IJARSCT

ISSN (Online) 2581-9429

International Journal of Advanced Research in Science, Communication and Technology (IJARSCT)

Impact Factor: 6.252

Volume 2, Issue 3, January 2022

Major Developments in the Indian Derivatives Market: Issues and Prospects

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Abstract: *The Indian market is heavily reliant on the derivatives market. It is a set of financial guidelines that are connected to a particular financial instrument, indicator, or commodity and through which certain risks may be managed on the financial markets on their own. In India, the derivative market has grown to a multi-trillion-dollar level and is still growing at an exponential rate. Commodities, precious metals, foreign exchange rates, bonds, shares and share warrants, short-term securities, and money market products are among the common derivative instruments. The National Stock Exchange (NSE) and Bombay Stock Exchange (BSE), along with smaller Indian exchanges, are the two main marketplaces in India where derivatives are traded. We may now talk about how derivatives products have performed in the Indian market. The author will discuss the worth of the derivatives market, its obstacles, and the significance of its prospects in the current set of investigations.*

Keywords: Exponential Rate, NSE, BSE, Derivatives

I. INTRODUCTION

Within fewer than three decades of its inception, the derivative markets have evolved into a crucial component of the modern financial system. However, as compared to the derivatives markets of other nations, the Indian market is still not as established. Therefore, it is important to comprehend the current state of the financial derivatives markets in India.

A derivative is a financial instrument, or more simply, an agreement between two parties or persons, whose value is based on the cost of another good or service. Indexes (such as the consumer price index (CPI), stock market index, weather conditions, or inflation), Bonds, Currencies, Interest rates, Exchange rates, Commodities, and Stocks are a few of the more well-known underlying assets (equities).

II. REVIEW OF LITERATURE

Chatrath, Ramchander and Song, 1995:

The derivatives market has been criticised for being a market for speculators. The fact that there isn't much money engaged in this market is what makes it so dangerous. As a result, it is claimed that participants in systems that permit large levels of leverage reduce the market's quality of information. These ignorant traders could contribute to market instability in the cash sector.

According to Ayuso and Nuez (1995), the spot market's transactions may significantly improve if risk were to be transferred to the derivative markets. This is due to the fact that a risk premium is not required in the spot market to cover price variations.

Hentchell and Smith (1997) discuss how derivative products might lessen the need for businesses and banks to have unused precautionary balances on hand to weather unforeseen setbacks. As a result, the proportion of money held by these organisations that are idle decreases.

According to Sahoo (1997), "Commodity-linked derivatives were the exclusive form of such products for many years. Derivatives products first originated, as hedging devices against change in commodity prices. According to Marlowe (2000), the origin of derivative market products, such as forwards, futures, and options, may be attributed to risk-averse economic actors' need to protect themselves against uncertainty brought on by changes in asset values. It is generally agreed upon that regulation plays a significant and essential part in ensuring the effective and seamless operation of the markets. The legal framework for trading in derivatives, according to Sahoo (1997), is an essential component of the entire regulatory framework for derivative markets. Instead of hindering efficiency and competitiveness, regulation is meant to promote them.

Although there is a perceived resemblance in regulatory objectives, according to Hathaway (1998), there is no one model that is favoured for the regulation of derivative markets.

According to Avadhani (2000), because the history of financial markets is rife with crises, a derivative, an innovative financial tool, evolved to safeguard against the dangers created in the past. Because of the extremely high degree of volatility and unpredictability of the financial markets, events like the breakdown of the fixed exchange rate system in 1971, Black Monday in October 1987, the sharp decline in the Nikkei in 1989, and the US bond fiasco of 1994, happened. As markets throughout the world have gotten increasingly integrated, such catastrophes have become more common.

Derivative trading in options reduces risk, according to Mr. Jitendra Pande's definition from 2002, as investors are aware of the maximum loss.

2005: Deana Mehta shown that share futures are more popular in India than anyplace else in the world because people there saw them as a badla replacement. The new system must be superior to the old one and must not increase market risk.

Jiménez (2008) demonstrated that bank borrowers are more likely to fail if the loans are granted while central bank interest rates are relatively low using a sizable dataset from the Spanish credit registry. Additionally, they demonstrated that I when short-term interest rates are low, the cost of risk tends to be low and the economy's "portfolio" of loans tends to be larger if the interest rate is low for an extended period of time.

An investigation on derivative trading in the Indian stock market was done by Srivastava, Yadav, and Jain (2008). According to the poll, investors are employing derivative instruments for a variety of goals, including risk management, profit enhancement, speculation, and arbitrage, in the Indian stock market. Financial derivatives have revolutionised the financial industry by paving the door for new approaches to understanding, measuring, and managing risks.

In their study, Vashishtha and colleagues (2010) looked at the origins of derivative trading, changes in law and policy, trends and growth, as well as the issues the derivative market in India faces going forward. They had also paid attention to how the Indian derivatives market compared to the state of the global derivatives markets.

In their study, Shree Bhagawat and colleagues (2012) attempt to characterise the idea of financial derivatives as the derivatives revolution in the world of finance owing to its full-fledged global expansion at such an unmatched rate of speed.

In an effort to extend the sustainability of derivative trading in regard to the Indian capital market, P. Hemavati (2013) looked at the history of derivative trading in India as well as its regulation.

III. RESEARCH METHODOLOGY

Exploratory research is one of the approaches and strategies for doing research, according to research methodology. Emerging In Indian Derivatives Market, Challenges And Future is the goal of the current study. Similar to this, it includes a thorough examination of the many requirements that each Indian stock exchange must meet in order to operate on the derivative market. It also explains how the derivative market varies from the cash market. The secondary published sources used to gather and evaluate the data and information for the study were the BSE, NSE, and SEBI websites, the Internet, reference books, cited journals, and trade publications. To accomplish the goals of the study, a conceptual analysis is employed to describe the many pertinent topics.

3.1 Objectives

1. To comprehend the idea and research the present state of the Indian derivatives market and its economic factors.
2. Gaining knowledge about stock market derivatives
3. To learn more about derivative marketing in India going forward
4. To determine whether derivatives are growing in India

3.2 Indian Derivatives Market

In India, derivative markets have existed in some capacity for a long time. The Bombay Cotton Trade Association began futures trading in the commodities market back in 1875. The initial structured futures market was this one. After that, the futures market was established in 1893 by Bombay Cotton Exchange Ltd., 1900 by Gujarat Vyapari Mandall, and 1919 by Calcutta Hesstan Exchange Ltd. After the nation gained its independence, the derivatives market completed a full circle, going from the outright ban on all derivative trading to their most recent return. After the Indian government outlawed cash settlement and option trading in 1952, the trade of derivatives moved to unofficial forwarding markets. Government policy has changed recently to promote a bigger role for market-based pricing and less dubious derivatives trading. The Securities Laws (Amendment) Ordinance of 1995 was the first step towards the establishment of financial derivatives trading in India. It allowed for withdrawal of securities option contracts upon prohibition. The restriction on trading in numerous commodities' futures was lifted throughout the past ten years, starting in the year 2000.

An essential factor in a nation's economic prosperity is the derivatives market. The financial risk to the business world has grown as a result of changes in interest rates, stock prices, and currency values across different financial markets. Even the continued existence of the corporate world is in danger due to negative developments in macroeconomic fundamentals. To address such risk, a new set of financial instruments known as derivatives must be developed for the Indian financial markets. These instruments' goals are to give commitments to prices for future dates in order to provide protection against adverse price fluctuations and to lessen the severity of financial risks. This essay chronicles the development and present standing of the Indian derivatives market. The goal of the current study is to examine derivative trading in India. It aims to illustrate the development and growth of NSE's financial derivatives in India from 2010–2011 to 2017–2018. From Rs. 17663664.57 Cr. in 2009–2010 to 1163539816.124 Cr. in 2017–18, the market turnover has increased.

3.3 Bombay Stock Exchange

The Bombay Stock Exchange, or BSE, was founded in 1875. India's first and oldest stock market is located in Asia. Trading in derivatives began on June 9, 2000, when it first began as a sub-tool of a derivative termed a "futures contract." On June 1, 2001, a new subtool called the "index option" is added. By introducing the unrivalled "weekly options" product on September 13, 2004, BSE reached a new milestone in the derivatives sector. BSE introduced currency futures on October 1st, 2008.

3.4 National Stock Exchange

The National Stock Exchange, sometimes referred to as NSE, was founded in 1992. The world's third-largest stock exchange is located there. It began trading in "Index future" as its first derivative product on June 12, 2000. On the other side, on June 4, 2001, the "index option" was introduced. 233 future contracts securities were required by SEBI. By establishing "Mini Index Future & Options" with a one lakh minimum contract size, NSE set a new precedent. On August 29, 2008, NSE launched a currency future contract on the US Dollar-Rupee in the Indian derivatives market.

IV. CHALLENGES OF DERIVATIVE MARKET

Although the derivative market has demonstrated tremendous promise recently, the underlying problems have not yet been fixed. Although the number of instruments traded in the derivatives market and its volume of transaction are rising daily, the fundamental goal, namely the establishment of several exchanges, has not yet been accomplished. On the other hand, the unresolved problems, which are characterised as significant obstacles in the way, make the future prospects of the derivative markets unsound.

- Cash vs Physical Settlement: Due to the Forward Contract Act of 1952, a relatively small fraction of commodities derivatives are settled physically. Cash payment of unfulfilled contracts at maturity is prohibited under this Act. In other words, at maturity, physical delivery should be used to fulfil any outstanding commitments. To get around this, the individuals in the huddle take positions before they are ready. The requirement for this Act's modification presents a significant problem for the derivatives market.

- Issue for market Stability and Development: Because of the counter derivative market's explosive expansion, regulators and supervisory agencies are keeping an eye on it. In the trying times of a global crisis, some OTC (Over the Counter) derivatives are used as stress relievers. The biggest obstacle, however, is dispelling the opponents' presumption that this market is less transparent, has laxer capital requirements, and is more susceptible to systemic risk.
- The Warehousing and Standardization: A successful and efficient warehousing infrastructure is required for the country's commodity derivative market to operate smoothly. The lack of well-standardized labs and high-quality testing facilities for the final consumer who accepts physical delivery is a significant barrier for the derivative market.
- Lack of Economics of Scale: The derivatives market has not yet reached the economic-scale stage. Despite the fact that 80 commodities are traded on a variety of exchanges, only a small handful of commodities are actually in demand. The Indian government intends to combine two marketplaces. This would improve the coordination between multiple regulatory agencies, including the Reserve Bank of India, Forward Market Commission, Securities and Exchange Board of India, and the Department of Companies Affairs, among others, while reducing the effort and fostering a culture of competition.
- The Regulatory: The establishment of a regulatory framework similar to the one that the Security Exchange Board of India, an independent agency, uses to oversee the security market, is necessary for the derivatives market. On the other hand, FMC (Forward Market Commission) regulates derivatives and is funded by the Department of Consumer Affairs. This market requires a single-minded agency in order to grow. For improved outcomes, strong collaboration between SEBI and FMC, the regulatory bodies, is also necessary.
- Competition of OTC derivatives with the Exchange traded derivatives: It is advised to convert OTC derivatives into Exchange trading derivatives after a financial crisis. According to advisors, this will improve the clearing and settlement process while also increasing transparency and liquidity. All of the aforementioned recommendations are predicated on the idea that there is no established clearing mechanism and that the only way of trading OTC items now in use is telephone trading.
- Strengthening the Centralized Clearing Parties: The sole centralised clearing party offering excellent processing and settlement services in India is CCIL, which began operations in 2002. It now offers a guaranteed settlement facility for trading in government securities, clearing CBLOs (cleared collateralized borrowing and lending obligations), trading in foreign currencies, and settlement of all Irs transactions (IRS). The Certified Financial Services Auditor (CFSA) report opinion states that the concentration of such a broad spectrum of activities results in the concentration of risk in one entity, even though the concentration of business relating to money, securities, and the forex market with the CCIL helps in pooling risk and reducing the overall transactions cost for the system. As a result, more and more clearing parties need to be strengthened.
- New derivative products for Credit Risk Transfer (CRT): There is a lengthy history of credit risk transfer, which includes guarantees, loan syndication, and securitization. However, the use of novel and creative CRT forms related to credit derivatives has grown steadily and quickly. Credit Default Swaps (CDS) on a single business entity and collateralized debt obligations are the two most popular credit derivatives. After 2005, CRT activity increased significantly for two more underlying asset classes: leveraged loans and asset-backed securities. Credit derivatives are now legal in India, but banks and other financial institutions can protect themselves against them internationally. The RBI stated that it was appropriate to tread cautiously on this matter in its second-quarter monetary policy 2009–2010. For corporate bonds issued by residents' businesses, subject to safeguards, the RBI has published rules for a basic, over-the-counter, single name CDS.

V. ECONOMIC CONTRIBUTION OF DERIVATIVE MARKET IN INDIA

It has been demonstrated that the derivative market in India, which is expanding, is also carrying out a number of economic activities, including:

- The pricing perception of market participants regarding the future is reflected in the derivatives market. This might result in the identification of present and upcoming market pricing.

- The derivatives market is a professionally run marketplace where risk is evenly spread among participants with varying risk appetites.
- Because of this attribute, a growing number of participants are engaging in large volume trading of derivatives, which are generated from the fundamental value of assets.
- Derivative has a history of influencing the educated elite with its transparent and inclusive outlook. All of this will support economic growth and the creation of new job opportunities and new business.

VI. FINANCIAL DERIVATIVES

An instrument is considered to be a derivative if its value is "derived" from another security or economic variable. The derivative is a good tool for transferring and managing risk since its value depends on other costs or factors.

A financial product whose value depends on (or originates from) the values of other, more fundamental underlying variables is known as a derivative, according to John C. Hull.

Robert L. McDonald added to the definition A derivative is only a financial instrument (or even more merely a contract between two parties) whose value is based on the cost of another commodity or service. An instrument is considered to be a derivative if its value is "derived" from another security or economic variable. The derivative is a good tool for transferring and managing risk since its value depends on other costs or factors.

Factors Affecting Growth of Derivatives:

Derivative growth is influenced by a variety of variables. The following list includes a few crucial elements. 1. A rise in asset price volatility in the financial markets. 2. A deeper integration of domestic financial markets with global ones. 3. Significantly improved communication capabilities and a substantial drop in their price.

Asset Used as the Basis for a Derivatives Contract:

A derivative instrument's value is determined by the underlying asset, as previously established. The underlying asset may take on a variety of shapes:

Currencies or foreign exchange rates; bonds of many kinds, such as medium- to long-term negotiable debt instruments issued by governments, businesses, etc.

Different sorts of bonds, such as medium to long term negotiable debt instruments issued by governments, firms, etc. Commodities, such as grain, coffee beans, and orange juice Precious metals, such as gold and silver Foreign exchange rates or currencies.

Stock Index and the shares and share warrants of publicly listed corporations.

T-bills and Over-the-Counter (OTC)2 money market products, such as loans or deposits, are examples of short-term securities.

VII. STOCK MARKET DERIVATIVES

In 1850, four Gujarati and one Parsi stockbroker met under a banyan tree in front of the Bombay Town Hall to establish the first stock market in India. As the number of members grew, the facility was moved to Dalal Street in 1874, and in 1875, the group was formally established as "The Native Share & Stock Brokers Association." The Securities Contract Regulation Act was originally adopted by the Indian government in 1956, and the BSE was the first stock exchange to receive this recognition. However, it wasn't until 2000 that the derivative market concept was first launched. This instrument has a significant impact on the Indian market. Derivative products have a recognised presence in the trading market after around ten years. The finest feature of this product is its risk-averter character, which aids investors in settling losses and making plans for upcoming challenges. Comparatively to other instruments in the stock market, whether they are classified as primary or secondary, derivative market earned reputation, renown, and dependability from investors and other investing institutes throughout this brief time span. It aided hedgers in offsetting the value of their asset (a commodity) in the futures market relative to the cash market. India has long had a futures market for trading equities on the spot market with weekly/fortnightly settlements. Without the benefits in price discovery and hedging services that come with separating the spot market from the futures market, these markets have all the dangers and challenges of the futures market. The primary market in India is familiar with two categories of derivatives.

- Exchangeable bonds
- The warrants

It may be argued that our market already has a small-scale options market because these warrants are listed and traded. Additionally, there are other intriguing derivatives markets in the non-formal economy. In these marketplaces, contracts like "bhav-bhav," "teji-mandi," etc. are transacted. These unofficial marketplaces exist outside of the traditional institutions of India's financial system and have relatively little involvement.

The Securities Laws (Amendment) Ordinance of 1995, which removed the ban on options in securities, was the first step towards the establishment of derivatives trading in India in its present form. But it was the SEBI that gave the Indian derivatives industry its major boost. A group headed by Dr. L. C. Gupta was established in November 1996 by the securities market watchdog to provide "adequate regulatory framework for derivatives trading in India."

NSE and BSE were given permission by SEBI to start trading index futures contracts based on the S&P CNX Nifty and BSE 30(Sensex) index in 2000. The trading of options based on these two indices as well as options on specific securities was then given the go-ahead. On November 9, 2001, futures contracts for certain equities were introduced. Trading and settlement are conducted in line with each exchange's own regulations. However, the early trade volumes were fairly low.

This could be because only a small number of members were first given permission by SEBI to deal in derivatives.

FII'S and MFS have been permitted to participate in a very restricted capacity; brokerage companies are required to have brokers who have completed the "SEBI approved-certification-test" in order to engage in derivatives trading. & The taxation and accounting elements of derivatives trading are not clearly understood.

According to the current trading patterns in the derivatives segments, single stock futures continue to represent a sizable percentage of the market. According to a recent press report, volumes for futures on Indian markets have surpassed those worldwide. Futures closely mirror the former Badla system, which may be one cause for the traders' skewed conduct. But the market is not interested in such distortions. Although not all of the listed equities are eligible, SEBI has allowed trading in options and futures on specific stocks. Stocks having a market capitalization that is deemed to be very volatile are not permitted for option trading. A segment of the market has strong feelings of resentment over SEBI's action. They contend that investors who seek to safeguard their investments from volatility should not require stock options. The more crucial it is to offer options on a stock, the more volatile the stock is. Instead of simply prohibiting trading in options on low market capitalization stocks, the y are very vocal in their argument that SEBI should design an effective monitoring, surveillance, and risk management system at the level of the exchanges and clearing house to avoid and manage the default risks that are likely to arise as a result of high volatility in those stocks. SEBI needs to investigate these claims. It might have to take a stance to stop all manipulations by punishing those who engage in them severely.

Mutual funds may now "hedging and portfolio rebalance" by using equity derivative instruments. Fund managers do not, however, prefer this practise since they believe that because the boundary between hedging and speculating is blurry, they may always be subject to regulatory authorities' scrutiny.

Unresolved Issues and Future Prospects of Derivatives Market:

Even while the derivatives market has made good strides in recent years, the true problems that the market will face in the future have not yet been solved. The number of products permitted for derivative trading has increased, as have the volume and value of business, but unless these pressing issues are resolved as soon as possible, it's possible that the goals of establishing various derivative exchanges won't be met and the growth rates observed won't be sustainable. The following are some of the major outstanding problems.

1. Issues for Market Stability and Development: Regulators and supervisory authorities have been interested in the Over the Counter (OTC) derivatives market due to its large size and rapid expansion. Certain OTC derivatives have been perceived as stressors in the ongoing global financial crisis. The more frequent objections centre on the OTC markets' lack of transparency, excessive leverage, lax capital requirements, and presence of submerged systemic risk.
2. The Warehousing and Standardization: The country must have a smart, cost-efficient, dependable, and easy warehousing infrastructure in order for the commodities derivatives market to function properly. The task committee established by Habibullah (2003) acknowledged that "a sophisticated warehousing business has yet to emerge." Additionally, independent labs or quality testing facilities should be established in each region to

certify the quality, grade, and quantity of commodities. This will ensure that they are appropriately standardised and that the final buyer, who receives the physical delivery, won't be in for any surprises.

3. Cash vs. Physical Settlement: Only 1% to 5% of all commodities derivatives transactions in the nation are resolved by physical delivery. The current storage system's inefficiencies are probably to blame. Due to the fact that a reliable delivery system is the foundation of every commodity exchange, the storage issue must thus be approached aggressively. The fact that cash settlement of outstanding contracts at maturity is currently prohibited under the Forward Contracts (Regulation) Act of 1952 presents a significant issue for the cash settlement of commodities derivative contracts. In other words, at maturity, physical delivery should be used to fulfil any outstanding commitments. Participants choose positions before they are fully developed to avoid this. Therefore, in reality, the majority of contracts are settled in cash before they mature. The legislation has to be changed to more closely reflect the common practise and spare the participants from pointless problems.
4. Increased Off-Balance Sheet Exposure of Indian Banks: The RBI has expressed worry over the expansion of derivatives as off-balance sheet (OBS) assets for Indian banks. OBS exposure and danger have greatly grown in recent years. At the end of March 2002, the notional principal amount of OBS exposure was Rs. 8,42,000 crore (about $181 billion at the currency rate of Rs. 46.6 to a US $), while at the end of March 2008, it was Rs. 149,69,000 crore (around $321 billion).
5. The Regulator: A robust and independent regulator, akin to the Securities and Exchange Board of India (SEBI), which oversees the securities markets, would undoubtedly be necessary as market activity and volume increase. The Forwards Markets Commission (FMC), in contrast to SEBI, which is an autonomous organisation, is a department of the Ministry of Consumer Affairs, Food, and Public Distribution and is financially reliant on it. For the commodities markets to flourish in a controlled manner, the government must give the FMC additional authority. The interdependence of the two markets necessitates close collaboration between the SEBI and FMC.
6. Lack of Economies of Scale: There are too many commodities exchanges (3 national and 21 regional). Although trading in derivatives is permitted for more than 80 commodities, only a small number of those commodities actually see widespread use. Once again, a small number of exchanges host the majority of the transaction. Volumes are divided as a result, and certain exchanges become unprofitable. Consolidating some exchanges may be a solution to this issue. Additionally, there has been much discussion on the potential convergence of the derivatives markets for commodities and stocks. The Indian government has stated that it wants to combine the two markets. There is an expectation that the convergence of various derivative markets would result in economies of size and scope without the need for duplication of effort, supporting the rise of commodity derivatives market.
7. Tax and Legal bottlenecks: Certain items cannot now be transported between states in India without paying taxes. To create a truly national market for commodities and derivatives, they must be eliminated.
8. New Derivatives Products for Credit Risk Transfer (CRT): In its broadest meaning, credit risk transfer (CRT) has a long history and includes loan syndication, guarantees, and securitization. However, the use of novel and creative CRT forms in connection with credit derivatives has grown steadily and quickly. Through the use of credit derivatives, banks and other financial institutions may shield themselves from credit default risk globally. Credit derivatives, however, were not previously permitted in India. On its second-quarter monetary policy 2009–10, the RBI declared that it was appropriate to move cautiously in this matter. The RBI has issued regulations for a fundamental, over-the-counter, single name CDS for corporate bonds for resident firms, subject to protections, beginning in December 2011.

VIII. CONCLUSION

A growing number of people believe that the financial derivatives market is crucial to risk management and economic expansion. Due to innovation and landscape upheaval, financial derivatives have cemented a substantial role in all financial instruments (products). The trading of several derivatives products has a long history in the Indian derivative market, which has experienced enormous expansion over the years. The market for derivatives has had ups and downs. To address the varying demands of the various sorts of investors, new and creative derivative products have developed over time. Due to innovation and landscape transformation, financial derivatives have acquired a well-deserved very prominent place among all financial instruments (products). Derivatives' rise in recent years has outpaced its counterpart's expansion on a worldwide scale. Finally, we can state that derivatives have a significant impact on the Indian market and are critical to its future prospects.

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