Report

of the

Group to Review

The Revised Carry Forward System

Mr. M. G. Damani

Mr. R. C. Gupta (Co-ordinator)*

Mr. K. Kannan

Mr. M. M. Kapoor

Dr. R. H. Patil

Prof. J. R. Varma (Chairman).

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* Mr. R. C. Gupta, Division Chief SEBI and Co-ordinator of the Group while providing outstanding administrative support did not participate in the deliberations of the group and in the drafting of the report.

Executive Summary

This Executive Summary highlights the principal recommendations of the Group (majority view). As explained in his note of dissent, Dr. R. H. Patil does not concur with some of these recommendations. The group recommends several significant changes in the Revised Carry Forward System (RCFS). The system emerging from these modifications is referred to below as the Modified Carry Forward System (MCFS).

The Group recommends abolition of the twin track system of segregating carry forward trades and delivery trades. A uniform margin of 10% on gross positions with *daily* marking to market should be applied to both types of transactions. Margin payments to the exchange must be value dated the same day. Over a period of time, exchanges must move towards realization of margin payments before the next day's trading begins. As a precondition for adopting the MCFS, an exchange should have a well designed software for margin computation and well established governance structures and administrative infrastructure for monitoring and enforcing the margining system.

The Group recommends elimination of the following elements of the RCFS:

a) Limit of 90 days for carried forward of transactions

b) Settlement only by delivery after 75th day

c) Limit of Rs 10 crore on financier funding

d) Overall limits, sub limits on purchase and sale, and scripwise limits on carry forward transactions and on overall transactions.

In the case of *vyaj badla* in respect of dematerialized shares, a pledge of the shares should be marked in the electronic records of the depository. In the paper based system, the Group recommends that shares received by *vyaj badla* financiers should continue to be deposited with the clearing house as at present. In addition to other risk containment measures, the clearing house should at all points of time have an insurance policy covering the aggregate value of shares lying in the clearing house.

The Group endorses and emphasises some of the existing safeguards:

a) Capital adequacy and other prudential safeguards must be strictly enforced

b) While choosing scrips for carry forward, the exchanges must ensure that the scrips have sufficient floating stock and high liquidity.

c) Exchanges should have adequate monitoring and surveillance systems to enable timely use of the various powers vested in them to regulate the market.

Acknowledgements

The Group has benefited from written and oral presentations by a number of individuals and organizations enumerated in Annexure 1. But the Group's debt to outside experts is much greater than this list might suggest. Over the last four years, a large number of academics, practitioners and other experts have written about the different forms of the carry forward system in the financial press as well as in other fora. The Group has benefited from the thinking of all these experts who are too large in number to thank individually. Finally, our intellectual debt to the G. S. Patel Committee report of March 1995 is evident in every page of our report.

The Group would especially like to thank its Co-ordinator, Mr. R. C. Gupta for outstanding administrative support. Mr. Gupta chose not to participate in the deliberations of the Group and in the drafting of the report, but his assistance was invaluable in all aspects of the Group's work.

Abbreviations

BSE	Stock Exchange, Mumbai (formerly, the Bombay Stock Exchange)
GSPC	G. S. Patel Committee to review the system of carry forward transactions which submitted its report in March 1995.
MCFS	Modified Carry Forward System as recommended in this report
RCFS	Revised Carry Forward System recommended by the GSPC and implemented by SEBI in somewhat modified form by its decisions of July 27, 1995 and October 5, 1995.
SEBI	The Securities and Exchange Board of India

I. Background and Terms of Reference

In December 1993, SEBI directed the stock exchanges to discontinue the traditional system of carry forward of transactions (*badla*). Subsequently, it proposed an alternative system in March 1994, but no agreement could be reached on implementing this system. In February 1995, SEBI set up the G. S. Patel Committee (GSPC) to review the system of carry forward transactions. The GSPC submitted its report in March 1995. SEBI adopted the system recommended by the GSPC with some modifications in its decisions of July 27, 1995 and October 5, 1995. This Revised Carry Forward System (RCFS) was implemented in the BSE in January 1996, but the other exchanges in which the traditional carry forward system had been prevalent before December 1993 did not come forward to adopt the RCFS. A year after the implementation of RCFS, the President of the BSE wrote to SEBI in January 1997 requesting a relaxation of certain aspects of the RCFS to make it more practical and efficient. In its meeting of March 27, 1997, SEBI reviewed the entire sequence of developments relating to the RCFS and specifically noted that while introducing the RCFS in July 1995, SEBI had decided that "the implementation of the revised carry forward system would be reviewed periodically by the Board, the first review being after three months". SEBI then decided to constitute a Group consisting of:

Mr. M. G. Damani , President, Stock Exchange, Mumbai

Mr. R. C. Gupta, Division Chief, SEBI (Co-ordinator)

Mr. K. Kannan, President, Tamil Nadu Investors Association

Mr. M. M. Kapoor, Executive Director, Unit Trust of India

Dr. R. H. Patil, Managing Director, National Stock Exchange Limited

Prof. J. R. Varma, Member, SEBI, (Chairman).

The terms of reference for the Group were to review the RCFS in its entirety.

II. The Group's Approach and Procedure

The Group took as the starting point for its deliberations the GSPC Report particularly para 149 describing the RCFS as recommended by them. The Group discussed each element of the RCFS mentioned in this paragraph, identified the rationale for the element, analysed the experience with this element during the last year or so, debated the continued relevance of this element, and deliberated on the desirability of retaining the item or of modifying or eliminating it. The Group also discussed various additional or alternative safeguards that have been proposed to improve the RCFS.

While much of the debate on the RCFS in the financial press and elsewhere has been couched in terms of *badla* versus futures/options, the Group consciously avoided any such flavour in its discussions and its recommendations. The Group focused instead on the regulatory issues

posed by carry forward trading and concentrated on the measures that are needed to achieve important regulatory goals like market efficiency, financial integrity, investor protection and regulatory compliance.

The Group benefited from written and oral presentations by a number of individuals and organizations enumerated in Annexure 1. The Group held three meetings (on May 6, 1997, June 20, 1997 and July 22, 1997) at the SEBI Head Office in Mumbai. Apart from these two meetings, the members of the Group communicated with each other by telephone, fax, email and courier.

III. Review and Modification of the RCFS

This section, constituting the core of the report, reviews each element of the RCFS and recommends modifications thereto. For convenience, the items are discussed in the order in which they appear in paragraph 149 of the GSPC report. The carry forward system as it emerges from these modifications is referred to in this report as the Modified Carry Forward System (MCFS) wherever it is important to distinguish it sharply from the RCFS.

1. Shares eligible for carry forward (specified shares)

The Group is of the view that though the actual choice of scrips for carry forward is a decision to be left to the exchange, it is essential for market integrity that the scrips have a sufficient floating stock and high liquidity. Essentially, the RCFS is a futures contract on individual stocks; since it is neither cash settled nor affords multiple delivery options as in many other future contracts, the RCFS would be prone to market manipulation unless the stocks are liquid, large cap stocks. The Group therefore endorses the GSPC recommendation that the stocks included in the RCFS must be those that do not lend themselves to price manipulation or cornering of shares.

2. Common list of specified shares

The GSPC recommendation that the specified shares in various exchanges should be chosen from a common pool of eligible stocks has not been of much relevance so far as only the BSE has adopted the RCFS, but this situation may not continue under the MCFS. The Group does not wish to impose excessive uniformity on the various stock exchanges, nor does it favour the involvement of SEBI in the choice of specified shares. It does however concur with the GSPC that the stocks eligible for RCFS in *any* stock exchange should be drawn from a list of stocks which satisfy the basic criteria discussed in item 1 above.

3. Stock exchanges eligible for RCFS

The GSPC drew a distinction between the major stock exchanges like those at Bombay, Calcutta, Delhi, Ahmedabad and Madras on the one hand and any other exchange which might wish to start carry forward trading. The Group is of the view that it is not proper to discriminate between different exchanges on the lines recommended by the GSPC. The Group prefers a uniform set of pre-conditions for any stock exchange which wants to adopt the

MCFS. Apart from screen based trading which is now becoming standard in all exchanges, the Group places great emphasis on the efficacy of the margining systems. Any exchange which intends to adopt the MCFS must demonstrate that it has a well designed software for margin computation and well established governance structures and administrative infrastructure for monitoring and enforcing the margining system. To this end, the Group recommends that prior to granting permission to an exchange to adopt the MCFS, SEBI should carry out an inspection of the exchange to satisfy itself about the adequacy of its margining system. A further inspection of the exchange should be carried out six months after adoption of MCFS to verify that the margining system works properly under actual trading conditions.

4. Ninety day limit for carry forward

The GSPC asserted that there was no sanctity for the ninety day limit on the length of time for which a transaction can be carried forward. While introducing the RCFS in July 1995, SEBI enforced the ninety day limit, but in October, it relaxed the requirement of an audit certificate and replaced it with self certification by the broker.

The Group is of the view that, with self certification, the 90 day requirement does not pose serious administrative problems. But, the Group agreed with the GSPC that the 90 day limit had no sanctity at all. It is also easily evaded in practice by shifting positions across exchanges or members. The Group is of the view that with strict mark to market, the time for which a position has been carried forward is totally irrelevant. The whole idea of mark to market is that the position starts from a clean slate just as if it were a new transaction. For this reason, the Group is of the view that the 90 day requirement should be scrapped entirely.

5. Screen based trading

The Group agrees that screen based trading is desirable, and notes with satisfaction that quite apart from the adoption of the RCFS, screen based trading is now becoming standard in all exchanges.

6. Four track/ Twin Track/ Single Track Trading

The GSPC recommended a four track trading system which was subsequently implemented as a twin track trading system in which transactions for delivery were separated from those for carried forward. The Group deliberated on this issue at length.

The majority view is that twin track system should be discarded. In the past when margining systems were extremely weak, there might have been some merit in the idea of segregating carry forward transactions (which were perceived as speculative in nature) and imposing stringent margins at least on these transactions. Today however, systems have evolved to the point where daily mark to market margins are being collected regularly in the major exchanges on *all* transactions. In this situation, there is no justification whatsoever for segregating carry forward transactions. When daily mark to market margins are levied properly, the risk to the trading system from all transactions is the same, namely that of adverse price movements during one day. As such the majority view of the Group is that having regard to their identical risk characteristic, the carry forward transactions and the delivery transactions should be

treated alike for margining purposes. Once margins are unified, twin track trading ceases to be an operational idea; with no preferential margins for delivery transactions, brokers would prefer to classify all transactions as carry forward transactions.

The majority view is also that from a pricing point of view, there is no distinction between the two types of transactions. Carry forward is conceptually identical to a closing out of the current week transaction and simultaneous initiation of the next week transaction. Thus carry forward transactions are also closed out on the same settlement date as delivery transactions. Since all transactions for the settlement date are priced identically, there is no pricing difference between the two types of transactions. If the settlement is by carry over instead of delivery, the spot-futures basis is reflected in the form of a contango or backwardation charge at the time of carry over, but there is no pricing difference at the time of initiation of the transaction. Thus single track trading would not vitiate price discovery in any way.

Dr. R. H. Patil is however of the view that separation of the cash market and the carry forward market is necessary in the interests of greater transparency and also to facilitate price discovery.

7. Squaring of carry forward transactions

The GSPC recommended that under the twin track system, delivery transactions should not be allowed to be squared, while carry forward transactions can be squared at any time. While introducing the RCFS in July 1995, SEBI stipulated that carry forward transactions could not be squared off after 75 days; this was done to facilitate enforcement of the 90 day limit (see item 4 above). With the abolition of twin track trading and the scrapping of the 90 day limit in the MCFS, all these provisions become redundant and the Group is of the view that they should be scrapped.

8. Common trading

The Group endorses the recommendation of the GSPC that there should be common trading for delivery and carry forward.

9. Vyaj badla

The Group discussed the implications of the current system under which shares given as collateral to the *vyaj badla* financier are deposited with the clearing house and are not allowed to be withdrawn by the financier. The Group considered proposals that the financier be allowed to withdraw the shares as well as proposals that the shares should be deposited with a depository instead of a clearing house. The discussion focused on the risks, costs, and administrative problems entailed by different approaches to *vyaj badla* transactions.

At the outset, the Group agreed that when a substantial degree of dematerialization of shares has taken place, *vyaj badla* becomes a very simple matter of recording a pledge of the shares in the electronic records of the depository. The real problems arise only in the system of paper based settlement.

In the paper based system, the Group recommends that shares received by *vyaj badla* financiers should continue to be deposited with the clearing house as at present. In addition to other risk containment measures, the clearing house should at all points of time have an insurance policy covering the aggregate value of shares lying in the clearing house.

10.Proper records of sources of vyaj badla finance

The majority view is that the *vyaj badla* financier is a client of the broker like any other buyer or seller and that the broker should (as at present) be required to maintain the same records in respect of the financiers as he is required to maintain of other clients (for example, under the Know Your Client scheme).

Dr. R. H. Patil is of the view that *vyaj badla* financiers must become members of the clearing house just as custodians do currently. This would prevent any money obtained from illegal sources from flowing into the market as *vyaj badla* finance.

The majority view is that few *vyaj badla* financiers would satisfy the stringent net worth and other entry norms that clearing houses rightly impose while admitting non members of the exchange as participants in the clearing house. The integrity of the clearing house must be jealously safeguarded.

11.Contango charges

The Group endorses the recommendation of the GSPC that payment of contango charges to short sellers should be permitted as it is an essential ingredient of the carry forward system.

12.Settlement and clearing process and reporting

The majority view to abolish twin track trading would simplify the daily reporting in as much as delivery and carry forward transactions would no longer be distinguished. (See item 6 above).

13.Duration of carry forward session

The Group is of the view that with electronic trading the recommendation of the GSPC to extend the carry forward session from half an hour to one hour is no longer relevant.

14.Daily margin

In the context of daily mark to market margins and the reduction of the settlement period the Group considered the possibility of reducing the margin. The Group noted that halving of the settlement period from two weeks to one week would not halve the margin requirement because the scaling of volatility is in proportion to the square root of the time scale. Similarly, if daily mark to market reduces the time scale from ten trading days to one, the reduction in price fluctuations is not by a factor of ten but only by a factor of approximately three (the square root of ten). It must also be considered whether the 15% margin proposed by the

GSPC for a two week settlement period was too low to begin with. Taking all factors into account, a reduction of the margin to 10% could be considered.

Under item 6 above, the Group has explained its recommendation for the abolition of twin track trading and the unification of margins on carry forward trades and delivery trades. Unification of margins would imply that margins on delivery trades would also be subject to a minimum of 10%. This could imply an *increase* in the margins from the current level in some cases. As we have emphasised, with daily mark to market, the key issue is the maximum price change within a single day; and it does not matter whether the transaction is for delivery or carry forward. The only exception to the uniform margining system would be for sale transactions where the seller deposits the shares for delivery.

The 10% margin is a minimum margin and exchanges would be free to levy higher margins. Moreover, during periods of excessive volatility as in mid January 1997 or end March 1997, there may be a need to step up the margins temporarily.

The Group reiterates that margins must be levied on gross positions as is mandated at present.

The Group would also emphasise the value dating of margin payments by the brokers. Where a broker deposits margins by cheque these must be value dated the same day. Otherwise, the exchange would be effectively exposed to the broker for more than a single day's price fluctuation. Same day value dating could be accomplished by accepting cheques only on the clearing house's own bank branch or by more rapid "high value clearing", "window clearing" or other similar processes. Over a period of time, exchanges must move towards realization of all margin payments before the next day's trading begins. In the long run, real time funds transfer would be imperative.

Dr. R. H. Patil is of the view that margins must be collected up-front (on both delivery and carry forward transactions) to reduce risks even further. The majority view is that this would not be practical in the absence of electronic funds transfer facilities.

15.Carry over margin and impounding of profits

The Group is of the view that daily mark to market has rendered the distinction between daily margin and carry over margin redundant, and there is only one comprehensive margining system. The Group is also of the view that the GSPC's proposal to impound 25% of the profits (which has never been implemented) does not serve any useful purpose.

16.Ad hoc margin

The Group endorses the recommendation of the GSPC to allow exchanges to levy ad hoc margins on members who have unduly large positions or are considered financially weak.

17.Computerized margin calculations and strict enforcement

The Group endorses the recommendations of the GSPC on margin enforcement. In fact, the Group has gone further in making it a precondition for the adoption of the MCFS (see item 3 above).

18.Mark to market

The GSPC recommended weekly mark to market (in the context of a two week settlement cycle). The Group is of the view that that this is totally inadequate and that daily mark to market is imperative.

19.Limits and sub limits

The GSPC recommended various limits on the carry forward position with scripwise sub limits. The Group is of the view that these limits and sub limits should be scrapped. Exposures should be linked to capital and there should be no rupee value limits. The Group is of the view that the GSPC's recommendation regarding limits on aggregate (market wide) outstanding position is redundant in view of items 1, 16 and 27.

20.Vyaj badla limit

The Group is of the view that with mark to market of *vyaj badla* financiers (see item 9 above), the limit of Rs 10 crore on *vyaj badla* recommended by the GSPC should be scrapped.

21.Institutional badla finance

While agreeing with the GSPC's recommendation to encourage institutional *vyaj badla* financing, the Group is of the view that the initiative for this lies elsewhere.

22.Overall limit on speculative position

The Group is of the view that these limits recommended by the GSPC (which were incidentally never brought into force) are unnecessary for the same reason as in item 19 and 20.

23.Capital adequacy

The Group considered and rejected proposals to mandate higher net worth or capital adequacy norms for brokers engaged in carry forward transactions. The Group however reiterates the importance of maintaining capital adequacy ratios at such levels as SEBI may mandate from time to time, and of conforming to various prudential guidelines of SEBI like segregation of broker and client accounts both for money and for shares.

24. Interim base capital requirement

The GSPC recommended increases in base capital pending introduction of capital adequacy norms. With the introduction of capital adequacy norms, this recommendation is now irrelevant.

25. Uniform settlement period

The Group is of the view that the GSPC's suggestion on a uniform settlement period is not connected with the RCFS at all. It may or may not be desirable by itself, but the RCFS does not make it any more or any less desirable.

26. Making up price

The GSPC recommended that in case of a suspicion that the closing price in any settlement period has been rigged or manipulated, the making up price should be based on an average of the last three days' closing prices. The Group is of the view that price rigging is a very serious matter and that an adjustment in the making up price is a very feeble response to this menace. The Group notes with satisfaction that in recent months, SEBI has taken firm measures to check price rigging and to compel price manipulators to disgorge their profits. The Group is of the view that while the campaign against price rigging must be carried out relentlessly, the sanctity of market prices must not be vitiated by discretionary adjustments to the making up prices.

27. Suspension of carry forward facility

The Group endorses the recommendation of the GSPC to allow exchanges to suspend carry forward trading in any scrip when aggregate outstanding position in any security exceeds pre-announced limits.

28. Other regulatory powers of stock exchange

The Group endorses the recommendation of the GSPC that exchanges should be allowed to use the entire armoury of regulatory powers vested in them to regulate the market. The Group does not however go into the merits or otherwise of the specific powers mentioned by the GSPC.

29. Governance and Administration

In items 29- 38 of para 149, the GSPC made sweeping recommendations on many matters concerned with the governance and administration of the stock exchanges whether or not the RCFS is in operation in the exchange. Some of these may be quite desirable, but they are desirable whether or not RCFS is permitted in any form. The Group refrains from commenting upon them. The Group however reiterates its view (see item 3 above) that an essential precondition for the introduction of the MCFS in any exchange is a well established governance structure and administrative infrastructure for monitoring and enforcing the margining system.

IV. Modified Carry Forward System (MCFS)

The Modified Carry Forward System (MCFS) which emerges from the recommendations of the Group (majority view) is summarized below.

1. Precondition for adopting MCFS in any exchange

Any exchange which intends to adopt the MCFS must demonstrate that it has a well designed software for margin computation and well established governance structures and administrative infrastructure for monitoring and enforcing the margining system. Prior to granting permission to an exchange to adopt the MCFS, SEBI should carry out an inspection of the exchange to satisfy itself about the adequacy of its margining system. A further inspection of the exchange should be carried out six months after adoption of MCFS to verify that the margining system works properly under actual trading conditions.

2. Shares eligible for inclusion in MCFS

Though the actual choice of scrips for carry forward is a decision to be left to the exchange, it is essential for market integrity that the scrips have a sufficient floating stock and high liquidity.

3. Uniform margin

A uniform minimum margin of 10% would be imposed on both carry forward trades and delivery trades on gross basis. This is a minimum margin and exchanges would be free to levy higher margins. Moreover, in periods of excessive volatility as in mid January 1997 or end March 1997, there may be a need to step up the margins temporarily. Margin payments by the brokers must be value dated the same day. Over a period of time, exchanges must move towards realization of all margin payments before the next day's trading begins. The Group reiterates that margins must be levied on gross positions as is mandated at present. Exchanges may levy ad hoc margins on members who are considered financially weak or have positions which are unduly large in relation to their capital adequacy.

The only exception to the uniform margining system would be for sale transactions where the seller deposits the shares up-front for delivery.

4. Capital adequacy and other prudential guidelines

The Group reiterates the importance of maintaining capital adequacy ratios at such levels as SEBI may mandate from time to time, and of conforming to various prudential guidelines of SEBI like segregation of broker and client accounts both for money and for shares.

5. Vyaj badla

In the case of *vyaj badla* in respect of dematerialized shares, a pledge of the shares should be marked in the electronic records of the depository. In the paper based system, the Group recommends that shares received by *vyaj badla* financiers should continue to be deposited with the clearing house as at present. In addition to other risk containment measures, the clearing house should at all points of time have an insurance policy covering the aggregate value of shares lying in the clearing house.

6. Regulatory powers of the exchanges

Exchanges may suspend carry forward trading in any scrip when aggregate outstanding position in any security exceeds pre-announced limits. Exchanges should have adequate monitoring and surveillance systems to enable timely use of the various powers vested in them to regulate the market.

M. G. Damani K. Kannan M. M. Kapoor

R. H. Patil J. R. Varma

Mumbai
July 22, 1997

Note of Dissent to
The Report of the Group to Review the Carry Forward System

By Dr. R. H. Patil

The main report has spelt out at various places the differing views held by me on some of the important recommendations made by the majority group. Since the logic underlying my differences with the recommendations of the majority have not been fully brought out at relevant places it would be appropriate that this is explained properly. In what follows I have made an attempt to explain my position briefly.

Twin Track Trading System

The logic of the twin track system is based on the fact that the risks associated with the transactions that have to be necessarily closed out within one week are materially different from the transactions which can be carried forward indefinitely. While the main report has argued that the daily margins should be unified and that the same daily margins should be applicable to both the segments, this argument has not taken into account the underlying risks between the two different types of transactions. Daily margins are just one instrument for controlling risk. As the carry forward system deals with transactions which need not be closed out for an indefinite period, the total exposure of a member can rise to a point which may pose serious danger to the system whenever there are sharp price fluctuations and surges in trading volumes.

In this context it should be noted that almost all the brokerage entities in India are heavily undercapitalised. Since their capacity to absorb shocks emanating from the system in unusual periods are severely limited any proposal to abolish the segregation of or the dividing wall between the two trading systems appears to be fraught with considerable risks. While computerisation of the trading system has enhanced the ability of the exchange authorities to regulate the system, it should at the same time, be noted that the ability of a trading member to build exposure vis-à-vis the rest of the market in a very short period of time has increased manifold because of the ease of trading on the computer and the substantially increased liquidity on the screen at any point of time during the trading day.

Another major reason why the two segments are different is that the price discovery process in each segment is different. The carry forward trading system is highly dominated by the speculative element while the weekly trading segment is dominated relatively by investor interests. Just as great importance is being given to the need to separate out the cash transactions from the futures transactions in the yet to be approved derivative segment, exactly the same principles of transparency and risk containment would call for the same separation between the cash market transactions and the carry forward transactions.

Registration of Vyaj Badla Financiers

The main report suggests that the Vyaj Badla financier is merely a client of the broker and therefore need not be separately registered with the clearing house. While this view perhaps

appears to be practical in the case of small financiers, it would not be proper to take this view for large financiers. The reason is that the vyaj badla financier is also akin to a lender/borrower of securities under the SEBI approved scheme for lending and borrowing of securities. When such lenders/borrowers of securities have to get registered and route their transactions through SEBI registered intermediaries like custodians, clearing houses/corporations, etc., there is no reason why vyaj badla financiers also should not be asked to deal through clearing house/corporation so as to lend transparency to such transactions. The main report has recommended removal of the limit of Rs. 10 crore on vyaj badla. When large amounts will start flowing into this activity it is desirable that these amounts flow from sources which can be clearly identified.

In the case of securities lending/borrowing scheme as approved by SEBI it is required that the securities have to be lent through an intermediary like clearing house/corporation and custodians. This condition has been stipulated to get over the problem of income tax and capital gains taxes as lending and borrowing transactions should not be treated as selling and borrowing of securities. All transactions done under the carry forward system are identical to lending and borrowing of securities. In view of this it would be appropriate that all the vyaj badla financiers are registered with the clearing house and all their transactions are routed through the clearing house so as to get over the problem of income tax / capital gains tax.

Need for Up-front Margins

The main report has argued in favour of reduction of daily margins from the earlier 15% to 10% on the ground that the margins should be based on the maximum price change within a single day and not whether the transaction is for delivery or carry forward. While this argument is correct in so far as mark to margin is concerned it may be noted that the current weekly trading system itself has three types of daily margins. These are mark to market margin, gross exposure margin and net exposure margin with the latter two types of margins being on a graded basis. It is important to note that the mark to market margin only covers the risk of the maximum price change within a single day. It presumes that the principal transaction is not at risk and the margin is actually received on the same day in question.

The main report has summarily dismissed the proposal for up front margin as not being "practical in the absence of electronic funds transfer facilities"(page 7). It has not been fully appreciated that it is mainly because of the absence of electronic transfer of funds that it is necessary to have up front margins. Under the current arrangements the notice by the exchange to pay mark to market margin is given to the members earliest at the end of the trading day say T. The member is expected to deposit the instrument to pay margin to the exchange or the clearing corporation on T+1 day. If the member is in a position to deposit the instrument in the early banking hours the cheque gets credited in the account of the exchange/clearing corporation at the end of the day. If the margin cheque is deposited later on T+1 day the amount gets credited in the account of the exchange or the clearing corporation earliest on T+2 day. In the meanwhile it is possible that the prices could have moved adversely thereby increasing risk to the trading and the settlement system.

Thus, because of the absence of the electronic funds transfer facilities the system would run large risks as members may not be able to bring the margins in time. The stock exchanges keen

to introduce MCFS should have the required software to calculate the mark to market margin and communicate to all their members on the same day. Unless they are able to do this risks to the settlements systems will be very high.

Several stock exchanges planning to expand its trading network to a large number of cities which are far away from their present areas of operations. When this happens the problem of delayed funds transfer would get further accentuated whenever the members especially from distant cities will not be in a position to pay margins in time. The problems arising from the weaknesses of our banking system in the funds transfer area should not be underestimated. It is primarily for this reason that NSE has been strictly adopting the system of up front margin deposits for its weekly cash market despite its ability to inform all the members at the end of each trading day the various margins they are expected to pay. This has been possible because of its excellent captive satellite based communication network and the margin software developed by it.

Trading limits to members should, therefore, be granted on the basis of the up front margin deposits they keep with the exchange(including those with the clearing corporation/house). An up front margin deposit of Rs 50 lakh should normally entitle an exposure limit of Rs 5 crore. Before considering removal of various trading limits on members' combined exposure to the market in both the cash and the carry forward segments a system of upfront margin should be in place. Members keen to have larger trading limits should be asked to deposit proportionately larger amounts with the exchange.

In this context it should be noted that the current capital adequacy requirements adopted by different exchanges are not stringent enough to protect market integrity especially under volatile conditions. The current capital adequacy requirements do not link capital adequacy with market exposure limits as is done internationally. The current capital deposit requirements only stipulate minimum amount of deposit that the members are required to keep with the exchange. They are currently exchange specific and within any exchange they do not make any distinction between members with large or small trading exposures. If the internationally adopted definition of capital adequacy is accepted the amount deposited by members with the exchanges in India may not be said to be determined by capital adequacy criteria

Based on the current deposit requirements the maximum permissible exposure that a member could possibly have jointly in the cash and the carry forward segments would be Rs 100 lakh if the principle of 10% up front margin is to be stipulated. For example, currently NSE grants an exposure limit of 7 times the amount of up front deposit. Thus the up front deposit insisted by NSE even for the weekly cash market is about 15%. Based on the performance record of members NSE is considering further lowering of this exposure limit to members who are not prompt in paying their margins to the exchange in time.

Given the large amplitude of price fluctuations of individual securities in India a tight margin system should be maintained. Further, with banks needing much longer time for funds transfer from the accounts of brokers to the account of the exchange there is a pressing need for

collecting up front margin deposits especially for the carry forward trading segment which is heavily influenced by speculative activity.

All the major steps taken by SEBI especially during the recent past have been to strengthen the surveillance and margining mechanism. Because of these market friendly steps it has been possible to prevent market disruption despite periodic sudden surges in trading volumes or volatile market conditions. During these volatile periods there have been some broker failures but the market integrity continues to be maintained. Before considering relaxation of any of the current margin or other requirements which have all been put in place for protecting the market integrity it may be worthwhile to carefully examine impact of these relaxations on the health of the market.

Dr. R. H. Patil

Annexure 1

Individuals and organizations which made written or oral presentations to the Group

1. The Stock Exchange, Ahmedabad
2. Associated Chambers of Commerce and Industry of India
3. B. N. K. Brokers Pvt Ltd. and 69 other trading members of the National Stock Exchange
4. Calcutta Stock Exchange Association Limited
5. The Delhi Stock Exchange Association Limited
6. Dr. Ramesh Gupta
7. Merchants' Chamber of Commerce