Corpsec Hotline

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TIME TO CREATE WIDER ONSHORE DERIVATIVE MARKET?

The Securities and Exchange Board of India (SEBI) approved the introduction of several new derivative products in the Indian market, based on the interim recommendations made by a committee headed by Prof. M. Rammohan Rao. The objective is to increase the activity in the Indian onshore market by adding more products to the market and provide investors with a larger range of risk mitigation avenues.

The final introduction of the products would be preceded by a wider consultative process to decide on the specifications of the products like product design, risk mitigation features and conformity to regulatory requirements.

The proposed products are:

1. Mini-contracts on equity indices,
2. Options with longer life/tenure,
3. Volatility index and F&O contracts,
4. Options on Futures,
5. Bond Indices and F&O contracts,
6. Exchange-traded currency (foreign exchange) Futures & Options, and
7. Introduction of exchange-traded products to cater to different investment strategies.

Development of derivatives market in India:

By way of historical background to the new initiatives, derivatives as a product was first introduced in the Indian market by suitably amending the Securities Contract (Regulation) Act, 1956 (SCRA) in 1995, which withdrew the prohibition on options in securities. Dr. L.C Gupta Committee constituted by SEBI had laid down the regulatory framework for derivative trading in India. Derivatives trading commenced in India in June 2000 and the products were introduced in a phased manner.

Currently, the derivative contracts permitted by SEBI are:

- Index Futures (June 2000)
- Index Options (June 2001)
- Options on Individual Securities (July 2001)
- Futures on Individual Securities (November 2001)
- Sectoral indices (December 2002)
- Interest Rate Futures on a notional bond and T-bill priced off ZCYC (June 2003)
- Exchange traded interest rate futures on a notional bond priced off a basket of Government Securities (January 2004)

Proposed products.

1. **Mini-contracts on equity indices:** At present, the minimum contract size is of INR 200,000. Introduction of this product would enable retail participation having contract size less than INR 200,000.
2. **Options with longer life / tenure:** The current maximum tenure of options is 3 months. With longer maturities, say 6 months or 1 year, there would be hedging opportunity with a longer horizon which is quite popular in foreign markets. Longer term contracts may also help investors in their capital gains tax planning. It is also felt that long-term contracts may work out to be cheaper.
3. **Volatility Index:** The market player would be able to assess the future volatility of the market in the near term. This may help to increase the volumes in the options market.
4. **Options on Futures:** Basically this would mean that the instead of stocks or index as underlying, stock futures or index futures shall be underlying. This would in real terms work as a derivative of an underlying derivative instrument and would have its own nuances. Liquidity has always been an issue in existing options market hence it remains to be seen how market participants would view this product.

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5. **Bond Indices and F&O contracts:** The highly regulated bond market is affected by adverse interest rates. This product would be a good hedging tool for banks and bond houses to take short positions to guard against adverse interest rates.
6. **Exchange-traded currency (foreign exchange) Futures & Options:** The idea is to assess the fluctuations in value of Rupees versus other currencies and make available local market for hedging the foreign currency risk. Recently, Indian rupee futures were permitted to be traded on the Dubai stock exchange. This product would provide local platform to Indian exporters and importers to hedge the Indian rupee that has been appreciating against all major currencies for some time now and thereby reduce the impact of losses arising out of appreciating rupee.

In addition to the above, they have also proposed the introduction of exchange-traded products to cater to different investment strategies.

Conclusion:

The above initiatives would no doubt align the Indian market with the global developed markets and is certainly a bold move by SEBI. According to SEBI Chairman, Mr. M. Damodaran, this step is to increase the number of products in the Indian market and make India's market an onshore market. These products would make the Indian markets more matured and robust and would attract many other investors. It remains to be seen how and in what form these products are eventually introduced and how the market participants would perceive them. As SEBI has indicated, the regulatory framework governing these products would be made based on a consultative process and we hope that the final blue print of the regulations would be workable and amenable to all the concerned market participants.

Source:

- Press Release dated November 14, 2007 issued by SEBI
- Economic Times dated November 15, 2007

- **Kajal Sheth**
You can direct your queries or comments to the authors

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