JOHANNESBURG STOCK EXCHANGE
SAFEX Commodity Derivatives

Market Notice

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Proposal to amend the option volatility mark to market (m-t-m) methodology

The trading activity specific to options continues to show positive growth with a 20% increase in contracts traded for January to May 2011 compared to the same period in 2010. This said the JSE consulted with a number of market participants to understand if there was anything that could be improved on. One point that was highlighted was the issue that the daily option m-t-m volatilities did not move as frequently as in the past.

A study undertaken by the Division revealed that for the Jul11 WMAZ contract the m-t-m option volatility did not change for 42 consecutive trading days whilst the underlying futures contract moved R174 down, then R120 up, then again R105 down and then R160 up all in the same 42 day trading period. The trend was similar for other products and expiries. The m-t-m option criteria and option trading patterns were then closely considered. It is evident that a number of option structures are matched before 11h00 thereby not included in the m-t-m process and so the minimum volume criteria to adjust the daily option volatility is seldom met. The JSE would prefer not to reduce the minimum volume criteria defining liquid vs illiquid contracts however proposes including an additional strike either side of the at-the-money strike so as to widen the accepted trading range for m-t-m purposes. By including the additional strikes for the same 42 day period as referred above, we saw the m-t-m volatility move from a flat 31% to vary between 29,5% and 35%.

In essence the JSE would like to propose the following minor enhancement to the daily m-t-m option volatility process as highlighted below:

- Options traded over the last hour of the trading session will be considered for the m-t-m process
- ~~Two~~ Three strike prices either side of the option at the money will be considered eg if at the money strike is 1600, then 1540, 1560, 1580 and 1620, 1640 and 1660 strikes will be considered in the process
- If 60 or more contracts have traded across all strikes for the entire day, the contract will be considered liquid
- The opposite applies to illiquid contracts, if less than 60 contracts across all strikes have traded for the entire day then the contract is classified illiquid
- If classified as liquid, then a volume weighted average of 40 or more contracts across the selected strikes will be required in the last hour of trade as the m-t-m volatility, if this quantity does not trade then the volatility will remain unchanged
- If classified as illiquid, then a volume weighted average of 20 or more contracts across the selected strikes will be required in the last hour of trade for the m-t-m volatility, if this quantity does not trade then the volatility will remain unchanged
- As an exception, where the future contracts trade limit up or down for most of the option m-t-m period, only options traded on the delta option window will be considered for m-t-m volatility purposes
- No options traded on price through the naked option window will be considered

- If the number of delta options traded do not meet the liquid or illiquid criteria as described above, the bids and offers on the delta window will be considered as a last resort and at the exchanges discretion
- The exchange reserves the right to make the final decision regarding the m-t-m volatility and may exercise its discretion as need be.

We believe the minor enhancements would more accurate reflect changes in the m-t-m volatility and therefore more accurate evaluations. Please could members review the proposal and forward any comments to commodities@jse.co.za . Should you prefer to discuss the changes over a telephone call please do so with Graham Voller on 011 520 7176.

All feedback is required by no later than Monday 20 June 2011 to ensure it can be included in the discussions at the Agricultural Advisory Committee meeting held later in the same week.

Rod Gravelet-Blondin

Designation	Senior General Manager
Division	Commodity Derivatives Division
Tel	+27 11 520-7258
Fax	+27 11 520-7558
E-mail address:	RodGB@jse.co.za

Distributed by the Company Secretariat +27 11 520 7591