Increasing Regulatory Role of Commodity Derivatives Exchanges: Challenges and Opportunities

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1. Introduction

The Commodity Derivatives Exchanges are critical Market Infrastructure Intermediaries (MIIs) that provide a platform for trading in commodity derivatives in a wide range of commodities. They must uphold the highest standards of market integrity and corporate governance while ensuring price discovery and price risk management in an asset class which is highly diverse and complex, not to mention highly volatile as well. The nature of the underlying assets – volatile, umpteen nuances of quality and the fact that the physical markets are under multiple regulatory jurisdictions – makes the task of Commodity Derivatives Exchanges a much greater challenging than their equity counterparts.

2. The Journey so far

Commodity Derivatives Markets in India have been in existence since the nineteenth century albeit in a fragmented manner throughout the country. The markets were organised around regional trade bodies or associations dealing with specific crops or commodities and were concentrated in local centres of production and consumption. These entities were not demutualised and mostly followed the open outcry method while being dominated by a group of regional traders.

In the early stages, the markets were functioning under the rules and procedures laid down by the individual trade associations before the legal and regulatory framework evolved gradually. There were wide variations in regulations and trading, clearing as well as settlement practices followed by various associations often giving rise to a variety of malpractices leading to frequent disputes amongst traders.

After independence, the Indian Constitution (1950) placed the subject of futures market in the Union List, hence the responsibility of regulating the market devolved on the Central Government. With the passage of Forward Contracts (Regulation) Act in 1952 and establishment of Forward Markets Commission (FMC) in 1953 to regulate and develop commodity futures market in India the Commodity Derivatives Markets were brought under a three-tier regulatory framework. While FMC provided the regulatory oversight under the powers delegated by the Central Government and functioned under overall administrative control Ministry of Consumer Affairs, Food & Public Distribution, the Commodity Derivatives Exchanges operated as front line regulators of trading of commodity derivatives on a day to day basis.

It is only in the new millennia that we saw the emergence of Nation-wide Multi-Commodity Derivatives Exchanges with electronic platforms. The regional players proved to be no match to these professionally run pan-India electronic platforms and gradually started withering away paving the way for the rise of dominant national players. The regulatory regime of FMC witnessed proliferation of national exchanges and at one point of time the markets witnessed six national level multi-commodity recognised exchanges. However, the market proved inadequate to absorb such a large number and some of them lost out on competition and had to cease their operations.

3. Roots of Regulatory Challenges and Opportunities

The merger of erstwhile FMC with SEBI in September 2015 was a watershed moment in the Commodity Derivatives Markets in India which immediately ushered in sweeping reforms in the realms of corporate governance, risk management and regulation of intermediaries and not to mention the new prudential regulations with respect to trading, surveillance and supervision. The Commodity Derivatives Exchanges now had to match up with their equity peers in excellence at all fronts. Throughout its chequered past till the regulation was taken over by SEBI, one thing that consistently stood out is the fact that the Exchanges as the Market Infrastructure Institutions (MIIs), assumed more prominence as the first level regulators with diverse responsibilities to regulate the commodity derivatives trading. Subsequently, with the introduction of concept of universal exchanges thereby permitting the equity exchanges to trade in commodity derivatives, the nomenclature of commodity exchanges was extinguished and all the exchanges, including the erstwhile commodity exchanges are now termed as stock exchanges. Similarly, the earlier regulatory mandate to register a separate brokerage arm for dealing in commodity derivatives was also done away with and all the trading segments of securities market are now being accessed by the clients through a single broker.

The introduction of universal exchanges opened the doors for equity exchanges like NSE and BSE to start commodity derivatives segments on their platforms – which they have done. However, the former commodity exchanges like MCX, NCDEX and ICEX , which are now referred to as stock exchanges and are free to launch trading in equity or currency segments, are yet to offer other asset classes on their platforms and are exclusively dealing with commodity derivatives till date. Is that an indication of the fact that commodity derivatives is the only asset class that offers an opportunity for growth? A point to ponder for everyone.

Set in the above context, all the references to Commodity Derivatives Exchanges in this article are in fact references to those stock exchanges which have a commodity derivatives segment either exclusively or along with other trading segments on their platforms.

Broadly speaking, the regulatory role of Commodity Derivatives Exchanges faces unique challenges and opportunities which stem from the very nature of the products available for trading , the trading platforms themselves where market participants trade for price discovery as well as the price risk management and the policies pursued to promote global standards of governance in the operations of the exchanges.

4. Managing the information asymmetry

The Commodity Derivatives Exchanges deal with derivatives products on a diverse range of commodities starting from agricultural complex (pulses, oilseeds, cereals), plantation crops like rubber, spices (jeera, pepper) to bullions, base metals, and energy. This is ideally a heady mix of commodities. Each of these products has its unique complex fundamentals, upstream and downstream value chains and a separate eco-system that influence the demand and supply side of the said commodity, with factors like monsoon , geopolitics, import and export dependability and government policies playing out a crucial role. All these factors make for an ideal recipe for great uncertainties and consequent price volatility.

The aforesaid challenges are further compounded by the fact that there is a lack of a robust and efficient market intelligence and information system which can provide reliable and timely estimates of trends in both supply and demand sides, such as production, consumption, stocks carried forward and market price trends etc. The forecasts and estimates that are available are either lagged or inaccurate or both, whereas for a market to be truly efficient, what is needed is dependable forward-looking forecasts, which could be regularly updated. In the absence of reliable and timely estimates, market players are unwittingly swayed by the inaccurate trade estimates and unfounded news or even rumours/ hearsay reports which bring in unwarranted volatility and disturbs market equilibrium. As the guardians of market integrity, the Commodity Derivatives Exchanges need to build capacity in commodity expertise and intelligence by leveraging their market experience and collaborating with government as well as private agencies, so that information asymmetry does not cause distortion of price discovery on their platforms. This is particularly true in case of agricultural commodities especially for that sub-set of narrow commodities like castor, rape mustard seed, guar gum and guar seed, coriander etc which have witnessed extreme market fluctuations in the past.

The Commodity Derivatives Exchanges can ill afford to lose sight of the basic fact that prices discovered on their platforms are supposed to reflect all the available demand-supply information about the underlying commodity. Thus, both dependability and timeliness of such information that flows into the process of price formation matters a lot. The exchanges should take upon themselves this regulatory role to invest in improving the market information and intelligence and to keep the participants informed about all such information about the underlying market that can be truly relied upon by the derivatives participants.

There is a need for constant and active engagement with all the stakeholders of the commodities including the state governments, to make commodity derivatives contracts more responsive to the needs of the value chain participants and more reflective of market fundamentals. The Commodity Derivatives Exchanges must assume greater role in raising the levels of awareness about all the products that they are dealing with amongst the Value Chain Participants (VCPs). These instruments and products would serve their purpose only if they are accessible and available to a larger and diverse set of participants. Unfortunately, lack of product awareness amongst the stakeholders has repeatedly been pointed out by various experts as one of the pain points for inadequate participation in the commodity derivatives markets in India. The Commodity Derivatives Exchanges have to be more proactive in harnessing social media and electronic medium apart from conducting physical outreach programmes to familiarise all stakeholders in the value chain about these products.

The Commodity Derivatives Exchanges also must grapple with lack of uniform, consistent and scientific delivery standards, which is especially true for agricultural commodities. Quite often it leads to disputes over quality of the goods and inhibits efficient hedging on exchange platform. This issue becomes even more pressing in the light of the fact that almost all the agricultural commodities derivatives are settled by way of compulsory delivery of goods on expiry of contracts. However, the market is confronted with inadequacy of logistics such as warehousing and assaying infrastructure, and even when such facilities are available, the costs/fees become prohibitively high for certain players. There is a need for greater investment in these facilities to make them more competitive, easily accessible, and cost-efficient for the derivative participants who wish to give and take delivery of goods.

To sum up, the Commodity Derivatives Exchanges should take upon themselves the duty of building capacities in market intelligence and information, awareness generation and greater engagement with stakeholders along with developing state of the art infrastructure, logistics and scientific standards for delivery . All these efforts would certainly lead to efficient contract design, greater participation of hedgers, curbing of excessive volatility and greater trust in price discovery mechanism.

5. Platform: Integrity, trust and efficiency

There seems to be an inherent tension between the role of Commodity Derivatives Exchanges to pursue profits and turnover vis-a-vis its prerogative to regulate the markets. This is often juxtaposed as a dichotomy between regulation and development. However, this is a spurious contradiction. It goes without saying that a prudent and well-regulated institution with a robust trading, clearing & settlement mechanism as well as sufficient checks and balances in place, will attract larger trading participation, spur innovation to develop the market and at the same time give an impetus to its turnover and profit.

The Exchange and Clearing Corporation business are technology intensive businesses focussing on efficient order matching system while facilitating low latency order placing and algorithm driven trades by the market participants. Technology play a pivotal role in seamless automated clearing and settlement of trades . While the Commodity Derivatives Exchanges are expected to remain well equipped with all the latest technology so as to remain ahead of the curve in customers service, they are also expected to ensure that usage of such technology has to be fair, equitable & transparent so as to dispense equal access to all the market participants without any discrimination . Unlike their equity peers, the Commodity Derivatives Exchanges cater to a wide spectrum of market participants, ranging from high-end sophisticated institutional investors to technology savvy brokers, from algo-based high net-worth proprietary traders to small corporates, commodity dealers, Millers, processors and also are expected to cater to the trading needs of the Farmer Producers Organisations, individual farmers etc. Therefore, the Commodity Derivatives Exchanges carry an onerous duty to provide a level playing field to all kinds of participants while deploying latest technology in their systems . Any unfair use of technology can potentially prove to be a huge governance disaster in no time, in an otherwise well-governed exchange.

The commodity space has repeatedly witnessed so called “governance shocks” that has dented both faith and turnover. During the regime of erstwhile FMC, the governance imbroglio at NMCE (2011) was followed by ignominy of NSEL settlement default in 2013. The latter had serious ramifications for MCX the leading Commodity Derivatives Exchange of the country, because of the common promoter and their dominant role in the management of affairs of MCX. There was a huge blot on the fit and proper status of the promoters of these institutions themselves. A similar episode occurred in UCX in 2014. These spate of governance fiascos highlighted the need for stringent internal checks and supervision. The transition to the regulatory umbrella of SEBI has helped the Commodity Derivatives Exchanges to significantly raise their benchmark in various aspects of corporate governance. These exchanges had to follow higher standards of compliances in the areas of the composition of the Board, constitution of Board Committees, Role of PIDs, checks on the role of MD & CEO, comprehensive risk management framework, separation of clearing and settlement functions, detailed warehousing norms, business continuity plan, tough cyber security measures including enhanced reporting standards and prompt enforcement actions etc . These measures along with comprehensive inspection of the Exchanges and CCs ensures compliance with all SEBI circulars in letter and spirit.

Commodity Derivatives Exchanges must imbibe the fact that their regulatory roles rest not only in compliance with the statute & the regulations framed thereunder, but also in bringing in greater transparency and accountability to the Board. The Board Committees, especially the Audit Committee comprising mainly of Public Interest Directors (PIDs) plays a critical role in setting the standard of governance of an exchange. Financial statements and reports are the heart and soul of a company and silently speak volumes about the self-governance of a company. By keeping a watchful eye over the financial affairs of an exchange and by maintaining utmost transparency in disseminating the financial statements to the Board and to the stakeholders at large, the audit committee can create and sustain a long term trust in the minds of the stake holders which would lead eventually build up a strong reputation attracting more participants to invest and trade in the exchange.

A good corporate governance and administration are sine qua non of a safe & secured exchange platform that can inspire confidence, attract trading interest from the stake holders and assure the public at large about the integrity of price discovered on its trading venue . The same view also applies to the Clearing Corporations who are expected to have an unimpeachable system in place including a flawless physical delivery system for carrying out seamless clearing and settlement of trades. The Commodity Derivatives Exchanges and their Clearing Corporations which are mostly the subsidiary entities of the Exchanges, are aptly called Market Infrastructure Intermediaries (MIIs) and the duties and obligations of these MIIs demand high level of vigilance and probity at all times without which sooner or later, the entire edifice of price discovery and price risk management will crumble.

6. Policy: Inherent Duality and translating intent into action

The commodity derivatives space has witnessed historic reforms after the merger of erstwhile FMC with SEBI in September 2015 especially in the domain of products and participants. Over the last five years, the derivatives market has witnessed introduction of a host of new commodities like diamond, steel and almond futures contracts, new products like Options on Futures, Commodity Indices Futures & Options and most recently Options on Goods. All these products need to be popularised and promoted amongst the potential participants who need them for meeting their hedging needs. In fact the launching of Option in Goods has heralded a new chapter in the history of commodity derivatives in India because of its utter simplicity, inexpensive and easy adaptability by Farmers and FPOs to insure them against adverse price movement of their crops during the harvest season.

Apart from introducing certain new goods in the notified list of commodities, launching of new products and instruments such as trading in options and indices as well as permitting new institutional participants like AIFs, MFs and PMS which were not permissible under the erstwhile FCRA,1952 have given a momentous stimulus to the market . The reforms in warehousing policy, risk management and other new prudential areas have given a regulatory facelift to the commodity derivatives landscape in India.

However, it is upto the Commodity Derivatives Exchanges to translate these policy initiatives into tangible results. Truly speaking the Commodity Derivatives Exchanges have not yet been able to bring in adequate liquidity beyond their present niche of successful contracts except for some encouraging participation noticed in a few options contracts. Some Exchanges are still struggling with the same set of illiquid contracts. It shows lack of experimentation and innovation and inability to reach out till the last potential participant in the value chain of those commodities. A combination of thorough and deep research of the commodity eco-system, the physical markets, the hedging needs of each VCP and customisation of the contract to suit the requirement of the physical market players as well as intensive out-reach programmes for the farmers, FPOs, processors, millers, importers/ exporters etc can evoke interest amongst the participants and make the derivatives market a truly pan-India market place for price risk management.

Another challenging area faced by the commodity derivatives exchanges is that the liquidity is concentrated in the near month contract with little interest in distant month contracts. Such a situation discourages participants with a genuine long-term view of the commodity. This shows that both the breadth and depth of participation is not impressive.

The regulatory framework for the comodity markets in India exhibits an inherent duality, wherein the spot markets are decentralised and fragmented operating under multiple regulatory frameworks mostly at state level, while a centralised regulatory apparatus exists for the derivatives market. Such a situation poses challenges for the convergence of spot and derivatives market at the time of expiry of the derivatives contracts. This was exacerbated by frequent impositions of suspensions and imposition of stock limits to control spiralling price rise in essential commodities. The recent spate of reforms brought in by the Government through various ordinances in Trade and Commerce in Agricultural Commodities thereby practically freeing the farmers to market their produce anywhere and to anyone as per their wish, and the amendments made in Essential commodities Act to liberalise the stock limits framework, should provide a much needed impetus to the agricultural spot markets. The emphasis of the Government on seamless nationwide agricultural markets and warehousing infrastructure should also provide a fillip to warehouse accreditation and wider participation of spot players. These reforms could augur well for establishment of integrated pan-India electronic spot markets for agricultural commodities enabling transparent spot price discovery of different commodities while a thriving warehousing infrastructure will enhance the threat of delivery. Both these factors will improve the convergence of future and spot prices.

The exchanges would not only have to be more proactive in attracting more institutional players like AIFs, PMS and MFs but also big corporates dealing with commodities for their business and other value chain participants to enhance liquidity which in turn would beget more liquidity. New products will serve their purpose only if they attract large participation by market players; institutional, corporate as well as retail, on a safe and secured platform to trade.

The glaring absence of high liquidity in many of the commodity derivatives being traded at present has led to a situation where, despite being a major producer or importer of many key commodities, Indian exchanges have always been price takers from global exchanges for organising trading in these commodities on their platforms. In this context there is an idea being floated that once an exchange builds on its existing strength and develops a new derivative product for trading on its platform, the said exchange should be permitted to deal with that product exclusively for a reasonable period of time . This will ensure that the liquidity so built up by the exchange through its engagement with the VCPs is not fragmented and the exchange is able to attract more and more trading interest . This in turn could eventually enable the prices discovered on that exchange to become the benchmark price for exchanges in other jurisdictions to follow.

There is a need for commodity derivatives exchanges to exit the zero-sum game mindset and think out of the box to ensure that they are globally competitive. The lack of sufficient participation by hedgers is a sad commentary and exchanges must correct this on a priority basis.

The recent reforms in agricultural marketing as highlighted earlier would also open many opportunities in the agricultural commodity derivatives space. With the decision of the Central Government to set up 10000 Farmer Producers Organisations (FPOs) in the country , the role of FPOs as aggregators for marketing of farmers' produce will substantially increase. The commodities exchanges trading in agricultural goods can tap these FPOs which can act as bridge or the medium through which stock exchanges can reach the farmers and help them participate in the commodity derivatives markets.

Interestingly, the aforesaid developments may seem to be posing challenges but actually they are more in the nature of opportunities which can be tapped only if Commodity Derivatives Exchanges move outside their comfort zones to explore and develop new products and instruments, attract new participants, build credible liquidity, create strong base of hedgers and thereby become exemplars in the international space.

7. Conclusion

The Commodity Derivatives Exchanges must realise that their own development and that of the derivatives market hang on how effectively they discharge their regulatory role. They must come out of the regulation versus development mindest. First and foremost, the challenge for them is to uphold their governance standards and imbibe the culture of compliance and transparency. Secondly, they must become the masters of their domain, which is product expertise ably supported by in-depth product research along with market intelligence and information which is dynamic and forward looking. They must realise that there is no substitute for active engagement with stakeholders on an almost real time basis. Their core output is the price they discover on the trade platform which must inspire trust. Lastly they must abandon status-quoist mindset and keep pace with the progress in technology, latest developments in global markets , adopt the best international practices in all aspects of the markets and consistently strive to make trading a user friendly activity and to disseminate reliable updated trade related information to the market. Commodity Derivatives regulations and reforms have progressed on a fast forward mode and over a short span of five years, the regulator has nurtured the market with series of reforms in the areas of policies, participants, and products. It is now the for the Commodity Derivatives Exchanges to perform to get the best out of these regulatory reforms by working in right earnest towards building liquidity, deepening participation, becoming a paradigm of excellence and beacon of trust and integrity.