

Report of the Group on Deferral Products in Rolling Settlement

In the meeting of the Stock Exchanges held on April 12, 2001 to ascertain the preparedness of the Stock Exchanges for the implementation of the rolling settlement, SEBI decided to review the need for having deferral products like ALBM/CFRS/BLESS and CNS in the rolling settlement. A Group was appointed under the Chairmanship of Prof. J R Varma, Member SEBI Board to examine this issue and submit its report by the first week of May 2001.

The Group consisted of:

Prof J R Varma Chairman

Shri Pratip Kar E.D., SEBI,

Shri A N Joshi E.D., The Stock Exchange, Mumbai

Shri Ravi Narain M.D., The National Stock Exchange

Shri C B Bhawe M.D., National Securities Depository Ltd.

Shri M G Damani M.D., Central Depository Services Ltd.

Shri P K Singhal E.D., The Delhi Stock Exchange

Ms K Kamala E.D., Bangalore Stock Exchange

The Group held one meeting on April 26, 2001.

Carry Forward/ALBM under Rolling Settlement (CFRS/ALBRS)

The Committee on Carry Forward under Rolling Settlements (the CFRS Committee) in its report of January 2000 had noted the similarity between CFRS and outright futures contracts on individual stocks. The Committee recommended that CFRS may be introduced as a carry forward product to make it easier for the market to understand and use the product. Two members of that Committee (Dr. Patil and Prof. Varma) went on to state that CFRS is conceptually very close to a futures contract on individual stocks with five different futures contracts (with maturities of 1, 2, 3, 4, and 5 trading days) open for trading on any day. Since the risk management of a proper futures contract is much better understood, these two members recommended that the CFRS product should swiftly migrate to a full fledged futures contract in individual stocks.

The Group noted that several important developments have taken place subsequent to January 2000:

- Index Futures contracts started trading in Indian markets in mid-2000. Options on the index are also likely to commence trading shortly. Until March 2001, the derivative market witnessed slow but steady growth.

- In November 2000, the CFRS/ALBRS facility was made available to 15 stocks in compulsory rolling settlement. After attracting some interest in the initial days, the volumes in this facility fell sharply. BSE indicated that currently the daily volumes in CFRS/ALBRS at BSE in these scrips amount to only 1% or 2% of the daily delivery in these scrips. NSE indicated that their experience with ALBRS was similar. By contrast, the volumes in MCFS/ALBM in account period settlements amount to about half the delivery volumes.
- In February 2001, the ALBRS facility was made available to all the ALBM stocks in the voluntary rolling settlement segment at NSE. NSE indicated that there has not been a single trade under this facility.

None of this rules out the possibility that CFRS/ALBRS may become popular when the bulk of the market moves to rolling settlement on July 2, 2001. However, these developments do force us to reconsider the view of the CFRS Committee that CFRS may be introduced as a carry forward product to make it easier for the market to understand and use the product. There is now some reason to doubt the proposition that CFRS/ALBRS is easier to use or understand than futures on individual stocks.

There now seems to be greater force in the minority view that since the risk management of a proper futures contract is much better understood, the CFRS product should swiftly migrate to a full-fledged futures contract in individual stocks. Under a scenario of “swift migration”, the natural time to move from CFRS/ALBRS to single stock futures would clearly be July 2, 2001.

The Group therefore recommends that CFRS/ALBRS should cease to be available from July 02, 2001 and that SEBI and the exchanges should work towards introduction of individual stock derivatives viz., options/futures in selected stocks by that date. These derivative products would perform the hedging functions currently being performed by CFRS/ALBRS.

The Group debated whether the cessation of CFRS/ALBRS should be conditional on the introduction of single stock futures. The Group concluded that while the two recommendations (cessation of CFRS/ALBRS and introduction of single stock futures) are logically tied to each other, they need not be chronologically tied. In other words, even if there were to be a slippage in the July 2, 2001 target for introduction of single stock futures, CFRS/ALBRS should cease to be available on that date. However, the recommendation on cessation does presuppose that SEBI will approve single stock futures and will work towards their speedy introduction.

Continuous Net Settlement (CNS)

The Group debated a variety of issues relating to CNS. Concerns were expressed about the asymmetric nature of the product in that the sellers have an option to postpone delivery while the buyers do not have an option to postpone payment. Concerns were also expressed about the differences between the CNS models proposed by BSE and NSE. While the CNS model proposed by BSE seemed to have substantial similarities with carry forward products, the BSE argued that their model is patterned on that of the National Securities Clearing Corporation of the United

States. While the CNS model proposed by the NSE was devoid of a carry forward element, it appeared to exacerbate the inherent asymmetry of the product.

In this context, the Group debated the need to have a CNS product at all. It noted that while in the United States, rolling settlement is accompanied by CNS, it is possible that there is a historical legacy behind this. In particular, it must be noted that because of disagreements about regulatory jurisdiction, single stock futures were not available in that country until recently. In an environment where dematerialisation is widespread, single stock futures are available and a mechanism of stock lending also exists, it is not self evident that the CNS facility is needed at all.

In this background, given the concerns that have been expressed about the CNS product, the Group recommends that the CNS facility should cease to be available from July 2, 2001. Needless to say, this recommendation too is logically (but not chronologically) tied to the introduction of single stock futures.

Conclusion

The Group is of the view that with the modernisation of the stock market that has taken place in the last few years particularly dematerialisation and the introduction of derivative markets, we are now in a position to achieve a clear segregation of the cash and derivative markets in stocks. The introduction of large scale rolling settlement from July 2, 2001 provides the natural opportunity to carry out this transformation. The Group therefore recommends that from July 2, 2001, the cash market must be a pure rolling settlement market without CFRS/ALBRS or CNS, and that simultaneously a complete set of derivative products on the index and on individual stocks should be introduced in the derivative markets.