Report of the Committee on

Carry Forward under Rolling Settlements

1. Background and Terms of Reference

In the context of the decision taken by the Securities and Exchange Board of India (SEBI) to introduce rolling settlements in the stock exchanges in a phased manner, the Stock Exchange, Mumbai (BSE) submitted a proposal for carry forward transactions in the rolling settlement. To examine this issue, SEBI decided to reconvene the Committee set up in 1997 (referred to below as the 1997 Committee) to review the carry forward system. The reconvened Committee (referred to below as the Committee) consisted of:

- Mr. P. K. Bindlish (Co-ordinator)
- Mr. M. M. Kapoor (Member)
- Mr. A K. Narayanan (Member)
- Dr. R. H. Patil (Member)
- Mr. Anand Rathi (Member)
- Prof. J. R. Varma (Chairman)

The terms of reference of the Committee were as under:

1. To consider the proposal of BSE for introduction of carry forward mechanism in rolling settlement
2. To suggest adequate safeguards in this regard
3. To consider revisions in the existing carry forward system

The Committee held three meetings in November and December 1999, and the members also interacted with each other by fax and email. The group would like to place on record the valuable inputs provided by Mr. Himanshu Kaji and Mr. Ravi Narain who attended the meetings by invitation.

The Committee also sought the views of the exchanges that have currently implemented the carry forward system. Written responses were received from the Calcutta, Delhi and Ludhiana stock exchanges. The Executive Director of the Delhi Stock Exchange requested an opportunity to present the Exchange's views before the Committee in person. Accordingly, an invitation was extended to him to meet the Committee at its meeting of December 30, 1999, but, unfortunately, he could not come for the meeting.

2. Modifications to the Existing Carry Forward System

2.1. Position Limits

The 1997 Committee did not recommend any position limits. While approving the scheme, however, the SEBI board introduced a position limit of Rs 200 million per broker for all scrips put together. In addition, the BSE imposed a scrip wise limit of Rs 40 million per broker. The Committee felt that it would be useful to borrow some of the ideas from the risk containment measures proposed for the index futures market. In particular, the Committee recommends that:

i) The position limit at the broker level for all scrips puts together should be the same as that proposed for index futures (15% of the open interest or Rs 1 billion whichever is higher).

ii) There should be a scrip-wise position limit at the broker level of a certain percentage of market capitalisation. The Committee noted that the trigger for the imposition of concentration margins is 3% of market cap and felt that to begin with this percentage could be used for the scrip-wise position limit.

iii) There should be a market wide scrip-wise position limit, but for ease of implementation, this position limit should be achieved through the use of prohibitively high margins. The Committee clearly understands that, normally, margins and position limits serve entirely different purposes – margins are designed to guarantee solvency, while position limits are designed to prevent market manipulation. However, in this case, the Committee recommends the use of prohibitive margins purely as a means to approximate a position limit. Specifically, there should be a position limit on market wide short positions in any scrip equal to 6% of market cap, and a position limit on market wide long positions in any scrip equal to 12% of market cap. To achieve this, the Committee recommends the following graduated scheme of floor levels on the aggregate margin for each security (including carry forward margin, incremental carry forward margin and other types of margins applicable to positions in that security):

Margins on Short Side in any Security	
Market-wide* short (open sell) position as percentage of market cap of the security	**Floor level for the aggregate of all margins on short (open sell) positions in the security**
4%	20%
4½%	30%
5%	50%
5½%	75%
6%	110%

Margins on Long Side in any Security	
Market-wide* long (open buy) position as percentage of market cap of the security	**Floor level for the aggregate of all margins on long (open buy) positions in the security**
8%	50%
9%	55%
10%	65%
11%	80%
12%	100%

* In the absence of systems for monitoring positions across all exchanges, the exchange-wide position may be used as a proxy for market-wide positions.

The Committee recommends that all the above position limits be reviewed at the end of six months on the basis of actual experience.

2.2. Gross versus Net Margins

The Committee's view was that the imposition of margins on gross basis was a conscious decision of the various Committees that have reviewed the carry forward system as well as the Committees that have looked at the derivatives markets. These Committees considered gross margins appropriate to the Indian ground realities even though the international practice is to margin on net basis.

However, the Committee was emphatically of the view that the risk mitigation concerns that favour gross margins apply with equal force to the cash markets as well, and that it would be inconsistent and unfair to persist with net margins in the cash market. The Committee was, therefore, of the view that gross margins should be extended to cash markets forthwith. The Committee further recommends that stock exchanges be required to make software changes to incorporate client codes in all transactions within a short period of time.

2.3. Maximum Time Limit for Carry Forward

Though the 1997 Committee did not recommend a limit on the maximum time period for which a transaction could be carried forward, the SEBI board while approving the revised carry forward system in 1997 imposed a 75-day limit. The Committee was of the view that this limit served no useful purpose.

2.4. Scrips Eligible for Carry Forward

The Committee was of the view that both the 1997 Committee and the scheme approved by SEBI had inadequate regulatory provisions regarding the choice of scrips

for carry forward. The Committee recommends that exchanges implementing carry forward should obtain SEBI approval for:

i) The eligibility criteria for scrips to be included in the carry forward list

ii) The process of choosing the scrips in the carry forward list

iii) Disclosure and transparency provisions relating to the above

3. Rolling Settlement

3.1. Carry Forward versus Continuous Net Settlement (CNS)

The Committee considered the view expressed by some members that the Continuous Net Settlement (CNS) system is a superior model for imparting liquidity to rolling settlement.

After considerable discussion, the Committee decided that CNS is a matter pertaining to rolling settlement and not to carry forward. As such, it decided that this matter be left to the Committee on rolling settlements. However, since CNS and carry forward could turn out to be competing products, the Committee was of the view that it is desirable that a decision on CNS be taken along with the decisions on carry forward under rolling settlement.

3.2. Daily Carry Forward under Rolling Settlement

The Committee felt that the proposal for daily carry forward under rolling settlement does not present any new conceptual issues. The carry forward period shrank from two weeks to one week when weekly settlements were introduced; it could shrink to a day when daily (rolling) settlements are introduced. The fundamental characteristics of the instrument would not change and the risk mitigating mechanisms would not be materially different.

There was some discussion about intra-settlement margins. The Committee was of the view that whether intra-settlement margins (intra-day) margins would be levied under rolling settlement is an issue to be deliberated upon by the group dealing with rolling settlements. Intra-day margins should be levied on carry-forward trades if and only if they are levied on normal trades.

3.3. Weekly Carry Forward under Rolling Settlement

The initial proposal submitted by the BSE provided for a weekly carry forward in the form of a carry forward for five trading days. In this system, the investor would have the choice of carrying forward for one day (daily carry forward) or for five trading days (weekly carry forward). A transaction that was carried forward for one week could not be squared off within the week. The only option was to take an offsetting position in the rolling settlement and carry that forward from day to day (using daily carry forward) till the maturity date of the weekly carry forward.

The Committee felt that the proposal for weekly carry forward in this form was fundamentally different from traditional carry forward and that the limited hedgeability of the contract during the week introduced risks that need to be addressed. In response to this concern, the BSE agreed to modify the original proposal for a weekly carry forward to make the product tradable during the week. The BSE expressed its willingness to work with either its original proposal or the new tradable variant.

Under the revised proposal, in the carry forward session at the end of each trading day, the investor would have the choice of carrying forward a position for 1, 2, 3, 4, or 5 trading days. There would be separate screens where bids and offers could be posted for each of these five variants. Therefore, an investor who carries forward for one week (five trading days) today, would be able to square off tomorrow by taking an offsetting position tomorrow in the four day carry forward market.

The Committee favoured the tradable weekly carry forward since the non tradable version could create systemic risks because of its poor hedgeability.

The Committee considered the relationships between the weekly carry forward system under rolling settlements and outright futures contracts on individual stocks. The Committee recommends that:

a. The weekly carry forward system under rolling settlements may be introduced as a carry forward product to make it easier for the market to understand and use the product.

b. Exchanges must be allowed to introduce futures contract in individual stocks directly (without first creating a carry forward product and then migrating it to a futures contract).

Dr. Patil and Prof. Varma while agreeing with the above recommendations were of the view that:

> The weekly carry forward system under rolling settlements 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. Moreover, the risk management of a proper futures contract is much better understood. As such, Dr. Patil and Prof. Varma recommend that the weekly carry forward product should swiftly migrate to a full fledged futures contract in individual stocks. When this is done, the product will cease to be regulated as a carry forward product and will be regulated exclusively as a derivatives contract.

Dr. Patil was further of the view that:

> The risk mechanisms to be adopted in the case of weekly carry forward system should be similar to the futures market as recommended the J R Varma Committee report on Derivatives. There should be initial margins, continuous monitoring of Value at Risk (VaR) at 99%

> confidence level, client level position monitoring and guarantee by a clearing corporation/clearing house.

The majority of the Committee were of the view that the two products – weekly carry forward under rolling settlements and futures contract on individual stocks – can coexist.

In this context, the Committee did discuss the recommendations of the L. C. Gupta Committee report on phased introduction of derivatives in the stock market. The Committee noted that phasing was recommended almost two years ago, but even the first step could not be implemented due to legislative reasons. This does not mean that the clock has been standing still and will start ticking only when index futures start trading. Reform and modernisation of the stock market designed to facilitate the introduction of derivatives have been taking place relentlessly. Thus the introduction of a second derivatives contract today almost simultaneously with the introduction of the index futures market would not be against the spirit of the L. C. Gupta Committee report.

3.4. Daily versus Weekly Carry Forward under Rolling Settlement

The Committee noted that the exchanges that responded in writing to the Committee have divergent views on the relative operational merits or demerits of daily carry forward and weekly carry forward. The Committee was of the view that since the Committee has recommended that both these products be permitted, the exchanges were free to decide to introduce either of the two or both or neither. This choice should be left to the marketplace.

4. NSE's 3D segment

The SEBI Chairman requested the Committee to consider a representation made by the BSE that the 3D trading segment introduced by the NSE recently was comparable to the carry forward system and should be regulated as such.

The majority view of the Committee was that:

> Like the tradable weekly carry forward under rolling settlements, the 3D segment was also similar to a futures contract in individual stocks. The Committee felt that such products in which the same securities trade for settlement on different dates should also be migrated to futures contracts in individual stocks and regulated as such. The Committee expressed the view that many of these controversies arise because the cash market is less tightly regulated than the derivatives markets and that the best solution is to bring the cash market regulation on par with that for derivatives.

Dr. Patil was, however, of the view that:

> The 3D trading segment introduced by the NSE recently has the same product characteristics as the 5D account period segment currently in

> place. The potential for closing out positions on the 5D segment and reopening them on the 3D segment or vice-versa is exactly the same situation as closing and opening of positions intra-day or across an account period cycle. This situation is applicable within a single exchange or across exchanges with a position closed on one exchange being reopened on another one. In any case, as the account period segment (3D and 5D) is poised to be replaced by rolling settlements, this problem would get automatically resolved. NSE has committed that trading in specific stocks in 3D segment would stop as soon as they move into the rolling settlement.

Mr. Rathi was, however, of the view that:

> The move to introduce 3D concurrent cycle may amount to introduction of 'Carry Forward' system without the attendant due checks and balances prescribed by J. R. Varma Committee and will also tantamount to acceptance of "chalu upla" as defined in Patel Committee report and will have the following implications for the market.
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> In 3D segment, any trader, who has bought shares on the normal segment can shift the position by squaring up in the normal segment and simultaneously creating an equal position in 3D segment, on the last day of the normal segment. He can then transfer the position to the normal segment by squaring up the trade on 3D segment and recreating the same position in the normal segment. A trader therefore can keep his position open perpetually/postpone settlement of a position indefinitely without paying any extra margins (as credit of margin in one segment can be used to meet margin obligations in another segment) by transferring and retransferring his positions. This would therefore amount to introduction of 'Carry Forward System' without the checks and balances which Modified Carry Forward System (MCFS) approved by SEBI has imposed.

P. K. Bindlish	M. M. Kapoor	A K. Narayanan
R. H. Patil	Anand Rathi	J. R. Varma