Thursday, 10 August 2017

CUTS International

Submission of Comments to the Securities and Exchange Board of India (SEBI)
On
Discussion Paper on Growth and Development of Equity Derivatives Markets in India

1. Background

The Securities and Exchange Board of India (SEBI) had issued a Discussion Paper on Growth and Development of Equity Derivatives Markets in India on 12 July, 2017 inviting comments from interested stakeholders.

Consumer Unity & Trust Society (CUTS, http://www.cuts-international.org/) is a non-profit, non-government vigilant institution working in the area of economic regulation, financial sector, consumer protection, competition, trade, and investment since last 33 years.

2. CUTS Broad Suggestions:

a. Need to correctly identify the problem:

The objective of the discussion paper is to evaluate whether there is a need to further strengthen the regulatory framework for Indian equity derivatives market. It expresses discomfort regarding the higher volumes of trading in equity derivative market, resulting in high volatility, as against the ongoing international trend. There are apprehensions that this can affect large number of individual investors who do not have adequate financial capability to withstand related risks.

While the paper provides an impressive overview of the existing scenario and points to the related data, there is a lack of linkage between the data provided, problem identified and the points of discussions. Basing regulatory interventions on apprehensions without clear data about problems might be self-defeating. For instance, it has been pointed out that in case of Korea, a series of research papers using trade data from Taiwan and Korea found some evidence that individual investors consistently made losses on their trades, and that institutional investors made profits at their expense on average. Such evidence led Korean regulators to explore interventions to reduce the participation of individual investors in these markets and thus, minimise their losses.[1]

[1] Nidhi Aggarwal et al, *Concerns about individual investors on the Indian equity derivatives market*, 29 July 2014, Ajay Shah blog

Consequently, in order to regulate a sector for consumer protection, there is a need to establish a market failure or identify the key problem[2]. Although there are concerns on the speculative practises in the derivatives market, there is no information on whether individual investors are losing their money in the derivatives trading due to their unsophisticated investment practises. In order to regulate the segment, there is a need to collect reliable data on losses to individual retail investors. In addition, the existing situation needs to be analysed with respect to prevailing regulatory framework, which restricts investments by sophisticated institutional investors in derivative markets.

Indian equity derivatives market has been growing rapidly in India over the last decade. This is evident from the fact that the ratio of turnover in equity derivatives to turnover in equity cash has grown from 1.54 in 2004-05 to 15.59 in 2016-17. This indicates that trades in the derivatives segment are 15 times higher than actual trading in shares. This growth in the derivatives market is way higher than in many other countries except South Korea. Against this backdrop, it would be judicious to examine whether the derivatives market in India is speculative in nature.

Alternatively, the lack of depth in underlying equity cash market in India might be resulting in higher trades in derivative segment. SEBI has also acknowledged the fact that equity cash and equity derivative markets are two sides of the same coin and a sound development is required for both of them.

Therefore, policy interventions need to focus towards developing equity cash market such that improvements get reflected in the equity derivatives market as well.

b. Specific Suggestions

Sr. No.	**Issues**	**Suggestions**	**Rationales**
1.	Ratio of turnover in derivative to equity cash might be overinflated		• It is important to ask if the ratio is providing the true picture of the derivatives markets in India. • Ratio of turnover in derivatives market is substantially made up of index options and index futures (which are composed of stocks of top performing companies) • Comparing an index of a portfolio of stocks against single stocks in equity cash

[2] https://ajayshahblog.blogspot.in/2014/07/concerns-about-individual-investors-on.html

Sr. No.	Issues	Suggestions	Rationales
			may not represent the risk of speculation • The volumes of top performing companies are always higher than small companies that are illiquid. • It has been suggested that a far better measure of the risk in the system is the open interest, or the value of the outstanding contracts in the market, relative to turnover far better measure of the risk in the system is the open interest, or the value of the outstanding contracts in the market, relative to turnover.[3]
2.	Falling liquidity in the equity cash market[4]	1. Facilitating participation of institutional investors in equity derivative market 2. Steps to improve liquidity in stocks of small companies	• Equity derivatives and equity cash markets are interdependent on each other. Therefore, it is important to ensure that the equity cash market is liquid. • It is important to promote entry of institutional investors in the equity derivatives markets. • Restrictions on institutional investors like Pension funds and insurance funds can be eased out. • This will also improve the turnover ratio of derivatives to cash. • This will also help in balanced participation in the derivatives market
3.	Lower Securities Transaction Taxes (STT) promoting trading in derivatives markets	Rationalise Securities Transaction Tax structure to promote derivative trading	• The STT is higher in the cash segment as compared to the derivative segment. • Therefore, there is a need to create a parity in the tax

[3] http://www.livemint.com/Opinion/S8f8UP6D9lSPjRJ6ruMrlO/Sebi-wants-to-know-if-individual-investors-are-fit-to-trade.html

[4] http://www.livemint.com/Money/BnQOHxGA7upjd9wES24KqN/India-has-alot-to-do-in-building-liquidity-in-equity-trading.html

Sr. No.	Issues	Suggestions	Rationales
			structure for both the segments to improve participation in the cash segment and reduce derivative trading
4.	Avoid over-regulation		• The paper expresses concerns over presence of large number of individual investors in the derivative market who do not have adequate financial capability to withstand the risks associated with the derivatives market. • However, the data provided in the paper shows that only around 5% (i.e. 17% of total 25% individual investors) of the total participants falls in the small investor category investing below INR 2 lakhs • Also, there is no data to prove that the investors are persistently losing money due to bad investing decisions • Therefore, it is important to ask if SEBI is over-regulating the sector to safeguard investors.

c. Other Suggestions:

Equity cash market and equity derivatives markets is an integrated market such that development of one sector cannot be looked in isolation, it is important that their progress and development needs a unified perspective and direction. The derivatives markets have a range of participants that are regulated by different regulators; the regulations should be made only after considering the impacts on both the segments.

This requires the cooperation of all the sector regulators like SEBI, RBI, IRDA, PFRDA, etc. to frame common regulations.

In addition, it has been noted that the volatility and speculation is present in equity cash segment. Investor education, awareness, training and capacity building can go a long way in ensuring a balanced market rather than regulatory fiat.[5] This will also help in increasing retail participation in equity cash market and closing the growth gap between equity and derivative segment.

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[5] http://economictimes.indiatimes.com/markets/stocks/news/should-fo-lot-sizes-increase-sebi-needs-views-by-tomorrow/articleshow/59989755.cms