Indian capital markets' regulator releases 'Discussion paper on the growth and development of equity derivatives market in India'

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In brief

The equity derivatives market in India has grown rapidly in recent years i.e. @ 35.10% compounded annual growth rate (CAGR) between Financial Year (FY) 2004-05 to FY 2016-17. The ratio of turnover of equity derivatives to equity cash segment was 15.59 for FY 2016-17.

The India capital markets' regulator, the Securities and Exchange Board of India (SEBI), in its recent board meeting held on 21 June, 2017, had decided to initiate stakeholder consultations to review the equity derivatives market framework, including aspects such as product mix, stock eligibility, product suitability for investors, etc. so as to further strengthen the framework in line with emerging trends and global best practices.

In connection with the above, SEBI has released a discussion paper on the "Growth and Development of Equity Derivatives Market in India" seeking comments[1].

The paper provides several data points and information around the equity derivatives market and lists matters for further discussion.

The last date for submission of comments on the discussion paper is 10 August, 2017.

In detail

This alert provides a snapshot of the key aspects related to the equity derivatives market and summarises the issues enlisted for further deliberation in the discussion paper.

Tracing the history of the equity derivative market, the paper recognises the recommendations of the L. C. Gupta Committee (LCGC) and the Derivative Market Committee under the chairmanship of Prof. M Rammohan Rao which have been pivotal in the development of the equity derivatives market in India. The paper notes, amongst other, the following:

Trading in derivatives

- Equity derivatives turnover is largely dominated by index options which contributed 77.14% to the total turnover, followed by stock futures at 11.79%, stock options at 6.47% and index futures at 4.60%.
- Between FY 2004-05 to FY 2016-17, the CAGR of turnover in cash market has been 11.39%, whereas the CAGR for turnover in equity derivatives has been 35.10%. The market capitalisation of listed companies has grown at 17.82% CAGR during this period. The ratio of notional turnover in equity derivatives to equity cash segment increased from 1.54 for FY 2004-05 to 15.59 for FY 2016-17.

[1] http://www.sebi.gov.in/reports/reports/jul-2017/discussion-paper-on-growth-and-development-of-equity-derivative-market-in-india_35295.html

- There is significant concentration of volumes in terms of products, exchange and investor category.
- In terms of indices, NIFTY futures is highly traded and volumes are almost divided between domestic and SGX Nifty futures indicating overseas interest in the NIFTY futures. The turnover ratio of NSE NIFTY futures to SGX NIFTY futures was 53.7 for FY 2016-17.
- Options dominate trading in the derivatives segment by accounting for 83.61% of total trading in derivative segment.

Participants' profiles

- The participants in equity derivatives market include institutional investors, proprietary stock brokers, corporates and other investors.
- Proprietary traders and individual investors contribute 42% and 26% respectively of the total volume of equity derivatives in India.

Product wise profiling of investors

- It is observed that foreign investors contribute between 15-20% of the total volume across all product categories available in the equity derivatives segment. The presence of foreign portfolio investors (FPIs) can be felt in all types of product categories.
- The FPIs participation is on the lower side which is attributable to trading of futures and options on major indices in foreign markets such as Singapore, Hong Kong and Dubai etc.
- The participation by mutual funds in derivatives is negligible. This could be attributed to certain regulatory restrictions applicable to mutual funds.
- Large number of individual investors are active in derivative segment. Going by their trading pattern in cash segment, it is observed that these investors may or may not have adequate financial capability to withstand risks posed by complex derivative instruments. In the absence of a product suitability framework, this may not be in the interest of securities market.

Factors governing trading behaviour

- Margin required for trading in derivatives
    - Margin for equity derivatives is computed using a software called Standard Portfolio Analysis of Risk (SPAN). The minimum margin requirement on index and stock futures is 5% and 7.5% respectively.
    - Investors that have off-setting positions can avail the cross margin benefit, which is not available in the cash segment. Currently, no adjustment in margin is permitted for taking off-setting positions in two different exchanges.
- Securities Transaction Tax (STT) framework in India
    - STT is levied on the transactions done in the equity derivatives segment of the stock exchanges. Various STT rates have been prescribed over the years in the cash, future and option segments.

SEBI initiatives

- SEBI has taken steps to develop the cash market by initiating various measures, which, amongst others, include the introduction of new products, redesigning existing products and investor awareness.
- Similarly, to enhance the liquidity in the Securities Lending and Borrowing (SLB) mechanism, the framework has been revised. SEBI has received many suggestions to further improve the SLB framework and is examining them to further improve the mechanism.

Feasibility of product suitability in derivatives

- The LCGC report had placed emphasis on the Regulation of Sales Practices and Disclosure for Derivatives, which is relevant now as well in the context of derivatives trading.
- SEBI had conducted an Investor Survey in 2015, which revealed the risk perceptions to investors with respect to various financial instruments. SEBI therefore considers that there is a need to have focused investor awareness for such financial instruments and particularly derivative products.
- Currently, trading members are required to have a qualified and approved user and sales person to operate in the derivative market. However, the concept of product suitability framework for investors as prevalent in other jurisdictions is not yet present in the Indian market.

Matters for discussion

The paper lists down the following matters for discussion:

- The ratio of turnover in derivatives to turnover in the cash market is around 15 times. To what extent are the drivers of this ratio in India comparable with drivers in other markets?

- What are the global best practices and experiences in international markets when it comes to align the cash and derivative markets?
- Considering the participants' profiles, what measures would be required to create balanced participation in the equity derivatives market?
- Taking into account trading of individual investors in derivatives, especially options, is there a need to introduce a product suitability framework in our market?
- Considering the participants' profiles, product mix and leverage in equity derivatives, what could be the guiding principles for setting the minimum contract size and open position limits for equity derivatives?
- Is there a need to review existing criteria for the introduction of derivatives on stocks or derivatives on indices?
- Taking into account the margin levied in the derivative segment and the consequent leverage, is the present margin framework adequate? Is there a need to review the trading and risk management framework for derivatives?
- Are there any inefficiencies in the market that need to be addressed?
- Is there any regulatory arbitrage that needs to be addressed?

To summarise

- SEBI's current initiative is a part of its larger objective of developing and aligning both cash and derivatives markets and introduce best practices.
- The paper identifies and seeks comments from stakeholders on critical aspects of the equity derivative markets which could be deliberated further.
- The consultative approach adopted by SEBI in this regard is a step in the right direction.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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