CHAPTER IV

REGULATION OF FINANCIAL DERIVATIVES: INDIAN SCENARIO

In India, the regulation of financial instruments has a chequered history. India had its own unique derivative products such as "*Badla*s" and there were market-made rules governing the regulation of these products. The English, while dealing with Indian merchants were initially applying local law of India. However, with the increasing influence of English Common law, the principles of English Common law began to be applied to contracts which have the nature of financial instruments. Subsequently, when wagers fell in favour from Victorian ideals, the provincial Gaming Acts came to be enacted in India. In 1872, Indian Contract Act codified the law of contracts in India, and S. 30 of Indian Contract Act contain a prohibition of wagers, which was none other than an extension of ban on wager under provincial gaming statutes. After India became Independent, the socialistic ideals promoted promulgation of Forward Contracts(Regulation) Act[1], and Securities Contract (Regulation) Act[2], that would go on to ban the derivative products from the Indian scene. In the wake of liberalisation of 1990's the government policy changed, and these instruments became recognised through the various amendments to SCRA and FCRA. Payments and Settlements Act, 2007 also contain a definition of derivatives. The Impact of the regulation of financial instruments and the need for

[1] Hereinafter referred to as FCRA.
[2] Hereinafter referred to as SCRA.

evolving a better framework that the existing regulations prompted the Government of India to set up Financial Sector Legislative Reforms Committee to suggest comprehensive guidelines for regulation of these instruments. A bird's eye view of Indian regulatory scenario is undertaken in the following pages.

OVERVIEW OF REGULATORY FRAMEWORK AND AGENCIES IN INDIA:

As per the reference note published by Lok Sabha Secretariat for use of Members of Parliament entitled "Financial Sector in India: Regulations and Reforms"[3], India has over 60 Acts and multiple rules / regulations that govern the financial sector. According to the paper, many laws from the 1950s and the 1960s have an emphasis on banning certain financial activity, rather than on establishing regulatory structures. In fact, the article makes an interesting note about the legislations and the timely amendment process: "The result is frame works which is at times complex, ambiguous, and inconsistent and occasionally open to regulatory arbitrage." However, it has to be seen that of these 60 statutes, most of them are statutes establishing various financial institutions[4]. Some of these are substantive

[3] "Financial Sector in India: Regulations and Reforms", Reference Note .No. 15 /RN/Ref./August /2013, Lok Sabha Secretariat, Parliament Library and Reference, Research, Documentation and Information Service (LARRDIS), available in http://164.100.47.134/intranet/financialsectorinindia .pdf, accessed on 26.04.2015 at 16.10 hrs.

[4] Some of the statutes establishing financial markets are as follows: The Securities Contracts (Regulation) Act, 1956 (42 of 1956), The Depositories Act, 1996 (22 of 1996), The Public Debt Act, 1944 (18 of 1944), The Government Securities Act, 2006 (38 of 2006), The Foreign Exchange Management Act, 1999 (42 of 1999), The Banking Regulation Act, 1949 (10 of 1949), The Forward Contracts (Regulation) Act, 1952 (74 of 1952), The Payment and Settlement Systems Act, 2007 (51 of 2007), The Insurance Act, 1938 (4 of 1938), The Reserve Bank of India Act, 1934 (2 of 1934), The Securities and Exchange Board of India Act, 1992 (15 of 1992), The Deposit Insurance and Credit Guarantee Corporation Act, 1961 (47 of 1961), The Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970(5 of 1970), The Acts establishing bodies corporate involved in the financial sector (for example, The State Bank of India Act, 1955 (23 of 1955) and The Life Insurance Corporation Act, 1956 (31 of 1956).

legislations. Others are promulgated for establishment of various regulatory agencies, and more or less lays down the institutional framework for the financial market regulations in India. Apart from these there are several state legislations like the Gaming Acts which is making inroads into financial markets by preventing certain specific activities. According to Financial Sector Legislative Reforms Commission,[5] the current Indian laws relating to financial markets are sectorial in nature and are organized around sub-sectors of finance such as securities, insurance or payments[6].

Regulatory Agencies:

In India, the regulatory bodies that work in the financial regulatory scheme are Reserve Bank of India,[7] Securities and Exchange Board of India,[8] Forward Markets Commission,[9] Insurance Regulatory and Development Authority,[10] Pension Fund Regulatory and Development Authority,[11] Ministry of Corporate Affairs,[12] Ministry of Finance[13] and High Level Coordination Committee.[14]

These bodies work primarily within the constitutional scheme and also within the framework of general law of contracts in addition to the statutory framework mentioned above. In fact, it would be interesting to note that one of the very first

[5]Hereinafter referred to as FSLRC.
[6] *Report of the Financial Sector Legislative Reforms Commission*, Vol. I, available at http://finmin.nic.in/fslrc/fslrc_index.asp, accessed on 10.05.2015 at 20.39 hrs, at p. 12.
[7] Hereinafter referred to as RBI.
[8] Hereinafter referred to as SEBI.
[9] Hereinafter referred to as FMC.
[10] Hereinafter referred to as IRDA.
[11] Hereinafter referred to as PFRDA.
[12] Hereinafter referred to as MCA.
[13] Hereinafter referred to as MoF.
[14] Hereinafter referred to as HLCC.

cases that went to the Judicial Committee of Privy Council from India was regarding the Opium wager popularly known as the Opium cases[15], where the Privy Council considered Hindu Law relating to wager. Erskin Perry in his classic work *Cases Illustrative of Oriental Life*[16] provides the complete text of these cases. While in a 1847 case *Ramlal Thakursidas* v. *Sujanmal Dhondmal*[17], Supreme Court of Bombay, through Pollock C.J. and Perry J, had held that though time bargains for goods may be enforced even if they are admitted by parties to be mere wagers; provided they do not come within established exceptions, quoting *Bryan* v. *Lewis*[18] the tendency of the wagers, being to create ruinous loss and to disturb the opium trade make them void as opposed to public policy.[19] Subsequently when the matter was taken to Privy Council, the Privy Council speaking through Lord Langdale, Lord Campbell, Dr. Lushington and Mr. Pemberton Leigh, held that the wagers in question were legal and not opposed to public policy, and also opined that the legislature at Calcutta may consider incorporating into statute a ban on such contracts if required. Consequent to these cases, when the Indian Contract Act was drafted, Sections 23 and 30 were incorporated to create a statutory ban on wagers. Most often the defence taken by the opposite side would be based on the fact that these types of agreements are wagering agreements and hence they are void and

[15]See Erskine Perry, *Cases Illustrative of Oriental Manners Decided in the H.M. The Supreme Court at Bombay: The Application of English Law to India*, Asian Educational Services, Bombay (1988).
[16]*Id at p. 178.*
[17]Contract between the parties amounted to a be a wager up on average price which Opium should fetch at the next government sale at Calcutta, so that if the price falls below an agreed price, one party will have to pay the other party, the difference between this price and the sum fixed, and vice versa, if the price comes above the agreed price.
[18] See *Supra* n. 15 at p. 188.
[19]*Id* at p. 192.

unenforceable by a court of law. Indian law is replete with examples of such contracts. This makes it imperative to understand the law relating to Contract Act and the interpretation given by court to derivative contracts. Before going to that, it is also essential to understand a more basic theme: Legislative Competency, for which a clearer understanding of the Constitutional Provisions relating to the power to legislate about financial markets and products is a must.

CONSTITUTION AND FINANCIAL MARKET REGULATION

Indian Constitution provides for a framework within which the regulatory agencies have to operate in the country. The legislative scheme outlined by Art. 246[20] of the Constitution of India states that the appropriate legislative body has power to regulate the "matters enumerated in" the relevant List of 7th Schedule. Part XI read with 7th Schedule of the Constitution provides the guidelines for legislative process. According to this Constitutional scheme, Parliament of India have exclusive authority to make laws on subjects coming in List I and State Legislatures shall have exclusive authority to make laws regarding any matter which comes within List II of the 7th Schedule. Both the Parliament of India and State Legislatures have concurrent power to make laws regarding the matters enumerated in List III of the 7th Schedule of the Constitution of India.

[20]Art. 246 read as follows: "(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in the Constitution referred to as the "Union List). (2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the "Concurrent List"). (3) Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters enumerated in List II in the Seventh Schedule (in this Constitution referred to as the "State List"). (4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included in a State notwithstanding that such matter is a matter enumerated in the State List.

Articles 249-255[21] provides guidelines in case of conflict between the legislative powers. Entry 43 of List I of Schedule 7 of Constitution of India reads as follows: "Incorporation, regulation and winding up of trading corporations, including banking, insurance and financial corporations, but not including co-operative societies. Entry 47 mentions "insurance" whereas Entry 48 mentions "stock exchanges and futures market." A perusal of the legislative scheme under which SEBI and IRDA works would make it clear that these bodies are established to regulate the "securities market" and "insurance business" and "re-insurance business". The term "securities market" is not defined in SEBI Act, but Sub Clause (2)(a) of Section 11 of SEBI Act gives an indication that it means any marketplace dealing in securities similar to stock exchanges. The other provisions of Section 11 also gives an indication that SEBI Act deal with entities and not the business of securities, though SEBI can regulate the market through regulation of entities which play in the market. Entry 34 of List II states "Betting and Gambling". Entry 7 of List III reads as "Contracts, including partnership, agency, contracts of carriage and other special forms of contracts, but not including contracts relating to agricultural land" and Entry 8 is "Actionable Wrongs" and Entry 9 and 10 are "Bankruptcy and Insolvency" and "Trusts and Trustees" respectively. Thus, it can

[21]Article 249 deals with the Power of Parliament to legislate with respect to a matter in the State List in the national interest. Article 250 deals with the Power of Parliament to legislate with respect to any matter in the State List if a Proclamation of Emergency is in operation. Article 251 deals with Inconsistency between laws made by Parliament under articles 249 and 250 and laws made by the Legislatures of States. Article 252 deals with the Power of Parliament to legislate for two or more States by consent and adoption of such legislation by any other State. Article 253 provides for Legislation for giving effect to international agreements. Article 254 provides to deal with situation of Inconsistency between laws made by Parliament and laws made by the Legislatures of States. Article 255 provides for Requirements as to recommendations and previous sanctions to be regarded as matters of procedure only.

be seen that there is no clear indication in the constitutional scheme regarding the regulation of financial derivatives, though by virtue of the entries nos.43, 47 and 48 of List I, Parliament of India has got the exclusive legislative power to legislate regarding the financial markets. At the same time, in case financial derivatives are considered as a type of betting, their regulation comes within the exclusive domain of respective states, and if they are contracts or actionable wrongs, the responsibility of making legislation on them are shared by both Central and State governments. To sum up, there is clear ambiguity in the Constitutional scheme regarding the regulation of financial derivatives, and SEBI or RBI can regulate these instruments only if they come within their respective domain.

CONTRACT LAW AND REGULATION OF FINANCIAL DERIVATIVES

Indian Contract Act, 1872, deals almost comprehensively with the general law of contracts in India. S. 23 of Indian Contract Act states that

> "The consideration or object of an agreement is lawful, unless-
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> it is forbidden by law; or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies, injury to the person or property of another; or the Court regards it as immoral, or opposed to public policy.

In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.

The main contention that is being raised before the courts is that contracts creating such monetary instruments, being wagering agreements are opposed to public policy. This in turn takes us to the question as to what is wagering agreements.

S. 30 of the Indian Contract Act, 1872 states 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 game or other uncertain event on which any wager is made.

It is to be noted that the Indian Contract Act does not define what is a wagering agreement, but only makes it void.

OTHER STATUTES

Securities Contracts (Regulation) Act, 1956

SCRA provides that the central government has power to declare certain contracts, either in general or those executed in certain areas as illegal or void, as the case may be.[22] It also vests power in the Central Government to license dealers in certain areas and in respect of certain securities. However, by virtue of S. 18 of the said Act, Spot delivery contracts were brought outside the purview of regulations under S. 13 to 17 of the said Act. More important to our context, S. 18A reads as follows:

> Notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are-
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> (a) traded on a recognised stock exchange;
>
> (b) settled on the clearing house of the recognised stock exchange, in accordance with the rules and bye-laws of such stock exchange

[22]See Ss. 13, 14 and 16 of the SCRA, 1956.

Section 18A was introduced in the statute book by the amendment to Securities Laws with effect from 22.02.2000. Though in the original statute, there was a prohibition in trading in options in Section 20 of the Act, the same was repealed by Securities Laws Amendment Act, 1995.

In the context of our discussion on regulation, it is also pertinent to keep in mind that Section 12A[23] deals with the power of SEBI to give directions, Section 21[24] lays down the conditions for listing, Section 31[25], provides the power of SEBI to

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[23] S. 12A: Power to Issue Directions: If, after making or causing to be made an inquiry, the Securities and Exchange Board of India is satisfied that it is necessary--
(a) in the interest of investors, or orderly development of securities market; or
(b) to prevent the affairs of any recognised stock exchange or clearing corporation, or such other agency or person, providing trading or clearing or settlement facility in respect of securities, being conducted in a manner detrimental to the interests of investors or securities market; or
(c) to secure the proper management of any such stock exchange or clearing corporation or agency or person, referred to in clause (b),
it may issue such directions,-
(i) to any stock exchange or clearing corporation or agency or person referred to in clause (b) or any person or class of persons associated with the securities market; or.
(ii) to any company whose securities are listed or proposed to be listed in a recognised stock exchange, as may be appropriate in the interests of investors in securities and the securities market.
[24] S. 21: Conditions for Listing: Where securities are listed on the application of any person in any recognised stock exchange, such person shall comply with the conditions of the listing agreement with that stock exchange.
[25] S.31: Power of Securities and Exchange Board of India to Make Regulations: (1) Without prejudice to the provisions contained in section 30 of the Securities and Exchange Board of India Act, 1992 (15 of 1992), the Securities and Exchange Board of India, may, by notification in the Official Gazette, make regulations consistent with the provisions of this Act and the rules made thereunder to carry out the purposes of this Act.
(2) In particular, and without prejudice to the generality of the foregoing power, such regulations may provide for all or any of the following matters, namely:--
(a) the manner, in which at least fifty-one per cent. of equity share capital of a recognised stock exchange is held within twelve months from the date of publication of the order under sub-section (7) of section 4B by the public other than the shareholders having trading rights under sub-section (8) of that section;
(b) the eligibility criteria and other requirements under section 17A.
(3) Every regulation made under this Act shall be laid, as soon as may be after it is made, before each House of Parliament, while it is in session for a total period of thirty days which may be comprised in one session or in two or more successive sessions, and if, before the expiry of the session immediately following the session or the successive sessions aforesaid, both Houses agree in making any modification in the regulation or both Houses agree that the regulation should not be made, the regulation shall thereafter have effect only in such modified form or be of no effect,

make rules and Section 9 deals with the power of recognised stock exchanges to create rules, In addition to the above, Sections 23A to H of the Act, provide for punishment of the members of the recognised stock exchanges for failure to comply with the disclosure requirements mentioned in the bye laws of such stock exchanges, and performance of the fiduciary duty cast on them as members of these stock exchanges.

A perusal of the said legal provisions would show that as per the existing legal framework, SEBI is vested with the role of supervision over the Stock Exchange Brokers and other participants in the derivatives market. It is also seen, that by virtue of Section 18A[26] of SCRA, exchange traded derivative products have been made perfectly legal in India. As the wording of this Section is couched in a positive terminology, even over-the-counter derivatives cannot be said to be illegal, after the introduction of Section 18A to this statute.

Forward Contracts (Regulation) Act, 1952

There is one more statute that deals with regulation of derivative products- FCRA. The purpose of the Act was to regulate the commodity futures trade in India. Till it was repealed, Section 19 of FCRA read as follows:

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as the case may be; so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that regulation.

[26] 18A. Contracts in derivative: Notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are - (a) traded on a recognised stock exchange; (b) settled on the clearing house of the recognised stock exchange, in accordance with the rules and bye-laws of such stock exchange.

(1) Notwithstanding anything contained in this Act or in any other law for the time being in force, all options in goods entered into after the date on which this Section comes into force shall be illegal.

(2) Any option in goods which has been entered into before the date on which this Section comes into force and which remains to be performed, whether wholly or in part, after the said date shall, to that extent, become void.

Further, Forward contracts in certain commodities can be regulated by notifying those commodities under Section 15[27] of the Act; forward trading in certain other

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[27] 15. *Forward contracts in notified goods illegal or void in certain circumstances*. - (1) The Central Government may, by notification in the official Gazette, declare this section to apply to such goods or class of goods and in such areas as may be specified in the notification, and thereupon, subject to the provisions contained in Section 18, every forward contract for the sale or purchase of any goods specified in the notification which is entered into in the area specified therein otherwise than between members of a recognised association or through or with any such member shall be illegal. (2) Any forward contract in goods entered into in pursuance of sub-section (1) which is in contravention of any of the bye-laws specified in this behalf under clause (a) of sub-section (3) of Section 11 shall be void- (i) as respects the rights of any member of the recognised association who has entered into such contract in contravention of any such bye-law and also, (ii) as respects the rights of any other person who has knowingly participated in the transaction entailing such contravention. (3) Nothing in sub-section (2) shall effect the right of any person other than a member of the recognised association to enforce any such contract or to recover any sum under or in respect of such contract: Provided that such person had no knowledge that such transaction was in contravention of any of the bye-laws specified under clause (a) of sub-section (3) of Section 11. (3A) Any forward contract in goods entered into in pursuance of sub-section (1) which at the date of the contract is in contravention of any of the bye-laws specified in this behalf under clause (aa) of sub-section 3 of Section 11 shall be illegal. (4) No member of a recognised association shall, in respect of any goods specified in the notification under sub-section (1), enter into any contract on his own account with any person other than a member of the recognised association unless he has secured the consent or authority of such person and disclose in the note, memorandum or agreement of sale or purchase that he has bought or sold the goods, as the case may be, on his own account: Provided that where the member has secured the consent or authority of such person otherwise than in writing he shall secure a written confirmation by such person of such consent or authority within three days from the date of such contract: Provided further that in respect of any outstanding contract entered into by a member with a person other than a member of the recognised association, no consent or authority of such person shall be necessary for closing out in accordance with the bye-laws for outstanding contract, if the member discloses in the note, memorandum or agreement of sale or purchase in respect of such closing out that he has bought or sold the goods, as the case may be, on his own account.

commodities can be prohibited by notifying these commodities under Section 17[28] of the Act.

It should be noted that despite this prohibition, both RBI and SEBI guidelines refer to Options in Interest Rates and Foreign Exchange. While an argument can be taken that these are not goods per se, it has been recognised in SEBI guidelines that there are options on indices, including commodity indices.

Originally the Act had its own regulatory body namely Forward Markets Commission. Very recently, with effect from 28.09.2015, Forward Markets Commission has been merged with SEBI, and the FCRA stood repealed from that date. The powers that were vested with Forward Markets Commission are now vested with SEBI.

REGULATORY BODIES

As noted in previous sections, there are the following nine regulatory bodies in India to regulate financial sector. These are: (1) RBI (2) SEBI (3) FMC (4) IRDA (5) PFRDA (6) MCA (7) MoF and (8) HLCC. The regulatory role of each of these agencies is examined next.

[28] 17. *Power to prohibit forward contracts in certain cases*. - (1) The Central Government may, by notification in the official Gazette, declare that no person shall save with the permission of the Central Government, enter into any forward contract for the sale or purchase of any goods or class of goods specified in the notification and to which provisions of Section 15 have not been made applicable, except to the extent and in the manner, if any, as may be specified in the notification. (2) All forward contracts in contravention of the provisions of sub-section (1) entered into after the date of publication of the notification thereunder shall be illegal. (3) Where a notification has been issued under sub-section (1), the provisions of Section 16 shall in the absence of anything to the contrary in the notification, apply to all forward contracts for the sale or purchase of any goods specified in the notification entered into on or before the date of notification] and remaining to be performed after the said date as they apply to all forward contract for the sale or purchase or any goods specified in the notification under Section 15.

Securities and Exchange Board of India:

The SEBI was created on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.[29] It is aimed to protect the interests of investors in securities and to promote the development of and to regulate the securities market and for matters connected therewith or incidental thereto. It consists of a Chair Person and eight member of which four, including Chairman are permanent and four members are part time. The part time members include two members nominated by the Central Government, under S. 4(1) (b) of SEBI Act from officials of the Finance Ministry and Company Affairs and one member from amongst the officials of RBI.

By virtue of the powers vested in it, SEBI has come out with its own guidelines for dealing in derivative products, by its Master Circular on Matters relating to Exchange Traded Derivatives.[30] A perusal of the said of Master Circular would show that it provides for near comprehensive guidelines with respect to (a) Index- Futures and Options (b) Stock- Futures and Options (c) Currency- Futures and Options (d) Interest rate futures on 10 year GOI Security(e) Interest Rate Futures on 91-Day Government of India (GoI) Treasury-Bill (TBill) (f) Interest Rate Futures on 2 Year Notional Coupon Bearing Government of India (GoI) Security (g) Interest Rate Futures on 5 Year Notional Coupon Bearing Government of India (GoI) Security and (h) Derivative Contracts on Foreign Indices.

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[29]Hereinafter referred to as SEBI Act.

[30]Dated 1.04.2013 available in http://www.sebi.gov.in/sebiweb/home/list/1/6/0/0/Master-Circulars, accessed on 17.05.2015 at 22.49 hrs.

In the case of Index, Stock and Currency based products the regulations cover the broad areas such as (1) Product Design (2) Risk Management and (3) Surveillance and Disclosures.

In the case of futures products, in addition to the above three, eligibility criteria for participants such as Derivative Exchange / Derivative Segment of the Exchange, Trading Members, Clearing Corporation/House for equity derivatives is also defined through these guidelines.

Under the product design criteria, the guidelines cover (a) Underlying (b) Eligibility Criteria (c) Trading Hours (d) Size of the Contract (e) Quotation (f) Tenor of the contract (g) Available Contracts (h) Settlement Mechanism (i) Settlement Price (j) Final Settlement Day and (h) Application of money.

In Currency Options Contracts, the guidelines also cover the exercise at expiry of the contract is also laid down.

Under the Risk Management aspect, guidelines are laid down by SEBI for the requirement of (a) Liquid Assets[31](b) Bank Guarantees (c) Securities (d) Initial Margin Computation (e) Margins for Calendar Spreads (f) Exposure Limits (i) Real Time Computation (g) Cross Margining (h) Margin Collection and Enforcement and (i) Reporting and Disclosure.

[31]The guidelines require that the clearing members Liquid Net Worth at any point of time shall not be less than Rs. 50 Lakhs, and the marked to market value of gross open positions (notional value in respect of Index Features at any point of time of all trades cleared through the clearing member shall not exceed 33 1/3 times (1/4) of his liquid net worth). See 1.2 of SEBI Master Circular, *Supra* n. 30.

For currency futures, in addition to above, additional guidelines regarding (a) Formula for determining standard deviation (b) Portfolio based margining (c) Extreme Loss margin (h) Liquid net worth (i) Liquid assets (j) Mark to market settlement (k) Margin collection and enforcement (l) Safeguarding client's money and (m) Periodic risk evaluation report.

Under the Surveillance and Disclosure topic the guidelines deal with (a) Unique client code (b) Position Limits (c) Monitoring of Position Limits and (d) Surveillance System.

SEBI guidelines regarding the Interest Rate Futures under the head Product Design, Margins and Position Limits, the guidelines exist regarding (1) Underlying (2) Coupon (3) Trading Hours (4) Size of the Contract (5) Quotation (6) Tenor of the Contract (7) Available Contracts (8) Delivery Month and Delivery Period (9) Daily Settlement Price (10) Settlement Mechanism (11) Deliverable Grade Securities (12) Conversion Factor (13) Invoice Price (14) Delivery Schedule and Delivery Process/Mechanism (15) Last Trading Day (16) Last Delivery Day (17) Initial Margin (18) Extreme Loss Margin(19) Calendar Spread Margin (20) Model for Determining Standard Deviation (21) Formula for Determining Standard Deviation and (22) Position Limits.

Under the head Risk Management Measures the SEBI guidelines contain (1) Introduction (2) Portfolio Based Margining (3) Real-Time Computation (4) Liquid Net worth (5) Liquid Assets (6) Mark-to-Market (MTM) Settlement (7) Margin

Collection and Enforcement (8) Safeguarding Client's Money and (9) Periodic Risk Evaluation Report.

SEBI guidelines on derivative contracts on Foreign indices cover (1) Underlying (2) Criteria (3) Failure to meet Eligibility Criteria (4) Currency Denomination (5) Risk Management Framework (6) Position Limits (7) Information Sharing (8) Legal Compliance (9) Enforcement (10) Trading, (11) Corporate Action Adjustments (12) Reporting and Disclosure including Monthly Activity Report and Reporting of derivative transactions to the media and the newspapers (13) straight through processing,[32] (14) Certification (15) Introduction of Volatility and Bond Index, which includes In Volatility Index, Derivatives on Volatility Index , bond Index, modification of client codes and penalty structure (16) modification of client codes of Non-institutional Trades Executed on Stock Exchanges (All Segments). (17) Short-collection/Non-collection of client margins, (18) Liquidity Enhancement Schemes for Illiquid Securities in Equity Derivatives Segment and (19) Requirement of Base Minimum Capital for Trading Member.

It has to be noted that in the guidelines, mention is made under the head Regulatory and Legal Aspects, about SEBI-RBI Coordination committee. SEBI-RBI Coordination Committee has an interesting back ground, related to regulation of financial derivatives. In 1969, Government of India, by a notification banned forward trading in exercise of the powers conferred under Section 16 of the SCRA.

[32]A mechanism that automates the end to end processing of transactions of financial instruments. See page 106 of Master Circular on Matters relating to Exchange Traded Derivatives, available in http://www.sebi.gov.in/cms/sebi_data/attachdocs/1364810013011.pdf, accessed on 07.06.2016 at 21.18 hrs.

However, in 1972, Bombay Stock Exchange evolved an informal system of "forward trading" with the tacit approval of SEBI, to prevent decline of traded volumes on stock markets. This system allowed carry forward between two settlement periods, which resulted in substantial increase in the turnover of the exchange. During December 1982 - January 1983, the Government, in exercise of the powers under S. 10 of 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. Subsequently, in the light of a report of Joint Parliamentary Committee on Irregularities in Securities and Banking Transactions, 1992 (JPC of 1992), SEBI issued a directive in December 1993 prohibiting the carry forward of transactions. In 1995, and thereafter in 1997, SEBI reviewed this prohibition, permitting such transactions with a number of restrictions. On the other hand, in June 1992, RBI banned all repo transactions except treasury bills. This led to an anomalous situation, where some carry forward transactions were allowed, even when there was a general ban on all forward transactions. At this time, it was thought fit to amend the SCRA to give power to RBI along with SEBI to regulate these transactions. However, the question as to 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, remained unanswered. After the passing of Securities Laws Amendment Bill in 1999, the government lifted the ban on derivative products by notification on 01st March 2000. Subsequently, the government issued a notification delineating regulatory responsibility of RBI and SEBI. In 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. As per the notification, such contracts if executed on stock exchanges would be regulated by SEBI in a manner that is consistent with the guidelines issued by RBI. Initially, it was believed that SEBI and RBI were acting in different turfs, with no common regulatory objectives. At a time when these regulatory agencies were viewed as departments of government, there was no issue. Subsequently, when the regulatory agencies started working as independent regulators, regulatory conflicts arose. In order to resolve such conflicts, initially RBI-SEBI Coordination Committee was created. Subsequently, further regulatory disputes evolved between other regulators also. In 2009-10 a dispute arose between IRDA and SEBI regarding Unit Linked Insurance Products (ULIP). The main point of dispute was whether the ULIPs are insurance products or "collective investment scheme" as defined in Section 2(ba) read with Section 11 AA of SEBI Act, 1992. In order to resolve the dispute, the High Level Coordination Committee was formed.

In any case, the extent SEBI guidelines recognise that there is overlapping jurisdiction of the currency futures, and leaves the same to a SEBI-RBI Constituted Committee to sort out such issues.

The term "securities market" is not defined in SEBI Act, but Sub clause (2)(a) of Section 11 of SEBI Act gives an indication that it means any marketplace dealing in securities similar to stock exchanges. The other clauses of Section 11 also gives an indication that SEBI Act deal with entities and not the business of securities, though SEBI can regulate the market through regulation of entities which play in the market. Similarly IRDA Act also provides for regulation of entities playing in the insurance market. While it is true that these regulatory bodies also gets the power to regulate specific products through the entities floating the products, the thrust of regulation is always on the activities of the bodies which are regulated by these bodies. Thus, it is clear that the role of agencies like SEBI and IRDA are more generic in nature, viz, to control the market place rather than the specific products, which come within the purview of regulatory regime of SEBI. Only those entities venturing into any of the activities mentioned in the SEBI Act could be regulated by SEBI. Similar is the case of IRDA. As such it should be seen that those entities carrying on a business or activity that comes within the purview and already regulated by one of such authority should not normally come within the regulatory regime of the other.

These provisions have been responsible for non-overlapping of the regulatory powers in India. Further unlike many other countries, regulation through specialized agencies is a relatively new phenomenon in India. Till very recently regulation was mainly done through the various departments of the government itself. This is also one good reason why regulatory overlapping was not very frequent in India. However even during the time regulation was handled by the various departments of government, there were disputes as to the jurisdiction and powers of various departments. In most of these cases resolution was possible without going for a legal battle since the matter involved the same branch of the government. However since the evolution of regulation through self-sustaining corporate bodies, the dispute resolution has become more difficult especially since jurisdiction means power and no regulatory body would be willing to forgo the power that comes along with the jurisdiction. In order to avoid such regulatory dispute, Raghuram Rajan Committee on Financial Sector Reforms has proposed establishment of a Financial Stability and Development Council which the planning commission has said would solve most of the issues relating to regulatory competition. However, the government, in its wisdom initially set up High Level Coordination Committee (HLCC) on financial and capital markets, which had the all regulators as members, chaired by the RBI Governor. Subsequently, the Government thought it fit to introduce Securities and Insurance Laws (Amendment and Validation) Ordinance, 2010, which replaced HLCC with Financial Stability and Development Council (FSDC) - a joint committee headed by the Finance Minister, with the financial sector regulators (such as the RBI, the SEBI, the IRDA and the Pension Fund Regulatory and Development Authority) and Finance ministry officials as members. At present, there is a move to amend the RBI Act to take away money market regulatory powers from the RBI and bring it under the purview of market regulator SEBI[33]. There is also a proposal for merger of SEBI and FMC[34]. According to Financial Sector Legislative Reforms Committee

[33] See "SEBI Needs More Powers to Deal with FMC Issues: FSLRC Chief", March 10, 2015, http://www.moneycontrol.com/news/business/sebi-needs-more-powers-to-dealfmc-issues-fslrc-chief_1324670.html, accessed on 18.05.2015 at 23.00 hrs.
[34] *Ibid.*

Chairman Justice B.N. Srikrishna[35], the move is welcome as it would make both the regulators more autonomous and SEBI needs more power than at present at hand with it to deal with Forwards Market Commission issues.

Reserve Bank of India:

RBI, as the central banker of the country as well as the formulator of monetary policy guidelines for the financial sector is also involved in the regulation of these financial products. The role of RBI in regulating these products are in two dimensions: firstly as a central banker and secondly as the regulator of foreign exchange dealings. RBI has in place a Comprehensive Guidelines on Derivatives,[36] as modified in 2011, and the same is currently undergoing revision. At present RBI is circulating a Draft Comprehensive Guidelines on Derivatives,[37] intended to replace the present guidelines.

Draft RBI Guidelines start with defining derivatives, markets, participants, purpose and eligibility criteria. What is important about the definitions in comparison with SEBI guidelines is that while SEBI guidelines cover only exchange traded products, RBI guidelines recognise and brings Over the Counter Derivatives into the regulatory capture. It also recognises two types of participants in the derivatives transactions: (1) User, who participates in the derivatives market to manage an underlying risk and (2) Market Maker, who provides continuous bid and offer prices to users and other market-makers, even without having an underlying risk,

[35] *Ibid.*
[36] Circular DBOD No.BP.BC.86/21.04.157/2006-07 dated April 20, 2007.
[37] See RBI website at https://rbi.org.in/scripts/Bs_viewcontent.aspx?Id=457, accessed on 18.05.2015 at 23.24 hrs.

and specifies that at least one party to a derivative transaction should be a market maker. RBI guidelines also puts eligibility criterion for both market makers (Scheduled Commercial Banks (excluding RRBs) & Primary Dealers (PDs)) and users (any entity with identified underlying risk exposure). Market makers need to have RBI approval to operate as market makers in the desired markets. The draft guidelines provide for the following broad principles while undertaking derivative transactions, of which the six are mandatory and two optional.

1. Market-makers may undertake any derivative structured product (a combination of permitted cash and generic derivative instruments) as long as it is a combination of two or more of the generic instruments permitted by RBI and the market-makers should be in a position to mark to market or demonstrate valuation of these constituent products based on observable market prices. Hence, it may be ensured that structured products do not contain any derivative, which is not allowed on a stand-alone basis. Moreover, second order derivatives, like swaption, option on future, compound option, etc. are not permitted.
2. A user should not have a net short options position, either on a stand-alone basis or in a structured product, except to the extent of permitted covered calls and puts.
3. All permitted derivative transactions, including roll over, restructuring and novation shall be contracted only at prevailing market rates. Mark-to-market gain/loss on roll over, restructuring, novation, etc. should be cash-settled.

4. All risks arising from derivatives exposures should be analysed and documented.

5. The management of derivatives activities should be an integral part of the overall risk management policy and mechanism. It is desirable that the board of directors and senior management understand the risks inherent in the derivatives activities being undertaken.

6. Market-makers should have a 'Suitability and Appropriateness Policy' vis-à-vis users in respect of the products offered, on the lines indicated in these guidelines.

7. Market-makers and users regulated by RBI should not undertake any derivative transaction involving the rupee that partially or fully offset a similar but opposite risk position undertaken by their subsidiaries/branches/group entities at offshore location(s).

8. Market-makers may maintain cash margin/liquid collateral in respect of derivative transactions undertaken by users on mark-to-market basis, irrespective of the latter's credit risk assessment[38].

RBI guidelines recognise only the following types of derivative instruments at present:

These regulations also cover in detail risk management and corporate governance aspects, such as (a) Corporate governance (b) Board and senior management oversight, (c) Suitability and Appropriateness Policy (d) Documentation (e)

[38]See *Supra* n. 37

Identification of risk (f) Risk measurement (g) Risk Limits (h) Management Information Systems (i) Independent risk control (j) Operational controls (k) Internal audit (l) Prudential norms relating to derivatives (m) Prudential limits on derivatives and (n) Regulatory reporting and balance sheet disclosures.

The Master Circular identifies and defines seven types of risk in monetary instruments being such as derivatives, including (1) Credit Risk, which includes (a) Settlement Risk and (b) Pre-settlement Risk (2) Market Risk (3) Liquidity Risk, including market liquidity risk and funding risk (4) Operational Risk (5) Legal Risk (6) Regulatory Risk and (7) Reputation Risk and attempts to mitigate these risks.

So far as guidelines is that it gives clear recommendations on operational control is concerned, the RBI guidelines direct the entities to ensure complete operational control by (1) Segregation of duties (2) Trade Entry and Transaction Documentation (3) Confirmation Procedure that provide for a documentation trail, (4) Settlement and Disbursement Procedures [39] (5) Reconciliation Procedures [40] (6) Revaluation Procedure[41] and (7) Exception Reports[42].

A comparison of the guidelines issued by SEBI and RBI reveal that SEBI guidelines are more sector-specific whereas the RBI guidelines are more product-specific. In fact the regulatory understanding in India is that RBI's power of

[39] These provide for specific procedure for fund transfer and independent reconciliation of transferred funds with NOSTRO accounts and general ledger
[40] It requires audit trail and reconciliation of unusual items and any items outstanding for inordinately long period
[41] It require full documentation of revaluation rates and calculations, which need be obtained from or verified by a source independent of dealers, representative of market levels.
[42] These reports would track frauds, errors and losses

regulation is restricted to currency based or monetary derivatives[43], whereas SEBI is the regulator for all other types of derivative instruments. While SEBI guidelines speak to the consumer, RBI guidelines are intended to ensure that market players such as banks and Primary Dealers should comply with prudential norms and regulates behaviour of the market agents.

Forward Markets Commission:

Under the FCRA, the Forward Markets Commission (FMC) was the chief regulator of commodity futures markets in India. It consisted of not less than two but not exceeding four members appointed by the Central Government, out of them one being nominated by the Central Government to be the Chairman of the Commission. Initially the commission was acting as a department under Ministry of Consumer Affairs, Food and Public Distribution, but since September 2013, the Commission was moved under Ministry of Finance recognizing its importance in the monetary policy of the country.

Forward Markets Commission used to provide regulatory oversight in order to ensure financial integrity (i.e. to prevent systematic risk of default by one major operator or group of operators), market integrity (i.e. to ensure that futures prices are truly aligned with the prospective demand and supply conditions) and to protect and promote interest of customers /non-members.

The Forward Markets Commission used to prescribe the following regulatory measures:

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[43]See page 179

a) Limit on net open position as on the close of an individual operator and at Member level to prevent excessive speculation.
b) Circuit-filters or limit on price fluctuations to allow cooling of market in the event of abrupt upswing or downswing in prices.
c) Imposition of margins to prevent defaults by Members/clients.
d) Physical delivery of contracts and penalty for default/delivery obligations.
e) Daily mark to marketing of the contracts[44]

The Commission had also prescribed simultaneous reporting system for the Exchanges following open out-cry system, to facilitate audit trail and make it difficult for the members to indulge in malpractices such as trading ahead of clients.

In the Finance Act, 2015, the Government of India has announced that FCRA will be repealed and the regulation of Commodity Derivatives Market will shift to SEBI under SCRA, 1956[45]. Accordingly in a press release[46], Ministry of Finance, Government of India has announced September 28, 2015 as the date on which FCRA, 1952 will get repealed. As on date, the FMC became merged with SEBI.

Other Regulatory Agencies in India:

Other than SEBI, RBI and FMC, there are bodies like SEBI-RBI Coordination Committee, HLCC, MoF and Ministry of Corporate Affairs in India in the area of

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[44]See http://fmc.gov.in/index2.aspx?slid=143&sublinkid=685&langid=2, accessed on 19. 05. 2015 at 10.15 hrs.
[45]See S. 131, 133 of Finance Act, 2015(Act 20 of 2015).
[46]See http://finmin.nic.in/press_room/2015/FCRAcommodityDerivatiesSEBI2015.pdf, accessed on 03.09.2015 at 8.32 hrs.

regulation of these instruments. These are basically regulatory coordination bodies to smoothen out differences between regulatory bodies.

In a paper entitled "*Unit Linked Insurance Products and Regulatory Tangle,"*[47] examining the regulatory framework for regulation of such products, a perusal was made of the legislative scheme under which SEBI and IRDA works. It would make clear that these bodies are established to regulate the "securities market" and "insurance business" and "reinsurance business." Further the SEBI Act mentions certain specific type of entities.

Apart from the above, there are other regulatory agencies in such as IRDA,[48] PFRDA[49] that deal with specific areas of financial markets. There are also other sector specific laws, such as cooperative society's laws, and other state laws, that govern these areas. They are not dealt with in detail for two reasons: (1) They do not deal with monetary instruments as their primary focus, and (2) The activities, within their regulatory capture is also covered by any of the major regulators.

[47] (2011) PL February S-12.
[48] Established under Insurance Regulatory and Development Authority of India Act, 1999.
[49] Established under Pension Fund Regulatory & Development Authority Act, 2013.