Universal Exchanges in India–A Critique

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Indian securities market have traversed a long journey from non-descript, outdated controlled by the stock brokers -- called the stock exchanges or share bazars' to one of the top five bourses in the world. From an 'Open Outcry system' the Indian stock exchanges have leap frogged into 'Online Real time market' regime – be it trading, surveillance or risk management. Consequently, the domestic equity market has grown and India's stock market capitalisation to GD Pratio now stands at 69.21 per cent and ranks amongst the top 20 nations of the world in this regard[1].

On September 28, 2015, the domestic securities market landscape underwent a major transformation - merger of the erstwhile commodities futures regulator, Forward Markets Commission (FMC) with the capital market regulator, Securities and Exchange Board of India (SEBI). On regulatory front, this has been a daunting task, predominantly emanating from fragmented underlying physical commodities market; not under the regulatory radar of SEBI. Activities and movements of commodities market governed by the State laws, do significantly influence the commodities derivatives market, regulated by SEBI. Maintaining a relatable parity between the spot (physical) market and the derivative market, has been a challenge for the market regulator. On a positive note, SEBI has started ensuring that the commodities derivatives market come at par with securities market in all aspects – corporate governance, new products and participants, risk management, regulations, supervision, surveillance, investor protection and enforcement[2]'. This may well be regarded as the flash-point for universalisation of Indian Exchanges.

The movement towards 'universal securities exchange' in India received another boost when the Hon'ble Union Finance Minister Shri Arun Jaitley while presenting the Budget 2017 announced, "The commodities and securities derivative markets will be further integrated by integrating the participants, brokers, and operational frameworks."To effectuate the budget announcement, SEBI announced its decision to permit the domestic exchanges to deal in both equities and commodities from October 2018.SEBI would issue a Discussion Paper in this regard. In March 2018, SEBI allowed single intermediaries, such as brokers, to deal in both commodities and equities under a single licence. Universal licence regime are the necessary concomitant steps towards migration to Universal securities exchanges in India.

Increased diversification, commercial orientation, and technology-driven inclusion, backed by improved legal, regulatory, and supervisory frameworks have propelled the maturity of the Indian securities market. However, that being aside, in the context of universalisation of exchanges, it is also a universal fact that without adequate development of all market segments, integration of different exchange platforms can even lead to a so-called 'too big to fail' institution that adds huge systemic risk in the financial market and hampers long-term growth and development of various markets.

With the above background, this article begins with deliberations on the preparedness of Indian securities market, followed by discussions on the margin fungibility across all assets class for an efficient Clearing and Settlement and Risk Mitigation system. Universalisation of the market should also be facilitated by the legal landscape of the jurisdiction. We will discuss some of the dominant legal concerns in effectuating the proposed market integration. Experiences of the other major jurisdictions will provide an informed learning curve for domestic market.

Preparedness of Indian Securities Markets

Successfully establishing and running the concept of 'Universal Exchange' requires development, implementation and maintenance of the enhanced functionality while maintaining reliability and ensuring that market architecture and infrastructure are not vulnerable to security risks. Creation of a single unified exchange traded market would mean development of infrastructure to support market-wide trading system for the instruments – securities and commodities both. The system should be robust enough to allow efficient price discovery and reliable clearing and settlement.

It would be gainful to stress here that before bringing all the asset classes on the same platform, there is a need to have deeply entrenched markets in each asset class in terms of infrastructure, operations, participation and the understanding of the products in the ecosystem. The basic existence of all these asset classes have different objectives. Equity markets operate with the objective of raising funds, price discovery and financialisation of capital. On the other hand in Indian context specifically, commodity derivative and currency derivative markets have their niche in terms of price discovery and risk management tools. Market experiences exhibit that both these market verticals are governed by variant sets of market conditions and rules. Two pillars of ideal market condition – Price

Discovery and Risk Management, are different for equity and commodities market in India. The objectives of securities market universalisation can be achieved when both these market segments are governed by similar mechanisms and are at the same stage of development.

From the trading platform perspectives, equity and commodities market operate differently. Commodity derivative market involve physical settlement in terms of hard core commodities, further involving vaults and warehouses, quality standards of the commodities, the logistics and taxation for delivery and intra state and interstate movement of commodities. Equity market has transformed into end-to-end seamless platform. Thus, the contract and market design peculiarities of equities and commodity derivative market are completely different. However, SEBI has recently displayed its intent on moving the equity derivatives markets towards physical settlement, through depositories. Similarly, for commodities derivatives, creation of repositories for electronic warehouse receipts would bring the two markets closer.

In addition, Commodity exchanges remain open for long hours, since many commodities track global prices but stock markets are time bounded. Here as well, SEBI has recently extended market hours for equity derivatives (to be effective from October 1, 2018) to align the trading hours of the two markets. Further, significant infrastructure requirements are also needed at brokers end to align stock and commodity market hours and deal with extended trading hours. This entails additional capex – technological as well as human capital perspective.

Margin fungibility

Robust risk management is a combination of risk management capabilities to assess clearing firms and their account exposure levels for all asset classes on one hand and the ability to safeguard adequately and protect from the credit risks of clearing members on other hand. Margin fungibility is imperative for clearing and settlement to avoid any systemic risk. In a universal securities market, efficient margin fungibility is the important vital. Interoperability of clearing corporations and perhaps unified trading, clearing and settlement across market segments will help bring in this fungibility and efficiencies. SEBI has already mandated that commodity derivatives trades also need to be cleared by clearing corporations, in line with other market segments.

Regulatory roadblocks

The equity market is governed by Central laws while the commodities market is predominantly regulated by State laws. Given the sensitivity of some of commodities, there are other overarching laws that regulate pricing, warehousing, transportation etc.[3]. To put it differently, firstly all the enabling laws, rules and regulations shall have to be amended to achieve its desired outcome of universalization of exchanges.

Global experience

Most of the world's largest / developed economies have pursued or demonstrated success in a Universal Exchange concept. Asset class traded on some of the major exchanges of the world is given in the following table.

Sl. No.	Name of Exchange	Country	Asset class		
			Equity, Equity derivative & Debt	Currency & Interest Rate derivate	Commodity derivative
1	NYSE	USA	✓	X	X
2	NASDAQ	USA	✓	✓	✓
3	MAS	Singapore	✓	✓	✓
4	HKSE	Hong Kong	✓	✓	✓
5	ASX	Australia	✓	✓	✓
6	LSE	London	✓	✓	✓
7	Deutsche Börse Group	Germany	✓	✓	✓
8	DGCX	Dubai	✓	✓	✓

Source: World Federation of Exchanges and respective exchanges of above countries

Conclusion

Universalisation of Indian bourses will bolster the competition in the commodities trading space with the foray of stronger players such as the NSE and the BSE. It would help BSE and NSE launch their commodity trading platforms. Currently, MCX enjoys more than 80% of market share in the commodity derivatives. Likewise, the move also allows MCX to offer trading platforms for other asset classes such as equities and currency.All these developments augur well for the Indian economy and securities market in particular. Competition will enhance product innovation, depth as well as liquidity in the market which in turn will boost the Indian economy. The Universal Exchange is a common occurrence internationally and the Indian experiment at GIFT IFSC is India's first attempt to unify the markets. While it will take time for the GIFT City Exchanges to grow and compete successfully with other International exchanges, the road ahead for Universal Exchanges in the domestic space looks very exciting. With economies of scope and scale for brokers and exchanges alike, this move should bring down the costs for trading and help in better liquidity and price discovery.

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[1] The GlobalEconomy.com, World Bank

[2] SEBI Annual Report 2015-16

[3] For the sake of brevity, they are not elaborated in this article.