

# Understanding the Derivative Contract and Its Regulatory Challenges in India

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## Abstract:

The present research will be focusing on the critical analysis of the derivative instrument with special emphasis on Indian derivative market. After the opening of the derivative market in India, there are confusion and fear concerning the use and enforcement of the derivative contract evident from many cases filed in the different High Courts and Supreme Court. The main theme of the research is to discuss the legal aspect of derivative instruments, problem and challenges in this area, loopholes in the existing legal framework, failure of the existing laws to address the issues, changing dimension and suggestions in the form of proposal to be incorporated in the current legal framework to regulate this market efficiently. Although the India legal frameworks on derivative contracts are consistent with international norms, there are certain elements which need to be addressed adequately in the line of adopting international best practices for this market.

**Keywords-** Derivatives, Taxation, Validity, Regulations, Legal Framework

## INTRODUCTION

Derivative contract has been legalised in a phased manner in India.<sup>1</sup> The contract has been present in different forms and has been used since antediluvian time. But question of legality of the contract were raised only after the foundation of British Rule in India. When India became colony of the Britain, contractual principles and rules of common law was also applied in India with some modifications. One of such established principles of common law is the declaring wagering contract null and void.<sup>2</sup> Wagering contract has always been compared with derivatives due to certain similarities between the same.<sup>3</sup> There are several cases where an arguments related to the validity of the derivative contract have been developed due to the wagering elements present in

derivative contract. The first time this argument was raised in the *Rajshree Sugars & Chemicals v. Axis Bank Limited*.<sup>4</sup> In this case one question was raised on the validity of the derivative contract being void *ab initio*, illegal and against the public policy. The company's arguments to proclaim the said OTC contract null and void were founded on Section 30, and 23 of the Indian Contract Act, 1872.<sup>5</sup> It was claimed that the said contract was a wagering agreement as there was no actual interest of the parties in the transaction and therefore it was in violation of the RBI guidelines<sup>6</sup> of RBI and consequently attract Section 23 of the Contract Act, 1872. The same arguments were also raised in *ICICI Bank Ltd. V. Sundaram Multi Pop Ltd.*<sup>7</sup> and *Sporting India Ltd. V. HDFC Bank Ltd.*<sup>8</sup> but in both the cases

<sup>1</sup>Derivative contract trading in India started right after the amendment in the Securities Contract Regulation Act, 1956 in 1995 and then establishment of committees such as Gupta Committee, Verma Committee for the study of regulatory framework of derivative in India and then amendment in the RBI Act, in 2006 by introducing Section 45U. Francis Xavier, *OTC Derivatives Market in India: Recent Regulatory Initiatives and Open Issues for Market Stability and Development*, (Working Paper No. 248)

INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS (2010).

<sup>2</sup>M. P. Jain, *The Law of Contract Before Its Codification*, JOURNAL OF THE INDIAN LAW INSTITUTE, 1972, 178-204, [www.jstor.org/stable/43950179](http://www.jstor.org/stable/43950179). (Last visited on Aug. 6, 2020)

<sup>3</sup>Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk*, COLUMBIA LAW REVIEW 100, no. 4 (2000): 1096-138

[www.jstor.org/stable/1123538](http://www.jstor.org/stable/1123538). (Last visited on Aug. 6, 2020)

<sup>4</sup>C.S. No. 240 Of 2008

<sup>5</sup>*Id.* at para 19 of the judgement

<sup>6</sup>RBI's Comprehensive guidelines on derivatives, RBI/2006-2007/333DBOD.No.BP.BC. 86/21.04.157/2006-

<https://rbidocs.rbi.org.in/rdocs/notification/PDFs/76926.pdf>

(Last visited on July 2, 2020)

<sup>7</sup>(2010) 153 Comp Case 424

<sup>8</sup>*Sporting India Ltd. V. HDFC Bank Ltd.* 2013 SCC Bom. 906

the court said though wagering agreements involve speculation but every speculation is not necessarily a wager. Court added that investment in stock market involves speculation but it is permitted by securities laws.<sup>9</sup> The dealing in futures may be categorise as wagers where there is no physical delivery and settlement is done through paying the differences but it is accepted as an exception to the wagering agreement. One of the elements of wager is the gain of one party will necessary cause a loss to the other party which is not present in derivative contract as both the parties may make profits in different time of the contract. On the question of public policy also enforceability of the derivative contract cannot be challenged as there are several amendment made in the relevant laws such as Securities Contract Regulation Act 1956, RBI act 1934 to validate and enforce the derivative contract. On the question of contract of differences there several cases which throw light on the actual legal position of these contract.

In *BhagwandasParasram v. BurjorjiRuttonjiBomanji*<sup>10</sup> a privy council case the enforceability of the forward contract was challenged on the basis of its nature being speculative and hence wager under Section 30 and not enforceable. The court held that every speculative contract is not a wagering agreement unless parties have a common intention to contemplate it for the payment of differences in the prices. The Court said that even though such contract does not requires actual delivery there is interests involve from both the side.<sup>11</sup> The same question was raised in *Firm of PratapchandNopaji v. Firm of KotrikenVenkattaSetty& Sons*<sup>12</sup> and Supreme Court upheld the Privy Council's decision.

### ARE DERIVATIVES WAGER?

There are some similarities between future trading and wagering activities, and in some specific cases of future trading, only differences are paid without any other obligation on the parties. Hence it becomes similar to wagering. Now come to the question of eliminating or finding out the wagering elements from the derivative contract. The deciding factor can

be to know what the parties intend to achieve through the contract. If parties of the derivative contract are using this financial instrument to hedge the risk associated with the underlying assets and they are intending to settle the contract by the performance of their part of obligation then it will not fall under the wagering agreements. The reason is that one of the elements of wagering is missing here that is actual performance of the contract by delivering the underlying assets to settle the contract. But when a contract of a derivative is made which are intended by the parties to be settled by paying differences, then its enforceability can be check. Every speculative transaction is not necessarily a wager if the intention of the parties is not common to use it for the speculations. Wagering agreements necessarily involve common intention that profit by one party will cause a loss to the other party. On the other side derivative contracts does not possesses this elements as even if parties are entering into the contract for speculation they do not intend to cause loss to the other party; there may be a win-win situation.<sup>13</sup>

Recently Delhi High court in a case<sup>14</sup> held that trade in derivatives is excluded from the definition of speculative transaction. One problematic question needs to be considered here that if wagering contract is illegal then what about the share market where investment is made with the same motive, i.e., to earn a profit by speculation. Another problem which arises is how to know the intention of the parties entering into this type of contract, whether they are willing to reduce the risk or chasing the profit. In this case, Delhi High court said that in the contract of wagering after the determination of the event one party must win and the other party must lose, but in derivatives contract, it is not necessary. If one analysis carefully there is many efforts have been made by the legislature validating the derivatives contracts. Some of them are an amendment made in section 18A of the SCRA validating derivatives contract in 1999. An amendment has been brought into the RBI Act, 1934

<sup>9</sup> Which para of the judgement

<sup>10</sup>(1917) PC 101

<sup>11</sup>Page no. 378 of the judgement (True copy can be accessed on [http://14.139.60.114:8080/jspui/bitstream/123456789/41174/1/044\\_Bhagwandas%20Parasram%20%28Plaintiff%29%20v.%20Burjorji%20Ruttonji%20Bomanji%20%28Defendant%29%20%28373-379%29.pdf](http://14.139.60.114:8080/jspui/bitstream/123456789/41174/1/044_Bhagwandas%20Parasram%20%28Plaintiff%29%20v.%20Burjorji%20Ruttonji%20Bomanji%20%28Defendant%29%20%28373-379%29.pdf))

(Last visited on Jan.12, 2019)

<sup>12</sup>1975 SCR (3) 1

<sup>13</sup>*BhagwandasParasram v. BurjorjiRuttonjiBomanji*, AIR 1917 PC 101.

<sup>14</sup>*CIT Delhi v. DLF Commercial Development Ltd.* (2013) 091 DTR 0049.

also which redefine the financial derivatives.<sup>15</sup>

## TAXATION DERIVATIVE CONTRACT

In India, derivative business Income which is earned by speculative activities<sup>16</sup> has been classified into two categories under the Income Tax Act.<sup>17</sup> These are speculative business<sup>18</sup> and speculative transactions.<sup>19</sup> If one reads the provisions of Income Tax Act related to levying of taxes on speculative income, there is some confusion in the treatment of speculative income to levy taxes and set off that income against the speculative income or losses. Section 43(5)<sup>20</sup> of the Act defines speculative business and says that any transaction which does not involve actual delivery will be considered as speculative transaction. One more point is that explanation 2 of section 28<sup>21</sup> uses the word speculative transaction(s) which says "to constitute speculative business there must not be a single transaction". Further, there is a clear demarcation under the Act between speculative transactions and speculative business. To impose a tax on the income from speculative activities, it must constitute a business. Now the question arises what business is and how it is different from the transaction.

**Transaction** means "an act of agreement or several acts of agreement connected directly or indirectly with each other where more than one person is concerned and by which legal relation of such persons among themselves are altered".<sup>22</sup>

**Business** means "employment, occupation, profession or commercial activity engaged in for gain or livelihood or enterprise in which person engaged shows a willingness to invest time and capital on future outcomes".<sup>23</sup>

If one reads both the definitions carefully, the conclusion would be that business is a broader term which includes transaction and one major difference is the intention of doing business is the livelihood. Income Tax Act takes into account these points and uses these terms separately. Taxes are imposed on businesses which may include transactions. This question was raised in a Delhi High Court case.<sup>24</sup> In this case, the question was related to the treatment of the Derivative. Derivative, as discussed above, is a risk mitigating instrument which derived their value from the underlying assets. Derivatives are considered as a speculative transaction as it is based on the contract of differences. The vital nature of the derivative contract is to speculate upon the prices or

<sup>15</sup>Mark J.Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120, HARVARD LAW REVIEW, (2006) 460–527 [www.jstor.org/stable/40042609](http://www.jstor.org/stable/40042609) (Last visited Oct.23,2020).

<sup>16</sup>Speculative activities are those which are based on a risk of loss in expectation of gain.

<sup>17</sup>The Income Tax Act, 1961.

<sup>18</sup>Taxguru, *Supra* note 438 (Examining the nature of speculative businesses)

A speculation business refers an arrangement between the parties to sale and purchase of an asset which are generally settled by paying the differences as the main intention of the parties to the arrangement are not to make actual delivery but to gain profits if prediction went right. But as per the Income Tax Act, speculative business does not include a trading contract in respect of raw materials or merchandise, made by a person in the course of a manufacturing or mercantile business to protect against loss through future price fluctuations for fulfilling the obligations of person's other contracts for the actual delivery of the goods to be manufactured or merchandise to be sold.

<sup>19</sup>The Income Tax Act, 1961 (S. 43 (5) of the Income-tax Act define speculative transaction-Speculative transaction" means a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips:

*Provided that for the purposes of this clause— (a) a contract in respect of raw materials or merchandise entered into by a person in the course of his manufacturing or merchanting*

*business to guard against loss through future price fluctuations in respect of his contracts for actual delivery of goods manufactured by him or merchandise sold by him; or (b) a contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holdings of stocks and shares through price fluctuations; or (c) a contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss which may arise in the ordinary course of his business as such member; [or] [(d) an eligible transaction in respect of trading in derivatives a referred to in clause 27[(ac)] of section 228 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956) carried out in a recognized stock exchange; [or]] [(e) an eligible transaction in respect of trading in commodity derivatives a carried out in a recognised association [, which is chargeable to commodities transaction tax under Chapter VII of the Finance Act, 2013 (17 of 2013),]] shall not be deemed to be a speculative transaction*

<sup>20</sup>The Income Tax Act, 1961, *Supra* note 443.

<sup>21</sup>The Income Tax Act, 1961 S. 28 Explanation 2-Where speculative transactions carried on by an assessee are of such a nature as to constitute a business, the business (from now on referred to as "speculation business") shall be deemed to be distinct and separate from any other business .

<sup>22</sup>Black Law Dictionary 6<sup>th</sup>ed.(1990).

<sup>23</sup>Black Law Dictionary 6<sup>th</sup>ed.(1990).

<sup>24</sup>The Commissioner of Income-Tax v. DLF Commercial Developer's Ltd. (2013) 091 DTR 0049.



performance of the underlying. The present case put forth the issues that whether income from derivative come under the category of "Speculative Income? The assessee claims that the income from derivative does not come under the category of "Speculative Income" and as such any loss incurred due to the fluctuations in the prices of the underlying cannot be treated as a speculative loss. His claim was rejected by the assessing officer by saying that income from derivatives transaction is speculative in nature and hence any loss will also amount to speculative loss. It was argued that it is not a business income as there is an express provision under explanation 2 of section 73<sup>25</sup> of the Income Tax Act that purchase and sale of shares do not come under the definition of business. Even though Section 43<sup>26</sup> of the Income Tax Act does not define the term derivatives but it expressly excludes derivatives from the purview of speculative income.<sup>27</sup>

Section 43 of the Income-tax Act, 1961, defines certain terms for section 28 to 41. On the other hand section, 73 provides a general principle regarding the treatment of speculative income and as such has a wider application. The question raised here is about the interpretation of these two provisions and hence it need to be resolved that which of these provisions have overriding effect in case of inconsistencies. The court said in this case<sup>28</sup> that there is no contradiction between these two provisions and if any such conflict arises then section 43 shall prevail. If one analyses these provisions, he will conclude that the Act is ambiguous regarding the treatment of speculative transactions including Derivatives.

One another ruling on this point is a case<sup>29</sup> where Income-tax Appellate Tribunal made a relevant observation regarding foreign currency swap transaction which comes under OTC settlement. Income tax tribunal said that hedging transaction related to fluctuation in the foreign currency made with the bank to hedge the risk inherent in the foreign

exchange transaction should be considered as a business income as the nature of the transaction shows that it is a business income as it is integral to foreign exchange dealing. In another world foreign currency swap one of the forms of the derivative contract made by banks to hedge the risk involved in the foreign exchange transaction needs to be taken as a business activity not speculative which is evident from its objective itself.

According to the Act, incomes from the speculative activities are also considered normal income and therefore they are also taxed according to the normal rate. So there is no different treatment of the income irrespective of the source of it. Thus, liability to pay tax depends on the taxable income. The crucial point to be noted in the context is that incomes from speculative transaction are available for set off against the losses from speculative activities. The whole reading makes it clear that non-speculative losses can be set off against the income from holding capital for long term or short term occurred in the same year.

## ISSUE

Explanation 2 to Section 28 says if speculative transactions are coming under the term business then it should be treated differently from the other business. Section 43(5) defines what does speculative transaction means and says any transaction which does not involve actual delivery shall be deemed to be speculative transactions. However, Section 43(5) defines only what speculative transaction is, but it does not define what speculative business is. Section 73 prohibits the set off of losses of speculative business against any income including business income.

Explanation to Section 73 provides that any loss relating to transactions of dealing in shares by a company would be subject to taxation and income loss accruing out of such purchase will be deemed to be a speculative business loss. Thus, unless

*to be carrying on a speculation business to the extent to which the business consists of the purchase and sale of such shares.)*

<sup>26</sup>Section 43 defines of certain terms relevant to income from profits and gains of business or profession for sections 28 to 41 and in this section.

<sup>27</sup>The Income Tax Act, 1961 (S. 43[5] {d}).

<sup>28</sup>The Commissioner of Income-Tax v. DLF Commercial Developer's Ltd. (2013) 091 DTR 0049.

<sup>29</sup>London Star Diamond Company (I) P. Ltd v. DCIT [2013] 38 taxmann.com 338 (Mumbai-Trib.)

<sup>25</sup>The Income Tax Act, 1961 S. 73, Explanation-1: *Where any part of the business of a company other than a company whose gross total income consists mainly of income which is chargeable under the heads "Interest on securities", "Income from house property", "Capital gains" and "Income from other sources", or a company the principal business of which is the business of banking or the granting of loans and advances consists in the purchase and sale of shares of other companies, such company shall, for the purpose of this section, be deemed*

speculative transactions constitute business activity, it cannot be treated as a speculative business, and so Section 73 cannot apply. Shares can be taxed either under the head of capital gain or business income. Investors who purchase shares for investment to get a return are bound to pay capital gain tax as per the holding period which may be long term or short term.<sup>30</sup> The general principle of taxation about derivative transaction depends on the accounting treatment of the derivatives in the balance sheet of the company. It should follow the accounting standards which are universal, i.e., generally acceptable.

The taxation of derivative contract should be based on the underlying to which derivative relates. Thus if the underlying asset is not the subject of taxation, the derivative contract should also be excluded from the purview of taxation. It means either the derivative contract should be taxed, or the underlying asset otherwise the parties will have to pay taxes on the same source twice. To avoid these inconsistencies properties which are subject to tax can be classified into financial assets such as shares and other securities and non-financial assets which comprise properties like land and other tangible and fixed. Nature of the taxation of a derivative contract also depends on the types of derivative entered into by the parties. In case of an option, the underlying subject matter is the property that is anticipated to be delivered when the option is exercised. If the property is another derivative contract, then the underlying of the original contract is the underlying subject matter of the subsequent contract. In case the contract is based on differences the underlying

is determined by the following criteria-

- If under the derivative contract, payments are determined by the price of the property which is the subject matter, then underlying is that property
- If the contract is based on the index or other factors, then the collateral is that property which provides the subject-matter of that index
- Contract of differences may be based on any other factors like interest rates etc.

### OTHER ISSUES CONCERNING THE USE OF DERIVATIVE

Derivative contracts regulations are based on their underlying asset and accordingly SEBI and RBI are the two bodies which is authorised to bring out rules and regulation according to the need of market. There are confusion regarding the use and enforcement of derivative contract by the corporate entity.<sup>31</sup>

The first issue concerning the use and validity of the derivative instrument rose in Rajsree Sugar Mill case<sup>32</sup> after the validation of the OTC derivative by the amendment in the RBI Act.<sup>33</sup> This case through a light on the controversy that derivative has some betting elements.<sup>34</sup> The case was resolved by the Madras High Court by stating several changes in the laws related to dealing in derivative instruments but afterward several cases were filed in different High courts and apex court in India. One another case<sup>35</sup> on the validity of option contract which is considered one of the form of derivatives, also draw our attention

<sup>30</sup>Intra trading is considered speculative income where there is no actual delivery takes place whereas investment for a period less than 12 months will be subjected to short-term capital gain. See, TAULLI TOM, WHAT IS SHORT SELLING, (McGraw-Hill, 2004) 4-45.

<sup>31</sup>There is a huge list of cases on the disputes and uncertainty about derivative contract filed in Indian courts some of them are Keynote Capital Ltd. V. Eco Recycling Ltd. (2018) Bom. 1269, Bonanza Commodities Brokers Pvt. Ltd. V. Roshanara Bhinder (2015) 5 Bom. CR 393

Edelweiss Financial Services Ltd. V. Percept Finserve Pvt. Ltd. (2019) SCC Bom 73, Sporting India Ltd. V. HDFC Bank Ltd. 2013 SCC Bom. 906. See also ICICI Bank Ltd. V. Sundaram Multi Pap Ltd. (2010) 153 Comp Cas 42

<sup>32</sup>Rajshree Sugars & Chemicals v. M/S. Axis Bank Limited, C.S. No. 240 Of 2008,

<sup>33</sup>The Reserve Bank of India (Amendment) Act, 2006.

(Derivative instruments were legalized by adding Chapter IIID Regulation of transactions in derivatives, money market instruments and securities etc.)

<sup>34</sup>C.S. No. 240 of 2008,

(Rajshree Mills entered into a foreign exchange derivative contract with Axis Bank to hedge the risk connected with the ups and down in the foreign exchange. Company's anticipation concerning the forex rate proved wrong and it suffered a loss of 50 crore. When the Axis Bank wanted to enforce the derivative contract the company challenges its enforceability *inter alia* the contract is void under section 30 of the contract as derivative is an agreement of wager. Although the Madras High Court rejected the arguments of the company but it raised a serious issue of speculative elements in the derivative contract. Those derivatives which are settled by paying differences may be subjected to wagering in future also unless Section 30 is amended.)

<sup>35</sup>MCX Stock Exchange Limited v. SEBI Writ Petition No. 213 of 2011 decided on March 14, 2012.

on the issue of validity of derivatives.<sup>36</sup>

An application by the MCX which is a commodity Exchange, was filed with the SEBI to get an authority for the running a stock exchange under the MIMPS Regulation, SEBI rejected the request on the ground that the manner in which MCX has complied the earlier order of the SEBI is against the SCRA. The issue arose when SEBI order MCX to reduce the equity shareholding of all the residents entity in the Exchanges as per the MIMPS regulation which put a cap of maximum 5% equity share holding by an India entity. To comply with this order MCX entered into an option contract with its two largest shareholders i.e. PNB and IL & FC whereby they were asked to exit with an option to buy back agreement.<sup>37</sup> Among the several issues before the court, it was also vital to bring out clarity in the form of declaration on the nature of options contract which are negotiated between the parties. SEBI argued that forward contract is not valid under the SCRA and hence the agreement made between the parties was illegal. Court refused the argument presented by SEBI that the buyback agreement was in the nature of an option without any obligation to exercise the option in future unlike the forward and hence valid under the SCRA.<sup>38</sup>

The recent cases made it inevitable for the higher judiciary to declare the position of law on the derivative due. Whether it can be considered as a loan or liability in the balance sheet of the banks in India? The lack of insight on this point by the higher judiciary making it problematic for the banks which are facing problems to enforce derivative dues against the companies as these companies have purchased different financial derivative contract with them. Further it has also become inevitable for the legislator to amend the laws related to the enforcement of loan

in the form of derivative contract by the banks. Recently Supreme Court has ruled that dues with regard to derivative contract by the borrower shall be deemed to be included in the circular issued by the RBI on wilful defaulters. If these companies fail to make payments due under the derivative contract, banks have authority to consider them as a wilful defaulter.<sup>39</sup> Companies are protesting the action of the banks on the basis that the said circular is applicable only on lender-borrower relationship and due under the derivative does not come under the definition of loan.

Due to the uncertainty Apex Court has resolved the matter temporally by saying that the said circular is also applicable on derivative dues.<sup>40</sup> An explanation is still required by adding a relevant provision to the law on derivative. The present ruling specifically deal with those derivative transaction which has been made under the FEMA regulation but it did not through any light on the issues that if the banks offer derivative contract which is in violation of the actual purpose for which the derivatives are used then whether it is enforceable?<sup>41</sup> The question concerning the one of the specific issue i.e. the relation of banks and opposite parties when they are entering into exchange rate swap contract, is resolved by the apex court when it declared that RBI circular apply to lending transaction of banks and financial institutions as well as exchange rate swap transaction offered by banks and therefore action can be taken against the opposite parties i.e. companies on account of swap contract.<sup>42</sup>

A recent case<sup>43</sup> also brings our attention towards the settlement issues in the derivative contract. In this case the respondent had trading account with the petitioner who was a trading member registered with

<sup>36</sup>Court had to decide *inter alia* the nature of option and forward contract and its validity under the SCRA and the MIMPS Regulation 2006.

<sup>37</sup>Y. Shiva Santosh Kumar, *Legality of put and call options in India is now beyond dispute*, COMPANY LAWYER, (2014) 1-4 (Analysing the nature of option contract)

An option to buyback deals with the right of the option holder without any obligation to buy back the shares before a particular time which is exercisable on the particular date specified in the contract and if the options is not exercised then the contract will become void.

<sup>38</sup>Writ Petition No. 213.

<sup>39</sup>Civil Appeal No. 8916 of 2012.

<sup>40</sup>Kotak Mahindra Bank Ltd. v. Hindustan National Glass & Ind. Ltd. & Ors. (2013) 7 SCC 369.

<sup>41</sup>*Id.*

(The main contention was that if banks oversold or illegally sold derivatives to the borrowers which are stated to be hedges but actually used for the speculating, then what legal course can be taken?)

<sup>42</sup>Smt. Shyamala Gopinath, *Over-the-counter derivative markets in India issues and perspectives*, Deputy Governor, RBI, ISSUE OF FINANCIAL STABILITY REVIEW, Banque de France., (Reproduced with permission from Financial Stability Review) (2010).

[https://www.rbi.org.in/scripts/FS\\_Speeches.aspx?Id=514&fn=2757](https://www.rbi.org.in/scripts/FS_Speeches.aspx?Id=514&fn=2757)

(Last visited June 12, 2020)

<sup>43</sup>Keynote Capital Ltd. V. Eco Recycling Ltd. (2018) Bom. 1269



National Stock Exchange Ltd. Due to the shortfall in maintaining the margin amount the petitioner misappropriated the money and sold out shares in the account of the respondent without its permission. The similar issue was arose in another case<sup>44</sup> where the petitioner was a broker registered with MCX and was trading on behalf of the respondent who entered into an agreement with petitioner to trade in futures and options. But due to the failure on the part of the respondent to keep margin money the account was adjusted by the petitioner which was challenged by the respondent. The case also bring out the issue that there are businesses who are using derivative for profit making and also the issue of settlement of futures and option when there is a margin shortfall. In a very recent case<sup>45</sup> related to exercise of options contract the issue related to the enforceability of the options contract for the share purchase agreement was raised. The share purchase options were challenged being illegal and unenforceable being inconsistent of the provision of SCRA. Several cases<sup>46</sup> on the validity and enforceability of the derivative contract prove lacuna in existing system of regulation which need to be addressed.

On the forex side there are broadly four types of product available to be traded by the banks to the end users. These are forward, options and currency swap. Banks are authorized to offer varieties of derivative product customize with the need of end users. On forex side problem started with the 2007 onwards. When the fluctuations in the foreign exchange rate become too high, the companies who were entered into the export and import started making loss. Banks realize the situation and started offering to these traders and companies exchange rate derivative. Many private banks made money during this period by convincing the foreign traders that they can make huge profit by the entering into derivative contract in two ways. Firstly, they can hedge the risk associated with the exchange rate and second, those who are not willing to use it for hedging they can use it for

speculating in the foreign exchange rate and due to the low transaction cost of the derivative product they can easily make money out of it. The reasoning of the bank was based on the weakening dollar during 2007 due to the financial crisis in U.S. Banks started selling speculative derivative purely based upon the betting on the value of different currency and paying the exporter a good amount. In the starting these exporters made handsome money and managed some credit to facilitate the same. This resulted into a huge selling of derivative contract to make profits without any underlying exposure in an un-hedged position.<sup>47</sup> When the bank approached them to pay the dues on account of derivative contract, they started opposing on several grounds.<sup>48</sup>

Banking Institution in India is highly regulated body due to the dealing in deposit of public money with them. They are not allowed to take a naked exposure in the currency derivative contract which implies that all cross-currency options and swap can be offered by them as market maker not as an end user. Banks have to hedge on behalf of all their customers simultaneously with the foreign banks. Hence banks are bound to settle the contract even if there is default by their customers.<sup>49</sup>

Current trend shows the increasing involvement of Indian banks in the derivative market has raised concern about the potential threat to the financial system. There is no doubt that about the fact that derivatives are crucial in risk management but if it is used for investment purpose then it became problematic as it is against the very nature for what derivative were innovated. Banks participation in the derivative market is motivated by two factors. One, it is a part of the risk administration that is used by the banks for their customer's benefit by reducing the risk exposure, secondly, financial instability is the growing concern and derivatives may help in reducing the probability of it. But innovative activities like derivative's use by the banks may be

<sup>44</sup>Bonanza Commodities Brokers Pvt. Ltd. V. Roshanara Bhinder (2015) 5 Bom. CR 393

<sup>45</sup>Edelweisse Financial Services Ltd. V. Percept Finserve Pvt. Ltd. (2019) SCC Bom 732

<sup>46</sup>Sporting India Ltd. V. HDFC Bank Ltd. 2013 SCC Bom. 906. See also ICICI Bank Ltd. V. Sundaram Multi Pap Ltd. (2010) 153 Comp Cas 424

<sup>47</sup>Vinod Kothari, *Forex Derivatives Litigation in India: Vague Rules And Lax Regulators Should Own It Up* (2012) <http://vinodkothari.com> (Last visited Jan.12, 2020) 1-13.

<sup>48</sup>The list includes firms like Rajshree sugars, Nahar Industries, Garg Acrylyte, Sundaram Brake Linings, Sabar International and Sundaram Multipap. The banks involved include ICICI Bank, Axis Bank, Kotak Bank and Yes Bank.

<sup>49</sup>MASTER CIRCULAR ON RISK MANAGEMENT AND INTER-BANK DEALINGS, (2012) <https://www.rbi.org.in/CommonPerson/english/Scripts/Notification.aspx?Id=995>, (Last visited Aug.2, 2020).

expensive for them due to the higher cost of new derivatives products. Assessing the importance of the derivatives for the bank is crucial which can be gauged by their balance sheets. Bank responds the fluctuations in the interest rate and other credit exposure by changing the entries and cash flow. However, these are not the only reason to induce the banks for the use of swaps contract.

Banks with healthy balance sheet and net interest margin usually do not use derivatives for risk hedging. In other words there is a negative relationship between difference in the borrowing and lending rate of banks and financial institutions and derivative usage by them.<sup>50</sup> Banks and financial institution with low net interest margin may also tend to use derivative instruments for the speculation and also offer their customer a range of derivative products.<sup>51</sup> In India the use of derivative instruments are more common in Public sector bank in compared to private sector bank. This implies that RBI is encouraging them to use and offer various derivative products and they are under the direct scrutiny of RBI and government. An empirical study shows big banks with low rate of interest margin tends to invest more in derivative products.<sup>52</sup> The study also reveals that banks are using interest rate swap to hedge the risk associated with the movement in the interest rate that is an evidence of the fact that banks in India are effective using interest rate and exchange rate derivative instruments to hedge inherent risk associated with their financial transaction. Impact of the derivative transaction on systematic risk are the most challenging aspect of the derivative regulation that need to be considered by the legislature and RBI before taking any further step to ease this transaction in India.<sup>53</sup>

These overly complex and less transparent derivative contracts are generally sold to two types of end users; one who view the derivatives as less priced and use leverage to make profits. The other one is who have positive assessment on the market trends but don't

have much idea about the pricing of derivatives and depend on the banks to provide valuations of the contract. New companies, traders and investors with little capital are the general victim of the derivative which lured them to enter into the same. When the derivative market is flourishing it becomes difficult to control the sale of these products and as such the use of leverage, highly complex nature of the products and less transparency about the buyers and sellers of these products lead the systemic risk and ultimately set the stage for market crash.<sup>54</sup>

In the OTC segment bank is one of the prominent player where their role is multidimensional. They play the role of market maker, market participants, and end user. In the Indian context Banks are highly regulated body and they are bound to report their market exposure due to the strict scrutiny by the RBI. But the same is not with other economy. In the open market economy banks are free to take any position in the market. Generally they have to disclose if there is any market risk which is associated with the fluctuations in the financial prices and rates. Banks that are dealing in derivatives may get into huge loss if the counter parties start making defaults. The issue here is that if the derivative dealers collapsed what would be the impact of it on the other segment of the market. In case of default by the counterparty under the derivative contract may present a threat of bankruptcy situation. If there is a failure to fulfil the obligations by the opposite party to the derivative contract then the existing rules and regulations does not provides any mechanism to recover the same. They may have to wait for year to adjust their claim.<sup>55</sup> The companies engaged in buying and selling of shares simultaneously may face problem related to settlement of the same. The settlement process is

<sup>50</sup>Pankaj Sinha and Sakshi Sharma, *Derivative use and its impact on Systematic Risk of Indian Banks: Evidence using Tobit model*, MUNICH PERSONAL REPEC ARCHIVE, (2016) 1-26 <https://mpira.ub.uni-muenchen.de/72251/>, (Last visited Feb.07,2020).

<sup>51</sup>*Id.* at 592 at 14.

<sup>52</sup>*Id.* at 592, at 16.

<sup>53</sup>*Id.* at 592, at 17.

<sup>54</sup>*Id.* at 19.

(There are studies on the different aspects of derivative instruments which show that many counterparties may face the failure due to the random exogenous movement in the cash flows across the class of instruments such as interest rates, currency prices, or equity prices around the world and if government do not interfere it may result into failure of the financial system).

<sup>55</sup>Piyusha Hukeri, *Domestic Derivatives: Issues, Risks and Proposals*, 42, ECONOMIC AND POLITICAL WEEKLY, (Mar. 31 - Apr. 6, 2007), 1072-1077.



called netting<sup>56</sup> and set off.<sup>57</sup> The process of netting consist two related but separate right which are generally joint in a single contract. Right to close out refer termination of the contract unilaterally under certain conditions, and right to set off the dues at termination of certain contract between the same parties when determining the final obligation. These rights of netting and set off may stipulate under the contract itself or recognized by the particular legal system.<sup>58</sup>

## CONCLUSION AND SUGGESTIONS

To prevent the application of the general rule of contract law that agreement like wagering is void, trading in the stock market and futures should be excluded. Delhi High court has made an observation in this regard. The High Court said that trading in derivatives is excluded from the definition of speculative transaction as if wagering agreement is void, the share trading where investment is made to earn a profit by speculation will also become void. The court further observed that in case of wagering agreement, after the determination of the event one party must win which must cause lose to the other party but in derivatives contract it is not necessary. There is many efforts have been made by the legislature validating the derivatives contracts. Some of them are an amendment made in section 18A of the SCRA validating derivatives contract in 1999. There were two committees<sup>59</sup> established by the Securities and Exchange Board of India to analyse the speculative activity in the stock market. The most important recommendations to reform the derivative market in India were the L. C. Gupta Committee which was set-up in November 1996. The committee made several recommendations to bring out an appropriate regulatory framework of

derivatives trading in India. The Committee submitted its final report in 1998 recommending the introduction of derivatives contract trading in a systematic way and in a phased manner by the permitting the trading of index futures in India on the recognised exchanges.<sup>60</sup> The other committee which recommended several reforms in the derivative laws and regulation in India was the establishment of J.R. Varma committee in June 1998 which proposed risk management strategies and monitoring mechanisms for derivative markets.<sup>61</sup> If one analyses the Derivatives contract, it will create confusion with wagering agreement as it also involves speculation. That is why a problem arises on its validity as wagering contract is illegal under the Contract Act. Both the contracts are based on the speculation. There are many claims that derivatives contract is a contract of the wager and as such, it is illegal.<sup>62</sup>

To conclude it can be said that trading in derivatives instruments have some amount of speculation but it has become a vital part of the financial market as an instrument to mitigate the risk. It is evident from the fact that now it has been legalized by an amendment made in the Securities Contract Regulation Act, 1956 which repeals section 20 and adds section 18A. With the increasing use of this instrument, the problem also arises about the taxation on the income accrues from derivative. There are many cases on this issue whether it should be treated as speculative business or transactions. There is a need of amendment in the Income Tax Act which should derivative contract, secondly, whether income accrues from trading in derivatives is taxable or not, thirdly to provide for the following criteria that in

<sup>56</sup>Netting refers the position taken by the party to a particular derivative contract who wants to offset the pricing of multiple positions or payments due to be exchanged between two or more parties. See *Banking And Finance document at LexisNexis* [https://www.lexisnexis.com/uk/lexispsl/bankingandfinance/document/391289/55KB-65S1-F185-X13T-00000-00/Set\\_off\\_and\\_netting\\_overview#](https://www.lexisnexis.com/uk/lexispsl/bankingandfinance/document/391289/55KB-65S1-F185-X13T-00000-00/Set_off_and_netting_overview#), (Last visited Oct.12, 2020)

<sup>57</sup>Set-off denotes settlement of two diverse claims between the same party who are debtor and creditor in each of the two transactions need to be set-off. There are several mode of settlement of the two diverse claims i.e. legal set-off, contractual set-off, bankers set-off and insolvency set-off. See *Id.*

<sup>58</sup>PiyushaHukeri, *Supra* note 55 at 1076

<sup>59</sup>L.C. Gupta committee Report on Control of trading and Settlement of derivative Contract, and J.R. Verma committee report on risk containment measures in the Indian Stock Index

Futures Market. See Sumon Kumar Bhaumik, *Stock Index Futures in India: Does the Market Justify Its Use?* 32 *ECONOMIC & POLITICAL WEEKLY*, (Oct. 11-17, 1997) 2608-2611

<sup>60</sup>DR. L.C. Gupta Committee Report, 1998 available at

[http://14.139.116.20:8080/jspui/bitstream/10603/96316/11/11\\_chapter3.pdf](http://14.139.116.20:8080/jspui/bitstream/10603/96316/11/11_chapter3.pdf) (Last visited on Feb.21,2020)

<sup>61</sup>J.R. Verma Committee Report, 1998 available at

[http://14.139.116.20:8080/jspui/bitstream/10603/96316/11/11\\_chapter3.pdf](http://14.139.116.20:8080/jspui/bitstream/10603/96316/11/11_chapter3.pdf) (Last visited on Feb.21,2020)

<sup>62</sup>Sumon Kumar Bhaumik, *Stock Index Futures in India: Does the Market Justify Its Use?* 32 *ECONOMIC & POLITICAL WEEKLY*, (Oct. 11-17, 1997) 2608-2610

what circumstances section 73 will apply.

When it comes to applying the taxation principle on the derivative contract and its use, it becomes complex how to tax derivative transaction. Several factors need consideration before adopting any law to tax derivative transaction. The first step is the generic classification of the several derivatives and then the specific designation of advance derivative contract like currency swap and swaptions etc. It is also vital to define each derivative contract well in advance to bring clarity in the taxation of the derivative contract. Therefore a well-defined tax structure is a pre-requisite. The first fundamental requirement is to analyse the different principle and policy to understand the taxation of these instruments. Several questions are still unanswered when it comes to the cross-border derivative transaction related to the identification of income from the spot dealing of the underlying asset and treatment of derivatives that are based on that underlying. Tax treatise generally exempt business income and other income in the source country if there is no permanent establishment and hence characterisation of income is crucial for the taxation of cross-border derivative transaction. The absence of international agreement on taxation could lead to multiple levying of a derivative activity.

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