CHAPTER - 4

GROWTH OF INDIAN DERIVATIVES MARKET

4.1 Introduction

This segment of the thesis particularly emphasis on the genesis and growth of Indian Capital Market over the years and also it shows the various factors which have contributed towards it. It also outlines the major events which took place over the years.

4.2 Genesis & Growth of Indian Capital Markets

(A) Pre- Liberalization:

The first instance of equity trading has started on or about 18th century and it was mainly by under British leadership. However, the trading structure was mainly unstructured until late nineteenth century because at that time, there were two trading points named Bombay and Calcutta. Bombay however can be regarded as the main and important trading center wherein initially shares of the banks were mainly traded.

Trading flourished inMumbaiin the middle of the 18th century as it was an important source of cotton and high demand of cotton resulted in boom in the share prices. After flourishing in the market for nearly half a decade market saw a major slump in year 1865. Also the Britishers didn’t want the
Indian economy to flourish therefore they didn't make any efforts to develop and organize the Indian capital market. At that point of time the investors depended mainly on London Stock Exchange (LSE) funds.

At this point of time trading was limited to only handful of brokers and there were no up-scale offices where trading could be done. However, these stock brokers initially formulated an informal association in Bombay in the name of Native shares & stock brokers in the year 1875. After some time, trading centers of Calcutta and Ahmedabad also materialized. Under the Bombay Securities Contracts Control Act of 1925, Bombay Stock Exchange (also known as BSE) was recognized in year 1927 (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011). The below table 4.2 shows that genesis and major events of Derivative Market.
**Table 4.2.: The major events & genesis of the Derivative Market**

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Year</th>
<th>Major events in the derivatives market</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1875</td>
<td>Birth of Native shares &amp; stock brokers Association</td>
</tr>
<tr>
<td>2</td>
<td>1927</td>
<td>Birth of BSE</td>
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<td>3</td>
<td>1952</td>
<td>Enactment of the forward contracts (Regulation) Act.</td>
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<td>4</td>
<td>1953</td>
<td>Setting up of the forward market commission.</td>
</tr>
<tr>
<td>5</td>
<td>1969</td>
<td>Prohibition of all forms of forward trading under section 16 of SCRA</td>
</tr>
<tr>
<td>6</td>
<td>1980</td>
<td>Khuso Committee recommends reintroduction of futures in most commodities.</td>
</tr>
<tr>
<td>7</td>
<td>1983</td>
<td>Govt. Amends bye-laws of exchange of Bombay, Calcutta and Ahmedabad</td>
</tr>
<tr>
<td>8</td>
<td>1992</td>
<td>Enactment of the SEBI Act</td>
</tr>
<tr>
<td>9</td>
<td>1993</td>
<td>SEBI prohibits carry forward transactions</td>
</tr>
<tr>
<td>10</td>
<td>1994</td>
<td>Kabra committee futures recommends trading in nine commodities</td>
</tr>
<tr>
<td>11</td>
<td>1995</td>
<td>Permission asked for trading index futures by NSE to SEBI</td>
</tr>
<tr>
<td>12</td>
<td>1996</td>
<td>L.C. Gupta committee set up by SEBI</td>
</tr>
<tr>
<td>13</td>
<td>1999</td>
<td>Interest rate swaps/ forward rate agreements allowed at BSE</td>
</tr>
<tr>
<td>14</td>
<td>2000</td>
<td>BSE &amp; NSE got permission to trade Futures by SEBI</td>
</tr>
<tr>
<td>15</td>
<td>2001</td>
<td>NSE has started trading of stock Options</td>
</tr>
<tr>
<td>16</td>
<td>2003</td>
<td>NSE has started trading of interest rate futures.</td>
</tr>
<tr>
<td>17</td>
<td>2006</td>
<td>Derivative exchange of the year award to NSE by Asia risk magazine</td>
</tr>
<tr>
<td>18</td>
<td>2007</td>
<td>NSE launches derivatives on Nifty Midcap-50</td>
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<tr>
<td>19</td>
<td>2008</td>
<td>Launch of Interest Rate futures</td>
</tr>
<tr>
<td>20</td>
<td>2009</td>
<td>BSE's new derivatives rate to lower transaction costs</td>
</tr>
<tr>
<td>21</td>
<td>2010</td>
<td>Introduction of European style stock option at NSE</td>
</tr>
<tr>
<td>22</td>
<td>2011</td>
<td>Launch of derivative on Global Indices at NSE</td>
</tr>
<tr>
<td>23</td>
<td>2012</td>
<td>BSE launched trading in BRICSMART indices derivatives</td>
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</table>

**Source:** Compiled by Researcher
Post-independence, the Indian economy took many years to organize and develop its capital market. This was mainly because of the intention and priority of the Indian Government to develop public sector undertaking and agriculture in the first phase. Even though the agricultural and public sector undertakings shares were not listed on the exchanges, because of the main reason that they were financially very strong and the Controller of capital issues very well managed every aspect of private sector undertaking like timing, compositions, interest rates, floating costs of new issues.

The tough and strictness in regulations halted the growth of Indian capital market for many years. This also demotivated the companies in releasing public interest litigations for almost 40-45 years (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

In 1950s, Indian stock market has witnessed certain types of speculation by the number of brokers especially on the shares of Tata Steel and Bombay Dyeing. The stock market at this point of time was also known as “Satta Bazaar”. In order to regulate the stock markets, government passed the Securities Contract Act in year 1956. Also simultaneously the company’s act was enacted in the same year. This decade also marked the establishment of development of financial institutions and state financial co-operations (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).
Next decade has witnessed the wars with neighboring countries and also has faced severe draught in the country. And at the same time, the Government has banned the Badla trading. Because of all these conditions, share market has faced tremendous set back and faced lot of financial difficulties. Luckily, few companies like GIC and LIC pumped money into the market and it has helped immensely by bringing back the stock market in a normal conditions and it has also helped to revive the investors’ confidence. Also the first mutual fund i.e. Unit Trust of India (UTI) was also launched in this decade in year 1964 (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

Badla trading which was banned in 1969 came into play and in 1974 again revived the market. However, market has faced a major setback because of restriction of dividend. The Government has introduced an Ordinance through which the companies can pay the dividend of 12% of the face value of the shares or on third of the profits of the company. It was another headache for the market. The BSE market saw a slump of 20% overnight. Also the effect of this slump was that the market was closed for almost 15 days. The market gained some momentum when under the FERA Act of 1973, the multinational companies were asked to reduce their shareholding by selling to Indian counterparts.
Dilution of shares by multinational companies created a cult equity market in India. Also this gave the opportunities to the Indian investors to invest in MNCs. Also in year 1977 Dhirubhai Ambani’s Reliance Textiles was launched in the market, which still dominates the trade circles (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

1980s saw tremendous growth in the securities market, as many investors took this as a lucrative or profitable way to expand one’s income. The liberalized policies initiated by the government led to the participation of small investors, and also enhanced speculation, plus ban on badla and then resumption of badla were some of the success factors behind the growth of Indian Capital Market.

Convertible debentures were also launched in this decade which acted as resource mobilizer in the primary market. Basically, this decade characterized the advent of other stock exchanges, saw an increase in the listing of companies, and also saw increase in market capitalization (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

(B) Post-Liberalization:

Through the liberalization and globalization, Indian Capital Market has showed a tremendous growth from the year 1990 onwards. Also the
Capital Issues (Control) Act was repealed during this period. New industrial policies were introduced by the government. SEBI emerged as a regulator of the market. Other than that, the period also saw the advent of investments from foreign institutions, new trading practices were introduced, and private mutual funds and banks were boosted the market. However, major scams were also observed in this decade which shocked the investors and discouraged small investors to participate in the stock investments. Also the scams made the government to work on efficient management of the stock exchanges and also regulate the financial system (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

The changes in the system also led to create the Over the Counter Exchange of India, National Stock Exchange, National Securities Clearing Corporation and National Securities Depository Limited and these have created a great momentum in the market.

Option trading was initiated in 1996-96 and rolling settlement was initiated in year 1998 for dematerialized segments of the company. The wider reach, better regulation and automation in the system lead to increase in the market participation (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

In the last decade, disinvestment in the public sector and privatization of the companies lead to further growth and development of the Indian
economy. The derivative market has also started on or about June 2000 after the final approval of SEBI.

Indian capital market saw a major slump in year 2008 when the world economies observed a period of recession. Indian market also took 2-3 years to gain back momentum. The present capital market is fairly organized, integrated with the world market, has modernized and its global reach as also expanded many folds in comparison to the time it was incepted. Internet trading which was until recently had been a global phenomenon has also reached India and most of the Indian traders today have their demat accounts which can be accessed through their mobile phones and laptops at any given time (Mishra, 1997, Rambhia and Ashok, 1997; Bhatt, 2003; Chatt, 2005 and Pathak, 2011).

4.3 Derivative Market in India
Since the inception, Indian Derivative market has seen immense growth and the growth is continue to grow for years to come. The growth has been observed due to traded contracts as well as total volume of the business.

4.3.1 The overall Derivatives Market Growth Story
Comparing the two markets i.e. BSE and NSE, the NSE is performing well and the performance of derivatives in BSE is not at all encouraging as far as volume and contracts are concerned. (SEBI Annual Report, 2001-2012;
Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

The total derivatives contracts and turnover since inception is shown in the Chart4.3.1. It reflects that the turnover in NSE was 23.65 billion and in BSE was Rs. 16.73 billion reflecting a total turnover of Rs. 40.38 billion. Over the years turnover rate increased manifolds in the National Stock Exchange.

The reason for the growth NSE was because of its efficiency and liquidity. As per Krishnamurti (2006), in his study at National University of Singapore, he found that the NSE showed more efficiency than BSE. As per the findings the trading frequency is lower on BSE as compared to NSE, while the average size per trade is higher on the BSE. But at the same time, BSE provided less liquidity compared to NSE. The number of contracts in year 2000-01 was 90,580 which in 2009-10 reached 679,293,922. As of March 2013, the number of contracts in National Stock Exchange had touched, 107,062,605 (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

However, in the Bombay stock exchange the turnover rate and number of contracts declined in FY 2005-06. Although it gained momentum in the subsequent years from 2006-07 till 2007-08 with turnover touching Rs. 2423.08 billion. However, again in FY 2008-09 the number of contracts
decreased to 496,502 with a turnover rate of Rs. 117.75. It further declined to 9,028 with a turnover rate of Rs. 2.34 billion. As of March 2013 the number of contracts in BSE were 94, 58,404 with turnover rate of Rs 2, 69,446 billion (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

**Chart 4.3.1: Comparing the NSE and BSE Turnover since Inception**

![Chart 4.3.1](image)

**Source:** NSE, BSE

As per the cumulative data, at NSE maximum turnover during a period of 2000-13, maximum turnover was observed in the last financial year i.e. 2012-13 i.e. 262,443,366 and the maximum number of contracts has been registered in financial year 2011-12 i.e. 120, 50, 45,464. (See Chart 4.3.1)
(SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

**4.3.2 Factors accountable for the growth of derivatives Market**

As per Gopinath, 2010, there are number of factors which have been responsible for the growth of derivatives. Prices of any asset can be determined by the supply and demand ratio of that asset. The changes in these forces can be lead to changes price dynamics which in turn leads to price volatility in the market. One of reasons for rapid growth in the derivative market across the globe has been the sharp volatility in the prices of different assets like; commodities, currencies and securities. There are imminent risks which are associated with price volatility which can be considerably reduced using a host of instruments, and techniques available in the derivatives market.

As seen in the previous paragraphs, the first integration between two international markets i.e. AMEX and PHLX took place in year 1975. Since then a number of integrations have taken place. The size, reach the magnitude and the volume of business operations have increased manifolds over the years. This can be attributed to the globalization of markets. Another effect of globalization could be seen on financial markets
as well. Global investors, exchanges, and financial institutions started participating on the global financial markets.

The growth in the Derivatives operations market can also be attributed to the kind and magnitude of technological breakthroughs in the communication industry. Much advancement has been observed in terms of computer satellite technologies which helped in the faster transmission of information across the globe.

The advancement in the theories related to financial management have also influenced and contributed towards the innovation of derivative products. These theories helped in the development of risk management tools and gave advantage of better and efficient management of risks which generally arise in the financial markets. Some of these theories which contributed towards the growth of financial markets are Black and Scholes Theory (1973) which helped in evaluating the value of put and call options and Lewis Edeington (1970s) who laid down ways of hedging financial risks, attached with financial futures.

4.3.3 Major Milestones in the Derivatives Market

Although the derivative trading commenced in FY 2000, however the foundation was laid down by half a decade ago in 1995, when NSE asked SEBI to grant the permission to trade index futures.
After almost 11 months, SEBI in order to initiate the derivative trading formulated a committee under the Chairmanship of L.C. Gupta and they have created a policy framework for the Index futures. They have taken two years to generate and submit the report. They submitted their report on May, 1998. On or about July 1999, the Reserve bank Of India permitted over the counter forward agreement and Interest rate swaps. Later on index futures, Nifty futures and futures and options on Nifty have commenced. Sebi has given permission for all these derivatives.

After almost a year later, NSE has started Equity Index Options and simultaneously in July 2001 trade of stock options was also initiated in NSE. Then after a gap of 1.5 years in November 2002, single stock options started trading in BSE interest rate futures were commenced in June 2003. In 2004 weekly options were commenced trading at the BSE. In 2008, BSE has started trading of Chhota (Mini) Sensex and accordingly, the NSE has initiated mini index futures and options. And at the same time trading of currency futures has started by NSE and BSE.

SEBI had standardized many equity derivatives in 2010. In 2010, the non-banking financial companies permitted to trade currency futures and it was initiated in the United Stock Exchange (NSE official Website, BSE Official Website, Muthukumaran, and Somasundaram, 2011).
Chart 4.3.3: Major events in the derivatives market.

- **Dec 1995**: NSE asked SEBI for permission to trade index futures.
- **May 1998**: L.C. Gupta Committee submitted report.
- **May 2000**: SIMEX chose Nifty for trading futures and options on an Indian index.
- **June 2000**: Trading of BSE Sensex futures commenced at BSE.
- **Aug 2000**: Trading of futures and options on Nifty to commence at SIMEX.
- **Jul 2001**: Trading of stock options at NSE.
- **Jun 2000**: Trading of Nifty futures commenced at NSE.
- **Aug 2000**: Trading of Equity Index Options at NSE.
- **Dec 2000**: Trading of single stock futures at BSE.
- **Jun 2001**: Trading of interest rate futures at NSE.
- **Jun 2003**: Weekly options at BSE.
- **Jan 2008**: Trading of chhota (mini) Sensex at BSE.
- **Aug 2008**: Trading of mini index futures and options at NSE.
- **Aug 2008**: Trading of currency futures at NSE.
- **Nov 2008**: Trading of currency futures at BSE.
- **Nov 2008**: A clearing and settlement arrangement on a non-guaranteed basis was put in place for the OTC interest rate derivatives trades.
- **Mar 2009**: 13 members participated in the non-guaranteed settlement of OTC rupee interest-rate derivatives.
- **Jan 2010**: SEBI standardizes lot size for equity derivatives.
- **Mar 2010**: SEBI for physical delivery in equity derivatives segment.
- **Aug 2010**: Currency futures opened for NBFCs.
- **Sep 2010**: USE to begin currency futures trading.

**Source**: BSE and NSE.
4.4 Growth of Derivatives: Marketwise

4.4.1 Equity Derivative System

Derivative product wise analysis also reflects a different story about the derivative trading. It is vibrant, active and important area of the overall derivative market. The increase in volume has increased manifolds over the years. The overall increase in turnover rate over the last financial year to this financial year has been recorded at 12.3%.

The equity derivative market captures nearly 81.5% of the total derivative market (See Table 4.4.1) (See Chart 4.4.1) (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).
Table 4.4.1: Product Wise Volume (No. of Contracts)

Turnover in Billion

<table>
<thead>
<tr>
<th>Year</th>
<th>Index Futures</th>
<th>Stock Futures</th>
<th>Index Options</th>
<th>Stock Options</th>
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<tbody>
<tr>
<td></td>
<td>Number of contracts</td>
<td>Turnover</td>
<td>Number of contracts</td>
<td>Turnover</td>
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<tr>
<td>2000-01</td>
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<tr>
<td>2001-02</td>
<td>1025588</td>
<td>214.83</td>
<td>1957856</td>
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<td>2002-03</td>
<td>2126763</td>
<td>439.52</td>
<td>40676843</td>
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<td>2003-04</td>
<td>17191668</td>
<td>554.46</td>
<td>32368842</td>
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<td>2004-05</td>
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<td>47043066</td>
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<td>15137.55</td>
<td>80905493</td>
<td>27916.97</td>
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<td>2006-07</td>
<td>81487424</td>
<td>25395.74</td>
<td>104955401</td>
<td>38309.67</td>
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<td>2007-08</td>
<td>156598579</td>
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<td>203587952</td>
<td>75485.63</td>
</tr>
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<td>2008-09</td>
<td>210428103</td>
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<td>146188740</td>
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<td>2012-13</td>
<td>96100385</td>
<td>25271.31</td>
<td>147711691</td>
<td>42238.72</td>
</tr>
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</table>

Source: NSE Annual Report 2012-13
1. Index Future

The Index future trading was initiated on the National Stock Exchange on or about June 2000. Now it is available on S&P CNX Nifty, CNX Bank, CNX IT etc. As far as all Index futures are concerned, the Nifty futures are in the number one position having around 94% of the total volume of the Index futures and it shows that retail investors are actively participating in this sector. Exploring the journey of Index futures since its inception in 2000, the index future registered a turnover of Rs. 23.65 billion. The
turnover rates increased massively in 2003-04 with a record turnover rate of Rs. 5,544.46 billion. Until financial year 2007-08, index futures registered upward moving trend with registered turnover rate in 2007-08 equal to Rs. 38, 206.67 billion, however during the recession period of 2008-09 it declined to Rs. 33, 501.11 billion. It again gained momentum in FY 2009-10 and in last FY 2012-13 it registered a turnover of Rs. 25, 271.31 billion which is lower in comparison to the overall trend in the last 12 years (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

2. Stock Future

As far as the trading in the stock future are concerned, in terms of contracts and turnover rate over the years, one can observe that the turnover rate has increased in NSE until 2007-08 when the turnover rate was Rs. 75,485.63 billion. However, just as the index future saw a slump during the period of global recession; stock futures also saw a dip in year 2008-09. It gained momentum in 2009-10 with 51,952.47. The growth of stock futures again saw a dip in year FY 2011-12 however it has started peaking upwards in the last FY with registered growth of Rs. 42,238.72 billion. As of 2012-13, 146 stocks have been allowed to trade at NSE (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).
3. Index Option

In India, the Index options were introduced on or about June 2001. Globally, we can see that Options are the number one product in the derivative market. In India, the futures contract has got the prominent importance. Index options were not traded much until FY 2007-08. In 2008-09 when the future contracts saw a slump, the index options gained momentum. Turnover rate at the start was Rs. 37.65 billion which increased to 13,621.11 billion in 2007-08 and jumped to 37,315.02 in 2008-09. As of FY 2012-13 the turnover rate of index options has touched Rs. 2, 27,81,574 crores (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

4. Stock Option

The single stock option was allowed to trade from 2001 and the stock options grew from Rs. 251.63 billion in 2001 slowly. It hasn’t gained any massive peak in the past 11 years. In FY 2010-11 the recorded turnover was Rs. 10,303.44 billion and currently in 2012-13 it has doubled to Rs. 20,004.27 billion. Currently 146 stock options are traded under national stock exchange (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).
4.4.2 Currency Derivative Market

Currency future trading was initiated in India in August 2008 at the National Stock Exchange. Later MCX-SX and BSE were also granted permission on October 2008. BSE has stopped its currency derivative trading activities since FY 2010. The third exchange, United Stock Exchange of India (USE), started trading currency future trading in September 2010.

As per the data the turnover rate for FY 2008-09 was near about same for both MCX-SX and NSE. As of FY 2012-13 the turnover rate among the three exchanges was not comparable. While it was Rs. 33, 031.79 billion in MCX-SX, it was Rs. 52,744.65 billion at NSE and Rs. 1,328.61 billion at USE.

The products of Currency futures were added at NSE and USE in FY 2010. Since USD: INR futures are the oldest product it dominates the market and therefore occupy 76.4% of the total market. This is followed by USD-INR options with market share of 20.2%. Other products like; EUR-INR futures 1.7%, followed by JPY-INR futures at 0.9% and GBP-INR futures at 0.8% (See Chart 4.4.2) (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).
Chart 4.4.2: Product wise market share in Currency Derivative

Source: MCX-SX, NSE, USE
4.4.3 Interest Rate Derivatives

Trading of interest rate derivatives have started in the National Stock Exchange on or about 2009. Further, interest rate futures on 91 day GOI treasury bills started at NSE on July, 2011. Since its inception in FY 2009-10, the number of contracts and turnover rate has decreased manifolds. At the starting period, there were 1, 60,894 contracts with net turnover of Rs. 2975 crores. A major slump was observed in FY 2010-11 with 3,348 contracts and turnover of Rs. 62 crores. The interest rate derivatives again gained momentum in the subsequent FY, however, in FY 2012-13 it drastically reduced to 12 contracts and Rs. 0.2 crores (SEBI Annual Report, 2001-2012; Muthukumaran and Somasundaram, 2011; BSE official website, NSE official Website).

4.5 Conclusion

This chapter discussed about the growth of derivative market in Indian Capital Market. Although the Capital market existed at the time of the British Rule, it didn’t flourish much until independence. Firstly the trade of cotton was initiated and after that with the advent of NSE and BSE, the
market scenario has improved. Derivatives were launched in FY 2000 and since then many activities have been undertaken under the derivative industry.

Presently there are four equity derivative products and they are stock future, index future, stock options and index options. There are currency derivatives and interest rate derivatives also. Of these future contracts are most popular among the masses. The turnover of all the products has increased over the years. It shows that the derivative products and markets have got tremendous growth opportunities in India.