Options Trading in India-Whether Come of Age

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1. Background

Derivatives trading in India commenced in June 2000 in NSE and BSE. The concept of derivatives was introduced for efficient price discovery, providing hedging mechanism and to increase the investor's returns by leveraged products. Options trading also followed. Options provide a right to the holder but not the obligation. If market moves as per holders' expectations, they will make enormous profit but if, the market goes against their expectations, they will suffer a small loss to the extent of premium paid. Therefore, options trading can be employed as a tool to minimize the risk and maximize the profit. This instrument is used by all sections of investors and traders, such as mutual funds, corporate, SMEs, banks, institutions, retail investors, etc.

If a comparison is made between Indian market and International market, one can find a steady positive trend in India in volume of derivatives. During quarter ended June 2009, number of contracts traded in India in Equity Index constituted almost 8.85% of global all market trade contracts. In terms of value, it shows almost 6.82% global market for the same period. Despite encouraging and positive trend in volume of derivatives, volume in stock options is minimal as compared to international volumes. Stock options contracts volume has not reached even one half percent of the global volume in stock options. In terms of number of contracts, volume for the quarter ended June 2009 in India is mere 0.16% of the global market.

2. Risk Factors

A new trader generally earns by the virtue of "*Beginner's luck*" and probably because of caution and conservatism. But, the trader becomes more aggressive as the time passes by and becomes a victim of the risks in derivatives. So, one has to keep an *Eagle's eye* on the following associated risks.

2.1 Option Trading Risk for Option Buyer

There is always risk associated with losing the entire investment in a relatively short period of time and, such risk increases as the option goes out of the money (OTM) and as expiration nears. The European style options which do not have secondary markets on which to sell the options prior to expiration can only realize its value upon expiration. Specific exercise provisions of a specific option contract may create risks. Regulatory agencies may impose exercise restrictions, which stops option trader from realizing value.

2.2 *Option Trading Risk for Option Seller*

Covered Call traders forgo the right to profit when the underlying stock rises above the strike price of the call options sold and continues to risk a loss due to a decline in the underlying stock. Writers of Naked Call Write risk unlimited losses if the underlying stock rises and vice-versa in Naked Put. Writers of naked positions run margin risks if the position goes into significant losses. Writers of call options can lose more money than a short seller of that stock on the same rise on that underlying stock. Writers of Naked Call Write are obligated to deliver shares of the underlying stock if those call options are exercised. Call options can be exercised outside of market hours such that effective remedy actions cannot be performed by the writer of those options. Writers of stock options are obligated under the options that they sold even if a trading market is not available or that they are unable to perform a closing transaction. The value of the underlying stock may surge or ditch unexpectedly, leading to automatic exercises.

2.3 *Other Option Trading Risks*

The complexity of some option strategies is a significant risk on its own. Option trading exchanges or markets and option contracts itself are open to changes at all times, the availability and conditions of which are not to be taken to be permanent. There is also a risk of erroneous reporting of exercise value. If an options brokerage firm goes insolvent, investors trading through that firm may be affected. Internationally traded options have special risks due to timing across borders. The option trading risks factors enlisted above are extremely detailed and "micro" in scope, surrounding a few basic themes which includes: Naked options positions has unlimited loss potential; Options can expire out of the money and worthless; Obligations and rights of buyers and sellers; etc. In India, NSE, in coordination with SEBI, has also prescribed some risks to be added in the account opening cum Know Your Client form in addition to the above mentioned and includes risk of Higher Volatility, risk of Wider Spreads, risk of Liquidity, risk of News Announcements and risk of Rumors.

Every of the above option trading risks can result in a catastrophic loss of capital, that is why one must fully understand stock options as a financial instrument so that one can lower the option trading risks posed by the above.

3. Barriers & Suggestions

3.1 *Cost of Transaction*

Transactions relating to both future and options attract turnover charges which are of great importance when intra-day trading (major volume generator) are concerned as there the margins are wafer thin and these additional cost can become the difference between a winning trade and losing trade. Similarly, different States in India have different rates for Stamp Duty, different rules for jurisdiction for levying the Stamp Duty which has resulted charges of stamp duty on all trades including non-client trades (pro) which has escalated the cost. Also, the premium paid per share by the buyer to the seller as determined by the market for options, is on higher side due to low liquidity in most of the tradable options especially in stocks segment.

Suggestions:

1. At present, no future contract is available for more than three months (except in some cases where very long-term option contracts are allowed but, which are not active). Out of the three contracts available (i.e. for Current Month, for Next Month and, for Next-to-Next Month), almost 60-70% volume remains in the first month contract only. On compulsorily roll-over, a full amount

of everything (STT, Exchange Turnover Charges, Stamp Duty and Service Tax) is payable which increases the cost tremendously. Therefore, it is suggested that the initial contract must be entered into, for at least two months which will facilitate 50% reduction in the cost. It can also be facilitated by charging 50% of nominal charges in roll-over which will further prevent the participants from entering into a contract for more than one month and also, not causing them to pay full amount of charges on roll-over.

2. There should be uniforms rates of stamp duty across India and preferably, there should not be any tax on financial transaction as it effect the impact cost. The basis of payment and jurisdiction be standardized and be uniform. Stamp Duty should be collected by the Exchanges from Brokers and be deposited directly with the respective states to smoothen the collection process.

3. Liquidity in the exchanges should be increased to reduce the premium. To increase the liquidity again, new hybrid products are to be introduced. The exchange should also reduce the transaction charges.

3.2 Income Tax

The money one makes as a day trader falls into different categories, with different tax rates and different allowed deductions. Beside STT, Income Tax Act also imposes tax over capital gain. There are two types of capital gains: Long-term (when stock is held for at least one full year) & Short-term (when stock is held for less than one year). Concessional tax rate is 20% and 15% for long-term and short-term capital gains, respectively. But if the transaction was levied with STT, one need not have to pay any tax on the gain.

Suggestions:

In the proposed Direct Tax Code (DTC) Govt. has proposed calibration of STT to a lower level and re-introduction of tax on long-term gains as well as short term. It is suggested that no tax should be levied on financial transactions because it distorts the price discovery mechanism and increase the impact cost. Similarly, to channelize the domestic savings into productive assets, it is suggested that exemption from long term capital gain tax be continued.

3.3 Exercise of Option

Presently, in India only two types of options products are introduced, viz., American in Stock Options and European in Index Options. However, all these are cash settled and no physical delivery can be given or obtained. American Options entered the holder of options to exercise his options at any time during the currency of the options period, and are exercised at the closing price of that day in the underlying segment (in Indian context, in CM Segment) and are settled on next day in cash. Seller of options is informed only after the closure of day trading, therefore, cannot square off his position on the same day. European Options are options that can only be exercised at the end of its life, at its maturity. European options tend to sometimes trade at a discount to its comparable American option. This is because American options allow investors more opportunities to exercise the contract.

Suggestions:

1. The Exchanges and the SEBI should consider introduction of physical delivery settlement in this segment so that prices are synchronized further with the cash market. Also, futures should be settled in physical mode rather than cash settlement. In the time to come when the market becomes more mature, options can also be settled in physical instead of cash.

2. American Options have to be squared off next day at their prevailing price by the seller. Therefore, seller are be given an option to put the deliveries instead of cash difference. Without deliveries mechanism, American system cannot infuse the efficiency in the market. Thus, physical settlement may be permitted for overcoming such problems. Instead allowing European options in stocks would be a better alternative. In both the cases however, the time mechanism should be so designed that seller of the options is assigned and intimated at least one hour before the close of the market so that he can cover his position on the same day and is not exposed to the market risk for the next day.

3.4 Lack of Education

Although Derivatives have been introduced in India for almost 10 years, yet there is not much awareness and literacy amongst the participants. These are leveraged products and if these increase chances of profit they also multiply the chances of losses. Buyers of options are continuously losing mainly because of lack of education: Options are being used as speculative products instead of risk managing tools. Hedgers also are not aware of techniques like Delta hedging or hedge ratio. Lack of proper educational & training and exposure to trading soft-wares is a major hindrance, as latest exotic options could not be employed which reduce the cost and increase the profitability.

Suggestions:

The Exchanges and SEBI have to embark upon financial literacy programme in a massive way, percolating down-up to school and college students. They should be wider association between exchanges and universities so that new curriculum can be designed for financial literacy, inclusion and expertise.

3.5 Limited Products

Limited products available in the market are no less than a barrier to the growth of the market. It creates lack of liquidity in the Capital Market (particularly in the derivatives segment). This barrier is being experienced and faced more by traders as compared to brokers, investors or institutions.

Suggestions:

Liquidity can be induced by introduction of new variant of options which should include Asian Options, Binary Options, Barrier Options, Limit Options (Bandhani), Differential Options, Capped Options

To conclude, Option Trading in India has still to go a long way. But, once the suggestions made, are accepted, it will pick the acceleration as a better hedging tool. This will provide more horizons to investors to have better return with minimum risk which is not there, at present, because of the existence of impediments as discussed.

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