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International Approaches to Derivatives Market Regulations: Common Global Regulatory Objectives

Financial Institutions Reforms and Expansion (FIRE) Project

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Financial Institutions Reform and Expansion (FIRE) Project
US Agency for International Development (USAID/India)

Price Waterhouse LLP
1616 North Fort Myer Drive
Arlington, VA 22209
Tel (703) 741-1000
Fax (703) 741-1616

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Financial Institutions Reforms
and Expansion (FIRE) Project

128. T. V. Industrial Estate
Worli, Mumbai 400 025

Telephone: 4946630, 4963599
Fax : (91 22) 4963555

Price Waterhouse LLP

27 October 1997

Mr. O.P Gahrotra
Senior Executive Director
Securities and Exchange Board of India
Mittal Court, B Wing
Nariman Point
Mumbai 400 021, INDIA

Subject: Development of Regulations for Derivatives Market

Dear Mr. Gahrotra,

As per the request of Securities and Exchange Board of India (SEBI) Ms. Kate Hathaway, consultant to Price Waterhouse Capital Markets has and will continue to provide assistance to SEBI in formulating the overall regulatory framework for Derivatives Market. This assistance is provided under the USAID funded Financial Institutions Reform and Expansion (FIRE) Project administered by Price Waterhouse LLP. Ms. Hathaway has extensive regulatory experience and was the Chief of Staff at Commodities Futures Trading Commission (CFTC), the primary derivatives market regulator in the US.

During her trip in August 1997, Ms. Hathaway met with Ministry of Finance, Dr. L.C. Gupta, representatives of SEBI, National Stock Exchange (NSE), the National Securities Clearing Corporation Ltd. (NSCCL) , and domestic and international financial institutions active in India to better understand the characteristics of the Indian financial markets.

During that trip Ms. Hathaway's began the process of developing and implementing market regulations associated with the introduction of an Indian derivatives market. She was assisted by Ms. Monika Jashani, a Price Waterhouse consultant with experience in the US derivatives market.

This report outlines a work schedule leading to the completion of derivative market guidelines and/or regulations during the next year. This report recommends:

- An appropriate regulatory framework which is based on the underlying purpose and intent of derivatives market.
- Current cash equities market practices and regulations not be adapted for use in the derivatives market because inappropriate regulations may hinder the function of a such a market.
- A proposed rationale for developing a regulatory framework.
- Common regulatory objectives identified by international regulators become the basis for derivative market regulations in India, and

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- Significant regulatory areas SEBI should consider when preparing guidelines for derivatives markets in India.

Next Steps

Ms. Hathaway will continue to work with SEBI in her forth coming trips in formulating guidelines for the derivatives market. Based on her interviews with members of the financial community in India and a review of the documents and files, the immediate follow up actions seem appropriate:

- A review of issues related to regulating screen based trading of derivatives with examples of the regulatory approach of other countries;

- A comparative analysis of the guidelines and regulatory approaches of other jurisdictions that may be useful in India;

- An in-depth review of the proposed National Stock Exchange rules and regulations and operations;

- Preparation of instructional materials that will dissect the anatomy of recent derivatives market disruptions, defaults and frauds. The purpose of this approach is to assist SEBI staff in understanding the intricacies and potential risks of certain aspects of derivatives markets and how to deal with them;

- Preparation of standards and guidelines to facilitate SEBI's on site review of NSE's surveillance system, testing and registration system and other self-regulatory approaches they plan to use.

Please find enclosed the details of Ms. Hathaway's current findings and recommendations.

Please contact me at telephone number 496-359 for any clarifications or further information you may require. Thank you.

Sincerely,

W. Dennis Grubb

W. Dennis Grubb
Principal Consultant

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I. EXECUTIVE SUMMARY

India is about to launch a derivatives market to trade stock index futures. The experiences of other jurisdictions that have successfully introduced derivatives markets during the past 25 years can provide valuable guidance to India.

In order to construct a regulatory framework that offers the necessary protections but does not restrict market development, regulatory structures must be based on:

- India's existing market environment, culture, potential participants and their perceived uses for these derivatives products; and
- The common regulatory objectives accepted by regulators and most exchanges around the global.

In light of these common regulatory objectives and the various regulatory programs and other methods other oversight regulators have used to achieve these objectives, this report makes the following specific recommendations:

Recommendation 1. Design A Regulatory Framework Expressly For Derivatives Markets.

The framework should be based on the underlying intent and purpose of derivatives markets to ensure the market institutions and their operations facilitate the functions of a derivatives market. Avoid trying to adapt current cash market practices and rules to regulate the new derivatives market.

Recommendation 2. Adopt The Role Of Oversight Regulator.

Most derivatives market regulators function as oversight regulators reviewing exchange, clearing house and financial intermediary rules and procedures expressly for the purpose of determining whether they are:

- consistent with minimum best practice derivatives market standards, and
- designed to ensure a market that is open and competitive (free from manipulation and other forms of trade practice abuse.

Recommendation 3. Adopt International Common Regulatory Objectives.

Adopt the following common regulatory objectives that derivatives market regulators around the globe have identified:

Financial safety, including the integrity of clearing houses and market participants;

Financial safety objectives are addressed through guidelines for:

- Capital-based qualifications for financial intermediaries,
- Adequacy of clearing and payment facilities,
- Margin and credit extension requirements,
- Financial compliance by market intermediaries,
- Customer funds protections and insolvency, and
- Reporting and record keeping by financial intermediaries.

Fairness, including fiduciary and related customer (investor) protection concerns;
To achieve *customer protection/fairness* objectives, the following areas need to be addressed:

- Broker qualification and good standing,
- Order execution,
- The availability of records and information to customers,
- Intermediary sales practices and
- Compliance need to be addressed.

Market efficiency and integrity,

Market efficiency and integrity are internationally recognised objectives which jurisdictions address through:

- Product design,
- Measures against market disruption,
- Market surveillance,
- Trading rules,
- Audit trail,
- Trade reporting requirements, and
- transparency (price, volume and open interest).

Recommendation 4. Set Minimum Best Practice Standards.

Provide self-regulatory organisations (SROs) and other market participants with guidelines that set minimum best practice standards based on globally accepted regulatory objectives. Setting these standards will facilitate the Securities and Exchange Board of India's (SEBI's) review of the proposed exchange rules and regulations and in the future will enhance regulatory transparency for SROs and other market participants.

Recommendation 5. Review The Regulatory Programs Used By Other Regulators.

SEBI should review the various methods and regulatory programs other regulators have used to meet the common regulatory objectives and consider similar provisions when preparing guidelines and reviewing proposed exchange rules.

Recommendation 6. Prepare Guidelines Or Regulations.

Guidelines for SROs and market intermediaries, as well as regulations should fit the characteristics of the market. A review of existing financial infrastructure during this process is also advisable.

Recommendation 7. Implement The Regulations And Follow-Up.

After implementation SEBI should continue to work with the exchange, clearing house and other market participants to identify gaps or difficulties in complying with the guidelines.

II. INTRODUCTION

A. The Current Status of the Indian Derivatives Market and its Regulation

Currently there is no existing exchange-traded financial derivatives market in India; and therefore, no appropriate regulatory framework. As India prepares to launch a derivatives market and develop a regulatory framework, focusing on the underlying purpose and intent of derivatives markets is crucial. Trying to adapt current cash equities market regulations to a new derivatives market will produce its own problems which will most likely be costly and perhaps irreversible.

The current equities cash market in India is sometimes referred to as a "five-day futures market." It does have some characteristics of a futures market: for example, squaring up and carry forward both appear similar to futures style cash settlement, mark-to-market margining, and a clearing organization to clear and guarantee trades. These characteristics, however, do not make it a futures or options markets.

There are several significant differences between exchanged-traded derivatives markets and India's current equity market. Several characteristics, among others, that define a derivatives market and which are not evident in the Indian equities market are:

- Derivatives are agreements which specify rights and obligations based on some underlying instrument, investment, currency, index, right or service - commonly referred to as the underlying interest.

- Exchange-traded derivatives markets refer to those products in which the market itself is the issuer.

- Futures markets are designed to serve an economic purpose for the economy as a whole: they shift price risk and provide price discovery. As such the operation and regulation of market institutions are appropriate to these characteristics and facilitate the functions they are designed to serve.

- In futures markets the daily loss and gain on a position is marked-to-market and generally the difference collected by the clearing house is passed through the market -- transferred from losing to gaining positions and *vice versa* -- each day.

As most markets, the current Indian equity cash market has developed many practices over time in piecemeal fashion. For example, net settlement of five days trading in the current cash market was an operational approach developed overtime as an alternative to a longer settlement cycle which was believed to pose greater risk. Later derivatives-like additions to the Indian cash market like mark-to-market margin enhance the financial safety of the market, but they do not provide the alchemy to transform it into a derivatives market.

In the US market, practices also have changed over time. After the 1987 market crash the equities markets adopted some derivatives market practices such as:

- Coordinated trading halts now referred to as circuit breakers exist on both futures and cash equities markets,

- Large trader reports are now required by the equities side as well as the derivatives markets, and

- Equities settlement periods moved from T+5 to T +3 toward the futures settlement which is generally T+1).

Adopting market practices from derivatives markets does not transform an equities market into a market that deals in risk.

Establishing market institutions, operations and a regulatory framework that are appropriate for a derivatives market will avoid patch work corrections to market practices and regulations that result from expensive mistakes. Policy mistakes are always expensive to both the private and public sectors, but "not getting it right" in these markets could result in immediate customer losses and long term costs for India within the international financial community.

B. Designing a Regulatory Framework

In many jurisdictions "successful" emerging derivatives markets have developed hand-in-hand with appropriate market regulations. To adopt that approach, the regulatory framework must provide the necessary protections but not restrict market development. Such a framework should be based on:

- The demand for such a market,

- Potential market participants and how they believe they would use the market,

- The existing financial and legal infrastructure and its integration into the regulatory structure, and

- The existing market environment and culture.

Information about regulatory structures and practices in other jurisdictions, including international minimum best regulatory practices can provide terms of reference for India as it prepares to launch a new derivatives market.

III. INITIAL STEPS NEEDED TO PREPARE AND IMPLEMENT DERIVATIVES MARKET REGULATIONS

A. *Develop Organizational Structure and Personnel Requirements*

1. Ensure Appropriate Personnel at SEBI

Over the long term, focus on the technical expertise necessary to regulate derivatives markets involving: (1) the economics of markets -- cash and derivatives -- and their interaction, (2) investigative techniques related to concentration of positions, fairness, efficiency, "fictitious trading" and other forms of market manipulation, (3) legal precedents involving global derivatives markets including the increased potential for fraud or manipulation when derivatives are traded in two jurisdictions and/or when bankruptcy involving derivatives occur across international boundaries, (4) financial accounting and record keeping standards and methods.

2. Further Organise the Structure of the Derivatives Cell

a. Determine the major regulatory programs,

b. Determine the division of responsibility for these programs at SEBI and document them into SEBI's program, as well as personnel descriptions.

B. *Design and Develop A Regulatory Framework*

1. Adopt the Role of an Oversight Regulator[1/]

The principal function of oversight government is to assure self-regulation is in the public interest. To accomplish this the oversight regulator reviews exchange rules and procedures expressly for the purpose of determining whether they are:

- consistent with minimum best practice derivatives market standards, and
- designed to ensure a market that is open and competitive (free from manipulation and other forms of trade practice abuse).

The self-regulator has the front line responsibility to assure financial integrity, to protect the customer and to ensure open and competitive markets that treat outside capital and all participants fairly and equitably. In addition to performing at least periodic auditing of all SRO programs and activities, the oversight regulator steps in to investigate alleged market manipulation or other wrongdoing and takes appropriate enforcement action when the SRO does not adequately fulfil its responsibility .

[1] See Appendix A, *The Benefits of an Oversight Regulator versus a Regulator-of-Last Resort.*

2. *Determine the Goals of the Regulator and Set Priorities*

Derivatives markets are international; market participants can and do trade in many markets around globe. At the same time these are highly leveraged, participants can loose more than their original investment in these markets. As a result regulators agree, at the very least, on basic regulatory objectives: *financial safety,* including the integrity of clearing houses and market participants; *fairness*, including fiduciary and related customer (investor) protection concerns; and *market efficiency and integrity*.[2][3] India can benefit from this international experience by adopting these globally accepted objectives.

C. *Set Minimum Best Practice Standards*

Set minimum best practice standards based on globally accepted regulatory objectives with which self-regulators must comply in order to qualify as a derivatives exchange, trade a particular contract, etc. Setting these standards will facilitate SEBI's review of the proposed exchange rules and regulations and in the future will enhance regulatory transparency for SROs and other market participants.

D. *Prepare Guidelines and Regulations*

Prepare guidelines appropriate for the market, market participants and market culture. Guidelines or regulations should fit the characteristics of the market -- not be determined by its geographic location or by any preference for one approach to another. Review existing financial infrastructure; are all necessary elements in place? Should the regulations or guidelines reflect any limitations in infrastructure?

E. *Implement the Regulations*

1. *Establish a Relationship between the SROs and the Oversight Regulator*

a. Open clear lines of communication. The lines of responsibility between the oversight regulator and SRO must be clear, understood and agreed to by both sides.

b. Expectations between the two (SEBI and the SRO(s)) should be discussed and clarified to the extent possible concerning various issues and areas. Misunderstanding and confusion must be avoided. This becomes crucial during any market disruption and emergency.

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2 These are the suggested core goals , or regulatory rationale, for SEBI as it designs and implements a regulatory structure.

3 The IOSCO Technical Committee agreed in 1990 that these regulatory objectives could be achieved in various jurisdictions by different means and that regulation need not be identical to adequately address these common regulatory goals.

2. *Prepare a confidential directory of key contact people*

a. Identify the person(s) at SEBI who are the contact persons for each specific regulatory area,

b. Identify the person(s) at the exchange and at the clearing house who are the contact persons for each specific regulatory area,

c. Identify key person(s) to contact at the Ministry of Finance in a market emergency situation,

d. Include their home and work telephone numbers as well as addresses in the directory and distribute to a small "need-to-know" group within relevant organisations.

3. *Work with the exchange, brokers and market participants to identify gaps in the guidelines or regulations.*

IV. A PROPOSED RATIONALE FOR DEVELOPING A REGULATORY FRAMEWORK: ENSURING MINIMUM BEST PRACTICE STANDARDS

Regardless of the method SEBI chooses to prepare derivatives market regulations or guidelines, the experiences of other jurisdictions during the past 25 years could prove valuable to India as it launches its first derivatives market. To assist SEBI in a review of these regulatory objectives this report provides a checklist of the common regulatory objectives accepted around the global and a checklist of methods other regulators have used to achieve those objectives as oversight regulators. SEBI should consider these regulatory objectives as it develops a regulatory framework, guidelines and reviews the exchange rules and regulations. A more detailed discussion of these objectives follows the check list.

A. *Checklist of Internationally Accepted Regulatory Objectives*

1. *Markets Integrity and Efficiency*

a. Product Design

b. Market Disruption and Surveillance

c. Trading Rules

d. Audit Trail

e. Reporting Requirements

f. Transparency (Price, Volume and Open Interest)

2. *Customer Protection/Fairness Regulation*

a. Authorization, Qualification and Good Standing

b. Order Execution Requirements

c. Practice Requirements

d. Compliance Monitoring

e. Records and Information Available to Customers

f. Self-Regulation vs. Direct Regulation

3. ***Financial Integrity Regulation***

a. Capital-Based Qualifications

b. Adequate Clearing and Payment Facilities

c. Margin and Credit Extension Requirements

d. Financial Compliance

e. Customer Funds Protections and Insolvency

4. ***Reporting and Record keeping for Financial Safety***

B. Common Regulatory Objectives

While there is no single regulatory framework for derivative products, markets, clearing houses or those who participate in such markets (directly or as intermediaries), there is a substantial similarity in perceived regulatory objectives. The IOSCO Technical Committee' agreed in 1990 that these regulatory objectives could be achieved in various jurisdictions by different means and that regulation need not be identical to adequately address common regulatory goals. At a minimum, there is international consensus that the core goals of regulation should be:

- **financial safety, including the integrity of clearing houses and market participants;**
- **fairness, including fiduciary and related customer (investor) protection concerns; and**
- **market efficiency and integrity**[4]

There may be a number of explanations for differences in regulatory structure and practice among jurisdictions. These include:

- The different nature and structure of markets - for example, pit trading as compared to screen-based or other electronic trading mechanisms;

4 These are the suggested core goals for SEBI as it designs and implements a regulatory structure. Most regulatory policy questions can be addressed in the context of these three regulatory goals with some analysis of the issue.

- The different nature and design of products;
- Different cultural and national customs and practices;
- Legal or juridical distinctions among jurisdictions for example, differences between common law and civil law jurisdictions, public and private markets, and universal banking and non-universal banking or mixed jurisdictions; and
- Historically, different legal implications of specified conduct; for example, in some jurisdictions, concerns related to anticompetitive practices are a fundamental aspect of the regulatory system.

C. Proposed Rationale for Developing a Regulatory Framework

In recent years there has been a trend towards globalisation of financial markets that has included the proliferation of derivatives markets in multiple jurisdictions. In many locations this growth has occurred in fits and starts. In China, for example, there were no futures exchanges six years ago. Three years ago there were 52. Now there are less than 20. The decrease from 52 to approximately 15 has been ascribed to development and activation of a regulatory system in response to market failures. Indeed, careful structuring and development of an effective regulatory framework have been central to the success of the markets that have prospered. Regulatory development invariably accompanying market development.

Throughout this period of market growth there have been many lessons about success and disaster. The defaults, such as Metellsgellschaft and Barings, have riveted public attention during the past few years and have made it clear that market problems in one jurisdiction reverberate in other jurisdictions around the world. One market's failure can be costly to another regulator's investors and market professionals, as well as deter the continuing viability of the marketplace where it occurs.

As a result regulators world-wide recognise that ensuring minimum best practice standards across markets through the use of guidelines is not only in their mutual interest it is also an approach to self-protection for each jurisdiction, as well as a competitive issue among markets in attracting investors. By providing confidence to outside users regulatory guidelines can help attract and retain capital, thereby promoting market success. By setting minimum best practice standards, guidelines also help protect the viability of a home market and minimise the systemic risk in the global financial community. They also offer the obvious benefit of protecting the markets from the misconduct or mismanagement of the participants. The guidelines also clarify the framework and the limits within which the regulator will operate.

In order to proceed with developing a regulatory structure, a point of reference is helpful. Since derivatives markets are global and traders can and do cut across jurisdictional lines, using internationally preferred and acceptable practices as the regulatory point of reference seems appropriate.

1. Markets and Product Regime

Most jurisdictions reported that official central or auction markets and most electronic multilateral execution markets must be "recognized," authorized by statute or otherwise, or created by grant. Many jurisdictions, however, have private, wholesale or other trading activity for which there exists no governmental or quasi-governmental supervisory authority. In addition, most jurisdictions reported that domestic products or certain domestic products must also be recognized, authorized, licensed and/or otherwise approved. In some jurisdictions, derivative products (including futures, futures options and options) are each specifically recognized, and must satisfy a test of economic utility. The majority of jurisdictions reported that domestic clearing houses must be recognized, authorized, approved or drawn from a specific class of market participant such as a bank.

In all jurisdictions, market integrity issues are central to regulatory programs relating to organized derivative markets. Various methods are used by relevant regulatory authorities to address these concerns.

a. Product Design.

Many markets report requirements for product design and restrict products which can be the subject of secondary trading, and most have delivery specifications or procedures for contracts settled other than by payment of a cash differential. Some jurisdictions require markets to report volume information, including information regarding secondary markets in instruments underlying option derivatives on an aggregated basis. These types of requirements appear to be unique to derivative markets.

b. Market Disruption and Surveillance

Most markets prohibit market manipulation. The precise definition of the term "manipulation" may vary from jurisdiction to jurisdiction. The means of preventing this practice differ among markets. Some common measures employed are direct surveillance, product design requirements, position limits, administrative or civil sanctions, other measures or some combination of the foregoing, as well as the extent to which markets are subject to direct regulatory oversight. Many jurisdictions have implemented circuit breakers, trading halts and/or price limits to minimize the adverse effects of market disruption.

c. Trading Rules

Rules relating to types of permitted orders. off-exchange trading restrictions. and types of permitted market-making activities differ considerably from jurisdiction to jurisdiction. one jurisdiction which previously had construed its regulatory requirements to apply primarily to market participants rather than the marketplace recently added guidance about wash trading and certain other discouraged activities.[5]

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5 See United Kingdom Securities and Investments Board ("SIB") Guidance Release 1-93 on "Proper Trades in Relation to On-Exchange Derivatives" and Guidance Release 2-93 on "Proper Markets in Relation to On-Exchange Derivatives." Both were intended to provide further content to the existing statutory and regulatory

d. Audit Trail

All jurisdiction report that they require some means to permit the reconstruction of trades and transactions (i.e., audit trail) and to address detection and proof of possible abuses. However, the manner in which the audit trail is recorded and made available differs among jurisdictions.

e. Reporting Requirements

Some jurisdictions impose large trader reporting requirements, which may be used for financial as well as market surveillance.

f. Transparency (Price, Volume and Open Interest)

Most jurisdictions require the same day dissemination of price and volume information on an aggregated basis. With respect to the real-time availability of post-trade information, most derivative exchanges provide price and volume information on a real-time basis to quote vendors.

2. The Regulation of Financial Intermediaries

Most jurisdictions report differences in applicable regulations based on the type of relationship of the intermediary to and its contact with the jurisdiction.

Some jurisdictions, and different regulators within others, distinguish the regulatory requirements to be applied to commercial and / or sophisticated customers from those applied to non-commercial and / or unsophisticated customers. Similarly, in some cases, regulatory (as opposed to enforcement) jurisdiction is not asserted in relation to customer orders which are "accepted" as opposed to "solicited."

No separate regulatory concerns were reported with respect to the authorization, licensing or recognition of financial intermediaries for the execution of transactions on screen-based trading systems or with respect to the effecting of transactions in derivative products.

3. Customer Protection/Fairness Regulation

Internationally, customer protection generally is addressed by regulatory standards imposed on financial intermediaries. These relate to: the integrity, skill and diligence of those who deal for or on behalf of customers; conflicts of interest; observance by persons who deal for customers with requirements related to the conduct of business, including order execution (e.g., best execution and prohibitions on payments for order flow), restrictions on the misuse of information, the equitable availability of information, prohibitions on misrepresentation, and required disclosure; and the availability of procedures and forums to resolve grievances.

provisions dealing with the integrity of UK financial markets.

Two of the main differences which exist among reporting jurisdictions, regulatory requirements for customer protection are the distinctions made between solicited and unsolicited business and sophisticated and unsophisticated customers. Certain regulatory authorities do not regulate firms located overseas which do not "solicit" business in their jurisdiction. Many jurisdictions differentiate in the application of investor protections between sophisticated and unsophisticated customers. The following customer protections are common to most jurisdictions:

a. Authorization, Qualification and Good Standing

All jurisdictions have fitness requirements for financial intermediaries, which consider previous violative conduct, character and competency. A bar from doing business in one jurisdiction is in all cases considered by other jurisdictions in making fitness determinations. Several jurisdictions supplement their domestic fitness screening process by cooperating with Interpol and foreign regulatory authorities to obtain fitness information on non-domestic applicants for registration in their jurisdiction which such other authorities may have. In the case of foreign regulatory authorities, these arrangements are facilitated where mechanisms for information sharing, such as memoranda of understanding, exist.

b. Order Execution Requirements

The trading rules relating to order execution differ from jurisdiction to jurisdiction but each reporting jurisdiction indicates that its rules are intended to provide fair execution to customers and to prevent fraud. Most jurisdictions report restrictions on the misuse of information; differences exist as to what constitutes misuse. Dual trading (i.e., the ability of industry professionals to trade for their own account and for customer accounts simultaneously) is effectively precluded for most options, but not for other derivatives. Generally, a "customer first" rule is imposed when dual capacity trading is permitted.

c. Sales Practice Requirements

Sales practice standards related to required disclosures, prohibitions on misrepresentations and improper trading activities such as unauthorized trading or trading ahead of customers exist in most jurisdictions. All jurisdictions with derivative markets require the provision of a risk disclosure statement to customers. However, the form of disclosure and required recipients differ from market to market. All regulated jurisdictions prohibit provision of false or misleading information but differences exist concerning liability for omissions and the legal standard for violations.

The general rules against misrepresentation and fraud apply to advertising in all cases, but some jurisdictions have special supervisory rules or explicit restrictions on the content of promotional material. Many jurisdictions place restrictions on cold calling by requiring, among other things, cooling off periods.

d. Compliance Monitoring

In most jurisdictions, the monitoring of compliance with sales practice programs focuses on internal controls (self-policing) and the investigation of customer complaints. The frequency of review of sales practices and the scope of such reviews, however, vary among jurisdictions. Enforcement cases also address abuses in the sales practice area which may not be readily addressed by audit or review programs.

e. Records and Information Available to Customers

All jurisdictions require the creation and maintenance of records, such as confirmations, with respect to the execution and financial effect of exchange transactions. Jurisdictions differ as to the records and information which must be made available to customers.

f. Self-Regulation vs. Direct Regulation

Most jurisdictions rely upon varying degrees of self-regulation coupled with regulatory oversight as the primary means of ensuring regulation over secondary markets. Self-regulation emphasizes reliance on industry knowledge and expertise in devising solutions to regulatory problems. Further, regulatory costs are thereby assessed directly on the industry rather than on the general public as would be the case with direct regulation, in most cases.

4. Financial Integrity Regulation

International regulators agree that prudential or financial safety requirements are intended to protect markets and funds from default and systemic risk and also are designed to ensure that only those persons who have been deemed to be creditworthy and have a stake in the proper conduct of business have direct access to the markets. In relation to derivative markets, these requirements are designed to reflect the special risk attributes of derivatives, for example, the fact that positions in these markets may be highly leveraged or geared. Financial requirements, then, generally are an aspect of all regulatory programs, and the types or combination of types of requirements are fairly similar in form. However, capital regimes applicable to securities firms are significantly different from those applicable to bank intermediaries. The degree of reliance on each of capital, credit, margin, guarantee deposits, segregation and surveillance may vary; the information with respect to such matters which is available to regulators will also differ and reflect variations in the relevant regulatory regimes. For example:

a. Capital-Based Qualifications

Capital requirements for financial intermediaries exist in all jurisdictions. However, none of the jurisdictions reported specified capital requirements for exchanges. There are jurisdictional differences as to whether requirements are imposed on clearing organizations and clearing members. Differences also exist regarding the type of organization which imposes such requirements. For example, in most jurisdictions, banking and securities/derivatives firms are supervised by different regulatory authorities. In many universal banking jurisdictions, banking and securities regulators allocate supervisory responsibilities for banks engaged in securities and other investment activities based on lead-regulator type arrangements.

For example, the European Community has reached consensus on minimum prudential standards for the proper funding of investment firms by adopting the Capital Adequacy Directive (CAD)[6]. The CAD addresses: minimum initial capital levels for investment firms which are not credit institutions; a common framework to measure risk for both firms and credit institutions; and a definition of capital.

Pursuant to the CAD, there are three levels of initial capital, or "own funds"[7] which investment firms must possess when starting up, depending upon the nature of the activities in which they are authorized to engage:

- ECU 125,000 (US $147,250) for investment firms which hold clients' money and or securities and which receive and transmit customer orders for financial instruments, execute investors' orders or manage individual portfolios of investments on financial instruments, provided they do not deal in any financial instrument for their own account or underwrite on a firm commitment basis;

- ECU 50,000 (US $58,900) where a firm is not authorized to hold clients' money or securities,

- ECU 730,000 (US $859,940) for all other investment firms.

The CAD requires institutions to maintain additional capital to reflect various categories of risk. It permits authorities to allow institutions to calculate capital requirements for their trading books[8] (proprietary trading) business in accordance with the Directive On A Solvency Ratio For Credit Institutions.[9]

b. Adequate Clearing and Payment Facilities

These facilities are an element of universal regulatory concern; while most jurisdictions have some operating and/or prudential requirements, many matters relevant to the clearing process may be determined at the discretion of the clearing house or the exchange. Not all clearing organizations guarantee daily variation settlement and the time of imposition of the guarantee may vary from market to market.

c. Margin and Credit Extension Requirements

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6 The CAD does not address transactions in non-financial commodities.

7 The CAD provides that "own funds" shall consist of capital, reserves, revaluation reserves, funds for general banking risks, value adjustments, commitments of members of credit institutions set up as cooperative societies, fixed term cumulative preferential shares and subordinated loan capital.

8 Not all regulatory authorities agree on the standards by which a bank's trading book should be distinguished from its investment book.

9 That Directive establishes how much of each type of capital a credit institution must have and specifically considers off-balance sheet items like swaps not traded on an exchange. The Directive distinguishes these from interest-rate and foreign-exchange contracts traded on recognized exchanges where they are subject to daily margin requirements and foreign-exchange contracts with a maturity of 14 calendar days or less. The solvency ratio is set at a minimum of 8% of capital in relation to the credit institution's risk weighted assets (including off-balance sheet items).

Margin requirements generally are set by the relevant exchange and, in many jurisdictions, are subject to some form of regulatory oversight (e.g., authority to approve levels established by exchanges or emergency authority). Levels of derivative margin ordinarily are set by reference, in part, to either a trading strategy or by using formulae or models related to volatility. The definition of good collateral varies among jurisdictions. Practice among clearing houses or exchanges varies as to whether letters of credit, equity securities or guarantees are acceptable as margin. A financial intermediary may accept different types of collateral from that accepted by the relevant clearing house or exchange. Certain jurisdictions restrict the giving of credit for securities-regulated derivative products; in other jurisdictions, the relevant regulatory authorities do not restrict credit.

Some clearing organizations or exchanges collect original margin on a gross basis and some collect net; if collected, variation margin which transfers gains in the market from "losing" positions to gaining positions and removes credit risk on a daily basis ordinarily is collected net.

All jurisdictions mark exchange positions to market daily. Some exchange markets (the London Metal Exchange, for example), although marking all positions to the market on a daily basis, do not transfer gains or losses until the positions are closed out.

Most markets settle daily on the day after the trade date (T+I), although some settle derivatives on T+2.

d. Financial Compliance

All reporting regulators of derivative markets maintain continuous and/or periodic financial surveillance of markets and financial intermediaries. The components and timing of these programs differ substantially from jurisdiction to jurisdiction.

e. Customer Funds Protections and Insolvency

There is some diversity in the manner in which protection of customer funds is achieved. Most jurisdictions have requirements relating to insurance or performance guarantees and segregation of customer funds from those of the firm -- the calculation of what must be segregated and for whom differs from jurisdiction to jurisdiction. Therefore, although some jurisdictions rely primarily on segregation to protect customer funds, most require a combination of segregation and other prudential requirements. In circumstances where a trust is implied by segregation, its scope (and hence its impact on clearing organization priority) varies among jurisdictions. In at least one jurisdiction, a regime of segregation is being phased in over time and in another jurisdiction the central bank guarantees obligations of clearing members to customers on organized exchanges. Most jurisdictions also have requirements governing the location of customer funds and the manner of their investment. For some jurisdictions, the segregation requirement is supplemented by compensation-type funds which may be used as a final "safety net" to compensate customers based on, among other things, the fraudulent acts of their firms.

These protections are intended to provide some protection from defalcation, to facilitate the transfer of positions in market disruptions, and to accord special treatment to customer funds when the financial intermediary becomes insolvent. Many jurisdictions which require segregation at the broker do not necessarily require segregation at the ultimate custodian. Most exchange markets have a form of clearing guarantee that permits multilateral netting by novation. Not all jurisdiction's insolvency laws support the enforceability of such arrangement.

f. Reporting and Recordkeeping for Financial Safety

All jurisdictions require the creation, maintenance and retention of current financial records, although the form and supervision of records and periods of retention differ.

V. Regulatory Programs and Areas of Significant Regulatory Areas: A Checklist

The following checklist cites specific regulatory programs and other significant regulatory areas that indicate methods various regulators have used in reaching the aforementioned common regulatory objectives. SEBI should consider them when preparing guidelines and reviewing proposed exchange rules.

A. *Exchange and Clearing House*

1. Criteria which must be met to qualify as a market to trade derivatives

2. Organizational structure, including the relationship between exchange and clearinghouse and their respective boards

3. Entry and eligibility for derivatives exchange/clearinghouse membership

4. Review of exchange rules and by-laws

5. Clearing/settlement systems operational capabilities

6. Trading systems operational capabilities

    a. Provides necessary transaction services (making and filing of records with respect to all aspects of the transaction)

    b. Prohibits dissemination of false or misleading information which may tend to affect the price of a product or instrument

7. Ability of the exchange to carry out self-regulatory programs

    a. Risk management controls

    b. Market surveillance

    c. Compliance programs

    d. Disciplinary programs

    e. Arbitration procedures

    f. Code of conduct

    g. Complies with all the regulatory requirements of the oversight regulator

8. Criteria for contract designation or approval

B. Financial Safety

1. Exchange provision for:

    a. Clearing house guarantee

    b. Margin

        i. Types and amounts, calculation and haircuts

        ii. Acceptable forms of collateral as margin, percentage of each type acceptable

        iii. Letters of Credit

        iv. Criteria for banks issuing letters of credit

        v. Gross/net basis for customer/house

        vi. Timing for pays and collects

    c. Mark-to-market

        i. Collection from customers by brokerage
        ii. Customer versus house

2. Other financial protections

    a. Capital requirements

        i. Minimum net capital requirements for brokerage firms: calculation, monitoring and reporting

        ii. Financial reporting requirements which each SRO must adopt and submit for approval

        iii. Audit/inspection procedures

        iv. Brokerage firm (or broker) responsibilities independent of SRO

    b. Segregation of customer funds from brokerage firm (or brokers) funds

        i. Creation of special bank accounts

ii. Account is for customer use only; there is no right of offset or other claim by the bank despite any market situation

iii. Records of transactions conducted through the special account

3. Record keeping

a. Audit trails including customer order entry and exit

b. Monthly records of transactions (affecting asset, liability, income, expense) capital accounts, net capital and minimum financial requirements

c. Investment of customer funds

d. All transaction generated papers and documents, including records of customer orders

e. Transaction activity associate with each customer account

f. Accessibility of books and records -- the period of retention and when and where accessible

C. Trade Practice Requirements

1. Competitive execution requirement
2. Prohibition against fraudulent transactions in connection with any order
3. Prohibition against fictitious trading
4. Prohibition against manipulation
5. Prohibition against insider trading
6. Prohibition against front-running, pre-arranged trading, etc.
7. Prohibition against false exchange membership/ or registration as a broker
8. Prohibition against alternation of trade records
9. Brokerage firms and broker requirements

D. Sales Practice and Disclosure Requirements

1. Provision against providing false or misleading information to a customer

2. Know your customer rule and procedures to ensure compliance

3. Written disclosure of risks of futures and options transactions to ensure customers understand the extent of these risks and procedures to ensure compliance

4. Use of promotional materials

5. Customer dispute resolution procedures

E. Market Surveillance

1. Daily price, volume and open interest data reports

2. Daily derivatives positions reports from the exchange and the traders to the regulator

3. Large trader reporting systems including information concerning hedging strategies upon request of the regulator

4. Monitor hedge/speculative activities

5. Monitor speculative position limits

6. Enforce price limits or circuit breakers/shock absorbers

7. Provide access to exchange surveillance screen and other surveillance related data/systems.

APPENDIX A

The Benefits of an Oversight Regulator versus a Regulator-of-Last Resort

The *oversight regulator* and the *regulator-of-last resort* have some similarities in their regulatory approach:

- both have a self-regulator (SRO), the NSE in this case, as the front line regulator to assure financial integrity, to protect the customer and to ensure open and competitive markets that treat outside capital and all participants fairly and equitably.

- both step in to investigate alleged market manipulation or other wrongdoing and take appropriate enforcement action only when the SRO does not fulfil its responsibility as the front line regulator.

Their differences are greater than their similarities.

The ***regulator-of-last-resort*** only acts <u>after</u> a market manipulation, broker fraud, market default, or other problem occurs. As I understand it, the regulator of last-resort acts after customer funds are lost, firms declare bankruptcy, or through a manipulation, certain members or traders reap unusually high profits while all other market participants are locked out. At that time the regulator can take action to correct the source of the problem (cause the exchange to rewrite certain rules or add rules, etc.).

Furthermore, when the *regulator-of-last-resort* does act the regulatory options available to redress the problems are unclear. Investors will have no idea of what regulatory outcome to expect.

The principal function of ***oversight government*** is to assure self-regulation is @in the public interest and is not anti-competitive. To accomplish this the oversight regulator reviews exchange rules and procedures expressly for the purpose of determining whether they are consistent with a market that is open and competitive (free from manipulation and other forms of trade practice abuse).

Benefits of Oversight Regulation:

<u>1. The SRO knows the rules of the game and is not subject to unexpected and/or unwarranted demands, changes in rules and requirements, or delays from the regulator.</u>

Prior to any review the oversight regulator establishes guidelines that provide criteria and set minimum best practice performance standards for the exchange (SRO) to use writing its rules and performing its self-regulatory role. These guidelines also result in setting the parameters within which the regulator can act. These guidelines, for instance, can prevent the regulator from:

- changing review criteria at will to suit itself or special interests,

- delay review decisions because of bureaucratic caution or uncertainty or pressure from outside special interests.

2. Guidelines help build investor confidence by providing the investor with information about the rules of the game. They determine the investor's expectations about rules and the intention of those rules.

Investors have confidence when they know how a market works and know they will not be at the mercy of insiders or operating under a different set of assumptions as to what the rules are.

The desire to know the rules is not just a desire for fair and equitable treatment, it is also a need for further certainty as to the outcome when problems occur or disputes arise. The more certainty that the market can provide its participants, especially in worst case scenarios, the more likely the participants will be willing to remain in the market when the inevitable problem occurs. The regulator's guidelines provide information about the outcome of market problems or dispute resolution -- before a problem occurs -- and they provide assurance that the self-regulator will adhere to the rules.

3. The benefits investors receive ultimately serve the marketplace. For example, building investor confidence builds investor loyalty which contributes to a successful market.

The expectation of an attractive return on investment may lure the investor into the market even if the price risks are great. However, for the investor to remain loyal and in the market, the investor must be confident about the framework of rules, customs and practices that govern market mechanisms and regulation that distinguish one emerging market from others.

The need for greater regulatory transparency (the need to know the rules of the game) was one of the regulatory principles highlighted in the Windsor Accords, which were agreed to by 19 international derivatives regulators in a meeting at Windsor Castle to discuss methods of avoiding another Barings.

4. Minimum best practice performance standards not only reduce systematic risk in the global financial marketplace, they also have become a competitive attribute between markets attempting to attract potential investors.

The defaults, such as Metellsgellschaft and Barings, that have riveted public attention during the past few years have made it clear that market problems in one jurisdiction reverberate in other jurisdictions around the world. One market's failure can be costly to another regulator's investors and market professionals, as well as deter the continuing viability of the marketplace where it occurs.

As a result regulators world-wide recognise that ensuring minimum best practice standards across markets through the use of guidelines is not only in their mutual interest it is also an approach to self-protection for each jurisdiction, as well as a competitive issue among markets in attracting investors.

In summary, oversight regulation assists the self-regulator by providing guidelines that make clear the responsibilities of the SRO and the purpose of SRO rules. The guidelines also clarify the framework, and the limits, within which the regulator will operate. By providing confidence to outside users regulatory guidelines can help attract and retain capital, thereby promoting market success. By setting minimum best practice standards, guidelines also help protect the viability of a home market and minimise the systemic risk in the global financial community. They also offer the obvious benefit of protecting the markets from the misconduct or mismanagement of the participants.

APPENDIX B

Significant Regulatory Areas SEBI Should Address in Regulating Derivative Markets

I. Designation of exchanges and the clearing house for which it clears.

   A. Criteria which must be met to qualify as a market to trade derivatives

   B. Organizational structure, including the relationship between exchange and clearinghouse and their respective boards

   C. Entry and eligibility for derivatives exchange/clearinghouse membership

   D. Review of exchange rules and by-laws

   E. Clearing/settlement systems operational capabilities

   F. Trading systems operational capabilities

      1. Provides necessary transaction services (making and filing of records with respect to all aspects of the transaction)

      2. Prohibits dissemination of false or misleading information which may tend to affect the price of a product or instrument

   G. Ability of the exchange to carry out self-regulatory programs

      1. Risk management controls

      2. Market surveillance

      3. Compliance programs

      4. Disciplinary programs

      5. Arbitration procedures

      6. Code of conduct

      7. Complies with all the regulatory requirements of the oversight regulator

   H. Criteria for contract designation or approval

II. Financial Safety

   A. Exchange provision for:

      1. Clearinghouse guarantee

      2. Margin

         a. Types and amounts, calculation and haircuts

b. Acceptable forms of collateral as margin, percentage of each type acceptable

c. Letters of Credit

d. Criteria for banks issuing LOCs

e. Gross/net basis for customer/house

f. Timing for pays and collects

3. Mark-to-market

a. Collection from customers by brokerage

b. Customer versus house

B. Other financial protections

1. Capital requirements

a. Minimum net capital requirements for brokerage firms: calculation, monitoring and reporting

b. Financial reporting requirements which each SRO must adopt and submit for approval

c. Audit/inspection procedures

d. Brokerage firm (or broker) responsibilities independent of SRO

2. Segregation of customer funds from brokerage firm (or broker=s) funds

a. Creation of special bank account

b. Account is for customer use only; there is no right of offset or other claim by the bank despite any market situation

c. Records of transactions conducted through the special account

C. Record keeping

1. Audit trails including customer order entry and exit

2. Monthly records of transactions (affecting asset, liability, income, expense) capital accounts, net capital an minimum financial requirements

3. Investment of customer funds

4. All transaction generated papers and documents, including records of customers orders

5. Transaction activity associate with each customer account

6. Accessibility of books and records -- the period of retention and when and where accessible

III. Trade practice requirements

A. Competitive execution requirement

B. Prohibition against fraudulent transactions in connection with any order

C. Prohibition against fictitious trading

D. Prohibition against manipulation

E. Prohibition against insider trading

F. Prohibition against front-running, pre-arranged trading, etc.

G. Prohibition against false exchange membership/ or registration as a broker

H. Prohibition against alternation of trade records

I. Brokerage firms and broker requirements

IV. Sales practice and disclosure requirements

A. Provision against providing false or misleading information to a customer

B. Know your customer rule and procedures to ensure compliance

C. Written disclosure of risks of futures and options transactions to ensure customers understand the extent of these risks and procedures to ensure compliance

D. Use of promotional materials

E. Customer dispute resolution procedures

V. Market Surveillance

A. Daily price, volume and open interest data reports

B. Derivatives positions reports from the exchange and the traders daily to the regulator

C. Large trader reporting systems including information concerning hedging strategies upon request of the regulator

D. Monitor hedge/speculative activities

E. Monitor speculative position limits

F. Enforce price limits or circuit breakers/shock absorbers

G. Provide access to exchange surveillance screen and other surveillance related data/systems.

SCHEDULE OF PROPOSED SEBI ACTION PLAN FOR DERIVATIVES REGULATION, SEPTEMBER 1997 THROUGH AUGUST 1998

Proposed SEBI Action Plan	1997				1998							
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
1. Review Gupta Report after current draft is completed												
2. Board review of the report												
3. Organize the derivatives cell within SEBI with appropriate personnel skills												
4. Develop an organizational structure as an Oversight Regulator with the derivatives cell as the resident core of expertise concerning the operations and regulation of derivatives markets												
5. Provide Staff Training to develop overtime necessary technical skills to regulate derivatives market, including												
a. Mock Trading Sessions,												
b. Experience in Front Office and Back Office Operations,												
c. The Opportunity to Field Customer Complaints.												
6. Design and Develop Regulatory Structures												
a. Review and analyze regulatory approaches of other jurisdictions												
Common International Regulatory Objectives												
<u>Financial Safety</u>, including the integrity of the clearing house and market participants; <u>Fairness</u>, including fiduciary and related customer (investor) protection concerns; and												

Proposed SEBI Action Plan	1997				1998							
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Market efficiency and integrity.												
b. Analyze the market, its functions, users, environment and culture and existing financial infrastructure												
7. Set minimum best practice standards with which self-regulators must comply in order to qualify as a derivatives exchange, trade a particular contract, etc. **based on globally recognized regulatory objectives and experiences adapted to the Indian market.** These standards become the guidelines for exchanges to prepare and write SRO rules and for SEBI's review procedures for proposed contracts, proposed rules, etc. from exchanges applying for "designations" or contract "approvals."												
8. Define the hardware and software requirements and professional services for the purpose of monitoring exchange activities and market surveillance. They will be developed in consultation with the exchanges												
9. Write rules and regulations appropriate for the market, market participants and market culture. a. Designation of exchanges and b. The clearing house c. Financial Safety d. Trade practice requirements e. Sales practice and disclosure requirements f. Market Surveillance												
10. Vet Exchange Proposed Rules & Refine Byelaws												

Proposed SEBI Action Plan	1997				1998							
	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
11. Legal Clearance of Regulations by Board												
12. Registration of Brokers (Certification and registration period to be determined in discussion with the exchange) • **Registration of other intermediaries**												
13. Implement the Regulations								1			2	
14. Continue to clarify the relationship between the SROs and the oversight regulator: Open and establish clear lines of communication Expectations between the two (SEBI and the SRO(s)) should be discussed and clarified to the extent possible concerning various issues and areas. Misunderstanding and confusion must be avoided. This becomes crucial during any market disruption and emergency.												
15. Identify unexpected problem areas and gaps and work with exchange to rectify												

Note: The above schedule depends on the time required by a number of entities - Gupta Committee, SEBI Board, Exchange, SEBI, hence theschedule is shown in two tones. The lighter tone indicates the possibility that additional time will be required for completion of that activity in case of delay.

1 Start of trading in the derivatives market 2 Start of trading in the derivatives market in case of delay