DERIVATIVE CONTRACT: WHETHER AN INSTRUMENT OF HEDGING OR A MERE WAGERING AGREEMENT?

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Comprehensive analysis of the wagering agreement under the Indian Contract Act 1872 and the derivative contract under the Securities Contract Regulations Act, 1956 reflects some similarities. On the one side, an agreement by way of a wager is declared void under section 30 of the Contract Act and on the other side derivative contract has been declared a valid contract by inserting section 18A and repealing section 20 through an amendment of the of the Securities Contract Regulation Act, 1956. The reason behind making a critical discussion on the nature of the derivative contract and other similar contracts is essential to know why the first is permitted and the other is prohibited. This study helps to understand truly why legal authorities have a different approach towards the two and treat them differently. Understanding a topic from the legal angle requires a comprehensive analysis of that topic, and it further requires a discussion on the same from every aspect. Therefore researcher is going to study this concept on one particular aspect, i.e., the true nature of the derivative contract. This article analyses what are those areas where derivatives are used only for speculation and the consequences if those speculative elements are not eliminated. This article will be focusing on the betting elements of the derivative contract mainly.

Wagering agreement was considered a valid contract and enforceable by the court under the common law earlier. Courts were highly disappointed with the idea of enforcing wagering agreements, and they started refusing to implement these types of agreement on several grounds. Gradually the law of contract developed and these types of agreements became void on the principle of public policy and convenience. The principle of the public policy founded the ground to invalidate wagering agreements.

CONCEPTUAL ANALYSIS BETWEEN WAGERING AND DERIVATIVE AGREEMENTS

Whether an agreement is a contract or not is decided by the court of Law. We make an agreement, and it is the court which declares that agreement as a contract. An agreement must be declared a contract when it has all the elements of a valid contract mentioned under section 10of the Contract Act.[1] On the issue of whether an agreement is valid or not, the court plays a vital role. In the context of Indian legal regime, an agreement cannot be declared as a contract if it comes under any of the category mentioned under from section 23 to 30 of the Act[2]. Classification of these agreements is based on the principle of Public policy and considered to be detrimental to the public interest and the freedom of individuals. Enforceability of a contract is the main reason which binds the parties to perform their obligation under a contract. Thus agreements are not enforceable due to the many reasons.

Our Indian legal regime on Contract Law makes classification of the void agreements. The first category is an absence of the essential, which are a pre-condition for the formation of a valid contract. A defect at the formation of an agreement implies that there was never a contract and it is void *ab-initio*. Another category of a void agreement is due to the principle of public policy. The term public policy is not defined anywhere in the Act. It is left to the court to decide what is considered to be against the public policy.

Wagering Agreement: The word wagering is not defined anywhere under the Contract Act.[3]Section 30 of the Indian Contract Act only says that agreement by way of a wager is void. But in case of any subscription or contribution made to give rewards to winners in horse racing shall be enforceable under the Act as an exception of wagering agreement[4]. Generally, wager means betting which mean two or more person bet on the determination of some future uncertain event and put money on the stake in case their anticipation proved wrong. The most referred definition to explain wagering is of Hawkins J. who defined wagering in a historical

[1]Section 10 of the Contract Act says "All agreements are contracts if they are made by the free consent of the parties competent to contract, for a lawful consideration and with a legitimate object, and are not expressly declared to be void".

[2] Section 13 and 23 to 30 of the Contract Act declares some agreement not a contract even if it is made with the consent of the competent parties with lawful consideration and object.

[3] Section 30 of The Contract Act, 1872 **says that agreement by way of a wager is void**, but it does not define the word wagering.

[4]. Section 30 of the Act provides that any prize to the winners of Horse racing as an exception to the wagering

case Carlill v. Carbolic Smoke Ball Co.[5] As per this definition, there are four important ingredients requires to be a wagering agreement. The first one is two parties having different views on an uncertain future event. Second is that parties do not have any control over that uncertain future event and third is that only one of the parties can be the winner which necessarily will result in a loss to the other party. The last essential is that parties have no real interest in the happening of the event except the amount he will win or loss.[6]

Sir Williams Anson[7] improvised this definition and said that "wagering agreement is a promise to give money or money's worth upon the determination and ascertainment of an uncertain event"[8]. On the analyses of this definition, one can understand that the event must be uncertain and it needs not necessarily confined to future events[9].

To examine whether a particular agreement is of wagering in nature or not can be determined by analyzing the nature and result of the particular transaction. In the case of wagering transaction, parties do not have any real interest in the particular future uncertain event except to win or lose the amount they have promised to pay. Formation of a valid contract requires a proposal from one party and the acceptance by the other, whereby both the parties do some act to perform their part of the obligation under the contract they have agreed upon. This performance forms consideration for the parties to the contract. In a contract, the interest of the parties is always different which results in a benefit for both the parties. But in the case of wagering agreement, the interest of the parties are common which makes mutual benefit impossible under the agreement and as such benefit of one party result into a loss for the other. There is no performance of the contract by the act of parties[10].

[5] "A wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependant on the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stakes; neither of the parties having any other interest in that contract except the sum on stake he will so win or lose, there is no other consideration for making of such contract by either of the parties. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract."

[6]"*Wagering **Contracts,***" William Harman Black, The Law of Stock Exchanges & Customers, 107 1940 http://heinonline.org, last accessed on Wed Nov 9 06:06:31 2016

[7]The Principles of the English Law of Contract,1884, 11th ed. 1906

[88] Sports Betting: Law & Policy," Paul M. Anderson & others, Springer Science & Business Media, 2011, p. 448

[9]. An example may be an election where the election is done, but the result is not out.

[10]"*Wagering Contract: A Question of Definition*," Harvard Law Review, Vol. 6, No. 4 (Nov. 5, 1892), pp. 203-204, http://www.jstor.org ,Accessed: 24-05-2016

Wagering agreements are made void on the principle of public policy of unjust enrichment. Under the common law, all kind of wagering transaction was not invalid. There was some category of wagering transaction which was discouraged by the court by disallowing their enforcement. Earlier under the common law agreements which would not affect the feelings or interest of others were enforceable. Later court started rejecting cases based on the chance to win. Courts said that it is against the public policy of providing justice by the court when judges had to take every case based on a mere chance for which they had to do nothing but betting on the happening of incidents occurs in the society which may lead to the bundle of cases filed in the court of justice.[11]

Different forms of wagering Agreement- Wagering agreement may be in different forms. Some of the popular forms of wagering are as follows-

Lotteries- Lotteries are a practice of giving money by more than one party to the other party who gives an offer that they will have a chance of winning money or money's worth which will be more than they are going to put on a stake in expectation of a chance to win.[12]

Gambling- Gambling is also one of the forms of wagering agreement. As mentioned earlier, all form of wagering is based on the bet and the same is with gambling. There must be three essentials to treat a transaction as gambling. These are bet, consideration, and prize. These all must be there to consider particular activities like gambling. A deal would be treated as gambling where some valuable things are put at risk of losing the same by the parties in expectation of high return if their luck supports them. This risk must be based on luck or chance. Public opinion is also critical while regulating a particular game. Public views are

[11] Elish Greenhood, The Doctrine of Public Policy in the Law of Contracts 222 1886, available on http://heinonline.org last visited on Sat Oct 17 04:15:19 2015

[12] According to 12 USCS § 25a , "lottery" includes any arrangement whereby three or more persons (the "participants") advance money or credit to another in exchange for the possibility or expectation that one or more but not all of the participants (the "winners") will receive by reason of their advances more than the amounts they have advanced, the identity of the winners which may be determined by a random selection or a game, race, or contest or any record or tabulation of the result of one or more events in which any participant has no interest except for its bearing upon the possibility that he may become a winner.

influenced by historical development and practices of a specific game which may defer from time to place[13]

Sports and wagering agreements- Game contract requires the players to makes mutual promises to pay money or money's worth on the determination of the result of their efforts for playing some activity. It requires skill, and rigorous training from both the side and its outcome does not depend on chance. As the contract of gaming requires skills and effort and it does not create any nuisance to the public at large, it is permissible under the law. In case there are only two parties in the game it may be considered as wagering if other elements of wagering also exist. As per entry 33 of the State list of the seventh schedule of the constitution, sports are the subject of laws made by States. Indian Constitution empowered State governments to regulate activities related to games subject to contract Act, Indian Panel Code, and other central legislation. State law on sports can override these provisions if it gets the assent of the President. In the context of a particular game if the parties have any amount of control over the result of the game, then it cannot be wagering transaction as wagering is based on a mere chance. Games and other sports are conducted by some rules set for the particular sports activity. Participants invest their time and energy to prepare for the specific games. There are some organizations which organize these contests by advertising the specification of the specific sports. These organizations collect money in the form of a ticket from the people who love watching particular sports. Out of these collections and some time out of state funding the prize is determined for the winner of specific games. In most of the sports, there is a little scope of mere chance in determining the winner, training and experience play a significant role. Thus sports are excluded from the purview of the wagering. But if people outside of these setups, speculate upon the result and fixed money on the particular players it becomes illegal. The reason behind making speculation on the outcome of these match as unlawful are clear as people put money on the result of a specific game which is a future uncertain event. They don't have any interest in the betting except to losing or winning amount which is the very basis of wagering agreement[14]

[13]*Ibid*

[14]. India sports betting has become a challenge for the government to control these betting activities as it leads to significant financial crime and also it is against the principle of fair play. People go to watch the particular match where participant puts their effort to take the result in their favor. But when betting is allowed on the outcome, these speculator starts offering money to the participants of the particular match who lead to match-fixing and as such, they try to mold the result on team or participants they have put their money.

INDIAN LEGAL REGIME ON WAGERING

If one traces the origin of wagering activities in India, the dice game of Mahabharata in which Pandavas put his wife on stake cannot be forgotten. That was a gamble in which pandva lost everything. Since then it was always in practice, but people see it as sin. Morally gambling has been considered wrong, and public sentiment towards gambling is still the same, and gambling is considered against morality. This general notion has been incorporated into the statute as well. In India, there are some forms of gambling which are allowed, and at the same time, some are expressly prohibited.

Existing laws on gambling are still not very clear. India Contract Act was enacted in the year of 1872 under which wagering agreement has been declared as null and void. No claim concerning any prize or money won under wagering can be brought, but it is not illegal. People can make wagering agreements, but the court will not enforce these agreements. Earlier there was no statute governing gaming in India before 1867[15]during the period of British India government enacted Gaming Act 1845 to control and monitor all gambling activities which may cause nuisance in the society and all such kind of arrangement were declared void and thus not enforceable.

This was the first statutory attempt in modern Indian legal system to regulate gambling which was made in the British period through The Public Gambling Act, 1867. The Act deals with gambling houses[16]where the public at large put their money on the stake in expectation of high return. One interesting point needs to be considered here is that public gambling is not allowed and places where gambling are conducted called gambling houses, are restricted. On the reading of the Act, the word gambling house has been used which cannot be run in public. The question arises whether private gambling is allowed? Gambling in any form is prohibited, but difficulty arises to find out these private places which are not easy to trace. There were some devices used for the purpose, venues used for the gambling and financing by allotting tickets all were punished in the form of a fine. Under the Act, gambling has been made illegal, and

[15]The Public Gambling Act, 1867 was the first attempt to regulate and prohibit gambling houses in India by the British government.

[16], A 'gaming house' has been defined as *"any house, walled enclosure, room or place in which cards, dice, tables or other instruments of gaming are kept or used for the profit or gain of the person owning, occupying, using or keeping such house, enclosure, room or place, whether by way of charge for the use of the instruments of gaming, or of the house, enclosure, room or place, or otherwise howsoever."*

any betting based on mere chance has been declared illegal. This Act will apply only to those activities which are in the form of the organized game conducted to invite the public at large to a stipulated place to put money on stake. The Act made the gambling illegal when it is used to earn the profit, or as a business. One point to be noted is that Act excludes any gambling activities which are based on mere skill. Under the Bombay Presidency Act, this law was amended in 1865 and wagering was declared illegal.

Under the Constitution the word gambling is defined under the state list, entry 34[17]. Constitution empowered the States to make laws to regulate lotteries. The Central Lotteries (Regulation) Act, 1998 prohibits all form of lotteries in India and any person conducting lottery without authorisation will be liable for punishment[18]. The Act empowers the State to make laws to regulate lotteries.[19]Over a period now it has been settled that lotteries cannot be conducted without authorization of State government. Only State government can run lotteries after fulfilling all the requirement of the Act.[20] To regulate the new form of lotteries and online lotteries Central government has enacted The Lotteries (Regulation) Rules, 2010 which take into consideration changing circumstances by defining electronics instruments used to conduct online lotteries. The Act prohibited the sale of the lottery ticket and prescribed that anything related to lottery business must be notified and published in the official gazette. One another Central legislation to regulate betting activities is Prize Competition Act, 1955. The objective of the legislation is to control the prize competition[21]The Act regularizes competition based on

[17], "'gambling' includes any activity or undertaking whose determination is controlled or influenced by chance or accident and an activity or undertaking which is entered into or undertaken with consciousness of the risk of winning or losing, e.g., 'prize competitions, a wagering contract, ...Where there is no actual transfer of goods but only to pay or receive the difference according to the market price which varies from the contract price."

[18] Section-7 of the Act, Where a lottery is organized, conducted or promoted after the date on which this Penalty Act receives the assent of the President, in contravention of the provisions of this Act, by any Department of the State Government, the Head of the Department shall be punishable with rigorous imprisonment for a term which may extend to two years or with fine or with both.

[19] A State Government may organize, conduct or promote a lottery, subject to the subject to conditions mentioned Section 4 of the Lotteries (Regulation) Act, 1998 Act

[20] Section 4 and 5 of the Lotteries (Regulation) Act, 1998 Act.

[21] Section 2(d) 'prize competition' means any competition (whether called a cross-word prize competition, a missing-word prize competition, a picture prize competition or by any other name) in which prizes are offered for the solution of any puzzle based upon the building up, arrangement, combination or permutation, of letters, words or figures.

any puzzle or question. There are limits set in the Act to validate prize competition.[22] In a case[23] Supreme Court observed that skill games are outside the purview of prize competition. After examining the legal framework on betting activities, it can be concluded that there is some ambiguity in laws regulating betting practices. Some of the games involve skills are prohibited, and there are some games based predominantly on chance are allowed.

A business of gambling is not covered by Article 19 (1)(g) of the Constitution, and thus any writ petition to enforce the gambling business as a fundamental right under Article 32 or 226 is not enforceable[24]

The position of agreements collateral to wagering Agreement-

Other arrangement of this kind is agreement collateral to wagering agreement. A question arises if wagering agreement is void whether any arrangement collateral to wagering is also void? Section 30 of the Contract Act is based on Gaming Act, 1845 of English Law. Section 18[25] of the English Gaming Act declared contract by way of wager null and void. The provisions of this Act have been gradually repealed by several statutes that deal with betting activities.[26]On the validity of a collateral contract, there are different approaches of the courts in the different jurisdiction. Under English law, contract collateral to wagering agreement is also void.[27]Supreme Court of India has adopted a different view on the validity of the collateral

[22] Section 4 Prohibition of prize competitions where the prize offered exceeds one thousand rupees a month"**.-** No person shall promote or conduct any prize competition or competitions in which the total value of the prize or prizes (whether in cash or otherwise) to be offered in any month exceeds one thousand rupees; and in every prize competition, the number of entries shall not exceed two thousand**."**

[23] R. M. D. Chamarbaugwalla v. The Union Of India, AIR 1957 SCR 930

[24]*Ibid.*

[25] Section 18 of the Gaming Act, "All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void; and no suit shall be brought or maintained in any court of law and equity for recovering any sum of money or valuable thing alleged to be won upon any wager, or which shall have been deposited in the hands of any person to abide the event on which any wager shall have been made: Provided always, that this enactment shall not be deemed to apply to any subscription or contribution, or agreement to subscribe or contribute, for or towards any plate, prize, or sum of money to be awarded to the winner or winners of any lawful game, sport, pastime, or exercise".

[26]Sections 1 to 9 and 15 and 16 and 19 to 24 and 26, and the First and Second Schedules, were repealed by Part I of Schedule 6 to the Betting and Gaming Act 1960.Sections 10 to 14 and the Third Schedule were repealed by section 1 of, and the Schedule to, the Billiards (Abolition of Restrictions) Act 1987. Section 25 was repealed by Part XIX of Schedule 1 to the Statute Law (Repeals) Act 1976

[27] Hill V William Hill (Park Lane) Limited [1949] 2 All Er 452, [1949] Ac 530

transaction. In a landmark case[28]Supreme Court deviated from the English court on this point. The issue before the court was whether an agreement made between the two parties to enter into a partnership contract to bet on the prices of wheat in future is enforceable or not. The Court had to decide the nature of the contract under section 23[29] read with section 30 of the Contract Act. One of the parameter to decide the legality of an object or consideration under a contract is that it should not be against public policy[30]. As per section 23 of the Act object and consideration would be illegal if the court considers it against public policy[31]. Now the question is whether wagering agreements are illegal or void. As per section 30, it has been declared void. Wagering agreements are declared void because it is regarded as against the public policy of unjust enrichment[32]The public policy behind making wagering arrangement void would be to discourage the practice of speculation on an uncertain future event which may lead to a bundle of the claim by people as it does not require any consideration and obligation to be performed by the parties. It is a public policy issue to examine the nature and consequences of these arrangements. The principle of public policy behind making wagering agreement void or illegal is the same in every jurisdiction. The word Public policy has been used under the contract law, but it is not defined anywhere. It means something which the court regards against the public interest. In case the court considers some claims against public policy then the agreement will become illegal. But in the case of section 30, there is no discretion given to the court to determine to a wager as illegal as it is declared void by the statute itself. Therefore it can be stated that making a contract illegal is not based on the same policy by which agreements

[28]Gherulal Parakh v. Mahadeodas Maiya and Others, AIR, 1959 SCR Supl. (2) 406

[29] Section 23 says, " What consideration and objects are lawful, and what not.—The consideration or object of an agreement is lawful, unless" it is forbidden by law; [14] or is of such a nature that, if permitted, it would defeat the provisions of any law; or is fraudulent; or involves or implies, injury to the person or property of another; or the Court regards it as immoral, or opposed to public policy. In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void"

[30] Clarke E. Cochran, "Understanding Public Policy", 14th ed. Boston, 2013 p.9 "the term public policy always refers to the actions of government and the intentions that determine those actions "

[31] The word Public policy indicates the broader approach of the government. This is a very broad concept which covers rules and regulations. Public policy involves a process of formulation, analysis, adoptions, and implementation of government actions. Public policy is a parameter to test the validity of any actions. It varies from time and place. It depends on the particular system or environment. It tells that in a given system what is good or bad? For example, what is the parameter to test any action in India may different from the public policy of other countries. Factors which determine public policy are culture, geographical conditions, economic conditions, political conditions, etc.

[32] Promise is a mutual consideration for both the party. The first point to make this void. The second point is if this kind of arrangement once allowed the judges would be overburdened to answer all the baseless claim where parties are only guessing on the certain event. As there is no liability attached with this kind of arrangement and people rends to guess on the uncertain situation it is considered that this kind of agreement is void.

are made void. Section 23 of the contract cannot be applied on wagering agreement as the section deal with an illegal contract which has been put in altogether different categories. On this basis, it was observed by the court that any contract collateral to wagering is not necessarily void. The implication would be that wagering is outside the purview of section 23 of the Act. Therefore in case of the betting, the court cannot declare it as illegal.

In the State of Presidency towns, Bombay, law related to wagering was different. Bombay Presidency Amendment Act of 1865 declares that in this Presidency collateral contract to wagering agreement is also prohibited, and no one can approach the court for the enforcement of collateral transaction to wagering. Thus from observation of Indian Laws on wagering and other related transaction, it can be concluded that collateral transaction to wagering allowed as per the court's ruling and as such any claim

WAGERING AND PUBLIC POLICY

Human beings are a social creature, and as such, they are dependent on the others to meet their needs. Contracts are made to serve the legal interest. The word legal is used to throw light on the legality of the purpose for what the contracts are made[33] which must be present to make an agreement contract. An agreement becomes void if there is lacking one of these essentials. Under the Indian Contract Act, an object of the contract must be legal, and it should not be against public policy. The word public policy is not easy to define. What is a public policy in one jurisdiction is not the same in the other jurisdiction. It evolves over a period as the society grows it also keep changing. It's a kind of framework within which the legislation is made. Laws made by the legislature and judgment delivered by the judges are bound to be as per the public policy. In other words, any practice which is against public interest or which lead the society to a corrupt practice is considered against public policy. Now the question arises what is against the public policy? It depends on time and place. There are several examples which were considered to be against the public policy but now acceptable. What is acceptable in one system may not be acceptable in other systems.

[33]Section 10 of the Contract Act, 1872 which forms the essentials of a valid contract, says that contract are agreements if they are made by the free consent of parties competent to contract, for a lawful consideration and with a legitimate object, and are not hereby expressly declared to be void,

Definition

What is the public policy? The following definitions can be quoted-

"*Public policy consists of political decisions for implementing programs to achieve societal goals*"[34]

Public order and individual freedom are one of the primary objects in every democratic country. Public policy can be referring as the mechanism for balancing the public interest while protecting personal freedom. To ensure public order some amount of limitation on the freedom of the individual is required. This limitation is created an atmosphere for the individual to enjoy their liberty and exercise the rights given to them. The word public policies have three components, i.e., public interest, public morality, and public security. If any of these aspects of the public life is hampered by any private act, then it would render that private act, i.e., wagering agreements unenforceable.

Public order concerning wagering agreements can be seen from the two points of view. One is the nature of the formation of the wagering agreements itself and by the consequences of these agreements. Contract law is the foundation for the development of all modern societies. It brought certainty in the public sphere that particular agreements must have some outcome which encourages others to respects their promises which are made in the public field. The concept of public policy is used to examine the consequences of the contract, and if it is found that the outcome of the contract is such which is against the interest of the public, then it would render the agreements void. The doctrine of public policy is helpful to promote the benefit of the public at large.[35]

Now the question comes why some of the agreements are considered as against to public policy? When wager agreement causes harm to the public at large, then it becomes void. English can be said that it against the public interest. Both the parties are making an arrangement where there is no consideration from one of the party at all.

[34] Charles L. Cochran and Eloise F. Malone, "*Public Policy: Perspectives and Choices,*" 4thed.Lynne Rienner Publishers, Boulder, 2010

[35]*The Concept of Public Policy in Law: Revisiting the Role of the Public Policy Doctrine in the Enforcement of Private Legal Arrangements"*,Farshad Ghodoosi," 94 Neb. L. Rev. 685 (2015)
Available at: http://digitalcommons.unl.edu/nlr/vol94/iss3/5 last visited on 21/01/2017

When there is only bet regarding a future uncertain event or a statement in the books of account regarding a payment made based on no real performance of the contract, then it can't be enforced. In considering whether a change of money is wagering or not the intention of the parties is one of the factors to decide the nature of the contract. In the context of the stock market if parties are intended to sell or buy the stock at a price calculated by parties, then it is a real contract, but if then intention of the parties are only to pay the differences then it may come under the wagering agreement[36]. If one of the parties to a contract intends to make a proper contract, i.e., not merely to bet on differences then even if the other party intends to gamble and make a profit it does not invalidate the contract.

THE POSITION OF SPECULATION IN STOCK MARKET

Wagering is speculating about the future uncertain events as already mentioned above. Thus wagering is nothing just speculation. If we compare wagering with the trading in the stock market, there are similarities between the two. Speculation started in the stock market with this institution itself. The stock market is as old as the market itself, but the present form of organized exchanges came in the 16th century when East India Company was formed. The evolution and growth of the organized exchanges were happening due to its various functions[37]movements of capital from less efficient to productive activities and a platform for investments is the essential functions served by it. Anyone can invest in the securities of the companies listed on these exchanges[38].

The question arises as to the validity of the practices in share market where investment is made by speculation about the future prices of shares. Dealing in futures and options are very similar to wagering and gambling. Some of the elements of wagering are present here which raise a question why wagering is permitted when this future event is related to stock prices. One has to keep in mind that in case of share market investors have some control over the consequences

[36]*Ibid.*

[37]. There is some function served by the exchanges but main features are allocation and formation of capital, It provides liquidity in the market, and thus investor can quickly enter and exit from the market. It also acts as a supervisor and thus controls the company's activities.

[38]*"Gambling by another Name; The Challenge of Purely Speculative Derivatives"* by Timothy E. Lynch, Stanford Journal of Law, Business &Finance, Vol. 17, 67, 2011-2012,http://heinonline.org , last accessed Feb 1 06:45:00 2016

of their investment. Before investment, they do lots of research about the companies of which shares they are dealing with and as such one of the essential elements of wagering, i.e., that parties do not have any control over the event can be avoided. Speculation about the share prices does not necessarily imply differences in opinion about the costs of particular stock but it indicates willingness to take risk or not with regard to investment in specific stock and as such speculation here play the role of shifting the risk from one who wants to avoid the risk to one who is willing to take risk[39].

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. 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. There were two committees[40]established by the SEBI of India to analyze the speculative activity in the stock market. L. C. Gupta Committee in November 1996 recommended for an appropriate regulatory framework for derivatives trading in India. In 1998, the Committee submitted its report recommending the introduction of derivatives markets in a phased manner beginning with the introduction of index futures. Another committee was established under the chairmanship of J.R.Varma in June 1998 which proposed risk management strategies and monitoring mechanisms for derivative markets.[41]

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 a wagering agreement 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.[42] Recently Delhi High court in a case[43]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

[39] Keynes's Hicks theory

[40]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

[41] As per the Committee Report on Regulation of Derivatives market.

[42]CIT Delhi lv v. DLF Commercial development ltd. (2013)

[43]*Ibid.*

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 are 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 also which redefine the financial derivatives.

TRADING IN STOCKS AND ITS NATURE

Trading in the stock market somehow involves speculation which is similar to wagering agreements. Thus intention of the parties dealing in stock is fundamental here. If they intend to receive and deliver the stocks apart from speculation, then it is nothing but a fair sale contract. In case of derivatives or future contract if the party intends to deliver the underlying assets in future date then even if it involves speculation about the prices of the underlying assets, it shall be a valid contract[44]. But if it is only to pay the difference of prices of the underlying stock, it would be purely betting nothing else.[45]In other words, the intention of the parties to deliver the underlying assets is critical even if the underlying is never delivered actually by the parties[46]. Here the intention refers to the mutual intention to make the speculation in the stock trading void. If one of the party is entering into stock trading or stock futures to make a profit by speculation, but the other party is using it as a risk hedging instruments, still it shall be a valid contract. Speculation here also is not a real betting, but it involved some amount of research of the particular stocks and skills on the part of the speculator. Here speculation is based on the past performance of the underlying stocks and market trends at a specific moment.

[44]*Ibid*
[45]*Ibid.*
[46]*Ibid.*

Derivatives are nothing but wagering

Derivatives contract are used primarily for hedging purposes, and as such it necessarily indicates that it involves speculation. Hedging is a form of speculation; only the purpose is different when it is compared to speculations. Both the activities involve putting money to bet upon the future movements of the prices of particular securities, but in case of hedging, hedger wants to avoid the risk, but in case of speculation, speculators are willing to take the risk. In other words, even if derivatives are used for risk hedging, it involves speculation upon the movement of the prices or performance of the underlying assets. Traditionally derivative contract was used for hedging, but over a period, nature of the products and motive behind using this instrument got changed tremendously.[47]The reason behind it is to cope up with the new situation arising in the world of finance. Uses of derivative instruments are increasing, and the reason of its excessive use is an intention to make profits which gives rise to speculative derivatives[48]. Speculative derivatives may be dangerous as it does not have any economic function to perform and as such, there is no actual performance of the contract, as the transaction cost is zero. Speculative derivatives do not bind the parties with any obligation because the moment parties realize that it is no more beneficial they exit from the contract which gives rise of a default risk which if accumulated gives further rise to systematic risk. Systematic risk is dangerous to the economy as a whole.

Derivatives are nothing but betting about the prices of underlying assets. There is no actual delivery of the assets or payments by the parties, but only a promise is made by them either to pay the price or deliver the underlying assets or to pay the differences. The derivative transaction involves betting upon the future rates or prices of underlying assets which shows it is wagering in nature. Wagering nature of the derivatives can be seen when it is used not to hedge but to speculate. When derivatives transactions are made by the parties to chase profits based on speculation, then it acquires purely wagering character. Uncertainty is the primary cause of the evolution and development of the derivatives instruments. Arguments may be

[47]"*Hedging and Wagering on Produce Exchanges"* by Edwin W. Patterson, Yale Law Journal, Vol XL. APRIL, 1931 No. 6, Wed, 843, 1930-1931, ,http://heinonline.org, last accessed Nov 9 06:08:16 2016

[48]Speculative Derivatives are the third form of derivatives where both the parties of the contract use derivative instruments to speculate upon the prices or performance of an underlying. The first form of derivative refers those contracts where both the parties are engaged in the derivative transaction for risk hedging. The other forms of derivatives are those where one of the parties is hedger, and the other is a speculator.

given that risk means uncertainty, but risk indicates the possibility of outcome which can be calculated, but uncertainty indicates those outcomes which cannot be estimated. The uncertainty of the performance of underlying assets in a derivative contract allows investors to predict different outcomes. This uncertainty is the main cause of derivative contracts which will enable investors to speculate.

If compared the social cost of speculative use of derivative instruments with its economic benefits, then the negative consequences will outweigh the positive effects and thus stand on the wagering point, and such should be null and void.

Speculative derivatives are wagering agreements due to its very nature which does not help in the creation of wealth or any economic activity instead they transfer the flow of money from one party to the other party. One another negative aspects of the derivative are that the transaction cost of it is decidedly less which is incurred by the counterparty; as a result, compensation to pay for the transaction is economically irrational. Less transaction cost of derivatives contracts encourage the participants mostly speculators to enter into speculative derivatives without any intention to generate economic activity. One another point is the task of risk management. Derivative instruments are used as a risk management tool. The risk may be an existing one or a future risk anticipated by the parties. There is one another risk called artificial risk which does not exist nor expect. It is used to enter into speculative derivatives. In the capital market the wealth is used from less efficient to more productive use of it and as a result, more and more creation of wealth which results in the growth and development of the overall economy. An artificial risk is a hype which is useful to those who want to make profits without any investments or performance from their side which gives rise to speculative derivatives in the name of this artificial risk[49].

It is a common notion that it is harmful only to those who are directly associated with it. But it is not always true. There are many cases where corporations and other investors use a fund which belongs to other stakeholders, which may hamper the interest of these stakeholders in

[49]*Supra Note 50*

case of loss of investments by these corporations and other investors[50]. Now come to the critical analysis of these speculative derivative instruments.

Speculative derivative instruments is wagering agreements and as such, they should be classified differently from the other derivative instrument and should be declared as void. The bases of these arguments are as follows-

Cost of the transaction- Financial instruments are used to generate income which are the backbone of the financial markets. These instruments are helpful in the creation of wealth and the overall development of the economy. But in case of speculative derivatives transaction, there is no real gain or loss in the total wealth of the parties, and no economic activities occurred. In other words, aggregate economic values generated by speculative derivative instruments are zero, i.e., the benefits of one party is necessarily a loss of another party.

Create risk- It is well-known that derivative instruments are risk hedging instruments. But speculative derivative instead creates risk. As already mentioned those in case of speculative derivatives risk are artificial which the parties to the contract are assuming. There is only one risk here, i.e., risk to lose the bet. This artificial risk gives rise to systematic default risks.[51]The other aspect is that it does not manage risk, but instead, it relocates the existing risk from one to another. If speculative derivatives are made by the participants using leverage, then the risk of not being fully repaid on time occurs and the risk to the borrower is, the undesirable provisions in the loan agreement.

Thus when derivative instruments are used excessively only for speculations then the very purpose of this get altered, and instead of reducing the risk it creates risk which is unnecessary, and undesirable yet sophisticated, and thus it requires regulation of this practice.

A similarity with gambling- Gambling[52] is a game based on the chance of winning money by taking the risk of losing the same in the hope of the desired result. If we apply these elements

[50]. When the firm is engaged in speculative activities and uses speculative derivative for this purpose, it gradually adds and creates systematic risk for the economy as a whole. Therefore not only these corporations and other investors get affected in case of loss but the interest of all those, whose money was used in these activities, get also affected and suffer damage. The best example can be asset management co. , mutual funds, insurance co. etc.

[51]*"The Challenge of Derivatives*," Saul S. Cohen, Fordham Law Review. Vol.63,issue 6/2, 1993 (1995). Available at: http://ir.lawnet.fordham.edulast accessed on 10/10/2017

[52] Gambling activities are casino gambling, sports betting, etc.

to derivative transactions[53]then it also becomes gambling. There are similarities between what activities are called gambling, and those are called derivative trading. It is an established rule that any contract based on only differences are void in almost every jurisdiction. A derivative contract where only the differences are paid instead of physical delivery seems to be void and thus not enforceable[54]. Thus the true nature of the derivative instruments which does not include physical delivery is nothing but wagering agreements[55].If one considers the nature of gambling and compare it with the true nature of derivative contracts both are same[56].

Nature of hedging- Hedging transactions has four elements, i.e., buying, selling, an underlying asset, and future agreements[57] i.e., opposite parties close the transactions. By engaging in hedging activities, a loss of the underlying assets will be compensated by a gain on the values of future agreements and the vice versa. Hedging is used in two ways one is to ensure against the unwanted price movements of an underlying asset, and the other is to fulfil the commitments under the contracts. Hedging transactions are made and concluded simultaneously with the cash settlement. If one analyses the nature of the hedging transaction in the context of commodity derivatives, the counterparty is never required or forced to make physical delivery of the underlying commodity. Hence very intentions of the parties are questionable here due to the elements of wagering agreements. Hedging itself speculation activities already mentioned. Therefore to differentiate between the hedging and wagering activities, an intention of the parties is an essential factor. Legality of hedging can be tested on the basis whether the parties whether they are making a mere contract of differences or the agreements involve more than that. Wagering activities have been made void in every

[53] Derivative trading are options, futures, interest swap, etc. Numerous commentators have previously noted the similarity between what is commonly referred to as derivatives trading (e.g., stock options, trading in commodity futures, currency futures, interest rates swaps)

[54]"*Insurance or Gambling? Derivatives Trading in a World of Risk and Uncertainty*", Lynn A. Stout, The Brookings Review, Vol. 14, No. 1 (Winter, 1996), pp. 38-41, http://www.jstor.org , Last Accessed: 17-10-2015

[55]Functionally Future contract and wagering agreements are same, i.e., betting upon the future price of underlying assets.

[56]Derivative contracts by one of the parties who use leverage to enter into it or ensures underlying assets which he does not own, increase the risk which is artificial, it is nothing but gambling. Transferring the risk held by the sellers of a stock to the buyer envisaged with the holding of the stock or a sale by a party of future assets in the form of forwarding contract, the risk is increased only, and it is transferred to both the parties, Which is nothing but gambling. This nature of a derivative instrument indicates that the parties are gambling in the name of the derivative contract and can be referred to as gambling.

[57]. A sale of futures contracts is a contract to sell the underlying assets, to be delivered on any day during pre-agreed months which can be chosen by the seller.

jurisdiction due to many reasons. One is that there is no productive work involve in wagering activities. Another one is it is a waste of time and energy of the parties which can be used in any other economically beneficial activities. This encourages unjust enrichment as the parties get money without doing anything. These are the central philosophy to make the wagering contract as void[58].

Now come to the question of eliminating or finding out the wagering elements from the derivative contract. One of the tests is to know the intention of the parties at the time of the contract. If parties of the derivative contract are using this financial instrument to hedge the risk associated with the underlying assets and the intention of the parties are to settle the contract by the performance of their part 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. Courts are bound to enforce all the derivative contracts which involved physical delivery and questioning them are not allowed in every jurisdiction. 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. In one of the case[59]A crucial point was discussed in this regard. The court of law observed that intention of the parties at the time of derivative contract refers intention of both the parties and in case, one of the parties of the contract is entering into the derivative transaction, intends to pay only the differences, then it would render the contract null and void. Hence the intention, to enter into a contract to bet or to pay the differences, or even one party make the contract void also if the other party were no intending so.

The approach of Judiciary in the organized exchanges- Raising question on the nature of the derivative transaction through exchanges are rare. Courts generally don't interfere in the matter where Exchanges are involved. Hence presumption about the derivative transaction which is entered into by the parties where one of the parties are a broker or the member of exchanges is always in favor of parties, i.e., Parties are making a real contract where their intention can be

[58] "*Hedging And Wagering On Produce Exchanges Edwin W. Patterson*" available on http://heinonline.org/*YALE LawJournal*Vol XL. April1931 No. 6

[59] Price v. Barnes, 300 Mo. 216, 254 S. AV.33 (1923). Where plaintiff was an agent appointed so to buy and sell the cotton and grain on behalf of Mr. Barns who was operating storage for the grain etc. It was found that the orders given by Barns were huge and there were no storage facilities for such a huge order. Evidence on record also proved that Barnes could not pay for such a considerable quantity and he was not a dealer in the particular commodity which confirmed that the agreements entered were nothing but an agreement of wager to earn a profit by speculation on prices of the underlying commodity.

questioned. In other words, courts are bound to enforce all the orders which are done through exchanges.

If one analyses the nature of these contract, they seem to be wager only. Parties of the derivative instruments never intend to settle the contract by way of physical delivery. Settlements of the order which are made on the recognized exchanges are always done through payment of the value of the contract or by way of set off. This nature necessarily involves betting upon the prices of an underlying by the party whether they are dealing in the particular underlying assets or not, as such of the contract is entered to speculate upon the prices of an underlying asset by those who may or may not be dealing in that.

When hedging is done through exchanges, some argues that intentions of the parties are that it will be binding on them. There are some interests involved in this contract irrespective of the nature of the settlement[60].

Quotations of prices of the commodities or other stocks are significant for the farmers as well as other investors or hedgers. There are more than mere speculations on the costs of underlying. When the parties of derivative instruments entered into the contract, they may be intending to pay the differences in the value of the contract, which is justified keeping in mind the surrounding and background situations. Hedging is one of the main reasons to make such contracts. Fluctuations in the prices create a risk for the dealers, farmers, or manufacturers. To ensure o get a reasonable price of the underlying assets, to fulfill the commitments in a particular delivery contract, are the main reasons behind the evolution and development of forwards and futures contracts. Investments and other business concern are also a reason for the growth of derivative transactions. If the parties of the derivative contracts are entering into these, they may intend to pay the differences when it comes to settlements; it does not render the contract void. The reason is that they want the best market price of their underlying assets which can be secured through the payment of differences which can offset the conditions which arise due to the price movements. There may be a situation when physical delivery is not required keeping in mind a particular case. Sometimes consequences are same, i.e., to deliver the specific underlying assets or pay the prices of that, this does not make any change in the

[60]. All the future contracts entered while using a platform of exchanges have serious business consequences and questioning them by the mode of settlements is not justified. Here derivative instruments are used for hedging against the fluctuations in the prices of the underlying and settlement can be legitimately changed as per the need of the parties and it does not affect at all the validity of the contract.

nature of the contract. There are insurable interests in these transactions and refereeing them as wagering is not justified. These contracts serve as price insurance against a particular underlying. Speculation or intention of one party to use the derivative instruments as wagering is not sufficient to put these instruments into the category of wagering.

There may be instances where a party entering into this kind of transactions is neither dealer in the particular underlying assets, nor they have any interest in the contract except the money on the stake. They are using it only for gambling to make a profit out of it. In these situations, if a question is raised about its enforceability, it is upon the parties questioning the transactions as wagering are required to prove its voidability. Factors[61]To know or analyze the true nature of the contracts are required proper considerations.

Different rules and regulations of exchanges and clearing houses are nowadays strengthening the financial system so that derivative instruments can be used only for the economic activities. A court does not have any discretion to analyze the true nature of these instruments except to validate the entire contract which is entered into by the parties under these rules and regulations.

CONCLUSION

Separating the wagering elements from the derivative transactions is impossible. It may be appropriate to bring a legislation to separate the hedging transactions from the wagering activities which practically seem to be difficult. Wagering agreements have always created a problem for the courts as it promotes unjust enrichments, manipulations, immorality, crime, etc. Hedging, which is the primary function of derivative instruments, helps businesses to run their business smoothly. It is difficult to differentiate strictly where the hedging end and speculation starts.

Hedgers make two contracts simultaneously, i.e., cash and futures contract which go side by side[62]. There is no doubt about the utility of the derivative instruments, and it becomes evident

[61]These factors which may help the court about the true nature of the contracts are the correspondence of parties, their course of conduct, to know the real intention of the parties, mode of delivery and method of settlements to see the interest of the parties.

[62]. The reason is quite apparent, i.e., the performance of the cash contract depend upon the future contract. In case the parties are not able to fulfill their obligations because of market factors, i.e., due to fluctuations in the prices

by seeing its growth and recognition in different jurisdictions. Forwards and futures create a great market for future sale. Exchanges serve as an indicator of the prices of commodities and stocks which helps in the discovery of the real prices of these commodities and stocks. Hence it can be suggested from the facts mentioned above that instead of analysing every derivative contract, whether it is purely speculative or not, there should be an express provision in the Contract act. Under section 30 there should be an explanation which can expressly provide that Derivatives instruments are an exception of the wagering agreement

of the goods, then they can ensure the performance by using the futures contract which is made to fulfill the obligation under the first contract.