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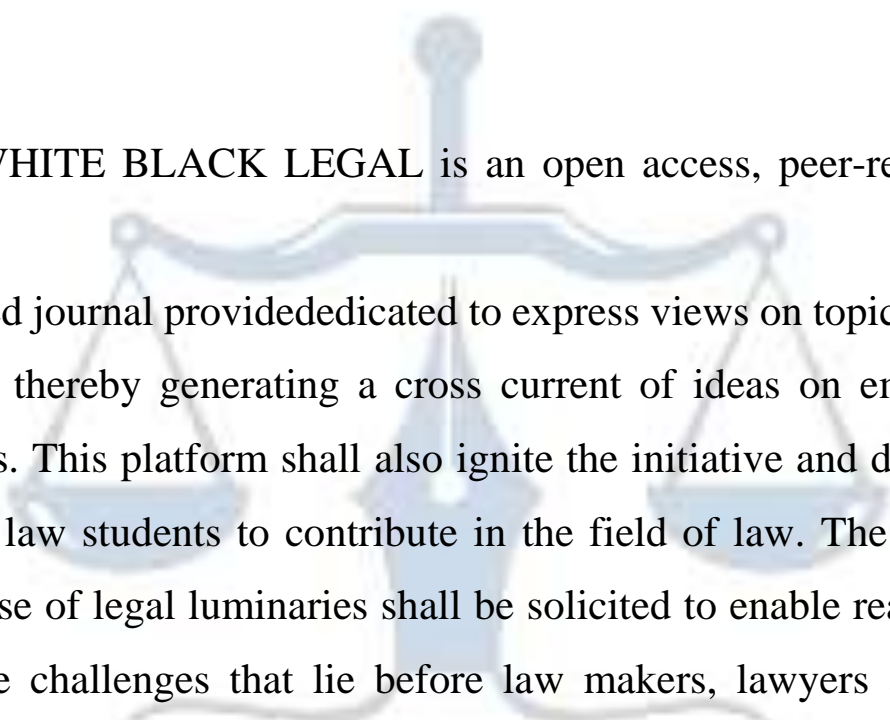


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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

REGULATORY CHALLENGES IN INDIA'S DERIVATIVES MARKET

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Abstract

India's derivatives market has grown rapidly, becoming an essential part of the country's financial landscape. This study looks at the regulatory issues that the derivatives market faces, with particular attention on risk management, investor protection, and over-the-counter (OTC) derivatives. It goes into great detail about how the Securities and Exchange Board of India (SEBI) and other regulatory agencies monitor market integrity and enforce compliance. Even with major regulatory improvements, there are still gaps that could jeopardize financial stability, especially in the regulation of over-the-counter (OTC) derivatives. Future trends and changes that could improve market infrastructure, boost product diversity, and encourage global regulatory harmonization are also covered in the report. Future growth will be fueled by technological advancements and ESG-focused tools, as well as the necessity of ongoing attention to systemic risk management. In order to ensure long-term market stability, the study concludes by highlighting the significance of a balanced regulatory framework that protects investor interests while promoting innovation.

Keywords: Derivatives Market, SEBI, Regulatory Challenges, OTC Derivatives, Systemic Risk

Introduction

Derivatives are financial tools that derive their value from a single asset or a collection of assets. The assets include stocks, bonds, commodities, currencies, interest rates, and market indices. SEBI, short for Securities and Exchange Board of India, was established by the Indian government in 1992 to protect investor interests and regulate the securities market, creating rules and guidelines while also facilitating derivative contract trading. The Indian commodity derivatives market has been regulated by the Securities and Exchange Board of India (SEBI) since September 28, 2015. Before September 28, 2015, the commodity derivatives market was regulated by the former Forward Markets Commission (FMC). The Indian Regulatory Framework is the combined set of laws, rules, and guidelines that govern corporate operations in India. These rules aim to ensure companies comply with the law and act in a fair and transparent manner.

Among the various types of derivatives are forwards, swaps, options, and futures. Each type has unique characteristics and uses. Derivatives markets aid in price discovery since they reflect market feelings and expectations. Market actors use arbitrage strategies to profit from price differences across connected assets or markets. By employing derivatives to hedge against changes in interest rates, currencies, commodities, and other variables, businesses can safeguard themselves against unforeseen market fluctuations.

Derivatives are frequently used for arbitrage, hedging, speculation, and risk management. By guarding against unfavourable changes in market prices, they enable firms and investors to reduce risks. By taking advantage of price differences between connected assets or markets, derivatives help determine fair market pricing. Over-the-counter markets and established exchanges, like stock exchanges or exchanges specifically for derivatives, are how the derivatives market functions. These markets offer a venue for clearing services, transaction settlement, and the purchase and sale of derivative contracts.

To sum up, derivatives improve market liquidity, aid in price discovery, and encourage financial innovation; but, because of their complexity, they must be carefully understood and used. Unintentional exposure to risks that beyond one's expectations can arise from ignorance of derivatives. Derivatives are used by investors to speculate on price changes, increasing their possible gains or losses.

Growth, Regulation and Future Outlook

India's derivatives market has grown significantly and is now a crucial part of the nation's financial system. Both the quantity and number of trading contracts have increased dramatically since its launch in June 2000. This study thoroughly examines the future trajectory and the elements driving this expansion, including market dynamics, regulatory scrutiny, historical analysis, and the overall economic impact of derivatives trading in India. An examination of the historical development of derivatives trading in India is conducted, emphasizing key turning points and regulatory actions that have influenced the state of the market now.¹

The study also describes the difficulties the Indian derivatives market is facing and offers an outlook on possible reforms and new developments that can affect the market's course in the future. The results of this research provide important insights into the development of the market and its consequences for the larger financial ecosystem, allowing for a more thorough understanding of the expansion of derivatives trading in India. In order to provide a comprehensive analysis of derivatives trading in India, the descriptive study makes considerable use of secondary data from a variety of sources, such as publications, websites, and journals.

A spike in derivative trading volumes, with tiny investors rushing to trade riskier options contracts, prompted India's market regulator to issue a warning on Thursday about the growing risks. The Securities and Exchange Board of India's chairperson, Madhabi Puri Buch, stated on Thursday that the thriving Indian stock market has attracted retail investors to the riskiest areas of the market, increasing their proportion of derivative trading volumes from 2% in 2018 to 41% at this time.

The remarks come after Nirmala Sitharaman, India's federal finance minister, warned last month that an unbridled surge in retail futures and options trading could pose problems for the markets, investor sentiment, and household finances in the future.

India's central bank highlighted those worries in a report it released earlier Thursday.

¹ Tewari, I. and Singh, L.K. (2023) 'Derivatives Market in India: Growth, Regulation and Future Outlook', *International Journal of Research in Business Studies*, 8(2).

As suggested in a discussion paper earlier this month, the agency also established new standards for selecting stocks that can be connected to derivative products, like futures and options.

Legal and Regulatory Framework

In India, SEBI sets up the regulatory framework for derivatives in the country, as mentioned earlier. SEBI is in charge of establishing guidelines for trading, clearing, and settling derivative contracts. SEBI's regulations aim to protect investors, maintain market integrity, and ensure the benefits of derivatives are balanced. Ashish Kumar Chauhan is the Managing Director and Chief Executive Officer of the Bombay Stock Exchange (BSE). His aim at BSE is to restore the prominence of BSE. Thanks to his hard work, the BSE's derivatives market was built from scratch and achieved a market share of more than 20% within a year. Under his guidance, the BSE's trading volume exceeded Rs 1.77 lakh crore in a single day. The CFTC's role is limited compared to the SEC, as the SEC is mainly responsible for regulating the securities market. FINRA regulates the participants of derivative contracts.

Regulatory Objectives: -

Fairness and Transparency:

The trade regulations ought to guarantee that transactions are carried out in an equitable and open way. Experience in other nations demonstrates that brokers and dealers of derivatives frequently neglected to warn consumers about such risks.

Protect client funds:

In addition to being kept in a separate client account, client monies and securities deposited with trading members should also be exempt from the broker's personal debts. It is important to ensure that the trading of dealers' own accounts is totally separate from that of their clients.

Qualified and Ethical Service:

In order to develop qualified and competent employees and offer clients and investors competent and honest service, eligibility conditions for trading members should be established. Establishing knowledge-based requirements for derivatives brokers/dealers and the salespeople they hire is necessary to achieve this.

Market integrity: The trading system should ensure that the integrity of the market is safeguarded by decreasing the probability of defaults. This calls for the development of appropriate rules pertaining to clearing corporations, margins, and capital adequacy, among other topics.

A. Market Quality: The idea of "Quality of Markets" strives to improve significant market attributes including cost-efficiency, price-continuity, and price-discovery, and it extends well beyond market integrity. This goal is far more expansive than maintaining market integrity.

B. Innovation: The regulatory framework should not hinder innovation, which is the foundation of all economic success, even as it curbs any bad inclinations. This is especially true given that financial derivatives are a new, quickly growing industry made possible by information technology advancements.

Regulation is crucial in derivatives because they become more complex and riskier due to excessive leverage and counterparty default, especially for over-the-counter derivatives. OTC derivatives pose higher risks as they are traded away from controlled exchanges. They are agreements made between two private parties, with a greater likelihood of one party not fulfilling its obligations, known as counterparty risk.

If investors, companies, and institutions have too much leverage in derivatives and prices go down, their losses can be massive and impossible to sustain. This is what caused the financial crisis in 2008. Nevertheless, the absence of regulations allowed it to happen. Regulation is crucial in lowering systemic risk, so it is no surprise that governments and institutions worldwide have been continuously improving the rules.

Some regulatory and legal frameworks are as follows -

The Securities and Exchange Board of India (SEBI) is in charge of overseeing the legal and regulatory environment for derivative markets in India.

Regulations and guidelines

SEBI creates rules, guidelines, and regulations for the trading, clearing, and settlement of derivative contracts. Additionally, SEBI regularly amends these laws and regulations to meet market expectations.

Requirements for investors

Investors are required to sign a Risk Disclosure Agreement and adhere to KYC regulations.

Criteria for the counterparty

Contracts involving derivatives require the consent of the parties. They also need to have a risk management policy and be aware of the dangers.

Stock Exchanges

Stock exchanges by providing standardized derivatives contracts on their trading platforms, stock exchanges enable the trade of derivatives.

Investor complaints

If an investor is unhappy with their member broker or discovers transactions that are not verified, they can contact the exchange's Investor Grievances Department.

Regulatory Gaps in OTC Derivatives

OTC derivatives are agreements between parties made privately, without involving intermediaries or an exchange. On the other hand, a broker could simplify the trading process. This direct negotiation offers a high level of flexibility, allowing the OTC derivatives' parameters to be tailored to the specific risk and return needs of each counterparty.

Reporting specifications

For certain kinds of over-the-counter (OTC) derivatives transactions, the Reserve Bank of India (RBI) has established reporting guidelines. However, the reporting period varies based on the parties and the nature of the transaction.

Securities and insurance company regulation

Federal restrictions regarding derivative operations by affiliates of securities and insurance firms are non-existent. Additionally, the state has little to no control over the derivatives operations of insurance firm affiliates.

OTC trading is less regulated than typical stock markets because there is no centralized exchange. Direct communication between buyers and sellers is possible through brokers or dealers.

In over-the-counter (OTC) trading, buyers and sellers can speak with one other directly through brokers or dealers. Because there is no centralized exchange, it is less regulated than regular stock markets.

Disadvantages of OTC-

Risk to the other party

the possibility that one of the parties to a transaction will stop making payments before the trade is finished. This is particularly problematic during financial crises or erratic markets.

Lack of liquidity

For a given stock, there can be fewer buyers and sellers, which makes it challenging to initiate or exit positions rapidly.

Absence of openness

Businesses that trade over-the-counter are exempt from the same disclosure requirements as those that list on major exchanges.

Broad spreads

Wide bid-ask spreads are common in OTC equities, which means that an OTC security's value might fluctuate greatly.

Deception

Pump and dump techniques, in which a stock's price is artificially boosted and subsequently sold at a higher price, are common in over-the-counter (OTC) marketplaces.

Intricacy

A thorough understanding of derivative goods and financial markets is necessary due to the high degree of customization, which can result in complex structures.

Slow

The requirement for price matching and the possibility of network delays can make OTC derivatives slower.

The following are several regulatory gaps in India's over-the-counter (OTC) derivatives

market:

Limitations imposed by policy

The participation of different economic agents in the OTC derivatives market is restricted by policy. The underlying exposure requirement. To engage in forex derivative transactions, an underlying exposure is still necessary.²

Tolerance in the real sector

The real sector has a limited capacity to tolerate significant fluctuations in interest rates and exchange rates.

The Securities and Exchange Board of India (SEBI) created the regulatory structure that regulates derivatives in India. SEBI creates rules, regulations, and guidelines pertaining to the trading, clearing, and settlement of derivative contracts.

OTC trading is less regulated than typical stock markets because there is no centralized exchange. Buyers and sellers trade over-the-counter (OTC) through brokers or dealers.

Does India regulate over-the-counter markets?

Through brokers or dealers, buyers and sellers can communicate directly in over-the-counter (OTC) trading. Compared to traditional stock markets, it is less regulated because there is no centralized exchange.

OTC regulations in Indian market

Drugs that are not prescribed medications are classified as over-the-counter (OTC) medications in India, although OTC is not legally recognized. In India, there is no clear process or law governing the transition from prescription to over-the-counter products. There are institutional processes in place in many nations for changing prescription drugs to over-the-counter status.

Risk Management and Compliance Issue

Market risk is the threat of a decline in the value of the underlying asset. This may occur in the

² Raju, K.V. (2024) A study of OTC drugs in India and regulations governing them, www.ijbpas.com. Available at: https://ijbpas.com/pdf/2024/April/MS_IJBPAS_2024_7946.pdf (Accessed: 22 October 2024).

event of an abrupt shift in market conditions, such as a natural disaster or a worldwide financial crisis. The value of the derivative may also drop if the underlying asset's value drops considerably, which could result in large losses for investors.

Market risk can be amplified by leverage. Since an investor only needs to pay the margin or premium, as appropriate, the actual exposure to the underlying would be a multiple of the amount paid. The investor may suffer enormous losses and possibly lose all of their money if they have not fully comprehended the margin or premium and have contributed a sizable sum of money. Another risk associated with derivatives is credit risk, which is the potential for the counterparty to the derivative contract to not carry out their end of the agreement. A derivative contract may result in losses for the investor if a counterparty defaults, preventing them from receiving the full contract value. However, since the clearing house or clearing organization serves as the counterparty in exchange-traded derivatives, this risk does not exist.

The risk posed by liquidity is another significant one. It explains the chance that an investor won't be able to sell their position in the derivatives market quickly or at a fair price. There could not be any liquidity risk because most regularly traded derivatives contracts in the Indian securities markets are short-term and will expire soon. The potential for experiencing a loss due to either external events or inadequate or ineffective internal systems, personnel, or procedures is known as operational risk. These circumstances may not occur frequently, but they have the potential to result in significant losses for investors who are unable to liquidate their holdings in a timely manner. In conclusion, investors in the Indian securities markets may find derivatives to be a useful tool despite the high risks involved.

The following are important areas of competence in derivatives regulation and compliance:

1. Respect for the Dodd-Frank Act and other derivatives laws, such as the initial margin requirements for uncleared swaps
2. SEC regulations, along with associated Fixed Income Clearing Corporation (FICC) regulations, mandate that US Treasury repo transactions be cleared.
3. FINRA Rule 4210: Margin requirements for securities forward transactions and associated paperwork
4. The Federal Reserve's QFC Rules, restrictions on the use of default remedies, and bans on cross-defaults are examples of macroprudential measures to reduce systemic risk.
5. Important ISDA protocols, such as those pertaining to the 2018 U.S. Resolution Stay

Protocol and the Dodd-Frank Act

6. Dodd-Frank Act's extraterritorial reach and global derivatives market regulation reforms.

Types of Market Derivatives

Market Risk

Market risk is the name given to the type of risk associated with any investment. The decrease in the value of an underlying asset or financial instrument determines it. International market conditions are closely tied to market risks. Traders make their investment choices considering different factors that could impact how well an asset will do in the future.

Credit Risk

Credit risk is the term used to describe the risk of financial loss if the other party fails to meet their obligations. The investor risks losing money in this situation as they may not get the complete amount. Nevertheless, because the clearing house acts as the counterparty in exchange-traded derivatives, there is no risk of credit

Liquidity Risk

Another important risk connected to trading derivatives is liquidity risk. It is the chance that investors will terminate a derivatives transaction before it matures at a reasonable price. In this case, there will be no reasonable price and a significant discrepancy between the bid and the offer.

Operational Risk

Another significant risk category in the trading of derivatives is operational risk. These risks could lead to losses as a result of technology malfunctions, human error, or insufficient protocols. Even though these situations are uncommon, investors may suffer large losses if they do not immediately sell their holdings.

Regulatory risk

Regulatory risk is the possibility that rules and regulations will change, which could have an effect on trading and financial results. Under severe circumstances, such changes might destroy a company's business model.

Risk management Strategies-

1. Hedging
2. Diversification
3. Use of risk metrics
4. Setting limits
5. Constant monitoring and review

Insolvencies and Derivatives

When a company or individual cannot pay their debts, they are said to be insolvent. When the liabilities of a business exceed the assets, the business is said to be insolvent.

The following factors regarding insolvency and derivatives should be taken into account:

Contracts for derivatives

The counterparty to a derivative contract may release monies owed under the contract while a company is in a formal insolvency procedure.

Bankruptcy and derivatives

To prevent the potential for financial instability, Congress has exempted derivatives transactions from the automatic stay.

Systemic risk and derivatives

Derivatives' bankruptcy handling has an impact on the counterparty's cost of insuring the company as well as the necessary collateral.

Regulation and derivatives

With the exception of general contract law, tax law, and specific regulations for banks and other financial intermediaries, derivatives products are mostly unregulated.

One form of financial difficulty is insolvency, which is the state in which an individual or organization is unable to make payments on their debts or other commitments. A person is considered insolvent by the IRS if their entire liabilities are more than their total assets.

Types of derivatives-

1. Options-

Under the terms of an options contract, the buyer has the right—but not the obligation—to

buy or sell an object at a specific price on or before a specified date. Forward contracts compel the buyer and seller to finish the transaction on the specified date, as opposed to options, which give the buyer the choice to execute their option and buy the asset at the specified price.

2. Forward Contract

The buyer agrees to purchase the underlying asset from the seller on a certain date and at a specified price in a forward contract. Forward contracts are more flexible and can be tailored to a specific product, amount, and date than futures contracts.

3. Future contracts

Futures contracts are standardized agreements for future delivery that unite buyers and sellers on an exchange. The buyer must purchase the underlying asset at the agreed price on the specified date.

4. Swaps

A swap is an arrangement to exchange future financial flows. One cash flow is often fixed, while the other is flexible. For example, a bank could swap a variable-rate mortgage on a house for a fixed-rate mortgage held by someone else to lock in a certain rate if the bank no longer wants to be impacted by changes in interest rates.

International Regulations and Harmonization

Various international regulations play a major role in shaping the global derivatives market by enhancing transparency, reducing systemic risks, and promoting market integrity. In response to the 2008 financial crisis, major economies established comprehensive regulatory measures to address weaknesses in derivatives trading, specifically focusing on over-the-counter (OTC) derivatives. Important rules, like the Dodd-Frank Act in the US, EMIR in the EU, and Basel III Accords, have set worldwide norms for risk control and oversight. These regulations aim to standardize reporting, strengthen capital requirements, and bolster counterparty risk management in order to ensure a more secure worldwide financial system. However, the challenge remains in achieving regulatory harmonization among numerous countries to prevent regulatory arbitrage and ensure consistent global processes.

G-20 DERIVATIVES REFORM

In response to the global financial crisis of 2008, the G-20 countries put in place a number of changes aimed at enhancing the OTC derivatives markets' stability, safety, and transparency.

The reform proposed five major commitments³:

1. Required Margin for Unclear Derivatives:

The failure of one party to meet its obligations in a derivatives deal, known as counterparty risk, was poorly managed, as the financial crisis revealed. Global guidelines for margining non-cleared derivatives were developed by the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS) in response to this issue. Here are the two kinds of margin involved:

- Initial Margin (IM): Amounts deducted to offset any exposure in the future (the risk of further market fluctuations prior to the closure of a position following a default).
- Variation Margin (VM): The daily mark-to-market gains or losses on a derivative contract that is collected to cover current exposure.

Two-Way Margining: Non-dealer counterparties used to generally post margin to cover risks prior to the changes. To ensure that risk is distributed fairly between the counterparties in a derivatives transaction, the G-20 reforms mandate that margin be posted by each of them.

Legal frameworks that enforce netting arrangements—that is, the capacity to offset several transactions between the same counterparties—are rare in many emerging markets. It becomes more challenging to properly implement margin requirements in the absence of enforced netting. Furthermore, margin requirements from major derivatives markets still apply to cross-border transactions with counterparties in emerging economies, posing a hurdle even in cases when the opposite party operates in a jurisdiction lacking enforceable netting.

2. Central Counterparty (CCP) Clearing for Standardized OTC Derivatives

CCPs act as intermediaries between buyers and sellers in derivatives trading, assuming the risk of counterparty default for both parties. CCPs reduce systemic risk by intervening between both parties and ensuring the transaction's completion in case of a default. By

³ Admin (2022) *Policy Framework for safe and efficient derivatives activity ...*, ISDA. Available at: <https://www.isda.org/a/YHVgE/Policy-Framework-for-Safe-and-Efficient-Derivatives-Activity-in-Emerging-and-Developing-Markets.pdf> (Accessed: 20 October 2024).

implementing margin requirements and establishing a default fund, clearing simplifies bilateral trades and lowers counterparty risk.

Due to low trading volumes and no product standardization, small derivatives markets might not be able to afford the setup and upkeep of a CCP. Mandatory clearing might therefore not be practical in areas with tiny or simple markets. It is recommended that developing nations prioritize the enforcement of netting regulations above the establishment of clearing mandates.

3. Cleared, Standardized Derivatives Trading on Online Marketplaces

The goal of the G-20 reforms is to decrease potential for market abuse and increase transparency by encouraging the trade of standardized derivatives on electronic platforms. Crucial elements include post-trade transparency, which discloses the price at which trades are conducted, and pre-trade openness, which lets market players view bid and offer prices. A large percentage of standardized derivatives, including interest rate swaps, are traded on regulated electronic platforms in major jurisdictions like the EU and the US.

Because of their small markets and inadequate infrastructure, emerging and developing countries do not have a large number of electronic trading platforms. In the absence of a substantial number of standardized derivatives deals, the advantages of deploying electronic trading platforms may be outweighed by their cost and complexity. Therefore, it is doubtful that these markets will require computerized trading of derivatives.

4. Mandatory Reporting of Derivatives Transactions

By reporting derivatives transactions to regulatory bodies, regulators can monitor systemic risk and enhance transparency. A trade repository must receive reports of transaction specifics (such as contract terms and counterparty information) from numerous jurisdictions.

Two Forms of Documentation:

- **Regulatory Reporting:** Under the law, counterparties must notify a trade repository or a regulator of transactions.
- **Public Reporting:** To maintain openness, several jurisdictions require that derivatives transactions and their prices be disclosed to the public.

It would be costly and ineffective to establish local trade repositories in every emerging or developing market. For these markets, partnerships with international trade repositories that provide local regulators with access to transaction data would be a more workable alternative. This approach satisfies regulatory requirements without necessitating the costly replication of infrastructure.

5. Increased Capital Requirements for Uncleared Derivatives

Higher capital requirements for non-cleared derivatives aim to reduce systemic risk by incentivizing market players to use CCPs for trade clearing. Non-cleared derivatives are required to meet stricter capital requirements due to their higher risk compared to cleared trades.

With a focus on exposure to CCPs, counterparty credit risk, and market risk, Basel III imposed stricter capital requirements for banks and other financial institutions. This has led to a large increase of centrally cleared derivatives.

The Basel III capital standards are largely designed to target large, globally engaged banks; however, many developing market institutions are smaller and less globally integrated. This presents challenges for emerging markets. Consequently, in these markets, capital requirements must be implemented proportionately. Emerging market policymakers have to strike a compromise between preserving financial stability and encouraging the expansion of regional derivatives markets. Simplified regulatory procedures for capital management may be advantageous for smaller organizations.

Dodd-Frank Act

Title VII of the Dodd-Frank Act gives the Commodity Futures Trading Commission (CFTC), which regulates "swaps" (roughly 95% of the market), primary regulatory authority over the OTC derivatives market. The Securities and Exchange Commission (SEC) is given secondary regulatory authority over "security-based swaps" (roughly 5% of the market). This law requires transactions to be reported to regulators and made public in order to address the opaque nature of the OTC derivatives market. Title VII requires certain swaps to be traded on exchanges and requires the clearing of standardized swaps through central counterparties (CCPs) in order to mitigate counterparty and operational risks. Additionally, it gives the CFTC the authority to

oversee clearinghouses through the application of fundamental CCP principles. To this end, the CFTC has implemented extensive regulations, especially Part 39, and a program of supervision that entails frequent inspections and continuous risk monitoring.⁴

Protections for customers were also established for major market participants and individuals engaging in swaps under Title VII. Requiring the collection and disclosure of initial and variation margins for uncleared swaps is a substantial change. Apart from a few cases, this margin rule has enhanced market stability by reducing concerns about the financial strength of counterparties, a significant issue during the 2008 financial crisis. Even if one party fails to meet their obligations, the exchange of initial margin and daily variation margin can protect solvent parties. Currently, the swaps market operates similar to the futures market, consolidating counterparty credit risk in CCPs.

These steps improve openness and reduce risk, but they are not without problems. Because CCPs bear a larger portion of the risk, Title VII has made the financial system far more reliant on them. This risk concentration may become an issue when more swaps, which are less liquid and have longer maturities than standard futures contracts, are cleared through CCPs. Former Federal Reserve Chairman Ben Bernanke warned that when concentrating risk in CCPs, careful oversight is required. Title VIII fortifies CCP oversight and ensures careful monitoring of this "basket" of concentrated risk, while Title VII creates a robust framework for managing derivatives risk.

European Market Infrastructure Regulation

EMIR, which came into effect in 2012, aims to reduce systemic risks in the derivatives market. It covers both exchange-traded and over-the-counter (OTC) derivatives. Its reach extends to parties outside the European Economic Area (EEA) if they trade with counterparties headquartered in the EEA and covers all counterparties trading derivatives within the EEA.⁵

Key Requirements

EMIR imposes several requirements on entities involved in derivatives trading:

⁴ Tarbert, H.P. (2020) 'The enduring legacy of the dodd-frank act's derivatives reforms', *Journal of Financial Regulation*, 6(2), pp. 159–171. doi:10.1093/jfr/fjaa011.

⁵ Admin (2022a) *Derivatives trading and Emir - the central bank of Iceland*, Financial Supervisory Authority. Available at: <https://en.fme.is/supervision/securities-market-and-funds/emir/> (Accessed: 20 October 2024).

- **Reporting:** Whether they are listed or OTC, all derivatives contracts need to be disclosed to a trade repository. This provision gives authorities a comprehensive picture of market activity, which ensures transparency. Regardless of their size or financial standing, all counterparties are required to publish the specifics of their derivative transactions.
- **Central Clearing of OTC Derivatives:** EMIR mandates that standardized over-the-counter (OTC) derivatives be cleared through a Central Counterparty (CCP) in order to reduce counterparty risk. Clearing significantly reduces the likelihood of one party defaulting by ensuring that a CCP serves as both the buyer and the seller to one another.
- **Risk Mitigation for Non-Cleared Derivatives:** For OTC derivatives exempt from central clearing, EMIR mandates counterparties to enforce risk mitigation measures. Some examples are: Prompt trade verification, Daily assessment of market values, Portfolio matching and simplification, Transfer of collateral (margin demands).

Categories of Counterparties

EMIR classifies counterparties into two main categories, each with different obligations:

- **Financial Counterparties (FCs):** Banks, investment businesses, insurance providers, pension funds, and other financial organizations are among them. Financial counterparties must follow strict risk mitigation guidelines and clear trades.
- **Non-Financial Counterparties (NFCs):** These businesses are not in the financial industry. Based on the size of their derivatives portfolio, EMIR further differentiates between NFCs above (NFC+) and below (NFC-) the clearing threshold: NFC+ are required to clear their trades and adhere to risk mitigation strategies that are comparable to those used by FCs. NFCs are free from clearing restrictions, but they still have to comply with certain risk-reduction standards, like portfolio reconciliation and dispute settlement.

A thorough structure for reporting and settling derivatives deals is established by EMIR, which also covers the usage of trade repositories and central counterparties (CCPs). To provide openness and efficient oversight, it mandates that counterparties record all derivatives transactions to trade repositories designated by ESMA. Certain entities are exempt from clearing responsibilities with respect to intra-group transactions if they satisfy certain risk management criteria. Strict risk mitigation measures, such as prompt confirmation, portfolio reconciliation and compression, dispute resolution, and collateral exchange for both bigger

non-financial counterparties (NFC+) and financial counterparties, are enforced by EMIR for non-cleared derivatives. By taking these steps, counterparty risk is reduced and disputes are avoided. ESMA monitors compliance, keeps track of authorized CCPs and trade repositories, and directs the application of the legislation. Furthermore, because of EMIR's extraterritorial application, non-EU companies doing business with EU counterparties are required to abide by certain rules, like reporting transactions and clearing through approved CCPs. Non-financial counterparties or intra-group transactions with sufficient centralized risk control mechanisms are exempt from risk mitigation, providing flexibility within the regulatory framework.

Investor Protection and Market Abuse

The number of players and trading volume in India's derivatives market have both grown dramatically. Over time, the Indian derivatives market has grown to provide a greater range of derivative products, such as index options, stock futures, commodity derivatives, and interest rate derivatives. One of the main forces behind growth has been the creation of currency derivatives, such as currency futures and options. It has made it feasible for investors to successfully hedge against currency risk and granted them access to the foreign exchange market. In the derivatives industry, exchanges and market authorities have encouraged product creation and innovation. Investor confidence in the derivatives market has grown as a result of SEBI's regulatory reforms and initiatives to strengthen risk management practices, provide transparency, and strengthen investor protection. India's derivatives market's fascinating history demonstrates the country's growing financial sophistication and adherence to international market trends.

The regulatory framework around the derivatives market is a significant component of India's overall capital market. The financial environment, product design, and potential for innovation are all described by a strong regulatory framework that is predictable. The J.R. Verma Committee Report and the L.C. Gupta Committee Report (1998) serve as the foundation for India's regulatory system. The Securities Exchange Board of India (SEBI) established a 24-member committee under the direction of Dr. L.C. Gupta with the primary goal of developing an efficient regulatory framework for the trading of derivatives in India. The report from this committee details how SEBI and the exchange divide up regulatory responsibilities. After accepting the committee's recommendations, SEBI authorized the phased launch of derivatives trading in India on May 11, 1998, starting with a stock index future. After observing a

significant growth in this sector, the SEBI Advisory Committee (2002) concentrated on the regulation and growth of the derivatives market in India. This committee addresses a number of significant issues, including the use of sub brokers in the derivative market, the physical settlement of stock options and stock futures contracts, guidelines for the use of mutual fund derivatives, and an evaluation of the standards for stocks on which derivative products are allowed. The RBI developed comprehensive guidelines on derivative goods in 2006, which cover most of the laws and rules pertaining to derivative markets.⁶

The regulations governing the trading of equity derivatives were strengthened by the Securities and Exchange Board of India (SEBI) through raising the barrier to entry and increasing costs for regular investors to participate in F&Os (futures and options). The new regulations will take effect on November 20, 2024.

The market regulator announced six measures which include increasing the contract size for index futures and options from Rs 5 lakh to Rs 15 lakh and allowing exchanges to offer contracts for only one benchmark index with weekly expiries.

The decision was made to raise the securities transaction tax on F&O trading in Budget 2024–2025, increasing it from 0.0125 percent to 0.02 percent for futures and from 0.0625 percent to 0.1% for options. Furthermore, increasing F&O trading volumes are starting to impact capital formation and present a systemic risk to India's economic growth, aligning with mounting concerns within SEBI and the Reserve Bank of India.

Further actions unveiled on Tuesday consist of receiving the option premium in advance from purchasers, supervising the intraday position limit, enhancing protection for tail risk, which is the chance of a loss from an unusual event, on the day of options expiry, and removing the treatment of calendar spreads on the expiration day.

It is anticipated that these actions will improve market stability and investor protection by fortifying equity index derivatives.⁷

⁶ Tewari, I. and Singh, L.K. (2023) 'Derivatives Market in India: Growth, Regulation and Future Outlook', *International Journal of Research in Business Studies*, 8(2).

⁷ Vyas, H. (2024) 'Sebi tightens F&O rules to curb derivatives market frenzy, protect small investor', *Indian Express*, 2 October.

Systemic risk is a worry due to the concentration of trading activity in derivatives. A big market event, such a precipitous drop in asset values, may start off a domino effect that affects not only the derivatives market but the entire economy.

Concerns over their protection have been raised by the growing participation of individual retail investors in the derivatives market. According to a January 2023 SEBI investigation, 89% of individual traders in the equity's futures and options (F&O) market experienced financial losses. 9.25 million sole proprietorships and individual traders lost ₹51,689 crore in index derivatives trading in FY24. According to the 2024 study, 85% of these merchants had net losses, and the costs of transactions made their financial issues worse.⁸

By modifying strike prices and raising margin requirements close to expiry, SEBI hopes to lessen speculative trading and enhance market stability. These actions are intended to safeguard long-term investments, safeguard retail investors, and guarantee effective risk management. The expansion of the market and the safety of all players will depend heavily on ongoing regulatory supervision.

Future Trends and Reforms

The derivatives market is essential to risk management, investment strategies, and financial innovation as India's financial sector expands and becomes more integrated with international markets. Notwithstanding notable advancements, the market still faces obstacles that must be overcome for resilience and long-term expansion. The way forward is being shaped by future trends and reforms, which centre on increasing product offers, enhancing market infrastructure, and conforming to global best practices. Key areas for future development and suggestions for bolstering India's derivatives market are highlighted in the paragraphs that follow⁹:

Future Trends

Extension of Product Offerings: The over-the-counter (OTC) derivatives market in India has experienced tremendous development, but there is a rising need to increase the range of derivatives products that are offered. These include equity derivatives, commodity derivatives, and credit default swaps (CDS), all of which are still in their infancy in India. In order to

⁸ Guest (2024) 'The Rise and Risks of India's Derivatives Market', *Financial Express*, 8 October.

⁹ Admin (2022) *Derivatives trading and Emir - the central bank of Iceland*, *Financial Supervisory Authority*. Available at: <https://en.fme.is/supervision/securities-market-and-funds/emir/> (Accessed: 20 October 2024).

promote sustainable investments and meet the demands of the global market, environmental, social, and governance (ESG) and climate derivatives are also anticipated to be introduced in the future.

Indian Rupee (INR) internationalization: India is working to make the Indian Rupee more widely available in foreign markets. India hopes to lessen its reliance on foreign currencies like the US dollar and expand the role of its currency in international financial operations by pushing derivatives priced in Indian rupees.

Enhanced Liquidity in Longer-Tenor Derivatives: Investors are looking for increased liquidity in overnight index swaps (OIS) and longer-tenor interest rate swaps (IRS). In order to manage long-term interest rate concerns, this would enhance price discovery and develop a deeper market.

Key Reforms

Adoption of International Risk Management Standards: India is implementing the Standardized Approach for Counterparty Credit Risk (SA-CCR) for banks in order to match its derivatives market laws with global best practices. The goal of this reform is to bring Indian financial institutions' risk management to level with that of their international counterparts.

Regulation Harmonization: India is attempting to standardize laws pertaining to a variety of financial industries, such as asset management, pension funds, and insurance. Market participation will rise and regulatory arbitrage will decrease if OTC derivatives are regulated consistently across these industries.

Expansion of Central Clearing: OTC derivatives are being cleared centrally, which lowers counterparty risk. It is suggested that the Clearing Corporation of India Ltd. (CCIL) broaden its purview in order to facilitate the central clearing of further derivatives. This lowers systemic risk and guarantees safer market practices.

Technological Advancements

Modernizing India's derivatives market requires technological developments, and electronic trading platforms (ETPs) provide a means of achieving greater efficiency and transparency. ETPs speed up, improve reliability, and lower costs by reducing the manual burden associated with trade execution. Although the Reserve Bank of India (RBI) has taken action to regulate these platforms, it is advised that the market use them further in order to improve trade procedures and reduce errors. A more effective trading environment will result from this

technological change, enhancing market accessibility and transparency.

Furthermore, the derivatives market's operational components could be completely transformed by implementing fintech innovations like blockchain in clearing, settlement, and reporting. By increasing transaction speed, avoiding fraud, and improving data accuracy, these technologies have the ability to lower operational risks. India may be able to compete globally while maintaining a safe and open market environment with the help of such digital reforms, which can provide it access to state-of-the-art financial infrastructure.

Sustainable Finance and ESG Integration

India's derivatives market can contribute to the advancement of environmental, social, and governance (ESG) objectives as sustainability becomes a more important priority for global financial markets. Investors would be able to engage in sustainable financial practices and protect themselves from climate-related risks with the creation of ESG-focused derivatives. These tools, which assist investors in reducing the risks associated with environmental developments, can include derivatives linked to ESG benchmarks, carbon credits, or hedges for renewable energy.

India's larger sustainability objectives, like its adherence to the Paris Agreement and attaining net-zero emissions, are in line with the market's integration of ESG derivatives. In addition to drawing in a new generation of socially conscious investors, India may establish itself as a global leader in sustainable finance by promoting the usage of these products. In a world where sustainability is becoming more and more important, this forward-thinking strategy would increase the relevance and competitiveness of India's derivatives market.

Recommendations for Market Development

It is essential to expand market access in order to further develop India's derivatives market. Increasing the number of corporate, institutional, and non-resident investors can deepen the market and increase its liquidity and dynamicity. The emphasis is now on encouraging non-residents to use India's onshore derivatives market, even though they are currently allowed to hedge INR risks in offshore markets. Market depth and liquidity can be raised by extending access to institutional players such as foreign portfolio investors (FPIs). Additionally, a stronger market will result from more domestic corporations using derivatives to hedge their

risk exposures. More foreign investors may be drawn to the Indian futures market by the need to simplify laws and offer tax breaks, such as exemptions in global financial hubs like GIFT City.

Reforms in margin and collateral management are also necessary to guarantee market stability and lower systemic risk. Market participants will have more options if the list of acceptable collateral is expanded, and operational efficiency will be further increased by establishing a framework for third-party custodians to handle collateral. Improving these systems will encourage more involvement overall by lowering transaction costs for market participants and improving risk management.

Conclusion

In summary, the derivatives market in India has grown significantly and is now an essential part of the country's financial system. But this growth also presents a number of regulatory issues that need for thorough and innovative answers. Despite its efforts to promote equity, openness, and risk reduction, the changing legal and regulatory environment still has flaws, particularly when it comes to investor protection and the regulation of over-the-counter derivatives. To protect market integrity, regulatory oversight must be strengthened, especially in areas like counterparty risk and speculative trading.

In order to guarantee sustainable development, the market must handle systemic risks as it incorporates international best practices, welcomes technological advancements, and uses financial instruments with an emphasis on ESG. Future changes will be essential to securing India's place in the global derivatives market, especially in the areas of increasing product offerings, improving market infrastructure, and encouraging international harmonization. India can build a more resilient and stronger derivatives ecosystem by promoting increased liquidity, lowering systemic risk, and enabling participation from a variety of market participants. In the end, the sustainable expansion of India's derivatives market on the international scene will depend on a well-balanced regulatory environment that encourages innovation while safeguarding investors.