CHAPTER 6
EMERGING TRENDS IN EQUITY DERIVATIVES MARKET IN INDIA

Index:

6.1 Introduction 250
6.2 Strategic Applications and Key Benefits of Equity Derivatives 253
6.3 Emerging Trends in Indian Equity Derivatives Markets 258
6.4 Problems of Indian Equity Derivatives Markets 273
CHAPTER 6
EMERGING TRENDS IN EQUITY DERIVATIVES MARKET IN INDIA

6.1 Introduction:

Since 2000, when the equity derivatives market was permitted by SEBI, there have been several changes in the landscape of equity derivatives trading in India. It is not only that the global equity derivatives markets have undergone change but the same were witnessed by the Asia Pacific derivatives market in general and India in particular. These changes had even greater impact on the entire capital market or the financial market as a whole. During this period of last decade, both the exchanges and the brokers have seen tremendous increase in the number of players and also the exponential growth in the total volume of equity derivatives trading.

There are two existing equity derivatives exchanges in India offering contracts in various indices and the single stocks. Since grant of permission for equity derivatives trading in India, while the derivatives exchanges have tasted varying degrees of success, the equity derivatives market in India is generally viewed as very successful. The successful derivatives market depends on successful exchanges, brokerage houses, other intermediaries and the participants as a part of overall success.

It is evident from SEBI’s actions that they have been open to new suggestions and have been more pro-active in accelerating the pace of development of derivatives trading in India. SEBI has equally supported the growth of the market by timely regulations and cleared the regulatory hurdles as and when required to assist the exchanges in encouraging the development of equity derivatives market in India without compromising on regulatory control and oversight.

The exchanges have also embraced new technologies and modern and transparent methods of doing business. The key issue required to be addressed in setting up effective exchanges is credible corporate governance which starts with ownership of the exchange. The trend in the international markets is of
ownership and access to trading rights on the exchanges to be separate issues. This is a sea change in the thought process from the original set up of exchanges where they were required to be association of members as a non-profit organization. The exchanges are expected to be now set up or seen as for profit companies.

The process of demutualising all the broker-run exchanges in India actually started with the Bombay Stock Exchange which was demutualised in August 2005. Amongst two equity derivatives exchanges namely BSE and NSE, NSE was already corporatized and demutualised since its inception, however, BSE was not so. SEBI announced the scheme of The BSE (Corporatization and Demutualization) Scheme, 2005 on May 20, 2005. Further, on June 29, 2007, SEBI in the Official Gazette announced that the Corporatization and Demutualization was achieved. Thus, BSE was successfully demutualised ensuring a reasonable balance of trading and non-trading interest.

Further, the management of the exchange needed to be strictly independent of the brokers and end users. Without this separation, the integrity of the exchange is questionable and is considered to be hurdle to develop liquidity. This was also achieved as a result of the demutualization of the stock exchanges.

The exchanges have made use of internet based technology to best of the possible way to develop market aggressively for a wide range of potential participants and users, from domestic traders and financial institutions to international traders and financial institutions to retail, domestic and international speculators and to hedge funds and programmed or High Frequency traders and international individual investors.

The intermediaries in the equity derivatives market also have witnessed a considerable change over this decade. Especially the broking industry has undergone through considerable change to service the end users. After laying down the basics about the net-worth requirement and setting the initial standards by SEBI, the exchanges had defined minimum standards for brokers based on capital, expertise and experience and types of activity wished to be carried out which were stringent than the SEBI prescribed norms.
The Exchanges have been putting thrust on encouraging only the quality broking entities in the market. The thrust also has been towards institutionalization of these broking entities or houses. There also has been large number of international broking houses, either as joint ventures with domestic brokers or independently who have entered the Indian Capital markets.

Currently, the equity derivatives exchanges have large number of brokers associated with them viz. BSE has 903 and NSE has 1309 as on December 31, 2011. Largely the brokers are trading members and out of these there are very few who are clearing for themselves or others on NSE and similarly on BSE.

 Besides broking, there are also other intermediaries which have seen the surge in their activities such as Custodians which were 23 as on March 31, 2012. Also, the Clearing Banks have geared up to meet the settlements by embracing the technology and they have been using very highly secured network for the fund movement through internet banking or through FTP enabling the broking industry to trade hassle free without being bothered about settlement delays or delays in making margin available. The banking system has also played important role in fueling the growth of internet trading since the money transfer could be done online by clients to ensure smooth and undisrupted trading experience to them.

The clearing corporation has been effectively managing the margin and collateral requirements and also had been executing the settlements on time. Their system capacities have gone up to ensure that the systemic risks do not occur to the market. Clearing corporations also have been able to develop a good corpus of Trade Guarantee Fund to ensure giving comfort to large foreign institutional players and Indian financial institutions that it will be able to guarantee settlement performance of contract through the process of novation.

The broking houses also had to embrace the technology and have been offering services through various platforms such as internet, low bandwidth sites, mobile trading, Direct Market Access, Co-location etc. to today’s techno savvy investors with the advent of technology savvy generation.

Market participants have also evolved over a period of time by moving away from traditional dealer terminal based trading activity to internet based
trading activity by taking trading reins in their own hands. Retail clients also now trade through mobile trading and low bandwidth sites of the member brokers. The clients have also been able to tremendously improve their knowledge base from complete novice to the derivatives trading to today’s strategy based trading activities.

6.2 Strategic Applications and Key Benefits of Equity Derivatives:

The investors were handicapped in their investment strategy because of the non-availability of portfolio hedging facility in India. There was acute need felt for derivatives, not for generating speculative profits, but for strategic purposes of controlling risk or restructuring portfolio by the investors.

Exchange traded derivative market helps investors in many different ways in planning the finances, hedging/mitigating various risks, appropriate price discovery, arbitrage opportunities, ease of speculations and in many other ways. Below is a brief explanation given as to what are the strategic applications, uses and benefits of the equity derivatives market in the Indian Markets in today’s economic scenario:

A. Edge over Equity Cash Market in terms of operational advantage:

Unlike equity cash market, derivatives market involves lower transaction costs. They also offer greater liquidity. Large cash market transactions can often lead to significant price changes. Hence, futures markets tend to be more liquid than spot markets since large positions can be taken by an investor by depositing relatively small margins or paying smaller premiums. Also, larger position in derivatives markets has relatively less price impact unlike the equity cash market transaction of the similar magnitude. Also, taking short positions in derivatives markets is easier than it is to sell short in equity cash market.

B. Provides efficiency to the capital market:

The capital markets become more efficient with the presence of derivatives markets since the equity cash and equity derivatives markets are intricately linked with each other. Since it is easier and cheaper to trade in derivatives, it is possible to exploit arbitrage and speculative opportunities quickly and to keep prices in check. Hence, the derivatives market help in
ensuring that the equity prices also reflect the correct prices and restricts manipulative activities.

C. **Helps mitigating the Risk:**

Futures and options contract can be very effectively used for changing the risk of investing in spot market. The derivatives contracts provide the ability for those with price risk in the underlying item to shift that risk to a market participant willing to accept it. Exchange traded derivatives markets help in transferring risk among investors to the ones who are willing to take such risks. An investor wanting to reduce risk can transfer some of that risk to other investor who is willing to take more risk. The risks can be transferred from risk-averse investor to risk taking investor. Since one can transfer risk exposure using futures and options, derivatives markets help in raising of the capital. It gives flexibility to investors to invest in an asset class and then transfer the risk to a level that is more acceptable to them by using derivatives contracts. Many risks in the financial markets can be eliminated by diversification. Index derivatives are special in so far as they can be used by investors to protect themselves from the one risk in the equity market that cannot be diversified away, i.e. a fall in the market index. Once investors use index derivatives, they suffer less when fluctuations in the market index take place.

D. **Equitable Price Discovery:**

Price discovery is the general process used in determining spot prices. These prices are dependent upon market conditions affecting supply and demand. Wherever there is price volatility, there is a potential need felt for futures and options on futures contracts. In the equity derivatives market, the price discovery depends on the market’s ability to determine true equilibrium prices. It is believed that the Futures prices reflect information about future spot prices and help in disseminating such information. The precise prices are vital in a free market economy to ensure proper allocation of resources. The volatility or risk of the underlying asset is provided by Options markets. Hence, the equity derivatives market helps in equitable discovery of price for the investors.
E. Gives cheaper avenue to Speculators:

Equity derivative markets provide the speculators a cheaper alternative than the equity cash market to speculate. This is also largely because of amount of capital required to take similar position in equity derivatives market is less in this case than the equity cash market. This is important because facilitation of speculation is critical for ensuring free, fair and transparent markets. A speculator normally accepts a level of risk only when the expected returns commensurate with the risk taken. Speculators normally take calculated risks. Thus equity derivatives market gives cheaper avenue to them.

F. Benefit to the India’s Financial market system:

India's financial market system will strongly benefit from smoothly functioning derivatives markets. Internationally, the launch of derivatives has been associated with substantial improvements in market quality on the underlying equity market. Liquidity and market efficiency on India's equity market has not remained so much of a concern since the equity derivatives commenced trading.

G. Attracts Foreign Investor by comforting:

Foreign investors coming into India get now more comfort since the hedging vehicles routinely used by them worldwide are available to them on the Indian shores through equity derivatives exchanges.

H. Development of Human Capital in India:

The launch of derivatives has a logical next step in the development of human capital in India. Skills in the financial sector have grown tremendously in the last few years, thanks to the structural changes in the market, and the economy is now ripe for complex derivatives as the next area for addition of skills.

I. To reduce the equity exposure in a mutual fund scheme:

The reduction of the equity exposure by Mutual Fund scheme could have a huge impact on the price of the equity since the mutual fund scheme typically offloads large quantities in the market. “Such selling results in depressing the equity prices to the disadvantage of the Scheme and the whole market. In the event the stock traded is not very liquid, such
offloading may not be achieved speedily and may take some months. Such offloading is also costly procedure because of brokerage and other transaction charges applicable in the equity cash market. The same objective can be achieved by mutual funds or large investor wanting to offload the stock in the market through index or stock futures at once, at far less cost and with much less impact on the price of the stock in the cash market."¹ The scheme or investor would be able to immediately sell index or stock futures. The actual sale of equity holdings can then be done gradually by the mutual fund or large investor depending on market conditions in order to get the best possible prices.

J. **To invest in the stocks by the new schemes:**

"Typically when a new scheme is floated by mutual funds, the money raised does not get fully invested for considerable time. Suitable securities at reasonable prices may not be immediately available in sufficient quantity for such schemes. Further, when the scheme wants to invest the whole money of the subscribers, it is likely to jack up the prices of the stocks to the disadvantage of the scheme and ultimately the unit holders. It is very important to time the investments in case of equity schemes to ensure better returns for the unit holders. If the scheme is launched by the mutual funds to take advantage of low equity prices, such advantage may get lost due to time taken for raising the funds by the schemes resulting in delay in acquiring suitable securities as the market situation may change in the interim period."² In such event, the availability of stock and index futures and options can help in providing the value to the unit holders.

K. **Helps in redemption of the units by the unit holders in case of open-ended fund:**

"In the case of an open-ended scheme, repurchases can also sometimes demand liquidation of a part of the portfolio, but then the schemes face problems in selling each holding in proportion to its weight in the portfolio is almost impracticable. Further, some of the stocks held by the schemes may be relatively illiquid and selling pressure may bring the prices in the equity cash market under pressure and further go down to the disadvantage of the unit holders. This may also result in realizing the actual worth of the stocks and may be different from the price used in NAV
computation for repurchase.” Largely, the unit holders redeem the units only when the markets are not good and they are looking for other asset classes or avenues to invest the money. Hence, the timing of liquidation is normally not right because of market depression. Stock and Index Futures help to overcome these problems to the advantage of unit holders.

L. Helps in preserving the value during the stressed market scenario:

Hedging can be potentially used by the Mutual Funds, financial institutions and foreign investors to protect them against any sudden crash event in the market. In the scenarios of market crashes, the main worry is the possibility that the value of the entire equity portfolio will fall substantially which will also reflect on the performance of the mutual fund. Thus, sell of Stock and Index Futures and Options can be used effectively to insure against such risk. Such insurance is specifically important when the accounts closing date is nearing because the yearly results get affected if the risk materializes. Thus, by use of Stock and Index Futures and options such risks can be neutralized.

M. Helps purchases and sell for FII, Sub-accounts and International investors:

“The buying and selling operations of FIIs cause disproportionate price-effect on the Indian equities market because there transactions are normally big sizes and they happen through the cash market only. This is one of the important factors which make the Indian equities market highly volatile. The FIIs’, sub-account’s and other foreign investors’ buying/selling is with an intention of either increasing or reducing their exposure to the Indian equities market.”4 This again in the similar way to the mutual funds offloading or purchasing can impact the price of the stock in adverse direction. The availability of stock and index futures in the Indian market can give them the flexibility to carry out the transaction with greater speed and less cost and without adding too much to market volatility. As seen in the past, the FII funds flow show sudden changes from time to time. The availability of stock and index futures and options gives them and the Indian investors a hedging device and will also help in increasing the appetite of the global investors for Indian equities.
N. Helps persons taking Directional trading view

If one has a strong view about any future direction of the market or the stocks allowed in the equity derivatives trading, the equity derivatives in the form of indices and stock contracts help them to take the positions on the exchange traded derivatives market. Also, for example if one has a strong belief that the interest rates will rise in the near future and wants to benefit in the future either by taking positions in the index and bank stock futures or by taking the positions in the index and bank stock options and benefit them from the falling or rising prices in the time to come. One would be able to do so by taking positions in the derivatives market.

O. Helps the investors to carry out Calendar Spread Trading

A Calendar Spread, also known as an Inter-delivery Spread. It is the simultaneous purchase of one delivery month of a given futures contract and the sale of another delivery month of the same underlying on the same exchange. This type of spread is called a "calendar spread" because it is based on different calendar months. For instance, buying a September 2011 contract and simultaneously selling a December 2011 contract. A market participant can profit (or lose out) as the price difference between the two contracts widens or narrows. The equity derivatives market helps these types of investors to carry out such kind of trading.

P. Arbitraging between cash and futures market

Arbitrage is the price difference between the stock and index prices in underlying cash market and the derivatives market without any view about the price movement of the underlying. One can earn the risk-less profit from realizing arbitrage opportunity and entering into the derivatives contracts traded on the exchanges by initiating offsetting cash. The equity derivatives market helps these types of investors to carry out the trading activity. This also helps keep check on the prices of underlying and aligns the prices to actual level across exchanges and across Indian and offshore markets where the underlying is traded.

6.3 Emerging Trends in Indian Equity Derivatives Markets:

The global derivatives markets have matured enough now over a period of time. Indian derivatives market has also undergone a period of immense change.
This change also had even greater impact on the industry than the change witnessed in the equity market segment when they moved from Open outcry system to the electronic system or when the physical shares were getting converted into the electronic dematerialized mode of storage through Depositories.

Some of the important changes that the exchanges witnessed during the last decade included:

1. the emergence of various channels of electronic communications such as leased lines, internet, mobile platform etc
2. other significant technology related developments such as Direct Market Access (DMA), Straight Through Processing (STP), Co-locations, Algorithmic trading, High Frequency trading, internet trading, low bandwidth sites, mobile trading etc
3. evolution of the systems and processes of the global standards including the Disaster Recovery Sites (DRS), Business Contingency Plans (BCPs) etc
4. globalization of equity derivatives markets where players now use multiple products on multiple exchanges;
5. launch of new products by derivatives exchanges to benefit investors.

The above factors also forced the equity derivatives exchanges to:

1. Become demutualised so that the ownership is no longer in the hands of the brokers but the exchange becomes corporatized exchange
2. Become for profit organizations to be able to raise capital as necessary and increase the speed of decision making to enable them to face competitive pressures.
3. Attempt to standardize and bring their operations to the global standards to cater to a global set of customers including FIIs, Sub-accounts, Foreign companies or funds and individuals.
4. Compete with each other since the exchanges can now copy the product immediately without any time lapse and capture the trading volume of the other exchanges
5. Make alliances or partnerships internally or with the international exchanges in order to compete more effectively against other exchanges by getting benefit of the expertise developed by these partners over period of few decades
6. Put in place the systems and processes of the global standards including the Disaster Recovery Sites (DRS), Business Contingency Plans (BCPs) etc to ensure that the large institutional players get the comfort of trading on the Indian Exchanges and also are least bothered about the systemic risks
7. Become market friendly to ensure that the lawfully permissible needs of clients or participants are met and to keep the pace of growth with the evolution of global and local markets.

These developments have given rise to some interesting trends which have been penned down below:

A. **Rise of screen based trading or internet trading:**

The rise of screen based trading, which has given the investors the ability to access markets directly via their own trading terminals through brokers or through internet sitting at home or through net cafe, is having a major impact on how a broking industry operates. The below given table highlights on the large number trades being carried out now through the internet trading as per NSE data:

<table>
<thead>
<tr>
<th>Financial Year</th>
<th>No. of Internet Trades</th>
<th>Trading Value through internet (Rs. in Cr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001-02</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>2002-03*</td>
<td>201079</td>
<td>5966.66</td>
</tr>
<tr>
<td>2003-04</td>
<td>1290043</td>
<td>54601.31</td>
</tr>
<tr>
<td>2004-05</td>
<td>4001697</td>
<td>120266.3</td>
</tr>
<tr>
<td>2005-06</td>
<td>10109586</td>
<td>428238.85</td>
</tr>
<tr>
<td>2006-07</td>
<td>22564037</td>
<td>1214961.31</td>
</tr>
<tr>
<td>2007-08</td>
<td>55778800</td>
<td>2372513.81</td>
</tr>
<tr>
<td>2008-09</td>
<td>99614694</td>
<td>1685691.67</td>
</tr>
<tr>
<td>2009-10</td>
<td>85737750</td>
<td>2624857.52</td>
</tr>
<tr>
<td>2010-11</td>
<td>68238474</td>
<td>4169323.55</td>
</tr>
<tr>
<td>2011-12</td>
<td>83468213</td>
<td>4910658.92</td>
</tr>
</tbody>
</table>

*Source: Compiled from NSE*

*Note: Data for 2002-03 is available from June 24, 2002 and hence considered since then for FY*

As can be seen from the above table, there has been significant rise in terminal based and/or internet trading and the clients have started preferring taking the calls on their own by taking the trading rights in their hand. This also gives the clients comfort that they may not get cheated by any dealers. Thus, there has been trend witnessed of increasing use of screen based trading or internet trading activity by the clients of brokers.
B. Reducing Brokerage Rates:

Stock Broking is one among various other businesses in India which is more technology driven & transparent. The key change is that this has resulted in execution services becoming very easy. Since there was hardly any value in providing execution services by brokers, the clients were not inclined to pay a fee for this. This trend has brought down the broking charges to pittance. Further, competition has brought down brokerages to almost 1/100th of the earlier levels. Today, the broking services are offered to clients at very low cost which is even less than 0.1% of the total traded value which used to be as high as 1% or more than that during the FY2000-2001. This also has been eating into the profits of brokers.

C. Providing value added services:

To retain their margins and to compete, brokers have been forced to provide other add on services such as clearing, execution in global markets, and more analysis and strategic advice. Also, with the widespread use of screen based trading systems the brokers are able to offer wide range of products to their clients. Thus, many brokers have diversified not just into other exchange products but other related financial products as well. Clubbed with screen based trading system the usage of internet trading facilities by the clients has also made it easier for them to go scouting for the cheaper options available for investment avenues worldwide.

D. Increased competition resulting in margins of brokers coming under pressure:

With margins more or less continuously under pressure, brokers have been reducing overheads which largely translate into cutting staff. This has led to a vicious cycle whereby cutting resources (staff), they offer fewer services to clients, which in turn reduces margins and, sometimes, results in fall in brokers’ incomes. However, brokers are downsizing and cutting costs to remain profitable. This trend was very evident post 2008 crisis faced globally.

E. Focus of large equity derivatives players on Clearing than transaction

The outlook on the global markets and also Indian markets has been sluggish during various periods in the last decade. Especially, the outlook
was very bearish in 2008 when there were large concerns on the global economy going into recession. Thus, the volumes on the exchanges and through the broking firms kept shrinking. Also, there has been increase in the number of brokers which has also divided the volume amongst those players. Thus, there has been increasing interest by large brokers on focusing on their clearing services to generate profits from this sector. Execution has become less important since even the clients have been shying away in the sluggish market. Clearing margins is now one of the major profit sources for many clearing members.

F. Consolidation of Broking Industry:

With the margins under pressure, many derivatives broking entities are feeling the heat. They also grapple with the thought that they may not be able to sustain for longer if the global concerns remain and the industry doesn’t do well. This trend is also seen globally where the industry players are merging. Equity derivatives brokers who have not been profitable and if this is a substantial number then these are being sold or merged. In the Indian Industry, we have seen mergers or acquisitions of some the broking arms such as Securities Trading Corporation of India (STCI) acquired UTI Securities, Edelweiss group acquired Anagram group, HSBC acquired IL&FS Investmart etc to name a few.

G. Large clients going Global:

With the NRI population increasing and also large HNI clients scouting for more avenues to divest their portfolio, these clients are becoming more global in their trading outlook. Large players are getting direct access to the global derivatives markets, via exchange screens and internet facility and hence have less need for Indian brokers today. Brokers today need to access other capital markets around the world to offer full fledged services to retain their larger clients, who are already investing in the foreign avenues available to them. Further, even retail trading clients have started feeling the need to diversify in other markets for trading and require access to global markets. This is also forcing brokers to globalise their operations in order to provide what their customers want. There has been tie ups with other global brokers of other futures exchanges taking place to provide such services to clients.
H. Shifting of loyalty from one exchange to other exchange has become easier

Traditionally, brokers used to be loyal to the exchanges where they used to participate in the open outcry system. They were also loyal to those exchanges since they were the members of the association which floated the exchange and effectively in some form or the other controlled the exchanges or felt part of the exchanges. Subsequently, with onscreen markets, a broker can now trade as many products that suit him or the clients, irrespective of which exchange it is being traded on. Also, with demutualization the loyalty factor of one exchange has eroded and brokers have started providing the services to clients as per client’s demands and depending on their comfort with the exchange. Thus, brokers have much less loyalty to any one particular exchange now compared to the old days.

I. Reduced loyalty to the Indian Exchanges

Besides, reducing the loyalty to any one Indian Exchange, the trend is also observed that brokers also have reduced their loyalty to Indian stock exchanges. Since, the clients and brokers are trading for making profits and also ensuring that the costs involved in such trading activity are minimal to increase the profits, they trade on any exchanges where the costs are less and they are able to generate higher profits. The investors, members and other participants have no longer remained loyal to any one Indian Exchange and in order to maximize profits and minimize costs, they are willing to flock to any part of the world on any exchange which has same or similar products and which offers them the best or competitive pricing or deal. “This is also observed from the news articles published in leading newspapers since January 2012, where it was observed that the Open Interest in NIFTY Index Futures is higher on Singapore Stock Exchange (SGX) than that of NSE. NIFTY Index is the index of NSE which got listed on SGX as well apart from being traded on its own exchange.”

J. Cross Margining benefit is also effecting the trading in the underlying

SEBI has allowed exchanges to give the cross margining benefits since May 2008 for institutional clients and since December 2008 to all categories of clients subject to certain criterions specified by SEBI. This cross margining benefit is available to clients for trading in Equity market.
and the Derivatives markets of the same exchange. It has been observed that NSE has been controlling almost more than 97.5% of the market share in the equity derivatives market in India. Also, the margins are levied only for the derivatives trading and not for the cash equity market trading. We have seen over a period of time, the underlying market share of NSE going up to 80% and BSE being reduced from around 40% to 20%. One of the reasons may be attributed as cross margining benefit available to clients on NSE since in order to avail the benefit of the cross margining the clients prefer to shift their regular equity trading activity from one exchange to other which can help the clients manage their capital efficiently.

K. Cross Listing of Global Indices

In September 2011, SEBI permitted the exchanges to allow listing of global indices on the Indian Stock Exchanges for derivatives trading. There are already various global indices that have got listed on the Indian Stock exchanges and some of them are also being actively traded on it. “Globally, since 2010 several exchanges have started offering trading services allowing domestic investors to trade foreign stock index options and futures. In 2010, Eurex started offering KOSPI 200 index options. In October 2011, Honk Kong Exchanges and Clearing, BM&FBOVESPA, National Stock Exchange of India, Bombay Stock Exchange, Johannesburg Stock Exchange Micex and RTS decided under an alliance agreement to cross-list each other’s stock index options and futures contracts.” This trend of cross listing is also gathering momentum and at this stage it is too early to make any comment on whether they would attract significant volumes in those indexes.

L. Exchange Corporatization and Demutualization

There has been a trend for exchanges to corporatize and demutualize and become for profit organizations. This was also forced upon by SEBI on many exchanges seeing the interference of the broker members in the day to day activities of the stock exchanges. Under corporatization and demutualization, the exchanges are run as commercial organizations and not necessarily in their interest of its former members who were stock brokers. Today, almost all the recognized stock exchanges are demutualised i.e.
exchanges are not being member owned but rather for profit firms. This has also paved way for its listing on the other exchanges.

M. Exchanges are increasingly forming alliances

As we see the exchanges are trying to build alliances to get the benefit of the international expertise and also attract the global players by comforting them with such alliances. Germany's Deutsche Boerse took 5% stake in BSE in February 2007. Subsequently, in March 2007, Singapore Stock Exchange (SGX) picked up 5% stake in BSE. The BSE stake is the first foreign acquisition by the SGX, which is Asia's third-largest listed bourse. Earlier, the US-based stock exchange, New York Stock Exchange (NYSE) had acquired 5% in National Stock Exchange (NSE) in January 2007. We have seen alliances on the Currency Derivatives side where BSE formed alliance with United Stock Exchange of India Ltd (USEIL) to offer the currency derivatives segment and suspended its currency derivatives segment. NSE has also sometime in 2009-10 signed an arrangement between Madras Stock Exchange (MSE) under which NSE would share trading platform of NSE with it and the same was also approved in-principle by SEBI. Looking at the way in which the developments are happening in the equity derivatives market where one more new player in the form of MCX-SX getting the permission to provide equity derivatives trading in India, the scenario of few more such alliances in this space cannot be ruled out.

N. Changing Structure of the Market Intermediaries:

The old structures of member, membership organization, and exchanges are disappearing. The centre of a market is no longer the exchange but the multitude of dealing screens of brokers and end user’s dealing rooms. Derivatives exchanges are merging or forming alliances due to increased competition for its survival globally. The trend has been seen in Currency Derivatives, the same would be seen in the equity derivatives as well where one exchange is having dominant share in the market and other negligible. Now, with the entry of the third equity derivatives exchange, the dynamics may undergo change and may see some changes in the exchange structures. We are already seeing the changes in the structure
of other market intermediaries where they are increasingly getting into diversified businesses to keep themselves afloat.

O. Emergence of Technology Based Trading

There have been several developments due to technological advancements in the way the trading activity is carried out. There is more thrust on the algorithmic trading by the bigger players and also some of the small players are also exploring the arbitrage opportunities through the use of algorithmic trading. There also have been large numbers of global players with considerable amount of strategies developed around trading in the algorithmic manner run by the machines without any manual intervention depending on the market scenario or kicking off of some event which triggers these strategies. These kind of trades are typically called as High Frequency Traders (HFTs)

P. Emergence of another mode of trading in the form of Mobile Trading:

SEBI vide its circular dated August 27, 2010 allowed Securities Trading using Wireless Technology (STWT) or mobile trading. Subsequently, the exchanges allowed market participants to offer the same to clients at large. This has not only further given fillip to the existing way of carrying out trading but also has enabled the large number of mobile users to trade on the go whether they are travelling, outstation, in the plane or somewhere in the remote location where mobile connectivity is available. This is setting a new trend and brining in the set of investors who can now trade in the market using mobile platform who might have stayed away from the market earlier.

Q. Direct Market Access to the FIIs, Sub-accounts etc:

Direct Market Access (DMA) is a facility which allows brokers to offer clients direct access to the exchange trading system through the broker’s infrastructure without manual intervention by the broker. Some of the advantages offered by DMA are direct control of clients over orders, faster execution of client orders, reduced risk of errors associated with manual order entry, greater transparency, increased liquidity, lower impact costs for large orders, better audit trails and better use of hedging and arbitrage opportunities through the use of decision support tools /
algorithms for trading. DMA facility was allowed by SEBI since April 2008. The trading members extend this facility at the location of the FIIs or sub-accounts as a trading terminal. FIIs/Sub-accounts can place the orders from these terminals which then pass through the risk management system of the members before routing them to the exchange’s trading platform. This facility has been increasingly found to be used by foreign investors. This has also changed the old trend of receiving the orders through Reuters, Bloomberg or telephonic conversation setting in the new trend of accessing market directly by FIIs, Sub-accounts etc.

R. Co-location Facility:

Since August 2009, the Exchanges had introduced co-location facility for members who were permitted DMA and ALGO trading by the Exchange. This is another trend getting developed in the derivatives market where the members take the rack space in the location closest to the exchange’s trading platform. Today in the world of technological development, the speed of placing the orders and execution of orders plays a very important role. It is very important from the members and client’s perspective that in the scenario of Price Time priority of the trading platform, they are able to grab the opportunity to execute the trades before anyone else is able to place the orders for the same. This with the algorithmic trading is now happening in the fraction of seconds or rather nano-seconds. Thus, in order to curtail on the order travel time to the Exchange’s trading platform the brokers and HFT clients have been wanting to get the space closer to the exchange or in the exchange premises to route their order earliest to the exchanges. This has been possible with co-location facility being allowed to them. Today, we find many members have their operations being carried out from the co-location facility for large clients and sometimes for their proprietary trading activity.

S. From skilled staff shortage to skilled staff abundance:

Since the day permission was granted to start trading activity in equity derivatives market in India, it was prerequisite to operate the trading terminals by certified dealers only. For the purpose, NSE and BSE both had training department which used to certify such dealers as NCFM and BCDO certification. In the initial days of equity derivatives trading, there
was dearth of skilled labour since there was good number of brokers in the market but less number of persons who were NCFM or BCDO certified who could operate Derivatives trading terminal. Hence, there was a shortage of experienced staff amongst other brokers and end-users, which restricted the creation of critical mass of trading in equity derivatives market. Insufficient training of staff at brokers and exchanges also resulted in salaries for experienced staff skyrocketing.

However, now the situation has changed, there are good numbers of certified staff which can handle the trading terminals. Besides this there is also shift to algorithmic trading by large clients or proprietary books of brokers and institutional clients. This has also made it redundant to actually need for manning the terminal even though certified persons certificate is required for such terminals.

T. Training by Exchanges to Training Institute of SEBI

Even though permission was granted for equity derivatives training, as mentioned earlier there was dearth of trained staff to operate Equity Derivatives Terminals. Also, the training was imparted by only two bodies i.e. NSE and BSE. These exchanges also had limitations in terms of number of centers at which the trainings could be conducted where as the trading could be carried out from the nuke and corners of the country. This made it difficult for many people to undertake the training even if they wished to take up the same. In the absence of education of these users, a critical mass of trading volume was difficult to generate since not all potential participants could have large number of trading terminals due to absence of skilled and trained workforce. In the derivatives market, the success would depend on generating critical mass as soon as possible which we have been able to do now over a period of time.

Over a period of time the number of centers at which the exchanges conduct trainings also have increased and at the same time SEBI has also set up its own world class training institute in the name of National Institute of Securities Markets (NISM) which now conducts trainings in various courses in the securities market apart from the training in derivatives as well. National Institute of Securities Markets (NISM) is a public trust, established by the Securities and Exchange Board of India (SEBI) in late
2004 to add to market quality through educational initiatives. Thus, now there are 3 entities which are conducting trainings and conducting tests in the derivatives markets. This has made it easy for staff to undergo training and today there is no dearth of skilled workforce.

U. From inexperienced industry to experienced industry

In the initial days, even though the exchanges were ready to offer the trading in the equity derivatives, the technology used was the one developed by the Indian IT firms. Thus they could not get the expertise of the international markets. Even though over a period of time, the systems have proved to be robust, it has taken time for international players to get the comfort to trade on the Indian Exchanges. The sharing or transfer of technology and knowledge is critical for the success of any young industry and in that sense exchange traded derivatives was completely young and new industry. The globalization of exchanges and brokers also meant that there would be significant interest by offshore brokers and exchanges developed in the Indian derivatives market. The derivatives industry could capitalize on this interest by attracting these brokers and exchanges to our country only through the comfort given in terms of systems, processes, economic and regulatory policies. Thus, today after almost over a decade after the trading started in the equity derivatives market, it has emerged as one of the successful industry and also now an experienced industry.

V. Doubt of Integrity of the Exchanges to Confidence in Integrity of the Exchanges:

Since, the exchanges were considered to be broker controlled there were doubts in the minds of the foreign players about the Exchange integrity. Exchange staff is usually the staff of the exchange promoters, who in turn are the dominant traders in the underlying physical markets. The president or chief executive office of the exchange is usually one of the dominant players in the physical market. Thus, foreign players shy away from trading in the derivatives markets due to this situation where possible conflicts of interest can occur. Thus, in the initial years there was not much interest developed by foreign players in the Indian derivatives market. However, over a period of this doubt of integrity has waned. BSE which was broker controlled, now has become completely demutualised exchange.
SEBI also vide various guidelines ensured that the market players get the comfort for trading on the Indian Derivatives Exchanges. This was achieved by guidelines for appointment of the Governing Board of Derivative Exchanges/Segment including Governing Council/Executive Committee, Clearing Council, Executive Committee of Derivatives Clearing House/Clearing Corporation, Chief Executive Officer of Derivatives Exchange/Segment, Chief Executive Officer of Derivatives Clearing House/Corporation and Statutory Committees such as Disciplinary Action Committee, Arbitration Committee, and Defaulters Committee etc.

It has ensured that there are more public representatives or independent directors on the board of derivatives exchanges, introduced a more diverse board structure including limiting board members who are representatives of brokers, introduced committee structures for various statutory committees such as Arbitration committee, Disciplinary Action Committee, Defaulters Committees etc. With all these steps taken by the Exchanges and the regulators, today there is hardly any doubt left for anyone to doubt the integrity of the exchanges.

W. Emphasis on Infrastructure Development:

In India, the trading system and the clearing corporation/house has been robust and tasted for long time now. NSE which has been running the equity market since 1994 has proved time and again that their system is robust to take care of systemic risk. BSE also has moved to the electronic platform subsequently. The main requirements for a derivative market are a trading system and a clearing house. It has been proved that both these technologies are well developed and available in scalable form. The main infrastructure challenges are:

a. Having robust surveillance systems to detect market abuses is critical to give the comfort to the investors at large. This is very difficult to achieve, but exchanges and SEBI have developed excellent tools for the same. It is very essential that exchanges are equipped to assure market integrity to the retail investors in general and institutional in particular to ensure capital flow in the derivatives market.

b. Effective online margining system to ensure that the market participants are aware of their margin applicability from time to time. Further, in
order to provide cross margining integration of various systems to assess margin requirements by considering the securities/derivative positions jointly. This even though not essential for launching a successful derivatives market, but this helps in providing substantial cost savings to participants, especially intermediaries and other active participants.

c. Having robust secured online trading systems to reach to the nuke and corners of the country and to the world at large since now globe is a village. This is must since now with the passing time the technology is used on very large scale to ensure that there is large participation in the market.

d. Today, the equity markets or derivatives markets can be shunned by the large investors and even the retail investors in general, if there is any event of natural calamities such as earthquake, flooding etc or terror attacks that hits the market resulting in discontinuity of the trading activity or takes longer time in reinstating the trading system. This is taken care by having putting in place Disaster Recovery Site (DRS) and Backup Contingency Plan. This is generally achieved by putting DRS at a place which are in different seismic zones so that the natural calamities and such other events does not disrupt the market and they can continue the trading activity despite a particular area or city is hit by letting the investors in all parts of the world trade unaffectedly.

X. Economic Factors are supporting and fueling growth

The economic factors that help in making the derivatives market successful are:

a. When there is natural hedging demand in the market, i.e. when good number of participants in the market has the businesses which requires them to take exposures.

b. When there are intermediaries in the market who do not have natural exposures, but take on exposures in the derivatives market. They are necessary to provide liquidity for natural hedgers. These are intermediaries who create speculative demand in the market.

c. When there is effective pricing mechanism in the underlying market which reflects genuine investor demand and is not subject to manipulation or sudden volatility caused by lack of liquidity.

d. When there is ample of supply of underlying assets.
When there is thorough knowledge among participants including retail investors about the functions, possibilities and risks of derivatives.

There is a need for all kind of investors in the market including the hedgers, speculators and arbitrators. All kinds of demands are must for the success of the derivatives markets. Considering the nature of Indian market where “Badla” system has been prevalent since long time, it is relatively easy to encourage speculative demand on the exchange traded derivatives market. In fact, all kind of markets have the class of intermediaries whose prime purpose is trading for the short term and they also keep on increasing the number of products in their basket for speculative trading.

In India, there has been quite a good growth of Institutional investor class since very long time and there has been large amount of capital which has found the investment avenue in the form of equity markets. Further, after liberalization of the economy there are also a large number of Foreign Institutional Investors who have been existing in India and have been investing a significant amount in the equity markets. This has created a natural demand for hedging due to their business since it requires them to invest for the long-term and manage their risk in the meantime.

Indian market has been also successful in developing extensive retail demand in the capital market. This demand is strongly supported by widespread internet usage which has not only simplified access to the market but also has tremendously reduced costs to retail clients. In India, the retail clients also have been providing the investment or hedging demand for derivatives. It has been observed that most of the time retail trading is speculative in nature. Hence, there is a need felt for long-term investment institutions to provide hedging demand which is satisfied by the financial institutions and FIIs in India. Also, if we look at the number of contracts traded in the Indian derivatives market it is found that the retail involvement is strong and has successfully provided the basis on which the equity derivatives markets are fostering.

Indian Stock Exchanges have transparent and fair trading systems. Manipulation and abuses are addressed by the legal/regulatory systems to monitor and investigate breaches. Hence, the other problem such as lack of
liquidity has been addressed through a decent equity market which is highly liquid.

6.4 Problems of Indian Equity Derivatives Markets:

As seen in our earlier chapters, the government policy with regard to derivatives market has been assorted. There has been slow progress in opening up the derivatives market to the Indian investors at large. Even though the pace of opening up the equity derivatives market has been slow, still there are concerns on the derivatives in the commodities market. The currency derivatives market was opened up only in 2008. There are few stumbling blocks in development of the successful derivatives market. Even though we have overcome few there are still few barriers in achieving the far greater heights.

1. Statutory / Regulatory barriers

Knowledge of derivatives is not highly advanced in many developing markets. This is true of practitioners, and is perhaps even more in the case for regulators. In fact, one of barriers to development of derivatives markets is cautionary moves/steps by regulators caused by a failure to understand the nature of derivative markets, or at a minimum to be at ease with their functioning. That is the precisely the reason for it taking so long in India to launch the equity derivatives market. Statutory barrier is one of the main regulatory barriers. There are countries where laws specifically prohibit derivatives or do not specifically permit them. We have gone through this phase for long time before the Laws were amended in …. 

There are also few nations where laws do not clarify which entity has regulatory jurisdiction over derivatives even though this is linked to the legal definition of “securities” and hence the Capital Market Regulatory Body becomes the regulator for them. However, as we have observed in India, it took long time for Currency Future derivatives to start since it was falling under multiple regulators and it was only when the go ahead came for Reserve Bank of India the Currency Derivatives were launched in India in 2008.

In some countries, laws prohibit gambling or make gambling contracts unenforceable and hence where derivatives are not clearly distinguished from gambling, the derivatives market cannot be given go ahead. Sometimes, the legal framework supports forward contracts where
the norm is physical delivery at the time of expiry but does not support the cash delivery contracts. However, since most exchange traded contracts are cash-settled and even if physical delivery is permitted there cannot be market developed for exchange traded derivatives market. Even though today, largely these issues have been addressed, it is perceived that the regulatory body is moving at the snail’s pace in terms of liberalizing the equity derivatives market and making it accessible to large number of investors offering bouquet of products to invest or trade in. It has often seen that the strongest barriers to derivative markets are often government policies or regulatory inhibitions. Thus, the openness of the government and the regulatory bodies to quickly comprehend the pace required for the derivatives and adapt to the quick changes happening in the derivatives market is primary thing required to give further boost to the existing derivatives markets. There is a need felt to expedite the regulatory clearances in order to give further fillip to the growth of the equity derivatives market in India.

2. Incorrect understanding / pre-conceived notions about the Derivatives Market leading to cautious approach

Derivatives are considered to be complex product compared to simple equity cash market trading by many. Many a times, the specific nature of derivatives markets is not understood by the regulators which gives rise to many fallacies such as Derivatives substitute the existing underlying markets, Derivatives only benefit FIIIs, Sub-accounts etc, Derivatives should be with physical delivery to have usefulness etc.

Many times, the decisions by the regulatory authority are driven by these pre-conceived notions coupled with the fear of taking a decision if taken in favour of the market may boomerang. Thus, the regulatory body tends to take a very cautious approach to avoid any controversies and also to safeguard themselves from any CAG or Parliamentary questions. This leads to either indecisiveness or putting stringent norms for the market without having any practical approach but which is rather governed by the conservative approach. In India, this is predominant where we have seen the regulators being subjected to the various enquiries and has been answerable to the parliamentary body. This does not give any independence to the
regulatory bodies to take quick decisions and enforces upon them to take cautious approach.

3. Apprehensive approach by the Government Bodies and Regulators:

Regulators are normally considered to be risk averse. Financial scams do not affect only the economy but also goes beyond that to tarnish the political image and in fact have far bigger impact in the political world beyond the financial markets. Thus scams leave deep blemishes that can last for a long time, leaving regulators very cautious and negative towards innovation. India has seen big scams like Harshad Mehta, Ketan Parekh in the recent past besides few small scams here and there. These scams have left the bad taste in the mouth of the regulators and some of them have even bitter taste as they had to face the music. In fact, most of the scams seen abroad do not involve derivatives but with the past experience about scams erupting when the regulations are relaxed little bit and also these scams have most of the time been attributed to weak regulation rather than anything else.

It is normally assumed that the derivatives market substitutes the underlying market. It is true and evident from the study that the derivatives market grow larger than the underlying market but it is also true that the derivatives market improve and complement the existing underlying markets by providing other options such as hedging tools, additional opportunities for speculators and arbitrage opportunities.

It is also feared that due to nature of derivatives products it causes an exponential upsurge of risks and exposures which may lead to causing systemic collapse. In practical terms, derivative settlements are very tightly controlled by a clearing-house by levying margins and also having settlement of mark-to-market losses on T+1 ensuring that there are no settlement losses built due to non-collection of margins or losses over a period of time. In fact, since the regulations of capital adequacy are stringent and effectively controlled by the exchanges the chances of derivatives causing systemic risk resulting in collapse of market is minimal.

It is also feared that the derivatives stimulate price speculation resulting in increased volatility. If we look at the way derivatives offering, it is an alternative offered at low cost for taking divergent positions. In fact,
derivatives help in reducing speculative volatility and providing liquidity to the market by managing the imbalances due to lack of liquidity.

All the above factors force government body and the regulators to be apprehensive about the derivatives markets and in turn affect the decision making.

4. Increasing in Market manipulative activities

Derivatives help manipulators and it make easier to abuse the market – It is often felt that the derivatives is easy tool used by the market manipulators to hinder the integrity of the market by one or group of scrupulous persons/entities. It is very much acknowledged fact that the derivatives open new possibilities for market abuse, and so present new challenges for monitoring and surveillance. However, it is not apparent that markets have successful derivative exchanges are more subject to market abuse than those that do not. It is easier to regulate markets that are open and transparent in comparison to unofficial markets for derivatives that often exist where exchange markets are not available. The regulators also often feel that the derivatives is a tool which can be used more frequently and without getting detected for hindering the integrity of the market and carrying out manipulative activities. Regulators have always feared short-selling activity and hence there has been ban on short selling from time to time in the developing Asian markets. The real effect it has is to prevent profiteering from trading in the bearish markets. The basic structure of derivatives make such a ban senseless, since selling futures or options gives the same exposure as short-selling and hence regulators having concerns on the short-selling are unlikely to vouch for or support derivatives markets. Thus, the fear always persist about short-selling by use of the derivatives instruments which has far bigger potential for market manipulation than the regular trading. Further, various derivatives instruments also have bigger potential of giving a tool in the hands of the manipulators to manipulate the market which can also have a cascading effect on the underlying equity market. Due to dearth of specialized investigative skills the manipulative activities in the equity derivatives market has so far has not surfaced. If we look at the investigation orders passed so far, they have been mostly for the manipulations carried out in the equity market and there have not been
hardly any orders passed against the manipulators in the derivatives market. Thus, there is need to increased vigilance through highly skilled employees specifically in the area of derivatives from the regulators and the self regulatory organizations to give the comfort to the investors in the equity derivatives market at large.

5. Complexity in the Tax Treatment given to the Equity Derivatives transactions:

Derivatives are fairly new from the concept of application of the tax treatment. There has always been ambiguity on the tax treatment of the earnings from transactions in equity derivatives. In the initial years of derivatives there has been lot of ambiguities in terms of what taxation laws would be applicable to these types of transactions. In India, the prime question arises is under which head of income this income would be taxable. The question also arises on the treatment to be meted out to such derivatives gains or losses and whether the same should be considered as business income, capital gains or income from other sources. Also, the question arises on whether the losses in derivatives should be treated as speculation losses and whether the income from derivatives transactions should be calculated when there are unsettled or carried forward derivatives transactions at the end of the year.

"With regard to the taxation treatment for the trader in the shares, if the derivatives transactions are merely an extension of the share trading activity, the derivatives income is regarded as business income and treatment given is same as that of the share trading income. When it comes to tax treatment for the income generated by investors in shares who has also transacted in shares, one has to independently verify the actual nature of these derivatives transactions. When there are frequent derivatives transactions which are not linked to the shareholding or the stock transactions, generally these derivatives transactions are regarded as the transactions carried out for earning short-term profits and income earned through these transactions is hence taxable as a business income. However, when these frequent derivatives transactions are closely linked with stock investments such as for hedging to safeguard against fall in stock prices of existing stock investments, then it can be said that these transactions are not in the nature of business transactions. The issue that remains is about the
nature of tax head they would fall in i.e. whether under capital gains or as income from other sources. Many tax payers take a view that the income from such derivatives transactions is taxable as capital gains, the chartered accountants feel that it is possibly a safer approach to treat such income as income from other sources. In any case, the rate of tax for both these types of income is the tax slab applicable to the tax payer since these capital gains are short-term capital gains on securities other than equity shares or units. Hence, other than for the purpose of setting off of loss, there is no difference if such income is taxed as capital gains or as income from other sources. Further, in the event the derivatives transactions are not in the nature of business then it is attributed to only the loss of a speculation business which is subject to the prohibition on set off against any other income. Normally, a transaction for purchase or sale of stocks and shares which is settled without delivery is regarded as a speculative transaction. Since derivatives are necessarily cash-settled without delivery by payment of differences between the initially transacted price and the final price, these transactions are regarded as speculative transactions. If such transactions constitute a business, then the loss from such business cannot be set off against any other type of income.\(^7\)

There is a specific exclusion for the exchange traded derivatives in shares and securities from the definition of speculative transaction. Derivatives transactions carried out through a registered broker on a recognized stock exchange are not regarded as speculative transactions. Only four stock exchanges are so far recognized for this purpose, viz. Bombay Stock Exchange, National Stock Exchange, since February 25, 2011, United Stock Exchange and recently in 2012 MCX Stock Exchange is added to the list. Since, we are covering here only the exchange traded derivatives market, hence loss from derivatives transactions in securities are generally not treated as speculation loss, and can be set off against other permissible incomes, depending on the head of income under which such loss falls.

In case of settled derivatives transactions, the gain or loss is determined and hence has to be taken into account while computing the tax payer’s income. In case of unsettled derivatives transactions as at the year
end, one is required to book the mark-to-market loss, but ignore any mark-to-market profit.

To summarize, in Futures since there is no transfer or delivery of the underlying asset in case of futures, the income or loss from it cannot be taxed under the head "capital gains". “Hence, depending upon the fact whether the assessee is a trader or an investor, the head of income, whether income from business and profession or income from other sources is determined, but in either case the income will be taxed on net basis at the rates of tax applicable to the assessee. In case of Options, the option premium is an income for the writer of the option and a tax-deductible expense in the hands of the buyer of the option. In case of a trader, the taxability of the gains on exercise of the option is similar to that in the case of futures trading. However, in case of an investor, the gain from these transactions is treated as a capital gain, instead of income from other sources and the premium is allowed as the cost of acquisition. With the insertion of Section 43(5) (d), eligible transactions on notified stock exchanges have been rendered non-speculative in nature. So far only few exchanges like BSE, NSE, USEIL and MCX-SX have been notified for this purpose. Therefore, trading in commodity and equity derivatives traded on stock exchanges other than those mentioned above, is still treated as speculative, the loss wherefrom cannot be adjusted against any other sources of income. Also, the losses are eligible to be carried forward only for a curtailed period of four years. In the event of a situation of the Open Interest, wherein on the date of the financial year end, there are outstanding derivatives contracts in the hands of the market participants. Since, under the prudent accounting principles, derivatives contracts are marked-to-market (MTM), there can be unrealized MTM gains or losses prevailing as on March 31st. Whether the assessee will be liable to tax on the gains or take the benefit of the losses in such a case. Only real income/loss attracts tax provisions and not the notional gains/losses. However, in certain judicial decisions notional losses have also been allowed as a deductible expense. Nevertheless, this is one area which can attract litigative exercise.”

Thus, even though there has been some clarity on the treatment of income from the trading in Equity Derivatives still there are few areas
which are ambiguous and they need to be clarified. Besides this, if there are complex products which would be added to the equity derivatives market this would create further ambiguity on the tax treatment for such products. Hence, there should be clarity given by the tax authority in this regard.

6. Transaction Costs on Trades Executed in Derivatives Segment:

Security transactions on the stock markets in India attract various taxes and charges such as Brokerage, Exchange transaction charges, SEBI Turnover Fees, Stamp Duty and Securities Transaction Tax (STT). Besides above charges, service tax is levied not only on the brokerage charged but also is charged on Exchange Transaction Charges and SEBI Fees. The structure of transaction costs borne by the investor in equity derivatives transaction is presented below:

<table>
<thead>
<tr>
<th>Cost Head</th>
<th>Futures</th>
<th>Options</th>
</tr>
</thead>
<tbody>
<tr>
<td>STT</td>
<td>51.7%</td>
<td>10.4%</td>
</tr>
<tr>
<td>Service Tax on Brokerage</td>
<td>22.5%</td>
<td>75.4%</td>
</tr>
<tr>
<td>Stamp Duty (Maharashtra)</td>
<td>12.2%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Transaction Charges</td>
<td>11.6%</td>
<td>12.2%</td>
</tr>
<tr>
<td>Service Tax on Trx charges and SEBI Fees</td>
<td>1.5%</td>
<td>1.5%</td>
</tr>
<tr>
<td>SEBI Turnover Fees</td>
<td>0.6%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

Source: Contract Notes and NSE

The market participants are more and more finding the multiple levies and cost of transaction heavy and burdensome. The multiple levies mentioned above have a cascading effect and adversely affects the competitiveness of the Indian markets compared to Global markets. There is a growing concern among market participants that the cost of trading in securities has been high, causing an adverse impact on the prospects of Indian Securities market amidst declining volumes on the bourses. According to market estimates, a securities transaction worth Rs. 1 lakh currently attracts a total cost of Rs 269, or 27 basis points. This includes brokerage, stock exchange transaction charges, depository charges, SEBI turnover fees, Securities Transaction Tax (STT) and stamp duty. Globally, total cost of transaction is estimated to be in the range of 9 basis points to 30 bps (100 basis points is 1%) of the traded value. With 27 bps, the trading
costs are at the higher end of the range after China and Hong Kong, according to an IMF paper. However, these countries do not have any statutory levies as high as in India, especially in the form of STT. It is also felt by the market intermediaries that high transaction cost has reduced market depth and liquidity, increased volatility and made Indian markets less competitive than its global peers.

7. **Impact of Securities Transaction Tax (STT):**

   Government of India, in the Union Budget of 2004-05 introduced the policy on taxation on securities and introduced the Securities Transaction Tax (STT). These levies of charges have worked for now almost eight years and it has been found to be an efficient and transparent method of tax collection. The rates applicable to different transactions have undergone periodic changes. Today, STT typically constitutes 52% of the over-all taxes and levies of a futures transaction. We may draw some inferences from the Korean markets which offer an interesting insight and can be considered to be relevant in terms of market size and dynamics which are somewhat similar to the Indian markets. The Korean markets were of a similar size in 2003, but currently the Korean volumes are almost five times the Indian market volumes. This can be attributed to various factors including a reason that Korea does not have a STT like levy and is often cited as the reason for the large volumes.

8. **Export of Indian Capital Markets to Offshore Exchanges like SGX**

   Indian markets are increasingly getting integrated with the global markets. This trend is expected only to gain momentum in the years to come. For the Indian market players (stock exchanges, market intermediaries, etc.), this poses new challenges as well as opens up new opportunities in terms of new products, increased trading volumes, etc. The scope for growth is vast and the market players are geared up to reap the benefits of the potential.

   “As per the recent news articles published in various financial newspapers published in the month of November 2012, Nifty volume growth on SGX has outpaced trading on NSE. Nifty contracts are heavily traded on SGX with improved volumes and open interest. SGX launched
Nifty futures in September 2000, a few months after NSE began that product on the Exchange.

The report stated that foreign institutional investor exposure to Nifty futures traded on the Singapore Exchange (SGX) hit a record high in the month of October 2012 overtaking volumes on the NSE this year which clearly highlights the continued export of India's financial markets amidst relative ease of doing business and greater offshore regulatory clarity. The average daily value of FIIs' open interest (OI), or outstanding positions on Nifty futures traded on the SGX, was Rs 21,700 crores against Rs 14,600 crores on the NSE in October 2012. This was 60% of the total open interest on both the SGX and the NSE in value terms, according to data compiled by financial services company Edelweiss.°9 SGX's OI began rising slowly after the introduction of the securities transaction tax (STT), a levy imposed on both buyers and sellers of securities and derivatives, in FY05. The growth spurted during the temporary ban on P-notes between September 2007 and October 2008. It exceeded that of NSE futures after the amendment of tax laws in the FY12 Union Budget this March. The comparison of transaction cost of Nifty Futures on NSE and SGX is given below in the table:

**Table 6.3**

<table>
<thead>
<tr>
<th>COST HEAD</th>
<th>NSE*</th>
<th>SGX*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities Transaction Cost</td>
<td>17</td>
<td>NIL</td>
</tr>
<tr>
<td>Stamp Duty</td>
<td>2</td>
<td>NIL</td>
</tr>
<tr>
<td>Service Tax</td>
<td>2.08</td>
<td>0.49</td>
</tr>
<tr>
<td>Regulatory Fee</td>
<td>.02</td>
<td>NIL</td>
</tr>
<tr>
<td>Exchange Fee</td>
<td>1.75</td>
<td>5.12</td>
</tr>
<tr>
<td>Total</td>
<td>23.03</td>
<td>5.61</td>
</tr>
<tr>
<td>For a round trip transaction</td>
<td>29.06</td>
<td>11.22</td>
</tr>
</tbody>
</table>

*Rs. per lakh turnover

*Source: The news article in the Business Line dated January 15, 2012*

One reason seems to be lower transaction costs in Singapore compared with the local markets. For every lakh of turnover (a round-trip transaction) in Nifty futures, an investor has to shell out Rs 29.06 on the NSE, against Rs 11.22 at SGX.
More importantly, average open interest on SGX matches or has even overtaken the average open interest on NSE. Trading on SGX cannot be explained in terms of time zone differences, as there is a considerable time overlap between the trading sessions on the exchanges. Feedback indicates that STT is a powerful deterrent against trading on Indian stock exchanges.

**Chart 6.1**

SGX Nifty Futures Volume as a percentage of combined NSE & SGX Volume

As can be seen from the above table there is a sharp trend of Indian capital markets getting exported to the offshore Exchanges due to a variety of reasons. Export of markets means that participants are shifting their trading positions from the domestic market to an offshore market, where the same asset is traded, to avail of cheaper taxes and lesser administrative hassles. For example, STT of Rs 17 per 1 lakh on Nifty futures functions as a tax on trading, irrespective of whether an investor makes a profit or loss and coupled with income tax on profits this raises the cost of transaction for an investor. Thus, FIIs have shifted their trading activity to Singapore Stock Exchange (SGX) for the same asset traded, i.e. Nifty Futures, which does not impose STT and even the income tax on the profits made by them is minimal.

Another reason could be attributed to the Government stand taken earlier on the GAAR proposal which is aimed at retroactively taxing indirect transfer of Indian assets. This created lot of instability on what would be the government strategy on taxation and other such issues due to uncertainty of events. The GAAR proposals now have somewhat thinned in the air and are likely to be deferred till April 2016 by the Shome Committee.
set up to examine the laws. Apart from the uncertainty over tax laws, market experts attribute the phenomenon to lower cost of doing business out of the island republic and fewer administrative hassles.

The flight of market overseas will pose adverse long-term threats and consequences to the Indian Equity Derivatives Markets as stated below:

a. Price discovery may happen abroad
b. Indian regulators ability to monitor and effectively regulate the market will get diluted
c. Loss of revenue to the Government in terms of STT, Stamp Duty and Service Tax
d. There will be higher impact cost in the domestic markets on account of thinner volumes
e. Marginalization of Indian stock exchanges and of the local markets
f. This will also lead to lower levels of transparency

There is already STT revenue loss causing to the Government due to trading on SGX. The losses in terms of STT revenue are slated only to increase if the trend acquires momentum. This is a disturbing trend and is to be fought on different fronts such as providing ease in doing business in India, effective policy interventions such as transaction cost rationalization, clarity on taxation and regulatory issues. Indian capital markets are to be retained within the country’s shores if we were to realize our full economic potential. Export of Indian capital markets will have significant adverse consequences if steps are not taken on an urgent basis to reverse the trend. Hence, there is need for the regulatory body and the Government to act fast and adopt measures to reverse the trend at the earliest before it’s too late to take any actions. Liquidity creates further liquidity and once the trend gains momentum and overseas market achieve critical mass in Indian securities it would be difficult to reverse the trend and will lead to irreparable damage by permanent export of the Indian markets to offshore exchanges.

9. **Problem of Shifting the Equity Derivatives Trading to Commodity Trading**

As they say, one problem leads to other and the other to the next one and may end up having a cascading effect. The problem of excess levy of charges transaction charges is also seen to be having the effect on the equity derivatives market internally by facing the competition from the increased
trading activity in the commodities trading. This is a trend seen where the equity derivatives trading activity has been slowly and steadily shifting to the commodity markets. The shifting trend can be seen from the following chart:

**Chart 6.2**

*Average Daily Commodities and Equities Volume (Spot and Futures combined) since 2005 (‘000 Cr.)*

Commodity trading in India does not attract an equivalent STT. Commodities Transaction Tax (CTT) was proposed in the commodities derivatives trading as well, but the plans of the same appear to have been shelved. The trend is clearly seen of increase in the trading volumes in Commodities Derivatives in the last five years at the expense of equity volumes which can be largely attributed to the absence of level playing field. It is widely believed that the low cost environment of commodity trading is attracting day traders and jobbers, diluting one vital source of liquidity in the equity markets.

To conclude, the Government needs to take quick steps to curtail flow of volumes and in turn liquidity to commodity markets and ensure growth of the equity derivatives markets in India. Trends, if continued, would only gather momentum and would be difficult to repair and reverse. The Government has so far taken a spate of measures to give a fillip to the economy and the policy pronouncements and other initiatives to boost and restore the confidence of international as well as Indian investors. In line with this, there is also a need to suitably rationalize STT.
10. Ambiguity in Applicability and Payment of Stamp Duty in various States:

In India, Stamp Duty is a state subject & since all states have their own individual Stamp Act, the provisions of respective States Acts is applicable. Indian Stamp Act applies only in cases where the State Act is silent on any matter or in Union Territories. The Indian Stamp Act 1899 read with the Indian Stamp Rules 1925 is a Central enactment and the States have powers to either adopt the Indian Stamp Act 1899 with amendments to suit the transactions peculiar in each State or enact a separate Stamp Act for their State. Accordingly, certain States have enacted a separate Stamp Act i.e. the Bombay Stamp Act, The Kerala Stamp Act etc whereas other States like Delhi, Punjab, Haryana, Andhra Pradesh etc have adopted the Indian Stamp Act with suitable amendments.

The provisions of State Stamp Act can be contradictory or different than Indian Stamp Act as the states are empowered to have their own rules. For example, in Mumbai, it is governed by the Bombay Stamp Act if the registered office of the company is in Maharashtra. Hence, the company will have to follow the provisions of Bombay Stamp Act. As mentioned, the Stamp Duty rates applicable across all the States in India differ from State to State. The table below is given to highlight the Stamp Duty applicable in various States:

**Table 6.4**

**Stamp Duty Rates Applicable across various States and Union Territories in India**

<table>
<thead>
<tr>
<th>Sr. No.</th>
<th>State / Union Territory</th>
<th>Prescribed Rate</th>
<th>For every Rs. or part thereof</th>
<th>Upper Limit in Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Andhra Pradesh</td>
<td>Rs. 0.50 (Fifty Paise)</td>
<td>10,000</td>
<td>50</td>
</tr>
<tr>
<td>2</td>
<td>Arunachal Pradesh</td>
<td>Rs.3 (Rupees three only) LAW/LEGN-14/2007of 20-Aug-2007</td>
<td>5,000</td>
<td>None</td>
</tr>
<tr>
<td>3</td>
<td>Assam</td>
<td>Rs.3 (Rupees three only) vide Act 22 of 2004</td>
<td>5,000</td>
<td>None</td>
</tr>
<tr>
<td>4</td>
<td>Bihar</td>
<td>Rs.15.00 (Rupee fifteen only) W.E.F July 2002</td>
<td>1,000</td>
<td>200</td>
</tr>
</tbody>
</table>
| 5       | Chhattisgarh             | Delivery  
Rs. 10.00 (Rupees ten only)  
Non-Delivery & F&O  
Rs.2.00 (Rupees two only) | 1,00,000                       | None                |
<p>| 6       | Goa                      | Rs.1.00 (Rupee one only) | 10,000                        | N.A.                |</p>
<table>
<thead>
<tr>
<th>Sl No</th>
<th>State</th>
<th>Delivery</th>
<th>Non-Delivery &amp; F&amp;O</th>
<th>Pro-Trade</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Gujarat</td>
<td>Delivery</td>
<td>Rs 0.20 (twenty paise only) for initial Rs. 2,500, then</td>
<td>0.01%</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Rs. 0.20 (twenty paise only)</td>
<td>0.002%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Non-Delivery &amp; F&amp;O</td>
<td>0.002%</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Haryana</td>
<td>Rs. 0.30 (Thirty paise only)</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>9</td>
<td>Himachal Pradesh</td>
<td>Rs. 0.30 (Thirty paise only)</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>10</td>
<td>Jammu &amp; Kashmir</td>
<td>Rs. 0.60 (Sixty paise only)</td>
<td></td>
<td></td>
<td>2,500</td>
</tr>
<tr>
<td>11</td>
<td>Jharkhand</td>
<td>Rs. 15.00 (Rupee fifteen only) W.E.F. July 2002</td>
<td></td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>12</td>
<td>Karnataka</td>
<td>Delivery</td>
<td>Rs. 1.00 (Rupee one only) As per amended act of 2010</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>13</td>
<td>Kerala</td>
<td>Delivery</td>
<td>Rs. 1.00 (Rupee one only)</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Rs. 1.00 (Rupee one only)</td>
<td></td>
<td>50,000</td>
</tr>
<tr>
<td>14</td>
<td>Madhya Pradesh</td>
<td>Delivery- Rs. 10.00 (Rs ten only) Non-Delivery &amp; F&amp;O</td>
<td>Rs. 2.00 (Rupees two only) As per amended act of Feb 2006 and May 2006</td>
<td></td>
<td>1,00,000</td>
</tr>
<tr>
<td>15</td>
<td>Maharashtra</td>
<td>Delivery</td>
<td>Non-Delivery &amp; F&amp;O</td>
<td>0.01%</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Pro-Trade</td>
<td>0.002%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>0.001%</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Manipur</td>
<td>Rs. 3(Rupees three only) vide Act 22 of 2004</td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>17</td>
<td>Meghalaya</td>
<td>Rs. 2.00 (Rupees two only) W.E.F. 28-May-1993</td>
<td></td>
<td></td>
<td>2,500</td>
</tr>
<tr>
<td>18</td>
<td>Mizoram</td>
<td>No amendment to Indian Stamp Act, 1899</td>
<td></td>
<td></td>
<td>N.A.</td>
</tr>
<tr>
<td>19</td>
<td>Nagaland</td>
<td>Rs. 2.00 (Rupees two only)</td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>20</td>
<td>New Delhi</td>
<td>Delivery</td>
<td>Rs. 1.00 (Rupee one only)</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Non-Delivery &amp; F&amp;O</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Rs. 0.20 (twenty paise only)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Orissa</td>
<td>Rs. 0.50 (Fifty Paise only)</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>22</td>
<td>Punjab</td>
<td>Rs. 5.00 (Rupees Five only)</td>
<td></td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td>23</td>
<td>Rajasthan</td>
<td>Delivery</td>
<td>Rs. 1.00 (Rupee one only)</td>
<td></td>
<td>10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Non-Delivery &amp; F&amp;O</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Rs. 0.20 (twenty paise only)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Sikkim</td>
<td>No amendment to Indian Stamp Act, 1899</td>
<td></td>
<td></td>
<td>N.A.</td>
</tr>
<tr>
<td>25</td>
<td>Tamil Nadu</td>
<td>Rs. 0.15 (Fifteen paise only)</td>
<td></td>
<td></td>
<td>2,500</td>
</tr>
<tr>
<td></td>
<td>State</td>
<td>Rate (Paisa)</td>
<td>Amount</td>
<td>N.A.</td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>----------------</td>
<td>--------------</td>
<td>--------</td>
<td>------</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Tripura</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Uttar Pradesh</td>
<td>Rs. 0.40</td>
<td>20,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Uttarakhand</td>
<td>Rs. 0.40</td>
<td>20,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>West Bengal</td>
<td>Rs. 0.50</td>
<td>5,000</td>
<td>N.A.</td>
<td></td>
</tr>
</tbody>
</table>

Source: Compiled from Stamp Duty Acts of Various States and other sources available as in Mar. 2012

Few State Acts like, the Bombay Stamp Act and the Delhi Stamp Act provide for levy of stamp duty on “record of transaction of securities” (delivery/non-delivery/futures & options/forward contracts of commodities) whether electronic or otherwise effected by a trading member through the association or stock exchange. Apart from few States, there is no specific article in the other State Stamp Acts for levy of stamp duty on “Record of Transaction” (Electronic or otherwise) effected by a trading member through a stock exchange or an association.

Besides, above there has always been ambiguity about which State’s Stamp Duty Act would be applicable for the transactions carried out for the clients since the clients reside on various States, the transaction is executed through a Broker who has his Corporate Office in different State, the processing of transactions and issuance of contract notes may take place from third State, the Exchanges are mainly located in Mumbai hence the State of Maharashtra also is a place involved in the transaction as the transaction takes place on the Exchange platform. There is so much of ambiguity for the broker to charge the Stamp Duty due to confusions created because of activities carried out in various jurisdictions by them. As mentioned earlier, the rates of Stamp duty leviable on Contract Notes differ from State to State, however it is learnt that the Government of India plans to introduce a uniform stamp duty for transactions of all kinds of securities. The proposed Indian Stamp (Amendment) Bill once approved may provide an enabling mechanism for a single stamp duty rate for all stock market transactions.

Thus, there is a need to introduce a unified rate of stamp duty on a pan-India basis and Government need to expedite the process of amendment of the Indian Stamp Act at the earliest. Maybe government also ought to think on withdrawal or substantial reduction in Stamp Duty to keep the Indian Capital markets competitive in the global environment.
11. Inconvenience faced by FIIs doing business in India

“Apart from a trading shift in Nifty futures to SGX, FIIs who are not allowed to trade currency derivatives on local exchanges like NSE and MCX-SX access the Dubai Gold & Commodities Exchange (DGCX) to bet on the rupee versus the dollar. The Indian rupee futures on DGCX maintained its high-growth trend in the year 2012, rising 101% year-on-year to reach 859,739 contracts in September 2012.”10

Even though FIIs do not pay any capital gains tax, if it has a presence in a country with a double taxation avoidance treaty with India, it has to pay a transaction charge of Rs. 17 per lakh on derivative trades and also has to hedge the currency risk. The investor also has to file returns and every remittance made out of India has to be audited by a chartered accountant. Further, it has to employ a compliance officer to interface with SEBI besides paying custodian charges when it trades in India.

At the time of scrutiny by tax authority, the tax authority decides whether the trades executed by FIIs are a case of treaty shopping. Hence, even for FIIs trading out of countries like Mauritius who don’t pay capital gains tax in India it causes inconvenience. Thus, many FIIs feel that doing business out of India is not easy and hence so many FIIs have shifted activity to Singapore.

In Singapore, the tax rate is lower and an FII which creates substantial employment can even get a tax waiver. Unlike in India, an FII also saves on currency hedging costs by trading in Singapore where the contracts are dollar-denominated.

Thus, to summarize FIIs do not get conducive environment to do the business out of India and also do not draw comfort due to taxation issues and other unnecessary levies and mandatory requirements.

12. Increasing cost of regulatory compliances:

The intermediaries are constantly feeling the increasing cost of regulatory compliances. There has been large number of compliance requirements that has been made applicable since last few years such as Know Your Client (KYC), In-person Verification, KRA Registration Requirement, Power of Attorney Requirements, providing the copies of KYC to all clients, issuing quarterly ledger and demat transaction
statements to the clients, Obtaining specific authorizations from client as separate document, provide policies and procedures of broker to clients, provide guidance note (Do’s and Don’ts for Investors), Rights and Obligation, Internet Trading clauses etc to clients, obtain PoA for Running account facility availed by client with specific authorization, KYC data of each client to be uploaded with KYC Registration Agencies (KRAs), obtaining additional information pertaining to Demat account required including KYC of joint holders, compulsory periodic settlement of funds/securities – Quarterly/Monthly based on client preference, risk categorization of client based on AML policy, PAN number verification with Income Tax database, Obtaining proofs towards financial details to be collected from clients opting for F&O, financial details to be collected periodically from clients, upfront margin collection from clients as prescribed by exchange based on VAR model, MTM to be collected in cash on daily basis, exchanges to be informed daily whether these margins have been collected from all clients, Collateral acceptance and management as laid down by exchanges, penalty for short collection and non collection of margin from clients, client order book maintenance in the prescribed format, framing policy for employee trading, Contract Notes to be issued to clients within 24 hours of trading day, obtaining acknowledgment copies of contract notes and preserving Electronic Contract Notes log, showing statutory levies like service tax, stamp duty, Turn over tax, SEBI fees and exchange fees separately on contract notes, penalty for even genuine client code modification for Non Institutional trades, maintaining securities register detailing shares received from and delivered to the clients in prescribed format, system to be put in place for not accepting third party cheques and/or shares, securities received in pay-out on clients’ behalf to be delivered within 24 hours, money due to the client to be paid within 24 hours of pay-out, client money to be kept in separate omnibus bank account, inter segment adjustment to be done within same legal entity only after receiving client consent, not to use one client’s money/securities to meet other client’s requirements, brokers not to fund client except for margin trading as stipulated by SEBI, appointing compliance officer and principal officer by every broker, SEBI certificates to be displayed in the broker
premises, notice board of a prescribed size and containing prescribed matter (Do’s and Don'ts) to be displayed at the entrance of the broker premises, filing of annual report of a broker every financial year along with net- worth certificate in prescribed format, prior approvals of SEBI/Exchanges to be obtained for any changes in MOA/OOA, share-holding pattern, directorship etc., each client to be sent quarterly statement of securities and funds, margin register in prescribed form to be maintained, Six monthly internal audit report to be submitted, 10% of sub-brokers/Branches to be inspected every year, all Authorized Persons to be inspected by Broker every year, books to be maintained at segment level, UCC details to be submitted to exchanges every day, redressal of the Investor grievance within 30 days, ensuring NISM Series-VII Certification is obtained by various category of persons of the Stock Broker, yearly submission of system audit report with SSL certificate and Network diagrams to Exchanges, having Stock Broker Indemnity Insurance policy, half yearly filing compliance certificate for Margin facility availed, preventing circulation of Unauthenticated News through various modes of communications by employees of brokers etc.

The above list is just illustrative. There are many more compliances which the stock Brokers feel they are burdened with. Besides above, the broker also undergoes through frequent audits, inspections and also has to monitor client activities and is responsible for any act by his clients.

Some of these requirements are very much required in order to protect the interest of the investors and also to ensure that the sanctity of the market is maintained. However, some are found to be taxing by the brokers and hence they feel there is burden of compliance. Further, if brokers start looking at these compliance requirements then they are bound to implement them on paper but not in spirit thereby defeating the whole purpose of putting these regulations and compliance requirements in place.

In addition to the high fixed costs, the industry has very low marginal cost. As a result the cost of adding an additional customer is low and per transaction costs are limited. Due to this reason, there is a constant pressure on the brokerage rates. This downward pressure on the brokerage rates along with lackluster volumes and increased compliance cost has intensified the competition in the industry and is resulting in consolidation
with the top players. The basic brokerage business is now sometimes a loss leader. The steps need to be taken to comfort the broking players by giving them respite from the continuously increasing compliance costs at the same time maintaining the sanctity of the markets by the regulators. There is a need to move from the rule based compliance approach to the principle based compliance approach.

13. **Broking Business plagued with losses leading to small players closing or selling the businesses**

With the persistence of the changed industry dynamics, market players continuously focus on containing costs, restructuring business models and relatively larger players with access to capital are exploring alternate sources of revenue and profits. The last few years have also seen a more focused attempt by brokerage houses to de-risk business models by continued diversification into many related as well as unrelated businesses like commodities broking, currencies broking, commodities and currencies proprietary trading, capital market financing, mortgage financing and gold loans. However, the smaller players have not been able to come out of the bad situation which started taking toll on them since 2008.

It may be noted that the volumes in the Cash market of the exchange which is a high margin business has come down from Rs. 17,000 crores in 2009-10 to Rs. 14,000 crores in 10-2011 and further came down to Rs. 11,300 crores in 2011-12 on average per day or a decrease of 34% over the last 2 years. The volumes in the derivatives segment of NSE grew marginally from average of Rs. 115,000 crores in 2010-11 to Rs. 125,000 crores in 2011-12. However, it is interesting to note that on one side average derivatives turnover increased marginally by 8.6%, the index turnover in futures decreased by 18% and stock turnover in futures decreased by almost 25% from 2010-11 to 2011-12. Most of the growth in the volume has come from trading in index options which constitute 73% of the entire derivative turnover recorded on the exchange. It is interesting to know that the exchange derivatives turnover is computed on contract value, whereas the income to Broking Company is a % on the premium value which is significantly lower. Hence, in effect even though the exchange volumes have increased by 8.6% in the derivative segment last year with a
significant part coming from index options turnover, it has not resulted in an increase in income for broking companies. The options trading, by virtue of the fact that brokerage is levied only on premium value is a very low margin business for the brokers. This continuous drop in high yielding cash market volumes has sharply impacted overall equity brokerage revenue pool.

Some of them are still plagued with the huge losses and sometimes there is also concern on their existence. That is the reason, we have been seeing consolidation happening in the broking industry and larger players are taking over smaller players. Only the scale and diversification has been able to keep the industry going as the turnover has come down and there is hardly any income now earned through the broking business.

14. Not having inter-market fungibility of funds/collaterals of the Clients:

As explained earlier, most of the broking entities are diversifying their activities in various other asset classes. The broking entities are moving towards becoming the one stop financial solutions. Most of these entities are offering various other services to their clients such as Commodity Derivatives, Currency Derivatives, Insurance Broking, Portfolio Management Services (PMS), Mutual Fund Distribution, Loan Against Shares (LAS) by Non Banking Financial Services, selling other financial products such as personal loans, housing loans, car loans, credit cards, structured products etc. either on their own wherever permitted under the law or otherwise through their group and associate companies.

For the above purpose, many a times client has multiple touch points. Also, there are various requirements of funds, collaterals, margins, obligations at various points of time with various entities. Thus, even though the client has enough margin money, securities or collateral available with any entity will not be able to get the exposure on the other for the want of fungibility of these collaterals/margins available with various group companies.

For example, a Stock Broking entity cannot become Commodity Broking entity. Thus, it has to form a subsidiary and obtain the license separately for the commodity broking. Now, if a client has collateral with this Commodity broking entity worth Rs. 1 crores lying idle and unutilized on a particular day. If the client finds a favorable situation in the equity
derivatives market, the client would not be allowed to take the position by the broker since there are no adequate collaterals/funds in that particular Stock Broking entity to get that much exposure and provide the margin money. Thus, this fungibility issue is one of the major hindrances in making the financial services seamless for the clients. This only ends up causing inconvenience to the clients.

15. Many Regulatory Bodies for the similar products but different asset classes:

The above problem of fungibility also can be attributed to the multiple regulatory bodies for various asset classes. Besides, the above problem, the derivatives market functions more or less in a similar manner, what differs in every derivative is the change in the underlying. Somewhere it is equity stock, somewhere it is commodities, government bonds, foreign exchange currencies etc the decisions with regard to most of these classes is taken by the respective regulatory bodies. For example, the decision pertaining to Commodities trading is taken by Forward Market Commission (FMC), with regard to securities market the decision is taken by SEBI, with regard to Foreign Exchange it is taken by RBI and so on. This not only slows the decision making when the multiple bodies are involved in decision making, as seen in the case of Currency Futures, which started as late as in 2008 due to multiple body involvements, but also the experience or knowledge base gained by one regulator remains with it and the other regulators may end up committing similar blunder without drawing anything from the rich experience gained by the other regulator.

For example, SEBI has reach experience of more than two decades in regulating the securities market and has so far been able to put the systems and process in place. However, its counterpart in commodities is considered to be lagging behind and many of the guidelines in the commodities which are drawing parallel to those already issued in the securities market long time back are getting issued now.
• **References:**

1. Dr. L. C. Gupta (1998), Report of the Committee on Derivatives, SEBI, Mumbai, PP21-23
2. Ibid, P22
3. Ibid, P23
4. Ibid, P24
7. Dr. Ajay Kumar & Vivek Dubey (2010), Derivatives trading in India and Taxing Effects, Taxmann, Mumbai, PP2-20
10. Ibid, PP2-3