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Literature Review On Derivatives Operations In Indian Capital Market With Special Reference To Protection Of Retail Investors In Mumbai, India

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Abstract:
Researcher has made an attempt to study on Derivatives market and its operations in Indian Capital Market with special reference to the protection of retail investors in Mumbai.
The derivative market has become multi-trillion dollar markets over the years. Although Derivatives have been around in some form for centuries, their growth has accelerated rapidly during the last 30 years. Even if, the exchange traded derivatives are in place to take care of the standardized contracts, the vast majority of derivativesare created in private transactions in the over-the-counter markets because of the needs of the parties for the non-standardized contracts. In the last few years, there are a lot changes that have taken place in derivatives market.
The aims and objectives of this literature review are to have an in-depth knowledge of the derivative markets in India and its operations in Indian capital market with special reference to protection of retail investors in Mumbai. I have tried my level best to make it simple and understandable.

***Key words**: Derivatives, Forward, Futures, Options, Swaps, Hedgers, Speculators,Arbitrageurs,Risk management, Exchange rate, National stock exchange, Bombay stock exchange, underlying asset*

1.1.Introduction To The Chapter
This chapter attempts to discuss the genesis of derivatives trading and regulatory framework in Indian Capital Market.

1.1.1.Defining Derivatives
"Derivatives" are a class of financial instruments, which in India mainly include forward, futures and options. The value of a derivative is dependent on the underlying asset and they do not have worth of their own. For example, Cheese is a derivative whose value is dependent on the price of Milk (which is the underlying asset in this case) whose price is in turn dependent on the supply and demand statistics of milk. Therefore, derivative means "deriving something from something else" (Vashishtha and Kumar, 2010). The underlying asset[1] could be a commodity or a financial asset and the value of this asset is dependent on many things.
As per the Section 2(ac) of Securities Contract Regulation Act (SCRA), 1996 Financial Derivative can be defined as;
- "A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security;
- "A contract which derives its value from the prices, or index of prices, of underlying securities" (SEBI.gov, n.d.).

The derivative market has gained tremendous growth and observed phenomenal increase in the trade of derivative product in the past decade. This can be attributed to the fact that risk aversion among the investors has increased and also there has been a significant increase in the number of investors who want to invest in the capital market. The financial derivatives market in India was initiated in financial year 2000 with the launch of stock index future by the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). Subsequently, since then many derivative products have been launched in the Indian Capital market (Siddaiah, 2011). The growth in the financial derivative market has not only been observed in India but this has been observed all across the globe (Siddaiah, 2011).
Initially when the trading of derivatives was initiated in different parts of the world, only commodity derivatives were available which later gained momentum and became popular among the investors. In 1970s financial derivatives also became prominent with the increase in the activity of the investors in the capital market. Today, two-thirds of the total derivative markets have been adopted by financial derivatives itself. Out of these, one-third of the market is occupied by the equity indices as of 2008 statistics. Region wise analysis reveals that 40% of the total global derivative trading population is occupied by North America, which is followed by Asia-Pacific region which accounts for 28% of the total derivative market (ISMR Report, 2012). The financial market

in FY 2008 was hit by turmoil in the credit crises which took a toll on the financial markets across the globe. However, in FY 2009, global future and options demand returned to rapid growth as more and more people invested in the capital market.
Analysing the global trends, it was observed that one of the most powerful drivers of increase in the sales of exchange traded derivatives was the currency sector which observed a percentage growth of 142.0% in the year 2010. However the currency derivative market saw a dip of -22% in year 2012 (Acworth, 2012, Futures Industry Annual Volume Survey, 2011), this followed by the growth in the agricultural derivative which grew at 40.73% which also dipped in FY 2012 reflecting a percentage change of 27.5%. This is followed by a growth 39.2% in the non-precious metal trading volume in 2009 and registered a % change of 27.4% from the previous year in 2012 (Acworth, 2012, Futures Industry Annual Volume Survey, 2011).
In terms of exchanges, the exchanges in Asia grew quite rapidly after the great recession of 2008 in financial year 2010. The growth rate in Asia was nearly 39.8% followed by North America which registered a rate of 32.2% and Europe (19.8%) in 2009. In terms of contracts traded in FY 2012, change in terms of market is observed, where the Asia-Pacific region occupies, 35.6% followed by 33.6% in North America, 20.7% in Europe, 8.2% in Latin America and 1.9% including other exchanges (Dubai, Israel, South Africa, and Turkey) (See Figure 1). Most of the contribution in the Asia Pacific region was from India, China and Korea.

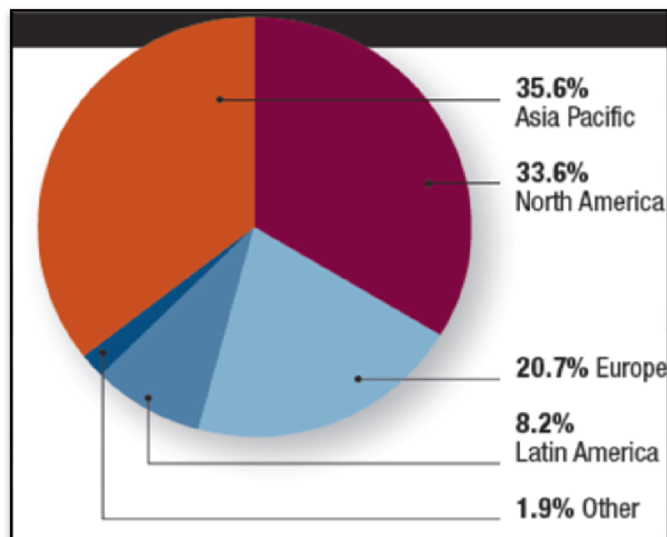

Figure 1: Global Future And Option Volume By Region
Source: Acworth, 2012

The main drivers of growth in India were financial derivatives contracts, and foreign exchange derivatives contracts. There is also an increase in the growth of equity derivatives (stock futures, stock options, index futures and index options). The Indian Stock Exchange (NSE) occupied second position after NYSE Liffe Europe on the basis of a number of single stock futures contracts traded in 2010. However, in terms stock options contracts traded in 2010, India's NSE didn't acquire any position among the top five exchanges. In this category, CBOE occupied the first position. In terms of stock index options, NSE occupied second position after Korean Exchange and in terms of stock index future; NSE occupied third position after CME group and Eurex (Acworth W., 2012, Futures Industry Annual Volume Survey, 2011).

1.1.2.Participants In The Derivative Market

The derivatives can be traded by different entities like; retail investors, financial institutions, and non-financial institutions. In terms of financial institutions like banks, they transact different currencies, and are exposed to different risks of defaults from their borrowers. Therefore, banks are most likely to trade in the derivative markets on interest rates and currencies and also to manage the credit risks. However, in India, financial institutes do not trade exchange traded derivatives and their total contribution to the total NSE trades was even less that 8% as of FY 2008. In contrast to the exchange-traded markets, domestic financial institutes and mutual funds have shown interest in the Over-the-counter fixed income instruments (Chitale, 2003).
The main reason why, financial institutes do not participate to a great extent in the derivatives market is the regulatory bodies have defined their limits to use derivatives only to hedge the existing positions or to rebalance the existing portfolios (Sarkar, A, 2006).
Foreign investors must register themselves as a Foreign Institutional Investor (FII) in order to trade in the derivatives market and also as per the regulatory guidelines of SEBI. Although, currently the number of FIIs in small in Indian Capital Market, they have been increasing their presence in the equity derivative market (Chitale, 2003). It is possible that unregistered foreign investors and hedge funds trade indirectly, using a local proprietary trader as a front (Lee, 2004).
Non-financial institutions are regulated differently which affects their incentives to use derivatives. The Indian insurance regulators haven't issued any guidelines regarding the use of derivatives by insurance companies (Sarkar, A, 2006).
The main participants of the equity derivatives market which accounts for more than 60% is occupied by the retail investors as per NSE. The success of the single stock futures in India is unique and the credit for the popularity goes retail investors. Another

reason for the rise of retail investors is that the size of the future contracts is small which attracts many small time investors. Retail investors also dominate the markets for commodity derivatives (Sarkar, A, 2006).
There are three main types of investors in the Derivatives Market (Vashishtha and Kumar, 2010):

- Hedgers: Hedgers are risk-averse investors who invest in the derivatives market in order to eliminate the risks associated with the price of an asset. Most of the investors who participate in the derivatives market belong to this category.
- Speculators: Speculators transact futures and options, in order to get extra leverage in betting on the future movements as per the price fluctuations in the underlying asset. Since speculators are high risk takers, they can either gain or lose highly in the derivative market operations.
- Arbitrageur: Arbitrageurs take the advantage of discrepancies in the prices of similar commodity/assets or same commodity /assets in different markets in order to lock them profit whichever market is growing.

1.1.3.Applications Of Derivatives Markets

Some of the applications of trading in the derivatives markets are discussed below (Vashishtha and Kumar, 2010; Gurusamy, 2009):

1.1.3.1.Risk Management

Risk management is all about eliminating and reducing the risk a trader generally faces when investing in the financial markets. Investments in the financial derivatives are one of the best ways to manage the risks. Effective use of derivatives can not only guard against risks but also ensure high return on investment.

- Trading Efficiency: Financial derivatives lead to increase in the efficiency of the market. Traders prefer trading for derivatives instead of the underlying asset mainly because of the liquidity in the market, and lower transaction costs.
- Speculative Trading: Although scholars do not consider speculations as an important application of derivative trading since speculation can lead to huge loss as well. However, for knowledgeable traders who investigate in and every move in the financial market in order to make a speculation could as well benefit higher gains in the derivative market as well.
- Stabilization of Prices: Short-term fluctuations which are common among the other markets maintain a stabilizing influence on the spot prices. Not many peaks and depths are observed in the derivative market as it causes price stabilization effect on the cash markets.
- Price Discovery: The future cash market prices can be easily predicted in the derivatives market. There is a diverse mechanism in the derivatives market, which helps in collection of scattered information from different resources. This information is then molded into readily discernible number which is actually a consensus of knowledgeable thinking.

1.2.Basic Regulatory Framework For The Derivatives Market

1.2.1.Regulatory Bodies

1.2.1.1.Reserve Bank Of India (RBI)

Reserve Bank of India has many important functions and objectives and one of which is the regulation of the capital market. The regulatory actions of RBI are however limited only to debt management through foreign exchange control, primary dealers and to support liquidity to market participants. RBI alsoregulates the primary dealers in the government securities market since March 1998 (RBI Official Website).

1.2.1.2.Securities And Exchange Board Of India (SEBI)

SEBI was set up as an administrative arrangement in year 1988. After the enactment of the SEBI Act on year 1992, SEBI got statutory status. Under Section 4 of SEBI Act, SEBI is controlled by Board of Members, consisting of Chairman, two members of Ministries of Central Government dealing with finance and law, 1 member from RBI and two members appointed by central government with relevant experience. The two main functions/objectives of SEBI are (SEBI official website; SEBI Annual report, 2001-2012):

- Protection of investor through regulation of the securities market;
- Encouraging the development of capital market

The functions and powers bestowed upon SEBI are through Securities Contract Regulation Act (SCRA). While some other functions are delegated through the Companies Act. The registration and regulations of the intermediaries, mutual funds, capital funds, service providers, and takeovers is undertaken under SEBI. Other than that SEBI has the power to issue directives and also inspect the books and records and if any discrepancies are found they can even cancel registrations (SEBI official website; SEBI Annual report, 2001-2012).

1.2.1.2.1.Objectives Of SEBI

- Maintaining a conductive environment: In order to raise money in the capital market, SEBI helps in creating a proper environment with the help of rule and regulations, fair trade practices, and also maintains healthy relations among institutions, brokers, investors and companies. The main aim of SEBI is to protect the trust of the investors especially retail investors.
- Encourage Education among Investors: Another important objective of SEBI is to educate the investors about their rights and how to operate in the capital market. The main motive behind this move is to maintain liquidity, safety for investors and enhance profitability for investors. Adequate, authentic and accurate information is made available on the SEBI's official website in order to ensure market efficiency.
- Development of Infrastructure: It is also aimed at development and automatic expansion of business among the middlemen i.e. brokers, commercial and merchant banks, jobbers, mutual funds, etc.

1.2.1.2.2.SEBI's Regulatory Role

After gaining the status of Statutory body in 1995, SEBI, appointed 24-member committee under the chairmanship of L. C. Gupta in November, 1996. The main of this committee was the development of regulatory framework for derivative trading in India. Different aspects of the derivative trading were studied by the then appointed committee and then accordingly made far-reaching recommendations. In fact committee conducted a survey among the investors, intermediaries and financial institutions in order to assess the needs and requirements of market participants (SEBI official website; SEBI Annual report, 2001-2012).

The regulatory framework of SEBI is focused on following activities:

- Bring Credibility to the Regulatory Structure: It is one the functions of SEBI to successfully create a credible regulatory structure of derivative trading operations in Indian Capital Market. For this purpose, SEBI has introduced internationally acclaimed practices and also engages itself in periodical modernization of the market infrastructure by enforcing regulations. In order to ensure credibility in the system, SEBI has introduced disclosure norms in order to observe integrity and fair practices which would protect the rights of the investors. In order to modernize the market infrastructure automated trading options have been facilitated. In order to ensure free transferability of securities depositories act of 1996 was also created.
- Improve the disclosure standards in order to bring transparency in the market: A committee was set up under the chairmanship of Mr. Y. H. Malegam in year 1995 in order to improve the disclosure standards and bring transparency to the market. Another committee was setup which could point out the problems in the present system and help in recommending measures to improve the continuing disclosures. This committee was set up under the chairmanship of Mr. C. B. Bhave. On the basis of the recommendations from the two committees SEBI initiated steps to impose barriers at the entry level on new issues specifying the minimum issue size requirements for the companies to be able to seek listing in the exchange. SEBI's Disclosure and Investor Protection Guidelines were initiated by SEBI in January 2000. The procedure helped in smoothening out the aberrations of the public offerings.
- Improve the standards of corporate governance: Based on the regulations of the report presented by N. R. Narayana Murthy, SEBI introduced a set of codes for corporate governance among the listed companies. The main objective behind the move was to protect the investors from fraudulent and unfair practices of certain companies. To secure the corporate governance clause 49 was amended in 2003. The clause highlighted the definition of independent director, remuneration of non-executive directors, responsibility of independent directors, amendment of board procedures, term of office of non-executive directors, requirements related to audit committee, meetings of audit committee, role of audit committee, etc. (SEBI.gov, Clause 49)
- Margin system and surveillance system should be efficiently managed in order to enhance the market safety: Market surveillance is important to maintain order in the overall functioning of derivative trading. Market Surveillance Division was set in 1995 itself to keep a track of the activities of the stock exchanges. Different policies have been formulated by SEBI for surveillance and risk containment measures. The Inter-Exchange Market Surveillance group is effective and efficient in making decisions on surveillance issues and also helps in coordinating between different exchanges. SEBI also inspects the functioning of the surveillance cell in order to gather evidence regarding violations of securities market. The enquiry reports are then prepared and presented to the Ministry of Finance.
- Building Confidence among investors: A number of initiatives have been undertaken by SEBI to allow better investor protection and for the development of efficient market. A compliance officer has been appointed by SEBI which would help resolving the problems of investor. Prudent corporate governance laws are in place which ensures that there is transparency and system. Also many grievances cells set up by the government so that investors can record their grievances and also access financial information related to companies and government policies and rules and regulations. Better monitoring and market surveillance system was also set up. Stock exchanges are being directed to take strict action against the listed companies. Finally, the investor's complaint system has been standardized so as to make the process simple for the investors.
- Margin system should be refined in order to reduce the transaction costs: The portfolio based margining approach is generally adopted which takes into account the risks involved in the portfolio. The margin system was designed under the committee of J. R. Varma. The initial margin requirements are based on the worse-loss scenario for an individual so that 99% of VaR is covered. This margin covers the price changes and volatility in the market.

- Increase the overall operational efficiency: If the market participants are working efficiently then it would improve the overall efficient of the system. In order to regulate the operational efficiency in the derivative market, SEBI has undertaken many measures. SEBI has made sure that transactions should be held in a cost efficient manner. Also frequent checks ensure desired level of protection for the investors. Prudential control on the intermediaries also facilitates financial integrity. Dematerialization and rolling settlements are major steps taken by SEBI in order to improve and modernize the market. Dematerialization has ensured that physical paper work is reduced and helped in elimination of problems associated with paper-based system. It has also improved the transparency, ensured efficient price discovery to curb unhealthy market practices (SEBI official website; SEBI Annual report, 2001-2012).

1.3.Requisites Of A Good Regulatory Framework In Financial Markets

Since the great recession of 2008 which had hit the entire world and their economies, it has been for five years, the regulators and policy makers are scratching their heads to come up with policies that would strengthen the financial system so that another such crises does not arise. Despite significant developments in the regulatory framework of the Indian capital market, there has been decline in the market in the recent past. The market is trying to recover from the loss and hopefully the upwards moving trend would come again. However, there are many issues and challenges which the Indian financial market faces and the regulatory bodies should focus on resolving these issues (Narayankar, n.d.).

- Market infrastructure and investor awareness needs to be improved. As inefficient flow of information and ineffective corporate governance can lead improper functioning of the market.
- The legal mechanism system should be activated by the regulatory bodies in order to protect small time investors i.e. retail investors by giving them speedy grievance redressal mechanism.
- The trading system although is transparent in today’s time in comparison to when it was launched. However, it needs to be made more transparent. Market information is very crucial for the investor especially retail investor who would not have much to put on stake. Therefore, market information should be made available to all the participants in order to achieve market efficiency.
- SEBI should tighten up the monitoring and surveillance system in order to closely track insider trading cases and price manipulation and also meet the challenges posed by the market makers.
- Also there is a need for an integration of the security market with the world economies through consolidation of the stock exchanges worldwide. This trend is not very popular in India, however, the whole world is regulating the norms and trying to consolidate and merge the existing stock exchanges.
- Integration of security markets with the banks are also an important requisite. This would help in improvement of the payment situation and would also reduce the risks of scams. Internet trading has been integrated in the system in India as well and regulatory committees have formulated many requisites so as to improve the financial system for the protection of investor.

1.4.Summary Of The Chapter

Innovation in the derivative market has redefined and revolutionized the landscape of the financial market in India. It has given opportunity to the investors especially the retail investors to invest in the derivative market. Derivatives are risk management tools which are bought as contracts in different stock exchanges across the globe. They were first launched in India the year 2000 after the recommendation of L. C. Gupta committee and since then equity-based, currency-based and interest rate based derivatives have been launched in the derivative product market. As far as the regulatory framework for the regulation of activity in the Indian Capital Markets are concerned, there are two main governing bodies, RBI and SEBI which control the regulatory framework in the financial markets and stock exchange.

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