




Chapter-3

*Indian Derivatives Market:
A Regulatory and Contextual
Perspective*



CHAPTER - III

INDIAN DERIVATIVES MARKET: A REGULATORY AND CONTEXTUAL PERSPECTIVE

3.1 Introduction

Regulation helps in controlling human or societal behaviour. It issued by an executive authority or regulatory agency of a government and having force of law. All the private and public behaviour are covered by regulation but its scope varies across countries. It can be clearly defined as taxes and subsidies of all sorts as well as open legislative and administrative controls over rates, entry and other aspect of economic activity.

For economic effectiveness and private incentives, regulation can have significant results; it is generally justified only under particular situations. Consequently, there are three sets of validations for regulatory involvements – avoidance of market failures, removal of anti-competitive practices, and promotion of public interest.

In the mid 1970, the Bretton Woods Fixed Exchange Rate system was terminated. At that time, Erratic Exchange Rates, fluctuations in interest rates and relatively higher levels of inflation was very common in the world. This situation was riskier for financial institutions.

With eco reforms in 1991, India began regulatory institutions for financial need but the developed regulatory environment does not appear standardized across sectors. The development of information technology which helps in financial innovation, had led to the introduction of the financial derivatives that can be used as a risk reduction tool for financial institutions. Growth in information technology, regulatory control led to a constant advancement in financial derivatives.

The objective of this chapter is to evaluate the regulatory structure and status of regulation in India for financial market. It also explains the background for regulation and details of its objectives. Further, it evaluates the factors, which affect the

regulatory environment. It also examines the regulatory process of financial derivatives market in India.

3.2 Brief History of Forward Trading

Sahoo (1997) state the precursor to exchange based derivatives in India was kind of “forward trading” in securities in the form of put option (mandi), call options (teji), and straddle (fatak) etc. The Securities Contract Regulation Act (SCRA, 1956) was enacted, inter-alia, to prevent undesirable speculation in securities. The contracts for “clearing commonly known as “forward trading” were banned by the Central Government on 27 June 1969. As the prohibition of forward trading in securities led to a decline of trade volumes on stock markets, the Stock Exchange, Mumbai (BSE), evolved in 1972 an informal system of “forward trading”, which allowed carry forward between two settlement periods, which resulted in substantial increase in the turnover of the exchange. However, this has also created several problems, and there were payment crisis from time to time and frequent closure of the market. During December 1982 – January 1983, the government reviewed the position and amended the byelaws of the stock exchanges to facilitate performance of contracts in “specified securities”. In pursuance of this policy the stock exchanges at Bombay, Ahmadabad and Calcutta introduced a system of trading in “specified shares” with carry forward facility after amending their byelaws and regulations.

The Joint Parliamentary Committee (JPC) appointed in 1992 on irregularities in Securities and Banking Transactions argued the issue of “carry forward deals” and concluded that this system was not running properly because there were a lot of abnormality in the stock exchanges in the form of non enforcement of margins, on reporting of transactions and illegal trading outside the stock exchange. SEBI thought that the carry forward transactions should not be allowed and transactions conducted strictly on delivery basis and trading in futures and options should be allowed in separate markets.

SEBI instructed the stock exchanges to stop the traditional system of carry forward of transactions (badla) in December 1993. Afterward, in March 1994, it recommended an alternative system, but this system was not implemented due to lack of agreement. To review the system of carry forward transactions, SEBI form a committee under the chairmanship of G.S. Patel in February 1995. On the recommendation of G.S. Patel

committee, SEBI adopted the carry forward system with some modification. This system was known as Revised Carry Forward System (RCFS). This RCFS was executed in the BSE in January 1996, but the other exchanges in which the traditional carry forward system had been common before December 1993 did not come forward to adopt the RCFS. After one year of implementation of Revised Carry Forward System (RCFS), the President of the BSE asked SEBI for relaxation of certain aspects of the RCFS to make it more practical and competent.

In 1997, It was further re-examined by Verma Committee report and the system was again amended subject to a number of protections such as segregation of the carry forward transactions at the time of implementation of trade, daily margin of 10%, 50% of which would be collected direct, overall carry forward limit of Rupees 20 Crores (CF-Conversion table) per broker per settlement and other prudential protection.

3.3 Genesis of Regulation in Financial Derivatives

The regulatory framework of derivatives market is based on the Gupta Committee report and the Verma Committee Report. It is mainly reliable with the international organization of securities commission (IOSCO). The Gupta committee report specified regulatory responsibility of Stock Exchange and SEBI. It advocated that SEBI's role should be confined as approving body for rules, byelaws and regulations for derivatives exchange. It also has to approve proposed derivatives contract before beginning of their trading. This highlights the supervisory and advisory role of SEBI. The committee also advised for establishment of a separate clearing corporation.

The Securities Laws (Amendment) Bill was passed by the Parliament allowing a legal framework for derivatives trading in India in December 1999. Subsequently, the Central Government removed a three-decade-old ban on forward trading in securities on 1st March 2000. Concurrently, in order to uphold a systematic development of market; another notification was issued by the Government on trading but permitted derivatives contracts as permissible under the Securities law.

3.4 Evolution of Legal Framework

The Government of India formed numerous committees at different time to develop a regulatory framework for futures trading. In 1950 A.D. Shroff Committee was formed by the Indian Government whose report shaped the basis of the forward contract (Regulations) Act, 1952. The M.L. Dantwals Committee examined the SCRA (Security Contract Regulation Act) and the functioning of the Forward Market Commission and gave certain suggestions. The A.M Khusro Committee was also formed to advance review of the functioning of forward market and FMC (Forward Market Commission) in 1979. Indian Government formed the K.N. Kabra Committee in 1993, which submitted its report in September 1994 with the following major suggestions:

3.4.1 Kabra Committee Recommendations (1994)

1. More members should enroll on the Commodity exchanges.
2. For smooth functioning, capital adequacy norms must be ensured.
3. The commodity exchanges should be computerized so as to online trading be made sure.
4. The exchange should be made stronger of its internal vigilance mechanism.
5. Non-transferable specific delivery forward contracts should be freed from limits.
6. Range forward contracts and options may be launched. Though, the Chairman of the committee was not agreed with it.
7. The exchanges should be identified on permanent basis.
8. The exchanges should be expanded into self-regulatory organizations.
9. The Forward Markets Commission should be made stronger with more powers.
10. Extra commodities should be included in futures trading like basmati rice, cottonseed, ground nut, rapeseed, linseed, copra, sesames seed, mustard seed, soya-bean, etc.

3.4.2 Sodhani Expert Group Recommendations (1994)

On Foreign Exchange, the forward contracts and options are performed through the over-the-counter (OTC) markets and regulated by the Reserve Bank of India. The RBI formed a committee under the chairmanship of O.P.Sodhani on foreign exchange markets functioning in November 1994. The committee gave the following suggestions:

1. The companies should be given consent to book, cancel and rebook options on foreign currencies.
2. Bank should propose range forward contracts.
3. There should be no maintenance taxes on derivatives transactions.
4. For using derivatives, additional right should be given to banks.
5. More derivative instruments like caps, dollars, floors, FRAs, swaps should be permitted to offer by the banks to the traders without the approval of RBI.
6. Different particular dealers should be permitted to offer derivative instruments.
7. There should be correct documentation and market practices developed for better functioning of the markets.

3.4.3 R.V. Gupta Committee's Recommendations (1997)

To review 'Hedging' through International Commodity Exchanges and other related issues, RBI formed a committee under the chairmanship of R.V.Gupta. The committee's main suggestions were as follows:

- a. All the Indian companies with real commodity price risk exposures are permitted to hedge throughout off shore commodity futures and options markets.
- b. For such hedging contracts, the Central Government should grant permission and the RBI should permitted the essential exchange control permission.

- c. International markets should be permitted only hedging contracts for actual price exposure, and not the speculative or profit seeking objectives.
- d. Vanilla swaps like OTC instruments would only be allowed where they have only efficient means of hedging.
- e. Use of options would not be permitted.
- f. The committee suggested a phased manner approach.
- g. Phase-I, the hedging should generally be through exchange traded commodity futures.
- h. Phase-I, would be an age of adaptation. Prior consent would be necessary at this stage (i) to make sure existence of actual underlying risk, (ii) the suitability of the hedging instrument and (iii) adequateness of risk management procedures.
- i. In Phase-II, No prior consent should be required, as suggested in Phase-I. Only periodic inspection of real transactions and auditor's certification satisfactoriness of control are sufficient.
- j. Further, the Committee suggested that hedging should be permitted through foreign derivatives markets.

Though, the futures markets experts examined that due to lack of experience of the Indian corporate sector about the functioning of international commodity derivatives and insufficient experience amongst auditors, a longer 'acclimatization' period of at least three years is desirable instead of one year as suggested by the committee.

3.4.4 Gupta Committee Report (1998)

SEBI formed a committee under the chairmanship of L.C. Gupta in November 1996 for the development of appropriate regulatory framework for derivatives trading in India. The major recommendations of this committee are as under:

1. The Committee is strongly suggested that there is urgent requirement of introducing of financial derivatives to help market development and hedging in a most cost-efficient way against market risk by the members such as mutual funds and other investment institutions.

2. Equity derivatives, interest rate derivatives and currency derivatives were required.
3. Further, derivatives trading should be commenced in phased manner, starting with stock index futures, which will be followed by options on index and later options on stocks. It will improve the efficiency and liquidity of cash markets in equities through arbitrage process.
4. For regulatory framework of derivatives trading, there should be two level regulation i.e., exchange level and SEBI level. Additional, there must be significant emphasis on self-regulatory ability of derivative exchanges under the overall supervision and guidance of SEBI.
5. The derivatives trading should be started on separate segment of existing stock exchanges having an independent governing council. Trading members will be limited to 40 percent of the total member. The head of the governing council will not be allowed to trade on any of the stock exchanges.
6. An independent clearing corporation/Clearing house should be settled the derivatives trading which will become counter party for all trades or alternatively guarantees the settlement of all trades. The clearing corporation will have sufficient risk containment measures and will collect margins through Electronic Fund Transfer (EFT).
7. On-line trading and adequate surveillance systems will be on the derivatives exchange. It will distribute trade and price information on real time basis through two information transaction networks.
8. There will be absolute separation of client money at the level of trading/clearing member and even at the level of Clearing Corporation.
9. The trading and clearing member will have strict qualified conditions. At least two persons should have passed the certification programme approved by the SEBI.
10. Minimum Rs. 50 lakhs should be deposited by the clearing members with Clearing Corporation and should have a net worth of Rs. 3 Crores.

11. Regulatory prohibition should be removed on the use of derivatives by mutual funds while making the trustees answerable to restrict the use of derivatives by mutual funds only to hedging and portfolio balancing and not for speculation.
12. The operations of the cash market on which the derivatives market will be based, required development in many respects.
13. SEBI should be created a Derivation Cell, a Derivative Advisory Committee, and Economic Research Wing.
14. Derivatives should be declared as 'securities' under Section 2(h) of the SCRA and suitable amendments in the notification issued by the Central Government in June 1969 under Section 16 of the SCRA.

The SEBI Board for regulation and control of trading and settlement of derivatives contracts approved the Byelaws that are suggested by the Gupta Committee.

In 1998, Verma committee was also formed by SEBI to recommend risk containment measures for derivatives trading.

The Government made a decision that a legislative modification in the securities law was necessary for preparing a legal framework for derivatives trading in India. Accordingly, in July 1998, the Securities Contracts (Regulation) Amendment Bill 1998 was introduced in the Lok Sabha and was submitted to the Parliamentary Standing Committee on Finance for examination and report there on. The Bill advised that derivatives may be incorporated in the definition of "securities" in the SCRA whereby trading in derivatives may be probable within the framework of that Act. On March 1999, the said committee submitted its report.

The Committee thought if derivatives implemented with proper safeguards and risk containment measures, will surely give an incentive to the drooping market, result in increased investment and inculcate confidence between investors and participants. The committee examined that since cash settled contracts could be categorized as "wagering agreements" which can be null and void under Section 30 of the Indian Contract Act, 1872, and since index futures are always cash settled, such futures contracts could be knotted in legal argument.

Consequently, the committee advised an intervening provision as a matter of abandoned vigilance – “Although anything enclosed in any other Act, contracts in derivatives as per the (SCRA) Securities Contract Regulation Act shall be legal and valid.” Further, since Committee was satisfied that stock exchanges would be better equipped to commence trading in derivatives in complicated environment. It would be careful to allow trading in derivatives by such stock exchanges only. The Committee, then recommended a clause-“The derivatives shall be traded and settled on stock exchanges and clearing houses of the stock exchanges, respectively in accordance with the rules and bye-laws of the stock exchange.” The proposed Bill, which is included the suggestions of the said Parliamentary Committee, was at last passed in December 1999.

Various operational and legal measures were also suggested by the Committee to protect the reliability of the capital market and protect investors. These measures, inter-alia, include the following:

1. Educate the Indian investors through providing investment knowledge among them by conducting intensive educational programs, so that they can easily understand their risk profiles in a better way.
2. Procedures should be obtained to make stronger the cash market so that they become strong and well organized.
3. The regulatory authorities make sure a strong inspection and enforcement machinery.
4. Derivatives trading need a vital group of refined investors supported by credit and stock analysts, SEBI should in consultation with the stock exchanges, attempting to organize certification program on derivatives trading with a view to generate the awareness to the investors and market intermediaries.
5. Protection should be provided to the small investors by avoiding them from risk in to options and futures market, which may be attracted by absolute speculative gains. The entry limit of the transactions should be pegged not below Rs. 2 lakhs.
6. The accounting standards should be set in the case of investors, dealers and also back office standards for intermediaries with a view to trim down the

possibility of hiding loss and doing the frauds by companies and intermediaries. Hence, the Institute of Chartered Accountants of India should prepare appropriate accounting standards and SEBI should lay down the same before the starting of derivatives trading.

7. The stamp duty should be exempted on derivatives transactions. The statutory regulators were executed the suggestion and recommendations of the said committee.

Therefore, the revoke of 1969 notification and the passing of Securities Laws (Amendment) Act 1999 offered a legal framework for securities based derivatives trading on stock exchanges in India, which is co-terminus with framework of trading of other 'securities' allowed under the SCRA. In June 2000, the trading of Stock Index Futures was started and latter on, other products such as, Stock Options, Stock Index Options and Single Stock Futures were also permitted. Under the said Act of 1999 (No. 31 of 1999) the derivatives are officially define as (a) a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security and (b) contract which derives its value from the prices or index of prices or underlying securities.

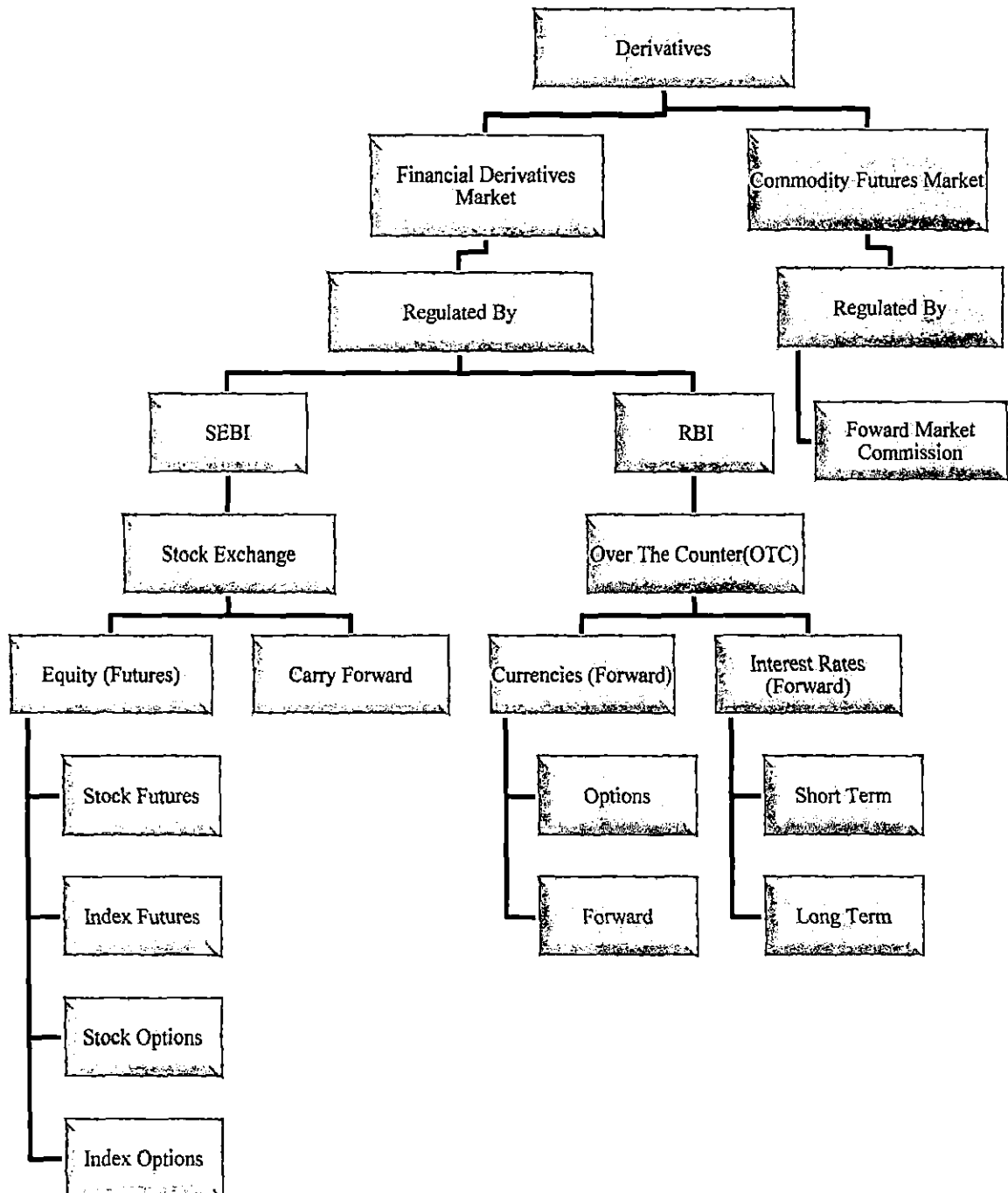
It is also explained by the Act that, even though anything include in any other law for the time being in force, contract of derivatives shall be legal and valid only if such contracts are traded on a recognized stock exchange and settled on a clearing entity of the recognized stock exchange in accordance with the rules and bye laws of such stock exchange

3.5 Market Structure and Regulatory Framework for Indian Derivatives Market

The regulatory framework of derivatives trading is based on two level regulation i.e., exchange level and SEBI level and it is significant emphasis on self-regulatory ability of derivative exchange under the overall supervision and guidance of SEBI.

The regulatory framework in India is mostly consistent with the IOSCO principles and regulatory framework for exchange traded derivatives talk to general concerns of investor protections, market efficiency and reliability and financial reliability.

Chart 3.1: Structure of derivatives markets in India



Source: Researcher's own compilation through S.L. Gupta, Financial derivatives theory, concept and problem. p.130

3.5.1 The Regulators

With increase the market activity and volume, a strong and independent regulator is needed.

The regulators make sure that the market participants perform in a desired manner so that securities market should protect the interest of the investor. In India, The Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Forward Market Commission (FMC) regulate derivatives instrument.

3.5.1.1 Reserve Bank of India

Reserve Bank of India (RBI) is one of the regulators of the Indian derivatives market, but this has been limited to debt management through primary dealers, foreign exchange control and liquidity support to market participants. The Securities transactions that related a foreign exchange transaction need the permission of RBI.

RBI is authorized to regulate the markets in interest rate derivatives, foreign currency derivatives and credit derivatives. In anticipation of the amendment to the RBI Act in 2006, there was some doubt in the legitimacy of OTC derivative which were cash settled. It has been tackled through an amendment in the said act regarding of derivatives which fall under the regulatory purview of RBI (with underlying as interest rate, foreign exchange rate, credit rating or credit index or price of securities) offered one of the parties to the transaction is RBI, a scheduled bank or any other entity regulated under the RBI Act, Banking Regulation Act or Foreign Exchange Management Act.

3.5.1.2 Forward Market Commission

Forward Markets Commission (FMC) is a regulatory body for commodity futures market in India. It is a constitutional body set up under Forward Contracts (Regulation) Act 1952.

The Central Government formed a commission by notification in the official Gazette to be called the Forward Markets Commission for the purpose of performing such functions and duties, which are assigned to it by the Act.

Functions of the Commission: The functions, which are performed by the commission, will be:

- 1) To advise the Central Government regarding the recognition of or the withdrawal of recognition from any association or in respect of any other matter occurring out of the administration of this Act;
- 2) Observed the forward market and to take such action for them as it may think necessary, in exercise of the powers allotted to it by or under this Act.
- 3) To collect and at any time the Commission thinks it necessary publish information regarding the trading conditions regarding goods to which any of the provisions of this Act is made applicable, including information regarding supply, demand and prices, and to submit to the Central Government periodical reports on the operation of this Act and on the working of forward markets relating to such goods.
- 4) To give suggestions generally with a view to improving the organization and working of forward markets.
- 5) To take on the inspection of the accounts and other documents of (any recognized association or registered association or any member of such association) whenever it considers it necessary.

3.5.1.3 Securities and Exchange Board of India

Securities and Exchange Board of India (SEBI) was formed as an administrative arrangement in 1988. The SEBI Act was passed in 1992, which provided statutory status to SEBI. It authorized SEBI to perform dual function as investor protection through regulation of the securities market and promoting the growth of this market. SEBI has been given major powers under the Securities Contract Regulation Act (SCRA), which brought stock exchanges, their members, as well as contracts in securities. It has also been assigned certain powers under the Companies Act. Besides registering and regulating intermediaries, service providers, mutual funds, collective investment schemes, venture capital funds and takeovers, SEBI is also has a power to issue directive to any person(s) related to the securities market or to the companies in

areas of issue of capital transfer of securities and disclosures. It also has authority to inspect books and records, suspend registered entities, and cancel registration.

3.5.2 Legislation

The various Acts of Government of India offered the framework of regulating derivative transaction such as Reserve Bank of India Act, 1934, Forward Contracts (Regulation) Act 1952 and Securities Contracts (Regulation) Act, 1956, and related Rules, Regulations, Guideline, Circulars etc.

Securities and Exchange Board of India (SEB) regulated Exchange traded equity derivatives market whereas the exchange traded commodity derivatives market is regulated by the Forward Markets Commission (FMC) in India. The exchange traded foreign currency and interest rate futures jointly regulate by the Reserve Bank of India (RBI) and SEBI. The foreign currency interest rate and credit derivatives traded in the Over the Counter (OTC) market it also under the control of RBI.

3.5.2.1 Reserve Bank of India Act 1934

Through Reserve Bank of India Act 1934, RBI mostly deals with transactions involving banking derivatives, money market instruments, securities etc., in a separate chapter III D and also deals with non-banking institutions by giving instructions on convertible debentures etc.

3.5.2.2 Forward Contracts (Regulation) Act 1952

Forward Contracts (Regulation) Act is an act to offer for the regulation of certain matters relating to forward contracts, the prohibition of options in goods and for matters associated therewith. The forward Market Commission (FMC) under this Act regulates the exchange traded commodity derivatives.

3.5.2.3 Securities Contract Regulation Act (SCRA) 1956

It offers for direct and indirect control of practically all parts of the securities trading including the running of stock exchanges, which aims to prevent undesirable transaction in securities. It provides the Central Government regulatory authority over:

- (i) Stock exchanges through a process of recognition and continued supervision,
- (ii) Contracts in securities
- (iii) Listing of securities on stock exchanges.

For the recognition, a stock exchange complies with the condition prescribed by the Central Government. The stock exchange frame their own listing regulations in connection with the minimum listing criteria set out in Securities contracts Regulation Rules 1956.

3.5.2.4 SEBI Act 1992

SEBI is main law for regulation of securities market in India. It has wide ranging powers and also draws from SCRA and Companies Act, 1956.

The SEBI Act 1992, was passed to empower SEBI with constitutional powers for –

- i) Protecting the interests of investors in securities
- ii) Encouraging the development of the securities market and
- iii) Regulating the securities market.

Its regulatory control expands over corporate issuing securities and all intermediaries and persons associated with securities market. It can perform enquiries, audits and inspection of all concerned participant and adjudicate offences under this Act. It is authorized to register and regulate allow the market intermediaries Further it can also punish them in case of violation of the provision of the Act, Rules and Regulations made there under. SEBI has full autonomy and power to regulate and develop an orderly securities market.

3.5.3 Major Regulations for Derivatives in India:

Some economic or in the public interest major regulations implemented in India are as below:

Table-3.1 List of Major Regulations in India for Derivatives

Act	Purpose
The Indian Contract Act, 1872	Governing legislation for contracts, which lays down the general principles relating to formation, performance and enforceability of contracts and the rules relating to certain special types of contracts like Indemnity and Guarantee; Bailment and Pledge; as well as Agency.
Securities Contracts (Regulation) Act, 1956	To prevent undesirable transactions in securities by regulating the business
The Company Act, 1956	To regulate setting up and operation of companies in India: it regulates the formation, financing, functioning and winding up of companies.
The Bureau of Indian Standards Act, 1986	To set standards (quality, safety etc.) for various kinds of products to protect consumer safety.
The Information Technology Act, 2000	To provide legal recognition for transactions carried out by means of electronic data interchange and other means of electronic communication, commonly referred to as "electronic commerce", which involve the use of alternatives to paper-based methods of communication and storage of information; to facilitate electronic filing of documents with Government agencies

Source: Researcher's own compilation through borjournals.com

Table 3.2: A Chronology of Events: Financial Derivatives in India

S. No.	Progress Date	Progress of Financial Derivatives
1	1952	Enactment of the Forward Contracts (Regulation) Act.
2	1953	Setting up of the Forward Market Commission.
3	1956	Enactment of SCRA
4	1969	Prohibition of all forms of Forward Trading under section 16 of SCRA.
5	1972	Informal carry forward trades between two settlement cycles began on BSE.
6	1980	Khuso Committee recommends reintroduction of Futures in most commodities.
8	1992	Enactment of the SEBI Act.
9	1993	SEBI Prohibits Carry Forward transactions.
13	1996	Revised Carry Forward system restarted on BSE.
14	18 th Nov.1996	SEBI setup Gupta committee to draft frame work for Index Futures
15	17 th March 1998	Gupta committee submitted report
16	1 st June 1999	Interest Rate Swaps/Forward Rate agreements allowed at BSE
17	7 th July 1999	RBI gave permission to OTC For Interest Rate Swaps/Forward Rate Agreements
19	25th May 2000	SEBI gave permission to NSE & BSE to do Index Futures trading
20	9th June 2000	Commencement of derivatives trading(Index Futures) at BSE
21	12th June 2000	Commencement of derivatives trading (Index Futures) at NSE
26	9th July 2001	Stock options launched at BSE
27	July 2001	Commencement of trading in Options on Individual Securities
28	1st Nov. 2001	Stock Futures launched at BSE
29	Nov. 2001	Commencement of trading in Futures on Individual Security

Source: Compiled from BSE, NSE website & borjournals.com

3.6 Regulatory Objectives

The regulation should be planned to attain particular well define objectives. It was aimed towards affirmative regulation planned to promote healthy movement and behavior. The main objectives are:

3.6.1 Investor Protection: The following four aspects are basically occurred in it.

- (i) **Fairness and Transparency:** It should be make sure by the trading rules that trading is performed in a fair and transparent manner. The practice in other countries explains that in various cases, the dealers and brokers of derivatives product unable to disclose possible risk to the clients. In such situations, the detailed regulation would require for sales practices in derivatives products for dealers. In some of the most commonly reported disasters in the derivatives market in another place, the basic reason was poor internal control system at the user-firm itself so that overall exposure was not controlled and the use of derivatives was for speculation rather than for risk hedging. These practices provide important lessons for us for drafting regulations.
- (ii) **Safeguard for clients' money:** The Moneys and securities which was deposited by the clients with the trading members should not only be stayed in a separate clients' account but should also not be attachable for meeting of the own debts of the broker. It should be make sure that the trading by the dealers on own account is fully separated from that for clients.
- (iii) **Competent and honest service:** The Committee suggested that the eligibility criteria should be draw carefully for trading members with the purpose of to promote competent and qualifies personnel with the aim of investors or clients are served well. For this purpose, it is important to define qualification for derivatives brokers or dealers and the sales persons appointed by them in terms of knowledge base.
- (iv) **Market integrity:** The trading system should make sure that reliability of market is maintained by minimizing the possibility of defaults. For this

purpose, the suitable rules should be framed about capital adequacy, margins, clearing corporation, etc.

3.6.2 Quality of Markets: The perception of “Quality of Markets” goes well beyond market reliability and aims at improving important market excellence, such as cost-efficiency, price-continuity, and price-discovery. It is much extensive objective than market reliability.

3.6.3 Innovation: Though restriction any unwanted tendencies, the regulatory framework should not smother innovation which is the foundation of all economic progress, more so because financial derivatives signify a new rapidly developing area supported by development in information technology.

3.7 Regulatory Instruments

Now a days, various types of derivatives are available in the market which are managed by different governing bodies like Stock Exchanges, Trade Associations, Clearing Houses and over-the-counters etc. Therefore, their issues relating to implementation and regulations are also different. To solve these issues, some important regulatory instruments are used by the different regulatory bodies from time to time. These regulatory instruments are:

3.7.1 Margin Variation:

A part of the value of the derivatives contract which has to be paid in cash or securities by the seller or the buyer or the both, as the case may be in the futures market is known as margin. The main objectives of such margin is to confirm the safety of the contract or protecting from the defaults caused by one of the parties to the contract. The higher margin will have more safety for the parties but at the higher cost. The volume of trading will be affected in particular asset by the increase and decrease in margin. To check the high speculation and thinness of the market this instrument is frequently used by the regulatory bodies.

3.7.2 Imposition of Special Margins:

When regulatory body imposed the margins, which are over and above of normal margin is known as special margins. It is imposed only in that condition when prices are higher or lower to specified limits.

3.7.3 Daily or Weekly limits on Price Changes:

Daily or weekly limits on price changes are another important tool to control the futures trading. The main purpose of such tool is to control the prices of the futures instrument in a certain limits.

3.7.4 Limit on Open Position:

The open position relates to the limit on volume of trading for a specific instrument for the traders in the market. The basic objective of this instrument is just to avoid manipulation or excessive speculation by the large operators. This limit is basically imposed in case of speculative open position.

3.7.5 Temporary Suspension of Trading:

Through such instrument, the regulatory body stops the trading in specific asset temporarily for particular period. The main purpose behind this is to curb speculation because it has been noticed in the market that, sometimes, over dose of speculative manipulation which rendered the markets completely out of tune with reality. Through this instrument the regulatory bodies can close out all the existing futures contracts at a fixed rate which does not give the 'offending' parties the speculative gain for which such deals were initiated.

3.7.6 Changes in Number and /or Timing of Contracts:

This instrument is related to change in number and timings of the futures contracts being traded because, sometime, it is not well suited to the seasonality of supply or demand of the particular asset or commodity.

3.7.7 Fixation of Price Limit:

In this method, the regulatory bodies fix the minimum and/or maximum price limits which the futures market is not allowed to move. The basic objectives of this technique is to protect the markets at the time of shortage or gluts.

3.7.8 Indefinite Suspension or Banning of Trading:

Sometimes, the futures market reached in that situation where trading is to be stopped indefinitely or till next order of the authority for restarting of the trading. This is done

only in that case when regulatory body or authority feels that there is no other alternative is available excepting tentative suspension of trading the market.

3.8 Risk Containment Measures in Indian Derivatives Market

Before the introduction of derivatives in India, SEBI felt that there was an urgent requirement to set the group to recommend the measures for risk containment in the derivatives market. Consequently, SEBI constituted a group under the chairmanship of J.R.Verma in 1998. The group recommended the following measures for risk containment in Indian derivatives market.

3.8.1 Recommended by Verma Committee

3.8.1.1 Estimation of Volatility

(Clause 2.1)

There occur numerous issues in the evaluation of volatility

1. When we compare the Indian market to the developed market the volatility looks very high in Indian market.
2. The volatility in Indian market is not stable and is changing over time.
3. The statistics on the volatility of the index futures markets are not be present (as these markets are yet to be introduced) and hence, in the early period, dependence has to be made on the volatility in the underlying securities market.
4. The GC advised that no cross margining would be allowed and separate margins would be charged on the position in the futures market and the underlying securities market. In the absence of cross margining, index arbitrage would be costly and therefore possibly inefficient.

3.8.1.2 Calendar Spreads

(Clause 2.2)

Calendar spreads are basically played on interest rates with small stock market exposure in developed markets. As such margins for calendar spreads are very low. On the other hand, in India, the calendar basis risk could be high due to absence of professional index arbitrage and insufficient channels for the flow of funds from the organized money market into the index futures market,

3.8.1.3 Traders Net Worth**(Clause 2.3)**

Exceeding the margin about once every six months whether an accurate 99% “Value at Risk” model would give increase to end of day mark to market losses. Traders net worth give an extra level of security to the market and works as prevention to the occurrence of defaults. A member who has a high net worth would try harder to keep away from defaults, as his own net worth would be at risk. The definition of net worth requires to be made accurate having in the view of existing accounting practices and laws.

3.8.1.4 Margin Collection and Enforcement**(Clause 2.4)**

Not only the correct calculation of margin is important but also the actual collection of margin is also of same importance. Because initial margins can be deposited in the form of bank guarantee and securities, the risk containment issues in regard to these requirement to be tackled.

3.8.1.5 Clearing Corporation**(Clause 2.5)**

The Clearing Corporation becomes the counter party and offers approval for each trade. In the conditions, the reliability of the clearing corporation assumes importance and issues of governance and transparency require to be tackled.

3.8.1.6 Position Limits**(Clause 2.6)**

It is important for the market to describe the position limits as a whole and for the individual clearing member, trading member and client.

3.8.1.7 Legal Issues

Some members stated that certain legal opinions seem to be offering that simple announcement of cash settled futures as securities under SCRA would not put them on a sound legal grip except if the contract Act were either amended or clearly ignored. In this matter, some court decisions in foreign countries were said to be enormously worrying.

3.8.1.8 Margining System**(Clause 3.1)****3.8.1.8.1 Mandating a Margin Methodology not Specific Margins** (Clause 3.1.1)

The GC suggested that margins in the derivatives markets would be based on a 99% Value at Risk (VaR) method. The committee argued the ways of operationalizing these suggestions keeping in mind the issues relating to calculation of volatility. It was confirmed that SEBI should empower the use of a particular VaR estimation approach but should not mandate a specific minimum margin level. The group gave some specific suggestions, which are as follows:

3.8.1.8.2 Initial Methodology**(Clause 3.1.2)**

For fixing the margins, the derivatives exchange and clearing corporation should be certified to commence index futures trading using VaR methodology.

3.8.1.8.3 Continuous Refining**(Clause 3.1.3)**

The derivatives exchange and clearing corporation should be helped to improve VaR methodology continuously. If there is any change required in the current methodology, the proposal should be filed with SEBI and issued to the public for comments along with detailed comparative back testing results of the proposed and current methodology. The date from which the new methodology will become effective shall be clear and it will not be less than three months after the date of filing with SEBI. SEBI may order the derivatives exchange and clearing corporation not to apply the change at any time up to two weeks before the effective date or the derivatives exchange and clearing corporation may on its own make a decision not to apply the change.

3.8.1.8.3 Periodic Reporting:

It is compulsory for derivatives exchange and clearing corporation that they should submit their reports periodically (quarterly or half yearly) to SEBI related to the functioning of the risk valuation methodology highlighting the particular instances where price moves have been beyond the estimated 99% VAR limits.

3.8.1.9 Initial Margin Fixation Methodology**(Clause 3.2)**

Value at Risk (VaR) approach is used for estimation of Initial Margin Fixation Methodology in Indian financial markets, which is provided by J.R. Verma. The exponential moving average method would be used to get the volatility estimate every day.

3.8.1.10 Daily Changes in Margins:**(Clause 3.3)**

The volatility calculated at the end of the day's trading would be used in estimating margin calls at the end of the same day. This means that during the course of trading, market participants would now understand the actual margin that would apply to their position. Hence, it was concurred that the volatility estimation and margin fixation approach would be clearly made known to all market participants so as to they can calculate their margin for any given closing level of the index. It was also concurred that the trading software would itself supply this information on a real time basis on the trading workstation screen.

3.8.1.11 Margining for Calendar Spreads:**(Clause 3.4)**

A position at one maturity, which is hedged, by an offsetting position at a different maturity is known as calendar spread. Thus the committee suggested that:

- a) The margin on calendar spreads be charged at a flat rate of 0.5% per month of spread on the far month contract of the spread subject to a minimum margin of 1% and a maximum margin of 3% on the far side of the spread for spreads with legs up to 1 year apart. A spread with the two legs three months apart would thus attract a margin of 1.5% on the far month contract.
- b) The margining of calendar spreads should be examined at the end of six months of index futures trading.
- c) A calendar spread should be treated as a naked position in the far month contract because the near month contract approaches expiry. The impact of this change should be in gradual steps over the last few days of trading of the near month contract. Particularly, during the last five days of trading of the near month contract, the percentages of a calendar spread shall be treated as a naked position in the far month contract are as follows: 100% on day of

expiry, 80% one day before expiry, 60% two days before expiry, 40% three days before expiry, 20% four days before expiry. The balance of the spread shall continue to be treated as a spread. This phasing in will apply both to margining and to the computation of exposure limits.

- d) The members' liquid net worth to fall below the minimum levels specified just because of the closing out of one leg of a calendar spread, his terminal shall be disabled and the clearing corporation shall take steps to liquidate sufficient positions to restore the members' liquid net worth to the levels mandated.
- e) The derivatives exchange should look at the possibility that the trading system could include the facility to place a single order to buy or sell spreads without placing two separate orders for the two legs.
- f) A calendar spread shall be regarded as an open position of one third of the mark to market value of the far month contract for the purposes of the exposure limit. The spread shall be treated as a naked position in the far month contract in the same manner as the near month contract approaches expiry.

3.8.1.14 Margin Collection and Enforcement

(Clause 3.5)

The correct calculation of margin as well as actual collection of margin is also of equal important. The group suggested that the clearing corporation should put down operational guidelines on collection of margin and standard guidelines for back office accounting at the clearing member and trading member level to help in finding out non compliance at each level.

3.8.1.13 Transparency and Disclosure

(Clause 3.6)

The clearing corporation and clearing house will be needed to show the details of events of failures in collection of margin and /or the settlement dues at least on a quarterly basis. A shortfall for three consecutive trading days of 50% or more of the liquid net worth of the member is known as failure.

3.8.1.14 Position Limits

(Clause 6)

The issue of position limits is at the customer level, trading member level clearing member level and market level.

3.8.1.14.1 Customer Level

(Clause 6.1)

Practically, it is not possible to impose the position limit at customer level unless

- The aggregate position of a customer who operates through several brokers can be determined by the use of a single customer code (for example the Income Tax permanent account number). Presently, every broker issued a code to a customer independently so the customer has as many codes as the number of brokers through whom he operates.

Rather than suggesting position limits at the client level, the group suggested a self-disclosure requirement similar to that in the take-over regulations:

- a) Any person or persons acting this work who together own 15% or more of the open interest shall be required to report this fact to the exchange and failure to do so shall attract a penalty as laid down by the exchange/clearing corporation/SEBI.
- b) The Exchange may not be watched this requirement on a real time basis, but at the time of investigation any violation is found, penalties can be imposed.
- c) This would not mean a ban on large open positions but only a disclosure requirement.

3.8.1.14.2 Trading Member Level

(Clause 6.2)

- a) A position limit at the trading member level should be of 15% of the open interest or Rs. 100 Crore whichever is higher.
- b) This is to be examined after six months of index futures trading.

3.8.1.14.3 Clearing Member Level

(Clause 6.3)

The extra position limit should not be lived at this level on aggregate trades cleared by a member. But, the clearing member shall make sure that his own positions and the positions of members clearing through him are within the limits definite in clause 6.1.

3.8.1.14.4 Market Level

(Clause 6.4)

- a) The limit should not be levied at this stage on the total market wide-open interest (as a percentage of the underlying market capitalization).

- b) This should be examined at the end of six months of index futures trading to find out whether position limits are needed at this level to guard against conditions where a very large open interest leads to attempts to manipulate the underlying market.

3.8.1.15 Customer Level and Trading Member Level Margins and Capital (Clause 7)

The clearing corporation can denote:

- a) The minimum margins to be collected from the customers who may be more than the margins charged to members.
- b) The minimum capital requirements should be in the form of deposits for trading members with the clearing member or Clearing Corporation.

3.8.1.16 Review After Six Months (Clause-8)

The group advocated that the SEBI should examine the risk containment measures at the end of six months of futures trading with specific reference to the following :

- a) Removal of the transitional provisions in clause 3.2 .
- b) Examine of the margins for calendar spreads as detailed in clause 3.4.
- c) Review of position limits as described in clause 6.1 and 6.4.
- d) Cross margining between cash and futures markets as defined in clause 6.9 of GC report.

3.8.2 VaR Framework

The GC Report laid down the fundamental principle of 99% VaR based margins: “The level of initial margin required on a position should be related to the risk of loss on the position. The concept of “Value at Risk” should be used in calculating required levels of initial margin. The initial margin should be large enough to cover the one day loss that can be encountered on the position on 99% of the days.” (Paragraph-6.13(3)).

“Since market volatility changes over time, the Committee feels that the Clearing Corporation should continuously analyze this problem and may modify the margin requirements to safeguard the market.” (Paragraph 6.4)

The suggestions related to the methodology for another committee putted operationalizing in the perspective of index futures down that committee submitted its report in November 1998. The key aspects of this framework were:

1. SEBI should grant a VaR estimation methodology but not put down the margins under which the margins are automatically updated every day.
2. The exponentially weighted moving average method, which is also known as the IGARCH, or Risk Matrix method should be used to estimate volatility daily. This VaR framework was again expanded when index options were introduced. Basically, the VaR was now based on a portfolio approach similar to that of the SPAN system employed by leading derivative exchanges worldwide:
3. The loss, which can be occurring on the complete portfolio of any client, is estimated under a variety of price and volatility scenarios.
4. For this reason, the range of prices measured at three standard deviations in consistency with the value used when only index futures were traded.
5. For option valuation, the range of volatility changes was set at 4%. For option valuation, the Black Scholes or other alternative models could be used.
6. The margin is calculated as the worst-case loss under these various price and volatility scenarios.
7. Though, the margin should not be less than 3% of the notional value of all short options. This minimum margin is proposed to cover model risk and impacts option portfolios which are just about Delta, Gamma and Vega neutral and consequently attract very low margins under the Black-Scholes valuation model.
8. The second line of protection was set at 3% for index options also on the basis of notional value. The same framework was expended by demanding when stock options were introduced.

9. The range of price movements considered was set at 3.5 standard deviations to account for the fatter tails of movements of stock prices as compared to index movements.
10. The range of volatilities to be considered was set at 10% to account for the higher volatility of stocks.
11. The second line of defence was set at 5% to account for the higher volatility of stocks.

3.8.3 Recommended by ACD

3.8.3.1 Cross Margining: Basic Principles

The GC advised that cross margining should be implemented only after the derivative markets have become well established and the systems should be competent for accepting such type of difficult system.

The Advisory Committee of Derivatives (ACD) felt that the primary stage denoted by the GC is now over. Presently, derivative markets are now well set up and the systems are capable for adopting complex margining systems now exists. At this time, cross margining is the logical next step. The ACD suggested the subsequent method of implementing cross margining without commingling the cash and derivative segments:

- Cross margining should be employed at the client level. The margin should be calculated on the incorporated position of a client across cash and derivative market.
- To get effectiveness in client level cross margining, it would be enviable that a client should be the same clearing member across both the cash and derivative segment. If a client selects to settle trades through more than one clearing member, at that time, the client would decide by way of an agreement which clearing member would collect margin from the client and in event of a risk what would be the obligation of other clearing members.

- The clearing corporations would settle the positions in their respective markets in the event of default and under an accord transfer the surplus, if any to the clearing corporation where there is a shortage.
- This technique of cross margining avoids commingling the two segments of the exchange. On the other hands, it does engage each clearing corporation taking a credit experience on the other. It should be restricted by internal prudential strategies and embodied in the agreement between the two clearing bodies.

Some legal amendments are required in the cash and derivative to achieve cross margining. These changes are –

- Legal terms related to default; TGF/SGF would have to be modified.
- Agreement between Clearing Corporation, client, clearing member and trading member to be draw and it would be suitably amended by byelaws.
- There is important that every client would have a common client identification number for cross margining at the client level. The safest way to do this would be to make a global unique client identification number (say PAN number) a pre-requisite for those clients who wish to avail of cross margining. The client, who does not have such global unique client identification, will still be able to trade but they will not avail the benefit of cross margining.
- With the view of risk management, there are technical problems to be resolved for cross margining between an index derivative position and balancing cash market position in a basket of stocks that track the index.

3.8.3.2 Cross Margining Between Single Stock Derivative and the Underlying

The positions that are eligible in the underlying for cross margining against positions in single stock derivatives are:

- The underlying in dematerialized form transferred to or guaranteed with the clearing corporation.

- The position which can be short or long in any cash market segment that has a cross margining agreement with the derivative market segment under consideration.

3.8.3.3 Cross Margining Between Index Options and Options on Constituent Stocks

The Cross margining will not be permitted between positions in index options and a basket of positions in options on constituent stocks in the index.

3.8.3.4 Cross Margining Between Two Indices

If two indices are highly correlated, no cross margining will be permitted between them.

3.8.3.5 Cross Margining Between Two Stocks

If two stocks are highly correlated, no cross margining will be permitted between them.

3.9 Unresolved Issues and Future Prospects

Similar to other financial markets, asymmetric information is invasive in financial derivatives markets. Regulation is required to tackle these problems of difficult selection and moral hazard. Financial derivatives exchanges, regulation aimed at “maintaining competition and protecting investors against fraud and similar abuses.” [Houthakker and Williamson, 1996 P. 285]

The regulation and the temperament of regulatory agency of financial derivatives exchange varies from country to country. The Commodity Futures Trading Commission (CFTC) controls all the futures markets in the United States. The Financial Services Act that was implemented in April 1988 eliminated the old system and formed the securities and Investment Board (SIB) in the United Kingdom. The SIB watches over a self regulation organization (SRO), The Association of Futures Brokers and Dealers which lay down the rules for transactions in the London. Securities and Exchange Board of India (SEBI) is the watchdog in India.

The equity derivatives market has now been in survival for thirteen years and the market have developed in size and variety of products, but there are some issues that have been facing the market have not yet been resolved. The new derivatives

products, the volume and the business value have increased, but the regulatory objectives of the derivatives exchanges may not be achieved and the growth rate observed may not be sustainable except these real issues are sorted out as early as possible. The following unresolved issues are:

3.9.1 Issues for Market Stability and Development:

The tremendous growth of the Over the Counter (OTC) derivatives market has invited the regulators and the supervisory bodies. In the present global financial crunch, some OTC derivatives have been observed as stress amplifiers. The OTC derivatives market faced a lot of criticism because less transparent and highly leveraged and it also have weaker capital requirements and comprise elements of hidden systemic risk.

3.9.2 Commodity Options:

The commodity trading in options contract was banned since 1952 in India. In the absence of options contract, the commodity derivatives market is not completed. The futures and options both are important for the development of the market. There is an urgent requirement to generate the important legal and regulatory changes to commence commodity options trading in the market. This issue should be under the active consideration of the Government and the options trading should be commenced in the near futures.

3.9.3 The Warehousing and Standardization:

A sophisticated, cost-effective, reliable and convenient warehousing system is required for smooth functioning of commodity derivatives market in India. Accordingly, for checking the quality, grade and quantity of commodities the quality testing centers or independent labs should be established in each region so that they are properly standardized and no shock will be bear by the ultimate buyer who takes the physical delivery.

3.9.4 Cash vs. Physical Settlement:

Due to inefficiency of the present warehousing system, only 1% to 5% of total commodity trade is settled in physical delivery in India. Thus, the warehousing issue should be tackled on the war level. A good delivery system is work as a backbone in any commodity market. Presently, cash settlement of outstanding contracts at maturity

is not allowed under the Forward Contract (Regulation) Act, 1952 which becomes the major problem in cash settlement of commodity derivatives. In other words, all outstanding contracts should be settled in physical delivery at maturity. Hence, in practice, most of the contracts are settled in cash but before maturity. Therefore, there is requirement to amend the law to make it transparent to the extensive practice and protect the investors from unnecessary stresses.

3.9.5 Increased Off-Balance Sheet Exposure of Indian Banks:

As off-balance sheet (OBS) items of Indian Banks, the growth of derivatives has been an area of concern for the RBI. In recent years, the OBS risk has been increased drastically

3.9.6 The Regulator:

A strong and independent regulator is required when the markets grow faster; like Securities and Exchange Board of India (SEBI) that regulates the entire securities markets in India. SEBI works as an independent body. Instead of SEBI, The Forward Market Commission (FMC) is come under the Department of Consumer Affairs (Ministry of consumer Affairs, Food and Public Distribution) and depends on it for funds. It is important that the Government should increase more power to the FMC to confirm an orderly development of the commodity markets. It is also important that SEBI and FMC should improve interrelationship between the two markets.

3.9.7 Competition of OTC derivatives with the Exchange-traded Derivatives:

After the recent financial crisis a common view has been developed that OTC derivatives trading should be relocated to an exchange platform. The followers of this view expect that this may be increase liquidity and reduce significantly the cloudiness of the market. They argued that exchanges provide transparent and reliable price formation mechanisms, objectivity, strong and appropriate technology, and better regulation and above all centralized clearing and settlement system. These arguments are based on the assumption that the existing method of trading in OTC products is all based on telephone trading and there is no clearing system in place.

3.9.8 Lack of Economies of Scale:

In India there are 5 national level and 19 regional level commodity exchanges are

present. Though, more than 100 commodities are allowed for derivatives trading, but very few are popular in practice. Instead of most of the trade takes place only on a few exchanges. This issue can be addressed by consolidating some exchanges. Further, the convergence of securities and commodities derivatives markets has been argued for a long time. The Government of India has announced its intention to merge the two markets. It would also help in resolving some of the issues related to the regulation of the derivative markets.

3.9.9 Strengthening the Centralized Clearing Parties:

The CCIL established in 2002 is the only centralized clearing party for trade processing and settlement services in India. It presently provides a guaranteed settlement facility for government securities trading, clearing of collateralized borrowing and lending obligation (CBLO), guaranteed settlement of foreign exchange trading, and settlement of all India Revenues Service (IRS). Though the focus of business relating to money, securities and forex markets with the CCIL help in pooling risks and reducing the overall transactions costs for the system, the Certified Financial Services Auditor's (CFSA) report orated that the attentiveness of such a wide range of activities leads to attentiveness of risks in one entity. Hence, there is the urgent requirement to strengthen more and more clearing parties.

3.9.10 Tax and Legal bottlenecks:

At present, there are certain tax restrictions for the movement of the goods from one state to other. In India, VAT has been introduced in 2005 but it has not yet been implemented by all the states. Thus, there is a requirement to remove such discrimination so that a truly national market could develop for commodities and other derivatives. Also, regulatory changes are needed to generate uniformity in octroi and sales taxes etc.

3.10 International Regulation for Derivatives Markets

The international best practices and outlooks on derivatives markets have been offering by the International Organization of Securities Commissions (IOSCO). In 1990, it has issued the principles for oversight of screen based trading systems for derivatives products. It was recommended that all the jurisdictions approve (SEBI, being a member organization, has adopted these principles) the 10 non-exclusive

common principles for the oversight of screen based trading systems for derivatives products, which identify areas of general regulatory concern.

Generally, these principles are related to compliance by system support with the regulatory necessity relating to legal standards, regulatory policies, risk management method and sufficient disclosures of attendant risks. These 10 principles were analyzed by IOSCO and for operating the derivative products on the cross border basis 4 additional principles were proposed in the year 2000 (IOSCO 2000).

The principles of 1990 also expected the International Organization of Securities Commissions (IOSCO) goals and principles of Securities Regulations of 1998 relating to safeguard of investors, fairness and transparency of markets and reductions of systemic risk. The further regulations recommended include, regulatory coordination and cooperation to keep away from potential duplication, inconsistencies and gaps, sharing of relevant information and sufficient disclosure and transparency of regulatory requirements in jurisdictions. The IOSCO issued reports on the "International Regulation of Derivative Markets, Products and Financial Intermediaries" in December 1996 offered a report of various models or approaches to the regulation of derivatives markets based on regulatory summaries prepared on common framework of analysis (IOSCO 1996b). It was felt that while there was no single model for the regulation of derivatives markets, there was large similarity in supposed regulatory goals.

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

3.11 Conclusion

The regulatory framework of derivatives trading is a critical part of overall regulatory framework of derivatives markets. The regulation and control of derivatives trading and settlement have been approved through suitable adjustment to the byelaws of the stock exchanges where derivatives trading were allowed. Though, the role of state interference in the functioning of markets is a matter of considerable debate. It is usually agreed that regulation has a very important and critical role to ensure the

efficient functioning of markets and avoidance of systemic failures (Sahoo 1997) the main objective of regulation is to promote the efficiency and competition rather than hamper it.

The main contributory factors for success or failure of derivatives market are market culture, the underlying market including its depth and liquidity and financial infrastructure including the regulatory framework (Hathaway 1998). The efficiency of derivatives market can make worse through government interventions. For example, Governmental price controls or trade agreements are the example of governmental intervention and it's aimed at stabilizing prices, which do not allow derivatives market to grow. Additionally, since the market efficiency, financial safety and integrity and customer protection (common regulatory objectives in all jurisdictions) are critical to the success of any financial market.

This chapter attempt to examine the regulatory framework of Indian derivatives market, present market structure, its loopholes and put forward suggestions for the development of derivatives market in India.

The next chapter explains the overall growth and development of financial derivatives market in India.