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BSE has carved out a unique position among the stock exchanges in the world in respect of knowledge development and management. BSE Training Institute, which is famously known by its acronym BTI, enjoys the patronage of the entire spectrum of financial community in India. It currently offers 30 courses on which about 250 programmes are conducted that are attended by over 9000 participants a year. BTI also conducts customise programmes various leading corporate, financial institutions and educational institutions.

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BTI conducts certification in various market segments, the cash market segment and the derivatives market segment being the major ones, as a part of the training scheme. This book is specially designed to cater to the reference and guidance needs of the participants for the certification in Currency Futures examination. This book is prepared by special in house personnel who are actually working on the processes and explains exhaustively the minute details on the Currency Futures in a Stock Exchange.

The readers will be duly awarded with the high knowledge content of this book and a pleasure to read experience

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TEAM

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BSE Training Institute has compiled this material to give the readers a broad understanding of the working of the Currency Futures Fuction in a stock exchange as per available SEBI guidelines. This material provides information regarding the activity of a Stock Exchange in the currency futures scenario with respect to an Indian scenario only. The matter published in this book is subject to change as and when new circulations are provided by SEBI.

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Chapter 1

INTRODUCTION TO CURRENCY FUTURES

Globalisation and integration of financial markets, coupled with the progressively increasing cross-border flow of funds, have transformed the intensity of market risk, which, in turn, has made the issues relating to hedging of such risk exposures very critical. The economic agents in India currently have a menu of over-the-counter (OTC) products, such as forwards, swaps and options, available to them for hedging their currency risk and the markets for these are quite deep and liquid. However, in the context of growing integration of the Indian economy with the rest of the world, as also the continued development of financial markets, a need has been felt to make available a wider choice of hedging instruments to the market participants to enable them to cope better with their currency risk exposures. While in some countries, exchange-traded derivative products, like currency futures and options on currency futures are already available for hedging of currency exposures, a closer examination reveals that these are mainly countries that have fully convertible capital accounts. In India as well, currency futures have so far not been allowed in view of the imperatives of the controls on the capital account. However, in the context of the increased capital account liberalisation, wider hedging opportunities could strengthen economic agents' ability to cope with market-induced currency movements. International experiences, albeit of select countries like South Africa and South Korea, suggest that currency futures could coexist with the OTC currency markets as well as capital controls. A few emerging market economies have set up currency futures exchanges onshore, even though they retained some controls on the capital account. The latest country to introduce currency fuures is South Africa. It allowed its securities exchange, Johannesburg Stock Exchange (JSE) to trade the Rand futures since June 2007, with the objective of further developing South Africa's financial markets and of improving liquidity in the currency market. However, in order to keep things in proper perspective, it must be noted that currency futures usually operate in markets which are fully convertible.

India has been experiencing heightened cross-border flows in recent times with globalization and relaxations in the rules governing external transactions. The flows have been strong on both current and capital accounts. There has also been some increase in volatility in exchange rates due to global imbalances and changing dimensions of the capital flows. According to the Bank for International Settlements (BIS) Triennial Central Bank Survey 2007, the share of India with daily turnover at USD 34 billion (daily average)has increased from 0.3 per cent in 2004 to 0.9 per cent in 2007. The depth in the domestic foreign exchange market is validated by the BIS survey data.

Currently, hedging of foreign exchange risk is possible only on the OTC market using forwards, currency swaps and options. Currency and interest rate swaps are permissible for hedging long - term exposures. The use of these products is subject to certain requirements as laid down in terms of FEMA Notification 25,

which normally permits hedging of transactions backed by underlying exposures. However, as part of capital account liberalization and simplification of procedures, resident individuals and Small and Medium Enterprises (SME) sector have been granted flexibility in hedging their underlying or anticipated exposures without going through the rigors of complex documentation formalities. Commodity hedging in overseas exchanges has been permitted to hedge exposure to commodity price risk in the international markets. The rules have been relaxed to cover domestic exposures as well in the case of select base metals and Aviation Turbine Fuel (ATF) for domestic airline companies, as the domestic commodity exchanges are not able to offer the volume and depth required. The domestic oil marketing and refining companies have also been allowed to hedge their commodity price risk to the extent of 50 per cent of their inventory in the international markets.

The Committee on Fuller Capital Account Convertibility (FCAC) has observed that internationally, many investors use futures rather than the cash market to manage the duration of their portfolio or asset allocation because of the low upfront payments and quick transactions. Entities also trade in futures with the hope of making profit out of speculation or arbitrage opportunity between the futures market and the underlying market. By having wide spread membership and bringing together a large number of interested parties, the futures market provides liquidity, making transactions possible and providing immediate information on prices. Since futures, like any other derivatives are linked to the underlying cash market, its availability improves trading volumes in the cash market as it provides an arrangement for handling risk. Speculative activity also tends to shift risk to a more controlled and organized market, away from the underlying cash market. Accordingly, the Committee has recommended that currency futures may be introduced subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment. In recognition of the perceived need for currency futures to enhance the menu of tools available for hedging currency exposure and considering the recommendations of the Committee on FCAC, Reserve Bank of India in the Annual Policy Statement for the Year 2007-08 proposed to set up a Working Group on Currency Futures to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework

1.1 BACKGROUND

Brief overview of the foreign exchange market in India During the early 1990s, India embarked on a series of structural reforms in the foreign exchange market. The exchange rate regime that was pegged earlier was floated partially in March 1992 and fully in March 1993. The unification of the exchange rate was instrumental in developing a market-determined exchange rate of the rupee and an important step in the progress towards current account convertibility, which was achieved in August 1994. Banks are now permitted to approve proposals for commodity hedging in international exchanges from their corporate customers. Cancellation and rebooking of all eligible forward contracts booked by residents, irrespective of tenor, has been allowed. The closing time for inter-bank foreign

exchange market in India has been extended by one hour up to 5.00 p.m. The ceiling for remittances for resident individual under the Liberalized Remittance Scheme for Resident Individuals has been enhanced in an phased manner and currently it stands at US $ 2,00,000 (per financial year). The limit on remittances for overseas investments to facilitate overseas acquisitions by corporate has been enhanced and the guidelines for external commercial borrowings have also been liberalized by raising the prepayment limits.

The foreign exchange market has acquired a distinct vibrancy as evident from the range of products, participation, liquidity and turnover. The average daily turnover in the foreign exchange market increased from US $ 23.7 billion in March 2006 to US $ 33.0 billion in March 2007 in consonance with the increase in foreign exchange transactions.

Although liberalization helped Indian forex market in various ways, extensive fluctuations of exchange rate also took place in Indian forex market. These issues have attracted a great deal of interest from policy-makers and investors. While some flexibility in foreign exchange markets and exchange rate determination is desirable, excessive volatility can have adverse impact on price discovery, export performance, sustainability of current account balance, and balance sheets. In the context of upgrading Indian foreign exchange market to international standards, a well- developed foreign exchange derivative market (both OTC as well as Exchange traded) is required.

Need for Exchange Traded Currency Futures With a view to enable entities to manage volatility in the currency market, RBI on April 20, 2007 issued comprehensive guidelines on the usage of foreign currency forwards, swaps and options in the OTC market. At the same time, RBI also set up an Internal Working Group to explore the advantages of introducing currency futures. The Report of the Internal Working Group of RBI submitted in April 2008, recommended the introduction of exchange traded currency futures.

Exchange traded futures as compared to OTC forwards serve the same economic purpose, yet differ in fundamental ways. An individual entering into a forward contract agrees to transact at a forward price on a future date. On the maturity date, the obligation of the individual equals the forward price at which the contract was executed. Except on the maturity date, no money changes hands. On the other hand, in the case of an exchange traded futures contract, mark to market obligations are settled on a daily basis. Since the profits or losses in the futures market are collected / paid on a daily basis, the scope for building up of mark to market losses in the books of various participants gets limited.

The counterparty risk in a futures contract is further eliminated by the presence of a clearing corporation, which by assuming counterparty guarantee eliminates credit risk.

Further, in an Exchange traded scenario where the market lot is fixed at a much lesser size than the OTC market, equitable opportunity is provided to all classes of investors whether large or small to participate in the futures market. The

transactions on an Exchange are executed on a price time priority ensuring that the best price is available to all categories of market participants irrespective of their size. Other advantages of an Exchange traded market would be greater transparency, efficiency and accessibility.

1.2 THE ORIGIN

The origin of futures can be traced back to 1851 when the Chicago Board of Trade (CBOT) introduced standardized forward contracts which were being traded in nonstandard bilateral form for the preceding three years. In comparison, the birth of currency futures is of a recent origin and was a sequel to the breakdown of the Bretton Woods system. The resultant currency volatility provided a business opportunity for launching futures contracts in foreign currencies. The Chicago Mercantile Exchange (CME) first conceived the idea of a currency futures exchange and it launched the same in 1972 amidst considerable skepticism, since traditionally futures market had traded agricultural commodities and not financial instruments. The CME commissioned Professor Milton Friedman to write a paper on currency futures in order to gain credibility in the market.

Prof. Milton Friedman stated: “Changes in the international financial structure will create a great expansion in the demand for foreign cover. It is highly desirable that this demand be met by as broad, as deep, as resilient a futures market in foreign currencies as possible in order to facilitate foreign trade and investment. Such a wider market is almost certain to develop in response to the demand. The major open question is where. The U.S. is a natural place and it is very much in the interests of the U.S. that it should develop here.”

The CBOT saw this as a competitive challenge, as also an opportunity to launch other financial futures and proposed trading options and futures on stocks.

1.3 THE RATIONALE

The rationale for establishing currency futures market is manifold. Both residents and non-residents are exposed to currency risk when residents purchase foreign currency assets and non-residents purchase domestic currency assets. If the exchange rate remains unchanged from the time of the purchase of the asset to its sale, no gains and losses are made out of currency exposures. But if domestic currency depreciates (appreciates) against the foreign currency, the exposure would result in gain (loss) for residents purchasing foreign assets and loss (gain) for non-residents purchasing domestic asset. In this backdrop, unpredicted movements in exchange rates expose investors to currency risks. Currency futures enable them to hedge these risks. Nominal exchange rates are often random walks with or without drift, while real exchange rates over long-run are mean reverting. As such, it is possible that over a long-run, the incentive to hedge currency risk may not be large. However, financial planning horizon is much smaller than the long-run, which is typically inter-generational in the context of exchange rates. As such, there is a strong need to hedge currency risk and this need has grown manifold with fast growth in cross-border trade and investments flows. The argument for hedging currency risks appear to be natural

in case of assets, and applies equally to trade in goods and services, which result in income flows with leads and lags and get converted into different currencies at the market rates. Empirically, changes in exchange rate are found to have very low correlations with foreign equity and bond returns. This in theory should lower portfolio risk. Therefore, sometimes argument is advanced against the need for hedging currency risks. But there is strong empirical evidence to suggest that hedging reduces the volatility of returns and indeed considering the episodic nature of currency returns, there are strong arguments to use instruments to hedge currency risks.

Currency risks could be hedged mainly through forwards, futures, swaps and options. Each of these instruments has its role in managing the currency risk. The main advantage of currency futures over its closest substitute product, viz., forwards which are traded over-the-counter (OTC) lies in price transparency, elimination of counterparty credit risk and greater reach in terms of easy accessibility to all. Currency futures are expected to bring about better price discovery and also possibly lower transaction costs.

Apart from pure hedgers, currency futures also invite arbitrageurs, speculators and noise traders who may take a bet on exchange rate movements without an underlying or an economic exposure as a motivation for trading1. Advantages and disadvantages of currency futures are further elucidated later in this Report in paragraphs

From an economy-wide perspective, currency futures contribute to hedging of risks and help traders and investors in undertaking their economic activity. There is a large body of empirical evidence which suggests that exchange rate volatility has an adverse impact on foreign trade. Since there are first order gains from trade which contribute to output growth and consumer welfare, currency futures can potentially have an important impact on real economy. Gains from international risk sharing through trade in assets could be of relatively smaller magnitude than gains from trade. However, in a dynamic setting these investments could still significantly impact capital formation in an economy and as such currency futures could be seen as a facilitator in promoting investment and aggregate demand in the economy, thus promoting growth.

Arbitrageurs play an important role of trying to profit from exchange rate differentials, say in spot and forward market or in futures and forward market or through more complicated carry. Such activity brings about convergence in prices and a better price discovery across markets. Speculators, in contrast, hope to profit purely from fluctuations in currency prices over time without buying an underlying asset for its regular income streams. Speculators are essential for providing liquidity to the market and unless they rig the market or overwhelmingly move the rates they may actually help in a more efficient price discovery. Noise traders act as compulsive traders and may trade in currency futures without any specific information of the currency movements. If the efficient market hypothesis holds, noise traders add to liquidity in the market without necessarily distorting valuations.

1.4 THE BASICS

A futures contract is a standardized contract, traded on an exchange, to buy or sell a certain underlying asset or an instrument at a certain date in the future, at a specified price. Where the underlying asset happens to be a commodity, the futures contract is termed as 'commodity futures' whereas in cases where the underlying happens to be a financial asset or instrument, the resultant futures contract is referred to as 'financial futures'. A currency futures contract, also called an FX future, is a type of financial futures contract where the underlying is an exchange rate. In other words, it is a futures contract to exchange one currency for another at a specified date in the future at a price (exchange rate) that is fixed on the last trading date. The buyer or seller in a futures market locks into an exchange rate for a specific value date or delivery date. In other words, currency futures are used primarily as a price setting mechanism rather than for physical exchange of currencies. The future date is called the delivery date or final settlement date. The pre-set price is termed as future price, while the price of the underlying asset on the delivery date is termed as the settlement price. The future price normally converges towards the spot price on the settlement date. The futures contract gives the holder the right to buy or sell, in contrast to the option contract which gives the holder the right, but not the obligation to buy or sell the underlying. Thus, both the parties of the futures contract must fulfill their contractual obligations on the settlement date.

However, such contracts do provide options to deliver the underlying asset or settle the difference in cash. The holder of a contract could exit from his commitment prior to the settlement date by either selling a long position or buying back a short position (offset or reverse trade). The futures contracts are exchange traded derivatives and the exchange's clearing house acts as counterparty to all contracts, sets margin requirements, etc.

1.5 UNDERSTANDING FUTURES BY ROBERT W KOLB

1.5.1 TYPES OF FUTURES

Many types of futures contracts, mirroring the underlying assets – forex, bonds, interest rates, index, stocks, commodities, etc are available in exchanges. While trading in commodities began in the 18th century, the contracts on financial instruments were introduced in the 70's.

1.5.2 ADVANTAGES OF FUTURES

The exchange traded currency futures offer different advantages over OTC market.

The advantages are:

i) Transparency and efficient price discovery. The market brings together divergent categories of buyers and sellers.

ii) Elimination of counterparty credit risk.

iii) Access to all types of market participants.

iv) Standardized products.

v) Transparent trading platform.

1.5.3 DISADVANTAGES OF FUTURES

The futures are also disadvantageous in a few areas when compared to OTC market. The major disadvantages are:

i) Standardization – it is not possible to obtain a perfect hedge in terms of amount and timing.

ii) Cost –forwards have no upfront cost, while margining requirements may effectively drive the cost of hedging in futures up.

iii) Small lots- not possible to hedge small exposures generally.

Chapter 2

FRAMEWORK OF THE CURRENCY FUTURES

2.1 PRODUCT DESIGN

2.1.1 Underlying

Initially, currency futures contracts on US Dollar – Indian Rupee (US$-INR) would be permitted.

2.1.2 Trading Hours

The trading on currency futures would be available from 9 a.m. to 5 p.m.

2.1.3 Size of the contract

The currency futures segment is meant to provide non-institutional market participants a means to hedge their currency exposures in a transparent and price-efficient manner, the size of the currency futures contract may not be unduly large. Large institutional and corporate customers are able to manage beneficial rates even in the OTC segment. The price discovery function of the exchanges is significant for the individuals and SMEs. Further, price discovery should be such that the individuals and SMEs are able to trade on the same prices as are available to the large customers. If the price discovery is done for a large size lot, the individuals and SMEs may not be able to capture the fineness of that rate for their small-sized lots. This is the bane of the OTC markets. Hence, it is important that the contract size be kept at such a level that it facilitates price discovery as well as trading, particularly for retail segment of the market. The retail focus of the contract should not in any manner disenchant the institutional clients since in the era of electronic trading, the cost efficiency is not compromised at all even if multiple contracts have to be purchased. A single contract would also ensure that market frictions are avoided, which could occur in case of multiple contracts.

The minimum contract size of the currency futures contract at the time of introduction would be US$ 1000. The contract size would be periodically aligned to ensure that the size of the contract remains close to the minimum size.

2.1.4 Quotation

The currency futures contract would be quoted in rupee terms. However, the outstanding positions would be in dollar terms.

2.1.5 Tenor of the contract

There is likely to be adequate interest in currency futures contracts beyond the first three months as is the case with the OTC forwards contract. Moreover, certain segments of the market expressed a desire for introduction of contracts with maturity of two years and beyond as currently such currency exposures cannot be hedged in the OTC market.

However, it was felt that while certain segments of the market may stand to benefit through introduction of long tenor currency futures contract, the liquidity in such contracts in the absence of an underlying OTC market of corresponding tenor is by no means assured. Hence, it was recommended that, initially, the tenors of the contract may largely replicate the tenors of the currency forwards and to this end, The currency futures contract shall have a maximum maturity of 12 months.

2.1.6 Available contracts

All monthly maturities from 1 to 12 months would be made available.

A Typical Currency Futures Contract

Category	Description
Underlying	Rate of exchange between 1USD and INR
Contract Size	USD 1000
Contract months	12 near calendar months
Expiration date and time	Last business day of the month
Minimum price fluctuations	.25 paise or INR 0.0025
Settlement	Cash settled in INR on relevant RBI reference rate

2.1.7 Settlement mechanism

A section of the participants in the currency futures segment may not have underlying currency exposures at all while a few participants may have economic exposures to exchange rate movements. In the absence of underlying flows, settlement based on delivery may impede participation from such segments of the market. While delivery based settlement provide tight cash - derivatives linkage, given the complications that delivery based settlement entail, and the fact that Indian Rupee is not fully convertible on capital account, the Group recommends that in the initial phase, settlement only on cash basis, based on spot Reserve Bank reference rate on the expiry date, may be permitted. Cash settlement would also ensure convergence between regulations in respect of OTC markets and currency futures market, since cancellation of a forward contract on the date of maturity is akin to cash settlement.

The currency futures contract shall be settled in cash in Indian Rupee.

2.1.8 Settlement price

The settlement price would be the Reserve Bank Reference Rate on the date of expiry. The methodology of computation and dissemination of the Reference Rate may be publicly disclosed by RBI.

2.1.9 Final settlement day/ Settlement Cycle

Certain sections of the market participants felt that the settlement cycle of the currency futures contract should be co-terminus with the settlement of month

end forward contracts. They argued that settlement at the month-end would enable SMEs and individuals to benchmark the prices available in the futures market with the OTC prices.

The experiences of the equity markets also suggest that settlement cycle of similar underlying across various exchanges eventually converge. However, FEDAI and some large banks opined that separating the maturity of forward contracts and currency futures contracts may be better for effective management of liquidity. The Group felt that the futures contracts settling in the mid month may allow the banks to transfer/ seek exposure on the futures segment. After taking into account the market feedback on the draft proposals, and the expert views of the TAC, the Group recommends that the futures settlement cycle may be co-terminus with the settlement of month end forward contracts.

The currency futures contract would expire on the last working day (excluding Saturdays) of the month. The last working day would be taken to be the same as that for Interbank Settlements in Mumbai. The rules for Interbank Settlements, including those for 'known holidays' and 'subsequently declared holiday' would be those as laid down by FEDAI.

2.2 PARTICIPANTS

The requirement of an underlying exposure to trade in OTC foreign exchange market is very difficult to implement in an exchange- traded regime. The international experience in this regard also supports the Group's views. Currently, resident individuals are allowed to hedge their underlying or anticipated exposures up to USD 100,000 in the OTC market without going through complex documentation formalities. Similarly, the SMEs which have direct and indirect exposure to foreign exchange have also been provided flexibility in hedging their exposures without going through the rigors of complex documentation formalities. All other categories of residents in India are permitted to access the OTC markets only if they have an underlying exposure or under the past performance window. As to whether any exposure limit need to be placed on the residents, the participation of residents in currency futures even in countries with capital controls, as is the case with India, has been generally unconstrained. Moreover, residents in the Indian context represent an amorphous group – day traders with limited capital and virtually no underlying exposure to foreign exchange to multinational corporates, relatively unconstrained by margin requirements and with fairly sizeable balance sheet foreign exchange exposures.

We may also take note of the fact that in major markets and increasingly in certain emerging markets, management of foreign exchange rate risk in respect of cash flow, balance sheet and economic exposures through forwards and futures involve a dynamic combination of hedging, unhedged and speculative positions with a motive to either reduce hedging cost or gain from exchange rate movements, within a proper risk management framework. This approach needs to be adopted/facilitated in India as well, if the real sector in India are to be able to face competition both at home and abroad vis-àvis their competitors overseas. In view of the foregoing, the Group recommends that no quantitative

restrictions may be imposed on residents to trade in currency futures. This is likely to ensure greater liquidity and wider participation and would be in line with usual policy where liberalization is done first for residents.

As regards non residents, the participation may be permitted in a gradual and phased manner. The Group is of the view that at the inception, the participation in the futures market may be restricted to residents alone in the interest of financial stability.

This is suggested purely from the perspective of evaluating the robustness of various systems such as surveillance, monitoring, reporting, etc. Once it is established that the systems are working properly, the participation of Foreign Institutional Investors (FIIs) and Non Resident Indians (NRIs), as hedgers, may be considered. Currently, in the OTC market, FIIs have been permitted to hedge their underlying exposures with flexibility for canceling and rebooking only up to 2 per cent of the underlying exposure. This stipulation cannot be replicated in the exchange format. However, it may be noted that allowing the FIIs, without any limits, in the futures market would mark a quantum leap for FIIs since effectively they would be able to dynamically hedge (freely cancel and rebook contracts) their entire portfolios, something that they are not permitted to do in OTC segment. This could possibly result in increase in volatility in the foreign exchange market but at the same time enhance liquidity in the currency futures market. Keeping in mind the current stipulation of participation of FIIs in OTC markets, the Group recommends that once the currency futures market systems stablised, including execution procedures, risk management framework and surveillance mechanism, FIIs may be allowed as hedgers with suitable position limits on their exposures in the futures market. In order to ensure adherence to the limits stipulated, the FII trades in currency futures may only be routed through the designated Authorised Dealers. Currently, the NRIs are allowed to hedge their exposures to the extent of their underlying exposures. Further, balances in the NRO account are repatriable up to USD 1 million per financial year. The Group, therefore, proposes that in line with the stipulation for FIIs, after establishing the effective functioning of all systems, the NRIs may be allowed to hedge their exposures in the futures market with suitable position limits. The transactions by the NRIs may also be routed through the designated AD banks. Given the current regulations in the OTC market, the categories excluded from the futures market, in the initial stages, are not being disadvantaged.

Traditionally, the futures market meets the needs of the three distinct sets of market users - those who wish to discover price information, those who wish to speculate and those who wish to hedge. Though speculation may not be a socially useful activity, the three types of users contribute to price discovery and hedging as well as add to liquidity. A speculator is a trader who enters the futures market, with no initial risk in pursuit of profit, thereby accepting an increase in risk. A hedger is a trader with a preexisting risk who enters the futures market to reduce or eliminate his currency exposure. There is a category

of speculators called scalpers who have an extremely short horizon view – ranging from a few seconds to a few minutes. Since, they are not looking for huge profits, they manage to generate a large volume of trades and contribute to increase in liquidity. Day traders take a far sighted approach to the market attempting to profit from the price movements that may take place over the course of a trading day. Position trader maintains positions overnight, weeks or months.

2.3 PRICING

In the foreign exchange market, every price or exchange rate is a relative price.

Fundamental factors influence the exchange rates between two currencies. Interest rate parity theorem explains how the forward/ futures exchange rate is essentially determined on the cost of carry model. In addition in the long run the exchange rates are expected tofollow Purchasing Power Parity (PPP). In the futures market, there are situations where the price of a currency for future delivery may be higher than the spot price, which is known as contango and where the future price is lower than the spot price, the phenomenon is known as backwardation.

Theoretically, if risk neutral speculators are available in sufficient numbers, their profit seeking activity will drive the futures price toward equality with the expected future spot price. The same process is expected to occur in the forward segment of forex markets. The linkages among interest rates, exchange rates, expected inflation rates emphasize the fundamental relationship between futures and forward prices on one hand and the expected future currency value on the other. The efficiency of forex futures markets has been researched and found to be generally poor. The same also applies to the forward market. The existence of premium in forward or futures market exist due to several possible reasons such as non-stationary risk premia, bias in regression coefficients arising from systematic error components due to non-rational response, microstructure and behavioural issues.

Ideally in the futures market, the difference between the spot and future prices reflect the covered interest rate arbitrage, which fosters interest rates in the two relevant countries. However, imperfections in the market, regulatory restrictions, capital controls, etc, may prevent the arbitrage activity from operating efficiently. In such a scenario, futures price may reflect more of a consensus forecast of prospective exchange rates rather than classical arbitrage pricing theory.

2.4 CLEARING HOUSE

The Exchange presently has a Clearing House that is ISO Certified and handles the Clearing & Settlement Functions for the Equity, Derivatives and Debt Segments of the exchange. The Exchange has already created a separate Company called the Indian Clearing Corporation Ltd., to which, eventually all the functions presently managed by the Clearing House would be transferred.

The clearing corporation has facilities for electronic funds transfer (EFT) for swift movement of margin payments. In situations where EFT is unavailable, the clearing corporation collects correspondingly larger initial margin to cover the potential for losses over the time elapsed in collection of mark to market margin.

The margin system functions through a hierarchy of market participants that links the clearing house with the individual trader. The members of an exchange may be classified as clearing members or non clearing members. A clearing member is a member of the exchange and the clearing house. The clearing house deals with clearing members only. Any non clearing member has to clear his transactions through a clearing member.

The clearing house collects margin deposits from clearing members to cover all futures positions that are on account of the particular member. For e.g., if a bank is a member of the clearing house, it has to maintain margins on account of all the trades executed though it. In turn the clearing member would insist on receiving margins from all traders whose trade it handles and thus the margin requirements travel down the chain to brokers and actual traders.

The clearing house does not take any active positions on the exchange, but interposes itself between two parties to a trade. The number of contracts bought in a futures market must therefore be exactly equal to the number of contracts sold. Without the clearing house, it would have been difficult for two totally unknown parties separated geographically to trust each other and trade. Because of the clearing house, the two parties to the trade are only concerned with the financial soundness of the clearing house.

The clearing house is invariably a large well capitalized financial institution. In the history of futures, there has never been a known failure of the clearing house.

There are four identifiable tiers in the futures market – the broker, the exchange and clearing house, a self regulatory body and the government agency. The KYC of the customer is the broker's responsibility. He is also responsible to the clearing house for all accounts handled by him directly or indirectly. Any restrictions on specific types of trades or limits on positions, etc laid down for smooth functioning and free determination of price have to be implemented through brokers. A broker has a duty to report any violation or attempt at price manipulation to the exchange. A code of conduct for brokers framed by the exchange, regulator or a self regulatory agency is generally put in place.

The futures exchange and the clearing house are themselves self regulated entities. They prescribe and enforce rules for trading and clearing on the exchange.

Exchange rules inter alia prohibit fictitious trading, rumour mongering, disclosure of customer positions, false declarations and statements, etc. by members. Any attempt at price manipulation by pre-arranged trades is strictly forbidden. Brokers are also forbidden from a practice called front running where a broker trades on his own account to the detriment of the customer. Futures exchanges can also set daily price limits, position limits and margin requirements. These will be within the framework of any limits set by the higher level regulator.

Often the various futures exchanges in a market form a self regulatory association.

This helps promote just and equitable principles of trade, remove impediments to free and open futures trading and generally protect public interest. Such associations undertake the tasks of screening and testing applicants for membership, prescribe record keeping and disclosure standards, etc. The ultimate regulator is the one with powers derived from statute, e.g. the Commodity Futures Trading Commission (CFTC) in USA. The ultimate regulator can lay down rules relating to trading, daily permitted price fluctuations, rules for delivery process, etc. It has powers to intervene by suspending trading if warranted by price manipulation. It can also prescribe competency standards for brokers, members, etc.

2.5 MARGINS

The credit risk in futures market is assumed by the exchange. In order to minimize the credit risk to the exchange, traders are required to post margins, typically in the range of 5 per cent – 15 per cent of the contracts' value. In some jurisdictions, different margin regimes are followed for hedgers and speculators. There are three types of marginsinitial margin, maintenance margin and the variation margin. The initial deposit called the initial margin is the amount a trader (buyer and seller), must deposit before trading in any futures. This normally is approximately taken as the maximum daily price fluctuation permitted for the contract being traded. The initial margin can be kept so small because of the safeguard built into the system of daily mark to market. Whenever the position held on the exchange shows a loss on mark to market, the same is deducted from the margin deposited. When this drops below a threshold level called the maintenance margin, established by the exchange, a margin call is made on the trader to replenish the margin and the additional amount deposited is called the variation margin.

2.6 SETTLEMENT

Settlement of futures contract can take place through physical delivery or cash settlement. Under physical delivery, the amount specified of the underlying is delivered by the seller to the buyer. Physical delivery is common in commodities and bonds. Under the cash settlement system, a cash payment is made based on the underlying reference rate at the time of expiry.

2.7 FORWARDS AND FUTURES

The foreign exchange futures market coexists worldwide with a very active forward market. In fact the presence of a strong OTC markets has somewhat limited the development of futures markets. Essentially, futures contracts are standardized forward contracts traded on an Exchange. The standardization of the futures contract will typically be in terms of quantity, expiration months, delivery/ settlement amounts, date and mode, trading days and hours. The biggest feature in favour of the futures is the existence of the clearing house to guarantee the fulfillment of contract obligations and virtually eliminate counterparty risk. The Clearing house may be organized as a separate corporation that offers clearing services to multiple exchanges or it could be a division of the futures exchange itself. The Clearing house guarantees all trades by adopting the position of counterparty to every trade. The Clearing house's safeguard against default is the margin money deposited by clearing member firms on behalf of their customers and their own

proprietary accounts. A second line of defense is the capital of the clearing members in the event of default by a clearing member.

The futures contracts and forward contracts have similar characteristics; but are different in many respects:

i) Futures are always traded on an exchange, whereas forward contracts are OTC product.

ii) Futures are highly standardized, whereas forwards can be customised.

iii) The future contracts are settled at the settlement price, while forwards are settled at the contract price specified upfront.

iv) The credit risk on futures is eliminated, unlike the forwards.

v) In forwards there are no margins, whereas futures require margins and daily marking to market of the positions.

MEMBERSHIP TYPE

2.8 The participation in the exchange can be for two reasons, viz., hedging and speculation. While in the equity markets such nomenclature is given as per the underlying transactions based on declaration by the participants, in the context of currency futures, whether the same format may be followed or certain participants can participate only as hedgers need to be resolved. While the former regime gives the flexibility to the participants, enabling participation of the non residents only to hedge their underlying INR exposure makes their participation, by definition, as hedgers only. It is appreciated that the segregation of the participants as hedgers and speculators and fixing differential margin is difficult to administer, as the Exchanges would be depending on declarations. It is also difficult to segregate and monitor the positions since the requirement of underlying is not extended to the futures Exchanges. Further, only non-residents are envisaged as pure hedgers in the market and suitable safeguards have been proposed for their participation in the futures market. Detailed study needs to be undertaken on the feasibility of segmenting the participants and fixing differential margins.

2.9 THE CONTRACT FORMAT

The contract specifications are summarized below in tabular form:

- Category Description
- Underlying Rate of exchange between one US dollar and INR
- Contract Size USD 1000
- Contract Months 12 near calendar months
- Expiration Date and time Last business day of the month
- Minimum Price fluctuation 0.25 paisa or INR 0.0025
- Settlement Cash settled in INR based on
- Reserve Bank reference rate of expiry date
- Margins As specified by the clearing corporation

SURVEILLANCE AND RISK MANAGEMENT

Chapter 3

3.1 SURVEILLANCE AND DISCLOSURES

The exchanges as first level regulators should have an online surveillance capability which monitors positions, prices and volumes in real time so as to deter market manipulation.

Unique client code The Exchange shall ensure that each client is assigned a client code which is unique across all members. The unique client code shall be assigned with the use of PAN number.

3.1.1 Position limits

Position limits act as an important surveillance measure designed to prevent large concentrated positions which may affect market integrity. However, the regulation of position limits needs to be viewed differently in the currency futures market as compared to the equity derivatives market. In the equity derivatives market, the maximum underlying shares available for trading is restricted to the extent of the free float market capitalization, whereas, there is no such constraint in the foreign exchange market.

The two markets also differ in terms of participation and the extent of positions held by each participant. Large transactions are executed by banks and corporates who wish to hedge their underlying exposure. Therefore, the monitoring of limits has to be with respect to the overall open interest in the market. Open interest is a dynamic measure which changes with every executed trade. Further, the objective of the position limits in the currency futures market would be more to detect market manipulation in the futures market rather than to address the threat of short squeeze in the underlying. Therefore, the following is being proposed with respect to monitoring and enforcement of position limits in the currency futures market:

i. Ideally, position limits have to be monitored on an online, real-time basis. However, the exchanges have represented that open interest of both the participant and the market are dynamic and therefore, monitoring on a realtime basis would be difficult. Therefore, the Committee recommends that to begin with, positions during the day shall be monitored based on the total open interest at the end of the previous day's trade.

ii. The above monitoring should be for both client level positions (based on the unique client code) and for trading member level positions.

iii. The exchange shall treat violation of position limits as an input for further surveillance action. Upon detecting large open positions, the exchange shall conduct detailed analysis based on the overall nature of positions, trading strategy, positions in the underlying market, the positions of related entities (concept of persons acting in concert would be applied), etc.

iv. The violators of position limits shall be accountable for their large positions and should submit detailed information pertaining to their trading activities whenever the information is sought by the exchange. The clearing member would be accountable for positions of all trading members and clients of trading members clearing through him. Similarly, the trading member would be accountable for the positions of his clients. The exchange may also call for information directly from the client itself.

The following position limits would be applicable in the currency futures market:

i. Client Level: The gross open positions of the client across all contracts should not exceed 6% of the total open interest or 5 million USD whichever is higher. The Exchange will disseminate alerts whenever the gross open position of the client exceeds 3% of the total open interest atthe end of the previous day's trade.

ii. Trading Member level: The gross open positions of the trading member across all contracts should not exceed 15% of the total open interest or 25 million USD whichever is higher.

iii. Clearing Member Level: No separate position limit is prescribed at the level of clearing member. However, the clearing member shall ensure that his own trading position and the positions of each trading member clearing through him is within the limits specified above.

3.1.2 Surveillance system

The surveillance systems of the exchanges should be designed keeping in view all the relevant aspects including the following -

i. The alerts in the online surveillance system should automatically generate material aberrations from normal activity.

ii. The surveillance systems and processes should be able to

- monitor open interest, cost of carry and volatility
- monitor closing prices
- capture and process client level details
- develop databases of trading activity by brokers as well as clients.
- generate trading pattern by a broker over a period of time or by a client/ group of clients over a period of time

iii. The information and feedback received from member inspections is vital input for effective surveillance. For this it is necessary that member inspections are taken up in a rational manner keeping in view the level of trading activity, client profile, number and nature of complaints received against the member, history of risk management related defaults and regulatory violations etc. Information obtained through member inspections should also be made available to the monitoring/ surveillance departments of stock exchanges.

iv. The information gathered by the risk management departments /clearing corporations while enforcing the risk management measures and settlement processes are critical inputs. Such information could include pattern of defaults related to specified contracts and special risk management measures taken keeping in view the market conditions.

v. The exchanges should call for information from members in a standard form, and preferably in electronic form, to facilitate faster analysis as well as building up of databases. It may also be ensured that duly authenticated information is submitted by the member or his designated agent.

vi. While implementing a stock watch type of system for currency futures, the system should be designed to provide online access to relevant historical data on derivatives trading for at least a year.

vii. In the interest of better surveillance, it is necessary that relevant information obtained through surveillance at one exchange should be shared with other exchanges. Exchanges are, therefore, advised to share information on positions in currency futures and any extraordinary price movement/ volume or concentration periodically or upon specific request by any stock exchange. The Clearing Corporations of the various eligible exchanges must meet periodically, say once a week, to discuss market integrity and other surveillance issues.

viii. Exchanges should study surveillance practices in various Global Forex Derivative Markets. Surveillance practices in commodities and bullion markets could also be studied where appropriate. Case studies on some market manipulations in various derivatives markets could be looked at to see what lessons could be drawn. Periodical benchmarking, atleast once in every six months, against international practices, systems performance etc., must be performed and documented.

The reporting of currency derivative transactions to the media and the newspapers should be in a uniform format. Accordingly, the Currency Derivative Exchanges/ Segments and their Clearing Corporations may be asked to report the following details for the transactions in derivative contracts, to the media/newspapers, on a daily basis:

a) Contracts Description

b) Number of contracts traded

c) Notional Value

d) Open

e) High

f) Low

g) Close

h) Open Interest (in number of contracts) Risk Management Measures

3.2 CLEARING MECHANISM

Usually, each Exchange has a separate clearing corporation. The clearing corporation and the exchange are akin to a single entity only. The only reason for separation of the two is to ensure that the liability of the exchange is limited. In practice, it appears that in the context of the multiple exchanges, a universal clearing corporation model may not be desirable since common margin system may not work in practice.

Hence, irrespective of whether it is decided to have a single exchange now or to expand the number further at a later date, it is preferable to have separate clearing corporation for each exchange. The Exchange specific Clearing Corporation approach is preferable since it is likely to lead to competitive pricing and services.

In exchange traded derivative contracts, the Clearing Corporation acts as a entral counterparty to all trades and performs full novation. The risk to the clearing corporation can only be taken care of through a stringent margining framework.

Also, since derivatives are leveraged instruments, margins also act as a cost and discourage excessive speculation. A robust risk management system should therefore, not only impose margins on the members of the clearing corporation but also enforce collection of margins from the clients.

3.3 MARGINING

While margin is an important credit risk mitigant, it could also be used effectively to deal with excessive leveraging. Thus, the Reserve Bank, as regulator of currency futures market may have overriding powers to prescribe margins and/ or impose specific margins for identified segments of the market, if considered necessary. In view of the recommendation that the settlement of the currency futures contract be done at Exchange specific clearing corporation, the day-to-day margining may be left to the discretion of such clearing corporation. The Exchanges and their respective clearing corporation may decide on the margining requirements purely from their credit risk management perspective

3.3.1 Initial Margin

The Initial Margin requirement shall be based on a worst case loss of a portfolio of an individual client across various scenarios of price changes. The various scenarios of price changes would be so computed so as to cover a 99% VaR over a one day horizon. In order to achieve this, the price scan range may initially be fixed at 3.5 standard deviation. The initial margin so computed would be subject to a minimum of 1.75% on the first day of currency futures trading and 1 % thereafter. The initial margin shall be deducted from the liquid networth of the clearing member on an online, real time basis.

Formula for determining standard deviation The committee examined the empirical tests of different risk management models in the Value at Risk (VaR) framework in the Re/$ exchange rate. Data for the period January 2,1998 to April 7,2008 was analysed. GARCH-GED (Generalized Auto-Regressive Conditional Heteroskedasticity with Generalized Error Distribution residuals), GARCH-normal and GARCH-t at 3 and 3.5 sigma levels were found to perform well even at 1% risk level, while the EWMA(Exponentially Weighted Moving Average) model used in J.P. Morgan's Risk Metrics® methodology was found to work well at 1 % risk level only at 3.5 sigma levels.

Given the computational ease of the EWMA model and given the familiarity of the Exchanges with this particular model (it is currently being used in the equity derivatives market), the Committee, after considering the various aspects of the different models, recommends the following:-

The exponential moving average method would be used to obtain the volatility estimate every day. The estimate at the end of time period t (ót) is estimated using the volatility estimate at the end of the previous time period. i.e. as at the end of t-1 time period (ót-1), and the return (rt) observed in the futures market during the time period t. The formula would be as under:

(ót)2 = ë (ót-1)2 + (1 - ë) (ót)2 where

ë is a parameter which determines how rapidly volatility estimates changes. The value of ë is fixed at 0.94.

i. ó (sigma) means the standard deviation of daily returns in the currency futures market.

ii. The "return" is defined as the logarithmic return: rt = ln(Ct/Ct-1) where Ct is the Currency futures price at time t. The plus/minus 3.5 sigma limits for a 99% VAR based on logarithmic returns would have to be converted into percentage price changes by reversing the logarithmic transformation. The percentage margin on short positions would be equal to 100(exp(3.5 ót)-1) and the percentage margin on long positions would be equal to 100(1-exp(-3.5ót)). This implies slightly larger margins on short positions than on long positions. The derivatives exchange / clearing corporation may apply the higher margin on both the buy and sell side.

iii. During the first time period on the first day of Currency futures trading, the sigma would be equal to 0.5%.

iv. The volatility estimation and margin fixation methodology should be clearly made known to all market participants so that they can compute what the margin would be for any given closing level of the currency futures price.

Further, the trading software itself should provide this information on a real time basis on the trading workstation screen.

3.4 PORTFOLIO BASED MARGINING

The Standard Portfolio Analysis of Risk (SPAN) methodology shall be adopted to take an integrated view of the risk involved in the portfolio of each individual client comprising his positions in futures contracts across different maturities. The client-wise margins would be grossed across various clients at the Trading / Clearing Member level. The proprietary positions of the Trading / Clearing Member would be treated as that of a client.

3.5 REAL TIME COMPUTATION

The computation of worst scenario loss would have two components. The first is the valuation of the portfolio under the various scenarios of price changes. At the second stage, these scenario contract values would be applied to the actual portfolio positions to compute the portfolio values and the initial margin. The exchanges shall update the scenario contract values at least 5 times in the day, which may be carried out by taking the closing price of the previous day at the start of trading and the prices at 11:00 a.m., 12:30 p.m., 2:00 p.m. and at the end of the trading session. The latest available scenario contract values would be applied to member/client portfolios on a real time basis.

3.6 CALENDAR SPREAD MARGINS

A currency futures position at one maturity which is hedged by an offsetting position at a different maturity would be treated as a calendar spread. The Calendar spread margin shall be at a value of Rs. 250/- for all months of spread.

The benefit for a calendar spread would continue till expiry of the near month contract. For a calendar spread position, the extreme loss margin shall be charged on one third of the mark to market value of the far month contract.

3.6.1 Extreme Loss margin

Extreme loss margin of 1% on the mark to market value of the gross open positions shall be deducted from the liquid assets of the clearing member on an on line, real time basis.

3.6.2 Liquid networth

The initial margin and the extreme loss margin shall be deducted from the liquid assets of the clearing member. The clearing member's liquid net worth after adjusting for the initial margin and extreme loss margin requirements must be at least Rs. 50 Lakhs at all points in time. The minimum liquid networth shall be treated as a capital cushion for days of unforeseen market volatility.

3.6.3 Liquid assets

The liquid assets for trading in currency futures would be maintained separately in the currency futures segment of the clearing corporation. However, the permissible liquid assets, the applicable haircuts and minimum cash equivalent norms would be mutatis mutandis applicable from the equity derivatives segment.

3.6.4 Mark to market settlement

The mark to market gains and losses shall be settled in cash before the start of trading on T+1 day. If mark to market obligations are not collected before start of the next day's trading, the clearing corporation shall collect correspondingly higher initial margin to cover the potential for losses over the time elapsed in the collection of margins.

The daily closing price of currency futures contract for mark to market settlement would be calculated on the basis of the last half an hour weighted average price of the futures contract. In the absence of trading in the last half an hour the theoretical price would be taken. The eligible exchanges shall define the methodology for calculating the 'theoretical price' at the time of making an application for approval of the currency futures contract to SEBI. The methodology for calculating the 'theoretical price' would also be disclosed to the market.

3.6.5 Margin collection and enforcement

The client margins (initial margin, extreme loss margin, calendar spread margin and mark to market settlements) have to be compulsorily collected and reported to the Exchange by the members. The Exchange shall impose stringent penalty on members who do not collect margins from their clients. The Exchange shall also conduct regular inspections to ensure margin collection from clients.

3.6.6 Safeguarding client's money

The Clearing Corporation should segregate the margins deposited by the Clearing Members for trades on their own account from the margins deposited with it on client account. The margins deposited on client account shall not be utilized for fulfilling the dues which a Clearing Member may owe the Clearing Corporation in respect of trades on the member's own account. The client's money is to be held in trust for client purpose only. The following process is to be adopted for segregating the client's money vis-à-vis the clearing member's money:

i At the time of opening a position, the member should indicate whether it is a client or proprietary position.

ii Margins across the various clients of a member should be collected on a gross basis and should not be netted off.

iii When a position is closed, the member should indicate whether it was a client or his own position which is being closed.

iv In the case of default, the margins paid on the proprietary position would only be used by the Clearing Corporation for realising its dues from the member.

3.6.7 Periodic risk evaluation report

The Clearing Corporation of the Exchange shall on an ongoing basis and atleast once in every six months, conduct back testing of the margins collected vis-à-vis the actual price changes. A copy of the study shall be submitted to SEBI along with suggestions on changes to the risk containment measures, if any.

OTHER SURVEILLANCE RELATED ISSUES

3.7 CURRENCY FUTURES MARKET : SURVEILLANCE AND REPORTING

A key prerequisite for smooth functioning of the currency futures market at the exchanges is to put in place a state-of-the-art surveillance system and an adequate reporting mechanism. Ideally, the surveillance system should be based on on-line trading system, with the capability of generating real time data, if required. It may also provide exception reporting at a fairly short interval of say every half an hour and be capable of providing warning mechanisms through alerts at the earliest possible. The surveillance system is of a critical importance, especially in respect of the generation of key reports on market manipulation. Preferably, a state-of-the-art surveillance system should also be able to identify the hedge trades from arbitrage and speculative trades, and treat them distinctly so that if the structure of currency futures contract is built upon separate treatment for the same, it should be able to support the same. It also needs to be considered if some kind of certification for the surveillance system would be necessary.

It may be appropriate to consider the surveillance model for the currency futures exchange at the introduction stage. The surveillance model could be based/ located on the exchanges, which would serve as Self Regulatory Organizations (SROs). The surveillance could also be multi-tiered one, in which the primary responsibility would be borne by the exchange and single or multiple settlement agencies together. They would need to function under broad guidelines and parameters which may be set up by the Reserve Bank as the regulator of the currency markets, including its futures segment. In either case, the exchanges may have to develop into effective first-level Self Regulatory Organizations (SROs). If a sole or multiple clearing agency/ies is/are set up, it/they may have to shoulder important responsibilities in respect of surveillance. As a clearing house for all currency futures transactions undertaken in one or more exchanges, a single clearing agency would be the repository of aggregate data and would be in a uniquely placed to monitor aggregate positions including position limits across multiple exchanges. All options should be urgently explored in this context to examine whether real time live monitoring of all positions could be made feasible at the end of the settlement agency. At the minimum, from inception the surveillance system should be able to detect market abuses and manipulations at a nascent stage through price and position monitoring.

The surveillance system for currency futures contracts, at both the exchange and the clearing agency, should support market integrity objective in a very strong way. Price and volume movements need to be monitored on a continuous basis along with computation of a range of volatility measures (unconditional as well as conditional). Value-at-risk measurements would be required on a near continuous basis. Work may be necessary on dynamic VaR, copulas and extreme value models in this respect. The surveillance system being put in place should be able to recognize risks of extreme events and focus on fat tails typical of distributions associated with exchange rates. It should be able to support

management of default risks through timely actions. The system, apart from covering price and position monitoring could also cover investigations where necessary. Price monitoring is mainly related to the price movement/ abnormal fluctuation in prices or volumes etc. whereas the position monitoring relates mainly to abnormal positions of participants, members, etc. in order to manage the default risk. Market abuse information should focus on fictitious/ artificial transactions, circular trading, false or misleading impressions, insider trading, etc. Basic information, as above, could be supplemented through strong investigation mechanisms within the exchange.

Introduction of currency futures could entail certain modifications in the system of risk monitoring at banks. The current risk management practices in the banks need to be dovetailed to accommodate live integration of futures positions in their position / risk limits. Banks participating in the currency futures market may be required to ensure that they have the capacity and the wherewithal to deal with market risk, and operational risks associated with currency futures even though the counterparty credit risk would be minimized through settlement guarantees by the exchange and the clearing organization.

The Boards of the banks may have to be specifically made accountable for ensuring that risks are properly assessed and are in proportion to the bank's ability to withstand extreme shocks. Banks should also ensure that they have appropriate risk mitigation techniques in place to withstand such shocks.

From the regulatory perspective, there is a need to regulate markets appropriately through effective regulatory filters. Apart from the exchange functioning as an SRO, the regulators may have to oversee basic decisions regarding participants price/position limits, etc, even while day-to-day margins are worked out by settlement agency/ies in consultation with exchanges. The price/position limits are essentially an exchange rate policy tool and the volatility tolerance would need to consider monetary and exchange rate policies in place. Typically, on the current reckoning, the volatility tolerance could be much lower when compared to other exchange traded products such as stocks or commodities.

The main focus of market surveillance has to be on detection of any attempt at market manipulation. To this effect, monitoring of large positions, demand/ supply factors as well as price distortions would have to be carried out on a continuous basis. The basic relationship must also be focused upon and in case of any break in the alignment, some alerts must be triggered. If the currency future contracts are cash-settled, close monitoring of cash markets would be essential to detect any price aberrations. The cash market activity of traders holding large positions in futures must be monitored, even as reference rate determination assumes critical importance. During market surveillance, information could be gleaned from a variety of sources and the integrity of these sources must be established on an ongoing basis. Problem resolution at an early stage would be important. The exchange could be given the first opportunity for tackling the problem, failing which other regulatory intervention might be required. In case the contracts

arephysically settled, short squeezes could come into play. While, these can be acceptable as long as these are part of normal market dynamics, if such situations are created by large position holders, the role of surveillance function in monitoring/ identifying such instances would become crucial.

Institution of regular and ad hoc audits at various levels for various types of entities holds the key to an effective surveillance system. It is important to recognize that the surveillance as well as reporting requirements would need to be different in case of regulated and non-regulated entities. The exposure control structure would need to be administered more strictly in case of regulated entities keeping in view the regulatory regime prescribed by different regulators for these entities. Surveillance and reporting requirements would also need to be worked out differently in case of large trader transactions, as also for bulk deals.

A risk-management system based on state-of-the-art techniques is a necessary concomitant of an efficient surveillance system. Surveillance system should throw up information on risk profiles of the trading members and along with the risk management system should ensure that leveraged positions remain under control.

Structures for Surveillance Committee for currency futures merit close attention in the context of the proposed introduction of currency futures. The primary task of the Surveillance Committee should be to ensure that day-to-day monitoring by the exchange ensures compliance with the best of the surveillance practices. Participants should adhere to the applicable rules and regulations, the rules should be implemented in a spirit of level playing field and specific regulatory or penal action should be taken in a timely and just manner.

Identified exchange(s) would need to take their regulatory and supervisory role more seriously and effectively than warranted in the case of other exchange traded products.

While the exchanges would need to work out their own procedures with this objective in view, they could be guided by simple facts such as: a) do the currency futures prices as they approach expiration move in a manner consistent with supply and demand factors and with OTC exchange rates? or b) do traders with large positions in the expiring currency future contracts have the capacity and ability to affect the OTC exchange rates used for settling the futures contract? The Surveillance Committees should also ensure compliance with exchange level limits or larger speculative position limits. While the bonafide hedgers could be exempt from limits in respect of hedged positions, the surveillance mechanism should look into the hedgers' compliance with exemption levels.

The policy for working out aggregation of accounts for the purpose of limits may also have to be clearly laid down. It is equally important that surveillance mechanisms in exchanges generate Suspicious Transactions Reporting (SRT) at varying frequencies. These reports should be discussed in the Surveillance Committees.

The Surveillance Committees should be distinct from dispute resolution mechanism, which should be handled separately. Adequate customer protection levels should also be laid down by policy of the exchange. A view may have to be taken on the margin trading. An option is to discourage margin trading in initial phases of introduction of currency futures. In any case, such trading should be restricted only to those entities which

(i) fully understand how the trading on margin is done,

(ii) have the ability and willingness to accept losses that exceed the margin amounts paid.

A data reporting system would need to be formulated with necessary flow of information from the exchanges to the Reserve Bank. In this respect, the requirements of a firm set of regulations and implementation of monetary and exchange rate policies should override all other requirements.

3.8 RULES AND REGULATIONS

3.8.1 LEGISLATIONS

The four main legislations governing the securities market are:

(a) the Securities Contracts (Regulation) Act, 1956, preventing undesirable transactions in securities by regulating the business of dealing in securities;

(b) the Companies Act, 1956, which is a uniform law relating to companies throughout India; (c) the SEBI Act, 1992 for the protection of interests of investors and for promoting development of and regulating the securities market; and

(d) the Depositories Act, 1996 which provides for electronic maintenance and transfer of ownership of dematerialised securities.

3.8.2 RULES AND REGULATIONS

The Government has framed rules under the SC(R)A, SEBI Act and the Depositories Act. SEBI has framed regulations under the SEBI Act and the Depositories Act for registration and regulation of all market intermediaries, for prevention of unfair trade practices, insider trading, etc. Under these Acts, Government and SEBI issue notifications, guidelines, and circulars, which need to be complied with by market participants. The self-regulatory organizations (SROs) like stock exchanges have also laid down their rules.

3.8.3 REGULATORS

The regulators ensure that the market participants behave in a desiredmanner so that the securities market continue to be a major source of finance for corporates and government and the interest of investors are protected.

The responsibility for regulating the securities market is shared by Department of Economic Affairs (DEA), Department of Company Affairs (DCA), Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and Securities Appellate Tribunal (SAT).

3.8.4 SECURITIES CONTRACTS (REGULATION) ACT, 1956

The Securities Contracts (Regulation) Act, 1956 [SC(R)A] provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges and aims to prevent undesirable transactions in securities. It gives Central Government regulatory jurisdiction over

(a) stock exchanges through a process of recognition and continued supervision,

(b) contracts in securities, and

(c) listing of securities on stock exchanges. All the three are discussed subsequently in this section. The SC(R)A, 1956 was enacted to prevent undesirable transactions in securities by regulating the business of dealing therein and by providing for certain other matters connected therewith. This is the principal Act, which governs the trading of securities in India. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organised trading activity in securities takes place on a recognised stock exchange.

3.8.5 Key definitions:

1. Recognised Stock Exchange: 'recognised stock exchange' means a stock exchange which is for the time being recognised by the Central Government under Section 4 of the SC(R)A.

2. Stock Exchange: 'Stock Exchange' means any body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

3. Securities: As per Section 2(h), the term 'securities' include:

   (i) shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate,

   (ii) derivative,

   (iii) units or any other instrument issued by any collective investment scheme to the investors in such schemes, (iv) Government securities, (v) such other instruments as may be declared by the Central Government to be securities, and

   (vi) rights or interests in securities.

4. Derivatives: As per section 2 (aa), 'Derivative' includes:

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;

B. a contract which derives its value from the prices, or index of prices, of underlying securities.

Further, Section 18A provides that notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are

(i) traded on a recognised stock exchange; and

(ii) settled on the clearing house of the recognised stock exchange, in accordance with the rules and bye-laws of such stock exchange.

5. Spot delivery contract: has been defined in Section 2(i) to mean a contract which provides for-

(a) actual delivery of securities and the payment of a price therefor either on the same day as the date of the contract or on the next day, the actual periods taken for the despatch of the securities or the remittance of money therefor through the post being excluded from the computation of the period aforesaid if the parties to the contract do not reside in the same town or locality;

(b) transfer of the securities by the depository from the account of a beneficial owner to the account of another beneficial owner when such securities are dealt with by a depository.' As mentioned earlier, the SC(R)A, 1956 deals with

1. stock exchanges, through a process of recognition and continued supervision,

2. contracts in securities, and

3. listing of securities on stock exchanges.

3.9 RECOGNITION OF STOCK EXCHANGES

By virtue of the provisions of the Act, the business of dealing in securities cannot be carried out without a registration from SEBI. Any Stock Exchange which is desirous of being recognised has to make an application under Sectio 3 of the Act to SEBI, which is empowered to grant recognition and prescribe conditions. This recognition can be withdrawn in the interest of the trade or public.

SEBI is authorised to call for periodical returns from the recognised Stock Exchanges and make enquiries in relation to their affairs. Every Stock Exchange is obliged to furnish annual reports to SEBI. Recognised Stock Exchanges are allowed to make bylaws for the regulation and control of contracts but subject to the previous approval of SEBI and SEBI has the power to amend the said bylaws. The Central Government and SEBI have the power to supersede the governing body of any recognised stock exchange.

3.10 CONTRACTS IN SECURITIES

Organised trading activity in securities takes place on a recognised stock exchange. If the Central Government is satisfied, having regard to the nature or the volume of transactions in securities in any State or area, that it is necessary so to do, it may, by notification in the Official Gazette, declare provisions of section 13 to apply to such State or area, and thereupon every contract in such State or area which is entered into after date of the notification otherwise than between members of a recognised stock exchange in such State or area or through or with such member shall be illegal. As per section 13A, a stock exchange may establish 'additional trading floor' (means a trading ring or trading facility offered by a recognised stock exchange outside its area of operation to enable the investors to buy and sell securities through such trading floor under the regulatory framework of the stock exchange) with the prior approval of SEBI in accordance with the terms and conditions stipulated by the said Board.

3.11 LISTING OF SECURITIES

Where securities are listed on the application of any person in any recognised stock exchange, such person should comply with the conditions of the listing agreement with that stock exchange (Section 21).

3.11.1 SECURITIES CONTRACTS (REGULATION) RULES, 1957

The Central Government has made Securities Contracts (Regulation) Rules, 1957, as required by sub-section (3) of the Section 30 of the Securities Contracts (Regulation)Act, 1956 for carrying out the purposes of that Act. Contracts between members of recognised stock exchange All contracts between the members of a recognised stock exchange should be confirmed in writing and should be enforced in accordance with the rules and bye-laws of the stock exchange of which they are members (Rule 9).

3.12 MAINTENANCE/PRESERVATION OF BOOKS OF ACCOUNT AND OTHER DOCUMENTS

1. Every member of a recognised stock exchange should maintain and preserve the following books of account and documents for a period of five years:

   (a) Register of transactions (Sauda book).

   (b) Clients' ledger.

   (c) General ledger.

   (d) Journals.

   (e) Cash book.

   (f) Bank pass-book.

   (g) Documents register showing full particulars of shares and securities received and delivered.

2. Every member of a recognised stock exchange should maintain and preserve the following documents for a period of two years:

   (a) Members' contract books showing details of all contracts entered into by him with other members of the same exchange or counter-foils or duplicates of memos of confirmation issued to such other members.

   (b) Counter-foils or duplicates of contract notes issued to clients.

   (c) Written consent of clients in respect of contracts entered into as principals. (Rule 15)

3.13 SECURITIES AND EXCHANGE BOARD OF INDIA ACT, 1992 Capital Issues (Control) Act, 1947

The Act had its origin during the war in 1943 when the objective was to channel resources to support the war effort. It was retained with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channelled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors. Under the Act, any firm wishing to issue securities had to obtain approval from the Central Government, which also determined the amount, type and price of the issue.

As a part of the liberalisation process, the Act was repealed in May 1992 paving way for market determined allocation of resources. With this, Government's control over issues of capital, pricing of the issues, fixing of premia and rates of interest on debentures etc. ceased, and the office which administered the Act was abolished: the market was allowed to allocate resources to competing uses. However, to ensure effective regulation of the market, SEBI Act, 1992 was enacted to establish SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market.

It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and also to penalise them in case of violations of the provisions of the Act, Rules and Regulations made thereunder. SEBI has full autonomy and authority to regulate and develop an orderly securities market. Its regulatory jurisdiction extends over companies listed on Stock Exchanges and companies intending to get their securities listed on any recognised stock exchange in the issuance of securities and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI can specify the matters to be disclosed and the standards of disclosure required for the protection of investors in respect of issues; can issue directions to all intermediaries and other persons associated with the securities market in the interest of investors or of orderly development of the securities market; and can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. In short, it has been given necessary autonomy and authority to regulate and

develop an orderly securities market. All the intermediaries and persons associated with securities market, viz., stock brokers and sub-brokers, underwriters, merchant bankers, bankers to the issue, share transfer agents and registrars to the issue, depositories, depository participants, portfolio managers, debentures trustees, foreign institutional investors, custodians, venture capital funds, mutual funds, collective investments schemes, credit rating agencies, etc., shall be registered with SEBI and shall be governed by the SEBI Regulations pertaining to respective market intermediary.

3.13.1 CONSTITUTION OF SEBI

The Central Government has constituted a Board by the name of SEBI under Section 3 of SEBI Act. The head office of SEBI is in Mumbai. SEBI may establish offices at other places in India. SEBI consists of the following members, namely:

(a) a Chairman

(b) two members from amongst the officials of the Ministry of the Central Government dealing with Finance and administration of the Companies Act, 1956

(c) one member from amongst the officials of the Reserve Bank (d) five other members of whom at least three should be the whole-time members The general superintendence, direction and management of the affairs of SEBI vests in a Board of Members, which exercises all powers and do all acts and things which may be exercised or done by SEBI.

The Chairman and the other members are from amongst the persons of ability, integrity and standing who have shown capacity in dealing with problems relating to securities market or have special knowledge or experience of law, finance, economics, accountancy, administration or in any other discipline which, in the opinion of the Central Government, shall be useful to SEBI.

3.13.2 FUNCTIONS OF SEBI

According to Section 11 of SEBI Act, 1992, SEBI has been obligated to protect the interests of the investors in securities and to promote the development of and to regulate the securities market by such measures as it thinks fit. The measures may provide for:

(a) regulating the business in stock exchanges and any other securities markets;

(b) registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers and such other intermediaries who may be associated with securities markets in any manner;

(c) registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as SEBI may, by notification, specify in this behalf;

(d) registering and regulating the working of venture capital funds and collective investment schemes including mutual funds;

(e) promoting and regulating self-regulatory organisations;

(f) prohibiting fraudulent and unfair trade practices relating to securities markets;

(g) promoting investors' education and training of intermediaries of securities markets;

(h) prohibiting insider trading in securities;

(i) regulating substantial acquisition of shares and take-over of companies;

(j) calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds, other persons associated with the securities market, intermediaries and selfregulatory organisations in the securities market;

(k) calling for information and record from any bank or any other authority or board or corporation established or constituted by or under any Central, State or Provincial Act in respect of any transaction in securities which is under investigation or inquiry by the Board;

(l) performing such functions and exercising such powers under the provisions of Securities Contracts (Regulation) Act, 1956, as may be delegated to it by the Central Government;

(m)levying fees or other charges for carrying out the purpose of this section;

(n) conducting research for the above purposes;

(o) calling from or furnishing to any such agencies, as may be specified by SEBI, such information as may be considered necessary by it for the efficient discharge of its functions;

(p) performing such other functions as may be prescribed.

According to Section 11A of SEBI Act, 1992, SEBI may, for the protection of investors,

(a) specify, by regulations,

(i) the matters relating to issue of capital, transfer of securities and other matters incidental thereto; and

(ii) the manner in which such matters, shall be disclosed by the companies

(b) by general or special orders,

(i) prohibit any company from issuing of prospectus, any offer document, or advertisement soliciting money from the public for the issue of securities,

(ii) specify the conditions subject to which the prospectus, such offer document or advertisement, if not prohibited may be issued. (Section 11A).

3.14 REGISTRATION OF INTERMEDIARIES

The intermediaries associated with securities market should buy, sell or deal in securities after obtaining a certificate of registration from SEBI, as required by Section 12:

1) Stock-broker,
2) Sub-broker,
3) Share transfer agent,
4) Banker to an issue,
5) Trustee of trust deed,
6) Registrar to an issue,
7) Merchant banker,
8) Underwriter,
9) Portfolio manager,
10) Investment adviser
11) Depository,
12) Depository participant
13) Custodian of securities,
14) Foreign institutional investor,
15) Credit rating agency,
16) Collective investment schemes,
17) Venture capital funds,
18) Mutual funds, and
19) Any other intermediary associated with the securities market.

3.15 POWER TO ADJUDICATE

(1) For the purpose of adjudging, the Board appoints any of its officer not below the rank of a Division Chief to be an adjudicating officer for holding an inquiry in the prescribed manner after giving any person concerned a reasonable opportunity of being heard for the purpose of imposing any penalty.

(2) While holding an inquiry the adjudicating officer has the power to summon and enforce the attendance of any person acquainted with the facts and circumstances of the case to give evidence or to produce any document which in the opinion of the adjudicating officer, may be useful for or relevant to the subject matter of the inquiry and if, on such inquiry, he is satisfied that the person has failed to comply with the provisions, he may impose penalty as he thinks fit in accordance with the provisions.

3.16 ESTABLISHMENT OF SECURITIES APPELLATE TRIBUNALS

(1) The Central Government by notification, establish one or more Appellate Tribunals to be known as the Securities Appellate Tribunal to exercise the jurisdiction, powers and authority conferred on such Tribunal by or under this Act or any other law for the time being in force.

(2) The Central Government also specifies in the notification referred to in sub-section (1) the matters and places in relation to which the Securities Appellate Tribunal may exercise jurisdiction.

3.17 PROCEDURE AND POWERS OF THE SECURITIES APPELLATE TRIBUNAL

(1) The Securities Appellate Tribunal is not bound by the procedure laid down by the Code of Civil Procedure, 1908, but shall be guided by theprinciples of natural justice and, subject to the other provisions of this Act and of any rules, the Securities Appellate Tribunal have powers to regulate their own procedure including the places at which they have their sittings.

(2) The Securities Appellate Tribunal has, for the purposes of discharging their functions under this Act, the same powers as are vested in a civil court under the Code of Civil Procedure, 1908, while trying a suit, in respect of the following matters, namely:

(a) summoning and enforcing the attendance of any person and examining him on oath;

(b) requiring the discovery and production of documents;

(c) receiving evidence on affidavits;

(d) issuing commissions for the examination of witnesses or documents;

(e) reviewing its decision;

(f) dismissing an application for default or deciding it ex-parte;

(g) setting aside any order of dismissal of any application for default or any order passed by it ex-parte;

(h) any other matter which may be prescribed.

(3) Every proceeding before the Securities Appellate Tribunal should be deemed to be a judicial proceeding within the meaning of sections 193 and 228, and

for the purposes of section 196, of the Indian Penal Code and the Securities Appellate Tribunal should be deemed to be a civil court for all the purposes of section 195 and Chapter XXVI of the Code of Criminal Procedure, 1973.

3.18 SEBI (STOCK BROKERS & SUB-BROKERS) RULES, 1992

In exercise of the powers conferred by section 29 of SEBI Act, 1992, Central Government has made SEBI (Stock-brokers and Sub-brokers) Rules, 1992. In terms of Rule 2(e), "Stock-broker" means a member of a stock exchange. In terms of Rule 2(f), 'Sub-broker' means any person not being a member of a stock exchange who acts on behalf of a stock-broker as an agent or otherwise for assisting the investors in buying, selling or dealing in securities through such stock brokers. A stock-broker or sub-broker shall not buy, sell, and deal in securities, unless he holds a certificate granted by SEBI (Rule 3).

3.19 CAPITAL ADEQUACY NORMS FOR BROKERS

Each stockbroker is subject to capital adequacy requirements consisting of two components:

(1) Base minimum capital, and

(2) Additional or optional capital related to volume of business.

The amount of base minimum capital varies from exchange to exchange. The form in which the base minimum capital has to be maintained is also stipulated by SEBI. Exchange may stipulate higher levels of base minimum capital at their discretion.

Conditions for grant of certificate to stock-broker (Rule 4) SEBI grants certificate to a stock-broker subject to the following conditions, namely:

(a) he holds membership of any stock exchange,

(b) he abides by the rules, regulations and bye-laws of the stock exchange or stock exchanges of which he is a member;

(c) in case of any change in the status and constitution, the stock broker obtains prior permission of SEBI to continue to buy, sell or deal in securites in any stock exchange;

(d) he pays the amount of fees for registration in the manner provided in the regulations; and

(e) he takes adequate steps for redressal of grievances of the investors within one month of the date of the receipt of the complaint and keep SEBI informed about the number, nature and other particulars of the complaints received from such investors.

Conditions o f grant of certificate to sub-broker (Rule 5) SEBI grants certificate to a sub-broker subject to the following conditions, namely:

(a) he pays the fees in the manner provided in the regulations,

(b) he takes adequate steps for redressal of grievances of the investors within one month of the date of the receipt of the complaint and keep SEBI informed about the number, nature and other particulars of the complaints received,

(c) in case of any change in the status and constitution, the sub- broker obtains prior permission of SEBI to continue to buy, sell or deal in securities in any stock exchange, and

(d) he is authorised in writing by a stock-broker being a member of a stock exchange for affiliating himself in buying, selling or dealing in securities; provided such stock broker is entitled to buy, sell or deal in securities.

3.20 SEBI (STOCK BROKERS & SUB-BROKERS) REGULATIONS, 1992

In terms of regulation 2 (g), 'small investor' means any investor buying or selling securities on a cash transaction for a market value not exceeding rupees fifty thousand in aggregate on any day as shown in a contract note issued by the stock-brokers.

3.21 REGISTRATION OF STOCK BROKER

A stock broker applies in the prescribed format for grant of a certificate through the stock exchange or stock exchanges, as the case may be, of which he is admitted as a member. The stock exchange forwards the application form to SEBI as early as possible but not later than thirty days from the date of its receipt.

SEBI takes into account for considering the grant of a certificate all matters relating to buying, selling, or dealing in securities and in particular the following, namely, whether the stock broker:

(a) is eligible to be admitted as a member of a stock exchange,

(b) has the necessary infrastructure like adequate office space, equipment and manpower to effectively discharge his activities,

(c) has any past experience in the business of buying, selling or dealing in securities,

(d) is subjected to disciplinary proceedings under the rules, regulations and bye-laws of a stock exchange with respect to his business as a stock-broker involving either himself or any of his partners, directors or employees, and

(e) is a fit and proper person.

SEBI on being satisfied that the stock-broker is eligible, grants a certificate to the stock-broker and sends intimation to that effect to the stock exchange or stock exchanges, as the case may be. Where an application for grant of a certificate does not fulfill the requirements, SEBI may reject the application after giving a reasonable opportunity of being heard.

3.21.1 FEES BY STOCK BROKERS

Every applicant eligible for grant of a certificate should pay fees and in such manner as specified in Schedule III; provided that SEBI may on sufficient cause being shown, permit the stock-broker to pay such fees at any time before the expiry of six months from the date on which such fees become due. Where a stock-broker fails to pay the fees, SEBI suspends the registration certificate, whereupon the stock- broker ceases to buy, sell or deal in securities as a stock-broker.

3.21.2 APPOINTMENT OF COMPLIANCE OFFICER

Every stock broker should appoint a Compliance Officer who will be responsible for monitoring the compliance of the Act, rules and regulations, notifications, guidelines, instructions, etc., issued by SEBI or the Central Government and for redressal of investors' grievances. The compliance officer should immediately and independently report to SEBI any non-compliance observed by him.

3.21.3 CODE OF CONDUCT

The stock-broker holding a certificate at all times abides by the Code of Conduct as given hereunder:

I. General

a) Integrity: A stock-broker, should maintain high standards of integrity, promptitude and fairness in the conduct of all his business.

b) Exercise of Due Skill and Care: A stock-broker, should act with due skill, care and diligence in the conduct of all his business.

c) Manipulation: A stock-broker should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting market equilibrium or making personal gains.

d) Malpractices: A stock-broker should not create false market either singly or in concert with others or indulge in any act detrimental to the investors' interest or which leads to interference with the fair and smooth functioning of the market. A stock-broker should not involve himself in excessive speculative business in the market beyond reasonable levels not commensurate with his financial soundness.

e) Compliance with Statutory Requirements: A stock-broker should abide by all the provisions of the Act and the rules, regulations issued by the Government, SEBI and the stock exchange from time to time as may be applicable to him.

II. Duty to the investor

a) Execution of Orders: A stock-broker, in his dealings with the clients and the general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price and not refuse

to deal with a small investor merely on the ground of the volume of business involved. A stock-broker should promptly inform his client about the execution or non-execution of an order, and make prompt payment in respect of securities sold and arrange for prompt delivery of securities purchased by clients.

b) Issue of Contract Note: A stock-broker should issue without delay to his client or client of sub-broker a contract note for all transactions in the form specified by the stock exchange.

c) Breach of Trust : A stock-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship.

d) Business and Commission:

(i) A stock-broker should not encourage sales or purc hases of securities with the sole object of generating brokerage or commission.

(ii) A stock-broker should not furnish false or misleading quotations or give any other false or misleading advice or information to the clients with a view of inducing him to do business in particular securities and enabling himself to earn brokerage or commission thereby.

e) Business of Defaulting Clients: A stock-broker should not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments in relation to securities with another stock-broker.

(f) Fairness to Clients: A stock-broker, when dealing with a client, should disclose whether he is acting as a principal or as an agent and should ensure at the same time that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and should not consider clients interest inferior to his own.

g) Investment Advice: A stock-broker should not make a recommendation to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment. The stock-broker should seek such information from clients, wherever he feels it is appropriate to do so.

h) Investment Advice in publicly accessible media:

(i) A stock broker or any of his employees should not render, directly or indirectly, any investment advice about any security in the publicly accessible media, whether real-time or non realtime, unless a disclosure

of his interest including the interest of his dependent family members and the employer including their long or short position in the said security has been made, while rendering such advice.

(ii) In case, an employee of the stock broker is rendering such advice, he should also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

(iii) Competence of Stock Broker: A stock-broker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients.

III. Stock-brokers vis-a-vis other stock-brokers

(a) Conduct of Dealings: A stock-broker should co-operate with the other contracting party in comparing unmatched transactions. A stockbroker should not knowingly and willfully deliver documents which constitute bad delivery and should co-operate with other contracting party for prompt replaceme nt of documents which are declared as bad delivery.

(b) Protection of Clients Interests: A stock-broker should extend fullest cooperation to other stock-brokers in protecting the interests of his clients regarding their rights to dividends, bonus shares, right shares and any other rights related to such securities.

(c) Transactions with Stock-Brokers: A stock-broker should carry out his transactions with other stock-brokers and should comply with his obligations in completing the settlement of transactions with them.

(d) Advertisement and Publicity: A stock-broker should not advertise his business publicly unless permitted by the stock exchange.

(e) Inducement of Clients: A stock-broker should not resort to unfair means of inducing clients from other stock- brokers.

(f) False or Misleading Returns: A stock-broker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to the Board and the stock exchange.

3.22 REGISTRATION OF SUB-BROKER

An application by a sub-broker for the grant of a certificate is made in the prescribed format accompanied by a recommendation letter from a stockbroker of a recognised stock exchange with whom he is to be affiliated along with two references including one from his banker. The application form is submitted to the stock exchange of which the stock- broker with whom he is to be affiliated is a member.

The eligibility criteria for registration as a sub-broker are as follows:

(i) in the case of an individual:

(a) the applicant is not less than 21 years of age,

(b) the applicant has not been convicted of any offence involving fraud or dishonesty,

(c) the applicant has atleast passed 12th standard equivalent examination from an institution recognised by the Government, Provided that SEBI may relax the educational qualifications on merits having regard to the applicant's experience.

(d) the applicant is a fit and proper person.

(ii) In the case of partnership firm or a body corporate the partners or directors, as the case may be, should comply with the following requirements:

(a) the applicant is not less than 21 years of age,

(b) the applicant has not been convicted of any offence involving fraud or dishonesty, and

(c) the applicant has atleast passed 12th standard equivalent examination from an institution recognised by the Government.

Provided that SEBI may relax the educational qualifications on merits having regard to the applicant's experience.

The stock exchange on receipt of an application, verifies the information contained therein and certifies that the applicant is eligible for registration.

The stock exchange forwards the application form of such applicants who comply with all the requirements specified in the Regulations to SEBI as early as possible, but not later than thirty days from the date of its receipt.

SEBI on being satisfied that the sub-broker is eligible, grants a certificate to the sub-broker and sends intimation to that effect to the stock exchange or stock exchanges as the case may be. SEBI grants a certificate of registration to the appellant subject to the terms and conditions as stated in Rule 5 of SEBI (Stock Brokers and Sub-brokers) Rules, 1992.

Where an application does not fulfill the requirements, SEBI may reject the application after giving a reasonable opportunity of being heard.

The sub-broker shall:

(a) pay the fees as specified in Schedule III;

(b) abide by the code of conduct specified in Schedule II; and

(c) enter into an agreement with the stock-broker for specifying the scope of his authority and responsibilities.

(d) comply with the rules, regulations and bye-laws of the stock exchange

(e) not be affiliated to more than one stock broker of one stock exchange

3.22.1 CODE OF CONDUCT

The sub-broker at all times abides by the Code of Conduct as given hereunder:

I. General

(a) Integrity: A sub-broker, should maintain high standards of integrity, promptitude and fairness in the conduct of all investment business.

(b) Exercise of Due Skill and Care: A sub-broker, should act with due skill, care and diligence in the conduct of all investment business.

II. Duty to the Investor

1. Execution of Orders:

(a) A sub-broker, in his dealings with the clients and the general investing public, should faithfully execute the orders for buying and selling of securities at the best available market price. A sub-broker should promptly inform his client about the execution or non-execution of an order.

(b) A sub-broker should render necessary assistance to his client in obtaining the contract note from the stock broker

2. Issue of Purchase or Sale Notes:

(a) A sub-broker should issue promptly to his clients purchase or sale notes for all the transactions entered into by him with his clients.

(b) A sub-broker should issue promptly to his clients scrip-wise split purchase or sale notes and similarly bills and receipts showing the brokerage separately in respect of all transactions in the specified form.

(c) A sub-broker should only split the contract notes client-wise and scrip-wise originally issued to him by the affiliated broker into different denominations.

(d) A sub-broker should not match the purchase and sale orders of his clients and each such order must invariably be routed through a member-broker of the stock exchange with whom he is affiliated.

3. Breach of Trust: A sub-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship.

4. Business and Commission:

   (a) A sub-broker should not encourage sales or purchases of securities with the sole object of generating brokerage or commission.

   (b) A sub-broker should not furnish false or misleading quotations or give any other false or misleading advice or information to the clients with a view of inducing him to do business in particular securities and enabling himself to earn brokerage or commission thereby.

   (c) A sub-broker should not charge from his clients a commission exceeding one and one-half percent of the value mentioned in the respective sale or purchase notes.

5. Business of Defaulting Clients: A sub-broker should not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments in relation to securities and is in default with another broker or sub-broker.

6. Fairness to Clients: A sub-broker, when dealing with a client, should disclose that he is acting as an agent ensuring at the same time, that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and should not consider clients' interest inferior to his own.

7. Investment Advice: A sub-broker should not make a recommendation to any client who might be expected to rely thereon to acquire, dispose of, retain any securities unless he has reasonable grounds for believing that the recommendation is suitable for such a client upon the basis of the facts, if disclosed by such a client as to his own security holdings, financial situation and objectives of such investment. The subbroker should seek such information from clients, wherever they feel it is appropriate to do so.

8. Investment Advice in publicly accessible media:

   (a) A sub-broker or any of his employees should not render, directly and indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-realtime, unless a disclosure of his interest including his long or short position in the said security has been made, while rendering such advice.

   (b) In case, an employee of the sub-broker is rendering such advice, he should also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.

9. Competence of Sub-broker: A sub-broker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients and continuouscompliance with the regulatory system.

III. Sub-Brokers vis-à-vis Stock Brokers

(a) Conduct of Dealings: A sub-broker should co-operate with his broker in comparing unmatched transactions. A sub-broker should not knowingly and willfully deliver documents, which constitute bad delivery. A sub-broker should co-operate with other contracting party for prompt replacement of documents, which are declared as bad delivery.

(b) Protection of Clients Interests: A sub-broker should extend fullest co-operation to his stock-broker in protecting the interests of their clients regarding their rights to dividends, right or bonus shares or any other rights related to such securities.

(c) Transactions with Brokers: A sub-broker should not fail to carry out his stock broking transactions with his broker nor should he fail to meet his business liabilities or show negligence in completing the settleme nt of transactions with them.

(d) Agreement between sub-broker, client of the sub-broker and main broker: A sub-broker should enter into a tripartite agreement with his client and with the main stock broker specifying the scope of rights and obligations of the stock broker, sub-broker and such client of the sub-broker

(e) Advertisement and Publicity: A sub-broker should not advertise his business publicly unless permitted by the stock exchange.

(f) Inducement of Clients: A sub-broker should not resort to unfair means of inducing clients from other stock brokers.

IV. Sub-brokers vis-a-vis Regulatory Authorities

(a) General Conduct: A sub-broker should not indulge in dishonourable, disgraceful or disorderly or improper conduct on the stock exchange nor shall he willfully obstruct the business of the stock exchange. He should comply with the rules, byelaws and regulations of the stock exchange.

(b) Failure to give Information: A sub-broker should not neglect or fail or refuse to submit to SEBI or the stock exchange with which he is registered, such books, special returns, correspondence, documents, and papers or any part thereof as may be required.

(c) False or Misleading Returns: A sub-broker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to SEBI or the stock exchanges.

(d) Manipulation: A sub-broker should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumours with a view to distorting market equilibrium or making personal gains.

(e) Malpractices: A sub-broker should not create false market either singly or in concert with others or indulge in any act detrimental to the public interest or which leads to interference with the fair and smooth functions of the market mechanism of the stock exchanges. A sub-broker should not involve himself in excessive speculative business in the market beyond reasonable levels not commensurate with his financial soundness.

3.23 SEBI GUIDELINES ON DISCLOSURE AND INVESTOR PROTECTION (DIP)

Major part of the liberalisation process was the repeal of the Capital Issues (Control) Act, 1947 in May 1992. With this, Government's control over issue of capital, pricing of the issues, fixing of premia and rates of interest on debentures etc. ceased and the market was allowed to allocate resources to competing uses. In the interest of investors, SEBI issued Disclosure and Investor Protection (DIP) guidelines in June 1992. The guidelines contain a substantial body of requirements for issuers/intermediaries, the broad intention being to ensure that all concerned observe high standards of integrity and fair dealing, comply with all the requirements with due skill, diligence and care, and disclose the truth, whole truth and nothing but truth. The guidelines aim to secure fuller disclosure of relevant information about the issuer and the nature of the securities to be issued so that investors can take informed decisions. For example, issuers are required to disclose any material 'risk factors' and give justification for pricing in their prospectus. The guidelines cast a responsibility on the lead managers to issue a due diligence certificate, stating that they have examined the prospectus, they find it in order and that it brings out all the facts and does not contain anything wrong or misleading. Issuers are now required to comply with the guidelines and then access the market. The companies can access the market only if they fulfill minimum eligibility norms such as track record of distributable profitsand net worth. In case they do not do so, they can access the market onlythrough book building with minimum offer of 50% to qualified institutional buyers. The norms for continued disclosure by listed companies also improved availability of information. The information technology helped in easy dissemination of information about listed companies and market intermediaries. Equity research and analysis and credit rating improved the quality of information about issues.

SEBI has been issuing clarifications to these guidelines from time to time aiming at streamlining the public issue process. In order to provide a comprehensive coverage of all DIP guidelines, SEBI issued a compendium series in January 2000, known as SEBI (DIP) Guidelines, 2000. The guidelines provide norms relating to eligibility for companies issuing securities, pricing of issues, listing requirements, disclosure norms, lock-in period for promoters' contribution, contents of offer documents, pre-and post-issue obligations, etc.

These Guidelines are applicable to all public issues by listed and unlisted companies, all offers for sale and rights issues by listed companies whose equity share capital is listed, except in case of rights issues where the aggregate value of securities offered does not exceed Rs.50 lakh. In case of the rights issue where the aggregate value of the securities offered is less than Rs.50 Lakh, the company shall prepare the letter of offer in accordance with the disclosure

requirements specified in these guidelines and file the same with the Board for its information and for being put on the SEBI website. Unless otherwise stated, all provisions in these guidelines are applicable to public issues by unlisted companies and also apply to offers for sale to the public by unlisted companies.

Eligibility Norms for Companies Issuing Securities The companies issuing securities offered through an offer document, should satisfy the following at the time of filing draft offer document with SEBI and also at the time of filing the final offer document with the Registrar of Companies (ROC)/Designated Stock Exchange:

- A company making a public issue of securities should file a draft prospectus with SEBI, through an eligible Merchant Banker, at least 21 days prior to the filing of prospectus with the Registrar of Companies (RoCs). The filing of the letter of offer with SEBI through an eligible Merchant Banker atleast 21 days prior to the filing of Letter of Offer with Regional Stock Exchange (RSE) is mandatory for a listed company issuing security through a rights issue where the aggregate value of securities, including premium, if any, exceeds Rs.50 lakh.

- A company cannot make an issue if the company has been prohibited from accessing the capital market under any order or direction passed by SEBI.

- A company cannot make a public issue unless it has made an application for listing of those securities with stock exchange(s). The company should also enter into an agreement with the depository before making any public / rights issue or an offer for sale of securities for dematerialisation of its securities already issued or proposed to be issued and also the company should give an option to subscribers/shareholders/investors to receive the security certificates or hold securities in dematerialised form with a depository.

- An unlisted company can make public issue of equity shares or any other security convertible into equity shares, at a later date, only if it meets all the following conditions:

  (a) The company has net tangible assets of at least Rs. 3 crores in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets.

  Provided that if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such excess monetary assets in its business/project;

  (b) The company has a track record of distributable profits in terms of Section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years; Provided further that extraordinary items should not be considered for calculating distributable profits in terms of Section 205 of Companies Act, 1956;

  (c) The company has a net worth of at least Rs. 1 crore in each of the preceding 3 full years (of 12 months each);

(d) In case the company has changed its name within the last one year, atleast 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name; and

(e) The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (i.e., offer through offer document + firm allotment + promoters' contribution through the offer document), does not exceed five (5) times its pre-issue networth as per the audited balance sheet of the last financial year.)

- Infrastructure companies are exempt from the requirement of eligibility norms if their project has been appraised by a public financial institution or infrastructure development finance corporation or infrastructure leasing and financing services and not less than 5% of the project cost is financed by any of the institutions, jointly or severally, by way of loan and/or subscription to equity or a combination of both. Banks and rights issues of listed companies are also exempt from the eligibility norms.

- For public and rights issues of debt instruments irrespective of their maturities or conversion period, it is mandatory to obtain credit rating from a registered credit rating agency and to disclose the same in the offer document. If the credit rating is obtained from more than one credit rating agency, all the credit ratings, including the rejected ones, need to be disclosed.

Thus the quality of the issue is demonstrated by track record/appraisal by approved financial institutions/credit rating/subscription by Qualified Institutional Buyers.

3.24 PRICING OF ISSUES

The companies eligible to make public issue can freely price their equity shares or any security convertible into equity at a later date in cases of public/rights issues by listed companies and public issue by unlisted companies. In addition, eligible infrastructure companies can freely price their equity shares subject to compliance of disclosure norms of SEBI. The public and private sector banks can also freely price their shares subject to approval by RBI. A company may issue shares to applicants in the firm allotment category at higher price than the price at which securities are offered to public. A listed company making a composite issue of capital may issue securities at differential prices in its public and rights issue. Further, an eligible company is free to make public/rights issue in any denomination determined by it in accordance with the Companies Act, 1956 and SEBI norms.

3.25 CONTRIBUTION OF PROMOTERS AND LOCK-IN

The promoters' contribution in case of public issues by unlisted companies and promoters' shareholding in case of 'offers for sale' should not be less than 20% of the post issue capital. In case of public issues by listed companies, promoters should contribute to the extent of 20% of the proposed issue or should ensure post-issue holding to the extent of 20% of the post-issue capital. For composite

issues, the promoters' contribution should either be 20% of the proposed public issue or 20% of the post-issue capital. The promoters should bring in the full amount of the promoters contribution including premium at least one day prior to the issue opening date. The requirement of promoters contribution is not applicable in case of

(i) public issue of securities which has been listed on a stock exchange for at least 3 years and has a track record of dividend payment for at least 3 immediate preceding years,

(ii) companies where no identifiable promoter or promoter group exists, and

(iii) rights issues.

For any issue of capital to the public, the minimum promoter's contribution is locked in for a period of 3 years. If the promoters contribution exceeds the required minimum contribution, such excess is locked in for a period of one year. Securities allotted in firm allotment basis are also locked in for a period of three years. The locked-in securities held by promoters may be pledged only with banks or FIs as collateral security for loans granted by such banks or FIs.

3.26 ISSUE OF SWEAT EQUITY

The SEBI (Issue of Sweat Equity) Regulations, 2002 have been framed and the main provisions laid down therein for issue of sweat equity are (a) under the new guidelines, the Sweat Equity shares can be issued by a company to its employees and directors as well as promoters, (b) the pricing of the sweat equity shares should be as per the formula prescribed for that of preferential allotment, (c) the sweat equity shares should be locked in for a period of 3 years. In case of a subsequent public issue being made, lock in shall be as per the SEBI (DIP) Guidelines, 2000.

3.29 ISSUE OBLIGATIONS

3.27.1 Pre-Issue Obligations

The lead merchant banker plays an important role in the pre-issue obligations of the company. He exercises due diligence and satisfies himself about all aspects of offering, veracity and adequacy of disclosures in the offer document. Each company issuing securities has to enter into a Memorandum of Understanding with the lead merchant banker, which specifies their mutual rights, liabilities and obligations relating to the issue. In case of undersubscription of an issue, the lead merchant banker responsible for underwriting arrangements has to invoke underwriting obligations and ensure that the underwriters pay the amount of devolvement. It should ensure the minimum number of collection centres. It should also ensure that the issuer company has entered into an agreement with all the depositories for dematerialization of securities. All the other formalities related to post-issue obligations like, allotment, refund and despatch of certificates are also taken care by the lead merchant banker.

3.27.2 Post - Issue Obligations

The Lead Merchant Banker should ensure the post-issue monitoring reports are submitted as per prescribed formats. These reports should be submitted within 3 working days from the due dates.

The Lead Merchant Banker should actively associate himself with post-issue activities namely, allotment, refund and despatch and should regularly monitor redressal of investor grievances arising therefrom.

The Post-issue lead merchant banker should maintain close co-ordination with the Registrars to the Issue and arrange to depute its officers to the offices of various intermediaries at regular intervals after the closure of the issue to monitor the flow of applications from collecting bank branches, processing of the applications including those accompanied by stockinvest and other matters till the basis of allotment is finalised, despatch security certificates and refund orders completed and securities listed.

The lead merchant banker should ensure that the despatch of share certificates/ refund orders/ and demat credit is completed and the allotment and listing documents submitted to the stock exchanges within 2 working days of finalisation of the basis of allotment.

The post issue lead manager should ensure that all steps for completion of the necessary formalities for listing and commencement of trading at all stock exchanges where the securities are to be listed are taken within 7 working days of finalisation of basis of allotment.

Lead Merchant Banker should ensure payment of interest to the applicants for delayed dispatch of allotment letters, refund orders, etc. as prescribed in the offer document.

3.28 BOOK BUILDING

Book building is a process of offering securities in which bids at various prices from investors through syndicate members are collected. Based on bids, demand for the security is assessed and its price discovered. In case of normal public issue, the price is known in advance to investor and the demand is known at the close of the issue. In case of public issue through book building, demand can be known at the end of everyday but price is known at the close of issue.

An issuer company proposing to issue capital through book building has two options viz., 75% book building route and 100% book building route.

In case of 100% book building route is adopted (a) not more than 50% of net offer to public can be allocated to Qualified Institutional Buyers (b) not less than 15% of the net offer to the public can be allocated to non-institutional investors applying for more than 1000 shares and (c) not less than 35% of the net offer to public can be allocated to retail investors applying for upto 1000 shares.

In case 75% of net public offer is made through book building (a) in the book built portion, not less than 25% of the net offer to the public, should be vailable for allocation to non Qualified Institutional Buyers and not more than 50% of the net offer to the public should be available for allocation to Qualified Institutional Buyers (b) the balance 25% of the net offer to the public, offered at a price determined through book building, should be available only to retail individual investors who have either not partic ipated or have not received any allocation, in the book built portion. Provided that 50% of net offer to public should be mandatorily allotted to the Qualified Institutional Buyers, in case the issuer company is making a public issue under Clause 2.2.2 and 2.3.2 of DIP Guidelines 2000) Other requirements for book building include: bids remain open for at least 5 days, only electronic bidding is permitted; bids are submitted through syndicate members; bids can be revised; bidding demand is displayed at the end of every day; allotments are made not later than 15 days from the closure of the issue etc.

The DIP guidelines for book building provides that the company should be allowed to disclose the floor price, just prior to the bid opening date, instead of in the Red herring prospectus, which may be done by any means like a public advertisement in newspaper etc. Flexibility should be provided to the issuer company by permitting them to indicate a 20% price band. Issuer may be given the flexibility to revise the price band during the bidding period and the issuers should be allowed to have a closed book building i.e. the book will not be made public. The mandatory requirement of 90% subscription should not be considered with strictness, but the prospectus should disclose the amount of minimum subscription required and sources for meeting the shortfall. The Primary Market Advisory Committee recommended the practice of 'green-shoe option' available in markets abroad which is an 'over allotment' option granted by the issuer to the underwriter in a public offering. This helps the syndicate member to over allocate the shares to the extent of option available and to consequently purchase additional shares from the issuer at the original offering price in order to cover the over-allotments.

3.29 ON-LINE INITIAL PUBLIC OFFERS (IPO)

A company proposing to issue capital to public through on-line system of the stock exchange has to comply with Section 55 to 68A of the Companies Act, 1956 and SEBI (DIP) Guidelines, 2000. The comp any is required to enter into an agreement with the stock exchange(s) which have the requisite system for on-line offer of securities. The agreement should cover rights, duties, responsibilities and obligations of the company and the stock exchanges interse, with provision for a dispute resolution mechanism between the company and the stock exchange. The issuer company appoints a Registrar to the Issue having electronic connectivity with the stock exchanges. The issuer company can apply for listing of its securities at any exchange through which it offers its securities to public through on-line system, apart from the requirement of listing on the regional stock exchange. The stock exchange appoints brokers for the purpose of accepting applications and placing orders with the company. The lead manager would co-ordinate all the activities amongst various intermediaries connected in the system.

In addition to the above, the DIP guidelines also provide details of the contents of the offer document and advertisement, other requirements for issues of securities, like those under Rule 19(2) (b) of SC(R) Rules, 1957. The guidelines also lay down detailed norms for issue of debt instruments, issue of capital by designated financial institutions and preferential/bonus issues.

3.30 SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992

Insider trading is prohibited as per SEBI (Prohibition of Insider Trading) Regulations, 1992. The same was amended in the year 2003.

The Key definitions:

- 'Dealing in securities' means an act of subscribing, buying, selling or agreeing to subscribe, buy, sell or deal in any securities by any person either as principal or agent.
- 'Insider' means any person who, is or was connected with the company or is deemed to have been connected with the company, and who is reasonably expected to have access, connection to unpublished price sensitive information in respect of securities of a company, or who has received or has had access to such unpublished price sensitive information;
- A 'connected person' means any person who-

  (i) is a director, as defined in clause (13) of section 2 of the Companies Act, 1956 of a company, or is deemed to be a director of that company by virtue of sub-clause (10) of section 307 of that Act; or

  (ii) occupies the position as an officer or an employee of the company or holds a position involving a professional or business relationship between himself and the company whether temporary or permanent and who may reasonably be expected to have an access to unpublished price sensitive information in relation to that company.
- A 'person is deemed to be a connected person' if such person-

  (i) is a company under the same management or group or any subsidiary company thereof within the meaning of sub-section (1B) of section 370, or sub-section (11) of section 372, of the Companies Act, 1956 or sub-clause (g) of section 2 of the Monopolies and Restrictive Trade Practices Act, 1969 as the case may be; or

  (ii) is an intermediary as specified in section 12 of SEBI Act 1992, investment company, trustee company, asset management company or an employee or director thereof or an official of a stock exchange or of a clearing house or corporation;

  (iii) is a merchant banker, share transfer agent, registrar to an issue, debenture trustee, broker, portfolio manager, Investment Advisor, sub-broker, Investment Company or an employee thereof, or, is a member of the Board of Trustees of a mutual fund or a member of the Board of Directors

of the Asset Management Company of a mutual fund or is an employee thereof who has a fiduciary relationship with the company;

(iv) is a member of the Board of Directors, or an employee, of a public financial institution as defined in Section 4A of the Companies Act, 1956; or

(v) is an official or an employee of a self regulatory organisation recognised or authorised by the Board of a regulatory body; or

(vi) is a relative of any of the aforementioned persons;

(vii) is a banker of the company;

(viii) relatives of the connected person;

(ix) is a concern, firm, trust, Hindu Undivided Family, company or association of persons wherein any of the connected persons mentioned in sub-clause (i) of clause (c) of this regulation or any of the persons mentioned in sub-clauses (vi), (vii) or (viii) of this clause have more than 10% of the holding or interest.

- 'Price sensitive information' means any information which relates directly or indirectly to a company and which if published is likely to materially affect the price of securities of company;

Explanation: The following shall be deemed to be price sensitive information:

(i) periodical financial results of the company;

(ii) intended declaration of dividends (both interim and final);

(iii) issue of securities or buy-back of securities;

(iv) any major expansion plans or execution of new projects;

(v) amalgamation, mergers or takeovers;

(vi) disposal of the whole or substantial part of the undertaking;

(vii) any significant changes in policies, plans or operations of the company.

- 'Unpublished' means information which is not published by the company or its agents and is not specific in nature.

Explanation: Speculative reports in print or electronic media shall not be considered as published information.

Prohibition on dealing, communicating or counselling (Regulation 3) No insider should:

- either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange when in possession of any unpublished price sensitive information;

- communicate, counsel or procure, directly or indirectly, any unpublished price sensitive information to any person who while in possession of such unpublished price sensitive information should not deal in securities; Provided that nothing contained above shall be applicable to any communication required in the ordinary course of business or profession or employment or under any law.

3.30.1 Regulation 3A

No company should deal in the securities of another company or associate of that other company while in possession of any unpublished price sensitive information.

Violation of provisions relating to insider trading (Regulation 4) Any insider, who deals in securities in contravention of the provisions of regulation 3 or 3A shall be guilty of insider trading.

Policy on disclosures and internal procedure for prevention of insider trading:

Chapter IV of the Regulations deals with policy on disclosures and internal procedure for prevention of insider trading. Accordingly, all listed companies and organisations associated with securities markets including:

(a) the intermediaries as mentioned in section 12 of the SEBI Act, 1992, asset management company and trustees of mutual funds;

(b) the self regulatory organisations recognised or authorised by the Board;

(c) the recognised stock exchanges and clearing house or corporations;

(d) the public financial institutions as defined in Section 4A of the Companies Act, 1956; and

(e) the professional firms such as auditors, accountancy firms, law firms, analysts, consultants, etc., assisting or advising listed companies, should frame a code of internal procedures and conduct as near there to the Model Code specified in Schedule I of these Regulations.

3.30.2 Disclosures (Regulation 13)

Disclosure of interest or holding by directors and officers and substantial shareholders in a listed companies:

3.30.3 Initial Disclosure

(1) Any person who holds more than 5% shares or voting rights in any listed company should disclose to the company, in Form A, the number of shares or voting rights held by such person, on becoming such holder, within 4 working days of: (a) the receipt of intimation of allotment of shares; or (b) the acquisition of shares or voting rights, as the case may be.

(2) Any person who is a director or officer of a listed company, should disclose to the company, in Form B, the number of shares or voting rights held by such person, within 4 working days of becoming a director or officer of the company.

3.30.4 Continual Disclosure

(1) Any person who holds more than 5% shares or voting rights in any listed company should disclose to the company, in Form C, the number of shares or voting rights held and change in shareholding or voting rights, even if such change results in shareholding falling below 5%, if there has been change in such holdings from the last disclosure made under sub-regulation (1) or under this sub-regulation; and such change exceeds 2% of total shareholding or voting rights in the company.

(2) Any person who is a director or officer of a listed company, should disclose to the company, in Form D, the total number of shares or voting rights held and change in shareholding or voting rights, if there has been a change in such holdings from the last disclosure made under sub-regulation (2) or under this sub-regulation, and the change exceeds Rupees 5 lakh in value or 25000 shares or 1% of total shareholding or voting rights, whichever is lower.

(3) The disclosure mentioned in sub-regulations (3) and (4) should be made within 4 working days of; (a) the receipt of intimation of allotment of shares, or (b) the acquisition or sale of shares or voting rights, as the case may be.

3.30.5 Disclosure by company to stock exchanges

(1) Every listed company, within five days of receipt, should disclose to all stock exchanges on which the company is listed, the information received under sub-regulations (1), (2),(3) and (4).

3.30.6 Code of Ethics

SEBI has advised stock exchanges to adopt the Code of Ethics for their directors and functionaries. This is aimed at improving the professional and ethical standards in the functioning of exchanges thereby creating better investors confidence in the integrity of the market. Code of Ethics has been discussed in details in section 3.32.

3.31. SEBI (SUBSTANTIAL ACQUISTION OF SHARES AND TAKEOVERS) REGULATIONS, 1997

3.31.1 The Key definitions:

- 'Acquirer' means any person who, directly or indirectly, acquires or agrees to acquire shares or voting rights in the target company, or acquires or agrees to acquire control over the target company, either by himself or with any person acting in concert with the acquirer;

- 'control' shall include the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner;

- 'target company' means a listed company whose shares or voting rights or control is directly or indirectly acquired or is being acquired;

- A 'person acting in concert ' comprises:

  (1) persons who, for a common objective or purpose of substantial acquisition of shares or voting rights or gaining control over the target company, pursuant to an agreement or understanding (formal or informal), directly or indirectly co-operate by acquiring or agreeing to acquire shares or voting rights in the target company or control over the target company.

  (2) Without prejudice to the generality of this definition, the following persons will be deemed to be persons acting in concert with other persons in the same category, unless the contrary is established:

    (i) a company, its holding company, or subsidiary of such company or company under the same management either individually or together with each other;

    (ii) a company with any of its directors, or any person entrusted with the management of the funds of the company;

    (iii) directors of companies referred to in sub-clause (i) of clause (2) and their associates;

    (iv) mutual fund with sponsor or trustee or asset management company;

    (v) foreign institutional investors with sub account(s);

    (vi) merchant bankers with their client(s) as acquirer;

    (vii) portfolio managers with their client(s) as acquirer;

    (viii) venture capital funds with sponsors;

    (ix) banks with financial advisers, stock brokers of the acquirer, or any company which is a holding company, subsidiary or relative of the acquirer.

    (x) any investment company with any person who has an interest as director, fund manager, trustee, or as a shareholder having not less than 2% of the paid-up capital of that company or with any other investment company in which such person or his associate holds not less than 2% of the paid up capital of the latter company.

Acquisition of 5% and more shares of a company

(1) Any acquirer, who acquires shares or voting rights which (taken together with shares or voting rights, if any, held by him) would entitle him to more

than five percent or ten percent or fourteen percent or fifty four percent or seventy four percent shares or voting rights in a company, in any manner whatsoever, should disclose at every stage the aggregate of his shareholding or voting rights in that company to the company and to the stock exchanges where shares of the target company are listed.

(1A) Any acquirer who has acquired shares or voting rights of a company under sub-regulation (1) of regulation 11, should disclose purchase or sale aggregating two percent or more of the share capital of the target company to the target company, and the stock exchanges where shares of the target company are listed within two days of such purchase or sale alongwith the aggregate shareholding after such acquisition or sale.

3.31.2 Continual disclosures

(1) Every person, including a person mentioned in Regulation 6 who holds more than fifteen percent shares or voting rights in any company, should, within 21 days from the financial year ending March 31, make yearly disclosures to the company, in respect of his holdings as on 31st March.

(2) A promoter or every person having control over a company should, within 21 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, disclose the number and percentage of shares or voting rights held by him and by persons acting in concert with him, in that company to the company.

(3) Every company whose shares are listed on a stock exchange, should within 30 days from the financial year ending March 31, as well as the record date of the company for the purposes of declaration of dividend, make yearly disclosures to all the stock exchanges on which the shares of the company are listed, the changes, if any, in respect of the holdings of the persons referred to under sub-regulation (1) and also holdings of promoters or person(s) having control over the company as on 31st March.

(4) Every company whose shares are listed on a stock exchange should maintain a register in the specified format to record the information received under sub-regulation (3) of Regulation 6, sub-regulation (1) of Regulation 7 and sub-regulation (2) of Regulation 8.

Acquisition of fifteen percent or more of the shares or voting rights of any company No acquirer should acquire shares or voting rights which (taken together with shares or voting rights, if any, held by him or by persons acting in concert with him), entitle such acquirer to exercise fifteen percent or more of the voting rights in a company, unless such acquirer makes a public announcement to acquire shares of such company in accordance with the Regulations.

Provided that no acquirer should acquire shares or voting rights, through market purchases and preferential allotment pursuant to a resolution passed under section 81 of the Companies Act, 1956 or any other applicable law, which (taken together with shares or voting rights, if any, held by him or by persons

acting in concert with him), entitle such acquirer to exercise more than fifty five percent of the voting rights in the company.

3.31.3 Appointment of a Merchant Banker

Before making any public announcement of offer referred to in Regulation 10 or Regulation 11 or Regulation 12, the acquirer should appoint a merchant banker in Category-I holding a certificate of registration granted by the Board, who is not associate of or group of the acquirer or the target company Timing of the Public Announcement of Offer

(1) The public announcement referred to in Regulation 10 or Regulation 11 should be made by the merchant banker not later than four working days of entering into an agreement for acquisition of shares or voting rights or deciding to acquire shares or voting rights exceeding the respective percentage specified therein:

Provided that in case of disinvestment of a Public Sector Undertaking, the public announcement should be made by the merchant banker not later than 4 working days of the acquirer executing the Share Purchase Agreement or Shareholders Agreement with the Central Government or the State Government as the case may be for the acquisition of shares or voting rights exceeding the percentage of share holding referred to in Regulation 10 or Regulation 11 or the transfer of control over a target Public Sector Undertaking.

(2) In case of an acquirer acquiring securities, including Global Depositories Receipts or American Depository Receipts which, when taken together with the voting rights, if any already held by him or persons acting in concert with him, would entitle him to voting rights, exceeding the percentage specified in Regulation 10 or Regulation 11, the public announcement referred to in sub-regulation (1) should be made not later than four working days before he acquires voting rights on such securities upon conversion, or exercise of option, as the case may be.

(3) The public announcement referred to in Regulation 12 should be made by the merchant banker not later than four working days after any such change or changes are decided to be made as would result in the acquisition of control over the target company by the acquirer.

(4) In case of indirect acquisition or change in control, a public announcement should be made by the acquirer within three months of consummation of such acquisition or change in control or restructuring of the parent or the company holding shares of or control over the target company in India.

3.31.4 Public Announcement of Offer

(1) The public announcement to be made under Regulations 10 or Regulation 11 or Regulation 12 should be made in all editions of one English national daily with wide circulation, one Hindi national daily with wide circulation and a regional language daily with wide circulation at the place where the registered

office of the target company is situated and at the place of the stock exchange where the shares of the target company are most frequently traded.

(2) Simultaneously with publication of the public announcement in the newspaper in terms of sub-regulation (1), a copy of the public announcement should be,

(i) submitted to the Board through the merchant banker,

(ii) sent to all the stock exchanges on which the shares of the company are listed for being notified on the notice board,

(iii) sent to the target company at its registered office for being placed before the Board of Directors of the company.

(3) Simultaneous with the submission of the public announcement to the Board, the public announcement should also be sent to all the stock exchanges on which the shares of the company are listed for being notified on the notice board, and to the target company at its registered office for being placed before the board of directors of the Company.

(4) The offer under these Regulations shall be deemed to have been made on the date on which the public announcement has appeared in any of the newspapers referred to in sub-regulation (1).

3.31.5 Submission of Letter of offer to the Board

(1) Within fourteen days from the date of public announcement made under Regulation 10, Regulation 11 or Regulation 12 as the case may be, the acquirer should, through its merchant banker, file with the Board, the draft of the letter of offer, containing disclosures as specified by the Board.

(2) The letter of offer should be despatched to the shareholders not earlier than 21 days from its submission to the Board under sub-regulation (1).

Provided that if, within 21 days from the date of submission of the letter of offer, the Board specifies changes, if any, in the letter of offer, (without being under any obligation to do so) the merchant banker and the acquirer should carry out such changes before the letter of offer is despatched to the shareholders.

Provided further that if the disclosures in the draft letter of offer are inadequate or the Board has received any complaint or has initiated any enquiry or investigation in respect of the public offer, the Board may call for revised letter of offer with or without rescheduling the date of opening or closing of the offer and may offer its comments to the revised letter of offer within seven working days of filing of such revised letter of offer.

(3) The acquirer should, along with the draft letter of offer referred to in sub-regulation (1), pay a fee of Rs. 50,000/- to the Board, either by a banker's cheque or demand draft in favour of the Securities and Exchange Board of India, payable at Mumbai.

3.31.6 Minimum number of shares to be acquired

(1) The public offer made by the acquirer to the shareholders of the target company should be for a minimum twenty per cent of the voting capital of the company.

Provided that where any public offer is made in pursuance of subregulation (2) of regulation 11, such public offer should be for such percentage of voting capital of the target company so that the acquisition does not result in the public shareholding in such company being reduced to a level below the limit specified in the Listing Agreement with the stock exchange for the purpose of listing on continuous basis

(2) Where an acquirer acquires more than fifty five percent (55%) shares or voting rights in the target company through an agreement or memorandum of understanding and the public offer made under regulation 10 or sub-regulation (1) of regulation 11 to acquire minimum percentage of voting capital as specified in sub regulation (1) of regulation 21 results in public shareholding being reduced to a level below the limit specified in the Listing Agreement with the stock exchange for the purpose of listing on continuous basis, the acquirer shall acquire only such number of shares under the agreement or the memorandum of understanding so as to maintain the minimum specified Public shareholding in the target company.

(3) If consequent to the public offer made in pursuance of global arrangement referred to in proviso to sub regulation (2A) of regulation 11, the public shareholding falls to a level below the limit specified in the Listing Agreement with the stock exchange for the purpose of listing on continuous basis, the acquirer shall undertake to raise the level of public shareholding to the levels specified for continuous listing specified in the Listing Agreement with the stock exchange, within a period of twelve months from the date of closure of the public offer, by

(i) issue of new shares by the company in compliance with the provisions of the Companies Act, 1956 and the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000; or

(ii) disinvestment through an offer for sale in compliance with the provisions of the Companies Act, 1956 and the Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000, of such number of shares held by him so as to satisfy the listing requirements; or

(iii) sale of his holdings through the stock exchange.

Provided that in case of acquisition of shares or voting rights or control in a target company where the public shareholding is below the limit specified for the purpose of listing on continuous basis in terms of the Listing Agreement with the stock exchange, the acquirer shall undertake to raise the level of public shareholding to the levels specified for continuous listing in terms of the listing conditions specified in the Listing Agreement with the stock exchange, within the period specified under the Listing Agreement.

(4) The letter of offer shall state clearly the option available to the acquirer under sub-regulation (3).

(5) For the purpose of computing the percentage referred to subregulation (1) and the voting rights as at the expiration of fifteen days after the closure of the public offer shall be reckoned.

(6) Where the number of shares offered for sale by the shareholders are more than the shares agreed to be acquired by the person making the offer, such person shall, accept the offers received from the shareholders on a proportional basis, in consultation with the merchant banker, taking care to ensure that the basis of acceptance is decided in a fair and equitable manner and does not result in non- marketable lots.

Provided that acquisition of shares from a shareholder shall not be less than the minimum marketable lot or the entire holding if it is less than the marketable lot.

3.32 COMPETITIVE BID

(1) Any person, other than the acquirer who has made the first public announcement, who is desirous of making any offer, shall, within 21 days of the public announcement of the first offer, make a public announcement of his offer for acquisition of the shares of the same target company.

Explanation: An offer made under sub-regulation (1) shall be deemed to be a competitive bid.

(2) No public announcement for an offer or competitive bid shall be made after 21 days from the date of public announcement of the first offer.

(2A) No public announcement for a competitive bid shall be made after anacquirer has already made the public announcement under the proviso to sub-regulation (1) of Regulation 14 pursuant to entering into a Share Purchase or Shareholders Agreement with the Central Government or the State Government as the case may be], for acquisition of shares or voting rights or control of a Public Sector Undertaking.

(3) Any competitive offer by an acquirer shall be for such number of shares which, when taken together with shares held by him along with persons acting in concert with him, shall be at least equal to the holding of the first bidder including the number of shares for which the present offer by the first bidder has been made.

(4) Upon the public announcement of a competitive bid or bids, the acquirer(s) who had made the public announcement(s) of the earlier offer(s), shall have the option to make an announcement revising the offer.

Provided that if no such announcement is made within fourteen days of the announcement of the competitive bid(s), the earlier offer(s) on the original

terms shall continue to be valid and binding on the acquirer(s) who had made the offer(s) except that the date of closing of the offer shall stand extended to the date of closure of the public offer under the last subsisting competitive bid.

(5) The provisions of these Regulations shall mutatis-mutandis (with the necessary changes) apply to the competitive bid(s) made under subregulation (1).

(6) The acquirers who have made the public announcement of offer(s) including the public announcement of competitive bid(s) shall have the option to make upward revisions in his offer(s), in respect to the price and the number of shares to be acquired, at any time upto seven working days prior to the date of closure of the offer:

Provided that the acquirer shall not have the option to change any other terms and conditions of their offer except the mode of payment following an upward revision in offer. Provided further that any such upward revision shall be made only upon the acquirer:

(a) making a public announcement in respect of such changes or amendments in all the newspapers in which the original public announcement was made;

(b) simultaneously with the issue of public announcement referred in clause (a), informing the Board, all the stock exchanges on which the shares of the company are listed, and the target company at its registered office;

(c) increasing the value of the escrow account as provided under sub-regulation (9) of Regulation 28.

(7) Where there is a competitive bid, the date of closure of the original bid as also the date of closure of all the subsequent competitive bids shall be the date of closure of public offer under the last subsisting competitive bid and the public offers under all the subsisting bids shall close on the same date.

3.33 OBLIGATIONS ON INVESTIGATION BY THE BOARD

(1) It shall be the duty of the acquirer, the seller, the target company, the merchant banker whose affairs are being investigated and of every directo, officer and employee thereof, to produce to the investigating officer such books, securities, accounts, records and other documents in its custody or control and furnish him with such statements and information relating to his activities as the investigating officer may require, within such reasonable period as the investigating officer may specify.

(2) The acquirer, the seller, the target company, the merchant banker and the persons being investigated shall allow the investigating officer to have reasonable access to the premises occupied by him or by any other person on his behalf and also extend reasonable facility for examining any books, records, documents and computer data in the possession of the acquirer, the

seller, the target company, the merchant banker or such other person and also provide copies of documents or other materials which, in the opinion of the investigating officer are relevant for the purposes of the investigation.

(3) The investigating officer, in the course of investigation, shall be entitled to examine or to record the statements of any director, officer or employee of the acquirer, the seller, the target company, the merchant banker.

(4) It shall be the duty of every director, officer or employee of the acquirer, the seller, the target company, the merchant banker to give to the investigating officer all assistance in connection with the investigation, which the investigating officer may reasonably require.

3.34 SUBMISSION OF REPORT TO THE BOARD

The investigating officer shall, as soon as possible, on completion of the investigation, submit a report to the Board: Provided that if directed to do so by the Board, he may submit interim reports.

3.34.1 Penalties for non-compliance

(1) Any person violating any provisions of the Regulations shall be liable for action in terms of the Regulations and the Act.

(2) If the acquirer or any person acting in concert with him, fails to carry out the obligations under the Regulations, the entire or part of the sum in the escrow amount shall be liable to be forfeited and the acquirer or such a person shall also be liable for action in terms of the Regulations and the Act.

(3) The board of directors of the target company failing to carry out the obligations under the Regulations shall be liable for action in terms of the Regulations and Act.

(4) The Board may, for failure to carry out the requirements of the Regulations by an intermediary, initiate action for suspension or cancellation of registration of an intermediary holding a certificate of registration under section 12 of the Act.

Provided that no such certificate of registration shall be suspended or cancelled unless the procedure specified in the Regulations applicable to such intermediary is complied with.

(5) For any mis-statement to the shareholders or for concealment of material information required to be disclosed to the shareholders, the acquirers or the directors where the acquirer is a body corporate, the directors of the target company, the merchant banker to the public offer and the merchant banker engaged by the target company for independent advice would be liable for action in terms of the Regulations and the Act.

(6) The penalties referred to in sub-regulation (1) to (5) may include:

(a) criminal prosecution under section 24 of the Act;

(b) monetary penalties under section 15 H of the Act;

(c) directions under the provisions of Section 11B of the Act.

(d) directions under section 11(4) of the Act;

(e) cease and desist order in proceedings under section 11D of the Act; (f) adjudication proceedings under section 15HB of the Act.

3.35 SEBI (PROHIBITION OF FRAUDULENT AND UNFAIR TRADE PRACTICES RELATING TO SECURITIES MARKETS) REGULATIONS, 2003

The SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating To Securities Markets) Regulations, 2003 enable SEBI to investigate into cases of market manipulation and fraudulent and unfair trade practices. The regulations specifically prohibit fraudulent dealings, market manipulation, misleading statements to induce sale or purchase of securities, unfair trade practices relating to securities. SEBI can conduct investigation, suo moto or upon information received by it, by an investigating officer in respect of conduct and affairs of any person buying, selling, and otherwise dealing in securities. Based on the report of the investigating officer, SEBI can initiate action for suspension or cancellation of registration of an intermediary.

The term 'fraud' has been defined by Regulation 2(1)(c). Fraud includes any act, expression, omission or concealment committed whether in a deceitful manner or not by a person or by any other person with his connivance or by his agent while dealing in securities in order to induce another person or his agent to deal in securities, whether or not there is any wrongful gain or avoidance of any loss, and shall also include:

(1) a knowing misrepresentation of the truth or concealment of material fact in order that another person may act to his detriment;

(2) a suggestion, as to a fact, of that which is not true, by one who does not believe it to be true;

(3) an active concealment of a fact by a person having knowledge or belief of the fact;

(4) a promise made without any intention of performing it;

(5) a representation made in a reckless and careless manner whether it be true or false;

(6) deceptive behaviour by a person depriving another of informed consent or full participation,

(7) a false statement made without reasonable ground for believing it to be true

(8) the act of an issuer of securities giving out misinformation that affects the market price of the security, resulting in investors being effectively misled eventhough they did not rely on the statement itself or anything derived from it other than the market price

9) any such act or omission as the law specially declares to be fraudulent; and 'fraudulent' shall be construed accordingly.

3.35.1 The regulation prohibits:

a) dealings in securities in a fraudulent manner,

b) market manipulation,

c) misleading statements to induce sale or purchase of securities, and

d) unfair trade practice relating to securities Prohibition of certain dealings in securities

(i) A person shall not buy, sell or otherwise deal in securities in a fraudulent manner.

(ii) use or employ, in connection with issue, purchase or sale of any security listed or proposed to be listed in a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of the Act or the rules or the regulations made there under;

(iii) employ any device, scheme or artifice to defraud in connection with dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange;

(iv) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person in connection with any dealing in or issue of securities which are listed or proposed to be listed on a recognized stock exchange in contravention of the provisions of the Act or the rules and the regulations made there under.

3.35.2 Prohibition of manipulative, fraudulent and unfair trade practices

(1) Without prejudice to the provisions of regulation 3, no person shall indulge in a fraudulent or an unfair trade practice in securities.

(2) Dealing in securities shall be deemed to be a fraudulent or an unfair trade practice if it involves fraud and may include all or any of the following, namely:-

(a) indulging in an act which creates false or misleading appearance of trading in the securities market;

(b) dealing in a security not intended to effect transfer of beneficial ownership but intended to operate only as a device to inflate, depress or cause

fluctuations in the price of such security for wrongful gain or avoidance of loss;

(c) advancing or agreeing to advance any money to any person thereby inducing any other person to offer to buy any security in any issue only with the intention of securing the minimum subscription to such issue;

(d) paying, offering or agreeing to pay or offer, directly or indirectly, to any person any money or money's worth for inducing such person for dealing in any security with the object of inflating, depressing, maintaining or causing fluctuation in the price of such security;

(e) any act or omission amounting to manipulation of the price of a security;

(f) publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities;

(g) entering into a transaction in securities without intention of performing it or without intention of change of ownership of such security;

(h) selling, dealing or pledging of stolen or counterfeit security whether in physical or dematerialized form;

(i) an intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself;

(j) an intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such security;

(k) an advertisement that is misleading or that contains information in a distorted manner and which may influence the decision of the investors;

(l) an intermediary reporting trading transactions to his clients entered into on their behalf in an inflated manner in order to increase his commission and brokerage;

(m) an intermediary not disclosing to his client transactions entered into on his behalf including taking an option position;

(n) circular transactions in respect of a security entered into between intermediaries in order to increase commission to provide a false appearance of trading in such security or to inflate, depress or cause fluctuations in the price of such security;

(o) encouraging the clients by an intermediary to deal in securities solely with the object of enhancing his brokerage or commission.

(p) an intermediary predating or otherwise falsifying records such as contract notes.

(q) an intermediary buying or selling securities in advance of a substantial client order or whereby a futures or option position is taken about an impending transaction in the same or related futures or options contract.

(r) planting false or misleading news which may induce sale or purchase of securities.

3.36 CORPORATE GOVERNANCE

Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.

In its constant endeavor to improve the standards of corporate governance in India in line with needs of a dynamic market, SEBI constituted a Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy, to evaluate the adequacy of existing corporate governance practices and further improve these practices. The issues discussed by the Committee primarily related to audit committees, audit reports, independent directors, related parties, risk management, directorships and director compensation, codes of c onduct and financial disclosures. The Committee's recommendations in the final report were selected based on parameters including their relative importance, fairness, accountability, transparency, ease of implementation, verifiability and enforceability.

3.36.1 CORPORATE GOVERNANCE IN LISTED COMPANIES

SEBI, based on the recommendations of the Committee and public comments received on the report, has approved certain amendments in the clause 49 of the Listing Agreement and directed all the companies to comply with the requirements of the clause with effect from January 1, 2006. The new clause 49 is as given below:

I. BOARD OF DIRECTORS:

(A) Composition of the Board

The Board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors shall depend on whether the chairman of the board is an executive or a non-executive director. In case of the chairman being an executive director, at least half of the board should comprise of independent directors, else one third of the board should comprise of independent directors.

(B) Non Executive director's compensation and disclosures Sitting fees paid to non-executive directors as authorized by the Companies Act, 1956 would not require the previous approval of shareholders.

(C) Other provisions as to Board and Committees

(i) The board shall meet at least four times a year, with a maximum gap of four months between any two meetings.

(ii) A director shall not be a member in more than ten committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

(iii) The Board shall periodically review compliance reports of all laws applicable to the company prepared by the company as well as steps taken by the company to rectify instances of non-compliances.

(D) Code of conduct

It shall be obligatory for the board of a company to lay down the code of conduct for all board members and senior management of a company. This code of conduct shall be posted on the website of the company. All the members of the board and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed by the CEO.

II. AUDIT COMMITTEE

(A) Qualified and Independent audit committee

The audit committee shall have minimum three directors as members. Twothirds of the members of audit committee shall be independent directors. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise.

The chairman of the audit committee shall be an independent director. The chairman of the audit committee shall be present at annual general meeting to answer shareholder queries. The audit committee may invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and a representative of the statutory auditor may be present as invitees for the meetings of the audit committee. The company secretary shall act as the secretary to the company.

(B) Meeting of Audit Committee

The audit committee should meet at least four times in a year and not more than four months shall elapse between two meetings. The quorum shall be either two members or one third of the members of the audit committee whichever is greater, but there should be a minimum of two independent members present.

(C) Powers of the audit committee

The audit committee shall have powers, which should include the following:

(i) to investigate any activity within its term of reference.

(ii) to seek information from any employee.

(iii) to obtain outside legal or other professional advice.

(iv) to secure attendance of outsiders with relevant expertise, if it considers necessary.

(D) Role of Audit Committee

The role of the audit committee shall include the following:

(i) Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and c redible.

(ii) Recommending to the Board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees.

(iii) Approval of payment to statutory auditors for any other services rendered by the statutory auditors.

(iv) Reviewing, with the management, the annual financial statements before submission to the board for approval, with particular reference to:

a. Matters required to be included in the Director's Responsibility Statement to be included in the Board's report in terms of clause (2AA) of section 217 of the Companies Act, 1956

b. Changes, if any, in accounting policies and practices and reasons for the same

c. Major accounting entries involving estimates based on the exercise of judgment by management

d. Significant adjustments made in the financial statements arising out of audit findings

e. Compliance with listing and other legal requirements relating to financial statements

f. Disclosure of any related party transactions

g. Qualific ations in the draft audit report.

(v) Reviewing, with the management, the quarterly financial statements before submission to the board for approval

(vi) Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems.

(vii) Reviewing the adequacy of internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.

(viii) Discussion with internal auditors any significant findings and follow up there on.

(ix) Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.

(x) Discussion with statutory auditors before the audit commences, about the nature and scope of audit as well as post-audit discussion to ascertain any area of concern.

(xi) To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.

(xii) To review the functioning of the Whistle Blower mechanism, in case the same is existing.

(xiii) Carrying out any other function as is mentioned in the terms of reference of the Audit Committee.

(E) Review of information by Audit Committee The Audit Committee shall mandatorily review the following information:

(i) Management discussion and analysis of financial condition and results of operations;

(ii) Statement of significant related party transactions (as defined by the audit committee), submitted by management;

(iii) Management letters / letters of internal control weaknesses issued by the statutory auditors;

(iv) Internal audit reports relating to internal control weaknesses; and

(v) The appointment, removal and terms of remuneration of the Chief internal auditor shall be subject to review by the Audit Committee

3.37 WHISTLE BLOWER POLICY

A whistle blower is an employee or ex-employee who provides information about his or her company which he/she reasonably believes provides evidence of:

a) A violation of law or regulation by the company

b) Financial malpractice

c) A danger to public health or safety As an internal policy on access to audit committees, personnel who observe an unethical or improper practice should be able to approach the audit committee without necessarily informing their supervisors. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars etc. the employment and other personnel policies of the company shall contain provisions protecting 'whistle blowers' from unfair termination and other unfair prejudicial employment practices.

III. SUBSIDIARY COMPANIES

(i) At least one independent director on the Board of directors of the holding company shall be a director on the Board of directors of a material non listed Indian subsidiary company.

(ii) The audit committee of the listed holding company shall also review the financial statements, in particular, the investments made by the unlisted subsidiary company.

(iii) The minutes of the board meetings of the unlisted subsidiary company shall be placed at the board meetings of the listed holding company.

The management should periodically bring to the attention of the board of directors of the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

IV. DISCLOSURES

(A) Basis of related party transactions

(i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee.

(ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the audit committee.

(iii) Details of material individual transactions with related parties or others, which are not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same..

(B) Disclosure of Accounting treatment Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial

statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlying business transaction in the Corporate Governance Report.

(C) Board Disclosures – Risk management

The company shall lay down procedures to inform Board members about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

(D) Proceeds from public issues, rights issues, preferential issues etc. When money is raised through an issue (public issues, rights issues, preferential issues etc.), it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus/notice and place it before the audit committee. Such disclosure shall be made only till such time that the full money raised through the issue has been fully spent. This statement shall be certified by the statutory auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.

(E) Remuneration of Directors

All pecuniary relationship or transactions of the non-executive directors vis-àvis the company shall be disclosed in the Annual Report. Further the disclosures on the remuneration of directors shall be made in the section on the corporate governance of the annual report. Non-executive directors shall be required to disclose their shareholding in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should be disclosed in the notice to the general meeting called for appointment of such director.

(F) Management

As part of the director's report or as an addition thereto, a Management Discussion and Analysis report should form a part of the Annual Report to the shareholders. Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest, that may have a potential conflict with the interest of the company at large.

(G) Shareholders

In case of the appointment of a new director or re-appointment of a director the shareholders must be provided with information giving a brief resume of the director, nature of his expertise in specific functional areas, and names

of companies in which the person also holds the directorship and the membership of Committees of the Board. Information like quarterly results, presentation made by companies to analysts shall be put on company's website, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own website. A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressal of shareholder and investors complaints like transfer of shares, non receipt of balance sheet, non receipt of declared dividends etc. This committee shall be designated as 'Shareholders/Investors Grievance Committee'. To expedite the process of share transfers, the Board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once on a fortnight.

(V) CEO/CFO Certification

The CEO, i.e. the Managing Director or Manager appointed in terms of the Companies Act, 1956 and the CFO i.e. the whole-time Finance Director or any other person heading the finance function discharging that function shall certify to the Board that:

(a) They have reviewed financial statements and the cash flow statement for the year and that to the best of their knowledge and belief:

(i) these statements do not contain any materially untrue statement or omit any material fact or contain statements that might be misleading;

(ii) these statements together present a true and fair view of the company's affairs and are in compliance with existing accounting standards, applicable laws and regulations.

(b) There are, to the best of their knowledge and belief, no transactions entered into by the company during the year which are fraudulent, illegal or violative of the company's code of conduct.

(c) They accept responsibility for establishing and maintaining internal controls for financial reporting and that they have evaluated the effectiveness of the internal control systems of the company pertaining to financial reporting and they have disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of such internal controls, if any, of which they are aware and the steps they have taken or propose to take to rectify these deficiencies.

(d) They have indicated to the auditors and the Audit committee

(i) significant changes in internal control over financial reporting during the year;

(ii) significant changes in accounting policies during the year and that the same have been disclosed in the notes to the financial statements; and

(iii) instances of significant fraud of which they have become aware and the involvement therein, if any, of the management or an employee having a significant role in the company's internal control system over financial reporting

(VI) REPORT ON CORPORATE GOVERNANCE

There shall be a separate section on Corporate Governance in the Annual Reports of company, with a detailed compliance report on Corporate Governance. Non-compliance of any mandatory requirement of this clause with reasons thereof and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The companies shall submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter as per the format. The report shall be signed either by the Compliance officer or the CEO of the company.

(VII) COMPLIANCE

The company shall obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance as stipulated in this clause and annex the certificate with the director's report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to stock exchanges along with the annual report filed by the company.

The provisions of the revised Clause 49 shall be implemented as per the schedule of implementation given below:

a) For entities seeking listing for the first time, at the time of seeking inprinciple approval for such listing.

b) For existing listed entities which were required to comply with Clause 49 which is being revised i.e. those having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, by April 1, 2005.

3.38 INVESTIGATION

Power to issue directions

SEBI has the power to issue directions, if after making or causing to be made an enquiry, the Board is satisfied that it is necessary -

(i) in the interest of investors, or orderly development of securities market; or

(ii) to prevent the affairs of any intermediary or other persons referred to in section 12 being conducted in a manner detrimental to the interests of investors or securities market; or

(iii) to secure the proper management of any such intermediary or person, it may issue such directions:

(a) to any person or class of persons referred to in section 12, or associated with the securities ma rket; or

(b) to any company in respect of matters specified in section 11A as may be appropriate in the interests of investors in securities and the securities market.

3.38.1 Power to order investigation

SEBI has the power to issue directions to investigate, where the board has reasonable ground to believe that

(i) the transactions in securities are being dealt with in a manner detrimental to the investors or the securities market; or

(ii) any intermediary or any person associated with the securities market has violated any of the provisions of this Act or the rules or the regulations made or directions issued by the Board thereunder.

SEBI may, at any time by order in writing, direct any person (referred as 'Investigating Authority) specified in the order to investigate the affairs of such intermediary or persons associated with the securities market and to report thereon to the Board.

Power of SEBI to make inquiries and inspection

(1) If the Board suspects that any person has violated any provision of the regulations, it may make inquiries with such persons or any other person

(2) The Board may appoint one or more officers to inspect the books and records of insider(s) or any other persons for the purpose.

3.38.2 SEBI's right to investigate

(1) Where the Board, is of prima facie opinion, that it is necessary to investigate and inspect the books of account, other records and documents of an insider or any other person, it may appoint an investigating authority for the said purpose.

(2) The purposes referred to in sub-regulation (1) may be as follows:

(a) to investigate into the complaints received from investors, intermediaries or any other person on any matter having a bearing on the allegations of insider trading; and

(b) to investigate suo- moto upon its own knowledge or information in its possession to protect the interest of investors in securities against breach of these regulations.

3.38.3 Procedure for investigation

(1) Before undertaking an investigation under regulation 5 the Board shall give a reasonable notice to insider for that purpose.

(2) Notwithstanding anything contained in sub-regulation (1), where the Board is satisfied that in the interest of investors or in public interest no such notice should be given, it may by an order in writing direct that the investigation be taken up without such notice.

(3) On being empowered by the Board, the investigating authority shall undertake the investigation and inspection of books of accounts and insider an insider or any other person mentioned in clause (i) of subsection (1) of section 11 of the Act against whom an investigation is being carried out shall be bound to discharge his obligations as provided in regulation 7.

3.38.4 Suspension or cancellation of registration

The Board may, by order, suspend or cancel a certificate of registration in such manner as may be determined by regulations. Provided that no order under this sub-section [section 12(3)] shall be made unless the person concerned has been given a reasonable opportunity of being heard.

Obligations of insider on investigation by the Board

(1) It shall be the duty of every insider, who is being investigated, or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act to produce to the investigating authority such books, accounts and other documents in his custody or control and furnish the authority with the statements and information relating to the transactions in securities market within such time as the said authority may require.

(2) The insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act shall allow the investigating authority to have reasonable access to the premises occupied by such insider and also extend reasonable facility for examining any books, records, documents and computer data in his possession of the stock- broker or any other person and also provide copies of documents or other materials which, in the opinion of the investigating authority are relevant.

(3) The investigating authority, in the course of investigation, shall be entitled to examine or record statements of any member, director, partner proprietor and employee of the insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act.

(4) It shall be the duty of every director, proprietor, partner, officer and employee of the insider to give to the investigating authority all assistance in connection with the investigation, which the insider or any other person mentioned in clause (i) of sub-section (1) of section 11 of the Act may be reasonably expected to give.

3.38.5 Submission of Report to the Board

The investigating authority shall, within reasonable time of the conclusion of the investigation submit an investigation report to the Board. Communication of Findings, etc.

(1) The Board shall, after consideration of the investigation report communicate the findings to the person suspected to be involved in insider trading or violation of these regulations.

(2) The person to whom such findings has been communicated shall reply to the same within 21 days; and

(3) On receipt of such a reply or explanation, if any, from such person, the Board may take such measures as it deems fit to protect the interests of the investors and in the interests of the securities market and for the due compliance of the provisions of the Act, the Regulations made thereunder including the issue of directions under regulation 11.

3.38.6 Appointment of Auditor

Notwithstanding anything contained in regulation 4A and regulation 5, the Board may appoint a qualified auditor to investigate into the books of account or the affairs of the insider or any other person mentioned in clause (I) of sub-section (1) of section 11 of the Act.

Provided that, the auditor so appointed shall have the same powers of the inspecting authority as stated in regulation 5 and the insider shall have the obligations specified in regulation 7.

3.38.7 Directions by the Board

The Board may without prejudice to its right to initiate criminal prosecution under section 24 or any action under Chapter VIA of the Act, to protect the interests of investors and in the interests of the securities market and for due compliance with the provisions of the Act, Regulations made thereunder issue any or all of the following order, namely: -

(a) directing the insider or such person as mentioned in clause (i) of subsection (2) of section 11 of the Act not to deal in securities in any particular manner;

(b) prohibiting the insider or such person as mentioned in clause (i) of sub-section (2) of section 11 of the Act from disposing of any of the securities acquired in violation of these Regulations;

(c) restraining the insider to communicate or counsel any person to deal in securities;

(d) declaring the transaction(s) in securities as null and void;

(e) directing the person who acquired the securities in violation of these regulations to deliver the securities back to the seller; Provided that in case the buyer is not in a position to deliver such securities, the market price prevailing at the time of issuing of such directions or at the time of transactions whichever is higher, shall be paid to the seller.

(f) directing the person who has dealt in securities in violation of these regulations to transfer an amount or proceeds equivalent to the cost price or market price of securities, whichever is higher to the investor protection fund of a Recognised Stock Exchange.

3.38.8 CODE OF ETHICS

The 'Code of Ethics' for Directors and Functionaries of the Stock Exchanges, is aimed at improving the professional and ethical standards in the functioning of exchanges thereby creating better investor confidence in the integrity of the market.

3.38.9 Objectives and Underlying Principles

The code of ethics for directors and functionaries of the exchange seeks to establish a minimum level of business / professional ethics to be followed by these functionaries, towards establishing a fair and transparent marketplace.

The code of ethics is based on the following fundamental principles:

a) Fairness and transparency in dealing with matters relating to the exchange and the investors

b) Compliance with all laws / rules / regulations laid down by regulatory agencies/exchange

c) Exercising due diligence in the performance of duties

d) Avoidance of conflict of interest between self interests of directors / functionaries and interests of exchange and investors Definitions

1. Functionaries: Functionaries of the exchange to whom this code shall be applicable shall be decided by the exchange but shall include all officials of the rank of General Manager and above.

2. Family: Family members will include dependent spouse, dependent children, dependent parents.

3. Securities: Securities for the purpose of this code shall not include mutual fund units and government securities.

3.38.10 General Standards

Directors and functionaries:

a) should endeavour to promote greater awareness and understanding of ethical responsibilities

b) should observe high standards of commercial honour and just and equitable principles of trade

c) should not use their position to do or get favours from the executive or administrative staff of the exchange, suppliers of the exchange or any listed company of the exchange.

d) should not commit any act which will put the reputation of the exchange in jeopardy The conduct of Directors and functionaries in business life should be exemplary which will set a standard for other members of the exchange to follow. Also, the directors, committee members and functionaries of the exchange should comply with all rules and regulatio ns applicable to the securities market.

Prohibition on dealings in securities in proprietary account by elected office bearers of the exchange Elected office bearers (President / Vice President / Treasurer) of the exchange should refrain from proprietary trades in securities, directly or indirectly, during the period of holding office. Disclosure of dealings in securities by functionaries of the exchange

(i) Functionaries of the exchange should disclose on a periodic basis as determined by the exchange (which could be monthly), all their dealings in securities, directly or indirectly, to the Governing Board / Ethics Committee / designated compliance officer.

(ii) The dealings in securities should also be subject to trading restrictions for securities about which functionaries in the exchange may have non-public price sensitive information. Requirement laid down under SEBI Insider Trading Regulations may be referred in this regard.

(iii) All transactions must be of an investment nature and not speculative in nature. Towards this end, all securities purchased must be held for a minimum period of 60 days before they are sold. However, in specific / exceptional circumstances, sale can be effected anytime by obtaining pre-clearance from the compliance officer or any other designated authority who will be empowered to waive this condition after recording in writing his satisfaction in this regard.

3.38.11 Disclosure of dealings in securities by directors of the exchange

(i) Directors (other then elected office bearers as per clause 2) of the exchange shall disclose on a periodic basis, as determined by the exchange (which could be monthly), their proprietary trading, directly or indirectly, to the Ethics Committee.

(ii) All Directors should also disclose on a periodic basis as above, the trading conducted by firms/corporate entities in which they hold 20% or more beneficial interest or hold a controlling interest; to the Ethics Committee.

Directors who are Government of India nominees or nominees of Government of India statutory bodies or Financial Institutions and are governed by their own codes shall be exempt from this requirement.

3.38.12 Avoidance of Conflict of Interest

(i) No director of the governing board or member of any committee of the exchange should participate in any decision making / adjudication in respect of any person / matter in which he is in any way, directly or indirectly, concerned or interested.

(ii) Whether there is any conflict of interest or not in a matter, should be decided by the governing board.

3.38.13 Disclosures of beneficial interest:

All Directors and functionaries should disclose to the Governing Board, upon assuming office and during their tenure in office, whenever the following arises,

(i) any fiduciary relationship of self and family members and directorship / partnership of self and family members in any broking outfit,

(ii) shareholding, in cases where the shareholding of the director, directly or through his family exceeds 5% in ay listed company on the exchange or in other entities related to the capital markets,

(iii) any other business interests.

3.38.14 Role of the President / Chairman and Directors in the day to day functioning of the Exchange

(i) The President and directors should not interfere in the day to day functioning of the exchange and shall limit their role to decision making on policy issues and to issues as the Governing Board may decide.

(ii) The President and directors should abstain from influencing the employees of the exchange in conducting their day to day activities.

(iii) President and directors should not be directly involved in the function of appointment and promotion of employees unless specifically so decided by the Governing Board.

3.38.15 Access to Information

(i) Directors should call for information only as part of specific c ommittees or as may be authorized by the Governing Board.

(ii) There should be prescribed channels through which information should move and further there should be audit trail of the same. Any retrieval of confidential documents/information should be properly recorded.

(iii) All such information, especially which is non-public and price sensitive, should be kept confidential and not be used for any personal consideration / gain.

(iv) Any information relating to the business / operations of the exchange, which may come to the knowledge of directors / functionaries during performance of their duties should be held in strict confidence, shall not be divulged to any third party and should not be used in any manner except for the performance of their duties.

3.38.16 Misuse of Position:

Directors / committee members should not use their position to obtain business or any precuniary benefit (as intermediaries like brokers or in any other capacity like professional or consultancies) in the organization for themselves or family members.

3.38.17 Ethics Committee to lay down procedures and designate compliance officer

a) The ethics committee should lay down procedures for the implementation of the code and prescribe reporting formats for the disclosures required under the code.

b) The ethics committee may designate a senior officer of the exchange as compliance officer for executing the requirements laid down by it.

Chapter 4

REGULATORY AND LEGAL ASPECTS

4.1 INFRASTRUCTURE

Entities which would serve as the Exchange

Since the RBI Act quite clearly underpins the regulatory powers of the Reserve Bank vis-à-vis exchange-traded interest rate/ currency contracts, the regulatory regime of the exchanges is less of an issue. As regards the choice of exchanges, derivatives being leveraged products, the management of trading in derivatives is somewhat different from that of managing cash products. Moreover, since over a period of time the product bouquet being offered on the exchanges may be enhanced to include contracts with nonlinear pay-offs, the expertise of the exchanges dealing with such products may be an enabling factor. The basic criteria for currency futures exchanges could be experience, net worth and capital adequacy. Besides, there should be documented Rules and Byelaws of the Exchange, separate membership criteria, trading rules, robust risk management framework, etc. In addition to this, the participating exchanges should have requisite systems and IT infrastructure. The ownership of the exchanges must be well diversified. The shareholders and directors must satisfy the “fit and proper” criteria. The FDI should not exceed the limits prescribed for infrastructure companies in the securities market. Further, no foreign investor including persons acting in concert would be permitted to acquire or hold at any point of time more than five per cent in the equity capital of the exchange. It is also recommended that the eligible exchanges should have adequate financial resources to undertake IT up-gradation from time to time.

Existing exchanges which meet the eligibility criteria as also new entities set up for the purpose may be considered for trading currency futures. Eligible Exchanges would have to set up separate segment within the Exchange, with separate membership criteria, trading rules, risk management framework, etc for trading of currency futures contracts.

4.1.2 Role of Reserve Bank

The role of Reserve Bank in the domain of exchange rate management will not undergo any change when currency futures are introduced. The Reserve Bank may therefore, retain the right to stipulate or modify the participants and / or fixing participantwise position limits or any other prudential limits in the interest of financial stability. Such over-riding powers are not without a parallel and are also used by other regulators in their respective jurisdictions. Illustrations of such emergency powers include being empowered to order the Exchange to take actions specified by the regulator. Such actions could include imposing or reducing limits on positions, requiring the liquidation of positions, extending a delivery period or closing a market.

Before the start of the currency futures segment, the exchange shall obtain prior approval of SEBI. In the case of existing exchanges, where equity derivatives are permitted for trading, the rules, regulations and bye-laws of the derivatives segment of the exchange/clearing corporation may be made applicable for the currency futures segment also. The exchange/clearing corporation shall make suitable changes to that effect. Any requirement which is specific to the currency futures segment shall be provided for after seeking SEBI's approval. Further, any amendments to the rules, regulations and byelaws shall be made after seeking SEBI approval.

The currency futures segment shall also prescribe a model risk disclosure document, model member-constituent agreement and know your client agreement.

The model documents should be framed in a manner similar to that applicable in the equity derivatives market.

Before the start of trading, the currency futures segment shall submit the proposal for approval of the contract to SEBI giving:

i The details of the proposed currency futures contract to be traded in the exchange;

ii The economic purposes it is intended to serve;

iii Its likely contribution to market development;

iv The safeguards and the risk protection mechanisms adopted by the exchange to ensure market integrity, protection of investors and smooth and orderly trading;

v The infrastructure of the exchange and surveillance system to effectively monitor trading in such contracts.

The trading members and clearing members of the currency futures segment should be registered as such with SEBI. This would be in addition to their registration as members of a segment of a stock exchange.

Participation

To begin with, FIIs and NRIs would not be permitted to participate in currency futures market.

4.1.3 SEBI-RBI coordination mechanism

A SEBI-RBI constituted committee would meet periodically to sort out issues, if any, arising out of overlapping jurisdiction of the currency futures market.

4.2 REGULATORY AND LEGAL ASPECTS

Eligibility criteria for members of the currency futures segment

The membership of the currency futures segment shall be separate from the membership of the equity derivative segment or the cash segment of a recognized stock exchange.

The trading member will be subject to a balance sheet networth requirement of Rs. 1 crore while the clearing member would be subject to a balance sheet networth requirement of Rs 10 crores. The definition of balance sheet networth would be the same as that in the equity derivatives market. The clearing member would also be subject to a liquid networth requirement of Rs. 50 lakhs as detailed in Chapter 3 of this report.

The trading members and sales persons in the currency futures market must ave passed a certification programme which is considered adequate by SEBI. The approved users and sales personnel of the trading member should have passed the certification programme.

Report of the RBI-SEBI Standing Technical Committee on Exchange Traded Currency Futures

4.3 ELIGIBLE INTERMEDIARIES

4.3.1 Banks as Members on Futures Exchange

Banks have the necessary expertise in the foreign exchange market being authorised dealers and can impart necessary liquidity to the market to make and keep it active and vibrant. Participation of banks would also provide linkages to the OTC market.

Furthermore, anyone with a foreign currency exposure necessarily has a linkage with an AD bank. The Group considered the aspect of desirability of banks as members of the exchange and it was felt that banks may be allowed to become direct members of the futures exchanges, both as a trading-cum-clearing member and also as professional clearing member as banks can provide liquidity and are regulated entities. This would essentially mean that the banks may be permitted to trade on their own account as also on behalf of the clients, and clear and settle all such deals. The banks could also be allowed to function as a professional clearing member i.e., they would be entitled to settle and clear trades executed by other members of the exchange as well.

Some segments of the market felt that, at this point of time, the banks should be the sole clearing members of the currency futures segment. They felt that the issue of whether non-bank clearing members (including professional clearing members) can also be allowed may be revisited in the second phase.

The banks, being present on both the OTC and the futures markets, will be able to arbitrage and weave the two markets together. Currently, as a matter of policy only subsidiaries of banks are allowed to undertake stock broking activities. However, in foreign exchange markets, banks have been operating on their own account as well as providing prices to their clients. Keeping in view the significance of the active participation of banks in the currency futures, the Group recommends

that banks may be permitted to become members of the proposed exchange for currency futures market. The Group considered fixing of entry criteria and it was felt that the banks could be subjected to complying with the prudential criteria such as minimum net worth, CRAR, profitability, risk management systems, etc.

4.4 BROKERS

As regards the other entities eligible for intermediation, it can be argued that since the success of the futures market also crucially hinges on bringing in newer sets of participants, the role played by other intermediaries (including brokers) would also be crucial. As brokers facilitate depth and liquidity required in these markets, it was felt that brokers could be permitted in the currency futures market, provided they meet "fit and proper" criteria as well as other eligibility norms, though their regulation and accreditation may be issues. It can also be argued that such intermediaries be chosen on multiple criteria like net worth, market reputation, regulatory framework, participation in the derivatives segment, etc.

The Group opined that there should be appropriate mechanism for dispute resolution, ensure adherence to code of conduct as well as for entering into dialogue with the regulator for addressing broader issues relating to market development. The method of regulating these markets should be adequate to ensure that the markets are safe and sound, investors' interest are protected and that disruptions from these markets do not spill-over into the broader economy.

4.4.1 **Eligibility criteria for the Clearing Corporation of the currency futures segment** A Clearing Corporation in the currency futures segment can function only after obtaining SEBI approval. To be eligible for such approval, it should satisfy the following conditions:

i The Clearing Corporation should be a company incorporated under the Companies Act, 1956 and should be distinct from the exchange. However, in case of an exchange operating through a Clearing House, a maximum time period of 6 months may be granted from the date of approval by SEBI, to the exchange, for fulfilling this condition.

ii The Clearing Corporation must perform full novation, i.e. the clearing corporation should interpose itself between both legs of every trade, becoming the legal counterparty to both or alternatively should provide an unconditional guarantee for settlement of all trades.

iii The clearing corporation should enforce the margin requirements and the mark to market settlement as outlined on Chapter 3 of this report.

iv In the event of unusual positions of a member, the clearing corporation should charge special margin over and above the normal margins.

v The clearing corporation must establish facilities for electronic funds transfer (EFT) for swift movement of margin payments. In situations where EFT is

unavailable, the clearing corporation should collect correspondingly larger initial margin to cover the potential for losses over the time elapsed in collection of mark to market margin. For example, if two days lapse in moving funds, then the value at risk should be calculated based on the prospective two-day loss.

vi In the event of a member's default in meeting his liabilities, the Clearing Corporation should have processing capability to require either the prompt transfer of client positions and assets to another member or to close-out all open positions.

Separation from the other segments of the Clearing Corporation

i The currency futures segment of the Clearing Corporation should be governed by a separate Clearing Council which should not have any member representation.

ii A separate settlement guarantee fund should be created and maintained for meeting the obligations arising out of the currency futures segment.

iii A separate investor protection fund should also be created and maintained for the currency futures market.

Report of the RBI-SEBI Standing Technical Committee on Exchange Traded Currency Futures

4.5 CURRENT LEGAL AND REGULATORY FRAMEWORK

There is growing evidence that legal and regulatory frameworks matter for enabling financial development to contribute to growth. In particular, legal and accounting reforms that strengthen creditor rights, contract enforcement, and accounting practices boost financial development and accelerate economic growth3. As such, in respect of currency futures while the key question is whether currency futures should be introduced or not, its introduction should also be considered from the viewpoint of appropriate legal and effective regulatory system being put in place. These aspects merit close attention as in the preceding Chapters have argued that currency futures are expected to be beneficial in net terms given that they would widen participation base and hedging choices in face of potential exchange rate volatility in the framework of open economy macroeconomics.

The Reserve Bank has the overall responsibility of managing the affairs relating to foreign exchange and exchange rate and also the mandate of maintaining monetary and financial stability. The preamble to the RBI Act provides the objective for the establishment of the Bank as to regulate the issue of Bank notes and keeping reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. The preamble makes it clear that operation of currency and credit system falls within the regulatory ambit of the Bank.

Furthermore, promoting orderly development and maintenance of forex markets is one of the main functions of the Reserve Bank. The newly incorporated provisions under section 45 U, 45 V and 45 W of the RBI Act are also relevant in this regard. These provisions have been brought into the statute book by the

Reserve Bank of India (Amendment) Act, 2006 (Act 26 of 2006). The term 'derivative' is defined in section 45U (a) of the RBI Act to mean " an instrument, to be settled at a future date, whose value is derived from change in interest rate, foreign exchange rate, credit rating or credit index, price of securities (also called "underlying"), or a combination of more than one of them and includes interest rate 3 For seminal work, Levine, Loyaza and Beck (1999)," Financial Intermediation and Growth: Causality and Causes", World Bank Policy Research Working Paper, No.2059, Washington, D.C., World Bank, may be cited. swaps, forward rate agreements, foreign currency swaps, foreign currency-rupee swaps, foreign currency options, foreign currency-rupee options or such other instruments as may be specified by the Bank from time to time". Section 45V (1) of the Act provides that 'notwithstanding anything contained in the Securities Contracts (Regulation) Act, 1956 (42 of 1956), or any other law for the time being in force, transactions in such derivatives, as may be specified by the Bank from time to time, shall be valid, if at least one of the parties to the transaction is the Bank, a scheduled bank, or such other agency falling under the regulatory purview of the Bank under the Act, the Banking Regulation Act, 1949 (10 of 1949), the Foreign Exchange Management Act, 1999 (42 of 1999), or any other Act or instrument having the force of law, as may be specified by the Bank from time to time." Further, 45 W deals with the power of the Reserve Bank to regulate transactions in derivatives. The Reserve Bank is empowered by section 45 W to give directions 'to all agencies or any of them, dealing in securities, money market instruments, foreign exchange, derivatives, or other instruments of like nature as the Bank may specify from time to time' and also to call for any information, statement or other particulars from such agencies or cause an inspection of such agencies to be made.

The objective of FEMA as contained in its preamble is of "facilitating external trade and payment and for promoting orderly development and maintenance of foreign exchange market in India." In terms of Section 3 of the FEMA, no person can deal in or transfer foreign exchange or foreign security to any person without general or special permission granted by the Reserve Bank. Sale or drawal of foreign exchange to or from an authorized person is subject to the reasonable restrictions imposed by the Central Government in consultation with the Reserve Bank. The Reserve Bank is also empowered under Section 7 of FEMA to prohibit, restrict or regulate capital account transactions. The Reserve Bank is empowered under section 10 of FEMA to authorize any person to deal in foreign exchange or foreign securities, etc. The Reserve Bank is competent to permit any person to trade in foreign exchange by way of spot, forward or futures in exercise of its powers under the FEMA.

The extant legal framework as discussed above confers on the Reserve Bank the required powers to enable introduction of currency futures. As discussed above, the RBI Act casts on it the responsibility of determining the regulatory policies relating to a wide range of instruments, including interest rates or interest rate products, foreign exchange, derivatives, or other instruments of like nature. The FEMA also provides the Reserve Bank with overriding jurisdiction over development and management of foreign exchange markets. Therefore, the Reserve Bank may specify currency futures as an added instrument.

4.6 CURRENCY FUTURES - FEMA PROVISIONS

The rules for domestic foreign exchange market are covered largely under the Foreign Exchange Management (Foreign Exchange Derivative Contracts Regulations, 2000 (Notification No. FEMA 25 dated 3.5.2000 (hereinafter referred to FEMA 25). The permission to a person resident in India to enter into a foreign exchange derivative contract is covered under regulation 4 of FEMA 25, which states that "a person resident in India may enter into a foreign exchange derivative contract in accordance with prvisions contained in Schedule I, to hedge an exposure to risk in respect of a transaction permissible under the Act, or rules or regulations or directions or orders made or issued thereunder" 5.02 Similarly, the permission to a person resident outside India to enter into a foreign exchange derivative contract is covered under regulation 5 of FEMA 25, which states that "a person resident outside India may enter into a foreign exchange derivative contract with a person resident in India in accordance with provisions contained in Schedule II, to hedge an exposure to risk in respect of a transaction permissible under the Act, or rules or regulations or directions or orders made or issued thereunder".

Schedule I of FEMA 25 deals with the foreign exchange derivative contracts permissible for a person resident in India. The various products permitted to be used by residents in India include foreign exchange forward contracts, options – both cross currency as well as foreign currency rupee, and foreign currency-rupee swap. While these products can be used for a variety of purposes, the fundamental requirement is the existence of an underlying exposure to foreign exchange risk. The requirement for qualifying to undertake a hedging transaction in the domestic foreign exchange market is the existence of a crystallized underlying which establishes that the entity has a genuine foreign exchange exposure which is sought to be hedged through the use of these permitted tools.

In a similar vein, Schedule II of FEMA 25 deals with the foreign exchange derivative contracts permissible for a person resident outside India. The category "persons resident outside India" includes Foreign Institutional Investors (FII), persons resident outside India having Foreign Direct Investment (FDI) in India and Non-resident Indians (NRI). For this category of participants as well, the hedging products that can be used are clearly specified as are the purposes for which hedging can be undertaken.

Under Schedule II also, the existence of a crystallized underlying is mandatory.

Therefore, under FEMA 25, the permission for hedging is basically predicated upon the existence of a crystallized underlying. However, some relaxation has been provided to SMEs and resident individuals. The underlying has to be evidenced by an Authorised Dealer Category – I bank and access to hedging is permitted only after such verification. Finally, the hedge can be undertaken only for purposes defined under FEMA for each category of participants.

Under a futures regime, the requirement of an underlying exposure doesn't remain valid since futures by definition are meant to be used not only for hedging but

also for speculation and leveraging. After introduction of currency futures, if an entity is permitted to take a speculative position, then this would clash with the FEMA requirement of hedging for permitted purposes which currently doesn't include speculation/leveraging. Therefore, the controls on permitted purposes would have to be modified and speculation (trades other than transaction backed) will have to be recognized under FEMA as a permitted activity.

Reserve Bank has in recent times undertaken a series of measures to liberalize the markets further. It was announced in the Annual Policy in April 2007 that SMEs engaged in export-import business may be permitted to hedge their foreign exchange exposures without complying with the complicated documentation requirements or past performance of exports and imports. The Annual Policy also permitted resident individuals to book forward contracts on the basis of current or anticipated exposures up to a limit of USD 100,000. Thus, the first step towards liberalization of hedging tools has already been initiated. However, the scope of the liberalization would have to be widened considerably, may be over a period of time, in order to permit trading of currency futures.

In conclusion, it may be necessary to substitute FEMA 25 with a new notification to enable trading of currency futures. The new notification may have provisions consistent with the regulatory framework for currency derivatives.

The Group had extensively debated the desirability of commencing currency futures in an environment where OTC contracts have restrictions especially the need for a crystallized underlying. The regulatory arbitrage between the OTC market and currency futures might give an initial boost to the futures market, but might also result in a clear demarcation between hedgers and speculators, with only the latter category dominating the futures market. The cost benefits of tailor-made solutions are likely to give an edge to OTC market for corporates who can access this market.

There was agreement that the OTC market restrictions need to be removed in a phased manner. It is proposed that compulsory disclosure of unhedged exposures and the results of hedging be mandated in the annual accounts of the corporates, which will obviate the need for strict insistence on the existence of underlying while accessing the derivatives market.

CURRENCY FUTURES IMPLICATIONS FOR MONETARY AND EXCHANGE RATE POLICIES

Chapter 5

Currency futures have certain implications for the conduct of monetary and exchange rate policy. These implications need to be clearly understood so that appropriate policy framework could be put in place with a view to ensuring that the market developments do not attenuate monetary policy efficacy and financial stability. The main implications of currency futures market for monetary and exchange rate policies arise from the following: (i) risks of possible dollarization of the economy, (ii) risks of possible increased volatility in the exchange rate, which could then spill over to other segments of financial markets and in the process have impact on interest rate, pace of economic activity, inflation and financial stability. Higher variability in output and prices is undesirable for the economy as the uncertainty makes economic contracts difficult and lead to potential loss in output. Financial volatility also has an adverse impact on the saving and investment decisions. They can fuel asset price bubbles and busts which can have adverse impact on the economy for a fairly long time. These possibilities ultimately impinge on the stability of the financial system also.

While the abovementioned risks exist, their probability is relatively low. At the same time, the loss value of the extreme events could be large. Hence, there is an imperative need to be better prepared to cope with such low probability extreme events. At the same time, the potential gains from the introduction of currency futures also need to be recognised. The gains are multi-dimensional in nature in terms of availability of better risk management tools to the market players, better price discovery mechanism and the resultant potential to lower transaction costs, apart from the improved two way information flows between the markets and the policy-makers. Currency futures would also contribute to a higher level of sophistication of the financial market and imbibe greater confidence to economic agents within and outside the country, which is an inherent strength of our financial system.

5.1 DOLLARISATION

Dollarisation refers to broad use of foreign currency as a substitute for domestic currency for transaction or other purposes. One of the risks inherent in the currency futures is the possibility of currency substitution of the domestic economy i.e. if the residents get induced to seek holding of foreign currency or assets to a significant extent by economising holdings of domestic currency and assets. Historically, dollar or foreign currency holdings have been a very small proportion of asset portfolio of different economic agents in India and even their current appetite for such holdings is not large.

Currency futures, however, entail some potential risk of permeating through the capital controls in place causing dollarisation of the economy, as its consequence or otherwise. It is, therefore, important to survey the phenomenon of dollarisation

of economies elsewhere, even though, so far, there has been no evidence of a direct causality between the introduction of currency futures and the dollarisation of economies.

Almost all the countries in the world issue their own currencies as it enables hem to conduct their own monetary policy and provides them the seigniorage benefits. However, given a choice, many residents might prefer to hold assets denominated in foreign currencies (US dollar or any other hard currency) in the interest of preserving the value of their holdings. Such a preference of the economic agents could potentially lead to dollarisation of an economy. There are countries which are officially dollarised. Official dollarisation occurs when a country eliminates its own currency and adopts the U.S. dollar (or any other foreign currency) as legal tender. Economic contracts, such as payment of wages and settlement of financial contracts could then be made in US dollar or other foreign currency. Consumers could make their purchases in foreign currencies as well.

Even the government accepts foreign currency for payment of taxes and debts, as also use it for making payments. Countries which are officially dollarised include Andorra (dollarised in Euro), Kosovo (Euro), Lichtenstein (Swiss Franc), Monaco (Euro), Montenegro (Euro), Nauru (Australian Dollar), San Marino (Euro), Tuvalu (Australian Dollar) and Vatican (Euro). Certain dependencies also are officially dollarised, such as the Cocoa Island (Australian Dollar), the Cooks Island (New Zealand Dollar), the Norfolk Islands (Australian Dollar), St. Helena (British pound) and Tokelau (New Zealand dollar).

While in the above mentioned countries domestic currency is completely eliminated, there are countries where the foreign currency co-exists with domestic currency as a legal tender and such countries are termed as semi-dollarised economies. These officially semi-dollarised economies include the Bahamas, Cambodia, Laos, Haiti and Liberia in all of which US dollar is also a legal tender, in addition to the respective domestic currencies.

Other such countries include Bhutan (Indian rupee), Brunei (Singapore dollar), Canary Island (British pound), Isle of Man (British pound), Lesotho (South African Rand), Namibia (South African Rand) and Tajikistan (any other currency).

5.2 THE POSITIVES OF DOLLARISATION

Some countries prefer to officially dollarise their economies because of high inflation which reduces public confidence in the domestic currency. Dollarisation is generally expected to lower the level of inflation as the domestic monetary policy gets determined by monetary authorities of the low inflation country whose currency is permitted as a legal tender. This also helps deepen the financial markets, lower the interest rates, and leads to fiscal discipline, all of which together could lead to faster economic growth.

5.3 THE RISKS OF DOLLARISATION

However, the dollarisation of an economy could also occur even if a foreign currency is not officially recognised as a legal tender. This could arise from the liberalisation of the current and, even more so, of the capital account, if the residents prefer to hold foreign currency. It is important to understand that dollarisation can pose serious risks to an economy, especially if it takes place in an unplanned manner. The serious risk emanating from the process of dollarisation is that it makes it very difficult for the domestic monetary authority to conduct an independent monetary policy. If the shocks facing the economy are asymmetric vis-à-vis the country of the currency of dollarisation (i.e., they are not coinciding or are of a similar nature to that of the country whose currency is permitted as a legal tender), they could pose serious policy dilemmas. Thus, it could be extremely damaging to the domestic economy if, for instance, the domestic demand shock warrants a monetary policy compression in the domestic economy at a time when the external monetary authority is pursuing an expansionary monetary policy on the basis of its own macroeconomic situation, or vice-versa. Since in a dollarised economy, the domestic monetary authority would also find it difficult to perform the lender-of-the-last resort (LOLR) function, on account of its inability to print additional money to provide emergency funding to the banks, it could potentially lead to financial stability problems with an accelerator effect. In addition, dollarisation also leads to loss of seigniorage for the dollarised economy, (seigniorage is the profit a country earns when it issues a currency as the difference between the products the currency can buy and the cost of printing that currency). It is in this context that the implications of dollarisation of the economy call for a comprehensive and thorough analysis while considering the introduction of the currency futures in India.

It needs to be noted that dollarisation of an economy, pursuant to the introduction of currency futures, is a possibility but not an inevitable outcome of introducing currency futures in the domestic market. If currency futures contracts are settled in domestic currency and capital account regime is in place the probability and extent of dollarisation are likely to be even less significant than the case where the contracts are settled with physical deliveries in domestic and foreign currency. However, cash settled contracts could weaken the link between cash-futures arbitrage and has risk of greater speculative investments than one would anticipate in case of physical deliveries. These aspects are explained later in Chapter 6, where the framework and the options for currency futures contracts are discussed. While prima facie dollarisation does not appear to be a significant probability, it is reasonably clear that costs of dollarisation could far outweigh the benefits for an economy like India's, as the country has neither faced nor is facing high/hyper inflation or a loss of confidence in its currency. It is important to recognize that with dollarisation of an economy, apart from the seigniorage losses, it is well nigh impossible to conduct an independent monetary policy. Inability to conduct an independent monetary policy could have serious consequences when shocks to the Indian economy are asymmetric and inflation could inflict sizeable costs on the poor. As such, it appears that the design of the currency futures market for the Indian system would have to be one which prevents dollarisation of the Indian economy and keeps the policy of capital account management in place so that problems of trilemma could best be avoided.

In an economy where a large segment of the population still lives below the poverty line in spite of a marked reduction in the poverty ratio, it is essential to aim for growth with emphasis on low inflation. This, in turn, underlines the importance of protecting the independence of monetary policy and of averting dollarisation. Price stability is the best means for protecting income levels of the poor and help them participate in the overall economic progress. Keeping the above in view, the Reserve Bank's objectives of monetary policy in India in the recent period have evolved as those of maintaining price stability and adequate flow of credit to the productive sectors of the economy. These have been pursued with emphasis on price stability and well anchored inflation expectations. In the recent period, financial stability has also assumed priority in the hierarchy of objectives of the Reserve Bank in view of increasing openness of the Indian economy and the financial reforms brought about. As such, the Reserve Bank has focused on issues of credit quality and on maintaining orderly conditions in the financial markets for securing macroeconomic and financial stability.

5.4 EXCHANGE RATE VOLATILITY

Volatility in exchange rate refers to the statistical measure of its dispersion of returns or change. In the financial world, volatility adds to risks. Typically it is seen in terms of standard deviation or coefficient of variation (the latter has the advantage that it is unit free). However, there are wide arrays of other measures, specially the conditional volatility measures which provide better insights into exchange rate volatility which is marked by clustering and symmetric dependencies in variances. The exchange rates could display higher volatility because of several factors such as deviation from fundamentals, excessive speculative activity, macroeconomic shocks or other news.

Excessive fluctuations and volatility in exchange rates could spill over to other segments of financial markets, can blur monetary policy signals and lead to financial stability problems. Excessive exchange rate fluctuations also have a detrimental impact on foreign trade and at times even on genuine investments. Investments could then be potentially guided by a view or a bet on exchange rate movements rather than by the underlying returns, especially if the umbilical cord between the cash-futures arbitrage is snapped.

Keeping in view the risks associated with possibility of large volatility in exchange rates, the Reserve Bank's exchange rate policy in recent years has been guided by the broad principles of careful monitoring and management of exchange rates with flexibility. The exchange rate policy does not aim at a fixed target or a pre-announced target or a band but is supported by the ability of Reserve Bank to intervene in the markets, if and when necessary, only to smoothen any undue volatilities or disorderly market behaviour, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly manner. The Reserve Bank sells/ purchases foreign currency in the foreign exchange market from time to time in order to even out lumpy demand and supply and also to smoothen out the exchange rate movements.

However, as the foreign exchange exposure of the Indian economy expands resulting in additional exposures of several Indian entities in a large number of currencies, there is a possibility that it could have an impact on the levels of exchange rate volatility in the domestic markets. While on one hand, the larger exposures could add to widening and deepening of forex markets and reduce volatility which presently arises from the thin volumes in forex market in India, on the other hand, larger exposures could also add to volatility if speculators take one-sided views on the movement of exchange rate. While, on a net basis, volatility could be expected to decline with growing liberalization, it is also important that larger exposures emerging in the system are matched with larger recourse to currency risk management. Currency futures market in India would make a notable contribution towards improving the menu of options available for currency risk management. Introduction of such a market by itself is neither expected to cause a change in the extant exchange rate policy which has yielded rich dividends to the economy, nor is likely to become a cause for debilitating the central bank's ability to carefully monitor and manage exchange rate with flexibility in tune with the policy in place.

Furthermore, in the days ahead, global developments are expected to have an increasing role in determining the conduct of monetary and exchange rate policies of the country. With the Indian economy having ascended a higher growth path and with the economy progressively moving towards fuller capital account convertibility, newer challenges could emerge necessitating continuous adjustment and adaptation to the changing environment. Moreover, in the context of progress towards further capital account convertibility, the market participants would be faced with increased risks on multiple accounts. Therefore, there is a need to develop the markets further to enable market participants to absorb greater exchange rate volatility and shocks. Towards this purpose, the introduction of currency futures in the forex market could prove to be one more channel for providing greater flexibility to the market participant to operate in the markets. In this direction, the introduction of currency futures in the forex market can play a crucial role. The liberalization in this direction would, however, need to be synchronized with that in the OTC market.

In view of the above, it is important that while establishing currency futures market in India, the policy framework and the product design are evolved so as to minimize risks to macroeconomic and financial stability. In line with this broad objective, the Reserve Bank has been working continuously towards development of sound and efficient intermediaries and markets in order to provide a foundation for a robust and diversified financial system. A robust and diversified financial system, in turn, promotes effective transmission of monetary policy. While there is emphasis on strengthening the structural factors in the economy, the endeavour of the Reserve Bank has also been to moderate the cyclical and excessively volatile elements of the economy that interfere with achieving its goal of price stability and growth. There is a general recognition that larger hedging opportunities would be required as capital account liberalization occurs. The Reserve Bank has taken several steps in the recent past to allow economic agents to benefit from dynamic hedging tools. It has also allowed hedging against economic exposures.

The conduct of monetary policy needs adequate monetary transmission and the appropriate monetary transmission takes place with efficient price discovery of interest rates and exchange rates. In this context, the development and integration of the money, government securities and foreign exchange markets becomes essential. The Reserve Bank, since 1990, has initiated wide- ranging policy measures for the development of financial markets, along with progressive liberalization of the exchange and payment regime with the institution of a market determined exchange rate policy. The developments of financial markets have been progressively made broad-based in regard to market segments, instruments and participants. Concomitantly, appropriate regulatory regime has been initiated with sharper emphasis on implementation and oversight.

While a carefully gradual and phased transition has been initiated over a period of time with minimal disruption, the market participants have been given adequate time to adjust to the new environment. The Indian foreign exchange market in particular, has widened and deepened with the transition to a market determined exchange rate system and liberalisation of restrictions on external transactions leading to current account convertibility under Article VIII of the Articles of Agreement of the International Monetary Fund. The capital account has also been substantially liberalized and has been buffeted by recent liberalization for residents investing abroad. Extensive liberalization and simplification of procedures in foreign exchange transactions have been initiated and this along with corresponding liberalization in other markets has resulted in vibrancy in activities of the foreign exchange market. Introduction of currency futures could be one more policy option in this direction.

International experience of the emerging markets with the introduction of currency futures is a mixed one. In several cases, the volatility is found to be reduced following the constitution of currency futures market, though empirical evidence to the contrary also exists. The transaction volumes in currency futures in these countries have remained too small to put any significant upward pressure on exchange rate volatility. Also, there is no clear evidence to prove that futures contracts traded on exchanges result in increased volatility in the prices for the underlying commodity. For most products, volatilities are higher or lower depending upon the choice of the time period and no causation is established. There have, however, been some episodes of build up of speculative price rise in case of some futures contracts. However, it is expected that the potential for increased volatility could in effect be neutralized by the presence of wider pool of market participants who would be having divergent perceptions, views, exposures and horizons.

Further careful examination of the potential impact of currency futures on the exchange rate volatility would be necessary if these futures contracts are to be allowed without an explicit underlying. Several countries have introduced cash settled currency futures contracts without any undue impact on volatility, though it is important to recognize that the experience of the most liquid currency futures exchange has been distinctly in favour of physical delivery based settlement. For instance, in the CME, during the period January till September

2007, 99.77 per cent of the total volume in FX futures contracts was in physical deliveries. These were mainly in terms of the developed country currencies. In contrast, cash settled FX futures contracts in Brazilian Real, Russian Rouble, Chinese RMB and Korean Won with US dollar were small and those for Chinese RMB with euro and Japanese yen do not appear to have taken off at all. If experience of other countries is any guide, it appears that physical delivery-based FX futures have been popular for countries with fully convertible currencies, while countries with less than complete convertibility prefer cash settled contracts, but volumes are restricted nevertheless. In either case, it is unlikely to significantly affect the liquidity of the spot market. From the viewpoint of monetary and exchange rate policies, physical delivery based contracts could result in lower exchange rate volatility, which reduces the need for intervention and so delivers better control on liquidity conditions. At the same time, physical delivery based contracts in presence of capital controls could result in uncontrolled changes in foreign asset positions and pose relatively greater risk of dollarization. This could consequently lead to weaker monetary control for reasons stated elsewhere in the Report.

There is a view that currency futures could result in enhanced volatility due to inherent differences in the regulatory prescriptions for the OTC and the futures markets.

In this context, it is important to consider whether it would be desirable to have different sets of regulations for the OTC and the futures markets and if so, whether these differences should be permitted for both the residents as well as non-residents. While for the exchange-traded FX-futures, the regulatory framework could possibly be placed somewhere between the extant capital account regime and that of a full convertibility, the desirability of such a regulatory framework would have to be viewed in the light of the path of fuller capital account convertibility, as currently envisaged. The impact of these changes on the exchange rate volatility in the currency futures market would need to be managed through appropriate regulatory prescriptions for the price/position limits, eligible participants, market access, and margins requirements in the context of settlements of the exchange-traded contracts.

In sum, as the Indian economy becomes more open to the forces of globalisation, the liberalization in the currency market segment with appropriate checks and balances and adequate regulations with a focus on implementation and supervision would help the Reserve Bank to conduct its monetary policy in a more flexible manner. The argument for going ahead with a currency futures market is that it provides an additional instrument in the market and enables participants to manage their risks prudently thereby contributing to smooth functioning of the markets. At the same time, it generally facilitates the conduct of policy and not necessarily impedes it, though the risks from dollarization and increased exchange rate volatility could arise. If currency futures add to the degree of dollarization in the economy, the risks in the form of exchange rate volatility would also grow. Eventually, this would impact interest rates, pace of economic activity and inflation. Appropriate product design, risk management, monitoring and surveillance,

could help introduce the currency futures while minimizing the above risks such that in net terms the risks are outweighed by the benefits and lower exchange rate volatility is achieved through currency future products.

Considering the above points, the gains likely from the introduction of currency futures in the Indian context could be set out as below:

- Provide an additional tool for hedging currency risk.
- Further development of domestic foreign exchange market.
- Permit trades other than hedges with a view to moving gradually towards fuller capital account convertibility.
- Provide a platform to retail segment of the market to ensure broad based participation based on equal treatment.
- Efficient method of credit risk transfer through the Exchange.
- Create a market to facilitate large volume transactions to go through on an anonymous basis without distorting the levels.

5.4.1 Impact of Futures on Spot and Forward Markets

There are concerns about impact of currency futures price on the spot price or vice versa. There is no clear evidence to suggest that currency futures result in enhancement of volatility in the spot exchange rates in a causal sense. Empirical evidence is ambiguous as to whether currency futures afford distinctly higher speculation than is possible without them. In theory, futures price would largely operate on a premise similar to forward markets i.e. it should largely reflect interest rate differentials. In India, as in most countries, even the forward prices do not stick to that script most of the time but are susceptible to the influence of sentiments. An appropriate term structure of forward premia is yet to develop in India. As such, while theoretically futures prices should reflect similar interest rate expectations, the real effect on prices remains to be seen.

Worldwide, the currency futures market remains small, though rapidly growing market, in relation to the size of OTC spot as well as forward market. According to the Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2004 (BIS, 2005), the average daily turnover in exchange traded currency contracts was USD 23 billion in a total foreign exchange turnover of USD 1,880 billion which included the USD 621 billion in the spot foreign exchange market. According to the preliminary results of the just released Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2007, the average daily turnover in exchange traded currency contracts has trebled since then to USD 72 billion in 2007. However, it is still small in relation to USD 3,220 billion total foreign exchange turnover, which includes USD 1,005 billion daily spot turnover in 2007. The exchange traded currency contracts comprise futures as well as options and options on futures. As such, currency futures still comprise less than 2 per cent of the foreign exchange market. Therefore, the currency

futures market is far from becoming a significant segment of the foreign exchange market and can be seen merely as an add-on to risk management kit and a tool for furthering transparent price discovery.

The low turnover of currency futures in the world foreign exchange markets could mean that price discovery in foreign exchange occurs primarily in the OTC spot and derivative market segments. It is likely that the spot segment may be a major driver of price discovery in the foreign exchange market, in spite of it being half of the OTC forwards and swaps where daily turnover slightly exceeded USD 2 trillion in 2007. Interest parity condition may ordinarily act as an error correction mechanism forcing forwards to converge with spot price changes. However, at times significant deviations in interest parity are observed and the role of forward market in exchange rate determination cannot be ignored.

The futures prices, however, are less likely to have significant information content and the role played by it in exchange rate determination is likely to be limited in view of the low volumes. It may, nevertheless be stated that the importance of futures market in price discovery might actually be larger than its share in turnover would indicate. This is so, because typical players such as hedgers could have considerable private information.

Also, for individuals, SMEs, small exporters, etc. currency futures could bring in transparency and coupled with anonymity, accompanying the order matching trading format can help reduce information asymmetry in the foreign exchange market, bringing in better price discovery. Empirical research on market microstructure of foreign exchange markets suggests that often future prices do lead the spot price changes by couple of minutes. Over longer horizons, however, the futures prices are found to have a more significant influence on foreign exchange price discovery, which is not commensurate with its relative market share. While exchanges bring together rational as well as noise traders, it is important to recognize that informed traders could prefer trading in currency futures which afford anonymity. On the whole, however, the inter-dealer trades through direct market or through electronically brokered market can be expected to have a more pronounced impact on spot and forward foreign exchange market than the trades in futures markets.

SUMMARY AND CONCLUSION

Chapter 6

Globalization and increased cross-border flow of funds have increased the exposure to market risk and hedging of such exposures has become critical. The current regulatory structure in India enables hedging by use of OTC products such as forwards, swaps and options, and structured products. With growing integration of the Indian economy with the rest of the world, the open economy framework for macroeconomics requires increased opportunities for economic agents to hedge their currency risk through a wider menu of hedging instruments. The need for introduction of currency futures has to be viewed in the context that wider hedging opportunities could strengthen economic agents' ability to cope with market-induced currency movements The Group recommends that introduction of currency futures may be considered favourably and that the requirements for trading and settlement infrastructure and regulatory framework and other aspects mentioned in this Report may be provided to create an enabling environment.

The Group had extensive discussions with a wide cross section of market participants including existing securities and commodities exchanges in India, associations, clearing and settlement agencies, brokers, legal experts, etc. Based on the discussions with market participants and the experiences drawn from international exchanges, the Group explored various options for the currency futures, analyzing the pros and cons of each option in the Indian context. The Group thereafter presented the menu of alternative proposals along with different options to the Technical Advisory Committee (TAC) for Money, Foreign Exchange and Government Securities Markets for its expert views. The draft report was then placed on the website of the Reserve Bank for public comments. The comments received from the market participants were again presented to the TAC for a final view. All these inputs have been taken into account while finalizing the Report.

The origin of futures can be traced back to 1851 when the Chicago Board of Trade (CBOT) introduced standardized forward contracts. Currency risks could be hedged mainly through forwards, futures, swaps and options. Each of these instruments has its role in managing the currency risk. The main advantage of currency futures over its closest substitute product, viz., forwards which are traded over-the-counter (OTC) lie in price transparency, elimination of counterparty credit risk and wider reach through easy accessibility. The futures are also disadvantageous in a few areas when compared to OTC market viz., inability to obtain a perfect hedge, margining requirements that drive up the costs, unique feature of Central Banks' interventions in the forex market.

A futures contract is a standardized contract, traded on a futures exchange, to buy or sell a certain underlying instrument on a certain date in the future, at a specified price.

Traditionally, the futures market meets the needs of the three distinct sets of market users - those who wish to discover price information, those who wish to speculate and those who wish to hedge.

The Group studied the impact of introduction of currency futures even in certain emerging markets like Mexico, Korea, South Africa and Brazil. One feature shared by all these countries with India, is the existence of capital controls in some form or the other. It seems evident that currency futures market can and does co-exist with capital controls.

The main implications of currency futures market for monetary and exchange rate policies arise from the following:

(i) risks of possible dollarisation of the economy, and

(ii) risks of possible increased volatility in the exchange rate, which could then spill over to other segments of financial markets and in the process have impact on interest rate, pace of economic activity, inflation and financial stability. The potential gains from the introduction of currency futures also need to be recognised. The gains mainly derive from better risk management, better price discovery and potential to lower transaction costs, as also information which the market gives to policy-makers and the signals which the policymakers transmit to the markets through these markets.

The Reserve Bank has the overall responsibility of managing the affairs relating to foreign exchange and exchange rate and also the duty of maintaining monetary and financial stability. The preamble to the RBI Act provides the objective for the establishment of the Reserve Bank as to regulate the issue of Reserve Bank notes and keeping reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage. The preamble makes it clear that operation of currency and credit system falls within the regulatory ambit of the Bank. Furthermore, promoting orderly development and maintenance of forex markets is one of the main functions of the Reserve Bank. The legislative framework arising from the RBI Act and the FEMA clearly suggests that the obligation for setting the policy and of regulating currency futures lies under the ambit of the Reserve Bank.

Section 45U(a) of the RBI Act clearly makes Reserve Bank responsible for derivatives whose underlying is a foreign exchange rate or an interest rate. Section 45V(1) provides that the derivatives transactions would fall within the regulatory ambit of the Reserve Bank if at least one of the parties to the transaction is a Reserve Bank regulated entity or covered under FEMA or any other Act , if specified by Reserve Bank.

The extant legal framework as discussed above confers on the Reserve Bank the required powers to enable introduction of currency futures. RBI Act casts on it the responsibility of determining the regulatory policies relating to a wide range of instruments, including interest rates or interest rate products, foreign exchange, derivatives, or other instruments of like nature. The FEMA also provides the Reserve Bank with overriding jurisdiction over development and management of foreign exchange markets. Therefore, the Reserve Bank may specify currency futures as an added instrument.

Further it will be necessary to amend FEMA 25 permitting currency futures. The amended notification may have provisions consistent with the regulatory framework for currency derivatives.

Framework for Introduction of Currency Futures / Recommendations Contract Menu

After taking due cognizance of the forex market and international developments it appears that introduction of currency futures may be considered to provide the participants with an additional hedging tool. Initially, a standardized USD-INR contract is recommended, with Euro–INR contract after a period of six months.

6.1 CONTRACT DESIGN

While attracting liquidity through product innovation is a feature of the competitive markets, in the initial phase, a standardized product across various exchanges (in terms of contract size, final settlement dates, settlement procedure of contracts, tenors of contracts, etc) would invite greater participation and add to the liquidity of futures markets.

6.2 SIZE OF THE CONTRACT

It is important that the contract size be kept at such a level that it facilitates price discovery as well as trading, particularly for retail segment of the market. Hence, a single contract of notional value USD 1,000 may be introduced.

6.3 TENORS OF CONTRACTS

Initially, the tenors of the contract may largely replicate the tenors of the currency forwards and to this end, the currency futures maturing in the first 12 calendar months may be offered.

6.4 SETTLEMENT OF CONTRACTS

Given the complications that delivery based settlement entail, and the fact that Indian Rupee is not fully convertible on capital account, settlement only on cash basis, based on spot Reserve Bank reference rate on the expiry date may be permitted. Cash settlement would also ensure convergence between regulations in respect of OTC markets and currency futures market, since cancellation of a forward contract on the date of maturity is akin to cash settlement. (Para 6.06)

6.5 SETTLEMENT CYCLE

The key issue was whether currency futures should have a maturity co-terminus with OTC forwards or not. Taking into account the market feedback and the expert views of the TAC, the maturity of the futures contract may be co-terminus with the settlement of the month end forward contracts.

6.6 ELIGIBLE PARTICIPANTS

The requirement of an underlying exposure to trade in OTC foreign exchange market is very difficult to implement in an exchange- traded regime. Participation in the currency futures market may initially be restricted to residents alone in the interest of financial stability. This is suggested purely from the perspective of ascertaining the robustness of various systems such as surveillance, monitoring, reporting etc. Further, no quantitative restrictions may be imposed on residents to trade in currency futures. This is likely to ensure greater liquidity and wider participation and would be in line with usual policy where liberalization is done first for residents. As regards non residents, the participation may be permitted in a gradual and phased manner. Once the currency futures market systems stabilise, including execution procedures, risk management framework and surveillance mechanism, participation of Foreign Institutional Investors (FIIs) and Non Resident Indians (NRIs), as hedgers through designated AD banks may be permitted. Suitable position limits on such entities may also be prescribed. Given the current regulations in the OTC market, the categories excluded from the futures market, in the initial stages, are not being disadvantaged.

6.7 UNIQUE IDENTIFICATION NUMBER

In order to distinguish various classes of participants in the futures exchanges, allotment of unique client identification numbers, preferably the PAN, as practiced in futures exchanges in other jurisdictions, may be considered. The Exchange shall ensure that each client is assigned a client code which is unique across all members. This would be ensured by the use of PAN number. To illustrate, a client X may be registered with a member A who may give him a client code as X123 with the PAN number of the client also being registered in the exchange UCC system. The Same client X may approach a get registered with member D who may give him a client code as XN321 with the same PAN number of the client in the exchange UCC system. Thus although client X is registered with member A and member D and has diffenect client codes in the front end of the respective members. as far as the exchange is concerened, all trades by client X across all members will be capable of being viewed by using the Pan number furnished by the member at the time of registration of UCC. Thus the PAN number will be the signle common indentifying factor for the exchange for the client across all members he is trading thru.

6.8 MARKET TIMINGS

The currency futures market may operate between 9 am – 5 pm on every working day.

6.9 MEMBERSHIP TYPE

Taking in to account the administrative difficulties, it was felt that a detailed study needs to be undertaken on the feasibility of segmenting the participants into hedgers and speculators and fixing differential margins.

6.10 ELIGIBLE INTERMEDIARIES

Banks may be allowed to become direct members of the futures exchanges, both as trading-cum-clearing members in respect of own account and clients account and also as professional clearing members as banks can provide liquidity and are regulated entities.

The issue of whether non-bank clearing members (including professional clearing members) can also be allowed may be revisited in the second phase. 8.21 Brokers may be permitted in the currency futures market, provided they meet "fit and proper" criteria as well as other eligibility norms. The brokers may be chosen on multiple criteria like net worth, market reputation, regulatory framework, participation in the derivatives segment, etc.

6.11 CLEARING

Exchange specific Clearing Corporation approach is preferable to centralized clearing since it is likely to lead to competitive pricing and services.

6.12 MARGINING

While margin is an important credit risk mitigant, it could also be used effectively to deal with excessive leveraging. Thus, the Reserve Bank, as regulator of currency futures market may have overriding powers to prescribe margins and / or impose specific margins for identified segments of the market, if considered necessary. In view of the recommendation that the settlement of the currency futures contracts be done at Exchange specific clearing corporations, the day-to-day margining may be left to the discretion of such clearing corporations. (Para 6.20) Entity/entities which would serve as the Exchange

Since over a period of time the product bouquet being offered on the exchanges may be enhanced to include contracts with non-linear pay-offs, the expertise of the exchanges dealing with such products should be an enabling factor. The basic criteria for currency futures exchanges could be net worth and capital adequacy. Besides, there should be documented Rules and Bye-laws of the Exchange, separate membership criteria, trading rules, robust risk management framework, etc. In addition to this, the participating exchanges should have requisite systems and IT infrastructure. The ownership of the exchanges must be well diversified. The shareholders and directors must satisfy the "fit and proper" criteria. The FDI should not exceed the limits prescribed for infrastructure companies in the securities market. Further, no foreign investor including persons acting in concert would be permitted to acquire or hold at any point of time more than five per cent in the equity capital of the exchange. The eligible exchanges should have adequate financial resources to undertake IT up-gradation from time to time.

Existing exchanges which meet the eligibility criteria as also new entities set up for the purpose may be considered for trading currency futures. Eligible Exchanges would have to set up separate segment within the Exchange, with separate

membership criteria, trading rules, risk management framework, etc for trading of currency futures contracts.

6.13 ROLE OF RESERVE BANK

The introduction of currency futures will not alter the role of Reserve Bank in the domain of exchange rate management. The Reserve Bank will continue to retain the right to stipulate or modify the participants and / or fixing participant-wise position limits or any other prudential limits in the interest of financial stability.

6.14 REFORMS REQUIRED IN THE OTC MARKET

Significant differences in regulatory norms, such as absence of requirements relating to the underlying, flexibility in unwinding of positions, transparency in pricing, etc in the futures market provides arbitrage opportunities for the participants. There is a need for progressive liberalization in respect of documentation and other procedures of the OTC market, in a phased manner.

6.15 CURRENCY FUTURES MARKET: SURVEILLANCE AND REPORTING

A key prerequisite for smooth functioning of the currency futures market at exchanges is to put in place a state-of-the- art surveillance system and an adequate reporting mechanism. Ideally, the surveillance system should be based on the on-line trading system, with the capability of generating real time data, if required. It may also provide exception reporting at a fairly short interval of say every half-an-hour and be capable of providing warning mechanisms through alerts at the earliest possible. The surveillance system is of a critical importance, especially in respect of the generation of key reports on market manipulation. It should also be able to treat distinctly hedge, arbitrage, and speculative trades.

Structures for Surveillance Committee for currency futures merit close attention in the context of the proposed introduction of currency futures. The primary task of the Surveillance Committee should be to ensure that day-to-day monitoring by the exchange ensures compliance with the best of the surveillance abilities.

A data reporting system would need to be worked out with necessary flow of information from the exchanges to the Reserve Bank. In this respect the requirements of a firm set of regulation and implementation of monetary and exchange rate policies should override all other requirements

Annex 1

CROSS COUNTRY EXPERIENCES

A1. Currency futures are of a recent origin when compared with several other derivatives contracts, especially the commodity futures. However, over the years more and more countries have introduced exchange traded currency futures. The first currency futuresexchange was set up by the CME in 1972 in USA. Such exchanges were later set up in Europe, Japan, etc. More lately, some emerging market economies have also introduced currency futures onshore. These include Brazil, Korea, and Mexico. South Africa is the latest addition to this group having introduced currency futures on June 18, 2007. The structures, products and regulatory framework in these countries were studied by the Group to draw upon their experiences.

THE CHICAGO MERCANTILE EXCHANGE (CME)

A2. The CME was the world's first financial exchange to introduce currency futures. It introduced futures in seven foreign currencies in May 1972. Though CBOT was launched in 1848 and had established commodity futures and the CME itself was founded in 1919 (out of Chicago Butter and Egg Board which was set up in 1898), it was only after the collapse of the Bretton Woods system that the idea of currency futures gained acceptance. At the time of its inception, the original currency contracts were floated for British pounds, Canadian dollars, Deutsche marks, French francs, Japanese yen, Mexican pesos and Swiss francs. The CME is also the first to introduce standardization of futures contracts, the formation of the clearing process, the creation of financial futurescash- settlement and electronic trading. It is interesting to note that despite introduction of electronic platforms, the CME still retains its trading floor which is also integrated into its electronic platform. It may be added that in July 2007, the CME completed its merger with CBOT forming the combined entity as the CME Group.

A3. The FX contracts listed at the CME go through a physical delivery process four times a year on the third Wednesday of March, June, September and December. The Mexican peso and the South African rand are traded on all twelve calendar months. The Brazilian real also is traded on all twelve calendar months but is not physically delivered — it is cash-settled. The Russian ruble is cash-settled, but currently is traded on only four calendar months (March, June, September and December). While only a small portion of all CME FX futures contracts actually result in physical delivery, the CME believes that an efficient and reliable delivery system is essential to the contracts' fair pricing.

A4. The clearing members are recognized as the parties to a trade, irrespective of whether those clearing members are acting on their own behalf or for other trading members or other customers. The Clearing house becomes the counterparty to every trade with the clearing member assuming the opposite side of the transaction.

A5. The CME is a Self-Regulatory Organization (SRO). The rules4 followed by the CME provide for electronic surveillance, which authorize the Exchange to intercept, record and use any electronic communication passing through the trading floor. The stated objectives5 of the CME in the areas of risk management and financial surveillance are:

- Anticipate potential market exposures
- Ensure that sufficient resources are available to cover future obligations
- Result in the prompt detection of financial and operational weaknesses
- Allow swift and appropriate action to be taken to rectify any financial problems and protect the clearing system
- Prevent the accumulation of losses

A6. The financial surveillance program of the CME is mainly aimed at monitoring the financial condition of the clearing members. The surveillance is carried out by the CME Audit Department and includes features such as reporting by clearing members at prescribed frequency, annual surprise inspections customized to capture specific risks of the clearing member, sharing of information regarding clearing members with other 4 http://rulebook.cme.com/Rulebook 5 www.cme.com clearing organizations/SROs, etc. The CME is also a member of Inter-market Surveillance Group (ISG), which has exchanges from different countries as its members. The objective of ISG is sharing of information related to surveillance, investigation, etc.

A7. The CME also carries out an analysis of the intra-day price movements during the entire trading session with an objective of monitoring the impact of price changes on the clearing member positions. Stress testing of such positions is also carried out on a daily basis to simulate different scenarios and their likely impact on the clearing member positions. Based on the results, the CME could seek additional information from the clearing member about its customer accounts or even ask for reduction in positions in case of adverse results.

A8. The Market Regulations Department of the CME has daily access to account position information of different classes of members, which allows it to identify concentration of positions as well as aggregation of positions through different clearing members. Such information, in conjunction with other data at its disposal, permits the CME to identify market situations that may adversely affect financial stability of clearing members. The Market Regulations Department is also empowered to collect information on the profile of the trader i.e. whether it is listed as a hedger or a speculator.

A9. The CME follows the rules laid down by the US regulator for futures and options, the CFTC. The Commission conducts daily market surveillance and, in an emergency, can order an exchange to take specific action or to restore orderliness in any futures contract being traded. The market surveillance program of the CFTC is aimed at safeguarding the functions of price discovery and risk

management. This is sought to be done through monitoring daily large positions, futures and cash price relationships, etc.

A10. The CFTC has a report titled Commitments of Traders (COT), which provides a breakdown of each Tuesday's open interest for market reports in which 20 or more traders hold positions equal to or above the reporting levels established by the CFTC. In other words, COT contains large trader reporting levels. According to CFTC, the aggregate of all large trader positions reported to it usually manages to capture 70 to 90 per cent of the total open interest in any given market. CFTC can specify between 25 contracts to over 1000 contracts as the reporting level for large trader reports and these levels are based on various factors such as total open positions, size of positions held by the trader in that market, surveillance history of the market etc. The CME has prescribed 200 contracts as the cut-off for major currencies and 25 contracts for all other minor currencies. The CFTC requires submission of Form 102 in case the open interest exceeds the large trader reporting level. The Form 102 includes very specific information on trader and accounts, which makes aggregation (if applicable) possible. This, in turn, provides an insight into potential market impact of a trader.

A11. The main objectives of the market surveillance program of the CFTC are:

- to detect and prevent manipulation or abusive practices.
- to keep the Commission informed of significant market developments
- to enforce Commission and Exchange speculative position limits
- to ensure compliance with Commission's reporting requirements

A12. The CFTC6 seeks to protect customers by

- requiring registrants7 to disclose market risks and past performance information to prospective customers, ?? requiring that customer funds be kept in accounts separate from those maintained by the firm for its own use, and 6 http://cftc.gov 7 Commodity Exchange Act requires all Futures Commission Merchants (FCMs) and Introducing Brokers (IBs) to register as such unless they qualify for an exemption
- requiring customer accounts to be adjusted to reflect the current market value at the close of trading each day.

A13. Before an exchange lists a new futures or option contract for trading, it must certify that the contract complies with the requirements of the Commodity Exchange Act (CEA) and the Commission's (i.e. CFTC) regulations, including the requirement that the contract terms reflect commercial trading practices and that the contract not be readily susceptible to manipulation.

MEXICO

A14. Mexico had weathered several financial crises, the most recent one being the 1994-95 currency crises brought about by a fixed exchange rate regime, somewhat

in line with the South East Asian crisis. The importance of an organized market for exchange-listed derivatives in countries like Mexico had been discussed by international financial organizations like the International Monetary Fund (IMF) and the International Finance Corporation (IFC). These institutions recommended the creation of markets for exchange listed derivatives in order to promote macroeconomic stability and to facilitate risk control for financial intermediaries and economic entities. As part of financial sector reforms,Mexico permitted the CME to commence trading in Mexican Peso, starting April 1995. The explicit objective of the recommendation was to promote macroeconomic stability and to facilitate risk control for financial intermediaries and economic entities. The CME claims that volatility in the CME Mexican Peso market has reduced significantly since the launch of the CME contract, the futures market acting as a safety valve relieving pressure in the market.

THE MEXICAN DERIVATIVES EXCHANGE WEBSITE (MEXDER.COM.MX)

A15. The Mexican Derivatives Exchange called MexDer (Mercado Mexicano de Derivados) was set up on December 15, 1998. It was incorporated as a corporation under the Mexican law (S.A. de C.V.), authorized by the Ministry of Finance and Public Credit (SHCP). MexDer and its clearinghouse (Asigna) are self-regulatory entities that function under the supervision of the following financial authorities: the SHCP, Banco de México, and the National Banking and Securities Commission (CNBV).

A16. As part of its steps for global financial risk management, MexDer assigns each participant a unique registration code called the “MexDer Account Number”, which permits position monitoring across various accounts of each client. The unique number is system generated at the time of registration. Some equivalence criteria in the system check for similarities between existing accounts and manual intervention will be required for assigning numbers in such cases. No account can be deleted when positions are open on the exchange.

A17. The Clearing House Asigna has a system in place (TIMS) to measure, monitor and manage the level of exposure of the member’s portfolio. The system uses advanced pricing models to generate a set of theoretical values based on current prices, historical prices and market volatility. Appropriate margin offsets are assigned by Asigna based on the entire position within product group and across classes of products taking into account correlations, etc.

A18. Incidentally, the CME had earlier stopped the peso contract in 1985 and reintroduced Mexican Peso currency futures trading in 1995 after the Bank of Mexico amended its exchange regulations to allow physical delivery of “CME Mexican Peso futures contracts”. In fact, the CME has access to Mexican payment systems for settlement of trades. MexDer introduced its domestic USD / Mexican Peso futures contracts in 1998, and it is claimed that both the MexDer & CME USD / MP futures contracts are successes.

BIS paper no. 24, 2005 – 10 years of Mexican experience

A19. MexDer, inter alia, lists currency futures on the Mexican Peso/US dollar and Mexican Peso/ Euro. The Mexican Peso/ USD contract design is given below:

- Contract Characteristics United Sates of America - Dollar
- Contract Size USD 10,000
- Delivery Months Monthly cycle for up to three years (thirty six months)
- Trading Symbol DEUA plus the month and year of maturity:
- DEUA MR06 (March 2006)
- Unit quoted Mexican pesos per dollar
- Minimum price fluctuation (Tick)
- 0.001 pesos, value of the tick per contract 10.00 pesos
- Trading Hours 07:30 to 14:00 hours (GMT -06:00)
- Last day of trading and maturity date
- Two previous days before settlement date
- Settlement day Third Wednesday of maturity month
- Settlement Physical delivery

BRAZIL

A20. Brazilian Real US dollar futures contracts were launched on August 1, 1991. The contracts trade on the Brazilian Mercantile & Futures Exchange (BM&F), which was founded in July 1985 and has undergone several mergers with other exchanges to develop into the present form. BM&F is a private not-for-profit association.

A21. BM&F has three separate clearing houses for derivatives, securities and foreign exchange which operate with the explicit objective of reducing the credit risk to all the participants and are all ISO 9001 certified. In April 2002, the Foreign Exchange Clearing house was launched alongside the new Brazilian Payment System (SBP). The FX Clearing House is responsible for the settlement of foreign exchange transactions in the inter bank, for which it acts as a counterpart of the transactions and adopts the Payment vs. Payment (PVP) system on a net basis. The FX Clearing House has about 41 broker 10 Brazilian Mercantile & Futures Exchange (www.bmf.com.br) members in addition to banks. BM&F has also established a BM&F Settlement Bank which is operating since November 30, 2004 to render settlement and custodial services.

A22. Banks, consumer finance agencies, cooperatives, development banks etc. are regulated and supervised by the Central Bank of Brazil (BCB). Entities like investment banks, futures and commodities exchanges, securities dealers and securities brokers, foreign investor's portfolios, etc are subject to joint regulation by the Central Bank and the Securities and Exchange Commission. The stability of the purchasing power of the Brazilian currency and the soundness of the financial system are the main institutional objectives of the Central Bank. Systemically important payment systems come under its purview. The Securities and Exchange Commission of Brazil (CVM) has the mandate to ensure proper functioning of the exchanges and the OTC market. They are also responsible for investor protection, transparency and prevention of price manipulation and other malpractices. The BM&F is subject to laws relating to Money Laundering, Non resident investor and the Payment System Regulation. The BM&F is otherwise a self regulated entity.

A23. The currency futures contracts come in two denominations of USD50,000 and another mini contract of USD 5,000. The Exchange also trades a Euro contract. The contract specifications are tabulated below:

- Contract Characteristics Exchange Rate of Brazilian Reals (R$) per U.S. Dollar for cash delivery
- Contract Size USD 50,000
- USD 5,000 Mini contract
- Delivery Months All months
- Maximum of twenty four, as authorized by BM&F
- Trading Symbol DOL – US Dollar futures
- WDL – Mini US Dollar futures
- Unit quoted Brazilian Reals per US$ 1,000.00 to three decimal places
- Minimum price fluctuation (Tick)
- R$0.50 per US$ 1,000.00
- Trading Hours DOL - 09:00 to 16:00 hours
- WDL - 09:00 to 18:00 hours
- Last day of trading and maturity date
- Last business day of the month preceding the contract month
- Settlement day First business day of the contract month on the basis of the rate announced by the National Monetary
- Council of the Central Bank.
- Settlement Cash settlement

A24. The USD 50,000 contract has a category called hedgers, which includes the following:

a) Institutions authorized by the Central Bank of Brazil to trade US Dollars

b) Other companies whose basic activity is related to the transactions regulated for this market

SOUTH KOREA

A25. The Korea Exchange (KRX), which currently trades currency futures, was launched in January 2005 by consolidating three domestic exchanges – Korea Stock Exchange (KSE), KOSDAQ Market and Korea Futures Exchange (KOFEX). The Exchange is committed to improve market and build itself as a leading capital market in Northeast Asia. The Clearing and Settlement Department securely brings all trades carried out in the Stock Market and Kosdaq Market to a close. The KRX's role as a central counter party (CCP) helps the investors to conduct trade with the anonymous third party without being concerned about the settlement risk.

A26. The Korea Exchange introduced Yen and Euro futures in May 2006. Monthly volumes on the Exchange for currency futures have amounted to a notional of USD 10.9 billion, while the daily turnover in the OTC forex market is around USD 10 billion. The CME introduced USD/KRW Futures and Options on Futures contracts on June 20, 2006.

The CME contracts are cash settled based on KRW NDF market. The Korean Government has also reportedly agreed to review the possibility of physical delivery of the CME Won contracts based on the volume and influence on the forex market. The Korean Won volumes onshore are significantly higher than the Won contract volumes traded on the CME. Highly liquid and more flexible NDF market is also said to be the cause of the thin traded volumes in KRW contracts in the CME.

A27. Non residents have access to the onshore currency market and account for about 6.6 per cent of the volume. Restriction on non resident participation is enforced through the types of accounts they can maintain and can be classified as accounts with free local access and limited repatriation and accounts with limited local access and free repatriation. For trading on KRX, non residents are required to hold limited local access accounts with no restrictions on repatriation. At the Exchange level there is no distinction between domestic and non resident participants. To trade futures and options contracts listed on KRX, a foreign investor may designate custodian banks (standing proxy) to facilitate operations related to futures and options trading. A custodian bank opens 11 www.krx.co.kr accounts at foreign exchange banks and futures companies, deposits and withdrawals investors' money and monitors investors' assets for them. Most foreign exchange banks also do custodian bank and standing proxy operations.

A28. The Korea Exchange currently trades three currencies – the USD, the Euro and the Japanese Yen. All contracts provide for physical delivery. There is a provision for putting in place position limits on all these contracts. Currency Futures market volumes have registered increase, while the OTC forward market has retained its volume over the years. Certain key features of the USD contract traded on the Exchange are listed below:

- Contract Characteristics Exchange Rate of USD against Korean Won
- Contract Size USD 50,000
- Contract Months The first three consecutive months (two serial expirations and one quarterly expiration) plus the next three months in the quarterly cycle (March, June, September and December)
- Price Quotation KRW per USD 1 to two decimal places
- Minimum price fluctuation (Tick size)
- 0.1 representing KRW 5000
- Settlement day Third Wednesday of contract month
- Final Settlement Physical delivery

A29. Members are classified as Stock Trading Members or Futures Trading Members depending on the type of market that they can participate in. Members are also classified as Settlement Members or Trading Specialist Members depending on whether or not they are responsible for settlement. Eligibility requirements in terms of financial strength, equity holding in the Exchange, deposit and reserve funds have been laid down for different category of members. A foreign investor should designate securities and futures companies to trade futures and options traded on KRX.

A30. The Central Bank of Korea administers control on foreign exchange transactions. These have been progressively liberalized and as per the Foreign Exchange Liberalisation plan, the time line for completion of foreign exchange liberalization has been brought forward to 2009 from 2011. The limits on overseas investments by residents, foreign investments in Korea by non residents, real estate acquisition abroad by residents etc have been raised in keeping with this objective. Korean financial system is regulated and supervised by the Financial Supervisory Commission (FSC), which was constituted as a part of the Structural Readjustment Process, when Korea accepted the bailout package of the IMF following the South East Asian crisis. The Korean Exchange is also under the supervisory jurisdiction of the FSC, while KRX itself functions as a self regulatory authority like any Exchange.

SOUTH AFRICA

A31. The currency futures started trading on the Yield-X (JSE's interest rate exchange) with effect from June 18, 2007. Standard Bank and Investec have been chosen to be the two market makers for the currency futures market. Yield –X, similar to other JSE markets, would be regulated by Financial Services Board (FSB), while South African Reserve Bank would also be an external regulator.

A32. The participants permitted to trade currency futures include the following:

- Individuals and foreigners without any limits
- Pension funds and long term insurance companies subject to their 15 per cent foreign allocation allowance
- Asset managers and registered collective investment schemes subject to their 15 per cent foreign allocation allowance
- Resident company, close corporation, trust, partnership or hedge fund, provided a valid exchange control approval is in place (from SARB) 12 www.yieldx.co.za/ currency_futures.aspx

A33. An authorized dealer can apply to be a market maker in currency futures by tendering a formal written application to the SARB. To begin with, only US dollar/ Rand contracts are permitted, to be followed by Euro/ Rand and Sterling/ Rand currency futures. The Yield-X system performs pre-trade checking and prevents trades between a member and a corporate. In other words, trades are allowed to go through only when these are between counterparties permitted to trade. Each participant is assigned an Exchange control approval number by SARB which is the basis for determining eligibility to trade.

A34. The contract specifications are tabulated below:

- Contract Characteristics Exchange Rate of foreign currency13 and the South African Rand
- Contract Size Mini – USD 1,000 nominal of underlying currency
- Maxi – USD 100,000 nominal of underlying currency
- Delivery Months March, June, September and December
- Trading Symbol j-Rand
- Unit quoted Number of Rand per 1 unit of foreign currency to four decimal places
- Minimum price fluctuation (Tick)
- Mini – 0.0001 equal to R0.10
- Maxi – 0.0001 equal to R10.00

- Last day of trading and maturity date
- At 1340 hrs on two business days prior to third Wednesday of expiry month (or the previous business day, if that day is not a business day)
- Settlement Cash settlement in ZAR
- Market Times As determined by Yield-X (09h00 - 17h00)
- 13 Currently only US Dollar, Euro and Pound Sterling Key Lessons for India

A35. India can draw several lessons from the international experiences. The economies in emerging markets have enabled futures to coexist with restrictions on capital account and regulated OTC markets. The participants have also been selected and approved by the Central Bank in some cases. Salient points to be noted are given below:

i) Regulation - The Securities Regulator and the Central Bank jointly regulate and supervise some of the Exchanges, while the Exchanges are self regulated entities everywhere.

ii) Capital Controls – A few countries like South Africa and South Korea have introduced currency futures in recent times despite having capital controls.

iii) Settlement - In Brazil, at the BM&F open positions at maturity of the contract are cash settled by an offsetting transaction on the same number of contracts according to a specified formula. The Korean Won and Mexican Peso provide for physical delivery. There seems to be no distinct advantage for physical delivery, though Korea feels that this is the reason for higher volumes onshore in relation to the CME.

iv) Multiple Contracts - Introduction of two contracts catering to different market segments is a feasible option. The Brazilian and South African experiences establish that this option is workable. Some participants who had discussions with the Group and more particularly some exchanges like NSE and MCX have also confirmed that operating more than one contract should not be an issue in terms of technology, infrastructure and cost efficiency.

v) Contract Size - South African Reserve Bank has permitted individuals as participants without limits since there is less risk of capital flight. The contract size has been kept low at USD 1,000, a sum small enough to ensure wider retail participation.

vi) Contract Denomination - Most exchanges have Euro contracts in addition to USD contracts. JSE has commenced with the Rand-US dollar exchange rate contract with Euro and Sterling denominated contracts to follow.

vii) Participants - Brazil has created a separate category of participants called hedgers. South Africa has excluded corporates14 and hedge funds from participating in the currency futures exchange (unless they have a valid exchange control approval from SARB). Hedge funds, may not be permitted till they are

regulated. Corporates have been kept out since it was felt that allowing them in would result in hedge funds also following them.

viii) Participation Limit for individuals - South African individuals have an annual foreign exchange allowance of R 2 million under their forex regulations. This has been waived for the currency futures market.

ix) Exchanges – There is no unique model for introduction of currency futures. These have been listed and traded on multiple product exchanges (Brazil, Korea, Mexico) as well as on stock exchanges. The BM&F is a private not-for-profit association, while the other Exchanges run on commercial lines.

14 Corporate refers to any entity which is not any one of the qualifying audiences

x) Clearing Mechanism - Existence of a clearing house with an excellent safety net that acts as counterparty to every trade on the Exchange, i.e. acts as a buyer visà- vis each seller and as a seller vis-à-vis each buyer, is critical to the success of any Futures Exchange. In most countries, the Clearing House is a separate set up.

For foreign exchange clearing most arrangements have members of the clearing house who have accounts with the Central Bank. Brazil also has an exclusive settlement bank.

xi) Client codes - Unique registration code assigned to each client facilitates tracking transactions across exchanges and brokers. The process of assigning these numbers could have checks and balances facilitating detection of multiple accounts of same entity or related accounts. A tight KYC for every entity authorized to trade on the Exchange will eliminate undesirable elements from the system.

xii) Approval of Members – In South Africa, each participant on the Yield-X is assigned an Exchange control approval number by South African Reserve Bank which is the basis for determining eligibility to trade.

xiii) Response to Currency Futures - In some countries, the initial response and volumes when currency futures were first introduced were reported to be tepid and slow. This could happen in our markets too and time has to be allowed for the market to experience growth and acquire critical mass.

xiv) Volatility – There is no clear evidence of an increase in volatility of exchange rates after the introduction of currency futures. There is, however, some empirical evidence that volatility has reduced in some countries. In Mexico, there was reduction in volatility and a more stable exchange rate despite financial turbulence and large swings in speculative positions15. Similarly, empirical tests have established that the introduction of futures contracts resulted in lower spot market 15 BIS paper no. 24, May 2005 - Central banking intervention under a floating exchange rate regime: ten years of Mexican experience by Jose Julian Sidaoui, Banco De Mexico (contributed paper) volatility for the Mexican Peso, while in Brazil and Hungary it did not have significant impact on spot market volatility16.

REFORMS REQUIRED IN THE OTC MARKET

The forward and futures markets function differently in many respects. The extant regulatory prescriptions in the OTC market may not necessarily be carried over to the futures markets. International experiences have also indicated that the OTC and the futures markets co-exist, even with varying regulatory frameworks in South Korea and South Africa. In India, the existence of an underlying foreign exchange exposure is a prerequisite for undertaking hedging in the OTC market. Such a stipulation may not be enforceable in the currency futures market. It must be appreciated that the two markets offer different products. While OTC requires an underlying to be evidenced, the major benefits are customised contracts, bilateral trading which could result in improved trade terms at least for prime customers, and the possibility of physical delivery of foreign exchange. On the other hand, trading of currency futures on exchanges provides freedom from production of an underlying and enables position taking even without an underlying.

However, this freedom comes with a cost in the form of strict mark-to-market and margin requirements and other prudential limits. Despite the advantages of futures over the OTC products in regard to the access to concentrated liquidity due to the provision of a common platform, greater transparency, mitigation of counterparty risk and enhanced confidentiality, the OTC market continues to be a much more significant part of the overall foreign exchange market globally. This could be because of its flexibility and ability to meet specific needs of customers at a lower cost as well as ability to provide a perfect hedge. In the Indian context, the key imponderable is whether commencing a relatively free futures market will provide incentives to a large proportion of OTC customers to shift to the futures due to operational convenience.

Hence, it is not essential that introduction of currency futures should result in substantial transformation in the OTC market. The two markets could co-exist since they have different product offerings. However, significant differences in regulatory norms, such as dispensing with the requirements of the underlying, flexibility in unwinding of positions, transparency in pricing, etc., in the futures market provide arbitrage opportunities for the participants. There is a need for progressive liberalisation in respect of documentation and other procedures of the OTC market, in a phased manner.

The Committee on FCAC had observed that ‘booking of contracts at present is conditional on having a position in the underlying. But, with the economy getting increasingly exposed to various types of forex/commodity risks/exposures arising out of exchange rates, their international competitive position needs to be strengthened by allowing them effective options to hedge. The spot and forward markets should be liberalised and extended to all participants removing the constraints, such as the requirement of past performance/underlying exposures, in a phased manner. It should be noted that there are no restrictions as such on unhedged exposures’.

In view of the above, whether there is a need to further liberalise the OTC markets require resolution. In case, a decision is taken to gradually liberalise the OTC markets, the contours of such a reform program need to be chalked out.

REFERENCES / SUGGESTED READINGS

The readings suggested here are supplementary in nature and would prove to be helpful for those interested in learning more about derivatives.

1. Surveillance in a Stock Exchange, BSE website
2. BSE' s Certification in Stock Exchange, BSE website
3. BSE 's Certification in Derivatives, BSE website
4. Introduction to foreign exchange & money markets / Reuters
5. Foreign exchange handbook for residents & non resident Indians / Khilani
6. Foreign exchange, international finance & risk management / Rajwade
7. Forex markets : exchange rate dynamics / ICFAI
8. How the foreign exchange market works / Weisweiller rudi
9. How the future markets work / Bernstein, Jake

MODEL QUESTION PAPER

	MODEL CURRENCY FUTURES EXAM						
1	_____expose investors to currency risks	unlawful activities	unpredicted movements in exchange rates	hedging	arbitrage	2	1
2	empirically , changes in exchange rates are found to have very low correlations with _____	bond returns	convexity of interest rate changes	foreign equity and bond returns	duration of bond returns	3	1
3	hedging of financial position by an investor reduces _____	transparency of returns	effieciency of risk	volatility of returns	none of the above	3	1
4	when the underlying asset is a commodity then the futures contract is called as _____	agricultural commodities contract	essential commodities contract	commodity futures contract	interest rate futures contract	3	1
5	a currency futures contract is also, called as _____	MX future	IX future	FX future	FY future	3	1
6	the currency futures are used as a _____rather than for physical exchange of currencies	price resolving mechanism	price evoking mechanism	price setting mechanism	price evolving mechanism	3	1
7	margins act as a cost and discourage excessive _____	speculation	examination	arbitrage	none of the above	1	1
8	the various scenarios of price changes on which the initial margin is based is computed so as to cover 99% VaR over _____	one day horizon	two day horizon	3 day horizon	none of the above	1	1
9	in order to achieve coverage of 99% of VaR the initial price scan range is fixed at _____	3.5standard deviation	3.4standard deviation	3.2standard deviation	none of the above	1	1
10	the initial margin is deducted from the liquid networth of the clearing member on an _____	real time basis	real time intervals	RTG basis	none of the above	1	1
11	the _____is adopted to interprete the risk involved in the portfolio of each individual client comprising his positions in futures contracts across various maturities	SPAN methodology	BOSSi methodology	ALGO methodology	none of the above	1	1
12	the client wise margins are grossed across various clients at the _____	Trading/Clearing member level	client level	proprietor level	none of the above	1	1
13	the surveillance system should focus on _____ associated with the exchange rates	long tails	odd tails	fat tails	even tails	3	1
14	since the currency future contracts are cash settled _____ should be monitored for price aberrations	derivative markets	cash markets	debt markets	fixed income markets	2	1
15	the risk profiles of traders should be tracked and it should be ensured by the surveillance system that _____ remain under control	traded positions	leveraged positions	pegged positions	unilevered positions	2	1
16	the surveillance activity needs to ensure 1.the the currency future prices at the expiration move in a manner consistent with supply and demand factors and with OTC exchange rates 2.whether traders with large positions in the expiring future contracts ha	only 1 is true	only 2 is true	both are true	both are false	3	1

	MODEL CURRENCY FUTURES EXAM						
17	Suspicious Transactions Reporting is necessary at various frequencies	TRUE	FALSE			1	1
18	the surveillance activity and the disputes resolution mechanism should go hand in hand	TRUE	FALSE			2	1
19	the currency futures segment in the exchange must prescribe the following document_____	model risk disclosure	model-member constituent agreement	know your client agreement	all of the above	4	1
20	the framing of the documents in the currency futures segemnt of the exchange is_____ that applicable in the equity derivatives segemnt	different from	similar to	diffusible to	distinguishable to	2	1
21	in precedence to the trading in currency futures segment the exchange shall submit the proposal for approval of the contract to _____	SEBI	FIMMDA	FEDAI	RBI	1	1
22	in precedence to the trading in currency futures segment the exchange submited proposal for approval of the contractmust contain _____	the details of the proposed currency futures contract to be traded in the exchange	the economic purposes it is intended to serve	the options above are untrue	both the options are true	4	1
23	in precedence to the trading in currency futures segment the exchange submited proposal for approval of the contractmust contain _____	its likely contribution to market development	the safeguards and the risk protection mechanisms adopted by the exchange to ensure market integrity, protection of investors and smooth and orderly trading	the infrastructure of the exchange and surveillance system to effectively monitor trading in such contracts	all of the above	4	1
24	the trading members and clearing members of the currency futures segment should be _____	registered with SEBI	furnished with SEBI rules	effectively organised	none of the above	1	1
25	the chairman of the governing council can perform the trading business activity during his tenure as Chairman	TRUE	FALSE			2	1
26	a trading / clearing member would be allowed to be simultaneously on the governing council of the currency futures and the cash/equity segment simultaneously	TRUE	FALSE			2	1
27	does a clearing corporation require SEBI' s approval before being operational	yes	no			1	1
28	a clearing corporation in the currency futures segment should be incorporated under the _____	Companies Act1956	SCRA1956	DIP	SEBI Regulations1992	1	1
29	the clearing corporation should be _____from the exchange	distinct	away	patented	evaluated	1	1
30	the clearing corporation must perform in_____	full novation	innovation	discreeteness	full ovation	1	1
31	the trading member should have a networth of_____	Rs 1 crore balance sheet	Rs 2 crore balance sheet	Rs 10 crore balance sheet	none of the above	1	1
32	the clearing member should have networth requirement of_____	Rs 10 crore balance sheet	Rs 1 crore balance sheet	Rs 2 crore balance sheet	none of the above	1	1

	MODEL CURRENCY FUTURES EXAM						
33	the clearing member is subject to maintain an additional liquid networth of _____	Rs 50 lakhs	Rs 25 lakhs	Rs 100 lakhs	none of the above	1	1
34	issuers of the securities needs to disclose the _____ and the _____in their prospectus	problem factors, pricing	risk factors, justification for pricing	track record,facts for pricing	due diligence,pricing	2	1
35	equity research and analysis and credit rating improved the quality of information about issue of capital by the issuers	TRUE	FALSE			1	1
36	the SEBI (DIP) guidelines ,2000 provide norms relating to 1.eligibility for companies 2.issuing securities ,3.pricing of issues, 4.listing requirements 5.forex operation	all are true	only first 4 are true	only last two are true	only first 3 are true	2	1
37	the SEBI (DIP) guidelines ,2000 provide norms relating to, 1.treasury operations,2.disclosure norms,3. lock in period for promoters contribution,4.contents of offer documents,5. pre and post issue obligations	only last 4 are true	only first 4 are true	only last two are true	only first 3 are true	1	1
38	if the rights issue where the aggregate value of the securities offered is less than _____, the company shall prepare the _____ in accordance with disclosure requirements specified in these guidelinesand file the same with the board for its informati	50l acs,offer letter	50 lacs,dismissal letter	20 lacs,offer letter	20 lacs,intimission letter	1	1
39	A company making a public issue of securities should file a draft prospectus with SEBI through an eligible _____, at least _____ prior to the filing of prospectus with the Registrar of Companies(ROCs).	chartered accountant,21days	Merchant Banker,21 days	Merchant banker,20days	merchant banker,15days	2	1
40	the _____ for directors and functionaries of the stock exchange s is aimed at improving the professional and ethical standards in the functioning of exchanges thereby creating beter investor confidence in the integrity of the market	style of ethics	code of ethics	commitment of ethics	evidence of ethics	2	1
41	fairness and transparency imndealing with matters relating to the exchange is an objective of code of ethics	TRUE	FALSE			1	1
42	compliance with all laws/rules/regulations laid down by regulatory agencies/exchange is an objective of code of ethics	TRUE	FALSE			1	1
43	exercising due diligence in the performance of duties is an objective of code of ethics	TRUE	FALSE			1	1
44	avoidance of conflict of interest between self interests of directors/functionaries and interests of exchange and investors is an objective of code of ethics	TRUE	FALSE			1	1
45	in the clause of code of ethics functionaries of the exchange to whom this code is applicable shall be decided by the exchange but shall include all the officials of the rank of _____	only deputy general managers	general manager and above	office assistant and above	managerial staff	2	1

	MODEL CURRENCY FUTURES EXAM						
46	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it involves fraud and may include_____	any act or omission amounting to manipulation of the price of a security	demanipulating the security	destructuring the security	none of the above	1	1
47	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it involves fraud and may include_____	launching an IPO	publishing or causing to publish or reporting or causing to report by a person dealing in securities any information which is not true or which he does not believe to be true prior to or in the course of dealing in securities	circulating preference shares	none of the above	2	1
48	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it involves fraud and may include_____	launching an NFO	entering into a transaction insecurities without intention of performing it or without intention of change of ownership of such security	circulating preference shares	none of the above	2	1
49	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it involves fraud and may include_____	scheduling a depository	opening of a subsidiary	selling ,dealing or pledging of stolen or counterfeit security whether in physical or dematerialised form	none of the above	3	1
50	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it involves fraud and may include_____	scheduling a depository	an intermediary promising a certain price in respect of buying or selling of a security to a client and waiting till a discrepancy arises in the price of such security and retaining the difference in prices as profit for himself	opening of a subsidiary	none of the above	2	1
51	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it include 1.an intermediary providing his clients with such information relating to a security as cannot be verified by the clients before their dealing in such sec	only 1 true	only 2 true	both true	both untrue	3	1
52	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it include 1. an intermediary not disclosing to his client, transactions entered onto his behalf in an inflated manner in order to increase his comission and broker	only 1 true	both true	only 2 true	both untrue	2	1
53	dealing in securities shall be deemed to be a fraudulent or an unfair trade practise if it include1.circular transactions in respect of a security entered into between intermediaries in order to increase comission to provide a false appearance of trad	only 1 true	both true	only 2 true	both untrue	2	1

	MODEL CURRENCY FUTURES EXAM						
54	if the chairman is the executive director then 1.atleast half of the board should comprise of independent directors 2.1/3 of the board should comprise of independent directors3. 1/4 of the board should comprise of independent director	only 1 is true	all 3 are true	only first 2 are true	only last 2 are true	3	1
55	sitting fees paid to non executive directors require previous approval from shareholders	TRUE	FALSE			2	1
56	the board shall meet at least _____ a year with maximum gap of ____ between any two meetings	4,4months	5,6months	2,5 months	none of the above	1	1
57	a director shall be member of not _____ 10 comittes	more than	less than	half of	1/4 of	1	1
58	a director shall not act as the Chairman of _____comittees across all companies in which he is a Director	more than 5	more than 4	more than 10	more than 3	1	1
59	it is _____ for a director to inform the companyy about the committee positions he occupies in other companies and notify changes as and when they take place	casual	mandatory	extraordinary	indicative	2	1
60	the function of the board is to _____ review compliance reports of all laws applicable to the company prepared by the company as well as steps taken by the company to rectify instances of non compliances	annually	periodically	weekly	eventually	2	1
61	incase of prohibition of insider trading the regulation on continuous disclosures states that any person who holds more than 5% shares or voting rights in any listed company should disclose the same in ____.	form C	form16	formD	form 15G	1	1
62	any person who is a Director or officer of a listed company, should disclose to the company, in _____ the total number of shares or voting rights	form 15G	form D	form C	form16	2	1
63	_____ means any person who, directly or indirectly , acquires or agrees to acquire shares or voting rights in the target company	retainer	acquirer	insider	receptor	2	1
64	_____shall include the right to appoint majortiy of the directors or to control the management or policy decisions exercisble by a person or persons acting individually or in concert	control	ideal	combination	central	1	1
65	_____company means a listed company whose shares or voting rights or control is directly or indirectly acquired or is being acquired	trust	target	finance	accountable	2	1
66	_____ is an individual who for a common objective or purpose of substantial acquisition of shares or voting rights or gaining control over the target company pursuant to an agreement or understanding directly or indirectly cooperate by acquiring or agreei	a person acting in conduct	a person acting in concert	a person acting in conserve	a person acting in course	2	1

	MODEL CURRENCY FUTURES EXAM						
67	as a part of continual disclosure pertaining to SEBI (substantial acquisition of shares and takeovers) regulations1997 every person mentioned in Regulation6 who holds more than _____ shares or voting rights in any company should within _____ days from	20%,21 days	15%,21 days	5%,21days	21%,15days	2	1
68	every company whose shares are listed on the stock exchange should within ____ from the financial year ending on march 31 as well as the record date of the company for the purposes of declaration of dividend, make yearly disclosures to all the stock excha	30 days	5days	15days	21days	1	1
69	the securities contracts(regulations) act,1956, _____by regulating the business of dealing in securities	preventing mistakes	preventing undesirable transactions in securities	preventing disasters	preventing undesirable banking transactions	2	1
70	the companies act 1956 is a _____	is a financial law	is a uniform law relating to companies through out India	is a legal entity	is a corporate governance	2	1
71	the Reserve Bank of Indiawas established on _____	April 1,1935	April 2,1935	2-Apr-36	April 1,1936	1	1
72	the RBI was established in accordance with the provisions of _____	Reserve Bank Of India Act,1934	Reserve Bank of India Act, 1935	Reserve Bank of India, 1936	RBI 1934	1	1
73	the central office of RBI was initially established in _____	Calcutta	Delhi	Chennai	Mumbai	1	1
74	Touchline provides additional fascility of ND	TRUE	FALSE			1	1
75	The system displays on ___basis information required by the traders	polished	discreet	continuos	break up	3	2
76	The News window fascility in BOLT to fascilitate the market with latest information	TRUE	FALSE			1	1
77	The ticker window appears at the right hand column of the trading screen	TRUE	FALSE			2	1
78	The ticker window appears at the bottom of the trading screen	TRUE	FALSE			1	1
79	The last _____ of live entries are reflected in the ticker when the trader user logs in to the BOLT TWS	24	34	44	54	1	2
80	The system would also allow to profile scrips	on weightage of Sensex scrips	Base minimum value of Scrips	BSE –100 scrips	None of above.	1	1
81	Default Basket name in BOLT –TWS is	Sensex	Nifty	BSE –100	BSE –500	1	1
82							1
83	Intra Day capital and Gross Exposure will not be blocked for	FI Clients	Own Clients	WH Clients	FI and WH Clients	1	1
84	The member will be suspended when he violates	100% Capital Adequacy	40% Capital Adequacy	60% Capital Adequacy	90% Capital Adequacy	1	1

	MODEL CURRENCY FUTURES EXAM						
85	What is the name of the online trading system of the BSE?	BALT	BOLT	BSLT	BST	2	1
86	the settlement price would be the_____on the date of expiry	federal reference rate	Reserve Bank Reference Rate	london reference rate	none of the above	2	1
87	the last working day on which the futures contract would expire would be as same as _____	for interbank settlements as laid down by FEDAI	for Reserve Bank of India	for Interbank settlements as laid down by FIMMDA	for interbank settlements as laid down by RBI	1	1
88	the introduction of currency futures segment is meant to provide non institutional market participants a means to hedge their currency exposures in a _____	in a transparent and price -efficient manner	in a effiecient manner	in transporting manner	in a fuel efficient manner	1	1
89	the price discovery function of the exchange is important for the_____	individuals and SMEs	NRIs and FII	banking institutions	exchange	1	1
90	the problem with long tenor i.e abve two years, currency future contracts is_____	non presence of long tenor OTC contracts leading to lesser liquidity	presence of ETF contracts	non presence of ETC contracts	non presence of OIC contracts leading to lesser liquidity	1	1
91	settlement in currency futures segment is on _____	cash basis	physical delivery	courier basis	none of the above		1
92	the term used to address a Deustch mark and dollar is _____	dollar -paris	dollar -swissy	dollar mark		3	1
93	the term used to address a a french franc and dollar is _____	dollar -swissy	dollar mark	dollar-Paris		3	1
94	the SAFE settlement based on the difference between the forward rate on the start date of the contract and spot rate at settlement is called as _____	ERA	ETA	FXA		3	1
95	the SAFE settlement based on two forward rates and not on a forward and spot rate is called as _____	ETA	FXA	ERA		3	1
96	the statement about forward rates ,"dealers use forward rates to estimate the likely future direction of exchange rates ", is_____	TRUE	FALSE			1	1
97	the statement about forward rates,"a six month forward rate can be known as an outright forward ", is _____	TRUE	FALSE			1	1