



Regulatory Mechanism Of Commodity Derivative Market - Fmc To Sebi

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Abstract: The Forward Contracts (Regulation) Act (FCRA), enacted in 1952, aimed to regulate forward trading, with the Forward Market Commission (FMC) established as its regulatory body in 1953. Despite intentions for autonomy, FMC faced limitations due to government interference, restricted powers, and inadequate infrastructure, leading to inefficiencies in commodity market regulation. The merger of FMC with SEBI in 2015 under the Securities Contract Regulation Act (SCRA) marked a significant regulatory shift. This article explores the shortcomings of FMC, the rationale behind the merger, and the potential for SEBI to enhance market integrity, efficiency, and innovation while addressing challenges in spot market integration and pricing mechanisms.

Keywords: FCRA, FMC, SEBI, Commodity derivative market, SCRA

I. INTRODUCTION

Forward Contract (Regulation) Act (FCRA) was enacted to regulate forward trading in 1952 and in 1953, Forward Market Commission was established. FCRA empowered government to appoint a four member committee to function as FMC and to nominate a member as its chairman. The idea was FMC to function as an autonomous organization and act as independent regulator. But honestly speaking, FMC never functioned to its potential and never been at its full strength of four members till its burial on 28th Sept, 2015. Its independence was always questionable and looked at as a feeble organization due to constant government interferences. Blame for this squarely lies on the doors of the government as it is never convinced of the economic utility of the commodity market. There was always a dichotomy in the powers and functions of FMC. While its powers are mostly advisory in nature, its functions are mostly executive in nature. At one time it had to manage six national and 13 regional commodity exchanges recognized under FCRA and regulate future trading in more than hundred commodities. Government recognizing above fact through Finance Act, 2015 amended Securities Contract Regulation Act (SCRA) to replace the FCRA in order to expand the scope of the commodity trading and enhance the regulatory power.

II. OBJECTIVE

In view of this background, this article sets out to study regulatory framework governing the derivative market, erstwhile FCRA, functioning and shortcomings of FMC, merger with SEBI, pricing issues pertaining to commodity derivative market.

III. REGULATORY FEATURES

With adoption of constitution on 26th Jan, 1950, the Government of India Act, 1935 was repealed and consequently “stock exchanges and futures market” which was earlier in the provinces list transferred to the union list and that empowered central government to enact FCRA in 1952, which was amended in 2010 and subsequently repealed in 2015 and replaced by amended SCRA. Even though regulations governing forward and derivatives market had undergone changes, the regulatory pattern had remained the same. The regulations governing the commodity market have these six distinct features:

- i. These are basically enabling legislations and do not apply automatically to all commodities. Central Government has the power to allow futures trading in particular commodities in specified areas and place ban on the future trading of other commodity.
- ii. The legislation applies to TSD (transferable specific delivery) contracts and commodity derivative or futures in commodities. Hence, unless notified to the contrary by the CG, regulation or banning of NTSD (non-transferable specific delivery) contracts are not in the purview of the legislations. However, CG has the power to put restrictions on NTSD contracts of specified commodities
- iii. Any amendment to the constitution or bye laws of any recognized commodity exchange has to be approved by the CG. CG can take suo motto cognizance and direct any amendment to the constitution and bye laws of any recognized exchanges.
- iv. In order to ensure better functioning of commodity exchange, the CG is empowered to supersede its management. A person can be nominated by the CG to the governing body to represent views of the government.
- v. It intends to create an independent regulatory mechanism; FMC under earlier FCRA and SEBI under SCRA for supervision and regulation of commodity market.
- vi. Lastly, the amended the SCRA allows trading of options as well as other derivatives like weather futures, index futures which allows settlement in cash through payment in price differential at the contract date and maturity date. Such trading are not allowed under earlier FCRA. But now the term commodity derivative has been amended to enable this.

IV. FCRA, ITS REGULATORY STRUCTURE & REASONS OF ITS AILMENT

The preamble of the FCRA states “it is to provide for the regulation of certain matters relating to forward contracts, the prohibition of options in goods and for the matters connected therewith.” A three tier structure prescribed by the Act for regulation of the commodity derivative market – a) regulatory and policy making power vested with CG; b) advisory and executor body set up u/s 3; c) commodity exchanges for controlling trading of derivatives. The power of the CG was exercised by the Department of consumer affairs, food and public distribution and many powers were delegated to FMC. FMC was not statutory body with adequate powers to regulate.

The case was pretty similar in the capital market but with setting up of SEBI in 1992, growth of the capital market led the experts to believe in 2003 similar autonomous regulator for the commodity market. In spite of the success story of SEBI, the reluctance of the CG for a similar mechanism for the capital market was due to fact that possible impact of commodity market was much larger in comparison to the stock market. While any misadventure in the capital market impacts a class of investor and value of their assets, in case of capital market it might have affected a large section of society having wide economic impact.

The FCRD suffered from following few major ailments:

1. Definition of goods: FCRA defined goods as “any immovable property other than actionable claims, currency and securities”. Thus prevented the exchanges to try out any innovative and tailored future contracts on intangibles such as commodity indexes, weather etc.
2. Lack of clarity in forward and futures contract: FCRA in its original form neither defined forward contract not stated the difference between forward and futures contract. It was also silent about the OTC (over the counter contracts). Though the exchange traded contracts are regulated, OTCs were left out of regulatory supervision, and this led to regulatory arbitrage and market abuse through dabba trading.
3. Limited powers of FMC: Sec 4 of the FCRA restricts the role of FMC as an advisor to the government, a supervisor of the market and collector of data pertaining to the commodity market. As per Sec 5 of FCRA, CG has all the policy making and regulatory powers u/s 17 and 28 of the Act.

4. Principal-Agent dichotomy: Principal agent problem was inherent to the regulatory structure prescribed by FCRA. The Government and Commission was in the position of principal as policy makers. The exchanges assume the role of both principal and agent having commercial interests. Exchanges performs legislative functions while making rules governing trading, margin, settlement, quality assurances etc and also have to look out their commercial interests in terms of trading volume and profits. Often both the interest conflicted and problem is accentuated by the situation when it becomes expensive for them to collect the information and regulate. Many such reports are highlighted by the audit the reports of the commission and suspense on trading were imposed in few cases.
5. Administrative structure: Sanctioned administrative strength of FMC was another are which led to ineffectiveness of implementation of FCRA and functioning of FMC. Total staff strength of FMC was 135 including the members, out of which 54 were professionals and 81 were clerical staff. This was severely inadequate considering it had to regulate around 20 commodity exchanges oversee trading in more than 100 commodities. Considering enormity of the task, mostly the manpower was diverted towards performing secretarial tasks and as a result technical and research works were neglected.

V. March towards Merger of FMC and SEBI

Ironically the biggest shock to commodity derivative market came from outside source which is neither controlled by the commodity derivative exchanges nor under the regulatory supervision of FMC. With regards to payment crisis of NSEL (national spot exchange limited), three thing were worth observing. First, government contributed to the crisis by putting sudden ban on the fresh contracts which led to dry up of flow of funds. Second, constant rollover of contracts was nothing less than ponzi schemes which could not have self corrected and needed regulatory intervention. Third, it exposed regulatory arbitrage which was used private players for personal gain. Various committees starting from Wajahat Habibullah Committee in 2003 by ministry of Consumer Affairs, Percy Mistry committee in by Finance ministry, Raghuram Rajan committee in 2009 by Planning Commission and B.N.Srikrishna committee in 2013 by Finance ministry had flagged off these policy concerns. But no actions were initiated and the matter was put to back burner due to difference of opinions between two nodal ministries – Finance and Consumer Affairs. But the payment crisis in NSEL shook things up and process was initiated which culminated in merger of FMC with SEBI in 2015.

VI. CONVERGENCE WITH SEBI – RATIONALITY AND OPPORTUNITIES

1. Global experiences from Australia, France, UK, South Korea, Taiwan etc suggest success of single regulator regulating both equity and derivative market. A single, unified and stronger regulator augurs well for the market regulation, achieves economies of scale, results in more liquidity and depth of market.
2. Comparability of financial information for risk management and price discovery improves due to uniform valuation practices of stock and commodities.
3. Cost of hedging will be reduced due to lower transactional costs. While dealing with the international commodities, many players had to take positions for both commodities and currencies and since both were dealt by separate regulator, they had to comply with both requirements. Now with convergence the situation will change and one set of requirements will have to be complied with leading to lower transaction costs.
4. The convergence might open up new avenues which was not earlier possible under FCRA. Various innovative products like index futures, weather derivatives can now be launched due to the change in the definition of goods.
5. After convergence of FMC with SEBI, commodities will be traded in stock exchanges, so margin money can be made available for all the segments as clearing house will be the same. This will lead to market depth and liquidity enhancement.
6. As the commodity market will be regulated by independent autonomous regulator, a new avenue will be on offer for banks and financial institutions and their participation will further increase the liquidity and depth of commodity market.

7. The exchanges often acting as agents tried to take advantage of lacunas in the regulatory mechanism whenever it is perceived as unfavorable. This leads to regulatory arbitrage. Now putting regulation in hands of an autonomous body will substantially reduce the regulatory arbitrage.
8. Some of the side effects of the convergence will be reduction of systematic risk, information costs. But there will be increasing threats of inter sectoral defaults. Also compliance with best practices like capital adequacy, margins, net worth etc will be far greater.
9. Post merger foreign institutional investors (FII) and foreign portfolio investors (FPI) may be allowed to participate in commodity derivative market.
10. Automatic derecognition of commodity derivative trading outside the purview of exchanges like illegal dabba trading can be done.
11. An important aspect of this merger will be managing the perception amongst common man with regards to impact of commodity derivatives as commodity prices are of significant importance to the common man.
12. Another challenge for the SEBI will be managing commodity market physical settlements as spot markets will be outside purview of SEBI.

VII. REGULATORY MECHANISM AND ITS EFFECT ON PRICES

With such sweeping change in the regulatory mechanism in commodity derivative market, it is interesting to look into the impact on the pricing mechanism of the commodity derivatives. Some of the important factors which affect the price and how those factors will now operate are being discussed here:

A. FACTORS AFFECTING COMMODITY PRICE MOVEMENTS IN DERIVATIVE TRADING

Some of the important factors which influence the price movements in commodities in derivative trading are seasonality, demand and supply, weather, macro economic conditions, currency movements, relevant news etc. Also the price influenced by various global factors and global movement in prices in various exchanges.

Factors like seasonality, demand and supply, weather cannot be controlled by SEBI. However SEBI with its better infrastructure, surveillance and monitoring mechanism definitely improve information flow and dissemination which will help in price discovery. Its similar expertise in capital market will be of great help. Under the FMC regime real time data collection and surveillance was a problem and unless high frequency data is collected and staff are encouraged to explore, there will diminishing chance of price discovery, which now hopefully will be corrected under SEBI regime. SEBI apart from absorbing staff of FMC had hired more staff which definitely going to improve this situation.

B. CONVERGENCE OF SPOT AND FUTURE PRICES

Through arbitrage process and threat of delivery forces future and spot prices converge. It is believed normally that the future and spot prices move in concert with future price slightly above of the spot price due to effect of cost of carry and just prior to the merger they converge with no cost of carry on the date of maturity. Ex- let's assume a situation where future price is trading at a higher price compared to the spot price and cost of carry. Then an arbitrageur can take short position in the futures market that means contract to sell at a higher rate in the futures market by buying it from spot market. With similar actions by many arbitrageurs, the price in spot market will start to rise due to increase in demand and in futures market price will start to fall due to increase in supply. So ultimately at the maturity date both the prices will converge with no cost of carry.

Studies have found put that due to functional adequacies in the exchanges, particularly in case of delivery based settlements, there was lack of arbitrage opportunities for convergence. Existing exchanges also hardly promote delivery based trading with limited link to the spot market, SEBI with its effort to integrate warehouse delivery through online platform will definitely improve the situation.

C. INTERNATIONAL REFERENCE PRICING

In commodity market, often benchmark is referred to as “external reference price which is outside control of the contracting parties and is acceptable to both buyer and seller to be used directly or as a base for an agreed price in contract.” ex- Brent crude oil futures traded in Intercontinental Stock Exchange are taken as benchmark price for Indian crude oil futures prices.

In this regard, SEBI already have benchmark regulation for equity and derivative trading which can be adopted for the commodity derivative market and adoption of sound system will a step in the right direction for many commodities.

D. OTHER FACTORS AFFECTING PRICE

Some other factors which impact the commodity derivative market trading are

- Commodity Transaction Tax
- Brokerage
- GST
- Stamp Duty
- SEBI turnover fee
- Stock exchange transaction charges
- Storage cost

Most of these charges will remain unchanged under the new regime. However SEBI and industry in talks with the government with their demand to abolish commodity transaction tax (CTT), so that trading and hedgers can be brought back to the market. Currently transaction cost in the commodity market is higher which is forcing the hedgers to opt for the international market. Let's hope that good sense prevails in this regard.

E. SPOT PRICE POLLING MECHANISM

Spot price of the underlying commodity is absolutely essential as it is required for final settlement of contracts. Spot prices are determined by the exchanges through spot price polling from various spot markets.

Transparency in polling and information in spot prices is critical as it affects the final settlement in derivative contracts. In this regard SEBI had already came up with a consulting paper which suggests and invites opinion for an efficient spot price polling mechanism. Some of the steps suggested are:

1. Appointing or accrediting independent spot price polling agencies
2. Enacting regulatory framework for participants and agencies of polling
3. Providing legal framework for the contract between participants and agencies
4. Providing incentives for the polling participants
5. Ensuring participation of large and heterogeneous group of participants.
6. Use of technology for real time data collection for polling
7. Also to increase the time and frequency of data for spot price polling mechanism.

all these measures suggested by SEBI definitely robust mechanisms to improve the settlement process by ensuring correctness in spot price.

VIII. CONCLUSIONS

The regulatory shift in the commodity derivative market from FMC to SEBI is definitely a major step to boost for the market integrity. To begin with FMC was financially dependent and with SEBI, now commodity derivative market will be governed by a financially independent regulator. This will definitely lead to increase in liquidity and depth of the commodity market. Compliance cost, transaction cost and overall efficiency bound to improve. However there will also be challenges, particularly in the spot market during settlement process. Ensuring quality of the product to be delivered is a challenging task unlike in case of shares where the quality is uniform. one way is to adopt only cash settlement but that will lead to inflation in the commodities due to heavy speculation activities. other problem is in the definition of the spot trading as in the commodity market delivery up to 11 days of the transaction is allowed unlike in case of spot market where T+2 system is followed. But in the entire picture a good move beneficial to both sector and investor.

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