

**DEPARTMENT OF COMMERCE AND FINANCIAL
STUDIES
BHARATHIDASAN UNIVERSITY, TIRUCHIRAPPALLI –
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MBA (Financial Management)**

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Course Name :FOREIGN EXCHANGE MANAGEMENT

**Unit – V / Topic : Regulatory Framework for Currency
Derivatives**

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Scheme of Presentation

- Features of Securities Contracts (Regulation) Act, 1956 [SC(R)A]
- Features of Securities and Exchange Board of India Act, 1992
- Recommendations of the RBI-SEBI Standing Technical Committee on Exchange Traded currency and Interest Rate Derivatives
- Regulatory framework for Clearing Corporations
- Codes of Conduct and Investor Protection Measures
- Grievance Redressal Mechanism for investors
- Arbitration mechanism at exchanges.

Introduction

- The Indian economy is integrating at a fast pace with the rest of the world.
- Indian Financial Markets have also been growing significantly.
- Although liberalization helped the Indian foreign exchange markets in various ways, extensive fluctuations of exchange rate also occurred.
- These issues have attracted a great deal of interest from policymakers and investors.
- Hence in the context of upgrading the Indian foreign exchange market to international standards, a well-developed foreign exchange derivative market (both OTC as well as Exchange Traded) is required.

Introduction

- The Committee on Fuller Capital Account Convertibility had recommended that currency futures may be introduced subject to risks being contained through proper trading mechanism, structure of contracts and regulatory environment.
- Accordingly, Reserve Bank of India in the Annual Policy Statement for the Year 2007-08 proposed to set up a Working Group on Currency Futures to study the international experience and suggest a suitable framework to operationalise the proposal, in line with the current legal and regulatory framework.
- The group has had extensive consultations with a cross section of market participants including bankers' associations, banks, brokers, and exchanges, both Indian and International.

Securities Contracts (Regulation) Act, 1956 [SC(R)A]

SC(R)A aims at preventing undesirable transactions in securities, by regulating the business of dealing therein and by providing for certain other matters connected therewith.

As per Section 2(h) of the Act, the ‘Securities’ include:

1. Shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.
2. Derivatives
3. Units or any other instrument issued by any collective investment scheme to the investors in such schemes.
4. Government securities
5. Such other instruments as may be declared by the Central Government to be securities.
6. Rights or interests in securities.

“Derivative” is defined to include:

- 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.
- A contract which derives its value from the prices, or index of prices, of underlying securities.

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

- Traded on a recognized stock exchange
- Settled on the clearing house of the recognized stock exchanges, in accordance with the rules and bye-laws of such stock exchanges.

RBI-SEBI standing technical committee on exchange traded currency and interest rate derivatives

With a view to enable entities to manage volatility in the currency market, RBI on April 20, 2007 issued comprehensive guidelines on the usage of foreign currency forwards, swaps and options in the OTC market.

At the same time, RBI also set up an Internal Working Group to explore the advantages of introducing currency futures.

The Report of the Internal Working Group of RBI submitted in April 2008, recommended the introduction of exchange traded currency futures.

RBI-SEBI standing technical committee on exchange traded currency and interest rate derivatives

- With the expected benefits of exchange traded currency futures, it was decided in a joint meeting of RBI and SEBI on February 28, 2008, that an RBI-SEBI Standing Technical Committee on Exchange Traded Currency and Interest Rate Derivatives would be constituted.
- To begin with, the Committee would evolve norms and oversee the implementation of Exchange traded currency futures.

The Terms of Reference to the Committee were as under:

1. To coordinate the regulatory roles of RBI and SEBI in regard to trading of Currency and Interest Rate Futures on the Exchanges.
2. To suggest the eligibility norms for existing and new Exchanges for Currency and Interest Rate Futures trading.
3. To suggest eligibility criteria for the members of such exchanges.
4. To review product design, margin requirements and other risk mitigation measures on an ongoing basis .
5. To suggest surveillance mechanism and dissemination of market information.
6. To consider microstructure issues, in the overall interest of financial stability.

- This committee submitted its report on 29th May 2008.
- The Report of the RBI-SEBI Standing Technical Committee on Exchange Traded Currency Futures is available on SEBI's web site.
- The trading of derivatives is governed by the provisions contained in the SC(R)A, the SEBI Act, the rules and regulations framed thereunder and the rules and bye-laws of stock exchanges.

Regulatory framework for clearing corporations

A Clearing Corporation in the currency futures segment can function only after obtaining SEBI approval. The conditions inter-alia includes the following:

- The Clearing Corporation should be a company incorporated under the Companies Act, 1956 and should be distinct from the exchange.
- The Clearing Corporation must ensure that all trades are settled by matching of buyers and sellers
- The Clearing Corporation should enforce the stipulated margin requirements, mark to market settlement, electronic funds transfer, etc.
- A separate settlement guarantee fund should be created and maintained for meeting the obligations arising out of the currency futures segment.

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

Codes of Conduct and Investor Protection Measures

Adherence to SEBI codes of conduct for brokers/ sub-brokers

- All trading members must at all times adhere to the Code of Conduct as specified by the Securities and Exchange Board of India (Stock Brokers and Sub-Brokers) Regulations, 1992.

Code of conduct for brokers

- A registered broker must at all times abide by the Code of Conduct as given below:

I. General

- a) Integrity: A broker should maintain high standards of integrity, promptitude and fairness in the conduct of all his business.
- b) Exercise of Due Skill and Care: A broker should act with due skill, care and diligence in the conduct of all his business.
- c) Manipulation: A broker should not indulge in manipulative, fraudulent or deceptive transactions or schemes or spread rumors with a view to distorting market equilibrium or making personal gains.
- d) Malpractices: A broker should not create false market either singly or in concert with others or indulge in any act detrimental to the investors' interest or which leads to interference with the fair and smooth functioning of the market. A broker should not involve himself in excessive speculative business in the market beyond reasonable levels.

II. Duty to the client

- a) Execution of Orders: A broker, in his dealings with the clients and the general public, should faithfully execute the orders for buying and selling of securities at the best available market price. A broker should promptly inform his client about the execution or non-execution of an order.
- b) Issue of Contract Note: A broker should issue without delay to his client or client of sub-broker a contract note for all transactions in the form specified by the exchanges.
- c) Breach of Trust: A broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship

- e) Business of Defaulting Clients: A broker should not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments in relation to securities with another broker.
- f) Fairness to Clients: A broker, when dealing with a client, should disclose whether he is acting as a principal or as an agent and should ensure at the same time that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and should not consider client's interest inferior to his own.

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

h) Investment Advice in publicly accessible media:

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

III. Brokers vis-à-vis other brokers

- (a) Protection of Clients Interests: A broker should extend fullest cooperation to other brokers in protecting the interests of his clients.
- (b) Transactions with Brokers: A broker should carry out his transactions with other brokers and should comply with his obligations in completing the settlement of transactions with them.
- (c) Advertisement and Publicity: A broker should not advertise his business publicly unless permitted by the exchange.
- (d) Inducement of Clients: A broker should not resort to unfair means of inducing clients from other brokers. 109
- (e) False or Misleading Returns: A broker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to the Board and the exchange.

Code of conduct for sub-brokers

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

I. General

- a) Integrity: A sub-broker should maintain high standards of integrity, promptitude and fairness in the conduct of his business.
- (b) Exercise of Due Skill and Care: A sub-broker should act with due skill, care and diligence in the conduct of his business.

II. Duty to the Client

1. Execution of Orders:

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

2. Issue of Purchase or Sale Notes:

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

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

- 3. Breach of Trust: A sub-broker should not disclose or discuss with any other person or make improper use of the details of personal investments and other information of a confidential nature of the client which he comes to know in his business relationship.
- 4. Business and Commission:
 - (a) A sub-broker should not encourage sales or purchases of securities with the sole object of generating brokerage or commission.
 - (b) A sub-broker should not furnish false or misleading quotations or give any other false or misleading advice or information to the clients with a view to induce him to do business and enabling himself to earn brokerage or commission thereby.

5. Business of Defaulting Clients: A sub-broker should not deal or transact business knowingly, directly or indirectly or execute an order for a client who has failed to carry out his commitments and is in default with another broker or sub-broker
6. Fairness to Clients: A sub-broker, when dealing with a client, should disclose that he is acting as an agent ensuring at the same time, that no conflict of interest arises between him and the client. In the event of a conflict of interest, he should inform the client accordingly and should not seek to gain a direct or indirect personal advantage from the situation and should not consider clients' interest inferior to his own.

7. Investment Advice in publicly accessible media:

- (a) A sub-broker or any of his employees should not render, directly and indirectly any investment advice about any security in the publicly accessible media, whether real-time or non-real-time, unless a disclosure of his interest including his long or short position in the said security has been made, while rendering such advice.
 - (b) In case, an employee of the sub-broker is rendering such advice, he should also disclose the interest of his dependent family members and the employer including their long or short position in the said security, while rendering such advice.
8. Competence of Sub-broker: A sub-broker should have adequately trained staff and arrangements to render fair, prompt and competent services to his clients and continuous compliance with the regulatory system.

- III. Sub-Brokers vis-à-vis Brokers
- (a) Protection of Clients Interests: A sub-broker should extend fullest cooperation to his broker in protecting the interests of their clients.
- (b) Transactions with Brokers: A sub-broker should not fail to carry out his broking transactions with his broker nor should he fail to meet his business liabilities or show negligence in completing the settlement of transactions with them.
- (c) Agreement between sub-broker, client of the sub-broker and main broker: A sub-broker should enter into a tripartite agreement with his client and with the main broker specifying the scope of rights and obligations of the broker, sub-broker and such client of the sub-broker.
- (d) Advertisement and Publicity: A sub-broker should not advertise his business publicly unless permitted by the exchanges.

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

- (a) **General Conduct:** A sub-broker should not indulge in dishonorable, disgraceful or disorderly or improper conduct on the exchange nor shall he willfully obstruct the business of the exchange. He should comply with the rules, byelaws and regulations of the stock exchange. 111
- (b) **Failure to give Information:** A sub-broker should not neglect or fail or refuse to submit to SEBI or the exchange with which he is registered, such books, special returns, correspondence, documents, and papers or any part thereof as may be required.
- (c) **False or Misleading Returns:** A sub-broker should not neglect or fail or refuse to submit the required returns and not make any false or misleading statement on any returns required to be submitted to SEBI or the exchanges.

Grievance Redressal mechanism for investors

Each Exchange has a process for grievance redressal.

The general features of these processes are mentioned below. Investor grievance resolution mechanism (against trading members).

All exchanges have a dedicated department to handle grievances of investors against the Trading Members and Issuers.

Generally these departments operate from all offices of the exchange so as to provide easy access to investors.

All exchanges also have supervision mechanisms for the functioning of this department/ cell.

Grievance Redressal mechanism for investors

- These include the Investor Service Committees (ISC) consisting of Exchange officials and independent experts whose nomination is approved by Securities and Exchange Board of India.
- SEBI also monitors exchange performance related to investor grievance redressal.

Receipt of Complaints

The investor is required to submit his complaint in the prescribed complaint form against the trading member providing the details as specified in the instructions annexed to the complaint registration form along with supporting documents substantiating his claim.

On receipt of the complaint, exchanges scrutinize the nature of complaint and adequacy of documents submitted along with the complaint.

If all the relevant documents are submitted, the complaint is recorded, a complaint number is assigned and an acknowledgement towards receipt of complaint is sent to the investor.

If the documents are inadequate, the investor is advised to set right the deficiencies in the documents.

Redressal of Complaints

- Generally, exchanges initially try to resolve the complaint by following up with the member and the complainant.
- The issues raised by the complainant are analyzed and the complaint is taken up the concerned trading member for resolution / response within the set timeframe.
- Subsequently, the response received from the trading member is reviewed.
- If the Trading Member has agreed with the contents of the complaint, he is advised to settle the matter immediately and confirm
- If the Trading Member states that he has already settled the complaint, proof of settlement is solicited and cross confirmation is obtained from the investor

Redressal of Complaints

- If the Trading Member raises issues from his side, the comments are analyzed and forwarded to the investor for his views and comments.
- If differences persist the Exchange holds meeting with the parties at the Exchange premises for expeditious resolution of the complaints.
- In case differences still persist, the investor is informed that he may opt for Arbitration proceedings.
- If the Trading Member has justifiable reasons for his actions which are within the regulatory framework, the investor is enlightened on the correct position on the matter.

Nature of complaints

- Exchanges provide assistance if the complaints fall within the purview of the Exchange and are related to trades that are executed on the Exchange Platform.
- These may be of the following types:
 - Non-Receipt of Corporate Benefit (Dividend/Interest/Bonus etc.)

- Complaints against trading members on account of the following :
 - Non-receipt of funds / securities
 - Non- receipt of documents such as member client agreement, contract notes, settlement of accounts, order trade log etc.
 - Non-Receipt of Funds / Securities kept as margin
 - Trades executed without adequate margins
 - Delay /non – receipt of funds
 - Squaring up of positions without consent
 - Unauthorized transaction in the account
 - Excess Brokerage charged by Trading Member / Sub-broker
 - Unauthorized transfer of funds from commodities account to other accounts etc.
- Complaints in cases where the member has surrendered his membership and the complainant has approached the Exchange before expiry of the time mentioned in the public notice

Exchanges may not take up the following types of complaints

- a. Complaints in respect of transactions which are already subject matter of Arbitration proceedings,
- b. Complaints involving payment of funds and transfer of securities to entities other than Trading Member,
- c. Claims for mental agony/harassment and expenses incurred for pursuing the matter with the ISC,
- d. Claims for notional loss, opportunity loss for the disputed period or trade,
- e. Complaints pertaining to trades not executed on the Exchange by the complainant,
- f. Claims of sub-broker/authorized persons for private commercial dealings with the trading member,
- g. Claims relating to transactions which are in the nature of loan or financing which are not within the framework defined by the Exchange.

Arbitration mechanism at exchange

- SEBI has instructed the exchange to have arbitration committees so that differences, disputes and claims between trading members and investors can be settled effectively and in a short time.
- Arbitration is also governed by Exchange Bye-laws.
- Arbitration is a quasi judicial process of settlement of disputes between Trading Members, Investors, Sub-brokers & Clearing Members and between Investors and Issuers (Listed Companies).
- Generally the application for arbitration has to be filed at the Arbitration Centers established by the exchanges.

Arbitration mechanism at exchange

- The parties to arbitration are required to select the arbitrator from the panel of arbitrators provided by the Exchange.
- The arbitrator conducts the arbitration proceeding and passes the award normally within a period of four months from the date of initial hearing.
- The arbitration award is binding on both the parties.
- However, the aggrieved party, within fifteen days of the receipt of the award from the arbitrator, can file an appeal to the arbitration tribunal for re-hearing the whole case.

Arbitration mechanism at exchange

- On receipt of the appeal, the Exchange appoints an Appellate Bench consisting of five arbitrators who re-hear the case and then give the decision.
- The judgment of the Bench is by a ‘majority’ and is binding on both the parties. The final award of the Bench is enforceable as if it were the decree of the Court.
- Any party who is dissatisfied with the Appellate Bench Award may challenge the same only in a Court of Law.

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