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Here's what changes for retail investors from today as Sebi's new F&O rules kick in

Market experts believe that the new set of F&O rules could help limit speculative activities in the derivatives market, protect the interest of retail investors, increase constructive participation, and bring stability to the market.

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Recalibration of contract size for equity derivatives, rationalisation of weekly index derivatives products, and increase in tail risk coverage on the day of options expiry will come into effect from November 20

Last month, markets regulator Securities and Exchange Board of India (Sebi) released a set of six measures to strengthen the equity index derivatives, also known as equity futures & options (F&O), framework.

Of those, three measures – recalibration of contract size for equity derivatives, rationalisation of weekly index derivatives products, and increase in tail risk coverage on the day of options expiry will come into effect from November 20.

The other three measures will be effective next year.

Market experts believe that the new set of F&O rules could help limit speculative activities in the derivatives market, protect the interest of retail investors, increase constructive participation, and bring stability to the market.

These are the three new measures that will come into force from Wednesday:

Contract size for index derivatives

On October 1, the markets regulator had announced it will [recalibrate the minimum contract size] for index futures to Rs 15 lakh at the time of its introduction in the market from the existing stipulation which says that contracts should have a value between Rs 5 lakh and Rs 10 lakh.

The contract size, the regulator said, should be fixed in such a manner that the contract value of the derivative on the day of review is between Rs 15 lakh and Rs 20 lakh.

Sebi's tweaks to F&O norms essentially aim to ensure that investors take on appropriate risks while participating in the derivatives market. (Express file)

This rule is effective for all new index derivatives contracts introduced after November 20, 2024, and essentially aims to ensure that investors take on appropriate risks while participating in the derivatives market.

Implications

"Increasing the contract size for index derivatives to Rs 15-20 lakh from Rs 5-10 lakh is expected to impact participation by smaller retail traders, who currently account for nearly 40 per cent of F&O trades," said Puneet Sharma, chief executive officer (CEO) and fund manager at alternative investment fund Whitespace Alpha.

This could lead to a short-term dip in liquidity as these participants adjust or exit the market.

However, institutional players, who contribute about 60 per cent of the turnover, are likely to fill the gap over time, he said.

Stock broking company HDFC Securities' Chief Strategy and Transformation Officer Kunal Sanghavi said that with higher margin requirements, a lot of retail investors may end up staying away from index derivatives.

This will also keep small players away, which is good for them as they get protected from unnecessary losses in the greed to earn money overnight, he said.

Explained | New SEBI rules to curb F&O frenzy, aim to protect small investors

Rationalisation of weekly index derivatives products

Sebi had said that expiry day trading in index options, at a time when options premiums are low, is largely speculative.

Different stock exchanges offer short tenure options contracts on indices that expire on every day of the week.

Due to this, there is hyperactive trading in index options on expiry day.

"Henceforth, each exchange may provide derivatives contracts for only one of its benchmark index with weekly expiry," it had said, adding that the new regulation will be effective from November 20, 2024.

Implications

HDFC Securities' Sanghavi said that single-index expiry for weekly contracts per exchange will limit uncovered/naked options selling due to fewer avenues.

A naked position is one that is not hedged.

"Currently, weekly options account for approximately 70 per cent of the volume in index derivatives. By limiting the choices, Sebi intends to moderate the explosive growth in speculative trades, about 90 per cent of which are loss-making for retail investors," Whitespace Alpha's Sharma said.

Increase in tail-risk coverage on the day of options expiry

The markets regulator has increased the tail-risk coverage by levying an additional ELM (Extreme Loss Margin) of 2 per cent for short-options contracts.

This is to curb the heightened speculative activity around options positions and the attendant risks on the day of options contracts expiry.

ELM is the additional margin that exchanges charge over and above the normal margin requirement.

Tail risk refers to the chance of a loss occurring due to a rare event.

The measure will be effective November 20.

Implications

The requirement for higher tail-risk coverage on expiry days is expected to increase margin requirements, impacting traders with aggressive positions, Whitespace Alpha’s Sharma said.

“This could reduce extreme volatility around expiry, which has historically accounted for sharp price movements. For context, peak-day losses in retail accounts during expiry sessions have exceeded Rs 1,000 crore in certain months,” he said.

Other measures

Upfront collection of options premium from options buyers

To avoid any undue intraday leverage to the end client, and to discourage any practice of allowing any positions beyond the collateral at the end-client level, Sebi has mandated the collection of options premium upfront from options buyers by the trading member (TM) or the clearing member (CM). The new rule will be applicable to the equity derivatives segment from February 1, 2025.

Intraday monitoring of position limits

Sebi had said that amid the large volumes of trading on expiry day, there is a possibility of undetected intraday positions beyond permissible limits during the course of the day.

“To address the risk of position creation beyond permissible limits, it has been decided that existing position limits for equity index derivatives shall henceforth also be monitored intraday by exchanges," Sebi said.

This will be effective April 1, 2025.

Removal of calendar spread treatment on expiry day

The markets regulator had said that expiry day can see significant basis risk, where the value of a contract expiring on the day can move very differently from the value of similar contracts expiring in future.

Given the large volumes witnessed on the expiry day, Sebi said that from February 1, 2025, the benefit of offsetting positions across different expiries ('calendar spread') will not be available on the day of expiry for contracts expiring on that day.

Basis is the difference between the futures price and stock price that gets extensively impacted during rollovers eventually impacting underlying asset price leading to undesired movement in prices of all derivatives instruments of the respective underlying asset.

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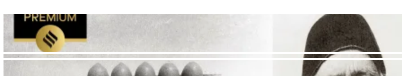

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