Consultation Paper on Measures to strengthen index derivatives framework for increased Investor protection and Market stability

1. **Objective**

Derivatives market assist in better price discovery, help improve market liquidity and allow investors to manage their risks better. However, bursts of speculative hyperactivity in derivative markets, particularly by individual players, can detract from sustained capital formation by endangering both investor protection and market stability. Given the changing market dynamics in equity derivatives segment in recent years with increased retail participation, offering of short tenure index options contracts and heightened speculative trading volumes in index derivatives on expiry date, this consultation paper seeks to introduce measures to enhance investor protection and promote market stability in derivative markets, while ensuring sustained capital formation.

2. **Background**

2.1. **Changing Market Dynamics – Trading Product mix**

2.1.1. Equity derivatives contracts generally have minimum tenure of a month. An exception in this regard is options contracts on an index (benchmark/ sectoral/etc.) wherein the contract tenure and expiry of contracts thereof is every week. From introduction of weekly options contracts by NSE in May 2016 on a sectoral index to introduction of weekly contracts in February 2019 on benchmark index by same exchange, the expiry date of all such weekly contracts was on a single day of the week till 2022 (other equity exchange i.e. BSE also had weekly expiry derivatives contract albeit with very less liquidity / activity).

2.1.2. Within the Regulatory ambit, the modalities around broad specifications of such weekly options contracts including deciding the expiry day is left to individual exchange. After reintroduction of weekly index derivatives contracts on BSE in May 2023, there has been shuffling by exchanges in terms of choosing expiry dates of the contract – to the extent that as of now there is expiry of weekly index derivatives contracts on all five trading days of the week.

2.1.3. Admittedly, the weekly index derivatives products have found favour with market participants especially around expiry of such contracts – viz. evident by extent of hyperactive trading activity happening on expiry day of such contracts when compared to other trading days. For illustration, consider the Table-1 below for proportion of notional turnover happening on the expiry day of the contracts for various index derivatives contracts compared to turnover 5 days before expiry (including expiry day).

Table-1 : Trend in Notional Turnover near contract expiry for a weekly expiry in July 2024

Notional Turnover	SENSEX	BANKEX	NIFTY	BANKNIFTY
Last 30 mins as % of expiry day	27%	20%	16%	13%
Last 60 mins as % of expiry day	40%	36%	28%	26%
Expiry day as % of 5 days before (incl. expiry day)	96%	97%	64%	62%

Source : Exchange data

2.2. Changing Market Dynamics – Trading Turnover

2.2.1. Derivatives market turnover in India has significantly surpassed cash market turnover. Reports suggest that Indian markets account for 30% to 50% of global exchange-traded derivative trades, aided by technology, increasing digital access and varied product offering. Post covid era has seen a generally heightened activity from retail investors. The total number of demat accounts in India rose to 15.8 crore as at the end of May-24, of which 12.2 crore accounts were opened since April-2020. With launch of weekly derivatives contracts on benchmark index by NSE in February 2019, there has been a shift in trading activity towards index options contracts. The trend witnessed in gross turnover in F&O segment vis-à-vis cash market segment has been tabulated in Table-2 below.

Table-2 : Trend in Annual Turnover in F&O segment

Turnover - Market wide (Fig. in Rs. Lakh Cr.)	FY18	FY19	FY20	FY21	FY22	FY23	FY24
Index Futures	48	55.5	67	90.5	84.5	95	74
Stock Futures	156	161.5	148.5	181	210.5	190.5	255.5
Index Options (Premium)	4.5	6.5	11	26.5	58.5	109.5	138
Stock Options (Premium)	1.5	2	2.5	6	10.5	9.5	14
Total turnover (Premium)	210	225.5	228.5	303.5	363.5	405	481.5
Notional Turnover	1650	2376	3445	6436	16952	38223	79927
Turnover in Cash Market	83.2	87.2	96.6	164.4	179.1	143.3	217.3

Turnover - Market wide (Fig. in Rs. Lakh Cr.)	FY18	FY19	FY20	FY21	FY22	FY23	FY24
Ratio of F&O turnover (Premium) to Cash turnover	2.5	2.6	2.4	1.8	2.0	2.8	2.2
Ratio of F&O turnover (Notional) to Cash Market turnover	19.8	27.2	35.7	39.1	94.7	266.7	367.8
Nifty 50 Index	10,211.80	11,623.90	8,597.75	14,690.70	17,464.75	17,359.75	22,326.90

Source: Exchange data

From the above table, it may be seen that recent growth in derivatives has been primarily driven by growth of index options as over the years primarily only index options segment has shown real growth in turnover (when compared with increase in benchmark index-last row of Table-2).

2.2.2. Within this sub-segment of Index options, there has been an influx of individual investors observed post Covid phase who have contributed an increasing share of turnover in the index options segment. The same has been tabulated in Table-3 below:

Table-3: Trend in Annual Turnover of Individual Investors in F&O segment

Gross turnover - Individual Investors (Fig. in Rs. Lakh Cr.)	FY18	FY19	FY20	FY21	FY22	FY23	FY24
Total Gross turnover for individuals in F&O - premium basis	65.8	65.7	62.6	90.1	87.2	101.3	117.4
% Index Futures	24%	28%	35%	39%	29%	30%	19%
% Stock Futures	74%	68%	59%	49%	45%	29%	36%
% Index Options	2%	3%	5%	9%	23%	38%	41%
% Stock Options	1%	1%	1%	2%	4%	3%	3%
Gross Individual Turnover In Cash Market	27.9	31.1	34.9	69.3	67.4	48.6	71.3
Ratio of gross Individual F&O turnover on premium basis to their Cash Market turnover	2.4	2.1	1.8	1.3	1.3	2.1	1.6

Source : Exchange Data. Individuals include individual/ sole proprietorship firm, HUFs and NRIs

From the above table, it may be seen that for every ₹100 traded by individual investor in FY 2018, only ₹2 went in to index options segment. This number rose to ₹41 in FY 2024.

2.3. **Illustration - Behavioral Analysis of market around contract expiry**

2.3.1. As per examination of data from June 2023 to July 2024, NIFTY was seen more volatile on the expiry day (i.e. High Low variation being highest on Thursdays for 6 months out of 12) compared to non-expiry days.

2.3.2. The data on intraday price variation for NIFTY and BANKNIFTY has been presented below at Table-4 from Jan 01, 2024 to July 04, 2024. It is observed that barring opening time movement, the last half an hour of continuous trading is most volatile on expiry days compared to non-expiry days. Also, last half an hour of expiry day happens to be more volatile than other half an hour movement on expiry day (barring opening time movement).

Table-4 : Intraday NIFTY movement (Thursday Expiry)

NIFTY	Monday	Tuesday	Wednesday	Thursday	Friday
09:15-10:00	0.53%	0.42%	0.49%	0.51%	0.45%
10:00-10:30	0.28%	0.25%	0.33%	0.35%	0.27%
10:30-11:00	0.22%	0.23%	0.29%	0.30%	0.23%
11:00-11:30	0.23%	0.19%	0.26%	0.27%	0.22%
11:30-12:00	0.21%	0.18%	0.27%	0.26%	0.23%
12:00-12:30	0.18%	0.18%	0.22%	0.22%	0.22%
12:30-13:00	0.18%	0.21%	0.21%	0.26%	0.24%
13:00-13:30	0.17%	0.19%	0.19%	0.25%	0.20%
13:30-14:00	0.21%	0.18%	0.24%	0.28%	0.24%
14:00-14:30	0.20%	0.23%	0.25%	0.27%	0.24%
14:30-15:00	0.26%	0.20%	0.27%	0.32%	0.24%
15:00-15:30	0.28%	0.25%	0.28%	0.33%	0.28%

Intraday BANKNIFTY movement (Wednesday Expiry)

BANKNIFTY	Monday	Tuesday	Wednesday	Thursday	Friday
09:15-10:00	0.68%	0.67%	0.77%	0.68%	0.57%
10:00-10:30	0.38%	0.35%	0.53%	0.47%	0.38%
10:30-11:00	0.26%	0.31%	0.44%	0.37%	0.29%
11:00-11:30	0.34%	0.26%	0.37%	0.37%	0.30%
11:30-12:00	0.27%	0.26%	0.33%	0.30%	0.30%
12:00-12:30	0.29%	0.24%	0.31%	0.30%	0.28%
12:30-13:00	0.24%	0.28%	0.26%	0.36%	0.31%
13:00-13:30	0.25%	0.25%	0.26%	0.28%	0.29%
13:30-14:00	0.30%	0.25%	0.29%	0.36%	0.32%
14:00-14:30	0.28%	0.34%	0.32%	0.33%	0.36%
14:30-15:00	0.33%	0.27%	0.37%	0.38%	0.34%
15:00-15:30	0.38%	0.31%	0.43%	0.37%	0.38%

Source : Exchange Data

2.3.3. From the preceding paragraphs, it is noted that significant trading activity happens on the day of contract expiry which happens to be more volatile day compared to other days.

2.3.4. Further, in the subsequent table, it is illustrated that on the day of contract expiry, significant speculative activity happens around the contract expiry period which also happens to be a more volatile time period (Table 4 above).

For this purpose, the 3-minute interval Open Interest (OI) and volume data for NIFTY was analyzed (Table-5). It can be observed that participants are initiating and squaring off positions in a time-span of less than 3 minutes, thereby speculating significantly, minutes before contract expiry.

Table-5: Trading summary in near money NIFTY options expiring on July 04, 2024

S No	Interval Start	Interval End	OI	Volume	Change in OI	Volume as multiple of change in OI
1	14:45	14:48	21,91,87,100	10,76,86,850		
2	14:48	14:51	21,61,15,875	16,48,51,775	-30,71,225	54
3	14:51	14:54	21,16,03,925	26,95,93,600	-45,11,950	60
4	14:54	14:57	21,19,06,950	24,90,35,500	3,03,025	822
5	14:57	15:00	21,52,64,000	20,88,58,000	33,57,050	62
6	15:00	15:03	21,76,87,625	25,23,37,350	24,23,625	104
7	15:03	15:06	21,58,39,200	19,96,69,750	-18,48,425	108
8	15:06	15:09	21,01,16,350	23,55,68,850	-57,22,850	41
9	15:09	15:12	19,95,58,325	29,68,36,050	-1,05,58,025	28
10	15:12	15:15	19,35,46,300	25,30,07,600	-60,12,025	42
11	15:15	15:18	18,77,06,225	18,62,03,750	-58,40,075	32
12	15:18	15:21	17,82,92,650	19,41,86,575	-94,13,575	21
13	15:21	15:24	16,58,16,450	17,49,86,400	-1,24,76,200	14
14	15:24	15:27	14,96,96,550	9,63,31,075	-1,61,19,900	6
15	15:27	15:30	13,77,88,700	4,81,21,525	-1,19,07,850	4

**NIFTY moved in the range of 24298 to 24346 and hence near money range of 24100 to 24500 was considered*

Source : Exchange Data

2.3.5. A high figure in the last column in Table-5 depicts the quantum of intra interval volume which cannot be attributed to closure of open positions and

hence may be considered speculative in nature, very near to contract expiry.

2.3.6. It is pertinent to note that mathematically, everything else being constant, option premiums reduce sharply as one approaches expiry. Illustratively, thirty minutes before expiry, ceteris paribus, the option premium of a comparable at-the-money strike could be just a fifth or less of the closing premium of the day before expiry. Similarly, five to ten minutes before expiry, ceteris paribus, the premium could be as low as a tenth or less of the premium of the day before. This lower premium on expiry day likely makes F&O trading on that day an accessible, cheap, and enticing lottery ticket for some individuals to purchase, sell, and speculate on, irrespective of how low the odds of success may be. It is very difficult to attribute any kind of benefit to the overall securities market ecosystem and capital formation from such concentrated hyperactivity in derivatives on expiry date. This issue is further elaborated at para 3.6 of the paper.

2.3.7. In this regard, reference is made to study conducted by SEBI in January 2023, on "Analysis of Profit and Loss of Individual Traders dealing in Equity F&O segment". The said study found that 89% of individual traders in the equity F&O segment incurred losses. The same study also highlights that trading in derivatives has proliferated beyond tier 1 cities in past 3-4 years.

2.3.8. For FY 2023-24, 92.50 lakhs unique individuals and proprietorship firms traded in index derivatives segment of NSE and cumulatively incurred a trading loss of ₹51,689 cr. This figure doesn't include transaction costs. Further, of these 92.50 lakhs unique investors, 14.22 lakhs investors made net profit i.e. approximately 85 out of 100 made a net trading loss (source: NSE data). The SEBI study, referred to above, found that over and above the trading losses, the loss makers expended an additional 23% of trading losses as transaction costs, while profit makers spent additional 15% of their trading profits as transaction costs during FY22. After considering the transaction costs, the outcome for FY24 will likely be very comparable to

our FY 22 study, which found 9 out of 10 losing money. On the other side, it has been observed that larger non-individual players that are high-frequency algo-based proprietary traders and/ or Foreign Portfolio Investors (FPIs), are, in general, making offsetting profits.

2.3.9. To put these numbers in perspective, the absolute value of the net trading loss borne by individuals during FY24 in index derivatives, as described above, in index derivatives is over 32% of the net inflows into the Growth and Equity oriented schemes of all Mutual Funds during FY24. It is also over 25% of the average annual inflows into all Mutual Funds across all schemes over the past five years.

Separately, large OI and hyperactive and abnormal trading activity close to expiry have implications for market stability, as elaborated at para 3.6.

2.4. In view of the aforesaid findings around increased speculative/ trading hyperactivity in index options segment combined with poor profitability outcome for individual investors, SEBI, with an objective of actively enhancing investor protection and ensuring market stability, created an Expert Working Group (EWG) to examine the matter further. The EWG comprised of individuals from various fields such as Academicians, Market Participants, Intermediaries, Market Infrastructure Institutions etc. The broad Terms of Reference of the EWG included suggesting near term and medium term measures to Enhance investor protection in Derivatives segment, improve Risk metrics & Risk Architecture in Derivatives segment with a view to enhance market development and market regulation. The immediate near term recommendations of EWG were deliberated by the Secondary Market Advisory Committee (SMAC) of SEBI.

2.5. Pursuant to the recommendations of the SMAC, SEBI, with an objective to strengthen the derivatives framework for enhancing investor protection and ensuring market stability, is proposing certain near term measures in the index derivatives segment. The objective of this consultation paper is to seek public comments on the following proposed measures.

3. **Measures proposed to be implemented in Index Derivatives segment**

3.1. Rationalization of strike price for options:

3.1.1. Existing practice:

Options strikes are introduced at uniform price intervals around prevailing index value by exchanges. For instance, NIFTY contracts have 35 In the Money and 35 Out of Money strikes at the time of introduction with interval of 50 points. BANKNIFTY contracts have 45 In the Money and 45 Out of Money strikes at the time of introduction. Due to this, the options strikes cover roughly 7% to 8% of index movement around prevailing index price at the time of introduction.

In addition, there are reserve strikes which enable exchanges to launch new strikes during intraday movement in index. Further, on daily basis, additional strikes are introduced if movement in the index warrant so.

3.1.2. Issues with existing practice:

For short tenure contracts, having a large number of strikes with very wide coverage could scatter trading activity / liquidity across multiple strikes which could cause sudden price movement in those options contracts. This may also create a possibility of artificial trades in illiquid strikes, at very low option premium.

3.1.3. Data Analysis:

3.1.3.1. The following examination was carried out for NIFTY options contracts expiring on July 04, 2024 and were more than 5% away from closing price of NIFTY on previous day (NIFTY closing price around 24280).

Table-6: Traded volume in far-away options strikes on expiry day (OI)

S No	Volume on expiry day as multiple of OI on Expiry-1 day	No of strikes	Max	Min
1	Greater than 5	18	19.9	5.1
2	3 to 5	12	4.7	3.1
3	1 to 3	32	2.8	1.1
4	Less than 1	26	0.9	0.0

Source : Exchange Data

3.1.3.2. The above table shows that there is a significant quantum of new positions created by participants on the day of expiry in the options strikes which are more than 5% away, which corroborates the observation made at para 2.3.6 of the paper in terms of buying cheap options at far away strikes regardless of how low the odds of success are.

3.1.3.3. On scattering of volume in far-away strikes, the average volume in those strikes is compared with the volume in individual strikes in Table-7.

Table-7: Traded volume in far-away options strikes on expiry day

S No	Volume as multiple of average volume in these strikes on Expiry day	No of strikes	Average	Min	Max
1	Greater than 1	16	1,29,864	1.1	23.7
2	Less than 1	72	6,924	0.0	0.93

Source : Exchange Data

The above table shows scattering of volume in far-away strikes on the day of expiry.

3.1.4. Proposal:

Existing strike price introduction methodology may be rationalized to incorporate the following principles:

3.1.4.1. Strike interval to be uniform near prevailing index price (4% around prevailing price) and the interval to increase as the strikes move away from prevailing price (around 4% to 8%).

3.1.4.2. Not more than 50 strikes to be introduced for an index derivatives contract at the time of contract launch.

3.1.4.3. New strikes to be introduced to comply with aforesaid requirement (3.1.4.1) on daily basis.

3.1.4.4. Exchanges to uniformly implement and operationalize the aforesaid principles after joint discussion.

3.2. <u>Upfront collection of options premium:</u>

3.2.1. Existing practice:

There is a stipulation for upfront collection of margin for futures position (both long and short) as well as options position (only short options

require margin whereas long options require payment of options premium by buyers). There is no explicit stipulation of upfront collection of options premium from options buyer by members.

3.2.2. Issues with existing practice:

Options prices depending on the moneyness move in a non-linear way and thus carry very high implicit leverage. These are timed contracts with possibility of very fast paced price appreciation as well as depreciation. In order to avoid any undue intraday leverage to end client and to discourage any market wide practice of allowing position beyond the collateral at the end client level, it is desirable to mandate collection of options premium upfront by TM/ CM from the options buyer. (At present, CCs block collateral at CM level for options buy trades).

3.2.3. Proposal:

The members to collect option premiums on an upfront basis from the clients.

3.3. <u>Removal of calendar spread benefit on expiry day:</u>

3.3.1. Existing practice:

Margin requirement for an F&O position reduces significantly by offsetting position on a future expiry as calendar spread margin applies on such position instead of normal margin on two positions.

3.3.2. Issues with existing practice:

While there is a valid reason for aforesaid margin benefit, expiry day can see significant basis risk where the derivative value for the contract expiring can move very differently from the derivative value on away month expiry. This is particularly true with the level of hyperactivity on expiry day in contrast to the activity in the away month expiry.

The element of liquidity risk is heightened as away week/ month options are generally not very liquid, and hence closing both legs of the calendar spread positions could result in a net loss.

3.3.3. Data Analysis:

3.3.3.1. Considering NIFTY as the underlying, for a sample day, an analysis was conducted for sample portfolios under a large retail

oriented TM, by calculating net delta equivalent positions of its clients in weekly expiry and other expiries put together. The clients who had positions across expiries with a different sign of delta between weekly and other expiries were identified and SPAN margin for both set of clients was calculated separately, thereby mimicking removal of calendar spread benefit. The exercise resulted in increase in margin requirements by approximately 50% for such clients. This suggests that retail participants are taking calendar spread positions.

3.3.3.2. Additionally, as mentioned in Table-5 above, there is a significant amount of speculative trading even minutes before expiry of options and removal of calendar spread benefit on expiry day is likely to enhance overall risk posture.

3.3.4. Proposal:

Given the skew in volumes witnessed on the expiry day vis-à-vis other non-expiry days and the inherent basis and liquidity risk present therewith, the margin benefit for calendar spread position would not be provided for positions involving any of the contract expiring on the same day.

3.4. <u>Intraday monitoring of position limits:</u>

3.4.1. Existing practice:

Position limits for various participants/ product types are specified by SEBI. These limits are monitored by MIIs (Clearing Corporations/Stock Exchanges) at the end of the day.

3.4.2. Issues with existing practice:

Particularly on the day of expiry, there is a possibility of undetected intraday positions beyond permissible limits as end of day open positions would be NIL.

In general, position limits should be complied with market participants at all points of time and hence there should be a check for breach of position limits intraday/real time.

3.4.3. Proposal:

Given the evolving market structure, the position limits for index derivative contracts shall also be monitored by the clearing corporations/ stock exchanges on intra-day basis, with an appropriate short-term fix, and a glide path for full implementation, given the need for corresponding technology changes.

3.5. Minimum contract size:

3.5.1. Existing practice:

Minimum contract size requirement for derivative contracts (i.e. ₹5 lakhs to ₹10 lakhs) was last set in 2015. During the last 9 years, the benchmark indices have gone up by nearly 3 times.

3.5.2. Issues with existing practice:

Given the inherently higher risk in derivatives and the large amount of implicit leverage, increase in minimum contract size would result in reverse sachetization of such risk bearing products.

3.5.3. Proposal:

In view of growth witnessed in the broad market parameters, the minimum contract size for index derivative contracts to be revised as under:

3.5.3.1. Phase 1: Minimum value of derivatives contract at the time of introduction to be between ₹15 lakhs to ₹20 lakhs.

3.5.3.2. Phase 2: After 6 months, minimum value of derivatives contract to be between the interval of ₹20 lakhs to ₹30 lakhs

3.6. Rationalization of weekly index products:

3.6.1. Existing practice:

Weekly expiry index derivatives contracts are offered by stock exchanges in addition to monthly contracts. There is expiry of such weekly contracts on all five trading days of the week across different indices/exchanges mirroring 0 DTE (Zero Day to Expiry) construct resulting in to speculative money moving from one expiry of index to another every single day.

3.6.2. Issues with existing practice:

Expiry day trading is almost entirely speculative. Given there is an expiry of weekly contracts on all five trading days of the week combined with previous findings on increased volatility on expiry day and within that increased volatility during closing time, speculative activity created near contract expiry and poor profitability outcome for individual investors in F&O segment, rationalization is warranted in the product offering.

3.6.3. Data Analysis:

3.6.3.1. Other than profitability figure, sample analysis carried out by exchanges show that an open position is on an average held by retail investor only for around 30 minutes. Also, in many cases, the expiry day trading in options constitutes as high as 80-90% of overall notional turnover of the weekly index option contracts in expiry week.

3.6.3.2. The decay in options premium as one approaches expiry, with everything else being constant, has been elaborated at para 2.3.6. To further illustrate and to gauge the quantum of implicit leverage on expiry day from the perspective of options writers, the premium of combined position of nearest In the Money (ITM) call option and put option of NIFTY is compared at different points of time on expiry day as follows:

Table – 8 : Price of nearest ITM call and put and corresponding Time Value

Date	Time	NIFTY Value	Option Type	Strike Price	Premium	Time Value
03-Jul	15:30	24286.00	CE	24250	93.00	126.00
03-Jul	15:30	24286.00	PE	24300	83.00	
04-Jul	12:30	24,339.25	CE	24300	54.55	29.20
04-Jul	12:30	24,339.25	PE	24350	24.65	
04-Jul	13:30	24,345.75	CE	24300	38.15	18.75
04-Jul	13:30	24,345.75	PE	24350	30.60	
04-Jul	14:30	24,335.30	CE	24300	29.15	7.65
04-Jul	14:30	24,335.30	PE	24350	28.50	
04-Jul	15:00	24,309.65	CE	24300	8.00	5.80
04-Jul	15:00	24,309.65	PE	24350	47.80	
04-Jul	15:15	24,300.30	CE	24300	1.65	1.20
04-Jul	15:15	24,300.30	PE	24350	49.55	

Source : Exchange Data

3.6.3.3. The overall pay-off from combined position of nearest ITM call and ITM put position on expiry would be ₹50 i.e. strike interval, if

expiry happens anywhere in that range. Hence, the additional component of the premium over this intrinsic value is Time value of position viz. mentioned in the last column of Table-8. In the above table, it is seen that an option writer had Time value of Rs. 126 a day before expiry (i.e. movement of 126 points outside the range in NIFTY would not result in a loss for the entity) which becomes merely ₹5.80 at 3 PM and ₹1.20 at 3.15 PM on expiry day. The above data may be juxtaposed with the quantum of speculative hyperactivity observed from 2.45 PM to 3.30 PM on expiry day in the contracts expiring within few minutes to gauge kind of positions created by market participants near contract expiry with a very small premium amount resulting in to high implicit leverage.

3.6.3.4. Large OI and hyperactive and abnormal trading activity close to expiry carry implications for market stability. If an extreme black swan event were to occur minutes before expiry, with heightened OI and activity at stake, the potential stress to the ecosystem with those that are short options rushing to hedge in cash, futures, and/or options markets can be immense. While the Indian market ecosystem continues to build in conservative safety buffers in terms of margins and default management waterfalls, the daily expiry of options contracts on different indices combined with unusual nature of hyperactivity around expiry does pause significant risk to market stability, as mentioned above.

3.6.4. Proposal:

In view of the data provided in the preceding paragraphs, to enhance investor protection and promote market stability in derivative markets, weekly options contracts to be provided on single benchmark index of an exchange.

3.7. <u>Increase in margin near contract expiry:</u>

3.7.1. Existing practice:

Trading activity, quantum of open positions and volatility increase around expiry however the same is not factored in the form of increase in the

margin to account for increased risk or to act as a deterrent or to build additional buffers to absorb sudden price shock or volatile black swan event impacting asset markets.

3.7.2. Issues with existing practice:

Near expiry the premium traded decreases thereby creating higher risk on notional basis for entities dealing in options and additional buffers are required.

3.7.3. Proposal:

To address the issue of high implicit leverage in options contracts near expiry, creating a high risk on notional basis for entities dealing in options, the margins on Expiry day and the day before expiry to be increased in the below stated manner:

a. At the start of the day before expiry, Extreme Loss Margin (ELM) to be increased by 3%.
b. At the start of expiry day, ELM to be further increased by 5%.

4. In view of the above, this consultation paper invites Public comments and suggestions along with supporting rationale from all interested stakeholders including individual investors Market Participants and intermediaries, Investor's Associations and Academic Institutions on the Measures to index strengthen derivatives framework for increased investor protection and market stability, discussed above and summarised as draft circular at Annexure-A. Comments may be sent latest by August 20, 2024, via online web based platform through the following link:

In case of any technical issue in submitting your comment through web based public comments form, you may contact the following through email with a subject Issue in submitting comments on Consultation Paper on Measures to strengthen index derivatives framework for increased investor protection and market stability.
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Annexure-A
Draft Circular

SEBI/HO/MRD/MRD-POD-TPD/ /2024

To

All Recognised Stock Exchanges
All Clearing Corporations

Subject: Measures to strengthen index derivatives framework for increased investor protection and market stability

1. Derivatives market assist in better price discovery, help improve market liquidity and allow investors to manage their risks better. Stock Exchanges / Clearing Corporations provide products for trading in derivatives market and also a platform facilitating smooth trading in these products, while ensuring online real time risk management, surveillance as well as settlement of trades, for orderly trading.

2. In view of the changing market dynamics in derivatives segment in recent years with increased retail participation, offering of short tenure index options contracts and heightened speculative trading volumes in index derivatives on expiry date, the role of product offering, risk management and surveillance by Stock Exchanges / Clearing Corporations has become crucial in ensuring integrity of securities market. Regulation 28 (2) read with Part–C of Schedule II of the SECC Regulations, 2018, considers Risk Management, Surveillance and Product development functions of Stock Exchange/Clearing Corporations as core functions. In addition, Clearing and Settlement is considered as a core function of Clearing Corporation.

3. The Securities and Exchange Board of India Act, 1992 (“SEBI Act”) inter alia requires SEBI to protect the interest of investors in securities and to promote the development of, and to regulate the securities market, by such measures as it thinks fit. One of the measures to achieve the aforesaid objective as provided in the SEBI Act is to regulate the market through measures that may provide for regulating the business in the stock exchanges.

4. In order to review existing regulatory measures for investor protection while ensuring the orderly development and strengthening of equity derivatives market as well as to identify measures to assist stock exchanges in carrying out their aforementioned core functions, SEBI formed an Expert Working Group (EWG) on derivatives to suggest measures for investor protection and market stability.

5. On the basis of the measures proposed by the EWG and subsequent deliberations held in Secondary Market Advisory Committee (SMAC) of SEBI, it has been decided that the following measures shall be adopted by the Exchanges and Clearing Corporations.

5.1. Rationalization of options strikes

The strike scheme for weekly/monthly index options contracts shall be based on the following principle;

5.1.1. Strike interval to be uniform up to a fixed percentage coverage near prevailing index price –i.e. 4% around prevailing index price.

5.1.2. Beyond the initial coverage threshold, specified at (a) above, the strike interval to be expanded so as to ensure that fewer strikes are introduced further away from the prevailing index price.

5.1.3. The number of strikes at the time of introduction not more than 50.

5.1.4. New strikes to be introduced to comply with aforesaid requirement at (5.1.1) and (5.1.2) above, on daily basis

5.2. Upfront collection of Option Premium from options buyers

Members to collect option premiums on an upfront basis from the clients.

5.3. Removal of Calendar spread benefit on the Expiry Day

The margin benefit for calendar spread positions would not be provided for positions involving any of the contracts expiring on the same day.

5.4. Intraday monitoring of position limits

The position limits for index derivative contracts shall be monitored by the clearing corporations/ stock exchanges on intra-day basis, with an appropriate short-term fix, and a glide path for full implementation.

5.5. Minimum Contract size

In view of growth witnessed in the broad market parameters, the minimum contract size for index derivatives contract to be revised, in phased manner:

5.5.1. Phase 1: Minimum value of derivatives contract at the time of introduction to be between ₹15 lakhs to ₹20 lakhs.

5.5.2. Phase 2: After 6 months, minimum value of derivatives contracts to be between the interval of ₹20 lakhs to ₹30 lakhs

5.6. Rationalization of Weekly Index products

Weekly options contracts to be provided on single benchmark index of an exchange.

5.7. Increase in margin near contract expiry

The margins on Expiry day and the day before expiry shall be increased in the below stated manner:

5.7.1. At the start of the day before expiry, Extreme Loss Margin (ELM) to be increased by 3%.

5.7.2. At the start of expiry day, ELM to be further increased by 5%.

6. The provisions of this circular shall come in to effect from DD-MM-YYYY.

7. This circular is being issued in exercise of powers conferred under Section 11 (1) read with Section 11(2)(a) of the SEBI Act, 1992, to protect the interests of investors in securities and to promote the development of, and to regulate the securities market.

8. This circular is available on SEBI website at www.sebi.gov.in under the category “Legal Circulars”.

Yours faithfully,