2.1 Introduction

The trading in derivative market comes under provision of SC(R)A. The Security Exchange Board of India (SEBI) created rules and regulation related to the trading in derivative market segment. As per the requirements of changing dynamics of the financial market, SEBI regularly changes or revises the rules and regulation. This is to safeguard the investor’s interest by reducing the level of risk with the help of different regulatory policies in Indian derivative market.

Derivative market is basically a subset of capital market, due to this, controlling body of both the markets is same. To run this market, various expert groups of people had developed a range of derivative market products. These products were run or executed under SEBI guidelines and are followed by every member who come under the agreement of derivative trade viz., client, banker, dealer, stock exchange, mutual funds companies and Foreign Institutional Investor (FII) etc (Gupta, 2005).

2.2 Regulation for Derivatives Trading in India

SEBI created a 24 member committee under the supervision of Dr. L.C. Gupta, to develop a well organised regulatory framework for derivatives trading in India. SEBI accepted the recommendation of this committee on 11 May 1998 and approved the introduction of derivatives trading in India in a phased manner beginning with stock index futures. The requirements in the SC(R)A and the regulatory framework developed there under control over trading in securities. The SC(R)A was modified to include derivatives within the frame work of that Act. Summary of derivative regulation are stated below on the basis of Dr. L.C Gupta committee recommendation.

1. Any exchange in India, interested to start derivative trading have to fulfil the eligible criteria as per Dr. L.C. Gupta committee report and apply SEBI for the purpose of approval for derivative trading under section 4 of SC(R)A 1956.
2. Derivative trading or clearing member should have a limit to maximum of 40% of total member council and the particular exchange should have separate governing council.
3. The exchange should have to obtain prior approval of SEBI before starting trading in any derivative contract or product and would have to regulate the sales practices of its members.
4. The exchange has a limit up to 50 members.
5. The member of present segment of exchange would not become the member of derivative segment automatically. Every existing segment member should take permission of SEBI and also fulfil L.C Gupta committee criteria to start derivative trading.

6. Clearing and any settlement of derivative contract or trade should be done through a SEBI approved clearing corporation or houses and every clearing corporation or houses should come under the criteria of L. C. Gupta committee and also take approval for SEBI to start clearing and settlement process.

7. Every broker, dealer and clearing members of derivative market should take approval along with registration in SEBI to start new derivative product.

8. Minimum amount of net-worth of clearing member of derivative clearing corporation or houses shall be Rs. 3 Cr. and net-worth should be computed on the basis of given function:

\[
f(N_w) = f(C_p) + f(F_r) - f(N_{assets})
\]  
(2.1)

Where  
\[N_w = \text{Networth;}
\]
\[C_p = \text{Capital;}
\]
\[F_r = \text{Free Reserve;}
\]
\[N_{assets} = \text{Non-Allowable assets; and}
\]

Non-Allowable assets included the following items:

I. Fixed assets;
II. Intangible assets;
III. Prepaid expenses;
IV. Bad deliveries;
V. Unlisted security;
VI. Member’s card;
VII. Pledged security;
VIII. Doubtful debts and advances; and
IX. 30% marketable securities;

9. The limit of contract value shall not be less than Rs 2 lakh;

10. Exchange should have submitted details of the futures contract they intend to introduce.
11. The initial margin obligation and introduction limit should be correlated to capital adequacy and marginal demands related to the risk of loss on the position will be approved by SEBI from time to time.

12. L.C Gupta committee gave more emphasis on ‘know your customer’ rule and prerequisite that every client shall be registered with the derivatives broker.

13. The member of derivative segment are also required to make their client aware about the risk participation of derivative contract and risk awareness document are also attached with customer document, which generate alertness to customer or client about derivatives losses.

14. Every person of trading member should be qualified as per SEBI requirement and he or she also passed certification program approved by SEBI.

2.3 Accounting for Futures

The Institute of chartered Accountant of India (ICAI) has issued guideline on accounting of Equity Index Futures and Equity Stock Futures. Accounting of futures is based on regulation of exchange and typical trading mechanism of derivative contract. Earlier, there were many issues relating to accrual of income, booking of losses, calculation of profit and disclosures. Now a day’s, most of the issues are solved or dealt with in guidance note issued by the institute. Equity derivative instrument are the type of instrument in which other parties are also involved in the trading process same as cash market or simple share market. These parties are brokers, trading members, clearing members, clearing corporations and client. Because of this, proper accounting is required to minimize the losses and to maintain proper working mechanism (See Bhattacheryya, 2006 for Accounting of future).

Some of the technical terms used in this section are as follows:

- Clearing member;
- Clearing corporation and houses;
- Client;
- Contract month;
- Daily settlement price;
- Derivative exchange or segment;
- Final settlement;
• Long position;
• Open position;
• Settlement date;
• Short position; and
• Trading member;

Most of the above terms itself define its meaning but few terms are not understandable such as Long position, Open position and Short position, which may be defined as follows:

*Long Position:* Long position in an equity index futures contract means outstanding purchase obligations in respect of the equity index futures contract at any point of time;

*Open position:* Open position means the total number of equity index futures contracts that have not yet been offset and closed by an opposite position; and

*Short Position:* Short position in an equity index futures contract means outstanding sell obligations in respect of the equity index futures contract at any point of time;

**Figure 2.1**

*Accounting for Equity Index Futures and Equity Stock Futures Include The Following Treatments*

**Accounting for The Payment or Receipt of Mark-to-Market Margin:** The amount pays or received on account of Mark-to-Market margin by the client would be credited or debited to the bank account and the subsequent debit or credit for the same should be made to an appropriate account, state, ‘Mark-to-Market Margin in Equity Index Futures account and Mark-to-Mark Margin in Equity Stock Futures account as the case might be. The amount of Mark-to-Market...
Margin received into or paid from approximately deposit with the clearing or trading member should be debited or credited to the deposit for margin money account with the consequent credit or debit to the Mark-to-Market margin in Equity Futures account or the Mark-to-Market margin in Equity Stock Futures account as the case might be.

**Accounting for Initial Margin:** When Futures Contract is entered into for purchase or sale of Equity Index or Equity Stock Futures, then no payment is required to be made except for the initial margin. Clearing Corporation or Houses determines this margin from time to time and it serves as security deposit for the exchange. The margin can be paid either in cash or in the form of collaterals like bank guarantees, securities and fixed deposits. Basically Initial margin paid in cash shall be debited to ‘Initial Margin Index or Stock Futures account’ and supplementary margin paid if any shall be accounted in the same manner. The Balance Sheet date the balance in initial margin account shall be shown individually in respect of each progression under the head ‘Current Assets’. The acknowledgment or receipt of initial margin in the form of collaterals shall be recorded in memorandum records and no entry is required to be made in the financial book. If any collateral is returned back the memorandum records shall be updated in view of that.

**Accounting for Open Interests in Futures Contract as on The Balance Sheet Date:** ‘Mark-to-Market margin in Equity Index Futures account or the Mark-to-Market margin in Equity stock Futures account’ are the debit or credit balance, which represent the net amount paid to or received from the clearing or trading member on the basis of the movement of in the prices of Equity Index Futures or Equity Stock Futures till the balance sheet date in regard of open futures contract. In another case the given accounts have a debit balance as the balance sheet date and the same should be shown as current assets or on the other case if given accounts have a credit balance on the balance sheet date, the same should be shown as a current liability. Accountant should keep in mind that ‘Prudence’ as a consideration for the preparation of financial statements, the provision for the anticipated loss in respect of open futures contract should be made. For this purpose the net amount paid or received on account of Mark-to-Market margin on open futures contracts on the balance sheet date should be shown index wise or script wise. In this process the index wise or script wise balance is a debit balance representing the net amount paid and this condition should be made for the given amount. In another case where the index wise or script wise balance is a credit balance represent the net amount received and the same should be ignored keeping in view the consideration of ‘Prudence’. To smoothen the progress of
these computations, the Mark-to-Market margin accounts may be maintained index wise or script wise. The provision which should be discussed on above lines should be credited to an appropriate amount under the heading ‘Provision of loss on Equity Index Futures Account’ or ‘Provision on loss on Equity Stock Futures account’ as the case might be. If in case of any opening balance in the ‘Provision for loss on Equity Stock or Equity Index Futures Account’, the same balance should be adjusted against the provision required in the current year and the profit and loss account should be debited or credited with the balance provision required to be made or excess provision written back. The ‘Provision for loss on Equity Index or Equity Stock Futures Account’ should be shown as a deduction from the balance of Mark-to-Market Margin of Equity Index or Equity Stock Futures Account, if it disclosed as a current asset. On the other hand, if the above given treatment of margin accounts are disclosed as a current liability then the above mentioned provision accounts should be shown as a provision on the liabilities side of the balance sheet.

**Accounting at The Time of Final Settlement or Squaring up of The Contract:** At the time of expiry of the contract or squaring up the contract, the profit or loss is computed and acknowledged in the profit or loss account. The profit or losses in such cases is the difference between final account price and contract price. The entries describing to profit and loss shall be approved by consequent debit to credit to the Mark-to-Market margin account and the balance in Market-to-Market account for a particular progression of contract; this will be documented as income or expenses on final settlement. Basically if balance exists in the provision accounts, which may have been created at the yearend for predictable loss and if any losses arising on such settlement shall be first charged to such provision account and the balance if any should be charged to profit and loss account.

**Account at The Time of Daily Settlement of The Contract:** This involves the accounting of payment or receipt of Mark-to-Mark margin money. Payment finished or received on account of daily arrangement by the client would be credited or debited to the bank and the subsequent debit or credit for the equivalent should be made to an account titled as ‘Mark-to-Market margin Equity Index or Stock Futures contract account’. For some time the client may deposit a approximate amount to the brokers or trading member in regard of Mark-to-Market margin money as an alternative of receiving or paying mark-to-market margin money on every day basis. The amount should be paid is in the form of a deposit and it is debited to a suitable
account, called: ‘Deposit for Mark-to-Market margin account’. On that basis the amount of
Mark-to-Market margin should be received or paid from such account and this account was
credited or debited to Mark-to-Market margin of Equity Index or Stock Futures account contract
with a corresponding debit or credit to Deposit for Mark-to-Market margin account. At the
financial year ending, any balance in the Deposit for Mark-to-Market margin account must be
shown as deposit under the head ‘Current Assets’.

**Accounting at The Time of Default:** When a client makes default in making payment in regard
of Mark-to-Market margin, then account should be closed out and the amount not paid by the
client is adjusted against the initial margin already paid by the client. In the accounting book or
ledger of the client, the amount of Mark-to-Market margin so adjusted should be debited to the
Mark-to-Market margin of Equity Index or Stock Futures account as the case may be, with a
related credited to the initial margin of equity derivative instrument account. If amount paid on
Mark-to-Market margin account exceeds initial margin then this excess amount is a liability and
should be shown as such under the head ‘Current Liability and Provisions’ and it is recorded
same on the balance sheet date. The amount of profit or loss in the given contract should be
calculated and predictable under profit and loss account by corresponding debit or credit to the
Mark-to-Market margin of Equity Index or Stock Futures account as the case may be.

**Disclosure Requirement for Futures Account:** The amount of bank assurance, book value and
also the market value of securities should be fixed and disclosed in respect of contract having
open positions at the year end. In this case initial margin money has been paid by way of bank
assurance or wedged of securitis. The total number of valuable or non-valuable contracts
entered and gross number of units of Equity Index or Stock futures traded individually for
purchase or sale of contract should be disclosed in respect of each progression of Equity Index or
Stock futures contract. The numbers of Equity Index or Stock futures contract have to maintain
open position and number of unit of Equity Index or Stock futures have to connect with those
contracts which are traded. The daily arrangement or settlement price as of balance sheet date
should be represented independently for long and short situations, in respect of each progression
of Equity Derivative futures market.
2.4 Accounting for Options

The Institute of Chartered Accountants of India (ICAI) issued guidance note on accounting for Index Options or Stock Options from the viewpoint of the parties who enter into such contract as buyers or holder and sellers or writer (See NSE derivative guide line for further detail). Most of the technical terms used in this section are same as futures accounting which are discussed above but the accounting process of options contract are little bit different from futures contract due to its nature. Following are the guidelines for accounting treatment in case of cash settled Index Options and Stock Options.

**Figure 2.2**

*Accounting for Equity Index Options and Equity Stock Options Include The Following Treatments*

- Payment or receipt of the premium
- Open interest as on Balance sheet date
- At the time of Final Settlement
- Squaring up of an option contract
- Method for determination of profit or loss in multiple option situations
- Cash settled stock options contracts
- Delivery settled stock options contracts
- In the book of buyer or holder
- In the book of seller or writer
- In case of buyer or holder
- In case of seller or writer
Chapter: 2

Accounting for Payment or Receipt of The Premium: If client or any investor enters into an options contract, the buyer of the options is supposed to pay the premium amount to the options exchange for placing the options contract. In this process the premium should be debited to a suitable account of buyer or holder, say, Equity Stock or Index Options Premium Account, as the case may be. In the ledger of seller or writer, such premium amount should be credited to an appropriate account, say, Equity Index or Stock Options Premium Account as the case may be.

Accounting for Open Interests in Options Contract as on The Balance Sheet Date: In accounting process the ‘Equity Index Options Premium Account’ and ‘Equity Stock Options premium Account’ should be placed under the head ‘Current Assets’ or ‘Current Liability’ as the case may be. In the book of the buyer or holder, the provision should be made for the amount by which the premium paid for the options exceed the premium on the balance sheet date since the buyer or holder can reduce his loss to the extent of the premium traditional in the market, by squaring up the transaction. The provision so created should be credited to an appropriate account, termed as, ‘Provision for loss on Equity Stock or Index Options Account’ as the case may be. The provision made as above should be shown as deduction from the balance of the ‘Equity Index or Stock Options Account’ which is shown in the book of buyer or holder under the head ‘Current Assets’. The excess of premium customary in the market on the balance sheet date over the premium paid is not predictable and keeping in view that the deliberation of carefulness. In the accounting book of the seller or writer, the provision should be made for the amount by which premium customary or prevailing on the balance sheet date exceed the premium amount got from the options. According to that this provision should be credited to ‘Provision for loss on Equity Index or Stock Options Account’ as the case may be, with a consequent or equivalent debit to profit and loss account. ‘Equity Index or Stock Premium Account’ and ‘Provision for loss on Equity Index or Stock Options Account’ should be or will be shown under ‘Current Liability and Provisions’. If in case of multiple open options at the year end, an index wise or script wise provision should be made for an allowance for all the open options of any Strike Price and any expiry date under the script taking together. The amount of provision required in esteem of each script or index should be aggregated and amalgamated under ‘Provision for loss on Equity Stock or Index Options Account’ and should be credited by debiting the profit or loss account. In case of any opening balance in the ‘Provision for loss on Equity Stock or Index Options Account’, the same should be fit against the provision required in
the current year and the profit and loss account be debited or credited with the balance provision obligatory to be made or excess provision written back. If we consider the case of multiple open options at the year end, the ‘Provision for loss on Equity Stock or Index Options Account as the case may be, should be shown as subtraction from the ‘Equity Stock’ or ‘Index Options Premium Account’ respectively, if these have a debit balance and are disclosed under the head ‘Current Assets’. On the other hand, if ‘Equity Index’ or ‘Stock Options Premium Account’ have a credit balance and are disclosed under the book of account under the head ‘Current Liabilities’, due to that reason particular provision account should be shown ‘Provision’ under the head ‘Current Liabilities and Provisions’

**Accounting at The Time of Final Settlement:** This section describes the accounting process of Equity Index Options or Equity Stock Options in the final settlement of cash-settled stock options contracts and delivery-settled stock options contracts for buyer or holder and seller or writer.

*In the process of cash settled stock options contract, two accounting books should be dealt as under:*

1. In the books of buyer and holder; and
2. In the books of the seller and writer;

In the books of buyer and holder on the implementation of the Options, the buyer and holder will identify premium as an outflow and debit the profit and loss account by crediting the ‘Equity Index or Stock Options Premium Account’. Apart from the higher arrangement in the above discussed segment, the buyer or holder will receive favourable difference, if any, between the final settlement price as on the exercise or expiry date and the strike price, which will be acknowledged as income.

In the books of the seller or writer on the exercise of the options, the seller or writer will be acquainted with premium as an income and credit the profit and loss account by debiting the ‘Equity Index or Stock Options Premium Account’. Apart from the higher arrangement in the above discussed segment, the seller or writer will pay the adverse difference, if any, between the final settlement price as on the exercise or expiry date and the strike price. Such kind of payment will be acknowledged as a loss.

*In the process of Delivery settled stock options contract, two accounting books should be dealt as under:*
If options are not exercised and also expire, then accounting entries will be the same as those in case of cash settled options. If the options are exercised, securities will be transferred in deliberation for cash at the strike price. In such a case, the accounting treatment should be as suggested in the subsequent ways which are given below:

1. *In case of buyer or holder; and*
2. *In case of seller or holder;*

In case of buyer or holder for a call option, the buyer or holder will receive the security for which the call options was entered into. The buyer or holder should debit the appropriate security account and credit cash or bank. For put options, the buyer or holder will deliver the security for which the put options were entered into. The buyer or holder should credit the appropriate security account and debit into cash or bank. In addition to this entry, the premium paid should be transferred to the profit and loss account, the accounting entries for which should be the equivalent as those in case of cash settled options.

In case of seller or writer for a call options, the seller or writer will deliver the security for which the call options was entered into. The seller or writer should credit the relevant security account and debit cash or bank. For put options, the seller or writer will obtain the security for which the put options were entered into. The seller or writer should debit the relative security account and credit cash or bank. In addition to this entry, the premium received should be transferred to the profit and loss account, the accounting entries for which should be the same as those in case of cash settled options.

**Accounting at The Time of Square up of an Options Contract:** At the time when an options contract is squared up by entering into a reverse contract, the difference between the premium paid and received, after adjusting the commission or brokerage charged, on the squared up contract should be transferred on the profit and loss account.

**Accounting Method for Determination of Profit or Loss in The Multiple Options Situations:** In the case of outstanding multiple options to work out profit or loss, we use the same script or index with the same strike price and the same expiry date, weighted average method should be followed on squaring-up of transactions. Similarly for working out profit or loss in case of remaining left multiple equity stock options of the same script with the same strike price and the same expiry date, weighted average method should be used where such options are executed prior to the running out date.
2.5 Position Limit of Various Members of Derivative Market

Position limit of various member of derivative market include the following particular under the different headings which are given in Figure 2.3

Figure 2.3

Position Limit of Various Member of Derivative Market

Source: National Stock Exchange Derivative Option Trading Segment
Derivative market position limit for FII’s and Mutual Funds

The position limits for Foreign Institutional Investor (FII), Mutual Funds (MF), FII sub-accounts and MF schemes are monitored based on the *Custodian Participant (CP) Codes* allotted to these entities by National Securities clearing Corporation Limited (NSCCL). The applicable position limits are as under:

**Custodian Participant (CP) Code:**

NSCCL provides a capability to entities like FIIs, Mutual Funds, NRIs, Domestic body, Corporate and Domestic Financial Institutions etc. To implement trades through any Trading Member (TM), this may be cleared and settled by their own Clearing Member (CM). To avail this advantage, the entities are vital to take a Custodian Participant (CP) Code from NSCCL through the clearing member. The client and clearing members are required to enter into an agreement as per specified format which are prepared by SEBI. Subsequently, all trades done by such CP through any Trading Member (TM) are also obligatory to have the CP code in the relevant field on the F&O trading system at the time of order entry. Such trades transaction can be executed on behalf of a CP are obligatory to be confirmed and finalized by their CM (and not the CM of the TM through whom the trade was executed), within the time given by NSE, using this authentication facility provided by NSCCL to the CMs in the F&O segment. Till such time the trade is confirmed by the CM of the CP, the same is well thought-out as a trade of the TM and the accountability of settlement of such trade vests with the CM of the TM. Once the trades have been confirmed by the CM of the CP, they form part of the obligations of the CM of the CP and they shall be accountable for all obligations arising out of such trades which will include the payment of margins and settlement of obligations. FII or Sub accounts of FII or MF/Scheme of MF which have been fixed a exclusive CP code by the Clearing Corporation shall only be allowable to trade on the Exchange.

**Procedure for Procurement of Custodian Participant (CP) Code by FII/Sub Account and MF Schemes etc:**

It is obligatory for the Clearing members to apply for the NSCCL to allot a CP code with respect of clients for which the member would be carrying out clearing and settlement and supply details of the client in a specified given format. The request should be made along with a letter from the client giving details of the clearing member, who shall clear and settle their trades in the F&O
segment. The client is required to procure a ‘No objection letter’ from the custodian in case the clearing member is different from the caretaker.

**Procedure for Change in Clearing Members:**
In case client need to shift from one clearing member to another clearing member, an NOC would need to be submitted by the old clearing member along with an application from the new clearing member. The application made by the client in the specified format to the new clearing member would also be required to be provided to NSCCL.

**Procedure for Procurement of CP Code by NRIs:**
An NRI is required to submit an application for a client code to the clearing member as per the specified format. The clearing member would apply for a Custodial Participant Code for the NRI client to the Clearing Corporation as per particular format. In case an NRI client wants to shift from one clearing member to another clearing member, an NOC would need to be submitted by the old clearing member along with an application from the new clearing member and the application to the new clearing member by the NRI client.

**At The Level of The FII and MF:**

1. *FII and MF Position limits in Index options contracts:* FII and MF position limit in all index options contracts on a specific underlying index are Rs.500 crores or 15% of the total open interest of the market in index options, whichever is higher. This limit is applicable on open positions in all options contracts on a specific underlying index.

2. *FII and MF Position limits in Index futures contracts:* FII and MF position limit in all index futures contracts on a particular underlying index is Rs.500 crores or 15% of the total open interest of the market in index futures, whichever is higher. This limit is pertinent on open positions in all futures contracts on a specific underlying index. In calculation to the above, FIIs and MFs can take experience in equity index derivatives subject to the following limits:
   a. Short positions in index derivatives such as short futures, short calls and long puts, which are not exceeding in notional value of the FII’s or MF’s holding of stocks.
   b. Long positions in index derivatives such as long futures, long calls and short puts, which are not exceeding in notional value of the FII’s or MF’s holding of cash, government securities, T-Bills and similar instruments.
In this connection we can say, if the open positions of an FII or MF exceed, the limits as acknowledged in item number (a) or (b), so such surplus is deemed to be consisting of short and long positions in the equivalent percentage of the total open positions if done individually. Such short and long positions in surplus of the said limits as compared with the FII’s or MF are holding in stocks, cash etc will be as discussed above. Members are required to inform their assets or holding in stocks, cash etc in a specified format.

3. **FII and MF position limit for Stock Futures & Options:**

   a. For stocks having appropriate ‘Market Wide Position Limit’ (MWPL) of Rs. 500 crores or more, the collective futures and options position limit is 20% of appropriate MWPL or Rs. 300 crores, whichever is lower and within which stock futures position can’t go beyond 10% of appropriate MWPL or Rs. 150 crores, whichever is lower.

   b. For stocks having appropriate ‘Market Wide Position Limit’ (MWPL) less than Rs. 500 crores, the collective futures and options position limit is 20% of appropriate MWPL and futures position can’t go beyond 20% of appropriate MWPL or Rs. 50 crores whichever is lower.

**At The Level of The FII Sub-account or MF Scheme:**

**Index Futures and Options:** A revelation is necessary from any person or persons acting in performance who jointly own 15% or more of the open interest of all futures and options contracts on a specific underlying index on the Exchange. Failure to do so is considered as a violation and attracts suitable penal and corrective action in accordance with the Rules given in guideline, Bye-Laws and Regulations of NSE or NSCCL. For Stock Futures and Options, The total maximum open position across all futures and options contracts on a specific underlying security, of a sub-account of an FII, or MF scheme should not go beyond the higher given policies which are below:

- 1% of the free float market capitalization in terms of number of shares.

Or

- 5% of the open interest in the derivative contracts on a specific underlying stock in terms of number of contracts. These position limits are appropriate on the combined position in all futures and options contracts on an underlying security on the Exchange.
**Procedures for FII Sub-account or MF Scheme:**

The Clearing Corporation regulates the FII position limits at the end of each trading day. For this purpose, FIIs or sub-account of FII interested to trade in the Futures and Options section of the Exchange are subjected to take a custodian participant (CP) code from NSCCL. Only FIIs or sub-accounts of FIIs which have been fixed a unique CP code by Clearing Corporation are allowable to trade on the Exchange. The FII or sub-account of FII should guarantee that all orders placed by them on the Exchange bear the relevant CP code fixed by Clearing Corporation in the applicable field in NEATFO trading system. Clearing Member or Members of the FII are obligated to submit the particulars of all the trades confirmed by FII to Clearing Corporation, by the end of each trading day, as per the working standard mechanism specified. Clearing Corporation supervise the open positions of the FII or sub-account of the FII for each underlying security and index on which futures and options contracts are traded on the Exchange, against the position limits specified at the level of FII or sub-accounts of FII respectively, at the end of each trading day. In the event of an FII breaching the position limits on any underlying, Clearing Corporation advises the Exchange to pull out the advantage granted to such FII to take any fresh positions in any derivative contracts. Such FII is obligated to trim down their open position in such underlying, in relation with the working mechanism provided by Clearing Corporation from time to time. The facility recluse is reinstated in the lead due to the agreement of the position limits. It is also obligatory on FIIs to report any breach of position limits by them or their sub-account/s, to Clearing Corporation and ensure that such sub-account/s does not take any fresh positions in any derivative contracts in such underlying. The sub-account of FII is required to reduce open position in such underlying, in accordance with the working mechanism specified by Clearing Corporation and it also allowed to take further positions only in the lead if it is in accordance with the due compliance of the position limits.

**Computation of Position Limits:**

The position limits are computed on the gross basis at the level of a FII and on a net basis at the level of sub-accounts and proprietary positions. The open positions for all derivative contracts are valued as the open interest multiplied with the closing price of the respective underlying in the cash market.
Derivative Market Position Limit for Trading Member

1. **Trading member position limits in equity index options contracts:** The trading member position limits in equity index options contracts is higher of Rs.500 crore otherwise it is 15% of the total open interest in the market in equity index options contracts. This limit is appropriate on open positions in all options contracts on a scrupulous underlying index.

2. **Trading member position limits in equity index futures contracts:** The trading member position limits in equity index futures contracts is higher the Rs.500 crore otherwise it is 15% of the total open interest in the market in equity index futures contracts. This limit is appropriate on open positions in all futures contracts on a scrupulous underlying index.

3. **Trading member position limits for combined futures and options position:**
   a) For stocks having appropriate Market-Wise Position Limit (MWPL) of Rs.500 crores or more, the collective futures and options position limit is 20% of applicable MWPL otherwise it is equal to Rs.300 crores, whichever is lower and contained by which stock futures position which cannot go beyond 10% of appropriate MWPL or it may be equal to Rs.150 crores, whichever is lower.
   b) For stocks having appropriate Market-Wise Position Limit (MWPL) less than Rs.500 crores, the collective futures and options position limit is 20% of appropriate MWPL and futures position cannot go beyond 20% of appropriate MWPL otherwise it is equal to Rs.50 crore whichever is lower. The Clearing Corporation shall identify the trading member-wise position limits on the last trading day month which shall be considered for the function during the next month.

Derivative Market Position Limit for Client

The gross open position for every client, across all the derivative contracts on an underlying, should not go beyond one percent of the free float market capitalization which include item in terms of number of shares or it should be five percent of the open interest in all derivative contracts in the same underlying stock or it read in terms of number of shares, whichever is higher.
**Derivative Market Position Limit in Terms of Number of Underlying Assets**

The market wide limit of open position (in terms of the number of underlying stock) on futures and options contracts on a separate underlying stock is 20% of the number of shares held by those member who are counted in the category of non-promoters in the relevant underlying security i.e. 20% of the free-float in terms of number of 95 shares of a company. This limit is appropriate on all open positions in all futures and options contracts on a separate or given underlying stock. The particular situation of the market wide limits is done in the following manner:

a) At end of the day, the exchange checks whether the market wide open interest for any scrip went beyond 95% of the market wide position limit for that scrip. In this case, the exchange takes note of open position of all client or Trading Members at the end of that day for that scrip and from next day onwards they can trade only to reduce their positions to make a balance on influence against an opposite influence so that there is no great difference as a result in positions.

b) At the end of each day for the period of which the ban on fresh positions is in force for any scrip, the exchange tests whether any member or client has augmented his obtainable positions or has created a new position in that scrip. If so, that client is subject to a penalty equal to a particular proportion or in terms of basis points of the raise in the position or in terms of ‘Notional Value’. The penalty is taken back before trading begins next day. The exchange specifies the proportion or basis points, which is set sufficiently higher to prevent violations of the ban on rising positions.

c) The standard trading in the scrip is resumed after the open stupendous position comes down to 80% or underneath of the market wide position limit. Further, the exchange also checks on a monthly basis, whether a stock has remained subject to the ban on new position for a considerable part of the month without fail for three months. If so, then the exchange phases out derivative contracts on that underlying.

**2.6 Requirements to Become Futures and Options Segment Members**

The licensing or eligibility criteria for connection on the F&O segment is as given in table 2.1. Requirements for professional clearing membership are given in Table 2.2. Any person(s)
interested in taking membership of Futures and Options division is obligatory to take membership of “CM and F&O segment” or “CM, WDM and F&O segment”. An obtainable member of CM segment can also obtain membership of F&O segment. A trading member can also be a clearing member by submitting supplementary requirements. There can also be only clearing members.

**Table 2.1**

**Eligibility Criteria for Membership on Futures and Options Segment**

<table>
<thead>
<tr>
<th>Particular (All value in Rs.)</th>
<th>CM and Futures and Options Segment</th>
<th>CM, WDM and Futures and Options</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net worth</strong> (No additional net-worth is required for self clearing member, however a net worth of Rs. 300 lakh is required for TM-CM and PCM)</td>
<td>Rs. 100 lakh (Membership in CM segment, trading or self clearing member in Futures and Options segment)</td>
<td>Rs. 300 lakh (Member in WDM segment, CM segment and Trading/self clearing member in Futures and Options segment)</td>
</tr>
<tr>
<td>Interest Free Security Deposit (IFSD) with NSEIL</td>
<td>Rs. 110 lakh</td>
<td>Rs. 200 lakh</td>
</tr>
<tr>
<td>Interest Free Security Deposit (IFSD) with NSCCL (In addition, a member clearing for other is required to bring in IFSD of Rs. 2 lakh per trading member he undertake to clear in Futures and Options segment)</td>
<td>Rs. 15 lakh [Additional IFSD of Rs. 25 lakh with NSCCL is required for trading and clearing (TM-CM) and for Trading or self clearing member (TM/CM)]</td>
<td>Rs. 15 lakh [Additional IFSD of Rs. 25 lakh with NSCCL is required for trading and clearing (TM-CM) and for Trading or self clearing member (TM/CM)]</td>
</tr>
<tr>
<td>Collateral Security Deposit (CSD) (In addition, a member clearing for other is required to bring CSD of Rs. 8 lakh per trading member he undertake to clear in the Futures and Options segment)</td>
<td>Rs. 25 lakh [Additional collateral Security Deposit (CSD) of Rs. 25 lakh with NSCCL is required for trading clearing (TM-CM), and for trading and self clearing member (TM/SCM)]</td>
<td>Rs. 25 lakh [Additional collateral Security Deposit (CSD) of Rs. 25 lakh with NSCCL is required for trading clearing (TM-CM), and for trading and self clearing member (TM/SCM)]</td>
</tr>
<tr>
<td><strong>Annual Subscription</strong></td>
<td>Rs. 1 lakh</td>
<td>Rs. 1 lakh</td>
</tr>
</tbody>
</table>

Source: www.nseindia.com
### Table 2.2
requirement for professional clearing member

<table>
<thead>
<tr>
<th>Particular (All Value in Rs.)</th>
<th>Clearing Member Segment</th>
<th>Futures and Options Segment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligibility</td>
<td>Trading member of NSE or SEBI Registered Custodians or Recognized Bank</td>
<td>Trading member of NSE or SEBI Registered Custodians or Recognized Bank</td>
</tr>
<tr>
<td>Net Worth</td>
<td>Rs. 300 lakh</td>
<td>Rs. 300 lakh</td>
</tr>
<tr>
<td>Interest free security Deposit (IFSD) (PCM is required to bring in IFSD of Rs. 2 lakh per trading member who trades in undertakes to clear in Futures and Options segment and Rs. 6 lakh per trading member in the CM segment and finally Rs. 9 lakh for respectively for corporate members.)</td>
<td>Rs. 25 lakh</td>
<td>Rs. 25 lakh</td>
</tr>
<tr>
<td>Collateral security deposit (CSD) (PCM is required to bring CSD of Rs. 8 lakh per trading member whose trade is undertakes to clear in Futures and Options segment and Rs. 17.5 lakh per trading member in the CM segment and finally Rs. 25 lakh respectively for corporate members)</td>
<td>Rs. 25 lakh</td>
<td>Rs. 25 lakh</td>
</tr>
</tbody>
</table>

Source: www.nseindia.com

### 2.7 Requirement to Become Authorized or Approved Users

Trading members and derivative market participants are permitted to select or appoint, with the authorization of the Futures and Options segment of the exchange. The certified persons and standard users are allowed to operate the trading workstation(s). These certified users can be individuals, registered partnership firms or Joint venture firms or corporate bodies as defined under the Companies Act, 1956 (See SEBI Guide line for further reading).

Certified persons cannot gather any commission or any amount openly from the clients he introduces to the trading member who selected him. On the other hand, he can receive a
commission or any such amount from the trading member who selected him as provided under regulation of derivative market.

Approved users on the Futures and Options segment have to clear a certification program which has been approved by SEBI on the basis of minimum passing marks criteria. Every approved user is given a matchless ID number through which he will have right to use the NEAT system. The approved user can enter in the NEAT system through a password and can also change such password on the basis of its requirement time to time.

2.8 Taxation on Derivative Transactions

Taxation on derivative transaction are divided in two parts see figure 2.4

![Figure 2.4](image)

**Securities Transaction Tax on Derivatives Transaction:**
Securities transaction tax on derivative transaction was introduced by Finance Act (No. 2) in 2004 for those who enter in recognised stock exchange. Basically this tax is payable by the sellers and buyers of derivative instrument. The rate of tax applicable in 2005 as per Finance Act was 0.0133% and this transaction tax is only paid by the seller of futures and options contract but not by the buyer of futures and options contract. After that, in 2006, the securities transaction tax changed to 0.017% but paying party condition was same as above. Finally, on 1st June 2008 Securities Transaction Tax (STT) was again changed as per Finance Act 2008 and is still in practice. In this Finance Act 2008, both buyer and seller paid transaction tax on options contract, however, in case of futures, only seller will pay transaction tax. For more detail related to transaction rate (see table 2.3).
Table 2.3
Tax on Derivatives Transactions

<table>
<thead>
<tr>
<th>Taxable Transaction</th>
<th>Rate of Tax</th>
<th>Payable by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales of an Options in Security</td>
<td>0.017%</td>
<td>Seller</td>
</tr>
<tr>
<td>Sale of an Options in Security, where options is executed</td>
<td>0.125%</td>
<td>Purchaser</td>
</tr>
<tr>
<td>Sale of a Futures in Security</td>
<td>0.017%</td>
<td>Seller</td>
</tr>
</tbody>
</table>

Source: www.nseindia.com

The value of taxable securities in transaction which belongs to ‘options in security’ is the summation of the strict price and the options premium of such ‘options in security’. The value of taxable securities operation link to ‘Futures’ is the price at which such ‘futures’ are traded. According to Securities Transaction Tax (STT) Rule 2004, which provides the facility for rounding off the value of taxable securities operation, amount of security operation or transaction, interest related payment, penalty payable and the amount of reimbursement outstanding to the nearest rupee.

**Taxation of Profit and Loss on Derivative Transaction in Securities:**

Before FY: 2005–06, dealings in derivatives were measured as ‘speculative transactions’ for the purpose of solving of tax burden under the Income-tax Act. This is dealt according to the guideline of section 43(5) of the Income-tax Act which defines ‘speculative transaction’ as a transaction in which a agreement for purchase or sale of any commodity, together with stocks and shares, from time to time or at the end of the day should be settled or else there should be actual delivery or transfer of the commodity. On the other hand, such contract dealings entered by safe investor and stock exchange members in course of arbitrage movement were particularly disqualified from the limit.

According to the observation of the above requirements, a good number of transactions get entered in the segment of derivatives by investors and speculators but these transactions are considered as speculative transactions. The tax requirements provided for degree of difference dealing with respect to set off and carry forward of loss on such transactions. Loss on derivative contract transactions might be set off only in opposition to other speculative income and the similar action could not be set off beside any new income and this result will be in payment of
higher taxes by an assesses. Another time, when losses on derivative transaction occur, which
could not be set off once more, any supplementary speculative gain could be approved onward
for the time of four years. If such kind of losses could not be set off against speculative income
over the given period, then assesses could not argue any tax break with the deference to the loss
suffered.
According to Finance Act 2005, under section 43(5), we have to exclude transactions in
derivatives which are not approved by “Documented or Recognized Stock Exchange” as per
SEBI guide line for this purpose. This implies that profit or loss on derivative transactions which
are carried out in a “Documented stock exchange” is not taxed as tentative or speculative profit
or loss. As a result, loss on derivative transactions can be place off in opposition to any other
income for the period of the given financial year. In case the same cannot be placed off, it can be
carried ahead to successive assessment year and place off in opposition to any other income of
the successive year. Such losses can be carried ahead for a period of eight assessment years. It
may also be noted that securities transaction tax compensated on such transactions is entitled as

2.9 Summary
In this chapter the researcher studies the policy and regulatory framework of Indian derivative
market. This includes the accounting for Futures & Options, position limit of various participants
of derivative market members (i.e FII, MF, TM and Client etc), basic requirement to become
Futures & Options segment member and authorised users and also covers taxation policy of
Indian derivative market.