Consultation paper on Review of Eligibility Criteria of Stock Derivatives in line with the market growth

1. Objective

1.1. Derivative markets enhance price discovery and market liquidity. However, without sufficient depth in the underlying cash market and appropriate position limits around leveraged derivatives, there can be higher risks of market manipulation, increased volatility, and compromised investor protection. To help develop the securities market while being mindful of these concerns, SEBI last established a framework in 2018 for the selection of stocks eligible for derivatives trading. Given the evolving market context since then, we now propose to update this framework and its criteria accordingly. This consultation paper solicits comments and inputs from all stakeholders on updating the selection criteria for entry and exit of stocks in the derivatives market.

2. Background

2.1. Derivatives contracts on stocks can be traded on recognized stock exchanges only if the underlying stocks satisfy certain objective criteria. Such criteria were last reviewed in 2018. The eligibility criteria for introduction of stocks in derivatives segment, as set out in chapter 5 of SEBI master circular on Stock exchanges and Clearing corporations, are as under:

2.1.1. The stock shall be chosen from amongst the top 500 stocks in terms of Average Daily Market Capitalization and Average Daily Traded Value (ADTV) on a rolling basis,

2.1.2. The stock's Median Quarter-Sigma Order Size (MQSOS) over the last six months, on a rolling basis, shall not be less than₹25 Lakh,

2.1.3. The Market Wide Position Limit (MWPL) in the stock shall not be less than ₹500 crore on a rolling basis, and

2.1.4. Average Daily Delivery Value (ADDV) in the cash market shall not be less than ₹10 crore on a rolling basis. (Note that on expiry, unlike index derivatives that are cash settled, single stock derivatives are physically settled).

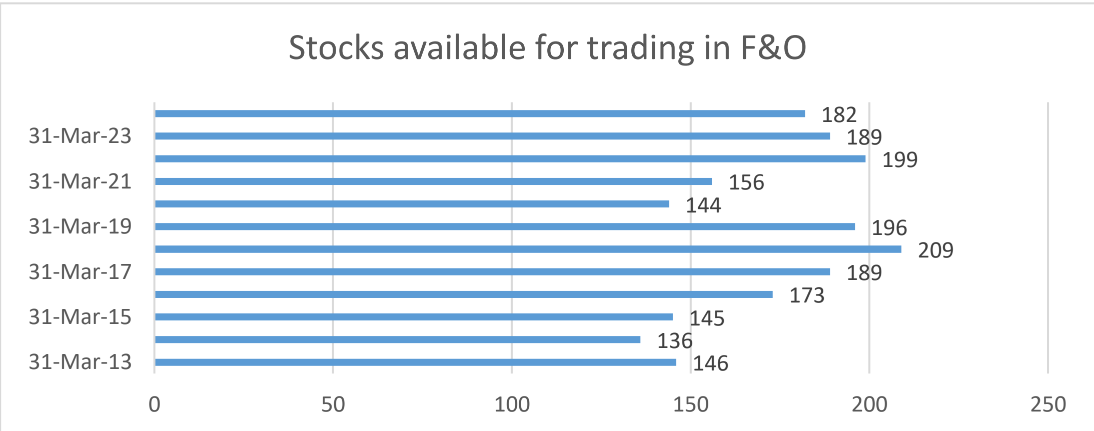
2.1.5. The above criteria need to be met for a continuous period of six months. In addition, other such as any surveillance concerns, ongoing investigations, or other administrative considerations are taken into account.

2.2. Further, if a stock fails to meet the abovementioned criteria for three months consecutively, then such stock shall exit from derivatives segment i.e. no new contract shall be issued on that stock. However, existing unexpired contracts are permitted to trade till expiry and new strikes may also be introduced in the existing contract months.

2.3. Such criteria have been put in place to ensure that only stocks meeting certain size and liquidity criteria in the underlying scrip are eligible for introduction of derivatives contracts. Further, to address any risk implications from low delivery-based activity in the underlying cash market, an additional criterion of ADDV, as mentioned in Paragraph 2.1.4 above, was introduced in 2018 for considering entry of stocks in the derivatives segment.

3. Need for review

3.1. The number of stocks in the derivative segment, year wise, for the past 10 FYs are as under:



(Source: NSE)

3.2. From the above, it can be seen that post review of eligibility criteria in 2018, the number of stocks in the derivative segment reduced for a brief period of time, before increasing post the COVID period.

3.3. As mentioned before, the last review of the eligibility criteria for introduction of stocks in the derivatives segment was conducted in 2018. Since then, market parameters reflecting the size and liquidity of the cash market, viz., market capitalization and turnover have moved up considerably, as described in the following tables:

3.4. Index Values

	Closing of the Month	
Period	**Nifty 50**	**SENSEX**
May-18	10,736.15	35,322.38
May-24	22,530.70	73,961.31
% Increase	110%	109%

3.5. Market Capitalization

End of Period	Market Capitalization (Rs Crores)
May-18	1,46,93,260
May-24	4,08,80,530
% Increase	178%

(Source: NSE)

3.6. Cash Market Daily Average Turnover

Period	Daily Average Turnover (Rs Crores)
May-18	31,819
May-24	1,12,179
% Increase	253%

(Source: NSE)

3.7. Average Daily Delivery Value

Month	Number of securities in F&O	Daily average delivery value (Rs Crores)
May-18	207	9,635
May-24	182	29,677
% Increase		208%

(Source: NSE)

3.8. As highlighted above, the broad market parameters have shown significant growth. In turn, the criteria for entry and exit of stocks in the derivatives market should keep pace with the evolving market.

3.9. One of the SEBI's key responsibilities is to protect the interests of investors while promoting the development of and regulating the securities market. Without sufficient depth in the underlying cash market and appropriate position limits around leveraged derivatives, there can be higher risks of market manipulation, increased volatility, and compromised investor protection. Given all this, there is a need for SEBI to ensure that only high-quality stocks in terms of size, liquidity, and market depth are available in the derivatives segment. In line with this, the extant market parameters for eligibility in derivatives segment need to be readjusted to keep pace with the evolving market conditions.

3.10. In addition, stocks that have low derivative turnover, low open interest, and narrower participation in the derivatives segment are vulnerable to manipulation and expose investors to heightened risk. The market has seen a wide range in average turnover and open interest across different stocks. The same has been illustrated below.

Stock	Average Daily Open Interest in the past 6 months (Rs. crs)	Average Daily Traded Value in the past 6 months (Rs. crs.)
A	684	218
B	2,551	80
C	3,693	18,875
D	14,467	79,613

3.11. It may be observed from the above that stocks A and B have substantially lower Average Daily Open Interest and/ or Average Daily Traded Value than stocks C and D. There is a need to weed out stocks with consistently low derivative turnover and open interest. Note that such a "Product

Success Framework” to weed out contracts with low activity already exists in respect of Index Derivatives.

4. **Review of parameters for eligibility**

4.1. **Introduce Product Success Framework (PSF) for stock derivatives** –

4.1.1. As discussed above, once a stock is introduced in derivatives segment, in order to ensure orderly trading and market integrity, derivatives contracts on such stock should have sufficient liquidity and should elicit sufficient trading interest from diverse market participants.

4.1.2. Currently, the product success framework is only applicable to index derivatives. The said framework mandates that derivatives on an index should have sufficient turnover, open interest, and widespread participation. If any index fails to satisfy any of these criteria, then no fresh contracts shall be issued on that index. On similar lines, it is proposed to introduce additional exit criteria for single stock derivatives, based on performance of derivative contracts.

4.2. **Proposed eligibility criteria for entry/exit of stocks in derivatives segment along with the proposed range of values for each of the proposed criterion**

In view of the changing market dynamics, the criteria for entry of stocks are proposed to be revised appropriately as under:

S. No.	Criteria	Existing criteria	Tentative threshold/ range	Rationale for change
1.	Average Daily Market Capitalization and Average Daily Traded value (ADTV) in the	Amongst top 500 stocks	Amongst top 500 stocks	No Change

S. No.	Criteria	Existing criteria	Tentative threshold/ range	Rationale for change
	previous six months on a rolling basis			
2.	The stock’s Median Quarter Sigma Order Size (MQSOS) over the last six months, on a rolling basis, shall not be less than:	Rs. 25 lakhs	Criterion proposed to be a figure between Rs. 75 and 100 Lakhs	Since average market turnover is now over 3.5 times the figure during the last review, MQSOS criteria would need to increase between 3-4 times.
3.	The stock’s market wide position limit (MWPL) on a rolling basis shall not be less than	Rs. 500 crs.	Criterion proposed to be between INR 1,250 crs. to INR 1,750 crs.	Market capitalisation now is now 2.8 times the last review, while turnover is over 3.5 times
4.	The stock’s Average daily delivery value (ADDV) in the cash market, in the previous six months on a rolling basis, shall not be less than	Rs. 10 crs.	Criterion proposed to be a figure between INR 30 crs. – INR 40 crs.	Average Daily Delivery Value has increased by over 3 times since the last review. Note that upon expiry, unlike index derivatives that are cash settled, single stock derivative are physically settled.

S. No.	Criteria	Existing criteria	Tentative threshold/ range	Rationale for change
5.	The stocks to meet the criteria laid down for the Product Success Framework (PSF) for Index derivatives	PSF criteria is applicable for index derivatives vide chapter 5 of SEBI master circular on Stock Exchanges and Clearing Corporations dated October 16, 2023. (Attached at Annexure-1)	The criteria proposed to be as under: A) At least 15% of trading members active in all stock derivatives or 200 members, whichever is lower, shall have traded in any derivative contract on the stock. B) Trading on minimum 75% of trading days. C) Average daily turnover (premium basis) would be minimum Rs 150 crores and D) Average daily open interest would be a minimum between Rs	This is required to ensure that stocks have sufficient turnover, open interest and widespread participation. The criterion of six months is needed so that stocks have a sufficient gestation period .

S. No.	Criteria	Existing criteria	Tentative threshold/ range	Rationale for change
			500 crore- 1,500 crores PSF shall be applicable only for those stock derivatives which have completed at least 6 months from the month of introduction.	

5. Public comments are sought on the following along with supporting rationale:

   5.1. Whether SEBI should review the eligibility criteria in line with the growth of broad market parameters reflecting size and liquidity of cash market?
   5.2. Whether the proposed revision in criterion related to MQSOS is appropriate
   5.3. Whether the proposed revision in criterion related to MWPL is appropriate
   5.4. Whether the proposed revision in criterion related to ADDV is appropriate
   5.5. Whether SEBI should extend product success framework to stock derivatives?

6. Considering the implications of the said matter on market participants, public comments are invited on the proposal. Comments may be sent to the following, latest by June 19, 2024 via online web based platform through the following link:

   https://www.sebi.gov.in/sebiweb/publiccommentv2/PublicCommentAction.do?doPublicComments=yes

   In case of any technical issue in submitting your comment through web based public comments form, you may contact the following through email with a subject: "Issue in submitting comments on Consultation Paper on Review of Eligibility Criteria of Stock Derivatives in line with the market growth ".

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Annexure-1

Product Success Framework for Index Derivatives

1. 15% of trading members active in all index derivatives or 20 trading members whichever is lower should have traded in any derivative contract on the index being reviewed in each of the month during the review period.
2. Trading on a minimum of 75% of the trading days during the review period.
3. Average daily turnover of at least INR 10 crore during the review period, and
4. Average daily open interest of INR 4 crore during the review period