

# Views of Brokers on Derivatives Trading in India: Issues and Challenges

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## Abstract

The purpose of the paper is to review the development of derivatives market in India and the regulatory framework for derivatives trading in India. It also highlights the views of brokers on derivative market. This study is based on the primary data. The data has been collected from brokers of NSE to highlight the issues faced by them in the market. The paper will be of value to those interested in evaluating a successful and sound trading environment of derivative products in Indian market. The finding shows that there are some challenges in Indian regulatory framework of derivative trading like accounting for derivatives, institutional participation, pricing and valuation of derivative securities, cross margining. This could be due to current volume of trade, variety of users and range of purposes for which they are being used.

**Keywords:** Regulation, Legislation, Derivative markets, risks.

**JEL Classification:** G00

## Introduction

Derivative exchange contributes to the development of the financial infrastructure of a country by providing the links among cash markets, hedgers and speculators. Attention to derivatives is justified on the enormous levels of global trading for both exchange — traded products and over the counter products. The derivatives are one of the categories of risk management tools. The primary function of derivatives market is to facilitate the transfer of risk among economic agent by offering mechanism for liquidity and price discovery (Tsetsekos and Varganis, 1997). The derivatives help to assist the business growth by disseminating effective price signals concerning exchange rates, indices and thereby render both cash and derivatives market more efficient. Expanded use of derivatives has prompted expression alarm from some legislators and regulators and the members of the press about the risks this new global activity poses to corporations, global capital markets and the overall economy (Culp and Mackay, 1997). The popular press has also dealt with derivatives market by reporting the risks caused by derivative trading and the regulation of derivatives markets (Herz (1993), Jordan (1995)).

As per International Accounting Standard (IAS) 39, a derivative is a financial instrument:

- (a) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or similar variable (Sometimes called the ‘underlying’);

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- (b) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and
- (c) that is settled at a future date.

For example, rice farmers may wish to sell their harvest at a price which they consider is 'safe' at a future date to eliminate the risk of a change in prices by that date. To hedge their risks, farmers can enter into a forward contract and any loss caused by fall in the cash price of rice will then be offset by profits on the forward contract.

There are four commonly traded derivative instruments (Durbin, 2008):

1. **Forward contract:** It is an agreement to buy or sell an asset at a certain future time for certain price. These contracts are entered between two financial institutions or between financial institution and its corporate client. These are traded at OTC (Over the counter).
2. **Future contract:** A financial future contract is an agreement between two parties to buy or sell standard quantity of specific asset at a future date at a price agreed between the parties through an organized future exchange. The future contract are standardized in terms of : quantity of underlying, the date and month of delivery, the units of price quotation, and minimum change in price (tick- size), location of the settlement.
3. **Option:** The holder of option has the right, but not the obligation, to buy or sell the underlying asset at the fixed rate on date in the future. In the case of a European option, the owner has the right to require the sale to take place on (but not before) the maturity date; in the case of an American option, the owner can require the sale to take place at any time up to the maturity date.
4. **Swap:** A swap can be defined as financial transaction in which two counter parties agree to exchange the streams of payment or cash flows, over a time.

## Development of Derivative in India

The trading of derivative securities commenced in India after much debate over the introduction of derivatives to hedge the risks posed by the securities and a long waiting

period. The National Stock Exchange (NSE) sought permission from the Securities and Exchange Board of India (SEBI) to trade stock index futures in December 1995, but it was only after five years that the first derivative security, i.e., stock index futures, was traded on the exchange. Stock index futures were introduced in June 2000, and thereafter, stock index options in June 2001. The options and futures on individual shares were introduced in July 2001 and November 2001, respectively. Later, more indices and shares were added in this segment. (Table I exhibits chronology of events relating to the development of derivative market in India.) As on December 31, 2009, there were 179 individual shares for which futures and options were traded. They are traded on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) wherein the latter contributes to more than 95 per cent of the total turnover in the derivative market in India (Srivastava *et al.*, 2008).

**Table I** Chronology of Derivative Market in India

Date	Event
14 Dec 1995	NSE wrote to SEBI for permission to trade index future
18 Nov 1996	SEBI formed L C Gupta Committee to develop the appropriate regulatory framework for derivative trading in India
7 Jul 1999	RBI permitted OTC Forward Rate Agreements (FRAs) and Interest Rate Swaps
24 May 2000	Singapore International Monetary Exchange (SIMEX) chose Nifty for trading futures and options on an Indian index
25 May 2000	SEBI permitted NSE and BSE to do index futures trading
9 Jun 2000	Trading of BSE Sensex futures commenced at BSE
12 Jun 2000	Trading of Nifty futures commenced at NSE
25 Sep 2000	Nifty futures trading commenced at Singapore Exchange (SGX)
4 Jun 2001	Index options introduced
2 Jul 2001	Stock options introduced
9 Nov 2001	Stock futures introduced
24 Jun 2003	Interest rate futures introduced

Source: [www.sebi.gov.in](http://www.sebi.gov.in)

Index option and future showed the largest rise. During 2000-2001, index future was introduced and number of

contracts entered in the year was 90580, average daily turnover was Rs 11 crore. Stock future, index option and stock option were introduced in 2001-2002 which increased the average daily turnover to Rs 410 crore which amount to 36 times of previous year turnover. The total turnover on the F&O Segment declined by 15.89 per cent to Rs. 11,010,482 crore during 2008-09 as compared with Rs.13,090,478 crore during 2007-08. The average daily turnover during 2008-09 was Rs.45,311 crore, a year on year decline of 13.12 per cent. The total number

of contracts traded increased by 54.68 crore to 66 crore contracts during 2008-09. Out of the total contracts traded, 33.71 per cent of the contracts were traded on Stock futures followed by index options on which 32.26 per cent of the contracts were traded. Number of contracts traded on Index futures was 32.01 per cent while 2.02 per cent of the total contracts were traded on stock options. As on December 31, 2009, the average daily turnover was Rs. 70844.26 crore. Table II shows the business growth in derivative market.

**Table II Business Growth in Derivatives Segment**

Year	Index future		Stock Futures		Index Options		Stock Options		Total	Average Daily Turnover (Rs. cr.)	
	No. of contracts	Turnover (Rs. cr.)	No. of contracts	Turnover (Rs. cr.)	No. of contracts	Notional Turnover (Rs. cr.)	No. of contracts	Notional Turnover (Rs. cr.)			
2009-10	141815953	3040402.59	110898147	3991311.79	247126260	5641701.75	9961346	361927.76	509801706	13035343.79	70844.26
2008-09	210428103	3570111.40	221577980	3479642.12	212088444	3731501.84	13295970	229226.81	657390497	11010482.20	45310.63
2007-08	156598579	3820667.27	203587952	7548563.23	55366038	1362110.88	9460631	359136.55	425013200	13090477.75	52153.30
2006-07	81487424	2539574	104955401	3830967	25157438	791906	5283310	193795	216883573	7356242	29543
2005-06	58537886	1513755	80905493	2791697	12935116	338469	5240776	180253	157619271	4824174	19220
2004-05	21635449	772147	47043066	1484056	3293558	121943	5045112	168836	77017185	2546982	10107
2003-04	17191668	554446	32368842	1305939	1732414	52816	5583071	217207	56886776	2130610	8388
2002-03	2126763	43952	10676843	286533	442241	9246	3523062	100131	16768909	439862	1752
2001-02	1025588	21483	1957856	51515	175900	3765	1037529	25163	4196873	101926	410
2000-01	90580	2365	-	-	-	-	-	90580	2365	11	

Source: www.nseindia.com

Note:

Notional Turnover = (Strike Price + Premium) \* Quantity

## Risk of the Derivatives Market

A large number of researchers has analyzed accidents in derivative market, including Hong Kong (1987), Baring (1995), Shanghai (1995), Sum it omo (1996), Thai and Indonesian currencies (1997), Korea SK Securities (1998), and China Aviation Oil (2004), which all have revealed important lesson on how derivatives can be misused. There are some types of risk which users have to face while dealing with derivatives:

1. Credit risk: Credit risk is the risk that a loss will be incurred because the party fails to make the payment

due. In the event of default, the loss is the cost of replacing the derivatives contract with a new party.

2. Market risk: It is the risk that the value of a contract, financial instrument, asset, or portfolio will change when market conditions changes. Interest rate risk is a common form of market risk.
3. Liquidity risk: It is the risk that a large transaction in a particular investment could have an adverse impact on its market price.
4. Operational risk: The risk that losses will be incurred as a result of inadequate computer system and

internal controls, inadequate disaster or contingency planning, human error, or management failure.

5. Legal risk: Risk of loss because a contract cannot be enforced. Because of the relative newness of derivatives transaction, their treatment under existing laws and regulation has been ambiguous.

## Legal Framework for Derivative Market in India

Regulation provides legal framework to cover risk. The regulatory framework basically performs three functions. The first is to write regulation which implements statutory obligation. The second is to monitor behavior to determine whether market participants are complying with the rules. The third is to enforce the rules by bringing actions against those who do not comply with the rules (Albrecht, 1995). The regulation of derivatives takes place at two stages:

- 1) Regulation of exchange at level of exchange itself,
- 2) External regulation of derivative exchanges.

The market operators prefer internal control, but it's necessary to have international coordination in order to limit the scope of regulation and supervision (Dixon & Bhandari, 1997)

The development of a market for derivatives was initially not possible in view of prohibitions in the Securities Contracts (Regulation) Act, 1956 (SCRA). The preamble to the Act itself spoke of prohibiting options. Section 20 of the Act explicitly prohibited all options in securities. Under this Act, by a notification in 1969, Government prohibited all forward trading in securities in order to curb unhealthy and to prevent undesirable transactions. Introduction of trading in derivatives required withdrawal of these prohibitions. The Securities Laws (Amendment) Ordinance promulgated on January 25, 1995 withdrew the prohibitions by repealing section 20 of the SCRA and amending its preamble. The market for derivatives, however, did not take off as there was no regulatory framework to govern trading of derivatives. SEBI set up a 24-member Committee in November 1996 under the Chairmanship of Dr. L.C. Gupta to develop an appropriate regulatory framework for derivatives trading in India. The Committee submitted its report in March 1998 prescribing necessary preconditions for the introduction of derivatives trading in India. It recommended that derivatives should be declared as 'securities' so that the regulatory framework applicable to trading of 'securities' could

also govern trading of securities. It also recommended that the 1969 notification should be amended to enable trading in derivatives. SEBI also set up a Group in June 1998 under the Chairmanship of Prof. J. R. Varma to recommend measures for risk containment in derivatives market in India. The Report, which was submitted in October 1998, worked out the operational details of a margining system, a methodology for charging initial margins, broker net worth, deposit requirement and real-time monitoring requirements. On the recommendations of the Committee, definition of securities under the Act was modified to include derivatives under Section 2(h), the Act. The 1969 notification was also repealed on March 1, 2000. Derivatives trading finally went underway at NSE and BSE after getting nod from SEBI to commence index futures trading in June 2000. To begin with, SEBI approved trading in index futures contracts based on S&P CNX Nifty and BSE – 30 (Sensex) index. This was followed by approval for trading in options based on these two indexes and options on individual securities. At BSE, trading in index options based on BSE Sensex commenced in June 2001, the trading in options on individual securities commenced on July 2001 and futures on individual stocks were launched in November 2001. At NSE too, trading in index options based on S&P CNX Nifty commenced in June 2001, trading in options on individual securities commenced in July, 2001 and single stock futures were launched in November 2001.

The Act renders a comprehensive definition on derivatives and even permits trading on derivatives. According to Section 2(aa) of the Act, A '*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 and (b) a contract which derives its value from the prices, index of prices, of underlying securities. Only those derivative products which are traded on a recognized stock exchange and are settled on the clearing house of the recognized stock exchange are legal and valid. Section 18A of the Act is a non-obstante clause and was recommended by the Parliamentary Standing Committee on Finance, which examined the Securities Contracts (Regulation) Amendment Bill, 1998. The object of this provision is that since derivatives, particularly index futures, are cash-settled contracts, they can be entangled in legal controversy by being classified as 'wagering agreements' under Section 30, Indian Contract Act, 1872 and thereby, declared null and void.

For trading in derivatives, permission from SEBI is mandatory (SEBI Notification No. S.O. 184(E), dated March 1, 2000). However, this permission is required for trading in only those derivatives contracts that are tradable and hence, no prior permission is mandatory for OTC derivatives. The Act further prescribes punishment of imprisonment for a term which may extend to one year, or with fine, or with both, in case of contravention of the Section 18A and rules made there under by SEBI or Central Government (Section 23, the Act). Trading and settlement in derivative contracts is done in accordance with the rules, byelaws and regulations of the NSE and BSE and their clearing houses, duly approved by SEBI and notified in the Official Gazette. The minimum contract size for a derivatives transaction is Rs. 2 lakhs. Thus, the enactment of Securities Law (Amendment) Act, 1999 and repeal of the 1969 notification provided a legal framework for securities based derivatives on stock exchanges in India, which is co-terminus with framework of trading of other securities allowed under the Act. However, these attempts are not sufficient for developing a buoyant derivatives market. The principal hindrance lurking before the hedgers and speculators is taxation on derivatives transactions. There is no apparent provision dealing with taxation of derivatives transactions. Section 73(1) read with Section 43(5) of the Income Tax Act, 1961 are two provisions which are of significant concern. Section 73(1) prescribes that losses of a speculative business carried on by the assessee can be set-off only against profits and gains of another speculative business, up to a maximum of eight years. Under Section 43(5) a transaction is a speculative transaction where (a) the transaction is in commodity, stocks or scrips, (b) the transaction is settled otherwise actual delivery, (c) the participant has no underlying position and (d) the transaction is not for jobbing or arbitrage to guard against losses which may arise in the ordinary course of his business. Derivatives are not commodities, stocks or scrips but are a special class of securities under the Act. Also, derivatives transactions, particularly index futures are never settled by actual delivery. And most importantly, under Section 43(5) a hedging or arbitrage transaction in which settlement is otherwise than actual delivery is regarded as non-speculative only when the participant has an underlying position, but in derivatives contracts hedgers and speculators have no underlying position in such transactions. In the light of these readings, derivatives contracts may be construed as speculative transactions and will be hit by Section 73(1). It is, therefore, imperative to declare derivatives transactions as non-speculative and

it should be taxed as normal business income or capital gains, as the case may be.

## 2. Previous Research

Financial markets are, by nature, extremely volatile and hence the risk factor is an important concern for financial agents. To reduce this risk, the concept of derivatives comes into the picture. Derivatives are growing as hedging instrument. The study of regulatory framework for derivatives trading is justified on the ground of number of accidents, including Hong Kong (1987), Baring (1995), Shanghai (1995), Sumitomo (1996), Thai and Indonesian currencies (1997), Korea SK Securities (1998), and China Aviation Oil (2004), which all have revealed important lesson on how derivatives can be misused. Numerous studies have been conducted on the regulatory framework for derivatives trading in different countries.

Petzel (1995) studied the history of market development and open issues faced by the industry in U.S. and other countries. He studied regulatory framework of U.S. in which he identified two major cracks. First, the establishment of CFTC as dominant regulator was too later. Second, the characterization of CFTC neither served the regulator nor affected market well. He has identified the issues of inadequate definition for derivatives, identical regulatory structure for public and professional participants, inadequate measure of risk and outmoded accounting standards for derivatives.

Albrecht (1995) studied the regulatory framework of U.S. He divided his paper in two parts. First part briefly discussed five issues: goal of financial regulation, nature of regulation, economic efficiency, need for regulation and regulatory failure. Second part examines the role of CFTC in establishing the current differential regulation of exchange traded and OTC derivatives and concluded that new legislation will be necessary to bring about the appropriate changes in the regulation of exchange traded derivatives.

Dixon and Bhandari (1997) studied what derivatives are and where there are calls for their use to be regulated in both U.K. and global capital markets and economies. They also review the principal concerns of regulatory bodies and also the latest developments in trading and regulation. They have identified the main concern areas like criteria used for the approval & recognition of market/product, regulation of financial intermediaries, market volatility

& market efficiency in respect of product design, market disruption and surveillance, trading rules. They have also highlighted the 20 recommendations of G-30.

Macey (1995) showed that the economic function of derivative trading are no different from economic function of other, more traditional, financial instruments. They also showed that the existing regulatory analysis has been unsuccessful. They used functional approach to study derivatives securities which will identify the practical problem that these securities are attempting to solve. Then, they take into consideration connection between derivatives and unrelated instrument that are attempting to solve same problem. They have highlighted the following problems that regulator faces: mandatory rules devised by policy maker do not benefit all investors or all market participants, lack of information available to regulators, creation of single regulator can impose systematic risk, politician decisions are likely to be politically motivated rather than economically motivated.

Culp and Mackay (1997) described the existing system of derivatives in U.S and proposals for broader and stricter regulation are presented and evaluated. They also described benefits of derivatives to end user, dealers and economy. They found that current legislative and regulatory proposal reflect eight common concerns about derivatives: accounting disclosure, and reporting ,suitability of derivatives transaction for particular end users, capital requirement, inadequate oversight of risk taking activities by management, unregulated activities of U.S derivatives dealers, inadequate training of examiners and regulators, proprietary trading and no criteria to determine whether any particular multilateral clearing association actually reduces systematic risk or increases it relative to bilateral netting arrangements.

Jobst (2008) reviews the current situation & recent development of equity derivative markets in emerging Asia. He offers a comprehensive set of principles for the development of equity derivative markets based on the current state of equity derivative trading in emerging Asia. He identified the issue of transparency, cash market liquidity, trading infrastructure & lack of capital requirement. This paper also explain the requirements for the development of well functioning and stable derivative markets: implementation of modern trading system, surveillance system to detect improvident behavior, sound risk management and centralized mechanism for mitigation of counter party risk and contract specification consistent with ISDA documentation & contract size.

Large numbers of studies are conducted on derivative in world but only few studied the regulatory framework of India. Srivastava *et al.*, (2008) conducted survey for the major concerns about derivative securities and found that 73 per cent brokers characterized liquidity as the issue of moderate to high concern, 69 per cent mentioned the valuation and pricing of derivative securities to be matter of moderate to high concern, 65 per cent respondents mentioned tax and regulatory issue to be matter of low to moderate concern and some of other concerns were volatility in underlying stock and the difficulty in measuring the impact of derivatives on cash market exposure due to illiquidity.

Anand and Kaushik (2008) examine management motivations of foreign currency derivatives usage in corporate India. They find that major objectives of using derivatives is hedging the risk (96.1 per cent responded as rank on one objective), for arbitrage purpose (55.3 per cent assigned rank two) and price discovery (36.4 per cent assigned rank two & 33.3 percent assigned rank three). The speculation as objective of using foreign currency derivative is the least preferred option (62.1 per cent assigned it as rank four).

Guru in her article (2009) presented the historical perspective in which derivatives have been developed in India & identified certain issues. Two important policy issues highlighted by her were Cash vs. physical settlement and OTC vs. Exchange traded derivatives. She concluded that that these markets, viz., exchange traded and OTC, are two competing market and each have unique characteristics.

### Gap in Existing Studies

Most of the studies on issues and challenges faced by regulatory framework for derivative trading are conducted in U.S., U.K, Australia and other countries. Only few studies are conducted on India which are done by Guru (2009), Anand and Kaushik (2008) and Srivastava *et al.*, (2008). Since only two empirical studies are conducted, it calls for need to carry more empirical research. This paper examines the views of members of NSE regarding issues and challenges considered in paper.

## 3. Research Methodology

### Data Collection

As the study is aimed to discover the objectives mentioned above, quantitative primary data was gathered

through sample survey method. The survey is based on questionnaire, restricted to the brokers of NSE with the sample size of 200 respondents. The questions covered in survey include: a) Categorization of respondents b) Their location c) Motives of dealing in particular segment of market d) Concern for some issues like Accounting for derivatives, restriction on institutional investment, lack of understanding on pricing and valuation and cross margining were also presented in form of questions to the respondents to know their opinion regarding these issues. The questionnaire was emailed to them. The response of 100 respondents was received which amounts to 50 per cent of total sample size.

### Findings

The analysis has shown that out of 100 respondents, 70 per cent were trading member-clearing members<sup>1</sup>, trading members<sup>2</sup> formed 20 per cent and self clearing members<sup>3</sup>, 7 per cent of the total. The professional clearing members<sup>4</sup>

was extremely low i.e., 3 per cent (Figure I represent the categorization of respondents)

1. Trading members may execute the trade on their own behalf or on behalf of their clients but the clearing and settlement of such trades is done by another clearing member.
2. Clearing members who are also trading members. Such clearing members may clear and settle their own proprietary trades, their clients' trades as well as trades of other trading members.
3. A clearing member who is not a trading member. Typically banks or custodians could become a professional clearing member and clear and settle for trading members.
4. A clearing member who is also a trading member. Such clearing members may clear and settle only their own proprietary trades and their clients' trades but cannot clear and settle trades of other trading members.

**Figure I Categorization of respondents**



<sup>1</sup>Trading members may execute the trade on their own behalf or on behalf of their clients but the clearing and settlement of such trades is done by another clearing member.

<sup>2</sup>Clearing members who are also trading members. Such clearing members may clear and settle their own proprietary trades, their clients' trades as well as trades of other trading members.

<sup>3</sup>A clearing member who is not a trading member. Typically banks or custodians could become a professional clearing member and clear and settle for trading members.

<sup>4</sup>A clearing member who is also a trading member. Such clearing members may clear and settle only their own proprietary trades and their clients' trades but cannot clear and settle trades of other trading members.

Table 3 shows the geographical distribution of respondents reveals a high degree of regional bias. More than half the respondents were from Mumbai (45 per cent) followed by Delhi (20 per cent), Kolkata (9 per cent) and Ahmadabad (5 per cent), Chennai (5 per cent), these five cities contributing to 84 per cent of the total respondents in the study. In line with the geographical distribution, these four cities contributed 80 per cent of the total turnover in the derivative market. The dominance of Mumbai is understandable given the fact that it is the financial capital of India and most of the large broking houses and institutional investors have their head offices in the city. A majority of fund managers are also stationed in Mumbai. Further, the treasury operations of different market players, like banks, are also located in Mumbai.

**Table III Geographical location of respondents**

<i>Geographical Location (Percentage)</i>						
<i>Delhi</i>	<i>Mumbai</i>	<i>Kolkata</i>	<i>Chennai</i>	<i>Ahmadabad</i>	<i>Others</i>	<i>Total</i>
20	45	10	5	5	15	100

There are four segments of market, namely, Capital Market, Futures & Options (F&O), Currency Derivatives and Wholesome Debt Market (WDM). It has been found that 10 respondents are operating only in capital market, fifty members in capital market and future and option; 34 members in capital market and futures & options and currency derivatives, and 2 members are operating in capital market, WDM, F&O and currency derivatives.

**Figure II Objectives**

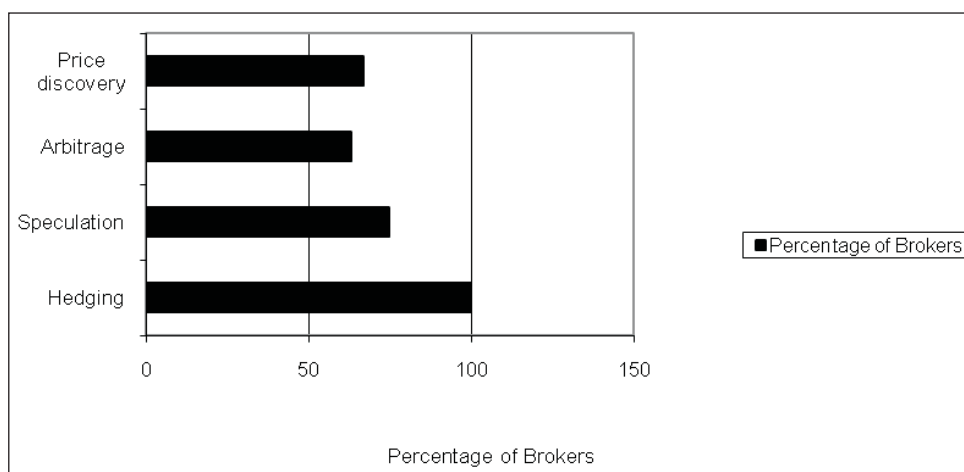


Figure II is related to the motives for investment. All the respondents mentioned hedging as their most important objectives for which their clients are entering into derivative market. 75 per cent of the respondents mentioned speculation as one of the objective of their clients for entering into the market. In addition, 63 and 67 per cent, respectively of the respondents mentioned that derivative securities were also used for arbitrage and price discovery.

**Table IV Issues in derivative market**

<i>Issues</i>	<i>No Concern</i>	<i>Low Concern</i>	<i>Moderate Concern</i>	<i>High Concern</i>
Accounting issues	5	10	22	63
Restriction on institutional investment	7	10	12	71
Lack of understanding on pricing and valuation	3	12	16	69
Cross margining	45	14	15	26

**Concerns about Derivative Securities**

While market participants perceived benefits in the derivative segment, there were some concerns as well. Table IV considers four issues in the survey: concerns like Accounting for derivatives, restriction on institutional investment, lack of understanding on pricing and valuation, and cross margining.

The most prominent issue was restriction on institutional investors. It is an issue of high concern for 71 per cent brokers. The absence of clarity on tax and accounting treatment, and incomplete internal approval processes continue to be cited as key reasons for their absence from this rapidly growing market (Ravi Narain, 2002)

Another area of concern was lack of understanding on pricing and valuation. 69 per cent brokers consider lack of understanding on pricing and valuation as issue of high concern. The reasons are manifold. For example, there were certain ambiguities regarding the benchmark interest rate, a critical input in derivative pricing. Further many of the market players were unaware of the nuance of highly mathematical models like the Black-Scholes option pricing model and preferred to abstain from using any scientific approach. The survey conducted by Srivastava *et al.*, (2008) revealed that 69 per cent investors mentioned it to be matter of moderate to high concern.

The third issue was the accounting for derivatives. It was found that 63 per cent members agree that accounting of derivatives is issue of high concern. The reasons are treatment of derivatives is based on the accounting for underlying instrument and derivative financial instrument are measured at fair value and accounting for changes in fair value of a derivative be dealt with through the earning statement. There is potential for increased volatility associated with fair value estimates and the potential for misleading reporting of gains and losses not yet realized.

The area of least concern was cross margining According to NSE:

1. The position in future and option segment for stock futures and index future should be in same expiry month to be eligible for cross margining benefit.
2. Position in option contract is not considered for cross margining benefit.

This make difficult for investors to avail the benefits of the cross margining. Therefore, NSE should improve its cross margining system to improve the derivative trading. Most of the respondents (37 percent consider the issue as of high concern)

## 4. Conclusion and Recommendations

Derivatives have been one of the most dynamic forces in financial markets over the past 25 years. The growth is being spearheaded mainly by retail investors, private

sector institution and large corporations, smaller companies and state-owned institutions. The variety of derivatives instruments available for trading is also expanding. Regulation of derivatives is necessary to protect the interest of investor and to maintain liquidity and transparency in derivatives dealing. A lack of understanding at the regulatory and legislative level about the nature of derivatives and management of derivatives risks could cause an increase in “regulatory risk”. The existing structure of India has not developed sufficiently to deal with fast growing complexities of derivatives instrument. Regulation should not stifle the innovation and competitiveness. Survey revealed the point of view investors regarding areas of regulatory concern in India: 1) Accounting for derivatives 2) Pricing and valuation of derivative securities 3) Institutional participation 4) Cross margining. By placing straight jacket on firm, regulation restrict innovation and shift valuable resources away from market driven risk management toward regulatory compliance and indeed, regulatory avoidance. Several alternatives should be considered for global derivatives exchange regulation:

Regulation may be performed through a global regulatory body that maintains the authority to adopt and enforce exchange rules.

Harmonize national regulation in way that exchanges are subject to the same rules.

Third alternative for global derivatives regulation requires greater coordination in the sense that national regulatory agencies would agree to give priority status to the removal of gaps or inconsistencies in national regulation that make it difficult for capital to flow freely or fraud to flow freely.

The starting point in making this possible would be better international harmonization of accounting standard, financial disclosure and trading practices. One way to achieve this would be for supervising and regulating authorities to set up or become an international recognized body to monitor the trading activities in international capital markets.

The further studies can be conducted on these problems individually and comparison can be made between different countries to know whether these problems are prevailing at global level.

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