SAFETY NET OR ENTRY BARRIER? SEBI'S NEW F&O REFORMS

Khushi Lunawat, School of Law, CHRIST (Deemed to be University), Bengaluru

Introduction

In the realm of financial regulation, the challenge lies not in creating rules, but in crafting ones that foster growth while mitigating risk. The Capital Market regulator, Securities and exchange board of India (SEBI) had appointed an expert working committee last month to address the issue of excessive speculation driven by high retail participation in recent years[1]. The suggested changes follow a sharp rise in F&O trading volume and retail involvement.

The proposed changes come in the wake of a dramatic increase in F&O trading volume and retail participation. The SEBI figures show that derivative turnover has more than doubled from Rs 210 trillion in FY18 to Rs 500 trillion in FY24 and the retail investor participation in index options has jumped from 2% in FY18 to 41% in FY24. Moreover, it was also discovered that almost 90% of retail traders lose money in F&O trading, with an average loss of Rs 1.1 lakh in FY22. This has sparked worries about the social effects of widespread speculative trading given reports of people borrowing money to trade options.

The SEBI-appointed panel was scheduled to meet on July 15[2] to gather input from various market participants. This meeting is expected to provide a forum for broad suggestions from different stakeholders in the F&O market (Business Standard article).

After this meeting, the Secondary Market Advisory Committee will consider their recommendations. If the proposed changes lead to successful implementation, it could lead to a significant overhaul of the current offerings and regulatory framework in the F&O market.

[1] "Sebi's F&O Crackdown May Curb Accessibility for Low-Ticket Retail Players: Kotak Report." Moneycontrol, July 11, 2024. https://www.moneycontrol.com/news/business/markets/sebis-fo-crackdown-may-curb-accessibility-for-low-ticket-retail-players-kotak-report-12766597.html

[2] Standard, Business. "F&O Expert Group Set up by SEBI Meets Monday for Industry Proposals." Business Standard, July 9, 2024. https://www.business-standard.com/markets/news/f-o-expert-group-to-meet-next-week-to-review-equity-derivatives-norms-124070900889_1.html

Key Proposals and Their Objectives

Increased Minimum Lot Size: The committee suggests raising the minimum lot size for derivative contracts from the current Rs 5 lakh to Rs 20-30 lakh. This move aims to make F&O trading less accessible to small traders. According to a study, many inexperienced individuals borrow money to trade options, hoping for quick profits in the highly risky F&O market. A SEBI study reveals that approximately 90% of retail traders lose money on options bets, with an average loss of ₹50,000.

Limited Weekly Options: SEBI aims to restrict weekly options to only one expiry per stock exchange per week. This measure, if implemented, would significantly narrow the playing field for traders and potentially reduce the frequency of speculative trading.

Fewer Strike Prices: The committee has suggested limiting the number of strike prices available for options contracts. This could simplify the options landscape and potentially reduce some of the complexity that can lead to speculative excesses.

Enhanced Margin Requirements: In order to further manage risk, the committee proposes increasing margin requirements as contracts approach their expiry date. This measure aims to ensure traders have adequate funds to cover potential losses in the volatile period near contract expiration.

Upfront Premium Collection: A suggestion has been made to implement upfront collection of option premiums from buyers. This could help ensure that traders have the necessary funds to cover their positions and potentially reduce default risk.

Stricter Position Limit Monitoring: The committee recommends implementing intra-day monitoring of position limits. This more frequent monitoring could help exchanges and regulators better manage risk and prevent excessive position building within a single trading day.

How the Proposed Reforms Could affect the participation of Small Traders

The proposed reforms would significantly impact small-ticket traders' participation in the F&O market. A substantial increase in the minimum contract size would effectively exclude many retail participants due to higher costs. Additionally, limiting the number of weekly expiries would reduce trading opportunities for small investors. These changes, coupled with other proposals such as reducing the number of strike prices and requiring upfront collection of option premiums, would create a more challenging environment for small traders to operate in.

Moreover, market experts argue that most weekly contracts offer minimal economic benefit, serving primarily as vehicles for speculation rather than their intended purpose of hedging against price fluctuations.

These reforms could also impact the dynamics of the Bombay Stock Exchange (BSE), Sensex and the broader share market, influencing investment strategies across various instruments, including mutual funds and demat accounts.

As the saying goes, "history doesn't repeat itself, but it often rhymes". In the derivatives markets, drawing parallels from international markets provides insight into the potential impact of regulatory interventions on F&O volumes. In Korea (2010-2011) and China (2015), similar regulatory actions led to significant declines in trading volumes[3]. Korea's fivefold increase in the minimum trading amount resulted in a collapse of trading volumes, while China's raise in mandatory margin requirements from 10% to 40% caused a sharp decline. These cases demonstrate how changes in derivatives regulations can have a lasting impact on market volumes.

In addition to SEBI's proposed reforms, the Indian government is considering reclassifying futures and options transactions from 'business income' to 'speculative income'. This reclassification would place F&O earnings in the same tax category as lottery winnings or cryptocurrency investments, potentially subjecting them to a flat tax rate of 30%. This tax reclassification, if implemented, will further discourage retail participation in the F&O market.

While some of the market veterans have expressed their apprehensions of the possibility of volume reductions, many are in support of SEBI's attempts at controlling the increased activity in the derivatives segment. Current F&O market activity is not even euphoria, says Vijay Kedia, the founder of Kedia Securities, but a stampede[4]. He calls for SEBI's intervention by stressing

[3] Livemint. "*Kotak Cites China, Korea Precedent to Oppose SEBI's Possible F&O Crackdown*." https://www.livemint.com, July 15, 2024. https://www.livemint.com/videos/kotak-cites-china-korea-precedent-to-oppose-sebis-possible-f-o-crackdown-what-happened-in-china-11721030453043.html

[4] "*Vijay Kedia's Warning on the Market Frenzy - 'this Will Not End Well'* - CNBC TV18." CNBCTV18, July 11, 2024. https://www.cnbctv18.com/market/vijay-kedia-market-warning-this-will-not-end-well-nifty-sensex-record-high-psu-fno-frenzy-sebi-19440582.htm

on the negative consequences that may be experienced if no action is taken.

How the reforms Could Reshape the BSE-NSE Dynamics

The proposed SEBI reforms could inadvertently alter the competitive landscape between the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) in the derivatives market. Currently, NSE dominates with about 80% market share, while BSE holds only 20% despite recent efforts to increase its presence. However, if SEBI implements the proposal to restrict options contracts to one expiry per stock exchange per week, it could significantly benefit BSE[5]. This change would force NSE to choose between its two most actively traded contracts, NIFTY and Bank NIFTY, for weekly expiries. Consequently, this could shift substantial trading volumes from NSE's derivatives contracts to BSE's nascent derivatives contracts, particularly the SENSEX derivatives. Industry experts, such as Rajesh Baheti of Crosseas Capital Services, suggest this could give BSE an opportunity to capture up to 50% of the derivatives market. This potential shift in market share could dramatically reshape the derivatives trading landscape in India, providing BSE with a significant boost in its long-standing competition with NSE.

Conclusion: Weighing the Pros and Cons

In the complex intersection of F&O trading, SEBI's role should be to install traffic lights that guide market participants, not to erect roadblocks that impede their journey. The challenge lies in determining whether these new reforms will act as necessary signals or unintended obstacles. To address this challenge, SEBI's has adopted multi-pronged approach towards the protection of the retail investors as well as to prevent the emergence of bubbles in the market. One of the recent measures that were taken by SEBI includes making brokers disclose risks and banning unauthorized financial advice from 'finfluencers'[6]. These reforms are intended to address high levels of speculation and protect new participants from high risk but they might be used to shift market share between exchanges. Also, it is possible that excessively stringent measures may push small-scale traders to unregulated betting sites in search of high-risk/high-return options that have been offered in regulated derivatives markets. The challenge is to design rules that strengthen the market's credibility and do not stifle growth or force market members to turn to

---

[5] "Could Sebi's New Proposal Unintentionally Favour BSE over NSE?" Finshots, July 12, 2024. https://finshots.in/archive/sebi-proposal-derivatives-f-o-bse-nse-market-share/

[6] "SEBI Board Meeting." SEBI. Accessed September 10, 2024. https://www.sebi.gov.in/media-and-notifications/press-releases/jun-2024/sebi-board-meeting_84448.html

the grey zone. This situation points to the fact that there is need to employ a balanced framework of regulating the financial markets where short-term protectionism measures should not be viewed separately from the long-term health of the markets.