

BM&F Bovespa and CETIP are readying a series of initiatives that should incentivise diversity in an equity options market dominated by just two names.

**Elise Coroneos** reports.



## The carnival is just beginning

Brazil's equity options market may be one of the largest in the world but it's also — perversely — a comparatively shallow one. That's because Brazil is home to the two most traded equity options in the world — those representing Vale, formerly known as Companhia Vale do Rio Doce, the large multinational mining corporation, and Petrobras, the largest company in Latin America by market capitalisation and revenue.

The leap in growth seen on Brazil's equity options market — the number of trades increased from 11.8m in 2008 to 14.9m in 2009 — was, however, largely driven by the increase in trading in these two names, according to data from the International Options Market Association, which represents a global group of exchanges and clearinghouses

affiliated with the World Federation of Exchanges.

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In 2009, trading in Vale's equity options almost doubled to a quite extraordinary 48% of the market. Petrobras in second place in 2009 took 42% of trades.

So, given the pair's 90% domination of the sector, what liquidity is there for

investors keen to take a position in other companies? And what kind of future does the sector have?

For the moment, liquidity is indeed scant in other stocks. However, the stage is set for change with BM&F Bovespa, Brazil's largest stock and derivatives market, and CETIP, its over-the counter clearing house, getting ready to implement strategies to expand liquidity in 2010.

### Enter the market-makers

BM&F Bovespa's plans to increase equity option market liquidity will involve the implementation of a newly formed market-maker programme to be executed this year, according to Julio Carlos Ziegelmann, the equity products officer at the exchange.

As part of the programme, the exchange will put market-makers in place on the 10 most traded equity options behind Vale and Petrobras.

While the number of market-makers to be used has yet to be determined — there might be the same market-maker for more than one stock, or there might be more than one market-maker for the same stock option — the goal is to give the Brazilian equity option market liquidity and depth in more than a couple of names.

While the equity options to be included in the programme has still to be officially released, based on 2009 figures, the top 10 traded equity options in Brazil behind Vale and Petrobras were Ibovespa, NET Serviços, OGX Petróleo e Gás Participações, Gerdau, Itaúsa, Itaú Unibanco, BM&F Bovespa, ALL — América Latina Logística, GVT (Holding) and Usiminas.

Also to be considered when settling on the final form of the programme will be the fact that of most value to the market will be equity options in companies without a lot of liquidity in the cash market. This is because the cash market in Brazil is more developed than the derivatives market.

This attempt to rectify the issue of liquidity, however, will come at a cost for the exchange. "Market participants who are interested will be able to receive reduced trading fees," says Ziegelmann. To receive this reduction in fees, however, market-makers will need to provide a minimum amount of auctions.

"Market-makers will have to

## BRAZIL: EQUITY OPTIONS

### Investors' participation in total market options (% share)

Investors	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Individuals	51.8	55.4	60.9	68.7	71.0	67.6	70.0	64.0	63.0	68.6
Institutional investors	7.6	9.3	9.4	13.1	15.4	14.0	11.7	17.6	20.5	15.2
Foreign investors	5.2	6.4	5.4	4.4	4.5	7.0	7.9	6.9	7.2	8.2
Private and public companies	3.4	3.6	1.9	2.4	1.7	2.6	2.1	1.7	2.3	2.4
Financial institutions	31.8	25.1	22.2	11.0	7.1	8.7	8.2	9.7	6.9	5.6
Others	0.2	0.3	0.2	0.5	0.3	0.1	0.1	0.1	0.1	0.1

Source: BM&F Bovespa

### General trading summary in 2009 – options

Markets	Nº of trades	Volume	Value (R\$)
Call index options exercise	961	227,140	11,861,810,000
Call options exercise	133,270	1,207,885,175	29,484,145,021
Call index options	6,184	902,350	1,866,110,792
Call options	14,826,473	53,903,592,292	55,795,457,594
Put index options exercise	98	19,770	1,154,310,000
Put options exercise	903	143,595,625	3,170,313,577
Put index options	6,864	1,089,120	1,552,032,945
Put options	16,862	746,236,250	1,054,094,592
Options market, total	14,856,383	54,651,820,012	60,267,695,924

Source: BM&F Bovespa

virtually buy and sell offers all the time in the market, so there will be spreads in the market, and these spreads will have to be very tight," says Ziegelmann.

#### Transparency made clear

While BM&F Bovespa is responsible for exchange-traded and some OTC contracts, the majority of OTC equity options are handled through custody and settlement house, CETIP. Brazil's high level of transparency — all trades, even OTC transactions, must be registered with an authority — is often a surprise to foreign investors.

This transparency, a product of Brazil's period of hyperinflation and attempts to keep a tight oversight on its banks' exposures, is a helpful defence in avoiding situations such as that seen in the US over the past 18 months, where complex derivatives transactions containing hidden toxic assets have ended up holding an entire economy to ransom.

Instead of seeing regulation requiring transparency as a burden, Brazilian authorities say they believe this level of oversight is prudent, but also gives investors security, thus encouraging greater market participation.

As such, CETIP is setting plans in place to deepen the liquidity of the

OTC equity options market. According to Wagner Anacleto, CETIP's chief operating officer, the company is working on broadening its infrastructure so as to allow it to

provide different types of equity derivatives, including options. "What we see in the Brazilian market are entities such as banks and brokerage houses looking for more flexible

## Finding the right investor mix

The main investors using in the Brazilian equity options are individuals, accounting for 69% of the market in 2009. This figure, while up from 52% in 2000, is down from a high of 71% in 2004. Most of these investors are using the instruments to leverage their investments.

Conversely, institutional investors account for only 15% of investors, up from 8% in 2000.

"Right now, in Brazil, institutional investors have little education in what stock options can do for them. So education is a key to getting them and their counterparties familiar with these transactions," says Daniela Anversa Sampaio Doria, a São Paulo-based partner at Pinheiro Neto Advogados.

Many expect to see a significant increase in the participation of institutional investors over the coming years, especially at BM&F Bovespa. The exchange plans to introduce market-makers on 10 of the most traded equity options which it expects to create more institutional interest.

"We expect much greater liquidity and trading volume for the impacted stock options, especially among brokers, hedge funds and institutions," says Julio Carlos Ziegelmann, equity products officer at the exchange.

There are also healthy prospects for sophisticated international institutions wanting to provide services into Brazil for equity options investors. "There is sound opportunity for firms wishing to get in on the ground floor of a growing business in this country that will bear fruit in the not too distant future," says Wagner Anacleto, chief operating officer at CETIP.

"It is particularly exciting to watch the inevitable expansion of the equities market in Brazil into this global, connected, multi-currency, multi-interest-rate, trading environment. Most of our clients come up with new strategies, new algos and new tools almost every week, to explore market distortions and opportunities. And we are just getting started in Brazil!"

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options," he says.

To enable greater flexibility, such as allowing investors the ability to set up any kind of strike price, CETIP is bolstering its information technology platform to provide the ability to engage in OTC transactions using automation, says Anacleto. "Delivering new kinds of derivatives, especially in the area of equity and index-options

are our focus this year," he says.

CETIP has developed a reputation as being a centre for innovation in Brazil's derivatives market. Five years ago the market was dominated by futures, swaps and a small number of options, mostly calls/puts and caps/floors, whereas today exotic options and bespoke derivatives trade regularly.

Furthermore, in 2010, CETIP is looking at what kinds of additional services, or regulation, it can perform in the OTC environment to bring about greater market participation. According to Anacleto, the company is looking at whether it can calculate options exposures and aggregate options in the OTC market. "This is new in Brazil and in the world as a whole. Nowhere do you have the ability to register transactions to control collateral," he says.

Daily average trading values per market sector (\$'000)			
Period	Options exercise	Call options	Put options
1991	985	4,123	1
1992	1,816	8,146	9
1993	9,548	18,892	8,232
1994	39,159	53,123	16,194
1995	24,234	31,797	14,553
1996	20,006	39,148	901
1997	36,166	65,737	1,916
1998	21,923	38,752	5,339
1999	16,635	18,627	1,292
2000	10,261	17,349	942
2001	8,799	13,613	930
2002	6,083	11,160	928
2003	14,322	21,212	339
2004	17,189	27,719	485
2005	24,606	34,008	1,252
2006	36,868	42,276	1,466
2007	108,994	90,498	3,242
2008	76,935	94,127	7,068
2009	98,178	121,033	5,291

Source: BM&F Bovespa

### Market factors

Overall, the derivatives market in Brazil is increasingly of interest to foreign investors, according to Carlos Eduardo Schahin of Schahin Securities, a pioneer in the derivatives markets. Foreign investors accounted for 5% of participants in Brazil's options markets in 2000, a figure which had increased to 8% in 2009.

Schahin Securities was the first securities firm to provide direct market access for international clients wanting to trade Brazilian assets.

Numerous macroeconomic factors such as elections and issues with Brazil's current accounts are likely to provide the volatility needed for a dynamic equity options trading environment this year, says Schahin.

Another factor likely to contribute to a healthy equity options market is the number of Brazilian companies readying public offerings over the next 12 to 18 months, says Daniela Anversa Sampaio Doria, a São Paulo-based partner at Pinheiro Neto Advogados, one of the largest law firms in Latin America.

"The sheer number of companies doing public offerings means there will be more and more equity options coming into play. The volume of questions about launching equity options has really increased in the last 12 months so there should be a substantial growth in the market this year and in 2011," says Doria. ■

Top 20 stocks traded on the options market – January-December 2009					
Stock	Type	Value (R\$)	Part.(%) (a)	Part.(%) Accumulated	
VALE	PNA N1	28,798,792,641	47.78	47.78	
PETROBRAS	PN EJ	25,115,587,259	41.67	89.46	
IBOVESPA	IBO	3,418,143,738	5.67	95.13	
NET	PN N2	761,602,585	1.26	96.39	
OGX PETROLEO	ON EB NM	429,345,036	0.71	97.11	
GERDAU	PN EJ N1	282,721,082	0.47	97.58	
ITAUSA	PN ED N1	241,456,587	0.40	97.98	
ITAUUNIBANCO	PN ED N1	143,031,854	0.24	98.21	
BMFBOVESPA	ON EJ NM	133,240,006	0.22	98.43	
ALL AMER LAT	UNT N2	106,191,628	0.18	98.61	
GVT HOLDING	ON NM	84,553,444	0.14	98.75	
USIMINAS	PNA EJ N1	84,342,561	0.14	98.89	
ISHARES BOVA	CI	82,481,022	0.14	99.03	
BRADESCO	PN EDJ N1	79,683,186	0.13	99.16	
SID NACIONAL	ON EJ	76,576,238	0.13	99.29	
EMBRAER	ON EJ NM	71,810,362	0.12	99.41	
JBS	ON ES NM	71,382,400	0.12	99.52	
TELEMAR	PN	57,801,976	0.10	99.62	
NATURA	ON NM	35,619,985	0.06	99.68	
BRASKEM	PNA N1	34,527,106	0.06	99.74	