighted structural challenges, for instance:

3.4.1 Liquidity formation in several agricultural contracts remains constrained, especially at the launch or relaunch stage. Low volumes and limited open interest can reduce market confidence, creating a feedback loop that further suppresses participation.

3.4.2 Although accredited warehouses and assaying mechanisms have expanded, their utilisation in certain commodities remains limited.

4. Proposed Framework for a Phased Approach to Physical Settlement

- 4.1 It is proposed that the Exchanges may be permitted to allow reviving existing illiquid contract and/or launch new delivery-based contracts on select agricultural commodities that commence trading as financially-settled contracts and mandatorily transition into physically settled contracts upon the occurrence of predefined objective thresholds.
- 4.2 Such contracts may enjoy exemption from settlement via physical delivery till the contract crosses a certain Average Daily Traded Volume (ADTV) and/or Open Interest or after expiry of two years, whichever is earlier.
- 4.3 The phased introduction of physical settlement is particularly relevant for such agricultural commodity derivatives that have historically faced issues like contract discontinuation, thin liquidity, etc. A selected agri commodity may be introduced under the framework, which would allow market participants to build familiarity and liquidity, while giving time for strengthening backend infrastructure. Once sufficient depth and participation are achieved, a gradual transition to physical delivery can help to reduce the risk of repeated contract failures. On a pilot basis, a couple of commodities could be considered under the proposed framework, for example, maize or groundnut or chilli.

5. Rationale for a Phased Approach to Physical Settlement

- 5.1 The proposal to permit select delivery-based agricultural commodity derivatives contracts to initially trade as financially-settled contracts is grounded in the need to adopt a calibrated regulatory approach that supports market development without diluting the foundational role of physical settlement in agricultural derivatives.
- 5.2 Physical settlement has been a cornerstone of India's regulatory framework for agricultural commodity derivatives, aimed at ensuring convergence between futures and spot prices and anchoring derivatives trading to underlying physical market fundamentals. This approach has strengthened market integrity and discouraged purely speculative activity. However, experience suggests that regulatory frameworks must also account for varying levels of market maturity across commodities.

- 5.3 In the case of newly introduced or thinly traded agricultural contracts, compulsory physical settlement from inception may unintentionally restrict participation to a narrow set of market participants who are operationally capable of taking or giving delivery. This can slow liquidity formation and weaken the price discovery function in the early stages of contract life.
- 5.4 Liquidity is a prerequisite for effective price discovery. In the absence of adequate trading volumes and open interest, futures prices may be volatile, susceptible to episodic trading, and less representative of underlying supply–demand conditions. Temporary cash settlement can encourage wider participation, thereby supporting deeper order books and more efficient pricing.
- 5.5 International and domestic experience indicates that newly launched commodity contracts are vulnerable to failure if they do not achieve critical mass within a reasonable period. Low liquidity, wide bid–ask spreads, and limited participant diversity can create a self-reinforcing cycle of declining interest.
- 5.6 The proposed framework seeks to balance these considerations by allowing temporary flexibility in settlement methodology, while reaffirming physical settlement as the eventual and mandatory outcome. A phased settlement approach recognises that building confidence in contract specifications, delivery standards, and warehouse systems requires time. Allowing contracts to initially operate as financially-settled instruments provides market participants with an opportunity to understand contract behaviour and price dynamics before being exposed to delivery obligations.
- 5.7 The proposal incorporates objective and transparent triggers—such as average daily traded value, open interest thresholds, or a predefined time period—for transitioning to mandatory physical settlement. This ensures that the flexibility provided is neither open-ended nor discretionary.
- 5.8 It is emphasised that the proposed approach does not represent a shift away from physical settlement as a regulatory principle. Contracts will be designed as delivery-based instruments from inception, with full specifications for quality, delivery centres, and settlement procedures. The financially-settled phase of the contract is envisaged purely as a transitional arrangement and shall be considered for agricultural commodities that fulfil a set of pre-defined criteria.

6. Comments / Suggestions Sought

Comments / suggestions are invited on the following aspects of the proposal:

- 6.1 Appropriateness of the Proposed Framework:** Do you agree with the proposal to permit delivery-based agricultural commodity derivatives contracts to initially trade as financially-settled contracts, with a subsequent transition to compulsory physical settlement for select agricultural commodities.
- 6.2 Safeguards During Financially-Settled Phase:** Do you agree that the existing risk management framework for commodity derivatives is sufficient for the financially-settled phase of the contract?
- 6.3 Selection of Suitable Agri Commodities:** Which agricultural commodity derivatives contracts should be considered for introduction under the phased introduction of physical settlement framework?
- 6.4 Overall Assessment and Suggestions:** Any other comments, suggestions, or alternative approaches that stakeholders may wish to propose to strengthen the proposed framework.

7. Public Comments:

7.1 Considering the implication of the aforesaid proposals on the market participants, public comments are invited on Paras 6.1 to 6.4. The comments/suggestions should be submitted latest by **June 02, 2026** through the following link:

<https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes>

7.2 In case of any technical issue in submitting your comment(s) through the web based public comments form, you may contact the following through email with the subject: "Phased Introduction of Physical Settlement in Select Agricultural Commodity Derivatives Contracts":

- 1) mrd_consultation@sebi.gov.in
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