

Forex Derivatives Litigation in India: Vague Rules and Lax Regulators should own it up



Vinod Kothari
vinod@vinodkothari.com
Vinod Kothari & Company
January, 2012

Check at:
<http://india-financing.com/staff-publications.html>
for more write ups.

Copyright:

This write up is the property of Vinod Kothari & Company and no part of it can be copied, reproduced or distributed in any manner.

Disclaimer:

This write up is intended to initiate academic debate on a pertinent question. It is not intended to be a professional advice and should not be relied upon for real life facts.



Article

Foreign exchange derivatives have become an extremely sore spot for corporate India. There is no doubt that greed of quick money made many of them undertake complicated foreign exchange derivatives that even specialists fear to tread. But that is precisely where regulation is needed, so that imposed discipline and not unbridled enticement rules civilised societies. There is apparently something basically contrasting in the way the regulation was cast, and the way it has operated. If the overarching spirit of derivatives regulation in India clearly is that users can engage in derivatives only for hedging purposes, it seems that what was designed to hedge might have caused such losses as Rs 90000 crores over 3 years. It is clear that users were not merely hedging risks but were actually taking risks, which could not have been permitted by regulations. In hindsight, it is possible to blame RBI regulations for being completely diabolical, and leave a huge gap by prescribing that zero cost structures are permitted, because what is zero cost for the user surely cannot be zero-risk as well. And if the user could take a net risk by entering into a zero-cost structure, how is it that the derivative would qualify as a hedge?

Today, the woes of forex derivatives that have turned painful are bothering lots of corporates all over the country. In particular, the pains of the mid-sized exporters are particularly acute, as fighting with the bankers for them is like fighting with the local police station. Even where borrowers have contested the right of the banks to claim losses, bankers have gone ahead and declared the borrowers as “willful defaulters”.

There is no doubt that foreign exchange derivatives are one of the weakest spots of financial regulation in the country. That the RBI took enormous time to come out with dedicated guidelines on foreign exchange derivatives¹ itself indicates either lack of clarity, or the complexity and enormity of the problem that had already become apparent by then..

No one has a clear idea of what has been the total amount Indian corporates have had to suffer – one seemingly exaggerated estimates put the value of claims made by banks against users as approximately 2500000 crore², or USD 550 billion. However, recently, in answer to a question, the Rajya Sabha was informed that the amount of losses may be nearly Rs 33000 crores per year over 2007 to 2010³. The total amount of forex derivatives as on 31st Dec 2009 was USD 774 billion, which includes USD 668 billion on account of forward contracts. Most disputes are in connection with option and swap

¹ The Guidelines were announced on 28th Dec 2010. When the RBI issued Comprehensive Guidelines of 20th April 2007, it said – separate guidelines for forex derivatives are being issued. The draft of these guidelines came only on 12th Nov 2009 – a good 33 months after it was talked about. That did not end the matter. The draft was never finalized for over a year, though in the Monetary Policy of Feb 2010, the RBI Governor had made a statement that the guidelines will be finalized by June 2010.

² <http://www.financialexpress.com/news/banks-violated-fema-in-forex-derivatives-contracts-cbi/538917/>

³ <http://www.business-standard.com/india/news/rbi-penalises-19-banks-for-flouting-derivative-norms-meena/153384/>



Article

contracts, which accounts for the balance approx USD 106 billion. But that too, is a huge amount.

International experience in derivatives mis-selling litigation

In the explosive growth of derivatives business over the last few decades, litigation on derivatives being mis-sold have been abundant. In the early days of the derivatives business, the UK House of Lords held in *Hazell v. Hammersmith and Fulham London Borough Council* [1992] 2 A.C. 1 that the interest rate swaps entered into by several UK municipal authorities were not hedges, and were therefore, void. The ruling had widespread ramifications, and culminated into restitution rulings by House of Lords in *Westdeutsche Landesbank Girozentrale v. Islington LBC* [1996] AC 669 (HL) - that is to say, the court ruled the parties to restore the position that prevailed prior to a null and void contract and therefore, reverse all payments that had been made thus far. Some of the leading cases in the USA pertaining to the pre-2007 crisis are: *Gibson Greetings Civil Action No. C-1-94-620* (S.D. Ohio, filed September 12, 1994)., *Procter and Gamble v Bankers Trust Company Civil Action No. C-1-94-735* (S.D. Ohio, filed February 6, 1995), *Dharmala, Adimitra, Orange County Ch. 9 Case No. SA 94-22272-JR, Adv. No. SA 94-1045-JR* (C.D.BR. Cal., filed January 12, 1995). Most of these involved Bankers Trust which was the largest derivatives dealer then, and most were settled out of court.

In the aftermath of the subprime crisis, there has been a flood of litigation in the USA. Most of the subprime crisis claims related to CDOs and credit derivatives. Goldman Sachs, for example, *SEC v. Goldman, Sachs & Co. and Fabrice Tourre* <http://www.sec.gov/litigation/complaints/2010/comp-pr2010-59.pdf>, etc⁴.

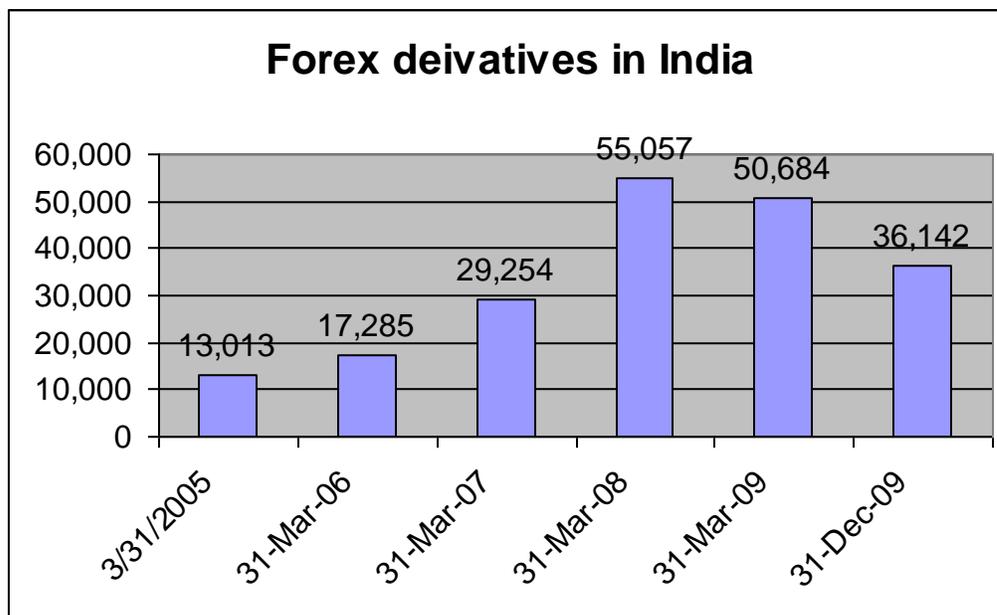
Forex derivatives litigation in India:

Forex derivatives shot up in volume in 2007, as may be seen from the graph below. The reasons are not difficult to understand – rupee was getting stronger as the dollar started weakening in the aftermath of the subprime crisis. Exporters apprehended that dollar will continue to weaken, and that would cause losses to the exporters. It is clear from the data below that volume of forex derivatives contracts nearly doubled March 2007 and March 2008.

⁴ Lot of CDO related derivatives litigation is discussed in <http://www.jonesday.com/files/pdfupload/Glennspresentation.pdf>



Article



Source: Compiled by author from RBI site; values INR in millions

As the demand for forex derivatives shot up, bankers turned on the innovation mill and started aggressively marketing forex derivatives. Attractive presentations with complex terminology and even more complicated graphs were used to trap the users. One of the banks even took several companies to a fully paid trip to Cape Town, South Africa.

For some months, the derivatives party was having a gala time. However, as dollar began to strengthen, these transactions started to bleed. From beginning of Jan 2008, in about 10 months, the rates went up from nearly INR 39 to a dollar, to about INR 51, a depreciation of about 30%.

It is important to understand that if the derivative in question was a forward, weakening dollar would mean a loss to the user who shorted the forward. However, if the derivative was a put option, there would have been no loss. However, in the name of the so-called zero cost structures, most of the users in India had simultaneously bought options and written options. The written option led to huge losses that took most users by surprise, as most of them did not even understand the transactions they entered into. Soon, courtrooms across the country started getting filled with litigation complaining mis-selling, fraud, and so on. Unlike several other countries where there exists a breed of young lawyers who have strong understanding of finance, it would be no offence to say that most Indian lawyers lack understanding of finance, let alone the complexities of derivatives transactions. However, in a very brief timeframe, matters have gone right upto Supreme Court.



Article

Rajshree Sugars <http://www.indiankanoon.org/doc/149400/> is arguably the first case to challenge the legality of derivatives⁵. Thereafter, there have been several cases many of which are at different stages before judicial or arbitral proceedings. There are various aspects of derivatives deals that are being agitated before courts: legality of derivatives, fraud and mis-selling, violation of exchange control, whether SARFAESI Act is applicable to derivatives dues of banks, whether a user contesting the bank's claim is a "willful defaulter", and so on.

One of the most curious pieces of litigation is the ruling of the Cuttack Bench of Orissa High court in response to a petition filed by Prabhanjan Patra. The Orissa High court directed the CBI to conduct investigation into derivatives deals of banks. FIMMDA intervened and appealed to the Supreme Court to grant a stay on the ruling of the Orissa High court. On behalf of the aggrieved parties, a forum called Forex Derivatives Consumers Forum is agitating the matter, currently pending before the Supreme Court.

Law of foreign derivatives in India:

The principal instruments of regulation of forex derivatives in India are:

- Sec 18A of the Securities Contracts (Regulation) Act
- Foreign Exchange Management Act read with Foreign Exchange Management (Foreign Exchange Derivatives) Regulations, 2000
- Sec 45V of the Reserve Bank of India Act

Section 18A of the Securities Contracts Act legalizes derivatives traded in recognized exchanges. Since the topic for this article is OTC derivatives, the Securities Contracts Act is not relevant.

Sec 45V of the RBI Act provides that derivatives contracts are valid only if at least one of the parties to the derivative is a bank or an entity falling under the regulatory purview of the Reserve Bank of India. The section also provides legality to all derivatives permitted by the RBI. The RBI Act provisions are pertinent to derivatives in general, and are not specifically directed to forex derivatives.

A forex derivative, besides being a derivative, also implies a transaction in foreign exchange. In view of the definition of capital account transactions in FEMA, a transaction in a forex derivative is a capital account transaction, and is therefore, barred unless specifically permitted. Permission has been granted to forex derivatives under item (k) of Schedule I of Foreign Exchange Management (Permissible capital account transactions) Regulations, 2000. The Foreign Exchange Management (Foreign Exchange Derivatives) Regulations, 2000 contain the space within which forex derivatives contracts

⁵ The Ld Judge says so: "Since this appears to be the first case of its kind in India (subject to correction) where derivatives contracts are challenged as illegal and void..."



Article

are permitted. Thus, in view of the general scheme of foreign exchange controls in India which grants only limited permission to capital account transactions, forex derivatives have to comply with FEM (FE Derivatives) Regulations 2000.

The relevant rule, Reg. 4 provides: “A person resident in India may enter into a foreign exchange derivative contract in accordance with provisions contained in Schedule I, to hedge an exposure to risk in respect of a transaction permissible under the Act, or rules or regulations or directions or orders made or issued thereunder.” This rule has to be read with the preceding rule, Reg 3, which puts a blanket ban on all foreign exchange derivative contracts, except that that have the prior permission of the Reserve Bank. In other words, for a forex derivative contract to be legal in India:

- It is either explicitly permitted by the RBI, or
- It is permitted as per FEM (FE Derivatives) Regulations 2000

As regards the explicit permission granted by the RBI, it may be presumed that the Comprehensive Guidelines on Derivatives, dated April 20, 2007, and subsequent Risk Management Guidelines, may be taken as enumerating the derivatives permitted in India⁶. Para 4 of the April 20, 2007 Guidelines states: “Users can undertake derivative transactions to hedge - specifically reduce or extinguish an existing identified risk on an ongoing basis during the life of the derivative transaction - or for transformation of risk exposure, as specifically permitted by RBI. Users can also undertake hedging of a homogeneous group of assets & liabilities, provided the assets & liabilities are individually permitted to be hedged”.

As regards derivatives permitted by the FEM (FE Derivatives) Regulations, as Reg 4 clearly provides, an Indian resident may enter into derivatives with 2 explicit conditions:

- To hedge an exposure to risk
- In respect of a transaction permitted under the Regulations.

In other words, an essential pre-requisite for any forex derivative to be legal in India is that it is entered into by a user only for the purpose of hedging. As that is the key element in both the FEM (FE Derivatives) Regulations and the RBI Circular, the details of the permissible products given by the RBI has to fit into the mould.

What are hedges?

At the first flash of thought, anyone who is an outsider to the derivatives business might think derivatives are nothing but hedges. Some even define derivatives to say these are contracts that an entity enters into to hedge an underlying risk. But once one understands

⁶ The April 20, 2007 Guidelines mentioned that separate guidelines will be issued for foreign exchange derivatives. It may be interred from this that these Guidelines were not applicable to forex derivatives . Later circulars have made the April 20, 2007 Guidelines applicable to forex derivatives as well.



Article

that the value of OTC derivatives is over USD 582 trillion⁷, which might easily be several times the wealth of the world, there is no doubt that a very large part of the derivatives activity is not hedging but trading. Some people might contend that at some end of the spectrum there might be someone hedging an exposure, while there may be several a long chain of dealers through whom the ultimate protection-seller might be providing that hedge. But even that is mistaken – since there is no monitoring or legal necessity of the fact whether there is a hedge, derivatives become leveraged bets. Every trade is a bet on the price of something, and so also derivatives are bets on value of an underlying, but derivatives require either no or negligible initial investment, therefore, derivatives provide huge degree of leverage relative to the investment by way of a margin account. The lure of leverage is so strong in a world that wants to achieve the most in the least time – hence, derivatives are the obvious love of anyone with strong trading instinct.

What is a hedge? A hedging instrument is one the potential cashflows of which neutralize the cashflows of the hedged item, that is, the source of risk. Let us take the simplest case of a farmer F who grows wheat and a banker B who buys wheat. For the farmer, a decline in the prices of wheat is a risk. For the baker, an increase in the price of wheat is a risk. If the farmer enters into a forward sale contract (or shorts a forward) for wheat, and the baker makes a forward purchase (or longs a forward) for wheat, in either case, the contract acts as a hedge. The hedge item for the farmer is the risk of downward variation in prices of wheat. The hedging instrument is the shorted forward. If the price of wheat actually declines, the farmer will have loss on account of reduced sale proceeds; there will be a gain on the shorted forward as the prevailing price is less than the price at which the forward was booked. Hence the gain on the forward will offset the losses on actual realization. On the other hand, if the price of wheat was to go up, sale realization will bring a profit, but the derivative will have a loss – once again, the two will get neutralized.

A forward is the simplest example of a derivative; however, the market abounds with a variety of option contracts. In our example above, the farmer was concerned about the decline in the price of wheat. His objective would have been served if he were to buy a put option on wheat. Put option is option to sell wheat⁸. Since the contract is merely an option, there would be one-sided gains – if the price of wheat does go up, the option does not lead to any loss, as the option need not be exercised. If the price of wheat goes down, the option leads to a profit. So, the farmer has protected his losses, but at the same, can enjoy his profits if the price of wheat goes up.

⁷ BIS Derivatives Statistics of June 2010 at <http://bis.org/statistics/otcder/dt1920a.pdf>. The volumes have come down over the last 3 years and in good times, it was in excess of USD 750 trillion.

⁸ For discussion on types of derivatives, see Vinod Kothari: **Basics of Option Valuation** at <http://vinodkothari.com/tutorials/option%20pricing.pdf>



Article

Let us reflect on the position of the person who sold the option contract. The writer or seller of the option would have no gain if the price of wheat went up (unlike the person who longed the forward contract – he would have gains or losses depending on whether the price went up or came down). He would, however, have losses if the price of wheat went down. Therefore, the writer of the option typically expects an upfront premium to write an option contract.

As a general rule, written options cannot be viewed as hedges at all. A written option creates a risk – it cannot hedge any risk. As per globally prevalent accounting standards on what instruments qualify as hedges, and it is a common prescription in all such standards that written options cannot qualify as hedges⁹.

So, if written options do not qualify as hedges, why would anyone write options? That a derivative does qualify as hedges does not mean derivatives desks of banks cannot enter into such contracts. One simple thing that an option writer might do is to write an option, and buy an option, and make a spread in the process. Lots of short positions in options are hedged by creating long position in the underlying assets, using a concept called *delta hedging*.

Derivatives permitted in India:

As mentioned above, the only derivatives permitted in India are those under the FEM (FE Derivatives) Regulations, or under so-called Risk Management guidelines of the RBI. Schedule I to the Regulations lists out derivatives that users may enter into. These may be classed as follows (excluding those permitted for non-residents only):

1. Forward contracts to hedge an exposure to risk for a transaction which is permitted under the Act
2. Forward contracts to hedge economic exposure¹⁰ in respect of such transactions as may be prescribed by the RBI
3. Interest rate swaps, currency swaps, coupon swaps, etc to hedge loan exposure, and unwinding of such hedges. A range of such swaps is listed, but all of these are connected with loan exposures.
4. Cross currency forward contracts to convert balances in FCNR (B) accounts from one currency into another.
5. Option contracts to hedge foreign exchange exposure. The proviso to this clause mentions that in case of “cost effective risk reduction strategies like range forwards, ratio-range forwards or any other variable by whatever name called there shall not be any net inflow of premium.”

⁹ See, for example, Para AG 94 of IAS 39.

¹⁰ *Economic exposure* is not by itself a different type of exposure, but the impact of foreign exchange fluctuations on the overall cashflows of the entity. As opposed to this, *transaction exposure* looks at the impact of foreign exchange fluctuations on specific transactions.



Article

The key word in each of these products is hedging. That is to say, no matter whether the product is listed in the Regulations or not, the transaction must be a hedge. That is to say, the expected cashflows from the derivative must be approximately the mirror image of cashflows from the underlying exposure, such that the gains/losses from the latter are offset by the losses/gains from the former.

As we have mentioned before, written options cannot be a hedge, as written options imply a risk rather than risk protection for the option writer. Hence, it would be easy to conclude that writing of options is simply not permitted in India. This is on top of the clear prescription in forex derivatives guidelines saying users cannot write an option.

Cost reduction structures and zero cost structures:

The biggest hole in the scheme of regulation is the so-called cost reduction structure and zero cost structure. Quite often, people may mistake these to the same – in fact, they are not.

Anyone familiar with derivatives will understand that buying of an option – whether put or call – will involve an upfront premium. The more the volatility of the underlying, the more will be such premium. A cost reduction structure limits the losses of the option writer, so that the cost of selling the option comes down. For example, if the protection sold by the option writer is range bound, or has knock out features, the cost of the option comes down. This may be called a cost reduction structure. Prima facie, there is nothing wrong in cost reduction structures – the option buyer gets limited protection, and therefore, there is a limited hedge, but it is a hedge nevertheless.

However, the case of zero cost structure is different. This is essentially a bet for a bet – that is, instead of paying premium on the bought option, the option buyer sells protection or writes an option with the counterparty. A common case is a collar, a combination of two options at different strike prices – one is bought by the user, and the other is sold by the user. For example, one may buy a put option on USD at the rate of 47, and sell a call option on USD at a different strike price, such that the premium receivable on the sold option neutralizes the cost of the bought option. There are other variants of such combination contracts, such as ratio options (notional amounts are different), and other synthetic structures.

It does not require a great ingenuity to understand that if a bank has devised a zero cost structure, it cannot be zero-profit structure for the bank. After all, the deal may have several back-to-back deals, each being structured by financial wizards who are far more sophisticated in the game of structuring derivatives than the end user. So, if the end-user ends up paying no premium, the only way it is possible is because he sold more risk than the risk protection that he bought. It surely cannot be the case that he was a net buyer of protection, and still did not pay any price for the protection he bought. Even if the cost of



Article

protection that he bought is embedded in the risk protection that he sold, it is unthinkable that there would be a hedge bought by a user, and yet the hedge costs nothing. Such free lunches can exist only in the world of fantasy. So, for a regulatory regime whose essential feature is to say that a user can engage in a derivative only for hedging, to say, at the same time, that the user may engage in a combination product that does not have any cost, is a contradiction in terms¹¹.

While the RBI circulars and committee reports have mentioned cost reduction structures ever since 2003, the reference to zero cost structures can be found for the first time in Master Circular on Risk Management of 2006: .

Annexure VII:

- d) i. Customers can purchase call or put options.
- ii. Customers can also enter into packaged products involving cost reduction structures provided the structure does not increase the underlying risk and does not involve customers receiving premium.
- iii. Writing of options by customers is not permitted. However, zero cost option structures can be allowed.

Similar statements have continued in the Risk Management circulars thereafter. The 2006 Circular was timed almost perfectly, since that was the time when rupee seemed strengthening, tempting exporters to tie complicated combinations of options bought and options sold. Within a short span of time, those who entered into zero cost structures started suffering crores of rupees in losses.

Realising the impact the self-contradicting provisions had had already¹², the draft of the Foreign Exchange Derivatives Guidelines issued in 12th Nov 2009 sought to prohibit cost reduction structures/zero cost structures. In July 2010, the RBI issued revised draft of the Guidelines, this time, permitting zero cost structures, but with conditions. This

¹¹ Other derivatives experts agree on this. Note the following by A V Rajwade [<http://www.rediff.com/money/2008/mar/24guest1.htm>]: “One also gets an impression that much of our corporate risk management culture does not seem to appreciate the difference between risk reduction and cost reduction; with few exceptions, the latter cannot be done without taking risks; that if deliberate, speculative risk-taking is to be done for reducing cost or making profits, it needs its own disciplines.”

¹² A news report in Economic Times, 29 July 2009 [<http://economictimes.indiatimes.com/news/economy/policy/curbs-likely-on-zero-cost-derivatives/articleshow/4823749.cms>] says this: In the basket of products, zero-cost derivatives turned out to be the hot pick as it allowed companies to get a better exchange rate, far more lucrative than the simple forwards, from banks and sign deals with them at no expense. While the true purpose behind such deals was to hedge the risks that a company faced from fluctuations in foreign exchange rates, the products involved complex packaging and risks that few clients understood.



Article

prescription was finally carried out in the final Guidelines implemented in December 2010.

The condition put in the Dec 2010 Guidelines for companies to use cost reduction structures are strange. Apart from the net worth requirement (Rs 100 crores), the condition is that the user should have adopted AS 30/AS 32. AS 30 corresponds to IAS 39 and AS 32 corresponds to IFRS 7. Since IFRS 7 is primarily focused on disclosure of aggregate risks, the precondition should basically boil down to adoption of AS 30/IAS 39. AS 30 is anyway mandatory for most companies (except small and medium companies, which anyway will not satisfy the net worth condition) from 1st April 2011. So, if the adoption of AS 30 is the only condition, this condition is anyway satisfied by all companies from 1st April 2011. There are certain other operational conditions, but those only rule out certain leveraged derivatives, range accrual transactions, and so on. Even the earlier Guidelines did say that exotics are not permitted in India. But the key question is – how does adoption of AS 30 exonerate companies from the basic principle of exchange control in India that forex derivatives cannot be entered into except for the purpose of hedging? After all AS 30 can only point out to bludgeoning losses before they become too large, by way of the mark-to-market requirements. But how does it make a zero-cost structure into a hedge at all?

Hedging of transformed exposures

The derivatives that ate into the flesh of Indian corporates included, apart from cost-reduction structures, transformation of rupee loans into foreign currency loans. One of the commonly used structure was transformation of a rupee loan into a foreign currency by a principal-only swap, and then hedging the risk of that currency by options. The economic driver of these contracts is the interest rate parity theory which holds that differences in interest rates in two currencies are neutralized by changes in exchange rates. By transforming the loan into a foreign currency, a user may stand to gain a regular carry or saving in interest rate. However, the user carries the risk of the foreign currency into which the loan has been transformed. This exposure may be hedged. To this hedging again, structurers used cost reduction devices - hence the hedge was coupled with several knock-out conditions. In other words, by swapping the loan amount into foreign currency, the user created a new risk – the risk of the currency in which the rupee loan was swapped, and then that risk was hedged, though ineffectively, with several option contracts.

A significant feature of regulations in India is that hedging is permitted only for an underlying transaction exposure, and not for a derived exposure. Quite often, derivatives are used to transform a rupee liability into a liability into a foreign currency, and the hedge such exposure. However, Indian regulations have not permitted hedging of such transformed or derived exposures. As the RBI Report on Currency and Finance, 2007 puts it:



Article

6.42 x x At present, exposures arising on account of swaps, enabling a corporate to move from rupee to foreign currency liability (derived exposures), are not permitted to be hedged. While the market participants have preferred such a hedging facility, it is generally believed that equating derived exposure in foreign currency with actual borrowing in foreign currency would tantamount to violation of the basic premise for accessing the forward foreign exchange market in India, i.e., having an underlying foreign exchange exposure.

6.43 This feature (i.e., ‘the role of an underlying transaction in the booking of a forward contract’) is unique to the Indian derivatives market.

Hence, there is no way the hedging of these transformed exposures could have been valid under Indian regulations.

Question of flavour – vanilla or exotic?

While banks were happily selling some of the most complex derivatives – range accruals, binary options, barrier options and so on, it is strange to find a benign statement in the Master Circular on Risk Management – “For the present, AD Category-I banks can offer only plain vanilla European options”. Though there is no clear definition of what is plain vanilla, but obvious enough, a plain vanilla European option is the one that does not have knock-out features, digital payouts, and so on.

During 2007-8 period, banks across the country have sold thousands of such contracts, which, by no means, can be called plain vanilla. The issue is – how was the RBI monitoring this? The periodic reports that banks were filing with the RBI contain only broad headings. The only way these products could have been highlighted is the on-site inspections carried by the RBI, but it is doubtful if the inspectors had the education and training to detect these.

A question of suitability and appropriateness:

Derivatives guidelines in India have consistently mentioned suitability and appropriateness. The April 20, 2007 Comprehensive Guidelines say that “market-makers should undertake derivative transactions, particularly with users with a sense of responsibility and circumspection that would avoid, among other things, misselling.” It also clearly says that “it may also be noted that the responsibility of ‘Customer Appropriateness and Suitability’ review is on the market-maker.”¹³ Hence, the onus of establishing whether the customer has a suitability and appropriateness policy, and

¹³ At first brush, it may be contended that April 20, 2007 Guidelines are not applicable to foreign exchange derivatives. However, suitability and appropriateness is generic – if there is obligation to ensure suitability and appropriateness in case of other derivatives, it cannot be that that obligation does not apply in case of forex derivatives. In addition, para 3 of part A of Master Circular on Risk Management, July 1 2009 clarifies that the general obligations of April 20, 2007 Guidelines are applicable to forex derivatives too.



Article

whether the derivative in question is suitable and appropriate for the user, is on the authorized dealer.

Putting the obligation of suitability and appropriateness in case of complex structured products on the banker/dealer is not unique to India. EU regulation called Markets in Financial Instruments Directive also requires a dealer in financial instruments to classify clients based on their sophistication and ensure suitability and appropriateness for the client in question.

When a banker deals with a customer, particularly where the banker has been specifically required by regulations to ensure suitability and appropriateness, there is a duty of care. Duty of care is a very vexed question of law and several rulings of House of Lords have gone into this question – notably, *Caparo Industries* [1990] 2 AC 605¹⁴ ..

Conclusion

The upshot of the discussion is that the regulator allowed the market to move unbridled. Even as rupee was getting highly volatile and it was clear that crores of losses on account of derivatives deals would create rumbles in the market, the RBI kept talking about draft guidelines, which took good 44 months after the April 2, 2007 Guidelines said separate guidelines were being issued for forex trades. That there is tale of woes in the making was forewarned by several persons. However, nothing worked, and eventually, we have one of the toughest litigations in financial instruments being fought in the courts.

¹⁴ There is a recent ruling of the UK High Court in *Standard Chartered Bank v Ceylon Petroleum Corporation* (2011] EWHC 1785 (Comm) where the question whether a bank entering into a derivative contract with a customer was acting in the capacity of a financial adviser has been probed. The answer of the court was in the negative. However, there is no indication that UK derivatives regulations threw the duty of suitability and appropriateness on the bank.