REPORT OF THE INTER-MINISTERIAL TASK FORCE ON CONVERGENCE OF SECURITIES AND COMMODITY DERIVATIVE MARKETS

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PREFACE

With the lifting of prohibition on forward trade in all the commodities at the beginning of the current year, the commodity derivatives market has been totally liberalized. There is an upsurge of interest in this market. The participants in other financial markets, particularly securities, look forward to the new emerging opportunities offered by this market. However, there are some regulatory barriers to permit them to benefit from this opportunity. Ramamoorthy Committee set up by SEBI to look into certain issues relating to fruitful cooperation between these two markets were specifically asked to examine the possibilities of: i) securities brokers participation in the commodities markets; ii) utilization of infrastructural facilities of stock exchanges by commodity exchanges; and iii) stock exchanges as well trading in commodities derivatives. While the committee endorsed the first two issues, on the third issue, it opined that it could be taken up for consideration at a future date as the two markets mature further. Based on the recommendations of the Committee, the Government have issued a notification and amended the Securities Contract (Regulation) Rule to permit securities brokers to participate in the commodities markets after constituting a separate legal entity. The issue of convergence of securities and commodity derivative markets was discussed at various levels in the Government. The idea of convergence of markets, institutions, players and regulators has been proposed by the Finance Minister in a communication to the Minster of Consumer Affairs, Food and Public Distribution, in response to which an inter-ministerial Task Force was constituted under my chairmanship in the Department of Consumer Affairs (DCA) with other members drawn from Department of Economic Affairs, Department of Consumer Affairs, Department of Company Affairs, Forward Markets Commission (FMC) and Securities and Exchange Board of India (SEBI), as given in the Annexure.

The Task Force chalked out its own Terms of Reference and held four meetings. The securities exchanges and commodities exchanges were invited to give their views on the subject. Draft Report of the Task Force was placed on the websites of the Forward Markets Commission and the Department of Consumer Affairs for wider dissemination and for views and comments. The Task Force also visited a few commodity exchanges and the National Stock Exchange to have an on-the-spot understanding of the issue. A panel discussion on the subject was held in the National Conference of Commodity Exchanges organized by FMC in Mumbai on September 2, 2003.The views received from them were considered and discussed in the meetings of the Task Force before drafting the Report. Dr. Kalyan Raipuria, ex-Senior Economic Advisor in the Department of Consumer Affairs retired on superannuation before finalisation of the Report. The Committee would like to acknowledge very useful contribution made by him. Inputs and support that the Task Force received from Shri Ajay Shah, consultant, Ministry of

Finance, Shri D. S. Kolamkar, Director, FMC, Shri C.K.G. Nair, Director, DCA, and Smt. Alice Chacko, Under Secretary, DCA, have been immense. I would like to place on record the appreciation of the Task Force for their contribution.

(Wajahat Habibullah)

CHAIRMAN

I. Backdrop

Currently, it is largely the agricultural commodities, which are traded on the existing commodity derivatives markets in India. Agriculture is a key sector in the Indian economy. But the share of non-agricultural commodities, like metals – particularly bullion - in the basket of commodities traded at the Indian commodity derivatives markets, has a potential to grow rapidly in the near future, Even though the share of agriculture in the Gross Domestic Product is declining and estimated to be around 23 per cent, it has backward and forward linkages with other sectors.

1.2 The policy of the Government has been to protect and promote the agriculture sector through procurement and administered price mechanism. However, in view of the fiscal pressure and that of WTO to reduce direct support to agriculture under Agreement on Agriculture, there is a policy shift towards a market-oriented approach. In recent years, a major theme in liberalisation of the agricultural sector has been the improved functioning of product markets. It is increasingly felt that efficient product markets serve to further the interests of the agricultural sector.

1.3 A key aspect of the process of strengthening agricultural markets is the question of obtaining efficient derivatives markets for commodities. The expert committee on strengthening and developing agricultural marketing headed by Shri Shankerlal Guru recognized the role of forward markets in price-risk management and in facilitating direct marketing. There is now a considerable consensus that the derivatives markets play a valuable role in shaping decisions of the market intermediaries, including by farmers about sowing and investments into inputs, in smoothing price volatility, and in giving farmers and consumers better means of protecting against the adverse effects of volatility. If derivatives markets can function adequately, then some of the core policy goals of addressing volatility of agricultural prices can be addressed in a market-oriented fashion. This argument has been articulated in the National Agricultural Policy of the Government of India, 2000, which was followed by the removal of the ban on futures trading for all commodities in 2003. In addition, from 1998 onwards, domestic entities facing price risk abroad have been given permissions to utilise foreign derivatives exchanges in addressing their risk management needs.

1.4 Though India is considered as a pioneer in some forms of derivatives in commodities, it has a chequered history of trading in commodities derivatives. The first derivative market was set up in Mumbai in 1875 in Mumbai, where cotton futures was traded. This was followed by establishment of futures markets in edible oilseeds complex, raw jute and jute goods and bullion. The volumes of trade were reported to be extremely large. With enactment of Defence of India Act, 1935, the futures trading was subjected to restrictions/prohibition from time to time. After independence, the subject of stock exchanges and futures markets, was placed in the Union List. The Union Government enacted an Act, the Forward Contracts (Regulation), 1952, to provide for prohibition of options in commodities, and regulation and prohibition of futures trading. The Union Government has been entrusted most of the regulatory powers, which are to be exercised on the recommendations of the Forward Markets Commission set up in 1953.

1.5 The futures markets in commodities, particularly, cotton, oilseeds complex, bullion and raw jute and jute goods were vibrant and attracted huge trading volume. However, in mid-1960s, the Government imposed ban on most of the commodities, except very minor commodities like, pepper and turmeric. The apprehensions about the role of speculation, particularly in the conditions of scarcity, prompted the Government to continue the prohibition till very recently. The misconceived apprehensions in some quarters that the futures trade leads to speculative and inflationary tendencies have largely been responsible for the strangulation of this industry. Speculation is an important element of the futures trade as it provides counterparty to the hedgers to transfer their pre-existing price risk. By taking a position in the market for the sake of profit the speculators bring to the market better information input and liquidity, thereby enabling the market to play an important economic function of price discovery and risk-management. It is manipulation, and not speculation, which is detrimental to the functioning of the market. Liquidity and risk management and regulatory oversight curb these tendencies, and make the market function efficiently for the general interest of the stakeholders and the economy.

1.6 The extended period of prohibition, resulted in driving a part of the trade underground, with a large number of participants shifting to other professions, including securities market, which functioned without interruption. There were extremely rapid advances in the systems of brokerages, market designs, trading, clearing, settlement, and governance of exchanges since 1970s, when derivatives in financial instruments were introduced in the western markets. Commodity derivative markets in India remained isolated from these developments on account of restrictive policies.

1.7 Liberalisation and reforms in commodity derivative markets started in right earnest only towards the end of the millennium. A three-pronged strategy was adopted to develop the commodity derivative markets. First, major legal, regulatory and policy-impediments for development of commodity derivative markets have been largely removed. For instance, restrictions on long-term party-to-party merchandising contracts were removed. The liberal and developmental approach of the Government towards the policies relating to commodity derivatives was announced unambiguously in the National Agricultural Policy (2000) and in 2001-2002, Budget speech of the Finance Minister. In pursuance of this approach, the prohibition on derivative trading in all the commodities has been withdrawn. The agenda of liberalization and reforms is however unfinished.

1.8 Second, with a view to upgrading the existing exchanges, best international systems and practices in respect of brokerages, trading, clearing, settlements, market monitoring and surveillance, regulation were studied through experts in the field. Awareness about these systems and practices was widely disseminated through workshops, seminars and training programmes and by organizing visits for the exchange office-bearers, traders and regulator to the developed markets abroad. A large number of the practices and systems was introduced in the existing exchanges. With a view to avoiding disruption, most of the upgradation was gradual and incremental in nature. This had a salutary growth effect on the market. Total volume of trade almost doubled from 217.72 lakh tonnes in 2001-2002 to 414.11 lakh tones 2002-2003. In value terms, the turnover, which was about Rs.35,000 crore in 2001-02, spurted to cross Rs.100,000 crore in 2002-03, and is expected to exceed

Rs.150,000 crore in 2003-04. The increase in the volume and value of the trade is concentrated largely in one commodity, soybean oil, and in one exchange, National Board of Trade.

1.9 Third, an initiative was taken to create competition, encourage the exchanges to trade multiple products and to establish new modern multi-commodity exchanges, which would follow the best international practices and systems. In pursuance of this initiative, the Government have already recognized one exchange at Ahmedabad as National Commodity Exchange, and 'in-principle' approval has been granted to three other exchanges. The expectations from these exchanges are very high not only because all of them will be demutualised, electronic exchanges, but also because, these are promoted by major public/private sector corporations, like, ICICI, NSE, NABARD, LIC, CWC, NAFED, etc. These exchanges have already invested their resources to create state-of-the-art market infrastructure, and are expected to be operational by October, 2003.

1.10 With a view to maintaining the momentum of development of commodity derivative market, it would be necessary to expedite action on the unfinished agenda of liberalization and reforms, both at the legal and policy levels as well as at the level of the regulator. The proposals to allow options in commodities and provide for registration of brokers by amending the Forward Contracts (Regulation) Act suitably has been pending in the Parliament for over five years. The issue of differential tax structure, particularly stamp duty and octroi is yet to be resolved. Some of the commodities like cotton continue to be subject to restrictions under the Essential Commodities Act. The progress in providing for national-level regulation on warehouses to pave the way for making warehouse receipts issued by the regulated warehouses negotiable and tradable across the country is slow.

1.11 To provide a developmental thrust, the existing commodity market needs a regulator with leadership, vision, capabilities, resources and empowerment. At present, most of the regulatory powers in respect of the commodity derivative markets are with the Central Government, and the Forward Markets Commission exercises the delegated powers or plays a recommendatory role. Forward Markets Commission continues to be a subordinate office of the Government department and has no autonomy to garner resources – human, financial and infrastructural – to discharge the responsibility expected of a regulator in the dramatically changed environment. The securities market had also faced a similar situation when it was liberalized in the early nineties. Establishment of an independent regulator with adequate resources and empowerment changed the very face of the market, though the path was not smooth and episode-free. Nevertheless, the regulator was able to respond to the challenges of the market. In this context, it is important to consider either a similar step for strengthening and restructuring the Forward Markets Commission, or to institutionalize some form of coordination or convergence with the Security Regulator, whose functions in respect of securities' derivatives have a lot in common with the functions of the Commodity derivatives regulator.

1.12 The idea of convergence was first conceived at the level of participants, when the commodity derivatives exchanges demanded removal of restrictions on participation of

stock-brokers. SEBI appointed a committee headed by Mr. Ramamoorthy to make recommendation on the issue of removal of restrictions contained in Rule 8(1)(f) of the S.C.(R) Rules, on participation of stock brokers in commodity derivatives markets. The terms of references of the committee also included use of the infrastructure available with the stock exchanges for derivatives trading in commodities. Based on the recommendations of the committee, a step has been taken in the direction of amending the Securities Contracts (Regulation) Rule to remove restriction on the stock-brokers from participating in the commodity derivatives market. The committee felt that there was no bar on commodity exchanges using the idle infrastructure of the stock exchanges; but the question of allowing stock exchanges to trade commodity derivatives was a much broader issue and some high-powered inter-ministerial committee or task force could address that issue.

1.13 Government appointed a Task Force under the chairmanship Shri R.C.A. Jain to make recommendations on implementation issues relating to the Report of the Expert Group on Strengthening Agricultural Marketing, headed by Shri Shankerlal Guru. The Task Force set up a few groups on different areas covered by the Guru Committee Report. The Group on Commodity Forward Markets headed by Dr. Kalyan Raipuria, recommended that the policy direction should be moving towards convergence of futures markets, i.e., the commodities derivatives exchanges should be free to trade in either or both the categories of derivatives products, like in the case of major derivatives exchanges in the world such as Chicago Board of Trade and London International Financial Futures Exchange. The group recognized that such a step would not only increase volumes, but would also benefit in terms of scale economies and in taking full advantage of specialized expertise in derivative trading.

1.14 The idea of convergence of the markets, institutions, players and regulation was also proposed by the Finance Minister in a communication to the Minister of Consumer Affairs, Food and Public Distribution. In response to this communication, this Inter-Ministerial Task Force was constituted, under the Chairmanship of Shri Wajahat Habibullah, Secretary to the Government of India, Department of Consumer Affairs, vide O.M. No 21/44/IT/2000 dated May, 14, 2003, a copy of which is enclosed at Annex - I.

II. RATIONALE FOR CONVERGENCE

Any rationale for convergence should hinge upon its capacity to ensure growth, liquidity and safety of the market as well as to improve accessibility to the public by spreading the network and reducing the transaction costs. Various steps have been taken to revitalize the commodity market. Abolition of prohibition on forward trading on all commodities by issuing a notification in April 2003 in respect of the last batch of banned commodities has opened up new opportunities and challenges for the market. The existing infrastructure and institutions are being upgraded; new exchanges have been approved with the mandate to set up world-class infrastructure and systems; more participants with resources, skills and expertise are being attracted from the securities markets. There is also a view that the commodity market will get a further fillip if this participation is broadened to all segments of the securities market by way of convergence of the two.

This intermarriage of these markets has a potential of providing growth impetus to commodity derivatives and opening new avenues of business opportunities to the securities market participants.

2.2 Even though there are some differences in commodity and financial derivatives markets, they have close resemblance in so far as trade practices and mechanism are concerned. Indian Securities market has witnessed significant structural change since 1990s. Some of the changes are enumerated below:

Reforms in Securities Market

2.2.1 Indian securities markets since 1990s have witnessed significant structural changes. With the abolition of the Office of the Controller of Capital Issues (CCI) and the repeal of Control of Capital Issues Act (CCI Act) in 1992, issuers have freedom to access securities market and price their issues freely. This has resulted in a phenomenal rise in the amount of capital raised by companies. An amount of over Rs. 1,29538 crore has been raised by the companies during the period, 1992-93 to 2000-2001. Market capitalisation increased from Rs 90,800 crore to Rs 5,71,554 crore (for BSE) between end March 1991 to end March 2001.

2.2.2 Significant changes were implemented in the secondary market to ensure transparency, safety and integrity of the market. The trading platform was computerized and the open outcry system was replaced by electronic, order book system. The automation of exchanges has improved the level of transparency, reduced spreads and lowered transaction costs. It has also facilitated connectivity and enabled the exchanges to widen their reach to all corners of the country. The transformation to technology-based trading systems and solutions was complemented by the numerous safety mechanisms, which were put in place at the same time. Clearing houses were set up to act as a counterparty for all trades. Settlement guarantee funds, risk based margining structure, exposure and capital adequacy norms were stipulated in order to contain the risk and prevent settlement failures. The Settlement cycle was reduced. From the era of Accounting Period Settlement of upto 14 days, the market has attained T+2 rolling settlement. The dematerialization of securities has been made possible with the enactment of the Depository Act in 1996. About 99 per cent of the deliveries on the NSE and BSE are in dematerialised form. In other exchanges also the dematerialized deliveries account for more that 90 per cent of the total deliveries.

Developmental role of SEBI

2.2.3 SEBI, as the sole regulator of the securities market, has taken several bold initiatives and has successfully implemented major reforms. The Listing Agreement has been amended to strengthen the disclosure requirements. SEBI has brought in an electronic disclosure system (EDIFAR) to facilitate disclosure and provide access to information. A Central Listing Authority has also been set up to bring about uniformity in the exercise of due diligence in scrutinising listing applications. A Corporate Governance code has also been laid down by SEBI to increase shareholder value and increase investor

confidence. Book building processes have been standardized in order to facilitate transparent and efficient price discovery process. SEBI has also approved a scheme for demutualization and corporatisation of the exchanges.

2.2.4 Stock exchanges are required to provide adequate infrastructure and risk containment measure in order to be granted recognition by SEBI. With the advent of technology, the open outcry system, accounting period settlement systems and tedious transfer of physical shares were all replaced speedily by electronic trading, T+2 rolling settlement and dematerialised shares. The exchanges also have to set up an Investor Protection Fund to provide compensation to the investor for defaults by member brokers of the exchange.

2.2.5 SEBI has issued regulations for regulating every category of intermediary in the securities markets. These intermediaries are required to be registered with SEBI and SEBI has been empowered to levy stringent penalties in cases of non-compliances. A code of conduct has been laid down to discipline and regulate the activities of all the intermediaries.

2.2.6 SEBI has been instrumental in effecting changes in the legal and institutional framework to facilitate introduction of derivatives in the securities market. This market now offers a complete array of exchange traded derivative contracts consisting of Index options, Index futures, stock options, single stock futures and interest rate futures contracts.

2.2.7 Though SEBI had faced a number of challenges in the past in its role as a regulator and developer of capital markets, yet, with continued perseverance, it has brought about a sea change in the securities markets over the decade. SEBI has faced criticism for failure to arrest the stock market scam in 2001, but the scam also highlighted the limitations of SEBI's powers in promoting the orderly development and regulation of securities markets. Subsequently, this handicap was corrected by adequately empowering SEBI with powers such as, search and seizure, and imposition of monetary penalty up to Rs 25 crores. This has enhanced the characteristics of SEBI as an independent and powerful regulator. Nevertheless, market misconduct, such as reported dabba trading in the recent past, has not been completely eliminated. The success of derivatives and the speedy transformation to dematerialised shares serve as a benchmark for the world. The reforms made by SEBI have made the Indian securities markets comparable in all respects to that of international securities markets.

Status of Securities Market

2.3 As on date, there are 23 recognised exchanges in the country. Of these, only two exchanges, NSE and BSE, are vibrant and account for over 99 per cent of total turnover in the securities market. Status of these exchanges in respect of various aspects are given below:

2.3.1 Trading

Both NSE and BSE are fully automated using anonymous order matching. They trade in a wide range of products, viz., equity, government bonds, corporate bonds, futures and options on equity index, futures and options on individual stocks, futures on government bonds and have nationwide distribution spread over 5,000 branch offices. In addition, trading takes place over the Internet, thus greatly multiplying the number of screens from where access is possible. Two principal cities account for almost 50 per cent of the volumes in these exchanges.

2.3.2 Easy access to intermediation

There are no complex procedures or hurdles faced in creating a broking firm on the securities markets. India is now a remarkably open regime by world standards, in terms of entry by foreign securities firms also. This has ensured a high degree of competition and reduction in intermediation cost.

2.3.3 Membership

NSE and BSE together have over 1,000 active brokerage firms. These firms have a combined net worth in excess of Rs.1,000 crore, and employ over 20,000 staff with specialised skills in securities markets.

2.3.4 Certification requirements

SEBI has made it mandatory that individuals who work at brokerage firms must pass a certification examination, which is directly linked, to their work profile. There are certification procedures for the spot market, derivatives market, depository operations, etc.

2.3.5 High transaction-processing capacity

In terms of number of trades in the year 2002, NSE was ranked 3rd and BSE 5th in the world. This is the only ranking in finance where India figures in the top ten nations of the world.

2.3.6 Risk management

The National Securities Clearing Corporation (NSCC) is a modern clearing corporation, which performs novation. That is, it adopts legal liability for the full net settlement obligations of every clearing member. This eliminates counterparty credit risk. NSE and BSE have adopted modern risk management systems computing Value at Risk in real-time, in order to eliminate the risk that emanates from delays between the trade and the moment at which collateral is in place.

2.3.7 Dematerialised settlement

National Securities Depository Ltd. (NSDL) and Central Securities Depository Ltd. (CSDL) are depositories, which use dematerialisation. Their feature-set is highly modern, and ahead of many other depositories in India and abroad. Almost all securities settlement is done using these depositories. NSDL has one of the lowest charge structures amongst depositories in the world.

2.3.8 Modern governance principles

NSE features a complete separation between three groups of (a) shareholders (b) managers and (c) trading members. BSE is at present a mutual form of exchange and is likely to be demutualised in due course.

2.3.9 Sound and sustainable revenue model

All the institutions of the securities markets - i.e. NSE, BSE, NSDL, NSCC and CCIL - are sustained by tariffs, which are charged to users. User charges are the only source of resources for these institutions. There are no subsidies from the government.

2.3.10 Regulatory capacity

SEBI is an independent regulator and has built the regulatory capacity, which has dealt with these enormous changes over the last decade. In particular, the SEBI Risk Management Committee plays a strong role in supervising the risk containment policies used in real-time, prescribes minimum statistical models, which should be used, etc. SEBI is part of the `HLCC' consultation mechanism through which the multiple regulators in the country interact and resolve inter-agency differences.

2.3.11 Huge Investment

Over Rs.1,500 crore has been invested over the last decade in the creation of this 'ecosystem' of the securities industry, comprising exchange institutions and brokerage firms.

Status of Commodity Market

2.4 During the last 4-5 years efforts have been made to introduce some of these features in the commodity exchanges (commixes) with varying degree of success. The network is spreading speedily, modern practices such as daily clearing, time stamping and immediate reporting, transparent clearing and settlement practices, professional management and broad-based governance have been introduced in the commexes. Margining and risk management practices have been strengthened. Adoption of modern technology is at various stages in different exchanges. The back-office operations have been computerized in a majority of 21 existing exchanges, and screen based anonymous order matching have been introduced in three exchanges. Exchanges have amended their

articles to provide for induction of independent directors on their boards to the extent of 1/3rd of the total strength. The older exchanges have not been able to generate resources and therefore not demonstrate the seriousness and flexibility to introduce these reforms. A part of the delay is because of legal and regulatory barriers. Till April 2003, there was a ban on futures trade in most of the important commodities thereby restricting the scope for growth by diversifying to new commodities. Even now, the freedom to diversify does not exist in most of the exchanges (except nationwide multi-commodity exchanges) as they have to seek fresh recognition every time they intend to add another commodity to their portfolio. The experience of the reforms process in securities market in the early nineties is almost being replayed in the commodity market.

2.4.2 The commodity market has taken significant strides during the last few years. The prohibition on futures trade have been abolished. Four new nationwide multi-commodity exchanges has been approved, one of which have already commenced trade; the other three are likely to commence trading in near future. These Exchanges will be technology driven and will adopt international best practices of risk management for trading, clearing and settlement. They are demutualised Exchanges. Two of these exchanges are promoted by reputed institutions. One of the exchanges, i.e., National Multi-commodity Exchange of India Ltd. (NMCEIL), has Central Warehousing Corporation, NAFED (Government of India enterprises) and Gujarat Agro Industries Corporation (Gujarat Government) as prominent promoters. The National Commodities Derivative Exchange Ltd. (NCDEX) has been promoted by a consortium comprising of ICICI Bank, National Stock Exchange, Life Insurance Corporation, and NABARD. The other two exchanges have also committed to invite institutional participation. They propose to set up an efficient Warehouse Receipt based delivery mechanism, which will have a bearing not only on futures market but also upstream in the spot market and collateral financing. The impending competition has imparted vibrancy among some of the existing exchanges. The Volume of Trade during 2002-2003 registered a jump of about 200 per cent. In value terms, the trade increased from Rs.35,000 crore in 2001-2002 to over Rs. One lakh crore in 2002-2003.

Expected Gains from convergence

2.5 Expected gains from convergence are given below:

a. Opportunity to speed up development of commodity market.

> If derivatives in commodities resemble securities, then the developmental challenge of obtaining sound institutions for trading commodity derivatives can be eased by using the stable and mature institutions that are found in the securities markets. The new multi-commodity exchanges have been approved recently and may take some time to pick up speed. If the institutions of the securities markets are used, this would speed up the pace at which modern market institutions become available to farmers, and accelerate the growth rate of the agricultural sector.

b. Commodity derivatives resemble securities

There are strong commonalities between commodity derivatives and securities derivatives. A commodity futures contract is tradable and fungible. Almost all commodity futures contracts are squared off, and do not go to delivery. In this case, the users of commodity futures markets are using the futures for purely *financial* purposes. Thus, almost all commodity futures contracts are akin to securities; however, there are certain differences with regard to delivery and settlment. In this case, knowledge and procedures for trading in securities is directly pertinent to trading in commodity futures.

c. *Economies of scale*

Sizable investment has gone into building India's securities infrastructure. This infrastructure can be used to start trading in commodity derivatives at a small incremental cost. Conversely, the viability of the new multi-commodity exchanges would be enhanced if they could trade derivatives on all underlyings. This would serve to reduce the extent to which capital is required in creating the desired institutional capacity for the commodity sector. It is, however, quite possible that convergence would provide economies of scale to some of the leading stock/commodity exchanges, particularly, BSE and NSE only, and other exchanges might see their liquidity migrating to these exchanges.

d. Economies of scope

In risk management, if the clearing corporation holds a single settlement guarantee fund, then it benefits from diversification. Hence, the collateral required in order to obtain a given level of safety is lower when a clearing corporation does novation for a wide variety of products with low correlations, as compared with having separate clearing corporations for each area. Existing SEBI and RBI rules prohibit such integration of the settlement guarantee fund. However, the basic opportunity to reduce the capital requirements of the clearing corporation in this fashion is there, and will be extended if commodity markets are also brought alongside equities, interest rates and credit risk.

e. Possibility of strengthening the commodity spot market

If the commodity futures markets obtain strong liquidity and price discovery in a transparent, anonymous, order matching environment, then this is likely to have a considerable impact upon the underlying spot market, which is likely to remain a fragmented, OTC market for many years. To the extent that convergence helps speed up the migration of commodity futures markets into screen-based, anonymous order matching, this would thus indirectly assist the strengthening of agricultural spot markets.

f. Better serving users

It is useful to emphasise that the convergence approach yields superior efficiency and sophistication, even when a brokerage firm chooses to be highly specialised. In the convergence approach, a brokerage firm that focuses upon cotton would simultaneously be able to access derivatives on cotton, equities trading about firms which deal with cotton, and derivatives on currencies (which are relevant for the currency risk involved in imports and exports of cotton). Thus, even for a brokerage firm that seeks to be a specialist on cotton, the convergence approach gives direct access to a more rich range of traded products as compared with the traditional approach. There is, however, a different point of view, viz., the skills required to price securities are very different and therefore the services that the stock broker could provide to the participants in commodity derivatives market would be limited.

g. Impact upon informal market

Presently, a major problem faced with commodity futures trading is a substantial informal market, which is illegal under Indian law. There have been persistent problems in fully eliminating illegal trading given limitations of enforcement mechanisms. The convergence approach offers the possibility of a market-based mechanism through which informal trading can be curbed, except to the extent that the participants choose informal markets to avoid taxation, elaborate paper-work, requirement of maintaining high net worth and service infrastructure and/or to invest black money to satisfy a speculative or gambling instinct. If the legal markets are able to rapidly migrate onto sophisticated, liquid, low-cost platforms, then this would spontaneously pull users into these platforms. Liquidity has a natural monopoly character, and once exchanges achieves a certain minimal `critical mass' of liquidity, there are strong incentives for each user of the market to seek the liquidity of exchanges. This is likely to ease the enforcement difficulties faced in eliminating illegal trading.

h. Consequences for government

At present, the Indian government engages in many policy measures, which interact with agricultural spot markets. These policies are unaffected by the convergence question. Whether commodity futures markets are closely integrated with securities markets or not has no impact upon the conduct of policies such as public procurement, support prices, etc. To the extent that convergence helps strengthen price discovery on the commodity futures markets, this would facilitate the design of public policy. If shortages or gluts are expected to take place at a future date, this would be revealed in the futures price well ahead of time. This information signal would help government mount an early response, if desired.

i. Simplicity

There would be important gains for the individuals and firms, if a broad range of derivative products came under a single, simple set of rules and procedures. This

includes the operations of the intermediaries, exchanges, regulation, taxation, accounting, IT interfaces, information sources, etc. This would reduce the overhead costs associated with doing transactions on these markets

Divergences, Apprehensions and Concerns

2.6.1 Whereas the strengths of securities markets and the expected gains of convergence to commodity market are significant, the divergences, apprehensions and concerns are also many. These need to be addressed.

2.6.2 Though derivatives in commodities resemble securities and financial futures and provide many of the same economic functions, there are some major differences. First, because financial futures generally have actively traded cash markets, cash prices are generally not "discovered" in the futures market. In fact, futures contracts are often settled from cash or indexes of cash prices. Second, the delivery and settlement process is different. A particularly useful function of exchanges is the facilitation and oversight of contract expirations and the related settlement, delivery or exchange of futures for physicals. Exchanges not only set the terms of delivery, but also oversee the actual delivery as well as the credit verification of members making or taking delivery. In addition, exchanges perform other financial services related to trading, delivery, clearing, and margining. For financial derivatives transactions, exchange delivery mechanisms or oversight are less necessary and can be alternatively accomplished as cash transactions through other institutions or inter-institutional arrangements.

2.6.3 There are fears that in the large securities exchanges, there would be a certain lack of focus upon agricultural commodities and the focus would be on organizing derivative trading only in commodities with close semblance to financials, viz., bullion. The most important policy goal, and policy concern, is safeguarding of the interests of producers – farmers in particular, consumers as well as manufacturers and other functionaries in the supply-chain.

2.6.4 Concerns are expressed that unlike securities market, - where the impact of the price volatility is on the willing participants in the market – the impact of the sharp rise or fall in price in commodities is borne by the entire economy, i.e., largely by innocent bystanders.

2.6.5 It is apprehended that the possibilities of convergence are limited, insofar as commodity futures trading requires highly specialised knowledge, which is different from that required for securities trading. Unlike the securities market, the factors affecting commodity prices are more complex and commodity-specific. It is also stated that the firms that engage in commodity futures trading differ from the firms that engage in securities trading.

2.6.6 There are strong concerns that removing restrictions on stock exchanges from trading commodity derivatives, would affect the viability of the exchanges, which have been granted in-principle approval only recently. These exchanges were required to set

up modern infrastructure involving huge investment. Changing the competitive environment so dramatically mid-stream raises the issue of fairness. It is apprehended that the established stock exchanges having huge reserves would easily be able to wipe out competition by leveraging their available resources and infrastructure.

2.6.7 Though allowing commodity exchanges to trade securities would appear to be equitable on paper, in reality the existing commodity exchanges will not be able to meet the high regulatory bars set by the SEBI for grant of recognition. This is also true for intermediaries in the commodity derivatives market. An illustrative statement indicating divergences between the two markets is given below:

Table I: Divergences between Security and Commodity Derivatives Markets

	Areas	Divergences	Action required for convergence
1.	Online trading	Besides domain knowledge of commodity markets, agri-products may require different process of online application giving flexibility for outcry system.	Traditional outcry system may have to be allowed for some time during transition as requested by largest Exchange, NBOT, Indore.
2.	Cash Basis	Agri-markets do not have liquid cash market to obtain price discovery.	Integration of agri-markets and financial sector to speed up.
3.	Market Determinants	Agri-products have different shelf life, demand-supply factors, and price determination. Metals notably gold also have different market conditions.	Standardisation of products and suitable storage facilities need to be build up.
4.	Storage of products	Scale and mode of depositing/warehousing structurally different.	Warehouse receipt system (WRS) a must for commodity futures.
5.	Taxation	Indirect taxation cascades in commodities. IT treatment also different.	Losses due to speculation not adjusted in corporate taxation in case of commodity futures – only carried forward.
6.	Regulation	Compliance of network, capital adequacy, margins,	Harmonisation possible though separate regulations to

		exposure norms different for commodity trading	continue.
7.	Role of banks and Mutual Funds	Under the Banking Regulations Act, Banks are not permitted to trade in commodities derivatives markets.	Allow Banks to hedge their commodity exposure.
8.	Unified Markets	Various State and Central Government laws impede the unification.	Fragmentation of commodity futures and markets to be overcome through agricultural marketing reforms.
9.	Market awareness	Limited for nascent commodity futures	Berries will take time to ripen.
10.	Centre-State Jurisdiction	Commodities and markets under purview of State Governments	Inter-state harmonization of Acts and rules needed.
11.	Price Discovery	Mostly in trading pit in commodity futures. Generally cash price quoted at a premium/discount to the futures prices.	Online trading positions in new exchanges need to be supervised.
12.	Base of players	Investors base 25 million and 9000 brokers in securities market. A few thousand brokers in commodity markets.	Farmers' involvement can help expand the base of commodity futures.

2.6.8 It would therefore be necessary to address these concerns, apprehensions and, if necessary, find graceful transition paths through which the adverse impact upon existing firms and exchanges could be smoothed. Adversely affected entities may have to be given a limited period of time to adapt to the new institutional environment.

2.7 Attaining growth in commodity market without convergence will need to replicate the infrastructure and regulation resources. This process may be slow. The world over exchanges trade both in physical and financial derivatives as is indicated in Table 2 below:

Table 2: International experience on convergence

Country	Exchange	Underlyings
Australia	Australian Stock Exchange	Equities, gold, grain, interest rates.
	Sydney Futures Exchange	Interest rates, equities, currencies, commodities.
Brazil	Bolsa de Mercadorias and Futuros	Debt, equity, currencies, gold, commodities
France	Matif	Interest rates, equities, commodities.
Singapore	Singapore Stock Exchange	Commodities, interest rates, equities, currencies.
UK	LIFFE	

Interest rates, equities, commodities.

US

CME

Agricultural and industrial commodities, equities, currencies, interest rates.

CBOT

Commodities, equities, interest rates.

NYBOT

Commodities, currencies, equities.

2.8 The financial futures have become preponderant trade in exchange and reduced the unit cost of transaction. The explosive growth in financial futures after they appeared on the scene in 1970s' has given thrust to the futures market, which the flat growth in physical futures could not have achieved. As may be seen from the table below, in 2002, there were 2.2 billion futures changing hands in 30 countries. Only about 20 per cent of these were futures on physicals. Chicago Mercantile Exchange, the largest Exchange in the world has only 2 per cent of its volume in physical commodities.

Table 3: Futures Trading Volume by Country of Trading Facility 2002

Rank	Country	Number of Exchanges Reported	Total	Futures on physicals	% Physicals
1.	US	10	851,310,387	187,249,728	22

2.	Germany	1	528,718,902	--	0
3.	UK	3	270,564,087	91,379,359	34
4.	Japan	10	167,706,309	138,470,746	83
5.	Brazil	1	95,912,579	799,698	1
6.	Korea	2	57,915,025	--	0
7.	Australia	1	33,987,967	20,208	0
8.	Singapore	1	32,623,190	1,282	0
9.	France	1	26,991,450	373,489	1
10.	Sweden	1	20,208,149	--	0
11.	China	2	18,401,120	12,173,083	66
12.	Spain	2	17,314,065	--	0
13.	South Africa	1	11,233,003	1,356,523	12
14.	Canada	2	10,214,294	2,156,620	21
15.	India	1	10,199,111	--	0
16.	Switzerland	1	7,295,018	--	0
17.	Italy	1	7,071,028	--	0
18.	Taiwan	1	6,377,808	--	0
19.	Netherlands	1	4,328,952	44,244	1
20.	Portugal	1	3,275,017	--	0
21.	Belgium	1	2,653,399	--	1
22.	Hungary	2	2,411,412	20,633	1
23.	Finland	1	2,157,629	--	0
24.	Malaysia	1	1,276,787	911,015	71
25.	Norway	1	881,278	--	0

26.	New Zealand	1	614,831	--	0
27.	Denmark	1	434,163	44,244	10
28.	Argentina	1	399,432	14,293	4
29.	Austria	1	167,939	--	0
30.	Israel	1	32,281	--	0
	Total		2,192,676,611	435,015,165	20

Source : FIA Monthly Volume Report (The data relates to all the exchanges which are members of Futures Industries Association)

2.9.1 The growth in the US market is quite revealing, with a similar trend observed in other countries. Therefore, in the context of the international experience, the restrictions separating the two markets in India would appear as an unnatural barrier on the growth of the market. It also appears that there is a potential for gains to the economy by pursuing convergence, by removing the present legal and institutional walls that separate the commodity futures market from the securities markets. But enforcing convergence abruptly may sharply increase avoidable collateral damage. If brokerage firms or exchanges find strength in highly specialized, narrow knowledge, then they should be free to follow a narrow course. The way should be opened for gains from convergence without specifically mandating convergence. What is required is a proper timeframe, sequencing and prioritization so that the process is not disruptive.

III. LEGAL, REGULATORY AND OTHER IMPEDIMENTS TO CONVERGENCE

Convergence of securities and commodity markets will need to overcome many legal and regulatory hurdles. Of course, they will depend on the level of convergence being attempted. Restrictions on participation of stock-brokers in the commodity derivatives markets have been removed. Restriction on the participation of Mutual Funds and Foreign Institutional Investors also needs to be removed by changing the relevant regulations of the SEBI. The restrictions on participation of banking institutions can be removed by amending section 6 of the Banking Regulation Act.

3.2 If a more comprehensive convergence is to be attained encompassing all segments of these markets, the hurdles to converge will be many. Some of them are given below:

3.3 At present there are two separate Acts viz. FC(R) Act 1952 and SC(R) Act, 1956 with Rules made there under governing the two markets. Even though there are many similarities in the text of these Acts, they will need to be harmonized so that, as far as possible, a common regulatory environment can be provided for the exchanges and participants.

3.4 Whereas the FC(R) Act provides for the appointment of FMC to recommend to the Government on various issues relating to forward trading and markets, the SC(R) Act does not provide for such a body. The securities market has SEBI as a regulator SEBI, created under as Securities Exchange Board of India Act 1992. The FMC constituted under the FC(R) Act is primarily a recommendatory body, which draws most of its delegated powers from the Government. On the other hand, SEBI is largely autonomous. This difference would pose difficulties in attempting any of the approaches to convergence.

3.5 "Stock exchanges and futures market" is a subject under the Union list in schedule VII of the Constitution of India thereby bringing both spot and derivative trades in securities under the jurisdiction of the Central Government, which make it easy to develop and regulate securities markets. As against this, the "trade and commerce", and, "agriculture" are subjects in state list of the Schedule, which implies that spot/cash trade in commodities is within the jurisdiction of the States whereas the futures trade rests with Central Government. The regulator of commodity exchanges does not have jurisdiction over spot markets even in non-agricultural commodities, like, bullion and other metals. Futures prices of commodities draw heavily on spot prices; therefore, it is argued that the regulator of commodity markets in India should have a mandate to regulate the spot markets in commodities. This makes harmonization of spot and futures markets difficult as State taxes and physical restrictions on spot trade fragment the commodities markets. Therefore, unless these issues are resolved the full benefits of convergence cannot be realised.

3.6 There are other supplementary legislations, such as the Depository Act, which make the functioning of securities markets smooth. In case of commodity futures markets, such supplemental institutions (like negotiable Warehouse Receipts) do not exist which makes the delivery mechanism complex and problematic, which is so essential to derive full benefits of futures trading for the promotion of agriculture and commodity sector.

3.7 All participants in securities market, viz. brokers, merchant bankers, registrars to issues, depository participants etc. have to seek registration from the SEBI. This ensures comprehensive control of the Regulator on the securities market. At present there is no such requirement under FC(R) Act, though an amendment to this effect is proposed. Thus regulatory bars in two markets are different.

3.8 The cash market of securities is highly organized and effectively regulated by other agencies like DCA, RBI etc., spot market for agricultural commodities is not so organized. There is a plethora of laws like APMC Act, ECA, Black Marketing Act curbing a free market in agricultural sector

3.9 The FC(R) Act, at present covers forward trading in "goods" only. The scope of commodity futures market will need to be broad-based to include the intangibles related to the commodity sector, such as, commodity indices, spreads and basis contracts, weather, electricity, and freight. The provision for purely cash-settled contracts also need to be introduced as delivery in such contracts is not possible.

3.10 There is stark contrast between capital markets and commodity markets. In the commodity market, statutes today keep out a huge section of the financial players, like, banks, insurance companies, mutual funds, and pension funds. There is therefore an urgent need to change the regulations relating to mutual fund, insurance and pension funds. Hedge funds should also be allowed in the commodity futures market with the same tax benefits that the mutual fund industry has in the securities market. Also banks are quintessential financial intermediaries and derivatives can play an important part in the risk-management strategies employed by banks and financial institutions and their customers. The Banking Regulation Act prohibits banks from dealing in goods. RBI has interpreted this to imply that banks are prohibited from dealing in derivatives on goods. This prevents banks from fully engaging in the agricultural economy. For example, a bank could give a loan to a farmer, and hedge itself against price fluctuations, so as to deliver a loan with a variable rate of interest - whereby lower interest rates are charged in the event that output prices are higher. However, such sophisticated product development is prohibited by the existing regulatory regime. In the spirit of convergence, we need to find solutions through which the banking system can embrace commodity derivatives exactly as is the case with derivatives on currency, equity or debt. Also, market making is necessary to ensure initial liquidity. Banks and financial institutions are historically considered stable institutions to provide market-making services, all over the world. In India, when NSE launched these in 2000, for nearly two years, ICICI Ltd acted as the market maker and provided up to 60 per cent of the volumes on both sell and buy sides; once the market5s took off in 2002, ICICI Ltd, scaled down its support. A similar role was played in corporate debt paper market. Market makers add to depth, liquidity and stability of markets. Of course, there is a need to develop supervisory guidance to ensure that these activities are conducted safely and soundly. The RBI could assemble a talented staff with outstanding expertise, who understand this business and take a risk-focused approach to applying that guidance to the banks they supervise. Banks could be required to demonstrate that they have established appropriate risk measurement and management processes – including board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems as well as an effective risk control function. Currently Banking Regulation Act does not permit banks to participate in the commodity markets.

Warehouse receipts as securities

3.11.1 One important mode of settlement of commodity derivatives contracts, internationally, is using warehouse receipts. The economic principle that is used is to treat the warehouse receipt as negotiable and fungible.

3.11.2 In this case, important gains would be obtained by modifying the legal structure so that warehouse receipts become negotiable. It should be possible to dematerialise warehouse receipts at NSDL and CDSL. But it will have to be preceded by appropriate upgradation of the systems and creation of a regulatory apparatus to facilitate development and adoption of uniform standards, creation of facilities for scientific grading, packing, storage, preservation and certification at the warehouses.

3.11.3 This is a highly appealing course of action, in that once there is a security which represents 10 grams of 99.99 per cent gold at the depository, the existing market design of the securities markets can be used, off the shelf, to create a T+2 spot market and a physically settled derivatives market for gold. From the viewpoint of traders, intermediaries, institutional investors, banks, etc. across the country, the existing business process, which is used for securities, would work *without a change*. For example, banks that have IT systems and staff, which give out loans against shares as collateral, would be able to effortlessly reuse these skills and processes to give loans against gold securities as collateral.

3.11.4 While this is an extremely appealing design owing to this simplicity, there are important practical problems faced also. The key question is that of guaranteeing the grade. If there are 10 banks in the system, who are accepting physical gold and issuing gold securities, and if a security (once issued) loses its history and becomes fungible, then how would disputes be handled, if (at a future date) a person uses the warehouse receipt to obtain physical goods, and finds that the purity of the gold is inadequate?

3.11.5 In India today, there are important gaps in the warehousing industry. A sophisticated warehousing industry has yet to come about. At present, public sector dominates warehouse sector and Central Warehousing Corporation and State Warehousing Corporations account for approximately more than $3/4^{th}$ of total warehousing capacity in the country. This infrastructure, including expertise in grading, standardization, and quality assurance can be fruitfully utilized by galvanizing it to meet the requirement of sophisticated market instruments, such as negotiable Warehouse Receipt System. This report seeks to address the limited question of evaluating the benefits and modalities of convergence between commodity futures markets and the securities markets. Hence, this report is restricted to the *legal* impediments to a sound warehousing industry.

3.11.6 The Committee recommends that the legal and regulatory framework should be created, through which negotiability and tradability of warehouse receipts is made possible.

Cash settlement

3.12.1 Cash settlement is an important and powerful method for organising derivatives markets. If someone has purchased dollars at a future date at a price of Rs.50, and when that future date actually arrives, the spot price of the dollar is Rs.45, then cash settlement would involve mere payment of Rs.5 to the clearing corporation. No dollars actually

change hands. Cash settled commodity derivatives are exactly like derivatives on financial underlyings. Hence, the use of cash settlement assists the process of convergence. The tradeoffs between physical settlement and cash settlement may be summarised as follows:

3.12.2 Cash settlement is preferable since the costs of settlement are eliminated. If physical settlement had to be done, the costs involved in dealing with physical goods (or warehouse receipts) are always higher than the costs of moving money.

3.12.3 Cash settlement is preferable since the risk of a short squeeze is substantially eliminated.

3.12.4 It is important to emphasise that while cash settlement substantially eliminates the vulnerability to a short squeeze, there are other important methods of manipulation, which remain open even under cash settlement. Suppose it costs Rs.X to manipulate the Nifty *spot market* to obtain an artificial movement of 1 point. Under cash settlement, the manipulator has an incentive to first adopt a long position on the Nifty futures market, which is so large, that after Rs.X is wasted on manipulating the spot market, the profit on the futures position is much larger than X.

3.12.5 There are no problems with the convergence of futures prices to spot prices under cash settlement. By definition, with cash settlement, the price of the futures on the last day is *defined* to be the official closing price of the spot market. This forces convergence, and generates arbitrage activities on all preceding days, which bring about market efficiency.

3.12.6 The central question about cash settlement is that of obtaining a well-respected and trusted settlement prices. If there is an underlying with a highly fractured spot market, where good data is not available, then it is difficult to construct a well-respected settlement price. In this case, economic agents would not trust a cash settled contract, and would prefer a physically settled contract.

3.12.7 This problem was faced in India in the fixed income market. The fixed income market is almost entirely an over the counter market, featuring a lack of transparency, an absence of intra-day data, etc. NSE created a `reference rate' on the inter-bank call money market, called Mumbai Inter-Bank Offer Rate (MIBOR). MIBOR is based on a sophisticated methodology. MIBOR has been well accepted by market participants, and is likely to be the underlying for cash settled futures, options and swaps in the future. The procedures used in constructing MIBOR can be utilised to obtain well-trusted reference prices, even from a spot market, which has a poor market design.

3.12.8 Cash settlement is appropriate for agricultural commodities, when a farmer or any other user of the futures market is located at a physical distance from the delivery point for the futures market. A farmer may be located 100 km. or 1000 km. from a delivery point, which induces substantial costs of making delivery using physical settlement. Using cash settlement, these issues are eliminated.

3.12.9 In summary, cash settlement has important strengths, except in situations where it is infeasible to produce a well-trusted settlement price. On the securities markets in India today, cash settlement is used intensively. Indeed, as of today, derivatives on equities and interest rates *exclusively* use cash settlement. This is motivated primarily by concerns about short squeezes in the event that physical settlement is used. On the commodity futures in India today, cash settlement is the *de facto* practice, even though it is not permitted *de jure*. The outcome that is envisaged is one where exchanges should be able to apply to the regulator for permission to introduce cash settled contracts. Cash settled contracts would only come about if both the exchange and the regulator agree that the settlement price is well trusted. It appears difficult to adopt cash settlement in commodity market, where spot market is fragmented and commodities are not sufficiently standardized. In such cases the threat of physical delivery is the best alternative to achieve convergence of spot and future prices, and thereby link futures market to physical market. However, in respect of derivatives of intangibles cash-settlement is the only way to settle the contract. Therefore provision for cash settled contract will need to be introduced in the FC(R) Act so as to widen the scope to intangibles, such as commodity indices, weather, freight derivatives. In any case, most of futures contracts are squared off before maturity and a very small fraction of contracts result in settlement by delivery.

IV. DIFFERENT APPROACHES TO CONVERGENCE AND THEIR SEQUENCING AND PRIORITISATION

It would be necessary to explore if there are different approaches to convergence so that it can be ensured that while the process of development is accelerated further, the changes are not abrupt resulting in avoidable disruption. The path of convergence has to address the apprehensions, concerns of the existing stakeholders and Exchanges. The gains from convergence have to outweigh the potential loss. It has to be equitable to both commodity exchanges and stock exchanges and participants in the two markets. It has also to be fair to the Exchanges, which have been granted in-principle approval only recently. It has however to be realized that convergence may not necessarily be a win-win game for both the existing stock and commodity exchanges and the new exchanges, and it cannot be guaranteed that the existing commodity exchanges and the participants in the commodity futures market will not be wiped out of the market. It would however be more prudent and pragmatic to chart a path, which causes minimum loss.

DIFFERENT APPROACHES

4.2.1 Different approaches to convergence can be thought of on the basis of extent or level of convergence. Some of the easily identifiable approaches are enumerated below:

I. Convergence at the level of brokerage firms

4.2.2 Securities Contracts (Regulation) Rules imposed restriction on participation of stock-brokers in the commodity derivative market. There was thus a persistent demand from commodity exchanges to remove this restriction. Accordingly, suitable notification has been issued removing this restriction. The Terms of the References of the Committee set up by the SEBI to consider this issue included the broader issue of utilizing the infrastructure of the stock exchanges for commodity derivative trading. According to a view, this was the starting point of the debate about convergence of the two markets. There could be two options within the approach of convergence at the level of brokerage firms.

Option A: Brokers to trade commodity derivatives as a separate legal entity

4.2.2.1 The first option would be to require the stock brokers to have distinct entities, one, for trading in securities and the other in commodities, each meeting the admission criteria independently. This option does not require any change in the existing legal or regulatory framework. Also, it is without any disruptive impact. Under this option, if a commodities brokerage firm seeks a membership for trading financial derivatives, it would be required to create a distinct legal entity (e.g. a 100 per cent subsidiary). Conversely, if a financial derivatives brokerage firm seeks to engage in commodity derivatives trading, it would be required to create a distinct legal entity.

4.2.2.2 Separation of legal entities between different exchanges is useful when net worth plays an important role in risk management. If the brokerage firm goes bankrupt owing to mistakes in trading financial derivatives, this should not generate negative externalities for a commodity derivatives exchange, which believed that the firm contained a certain net worth. With the amendment to Securities Contracts (Regulation) Rule this option has already been implemented. Gains from this option are however sub-optimal, as this does not allow brokers flexibility to move their networth from one market to another to take advantage of different cycles in the two markets. Also, whenever the risk management of the Exchanges is based on the upfront margins rather than the net worth of brokers, the requirement of separate legal entity creates artificial Chinese wall between the two markets, in securities trading for trading in commodities, and vice versa.

Option B: Multiple Membership with different Regulators

4.2.3.1 Under this option, brokerage firms can be permitted multiple memberships, i.e., brokerage firms can be permitted to engage in multiple activities under one roof. The commodity derivatives brokerage activity of the firm could be subject to regulation, inspections and penalties by FMC; the financial derivatives brokerage activity could be subject to regulation, inspections and penalties from SEBI.

4.2.3.2 There are examples of such `functional regulation' in India today. For example, banks are regulated by RBI for the purpose of banking, but their depository participant activities are regulated by SEBI. Internationally, the brokers are permitted to have multiple membership.

4.2.3.3 In terms of risk management, it would be essential that each exchange that the brokerage firm deals with should have an online, upfront margining system. In this case, the net worth of the firm becomes unimportant. Each exchange would have possession of liquid collateral, and bankruptcy of the brokerage firm would not induce negative externalities.

4.2.3.4 Certain brokerage firms could legitimately choose to specialise. For example, a certain firm may choose to trade only cotton. That is the legitimate choice of the firm. Different brokerage firms could choose different kinds of specialisations. But in this policy alternative, there would be no legal or regulatory prohibitions upon conducting commodity derivatives and financial derivatives activities within the same intermediary firm.

4.2.3.5 In order to implement this option, the risk management systems in both commodity and securities markets will have to be based on real-time upfront margins. Though reliance on net worth criteria would have to be reduced, as a measure of abundant precaution, net worth criteria of the clearing members too will have to be enhanced and the leverage that such a member has vis-à-vis his net worth may have to be reduced. The most safe and perhaps the most efficient way of implementing this option is to mandate clearing and settlement of trades in both the markets through one independent, professionally managed and well-capitalised clearing corporation with broad-based ownership. This measure would substantially take away the discretion presently available with the office-bearers of the Exchanges; it is, therefore, less likely to be accepted by most of the existing Exchanges.

II. Convergence At The Level Of Policy Making

4.2.4 The general need for a convergence at the level of policy-making arises on account of the fact that the mandate of Department of Consumer Affairs is to protect and promote interests of consumers. The consumers would be better off if the prices of commodities are low. But lower prices adversely affect producers, and consequently production. Properly regulated commodity derivative markets only help to discover prices, which are primarily influenced by basic demand and supply factors. Such commodity derivatives markets in fact help to reduce intra-seasonal and also inter-seasonal price fluctuations. Commodity futures markets provide price-discovery and price-risk management benefits not only to producers and consumers but also to all the participants in the supply chain. Thus, it would be more desirable if the subject of commodity futures trading vests with the Ministry with broader mandate. This approach also entails alternative options of convergence with or without convergence at the level of brokerages.

<u>Option A: Closer coordination</u>

4.2.4.2 Under this Option, Department of Consumer Affairs and Department of Economic Affairs would set up a committee through which there could be closer coordination on policy issues connected with Exchanges, product launches, membership, international participation, etc. The effective way to achieve such coordination is to

include the Department of Consumer Affairs in the High Level Coordination Committee. This option is useful when compared with the existing state, where there is an absence of coordination between the efforts at DEA on financial derivatives and the efforts at DCA on commodity derivatives. At the same time, while this option will achieve consultation and discussion, the possibility of inconsistent policies being adopted by the two departments remains, particularly in view of the specific mandate of the Department of Consumer Affairs for consumer protection only.

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<u>Option B: Merge functions into a single department</u>

4.2.4.3 Under this option functions related to the development and regulation of commodity futures markets should be vested in one Ministry. This will require change in the rules relating to Allocation of Business. This option offers the promise of stronger coordination of work on derivatives on commodities as opposed to financials. If the choice of vesting this function between one of the two ministries, (viz., DCA v/s DEA) is to be made, the MOF seems to have an advantage. DEA has already dealt with the policies in the securities market, which are relatively mature. The commodities markets will gain from the experience acquired by the DEA over the years in devising policies for securities markets. However, the experience of devising policies for the securities markets may not be totally replicable for development of commodities derivatives markets and may require some understanding of distinctive features of these markets.

III. Convergence at the level of Regulators

<u>Option A: Closer coordination</u>

4.2.5 Under this option, the regulators, FMC and SEBI, would embark upon a program of closer coordination of their activities. This would consist of:

a. A coordination committee, which would meet regularly and examine issues of harmonisation of regulatory requirements, and
b. A program for staff exchange, so that both agencies can acquire stronger knowledge and human networking on the other side of the fence. This would particularly be beneficial to the Commodity Regulator, as the Security Regulator has developed sufficient expertise, skills and systems to steer the market. The part-time members of the FMC can be drawn from SEBI and also RBI to ensure better coordination. Staff also can be shared on secondment basis. Similarly, the Forward Markets Commission should be given representation on the SEBI.

4.2.5.2 This option is clearly a step forward when compared with the existing regime, where there is no institutional mechanism through which the regulatory work on commodity derivatives interacts with the regulatory work on financial derivatives.

Option B: United States model

4.2.6 In the US, a compromise was worked out when faced with these debates on convergence, whereby the SEC regulates the spot market for securities but the CFTC regulates all derivatives markets (including the commodity derivatives markets). Under this approach, there would be one agency, which regulates the equity spot market, and another agency, which regulates the equity derivatives market. Similarly, the spot market regulator would regulate the bond market, but the derivatives market regulator would regulate interest rate futures. There have been some practical difficulties in implementing the Shad-Johnson accord. In 2000, the SEC and the CFTC agreed on a program of joint jurisdiction for single stock futures and narrow stock indices.

Option C: Merger into a single Regulator with existing Legal Framework

4.2.7 Under this option, regulation of financials and commodity derivatives would be merged into one entity. This single entity would be charged with administering both the SC(R)A and the FC(R)A. It appears that there are strong commonalities between the two Acts (including a significant amount of common text). This should make it feasible to engage in such a merger, even though the two acts remain distinct. The existing two organizations viz. SEBI and FMC will need to be merged. Even though the merged entity will have to create two separate Divisions to regulate securities and commodity markets, training and inter-mixing of the staff for the purpose of fusion into a single entity will be required. This can be attained by taking an administrative decision by Cabinet, by changes, Allocation of Business Rules.

Option D: Merger into a single regulator with a single Act

4.2.8 Under this option, regulation of financials and commodity derivatives would be merged into one entity. In addition, SC(R)A and FC(R)A would be subsumed into a single Act.

IV. Convergence at the level of exchanges

Option A: Distinct segments

4.2.9 The first alternative in achieving convergence at the level of exchanges could be to require distinct segments for trading commodity derivatives as opposed to financial derivatives. There is a history of such segments being used in the past. On NSE, there is a segment named ``Wholesale Debt Market'' (WDM), where there is a significant involvement of RBI in formulating the rules and procedures. This is distinct from the ``Capital Market'' (CM) segment, which is the spot market for equity, corporate debt, and government bonds, where SEBI is the regulator. The two segments have a distinct membership, distinct market design, and distinct regulatory framework.

4.2.9.2 Each commodity futures exchange will also have a separate segment to start a financial derivatives. Each securities exchange would be permitted to start a commodity

derivatives segment. All commodity derivatives trading would be regulated by FMC. All financial derivatives trading would be regulated by SEBI. However, to the extent that exchanges have economies of scope and scale, these would be partially harnessed.

Option B: Full convergence

4.2.10 Option B would be like the international convention, where derivatives exchanges have no restrictions on the range of products that they can offer, where financials and commodities trade under a single roof. This differs from Option A in not requiring a distinct segment with a distinct membership and a distinct market design. This option has potential to achieve maximum synergy. However, this option will have a detrimental effect on the existing commodity exchanges.

B. RECOMMENDATION

4.3 The different approaches listed in the previous paras can also be taken as different stages of convergence. The pace and sequence of convergence of markets should ideally be left to the dynamic market forces. International experience shows that markets are converging not only across products but also across geographies. The considerations, competition and economies of scale made possible by new technology are forcing markets to converge. It is only the markets with strong niche or regulatory protection that are able to retain a separate entity. Once regulatory barriers are withdrawn, the competition will take away the business to more efficient exchanges forcing merger and or the demise of less efficient exchanges. This is not a distant possibility considering that Indian economy is liberalizing and integrating with the world economy. Some of the successful international exchanges may step in and compete for the business. It is, therefore, logical that domestic competition is allowed to equip the exchanges to develop world-class infrastructure and capability to provide services to the customers and to face the emerging competition. The convergence of markets seems to be a natural process for which the artificial regulatory barriers will need to be removed. The question is not whether, but of how to attain convergence reaping its benefits with minimal costs.

4.4 The role of the regulator to develop the market is crucial. The regulator must possess capabilities in terms of expertise, resources, empowerment and operational flexibility to meet the challenges. The structure of the Forward Markets Commission set up in 1953 as a recommendatory body is not fully suited to the challenges of the emerging market. The structure of this Commission will need to be totally overhauled to provide it the autonomy and the resources as done in case of many regulators set up in recent times. After examining the various alternative approaches to convergence, tradeoffs in their sequencing, and debates on prioritization mentioned above, the Task Force unanimously makes the following recommendations:

1. In the interim, the Department of Consumer Affairs should take administrative decisions, which would strengthen and empower

FMC. Immediately, FMC should be made independent and autonomous, through executive orders. This should cover personnel and financial autonomy, among other.

2. The development of commodities derivatives markets is impeded on account of some of the policies relating to cash markets, which have the effect of distorting the market forces of demand and supply. These policies include Minimum Support Price, Monopoly Procurement Scheme, APMC Act, Black Marketing Act, Differential Sales Tax, differential Stamp Duties and entry taxes and permits imposed by various State Governments. These market-distorting and fragmenting policies need to be corrected expeditiously.
3. The restrictions on participation of banking institutions in commodities markets, at least for hedging purpose, for a start, should be removed by amending section 6 of the Banking Regulation Act.
4. The enactment of national-level regulation on warehouses to pave the way for making warehouse receipts issued by the regulated warehouses negotiable and tradable across the country may be expedited. The legal and regulatory framework should be created, through which negotiability and tradability of warehouse receipts is made possible.
5. The new legal framework should widen the scope of futures markets to include the intangibles related to the commodity sector, such as, commodity indices, spreads and basis contracts, weather, electricity, and freight. Restriction on the participation of Mutual Funds and Foreign Institutional Investors also needs to be removed by changing the relevant regulations of the SEBI.
6. The Secretary, Department of Consumer Affairs, should be inducted in the High Level Committee on Capital Markets (HLCC)
7. In parallel, legal changes should be undertaken through which the regulation of commodity futures markets and financial markets are placed in a unified entity. This may require amendment/modification/repeal of Forward Contracts (Regulation) Act, 1952. In this unified entity, there should be one full time board member who looks after commodity futures markets. This will ensure an adequate focus on the commodity markets in the unified entity.
8. Questions of convergence pertaining to brokerage firms and exchanges, which would harness economies of scope and economies of scale in these areas, should be taken up by the unified entity when it comes into operation.
9. These changes require extreme care and though in implementation. Hence, a Working Group should be set up to oversee the post-legislative oversight of commodities futures markets and financial

markets under the unified entity, particularly the administrative aspect.

(Nagendra Parakh) (Kewal Ram) (Paul Joseph)

Member Member Member

(Kalyan Raipuria) (Ashok Lahiri)

Member Member

(Wajahat Habibullah)

CHAIRMAN

ANNEXURE –1

NO. 21/44//IT/2000

GOVERNMENT OF I NDIA

MINISTRY OF CONSUMER AFFAIRS, FOOD AND PUBLIC DISTRIBUTION

DEPARTMENT OF CONSUMER AFFAIRS

Shastri Bhavan, New Delhi

14th May 2003

OFFICE MEMORANDUM

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Major changes have been taking place in the Indian securities and commodity derivatives market in the last few years. Introduction of derivatives trading in the security market has meant that many of the assets of its infrastructure and skills can be used by the commodity derivatives market and they can work together. The idea of convergence of the markets, institutions, players and regulation has been proposed by the Finance Minister in a recent communication to the Minister for Consumer Affairs, Food and Public Distribution

2. While examining the matter, it was, however, felt that the issue of existing divergences need to be analysed in detail in order to chart a path of convergence, if found possible. It has, therefore, been decided by this Department to constitute a Task Force, with the following composition:

i. Secretary, Department of Consumer Affairs Chairman

ii. Chief Economic Adviser, Deptt. of Economic Affairs

Member

iii. Sr. representative of Deptt. of Consumer Affairs Member

iv. Senior representative of Deptt. of Company Affairs Member

v. Senior representative of SEBI Member

vi. Member, Forward Markets Commission Member Secy

3. It is proposed to chalk out the terms of reference of the Task Force in its first deliberation, date and time of which will be communicated separately. Comments and suggestions, if any, may please be sent to facilitate discussion on the TOR of the Task Force.

(C K G Nair)

Director

Tele No. 23384390

Shri A K Bhatt,

Chairman,

Forward Markets Commission,

Everest,

100, Marine Drive,

Mumbai, with a request to nominate a Member of the FMC as Member Secretary of the Task Force