“Derivatives are popping up everywhere and it is also making financial advisers and regulators nervous. And to the average investor, derivatives can seem very complicated, and if used in strategies to enhance yield derivatives may be adding to the risk of the investment in a way that is not transparent to the investor. Investors may be taking on more risk than they realize and according to Warren Buffet, the derivatives are time bombs, both for the parties that deal in them and the economic system.” (Berkshire Hathaway, 2002).

Good regulation underlies good business. It provides a level playing field, so that business can be carried on in an environment where everyone has confidence that the same rules apply to all. There is ready access to suitable legal remedies if things go wrong, and firm action is taken against fraud, dishonesty and misconduct. As a result, the regulatory system is respected, and everybody can find and understand their obligations. The purpose of the regulation of financial markets is to ensure that their operation is fair, orderly and transparent. This will encourage investors and consumers to participate confidently in the financial system, using reliable and trustworthy information to make decisions.

The objectives of derivatives regulation are to ensure the integrity of markets, to deter manipulation by agents, and to protect participants from
losses arising from fraud or the insolvency of counterparties. However no market is ever truly unregulated (Greenspan 1997).

Globally, there are increased evidences to suggest that investor confidence has assumed an important role in the economic development of a country. In this context ‘The Economist (1998)’ indicated that a lot of issues need to be addressed to make the capital markets safer.

In derivatives contracts either party may default during the life of the contract. For example, either counterparty may default on any of the settlement dates during the life of a swap agreement. Default risk has two components: first, the expected exposure (that is, the expected replacement cost of the contract minus the expected recovery from the counterparty); and second, the probability that default will occur (Hentschel and Smith 1995). Credit risk is often negligible in exchange-traded contracts since trades are settled via a clearinghouse. For OTC derivatives trading, banks and other dealers usually only cater to highly rated clients (Bhaumik 1998).

Legal uncertainties are another danger in derivatives markets. Sometimes counterparties enter into derivative contracts without the legal or regulatory authority to do so. This may result in large losses for banks. Legal risks also include compliance and regulatory risks, which concern activities that might breach government regulations, such as market manipulation, insider trading, and suitability restrictions (INTERNATIONAL MONETARY
But what is the optimal balance between governmental regulation and self-regulation? The two forms of regulation should be compared simultaneously by evaluating their competencies and flaws (Lazzarini and Mello 2001). Those in favour of Governmental deregulation stress on the costs associated with government intervention, ignoring the shortcomings of self-regulation, while those supportive of governmental regulation tend to disregard the costs of government regulation. Proponents of government regulation also suggest that the presence of market failures justifies intervention, sometimes overlooking the feasibility of the proposed change (that is, more governmental or self-regulation).

Lazzarini and Mello (2001) compare the two regulatory mechanisms by focusing on the regulatory failures of both - that is, how each mechanism creates inefficiencies. The authors rely on Coase’s insistence that market failures do not necessarily justify market intervention: “...and solutions have costs and there is no reason to suppose that government regulation is called for simply because the problem is not well handled by the market or the firm...” (Coase, 1960, p.18) They stress the importance of studying the least costly mechanism to moderate market failures and the feasibly of implementing the proposed change (more regulation or self-regulation). The institutional environment of the particular country (for instance, how politics can influence the credibility of governmental regulation) needs to be
considered and there should be the avoidance of ‘one-size-fits-all’ recommendations.

There are four types of failures associated with governmental regulation: 1) the costs to run regulation bureaus, to collect information and to monitor markets, 2) the credibility of the proposed mechanism, 3) rent seeking behaviour by constituencies directly or indirectly affected by the regulation, and 4) constraints on financial innovation (Lazzarini and Mello 2001). Problems associated with self-regulation include: 1) agency problems in the organisational structure of the exchange; and 2) nonsocially optimal provision of goods (Lazzarini and Mello 2001).

It is also observed that the successful regulatory system can complement the incentives for self-regulation while reducing the incentives and opportunity for behaviour, which threatens the success and integrity of market (International Organisation of Securities Commissions 1996a). Lee Hsien Loong (2000) emphasized upon the importance of rebuilding investor confidence for prosperity of ASEAN countries. He indicated that for investor confidence, rebuilding of sound fundamentals, dealing with capital account risks, economic co-operation among ASEAN countries, corporate restructuring, banking sector reforms and improvement of social and political conditions is important.

Joseph Oliver (2002) studied the steps taken by the Canadian Government to develop healthy capital market, enhance investors’ confidence, and the
importance of regulatory and intermediaries in capital market in ensuring
good corporate governance. He suggested that half of all Canadians have
investments in equities and their confidence is essential to healthy and
dynamic capital market. Deep bear markets, corporate scandals, insider
trading, high levels of executive compensation and inaccuracy of published
financial statements are cited as reasons for lack of investor confidence in
Canadian capital markets. He was of the opinion that regulators,
accounting professionals, analysts and broking firms, public companies,
shareholder and Government must contribute to ensure good governance
and reduce corporate failures.

McCall (2002) in his testimony before the Committee on Financial Services
United States House Representatives, observed that the integrity of the
financials markets and economic wellbeing of the country depend on
corporate accountability and investor confidence.

Bumgarner and Pime (2000) have studied the capital flows to and from
Hong Kong in the years prior to its reversion to Chinese sovereignty and
during the transition. They have indicated that Government policies have
an impact on investor confidence and capital mobility. Bloomfield, Libby
and Nelson (2002) have indicated that less informed investors are over
confident in investments. Brian J. Porter (2005) pointed out that a market
that is unregulated could fail to properly protect investors – prompting them
to take their capital elsewhere. But a market that is over regulated could
easily stifle growth, innovation and efficiencies. What is required is
“balanced regulation” not too loose and not too rigid. In India, Commodity futures trading has been in existence since 1953 and certain OTC derivatives such as Forward Rate Agreements (FRAs) and Interest Rate Swaps (IRSs) were allowed by RBI through its guidelines in 1999. The trading in “securities” based derivatives on stock exchanges was permitted only in June 2000. The Government decided that a legislative amendment in the securities laws was necessary to provide a legal framework for derivatives trading in India. Consequently, the Securities Contracts (Regulation) Amendment Bill 1998 was introduced in the Lok Sabha on 4\textsuperscript{th} July 1998 and was referred to the Parliamentary Standing Committee on Finance for examination and report thereon. The Bill suggested that derivatives may be included in the definition of “securities” in the SCRA whereby trading in derivatives may be possible within the framework of that Act. The said Committee submitted the report on 1\textsuperscript{st} March 1999.

However, since there was no regulatory framework to govern trading of securities, the derivatives market could not develop. SEBI set up a committee in November 1996 under the chairmanship of Dr. L.C. Gupta to develop appropriate regulatory framework for derivatives trading. The committee suggested that if derivatives could be declared as “securities” under SCRA, the appropriate regulatory framework of “securities” could also govern trading of derivatives. SEBI also set up a group under the chairmanship of Prof. J.R. Varma in 1998 to recommend risk containment measures for derivatives trading.
The regulatory framework in India is based on the L.C. Gupta committee report on derivatives and J.R. Varma group reports on risk containment measures for derivatives products. The regulatory framework in India is mostly consistent with the IOSCO principles and regulatory framework for exchange traded derivatives and addresses the common concerns of investor protection, market efficiency and integrity and financial integrity.

The J.R. Varma group suggested a methodology for risk containment measures for index futures market and for options on indices, stock options and single stock futures. The risk containment measures include calculation of margins, position limits, exposure limits and reporting and disclosure.

In the opinion of a great majority of ordinary investors, the regulation of the Indian Stock Market was largely ineffective in protecting investors and ensuring fair dealing and orderly markets. This was the dominant perception of household investors both in 2001 and 2002 is high. As high as about 70% of the sample household heads across all income and age classes said “No” when a question was asked “Are Govt./SEBI measures for protecting investors in companies adequate for reviving investors’ confidence?

The worsening of this problem compared to 2001 meant that the regulatory measures against corporate malfeasance and mismanagement were absolutely inadequate. A need was identified for more drastic reform of the corporate governance system from the viewpoint of its accountability to the
“minority” shareholders. This also meant that SEBI prescribed corporate governance code had absolutely no effect.

Dr. K. Santi Swarup conducted a survey in December 2003 and published a paper on measures for improving common investor confidence in Indian Primary Market. This study is based on questionnaires administered to investors in ten cities of India.

A subsequent survey was carried out by Dr. L. C. Gupta, Naveen Jain, Utpal Chaudhary and Sacgut Gyota (2004), an interim report of which was submitted on October 1, 2004. This study was sponsored by the Department (now Ministry) of Company Affairs under the Investor Education and Protection Fund (IEPF). The purpose of this study was to deepen understanding about investors’ protection and needs. The sample size was 5908 household heads spread over 90 cities/towns across 24 states/union territories. This study was based on two partially overlapping questionnaires, one which was filled through personal interview and other being a supplementary questionnaire sent through post along-with a business reply envelope. There are plenty of booklets published by SEBI, BSE, NSE and investors associations for guiding investors. But these have not been studied in a comprehensive manner and hence this study has been taken up. In conclusion, it can be seen from this chapter that lot has been written, surveyed and examined in the Indian Capital Market. However, there remain some gaps which this study aims to fill in.