Regulatory Framework of Derivative Trading in India

Subeesh V. K.[1], Liya K[2]

[1]Assistant Professor, SARBTM Govt. College, Koyilandy
[2]Assistant Professor, [2]CKGM Govt. College, Perambra

Abstract:
Important functions carried out by derivatives include market efficiency, underlying asset deal price discovery, and risk mitigation through hedging. The significance of derivatives is demonstrated by the daily growth in trading volume. By examining pertinent literature in the field of derivative markets, this study seeks to determine India's derivative trading regulatory structure. A combination of contractual, self-regulatory, franchising, and command control mechanisms govern derivatives trading in India.

1. Introduction and methodology

The worldwide 'derivative market' has grown exponentially during the previous decade (Palathara & Yadukrishnan, 2020). Derivatives perform critical purposes such as risk mitigation through hedging, market efficiency, and underlying asset deal price discovery. Derivatives are financial products that derive their value from some other asset called the underlying asset (Srivastava, 2014). The Underlying asset can be a stock index, a stock, a commodity such as pepper, or even a complex characteristic such as the interest rate. Derivatives were first developed as risk management tools, but now the majority of people use them to make speculative gains, increasing their popularity. The volume of derivatives trading is expanding every day, indicating the importance of derivatives. This study aims to identify the regulatory framework of derivative trading in India based on reviewing relevant literature in the area of derivative markets.

2. Findings and Discussions

Financial derivatives were first introduced in the nation in June 2000, despite the fact that carry forward of positions and weekly settlement had allowed for the existence of a quasi-forward market for more than a century (Gupta, 2017). There were a number of factors which contributed to the development of a regulatory framework for trading Derivative Instruments in India. The first trade in derivatives was a culmination of legislative and legal efforts which had begun as early as 1995. In 1995, SEBI appointed a committee for exploring issues in the introduction and creating a regulatory framework for a derivative market (Gupta, 2017). L. C. Gupta Committee (1996) recommended that proper regulatory initiatives should provide for a clear description of the concept of Derivatives, how they should provide for market efficiency and remove the differences in the trading cycles of different stock exchanges, improve administrative and monitoring machinery and the acceleration of progress towards a Depository System.

Soon after independence, Forward Contracts (Regulation) Act, 1952 and Securities Contract (Regulation) Act, 1956 were enacted in quick succession in India, and the objectives of these Acts, interestingly, were to prevent undesirable transactions in securities by regulating the business of dealing therein, "by prohibiting options and by providing for certain other matters connected therewith". There were specific provisions in these statutes, which prohibit the trading of certain financial derivative products. However, trading in such financial derivatives continued in the grey market throughout this period.

Derivative trading in India is currently regulated by three agencies, namely the Securities and Exchange Board of India (SEBI), Forward Markets Commission (FMC), and Reserve Bank of India (RBI). The derivatives can be classified into two categories: Commodities Derivatives and Financial Derivatives. In India, the statutory basis for regulating commodity derivative trading is enacted through the Forward Contract Regulation Act

(FCRA), 1953 which has laid down certain fundamental ground rules. Under this Act, a permanent regulatory body known as Forward Markets Commission is also created which carries out its functions through the recognized associations and holds the overall charge of regulation of all forwards in commodities specifically. The SEBI is entrusted to regulate the carry-forward trading on the stock market and other financial derivatives like, equity stock, stock index, options, etc. through recognized stock exchanges of the country. Over-the-counter (OTC) forward contracts and options on foreign currencies are regulated by the Reserve Bank of India (Gupta, 2017). There is also a level of self-regulation among the market players. However, each of these regulators plays on a different turf, for example, Reserve Bank of India is concerned with only the activity of banks and Non-Banking Financial Companies (NBFCs) in dealing with derivative instruments; whereas other companies dealing in derivatives are being controlled by SEBI (Varghese, 2011).

In India, derivatives trading is regulated by a mixture of command control, franchising, contractual and self-regulatory mechanism. As already mentioned, the Securities Contract (Regulation) Act 1956 (SCRA), the Forward Contracts (Regulation) Act, 1952, Depositories Act, 1996 and certain provisions of the Companies Act, 1956 provide the statutory backbone for derivatives regulation. However, it is worth noting that apart from creating a regulator and entrusting the duty of regulating derivatives to the regulator, these statutes do not deal with the regulation of derivatives in great respect (Varghese, 2011).

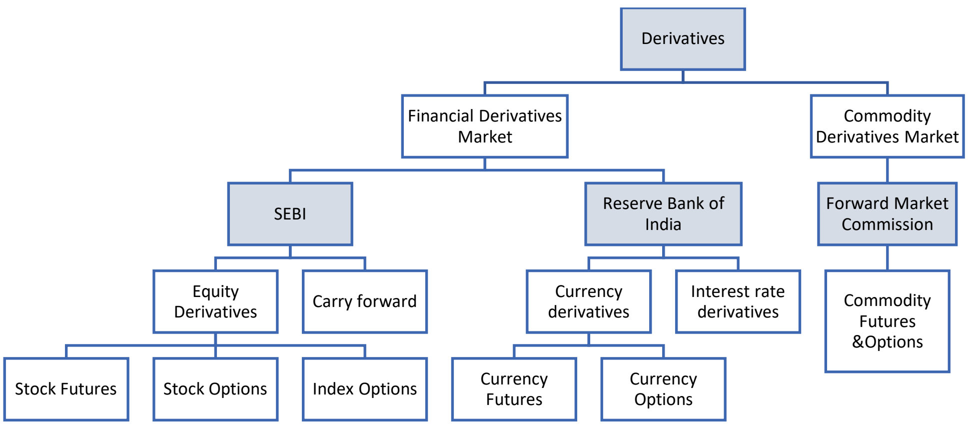
While Section 17 of SCRA entrust the regulatory responsibility of certain types of derivatives to SEBI, Sections 20, 21 and 21A of the Reserve Bank of India Act, 1934 empowers RBI as the regulator in respect of certain government securities market and also regulate the major players in the derivatives banks-the financial institutions (Varghese, 2011).

SEBI has created certain Self-Regulatory Organisations (SROs) which are non-governmental bodies with the responsibility to regulate their members through a set of rules of conduct for fair, ethical and efficient practices. SEBI also exercises its regulatory oversight through Stock Exchanges. Stock Exchanges are bodies created by cooperation among market players and the SEBI generally maintains tight regulatory oversight over these marketplaces. These bodies like the National Stock Exchange, Bombay Stock Exchange (BSE), Multi Commodities Stock Exchange (MCX) etc, act as franchisees to SEBI to enforce regulation of players in the derivatives market through a process of listing contracts, rules and guidelines (Varghese, 2011).

The commodities market is regulated by yet another regulator, Forwards Market Commission (FMC) which, unlike SEBI and RBI is not a statutory body but a department of Ministry of Consumer Affairs. FMC exercises considerable powers under Forwards Contract (Regulation) Act, 1952 regarding futures and options trading in commodities, (which is a variant of derivatives) and exercises its control both through command and control mechanism as well as through franchising regulatory duties to commodities exchanges like MCX etc., (Varghese, 2011). Figure 3.1 illustrated the regulatory framework of derivatives trading in India.

Figure 3.1

Regulatory Framework of Derivatives Trading in India



Source**:** Gupta, (2017)**,** Varghese, (2011)

3. Conclusion

In India, derivatives trading is regulated by a mixture of command control, franchising, contractual and self-regulatory mechanism. Derivative trading in India is currently regulated by three agencies, namely the Securities and Exchange Board of India (SEBI), Forward Markets Commission (FMC), and Reserve Bank of India (RBI). The commodity derivative trading is regulated by the Forward Market Commission, whereas the trading of stock and other financial derivatives is regulated through Securities Exchange Board of India (SEBI). Over-the-counter (OTC) forward contracts and options on foreign currencies are regulated by the Reserve Bank of India.

References

1. Gupta, S. L. (2017). Financial Derivatives - Theory Concepts and Problems (Second Edi). PHI Learning Private Limited.
2. Palathara, D. J. S., & Yadukrishnan, V. (2020). A Study on Recent Trends in Derivative Markets in India. International Journal of Advance Research and Innovative Ideas in Education, 6(3), 1743–1751. https://doi.org/10.31142/ijtsrd23902
3. Srivastava, R. (2014). Derivatives and Risk Management. Oxford University Press.
4. Varghese, J. (2011). Regulation of Financial Derivatives: Some Policy Considerations. The IUP Law Review, 1(3), 27–42. https://ssrn.com/abstract=2063695