14

# Legal Aspects of Derivatives Trading in India

Shashank Saksena

## 1 Evolution of derivatives trading in India

All markets face various kinds of risks. This has induced the market participants to search for ways to manage risk. The derivatives are one of the categories of risk management tools. As this consciousness about risk management capacity of derivatives grew, the markets for derivatives developed.

Derivatives markets generally are an integral part of capital markets in developed as well as in emerging market economies. These instruments assist business growth by disseminating effective price signals concerning exchange rates, indices and reference rates or other assets and thereby render both cash and derivatives markets more efficient. These instruments also offer protection from possible adverse market movements and can be used to manage or offset exposures by hedging or shifting risks particularly during periods of volatility thereby reducing costs. By allowing for the transfer of unwanted risk, derivatives can promote more efficient allocation of capital across the economy, increasing productivity in the economy.

Commodity futures trading has been in existence since 1953 and certain OTC derivatives such as Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs) were allowed by RBI through its guidelines in 1999. The trading in “securities” based derivatives on stock exchanges was per-

mitted only in June 2000. The discussion that follows is mainly focused on securities based derivatives on stock exchanges.

The legal framework for derivatives trading is a critical part of overall regulatory framework of derivatives markets. This will be clear when it is discussed later on how the regulation and control of derivatives trading and settlement have been prescribed through suitable amendment to the bye-laws of the stock exchanges where derivatives trading was permitted. While the role of state intervention in the functioning of markets is a matter of considerable debate, it is generally agreed that regulation has a very important and critical role to ensure the efficient functioning of markets and avoidance of systemic failures (Sahoo 1997). The purpose of regulation is to promote the efficiency and competition rather than impeding it.

While there is a perceived similarity of regulatory objectives there is no single preferred model for regulation of derivatives markets. The major contributory factors for success or failure of derivatives market are market culture, the underlying market including its depth and liquidity and financial infrastructure including the regulatory framework (Hathaway 1998). Government interventions can impair the efficiency of derivatives market. For example, governmental price controls or trade agreements aimed at stabilizing prices are such examples of government intervention, which do not allow derivatives market to flourish. Further since the market integrity and efficiency, financial safety and integrity and customer protection (common regulatory objectives in all jurisdictions) are critical to the success of any financial market, anyone responsible for operating such a market would have strong incentives independent of external regulation to ensure that these conditions are present in the market place.

It is also observed that the successful regulatory system can complement the incentives for self-regulation while reducing the incentives and opportunity for behaviour, which threatens the success and integrity of market (International Organisation of Securities Commissions 1996a). Emergence of derivatives market will normally require legislation, which addresses issues regarding legality of derivatives instruments, specifically protecting such contracts from anti-gambling laws because these involve contracts for differences to be settled by exchange of cash, prescription of appropriate regulations and powers to monitor compliance with regulation and power to enforce regulations. As the industry grows, the type and scope of regulation also change. Therefore, regulatory flexibility is criti-

cal to the long run success of both regulation and the industry it regulates. It would be interesting to observe the historical evolution of development of derivatives market and then examine what further needs to be done to develop these markets.

## 1.1 A brief history of forward trading

The precursor to exchange based derivatives in India was a kind of "forward trading" in securities in the form of call options (teji), put options (mandi) and straddles (fatak) etc. (Sahoo, 1999) The Securities Contracts Regulation Act, 1956 (SCRA) was enacted, inter-alia, to prevent undesirable speculation in securities.

Contracts for "clearing" commonly known as "forward trading", were banned by the Central Government through a notification issued on $27^{th}$ June 1969 in exercise of the powers conferred under Section 16 of the SCRA. As the prohibition of forward trading in securities led to a decline of traded volumes on stock markets, the Stock Exchange, Mumbai (BSE), evolved in 1972 an informal system of "forward trading", which allowed carry forward between two settlement periods, which resulted in substantial increase in the turnover of the exchange. However, this also created several problems and there were payment crises from time to time and frequent closure of the market. During December 1982 - January 1983 the Government reviewed the position and in exercise of its powers under Section 10 of the SCRA amended the bye-laws of stock exchanges to facilitate performance of contracts in "specified securities." In pursuance of this policy the stock exchanges at Bombay, Calcutta and Ahmedabad introduced a system of trading in "specified shares" with carry forward facility after amending their bye-laws and regulations.

The Joint Parliamentary Committee on Irregularities in Securities and Banking Transactions, 1992 (JPC of 1992) discussed the issue of "carry forward of deals" and observed that this system was not functioning appropriately as there were lot of irregularities in the stock exchanges in the form of non-enforcement of margins, non-reporting of transactions and illegal trading outside the stock exchange. SEBI was of the view that carry forward transactions should be disallowed and transactions conducted strictly on delivery basis and trading in futures and options should be permitted in separate markets. Consequently, SEBI issued a directive in December 1993 prohibiting the carry forward of transactions.

However, this was reviewed by SEBI, and pursuant to the recommendations of the G.S. Patel Committee to review the system, carry forward transactions in securities were permitted in 1995 subject to certain safeguards. This was further reviewed by the J.R. Varma Committee report in 1997 and the system was further modified subject to a number of safeguards such as segregation of carry forward transactions at the time of execution of trade, daily margin of 10 percent, 50 percent of which would be collected upfront, overall carry forward limit of Rs.20 crore per broker per settlement and other prudential safeguards.

On the other hand, repo transactions in Government securities and public sector bonds developed during 1980s (Sahoo 1999). Following the discussion of JPC of 1992, which indicated that some banks were found to have entered into transactions in violation of RBI circulars, RBI banned all repos except treasury bills since June 1992. The Special Court declared such transactions null and void in December 1993 as being violative of the provisions of SCRA and Banking Regulation Act, 1949. The Supreme Court, however, decided in March 1997 that the ready forward contracts (Repo) were severable into two parts, viz. ready lag and the forward lag. The ready lag of transactions having been completed, the forward lag, which alone was illegal, had to be ignored.

As repo transactions violated the Government notification of $27^{th}$ June 1969 under SCRA, certain institutions such as banks, co-operative banks and other RBI registered dealers were permitted to undertake ready forward transactions in Government securities through amendment notifications from time to time during second half of 1990s. The objective was to enhance liquidity market for Government securities and to further develop it. There were problems with such kind of facility such as, no standard documentation, “master agreement”, non-use of clearing houses to undertake counter party risk and opacity of the regulatory validity in view of the pronouncements of the Special Court and the Supreme Court. As a result the repo market was neither deep nor liquid.

This was an anomalous situation where there was a notification, which prohibited forward trading, while some form of forward trading (carry forward/ready forward) was prevalent. In view of the changed circumstances particularly the need to develop derivatives market the repeal of 1969 notification was considered desirable not only to remove the existing anomaly, but also as a measure of market reforms. The issue was that the notification

was to be repealed only after amendment of the SCRA so that the powers could be appropriately delegated to RBI in addition to SEBI.

There were complex regulatory issues relating to repeal of the said notification and delegation of powers to RBI and SEBI. The issue was what powers in respect of which transactions in which securities should be delegated to RBI, since SEBI was already exercising delegated powers under SCRA, irrespective of type of transactions/securities. The Securities Laws (Amendment) Bill, 1999 was passed (before the legislation sufficient ground work was done as would be discussed later) by the Parliament permitting a legal framework for derivatives trading in India in December 1999.

Consequently, the Central Government lifted a three decade old prohibition on forward trading in securities on 1st March 2000. Simultaneously, in order to promote an orderly development of the market, the Government issued another notification on 1st March 2000 delineating the area of responsibility between RBI and SEBI. In terms of this notification, the contracts for sale and purchase of Government securities, gold related securities, money market securities and securities derived from these securities and ready forward contracts in debt securities were to be regulated by RBI. Such contracts if executed on stock exchanges, would be regulated by SEBI in a manner that this consistent with the guidelines issued by RBI. On the same date, both RBI and SEBI issued notifications specifying the regulatory framework in their respective areas. The RBI's notification while retaining the general prohibition on forward trading, permitted ready forward contracts by the specified entities subject to certain conditions, such as, maintenance of subsidiary ledger account and a current account and such other conditions, as may be prescribed. SEBI also retained the general prohibition on forward trading but permitted derivatives contracts, as permissible under the securities law. Since both the regulators have been made responsible for regulation of debt markets, of course, with some demarcation, issues of coordination become important to prevent the emergence of regulatory gaps or overlaps.

## 1.2 Evolution of a legal framework for derivatives trading

An important step towards introduction of derivatives trading in India was the promulgation of the Securities Laws (Amendment) Ordinance, 1995,

which lifted the prohibition on “options in securities” (NSEIL, 2001). However, since there was no regulatory framework to govern trading of securities, the derivatives market could not develop.

SEBI set up a committee in November 1996 under the chairmanship of Dr. L.C. Gupta to develop appropriate regulatory framework for derivatives trading. The committee suggested that if derivatives could be declared as “securities” under SCRA, the appropriate regulatory framework of “securities” could also govern trading of derivatives. SEBI also set up a group under the chairmanship of Prof. J.R. Varma in 1998 to recommend risk containment measures for derivatives trading.

The Government decided that a legislative amendment in the securities laws was necessary to provide a legal framework for derivatives trading in India. Consequently, the Securities Contracts (Regulation) Amendment Bill 1998 was introduced in the Lok Sabha on $4^{th}$ July 1998 and was referred to the Parliamentary Standing Committee on Finance for examination and report thereon. The Bill suggested that derivatives may be included in the definition of “securities” in the SCRA whereby trading in derivatives may be possible within the framework of that Act. The said Committee submitted the report on $17^{th}$ March 1999.

The Committee was of the opinion that the introduction of derivatives, if implemented, with proper safeguards and risk containment measures, will certainly give a fillip to the sagging market, result in enhanced investment activity and instill greater confidence among investors/participants. The Committee was of the view that since cash settled contracts could be classified as “wagering agreements” which can be null and void under Section 30 of the Indian Contracts Act, 1872, and since index futures are always cash settled, such futures contracts can be entangled in legal controversy. Therefore, the Committee suggested an overriding provision as a matter of abandoned caution – “Notwithstanding anything contained in any other Act, contracts in derivatives as per the SCRA shall be legal and valid.”

Further, since Committee was convinced that stock exchanges would be better equipped to undertake trading in derivatives in sophisticated environment it would be prudent to allow trading in derivatives by such stock exchanges only. The Committee, therefore, suggested a clause- “The derivative shall be traded and settled on stock exchanges and clearing houses of the stock exchanges, respectively in accordance with the rules and bye-laws of the stock exchange.” The Proposed Bill, which incorporated the recom-

mendations of the said Parliamentary Committee, was finally enacted in December 1999.

The Committee also recommended various operational/legal measures to safeguard the integrity of the capital market and protect investors. These measures, inter alia, include the following:

1. The Committee observed that Dr. L.C. Gupta Committee appointed by SEBI had drawn out detailed guidelines pertaining to the regulatory framework on derivatives prescribing necessary preconditions which should be adopted before the introduction of derivatives. The Committee, therefore, recommended that these should be adhered to fully.
2. The Committee felt that there was an urgent need to educate the Indian investors by creating investment awareness among them by conducting intensive educational programmes, so that they are able to understand their risk profiles in a better way.
3. Measures should be taken to strengthen the cash market so that they become strong and efficient.
4. The Committee felt that it is imperative that the regulatory authorities ensure a strong surveillance/vigilance and enforcement machinery.
5. The Committee was of the view that since derivatives trading requires a critical mass of sophisticated investors supported by credit and stock analysts, SEBI should, in consultation with the stock exchanges, endeavour to conduct certification programme on derivatives trading with a view to educating the investors and market intermediaries.
6. Keeping in view the swift movement of funds and the technical complexities involved in derivatives transactions, the committee felt that there was a need to protect particularly the small investors by preventing them from venturing in to options and futures market, who may be lured by the sheer speculative gains. The Committee, therefore, recommended that the threshold limit of the transactions should be pegged not below Rs.two lakhs.
7. The Committee was of the view that there is an urgent need to prescribe pronounced accounting standards in the case of investors/dealers and also back office standards for intermediaries with

a view to reducing the possibility of concealing loss and perpetrating the frauds by companies/intermediaries. The Committee also noted that the need of accounting disclosure had also been recognized by Dr. L.C. Gupta Committee. The committee, therefore, recommended that the Institute of Chartered Accountants of India, in consultation with the stock exchanges, should formulate suitable accounting standards and SEBI should prescribe the same before trading in derivatives is commenced.

8. The Committee also asked the Government to consider exempting derivatives transactions from the imposition of stamp duty.

It is important to note that the suggestions and recommendations of the said Committee were implemented by the statutory regulators.

Thus the enactment of Securities Laws (Amendment) Act 1999 and repeal of 1969 notification provided a legal framework for securities based derivatives trading on stock exchanges in India, which is co-terminus with framework of trading of other "securities" allowed under the SCRA. The trading of stock index futures started in June 2000 and later on, other products, such as, stock index options and stock options and single stock futures were also allowed. The derivatives are formally defined under the said Act of 1999 (No. 31 of 1999) to include: (a) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security, and (b) a contract which derives its value from the prices or index of prices or underlying securities.

The Act also clarified that, notwithstanding anything contained in any other law for the time being in force, contracts in derivatives shall be legal and valid only if such contacts are traded on a recognized stock exchange and settled on a clearing entity of the recognised stock exchange in accordance with the rules and bye-laws of such stock exchange, thus precluding OTC derivatives (this has implications for legal validity of such derivatives, as discussed later). The detailed legal framework for derivatives trading on stock exchanges was suggested by the L.C. Gupta Committee on derivatives, which had submitted its report in March 1998. It not only provided a conceptual basis for various regulatory features, but also suggested bye-laws for derivatives exchanges and clearing corporations. These bye-laws were required to be adopted by the stock exchange and clearing entities before derivatives activity can start within their jurisdiction.

## 2 International regulation of derivatives markets

The International Organisation of Securities Commissions (IOSCO) has been providing international best practices and perspectives on derivatives markets. In 1990, the IOSCO published the Principles for Oversight of Screen Based Trading Systems for Derivatives Products. It was suggested that all the jurisdictions adopt (SEBI, being a member organization, has adopted these principles,) the 10 non-exclusive general principles for the oversight of screen based trading systems for derivatives products which identify areas of common regulatory concern. These principles basically relate to compliance by system sponsor with the regulatory requirements relating to legal standards, regulatory policies, risk management mechanisms and adequate disclosures of attendant risks. These 10 principles were reviewed by IOSCO and 4 additions were proposed in the year 2000 (IOSCO 2000) for derivatives products operating on the cross-border basis.

The 1990 principles also anticipated IOSCO Objectives and Principles of Securities Regulations of 1998 relating to protection of investors, fairness and transparency of markets and reduction of systemic risk. The additional regulations suggested include, regulatory coordination and cooperation to avoid potential duplication, inconsistencies and gaps, sharing of relevant information and adequate disclosure and transparency of regulatory requirements in jurisdictions. The IOSCO report on the "International Regulation of Derivative Markets, Products and Financial Intermediaries" released in December 1996 provides a description of various models or approaches to the regulation of derivatives markets based on regulatory summaries prepared on common framework of analysis (IOSCO 1996b). It was observed that while there was no single model for the regulation of derivatives markets, there was substantial similarity in perceived regulatory objectives.

The IOSCO framework identifies the three objectives of regulation, which need to be specified by the regulatory framework of the securities markets. These are market efficiency and integrity, customer protection/fairness and financial integrity (IOSCO, 1996a).

### 2.1 Market efficiency and integrity

International practice suggests that such derivatives markets must be "recognized", authorized by the statute or otherwise created by grant before

trading can start. Derivative products are similarly specifically recognized and must satisfy a test of economic utility. Further, domestic trading houses must also be recognized, authorized and approved by regulators.

Many markets prescribe regulatory requirements for product design. The contract design is supposed to address the functional priorities of risk shifting and price discovery. It is felt that a well designed derivatives contracts is the first line of defence against market manipulation. The underlying must be specifically defined to facilitate hedging. Specific features of derivatives instruments have implications for regulatory authorities. Since in the derivatives contract, the transfer of underlying interest occurs as part of a separate transaction unless the contract is extinguished by offset, there is no limit to the number of outstanding open positions of a particular derivatives instrument. The regulatory concern is, therefore, reflected into emphasis on fairness and efficiency, concern on concentration of positions and delivery processes.

Most markets prescribe that "market manipulation" is prohibited though the precise definition of "market manipulation" is not uniformally prescribed in law. The common regulatory measures used to address this practice are direct surveillance, prudent design requirements, position limits, administration of civil sanctions and other measures. Many jurisdictions also use circuit breakers, trading halts and or price limits to minimize the adverse effects of "market disruption."

The issue of active surveillance of large exposures by market authorities and or regulators was emphasized in the Windsor declaration of 1995 following the failure of the Barings PLC. In some jurisdictions this is manifested in the form of institution of "large trader reporting system" and direct oversight programme on financial information system (e.g., by US Commodities Futures Trading Commission, (CFTC)). The other manifestation of such responsibilities is prescription of speculative position limits and requirements of specific exemption from such limits. Surveillance systems produce exception reports which generate inquiries by the regulatory staff about large positions related to market, the positions which generate or could generate large losses compared to margins and the known capacity of the firm involved and other unusual transactions. Most markets have exchange trading rules to produce accurate and transparent dissemination of price information. Most markets also have rules against unfair or manipulative practices such as conflicts of interests, dual trading, front

running, wash deals or accommodation trades. The regulatory responsibilities are shared between the exchanges and self-regulatory organisations in conjunction with Government regulators. This also requires audit trails to address detection and proof of possible market abuses.

## 2.2 Financial integrity

Most of the jurisdictions agree that prudential or financial safety requirements are required to not only protect markets and funds from credit and systemic risk, but also to ensure that only those persons who are deemed credit-worthy and have a stake in the proper conduct of business should have access to the markets. The financial requirements are designed to reflect the special risk attributes of derivatives (highly leveraged positions in the market) and are generally fairly similar in form though the different jurisdictions rely to varying degrees on capital, credit, margin, guarantee, deposits, segregation and surveillance. These requirements are discussed below.

Although capital requirements for financial intermediaries are prescribed in all jurisdictions, none of the jurisdictions reported specific capital requirements for exchanges. There are jurisdictional differences with reference to capital requirements as well as the type of organization which imposes such requirements. Provision of clearing and settlement facility is a universal regulatory concern. While most jurisdictions have operating and or prudential requirements, many matters relevant to clearing are determined at the discretion of the clearing house or the exchange. For example, not all clearing entities guarantee daily variation settlement or the time of imposition of the guarantee may differ from market to market.

Margin requirements are generally determined by the relevant exchange and subject to some form of regulatory oversight (for example, authority to approve levels of margins instituted by exchanges by the statutory regulators). Levels of margin are usually determined by reference to formulae related to volatility, including stress testing. The definition of good collateral differs in various jurisdictions. The type of collateral accepted by a financial intermediary may be different from that accepted by a clearing house or exchange. Some jurisdictions restrict use of credit for securities regulated derivatives products. Some clearing entities collect original margin on a gross basis and some collect net. However, variation margin on

a daily basis is generally collected on a net basis. In so far as customer funds' protection and insolvency are concerned, most jurisdictions have prudential requirements relating to insurance or performance guarantees and also rely on segregation of customer funds from those of the firms. Many jurisdictions also have requirements for location of customer funds and investment criteria to ensure protection from defalcation and to record special treatment to customer funds when the financial intermediary becomes insolvent.

In order to undertake supervision of records over time all jurisdiction require recreation, maintenance and retention of financial records. For some jurisdictions the segregation of customer funds is supplemented by composition type funds, which may be used as a "final safety net", Most exchange markets generally have provisions for providing clearing guarantee that permits multilateral netting. However, not all jurisdictions' insolvency laws support the enforceability of such arrangement. This is an important issue because multilateral netting of contracts is not supported by the insolvency law in India, which is a deterrent to market development.

## 2.3 Customer protection regulation

Customer protection concern is usually addressed by regulatory standards imposed on financial intermediaries relating to the integrity, skill and diligence, conflicts of interest, conduct of business, including order execution, restrictions on misuse of information, prohibition on misrepresentation, disclosure standards and the availability of procedures to resolve customer grievances. Most jurisdictions have fitness requirements for financial intermediaries, which consider past violative conduct, character and competency. In the order execution requirements, fair execution requirements are prescribed. For example, "customer first rule" gives priority to execution of client orders when dual capacity trading is permitted. Standards relating to sales practice relate to disclosures, prohibition on misrepresentation and improper solicitation are almost universally prescribed. While all the jurisdictions require segregation and maintenance of records such as execution confirmation and financial effect of exchange transactions, there are differences in so far as the availability of such records to customers.

However, information relating to trading should be available both to customers and financial intermediaries in an equitable manner and ideally

on a real time basis. The code of conduct for trading members and other legal provisions suitably incorporate all such standards in the bye-laws of stock exchanges in India.

## 3 Regulatory framework for derivatives in India

As discussed earlier, the regulatory framework in India is based on the L.C. Gupta committee report on derivatives and J.R. Varma group reports on risk containment measures for derivatives products. The regulatory framework in India is mostly consistent with the IOSCO principles and regulatory framework for exchange traded derivatives (a comparison of IOSCO framework and Indian framework is in the annex 1 of this paper) and addresses the common concerns of investor protection, market efficiency and integrity and financial integrity (though there is no mention in the L.C. Gupta committee report on derivatives that its recommendations have been guided by IOSCO principles).

The L.C. Gupta committee report provided a perspective on division of regulatory responsibility between the exchange and SEBI. It recommended that SEBI's role should be restricted to approving the rules, bye-laws and regulations of derivatives exchange and approval of proposed derivatives contracts before commencement of trading. The emphasis should be on exchange level regulation while providing supervisory and advisory role to SEBI with a view to permitting desirable flexibility, maximizing regulatory effectiveness and minimizing regulatory cost. The authorization for derivatives brokers/dealers includes regulatory requirements relating to capital adequacy, net worth, certification requirement and initial registration with SEBI. The committee also suggested establishment of a separate clearing corporation, maximum exposure limits, mark to market margins, margin collection from clients and segregation of clients' funds, regulation of sales practice and accounting and disclosure requirements for derivatives trading.

The J.R. Varma group suggested a methodology for risk containment measures for index futures market and for options on indices, stock options and single stock futures. The risk containment measures include calculation of margins, position limits, exposure limits and reporting and disclosure.

# 4 Policy issues for further development of the markets

## 4.1 Strengthening of financial infrastructure

While the Indian regulatory framework for derivatives is mostly consistent with the international practices, some elements of financial infrastructure need to be strengthened. It is suggested that the bankruptcy and insolvency laws should clearly prescribe providing due concern to rights of securities holders on winding up or on insolvency of intermediaries and multilateral netting procedures in novation.

## 4.2 Transparency of derivatives transactions and financial stability

The Basel Committee on Banking Supervision and IOSCO Technical Committee have presented recommendations for public disclosure of trading and derivatives activities of banks and securities firms which could also be used by such non-financial companies that make material use of complex financial products. These recommendations emphasize the importance of transparency in promoting financial stability. It is observed that transparency based on meaningful public disclosure plays an important role in reinforcing the efforts of supervisory authorities in encouraging the sound risk management practices and promoting financial market stability (IOSCO 1999). This goes beyond simple accounting treatment of derivatives in the books of the clients or participants. Enhanced transparency would also benefit bank and securities firms themselves by enhancing their ability to evaluate and manage their exposures to counterparties. Institutions should, therefore, provide meaningful information, both qualitative and quantitative, on the scope and nature of trading and derivatives activities and elaborate how these activities contribute to their earning profile.

Accounting and valuation and reporting requirements for forward rate agreements and interest rates swaps have been prescribed in the RBI guidelines (for regulatory reporting), to all scheduled commercial banks, primary dealers and All India Financial Institutions by RBI in July 1999. However, what is being suggested is that the IOSCO principles would need to be suitably incorporated (through a statutory mandate) in the public disclosure of trading and derivatives activities of banks and securities firms.

The disclosure should be on the major risks associated with their trading and derivatives activities including credit risk, market risk, liquidity risk, operational risk, legal risk and reputational risk. Further, institutions should also disclose about their performance in managing these risks. The qualitative disclosures should also describe the accounting policies and methods of income recognition that are used for trading activities and non-trading derivatives activity. Since the accounting practices for derivatives are not consistent across countries it is important that an institution sufficiently describes the accounting treatment of its derivatives holdings. These qualitative disclosures may include the methods used to account for derivatives, criteria for each accounting method used (for example criteria for recognizing hedges), policies and procedures followed for netting, assets and liabilities of derivatives transactions, methods used to determine the fair value of traded and non-traded derivatives instrument, nature and justification for reserves for valuation adjustments against instruments or portfolios. In order that disclosures are consistent with innovations in risk measurement and management techniques, institutions should also make disclosures produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing these exposures.

## 4.3 Declaring transactions in derivatives as non-speculative

The derivatives markets have three categories of participants - hedgers, speculators and arbitrageurs. Viewed from the perspective of risk management, derivatives markets are an interplay of hedgers and speculators, i.e., those who are risk averse need to have a counterparty who are risk takers. That is why it is absolutely essential that while taking decisions about various aspects of derivatives trading, such as taxation, accounting etc. a balance needs to be struck between the interests of hedgers as well as speculators (Sahoo, 2000).

There are no specific tax provisions for derivatives transactions under the Income Tax Act, 1961. However, some provisions have indirect relevance for derivatives transactions. Under section 73(1) of the Income Tax Act, 1961 any losses on speculative business are eligible for set off against profits and gains of speculative business only, up to a maximum of eight years. The section 43(5) of the Income Tax Act, 1961 defines a speculative transaction where the contract for purchase or sale of any commodity,

including share, is settled otherwise than by actual delivery. There are exceptions given to jobbing/arbitrage transactions and hedging of underlying positions. It follows that a transaction is speculative if it is settled otherwise than by actual delivery. The hedging and arbitrage transactions, even though not settled by actual delivery, are considered non-speculative. Thus, a speculative transaction is one which is (i) a transaction in commodities/ shares, (ii) settled otherwise than actual delivery, (iii) the participant has no underlying position, and (iv) the transaction is not for jobbing/arbitrage.

In the absence of a specific provision regarding taxability of income from derivatives in the Income Tax Act, 1961, it is apprehended that derivative contracts are treated as "speculative" in nature and therefore, the losses, if any, will not be allowed to be set-off against any other income of the assessee, but only speculative income, up to a maximum of eight years. However, derivative contracts are not undertaken for purchase/sale of any commodity, stock or scrip, but are a special class of securities under the SCRA. Derivatives contracts, particularly, the index futures are always cash settled (because delivery of an index is an impossibility). At least one of the parties to a derivatives contract is a hedger or an arbitrageur. Therefore, treating derivatives transaction as speculative would amount to penalizing hedging transactions, which the securities laws seek to promote.

Derivative transactions serve economic purpose of price discovery, hedging, portfolio balancing, enhanced liquidity and cost effective way of risk management. Further, these transactions are under a regulatory framework of the stock exchanges recognized by SEBI. Any administrative attempt to ascertain if the transaction is for speculation, hedging or arbitrage, in the absence of objective criteria, may result in arbitrary outcomes and open numerous litigations at the time of assessment.

A transaction is construed as speculative, if a participant enters into a hedging transaction in shares outside his holdings. It is possible that an investor does not have all the 30 or 50 stocks represented by the index. As a result, it is apprehended that an investor's losses or profits out of derivatives transactions, even though they are of hedging nature, may be treated as speculative. This is contrary to capital asset pricing model, which states that portfolios in any economy move in sympathy with the index although the portfolios do not necessarily contain any security in the index. The index futures are, therefore, used for hedging the portfolio risk of even non-index stocks. An investor who does not have the index stocks can also

use the index futures to hedge against the market risk as all the portfolios have a correlation with the overall movement of the market (i.e., index).

To summarise, in view of (i) practical difficulties in administration of tax for different purposes of the same transaction, (ii) innate nature of a derivative contract requiring its settlement otherwise than by actual delivery, (iii) need to provide level playing field to all the parties to derivatives contracts (which includes hedgers as well as speculators and treating the income of all parties to a derivatives contract equitably), and (iv) and the need to promote the economic purpose of future price discovery, hedging and risk management in the securities market, it is suggested that the exchange-traded derivatives contracts are exempted from the purview of speculative transactions. These must, however, be taxed as normal business income or capital gains at the option of the assessee. This would be fiscally more prudent since it would avoid arbitrary exercise of discretion and possible resultant litigation. This suggestion would need to be flagged to the tax authorities.

# 5 Issues for further development of OTC derivatives

## 5.1 Legality of OTC derivatives: International experience and lessons for India

Pursuant to the amendment made through the Securities Laws (Amendment) Act, 1999 in SCRA regarding legally permitted "derivatives", a doubt was raised about the legality of the OTC derivatives such as forward rate agreements and interest rate swaps permitted under RBI guidelines issued to banks, primary dealers and All-India financial institutions in July 1999. It was felt that these OTC derivatives could be deemed as illegal in view of express exemption to only exchange based derivatives from wagering contracts under SCRA. Efforts need to be made to examine solution to the issue so that the legality of OTC derivatives can be ensured. In this connection, it would be instructive to study the US experience of the recent past when the US Government was involved in clarifying the uncertainty in the OTC derivatives markets. The US efforts are documented in the report of the President's Working Group on Financial Markets (Report of The President's Working Group on Financial Markets 1999) entitled "Over the

Counter Derivatives Markets and the Commodity Exchange Act" and the Commodity Futures Modernization Act (CFMA) of 2000. The important features of the said Working Group and the Act are as follows:

Prior to the enactment of the CFMA, the Commodity Exchange Act (CEA) required that all futures contracts must be traded on regulated exchanges, off-exchange futures contracts were illegal and unenforceable. Thus, characterizing a swap or other OTC derivatives as a futures contract by a court or a regulator would have rendered it illegal and unforceable. The other limitation was that if the swap exemption from the off-exchange trading prohibition under the Futures Trading Practices Act of 1992 did not apply to OTC derivatives on securities it would imply that electronically traded swaps might be subject to CEA's exchange trading requirement. While the CFMA clarifies the status of individually negotiated swap agreements by "eligible contract participants" by exempting them from most provisions of the Securities Act 1933 and Securities and Exchange Act of 1934, however, it does subject such swaps to federal securities law prohibitions against fraud, manipulation and insider trading.

Since government regulation on a market can impair its efficiency, so, when evaluating the need for Government regulation, one must clearly identify the public policy objective(s) of the regulation. The primary public policy or purposes of the CEA are to deter market manipulation and to protect investors against fraud and other unfair practices. The President's Working Group thus considered whether regulation of OTC derivatives is necessary to achieve these public policy objectives of the said Act. Since these OTC derivatives transactions were between professional counterparties, the Working Group agreed that such regulation was unnecessary. The rationale for this position was that such OTC derivatives are not susceptible to manipulation, since a vast majority of such contracts are settled in cash based on a rate or price determined in a separate highly liquid market with a very large or virtually unlimited deliverable supply. Further, the prices established in such transactions do not serve a price discovery function. The professional counterparties, therefore, do not require the protection from fraud and unfair trade practices that CEA provides for retail investors. These counter parties can obtain redress under the laws applicable to contracts generally.

The Working Group also considered if the introduction of centralized trading and settlement mechanisms for purely bilaterally negotiated and

settled transaction would give rise to a need for additional regulation. In the case of electronic trading systems the Working Group came to a conclusion that regulation under CEA was not necessary and such systems could be excluded from the provisions of the said Act provided the contracts are not based on non-financial commodities with finite supplies and that the participants are limited sophisticated counterparties trading on a principal-to-principal basis. Electronic trading systems need to be regulated in a limited sense if these came to serve a price discovery function. However, creation of a regulatory system for such systems in anticipation of problems was inappropriate. In the case of clearing systems for OTC derivatives the Working Group came to a conclusion that Government oversight is appropriate. Clearing tends to concentrate risk and responsibilities for risk management in a central party. Therefore effectiveness of the clearing entities' risk management is critical for the stability of the markets that it professes to serve. Depending on the types of transactions cleared such oversight might appropriately be conducted by CFTC under the CEA or by Securities and Exchange Commission, the Federal Reserve or the Office of Comptroller of the Currency or a Foreign Financial Regulator that the appropriate US regulator has determined satisfies appropriate standards. Provided such oversight of the government is in existence, OTC transactions that would otherwise be excluded from the CEA should not fall within the ambit of the said Act simply because they are cleared.

The Working Group also dealt with other issues such as improvements in the close out netting regime for derivatives and other financial instruments under the bankruptcy code and bank insolvency law. There were proposals to expand and clarify definitions of the financial contracts eligible for netting and to explicitly allow eligible counterparties to net across different type of contracts. Further, there was a proposal to clarify the netting regime for certain financial contracts in the case of a bank failure.

The first lesson learnt from the said Working Group report and CFMA is that it could be clarified that such transactions are not covered under the securities laws in India because this may require compulsory trading on recognized stock exchanges if such transactions are to be legally valid. However, it seems that this course of action is not legally permissible. Since these OTC contracts are not "securities" under SCRA, SCRA is not the place to give specific exemption to such contracts. A better option is

to propose that there should be a second proviso in the Section 30 of the Indian Contracts Act as follows (the amendments are highlighted):

"Section 30 of the Indian Contract Act (Act IX of 1972) be and is hereby amended in the following manner:

(Paragraph 2 of section 30 be and is hereby substituted as follows:)

Agreements by way of wager are void; and no suit shall be brought for recovering anything alleged to be won on any wager, or entrusted to any person to abide the result of any gain or any uncertain event on which any wager is made.

**This section shall not be deemed to render unlawful:-**

1. **a subscription, or contribution, or agreement to subscribe or contribute, made or entered into for or toward any plate, prize or sum of money, of the value or amount of five hundred rupees or upwards to be awarded to the winner or winners of any horse-race;**
2. **a contract relating to derivatives or derivative products.**

**Explanation:**

**For the purposes of this section, derivative means any financial product which gives one party the right or an option to make a claim on an underlying asset at some point in the future and binds another party to meet a counter-balancing obligation and includes option, futures and swaps, whether traded on a recognized exchange or over the counter (OTC).**

Nothing in this section shall be deemed to legalise any transaction connected with horse-racing to which section 294A of the Indian Penal Code apply."

This will provide only negative protection to derivative contracts. However, there will be still no mechanism except general law of contracts in India, which would give positive protection to these contracts so as to reduce the counter party risk associated with such contracts. Since the other financial infrastructure, which exists in developed countries, is not available here, besides the other measures suggested below, a provision including a separate legislative provision, may have to be made, which may include eligible entities who can enter into such transactions, the broad parameters for such contracts, clearing and settlement, and effective and expeditious dispute resolution mechanism.

The second lesson learnt is that if electronic trading systems are used for OTC derivatives transactions such systems could be allowed to grow unburdened by a new anticipatory statutory structure that could prove entirely inappropriate to their eventual evolution. Thirdly, a clear basis could be provided through an appropriate legislation for regulation of clearing systems that may develop for OTC derivatives. Fourthly, appropriate netting regime for certain financial contracts and for eligible counterparties to net across different types of contracts could be instituted under the insolvency law which would have due concern for security holders.

## 5.2 Risk Management for OTC Derivatives

The report of the Bank for International Settlements (BIS) on "OTC Derivatives: Settlement Procedures and Counterparty Risk Management" (Bank for International Settlements 1998) makes a series of recommendations for actions by derivatives counterparties, prudential supervisors and central banks that could reduce risks to the participants and to the financial system. These need to be flagged to the statutory regulators.

- Both the derivatives counterparties and prudential supervisors should ensure that the "master agreements" and "confirmations" for OTC derivatives should always be executed in time. The backlogs and associated risks should always be strictly monitored, since some jurisdictions permit close-out netting upon a counterparty's insolvency only if the parties had entered into a "master agreement." Thus, failure to sign a master agreement may jeopardize a dealer's ability to enforce close-out netting in the event of its counter party's default.
- Since an enforceable collateral agreement generally reduces counterparty credit risk and thereby enhances the stability of OTC derivatives markets, wherever necessary, legal uncertainty about the enforceability of collateral agreement should be reduced.
- Further, since a clearing entity has the potential to mitigate each of the types of counterparty risks associated with OTC derivatives, the central banks and prudential supervisors of counterparties should ensure that there are no unnecessary legal or regulatory barriers to the establishment of clearing entities for OTC derivatives. It is observed that safeguards that have proved effective in clearing entities for exchange-traded derivatives appear likely to be effective for OTC derivatives as well.

## 6 Conclusion

The article traces the evolution of regulatory framework and how it facilitated the development of derivatives trading in India. It also suggests some concrete measures to further develop the derivatives markets. These relate to basically strengthening the financial infrastructure including payment system and providing due concern to the security holders in the event of insolvency situation in multilateral netting contracts. The tax treatment of derivatives needs to be formulated to accord non-discriminatory treatment for all the participants in the derivatives transactions. Importance of adequate disclosures in the derivatives transactions by banks and securities firms for their own success and for financial stability are flagged for the statutory regulators so that these could be further strengthened. The legality of OTC derivatives market needs to be clarified lest the risk management tools should themselves become victims of legal risk.

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# Annexure 1

## Comparative Chart of International Regulation of Derivatives Market and Regulatory Framework in India

A global survey on the common objectives of regulation of derivatives market was conducted and the regulatory summaries of the practices are contained in the IOSCO report on the International Regulation of Derivatives Markets, Products and Financial Intermediaries issued in December 1996. International regulatory practices to meet the goals of market efficiency and integrity, customer protection/fairness and financial integrity of 21 regulators across the globe and regulatory framework in India are summarized as below:

| International Regulatory Practices | Indian Regulatory Framework |
|---|---|
| **Market Efficiency & Integrity** | |
| Official recognition and authorization by statute for derivatives markets | Yes |
| Specific recognition of derivatives products under law and satisfaction of economic utility criteria | Yes |
| Product Design Standards contract design to address the functional priorities of risk shifting and price discovery | Yes |
| Market disruption and surveillance Prohibition of market manipulation | Yes |
| Direct Surveillance, position limits, administrative or civil sanctions and other measures as well as direct regulatory oversight | Yes |
| Large trader reporting system | Yes |
| Trading Rules | |
| To permit fairness | Yes |
| Audit trail | Yes |
| Same day dissemination of price and volume information on an aggregate basis to increase transparency | Yes |
| **Customer Protection/Fairness Regulation** | |

(Continued...)

| International Regulatory Practices | Indian Regulatory Framework |
|---|---|
| Authorisation based on fitness requirements relating to qualification and good standing | Yes |
| Fair order execution requirements. “Customer first rule” in dual capacity trading | Yes |
| Sales practice standards including required disclosures, prohibition on misrepresentation and unauthorized trading | Yes |
| Monitoring of compliance with sales practices | Yes |
| Creation and maintenance of records on transactions including executed confirmations and information to customers | Yes |
| **Financial Integrity Regulation** | |
| Capital based qualifications for financial intermediaries | Yes |
| Adequate clearing and payment facilities | Yes, partially |
| Margin requirements and regulatory oversight over levels of margins | Yes |
| Use of credit with some credit restrictions | Yes |
| Monitoring of financial compliance by regulators | Yes |
| Protection of customer fund including segregation of customer funds from those of the firms and performance guarantee | Yes |
| Compensation type funds | Yes |
| Clearing guarantee which permits multilateral netting by novation | Yes |
| Enforceability of multilateral netting by clearing entities under the insolvency laws and priority treatment | No |
| Maintenance and retention of financial records | Yes |
| Contingency planning | Yes |

# Appendices