Chapter-V

A Case for Integration of Commodity Derivative Market and Capital Market: An Analysis

5.1 Introduction

In India there is a clear-cut demarcation between the commodity derivative market and the security market, where each market is expected to function independently of one another. Brokers in the security market are not allowed to be members of the commodity market under rule 8 (1) (f) of SEBI. Besides security market were forbidden to transact in commodities and to share their infrastructures with the commodity derivative market. However with the impressive growth in the commodity derivative market , especially after 2003, there were growing demands for integration of the two markets, which the proponents claim , would enable both the markets to benefit from economies of scale and also from the synergy generated.

Under pressure from various stakeholders the Forward Markets Commission (FMC), initiated the integration process in May 2003, by urging the Securities Exchange Board of India (SEBI) to permit brokers in the securities market to take up membership of commodity derivative exchanges.

The idea of convergence of commodity and capital markets was also forwarded in 2003 by Finance Minister P.A. Chidambaram in a communication to the Inter-Ministerial Task Force (Minister of Consumer Affairs, Food and Public Distribution, 2003). Acting on that initiative, an inter-ministerial Task Force was constituted under the chairmanship of K.R. Ramamoorthy in the Department of Consumer Affairs (DCA) with other members drawn from Department of Economic Affairs (DEA), Department of Consumer Affairs, Department of Company Affairs, Forward Markets Commission (FMC) and Securities and Exchange Board of India (SEBI) to make recommendation on the issue of removal of restrictions contained in Rule 8 (1) (f) of the S.C.(R) rules 1957, on participation of stock brokers in commodity derivatives markets with specific focus on the following key issues-

(I) Securities brokers participation in the commodities derivative market;

(II) Utilization of infrastructural facilities of stock exchanges by commodity exchanges; and

(III) The possibility of stock exchanges trading in commodity derivatives.

After much deliberation the committee endorsed the first two issues, while refrained from making a direct recommendation on the third issue of integration of the securities market and commodities market, which would have implied allowing stock exchanges to trade in commodity derivatives. The Committee was of the view that given the current statutory and regulatory framework and existence of two separate and established regulators, the issue of integration of the two markets would require a detailed examination, particularly for the purpose of defining clearly the scope of regulatory purview and responsibility. Also, given the concerns raised by a section of members that such integration may lead to further fragmentation of volumes and liquidity in the nascent commodity markets, the Committee was of the view that the issue of stock exchanges trading in commodity derivatives 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) Act, 1956 to permit securities brokers to participate in the commodities markets, but only as a distinct and independent legal entity.

5.2 Possible pay-off in the integration

The participation of intermediaries like securities brokers in the commodity futures market is expected to increase the number of quality players, introduce healthy competition, and boost trading volumes. These in turn would provide more liquidity and give greater impetus to the overall growth of the commodity market. Similar benefits are expected to accrue to the securities market if the commodity derivative brokers are allowed to participate in it.

Sizeable investment has gone into building India's securities infrastructure. The existing infrastructure in security market, if thrown open to commodity derivative trading, can reap great returns at very low incremental cost. Conversely, the viability of the new multi-commodity exchanges would be enhanced if they could trade derivatives on all underlings. Thus such a policy would fulfil a sizeable portion of the capital that is required to create the desired institutional capacity for the commodity sector. Finally almost all participants in both the security market as well as in the commodity derivative market agree to the withdrawal of all restrictions on participation in each other's market as that would expands their opportunities for business.

The Securities Contracts (Regulation) Act, 1956 had been thereby amended where members of a stock exchange now can be members of a commodity exchange by forming a distinct and independent legal entity that conform to the regulatory prescriptions of capital adequacy, net worth, membership fee, margins, etc., as stipulated by Forward Market Commission from time to time. This is essential because at present there are two regulators and each one will exercise his supervisory powers as provided under the rules in the respective market. The net worth for becoming a clearing member can be fixed separately for the two exchanges and this will play an important role in risk management. This separation means that even if there is a risk in one market, no cascading effect will be felt in the other. There is also the fact that net worth from one market cannot be moved to another. This will provide the necessary firewall between the two markets and hence will benefit all the participants.

There were no legal restrictions on stock exchanges letting out their surplus infrastructure to commodity exchanges on mutually agreeable commercial terms. In fact, some of the stock exchanges like Bangalore Stock Exchange and Ahmadabad Stock Exchange are already sharing their physical infrastructure with commodity exchanges. Sharing of physical infrastructure between stock exchanges and commodity exchanges is and should be a business decision based on commercial considerations only.

The convergence theory argues that, a brokerage firm that focuses on cotton would in an integrated market, can simultaneously access derivatives on cotton, while trading on equities of firms which deal with cotton. Besides they are also in a position to deal in derivatives on currencies (which are relevant for the currency risk involved in imports and exports of cotton) which enable them to keep a finger on the pulse of all business related to cotton.

The integration of the security market and the commodity derivative market is objected to in apprehension of regulatory overlap. However at present, stock exchanges (NSE/BSE) were already operating successfully in more then one markets (e.g., cash market, derivatives market, wholesale debt market) on a single platform. As these stock exchanges have achieved necessary segregation of the markets which ensure adequate risk containment, it is argued that the existing arrangement could be expanded to include the commodity market too.

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 state policies on public procurement, support prices etc. To an extent convergence rather helps in price discovery on the commodity futures markets, which facilitate effective public policy. Thus 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. Such signal help government mount an early response, and in the process facilitate more effective intervention.

Indian commodity derivative markets had been facing problems from the substantial informal market, which is illegal. 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. 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 achieve 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.

If the commodity derivative exchanges free to trade in either or both the categories of derivative products as in the case of major derivative exchanges in the world (Table-21) would not only increase the volume but would also benefit from economies of scale and also from specialized expertise in derivative trading.

Table-21: International experience on convergence

Country	Exchange	Underlying
Australia	Australian Stock Exchange (ASE)	Equities, gold, grain, interest rates
Australia	Sydney Futures Exchange (SFE)	Interest rates, equities, currencies, Commodities
Brazil	Bolsa de Mercadorias and Futuros	Debt, equities, commodities
Singapore	Singapore Stock Exchange	Commodities, interest rates, equities, Currencies
United Kingdom	London International Financial Futures Exchange (LIFEE)	Interest rates, equities, commodities
United States of America	Chicago Mercantile Exchange (CME)	Agricultural and industrial commodities, equities, currencies, interest rates
United States of America	Chicago Board of Trade (CBOT)	Commodities, equities, interest rates
United States of America	New York Board of Trade (NYBOT)	Commodities, currencies, equities

Source: Future Industries Association (FIA) Monthly Volume Report.

5.3 Constraint to Effective Integration

Though derivatives in commodities resemble securities derivatives and provide many of the same economic functions, there are some major differences. These differences may act as a constraint to the effective integration of the two markets.

The task force has identified many legal and regulatory hurdles (Minister of Consumer Affairs, Food and Public Distribution, 2003) in the way of convergence of securities and commodities markets. At present there are two separate Acts viz. Forward Contract

(Regulation) Act 1952 and Security Contract (Regulation) Act, 1956 for governing the two markets.

The FC(R) Act provides for the appointment of Forward Market Commission to advice the Government on various issues relating to forward trading and markets. However the SC(R) Act does not provide for such a similar body. The securities market has an autonomous regulator (i.e. SEBI) which is constituted under as Securities Exchange Board of India Act 1992. The FMC constituted under the FC(R) Act in 1953 as a primarily recommendatory body, draws most of its delegated powers from the Government and is not fully suited to the challenges of the emerging market. This is because FMC is forced to adopt various policies which are more dictated by political and other non-market compulsions rather then what constitutes the rational market requirements.

"Stock exchanges and futures market" is a subject under the Union list in schedule VII of the Constitution of India therefore both spot and derivative trades in securities are under the jurisdiction of the Central Government, which make it easy to develop and regulate securities markets. As against this, "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. This makes harmonization of spot and futures markets difficult as State taxes and physical restrictions on spot trade fragment the commodities markets. This poses considerable problem in coordination between the two tiers of government. In many instances policies followed by the two tier of government are contradictory, leading to conflicting signals. Futures prices of commodities draw heavily on spot prices; therefore it is argued that the regulator of commodity derivative market in India should have a mandate to regulate the spot markets in commodities.

Indian commodity derivative market constituted by the four national multi-commodity derivative exchanges and a number of regional exchanges which specializes in the trading of specific commodities. Commodity exchanges in different tiers commands importance in their field of specialization. However in the capital market regional exchanges have been marginalized with the introduction of electronic trading in national exchanges like NSC and BSE. It is feared that integration of the commodity derivative market and capital market may lead to the marginalization of the regional commodity derivative exchanges to the detriment of the existing commodity derivative market structure.

Another important distinction between commodity and capital market is in the area of price impact. The stock market players regard a boom in the stock market as an advantage and the regulators do not even bat an eyelid over it. Not so with the commodity exchange. The abnormal rising in commodity prices more often than not forebodes an impending crisis. Not only does it hurt manufacturers and consumers badly but also may fuel inflation in the economy bringing in the wake the much dreaded recession with the authorities lose their sleep overnight.

At the other hand, a slump in the securities exchange no doubt burns the fingers of reckless investors and speculators who fail to look before they leap and may even incur the wrath of the helpless regulator. But a sharp slide in commodity prices though benefiting consumers impoverishes cultivators leading frequently to a spate of suicides. Apart from that it may cause needless shifts in the cropping pattern and at times may be a forerunner to a depression in the economy at large too. Commodity prices therefore need to be monitored carefully. Given the contradictory fallout of similar price movement in the two markets, it is realize that finding a point of convergence in their integration would be a very difficult task.

5.4 Different Approaches to Integration

Integration of commodity derivative market and the capital market can be brought about to varying level and to different extent. Some of the more acceptable models for convergence are illustrated below-

I. Integration at the level of brokerage firms

Securities Contracts (Regulation) Rules impose restriction on participation of stock-brokers in the commodity derivative market and at the same time commodity derivative brokers are denied entry into the security market. There was thus a persistent demand from many stakeholders in both exchanges to remove these restrictions. Integration of the two markets at the brokerage level can be brought about using two strategies.

The first strategy would be to allow security brokers to trade in commodity derivative as a separate legal entity and vice-versa. This will require stock brokers to have two distinct identities, one, for trading in securities and the other in commodities, each meeting the eligibility criteria independently. This option does not require any change in the existing legal or regulatory framework. Also, this does not have any disruptive implications for the existing setup.

In the second strategy, 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 whereas the financial derivatives brokerage activity could be subject to regulation, inspections and penalties from SEBI. There are examples of similar `multiple functional regulation' in India today. For instance banks are regulated by RBI in their banking operation, but depository participant activities of the same bank are regulated by SEBI. Internationally, it is an accepted practice for brokers to have multiple memberships at both exchanges.

II. Integration at the level of policy making

More integrated and consistent policies can be framed and executed with a higher level of coordination between the Department of Economic Affairs (DEA) and the Department of Consumer Affairs (DCA). This can be achieved by setting up a high level coordination committee through which there could be closer coordination on policy issues connected with exchanges, product launches, membership, international participation, etc. While this option will achieve greater consultation and coordination, the possibility of inconsistent policies being adopted by the two department's remains, particularly in view of the diverse mandate of the two departments.

Alternatively the development and regulation of both the markets should be vested in one Ministry. It is felt that DEA which already handles the securities market would be ideally placed to control both the two markets in an integrated set-up. 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. Integration at the level of Regulators

Integration at the level of regulators can be brought about on the basis of three alternative strategies. These consists of

Option A: Closer coordination between two regulators

Options B: United States model

Option C: Merger into a single regulator.

Closer coordination between two regulators- Synergy between the commodity derivative market and the capital market can be generated if an integration is brought about which is facilitated by greater coordination by their respective regulators, FMC and SEBI. This could be administered with the setting up of a coordination committee, which would meet regularly to resolve various problems that have implications in the operational activities of both the regulators. This would particularly be beneficial to the commodity regulator, as the establish security regulator has developed sufficient expertise, skills and systems to steer the market.

United States Model- In the USA, an integration of the commodity derivative market and the capital market was brought about by an unique arrangement where the securities exchange commission (SEC) regulates the spot market for securities and the commodity futures trading commission (CFTC) regulates all derivatives markets (including the commodity and security derivatives markets). Under this modality, one agency regulates the equity spot market, whereas another agency regulates the equity derivatives market. Such a setup appears to have sufficient rationale to merit serious deliberation from the policy makers as it could provide a solution for the vexed issue of the integration of the two markets.

Merger into a single Regulator- Under this option, regulation of capital market and commodity derivatives market could be vested with the single regulator. Under such a scenario the two existing regulatory organizations viz. SEBI and FMC, will have to be merged into a single entity. Even though the merged entity will have to create two separate divisions to regulate securities and commodity markets, however the existence of the common central decision making unit will ensure the necessary coordination in the agency which would synergize the two markets.

IV. Integration at the level of exchanges

Convergence at the level of exchange also can implement in two forms.

Options 1: Distinct segment for different markets within the same exchange

Option 2: Comprehensive integration.

The first alternative in achieving integration at the level of exchanges could be to have distinct and independent segments for different markets within a single exchange. There are many instances in the past where a single exchange operated under such modalities. Segmentation in operation is also practiced in NSE, where there is a significant regulatory involvement of RBI in the ``Wholesale Debt Market" (WDM), which is distinct from the "Capital Market" (CM) segment, where SEBI is the regulator. The two segments have a separate membership, distinct operational structure, and different regulatory framework.

Under such a setup, each commodity derivative exchange will also have a separate segment to deal in security instruments and conversely each securities exchange would be permitted to start a commodity derivatives segment. Here individual segment would be regulated by their respective regulator implying that all commodity derivatives trading would be regulated by FMC whereas all capital market transactions would be regulated by SEBI.

Alternatively existing international model can be adopted where exchanges are free to deal with both securities and commodity derivative. Under such a setup comprehensive integration of the two exchanges would imply that there would be no restrictions on the range of products that such exchanges can offer. Accordingly here both securities and commodity derivatives would be traded under a single roof.