ISAS Insights

No. 494 – 7 June 2018
Institute of South Asian Studies
National University of Singapore
29 Heng Mui Keng Terrace
#08-06 (Block B)
Singapore 119620
Tel: (65) 6516 4239 Fax: (65) 6776 7505
www.isas.nus.edu.sg
http://southasiandiaspora.org

The NSE-SGX Impasse and the Path Ahead

India's National Stock Exchange's (NSE) concerns over migration of trading in Nifty 50 futures to Singapore resulted in a series of actions by the NSE and the Singapore Exchange (SGX), culminating in suspension of trading rights for the Nifty 50 futures on the SGX, a court action and an eventual referral to arbitration. The arbitration award is to be announced on 16 June 2018. The SGX and the NSE have a mutually beneficial relationship that has lasted decades. There is too much at stake to allow the current disagreement to hamper a partnership that holds considerable promise for the future.

Dipinder S Randhawa[1]

The Issue

Since their inception in 2000, the Nifty 50 index[2] futures contracts trade on the Singapore Exchange (SGX). The SGX and India's National Stock Exchange (NSE) entered a licensing agreement that allows futures and options, based on the benchmark NSE Nifty 50 Index, to

---

[1] Dr Dipinder S Randhawa is a Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be contacted at isasdsr@nus.edu.sg. The author bears full responsibility for the facts cited and opinions expressed in this paper.

[2] The NIFTY 50 index is the NSE benchmark index for the Indian stock market. It represents the weighted average of 50 Indian blue chip stocks across 12 sectors. Changes in the stock index are a proxy for changes in the value of the market. The NIFTY 50 Futures contracts are the futures contracts on the underlying Nifty 50 index.

be cross-listed on the SGX and several other overseas exchanges, including the Osaka Exchange, the Taiwan Futures Exchange and the Chicago Mercantile Exchange. Overseas listings provide recognition and expand markets for the index futures among foreign investors, who may otherwise be reluctant to invest directly in the country of origin. The contracts are an important tool for managing risks of investing in Indian equity securities, including stock indices such as the Nifty 50. Listing on the SGX, which is well regulated, offers deep and liquid markets, lower trading costs and tax rates and a simpler tax code – attributes that would attract investor interest from across the world, thereby imparting greater liquidity to the securities. Demand for the Nifty 50 futures on the SGX has risen rapidly over the years with increasing global interest in investing in India's growing economy. During the 2017-18 fiscal year, trading volume of the Nifty 50 futures on the SGX was 22.45 million contracts, accounting for about 11 per cent of derivative trading on the exchange.

Over the past several years, the impressive performance of the Indian economy, reflected in the sustained increase in the stock market, has raised interest among international investors in India. As liquidity and disclosure requirements on Indian exchanges improved, exchanges and policymakers sought to boost trading and, thus, liquidity in Indian markets. Foreign investment in Indian financial assets has been growing steadily, as evident in the growing portfolio flows into India, especially by foreign institutional investors. Nevertheless, there is still a large cohort of investors that is hesitant to enter the Indian market directly due to complex regulations, high trading costs and uncertainties about the tax regime, and prefers to do it through stock exchanges elsewhere. The desire to cater to this important constituency of investors and broaden the investor base motivates India and many other emerging, as well as developed, markets to cross-list indices in several international markets.[3] Interest in the Nifty futures traded in Singapore has grown steadily.

The NSE has been trying to assert its right over one of its flagship products, the Nifty 50 index futures, and draw trading back to India. This puts it in conflict with SGX's Nifty 50 futures as well as other overseas exchanges with whom NSE had entered into cross-listing and trading agreements in 2000. The first signs of friction between the NSE and the SGX were evident in January 2018, when the NSE asked the SGX to delay the introduction of

[3] As mentioned earlier, in the case of NIFTY 50 futures, amongst others, this includes the Singapore, Osaka, Taiwan and Chicago exchanges. The highest volume of trading outside the NSE is in the Singapore Exchange (SGX).

single-stock futures, an asset in demand by overseas investors keen to enhance their stakes in India and fine-tune investments into specific companies rather than just the broad index. Discussions on this issue did not make much headway and the SGX decided to go ahead with plans to introduce the futures that would track some of India’s largest companies. In response, on 9 February 2018, India's three national exchanges, the NSE, the Bombay Stock Exchange (BSE) and the Metropolitan Stock Exchange of India (MSEI), announced they would cancel their offshore agreements, barring 10 overseas exchanges from trading in the Nifty 50 futures. Almost simultaneously, the India Index Services & Products Ltd (IISL),[4] an NSE-owned company that supplied data for the futures contracts, announced that from 12 August 2018, it would terminate its licencing contract with the SGX. The NSE contended that the SGX was in breach of the licence agreement. Consequently, these exchanges, including the SGX, could no longer offer investors the opportunity to trade in the Nifty 50 index futures. Subsequent discussions between the NSE and the SGX did not yield any meaningful outcomes.

On 11 April 2018, the SGX announced it would launch three new derivative contracts called SGX India Futures, SGX India Options and SGX Indian Bank Future. These securities would fill the vacuum created by the ban on the supply of data by the IISL. The NSE responded by asserting that the products proposed by the SGX amount to alleged misappropriation of its proprietary creation, the Nifty 50, one of two most well-known share indices of India. Subsequent talks did not make much headway and the NSE filed a suit in the Bombay High Court on 23 May 2018. On 29 May 2018, the High Court decreed that the dispute be put forth for arbitration with a decision scheduled for 16 June 2018.

What are the consequences of the dispute between the SGX and the NSE? How will it impact overseas investors’ investments in India? How do the contentions fare against experience?

Why did the NSE have a change in heart in the first place and decide to draw trading back to India? The NSE believes it is losing a major source of revenue and liquidity, along with ancillary business. The Indian exchanges deem it in their business interest to curb overseas

[4] The IISL was setup in May 1998 to provide indices and index-related services for the capital markets. Many investment and risk management products based on IISL indices have been developed in the recent past, within India and abroad, including index-based derivatives traded on NSE, SGX, Chicago Mercantile Exchange Inc and Osaka Exchange Inc, and several index funds and exchange traded funds. The flagship 'Nifty 50' index is widely tracked and traded as the benchmark for Indian capital markets.

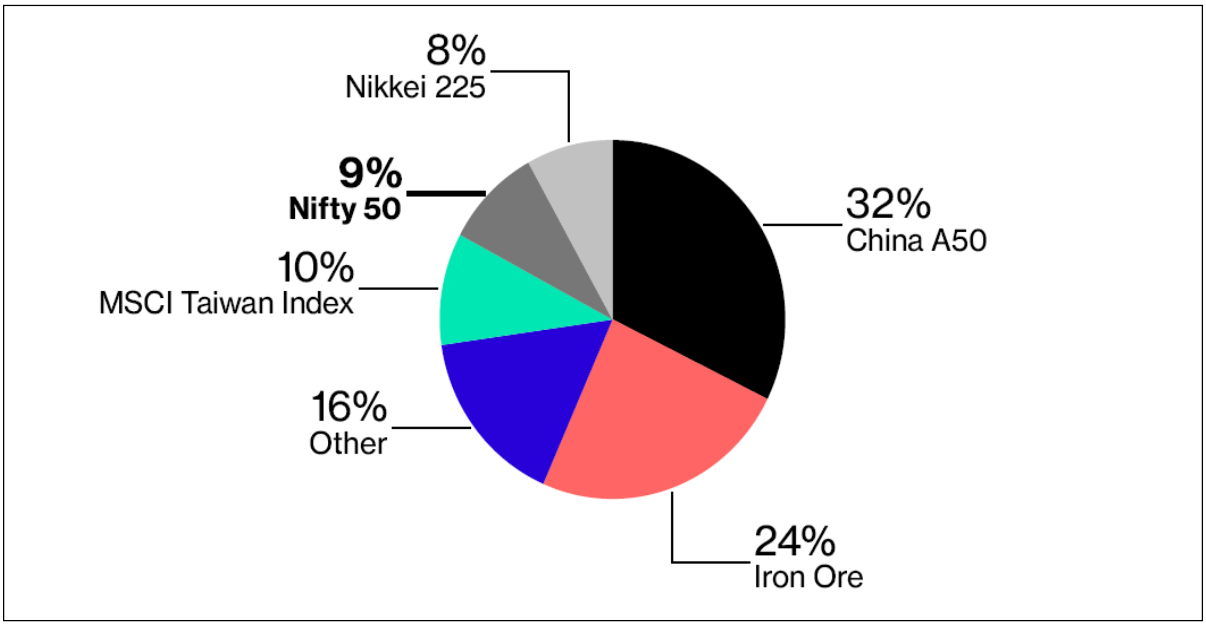
trading of derivative products linked to national indices and ensure that liquidity stays in the country. The ban on index providers from supplying data to foreign exchanges for pricing, trading and settlements reflects an effort to induce trading in India.

The establishment of the Gujarat International Finance Tec-City (GIFT City) as a ‘smart city’ and India’s first financial services centre (IFSC), which offers lower tax rates and less documentation, is an effort in this direction. The exemption of short-term capital gains tax on derivatives traded on the GIFT IFSC exchanges and providing an omnibus structure to foreign investors to invest in equity in the GIFT City aim at removing some of the reservations overseas investors have about committing their funds in India.

Investors seek a financial centre with a stable economic and regulatory regime, a convertible currency and competitive tax rates. These are attributes that cannot be developed through bureaucratic fiat or initiatives. All international financial centres have developed organically as the credibility of the regulatory system, payments and settlements system, the tax regime, disclosure laws and accounting standards, the stability of the financial system and overall credibility for investment improve. It is revealing that China’s A50 futures contracts and the Taiwan Morgan Stanley Capital International (MSCI) index trade heavily in Singapore, attracted by Singapore’s reputation as a safe, stable international financial centre. The Nikkei 225 index has been trading in Singapore longer than most other indices, despite Tokyo’s own strength as an established international financial centre. Investors taking stakes in derivatives or indeed any security listed outside the country of origin are doing so as a conscious value-maximising decision. Attempts at compelling them to shift to the country of origin can easily result in a reversal of investment decision and a liquidation of the position – to the detriment of all. The most recent data seems to suggest a fall in trading of the Nifty 50 futures on both the SGX and the NSE.[5]

[5] “Tussle between NSE, SGX hits Nifty futures trading”, Palak Shah, *The Hindu Business Line*, 3 June 2018. https://www.thehindubusinessline.com/news/tussle-between-nse-sgx-hits-nifty-futures-trading/article24073294.ece. Accessed on 4 June 2018.

Figure 1: **SGX's derivatives sales in Q1, 2018**



Source: Company filings, Bloomberg Intelligence calculations (Figure culled from Bloomberg article "Fight Between Singapore, India Stock Exchanges Worries Investors", by Andrea Tan, Santanu Chakraborty, Benjamin Robertson, and Kana Nishizawa, 25 March 2018).

Assessment of the NSE's Stance

Ending overseas derivatives trading in India's benchmark equity indices will not necessarily bring liquidity back to the local exchanges. The recent restrictions placed by the Indian exchanges may work against India's own long-term interests. Investors seek fair, competitive markets and will shift to venues that offer the best liquidity, execution and the lowest transaction costs with minimal intrusive regulation. Large global investors, including hedge funds, insurance companies, pension funds and sovereign wealth funds, will seek the optimal location, wherever it may be. Despite its promise, India is still an emerging market. If investors find trading conditions too restrictive, they will simply exit the market. The MSCI has already issued caution against the move to restrict data access, terming it 'an unprecedented anti-competitive' move.

Eliminating competition is unlikely to help enhance the credibility of domestic exchanges. To attain world class standards, exchanges need to be open to competition and investors from everywhere. Attempts at diverting liquidity seldom, if ever, work. Experience suggests that policies that aim at the alignment of standards and regulatory principles with international best practices, enhancing market access, building networks of intermediaries and technological capabilities help attract liquidity. Indian exchanges have been moving in this direction, though there is still some ground to cover in the efforts towards aligning standards and regulatory principles with international best practices.

The ‘Draft Red Herring Prospectus’,[6] issued by the NSE to the market regulator, the Securities and Exchange Board of India (SEBI), states the contribution of overseas partners to NSE earnings: “Our revenue from index license fees outside India contributed 71.8%, 69.5%, 75.3%, 85.6%, 89.1% and 89.0% of our consolidated revenues from licensing services for fiscal 2012, 2013, 2014, 2015 and 2016 and the six months ended September 30, 2016, respectively. In fiscal 2016, 82.5% of our index license fees outside India were from exchange customers, of which 98.7% was from our top index licensing customer[7].” The attempts at curbing overseas trading risk a massive loss in the NSE’s earnings – an unfortunate signal to send to prospective investors when endeavouring to go for an initial public offering.

The SEBI, as the market regulator, bears a responsibility to provide fair competitive markets to investors. Restrictions on investments risk reducing capital inflows, resulting in lower liquidity, higher risk premia, lower valuations and slow price discovery.

The GIFT City may eventually live up to the promise expounded by its founders, though Mumbai, with most major international banks and investment firms present, would seem the ideal choice for investors keen on India due to its reputation as an emerging international financial centre. At present, the GIFT City lacks volume, and investors cannot be forced to trade there. The SGX and the NSE have also abandoned talks on a cross-border trading link between the SGX and the GIFT City. Media reports suggest that the companies could not reach a consensus on the issues of timing, the regulatory framework and the resource commitment needed to make the project operational. The collaboration would have enabled traders in Singapore to trade derivatives in the GIFT City.

As an illustration of the consequences of restricting market access, South Korea, despite being a rich Organization for Economic Cooperation and Development (OECD) economy, is still on the MSCI’s list of ‘emerging’ markets, due to restrictions on convertibility and use of

[6] NSE Draft Red Herring Prospectus, 28 December 2016, filed with the SEBI.
[7] Ibid.

data by overseas listings. Similar restrictions on convertibility and market access in Taiwan, Turkey and Brazil constrain their weights in the MSCI indices. Money managers with more than US$1.5 trillion (S$2 trillion) track developments in emerging markets. However, constraints on capital flows dissuade fund managers from investing in such markets and may also result in the MSCI capping weights on portfolios.

Precedent

The legal precedent offers mixed references. Other exchanges have approached the courts to protect what they believe were infringements of their proprietary information and trademarks. A landmark judgement in this regard was in the United States) when the New York Mercantile Exchange (NYMEX) sued the Intercontinental Exchange Inc (ICE) on the use of its settlement prices for some over-the-counter (OTC) derivative contracts. The judge, Joh Koeltl, ruled in favour of the ICE, stating that the NYMEX's settlement prices were not in view of the law, copyrightable works, and the ICE's action in referencing the NYMEX's publicly accessible settlement prices for its OTC derivative contracts was not an infringement of copyright or a trademark. The principle in this judgment has been followed in other cases. The Multi Commodity Exchange's launch of crude contracts with NYMEX prices as the reference was precisely based on the above ruling. It had no partnership with the US exchange to use its data, although, some years later, it eventually entered into a partnership with the exchange.

It is understood that the SGX will point to the principle while defending its stance. In the GIFT City, BSE's India International Exchange settles futures contracts on stocks, such as Apple and Facebook, using the closing price at the Dubai Exchange, which, in turn, states on its website that it uses home market prices for these stocks that are in the public domain. The] NSE has a licensing arrangement with LBMA [London Bullion Market Association] for Gold/Silver and permission from NASDAQ for using their prices for settling single stock futures contracts on Global securities.

Critics of Judge Koeltl's ruling point out that another judge decided differently while hearing Euronext's trademark infringement lawsuit against The Order Machine (TOM). However, the judge's ruling, in Dutch, has caused confusion, with both Euronext and TOM claiming victory. Importantly, the ruling said, TOM could continue offering options on Euronext's Amsterdam Exchange index, but by another name. The SGX may well have studied this ruling well, as it has been very careful in avoiding the NSE's trademark, the Nifty, in the specifications of its new contract.

A Compromise Solution

Although it is serious, the disagreement between the SGX and the NSE has been blown out of proportion by certain sections of the media portending an accompanying diplomatic crisis. This is essentially a dispute between two private institutions, with positions endorsed by state or quasi-state institutions. Relations between Singapore and India are far too broad-based and deeply entrenched for a small bilateral commercial issue to impact broader relations.

Some compromise solutions suggest themselves. Linking the SGX to the GIFT City and providing offshore access to onshore markets, as Hong Kong does with exchanges in China, could be a useful idea to explore. The NSE wanted the SGX to expedite the project but delays in execution resulted in the SGX preparing new contracts to replace the Nifty 50 futures. Officials at the SGX believed it would take months for the link to be operational. Although an extension for the futures contract may have been possible, enduring concerns over client privacy in the GIFT City led to a shelving of the project. Nevertheless, with the immediate pressures set aside, a mutually satisfactory solution should be well within reach.

The extent to which investors will be willing to head over to India without the offshore alternatives is not clear. The hurdles impeding foreign capital include a recent 10 per cent tax on capital gains in securities held for more than a year. India also taxes securities transactions and equity investments held for less than a year. The main problem with exchanges in the GIFT City is the absence of a track record and the lack of volume. Despite tax exemptions extended to investors in the GIFT City, inducing them to trade on the GIFT IFSC could prove to be an uphill task, with talks between the NSE and the SGX, on transitioning investors from Singapore to the GIFT City, breaking down. Over time, as the GIFT City establishes a track record of stability and reliability, trading will gravitate towards exchanges there.

Even if the arbitration is in favour of the NSE, allowing it to establish rights over the Nifty 50 and other indices, it may still be a hollow victory. Many institutional investors are reluctant to invest directly in India and prefer the SGX's India securities as they would need to bear extra expenses for compliance or move to the yet-to-be-tested GIFT City. The NSE will have to build liquidity in its own contracts, while losing significant revenue and, in the view of international investors, credibility, as the move is widely viewed as anti-competitive. It will still need to develop liquidity for its own contracts. Moving liquidity from an established globally recognised exchange such as the SGX to a greenfield project in an emerging market fraught with an uncertain tax and capital repatriation regime will face many challenges. In the 2018-19 budget, a new long-term capital gains tax was introduced. Granting exemption to the GIFT City may not be sufficient to remove doubts and lingering uncertainty in the minds of investors.

Taxes undoubtedly influence trading decisions. The GIFT City may even offer a tax-free zone for operations. However, the rule of law, availability of a cohort of trusted peers, a stable policy and regulatory regime, predictability of outcomes (including counterparties' bankruptcy), are also important considerations. India needs to finesse these "softer" aspects while allowing investors to continue to access Indian risk offshore. China used Hong Kong's jurisdictional advantage just as a lever, retaining the former British colony as an international financial centre despite its own development as a financial centre.

The timing is unfortunate for the NSE for several reasons. With monetary tightening expected in developed economies, rising interest rates in the US will likely induce a reversal in portfolio flows back to the US. The falling Rupee will dissuade overseas investors. The Indian market has been volatile but moved little in value from the levels recorded since the turn of the year. Growing uncertainties abut the banking sector could cloud prospects for sustained growth.

Over the medium and longer term, there are compelling synergies between the SGX and the NSE. With growth in India, capital markets will demonstrate broad-based growth with an expanding set of opportunities in the financial sector, as well as the emergence of new products and processes. For Singapore, India will present expanding investment opportunities. There will be a large demand for new products and processes, and the breadth of expertise, institutions and access Singapore offers to global markets. As fund managers shift into India-based assets, concerns about risk-adjusted returns will offer attractive opportunities to invest into the Indian success story via Singapore. For India, Singapore offers a familiar, globally credible and a tested path to raise capital and for risk management solutions for its growing and globalising corporate sector. There is too much at stake to allow the current disagreement derail cooperation that has benefitted both entities in the past and holds great promise into the future.

. . . . .