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**STANDING COMMITTEE
ON FINANCE
(1998-99)**

TWELFTH LOK SABHA

**MINISTRY OF FINANCE
(DEPARTMENT OF ECONOMIC AFFAIRS)**

**THE SECURITIES CONTRACTS (REGULATION)
AMENDMENT BILL, 1998**

FOURTEENTH REPORT



सत्यमेव जयते

**LOK SABHA SECRETARIAT
NEW DELHI**

March, 1999/Phalguna, 1920 (Saka)

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(TWELFTH LOK SABHA)

MINISTRY OF FINANCE
(DEPARTMENT OF ECONOMIC AFFAIRS)

THE SECURITIES CONTRACTS (REGULATION)
AMENDMENT BILL, 1998

Presented to Lok Sabha on 18 March, 1999

Laid in Rajya Sabha on 17 March, 1999



LOK SABHA SECRETARIAT
NEW DELHI

March, 1999/Phalgun, 1920 (Saka)

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LIST OF MEMBERS OF STANDING COMMITTEE
ON FINANCE (1998-99)

Shri Murli Deora — *Chairman*

MEMBERS

Lok Sabha

2. Shri Dhirendra Agarwal
3. Shri Mohanbhai Sanjibhai Delkar
4. Shri Haribhai Parathibhai Chaudhary
5. Shri Uttam Singh Pawar
6. Shri Girdhari Lal Bhargava
7. Shri Chetan Chauhan
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25. Dr. Bikram Sarkar
26. Shri S. Jaipal Reddy
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28. Shri P. Chidambaram
29. Shri Buta Singh
30. Shri Ch. Vidyasagar Rao

Rajya Sabha

31. Dr. Manmohan Singh
32. Shri Krishna Kumar Birla
33. Shri N.K.P. Salve
34. Shri M. Rajsekara Murthy
35. Shri Narendra Mohan
36. Shri O. P. Kohli
37. Shri Raghavji
38. Dr. Biplab Dasgupta
39. Shri C. Ramachandraiah
40. Shri Amar Singh
41. Shri Prem Chand Gupta
42. Shri R. K. Kumar
43. Shri Gurudas Das Gupta
44. Shri Satishchandra Sitaram Pradhan
45. Shri Suresh A. Keswani

SECRETARIAT

1. Dr. A. K. Pandey — *Additional Secretary*
2. Dr. (Smt.) P. K. Sandhu — *Director*
3. Shri N.S. Hooda — *Assistant Director*
4. Shri L.V. Ramana — *Reporting Officer*

INTRODUCTION

1. The Chairman, Standing Committee on Finance (1998-99) having been authorised by the Committee to submit the Report on their behalf, present this Fourteenth Report on the Securities Contracts (Regulation) Amendment Bill, 1998.

2. The Securities Contracts (Regulation) Amendment Bill, 1998 was introduced in Lok Sabha on 4 July, 1998. The Bill was later referred to the Committee on 10 July, 1998 for examination and report thereon, by the Hon'ble Speaker, Lok Sabha, under Rule 331E of the Rules of Procedure and Conduct of Business in Lok Sabha.

3. The Committee at their sitting held on 25 August, 1998 decided to issue press communique for inviting suggestions/views/memoranda from the individuals, experts, professional bodies, stock exchanges and interested organisations/parties on the Bill.

4. To have the benefit of better understanding on various aspects of the Bill, the Committee took oral evidence of representatives of National Stock Exchange of India Ltd. (NSE), The Stock Exchange, Mumbai (BSE), Delhi Stock Exchange Association (DSE), Unit Trust of India (UTI) and Shri G.S. Patel, former Chairman, UTI and the representatives of Ministry of Finance (Deptt. of Economic Affairs), Securities and Exchange Board of India (SEBI) and Reserve Bank of India (RBI) on 6 January, 1999 and sought clarifications on the provisions of the Bill. The Committee considered and adopted the draft Report at their sitting held on 10 March, 1999.

5. The Committee wish to express their thanks to the Officers of the Ministry of Finance (Deptt. of Economic Affairs), Securities and Exchange Board of India and Reserve Bank of India for placing before the Committee the requisite information in connection with the examination of the Bill.

6. The Committee would like to place on record their appreciation for the valuable assistance rendered to them by the officials of the Lok Sabha Secretariat attached to the Committee.

7. For facility of reference, the observations/recommendations of the committee have been printed in thick type.

NEW DELHI;
10 March, 1999

19 Phalgun, 1920 (Saka)

MURLI DEORA,
Chairman,
Standing Committee on Finance.

REPORT

Introduction

Derivatives are financial vehicles based on or derived from financial assets, commodities or indexes. The term 'derivative' indicates that it has no independent value *i.e.* its value is entirely 'derived' from the value of the cash asset. A derivative contract or product of simply 'derivative' is to be sharply distinguished from the underlying cash asset *i.e.* the asset bought/sold in the cash market on normal delivery terms. 'Derivative' in other words means, forward, future or option contract of pre-determined fixed duration, linked for the purpose of contract fulfilment to the value of specified real or financial assets or to index of securities.

2. Derivatives are essentially meant to facilitate temporarily (usually for a few months) hedging of price risk of inventory holding or a financial/commercial transaction over a certain period. In practice, every derivative 'contract' has a fixed expiration date, mostly in the range of three to twelve months from the date of commencement of the contract. In the market's idiom, they are "risk management tools". The use of forward/futures contracts as hedging techniques is a well established practice in commercial and industrial operations. Their application to financial transactions is relatively new, having emerged only about 25 years ago.

3. Both forward and futures contracts are used for hedging. Forward contracts are private bilateral contracts and have well established commercial usage. They are exposed to default risk by a counter party. Each forward contract is unique in terms of contract size, expiration date and the asset type/quality. The contract price is not transparent as it is not publicly disclosed. Since the forward contract is not typically tradable, it has to be settled by delivery of the asset on the expiration date.

4. In contrast, futures contracts are standardised tradable contracts. These are standardised in terms of size, expiration dates and all other futures. These are traded on specially designated exchanges in a highly sophisticated environment of stringent financial safeguards. These are also liquid and transparent and their market prices and trading volumes

are regularly reported. The futures trading system has effective safeguards against default in the form of Clearing Corporation guarantees for trades and the daily cash adjustment (mark-to-market) to the accounts of trading members based on daily price change. Futures are far more cost efficient than forward contracts for hedging.

5. Forward contracts are being used in India on a fairly large scale in the foreign exchange market for covering currency risk but there are neither currency futures nor any other financial futures in India at present. However, Forward Markets Commission has allowed trading in Commodities Forwards on Commodities Exchanges which are called Futures in international markets. Commodities Futures in India are available in turmeric, black pepper, coffee, gur (jaggery), hessian, castor seed oil etc.

6. Efforts have been made in the recent past to reduce the prevalent risks in the capital market by way of resorting to such measures as prescribing requirement of adequate capitalisation, margining, establishment of Clearing Corporation in the Stock Exchanges etc. Systematic improvements have also been made by introducing screen based trading, book entry transfer of securities through depository etc. It is seen that growth of the market often gives rise to the demand for different instruments which enable the investors and participants to diversify as well as control the different risks in the capital market. One of such demands relates to having an options and futures market where investors/participants can diversify their risks. The existence of such a market not only helps in diversification of risks but also helps strengthen and deepen the cash market.

7. Keeping in view the pressing need for trading in derivatives in Indian capital market, the Government decided to include derivatives under the broad connotation of securities under Section 2(h) of the Securities Contracts (Regulation) Act, 1956 by bringing in the proposed Securities Contracts (Regulation) Amendment Bill, 1998, which was introduced in Lok Sabha on 4th July, 1998. Besides, keeping in view the fact that recently many companies particularly plantation companies have been raising capital from investors through schemes which are in the form of collective investment schemes and there is no regulatory framework to allow an orderly development of this market, the Government have also proposed to amend the definition of 'Securities'

in the proposed legislation, so as to include within its ambit the derivatives and the units or any other instrument issued by any collective investment scheme to the investors. In addition, the Bill also proposes to substitute Section 29A of the principal Act relating to delegation of powers. At present powers can be delegated to the Securities and Exchange Board of India. It has now been proposed to delegate powers to the Reserve Bank for India also.

8. The Securities Contracts (Regulation) Amendment Bill, 1998 was referred to the Standing Committee on Finance by Hon'ble Speaker on 10 July, 1998 for examination and report thereon. With a view to having expert opinion on the provisions of the Bill, the Committee sought memoranda from experts, professional bodies, stock exchanges and individuals. In order to seek clarifications, the Committee also took the oral evidence of the representatives of National Stock Exchange of India Ltd. (NSE), the Stock Exchange, Mumbai (BSE), Delhi Stock Exchange Association Ltd. (DSE), Unit Trust of India (UTI) and Shri G.S. Patel, former Chairman, UTI and the representatives of Ministry of Finance (Department of Economic Affairs), Securities and Exchange Board of India (SEBI) and Reserve Bank of India on 6 January, 1999. Strong views have been expressed by some of the experts/individuals against the proposed amendment on the grounds that the Indian capital market has not yet attained the requisite levels of maturity to trade in derivatives and an apprehension has been advanced that due to the prevailing host of market abuses such as excessive short term speculation, insider trading, price rigging, front running, green mail tactics etc. the retail investors would be the worst sufferers. Besides, lack of adequate safety and regulatory mechanism in place prior to the introduction of derivatives would result in spiralling speculation, excessive volatility in the stock market which would further cast doom on the prospects of the Indian economy. A strong, efficient, liquid and transparent stock market is a pre-requisite and the Indian stock exchanges which are purely functioning as trading organisations are not only ill-equipped but also have not been properly integrated and are prone to terrific speculation.

9. The representatives of the Stock Exchange and the Unit Trust of India while countering the above view points stated that the advent of derivatives trading would bring in liquidity, the facility of risk transfer, transparency and efficient price discovery to the secondary market. They also contended that with the commencement of the futures market, a major portion of existing speculative trade of the

cash market would shift to derivatives market, making the cash market a pure cash market and would result in reducing its volatility. They were of the view that in view of the strong risk containment system which the derivatives market will have, the speculation levels will be kept within the manageable limits.

10. The Finance Secretary while responding to a query regarding the need to introduce derivatives trading stated as under :

“...For the last several months, the investment which was really the engine of demand, has just disappeared. One of the ways to promote investment is to reduce the cost of equity and the best way to reduce the cost of equity is to stimulate the capital market. If you want to bring back the investors to the capital market, you require growth of mutual fund which is one way of promoting the interests of individual investors. The proposed amendment allows the development of risk mitigating instrument. This will help improve the mutual fund industry. To my mind, it is very important if we develop our capital market and make it more effective, more transparent and give greater protection to individual investor. I would not have argued the case, had I believed that it would not help the Indian economy. I genuinely believe that this will help the Indian economy. India is a pioneer in futures market. Before the world discovered the futures market, India started the commodity market. We are world's best traders. We were very much worried that when the foreign traders will come our industry will collapse, on the contrary our industry has probably become more efficient. We have the skill and we can really help the investors. Hence, there is economic logic or reason for this.”

11. When asked about the road map that prescribes necessary pre-conditions which are to be in place prior to the introduction of derivatives, the Finance Secretary further deposed as follows :

“Coming back to readiness, we have a road map in terms of what needs to be done at the level of the Regulatory Authority, namely the SEBI, what needs to be done by the concerned exchanges and what should be the step to ensure financial strength to the operators. There is also a Chinese wall between two operators of the same exchange. There are a number of points

that have been suggested by the Committee which the SEBI will incorporate to alleviate the fears which many people have. I expect, they can be protected as much as possible. But let me mention that what we are trying to do is not something new. It is done all over the world."

12. Regarding the details of the recommendations given with regard to the pre-conditions which have to be in place prior to the introduction of derivatives as suggested by L.C. Gupta Committee, the Committee were informed by the Ministry in a separate note as under :

- (a) The derivatives trading should take place on a separate segment of the existing stock exchange with independent Governing Council where the number of trading interest will be limited to 40% of the total number of members on the Council. The Chairman of the Governing Council will not be permitted to trade on any of the Stock Exchanges.
- (b) The settlement of derivatives trade will be through independent Clearing Corporations/Clearing House which will become counter party for all trades or alternatively guarantee the settlements of all trades.
- (c) The Clearing Corporation will have adequate risk containment measures and will collect the margin through Electronic Fund Transfer.
- (d) The derivatives exchange will have on-line trading and surveillance system. It will disseminate the price and trade on real time through two information vending networks. It should inspect 100% members every year.
- (e) There will be phased introduction of derivatives product. To start with, index futures will be introduced which will be followed by option on index and later options on stocks.
- (f) The complete segregation of the client money at the level of trading/clearing members and even at the level of Clearing Corporation. The client will be compulsorily required to pay margin to the broker.

- (g) The trading/clearing member will have stringent eligibility conditions. At least two persons should have passed the certification programmes approved by SEBI. The clearing member should deposit minimum Rs. 50 lakhs with the Clearing Corporation and should have a net worth of Rs. 3 crores.

13. With regard to the precautionary measures which shall be adopted before introduction of the derivatives, Chairman SEBI, *inter alia* stated as under:—

“It is not that all the stock exchanges would be allowed to trade in this. Only Exchanges which are prepared would be allowed. I am not saying that all are prepared. The NSE has already taken some steps. The BSE may come forward. Before they do that, they have to take all the precautions which we prescribe. They have to have separate governing board, separate bye-laws etc. They would be permitted to trade only if they are competent enough to do it. They would be allowed to trade only when we are satisfied with their software, hardware, human resources and their bye-laws.”

14. While the Committee, after having considered the viewpoints expressed in favour and against the introduction of the derivatives in the Indian capital market, are in general agreement that derivatives as a financial vehicle will help facilitate the retail investors, institutional investors and the mutual fund industry to hedge their risks in the long run, but at the same time they also share some of the apprehensions expressed by the experts in this regard. They note that L.C. Gupta Committee appointed by SEBI have drawn out detailed guidelines pertaining to the regulatory framework on derivatives prescribing necessary pre-conditions which should be adopted before the introduction of derivatives. They are of the view that these should be adhered to fully. Besides, keeping in view the fact that perception of the anatomy and complexities of risks and their evaluation, measurement, management and control are very elementary and poor among the Indian investors, they feel that there is an urgent need to educate them by creating investment awareness among them by conducting intensive educational programmes, so that they are able to understand their risk profiles in a better way. Steps should also be taken with a view to strengthen the cash markets so that they become strong and efficient. The Committee

are also of the firm view that only a strong, surveillance/vigilance and enforcement machinery can allay most of the apprehensions which have been expressed before the Committee and it is therefore incumbent on the regulatory authorities to ensure their existence. The Committee opine that the introduction of derivatives, if implemented with proper safeguards and risk containment measures will certainly give a fillip to the sagging market, result in enhanced investment activity and instill greater confidence among the investors/participants. The Committee after having examined the provisions of the Securities Contracts (Regulation) Amendment Bill, 1998 and having been convinced of the need and objectives of the Bill, therefore approve the same for enactment by Parliament with certain modifications/recommendations which are detailed in the succeeding paragraphs of the Report.

Clause 2—Amendment to Section 2(h)

15. Under Clause 2 of the Bill, Section 2 of the Securities Contracts (Regulation) Act, 1956 has been proposed to be amended by including derivatives and collective investment scheme within the ambit of Securities. A viewpoint has been expressed that since under Section 30 of the Indian Contract Act, 1872, the contracts which are cash settled are classified as wagers and trading in wagers is null and void, the index futures which are always cash settled would also be classified as wagers under the Indian Contract Act. Due to this, no proceedings to enforce an index futures contract, either by an exchange against a defaulting broker or client against his broker would stand the legal scrutiny before the court of law. It was therefore suggested that with a view to safeguard such an anomalous situation an overriding provision needs to be incorporated.

16. While clarifying the position in this regard, the Ministry of Finance informed the Committee in their written reply that the Department of Legal Affairs had been consulted on the issue and they were of the view that once index of securities prices is declared as a security under the Securities Contracts (Regulation) Act, it would be deemed to be a security under the Act and the general Acts like the Contract Act will not be applicable to such contracts of security. However, in case it was felt necessary to have an overriding provision the same could be incorporated. The Committee were informed that Section 18 of England's Gaming Act, 1845 which provides, *inter alia*, that "All contracts or agreements by way of wagering shall be null

and void is analogous to Section 30 of the Indian Contract Act, 1872." However, Section 63 of England's Financial Services Act, 1986 provides a safeguard in this regard by way of an overriding provision."

17. In view of the fact that some of the representatives particularly from the Stock Exchanges had expressed their apprehensions to the effect that in the absence of an overriding provision, the futures contracts could be entangled in legal controversies, the Committee are of the view that there is no harm in having such an overriding provision as a matter of abundant caution. They therefore, suggest that under Clause 2 of the proposed Bill the following provision be incorporated :—

"Notwithstanding anything contained in any other Act, contracts in derivatives as per this Act shall be legal and valid."

18. The Committee note that L.C. Gupta Committee has throughout its report stressed the need for close monitoring and has emphasized on exchange level regulations. It has recommended that a derivatives exchange should be designed right from the very inception as a competent and effective regulatory organisation. It has also been recommended that all the exchange level regulations have to be much stricter for derivatives trading than the existing regulations for cash trading. Besides, in view of the fact that the derivatives trading, clearing, settlement, margining, reporting and monitoring all involve the application of most modern on-line screen-based system, the exchanges should be designed to be both fool-proof and fail-proof. It has also been stressed in the report that every derivative trader/member should be inspected by the derivative exchange annually, both to provide guidance in the initial years and to check compliance.

19. In view of the above, the Committee are convinced that the Stock Exchanges which are presently working shall be better equipped to undertake trading in derivatives in a sophisticated environment. Most of these exchanges have already been modernised having state-of-the-art technology, the facility of depository and clearance house and moreover, since they are in a better position to handle the risk profiles of the retail investors, institutional investors and corporate bodies, it would be prudent to allow trading in

derivatives by such exchanges only. The Committee, therefore, propose that the following explanation may be added under the proposed clause 2(aa):

“Explanation : The derivative shall be traded and settled on the Stock Exchange and Clearing House of the Stock Exchange respectively in accordance with the Rules and Bye-Laws of the Stock Exchange.”

Collective Investment Schemes

20. The Committee find that “Collective Investment Schemes”, have nowhere been defined in the proposed Bill. When asked whether it is necessary to define the “Collective Investment Schemes” to be included under Section 2 of the Securities Contracts (Regulation) Act, 1956, the Finance Ministry in their reply, *inter alia*, have stated as follows :

“Collective Investment Schemes” is a generic term, it finds mention under Section 11 and 12 of the SEBI Act, 1992, wherein powers and functions of SEBI, especially those relating to grant of certificate of registration, has been laid down. The Central Government, vide its Press Release dated November 18, 1997, specified that Schemes through which instruments such as agro-bonds, plantation bonds etc. are issued would be treated as Collective Investment Schemes coming under the provisions of the SEBI Act. In the inclusive definition of ‘Securities’ under Section 2(h) of the Securities Contracts (Regulation) Act, 1956, the Government under sub-section (iia) has the powers to declare such instruments to be securities.”

21. Incidentally, the Dave Committee constituted to frame the regulations for Collective Investment Schemes has defined Collective Investment Schemes as follows :

“Collective Investment Scheme” means any scheme or arrangement:

- (i) with respect to property of any description, the purpose of which is to enable the investors to participate in the arrangements by way of contributions and to receive profits or income or produce arising from the management of such properties or investments made thereof;

- (ii) the contributions of the investors, by whatever names they are called, are pooled, and are utilised solely for the purposes of the scheme or the arrangement;
- (iii) the property or such contributions is managed as a whole on behalf of the investors, whether or not such properties or contributions and the investments made thereof are evidenced by identifiable properties or otherwise or;
- (iv) the investors do not have day to day control over the management/operation of the property/scheme.

The following arrangements are not Collective Investment Schemes.

- (i) Acceptance of deposits by companies under Section 58A of the Companies Act, 1956 and Non-Banking Financial Companies (NBFCs) as defined under section 45-I of the RBI Act, 1934;
- (ii) Acceptance of fund by chit funds in terms of Chit Funds Act, 1982;
- (iii) Acceptance of fund by nidhi companies from its members as per direction of the Central Government issued under section 637A of the Companies Act;
- (iv) Contracts of insurance under the Insurance Act, 1938;
- (v) Any scheme of the employer for the benefit of its employees under the Provident Fund Scheme as per Employees' Provident Fund and Miscellaneous Provision Act, 1952;
- (vi) Arrangements of building societies or cooperative societies under Cooperative Societies Act, 1912 including Cooperative Societies under State Legislation;
- (vii) Any other schemes as may be declared as such by Securities and Exchange Board of India including mutual funds registered under the SEBI (Mutual Funds) Regulations, 1996.

22. The purpose of the legislation is only to include the products of Collective Investment Schemes as security so that the market develops in an organised way and the products are brought within

the purview of the regulator. The amendment Bill has been drafted with this end in view. As the Draft Regulations framed by the Dave Committee constituted by SEBI to frame the regulations for collective investment schemes has defined the term "Collective Investment Schemes" exhaustively, it may not be necessary to define it in the Securities Contracts Regulation Act. The Dave Committee, to avoid any ambiguity, has also indicated what arrangements are not collective investment schemes. It is, therefore, felt that no changes are required in the proposed legislation.

23. The Committee note that under the SEBI Act, 1992, SEBI has been empowered to regulate Collective Investment Schemes. Recently, many companies especially Plantation companies have been raising capital from the investors under such schemes. Reports of small retail investors having been duped by some of such companies have also appeared in the Press, however, in the absence of any proper regulatory framework it has not been made possible to either keep a check on the dubious activities of such companies or to allow an orderly development of this market with a view to protect the vital interests of the investors. Though in the proposed Bill, it has been suggested to widen the definition of securities so as to include instruments as well as units of collective Investment Schemes under these, but the Committee are of the considered view that absence of the proper definition will always leave scope for different interpretation which may further lead to legal wrangles in the courts.

24. The Committee are therefore not inclined to accept the contention put forward by the Ministry in this regard and they are of the opinion that there is a need to define 'Collective Investment Schemes' clearly in the Act itself. In this connection, they have examined the spirit and content of the definition endorsed by Dave Committee which is exhaustive enough. They, therefore, recommend that a definition suitably worded in consonance with the definition recommended by Dave Committee should also be included under Section 2 of the principal Act. They also desire that in order to protect the interests of particularly small investors, SEBI must ensure close monitoring of such schemes.

Clause 3 – power to delegate

25. Under Clause 3 of the Bill, it is proposed to substitute Section 29A of the principal Act relating to delegation of powers.

At present, the Government can delegate the powers to the Securities and Exchange Board of India whereas it has now been proposed under the Bill to delegate powers to the Reserve Bank of India also.

26. Commenting on the issue whether there should be a single organisation invested with regulatory powers to overcome the problems of co-ordination and free exchange of relevant information between SEBI and RBI, the Ministry of Finance in their written note have stated as under:

“SEBI has been established to protect the interest of investors in securities and to promote the development of and to regulate the securities market. SEBI being the exclusive regulator of the securities market, it is logical that SEBI also supervises the market for derivatives of securities. L.C. Gupta Committee has however, recommended a formal mechanism in respect of all financial derivatives markets for coordination between RBI and SEBI. The Ministry of Finance already has such an arrangement called High Level Committee on Capital Markets where the Governor, RBI is the Chairman and the Finance Secretary and the Chairman, SEBI are the members. The derivatives will be traded on a recognised stock exchanges under the provisions of Securities Contract (Regulation) Act and would be regulated by SEBI. As regards exposure to the derivatives by the participants such as banks, public sector, mutual funds etc. RBI may limit their exposures. Therefore, there is no need to set up a single regulatory organisation.”

27. The Committee note that the CRB and the Barings fiasco took place due to coordination lapses and jurisdictional overlapping among various regulatory bodies. They are, therefore, of the view that there is an imperative need to have a mechanism in existence which besides acting as a watch dog can also act as an effective co-ordinating body between the SEBI and the RBI. The High Level Committee which is already in existence should therefore be further broad based by including the representatives of the Ministry of Law, Justice and Company Affairs and should meet at least once in a month in order to exercise due control and monitoring over the regulatory bodies.

28. In addition to the modifications/amendments suggested above, the Committee also recommend the following :

“The Committee note that the L.C. Gupta Committee with a view to familiarise the brokers/dealers with derivatives trading and to minimise the possibility of risk due to ignorance, has recommended that the trading member/clearing member should have at least two persons (authorised dealer and sales person) who have passed the certification examination approved by SEBI. The Committee have been informed that National Stock Exchange has conducted many training programmes alongwith the Institute of Chartered Accountants, Institute of Company Secretaries of India and NSE Trading Member in various cities across the country. Trading members of NSE have also been trained on the finer aspects of using these products. NSE has commenced a completely automated examination for the first time in India. This certification testing is currently available in five cities in India *viz.* Mumbai, Delhi, Calcutta, Chennai and Hyderabad.”

29. The Committee are of the view that derivatives trading requires a critical mass of sophisticated investors supported by credit and stock analysts. In view of the fact that education of investors, participants and trading members is of vital importance and qualifying the certification examination enables a person to test his knowledge in the field of derivatives including concepts, strategies legal and regulatory framework, client servicing, trading, clearing, settlement, accounting and taxation etc., there is a need to popularise this programme further. The Committee therefore desire that SEBI should in consultation with the Stock Exchanges endeavour to conduct the certificate programme on derivatives trading in other parts of the country also with a view to educate the investors and market players.

30. Elucidating in response to a query regarding the kind of steps that would be taken to protect the small investors, the Ministry of Finance in their written note have, *inter alia* stated as follows :

“Adequate precautions have been taken to protect the interests of small investors. The minimum value of the derivative contract has been fixed as Rs. 1 lakh which will virtually eliminate the participation of very small investors. The investor money will be completely segregated from the brokers’ fund and will not be available for set off against any shortfall of trading member/clearing member or any other client. A risk disclosure document

would be issued by the trading/clearing member to the investors before he enters the derivatives market which will make him aware of the risk associated with the derivatives trading. The investor complaints and arbitration cases would be resolved from all the four regions of the country thereby providing easy access to the investors of redressal of disputes and complaints, if any. The derivatives exchange will have to disseminate information relating to prices and trades on-line through at least two information vending agencies for enabling the investors to take an informed decision. The contract note issued to the client will bear the time stamping for order entry, order execution and prices. The investor will also be given the trade confirmation slips generated through the trading system. There is a separate investor protection fund to protect the interests of investors so that they have adequate protection for their money and have access to all information relevant for taking decisions in the derivatives market."

31. The Committee keeping in view the swift movement of funds from one account to another and the technical intricacies involved in every derivatives transaction are of the opinion that there is a need to protect particularly the small investors by preventing them from venturing into options and futures market, who may be lured by the sheer speculative gains. They therefore recommend the threshold limit of the derivatives transactions should be pegged not below Rs. 2 lakhs.

32. While delving on the need for setting up back office accounting standards for intermediaries, investors including corporates in derivatives market, the Stock Exchange, Mumbai through a written note pointed out that SEBI had set up Professor J.R. Varma Committee to assess risk involved in trading derivatives specifically index futures and to assess risk management measures for the same. SEBI has also made it mandatory for all Stock Exchanges desirous of starting derivatives trading to implement the observations of Professor J.R. Varma Committee Report in toto as a pre-condition for giving permission to such Exchanges. However, the issue of having accounting standards for investors/dealers in derivatives and also back office standards for intermediaries could not be deliberated upon in the Committee. They have, therefore, suggested that it is essential that back office and accounting standards for intermediaries and brokers be formulated in detail by SEBI in consultation with the Stock Exchanges and the Institute of Chartered Accountants of India. It is also imperative that these standards are applied uniformly by each

Exchange on their respective members who are members of the derivatives segment. Same is the need in the case of public limited companies which choose to deal in derivatives.

33. The Committee are in agreement with the views expressed above and are of the considered opinion that there is an urgent need to prescribe pronounced accounting standards in the case of investors/dealers and also back office standards for intermediaries with a view to reducing the possibility of concealing the loss and perpetrating the frauds by companies/intermediaries to a minimum. The Committee also note that the need of accounting disclosure had also been recognised by L.C. Gupta Committee. They, therefore, recommend that the Institute of Chartered Accountants of India, in consultation with the Stock Exchanges formulate suitable accounting standards and SEBI should prescribe the same before trading in derivatives is commenced.

34. The Committee have been informed that the derivatives transactions would attract the stamp duty as in the case of underlying securities market. A viewpoint has been expressed that if the existing stamp duty rates are charged then trading in index futures will be a costly proposition when compared to the international trading norms. This will also render the trading in derivatives uneconomical and result in stifling the growth of futures market from its very inception. It has therefore been suggested that the Government should exempt the derivatives contract from imposition of stamp duty. In this connection, the Ministry of Finance have stated in a written note submitted to the Committee that "we are moving gradually towards trading in securities in the dematerialised form in the cash market where the stamp duty in respect of equity transactions has been exempted. The issue of exemption of derivatives contract from payment of stamp duty as in the case of dematerialised transactions in underlying securities would be taken up separately".

35. The Committee desire that the Government should give a serious thought to the viewpoint expressed above and consider exempting derivatives transactions from the imposition of the stamp duty.

NEW DELHI;
10 March, 1999

19 Phalgun, 1920 (Saka)

MURLI DEORA,
Chairman,
Standing Committee on Finance.

NOTE OF DISSENT

Dr. Biplab Dasgupta, MP

This bill intends to regulate, as well as legalise, trading on derivatives. Trading on derivatives includes two elements—it is a hedging operation, to provide the holder of a security some floor in case his speculation does not work, and a speculative one to profit from the misjudgement of others. Till now trading in derivatives occupies a small part of the Indian share market. Share market itself is not new, but until 1991 no government sought to make it the main source of funding for the industries and other activities, by way of setting up new institutions and providing fiscal investment to transactions in the capital market.

Over the past few years we have seen how, despite the strong patronage of the government, the capital market has not developed at the rate desired by the Indian government, and, after an initial flush of enthusiasm, the common people with some money for saving are shying away from the capital market. This is reflected in the share prices indices. The claim made in the statement of objects of the bill about “substantial improvement in the functioning the capital market”, would be contested by many experts as also by the ground level reality itself. It is being asked whether the policy of the government since 1991 is right when the countries of East Asia were relying for the lion’s share of their industrial funding on the banks during their course of development. The current currency crisis in South East Asia is attributed by many to a move away from the banking norms, following the pressure for widening globalisation from the World Bank and IMF, to rely on non-banking sources and to participate more actively in speculative activities. In this situation, it was necessary for the government to take into account various global experiences with share market and derivatives, reassess its policy towards share markets as a source of industrial funding, and not to encourage further speculation in derivatives market.

Options and future market is highly sophisticated and at the same time a high-risk area like full convertibility of the Indian currency in

the capital account. These instruments have evolved in the capitalist developed countries after a long period of development of the capital market itself. Again, like full currency convertibility, this is a new experience in the developed countries—of about two decades. We should not copy those mechanically just because these are fashionable in the west. Their own experience in this is limited, and our own capital market is comparatively new in age and experience. This issue is separate from the question of how collective investment schemes of the plantations should be controlled by SEBI

Best wishes,

Sincerely Yours

Sd/-
(Dr. Biplab Dasgupta)

APPENDIX I

MINUTES OF THE THIRTEENTH SITTING OF THE STANDING COMMITTEE ON FINANCE (1998-99)

The Committee sat on Tuesday, 25 August, 1998 from 1500 hrs. to 1645 hrs.

PRESENT

Shri Murli Deora — *Chairman*

MEMBERS

Lok Sabha

2. Shri Girdhari Lal Bhargava
3. Shri Bhagwan Shanker Rawat
4. Shri Rayapati Sambasiva Rao
5. Shri Kavuru Sambasiva Rao
6. Shri Prithviraj D. Chavan
7. Shri Magunta Sreenivasulu Reddy
8. Shri Rupchand Pal
9. Shri Varkala Radhakrishnan
10. Shri Tathagata Satpathy
11. Dr. Bikram Sarkar
12. Shri Joachim Baxla
13. Shri Buta Singh

Rajya Sabha

14. Dr. Manmohan Singh
15. Shri N.K.P. Salve

16. Shri M. Rajsekara Murthy
17. Shri O.P. Kohli
18. Shri Raghavji
19. Dr. Biplab Dasgupta
20. Shri C. Ramachandraiah
21. Shri Prem Chand Gupta
22. Shri R.K. Kumar
23. Shri Gurudas Das Gupta
24. Shri Suresh A. Keswani

SECRETARIAT

- | | | |
|----------------------------|---|---------------------------|
| 1. Dr. (Smt.) P.K. Sandhu | — | <i>Director</i> |
| 2. Shri S.B. Arora | — | <i>Under Secretary</i> |
| 3. Shri N.S. Hooda | — | <i>Assistant Director</i> |

2. At the outset the Chairman welcomed the Members to the sitting of the Committee and invited their suggestions with regard to the modalities to be adopted for examining the Bills referred to the Committee for detailed examination.

** ** ** **

3. The Committee after deliberations; desired that since each of the Bills referred to the Committee required in-depth examination, detailed preliminary/background material may be procured from the respective Ministries.

** ** ** **

In order to have the benefit of wide ranging views on various provisions of (i) The Foreign Exchange Management Bill, 1998, (ii) The Prevention of Money Laundering Bill, 1998 and (iii) The Securities Contracts (Regulation) Amendment Bill, 1998, the Committee decided

to issue a Press Communique for inviting suggestions/views/memoranda from the public, experts, Chambers of Industry and interested Organisations/Parties/individuals on these Bills. It was also decided that in order to save time the Members of the Committee desirous of giving their suggestions with regard to the provisions of the Bill may send the same to the Secretariat.

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|----|----|----|----|----|
| 4. | ** | ** | ** | ** |
| 5. | ** | ** | ** | ** |
| 6. | ** | ** | ** | ** |
| 7. | ** | ** | ** | ** |

The Committee then adjourned.

APPENDIX II

MINUTES OF THE TWENTY FOURTH SITTING OF THE STANDING COMMITTEE ON FINANCE (1998-99)

The Committee sat on Wednesday 6 January, 1999 from 1100 hrs. to 1330 hrs. and again from 1500 hrs. to 1740 hrs.

PRESENT

Shri Murli Deora — *Chairman*

MEMBERS

Lok Sabha

2. Shri Dhirendra Agarwal
3. Shri Haribhai Parathibhai Chaudhary
4. Shri Uttam Singh Pawar
5. Shri Girdhari Lal Bhargava
6. Shri Bhagwan Shanker Rawat
7. Shri Rayapati Sambasiva Rao
8. Shri Kavuru Sambasiva Rao
9. Shri Prithviraj D. Chavan
10. Shri Magunta Sreenivasulu Reddy
11. Shri Rupchand Pal
12. Shri Beni Prasad Verma
13. Shri S. Murugesan
14. Shri M. Sahabuddin
15. Shri Tathagata Satpathy
16. Kum. Kim Gangte

17. Shri S. Jaipal Reddy
18. Shri Joachim Baxla
19. Shri Buta Singh

Rajya Sabha

20. Dr. Manmohan Singh
21. Shri N.K.P. Salve
22. Shri M. Rajsekara Murthy
23. Shri Narendra Mohan
24. Dr. Biplab Dasgupta
25. Shri C. Ramachandraiah
26. Shri Amar Singh
27. Shri Prem Chand Gupta
28. Shri R.K. Kumar
29. Shri Gurudas Das Gupta
30. Shri Satischandra Sitaram Pradhan
31. Shri Suresh A. Keswani

SECRETARIAT

1. Dr. (Smt.) P.K. Sandhu — *Director*
2. Shri N.S. Hooda — *Assistant Director*

WITNESSES

1100 hrs.

I. National Stock Exchange of India Ltd. (NSE)

1. Shri S.H. Khan — **Chairman**
2. Dr. R.H. Patil — **Managing Director**
3. Shri Ravi Narayan — **Dy. Managing Director**

II. The Stock Exchange, Mumbai (BSE)

1. Shri R.C. Mathur — Executive Director
2. Shri Himanshu Kaji — Member

III. Delhi Stock Exchange Association Ltd. (DSE)

1. Shri S.S. Sodhi — Executive Director

IV. Unit Trust of India (UTI)

1. Shri P.S. Subramanyam — Chairman
2. Dr. B. Sen — Executive Director

V. Expert

1. Shri G.S. Patel — Former Chairman, UTI
1500 hrs.

I. Ministry of Finance

1. Dr. Vijay L. Kelkar — Finance Secretary
2. Dr. U. Saratchandaran — Joint Secretary, CM&ECB
Division

II. Securities and Exchange Board of India (SEBI)

1. Shri D.R. Mehta — Chairman
2. Shri O.P. Gahrotra — Sr. Executive Director
3. Smt. D.N. Raval — Executive Director
4. Shri Pratip Kar — Executive Director
5. Smt. Anita Kapur — Regional Manager

III. Reserve Bank of India (RBI)

1. Shri Jagdish Capoor — Deputy Governor
2. Shri Khizer Ahmed — Executive Director
3. Shri Amalendu Ghosh — Chief General Manager
4. Smt. Usha Thorat — Chief General Manager

Part - I

2. At the outset, the Chairman welcomed the representatives of National Stock Exchange of India Ltd. (NSE), The Stock Exchange, Mumbai (BSE), Delhi Stock Exchange Association Ltd. (DSE), Unit Trust of India (UTI) and Sh. G.S. Patel, Former Chairman, UTI to the sitting of the Standing Committee on Finance and invited their attention to the provisions of Direction 55 of the Directions by the Speaker, Lok Sabha.

3. The Committee then heard the views of the representatives of the above mentioned Stock Exchanges, Unit Trust of India and Shri G.S. Patel on the Securities Contracts (Regulation) Amendment Bill, 1998.

The Evidence was concluded.

A verbatim record of the proceedings was kept.

(The witnesses then withdrew).

The Committee then adjourned to meet again at 1500 hrs.

Part - II

2. The Committee resumed their sitting at 1500 hrs. to take further oral evidence on the Securities Contracts (Regulation) Amendment Bill, 1998.

3. The Chairman welcomed the representatives of Ministry of Finance, SEBI and RBI to the sitting of the Committee and invited their attention to the provisions of Direction 55 of the Directions by the Speaker.

4. The Committee then took the oral evidence of the representatives of the Ministry of Finance, SEBI and RBI on the Securities Contracts (Regulation) Amendment Bill, 1998.

The Evidence was concluded.

A verbatim record of the proceedings was kept.

(The witnesses then withdrew).

The Committee then adjourned.

APPENDIX III

MINUTES OF THE THIRTY SECOND SITTING OF THE STANDING COMMITTEE ON FINANCE (1998-99)

The Committee sat on Wednesday, 10 March, 1999 from 1700 to 1740 hrs.

PRESENT

Shri Murli Deora — *Chairman*

MEMBERS

Lok Sabha

2. Shri Haribhai Parathibhai Chaudhary
3. Shri Bhagwan Shanker Rawat
4. Shri Rayapati Sambasiva Rao
5. Shri Kavuru Sambasiva Rao
6. Shri Sandipan Bhagwan Thorat
7. Shri R.L. Jalappa
8. Shri Magunta Sreenivasulu Reddy
9. Shri Varkala Radhakrishnan
10. Shri S. Murugesan

Rajya Sabha

11. Dr. Manmohan Singh
12. Shri N.K.P. Salve
13. Shri M. Rajsekara Murthy
14. Shri Narendra Mohan
15. Shri Raghavji

16. Shri Prem Chand Gupta
17. Shri R.K. Kumar
18. Shri Gurudas Das Gupta
19. Shri Suresh A. Keswani

SECRETARIAT

- | | | | |
|---------------------------|----|---------------------------|----|
| 1. Dr. (Smt.) P.K. Sandhu | — | <i>Director</i> | |
| 2. Shri N.S. Hooda | — | <i>Assistant Director</i> | |
| 2. | ** | ** | ** |

3. Thereafter, the Committee, took up for consideration the draft Report on the Securities Contracts (Regulation) Amendment Bill, 1998. The Committee, after deliberation, adopted the draft Report with minor modifications/changes.

4. The Committee then authorised the Chairman to finalise the Report and present the same to the Parliament.

The Committee then adjourned.

APPENDIX IV

AS INTRODUCED IN LOK SABHA

Bill No. 73 of 1998

THE SECURITIES CONTRACTS (REGULATION)
AMENDMENT BILL, 1998

A

BILL

*further to amend the Securities Contracts
(Regulation) Act, 1956.*

BE it enacted by Parliament in the
Forty-ninth Year of the Republic of
India as follows :—

1. (1) This Act may be called the
Securities Contracts (Regulation)
Amendment Act, 1998.

Short title and
commencement.

(2) It shall come into force on such
date as the Central Government may,
by notification in the Official Gazette,
appoint.

2. In section 2 of the Securities
Contracts (Regulation) Act, 1956
(hereinafter referred to as the principal
Act),—

Amendment of
section 2.

42 of 1956.

(a) after clause (a), the following
clause shall be inserted namely:—

“(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;'

(b) in clause (h), after sub-clause (i), the following sub-clauses shall be inserted, namely:—

“(ia) derivative;

(ib) units or any other instrument issued by any collective investment scheme to the investors in such schemes;”.

Substitution of new section for section 29A.

3. For section 29A of the principal Act, the following section shall be substituted, namely:—

Power to delegate.

“29A. The Central Government may, by order published in the Official Gazette, direct that the powers (except the power under section 30) exercisable by it under any provision of this Act shall, in relation to such matters and subject to such conditions, if any, as may be specified in the order, be exercisable also by the Securities and Exchange Board of India or the Reserve Bank of India constituted under section 3 of the Reserve Bank of India Act, 1934.”.

2 of 1934.

STATEMENT OF OBJECTS AND REASONS

In the last few years there have been substantial improvement in the functioning of the capital market. As the market grows, there is a demand for different instruments which would enable the investors to diversify as well as control the different risks in the capital market. One such demand relates to option and future market where investors can diversify their risks. The new instruments in capital market would not only help in diversification of risks but also strengthen and deepen the cash market. Thus there is an urgent need to include the derivatives as securities in the Securities Contracts (Regulation) Act, 1956 whereby trading in derivatives may be possible within the framework of that Act.

2. Recently many companies especially plantation companies have been raising capital from investors through schemes which are in the form of collective investment schemes. However, there is no regulatory framework to allow an orderly development of this market. In order that the interest of investors is protected, it has been decided that the Securities and Exchange Board of India would frame regulations with regard to collective investment schemes. It is, therefore, proposed to amend the definition of "securities" so as to include within its ambit the derivative and the units or any other instrument issued by any collective investment scheme to the investors in such schemes.

3. In addition to above, it is also proposed to substitute section 29A of the aforesaid Act relating to delegation of powers. At present powers can be delegated to the Securities and Exchange Board of India: It is now proposed to delegate powers to the Reserve Bank of India also.

4. The Bill seeks to achieve the above objects.

NEW DELHI;
The 23rd June, 1998.

YASHWANT SINHA.

ANNEXURE

EXTRACTS FROM THE SECURITIES CONTRACTS (REGULATION) ACT, 1956
(42 OF 1956)

* * * * *

Definitions.

2. In this Act, unless the context otherwise requires,—

* * * * *

(h) "securities" include—

* * * * *

Power to delegate.

29A. The Central Government may, by order published in the Official Gazette, direct that the powers exercisable by it under any provision of this Act shall, in relation to such matters and subject to such conditions, if any as may be specified in the order, be exercisable also by the Securities and Exchange Board of India.

* * * * *

LOK SABHA

A

BILL

further to amend the Securities Contracts (Regulation) Act, 1956.

(Shri Yashwant Sinha, Minister of Finance)