Forward Trading in Securities in India*

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The organised securities market in India presents a classic example of forward trading of securities. A variety of interesting forward trades also take place in the informal market. This article traces the evolution of the regulatory framework governing forward trading in securities in India.

FORWARD trading is simply an arrangement between two parties to buy or sell a certain quantity of securities at a certain future time for a certain price. The securities and consideration do not change hands at the time the contract is entered into. The contract is settled at maturity when the seller delivers the securities to the buyer in return for the consideration or carried forward for settlement at a further future time. This arrangement enables market players to carry huge positions far more than supportable by funds available with them and trade in the same actively. While this helps to make the market active and liquid, it has the danger of encouraging excessive speculation, if not effectively regulated. Voluminous regulations have developed in course of time to reduce excessive speculation and consequently price manipulation with a view to protect integrity of the market and interest of investors. Now ours is a very peculiar market which exemplifies the proverbial gap between what we preach and what we do, in the sense, that the law relating to securities market provides for one thing while our market has something exactly opposite. Law does not permit any form of forward trading but our market has only forward trading and nothing else The organised securities market in India is a classic example of forward trading in securities. A variety of interesting forward trades also take place in the informal market. Depending on the needs of the market, forward trading has acquired different degrees of sophistication. This ranges from usual transactions in the so-called cash segment (including badla / carry-forward), ready purchase (repo) and derivatives of securities.

Forward trading in securities in India has a very long and checkered history. There used to be trading of derivatives in the form of call options (Teji), put options (Mandi) and straddles (Fatak) etc. The Securities Contracts (Regulation) Act, 1956 (SCRA) was enacted, among others, to specifically prohibit these trades. The contracts for 'clearing' popularly known as forward trading was banned by a notification issued on 27th June 1969 under SCRA. In 1983, a form of trading in 'specified' shares was developed which permitted postponement of settlement by further periods of a settlement cycle at a time. Such trading in 'specified' shares was banned by the Securities and Exchange board of India (SEBI) on December 13, 1993. The repo transactions in government securities and public sector bonds developed during 1980s. The Special Court, however, declared such transactions null and void being violative of the SCRA and the Banking Regulations Act. Then dawned the process of liberalisation and deregulation. The prohibition on options in securities was lifted by the Securities Laws (Amendment) Act, 1995. SEBI reconsidered its ban on trading of 'specified' shares and permitted in 1995 carry forward transactions in securities subject to certain safeguards. The 1969 notification, which banned forward trading, is being amended since 1994 to permit repo transactions in specified securities by specified entities. In 1997, the Supreme Court held as legal the first leg of the repo transactions. Legislative efforts are on to bring derivatives within the ambit of 'securities' by an amendment to SCRA.

TRANSACTIONS IN CASH MARKET

The transactions entered into in the cash segment are peculiar forms of forward trading, as these are not settled immediately or on the same day. These accumulate over a trading cycle and at the end of the cycle, all the transactions are clubbed together, positions are netted out and the balance is settled by payment of cash and delivery of securities. Since these transactions mature for settlement after about a fortnight, these are akin to forward trading. Such transactions are usually called "hand delivery" contracts, i.e. for delivery and payment within the time or on the date stipulated when entering into contract which time or date shall not be more than 14 days following the date of the contract. This sort of cash market carries the risks and difficulties of futures market sans gains in price discovery and hedging services. Many things can happen between entering into the contract and its performance providing incentives for either of the parties to go back on its promise. Since the contracts do not require performance immediately and can be squared up by another contract entered into before the end of the trading cycle, some parties get tempted to engage in speculation. For example, an operator may do any amount of short selling or accumulate a long position and square up the trades before the end of the settlement period. He merrily indulges in huge speculation as he is at best required to pay only a small margin money. He does not have to give or take delivery. Even if he is required to give delivery, he has the option to carry forward to the next settlement period. The introduction of on-line trading has also resulted in a sharp increase in speculative transactions. Since the orders are executed at a quick pace, a large number of operators indulge in short term speculation in the active scrips.

* *Views expressed herein are of the author and not necessarily of his employer.*

However, in an attempt to discourage parties from going back on their promises and to keep a check on excessive speculation, systems like collection of margins (upfront, mark to market, adhoc, volatility, concentration), trading and exposure limits, trade guarantee/clearing corporation have developed. If speculation is to be harnessed for socially beneficial purposes, squaring up facility should be restricted to professionals like market makers and the settlement period should be shortened. The market has to shift to rolling settlement if it has to be a true cash market. Settlement should take place on 'T+3' or 'T+5' basis. If it is considered that the market infrastructure/environment is not yet adequate/conducive, the settlement can take place on 'T+10' basis.

CARRY-FORWARD TRANSACTIONS

Another peculiar form of transaction in the cash market is called 'carry forward transaction'. It has undergone metamorphosis over time. It had origin in a form of transaction which were settled on monthly basis. These were converted into fortnightly clearings in 1946 and called contracts for 'clearing'. The notification dated June 27, 1969 prohibited such contracts for clearing. It banned contracts for the sale or purchase of securities other than spot delivery contract or contract for cash or hand delivery or special delivery in any security. This notification was issued in order to curb certain unhealthy trends that had developed in the securities market at the time and to prevent undesirable speculation. Following this prohibition, the stock broking community started a strong agitation in favour of resumption of trading for the 'clearing'. A committee appointed by Government on "Forward Trading in Securities" under the chairmanship of Prof. J.J. Anjaria, in its report submitted in May 1970, recommended resumption of trading for "clearing" with adequate safeguards such as large scale revision of margin requirement, automatic suspension of dealings in a security, etc. No decision, however, followed the recommendation.

As the prohibition on forward trading in securities or trading for the "clearing" led to a shrinkage of business in the stock market, The Stock Exchange, Mumbai (BSE) evolved in 1972, a pattern of trading which conformed in all respects to the requirements of the notification prohibiting trading for the "clearing", but at the same time provided for a substantial increase in the turn-over on the exchange. Such a pattern of trading was later followed by the stock exchanges at Calcutta, Delhi and Ahmedabad. Under this system of trading, these stock exchanges categorized certain active shares under "A" group and trading in these shares were carried forward from one settlement period of 14 days to another by the concerned stock-brokers by entering into fresh contracts of purchase and sale at the beginning of every new settlement period. Such an informal system of forward trading periodically created several problems and crisis situations in the stock exchanges because of the lack of necessary regulation by the stock exchanges, under their byelaws and regulations of such trading. There were payment crises from time to time and frequent closure of the market. An in-depth study of the steadily deteriorating situation on stock exchanges was undertaken by a Committee of Executive Directors of Stock Exchanges which recommended in April, 1982, that trading for the 'clearing' be resumed subject to stringent regulatory measures. The safeguards suggested were much stricter than those suggested by Anjaria Committee. However, the atmosphere was probably not conducive to repeal of the 1969 notification.

The Government, during December 1982 – January 1983, reviewed the system of trading in "A" group shares in the major stock exchanges. Since it was felt at that time that resumption of forward trading was not feasible, necessary changes were made in the bye-laws and regulations of stock exchanges in order to regulate the system of trading in "A" group shares. Accordingly, in exercise of its powers under section 10 of the SCRA, Government amended the byelaws of stock exchanges to facilitate performance of contracts in specified securities. Performance of contracts entered into in "A" group shares could be postponed from one settlement period to another subject to a maximum period of 90 days and several safeguards and precautions such as payment of daily margins, ad hoc margins, carry-over margins and other regulatory measures such as inspection and audit of books of accounts and other documents of the stock-brokers. In pursuance of this policy, the stock exchanges at Mumbai, Calcutta and Ahmedabad introduced a system of trading in "specified shares" with carry-forward facility after amending their byelaws and regulations.

As mentioned earlier, trading in specified shares with carry-forward facility had been taking place in the major stock exchanges until SEBI issued on 13th December 1993, a directive to the stock exchanges to ensure that no carry-forward of transaction in stock exchanges would be allowed except for the purpose of liquidating the then existing carry-forward business positions of members and that, henceforth, all transaction in securities would be settled at the end of each settlement by delivery and payment. Subsequently, SEBI decided on 9th March 1994, to allow carry-forward facility in the stock exchanges under a framework of transparency and effective regulation provided the stock exchanges satisfied SEBI that they were in a position to implement the system as proposed by SEBI. However, the new scheme of trading was not implemented by any stock exchange. Taking into account various factors prevailing in the stock market, SEBI, in February 1995, appointed a committee under the Chairmanship of Mr. G. S. Patel for reviewing the system of carry-forward of transaction in shares in the stock exchanges. The committee in its report recommended that trading with carry-forward facility should be permitted in stock exchanges subject to adequate standards of transparency, prudence and monitoring by the stock exchanges. On considering the recommendations of the committee, SEBI decided to allow the stock exchanges to introduce a new system of carry-forward of transaction after seeking formal approval from SEBI and after satisfying the conditions and the modalities prescribed in this regard. Only the BSE implemented the new system of carry-forward transactions. The Verma Committee further reviewed the system. Based on the recommendations of the committee, SEBI modified the carry-forward system. The modified system has a number of safeguards, namely: carry-forward transactions must be segregated at the time of execution of trade and would attract a daily margin of 10%, 50% of which would be collected up front; such transactions shall be finally settled at some point of time and stock exchanges must ensure that no rolling over of transactions takes place beyond 90 days; overall carry-forward limit would be Rs.20 crore per broker per settlement; there would be strict enforcement of capital adequacy and other prudential safeguards and effective monitoring and surveillance system; the scrips chosen for carry-forward should have sufficient floating stock and high liquidity, etc. However on line with reduction in period of trading cycle from 14 days to 7 days, the trades are now carried forward for a period of 7 days at a time.

The modified carry-forward system is now available on a few exchanges, while unauthorised carry-forward transactions take place on a few others. Besides the system suffers from certain deficiencies. In the absence of any guidelines by SEBI, the selection of scrips for carry-forward facility is not being done professionally. The stock exchanges do not have any means to ensure that a transaction is not carried forward beyond 90 days and have to rely on members' certification that no transaction is carried forward beyond 75 days. The netting of broker-wise positions is undermining margin liability. The limit of Rs.20 crore irrespective of adequacy of base minimum capital deposited by a broker probably needs review. There should be a system in place to disable a member if he exceeds the carry-forward limit. There is a system of payment of difference bills i.e. mark to market margin is passed on to the other party and is not kept with the clearing house or stock exchange. All these appear to be creating avoidable systemic risks.

READY FORWARD TRANSACTIONS

A ready forward transaction, usually known as repo, allows a holder of securities to sell with a commitment to repurchase them at a predetermined price and date. In a reverse repo securities are bought with a commitment to resell them to the original holder. The ingredients of a repo are: there must be a sale or purchase with the commitment to repurchase or resell in future; the contract must be between two parties; it must be in respect of some kind of securities and for the same quantum of securities; it must be entered into on the same day or contemporaneously and the price of resale or repurchase would be fixed at the stage of first leg itself. In India the repo market in government securities and public sector bonds became active in the 1980s among banks and financial institutions on their own account and on behalf of their clients under portfolio management services. RBI, being regulator for these participants, prohibited by circulars issued in 1987, buy back arrangements in respect of corporate securities and bonds issued by public sector undertakings. In respect of government and other approved securities, buy back arrangement was permitted subject to certain conditions. As some banks were found to have entered into certain transactions in violation of these circulars, RBI banned all repos except Treasury Bills since June 1992 in the aftermath of irregularities in the securities transactions.

Justice Variava of the Special Court delivered a judgment on 14th December 1993, that ready forward contracts were prohibited and illegal both under the SCRA and the Banking Regulations Act. These violated the 1969 notification issued under the SCRA and the circulars issued by RBI under the Banking Regulations Act. They were void and no right, title or interest in the securities would be created by virtue of such contracts. The Court was not inclined even to accept the argument that as repo contract could be severed into two parts and one of the parts could be held as legal. It was observed that if these could be severed, then there was no repo. It was, therefore, held that the two parts were not severable and the contract was one composite contract, which had to be taken as a whole. The contract as a whole was illegal and could not be enforced. However by a pronouncement on March 19, 1997 Supreme Court held that the ready forward contract was severable into two parts, namely the ready leg and the forward leg. The ready leg of transactions having been completed, the forward leg, which alone was illegal, had to be ignored.

As repo transactions violated the GOI notification of June 1969, the Government permitted, in order to enhance liquidity in the market for government securities and to further develop the market, certain institutions like a banking company, a cooperative bank, DFHI, STCI, SBI Gilts Limited, PNB Gilts Limited, Gilt Securities Trading Corporation Limited, ICICI Securities & Finance Company Limited and RBI registered satellite dealers to undertake ready forward operations in government securities through amendment notifications of June and October 1994, June 1996 and March 1998. Government also permitted 24 non-banking entities to undertake reverse ready forward transactions through amendment notifications of November 1997 and April 1998. These notifications provide that ready forward/reverse ready forward contracts may be entered into by specified entities in such dated securities as approved by RBI in consultation with GOI. As a result, Government has been regularly receiving and approving proposals from RBI seeking ready forward facility for specific securities. Similarly, RBI has been coming up with proposals to permit more and more entities to undertake ready forward/reverse ready forward transactions. This is being granted by issue of periodic amendments to the 1969 notification.

The repo facility is restricted to certain identified players and thus a large number of potential users are denied participation. Such transactions are permitted only in government securities. Other securities such as shares, bonds, commercial paper do not have this facility. The mechanism does not permit players to go short. There is no standard documentation/master agreement governing a repo transaction. There is no clearing house to take counterparty risk. The securities are not dematerialised. The regulatory view is blurred in view of pronouncements of the Special Court and the Supreme Court. As a result, the repo market is neither deep nor liquid.

DERIVATIVES OF SECURITIES

Derivatives are the contracts, which derive their value from the prices or index of prices of underlying securities. Futures and options are the dominant forms of derivatives. These are useful in allocating risk across time and among entities. India had a flourishing derivatives market prior to enactment of SC(R)A which dealt a severe blow to such transactions by declaring all options in securities entered into after 20th February 1957, as illegal. Option in securities was defined to mean a contract for the purchase or sale of a right to buy or sell, or a right to buy and sell, securities in future, and includes a teji, a mandi, a teji mandi, a galli, a put, a call or a put and call in securities. The Act also empowered government to prohibit by notification any type of transaction in any security. In exercise of this power, Government by its notification in 1969 prohibited all forward trading in securities. The need for derivatives trading was formally realised with the Securities Laws (Amendment) Ordinance of 1995, which removed the ban on options in securities. It was then felt that if the ban was lifted, trading in derivatives could commence. However, it did not happen as there was no suitable legal and regulatory framework. It was thought that if the derivatives were declared as 'securities' under the SCRA, the whole regulatory framework applicable to trading of securities would apply to trading of derivatives. It was then thought that derivatives could be declared 'securities' under the delegated powers of the Central Government.

With this understanding market went ahead with preparations. SEBI set up a Committee under Dr. L. C. Gupta to develop a suitable regulatory framework for derivatives trading. The Committee prescribed a set of stringent standards: (a) The derivatives trading should take place on a separate segment of the existing stock exchange with an independent Governing Council where the number of trading members will be limited to 40% of the total number of members on the Council. The Chairman of the Governing Council will not be permitted to trade on any of the Stock Exchanges. (b) The settlement of derivatives trades will be through an independent clearing corporation / clearing house which will become counterparty for all trades or alternatively guarantee the settlement of all trades. (c) The clearing corporation will have adequate risk containment measures and will collect the margin through electronic fund transfer (EFT). (d) The derivative exchange will have on-line trading and surveillance systems. It will disseminate the price and trade information on real time basis through two information vending networks. It should inspect 100% members every year. (e) There will be phased introduction of derivatives product. To start with, index futures will be introduced, which will be followed by options on index and later options on stocks. (f) There will be complete segregation of the client money at the level of trading/ clearing member and even at the level of clearing corporation. The client will be compulsorily required to pay margin to the broker. (g) The trading/clearing member will have stringent eligibility conditions. At least 2 persons should have passed the certification programme approved by SEBI. (h) The clearing member should deposit minimum Rs.50 lacs with the clearing corporation and should have a networth of Rs.3 crore. The recommendations were received well and accepted by SEBI.

However it was soon realised that Government's power to declare instruments as 'securities' was limited to 'such other' instruments. Derivatives did not conform to the description 'such other' instruments. The possibility of amending the SCRA to explicitly define derivatives as securities was explored. The Securities Contracts Regulation (Amendment) Bill 1998 was moved in Parliament on 4th July 1998 proposing to expand the definition of 'securities' to include derivatives within its ambit so that trading in derivatives could be introduced and regulated under the SCRA. The Bill was then referred to the Standing Committee on Finance for examination and report thereon. The Committee, in their report dated 17th March 1999, have expressed 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 the investors/participants and favoured the passage of the Bill with minor modifications. However the Bill has lapsed on dissolution of the Lok Sabha. It is for the Government to purse the matter further. In all probability, given the favourable recommendation of the Standing Committee, a fresh Bill would be passed. Even after the Bill is passed, trading in derivatives would have to wait for repeal/modification of the 1969 notification.

ISSUES RELATED TO DERIVATIVES

A number of issues requiring satisfactory resolution has been engaging the attention of experts in the area of derivatives. The following paragraphs analyse a few critical ones.

1969 Notification

Even though the notification of 1969 is in force, exceptions have been carved out in course of time as market needs changed. Carry forward transactions in shares are being permitted on stock exchanges through amendments in their bye-laws and regulations. A revised carry forward mechanism for stock exchanges has also been approved by SEBI. Ready forward/reverse ready forward transactions in government securities are being permitted by periodic amendments to 1969 notification. Thus, on the one hand there is a notification, which prohibits forward trading and on the other, some form of forward trading (carry forward/ready forward) is prevalent. This is an anomalous situation, which needs to be corrected. Further in the changed financial environment, the relevance of the1969 notification is vastly reduced, particularly when derivatives trading and repo facilities for public sector bonds and privately placed debentures are being contemplated. The repeal of the June 1969 notification is desirable not only in terms of overcoming the anomaly existing at present but also as a measure of market reform to make way for the introduction of derivatives. If it can not be repealed it has to be modified at least to carve out another exception for derivatives.

Who will repeal or modify the notification ? In order to strengthen the effectiveness of SEBI, which was set up as a statutory body in 1992 with the objectives of protection of interest of investors in securities and for the orderly development and regulation of the securities market, Government directed in exercise of its powers conferred by section 29A of the SCRA that the powers exercisable by it under section 16 of the said Act shall also be exercisable by SEBI. Hence, though Government had issued the 1969 notification, both Government and SEBI now have powers to issue/ amend the same/similar notifications. Modification/repeal by SEBI would explicitly bring RBI under its regulatory jurisdiction. This may not be appreciated by RBI.

Ready forward/reverse ready forward transactions in government securities are now being permitted by periodic amendments to 1969 notification. Hence, with the repeal of the said notification, the existing regulatory framework governing ready forward/reverse ready forward transactions in government securities would disappear. It may, therefore, be necessary to provide an arrangement whereby the RBI/SEBI could regulate such transactions. The repeal of 1969 notification coupled with the fact that the powers under section 16 of SCRA are already exercisable by SEBI, would enable SEBI to draw-up required regulations for forward trading under the SCRA and incorporate the same in the bye-laws of stock exchanges. However, the repeal of the 1969 notification has to be done simultaneously with the incorporation of SEBI's regulations in the bye-laws of stock exchanges. Forward trading in government securities including gold linked securities could be exempted from the provisions of the SCRA under section 28. A view needs to be taken if trading of government securities can altogether be exempted from the regulatory purview of the SCRA. This may not be appreciated by SEBI.

Alternatively, on repeal of 1969 notification all intermediaries in government securities will be eligible to transact ready forward contracts in government securities, which may be regulated by RBI. Similarly, ready forward contracts/carry-forward facility would be available for corporate securities in stock exchanges, which may be regulated by SEBI. If RBI is to regulate, it needs to be authorised to do so. This requires an enabling provision in the statute to empower Central Government to delegate powers to RBI in addition to SEBI. Probably, with this in mind, the Securities Contracts Regulation (Amendment) Bill, 1998 also proposed to empower Central Government to delegate powers under the SCRA to RBI. If the Act is amended, Central Government can authorise RBI to exercise specified powers under the SCRA. A view then has to be taken as to what powers in respect of which transactions and in which securities should be delegated to RBI. Presently powers under specific sections of the Act, irrespective of the type of transactions/securities, have been made exercisable also by SEBI. If RBI is to exercise similar powers as SEBI in respect of government securities, all earlier notifications delegating powers to SEBI may have to be modified. The modification would be such as to enable RBI to exercise all powers under those sections in respect of government securities and SEBI in respect of corporate securities. If this is done, both RBI and SEBI, in addition to Government, would simultaneously have powers to regulate trading in securities in stock exchanges. Such dual, rather triple, control over stock exchanges may result in regulatory conflict. It may be better if an arrangement evolves whereby SEBI continues to be the sole regulator for the securities market and to have exclusive jurisdiction over trading in securities including government securities on stock exchanges. Only off-stock exchange transactions like ready forward/reverse ready forward transactions in government securities and other related instruments under RBI's jurisdiction could be regulated by RBI. This may be achieved by carving out an exception u/s 28(2) of the Act without compromising the authority of SEBI.

A corollary to the above is the issue of co-ordination among regulators. There is a feeling that a number of derivative fiascoes has taken place due to lack of co-ordination among regulators. In order to avoid this, there is a need to have a mechanism, which can act as an effective coordinating body between SEBI and RBI. Dr. L.C. Gupta Committee also had recommended a formal mechanism in respect of all financial derivatives markets for co-ordination between RBI and SEBI. It is understood, however, that there is such an informal arrangement in the form of the High Level Committee on Capital Markets, where Governor RBI is the Chairman and Finance Secretary and Chairman, SEBI are members, which has been set up to facilitate co-ordination between SEBI and RBI. Probably there is no need to create a formal super body to supervise market regulators. SEBI being the exclusive regulator of the securities market, it is logical that SEBI alone supervises the market for derivatives of securities. The derivative contract should be traded on a recognised stock exchange under the provisions of SCRA and regulated by SEBI. As regards exposure to derivatives by the participants such as banks, public sector, mutual funds, etc. RBI may limit their exposures.

Securities Contracts (Regulation) Amendment Bill, 1998

A view is being expressed that mere inclusion of derivatives in the definition of 'securities', as proposed in the Bill, may not be adequate. Contracts which are cash settled are classified as wagers and trading in wagers is null and void u/s 30 of the Indian Contract Act, 1872. Since index futures are always cash settled, these could be treated as wagers. Hence it is apprehended that derivative contracts may not be enforceable in a court of law. The other view is that once derivatives based on index of securities prices are declared as 'security' under the SCRA, general Acts like the Contract Act will not be applicable to such contracts of securities. Following the principle that a general law gives way to a special law in case of conflict, the SCRA would prevail over the Contracts Act for such contracts in securities. However, there is no harm in providing an overriding provision as a measure of abundant precaution to the effect that notwithstanding anything contained in any other law for the time being in force, contracts in derivatives as per SCRA shall be legal and valid.

The major chunk of derivatives trading takes place outside exchanges by financial institutions and their corporate clients in what is termed as over-the-counter market. However, as derivatives trading needs a modern on-line screen based system to effectively monitor transactions, a view is being expressed that it would be prudent to allow trading in derivatives only on stock exchanges. It may, therefore, be better if it is specified in law that derivatives would be traded and settled on the stock exchange and clearing house of the stock exchange respectively in accordance with the rules and bye-laws of the stock exchange. The other view is that when Government and SEBI have powers to prohibit any type of transaction in securities, such a requirement may be superfluous. This may rather restrict growth of the market and flexibility of regulators. If at any time it is felt desirable to permit over-the-counter derivatives, the law needs to be amended. However, given the apprehension and recommendation of Dr. L. C. Gupta Committee, such a requirement may be provided in the Law. The fresh Bill may incorporate these two clarifications.

Exemption from stamp duty

It is felt in some quarters that if the derivative contracts attract stamp duty at existing rates, trading in index futures may be uneconomical. It is, therefore, suggested that derivative contracts may be exempted from stamp duty. The other view is that there should not be any discrimination between the cash market and the futures market in terms of stamp duty. The securities transactions attract stamp duty at two stages, namely, at the time of entering into the contract, i.e. on contract note and at the time of transfer of securities i.e. on transfer deed. Transfer of securities in the demat mode has recently been exempted from stamp duty. In case of index futures, no transfer of securities is involved and hence no stamp duty is payable. In case of futures on individual securities, there will be no stamp duty on transfer, if it is in demat mode. The contract notes for confirmation of trades done in both cash segment and derivatives segment would attract stamp duty. Hence, securities transactions in cash segment as well as derivatives segment would attract equal treatment in terms of stamp duty. Further, the rate of stamp duty on such contracts is not prohibitively high. In respect of contract notes issued by brokers to clients in Delhi, the stamp duty is applicable @ fifteen paise for every Rs.10,000 or part thereof of the value of the security subject to a maximum of Rs.15. It is Re.1 for every Rs.10,000 or part thereof of the value of the security i.e. 0.01% in Maharastra. Such low rates of stamp duty on contract notes only may not have any significant impact on derivative transactions. Further, stamp duty on contract notes being a state subject, efforts to exempt such duty can virtually stall derivatives trading.

Taxation

Doubts have been expressed about tax treatment of profits/losses on derivative products. It is possible that an investor does not have all the 30 or 50 stocks represented by the index. As a result an investor's losses or profits out of derivative transactions, even though they are of hedging nature in real sense, it is apprehended, may be treated as speculative. This means that they may not be set off against other income. As per the Capital Asset Pricing Model, 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 even for hedging the portfolio risk of 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). His profit/loss should not be speculative. However, since the index futures contract and other cash settled derivatives are essentially speculative transactions, any profit/loss arising therefrom, if it is not for hedging, will be construed as speculative profits or losses defined under the Income Tax Act and therefore the losses, if any, will not be eligible for set off against the other income of the assesses. A clarification to these effect by Income Tax Department would be useful.

Mutual Funds

Can mutual Funds trade in derivatives ? Following the recommendation of the Dr. L. C. Gupta Committee, SEBI has decided that mutual funds should disclose their intention of trading in derivatives in the offer documents at the time of launch of schemes. They will also be required to disclose the risks and returns ensuing from trading in derivatives by giving simple quantitative examples. In case of existing schemes, where the aforesaid disclosures have not been made in the offer documents, the mutual funds would be required to take approval from the unit holders before trading in the derivatives market. In exceptional cases, SEBI may consider permitting mutual funds to take approval from the trustees. The trustees should ensure that the Asset Management Company possesses adequate expertise and Infrastructure for trading in derivatives.

Preparedness

It is frequently asked if the market is prepared for introduction of derivatives trading. Is the system in place ? Are the participants well equipped ?

The securities market in India is accustomed to the style of settlement in the futures market. Market participants are used to trading, clearing and settlement systems which are akin to futures market. In addition, the basic requirements of a futures markets such as Initial Margin, Daily Mark to Market Margin, Clearing Corporations for Trade Guarantee, Surveillance System, Netting of Trades for a Specific Period etc. have been in place for quite some time now. All the stocks in the Sensex and Nifty are traded in demat form. There is complete transparency in order execution through on-line trading system and more than 99% of the trades are conducted on-line. The NSE collects the margin from its members through EFT facility. There are enough research papers being generated in the market, which disclose information on the market behaviour, corporates, etc. The corporates are required to disclose their results to the market on a quarterly basis. SEBI is working on risk containment measures, which include the collection of initial margin based on 99% value-at-risk in advance. The Dr. L. C. Gupta Committee recognised the state of preparedness of the market and therefore has recommended a phased introduction of derivatives products in the sequence of index futures, index options and options on stocks. What more needed is separation of cash market from futures market, which would shift some of the speculative transactions from the former to the latter. This can be achieved by introducing rolling settlement for all transactions on stock exchanges

There is, however, no barometer to judge the preparedness of the market for introduction of derivatives trading. It is also not necessary that all the pre-conditions must be in place before trading of derivatives is introduced. Moreover, if the market participants feel the need for derivatives trading but are deprived of it, it is likely that the derivatives market on the Indian indices may develop elsewhere in the world. □

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