



19 August 2024

To: SEBI

Dear Sirs/Madams

SEBI - Consultation Paper on Measures to Strengthen Index Derivatives Framework for Increased Investor Protection and Market Stability

FIA¹ appreciates the opportunity to provide comments on SEBI’s “Consultation Paper on Measures to strengthen index derivatives framework for increased Investor protection and Market stability”.

FIA’s mission is to promote open, transparent, and competitive markets worldwide. SEBI’s objectives in the proposed measures—specifically enhancing investor protection, promoting market stability, and ensuring sustained capital formation—strongly align with our mission. We fully support the overall intent of the proposals and have some suggestions to enhance them and better assist SEBI in achieving its regulatory objectives.

Healthy, well-functioning markets are characterised by complex and dynamic interdependencies among all market participants and investors. This can make it challenging to accurately forecast and model the consequences of regulatory changes and assess whether they achieve their intended policy objectives. Introducing multiple new measures simultaneously increases the risk of unintended consequences, potentially counteracting policy makers’ original goals.

To mitigate these risks, we recommend an incremental, cautious, and conservative approach to implementing regulatory changes. This should be accompanied by a transparent roadmap that allows for thorough analysis of the impact of each change before proceeding with additional measures.

It is also important to focus on investor suitability for trading specific financial products. This targeted approach will significantly strengthen investor protection and help minimise the unintended consequences that broader measures might impose on the overall market.

¹ FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in Brussels, London, Singapore and Washington, D.C. FIA’s membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from about 50 countries as well as technology vendors, law firms and other professional service providers. FIA’s mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA’s clearing firm members play a critical role in the reduction of systemic risk in global financial markets. Further information is available at www.fia.org.



In view of these considerations, we offer the following key recommendations:

1. Gradual Implementation of the Measures

We recommend that SEBI adopt a gradual approach to implementing the measures rather than enacting all changes simultaneously. This involves introducing a limited number of measures at a time and rolling them out in stages. This approach allows SEBI to evaluate the effectiveness of each change before making further adjustments.

Gradual implementation is crucial, as some measures may disproportionately affect smaller market participants or fail to achieve their intended goals if not introduced incrementally. For instance, changes to ELM could be phased in similarly to the gradual adjustments made to lot sizes. This method will provide a clearer understanding of each measure's impact and help mitigate the risk of unintended consequences that could arise from a sweeping overhaul.

2. Consideration of Potential Unintended Consequences

The potential for the proposed measures to inadvertently produce counterproductive outcomes should be thoroughly evaluated.

For example, increased ELM measures could disproportionately penalize conservative options strategies (e.g., call, put, and calendar spreads), leading investors towards riskier strategies that now incur similar margin costs.

Additionally, a substantial reduction in expiries and strikes may concentrate the market in fewer financial instruments, limiting investor choice and impacting the precision and cost-effectiveness of strategies. This ultimately undermines the effectiveness of the derivatives market.

3. Ensuring Investor Suitability

Ensuring investor suitability for trading specific financial products is vital for protecting investors. By implementing rigorous requirements to verify that traders have the necessary knowledge, experience and financial capacity, only those with the appropriate qualifications will be permitted to trade leveraged products. This approach not only promotes informed trading practices and safeguards investors but also supports market development while minimizing impacts on liquidity and volatility.

4. Balanced Development of the Derivatives Ecosystem

India's derivatives market is distinguished by its robustness, stringent regulation, and systematic safety. It benefits from rigorous oversight by SEBI, which ensures robust safety



measures including effective margining practices, collateralization by CCPs, and comprehensive broker education. This solid regulatory framework is crucial for maintaining market integrity.

The market's strength also lies in its diverse and balanced investor composition, alongside a significant demand for short-dated options. It is globally celebrated for its vibrancy and adaptability. The market maintains a stable and diverse composition, with a balanced mix of institutional, individual, and proprietary trading firms. According to NSE statistics, individual investor participation has remained around 25% for over a decade, aligning with trends in other regional markets such as Korea, Taiwan, and China. This stability highlights the market's resilience and broad appeal.

Maintaining this strong foundation is essential to preserve the market's appeal and stability. Measures that inadvertently disrupt this balance could drive investors toward less regulated or alternative markets, such as cryptocurrencies and CFDs, thereby diminishing investor protection and increasing their risk exposure.

Globally, financial markets are trending towards greater efficiency, automation, and cost-effectiveness, enhancing investor flexibility across expiries, instruments, and strikes. To remain aligned with these evolving practices observed in international options markets, it is essential to focus on improving investor education, enhancing risk awareness, and deepening understanding of financial instruments.

High levels of activity in weekly options are now a global standard and not unique to India. The significant trading activity near expiry observed for Indian benchmark index products aligns with global trends observed at exchanges such as the CBOE. Additionally, major exchanges in Europe and the US offer daily and intra-day options, catering primarily to institutional investors.

While we fully support the underlying policy intent of the proposed measures, we advocate for a more balanced approach to the development of the derivatives ecosystem. Specifically, we recommend:

- a. **Promoting Institutional Usage of Derivatives:** Encouraging greater institutional participation can strengthen market depth and resilience.
- b. **Enhancing Liquidity in Longer-Dated Instruments:** Improving liquidity for instruments with expiries ranging from 1 week to 6 months is essential. This can be facilitated



through measures such as optimizing capacity, adjusting margin requirements, revising fees, and implementing targeted liquidity programs.

Additionally, we would like to present some specific comments on the proposals for SEBI's consideration. Capitalized terms used in this letter will carry the same meanings as defined in the consultation paper, unless otherwise specified.

Reference	Proposal	Comments
3.1	<p><u>Rationalisation of strike price for options</u></p> <p>Existing strike price introduction methodology may be rationalized to incorporate the following principles:</p> <p>3.1.4.1. Strike interval to be uniform near prevailing index price (4% around prevailing price) and the interval to increase as the strikes move away from prevailing price (around 4% to 8%).</p> <p>3.1.4.2. Not more than 50 strikes to be introduced for an index derivatives contract at the time of contract launch.</p> <p>3.1.4.3. New strikes to be introduced to comply with aforesaid requirement (3.1.4.1) on daily basis.</p> <p>3.1.4.4. Exchanges to uniformly implement and operationalize the aforesaid principles after joint discussion.</p>	<p>We agree that the rationalizing of strike prices (i.e. reducing the amount of strikes) should have the intended impact of protecting retail participants.</p> <p>However, there are several potential consequences that need to be carefully considered:</p> <ul style="list-style-type: none"> • Concentration of Activity and Open Interest: Fewer strike prices could lead to concentration of activity and open interest in a smaller number of strikes, potentially heightening volatility and increasing the risk of market manipulation. This concentration might also lead to higher costs for investors and limit their options. • Diminished Hedging and Risk Management Capabilities: Genuine portfolio hedgers could lose their ability to protect their investments at targeted levels ahead of significant events, such as elections or regulatory changes, by using instruments like a 90% put. This loss of precise hedging options may also impede their ability to safeguard positions during volatile days, potentially worsening market instability. For example, on 4 June 2024, the market fell 8% from the opening to its lowest point of the day. The reduction in available hedging tools could amplify market volatility and stress,

ultimately diminishing the effectiveness of risk management strategies.

- **Increased Margin Management Challenges:** Investors may face difficulties managing margin requirements effectively without adjacent strike prices to offset positions. This could lead to liquidity dislocations driven by the SPAN margining model.
- **Market Instability:** Concentrated options positions can have a pronounced impact on the underlying futures, potentially causing greater market instability.

Given these potential impacts, it is essential to implement this measure in a carefully calibrated manner. We recommend a phased approach to implementation, allowing for a thorough assessment of its effects on liquidity, market stability, and trading costs. This method will enable a comprehensive evaluation of the measure's consequences and provide the opportunity for adjustments based on observed outcomes.

We also note that other markets offer a broader range of strike prices:

- KRX lists strikes for the nearest three months that are approximately 80 points (around 22%) above and below the at-the-money (ATM) position.
- HKEX sets index strike prices within a minimum range of 10% around the ATM.
- OSE provides index strikes that are $\pm 16\%$ from the ATM.

In light of the above, SEBI could consider delegating responsibility for managing product features such

		<p>as strike ladders to individual Exchanges, under the guidance of SEBI’s risk management principles and subject to SEBI’s oversight. This approach, in contrast to rigid and absolute rules, allows for greater adaptability to the rapid pace of market changes and the need for continuous adjustments, ensuring a more flexible and responsive system.</p>
<p>3.2</p>	<p><u>Upfront collection of options premium</u></p> <p>The members to collect option premiums on an upfront basis from the clients.</p>	<p>We support SEBI’s objective of restricting market practices that enable participants to hold positions that exceed the end clients’ available collateral. This is crucial for safeguarding individual investors by reducing excessive risk and fostering a more secure and stable trading environment.</p> <p>However, we have concerns that this rule might inadvertently disadvantage well-capitalized participants. We recommend that premium payments be calculated based on the collateral available to participants, rather than solely on liquid cash, to avoid penalizing those with substantial collateral holdings.</p> <p>Currently, participants optimize their financing by holding a significant portion of their INR in GSECs rather than cash, due to the lack of interest earned on INR balances. The proposed requirement for upfront margin collection could compel these firms to hold cash, which generates no interest, creating a significant financial burden.</p> <p>Such a change would be highly punitive for these firms. It is essential that they can optimize their financing to continue providing liquidity in the options market and managing their trading costs effectively. Increased costs could lead to reduced trading volumes and higher expenses for all market participants.</p>

<p>3.3</p>	<p><u>Removal of calendar spread benefit on expiry day</u></p> <p>Given the skew in volumes witnessed on the expiry day vis-à-vis other non-expiry days and the inherent basis and liquidity risk present therewith, the margin benefit for calendar spread position would not be provided for positions involving any of the contract expiring on the same day.</p>	<p>We recognize the intention behind this measure and agree that reducing or eliminating margin offset benefits for calendar spreads could potentially decrease retail participation. However, this proposal appears to overlap with other initiatives designed to increase margin requirements near contract expiry. To ensure a clear understanding and effective implementation, we would appreciate further clarification on how this proposal differs from or complements those existing measures.</p> <p>We also have concerns about the impact on participants who use options for genuine portfolio hedging or risk management. These participants may be penalized as they are forced to roll positions ahead of expiry. This requirement might limit their ability to manage positions effectively, potentially driving them out of the options market.</p> <p>Furthermore, the current method of separating SPAN margin calculations between front and back-month options does not accurately reflect risk. For example, a participant holding an in-the-money option to expiry may face penalties for holding a long position in the front expiry and a short position in the longer-dated expiry, even though their risk is minimal at that point.</p> <p>Liquidity providers could also face increased margin costs, leading to wider bid/ask spreads and creating market distortion. These higher spreads will ultimately be absorbed by retail traders, creating unintended additional cost for both retail and institutional investors.</p> <p>Additionally, implementing these changes could pose challenges due to limitations in the current system on both broker and client sides. Significant</p>
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<p>3.4</p>	<p><u>Intraday monitoring of position limits</u></p> <p>Given the evolving market structure, the position limits for index derivative contracts shall also be monitored by the clearing corporations/ stock exchanges on intra-day basis, with an appropriate short-term fix, and a glide path for full implementation, given the need for corresponding technology changes.</p>	<p>We support this approach, as there should be measures in place to prevent a last-minute rush and maintain strict risk management, particularly if liquidity begins to diminish. We also believe this gives the exchange more detailed insights into market exposure throughout the trading day.</p> <p>However, we also note that such limits tend to have a relatively limited impact on retail investors.</p> <p>Potential limitations within the current system on both the broker and client sides should also be considered. Implementing these changes will require enhancements to real-time technology and adjustments to margin replication engines. Therefore, careful management of implementation timelines is recommended to accommodate these necessary updates.</p> <p>Most crucially, we strongly urge SEBI to revisit the restrictive position limits on futures and options introduced during the COVID-19 pandemic. These limits disproportionately affect larger institutional participants compared to smaller retail investors. Larger participants typically reduce market volatility and costs for retail investors by providing liquidity. Restricting their participation can lead to increased</p>

volatility and decreased liquidity, without effectively curbing retail volumes.

NSE sets position limits in equity index futures and option contracts at the higher of Rs.500 crores or 15% of the total open interest in the market in equity index futures contracts (see NSE webpage [here](#)). This approach exemplifies a well-balanced system that combines both dynamic and fixed position limits. It effectively safeguards against market manipulation while ensuring that market efficiency and price discovery are not unduly constrained.

During the COVID-19 pandemic however, starting in March 2020, SEBI introduced a new rule that modified the NSE's position limits by capping them at Rs. 500 crores (as detailed in this [SEBI Circular](#)). This change effectively replaced the dynamic limit with a static one, irrespective of market fluctuations. Consequently, the advantages of a "net" limit were overshadowed by the constraints imposed by the fixed Rs. 500 crores cap.

We believe this restrictive net position limit is a major factor driving excessive volume turnover on deep out of the money options.

As the position limit is on a net basis, institutional investors can trade significant volumes of options by executing paired trades that balance long and short puts and calls, effectively netting off the directional notional. These trades are often non-economic and are primarily executed to meet the limit requirements.

We believe this activity, driven by restrictive net position limits, has led to a substantial increase in overall options volumes among institutional

		<p>participants. This creates what is in effect artificial liquidity, with knock-on effects on price discovery and market efficiency.</p> <p>To address SEBI’s concerns about “hyperactivity” in index derivatives near maturity—especially for strikes far from the prevailing index spot with minimal payout potential—we strongly recommend reviewing and adjusting the position limits. Increasing these limits would help reduce the liquidity available to retail participants in far away strikes and decrease the appeal of buying these cheap options.</p> <p>Moreover, given the end of the COVID-19 pandemic, maintaining the fixed position limit makes India an outlier globally regarding index liquidity relative to position limits.</p> <p>In light of the above, we recommend reinstating the NSE's original position limit framework, which incorporates both dynamic and static components. This adjustment would help reduce some of the liquidity available to retail participants in distant strikes and diminish the attractiveness of buying these inexpensive options. Additionally, it is expected to enhance market structure and efficiency.</p> <p>In this regard, we would like to share FIA’s paper titled <i>“Derivative Position Limits: Best Practice Recommendations for APAC Exchanges,”</i> which may offer valuable insights and guidance on this topic.</p>
<p>3.5</p>	<p><u>Minimum contract size</u></p> <p>In view of growth witnessed in the broad market parameters,</p>	<p>We acknowledge that increasing the lot size could reduce retail participation as intended.</p>

	<p>the minimum contract size for index derivative contracts to be revised as under:</p> <p>3.5.3.1. Phase 1: Minimum value of derivatives contract at the time of introduction to be between `15 lakhs to `20 lakhs.</p> <p>3.5.3.2. Phase 2: After 6 months, minimum value of derivatives contract to be between the interval of `20 lakhs to `30 lakhs</p>	<p>At the same time, we wish to highlight that this change carries the risk of unintended negative consequences for retail investors. The scale of the increase may adversely impact market liquidity, leading to higher hedging costs and increased volatility, which could ultimately undermine the protection intended for retail investors.</p> <p>To mitigate these risks, we recommend adopting an incremental approach. We support moving forward with Phase 1, followed by a period of monitoring to assess its impact on the market before advancing to Phase 2. This will allow for a thorough evaluation of the measure’s effectiveness and its broader implications before considering further increases.</p> <p>Additionally, we recommend a regular review of contract sizes and endorse a gradual implementation strategy as proposed by SEBI. Larger contract sizes can increase trading and hedging costs and may eliminate smaller accounts from the market. Hence, a phased and carefully monitored approach will help balance these considerations effectively.</p>
<p>3.6</p>	<p><u>Rationalisation of weekly index products:</u></p> <p>In view of the data provided in the preceding paragraphs, to enhance investor protection and promote market stability in derivative markets, weekly options contracts to be provided on single benchmark index of an exchange.</p>	<p>A diverse range of indices, including midcaps, financials, and large caps, plays a crucial role in effective portfolio hedging. Weekly contracts, in particular, provide more cost-effective hedging solutions and are characterized by higher liquidity. If the availability of these weekly contracts is reduced, it could lead to decreased liquidity and turnover. Additionally, short-dated options are valuable for risk management, with their growing presence in major developed markets highlighting their appeal to investors.</p>

While we understand the intent behind the proposed measures, we have concerns about their potential detrimental effects on the market:

- **Limited Impact on Retail Volumes:** Transitioning to a single flagship weekly contract per exchange may not achieve the desired reduction in retail volumes, especially in comparison to the other proposed changes.
- **Increased operational complexity:** NSE currently offers multiple weekly expiring contracts. Reducing these could significantly increase operational complexity for market participants who depend on these contracts for their hedging and investment needs.
- **Reduced Liquidity and Higher Costs for Investors:** Reducing the number of available contracts could result in lower liquidity and turnover, leading to higher costs for investors. This may manifest as increased premiums, making it more expensive for investors to express their market views.
- **Less Precise Hedging and Strategy Deployment:** Institutional investors have demonstrated a strong appetite for short-dated options, with 68% of SPX options traded on Cboe having an expiry of less than 7 days. These options play a crucial role in portfolio optimization and risk mitigation strategies. Eliminating weekly options would significantly limit their hedging choices and force investors to seek alternative products. Fewer expiration dates could lead to reduced precision in hedging and strategic planning, particularly around significant events.

- **Impact on Cash and Single Stock Futures** – The expansion of options markets has spurred increased activity in cash and single stock futures volumes. Eliminating weekly expiries could unintentionally affect these volumes, potentially leading to significant impacts on both cash and single stock, as well as index futures markets.

- **Global Trends:** There is a global movement towards increasing the availability of weekly expiries, as they provide substantial benefits to market participants. Most major developed markets support weekly or more frequent expiries of index derivatives contracts:

- **United States:** Most major U.S. exchanges offer daily options expiries on major indices. Examples include SPX, NASDAQ 100, and Russell 2000 options by CME, and SPX, SPY, and XSP options by CBOE.

- **Europe:** Eurex offers daily options expiries on major indices such as Euro Stoxx 50 and DAX.

- **APAC:** Weekly options are offered on Nikkei 225 and Kospi2 listed in Japan and Korea respectively

The absence of excessive speculative activity in these markets suggests that frequent expiries alone are not the primary driver of the investor behaviour concerns highlighted by SEBI. Therefore, adopting the proposed measure might position India as an exception relative to the prevailing international approach, potentially without fully achieving SEBI’s objectives.

In light of the above, and to minimize disruption for participants who derive significant utility from the

existing product set while preventing the proliferation of sub-optimal products, we propose **increasing the barriers for new products** to be listed, such as new weekly options. We also suggest **establishing minimum liquidity requirements for existing weeklies** so that only those products with genuine demand and sufficient liquidity beyond expiry day remain available. This approach would ensure that less-utilized products are phased out, while retaining those that meet actual market needs.

Additionally, we recommend implementing enhanced **investor suitability checks** to ensure trading practices are better aligned with investor qualifications, rather than pursuing a broad delisting of products. For instance, the U.S. SEC mandates² brokerages to gather information on trading experience and financial details to evaluate a client's suitability for options trading. Similarly, Korea's FSC requires³ financial institutions to conduct suitability and appropriateness tests based on customer information to ensure that investment products match the investor's profile.

If the above proves unfeasible, we suggest the following alternative approaches:

- A. Enable each exchange to retain the flexibility to list products based on key factors determined by the exchange itself, preserving the vibrant and competitive environment crucial to a market's success. Rather than controlling the specific venue for each contract, aligning expiry days across exchanges

² https://www.sec.gov/resources-for-investors/investor-alerts-bulletins/ib_openingoptionsaccount

³ [Press Releases - Financial Services Commission \(fsc.go.kr\)](http://www.fsc.go.kr)

		<p>and restricting them to a certain day or number of days per week will foster inter-exchange competition and help manage expiry frequency, which can contribute to volatility. This approach promotes open competition among venues, avoiding the scenario where exchanges monopolize specific contracts. It also simplifies the operational landscape for clearing members and FPIs, reducing the need for multiple memberships across different exchanges.</p> <p>B. To support market efficiency, we suggest retaining the most liquid contracts as a baseline measure. Given the global recognition of the NSE Nifty and Bank Nifty as India’s leading benchmark indices, we recommend at a minimum maintaining weekly expiries for both series. At least two weekly expiring options on the BSE, such as BANKEX and SENSEX contracts, should also be maintained. This approach aims to enhance liquidity and stability across these key indices.</p>
<p>3.7</p>	<p><u>Increase in margin near contract expiry:</u></p> <p>To address the issue of high implicit leverage in options contracts near expiry, creating a high risk on notional basis for entities dealing in options, the margins on Expiry day and the day before expiry to be increased in the below stated manner:</p>	<p>We understand that the primary goal of this proposal is to reduce retail participation by increasing margin costs. However, margin requirements are essential tools used by regulators and exchanges to reflect the inherent risk of exchange-traded products, typically mirroring underlying volatility. Their main purpose is to ensure proper risk management rather than to influence trading volume, direction, or frequency.</p> <p>We therefore urge SEBI to consider a robust margin requirement framework that addresses the structural risks of the market, rather than focusing solely on options contracts nearing maturity.</p>

<p>a. At the start of the day before expiry, Extreme Loss Margin (ELM) to be increased by 3%.</p> <p>b. At the start of expiry day, ELM to be further increased by 5%.</p>	<p>For instance, Nifty weekly options are launched approximately one month before expiration. As a result, if excess volatility occurs on the expiry day (Thursday), it impacts not only that day but also the preceding Thursdays. Similarly, monthly expiries experience this "heightened volatility" each Thursday throughout the contract's life. The reduction in premium near expiry does not necessarily translate to higher risk on a notional basis for investors dealing in options. The fact that the premium decreases near the expiry does not create higher risk on a notional basis for investors dealing in options.</p> <p>Moreover, the proposed measures could inadvertently make trading more burdensome for both genuine investors and retail participants, potentially affecting market stability and investor outcomes:</p> <ul style="list-style-type: none"> • Liquidity Dislocations: Investors will need to square off positions on 2DTE and 1DTE to avoid margin calls and liquidations, leading to increased stress on systems, brokers, and CCPs. • Deviation from Fair Value: Increased margin requirements can lead to significant deviations in options prices from their fair value. For example, an investor seeking to hedge with a 98% put would see costs rise by approximately 11% on 1DTE and 46% on 0DTE in outright premium terms, escalating further throughout the trading day for the same strategy and exposure.
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- **Increased Costs for Hedging Strategies:** Genuine hedging strategies would become considerably more expensive. Additionally, the increased margin requirements penalize spread strategies (such as puts, calls, and calendar spreads) which are generally intended to be more conservative.
- **Wider Spreads:** The costs associated with margin requirements may cause spreads to widen, particularly with larger positions, as options sellers might lack the collateral needed to offer competitive prices.

Given the potential adverse effects and the belief that current measures are already sufficient to meet SEBI's objectives, we recommend against implementing this proposed change. Instead, we suggest adopting a risk-based framework that applies uniformly to the derivatives segment, using appropriate market stress scenarios.

Nevertheless, we acknowledge SEBI's policy goals and appreciate the intent behind the proposed measure. To balance these considerations, we recommend an incremental approach.

Specifically, we suggest a modest initial increase in ELM margins, raising the rate from 2% to 3% on ODTE options only. This should be followed by a monitoring phase against clearly defined metrics to assess the impact accurately and allow for further adjustments as necessary. This gradual approach aims to minimise the risk of unintended negative consequences.

Implementing these changes will also necessitate substantial system upgrades and the collection of

upfront data to enable clearing members to manage margin requirements effectively in real time. Without these enhancements, challenges in margin collection and real-time monitoring could arise, potentially impacting market stability. Therefore, careful management of implementation timelines is essential to accommodate these updates.

Additionally, similar to calendar spread adjustments, SEBI might consider allowing Exchanges to modify initial margin requirements based on existing risk management models. The SPAN system already includes a minimum option margin parameter that could be leveraged for this purpose.

We welcome the opportunity to work with SEBI to address these comments. Please feel free to contact me at bherder@fia.org or TzeMin Yeo, Head of Legal & Policy, Asia Pacific at tmyeo@fia.org should you wish to further discuss.

Yours



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