A Descriptive Study on the Recent Developments in Indian Commodity Derivatives Market

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Abstract

ASEBIT ask Force was constituted in February 2016, with the objective of reviewing and giving suggestions to further strengthen the regulation of the commodity derivatives market and to avoid any systemic risks. Based on its recommendations and further discussions in the Risk Management Review Committee (RMRC), additional / modified risk management norms, some of which are unique to commodity derivatives, were prescribed to further strengthen risk management systems of commodity derivatives exchanges. The initial margins being imposed by national commodity derivatives exchanges were designed to cover 99 per cent value at risk over a one day horizon and they thus covered price risk between consecutive daily mark-to-market settlements only. Thus, the price risk subsequent to any pay-in default till the time of liquidation of open positions was not covered. The risk was especially more in illiquid contracts where more than one day may be required to close a defaulter's positions. Accordingly, exchanges were required to scale up initial margins based on the liquidity of each product and a minimum of two days risk coverage by initial margins was specified for all commodity derivatives contracts. The study describe the outline of the recent facts behind the derivatives market in Indian context and brings the

Key Words: Commodity Market, Derivatives, Risk Management, SEBI regulations

Introduction

Initial margins are the first level of resistance against default. As per the CPMI-IOSCO Principles for Financial Market Infrastructures (PFMI), in initial margins should be sufficient to cover potential future exposure in the interval between the last margin collection and the close out of positions following a participant default. Default in concentrated positions pose a greater risk as a longer period will be required to liquidate the concentrated positions. Thus, concentrated positions warrant higher safeguards commensurate with the risks that they pose. Exchanges were therefore required to impose higher margins on concentrated positions based on the size of the position and the available liquidity. There may be situations of drying up of market liquidity and exchanges notbeingabletoliquidatepositionsfollowingdefaultbyamember.Toeliminatetheriskofsuchopen positions, the following tools were prescribed to be preferably utilized in order of priority so as to avoid market disruptions: Liquidation in the normal market in an orderlymanner, Auction of positions, Voluntary tear-up with compensation

to impacted parties, and Partial tear-up with higher compensation to impacted parties. Repeated shortfalls in margins/pay-ins by a member are an in dictation of the stressed condition of the member. To avert any potential risk from such a member, the following preventive measures were pre scribed: Require the member to reduce positions and higher initial margins/exposure free deposits for a month for such members. In order to instill greater confidence in participants of the clearing and settlement system and till the clearing and settlement of commodity derivatives is transferred to clearing corporations, a uniform default waterfall was prescribed for commodity derivatives exchanges in alignment with that prescribed for clearing corporations in the securitiesmarket.Exchangeswererequiredtomakegoodanyshortfallsin SGFbased on the results of stress tests without any upper ceiling (which was earlier capped at 5 per cent of the gross revenue in any year)

Goods Notified Under SCRA

There were 113 goods notified by the central government under the Forward Contract Regulation Act, 1952 (FCRA) on the basis of which, the Forward Market Commission (FMC) granted permission to the exchanges to launch futures on different commodities. Apart from these notified goods, there were a few commodities which were neither notified under Section 15 of FCRA, nor were they prohibited under FCRA Section 17, futures on which were permitted by erstwhile FMC for trading on commodity derivatives exchanges. In exercise of the powers conferred by clause (BC) of Section 2 of the Securities Contracts (Regulation) Act, 1956 (SCRA) and in consultation with SEBI, the central government notified 91 goods for derivatives trading. These notified goods include earlier notified goods after reorganizing/clubbing names of the related commodities and also include six new goods for derivatives trading -- diamonds, brass, pig iron, eggs, cocoa and tea.

Options in the Commodity Derivatives market

In his Union Budget speech for 2016-17, the Finance Minister announced that ‘new derivatives products will be developed by SEBI in the commodity derivatives market.’ Introduction of new commodity derivatives’ products has been a subject of deliberations as their introduction is considered to be conducive for the overall development of the commodity derivatives market by attracting broad based participation, enhancing liquidity, facilitating hedging and bringing in more depth to the commodity derivatives market. The recommendations made by the Commodity Derivatives Advisory Committee (CDAC) *inter-alia*, on the introduction of new products were considered by the Board and subsequently in September 2016, SEBI allowed trading in options subject to detailed guidelines that it will issue.

Strengthening Risk Management

Immediately after the merger of FMC with SEBI, a comprehensive risk

management frame work was prescribed to streamline and strengthen risk management at the national commodity derivatives exchanges and align these to the extent appropriate with the securities market's norms. To further strengthen the risk management framework of national commodity derivatives market and to avoid any systemic risks, additional risk management norms were issued during September 2016. Some important features of the new system are: Enhancement in initial margins to have better risk coverage, Concentration margins on big positions, and Tools for handling default such as liquidation in the normal market, auction of positions, voluntary tear-up and partial tear-up.

Strengthening Delivery infrastructure

In order to have robust and credible warehousing infrastructure in the commodity derivatives market, SEBI reviewed the existing norms for exchange accredited warehouse service providers (WSPs), warehouses and assayers. Based on the feedback, in September 2016 SEBI issued revised warehousing norms for agricultural &agro-processed commodities traded on the national commodity derivatives exchanges to ensure good delivery and to maintain the integrity of the delivery mechanism in the interest of trade. The key features of the norms for WSPs are: Minimum net worth requirement of ` 25 crore for multi-commodity WSPs, Storage value of goods in the warehouse not to exceed 33 times the net worth of WSP, Fit and proper criteria and Compulsory accreditation of assayers.

Criteria for Eligibility, Retention and Re-Introduction of Derivative Contracts on Commodities

Since the nature/properties of one commodity differ from another, all commodities may not be suitable for commodity derivatives trading. Hence, before allowing any derivatives contracts on any commodity, the appropriateness/usefulness of commencing futures trading in products (not necessarily of just commodities), needs to be ascertained. Therefore, in January 2017 SEBI laid down criteria for eligibility, retention and re-introduction of derivative contracts on commodities which will be followed by all national commodity derivatives exchanges.

Various Norms Prescribed By SEBI

During the course of the financial year, SEBI issued guidelines/norms for developing markets through various circulars:

- **Position Limits for Hedgers:** In order to facilitate wider participation by genuine hedgers, SEBI issued broad guidelines to be followed by exchanges while granting such additional position limits to hedgers.

- **Programs Sponsored by the Exchanges through Media Channels:** Exchanges were prohibited from sponsoring or associating themselves in any manner, either as an institution or through their functionaries, with programs / seminars /workshops/ activities etc. at various for including but not limited to

TV / radio / social networks / websites or any other media in which the discussions/suggestions are related to price behavior, price outlook, trading strategy, buying / selling recommendations or similar subjects related to commodity derivatives.

- **Price Dissemination through the SMS/ Electronic Communication Facility:** SEBI prescribed norms for exchanges for providing a facility of price dissemination to market participants.

- **Trading Hours / Trading Holidays on Commodity Derivatives Exchanges:** SEBI prescribed norms related to trading hours / trading holidays.

- **Spot Price Polling Mechanism:** SEBI directed commodity derivatives exchanges to have a documented policy for the spot price polling mechanism. Exchanges were directed to display the spot price polling mechanism adopted for every contract on their websites.

- **Daily Price Limits (DPLs) for Non- Agricultural Commodity Derivatives/ First Day DPLs for all Commodity Derivatives:** SEBI introduced norms with regard to daily price limits (DPLs) of non-agricultural commodity derivatives as well as norms for determining DPLs on the first trading day of the derivatives contract on agricultural as well as non-agricultural commodities.

- **Guidelines for Due Date Rate(DDR)fixation for Regional Commodity Derivatives Exchanges:** A framework for computing due date rates at which futures contracts are to be settled on expiry covering constitution of Due Date Rate (DDR) committee, eligibility criteria for polling participants, mode of polling, record keeping, etc. were prescribed by SEBI.

- **Mechanism for Regular Monitoring of and Penalty for Short Collection/Non-collection of Margins from Clients:** SEBI specified penalties in case of various scenarios of short collection / non-collection of client margins by members and maintained that the penalties are to be credited to the Investor Protection Fund.

- **Settlement Guarantee Fund, Stress Testing and Base Minimum Capital:** SEBI specified norms on the Settlement Guarantee Fund, stress test to determine the adequacy of the Settlement Guarantee Fund and the base minimum capital requirements for various types of members.

- **Unique Client Code:** SEBI issued directions regarding a unique client code (UCC) and mandatory requirement of a permanent account number (PAN).

- **Permission for Trading in Futures Contracts and Modification in Contract Specifications at the Exchange Level:** SEBI specified a check-list of information to be submitted by exchanges while seeking permission for trading in futures contracts, the terms and conditions governing contracts approved on a continuous basis and the parameters which exchanges are permitted to modify on their own and the conditions there for.

- **Staggered Delivery, Early Delivery System, Early Pay-in Facility, and Penalty on Delivery Default, Fixation of FSP and Changes in Expiry Dates:** SEBI prescribed the framework for staggered delivery, early delivery, early pay-in facility and norms for delivery default penalty, fixing of the final settlement price (FSP) and change in expiry dates of futures contracts.

- **Commodity Derivatives – Miscellaneous Norms:** SEBI *inter-alia* updated the norms with regard to the disclosure of disablement of member terminals, timelines for marking delivery intention and location premium/ discount.

- **Investor Protection Fund and Related Matters:** SEBI issued detailed norms with regard to the Investor Protection Fund (IPF) and its related matters.

- **Algorithmic Trading:** SEBI issued broad guidelines on algorithmic trading for national commodity derivatives exchanges.

- **Disclosure by Commodity Derivatives Exchanges on their Websites:** SEBI issued directives with regard to disclosures by commodity derivatives exchanges on their websites to promote transparency in the markets.

- **Position Limits:** SEBI issued direction regarding position limits for commodity derivatives, clubbing of open positions and penalties for violation of position limits with an objective of consolidating and updating norms regarding position limits and also for prescribed numerical position limits for all commodities which are presently being traded on commodity derivatives exchanges.

- **Portfolio Management Services:** SEBI informed the commodity exchanges and their members that it is reviewing norms with regard to participation in the commodity derivatives market. Therefore, the norms issued earlier by FMC with regard to portfolio management services (PMS) will be continued and hence PMS will not be permissible in commodity markets.

- **Alignment with Norms Applicable in the Securities (other than commodity derivatives) Markets:** SEBI aligned and streamlined the norms governing commodity derivatives exchanges with that of the stock exchanges on the following issues: Modification of client codes post execution of trades on national and regional commodity derivatives exchanges, The cyber security and cyber resilience framework of national commodity derivatives exchanges, Transaction charges by commodity derivatives exchanges, Annual system audit of stock brokers / trading members of national commodity derivatives exchanges, Maintaining and preserving records, Disclosure of proprietary trading by commodity derivatives broker to client and the 'pro – account' trading terminal, and Sharing of information in case of declaration of member as a defaulter in case of multiple memberships.

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- **Bullion as Collateral and Spread Margin Benefits:** SEBI permitted higher limits for bullion as collateral; exchanges are required to remove margin benefits on spread positions latest by the start of the tender period or the start of the expiry day, whichever is earlier.

Consultative approach

Policy decisions and reform measures taken by SEBI generally emanate after extensive consultative processes through various advisory committees. While evolving policy changes, SEBI endeavors to seek comments from the investing public and stakeholders through the public comments process. **Advisory Committee:** In order to advise SEBI to effectively regulate and develop the commodity derivatives market, an advisory committee, the Commodity Derivatives Advisory Committee (CDAC) was constituted under the Chairmanship of Professor Ramesh Chand, Member, NITI Aayog. CDAC in its first meeting held on March 04, 2016 constituted three sub-groups: (i) Group-I to examine the impact and utilization of commodity derivatives market and frame objective criteria for inclusion / exclusion of commodities from derivatives trading. This group conducted five meetings during the financial year and deliberated on various issues and presented its reports and recommendations to CDAC on the following matters: Guidelines for permitting derivatives on commodities, Criteria for exit of commodities for derivative contract, Notification of commodities and new commodities, Increasing participation in the commodity derivatives market, Introduction of new products in the commodity derivatives market, and Promoting hedgers' participation in the commodity derivatives market. (ii) Group–II was formed for improving spot polling prices, and (iii) Group–III to review position limits. It conducted two meetings during the financial year. **Stakeholders Meeting:** SEBI organized various meetings with stakeholders and market participants such as mutual funds and alternative investment funds (AIFs) to deliberate on issues related to participation by MFs and AIFs in the commodity derivatives meetings. Besides this, SEBI organized meetings for various stakeholders -- members of commodity derivatives exchanges, value chain participants of commodities such as diamonds, castor seeds, sugar, soya complex including meal and soya oil, nickel, aluminum and cotton as well as various hedgers.

Mutual Funds' Participation in the Derivatives market

In February 2017 SEBI decided that the provision for obtaining positive consent from a majority of the unit holders for participation in derivative instruments by existing schemes will be removed because of the challenges involved in obtaining positive consent from existing investors. However, before a scheme's participation in derivatives, all investors of the scheme will be given an exit option with no exit load for 30 days as against an exit option for only dissenting unit holders mandated earlier.

Investments in Real Estate Investment

Trusts (Reits) and infrastructure investment trusts (Invits) By Mutual Funds chemes

Mutual funds have been allowed to invest in hybrid securities such as units of REITs and InvITs subject to investment restrictions vide amendment dated February 15, 2017. Any existing scheme intending to invest in units of REITs/InvITs will have to abide by the provisions of Regulation 18 (15A) of SEBI (Mutual Funds) Regulations, 1996. For investment in units of REITs/InvITs by an existing MF scheme, unit holders of the scheme will be given a time period of at least 15 days for the purpose of exercising the exit option.

Disclosure of Performance Related Information in mutual fund advertisements

With an objective to disclose a MF scheme's performance related information in a more effective and simple manner in advertisements, in March 2017 SEBI decided that: (a) Performance of MF schemes will be advertised in terms of the compound annual growth rate (CAGR) for the past year, three years, five years and since inception in place of the earlier requirement to publish the scheme's returns for as many 12-month periods as possible for the past three years. (b) Performance advertisements of MF schemes should provide information based on the last day of the month-end preceding the date of advertisement, instead of the earlier requirement of publishing such data based on last day of preceding quarter-end. (c) Performance of other schemes managed by the fund manager will be disclosed in a summarized manner and MFs will be permitted to provide an exact link to such summarized information in internet-enabled media. It was also decided that celebrity endorsements of mutual funds will be permitted at the industry level and not for endorsing a particular MF scheme or as a branding exercise of a MF house. Further, SEBI prior approval will be required for issuing advertisements which feature celebrities.

Advisory Committee on Mutual Funds (Mfac)

SEBI has an Advisory Committee on Mutual Funds (MFAC) which comprises industry representatives, investor associations, government representatives and other stakeholders. The committee provides a platform for interaction and deliberations on issues related to the Mutual Fund Industry. It acts as a platform for SEBI to place its various regulatory development activities and at the same time the industry places its agenda before SEBI for furtherconsideration.Duringfinancialyear2016-17, the committee under the Chairmanship of Shri Janki Ballabh, the former Chairman of the State Bank of India, met twice on November 17, 2016and December 23, 2016 and gave its recommendations on various policy issues encompassing the MF industry.

Conclusion

This study envisages the importance of derivatives and its remarkable developments hits the market in a significant way that have implications

in the outcomes and also imbibes the operations of economy and more particularly investments arena. The consequences has instigates in the minds of the investors for their investment decisions styles and pooling of funds in various verticals of industry.

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