International competitiveness quarterly update
January – March 2016

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Contents

1 Executive Summary

This update has three parts. In the first part, we present how Indian markets for currency derivatives, equity derivatives, commodity derivatives and equity trading are faring with respect to their global competitor markets in the quarter Jan – Mar 2016.

In the second part, we provide an update on the implementation status of the policy recommendations made to the Standing Council for International Competitiveness of Indian Financial System (SCIIFS) for each of the above markets. In this part, we also present a brief on the regulatory interventions in these markets during the period October 2015 – March 2016.

In the third part, we analyse the impact of a recent regulatory action taken by SEBI in the equity index derivatives market, an increase in the trading lot size from Rs. 200,000 to Rs. 500,000.

2 Part I: International competitiveness update

2.1 Currency derivatives market

Table 1 shows that:

- In the exchange traded market:
  - In Q1-16, the futures market, both onshore and offshore, saw an increase in traded volume (TV) relative to the previous quarter (Q4-15). The quarter on quarter (Q-o-Q) increase was higher onshore (26.2%) than offshore (11.8%).

    Onshore, the increase in TV was accompanied by an increase in the open interest (OI) (by 11.2%). However, the offshore market saw a decline in OI (by 20%).
  - The onshore options market saw a Q-o-Q increase in TV (by 39.5%) and in OI (by 6.8%).
- The onshore over-the-counter (OTC) market volume saw a Q-o-Q increase (by 3.9%).

Summary: Onshore futures markets have seen an improvement vis-a-vis the offshore markets. There has also been an improvement in the options market onshore.

2.2 Equity derivatives market

Table 2 shows that:

- For equity index futures, on a Q-o-Q basis:
  - The onshore TV increased (by 30.5%) while the offshore TV declined (by 75.9%).
  - Onshore OI increased (by 6.4%) while offshore OI declined (by 38.8%). Despite this, in Q1-16, offshore OI was higher than onshore OI (by 18.4%).
- India retains the dominant status on equity index options.
  - Both TV (by 39.8%) and OI (by 5.8%) increased Q-o-Q.
- There was a decline in OI for participatory notes (PNs) (by 13.3%).

Summary: There has been an increase in interest in the onshore equity index futures market. However, the offshore market continues to have a higher OI.

2.3 Commodity derivatives market

- Table 3 shows that agri commodity derivatives trading in India is negligible. This is despite the fact that India is one of the largest producers of agricultural commodities such as wheat, cotton and sugar.
- Table 4 shows that in commodities like gold, silver and crude oil derivatives trading in India is in line with global exchanges.

2.4 Equity trading market

Table 5 shows that:

- The liquidity in the onshore exchanges is concentrated in the first 10% of firms (around 290 firms).
- The top 10% firms capture 80% of daily traded volumes in the equity markets.

Table 1 The quarterly report card for currency derivatives, October 2014 – March 2016

	Size of Participation												**Cost**					
	Traded Volumes (USD Billion/day)						Open Interest (USD Billion)						Impact Cost (%)					
	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16
Futures																		
India	2.45	2.87	2.80	2.83	2.56	3.23	4.62	4.47	4.92	5.65	5.08	5.65	0.105	0.099	0.093	0.084	0.069	0.079
Intl.	1.31	1.51	1.36	1.74	1.70	1.90	1.99	2.01	2.59	6.56	4.40	3.52	-	-	-	-	-	-
Options																		
India	0.85	1.93	1.55	1.5	1.52	2.12	2.53	2.73	2.84	3.75	3.81	4.07	4.05	3.39	2.90	2.86	2.19	2.07
Intl.	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
OTC																		
India	17.93	16.14	18.25	14.89	14.33	14.89[1]	-	-	-	-	-	-	-	-	-	-	-	-
Intl.	3.76	4.43	3.70	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-

Notes:
Q1 denotes January-March, Q2 denotes April-June, Q3 denotes July-September and Q4 denotes October-December.
Example: Q4-14 denotes October-December, 2014.

TV and OI is calculated using NSE bhavcopy data.
For futures, impact cost are for a transaction of Rs. 1 million, from snapshots of the NSE limit order book costs for India.
For options, impact cost are for a transaction of Rs. 50,000, from snapshots of the NSE limit order book costs for India.

The traded volume for India OTC market is computed from RBI weekly statistical supplement.
The traded volume for Intl. OTC market is DTCC data on non-deliverable forwards (NDF) and non-deliverable options (NDO) reported on Thomson Reuters Eikon.
[1] Updated up to February 2016.

Blank fields indicate that data is currently not available.

Table 2 The quarterly report card for equity derivatives, October 2014 – March 2016

	Size of Participation												**Cost**					
	Traded Volumes (USD Billion/day)						Open Interest (USD Billion)						Impact Cost (%)					
	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16	Q4-14	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16
Futures																		
India	2.61	2.08	1.97	1.95	1.51	1.97	4.40	4.92	3.78	3.89	3.57	3.80	0.004	0.005	0.005	0.005	0.005	0.005
Intl.	0.95	0.36	0.31	0.26	0.83	0.20	9.78	7.95	6.47	5.68	7.35	4.50	0.018	0.014	0.011	0.016	0.017	0.017
Options																		
India	62.04	36.28	32.49	26.24	21.77	30.45	22.33	22.38	22.19	22.58	21.52	22.76	0.429	0.506	0.533	0.409	0.413	0.304
Intl.	0.002	0.006	0.002	0.001	0.001	0.001	0.25	0.27	0.36	0.17	0.26	0.22	-	-	-	-	-	-
PNs																		
	-	-	-	-	-	-	33.57	39.11	38.62	35.02	33.23	28.80[1]	-	-	-	-	-	-

Notes:
Q1 denotes January-March, Q2 denotes April-June, Q3 denotes July-September and Q4 denotes October-December.
Example: Q4-14 denotes October-December, 2014.

TV and OI for India are calculated using daily NSE bhavcopy data, daily BSE bhavcopy data, and Thomson Reuters trades for SGX.
Impact cost are for a transaction of Rs.1 million for Nifty futures and at-the-money Nifty options, from market-by-price data from NSE, and Thomson Reuters quotes for SGX.

PN data is from SEBI.
[1] Updated up to February 2016.

Blank fields indicate that data is currently not available.

Table 3 The report card for agri-commodity derivatives, January 2015 – March 2016

		Size of participation (daily average)									
		Traded Value (USD Billion)					Open Interest (USD Billion)				
		Q1-15	Q2-15	Q3-15	Q4-15	Q1-16	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16
India											
Wheat	NCDEX	0.002	0.007	0.0004	0.0001	0.0004	0.010	0.031	0.002	0.0007	0.0001
Sugar	NCDEX	0.014	0.030	0.004	0.006	0.013	0.095	0.134	0.012	0.021	0.046
Cotton	MCX	0.007	0.010	0.003	0.004	0.011	0.024	0.034	0.015	0.013	0.027
Soyabean	NCDEX	0.130	0.374	0.031	0.031	0.017	0.293	0.286	0.024	0.027	0.024
Soya Oil	NCDEX	0.138	0.167	0.043	0.026	0.021	0.264	0.358	0.093	0.036	0.031
Intl.											
Wheat	CME/ZCE	1.318	1.562	1.084	1.344	1.572	3.762	2.958	3.080	3.705	4.094
Sugar	ICE/ZCE	1.178	0.858	0.956	3.037	1.023	5.578	4.090	4.970	8.320	3.848
Cotton	ICE/ZCE	0.506	0.432	0.052	0.470	0.538	2.805	1.843	0.263	3.320	2.510
Soyabean	CME/DCE	3.925	4.349	1.483	4.486	4.114	8.643	8.993	3.957	7.653	7.464
Soya Oil	CME/DCE	0.875	1.075	0.261	0.665	0.746	2.565	2.335	0.459	1.292	1.650

Table 4 The report card for non-agri commodity derivatives, January 2015 – March 2016

		Size of participation (daily average)									
		Traded Value (USD Billion)					Open Interest (USD Billion)				
		Q1-15	Q2-15	Q3-15	Q4-15	Q1-16	Q1-15	Q2-15	Q3-15	Q4-15	Q1-16
India											
Gold	MCX	0.640	0.477	0.599	0.485	0.681	0.316	0.271	0.274	0.225	0.257
Silver	MCX	0.400	0.375	0.338	0.303	0.334	0.162	0.171	0.193	0.194	0.165
Crude Oil	MCX	0.831	0.877	0.843	0.778	0.899	0.135	0.072	0.089	0.114	0.108
Natural Gas	MCX	0.205	0.149	0.126	0.152	0.128	0.029	0.027	0.021	0.031	0.016
Intl.											
Gold	CME/SHFE	0.267	0.375	0.132	0.508	0.213	0.086	0.558	0.143	0.589	0.119
Silver	CME/SHFE	0.003	0.249	0.002	0.286	0.010	0.014	0.159	0.009	0.261	0.077
Crude Oil	ICE	2.834	2.591	2.130	1.868	1.657	2.995	3.846	2.730	3.348	2.404
Natural Gas	CME	3.067	3.025	3.100	2.513	2.155	37.639	40.221	37.860	35.699	27.283

Notes:

Source: Thomson Reuters Eikon database.

Data for only the most liquid near month futures contracts has been reported.

For international exchanges, sum of the daily average numbers for two exchanges has been reported.

NCDEX - National Commodities Derivatives Exchange, MCX - Multi Commodity Exchange, CME - Chicago Mercantile Exchange, ZCE - Zhengzhou Commodity Exchange, ICE - Intercontinental Exchange, DCE - Dalian Commodity Exchange, SHFE - Shanghai Futures Exchange

Table 5 The report card for equity trading

	Total Market Cap[1] (USD Billion)			Avg. Daily Volume[2] (USD Billion)			Avg. Trade Size[3] (USD)			Turnover Ratio[4]		
	Q3-15	Q4-15	Q1-16	Q3-15	Q4-15	Q1-16	Q3-15	Q4-15	Q1-16	Q3-15	Q4-15	Q1-16
Onshore												
All firms	1486.49	1515.12	1381.56	2.97	2.34	2.35	328	325	319	0.0015	0.0012	0.0014
Decile 1	1327.03	1344.89	1236.15	2.17	1.69	1.84	390	397	375	0.0014	0.0011	0.0013
Decile 2	100.88	105.73	91.40	0.37	0.33	0.25	234	245	221	0.0025	0.0021	0.0017
Decile 3	32.35	34.73	29.29	0.11	0.12	0.08	168	187	164	0.0021	0.0019	0.0017
Decile 4	13.33	15.27	12.76	0.09	0.05	0.04	190	157	135	0.0020	0.0020	0.0015
Decile 5	6.46	7.28	6.01	0.08	0.03	0.01	282	129	109	0.0015	0.0016	0.0012
Decile 6	3.27	3.71	3.05	0.01	0.01	0.01	116	113	119	0.0013	0.0013	0.0011
Decile 7	1.68	1.90	1.56	0.003	0.004	0.003	91	109	101	0.0008	0.0009	0.0007
Decile 8	0.90	0.98	0.82	0.003	0.002	0.001	115	88	103	0.0006	0.0005	0.0005
Decile 9	0.45	0.47	0.38	0.001	0.001	0.001	106	101	118	0.0006	0.0007	0.0003
Decile 10	0.15	0.15	0.13	0.002	0.0002	0.0005	127	52	180	0.0003	0.0003	0.0003
Offshore												
ADR/GDR	-	-	-	0.011	0.010	0.011	-	-	-	-	-	-
Index derivatives	-	-	-	0.26	0.83	0.20	-	-	-	-	-	-

Notes:

Q1 denotes January-March, Q2 denotes April-June, Q3 denotes July-September and Q4 denotes October-December.

Example: Q2-13 denotes April-June, 2013; Q1-14 denotes January-March, 2014.

Decile 1 denotes first decile, Decile 2 denotes second decile, and so on. Deciles are based on market capitalisation. There are approximately 290 firms in each decile.

[1] Total market capitalisation on the first day of the quarter for NSE/BSE listed firms.

[2] Traded volumes are daily averages of volumes summed across firms at BSE and NSE.

[3] Average trade size is calculated as the ratio between total traded volume on BSE and NSE to total number of transactions for all stocks.

[4] For a firm i, Turnover Ratio is computed as: $TR_{it} = \frac{volume}{mcap}$, where volume is the sum of traded volume at BSE and NSE and mcap is the market capitalisation for firm i at time t. For a given quarter, median TR is computed for each i and subsequently the median TRs are weighted by market cap across all firms.

3 Part II: Implementation status of policy recommendations

This part is divided into five subsections:

1. Section 3.1 – Policy recommendations that are common across all the areas in Volume 1.
2. Section 3.2 – Recommendations for currency derivatives.
3. Section 3.3 – Recommendations for equity derivatives.
4. Section 3.4 – Recommendations for commodity derivatives.

3.1 Status of policy recommendations common across all areas

Table 6 Policy recommendations common to all work areas

Proposals	Implementing agency	Implementation status
Short term actions		
• For foreign participants, eliminate the regulatory uncertainty regarding the Singapore and Mauritius tax treaties.	**CBDT, DEA**	
• Rationalise KYC and compliance requirements for non-resident participants in line with CDD requirements under FATF.	**SEBI, RBI**	Partially implemented.
• Avoid banning market segments, participants or products. All regulatory intervention should be as per Handbook (2013) procedures.	**DEA, RBI, SEBI**	
• Allow access to all foreign participants that meet the FATF CDD requirements.	**SEBI, RBI**	
• Eliminate the regulatory uncertainty about availing treaty benefits under the proposed GAAR.	**DEA, CBDT**	GAAR implementation date extended to 2017.
• Devolve market timing decisions from regulator to exchanges.	**SEBI**	
Medium term actions		
• Sign tax treaties similar to the Mauritius and Singapore treaty with other FATF-compliant countries.	**DEA**	
• Implement Handbook (2013) process for governance of the regulation making process at RBI and SEBI.	**DEA, RBI, SEBI**	In progress at SEBI.
• Set up an expert committee to rationalise position limits and margins and design a framework within which the power to set position limits and margins is devolved to exchanges. This committee should: (a) Rationalise position limits across all market segments; (b) Create single margin system across market segments in two phases; and (c) Rationalise margins vis-a-vis competitor markets like SGX.	**DEA, SEBI**	
• Create a working group for common clearing among exchange traded products, equity, equity derivatives and currency derivatives, in phases. Phase I for multiple segments within a single exchange and in Phase II across exchanges, with multiple competing clearing corporations.	**SEBI, RBI**	
Long term goals		
• Move to a residence-based taxation regime over the longer term.	**DEA, CBDT**	

3.2 Currency derivatives market

3.2.1 Implementation status of policy recommendations

Table 7 Currency derivatives market policy recommendations

Proposals	Implementing agency	Implementation status
Short term actions		
• Clarify ambiguities in direct tax treatment of ETCD transactions for domestic firms, since this market is STT exempt.	**CBDT, DEA**	CBDT does not view this as an ambiguity.
• Remove documentation requirements for taking positions in the ETCD market that were introduced in the RBI Circular: June (2014).	**RBI**	Documentation requirements continue for positions above $15mn per exchange.
• Remove restrictions on cancelling and re-booking OTC contracts.	**RBI**	Restrictions continue for FPIs.
• Devolve trading time linked decisions to exchanges and AD I Banks.	**SEBI, RBI**	SEBI/RBI extended trading time on non-rupee cross currency contracts from 5 p.m. to 7.30 p.m. (December 2015).
• Devolve product innovation decisions from regulators to exchanges.	**SEBI**	SEBI/RBI allowed exchanges to introduce non-rupee cross currency futures and options (December 2015).
Long term goals		
• Consider a time-bound plan for the internationalisation of the INR, in line with the plans of the Chinese government for the internationalisation of the Renminbi.	**DEA**	

3.2.2 Currency derivatives regulatory update, October 2015 – March 2016

1. **Relaxation of facilities for residents for hedging of foreign currency borrowings** vide RBI circular dated 5th November, 2015.[1]

   RBI has permitted residents to hedge their long term foreign currency borrowings by entering into foreign currency–INR swaps with Multilateral or International Financial Institutions (MFI/IFI) with the following conditions:

   - These swap transactions will only be undertaken by the MFI/IFI with an AD-I bank in India.
   - AD-I banks will only do these transactions with those MFI/IFI in which Government of India is a shareholding member.
   - These swaps will have a minimum tenor of three year.
   - If the resident borrower defaults on its swap obligations, the MFI/IFI concerned will bring in foreign currency funds to meet its corresponding liabilities to the counterparty AD-I bank in India.
   - AD-I banks will report these swaps transactions on a back-to-back basis to CCIL reporting platform.

[1] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10114&Mode=0

2. **Revised Position Limits for Currency Derivatives Contracts for Bank members**

   vide SEBI Circular dated 15th January, 2016.[2]

   - Gross open position limits for bank members across all contracts has been increased from higher of 15% of open interest or USD 100 mn to higher of 15% of open interest or USD 1 bn.
   - For non-bank members, domestic institutional investors and category I and II FPIs, the position limit remains the same – higher of 15% of open interest or USD 100 mn across all contracts.

3. **Introduction of exchange traded cross currency derivatives contracts and exchange traded options contracts.**

   vide SEBI Circular dated 9th March, 2016[3] and RBI Circular dated 10th December, 2015.[4]

   - Cross currency futures and options (F&O) on EUR-USD, GBP-USD and USD-JPY contracts are allowed to be introduced on the exchange traded currency derivatives (ETCD) platform with the following position limits:
     - For bank and non-bank members, category I and II FPIs and domestic institutional investors – higher of 15% of open interest (OI) or EUR/GBP/USD 100 mn.
     - For proprietary positions of non-bank members – higher of 15% of OI or EUR/GBP/USD 50 mn.
     - For clients and category II FPIs – higher of 6% of OI or EUR/GBP/USD 10 mn.
   - Options on EUR-INR and GBP-INR and JPY-INR are also allowed to be introduced, in addition to the existing USD-INR options. For these:
     - The existing position limits without documentation at every exchange, USD 15 million for USD-INR contracts and USD 5 million for all other currency pair contracts (i.e. EUR-INR, GBP-INR and JPY-INR) remain unchanged.
     - Synthetic positions created using INR based and cross-currency contracts cannot exceed the prescribed position limits.
   - The trading hours for cross-currency derivatives contracts are between 09:00 a.m. and 07:30 p.m. This is a two hour extension over the trading time for all other ETCD contracts.
   - Stock exchanges are now required to implement a mechanism of dynamic price bands in the ETCD segment to prevent orders placed above the defined price limits from being accepted.

[2] http://203.199.247.102/cms/sebi_data/attachdocs/1452858663250.pdf

[3] http://203.199.247.102/cms/sebi_data/attachdocs/1457523461184.pdf

[4] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/APDBCDEC1B7F4A4487095CC9900E2B2791A.PDF

3.3 Equity derivatives market

3.3.1 Implementation status of the policy recommendations

Table 8 Implementation status of the equity derivatives policy recommendations

Proposals	Implementing agency	Implementation status
Short term actions		
• Remove STT but without the adverse impact of higher capital gains tax.	**SEBI, DEA, CBDT**	Budget 2016 announcement to increase STT on option premium from 0.017% to 0.5%.
• Remove stamp duty as index derivatives are cash settled and no delivery of the underlying takes place.	**SEBI, DEA, CBDT**	
• Make trading and clearing rules nationality and participant neutral: (*a*) Allow FPIs and MFs the same list of permissible securities that are allowed to domestic participants as collateral; and (*b*) Allow FPIs access to ETCD market.	**SEBI, RBI**	(*b*) Implemented by RBI in June 2014.
• Clarify the regulatory position on PNs.	**SEBI**	Partially implemented.
• Move towards FATF compliant CDD disclosures for PNs.	**SEBI**	
Medium term actions		
• Remove regulatory restrictions on domestic FIs participation in equity derivatives.	**SEBI, RBI, IRDA, PFRDA**	
Long term goals		
• Set up an expert committee for creating an onshore OTC market for equity derivatives. Amend SCRA suitably for this to happen.	**DEA, SEBI**	

3.3.2 Regulatory update, October 2015 – March 2016

1. No new regulatory changes.
2. Budget announcement on increasing STT on equity options premium from 0.017% to 0.5%. Yet to be implemented.
3. The lot size change for equity F&O from Rs. 200,000 to Rs. 500,000, announced in August 2015, became effective from November 2015.

3.4 Commodity derivatives

3.4.1 Implementation status of the policy recommendations

Table 9 Implementation status of the commodity derivatives policy recommendations

Proposals	Implementing agency	Implementation status
Short term actions		
• Remove regulatory constraints on banks and MFs to participate in commodity derivatives.	**RBI, SEBI, DEA**	RBI May 2015 circular – banks to *encourage* large agri borrowers to hedge using domestic commodity derivatives.
• Create a high level committee to establish (a) A robust warehousing system to strengthen delivery against contracts; and (b) A well-functioning market for warehouse receipt finance.	**SEBI, WDRA, RBI**	In progress.
• Extend non-speculative status on direct taxes for all exchange traded commodity derivatives contracts.	**DEA, CBDT**	23 pure farm commodities exempt from CTT and may be deemed speculative (as per Finance Act, 2014).
Medium term actions		
• Allow foreign entities with commodity exposure to participate in Indian commodity derivatives: (a) Create a mechanism for registering commodity specific participants. (b) Ensure co-ordination between RBI and SEBI to avoid multiple registration and compliance requirements.	**DEA, SEBI, RBI**	
• Implement the following key proposals of the FCRA Amendment Bill, 2010: (a) Provide statutory powers to FMC to become an independent regulator. (b) Widen FMC's powers on investigation, enforcement and imposition of penalties. (c) Make SAT the appellate body for FMC orders. (d) Widen definition of commodity derivatives to include goods, services, activities and events. (e) Permit options. (f) Permit cash-settlement of index like products. (g) Demutualisation and corporatisation of all recognised associations.	**DEA**	(a), (b), (c) implemented as part of SEBI-FMC merger. (g) in progress. Widening of products announced in Budget 2016.
• Enhance regulatory capacity and resources at FMC.	**DEA**	In progress as part of SEBI-FMC merger.
• Set up an expert committee to rationalise margins and position limits taking into account (a) the diverse nature of the underlying commodities; and (b) position limits and margins on competitor offshore exchanges.	**DEA, SEBI**	
• Remove Central government's power to ban commodity derivatives trading.	**DEA**	
• Focus on implementing GST.	**Central and state governments**	GST Bill in parliament.
• Rationalise stamp duty through the India Stamp (Amendment) Bill, 2014.	**Central and state governments**	
Long term goals		
• Rationalise and reduce legislative contradictions around the interaction of derivatives and spot market for commodities.	**Central and state governments**	
• Set up an expert committee to evaluate setting up of a full fledged OTC commodity derivatives market. Amend FCRA to enable an OTC market.	**DEA**	FCRA Amendment 2015 and SCRA Amendment 2015 enables this.

3.4.2 Regulatory update, October 2015 – March – 2016

1. **Comprehensive risk management framework for national commodity derivatives exchanges**

   vide SEBI Circular dated 1st October, 2015.[5]

   - Through this circular SEBI seeks to align and streamline the risk management framework across national commodity derivatives exchanges in line with the securities market exchanges.
   - It has provided commodity derivatives exchanges time till 1st January, 2016 to comply with this risk management framework.
   - SEBI has allowed norms specified by the FMC to be in force, unless modified by this circular.

2. **Risk management for regional commodity derivatives exchanges**

   vide SEBI Circular dated 21st October, 2015.[6]

   - All recognized associations under the Forwards Contracts Regulation Act (FCRA) are recognised as stock exchanges under the Securities Contract Regulation Act from September 28th, 2015.
   - SEBI has outlined a risk management framework for these entities. All risk management norms stipulated by FMC, unless specifically modified by SEBI, will continue to be in force.

3. **Annual System Audit, Business Continuity Plan (BCP) and Disaster Recovery (DR)**

   vide SEBI circular dated 16th November, 2015.[7]

   - Through this Circular SEBI requires national commodity derivatives exchanges to conduct an Annual Systems Audit as per prescribed norms for securities exchanges.[8] The first such Audit needs to be conducted on or before 30th June, 2016.
   - It also requires them to have a BCP and DR in line with SEBI provisions.[9] The commodity exchanges need to submit their BCP – DR policy to SEBI along with an implementation plan by 1st April, 2016.

4. **Investor grievance redressal system and arbitration mechanism**

   vide SEBI circular dated 16th November, 2015.[10]

   - Through this Circular SEBI seeks to align and streamline the framework of investor redressal and arbitration mechanism at commodity derivatives exchanges in line with the securities market exchanges.
   - It requires national commodity Derivative exchanges to set up investor service centers (ISC) for the benefit of the public/ investors[11] and to constitute a Investor Grievance redressal Committee (IGRC)[12].

[5] http://203.199.247.102/cms/sebi_data/attachdocs/1443700933819.pdf

[6] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1445422330733.pdf

[7] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1447679358432.pdf

[8] Defined in SEBI circular no. CIR/MRD/DMS/13/2011dated November 29, 2011.

[9] Defined in Circular no. CIR/MRD/DMS/12/2012 dated April 13,2012 read with circular no. CIR/MRD/DMS/17/2012 dated June 22,2012.

[10] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1447679562764.pdf

[11] In line with provisions of Circular CIR/MRD/DSA/03/2012 dated January 20, 2012.

[12] This is in line with the provisions of Circular no CIR/MRD/DSA/03/2012 dated January 20, 2012, and will perform all such functions and responsibilities as stated in the SEBI circular no CIR/MRD/ICC/30/2013 dated September 26, 2013

- It also requires them to form an Arbitration Panel and enable Appellate Arbitration.[13]
- For the above, the national commodity derivatives exchanges are required to pool all their arbitrators in a common pool across all national commodity derivatives exchanges and facilitate automatic selection of arbitrators from the common pool.[14]
- All the above actions need to be completed on or before 1st April, 2016.

5. **Timelines for compliance with with provisions of Securities Laws by Commodity Derivatives Exchanges**

   vide SEBI Circular dated 26th November, 2015.[15]

   The following compliance timelines for commodity exchanges are applicable from 28th September, 2015:

Area	National exchanges	Regional exchanges
Corporatisation & Demutualisation		Three years
Separate Clearing Corporation	Three years	Three years
Regulatory fee	Immediate	Immediate
Networth requirement	By 5th May, 2017	Three years
Ownership	By 5th May, 2019	Three years
Governance	One year	Three years
Segregation of regulatory departments	Six months	Six months
Oversight Committees	Three months	
Advisory and Statutory Committees	One Year	Three Years
Risk management Committee	Immediate	Immediate
Compliance Officer appointment	Immediate	Immediate
Disclosure and Corporate Governance norms	Immediate	Three years
Dematerialisation of securities	Six months	Three years
Transfer of penalties to Settlement Guarantee Fund (SGF)	Immediate	Immediate

6. **Monthly development report for commodity derivative exchanges**

   vide SEBI circular dated 9th December, 2015.[16]

   - Commodity Derivative Exchanges are required to submit a Monthly Development Report, in a prescribed format, to SEBI by the 7th of each month, starting from April, 2016.

7. **Mandatory requirements / Exit Policy for Commodity Derivatives Exchanges**

   vide SEBI circular dated 11th January, 2016.[17]

   - In line with the Forward Markets Commission (FMC) Circular No. 9/1/2014-MKTI (Vol-II), dated May 19, 2015[18], SEBI has decided that if there is no trading on a commodity derivatives exchange for more than twelve months, then the exchange will be liable to exit.
   - In addition, a national commodity derivative exchange is required to continuously meet the turnover criteria of Rs.1000 crores per annum.

[13] In line with Circulars no. CIR/MRD/DSA/24/2010 dated August 11,2010; CIR/MRD/DSA/04/2012 date January 20, 2012 and CIR/MRD/ICC/20/2013 dated July 05, 2013; Circular No CIR/MRD/DSA/29/2010 dated August 31, 2010 read with CIR/MRD/ICC/29/2012 dated November 07, 2012 and CIR/MRD/ICC/29/2013 dated September 26, 2013.

[14] As per Circular CIR/MRD/ICC/8/2013 dated March 18, 2013

[15] `http://www.sebi.gov.in/cms/sebi_data/attachdocs/1448537071190.pdf`

[16] `http://203.199.247.102/cms/sebi_data/attachdocs/1449661588536.pdf`

[17] (`http://203.199.247.102/cms/sebi_data/attachdocs/1452508541677.pdf`)

[18] FMC had directed commodity derivatives exchanges, who had suspended their trading operations, to refund clients margin money, resolve client disputes, refund members deposits and in case any exchange failed to revive their trading operations within 12 months from the date of suspension of trading, initiate steps to cancel their registration and lead to the withdrawal of recognition of the exchange.

- If any recognized commodity derivatives exchange, for any reason suspends its trading operations, it can only resume its trading after obtaining prior SEBI approval.
- The circular also provides other conditions for exit such as treatment of assets of a de-recognized exchanges, transfer of Investor Protection Fund to SEBI and payment of outstanding dues to SEBI.

8. **Reduction in Daily Price Limits and Near month Position Limits for Agricultural Commodity Derivatives and Suspension of Forward Segment**

   vide SEBI Circular dated 15th January, 2016.[19]

   - To curb speculative participation and consequent volatility in agricultural commodity derivatives' prices, SEBI has revised the daily price limits as follows:
     - The initial limit for Barley, Chilli, Jeera and Turmeric contracts is 2%, the enhanced limit is 2% and the total daily price limit is 4%.
     - For all other agricultural commodities, the initial limit is 3%, the enhanced limit is 1% and total daily limit is 4%.
     - Once the initial limit is reached in any contract, it will be increased by the enhanced limit after a period of 15 minutes for that contract.
     - After the limit is enhanced, trades will be permitted throughout the day within the enhanced total daily price limit of 4%.
   - Near month position limits have been reduced from 50% to 25%.
   - Through this Circular SEBI has suspended the forward segment. Participants in this segment will not be allowed to enter into fresh contracts but will be allowed to settle existing contracts as per the terms defined in the contracts.

9. **Position limits for agri-commodity derivatives**

   vide SEBI Circular dated 29th January, 2016.[20]

   - At the client level:
     - Near month position limit for a contract to not exceed 25% of the client overall position limit in that contract.
     - Client level position limit of 5% of market wide position limit discontinued.
     - For calculating overall position, all long and short positions of the client across all contracts on the underlying will be added up separately and higher of the two will be considered as overall open position.
     - For calculating near month open position, higher of long and short positions of the client in near month contracts will be considered.
     - The practice of netting out near month contract with off-setting positions in far months contracts of any client no longer permitted.
   - At the member level:
     - At the member level, overall position limit will be higher of the numerical position limits as mandated from time to time or 15% of market wide open interest.
     - Near month position limit for a particular commodity to be be 25% of the members' overall position limit in that commodity.
     - Position limits for members' proprietary positions will be same as client level position limits.

[19] http://203.199.247.102/cms/sebi_data/attachdocs/1452863608911.pdf
[20] http://203.199.247.102/cms/sebi_data/attachdocs/1454071477614.pdf

  - For calculating overall position, the position of the clients will be added without netting off among themselves as also against proprietary position of the member. All longs and shorts will be added up separately and higher of the two will be considered.
  - For calculating near month open position, the position of the clients will be added without netting off among themselves as also against proprietary position of the member. All longs and shorts will be added up separately and higher of the two will be considered.

10. **Inclusion of commodity derivatives in eligible securities in IFSC**

    vide SEBI Circular dated 17th March, 2016.[21]

    - All recognized associations (commodity derivatives exchanges) under the Forward Contracts (Regulation) Act, 1952) are now recognized stock exchanges under the Securities Contracts (Regulation) Act, 1956
    - In addition, Commodity Derivatives' are permitted as eligible securities for trading on stock exchanges operating in International Financial Service Centers (IFSCs).

11. **Modification of Client Codes post Execution of Trades on National and Regional Commodity Derivatives Exchanges**

    vide SEBI Circular dated 29th March, 2016.[22]

    - Through this Circular SEBI requires commodity derivatives exchanges to comply with the norms for modification of client codes post trade execution.[23]

12. **Cyber Security and Cyber Resilience framework of National Commodity Derivatives Exchanges**

    vide SEBI Circular dated 29th March, 2016.[24]

    - Commodity derivatives exchanges are required to comply with SEBI framework for Market Infrastructure Institutions (MII) in the securities market with respect to cyber security and cyber resilience[25] by 1st January, 2017.

[21] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1458199534216.pdf
[22] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1459251042803.pdf
[23] As defined in circulars CIR/DNPD/6/2011 dated July 05, 2011 and CIR/MRD/DP/29/2014 dated October 21, 2014.
[24] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1459250540053.pdf
[25] As defined in the Circular CIR/MRD/DP/13/2015 dated July 06, 2015.

3.5 Equity trading

3.5.1 Implementation status of the policy recommendations

Table 10 Implementation status of the equity trading policy recommendations

Proposals	Implementing agency	Implementation status
<u>**Short term actions**</u>		
• Remove STT. If STT is to remain: apply a uniform STT rate on equity transactions and remove STT on sale of units of MFs.	**DEA, CBDT**	
• Remove stamp duty from non-delivery transactions. Enact the Indian Stamp (Amendment Bill, 2014 (to harmonise stamp duty rates across states).	**Central and State governments**	
• Equalise tax rules for similar transactions, regardless of whether they are done on-exchange or off-exchange.	**DEA, CBDT**	
• Allow equity participation by EPFO.	**MoLE**	5% of incremental corpus can be invested in equity.
<u>**Medium term actions**</u>		
• Equalise access rules to trading (position limits), clearing (collateral and margins) and settlement across all participants to enable level playing field.	**SEBI, RBI**	
• SEBI should consider investing part of its investor protection fund in equity shares of proxy advisory firms.	**SEBI**	

3.5.2 Regulatory interventions in the period January – March 2016

1. **Regulatory interventions to improve disclosures by listed entities**
   - Format for voting results vide SEBI Circular dated 4th November 2015.[26]
     - Voting results must be submitted within 48 hours of the conclusion of the board meeting in the format provided in this circular, under the Listing Obligations and Disclosure Requirements (LODR) Regulations, 2015.
   - Format for the business responsibility report vide SEBI Circular dated 4th November, 2015.[27]
     - Ministry of Corporate Affairs, in July 2011, came out with the 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business'. These guidelines provide a structured business responsibility disclosure format for companies to implement.
     - Those listed entities which have been submitting such reports to overseas regulatory agencies/stakeholders based on internationally accepted reporting frameworks need not prepare a separate report.
     - SEBI requires this report to be disseminated on the companies' websites.
   - Format for publishing financial results vide SEBI Circular dated 30th November, 2015.[28]
     - SEBI specifies the formats for filing quarterly and annual financial results by listed entities under the LODR Regulations, 2015. These are also aligned with the requirements under Companies Act, 2013.

[26] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1446631975258.pdf
[27] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1446638214636.pdf
[28] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1448885855487.pdf

2. **Format for disclosure for IDR holding and procedure for two way fungibility of IDRs**

   vide SEBI Circular dated 4th November, 2015.[29]

   - Listed entities now required to file their Indian Depository Receipt (IDR) holding pattern with the stock exchange on a quarterly basis within fifteen days of end of the quarter in the format specified in this circular.
   - They are also required to provide a comparison between corporate governance reporting requirements on overseas exchanges and Indian exchanges.
   - A circular also provides the procedural details for providing two way fungibility to IDR holders. For future IDR issuance, continuous two way fungibility is to be provided after one year of the listing of the IDR.

3. **Facility for basic services demat account**

   vide SEBI Circular dated 11th December, 2015.[30]

   - In August 2012, SEBI introduced a Basic Services Demat Account (BSDA).[31] with the objective of reducing cost[32] associated with demat accounts to achieve widening of holding of demat accounts.
   - However, despite a large number of demat accounts being eligible for conversion to BSDA, very few actual conversions have taken place. Through this circular, SEBI has advised depository participants to convert all eligible demat accounts into BSDA, unless beneficial owners specifically opt to continue with a regular demat account.

[29] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1446701154442.pdf

[30] http://203.199.247.102/cms/sebi_data/attachdocs/1449831640832.pdf

[31] Vide circular dated August 27, 2012 (https://www.cdslindia.com/whatsnew/SEBI%20Circular%20-%20Facility%20for%20a%20Basic%20Services%20Demat%20Account%20(BSDA).pdf).

[32] BSDAs have no annual maintenance charges (AMC) for holding up to Rs. 50,000 and an AMC not exceeding Rs. 100 for holdings from Rs. 50,000 to Rs. 200,000.

4 Part III: Impact assessment of increase in lot size for equity derivatives

On 13th July, 2015, SEBI changed the minimum contract size in the equity derivatives segment from Rs. 2 lakhs to Rs. 5 lakhs.[33] No rationale was provided for this regulatory intervention.

The impact of this intervention is assessed by measuring the quality of market after the effective date of the intervention (which is called the "event date"), and comparing this with the quality before the intervention. For the analysis, 24th October, 2015 is take as the event date, since the change was applicable from the next trading day after the October expiry.

4.1 Market measures used for comparison

Four measures of market quality are used to assess the impact: (1) composition of market participants, (2) trade size by participant category, (3) size of market, and (4) liquidity. These measures are calculated for the Nifty futures and Nifty options contracts traded on the National Stock Exchange (NSE). The assessment period is 120 days before and after the event date.

Composition of market turnover by participant type: What is the extent of participation in turnover by the three categories of participants: (1) Custodian (C) – trades by institutions; (2) Proprietary (P) – trades by brokers for their own account; and (3) Non-custodian and Non-proprietary (NCNP) – trades by participants that do not fall in the C and P category. NCNP trades are often chracterised as trades by retail investors. (Unit: percentage of daily turnover)

Trade size by participant category: This is the median value of each trade undertaken by the different categories of market participants. (Unit: Rs. lakhs)

Size measured by open interest (OI): This is the value of contracts that have not yet been settled. Participants have to set aside margin capital for all their open positions. (Unit: USD billion per day)

Liquidity measured by traded volume (TV): This is value of the total near-month contracts traded on a single day. (Unit: USD billion per day)

Liquidity measured by impact cost (IC): This is the cost of executing a transaction in a given security, for a specific predefined order size (Rs. 1 mn), at any given point of time. Lower IC indicates better liquidity conditions. (Unit: percentage)

4.2 Methodology

Three questions are asked in the analysis:

1. What was the median size per trade before and after the intervention?
2. Was there a change in the composition of market participation, measured by any change in the share of C, P and NCNP?
3. Was there an impact on market size and market liquidity?

The median values of the measures described in Section 4.1 are calculated for both the event period before the event and after. The Wilcoxon signed-rank test is used to check

[33] SEBI Circular CIR/MRD/DP/14/2015 (`http://www.sebi.gov.in/cms/sebi_data/attachdocs/1436782665000.pdf`).

Table 11 Participant composition and trade size before and after the lot size change by SEBI

	Share of turnover (%)		Trade size (Rs. lakhs)	
	Before	After	Before	After
Nifty Futures				
Custodian trades	21	21	2.09	5.62
Proprietary trades	34	32	2.16	5.72
Non-custodian non-proprietary trades	45	46	2.09	5.72
Nifty Options				
Custodian trades	10	16	3.07	6.15
Proprietary trades	53	51	3.97	6.39
Non-custodian non-proprietary trades	37	34	4.29	6.47

Table 12 Market quality before and after the lot size change by SEBI

	Nifty Futures		Nifty Options	
	Before	After	Before	After
TV (USD bn)	1.52	1.59	20.82	22.49
OI (USD bn)	2.86	2.53	17.89	18.10
IC (%)	0.005	0.005	0.398	0.360

whether the change between these values are significantly different. A test value more than 0.05 says that the change is significant.

4.3 Findings

Table Table 11 and 12 compare the measures before and after the event date.

- For Nifty Futures:
  - There is a decline in P (by 5.8%) and in increase in NCNP (by 2%). The share of C (instiutional trades) has remained the same. Before the change, 55% of the trades came from financial institutions and brokers. After the change, their participation declined to 53%.
  - Traded volumes (TV) has increased by 4.6%, and open interest (OI) has dropped by 11.5%.
  - The market liquidity measured by impact cost (IC) has remained the same.
- For Nifty Options:
  - There is a decline in P (by 3.7%) and in NCNP (by 8%). Institutional participation (C) has increased by 60%. Before the change, 63% of the trades came from financial institutions and brokers. After the change, their participation increased to 66%.
  - TV has increased by 8% as has OI which increased by 1.2%.
  - Market liquidity measured by IC has declined.

Table 13 gives the results of whether the change in the market quality is significant. The results are that:

- For Nifty futures:
  - Traded volume and impact cost have not changed significantly.
  - The open interest is significantly different.
- For Nifty options:
  - Traded volume and open interest have not changed significantly.

Table 13 Wilcoxon paired test results for pre and post event period measures

	Nifty futures	**Nifty options**
Turnover (TV)	0.22	0.96
Open Interest (OI)	**0.002**	0.60
Impact cost (IC)	0.76	**0.048**

*Value below 0.05 indicates dissimilarity between periods

– Market liquidity has improved significantly after the change. However, it is difficult to establish whether this is because of the change or because liquidity in the options market has been improving as observed from the long time series of quarterly impact cost values in Table 2.

4.4 Conclusion

We set out to answer three questions in this analysis, and we find the following:

1. *What was the median size per trade before and after the intervention?*

   The median trade size for Nifty futures before the intervention was close to Rs. 2 lakhs, and remained the same for all types of participants (Institutions, Proprietary and retail). This has gone up by more than double after the lot size change by SEBI.

   For Nifty Options, the median trade size for institutional trades was Rs.3 lakhs and it was Rs.4 lakhs for proprietary and retail before the change. This has also increased.

2. *Was there a change in the composition of market participation, measured by any change in the share of each type of participant?*

   The pattern of participation has remained the same after the change as before.

3. *Was there an impact on market size and market liquidity?*

   • Traded volumes on both the Nifty futures and options markets have *remained the same*.

   • Open interest has *worsened* for the Nifty futures.

   • Market liquidity has *improved* for the Nifty options.

The analysis suggests that the there is no clear impact of this intervention because some of the market quality measures have worsened, some have improved, and most have remained the same.[34] This raises a question about what objective SEBI had in mind when introducing this change in the contract size of equity index derivatives[35]. The Circular was silent on objectives and intended impact.

We conjecture that a possible objective could have been to reduce trades by certain participant categories. But the analysis in Table 11 does not indicate significant changes in participation across institutional (C), proprietary (P) or retail (NCCP) participants. Thus, we infer that there was no effective change in market quality that can be clearly attributed to the change in lot size.

Further, the manner in which this intervention was carried out raises concerns about the regulatory governance process at financial sector regulators in India. On October 24, 2013, as part of the Financial Sector Development Council (FSDC) Resolution, all financial sector regulators agreed to comply with the Handbook (2013) procedures for framing regulations. Handbook (2013) compliance requires a public consultation process before framing

[34]The analysis does not make any assertions of causality or lack of it. Outcomes may have been driven by a variety of factors affecting market development.

[35]The change in contract size was also applicable to single stock futures and options (F&O). This note does not reflect on the impact of this intervention on single stock F&O.

any regulation. This includes making available draft regulations, its objectives and a cost benefit analysis of its potential impact to the public, and the comments received taken into account while framing the final regulation. For this particular intervention, this process was dispensed with entirely by SEBI. No public consultation was undertaken and in fact even the final regulation was silent on objectives and impact. Such an approach increases the uncertainty about regulatory action for all participants. This in turn leads to a lack of trust in the stability of the system, and acts as a disincentive for long-term business development and investment in the financial sector.

4.5 Graphs

4.5.1 Nifty Futures

Figure 1 Open interest

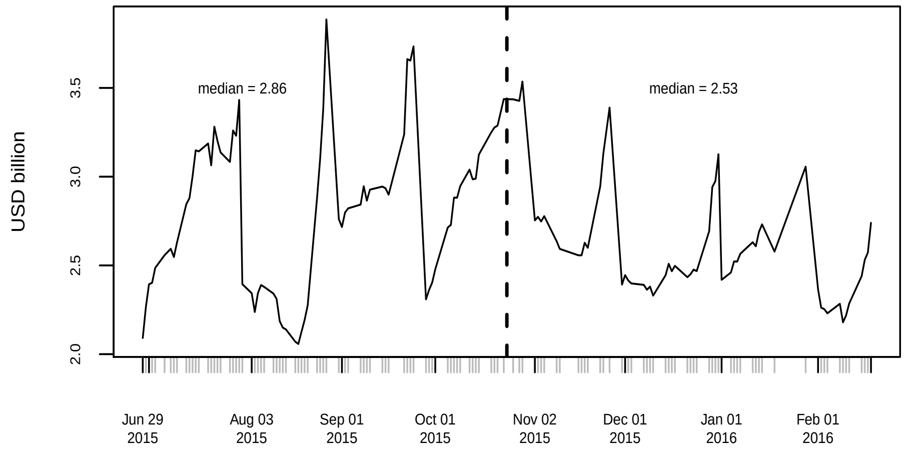


Figure 2 Turnover

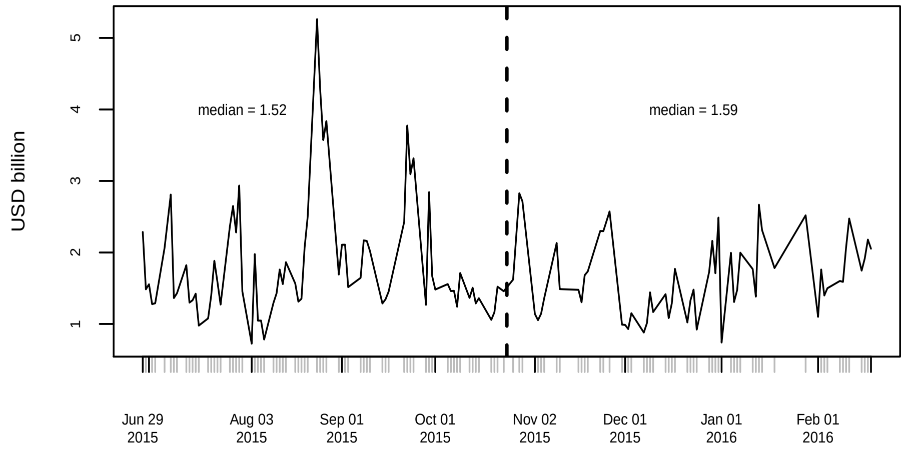


Figure 3 Impact cost

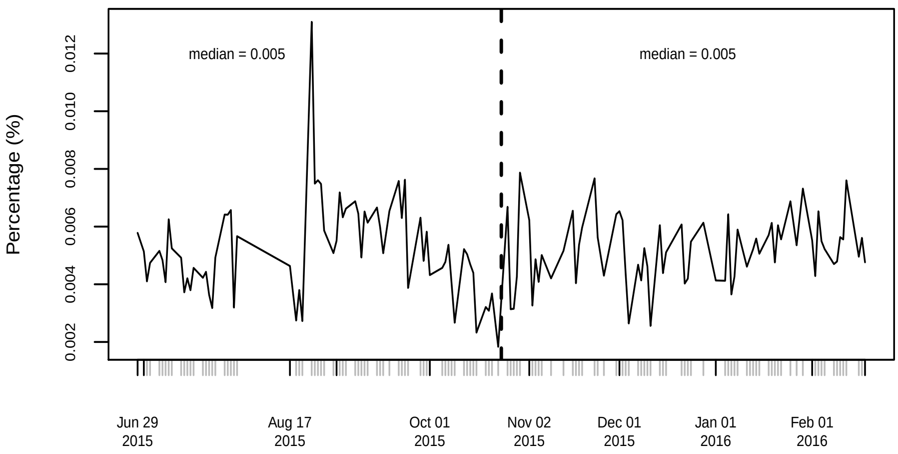
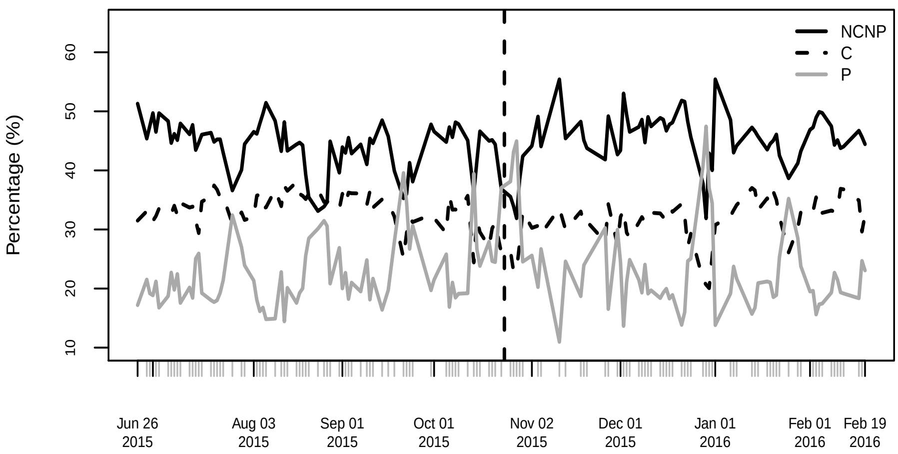


Figure 4 Composition of participation



4.5.2 Nifty Options

Figure 5 Open interest

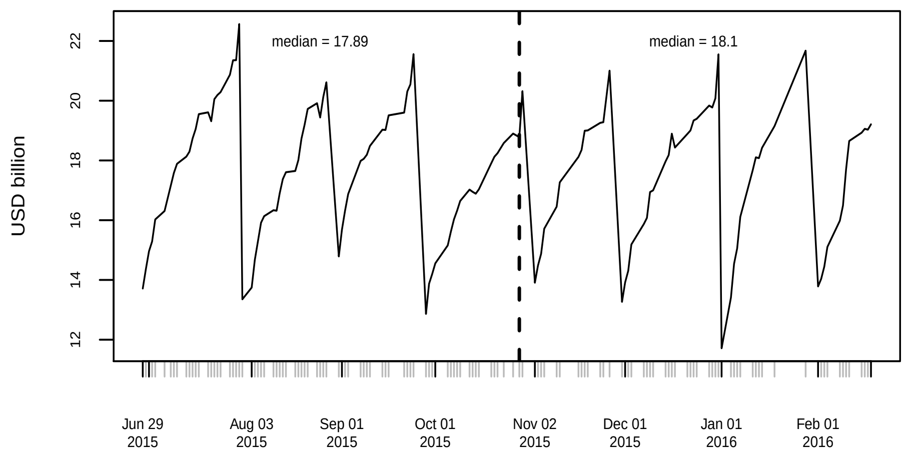


Figure 6 Turnover

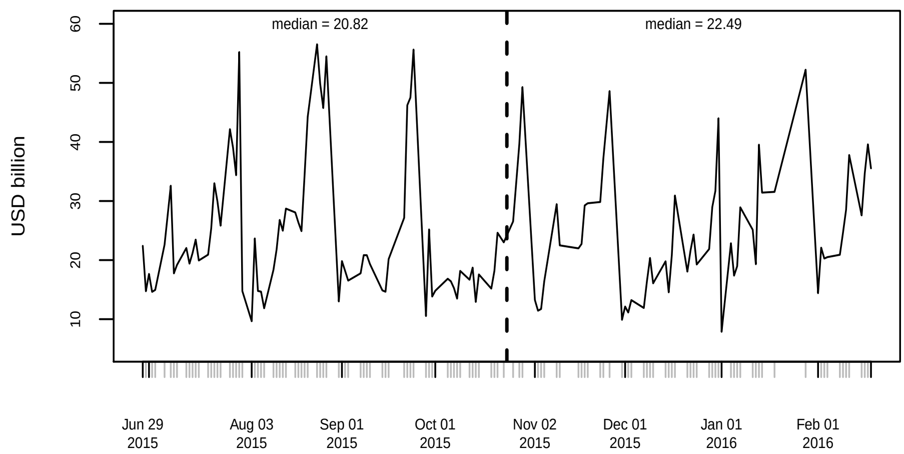


Figure 7 Impact cost

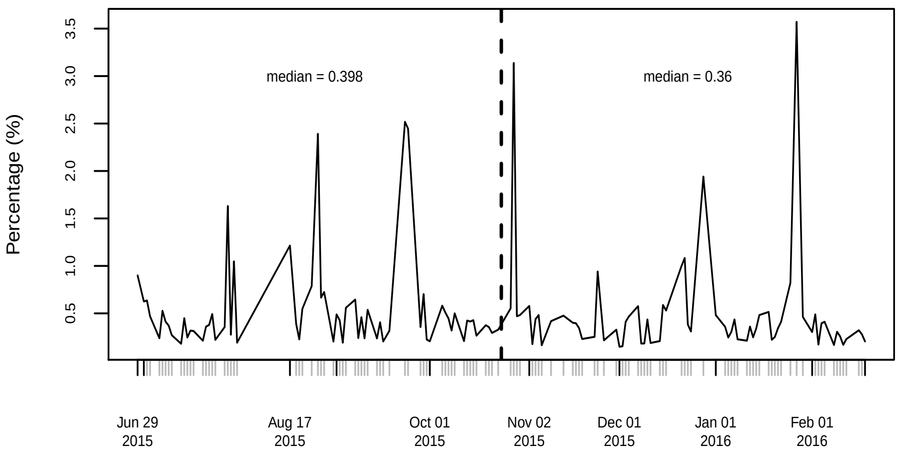
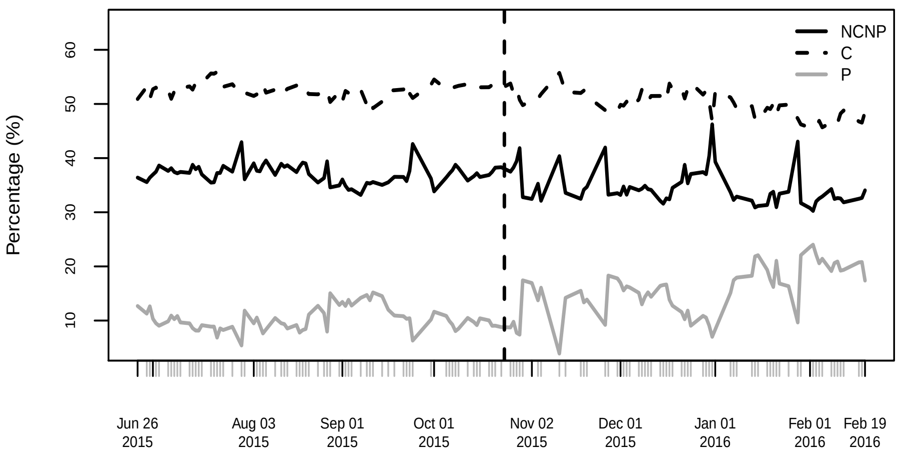


Figure 8 Composition of participation



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