Decisive Scrutiny of Regulatory Framework for Derivatives Products in Indian Stock Market with Special Reference to Single Stock Futures

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Abstract
The ability of the derivatives market to function as a risk management tool for risk avoiders has resulted in the popularity of the derivative products and, therefore, volatile underlying assets have recorded high trading volumes in the derivative market. A cautious approach was employed by market regulators and the government in the introduction of derivative products, and concerns about extreme market movements and manipulations are addressed as and when such events are detected. Derivatives markets are expected to bring in increased investments to the economic sector in the long run by boosting the confidence of market participants and catering to their risk management needs. Because derivatives markets are expected to provide investors higher overall returns, they are expected to foster the saving habit of market participants and bring about economic growth. Handling innovative products in the market calls for a very secure, dynamic, and sustainable framework of regulatory authorities. When the history of Indian derivative markets is considered, it is seen that The regulatory framework for the derivative trading is as effective as, during the post-global financial crisis period, the recovery of the Indian markets was commendable. The present study undertakes an analysis of the regulatory framework for the derivatives market in the Indian scenario with special reference to single stock futures.

Keywords: Derivatives Market, Regulatory Framework, Single Stock Futures.

JEL Codes: G100, G280

Introduction
The entry of innovative products and the rapid expansion of financial markets calls for a strong and efficient regulatory mechanism. Primarily, the regulatory framework needed for the derivative market is the rubric orderly market provisions. These set norms of regulations have withstood the test of time across the world. This framework is designed to mold the market into a liquid, efficient market with minimal chances of being disrupted. The requirements of registration and reporting, creating a field of uniformity for all levels of players, a system of mitigating default risks, safeguarding the interest of investors are the necessities of this framework of regulations. Risk containment measures embrace the capital adequacy norms for members, monitoring of the activities of the members, strict margin requirements, online monitoring, and circuit breakers. And the Indian market has borrowed this system of the regulatory mechanism.
The framework for governing the trading in derivatives was evolved from the recommendations of various committees set up for allowing the trading in the Indian scenario, the major recommendations flowing from the L. C. Gupta Committee (LCGC) in 1996. The regulatory framework in India is consistent with the International Organisation of Securities Commission (IOSCO) principles and regulatory framework for OTC derivatives and addresses the general concerns on investor protection, market efficiency and integrity, and financial probity.

Derivatives trading in India takes place either on a separate and independent derivative exchange or on a separate segment of an existing stock exchange. These exchanges function as a Self Regulatory Organisations (SRO), and the Securities and Exchange Board of India (SEBI) acts as the regulator. The trading in derivatives in India is regulated by the laws contained in SCR(A), the SEBI Act, the rules and regulations framed under these Acts, and the rules and bye-laws of the stock exchanges.

SEBI has set up clear cut norms for the clearing and settlement of all trades on derivatives exchanges to be enacted through a Clearing Corporation/House. SEBI has framed the eligibility conditions and norms to be met by all the participants in the derivatives exchange for providing a safe, transparent trading environment. The main factor which enables the exchange-traded derivatives is the credit guarantee furnished by the clearing corporation. Integrity and grievances redressal mechanism is also the prime concern of SEBI while setting up such an exchange. The eligibility criteria are strictly complied with while permitting derivatives on security. In the case of exchange-traded derivatives, the main factor which enables the trading is the credit guarantee furnished by the clearing corporation. The present study aims to throw light on the regulatory framework for derivatives trading in the Indian Market with special attention paid to single stock futures.

Critical Analysis of Regulatory Framework for Derivative Trading

The regulatory framework for derivatives trading in the Indian market started evolving with the promulgation of the Securities Laws (Amendment) Ordinance, 1995, which withdrew the prohibition on ‘options in securities’ by repealing Section 20 of the SC(R)A, 1956. Henceforth, SEBI appointed Dr. L. C. Gupta Committee in November 1996, which recommended a suitable regulatory framework for the derivative trading in India. In March 1998, the L. C. Gupta Committee submitted its report in favor of the inception of derivative trading in Indian bourses over a phased manner, starting with stock index futures. The Committee noted that:

“The evolution of markets in commodities and financial assets may be viewed as a worldwide long term historical process. In this process, the emergence of futures has been recognized in economic literature as a financial development of considerable significance.”

In the report, it was further stated as...

“......financial futures have quickly spread to an increasing number of developed and developing countries. They are recognized as the best and most cost-efficient way of meeting the felt need for risk-hedging in certain types of commercial and financial operations. Countries not providing such globally accepted risk-hedging facilities are disadvantaged in today’s rapidly integrating global economy.”

Hence a decision arrived at the introduction of derivatives, and in its wake, another committee was appointed under the Chairmanship of Prof. J. R. Varma in June 1998 to recommend the measures for risk containment for the derivatives markets.

Even though the Gupta Committee favored the introduction of derivatives in Indian markets, it opined that:

“....the introduction of equity derivatives in a phased manner so that the complex types are introduced after the market participants have acquired some degree of comfort and familiarity with the simpler types. This would be desirable from the regulatory angle too.”

Along with the recommendations of the introduction of equity derivatives in a phased manner, the Committee also recognized the need for a strong regulatory architecture for embracing the innovative instruments. The Committee also recognized that:

“While curbing any undesirable tendencies, the regulatory framework should not stifle innovation, which is the source of all economic progress, more so because financial derivatives represent a new rapidly developing area, aided by advancements in information technology.”

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Following the lines of a monitoring mechanism for derivatives markets, SEBI set up a Derivatives Market Review Committee, in March 2007. The aim of this Committee was to look into the developments in the derivatives market in India and also propose future potential and further itinerary of action. In December 2007, the Committee recommended the inception of new innovative derivative products based on global knowledge and the perceived desire for new products in the Indian markets. Thereby many new innovative derivative products were introduced in the market like mini contracts in equity indices, long term option contracts, options on futures, exchange-traded currency futures, the list is endless.

The ban on options on securities was withdrawn with the promulgation of Securities Law Amendment Ordinance, 1995, thereby introducing the financial derivatives in the Indian Financial Markets. 24 member committee was set up under the Chairmanship of Dr. L. C. Gupta on November 18, 1996, to carve a tentative regulatory framework for the derivative trading in the Indian market. The Committee opined that the term derivative to be included in the purview of securities to be brought under the regulatory framework of securities.

The LCGC report was accepted on May 11, 1998, by SEBI. The report stated in the clear light that there should be a phase-wise introduction of derivatives trading in India with the stock index futures to be introduced at first. The report favored the introduction of stock index futures at first and then stock index options to follow. Options on individual stocks were the last to be introduced. This report was based on series of interviews, market surveys, observations, and discussions with brokers, financial institutions, banks, Non-Banking Financial Companies clarifying the fact that there are only limited products in the market for hedging. The committee’s quote on SSFs in the report was: “Individual stock futures were favored much less. It is pertinent to note that the USA does not permit individual stock futures. Only one or two countries in the world are known to have futures on individual stocks. Stock individual futures are internationally the most popular forms of equity derivative.”

The report also mentions that three-month futures as the most preferred product, and in the category of options, American options were preferred over European options. While approving the recommendations of Gupta Committee and for effective implementation of the same, another committee under the chairmanship of J. R. Varma was set up for “Risk Containment Measures in the Indian Stock Index Futures” in June 1998. The Varma Committee, in its report, worked out all the details regarding the margining system, initial margins, broker net-worth, requirements for deposit, and real-time monitoring system.

Following the recommendations of both these committees, an amendment of The Securities Contract Regulation Act (SC(R)A) was carried out in the year 1999 to bring derivatives within the ambit of securities. Then a regulatory framework was developed for governing the trading in derivatives. The Act made the exchange-traded derivatives legal and valid. The Government also rescinded in March 2000, the three-decade-old notification prohibiting trading in securities.

SEBI approved derivative trading based on futures contracts at both BSE and NSE as per the rules and regulations of the Stock Exchanges. A beginning with equity derivatives was made with the introduction of Stock Index Futures by BSE and NSE. The introduction of derivatives in June 2000 in the Indian Financial Market is hailed as the most notable development concerning the secondary segment. While BSE introduced Index Futures for Sensex of 30 scrips on June 9, 2000, and NSE introduced the same on S & P CNX Nifty comprising of 50 scrips on June 12, 2000. Index options were introduced by NSE on June 4, 2001, followed by the introduction of Stock options on July 2, 2001. The last of the derivative products to be introduced in this stream was single stock futures on November 9, 2001. It is a notable fact that it is only after the introduction of SSFs in the Indian Market, re-introduction of SSFs took place in the USA in November 2002. The derivative product base has then been increased to include the trading in futures and options on S&P CNX Nifty Index, futures and options on CNX IT Index, Bank Nifty and single securities (226 as stipulated by SEBI) and futures on the interest rate (Bhalla, Investment Management, 2012).

The turnover in the derivatives market has witnessed remarkable growth since its introduction.
in the Indian scenario. In the global market for the year 201, NSE ranks fourth in position in terms of traded volumes in global futures and options and third position in terms of the number of single stock futures traded for 2014 (ISMR Issues & FIA Survey, March 2014). Since its introduction, NSE has established itself as the sole market leader in this F&O Segment in India with more than 99.5% market share as in the year 2013. But this market share came down to 78%. This can be attributed to the volume explosion which took place in BSE in 2013-14. Even though the share of NSE has come down; it remains the market leader in the equity derivative scenario retaining its position as a benchmark for all leading indices.

Single Stock Futures in India

Following the report of LC Gupta, the introduction of stock futures was least favored. R. H. Patil (2006), the Former Managing Director & CEO of NSE, Chairman of CCIL, expressed his opinion as; “The original plan of bringing futures to the country in place of badla was to introduce index futures, index options, and stock options. The SEBI Committee that went into the whole issue of equity-based futures was not in favor of futures in individual stocks, which are, however, currently being traded on the NSE. All over the world, the widely accepted futures products are index futures, index options, and stock options. In most of the countries, whenever equity futures are traded, the individual stock futures either do not find any place or even if they are grudgingly allowed, no much trade takes place in them. Most of the market players either do not find individual stock futures to be useful products, or they consider them and very rightly so... as highly risky products.”

It is very much evident from these words that SEBI did not have any intention to initiate the trading on single stock futures, one of the reasons being these products were very widely criticized for their speculative nature. The other instruments carried a lower risk attached to them, especially stock options, where risk was restricted to the extent of margin money paid for it. The stock futures carry a minimal sum of margin, chances of speculators forming a group, and manipulating futures price is too high. Even after the inception of single stock futures on NSE and BSE, there existed Badla trading on BSE, one of the major reasons why trading of derivatives was low at BSE even though derivatives were first introduced on BSE. It was only after market crashed in 2001, badla trading was banned, and there was the introduction of compulsory rolling settlement.

Simultaneously, as an alternative mechanism needed to provide for hedging, the risks for brokers and other investors, index options appeared on the scene in June 2001, followed by stock options in July 2001. But, from the market point of view, these instruments were not so successful. There are many reasons cited for the failure of options, but these faults paved the way for the introduction of single stock futures on November 9, 2001. There were still many apprehensions regarding its introduction to the Indian market. As per the words of R. H. Patil (2006) about the introduction of SSFs, “Despite the obvious risks that individual stock futures pose to the safety and integrity of the capital market of the country, they have been introduced in a hurry in our country. In my opinion, it was not wise for us to have introduced stock futures. All those who had mourned the death of badla are very happy that a similar product is now available for them to play their games.”

Inception of Single Stock Futures in Indian Derivatives Market

In India, Single Stock Futures were permitted on NSE for trading on November 9, 2001, on those securities where options on such securities were permitted. The Exchange had introduced the options trading on 31 individual stocks on July 2, 2001. Table 1 furnishes the list of securities on which options trading and, subsequently, stock futures were introduced.

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<td>1</td>
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<td>2</td>
<td>Bajaj Auto Ltd.</td>
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<td>Hindalco Industries Ltd</td>
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In the inception year, the stock futures were permitted on these above 31 scrips, which were increased to 51 stocks in the year 2003, 119 stocks in 2005, 122 scrips in 2006, 221 stocks in 2007, 226 scrips in the year 2014 and finally 173 scrips in December 2015. The highest percentage of stock futures turnover was witnessed in the year 2002-03 (65.14%), which showed the market confidence in the single stock-based derivatives, which accounted for nearly 88% of the market share in the derivatives turnover (Barot & Gajjar, 2013).

But since then, there has been a fall in the number of contracts traded in the case of Single Stock Futures. A massive set back was noted in the year 2008–09 when the percentage share of SSFs to total derivative turnover declined to 31.60% as compared to that of the previous year 57.66%. After that, the share has been on a continuous decline touching its lowest share of 13% in the year 2013-14.

Indian markets are unique because of unusual dominance shown by stock futures in the inception years. Among world exchanges, only around 16 exchanges out of 40 exchanges have allowed stock futures trading. Of them, substantial trading is seen in only a few exchanges. Even though it was on the recommendation of the L. C. Gupta Committee that the derivative trading was started, the Committee was very much against the introduction of stock futures. It was the other three derivative instruments that the Committee preferred to introduce. The Committee had even named the United States, which did not permit the individual stock futures to cite their disregard towards the introduction of stock futures. Yet, stock futures were formally introduced in the Indian markets in the year 2001.

The impact of the introduction of stock futures was felt immediately. The volume of derivatives turnover saw a sharp rise from ` 2,365 crores in the year of introduction of derivatives 2000-01 to ` 1,01,926 crore in 2001-02, and after that it kept on climbing except the GFC year 2007-08, standing at ` 38,211,408 crores for the year 2013-14. It was the introduction of stock futures and the consequent surge in the volumes of derivative turnover, which catapulted the NSE into the first five top exchanges worldwide. The unusual success of stock futures has been attributed to its similarity to the earlier “bad trading,” and the market participants of the same became active in this market also. In stock futures trading, the investor pays a small margin and can hold very large leveraged positions. This provides a speculative opportunity for the traders to manipulate the stock futures for making profits (Hukeri, 2007).

The fact that the introduction of Single Stock Futures on NSE alone accounted for the lion’s share of 88% in its inception year itself showed the market confidence in the SSFs. Another fact was that the Indian market participants were better familiar with the instrument allowed to be traded on NSE against much dislike of the prominent policymakers. These interesting facts form the basis of selecting single stock futures for the present study.

Conclusion

In India, the success of single stock futures is unique. The success of the instrument can be attributed to the fact that Indian investors are familiar with the concept of bad trading. Of all the derivative instruments, the single stock futures have emerged out a clear winner. It is only in the last two years,
the ranking of NSE in case of SSF has been affected to the effect that the ranking had gone down to the fourth position in 2012 from top for the years 2003 – 2006, second for the years 2007-2010, third for the year 2011 but then recovered to the third position in the year 2013.

In the opinion of L. C. Gupta (2006), the dominance of stock futures is the most important architectural weakness, which originates from its settlement mechanism. At the time of its introduction, it was opined that the physical settlement would be arrived at within six months. But even now, the physical settlement is yet to be arrived at. In his report, L.C. Gupta had put forward an argument against the FIIs being allowed in trading in stock futures. But the opinion of another school of thought prevailed, which was the physical settlements would increase the possibility of the bear squeeze, especially where floating stocks were low. In a bullish market, the floating stock available daily declines rapidly even though the volumes on the markets appear to be high. The primary objective of introducing derivatives trading in the Indian market was that derivative trading would definitely encourage the arbitrage between derivatives and cash market and thereby assist in the price discovery process and making the underlying markets efficient.

The former Chairman of Clearing Corporation of India, R. H. Patil (2006), argued in his speech: “Most of the countries that have introduced equity futures have preferred to introduce the index futures and options in the index and individual stocks. Very few countries have taken the risk of introducing individual stock futures. Even in those countries where any individual stocks futures have been introduced, the relative trading volumes are quite modest. The Italian Stock Exchange, which ranks next only to NSE in terms of traded contracts in individual stock futures for only 25 percent of NSE’s volume. But when it comes to the value of contracts in index futures, the volume of Italian exchange is nearly twice that of the NSE. This is indicative of the fact that the individual stock futures are not considered as safe as index futures even in the countries in which such futures products are traded. All the major future exchanges of the world in the US or Europe consider that the individual stock futures are not only highly unsafe but also that they do not serve any justifiable purpose. Despite the obvious risks that individual stock futures pose to the safety and integrity of the capital market of the country, they have been introduced in a hurry in our country”.

Another major highlighted aspect in the speech was that the possibility of manipulation of index futures due to the presence of stock futures. As manipulators can hold huge positions in those stocks which have large weights in the index and there by manipulating the index, had there been no stock futures, manipulating the index futures would need huge quantities, which would not be feasible in the current scenario.

Drawing an inference from the L.C. Gupta report, which cites that the stock futures are highly probable to bring forth architectural weakness into the markets due to their settlement mechanism, there was a suggestion as to ban the stock futures from the market. But, having whetted the appetites of vocal trading class, it was found not to be a feasible option at that stage.

But a very strong point in favor of stock futures is that amongst all the major derivative disasters cited in the global scenario have occurred, not one such disaster that could be attributed to stock futures. In the case of the Metallgesellschaft hedging disaster in 1993, the culprit for the disaster was massive speculative positions in energy futures and OTC energy swaps. The next to follow was the Orange County case in 1994, where the use of derivatives because of their leveraging benefit ended up in a massive disaster. The death knell, which was meant for age-old Bank of Barrings in 1995, can be devoted to the usage of options for arbitrage purposes. The use of Credit Default Swap is hailed to be the reason for the collapse and bail out of insurance giant AIG in 2008. The same instrument could be hailed as the reason for the Sub -Prime crisis in 2008-09.

To conclude, the single stock futures were launched with a lot many apprehensions in the Indian market; they are found to the safest bet of all the derivative instruments launched at that time. The allegations raised against the instrument can hence be regarded as baseless, in the wake of experience till now. Also, the present condition in the derivatives market, suggests the move towards index futures and
stock options as a healthy one for the betterment of market infrastructure and the growth of NSE. The declining volumes in the turnover of index futures and stock futures and the simultaneous rise in the turnover of index options over the last few years suggest a positive movement towards this opinion. This reveals that the Indian market is at last maturing and embracing the better concept of using options as risk management tools.

References


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